A Market Note: Cat or Dog?

Following WW2 a team of researchers from UC Berkeley set out to uncover the unique psychological traits at the root of authoritarianism and prejudice. Born from this effort were several "tests of perception".

Many of these tests proved controversial at the time but one test in particular is relevant to those of us who play in markets. This study is the famous cat-dog experiment led by Psychologist Else Frenkel-Brunswik.

In this study, Else's team showed a series of sketches of a single animal to a group of participants. At first, the animal shown clearly resembles a cat. After each sketch was displayed the participants were asked to name the animal. Each replied confidently that the animal was a feline.

The rub was that in each successive picture, a tiny feature would change. At first, it would be an ear, then maybe the shape of the tale, and then a slight shift of the muzzle… until the middle of the deck when the animal pictured became indeterminate.

This progressive shapeshifting would continue until the end when the animal completed its transformation into a dog.

The interesting part of this study, and why it's relevant to us as traders and investors, is that the researchers found that the participants were *very* reluctant to change from their first answer until the very end of the deck, well after the point where the sketch began to resemble a dog.

Not only that, but many of the participants became unnerved and agitated while going through the middle of the stack; as if they were being forced into mental contortions to justify sticking with their initial response.

Else noted that participants showed "a preference to escape into whatever seems definite." Her concluding thoughts from the study were that a key trait of an authoritarian was their intolerance for uncertainty… And, also, importantly, that we all have a little authoritarian in us to some degree.

Change cat-dog to bull-bear and we're right into markets. We make bets, form opinions, and all too often, unconsciously cling to these opinions, even though the picture (or inputs) have shifted. The problem is that we're not seeing the environment with fresh eyes. We've already formed our opinion and the pull "to escape into whatever seems definite" is strong, and it alters our perception of the world. Basic sunk costs and all that jazz.

This topic of uncertainty… of handling the mushy grey areas of markets, where you once had a strong opinion on trend but are now just not so sure… well, this is something I write about a lot. For instance, we have this section from my piece on *The Naked Sniper*:

> *And this is what I now know. This is the **not** a secret, secret sauce of trading.*
>
> *Trading (and investing) is not about knowing things. That's like maybe 10% of the game if I'm being generous.*
>
> *You know what's a more apt descriptor of a successful trader?*

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> *An **UN**certainty manager. Someone who can successfully manage not knowing things. Someone who can make money over a full cycle, while knowing that he only knows maybe 30% of everything that's critically important to his trade or investment successfully working out.*

The funny thing is that despite my constant harping on this topic of learning to manage uncertainty, of being conscious about regularly stepping back so as to approach the market with fresh eyes, I still occasionally find myself calling a dog a cat.

Last year is a case in point. We started 2023 with a tactically bullish but strategically bearish bent, saying that the consensus *recessionistas* were far too premature with their "the end is nigh…" ranting. And that a downturn wouldn't hit until near the end of the year. The first part was true. The second part not so much.

And even though we managed to do okay (up +24% on the year), the anchoring to the recession belief kept us from turning more *aggressively* bullish, when the data (sentiment/positioning, HY spreads, market internals, etc…) said to do so.

We were still saying cat when the picture had clearly morphed into a bull.

There are two big takeaways from this, that I believe if correctly applied, can help us retain our mental acuity. One of these is to treat our opinions just as we treat our positions… we have clearly predefined stops, whether that be a time stop, a change in the underlying data, or a level in the market that if reached would suggest we take a step back and seriously assess our priors.

Mark Spitznagel wrote in *The Dao of Capital* that the most valuable lesson he learned from his Chicago trading pit mentor, Everett Klipp, was that "you've got to love to lose money."

Let's replace "lose money" with "being wrong". We have to *love* being wrong… this game isn't for feeding egos, and to be right over the long run you need to be willing to be wrong a lot in the present… which reminds me of this great story told by Malcolm Gladwell about George Soros, where he writes:

> *An old trading partner of Taleb's, a man named Jean-Manuel Rozan, once spent an entire afternoon arguing about the stock market with Soros. Soros was vehemently bearish, and he had an elaborate theory to explain why, which turned out to be entirely wrong. The stock market boomed. Two years later, Rozan ran into Soros at a tennis tournament. "Do you remember our conversation?" Rozan asked. "I recall it very well," Soros replied. "I changed my mind, and made an absolute fortune." He changed his mind!*

This fact has been born out by research performed by Philip Tetlock who found that rapid belief-updating is *3x* more important for successful forecasting than intelligence. The truth is that it's not about consistently nailing grand forecasts at all. Rather it has much more to do with *attunement*, and quickly adjusting when needed to stay in the flow with reality as it unfolds. Soros was the GOAT at that, and it should always be a guiding North Star for us as well.

Like writers, we need to be willing to kill our babies, love to be wrong, and be willing to rapidly update our beliefs.

Secondly, we can more effectively update our priors and accept we're wrong when we have a simple

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and concise funnel for making decisions. The most important aspect of this is to know what the *critical* information inputs in our decision tree are and limit these inputs to a manageable amount less we make ourselves susceptible to analysis paralysis and/or confirmation bias.

German psychologist, Gerd Gigerenzer, calls this "The less-is-more Effect". If you'd like to dive into this then I recommend picking up his book "Gut Feelings". Essentially what the less-is-more effect refers to is that heuristic decision strategies can yield more accurate judgments than strategies that utilize large amounts of information.

The way I think about this in trading and investing is that if you need 20 pages of notes to convince you to put on a trade then you shouldn't put on the trade. This is what the famous psychologist Paul Slovic discovered in his study of professional horse bettors, which is that additional information beyond a minimal amount not only didn't improve their predictive abilities but it made them much more confident than they should have been. This of course led to poorer results in the form of misplaced bet sizing.

The Macro Game is rife with noise, nonsense, and distracting shiny objects. After roughly 15 years of playing this game, I've concluded that the number one cognitive blindspot that straight kills the vast majority of traders and investors is that most unconsciously play this game to prove to themselves and others just how smart they are.

But markets are dynamic non-linear complex ego incineration machines. And if your sole objective isn't to *make money and let ego be damned*… then, well, you're in for a rough go of it.

An all-too-common example of playing the "I'm smart" versus the "make money" game is the macro analysis, typically in the form of a 50-slide PowerPoint deck, that uses 50 different indicators to say the same damn thing.

I get it, I have a fetish for charts too. I mean, I publish a dozen of them every Monday. But when it comes to proper analysis — if we're playing the *make money* game — then our process needs to be laser-focused on our system, our funnel of analysis.

This funnel should be comprised of a small but well-rounded grouping of data points that look at key markers from enough angles to guard against anomalous episodes (the last 3 years in macro being a prime example of an anomalous episode) and no more, lest we breed false confidence.

These data points should be thoroughly tested. So you're intimate with their strengths and shortcomings. And more importantly, how they all complement one another, which then should give you a sense of how to read and make decisions using this system (ie, level of appropriate conviction, which strategy to deploy, subsequent bet sizing, etc…).

This is what we attempt to do with our evolving HUD, our weekly *Play The Player* report, and our overall approach to research and markets. Einstein was onto something when he said "everything should be made as simple as possible, but no simpler." This is a far less sexy approach than your popular "Macro Professor" on Twitter who loves sharing his airy pontifications about the world. But it works… One gets you attention, the other makes your nut.

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And I should add that the point of analysis isn't to form any level of certainty about a market outcome. Certainty isn't the game here. We're UNcertainty managers knowingly involved in a wicked game after all. So, false-certainty, no thank you… rather we're concerned with rough odds and probabilities, specifically downside risks… risks of ruin… risks of getting Archegos'ed, as well as skew, tail events, and bet sizing, etc…

Not to mention there's the idea that focused attention on a few things naturally breeds a kind of deepening mastery. While having no clear framework and therefore giving away your awareness to every new flashy data point that prints on your BBG terminal, well, that's like digging a hole a mile wide and a quarter inch deep… It's similar to Bruce Lee's point about kicking people:

> *I am not afraid of a person who knows 10000 kicks. But I am afraid of a person who knows one kick but practices it for 10000 times.*

So when you sit down at your desk, toss your ego out the window. Learn to relish being wrong, so you can rapidly iterate your beliefs and your subsequent positioning. Simplify and hardcode your analysis funnel. Study it inside and out. Know its strengths and weaknesses. And then aim to execute it ruthlessly as you play the make-money game of edges and probabilities.

Do that… and you'll have no problem calling a dog a dog, a bull a bull, a cat a cat, a bear a bear, or just simply admitting that you don't know when the picture is all mangled.

Where things currently sit…

2023 was a great teachable year for macro traders.

If there is one major takeaway from last year and reading the macro environment, it's to listen to what the market is saying over what the economic data is saying.

This is always true but even more so in today's environment where we have more aggressive meddling from the Game Masters (Fed, Treasury, Fiscal spending, etc…).

There's also been a sharp trend shift in geopolitical instability that means more upside volatility in supply chain disruptions and input prices. Plus we have growing internal political disunity which means a bias towards more populist governance and direct interference in markets.

Case in point, an investor would have performed significantly better last year if they'd completely cut out economic data altogether; no recession indicators, no dissection of CPI reports, not even a care for what the Fed was saying and doing.

Instead, if they'd just looked at market prices relative to the sentiment and prevailing narratives, followed the signals from market internals (ie, cyclical vs defensive, QQQ vs SPY, discretionary vs staples, etc…), and tracked liquidity using something as simple as high-yield spreads, they would have done a much better job of staying on the right side of the trend — with a lot less work to boot.

Doing so is what kept us on the right side of markets. But, as I said earlier, it was the over-anchoring to the economic "signals" that kept us from aggressively playing the bull side despite that being exactly what the Hierarchy of Technicals was telling us to do.

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Moving on…

We closed out the trading month on Friday so let's start at the top of our funnel and quickly run through some charts, going from the 30,000ft view on down starting with the S&P 500.

The SPX closed at a new all-time monthly high. This in itself is very bullish as new highs beget new highs. The technical picture shows the completion of the first bull leg up from a nearly 2-year-long Cup-n-Handle pattern where the market put in five consecutive bull bars followed only by a one-bar pullback.

What does this mean?

> *All of the bars to the left showing buying and selling pressure, support and resistance. The circumstances that support or oppose the execution of a trade setup, or its trade management.*
> ~ Al Brooks

There are a handful of traders that have had a significant impact on the way I think about markets. Al Brooks is one of them. His books and video courses are a slog to get through — his delivery style is about as exciting as watching paint dry. But, the fundamentals of his teachings surrounding price action analysis, are priceless.

There's a lot to what he teaches. But the most important aspects of his teachings can be boiled down to two things **(1) Trade in the direction of the trend and (2) Look to the bars to the left to develop context and probabilities.**

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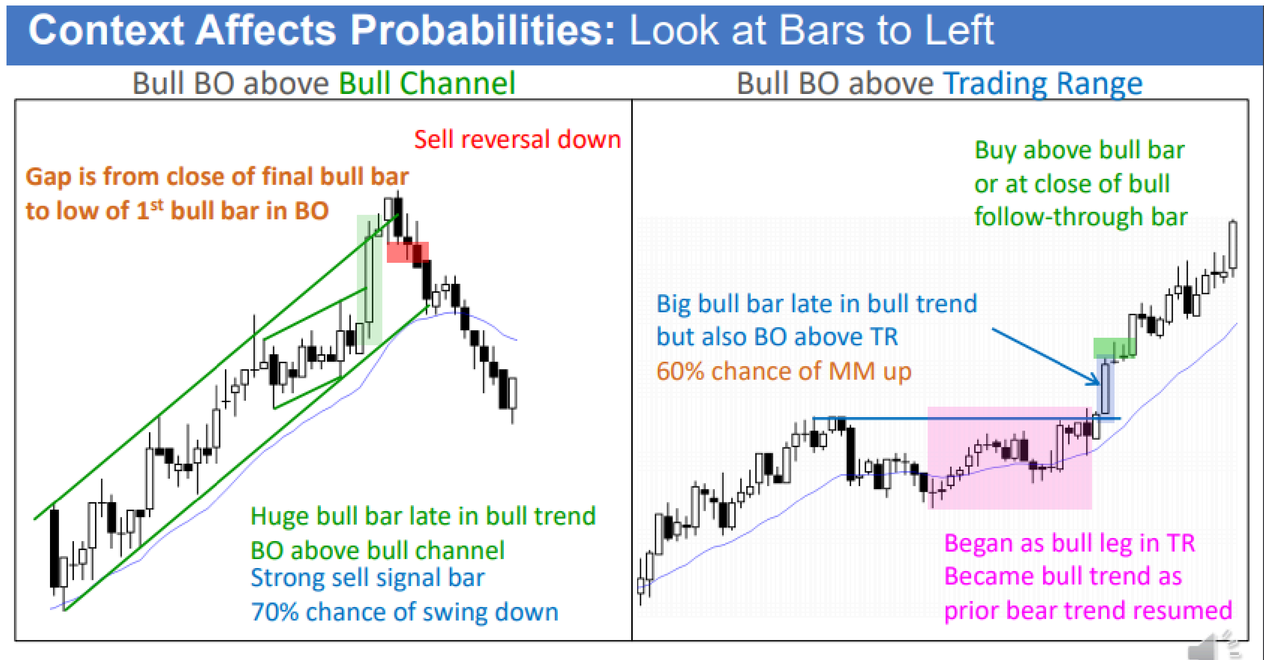
Here's a slide from one of his webinar decks (link here) giving an example of how he builds context through "bar by bar" analysis.



The approach is beautiful in its simplicity… Every bar on the chart is a two-dimensional representation of real-time supply and demand. While each bar contains information, **we must look to the bars to the left to establish effective context for the current bar.**

For example, a large bull-bodied bar within a broader sideways range does not mean the same thing as one that occurs in an uptrend. Looking left for context at a sideways range we know that Newton's 1st Law of Markets states that markets in ranges tend to stay in ranges (roughly 80% of the time). This means that most breakouts from ranges will fail.

The same goes for trends. Markets in trends tend to stay in trends approximately 80% of the time. This means that most reversals within trends fail.

This is a simple yet incredibly valuable framework for reading the tape. Your average trader has the tendency to overweight the recent price action while disregarding what's come before it (the bars to its left). Even worse, is that **we all have a tendency to apply our biases to the tape which leads to building false conclusions**.

Again, this is remedied by looking left and understanding how to use bar-by-bar analysis to build effective context of market supply and demand.

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As a result, each bar tells us a story of who is winning this fight. So there's quite a bit of valuable info in each one. The longer the time frame (daily candles vs weekly vs monthly and so on) the more signal there is relative to noise.

Large green-bodied bull candles with little to no wicks on top (like we saw last month) show that bulls are strongly in control of the market. Large red, or tan in this instance, bear bars with little or no tails show that bears are in control. Small-bodied candles that close near the middle of the monthly range show indecision. Reversal candles (ie, hammers & shooting stars) marked by large upper wicks or large lower tails, show key failure points that often mark technical inflection points.

This is probably basic stuff for most of you. But I cover it here because bar-by-bar analysis is such a simple yet vitally important skill for helping to keep you on the ride side of the trend. If you get good at this, then you don't really need much else. And importantly, this keeps the game simple, which is really how it should be.

Looking at the above monthly SPX chart alone, I know I don't want to be shorting this market. I don't need to be thinking about an imminent market top. I want to be long, buying dips, and adding at rips.

Sure, we'll see the inevitable 7-10% pullback which is perfectly normal and healthy within a primary bull trend. And we can hopefully dodge most of these by drilling down to the smaller timeframes (weekly and daily), as well as using some of the other tools such as those found in our Trifecta process.

So the tape says to lean bullish US markets over the intermediate term. This bullishness is further confirmed by global markets; Europe a hair's breadth off 20yr+ highs, UK's FTSE 100 closed at new all-time highs, Japan just off all-time highs, India new highs, etc…

The weekly chart shows a similar story of dominance from the bulls. Bears tried to drive the market lower but bulls came in and beat them around, reversing most of the losses for the week.

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Looking at the daily we have a bullish reversal right at the midline within a Bull Quiet SQN regime. This is a valid technical entry point. You can put in a buy stop right above Friday's highs and a sell stop right below and see if the market can pull you in long.

We can then turn to our HUD or our weekly *Play the Player Report* and go through the rest of our analysis funnel to provide the additional context that helps us with sizing, conviction, and keep an eye on our six. And there we see the data is supportive of what the tape is telling us… buy dips and add on rips.

Some trade setups we're watching…

UK's FTSE 100 closed at new all-time highs last month. It's solidly in a Bull Quiet regime. It traded down to its lower band on Thursday but then put in two reversal bars. This gives us a technical inflection point to put in a buy stop right above Friday's high with a stop right below Thursday's lows, enabling us to get good size on with little risk.

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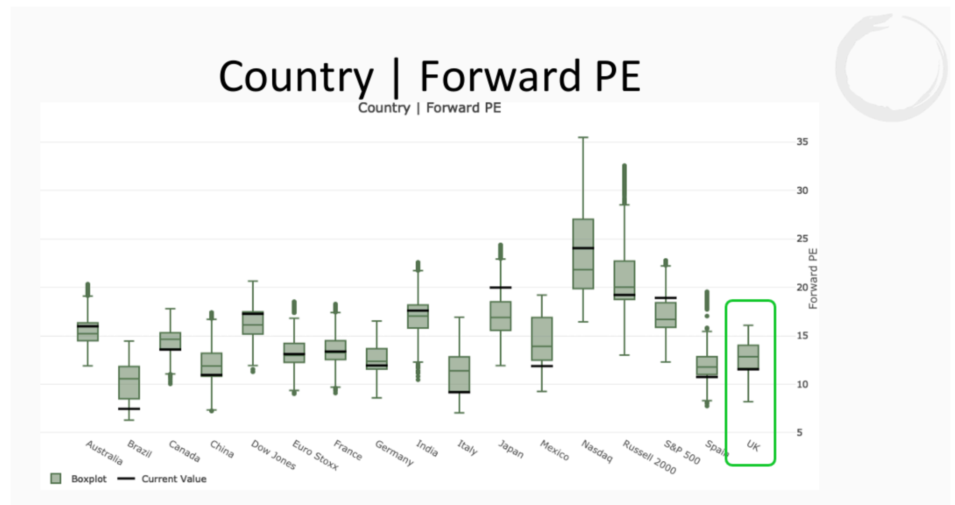
The UK market is trading in the lower decile of its historical valuation range. The latest BofA Global Fund Manager Survey showed that it's also one of the most under-owned markets globally and has been for some time (see charts below).



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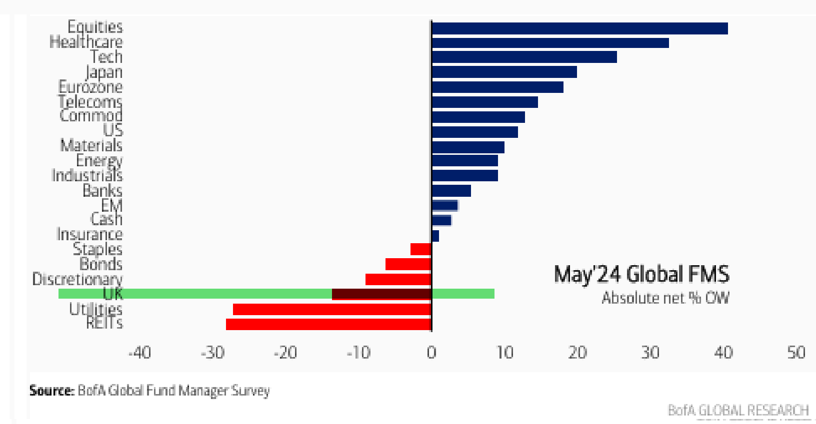
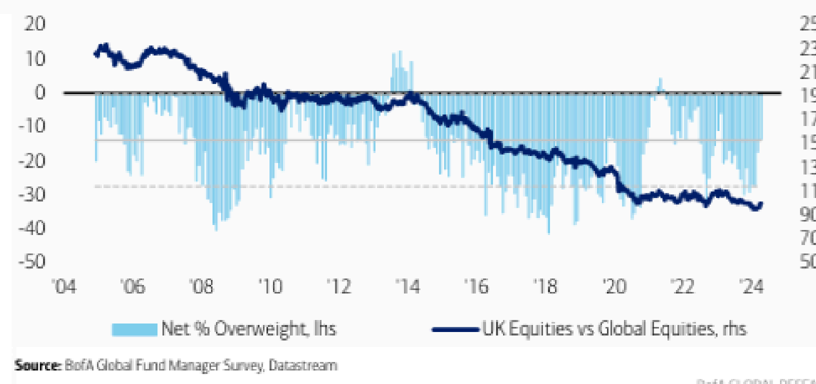


This chart shows absolute FMS investor positioning (net % overweight).

Bullish: equities, healthcare, technology, and Eurozone;

Bearish: real estate, utilities, UK, and consumer discretionary.



FMS allocation to UK equities rose 3ppt MoM to net 14% underweight, the smallest underweight since Mar'23.

FMS investors have been consistently underweight UK equities since Jul'21.

Current allocation is 0.1 stdev above its long-term average.

Similar to the US, this is a trend we want to be long. Brandon and I have also been digging into single stock names in the market and will be sharing with the group what we find.

B and I are also stalking the shipping/tanker space. We've been going back and forth on whether to put money into these names for the past 18 months but haven't, much to our chagrin…

Years of underbuilding, dwindling CAPEX spend, tougher financing availability, and now rising geopolitical instability have created a big mismatch in supply and demand. As a result, the broader shipping market has been on fire. And better yet, there's essentially zero fanfare or public notice of this trend. Your typical crowd that'd be harping on this space is too caught up in other themes, such as uranium and crypto.

Strong technicals meet maximum apathy seems like a good recipe for a large bull trend to me. Here's a few charts of names we're digging into.

Global Shipping Lease Inc. (GSL) (monthly chart).

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Danaos Corp (DAC) (monthly chart)

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Matson Inc (MATX) (monthly chart)

These are charts you want to buy and sit on. It's quite likely a cyclical bull market in shipping is getting underway.

Concluding thoughts…

Our book is up 35% on the year, down from the YTD high of 44% two weeks ago. We'll publish our 6-month portfolio review here soon where we'll dive into our mistakes, blunders, and the few things we've done well.

We'll be coming out with a monthly macro slide deck within the next two weeks where we'll cover the fundamental macro side of our analysis funnel. This will be an ongoing recurring monthly report that we look forward to sharing with you.

Suffice it to say, there's not much to do at this moment other than to trade the trend and adhere to our process. The market is currently pricing in one cut this year which feels about right. The Zimbabwean run-up in inflation that many were predicting earlier in the year is turning out to be not quite that. The components that have kept core elevated (ie, housing/rent costs, food services, etc…) should trend lower in the months ahead.

However, I don't expect inflation to get down to the Fed's target (outside of recession) for the reasons I outlined in this Slack thread (link here). We should see it chop around the 3-handle range. The two things that'd change my view on that is if we see (1) a material trend change in the USD lower and/or (2) wages start inflecting significantly higher again, though I don't see what fundamental pressures could drive that at this point.

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The most interesting developments in markets right now are in currencies. There are a number of USD pairs entering major monthly compression regimes (see CAD, AUD, CNH). This tells us that a big trade is brewing.

While I'm directionally agnostic on CNH since that's largely dependent on what Xi and team decide to do, and we don't have an ear in that room. But CAD and AUD look like longs to me. Positioning is certainly crowded short on both. On this front, CHF is also interesting.

The question then is what would be the catalyst?

And I'm thinking it could just be a rates play. The "higher for longer" side of the table certainly seems more crowded.

One of my favorite sentiment/narrative tools is to watch Bloomberg's Real Yield each week, at least the first 10 minutes.

The show interviews real money managers. These are the people who move markets. And the last few weeks the narrative pendulum sure seems to have swung all the way into the higher for longer camp.

I find that interesting because we're starting to see a real softening start in the labor market. And all signs point to this weakness accelerating in the months ahead.

Also, the DXY's yield oscillator (see HUD or PTP) is rolling over. This typically leads major turning points.

We may start probing the long side in CAD, AUD, and CHF this week. Keeping it small until we get technical confirmation. But keep your eyes peeled on this one. There may be some big money to be made here.

Finally, I want to address my partial absence from my usual tempo of writing for, well, way too long now. Please accept my sincerest apology…

The last two years were the most brutally challenging years of my life, in every single way possible. Decades of untended chronic illness culminated with me nearly dying from serious health complications. At the same time, I went through a complete unraveling or what I can only describe as something akin to Joseph Campbell's Hero's Journey, or exploration of the shadow self or unconscious mind.

I have so many words to say about this odyssey but at the current moment don't quite yet have the words. But in time I do plan to share all that I can because I've learned some incredibly valuable lessons on not just health, but also the game of life and how to play it well, along with so much more.

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My health, on all fronts, is now better than it's ever been in my life. I'd been sick to varying degrees for the entire 9 years that I've been running MO. And despite that fact, we've done all right. I'm excited to see where we can take things now that I'm in full health and ready to run on all fronts — and genuinely excited to do so.

I want to thank you for being a member of this awesome community. Truly, from the bottom of my heart, I appreciate it.

And lastly, I want to thank my team, and Brandon in particular, for picking up my slack and doing a killer job on all fronts.

Going forward I'll be back to publishing these Market Notes every week. We also have several exciting new developments that we'll be announcing soon and that we think will provide a lot more value to this community.

Until then, stay frosty and keep your head on a swivel.

Your Macro Operator,

Alex

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