Newton's First Law

Summary:

- Don't fight this tape
- The 3 drivers of the bull
- Some growing signs of concern
- Macro Assets: Bonds, Gold, Dollar
    - Peso and krona
- Portfolio
    - MTCH

Take a minute and look at this weekly chart of the SPX. It's gone up for nearly 10 straight weeks now. And the most damage the bears have been able to inflict has been just two small Doji bars along the way.

As I wrote in today's *Dirty Dozen* this is not a tape you want to fight. Is it technically overbought? Sure. Are there signs of growing complacency and FOMO chasing? A few, but to be honest sentiment is fairly muted considering the price action. Will a larger correction eventually come? Of course. But right now the key is to sit tight and stay long until the market can prove the bears have control.

There are three drivers behind the global rally in risk assets since mid-year:

1. **Repositioning:** This is the BIG one. Investors went all Harry Dent last December and were reluctant to change their views. The majority positioned for GFC redux but instead, all they got was a slow and steady bottoming in global growth. This rally has been driven by a reversal of this mistake. Eventually, they'll swing too far back in the other direction and it'll be time to fade but we're not quite there yet.
2. **A Fed on hold:** Jerome Powell essentially took the Fed out of the 2020 market equation. He and the FOMC pushed back the next planned rate hike to 2021 at the earliest and significantly raised the bar for action (to both hike and cut). When rates are this far below GDP it's tough for financial conditions to constrict to the point that a recessionary feedback loop occurs (see chart below).
3. **Temporary Trade Truce**: Though this is what the mainstream narrative has primarily focused on it's actually the least important driver of the bunch. The recent announcement of a "phase 1" deal is not significant in any material sense. The US-China trade war is still alive and well and will be so for years to come. What is important is that with elections coming up Trump is looking to sideline further escalation and work his magic to boost the market, which is not a bearish development.

Chart shows the effective fed funds rate (white line) and nominal GDP growth (red line) going back 30-years.

Hedge fund Verdad Capital recently put out an interesting note on the small-cap/large-cap divergence and what it means historically for returns going forward (link here). Here's the meat of their findings.

> "Based on our research, the only times worse than 2019 for US small-cap value on a relative basis were right before the Great Depression in 1929 and at the height of the tech bubble in 1999. In Figure 3 below, we show the ten worst 10-month periods for US small-cap value relative to large-cap growth over the past 100 years. On average, when small-cap value stocks have lagged by around 30%, the one- and three-year forward returns have been very attractive on an absolute and relative basis.

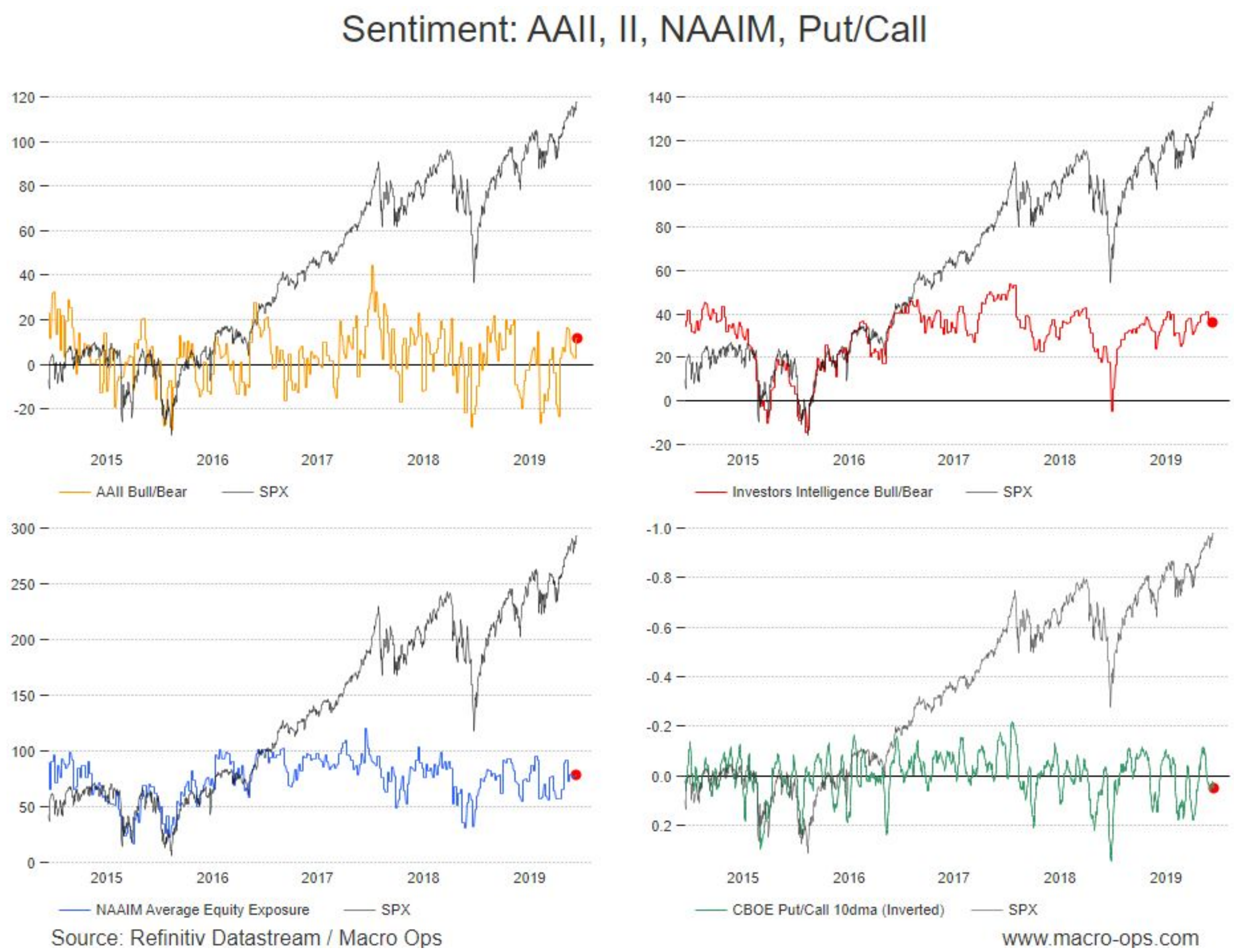
Rank	Trailing 10 Months	Date	Relative Return 1 Yr Fwd	Relative Return 3 Yr Fwd	Absolute Return 1 Yr Fwd	Absolute Return 3 Yr Fwd
1	-48%	Aug-1929	-8%	37%	-43%	-34%
2	-44%	Sep-1929	-8%	32%	-49%	-37%
3	-40%	Mar-1999	41%	116%	68%	107%
4	-36%	Dec-1998	11%	96%	36%	91%
5	-35%	Aug-2019				
6	-35%	Nov-1938	25%	49%	27%	36%
7	-35%	Dec-1990	17%	214%	61%	267%
8	-34%	Aug-1938	-19%	62%	-20%	64%
9	-34%	Sep-1938	58%	61%	69%	62%
10	-33%	Feb-1935	183%	88%	231%	114%

> ...Moments like these are extremely rare in market history. However, looking at every 10-month period during the last ~100 years when small value has underperformed large growth by more than the YTD figures in 2019 (about 50 different times), you would have done quite well in the long haul to shift over to small value. You would have outperformed large growth 63.4% of the time over one year and 87.8% of the time over the next three years, earning a premium of 70% over three years relative to large growth. On an absolute basis, you would have made money in small value 65.9% of the time over the next year and 85.4% of the time over three years."

I should highlight the "long-haul" detail. Over the short-term, Newton's first law drives markets and a trend in motion stays in motion and almost always goes much further than anybody thinks.

Getting back to the broader market and the current rally. One thing that continues to really stick out is how reluctant the market is to go all-in on this bullish trend. Typically, an incessant rally like the one we've been in sucks in all the bulls and converts or sidelines the recalcitrant bears.

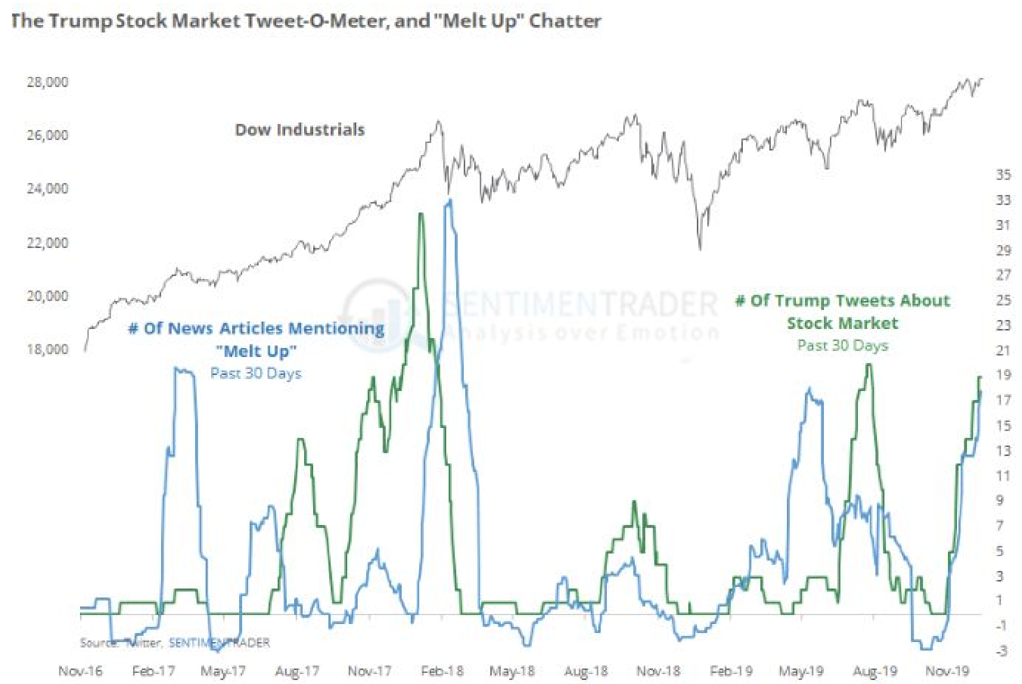
And while there are certainly some signs of increasing FOMO — at least short-term indications — the bigger picture sentiment data remains fairly muted as we can see on the chart below.



I'd guess that after nearly 2-years of mostly volatile sideways action bearish sentiment has become somewhat entrenched. This is a very bullish thing. The longer it takes to convince the masses that its a good time to buy the longer the market will stay bid.

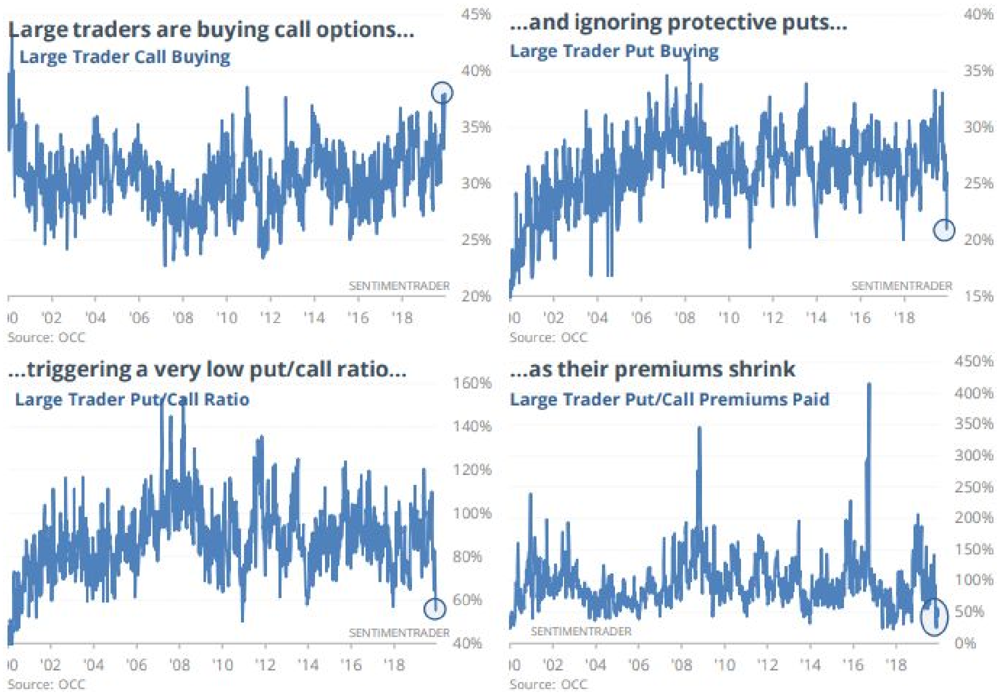
That's not to say there aren't any concerns.

The lame "Melt Up" narrative that the financial journos and Investment Banking shops started peddling in Jan 18' is beginning to slowly seep back into the collective chatter.



The Total Put/Call 10 & 5-day moving averages show signs of extreme short-term complacency as fund managers chase to juice their returns going into the end of year. The 5dma (red line) has only been this low a few other times in recent history and usually leads to short-term weakness (1-3 day selloff).

Sentiment Trader pointed out recently that large option traders have “positioned themselves in one of the most bullish stances in 20 years. They abandoned protective puts, piled into speculative calls, driving the LOBO Put/Call Ratio to one of the most extreme readings since 2000”.



This will eventually lead to a period of extended weakness sometime in Q1 when the market will also be battling elevated valuations, low earnings growth, and muted election year seasonality trends. But, until then, listen to Newton; a trend is your friend until it bends and all that.

Year 1 Performance—Better than Average Since 1980

We found that the first year after the election, "Year 1" of the new political cycle, has generated higher average and median returns—both for large and small cap stocks:

Price Appreciation by Year of Election Cycle-Large- and Small-Cap Indices. Year 1 Wins

S&P 500 Price Change	All years 1980-2015	Campaign Year	First Year of Term	Years 2 and 3	Russell 2000 Price Change	All years 1980-2015	Campaign Year	First Year of Term	Years 2 and 3
Average	9.83%	3.08%	11.92%	11.26%	Average	10.34%	6.96%	13.47%	9.96%
Median	12.59%	6.73%	15.25%	14.12%	Median	15.56%	15.56%	15.61%	10.47%

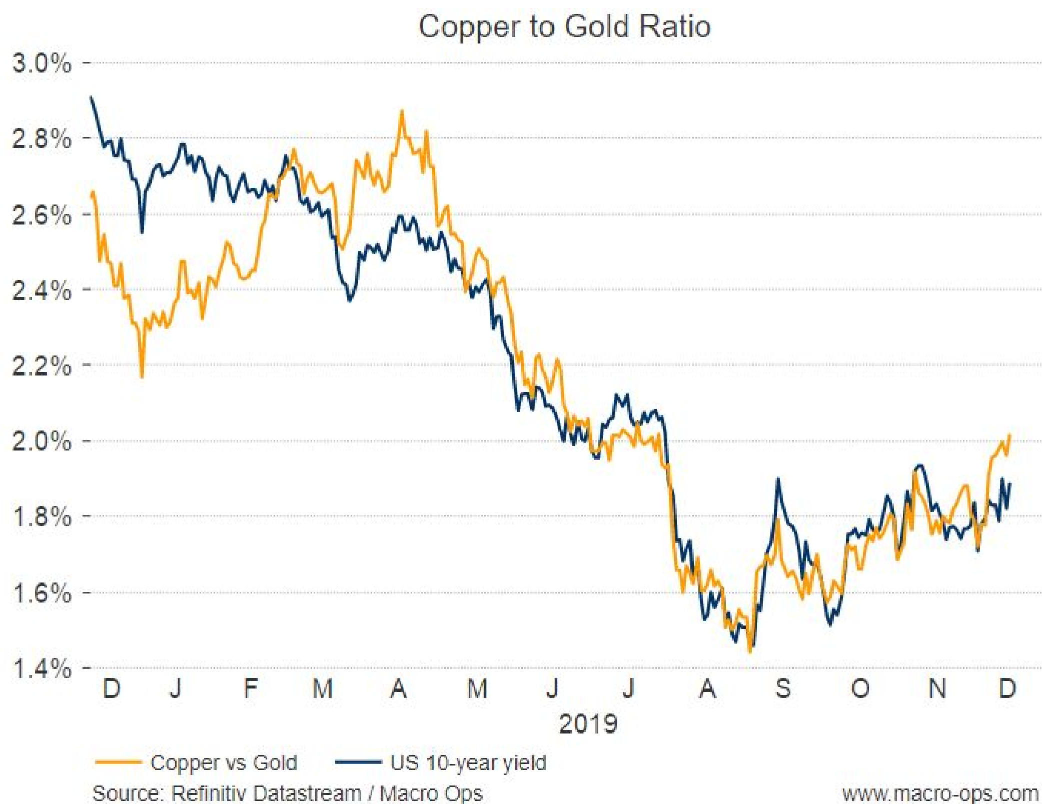
Source: Bloomberg data, Guggenheim

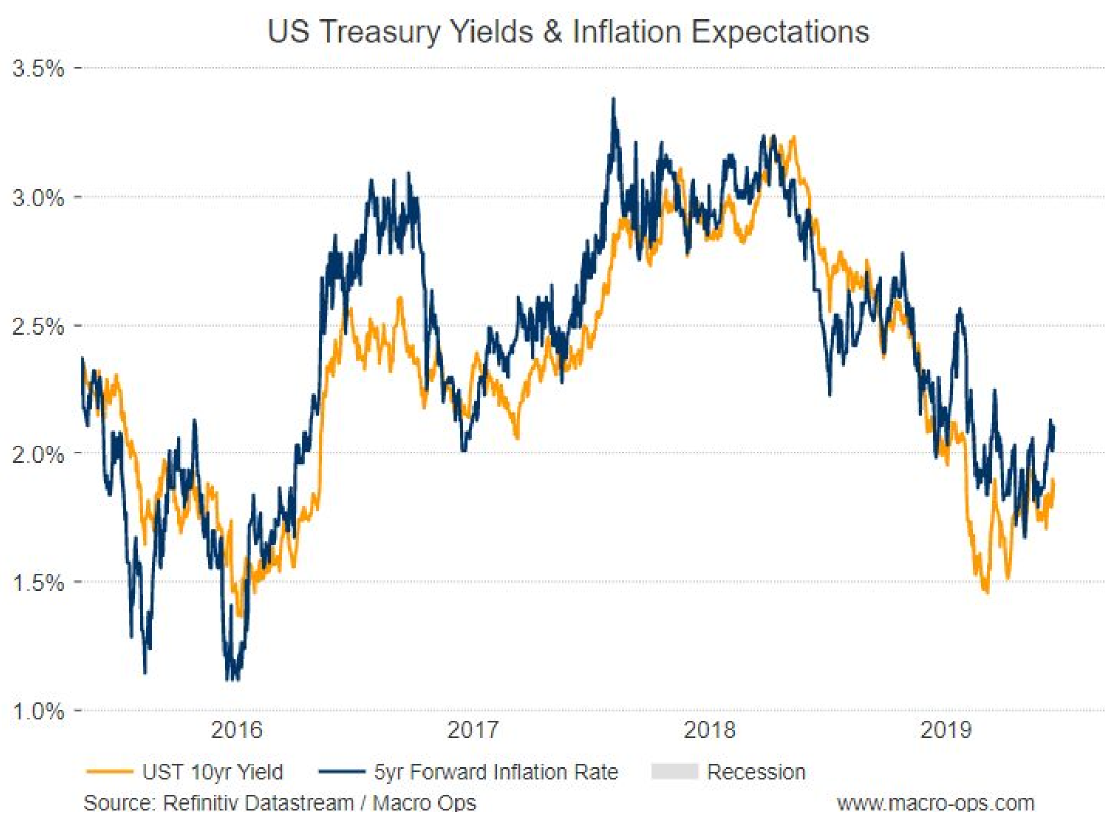
A few of you have DM'd me over the last few days asking me about my thoughts on bonds and gold. So let's quickly go through the major macro assets and I'll show you my thinking on each, starting with bonds.

Bonds

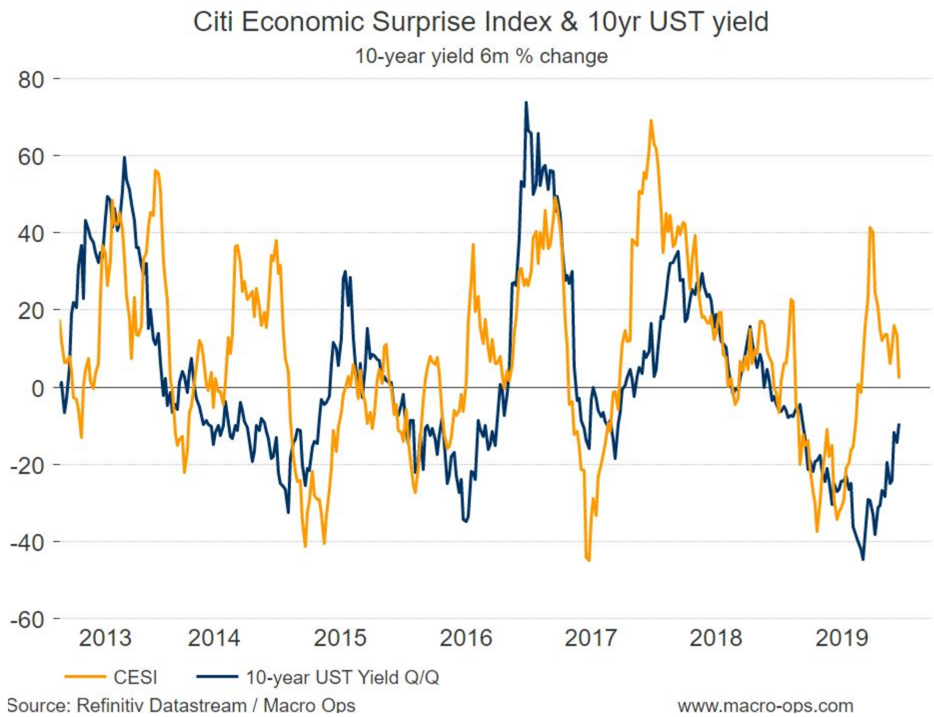
Bonds have been putting in a series of lower highs and lower lows since September. As of right now, there's nothing on the immediate horizon that makes me expect this downward trend to change.

The copper v. gold ratio continues to point to higher yields (lower bonds) as well as inflation expectations.

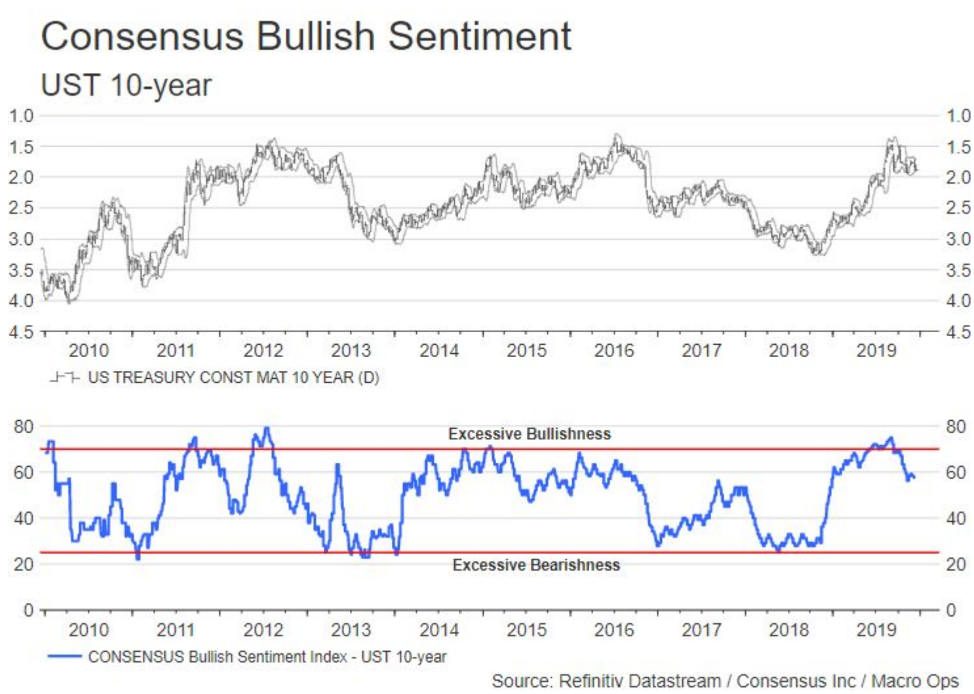

Copper to Gold Ratio
3.0%
2.8%
2.6%
2.4%
2.2%
2.0%
1.8%
1.6%
1.4%
D J F M A M J J A S O N D
2019
Copper vs Gold
US 10-year yield
Source: Refinitiv Datastream / Macro Ops
www.macro-ops.com


US Treasury Yields & Inflation Expectations
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
2016
2017
2018
2019
UST 10yr Yield
5yr Forward Inflation Rate
Recession
Source: Refinitiv Datastream / Macro Ops
www.macro-ops.com

And while positive economic surprises have cooled somewhat over the last few months the pull remains for slightly higher yields.



Plus, we still have plenty of bullish sentiment to work off.

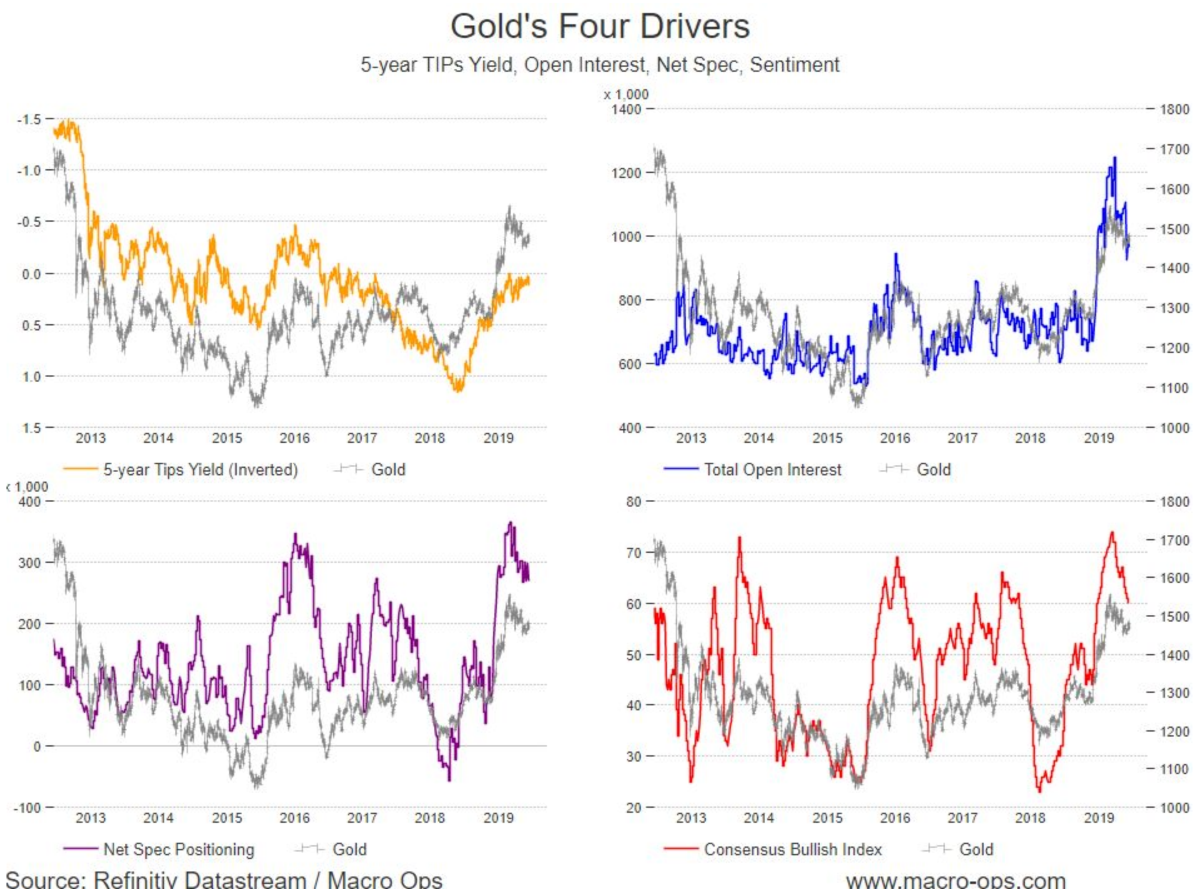


So my view for bonds is more of the same: down and sideways chop. Lower bonds mean higher yields which isn't good for our next asset. Gold.

Gold

Similar to bonds gold has been making consecutive lower highs and lower lows since September forming a downward bear channel or bull flag depending on your viewpoint and timeframe.

Gold's primary drivers also support a further continuation of this trend. Yields are trending higher, open interest remains elevated, as well as speculative positioning and sentiment.



If I were going to short one of the two (bonds or gold) I'd pick gold since there's plenty of positioning to wash out. Good tactical entries are around the upper channel line and 50-day moving average with targets being near the bottom of the channel.

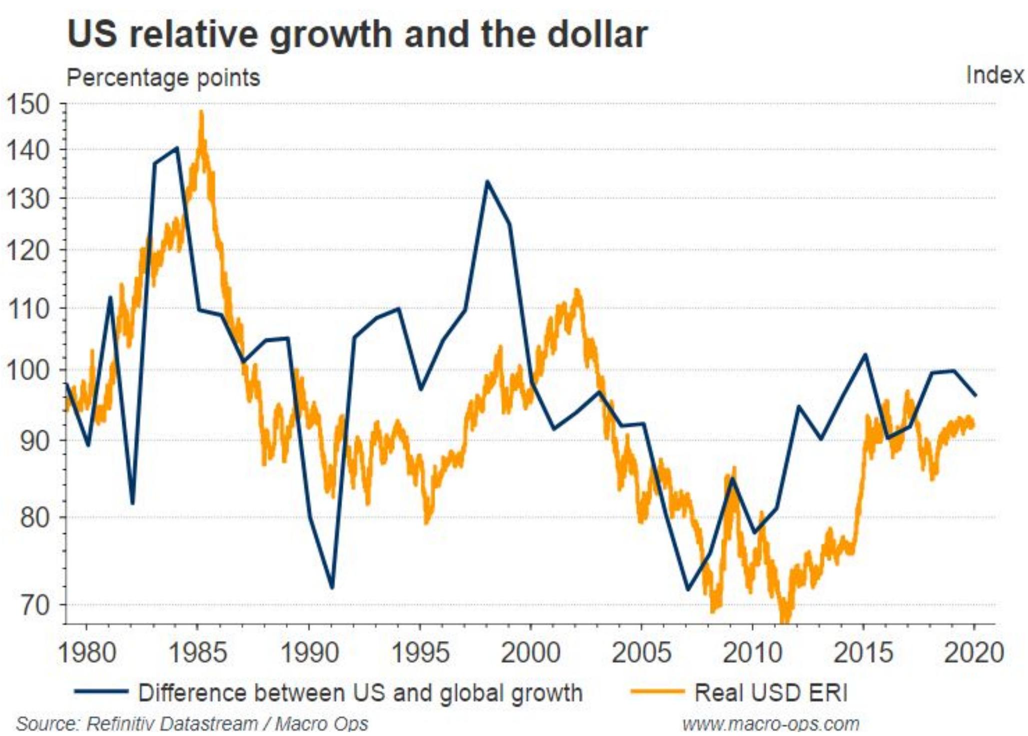
I flattened out our Core gold position in the portfolio and may consider taking a short-term trade to the short-side.

US Dollar

Chris and I have been noting the extremely compressed volatility in major dollar pairs for the last few months. Inevitably this will lead to explosive moves and 2020 should be a fun year in the FX markets.

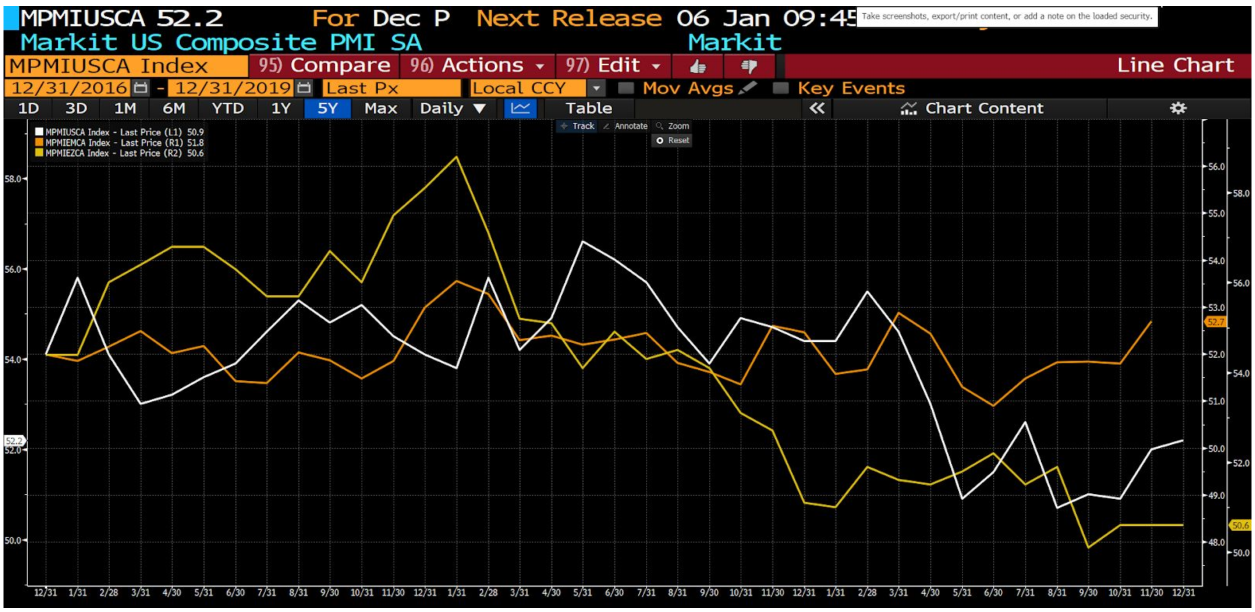
As of late, the trade-weighted dollar (DXY) has been trading a bit heavy. But despite the weak tape it remains in a 2-year bull channel and more technical damage needs to be done to convince us that a change in trend is taking place.

Capital flows to where it's treated best — where it's believed that it'll earn the highest risk-adjusted returns. Ultimately, these beliefs are based on recent relative performance (of local equities and bonds) which are driven by growth. That's why when you're analyzing currencies you need to look at relative growth rates between countries. We can see this relationship in the chart below.



The US's relative outperformance has stalled over the last year. If this trend continues then perhaps we'll see the dollar turn.

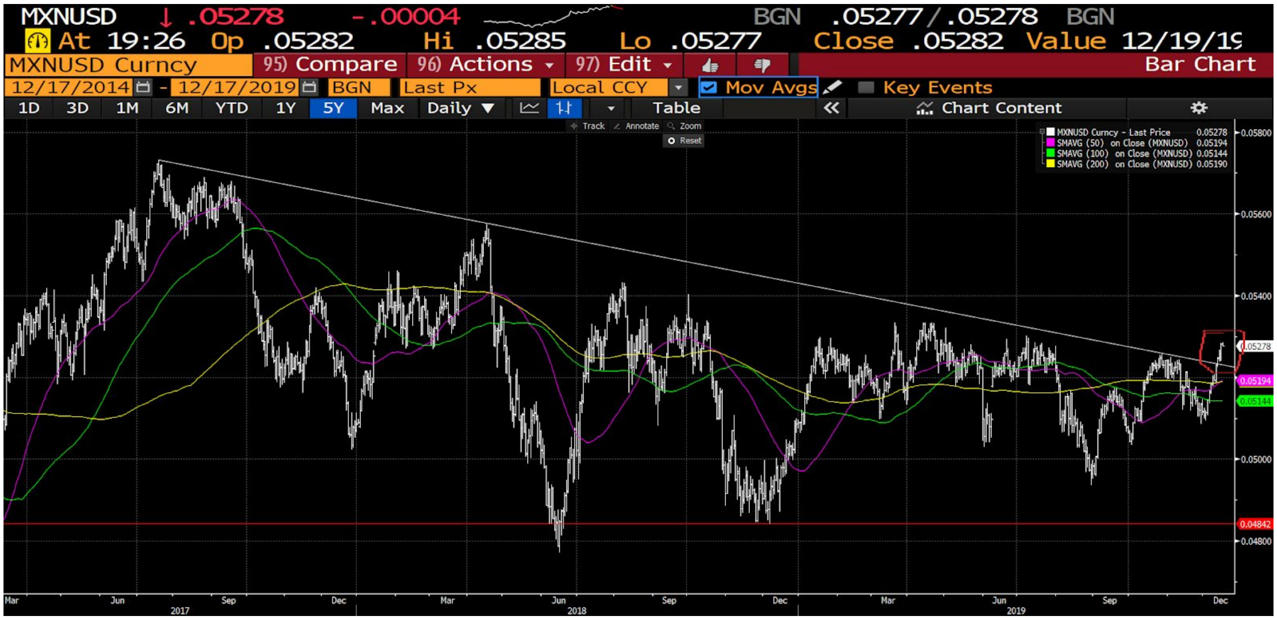
Markit's Composite PMIs show that EM's have turned up (orange line) and are outpacing the US (white) and Europe (yellow). Since the euro makes up roughly 60% of the dollar trade-weighted basket we need to see European growth accelerate.



To me, it seems like it'll take some actual fiscal stimulus from the Germans and Europe proper to get that kind of growth going. Until then, I'd expect more slightly higher / sideways action out of the dollar except for a few select dollar pairs.

The select dollar pairs I'm thinking of are the Mexican peso and Swedish Krona.

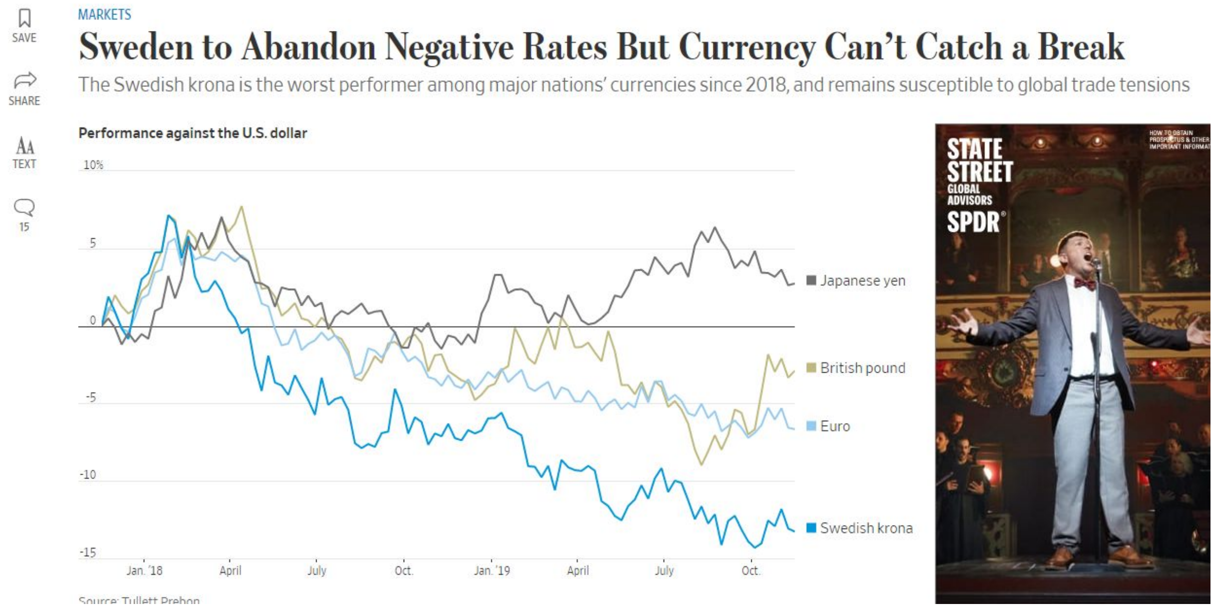
The peso I've been commenting on for months. It's been forming a tight coiling wedge over the last three years. It just broke out this past week.



The peso provides the highest carry of all the major currencies. The USCMA (new Nafta) is looking like it'll soon be a done deal. The MEXBOL is breaking out of a basing pattern after a 2-year long bear market. Also, Mexico is the biggest beneficiary of the longer-term US-China trade war and the inevitable trend to regionalization from globalization.

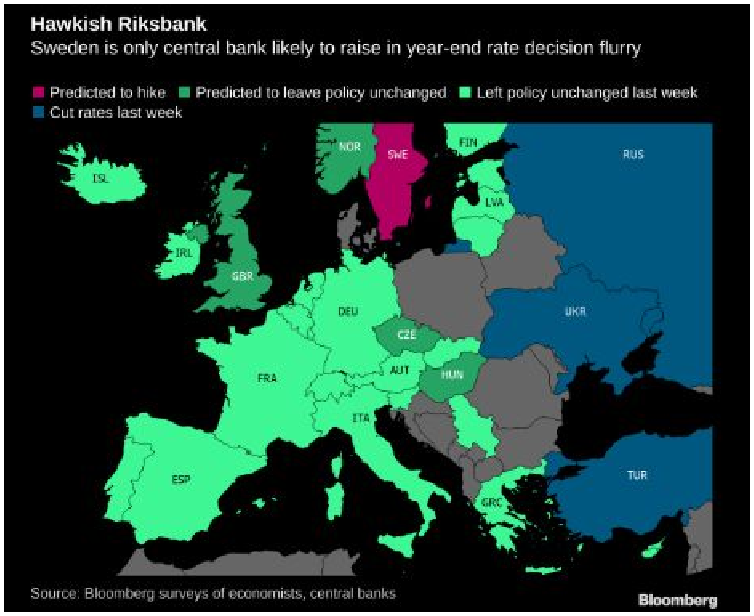
So worth a shot to the long-side here, in my opinion. We put on a starter position today risking 100bps with a stop right below last week's low.

The second is the Swedish Krona which became the poster boy for struggling FX markets over the last few years in the financial media.



The krona recently completed an inverted H&S bottom and is close to putting in a significant new pivot high.

The Riksbank is set to be the first and only central bank to claw its way out of the incredibly dim-witted idea that is negative rates at their meeting this Thursday.



Sweden is an export-oriented country and is therefore sensitive to the trends in global trade growth as well as general trade war rhetoric. With an improvement in both, the krona should finally start finding itself a bid.

Portfolio

We continue to sit in our full positions in both Disney (DIS) and Scorpio Tankers (STNG). Our Core equity position is back up to 100%, bonds are neutral, and gold is flattened out completely.

The Four Pillars Portfolio

	YTD
	18.16%

The Core	Fixed Allocation	Market-Timing	Net Position
Large Cap Equities (/ES_Z or VOO)	25%	75%	100%
Short-term Bills (/ZT_Z or VGSH)	25%	0%	25%
Long-term Bonds (/ZB_Z or TLT)	25%	0%	25%
Gold (/GC_Z or GLD)	25%	-25%	0%

Big Bets	Thematic	Cost Basis	At Risk	Notional %	Risk Point	Last Price
Disney (DIS)	Value	$129.37	Above B/E	22%	$130.00	$149.00
Scorpio Tankers (STNG)	Turn in Shipping Cycle	$35.35	Above B/E	21%	$26.50	$33.50
CADUSD (6C Mar' Futures)	FX relative value	0.7565	100bps	70%	0.7467	0.7520
MXNUSD (6M Mar' Futures)	FX relative value	0.0519	100 bps	70%%	0.0510	0.0521

There are a number of equities I'm looking at to take a swing trade in. Match (MTCH) is at the top of my list and we may put on a position in the next few days. I'll post to the slack channel if/when we do.

The shipping thesis continues to develop nicely and I'm looking to add another position, most likely in EURN or DHT, in order to boost our exposure. I'm waiting until the technical picture firms up a bit more before doing so.

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

Your Macro Operator,

Alex