# Total Sentiment Capitulation

Happy Monday everybody,

Here's a quick market note with some things we're looking at this week along with some trades we're planning to execute.

First up, the big news last week was Apple (AAPL) cutting first quarter revenue guidance on weaker than expected iPhone sales.

Apple gapped down on the news, bringing its recent selloff close to -40% from all-time highs.

Tim Cook blamed the lowered guidance on slowing the slowing Chinese economy. Here's Tim in his own words:

> While we anticipated some challenges in key emerging markets, we did not foresee the magnitude of the economic deceleration, particularly in Greater China. In fact, most of our revenue shortfall to our guidance, and over 100 percent of our year-over-year worldwide revenue decline, occurred in Greater China across iPhone, Mac and iPad…
>
> Lower than anticipated iPhone revenue, primarily in Greater China, accounts for all of our revenue shortfall to our guidance and for much more than our entire year-over-year revenue decline. In fact, categories outside of iPhone (Services, Mac, iPad, Wearables/Home/Accessories) combined to grow almost 19 percent year-over-year.

Ben Thompson, who is the author of my favorite blog (Stratechery) on everything consumer technology related, shared this chart in a recent post showing the contracting revenues out of China over the last two Q2s.

Apple Revenue (in billions)

| | Q2 2017 | Q2 2016 | Q2 2015 |
|---|---|---|---|
| Americas | $21.2 (+11%) | $19.1 (-10%) | $21.3 (+19%) |
| Europe | $12.7 (+10%) | $11.5 (-5%) | $12.2 (+12%) |
| China | $10.7 (-14%) | $12.5 (-26%) | $16.8 (71%) |
| Japan | $4.5 (+5%) | $4.3 (+24%) | $3.5 (-15%) |
| Rest of Asia Pacific | $3.8 (+20%) | $3.2 (-25%) | $4.2 (+48%) |
| Total | $52.9 (+5%) | $50.6 (-13%) | $58.0 (+27%) |

Ben argues that slowing Chinese demand for the iPhone — when we're talking Apple revenue we're really talking iPhone sales as they comprise 63% of the company's revenues — has less to do with the slowing Chinese economy and more to do with their relative lack of a product moat in the country. Here's Ben with emphasis by me:

- *In most of the world, Apple is differentiated first-and-foremost by its integration between hardware and software; the company has a "monopoly" on iOS, which allows it to sell its hardware at much higher prices than the competition.*
- *However, in China iOS is much less of a lock-in, thanks to the dominance of cross-platform Chinese-specific services, particularly WeChat (WeChat, while the most important factor, is not the only one: indeed, given that Android in China is specifically tuned to the Chinese market by Chinese OEMs, iOS is if anything a hindrance).*
- *The net result is that **Apple in China competes not on the basis of integration, but rather on the attractiveness of its hardware**; in other words, **Apple is, to far greater degree in China than anywhere else, simply another OEM**.*

In much of the world Apple enjoys the high retention rate of 80% amongst iPhone users; meaning iPhone users tend to buy new iPhones rather than, say, an Android. But, in China, due to the ubiquitousness of WeChat, Apple's iOS holds a less prominent place in the Chinese user's mindspace — the iPhone retention rate there is only 50%.

And so, the major differentiator then for the Chinese consumer, becomes the look of the phone itself (ie, it's role as a status symbol). Since the most recent iPhone product cycles have not materially changed its appearance there's been less reason for Chinese people to upgrade. Hence, the recent disappointing sales…

Ben goes on to conclude (and I agree with him) that:

> The good news for Apple is that, to the extent these errors really were predictable, there is nothing structurally different about the company's competitive position today versus six

months ago, when the current stock slide began.

The next iPhone hardware revision should sell better in China, simply by virtue of being new (and the implication of it being easy to switch away from iOS is that it's easy to switch back).

Customers still prefer Apple's flagship iPhones, no matter how expensive they are. Headwinds like currency and battery replacement programs will go away, and phones, thanks to their centrality in people's lives as well as the greater likelihood of harm, will always have a faster replacement cycle than PCs.

Meanwhile, the company's Services business continues to grow, along with its installed base (including in China); the company is clearly putting more strategic emphasis in this area, effectively abandoning also-ran hardware products like HomePod and Apple TV to increase the reach of its services. I would expect significant announcements in this area through 2019.

If you want to read more of Ben's thoughts on Apple then give these links a look (link, link).

With all this said, let's give Apple's long-term chart a look (chart is a weekly). The stock is currently going through its fourth 30%+ drawdown over the last 12-years. We can see that its trading at its 200-week moving average (blue line) which has acted as significant support in the past, following similar declines.

From a valuation standpoint the stock is trading cheap.

It's selling for a TTM PE of 11.9x; which is near the low end of the range of multiples that it has traded at in the past and well below the market's TTM PE of 19.5x. Even more interestingly is when you look at this valuation relative to the size of the company's cash balance. At $66.3B it's nearly 80% higher than the last time AAPL was trading at this low of a multiple. Excluding cash, the company's earnings trade for a multiple of just 10x.


If the past is any indication, then the stock should trade around its 200-week MA for a while. Likely, a few months. We're going to keep an eye on it and consider adding it to our books once the technicals shape up a bit.

The other big news last week was of course the central banker powwow including Powell, Yellen, and Bernanke. Powell gave some important signalling to the market during the presser, really trying to beat home the fact that he has no qualms about changing course on monetary policy — referring to both interest rate hikes and balance sheet normalization — should the data say to do so.

The entire talk is worth a read. You can find the transcript here. But I'll share the important bits. The following is all from Powell unless otherwise noted (with emphasis from me).

> Now when we get conflicting signals, as is not infrequently the case, policy is very much about risk management, and I'll offer a couple of thoughts on that to wrap up. First, as always, **there is no preset path for policy, and particularly with the muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves**. But we're always prepared to shift the stance of policy **and to shift it significantly, if necessary,** in order to promote our statutory goals of maximum

employment and stable prices.

And I'd actually like to point to a recent example when the committee did just that in early 2016, and I mentioned this is in this December press conference in passing. As many of you will recall, in December 2015, when we lifted off from the zero lower bound, the median [Federal Open Market Committee] participant expected four rate increases for 2016. **But very early in the year in 2016, financial conditions tightened quite sharply, and under Janet's leadership, the committee nimbly – and I would say flexibly – adjusted our expected rate path**.

After being asked if the market is saying the Fed made a policy mistake Powell answers:

I think the markets are pricing in downside risks, is what I think they are doing, and I think they are obviously well ahead of the data, particularly if you look at this morning's labor market data and the other data that I cited. So markets are expressing concerns, again, about global growth in particular – I think that's becoming the main focus – and trade negotiations, which are related to that. And I'll just say that we're listening carefully to that. **We're listening with – you know, sensitively to the message that markets are sending, and we're going to be taking those downside risks into account as we make policy going forward**.

Regarding balance sheet normalization:

So if we ever came to the conclusion that any aspect of our normalization plans was somehow interfering with our achievement of our statutory goals **we wouldn't hesitate to change it, and that would include the balance sheet, certainly**. So I would say today, of course, we're hearing a lot from different groups of people about the role that the balance sheet normalization may be playing in the markets.

I think we are of the view that what really happens mechanically when – you know, when our securities mature is Treasury issues a comparable amount of securities, but they do so across the yield curve. The amounts are not that big. They haven't been that big compared to the issuance Treasury has already undertaken.

So we don't believe that our issuance is an important part of the story of the market turbulence that began in the fourth quarter last year. But I'll say again, if we reached a different conclusion we wouldn't hesitate to make a change. **If we came to the view that the balance sheet normalization plan or any other aspect of normalization was part of the problem, we wouldn't hesitate to make a change.**

The signalling is clear. Powell is telling the market that if the data continues to deteriorate — which it will over the coming quarters — then he will adjust fire on both interest rates and QT.

This is significant because the US's ability to steer clear or recession over the coming year while much of the rest-of-the-world (RoW) likely dips into it, almost entirely depends on the Fed's nimbleness and willingness to change course in response to softening data — an important lesson I think the Fed has learned since the GFC.

I was recently discussing this with a few of you in the CC over the weekend. A number of you believe that the US is headed for a recession this year. I'm open to this possibility but I don't think it's the highest probability scenario, currently.

Certainly, much of the RoW is already in or headed for recession. A number of China watchers I talk with tell me the that current GDP growth is likely zero or negative, and heading lower in the coming quarters. Prof. Xiang Songzuo, gave a fantastic speech at Renmin University last month where he touched on the many troubles facing the country. Here's a clip:

> *How bad are things? The number that China's National Bureau of Statistics (NBS) gives is 6.5 percent, but just yesterday, a research group of an important institution released an internal report. Can you take a guess on the GDP growth rate that they came up with using the NBS data?*
>
> *They used two measurements. Going by the first estimate, China's GDP growth this year was about 1.67 percent. And according to the other calculation, the growth rate was negative.*

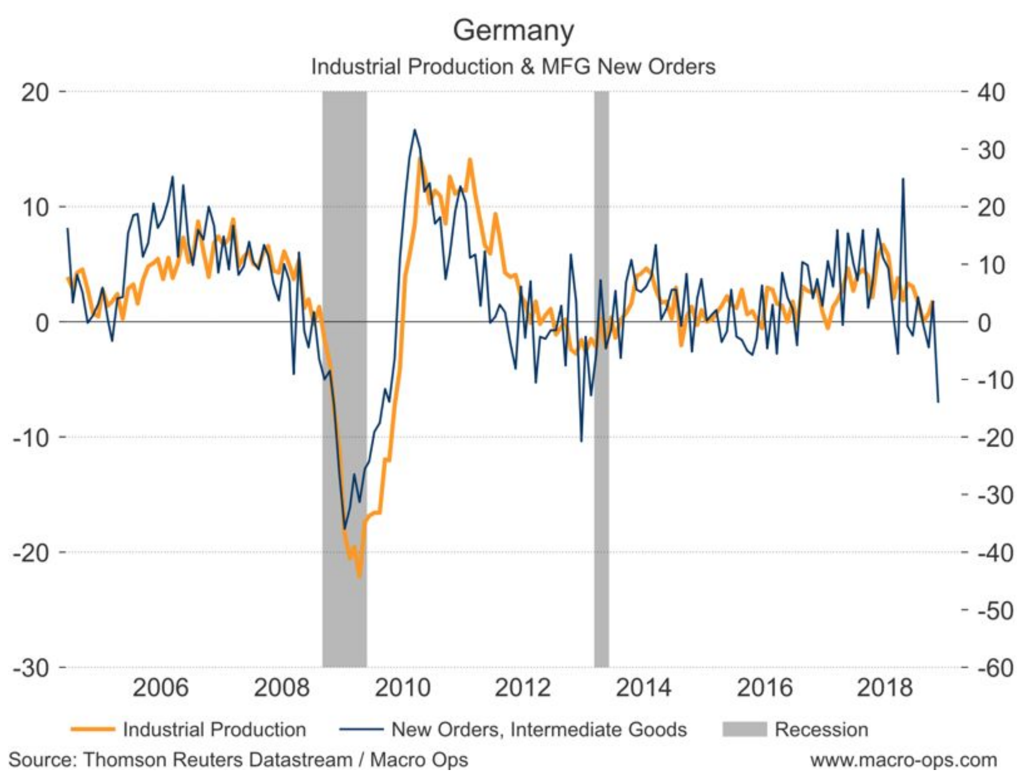
The speech is worth reading in full (here's the link) and h/t to Operator Kean Chan for sharing this in the CC.

This, of course, isn't a surprise to us. We've been harping on the China slowdown for the last year. For those of you who are new to the group, I suggest giving this a read which explains the major structural headwinds facing China and what it means going forward. And then also check out this which discusses the Balance of Payments trap that much of emerging markets finds itself in and why EM is unlikely to see a v-bottom recovery similar to the ones they've experienced in the past.

Then there's Europe, who has a large exposure to China through trade, and which is also struggling with social unrest (see France) as well as political uncertainty.

The Sentix Eurozone economic expectations index has turned deeply negative — the index has a leading correlation to GDP.

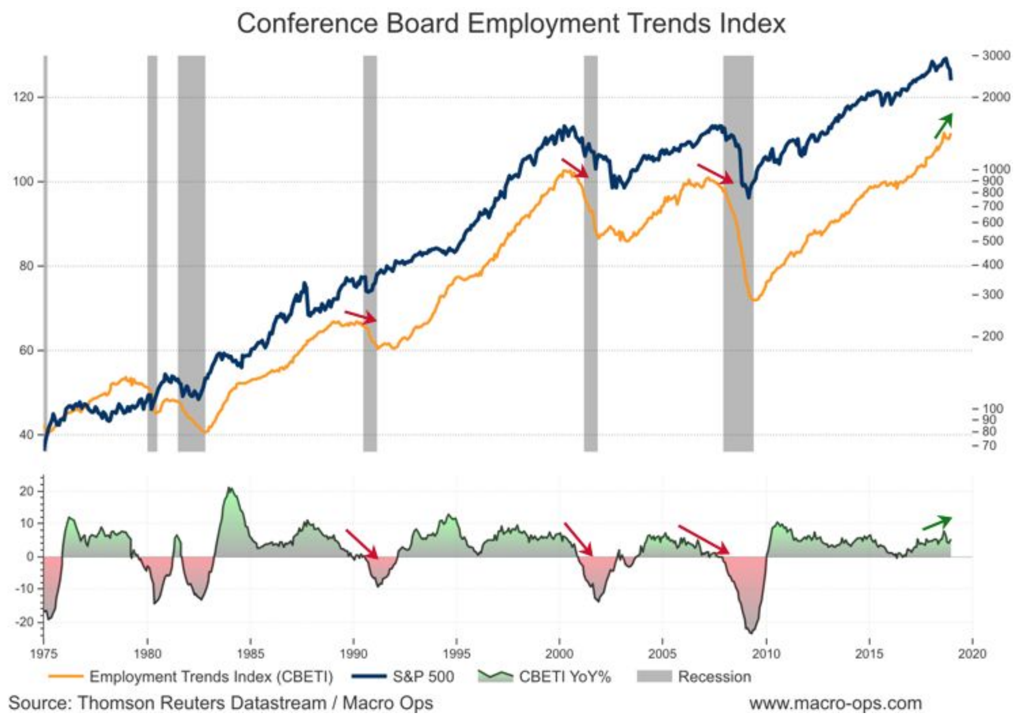

New intermediate goods in Germany are at their lowest levels since 2012. This indicator has a strong 4-month leading correlation to German industrial production, and suggests recession is coming in the next quarter.



The US on the other hand continues to hold up well. All of my recession indicators (LEI, unemployment MA crossover, yield curve, and credit/delinquency) suggest a US recession in the next 6-months is highly unlikely and one in the next 12-months is improbable as well.

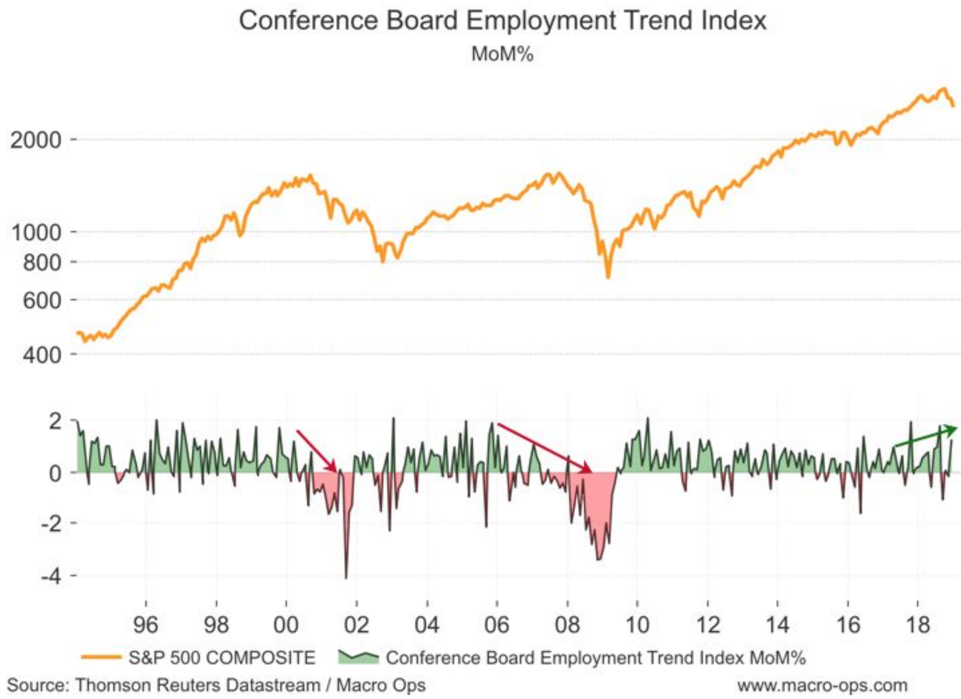
Just take a look at the Conference Board Employment Trends Index (ETI) which aggregates eight different labor market indicators (more info here) and provides the best look into the health of the labor market.

The orange line is the ETI, blue is the SPX, and the indicator at the bottom is just the ETI on a YoY% basis.

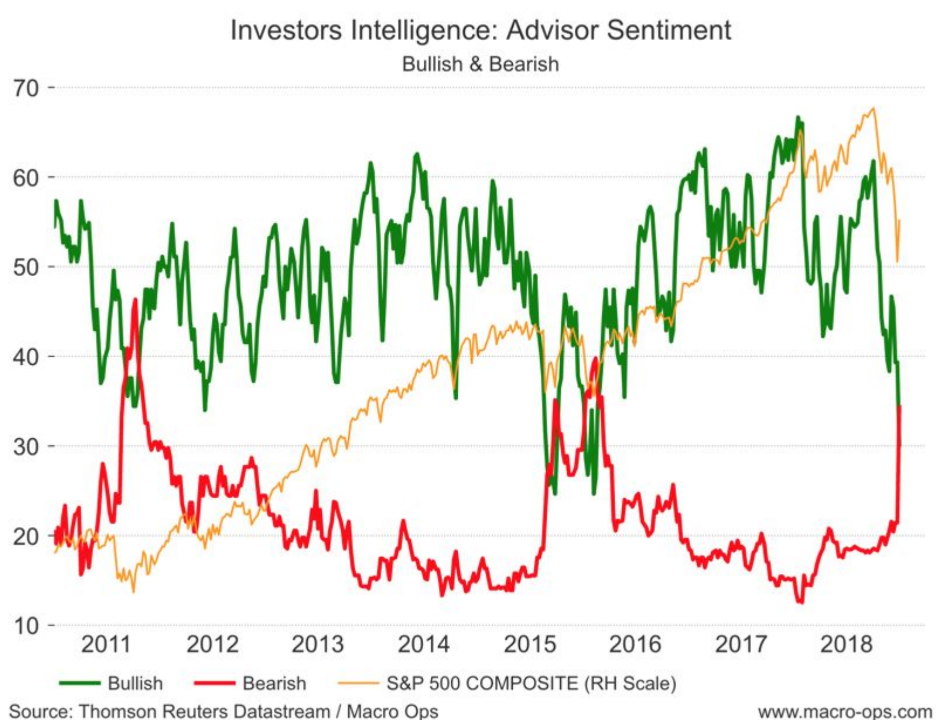



You can see that the ETI turned over at each of the market peaks going back to 1975 leading every recession by at least 6-months. Well, the ETI is near all-time highs and is still showing strong YoY growth.

Here's a more granular look at the ETI on a MoM% basis. No visible deterioration in the labor market yet. Employment drives income and income means demand which equals growth. So until this, along with the other data we track, falls meaningfully, I want to keep a bullish bias as I think the risk is to be too underweight US risk assets going into this year versus being overweight them.

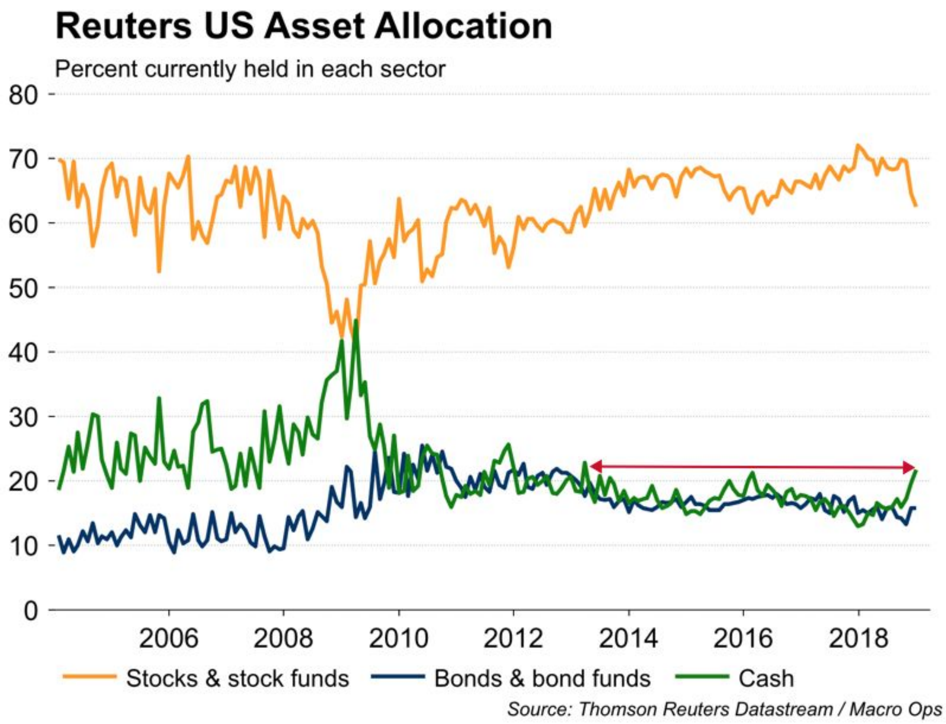



But for the market to really rally, we need the majority of participants to be over-discounting US recession risk (thus, underweight stocks). And looking at the latest sentiment and positioning data it seems that's becoming the case.

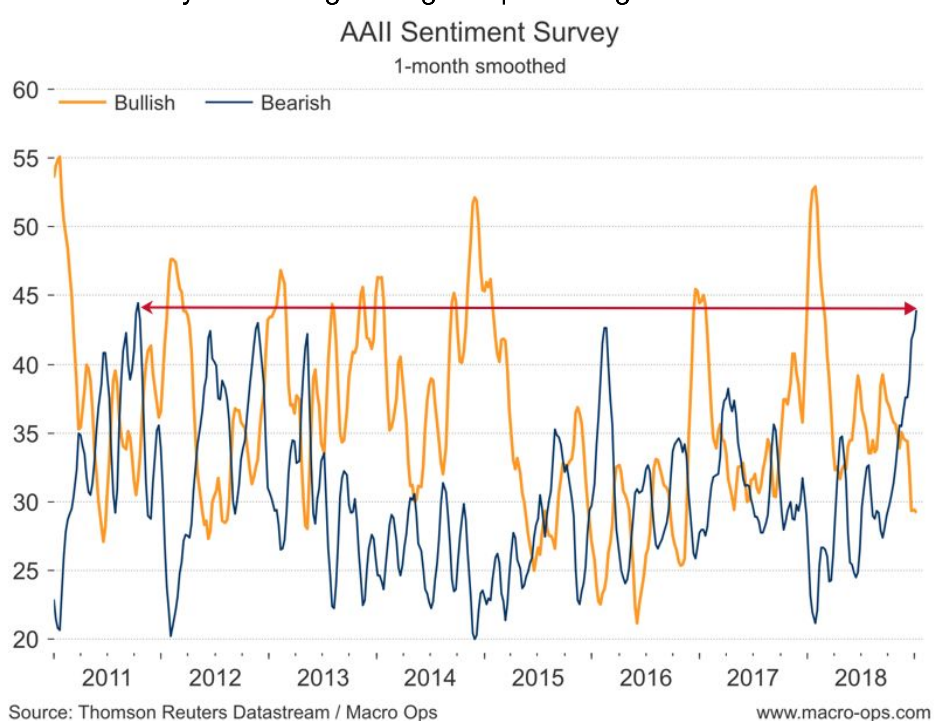


II Adviser sentiment is finally showing signs of the total sentiment capitulation we've been waiting for. I expect this will reset further in the weeks ahead.

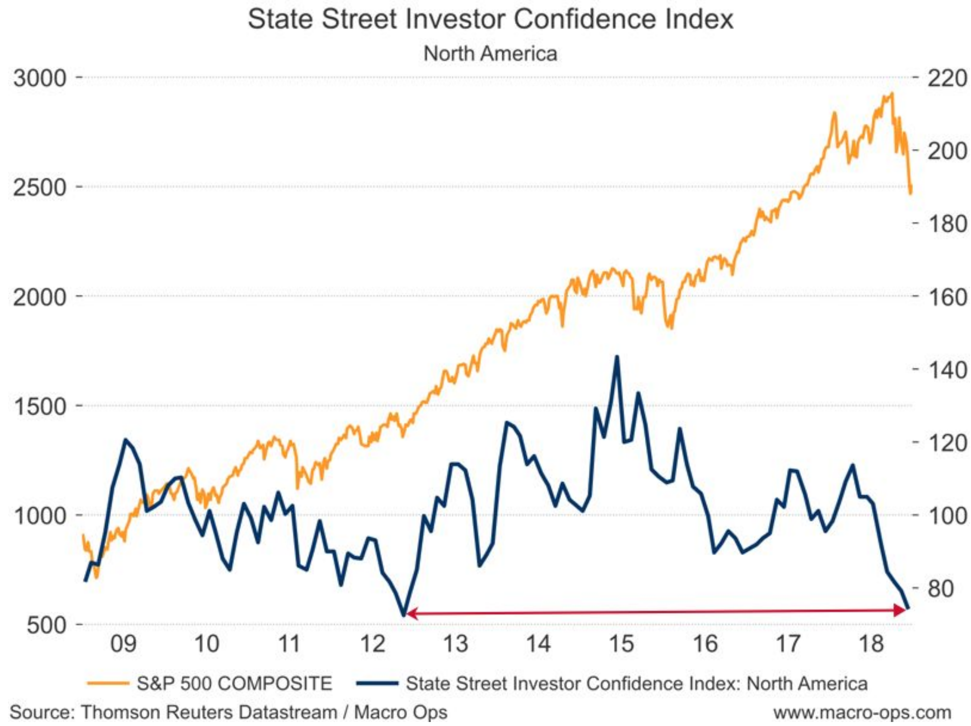
Investors are now holding their largest cash position in over 5-years.



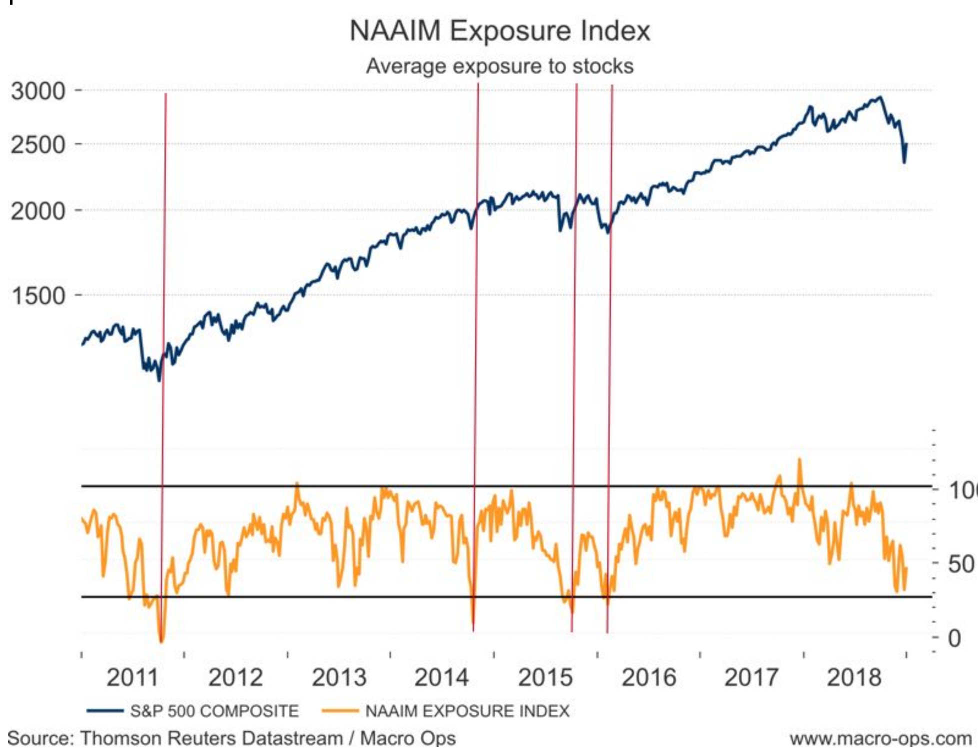

The AAII sentiment survey is showing the highest percentage of bears since 2011.



The State Street Investor Confidence Index for North America is at its lowest level since 12'.




And the NAAIM Exposure Index is nearing the sub-30% level which has marked every major bottom this cycle. We should see this trigger in the weeks ahead following more market volatility and perhaps a double bottom in the SPX.



Lipper Alpha Fund flows show that money managers have been piling into the money market over the last month.

| Asset Type | Flow $B |
|---|---|
| Money Market | 56.77 |
| Equity | -4.01 |
| Mixed Assets | -11.77 |
| Other | -13.56 |
| Bond | -28.4 |

EUROPE

| Asset Type | Flow $B |
|---|---|
| Money Market | 22.46 |
| Other | -6.02 |
| Equity | -10.94 |
| Mixed Assets | -14.68 |
| Bond | -22.1 |

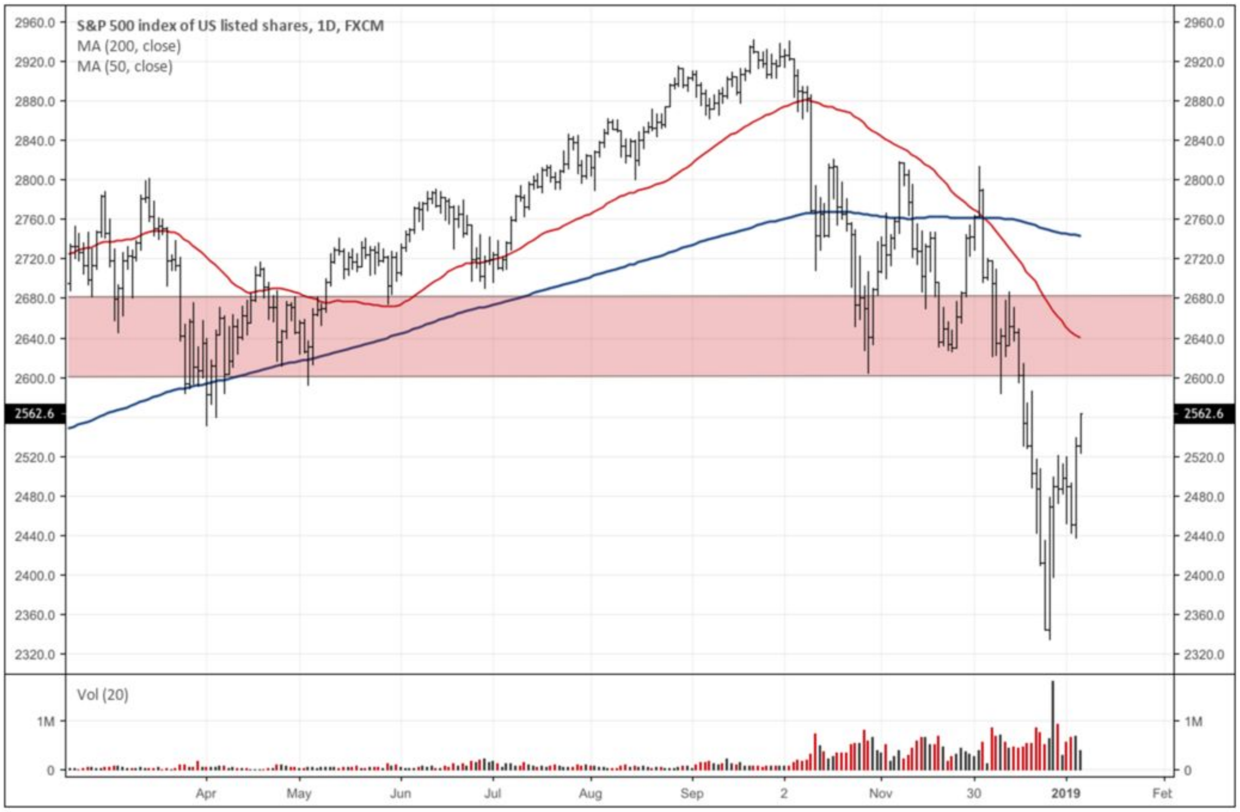
ASIA

| Asset Type | Flow $B |
|---|---|
| Equity | 10.01 |
| Other | 0.83 |
| Mixed Assets | 0.42 |
| Bond | -1.54 |
| Money Market | -4.29 |

GLOBAL

| Asset Type | Flow $B |
|---|---|
| Money Market | 61.24 |
| Equity | 8.08 |
| Mixed Assets | -0.87 |
| Other | -17.64 |
| [illegible] | [illegible] |

Bull markets climb a wall of worry and bear markets dive off a cliff of hope. We're seeing the "wall of worry" being built. This is good.




We're still looking at the 2,600-2,680 range as a major area of resistance for the market. It's likely we see the price get rejected and sent back down to test the lows. But in case that doesn't happen we're going to begin adding to our long book this week by initiating some new positions in small size.

For those of you who missed it, here's our [stock shopping list].

We're going to start buying Fiat (FCAU), Box Inc (BOX), Facebook (FB), and Sharpspring (SHSP) today.

In an effort to diminish spamming your email inbox, we've decided to post our trade alerts to the trade update channel in slack and the weekly Briefs and forego sending them out in emails. We plan on sending out more high valued content to your inbox going forward and don't want to overwhelm you guys and gals with emails. Please let us know if you have any feedback regarding the change!

It appears as if though gold is/was acting as a leading signal for the dollar. The dollar (DXY) looks like it's ready to puke. The below chart is a weekly. We can see that price is currently below the 200-week MA (blue line). I would not be surprised if we see it fall to the spot 94 level.

This would completely reset the still crowded long positioning, setting up the greenback for its next leg higher.


This should be a tradeable move as many dollar pairs have become quite coiled which means we could see a sharp run.

Take the EURUSD for example, price is currently breaking out of its descending triangle. We will be putting on a small (30bps risk) tactical long position in EURUSD near the close today. Another option to play this potential dollar selloff is by going long oil or some energy names (ie, RIG, MTDR, AR, CRR etc…).

Our long position in the Argentinian bank (GGAL) is up a nice 22% since we initiated the it back in November. This trade should see a further boost on the back of dollar weakness. And I'd consider this level a good area to add to the position.


That's all I've got for now. We're making some major changes to how our portfolio is constructed and will be adding a smart-beta component to it. I'll be sending out the info on that tomorrow.

If you've got any questions for us in the meantime, let us know in the Comm Center. Have a great week!

Your Macro Operator,

Alex