John Netto: Gold will hit $1500 this month

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Erik: Joining me now is author John Netto, author of *The Global Macro Edge*.

John, it's great to have you on the program. Usually I ask the question about the issues that I see as the real drivers of the market. Frankly, my question today is what the heck is driving this market?

Because it seems like everybody is obsessed with this Trump-Xi negotiation thing. Frankly, it feels to me like it's produced for public consumption. I think we're going through theatrics here.

Is this really about FOMC policy and expectations of rate cuts? Why are we seeing over this last weekend the huge gap-up open? What is driving the market, in your opinion, right now? And what should investors be paying the most attention to?

John: First of all, thanks for having me on Erik. It's a pleasure to be here. I'm a long-time fan of the show. So I feel like I'm on hallowed ground right now.

To you question. I think when you look at the gap-up that took place in the S&P from Sunday from the G20 reconciliation, the Trump-Xi trade talk reconciliation that happened in Osaka, it's more about a quasi-Goldilocks scenario.

And I use that term hesitantly ,because we've heard it applied when inflation is just low enough but not running away, growth is [at the] 1-1/2 to 2-1/2% threshold. No threat of the FOMC coming in and getting in the way because you're kind of in that area where corporations continue to generate profits and cash flow remains relatively cheap.

So I think, while not the quintessential Goldilocks situation, the sentiment – not that I agree with it *per se* – but being that, okay, the Fed is going to be moving 25, maybe even 50. Although 50 doesn't seem like it's possible in July now. But the Fed is now going to be reducing rates. Inflation is in check. The trade war is not escalating.

And this is where I think technical analysis can benefit, in regards of what is the price trend? So was the outcome a base case for a lot of people from the G20 meeting? Absolutely.

But if it was a base case, would the S&P be making new lows or selling off from the throes of a bear market? Then your inclination is that the previous price action will resume.

Well we happen to have a market, an equity market, a risk market that are near highs. Now, the composition of what has near highs is a little concerning in terms of consumer staples and dividend payments, stocks like that, which have led the way up.

But, looking at the price action on the S&P, and looking at no further tariffs will happen as a result of the G20 meeting, if we stand enough refactors for the S&P to continue not going lower, in which case, what do we have? 20 points or 15 points from the close, from Friday's close, so net-net that's what I see on the risk side.

I think more broadly and more importantly is what has happened since the [June] 19 FOMC meeting. And a couple of things happened within that statement or within the summary of economic projections which lent themselves very favorably to the price of gold and, really, to global yields that are going to keep heading lower.

We saw, of course, the dot plot projections came down surprisingly. I build models that synthetically score FOMC events. And that was – the dot plot movement was definitely a surprise.

It was also a surprise, occurred on the second paragraph – and this grabbed one of the Bloomberg hot headlines – was the reference to increased uncertainties.

Now, in the second paragraph of the FOMC statement, they walked through what their base case is. And of course up until now it considered a return to their symmetric inflation goal and growth as the most likely outcome.

Well, the Fed really hedged that statement with a qualifying sentence in the second paragraph, which if qualitative things Erik, don't necessarily get into the – into the market, there's a bad gestation period.

And, effectively, what that qualification statement did, that was again another surprise. And what the statement surprisingly does is roll what market expectations – and really kind of gave the all-clear for Canadian dollar to perform as well as it has been for – we have oil rallying, we have Canada looking better.

Also, I'm a little surprised at the lack of [INAUDIBLE WORDS] in the Mexican case. But it also gave the go ahead for gold to top. Gold that night put in a $40 move within hours of the FOMC statement. Again, sometimes this stuff just takes a while to process.

And so, for me, it seems just this synchronized G3 central bank dovish chorus that has basically said that we've basically highlighted growth as the main issue and further compounded this chase for yield. And so what does that do? That sends bunds higher.

Now we're talking about Christine Lagarde prospectively being the perspective ECB head. And I

think the idea that she is potentially in place would mean a further 10 or 15 basis point decline on what are already negative yields. I believe I read this morning that 62% of all European debt is now yielding negative rates. So imagine compounding that even further.

When you look at all this stuff, I think it's very conducive for gold, which is why gold rallied as high as $1,440, gave us some nice pullback. And it really sets up tactically to buy any kind of different fixed income.

So if there is positive news out of China out of a trade deal, that's simply an opportunity to buy because, on a more broader scale, global portfolio managers have to own yielded face. There's simply not much else to do out there.

So that means dividend-paying stocks, that means consumer staples. Those guys should continue to perform really well, as ridiculous as that sounds given where they are on the charts. The macro environment is very much in place for that to continue. That's why I think gold is going to be – it's going to put a $1,500 price sometime here in July.

Erik: I want to come back to that subject, John, of what is going on in the fixed income market. But first let's go a little deeper on this subject of gold, because it's on so many people's minds.

I was really, really surprised before the FOMC announcement and the big move happened. I had Greg Weldon on, who is a very well known – he literally wrote the book on gold investing – and was just uber-uber-bullish gold when we interviewed him a couple of weeks ago.

To my surprise, I talked to him off the air a little bit after the announcement and I was expecting him to say I told you so. It's headed higher from here. Jump on if you were late.

To my surprise, what he said is hold your core position, but we moved awfully hard awfully fast. I think it's time to take some profits technically and wait for a pullback. And if you get a dip below about $1,395, it's probably time to get ready for the possibility of a dump and much lower numbers.

And I was really surprised to hear that from such a gold bull. And certainly it's not changing his long-term view. But he sees room for this to have been a false breakout that could potentially break down and lead to much lower numbers. Or at least that was his view as of a week or so ago.

How does that jibe with your view? We've closed the gap now that we saw. If that's going to be proven true, I guess it could be all downhill from here or it could be all uphill from here.

John: His view is antithetical of mine in every sense. Not in every sense, but in terms of the tactical sense. I have a good respect for his opinion. However, my perspective rests in the fact that we are once again remerging; a complete debasement of global currencies, of prominent

G7 currencies out there.

And we've seen this – you know, naturally Bitcoin has pulled back again as well. But we are seeing a migration into gold. We are seeing, after months or even a protracted period of consolidation, that the gold has made a key breakout.

Having traded gold, in the 2000s and the early 2010s, and been through the ups and the downs, with every trade you put on, Erik, it's about what your views are. But then also how you structure it.

To me, what's compelling about gold right now is that you can purchase upside optionality on it, which there's elevated prices over the last three years, but they are much lower prices than what they were 6-8-10 years ago.

And so he can be right and I can be right, because the structuring of the trade bears value on both sides. I believe there's value in terms of owning gold because I believe it's going to almost $1,500 print on a [INAUDIBLE WORD] in the month of July of 2019. And I'm saying that as we're at $1,407 right now.

But I also think that I can own gold via options. If I can own 23 days out for 120 basis points for upside optionality, that is a little richer than it has been. But if we take on a regime or a profile, especially with the non-farm payroll coming this Friday and a broader chase for yield taking place, the structure of that becomes very compelling and gives me multiple outs.

The guy that lives in Las Vegas and is a professional speculator, it can't just be your view but how you effectuate in that view. How are you executing that view?

And for me, controlling risk through options on gold right now, so that if it does turn back around and dump again, well, we provide a defined risk point. But everything I'm saying and the price action around this and how does it fit into this pullback is indicative that we're headed topside.

Erik: John, let's come back to fixed income, because this has perplexed the heck out of me. I've been saying, okay, we're here at 2% and we've moved so far so fast there's got to be a pullback. There's got to be a pullback in yields. There's got to be a chance to buy this long duration trade at a better price. It's got to be coming. Because we've moved so fast there has to be a pullback.

What has it been, three weeks now? And we're almost pinned on 2%. Am I making a mistake to wait for the pullback? Or what do you think is coming here?

Because I want to be exposed long. I was exposed to the short end of the curve in 2-year futures. I want to be long 10-year futures, but I was hoping for a better price. What should I do?

John: Take a tactical or more tactical approach to what you already are. It sounds like you have obviously some aspect of tactical entries into how you're putting this on. I would say that, when you really look at the chart of the 10-year Treasuries, like you're saying, it's obviously in a protracted uptrend since mid-April.

But sentiment has shifted rather violently as well. Let's keep in mind that, as of May 3, before Trump tweeted out, May 1 the Fed had – I'm going to give some backdrop here and then get directly to your question, Erik.

On May 1, the Fed had a meeting where Powell referenced – it was more of a hawkish press conference following this, following the FOMC meeting on May 1. This was Wednesday. We came out Friday, May 3 with one of the more bullish or more hawkish economic reports in some time. I believe we had close to 300,000 jobs on the payroll.

Sunday night, the tweet war begins between Trump and Xi. This obviously began a pretty dramatic shift in sentiment that coincided with a broader shift in the economic data out there. And that reprice that we saw in May where, effectively, you did see that precipitous decline in 10-year yields, was part of a more natural reprice. And when you get caught in these reprices, Erik, they tend to move pretty dramatically.

So the question then to you – and we can maybe go to gold a little bit – you say, well, John, I want to find a spot. I want to find an entry point.

You know, I would say that maybe part of your entry point is a derivative trade which may end up being long gold. Because gold has broken out, but gold hasn't seen the same risk-adjusted depreciable decline that fixed income has since early May. Gold has obviously put in a great move. But maybe playing gold to $1,500 becomes a way that you benefit from this larger, more prolific, more structural central bank accommodation flattening yield curve. And that's something to sort of keep in mind, that maybe it's not just the [INAUDIBLE WORDS] side.

I also say that markets are a function of a lot of noise. They are a function of rebalancing. So as fixed income does better and there's a little bit of rebalancing going on, it's measuring how that rebalancing and measuring how maybe a headline can influence things.

For example, this Friday we have a non-farm payroll number. Maybe it comes in a little stronger than most were suspecting. That strength is large – should it come in stronger – to me it's largely inconsequential to what the Fed does.

Maybe even on the Fed decision and Jerome Powell speaking on July 11. He might make some comments that cause people to square away some of their positions beforehand. At least score other positions before that happens. Or subsequent to those comments. Very few of those things are going to derail what's happening in this fixed income rally right now.

And as a result of that, this chase for yield which is happening at a trillion-dollar level – you get

these tactical pullbacks, Erik, that's where you step in and buy. You work these thresholds and then you play those balances back. And it's been a very reliable trade and I think that's going to continue.

Erik: Let's talk a little bit more about what to me is an unobvious aspect of the drivers for this widely, widely expected Fed rate cut. The usual story, at least for the last few years, has been, okay, it feels like the stock market is on the edge of crashing and the Fed's got to come to the rescue and a rate cut is always the way to save the day. But, clearly, that's not the situation or the setup here. We've got the S&P literally at all-time highs, or within a few points of all-time highs. So that's not the driver.

Why is it that now is the time that the Fed has to cut rates? What are the things that are causing so many analysts to conclude that it's nearly inevitable that there's going to be a rate cut?

John: Well, the obvious answer is because the Fed has told us. And there is a historical – I mean they're pretty reliable that if the Fed funds futures are above 30% going into a rate hike, or going into a rate decision (either a hike or a cut), the Fed does that. What the Fed does not do, Erik, is surprise the market.

So the first reason is that the Fed believes, based on their own internal analysis, based on their own process, that it is appropriate to cut rates. So let's just start with the big picture on that.

And we know that, through their communication mechanism, when they lay out a framework that says we're going to make a policy decisions either one way or the other, or none at all, whatever message they give to the markets (and that's when the price is above a certain level), that is what happens.

So that's number one as to why we are going to cut in July, okay?

Now, taking a little bit deeper dive, when the Fed did their first rate hike back in December 2015, the 5-year Treasury at that point in time was sitting at under 75 basis points. And it's a good rule that when the Fed rate hiking cycle would finish it would match up to where the 5-year Treasury yield was at the time that the cycle started.

Well we went about 75 basis points above that. Or at least 50 to 75 with the lower-bound/upper-bound dynamics on the 2.25 and 2.50. And to me, and to a lot of people as well, some maintenance cuts to return us back to there, especially given the day – at least on the guise they want to reach their symmetric inflation target, is defensible.

And, given the slowdowns we've seen globally, the global PMIs that we've seen, it really is a question of 25 or 50.

Now, again, I talked about the surprise factor, if we're at 50 basis points, is almost negligible.

There's a very small shot right now. We're going to cut 25 in July and we'll see what they lay out for the rest of the year. But I think we're cutting three times this year and on track to cut another two or three times next year.

Erik: John, I also want to touch on the Mexican peso. What's going on with the price action there?

John: To my surprise, the Mexican peso has not responded as well to the Fed decision that took place two weeks ago. I actually think that, when you look at, again, what the narratives are out there, the yield paid by the Mexican peso, the fact that it's on our border and central for a situation where – I think the peso could get back to multi-month highs here relatively quickly.

And I think what's also unique about the peso is that purchasing optionality on it is not that expensive. And obviously there's a different level of emerging market risk that goes with that. But as bullish as I am on gold, and I think if the Fed is cutting to the extent that it is, and I see this global chase for yield that we've talked about, looking at Mexico now –

Now, clearly, when we talk about a global chase for yield, there's some hedging costs involved. But 850 basis points for owning MXN energy prices that are rising, we worked out a trade deal that seems to suggest that that's going well. And just sort of in an obligatory way or in a derivative way, that this Mexican peso turns around and we see it appreciate rather considerably over the next even 90 days.

And I think that us going back to the 186 level is a real possibility, even the 185 level by Labor Day. I'm speaking USD/MXN extent on that, getting back down to 185.

Erik: John, I'd like to shift gears now and step back to the bigger picture. Because I wanted to start with some tactical issues, because everybody is so interested in what's going on the market. But a lot of what you're known for is your book, *The Global Macro Edge*, and the whole approach that you take to global macro investing.

So why don't we start with the Netto Number? What is the Netto Number and how did you come up with that?

John: The Netto Number allows me to measure the performance of a stock, a market, a portfolio, a strategy under a return per unit of risk basis. And that's critical because a lot of mistakes that investors have made, that I have made, have come from only having a one- or even two-dimensional perspective on the market. So when we talk about three-dimensionality.

Well, let's talk about what one-dimensional performance assessment entails.

So a one-dimensional performance assessment, it might be, hey, Erik, how much is gold up today? Well, gold's up 1%. All right, what's lacking from that, Erik? Well, we know it's up 1% but we don't know how much it was down, we don't know was it up 7%, we don't know how much

one had to risk to make that 1%.

So let’s go to the second part of that, which is pretty common amongst institutional circles. You’ll see it on a manager tear sheet, which will be, okay, what is the risk-adjusted return of gold today, or for the year ,or for the month? And you’ll hear terms like a Sharpe ratio, or a Sortino ratio, or a Calmar ratio (which helps measure gold relative to the realized volatility it has). So if gold is trading at a 1% standard deviation on a daily basis and it makes 50 basis points, well that’s cool. But it’s more impressive if gold makes 50 basis points but only has a 30 basis point standard deviation.

So that comparison helps out.

However, what the Netto Number does is it takes a pre-defined risk budget. So for a manager, if I say, Erik, I’m going to give you $1 million. But if you lose $200,000 of that, that’s your risk budget. But you lose $200,000 of that $1 million, I’m going to stop you out.

Another investor says I’m going to give you, John Netto, that same $1 million, but I’m going to give you a $400,000 risk budget. Well, at the end of the year, Erik, you made 15% on that. And I made 15%. And we have similar drawdowns and a similar Sharpe ratio.

But the one thing missing – and this is what hangs up investors so much – is, Erik, you only a 20% risk budget. You could only lose $200,000, while I could lose $r00,000. So that flexibility premium, that risk budget that went in, is that third-dimensional component that isn’t known by many investors and not commonly used.

So what I do when I measure performance of markets, when I look to assess where money flows are going, when I look to assess opportunity? The strategy is I take the Netto Number and measure, okay, I want to take performance and measure it against a risk factor.

So the risk factor consists of the size of that risk budget, which in your case, in that example, would have been $200,000. Plus the volatility associated with those returns. Okay.

I take those two and I equally weigh them and I rake the average of them. So now, all of a sudden, I have rewarded someone that manages, you know, that keeps volatility down while making money. At the same time, I’ve also rewarded someone who does well to, in essence, to make more by risking less.

So the Netto Number divides the performance by those two components. It’s obviously elaborated on in my book and I’ll stay away from abstract mathematical formulas on your podcast to be gracious to your listeners. But that, at its essence, is how I begin to assess the macro narrative.

We talked about China trade talks and we talked about what the Fed is doing. To me, it ultimately filters down to how you can synthesize that information into something that’s

actionable, so I can say that this macro narrative is in fact what's leading things.

But if I don't have the Netto Number, or the equivalent Netto Number, demonstrating to me that that is in fact the narrative, then that's something that I'm going to take a back seat to.

So when we go through repricings of markets or when the macro narrative changes, that's where you can combine both the quantitative studies, which are things like the Netto Number – And I have other unit-of-risk ratio like the [INAUDIBLE WORDS] ratio, which measures how much a stock was up on the day versus how much it was down from its previous net change. I have the impact ratio where I measure how certain events affect certain asset classes and how that can affect a risk budget behind things.

And then, ultimately, what I do is – let's just say I'm the money manager. I'll use the Netto Number to determine how much compensation I should get. So the higher the Netto Number – and I would say in your case, Erik, in our situation again, you would actually be entitled to – if you made 15% and I made 15%, you would be entitled to a higher percentage compensation because you made more with less risk.

So when people talk about, oh, I run this strategy and I'm this great trader, it's like, great. Let's figure out a way to create a goal-congruent compensation structure that rewards managers when then maximize return per unit-of-risk – which is the subtitle of my book *The Global Macro Edge – Maximizing Return Per Unit-of-Risk* – let's have a way that doesn't reward them when they don't.

If you go and take a big shot, if you take a big bet, and you win, that's not as impressive as if you take a small bet but you manage that small bet and generate the same return. And so the Netto Number and the risk factor compensation system account for that. And it's a big part of how I conduct my macro analysis.

Erik: John, I want to go a little deeper on this. Because, quite frankly, having run a hedge fund and having met some other people who have run hedge funds, I personally have become pretty cynical about Sharpe ratios and Sortino ratios and all of these other hedge fund risk metrics.

Because I know what really goes on is these are numbers that are tracked based on monthly closing performance. And I've met plenty of managers who have had absolutely crazy risk excursions that happened intramonth and they didn't close the month with anything close to the crazy 45% drawdown that they had up at the 12th of the month.

And nobody ever finds out. And it seems to me that these risk metrics that are only calculated from monthly numbers are almost completely irrelevant.

Now, what a lot of people are doing, at least a lot of very sophisticated institutional investors, are there insisting on separate managed accounts for this reason, so that they can see the daily volatility as opposed to just monthly.

Is there a reason that investors investing in managed funds – whether it be a hedge fund, managed commodity pool, or whatever – should take things like Sharpe rations and Sortino ratios, which are only represented on a monthly basis, seriously? Am I missing something there?

John: Let's talk about the good and the bad, because you've hit on a lot of great points. The two main points are, number one, the limits with the Sharpe and Sortino ratio. And then, two, the granularity and the [INAUDIBLE WORDS] with which you receive investor data.

So there's two aspects to that. And I can speak extensively about both of them.

The first side about the Sharpe and Sortino ratio, of why it is limiting from the monthly perspective, is everything you've just mentioned. The fact that it misses so much is limiting.

But it's also why you need to have a risk budget in place. Because that at least gives you some semblance of security, that this person was trading with a risk budget. So a Sharpe ratio of 1.6, while Erik was running – let's go back to the example of your $1 million allocation that I gave to you, with the $200,000 deal.

One. if I know that your Sharpe ratio, even on a month-on-month close is 1.6, but I know that the entire time, Erik, you were managing it around a risk budget, that Sharpe ratio has a little credibility to it. Because you never were down, you never blew through your risk budget in the first place.

And so that's why I think that lack of three-dimensionality is such an issue.

Think of something like – the kind that you and I love so much, the option-selling strategies – you see investors see this incredible return, month after month. But they're not asking the right questions, Erik. They're not putting the returns in the right context. How much were you risking to generate those returns?

And what the Sharpe ratio doesn't do, what the Sortino doesn't do, is it doesn't ask those questions. It gives you performance relative to realized volatility on a monthly basis. So if you generate a 2 Sharpe, but in order to generate that you had to put 70% of your portfolio out there at risk, or risk $700,000 and a potential XIV moment, if you will, when it doesn't give investors that granularity.

It's a lot like a sailing map used 400 years ago. If you look at it, the size of Greenland looks like the size of North America. But that's not true because they didn't have the right dimensionality behind it.

Yes, you can generate 20% returns, but I was literally selling, you know, ten delta options for three years in a row until one day I lost it all.

So without having that risk budget as a context, that three-dimensionality, the Sharpe ratio and the Sortino ratio are very limiting. And that's why.

Erik: John, in my opinion we have an epidemic in institutional finance. And it's an epidemic of understanding what risk really is. And you mentioned an XIV moment. Before the vol complex ever blew up, I remember going to institutional conferences and talking to people who should know better, fund managers, saying, look, these guys on this short-vol trade are crazy with the risk that they're taking.

And I would have people who are fund managers interrupt me and say, you don't know what you're talking about. That's a low-risk strategy. Just look at the Sharpe ratios these guys are delivering.

It's like, Dude, you don't get it. You don't get it.

John: I know, it's ridiculous.

Erik: To me, there is this really huge problem, which is we've got this academically prescribed model where the reason that volatility is perceived as a meaningful proxy of risk is based entirely on this conceptual idea of evenly distributed normal returns. Which is not the way the real world works, despite what academic finance thinks.

So what you end up with is these guys who really believe that these risk models accurately measure risk.

And one of the most famous things, these guys that are just selling, they lever up these strategies to sell out of the money calls and puts on the S&P, because they know that they're going to make a lot of money in their own pocket before the day comes that that strategy blows up and they lose all of their investors' money.

And the people that are evaluating these things, they're professionals, that's their job. They're saying, well, look at the Sharpe ratio. It looks great. There's not a lot of risk here.

And they don't think through what the real risk is because they don't understand that this business of volatility equating to risk is entirely theoretical and it's based entirely on normal distribution. Which is not the way the world works.

Does the Netto Number make a meaningful inroad into solving these problems?

John: Yes, because what the Netto Number does – while a Sharpe ratio measures performance relative to realized vol, the Netto Number measures performance relative to implied vol.

So we think about how – going back to the institutional case you just brought – a lot of institutions may allocate what's called a volatility target, where they give a manager – now, by the way, that doesn't insist that a manager adheres to that target, but that's (quote unquote) what the target is.

So I give the manager, okay, your vol target for the year is 12%. Your vol target is 16%. So if we back this out, whereas the Sharpe and Sortino measure performance relative to that realized vol, the argument to have with those guys at that conference was, well, guys, the mistake you're making is that you are measuring performance relative to realized vol, when you should be measuring it to implied vol.

Now, we go one step further with the Netto Number, because it puts your actual hard budget there.

Because, back to your point, what the academics do is send this sorrowful letter about somehow, Erik, can you believe, the model experienced a one-in-10-million event. When the XIV moment happened, that's only supposed to happen once every 17 million years. But apparently now it happens every four years. I don't know what happened.

And so the risk budget acts as a real-world braking system for a portfolio manager. And the Netto Number catches that because, by having the braking system in, it limits your flexibility. But that's okay because that's real.

Because, as managers, Erik, when we lose money we have to tighten our belts. We have to trade within that budget. Households have to spend within a budget. The government, well they don't spend within a budget. But we have to spend within a budget in the real world.

And so why shouldn't a manager have to manage risk within a budget? And the Netto Number tells you how well a manager does that.

So you can still sell option premiums. But the risk budget and Netto Number is going to capture how much of your portfolio you have to risk to do that.

And as a result, you can actually say, oh, so your Sharpe ratio is 2 but your Netto Number is only 0.6. Well that tells me that, yeah, you had great returns, but, man, you had a lot of risk out there.

Or your Sharpe ration is 1.2 but your Netto Number is 2.7. Well, you made some great returns well within the small risk budget I gave you. Because we're in the business, Erik, of risking less to make more.

Erik: Well, John, I'll just come back to you that that event on the VIX was in fact a million-year event. It was impossible for anyone to have seen it coming. I've been assured of that by lots of people. And the fact that three separate MacroVoices feature interview guests saw it coming

and predicted it within six months of it happening was just pure coincidence. I'm sure of it. Anyway... [laughter]

Let's move on to the subject of academic nonsense. And there's plenty of it. One of the things that is taught is this whole idea of rational expectations theory and the efficient markets hypothesis.

Nobody in the professional finance community ever allows their emotions or human factors to get involves and psychology doesn't enter the market, according to a lot of academic models. I'm sure you know where I'm going, which is Chapter 19 of *The Global Market Edge*. Let's talk about traders and psychology.

John: As a person that uses both quantitative tools and qualitative tools, I rely very heavily on my ability to use a skill known as cognitive empathy. Or to, in essence, think about how other people will likely behave in a situation and to feel what other people may be thinking or feeling.

And so I have spent an exhaustive amount of time, over 15 years, journaling and building to weaponize my emotions for the purpose of creating more robust trading signals. So what do I mean by that?

I actually spend a lot of time journaling my emotions when I'm trading. Because I incorporate them into what I do. So if I'm feeling particularly fearful or I'm feeling particularly complacent, these in and of themselves can be signal sources for me on top of that. And so –

Let's just take a step back for a moment.

It was important for me when I wrote *The Global Macro Edge*, Erik, that if people are going to spend the kind of time and money to read a 600-page book, if they knew that the people who wrote it, myself and the other contributing authors, were actually successful practitioners.

So what I did was I hired a CPA to come in and verify my trading P&L. And effectively what he did was show that from January 1, 2010 up till when the book had to go to press, which was December 31, 2015, before we sent it off to the press – I took a $100,000 dollar account and I generated $3.1 million in P&L over that six-year period. By any metric you use, those sort of returns are pretty profound and pretty compelling.

So what I'm telling you now about the intuition infrastructure was a key component. It was integral to generating those returns, along with the other stuff I've shared with you. But that intuition infrastructure, that understanding of when the market is in a sweet spot and what I like to call the Uh! factor, like when you have these butterflies in your stomach in a position.

Those butterflies, Erik, are a real signal. That complacency when you feel – like did you ever notice when you get into a trade and you feel really good about it and you start eyeing it at all your friends, that pretty much marks the high tick that you bought it at that point in time. Like,

it’s almost destined to not work out for you.

When you can confidently and exuberantly say, hey, my goodness, look at this trade I just bought –

The other day actually I saw when bitcoin hit like $13,500 I believe. One of the Winklevoss twins tweeted out about it going to the stratosphere, the mesosphere. That was actually – when you feel confident enough to exhibit that much enthusiasm, that much unbridled enthusiasm about a particular market, those can be very powerful sentiment indicators.

And so how do we internalize, how do we harness, how do we memorialize those sentiment indicators? How do we incorporate that into what we see?

So all of Chapter 19, with Denise Schull’s help – she wrote *Market Mind Games*, a very prominent performance coach in the hedge fund industry – and helping people really take their emotions and use them, use that intuition on top of all the hard skills that are necessary to be a great trader to succeed.

Erik: Now I want to go a little bit deeper on this. Because there’s an aspect to this which is using these signals to gauge what might be going on inside of oneself.

I know Rick Rule is famous for saying if you’re feeling smart, I mean really smart, sell. It’s time to get out of that trade because you’ve already had your success.

And I guess there’s another aspect to it, though, which is do you use these signals based on your own feelings in order to gauge what the rest of the market is feeling? Or do you only use it to gauge your own personal mental condition relative to your own trades?

John: A little bit of both. And let me elaborate on what I mean by that. I spend a lot of time canvassing my network and trying to form a consensus of what the market is thinking.

For example, the Federal Reserve meeting two weeks ago. I’d formed a consensus, a pretty crystallized view of what was expected to come out from both the dot plot and the composition of the statement. And so the sentiment, the feeling I get is relative to what the market is expecting.

Now, I have my own internal feelings as well, in terms of I just bought this or I just bought that. But the first point of reference is how is the market responding to this? And that’s why I go back to the whole cognitive empathy thing and the whole intuition thing.

It’s like, wow, the market was not ready for that qualifier in the second paragraph when it described that uncertainties have increased about this most likely scenario happening. And the market was not ready for such a dramatic drop in the dots for 2019 and 2020. And the downgrade in the inflation forecast.

So at first it's refracted through that lens of, okay, how is the market feeling about this? Now we get into more tactical situations of like – am I becoming complacent or brazen about a position? And that feeds into still some of the more management styles of wealth.

So it's a combination of both. But that's what I'm looking for on both sides of this. I have my internal sense of what I'm doing but also it starts with what the market is doing and how the market should respond to this. And from a control perspective, how a random market will respond to this.

Like I said, some of this takes time to process and filter. [INAUDIBLE WORDS] can't process this and allocate the kind of risk to this in an instantaneous manner. It takes days, even weeks, to truly work its way in sometimes.

Erik: John, I could go on for hours about this stuff. Unfortunately, we need to leave it there.

But before I let you go, I want to ask you: On Sunday, July 21 you and Patrick Ceresna, my cohost, and our good friend Kevin Muir are all going to be travelling to Chicago for an event called TradersEXPO. You're actually running a series there.

Tell us about what you're doing, how Patrick and Kevin fit into it, and how people who are interested in attending can find out more information.

John: On Sunday, July 21 we will continue an ongoing series that has happened in New York and Las Vegas, and now in Chicago. It is put on for free. It's part of the TradersEXPO. It begins at 9am Chicago time on Sunday the 21st. It goes to 1:30 and it's very much emblematic of market voices itself.

We believe that we live in an era where there is more information available to a more diverse group of people than at any point in time in the market's history. And for those of us that do this for a living, this is our way of giving back. We believe in investor empowerment, as does the MacroVoices show. So that's an opportunity to do that.

And particularly, you just mentioned Patrick and Kevin. They will be having a bull-bear Smack-down where they will be sharing different opinions and different ideas about why stocks can go up, why stocks can go down, why bonds can go up, why bonds can go down. And I will be emceeing that event.

So when you look at the substantive content that we shared on today's show, image that spread over four and a half hours. For us, it's critical that we can share these ideas, share these approaches, share the processes so that investors can now take them and apply them to their own portfolio, to their own investing. And that in a nutshell is what the series is about.

Erik: And, John, before I let you go, give us your Twitter handle. And for people who are

interested in learning more about your book *The Global Macro Edge*, please tell them where they can find it.

John: my twitter is @johnnetto. And *The Global Macro Edge*, the link will be available at my twitter handle. Find it on Amazon, order on Kindle. And I would appreciate any interest you have.

Erik: Fantastic. Well, I can't thank you enough for a fantastic interview John.
Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.