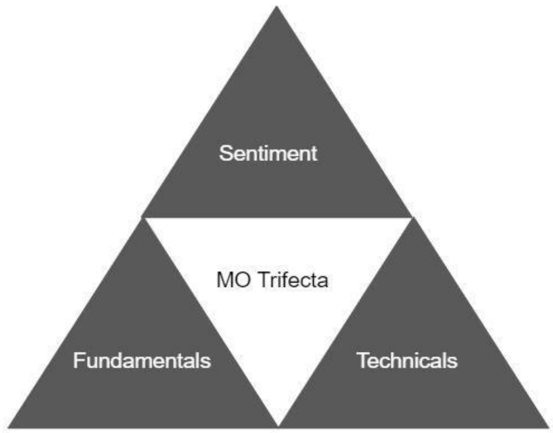
We're going to start our deep dive into Sentiment analysis today — one third of the Macro Ops Trifecta approach.



Now the point of analyzing sentiment is to understand what the general market is thinking and feeling. And based on that, you can position yourself to profit.

Oftentimes, you'll actually be taking the *opposite* side of the market. This is something that's referred to as **contrarianism**.

But this concept is very misunderstood. So to start, let's break down what it really means…

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On being a contrarian from Michael Lewis' *Liar's Poker*:

> *Everyone wants to be, but no one is, for the sad reason that most investors are scared of looking foolish. Investors do not fear losing money as much as they fear solitude, by which I mean taking risks that others avoid. When they are caught losing money alone, they have no excuse for their mistake, and most investors, like most people, need excuses. They are, strangely enough, happy to stand on the edge of a precipice as long as they are joined by a few thousand others…*

Contrarianism is the most abused platitude in trading. Everybody thinks they're a contrarian, but few actually are.

And that, by its very nature, *has* to be the case. Because to be a contrarian is to go against the herd (the majority).

As traders, we make our money on price movement. But for price to move, the *current* price must be wrong. If you're betting on a trend, you're betting that the market is currently wrong. And by disagreeing with the market, you're disagreeing with the consensus. You're being a contrarian.

This is very important to grasp.

Hedge fund legend Ray Dalio puts it like this, "You can't make money agreeing with the consensus view, which is already embedded in the price."

Exactly.

To be successful in this game over the long haul, you have to be a market salmon of sorts. You have to be willing to swim (trade) against popular opinion.

This is no easy feat. The vast majority of market participants don't have an inkling of what true contrarianism means.

But their loss is our gain. The following will lay out exactly how to be a smart contrarian.

First off, market prices aren't set according to independent facts. They're the result of an aggregation of various individuals' beliefs. The average of these beliefs sets the market price.

Sometimes beliefs are widely dispersed and the market is relatively balanced. Trends develop as market participants abandon one belief and adopt another. Occasionally a trend develops a reflexive feedback loop where the price trend spurs greater belief adoption spurring a stronger trend. This sometimes leads to a market consensus and extreme price trends.

Understanding the market's belief structure to your advantage goes back to Keynes' famous Beauty Contest analogy. Keynes likened profitable investing to a common newspaper game of the time:

> *… in which the competitors have to pick out the six prettiest faces from 100 photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole: so that each competitor has to pick, not those faces that he himself finds prettiest, but those the he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view… We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the*

> *average opinion to be. And there are some, I believe, who practise the fourth, fifth, and higher degrees.*

Our goal isn't to identify "correct" asset pricing. There's no such thing as "correct" prices. It's all based on investors' opinions and beliefs.

What *we're* concerned with is understanding how future market outcomes affect these beliefs, which in turn determines how securities will be valued.

First we need to identify the beliefs driving the market. Now we can't possibly do this for *every* belief affecting pricing, but we don't need to. We just need to identify the <u>dominant</u> beliefs.

There's always one or two dominant beliefs driving prices because investors find safety in numbers. Most, whether they realize it or not, do not like to think for themselves. To go back to the quote from *Liar's Poker*:

> *Investors do not fear losing money as much as they fear solitude, by which I mean taking risks that others avoid...They are, strangely enough, happy to stand on the edge of a precipice as long as they are joined by a few thousand others.*

Man's tendency towards herding ensures that large sections of the market will always interpret information through similar belief structures.

As smart contrarians, our job is to sniff out consensus views and exploit them.

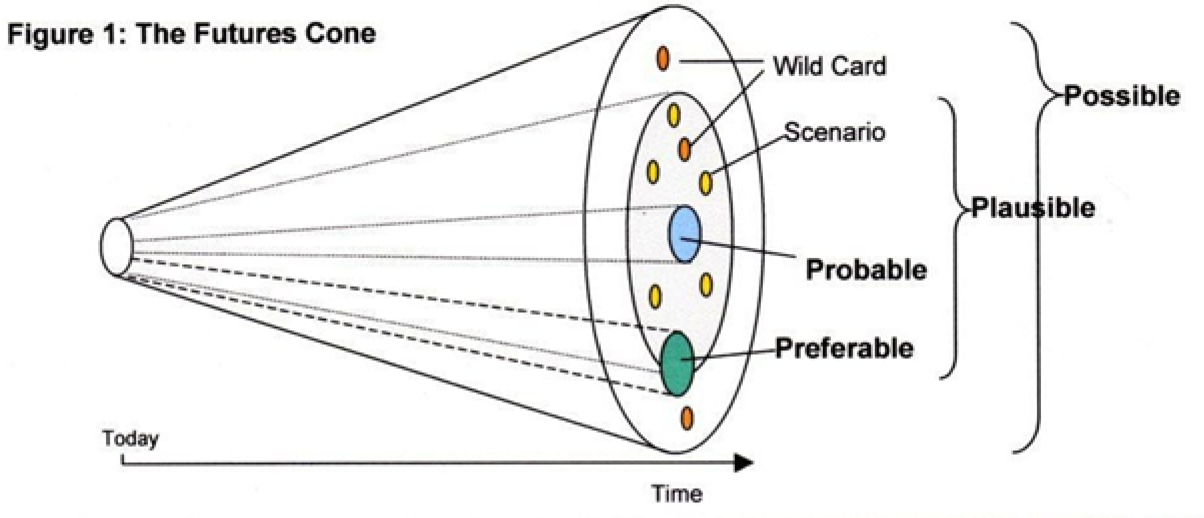
For an explanation on how to put this into practice, let's turn to Drobny's interview with *The Philosopher* from his book [*The Invisible Hands*]() (emphasis mine).

> *It is important to note that a key element to this exercise is the fact that what other people believe will happen is just as important as the eventual outcome.* ***A market is not a truth mechanism, but rather an interaction of human beings whereby their expectations, beliefs, hopes, and fears shape overall market prices.*** *People in the private equity business can decide if something is a good idea or not if held to maturity. My horizon is much shorter term.*

> *A good example of this psychological element can be seen in inflation.* ***At the end of 2008, U.S. government fixed income was pricing in deflation forever. At that point, the only thing of interest to me was the question of whether people might think that there could be inflation at some point in the future.***

Quantitative easing made it easy to answer this question affirmatively, because there are many monetarists in the world who believe that quantity of money is the driver of inflation. ***Whether they are right or not is a problem for the future — what is important to me is that such people exist today.*** *Their existence makes the market pricing for U.S. long bonds completely lopsided. Such pricing only makes sense if you are a died-in-the-wool output gapper who believes that when unemployment goes up, inflation goes down, end of story.* ***Market prices reflect the probability of potential future outcomes at that moment, not the outcomes themselves.*** *Some people do not believe in the output gap theory of inflation, and these people believe that pricing for U.S. bonds should be somewhere else. Because these two divergent schools of thought exist, it is possible that market sentiment can shift from deflation to inflation and that pricing will follow.*

One way to think about my process is to view markets in terms of the ***range of reasonable opinions.*** *The opinion that we are going to have declining and low inflation for the next decade is entirely reasonable. The opinion that we are going to have inflation because central banks have printed trillions of dollars if also reasonable.* ***While most pundits and many market participants try to decide which potential outcome will be the right one, I am much more interested in finding out where the market is mispricing the skew of probabilities. If the market is pricing that inflation will go to the moon, then I will start talking about unemployment rates, wages going down, and how we are going to have disinflation. If you tell me the markets are pricing in deflation forever, I will start talking about the quantity theory of money, explaining how this skews outcomes the other way****…. People tell stories to rationalize historical price action more frequently than they use potential future hypothese to work out where prices could be.*



Here's how to put theory into practice.

1. Identify the dominant beliefs driving markets
2. Imagine alternative future scenarios that would impacts these beliefs and their subsequent pricing
3. Wait for indications to see which scenario is playing out (price action helps here)

Financial news is a great place to begin your search for dominant beliefs. But remember, you're not reading the news for facts, you're reading it to get a sense of how other players are thinking.

You need to read the news as a contrarian.

Journalists get their tips and leads from traders, investors, researchers, etc… They report on where the large moves in the market have *already* happened. Key word being "already". The news is backward looking. As traders, we care about the future, not the past. By the time reports start hitting the papers, especially the front page, they've long been priced in.

This is key to remember. If you're reading about a trend or market development on the front page of the newspaper, or in a big story in Barron's, chances are it's **already priced into the market.**

When you see this happen, your job is to start asking "What if?"

All a good contrarian had to do was ask these *what if* questions and then wait to see how the price action and fundamentals unfolded.

When there's consensus it means there's a singular belief driving market pricing. That belief can quickly become overly discounted. And when something becomes overly discounted, it means it wouldn't take much contrary evidence to flip people's belief and drastically move prices.

A prime example is oil in 2014.

In early 2013, I remember going to a "peak oil" lecture given by a very respected academic. You probably know the one. For a number of years it became somewhat of a consensus view that we were nearing peak oil supplies and that the earth's reserves would inevitably decline.

I remember the lecturer making a very compelling case that in just a decade's time skyscrapers would no longer be in use. Energy would be so expensive that we wouldn't have the means to power common things like elevators or air conditioning.

Laughable right? But at the time this was a serious belief that was being debated by many "experts". Triple digit prices as a floor for oil were all but given. The real question at the time was, how long until oil goes over $1,000bbl?

Of course we all know how that played out. Right around that time fracking was developed. All of a sudden we were able to pull vast amounts of new energy from the ground, even as the "peak oil" belief dominated markets. This belief was completely baked into the price at around

$100bbl. It didn't take a genius to ask the right *what ifs* to uncover this HUGE mispricing and asymmetric opportunity.

2014 still remains my most profitable year. The highly contrarian trades of short oil and long dollar paid out the easiest and most consistent double digit monthly gains I've ever had.

At the same time, the majority got crushed.

This is how the market works. To quote market wizard Bruce Kovner, "One of the traders I know does very well in the stock index markets by trying to figure out how the stock market can hurt the most traders. It seems to work for him."

The stock market works to transfer money from the many to the few.

Those few are the ones who identify and exploit market prices dominated by narrow singular beliefs and consensus views.

As George Soros said, *"The prevailing wisdom is that markets are always right. I take the opposite position. I assume that markets are always wrong. Even if my assumption is occasionally incorrect, I use it as a working hypothesis."*

That's how to operate as a smart contrarian.

It's not easy holding an independent opinion. But that's why it works.

We'll continue our sentiment discussion in the next email.

Your Macro Operator,

Alex

P.S: If you have questions on any of this, or if you want to skip ahead, **check out our FAQ here.**