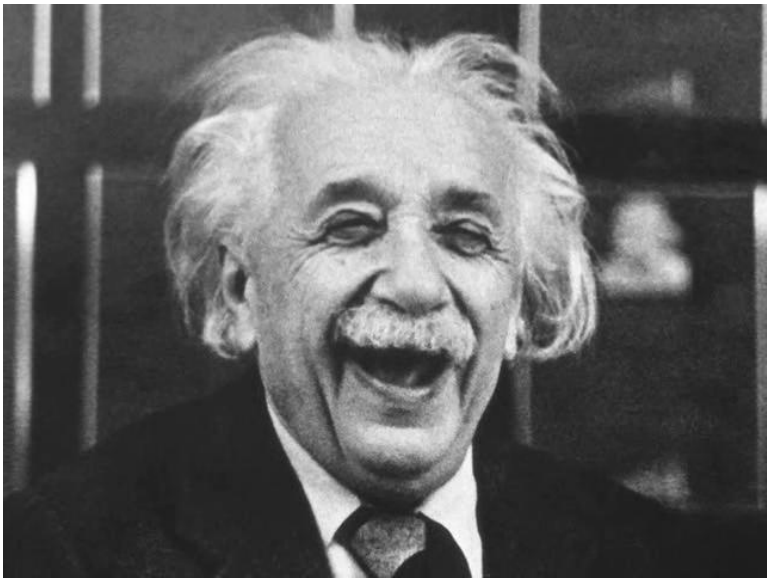
MACRO INTELLIGENCE REPORT

April 4th, 2017

Market Overview: The Dead Hand Of Inevitability



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In 1931, Einstein said the following when asked about free will:

> *If the moon, in the act of completing its eternal way around the earth, were gifted with self-consciousness, it would feel thoroughly convinced that it was traveling its way of its own accord on the strength of a resolution taken once and for all. So would a Being, endowed with higher insight and more perfect intelligence, watching man and his doings, smile about man's illusion that he was acting according to his own free will.*

He was referencing the philosophy of Determinism, which defined by *Oxford* is the "doctrine that all events, including human action, are ultimately determined by causes external to the will. Some philosophers have taken determinism to imply that individual human beings have no free will and cannot be held morally responsible for their actions."

Determinism is a Newtonian view of the universe, in which the stars, the sky, and everything under it, including man, are moved by mechanistic forces outside their control.

Newtonian thought dominated science and philosophy until German physicist Werner Heisenberg came along. He injected some uncertainty into the mix with his Heisenberg Uncertainty Principle (here's a short video explaining the principle).

He found that uncertainty lies at the very foundation of nature. When we drill down to the sub-atomic level through quantum physics, we find that electrons spark and fizzle in and out of existence, sometimes showing up in multiple places at once, in a seemingly random and unpredictable nature.

At this point you may be wondering, "umm… I thought this was a market newsletter, why are we talking about Heisenberg and the free will of the moon?"

Fair question…

We bring up this discussion of determinism and free will because it's at the heart of how we view the world, historical events, and the macro movements of markets.

We believe *both* determinism and free will are true. Our futures are largely predetermined and yet we as individuals still possess free will.

To explain this obvious contradiction, let's revisit an article we wrote a year ago titled Cycles, Civilizations, and Empires.

> *One of my favorite sci-fi series is "The Foundation Trilogy" by Isaac Asimov. The book was first published in 1951 and is a grand "space opera" that takes place in the distant future. At the heart of the series (and what makes it so interesting) is the fictional-philosophy of **"psychohistory"**. Psychohistory is a blend between mass-crowd psychology and probability theory.*
>
> *It's founded on the principle that while it's impossible to predict actions at the singular individual level, it's possible to successfully apply statistical probability theory at the group level to predict the general flow of future events.*
>
> *Asimov discusses how he came up with the idea of psychohistory in the following interview:*
>
> *At the time I started these stories, I was taking physical chemistry at school, and I knew that because the individual molecules of a gas move quite erratically and randomly, nobody can predict the direction of motion of a single molecule at any particular time. The randomness of their motion works out to the point where you can predict the total behavior of the gas very accurately, using the gas laws. I knew that if you decrease the volume, the pressure goes up; if you raise the temperature, the pressure goes up, and the volume expands. We know these things even though we don't know how individual molecules behave.*

> *It seemed to me that if we did have a galactic empire, there would be so many human beings—quintillions of them—that perhaps you might be able to predict very accurately how societies would behave, even though you couldn't predict how individuals composing those societies would behave.*
>
> *So, against the background of the Roman Empire written large, I invented the science of psychohistory. Throughout the entire trilogy, then,* ***there are the opposing forces of individual desire and that dead hand of social inevitability.***

Like Asimov, we view people at the individual level similar to gas molecules; unpredictable and seemingly random… which gives credence to the argument of individual free will.

But if we pull back and view large groups of people such as societies and nations, we find that their collective decisions under certain conditions are not only explainable, but completely foreseeable.

In a sense, the broad strokes of history are predictable while the details are not.

And just as we need to understand the "gas laws" to predict the behavior of gas on a macro level, so too do we need to understand the "laws of social history" if we want to anticipate the grand tide of human affairs.

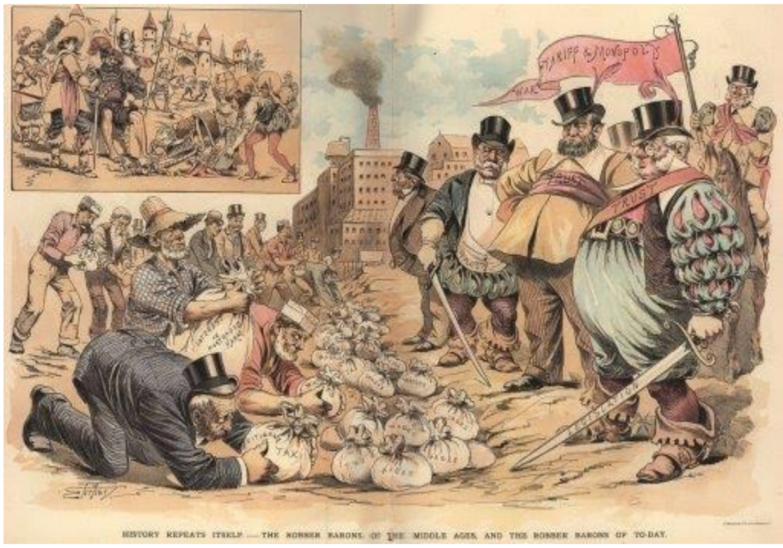
At the foundation of these laws is economics — the study of human interaction.

History is the recollection of what groups of people have done and economics is the study of how and why they did those things.

There are three socio-economic truths that we know of:

1. Nations (large tribes of people) are relatively open and peaceful when their standard of living is perceived as improving.
2. Nations become closed and retaliatory when their standard of living is perceived as getting worse.
3. We measure our standard of living on a relative scale. It's better for a society to benefit less, if all together, than for parts of the society to materially benefit more than others, even if the standard of living is higher for all. When there's a large gap between those who benefit and those who don't, the society becomes increasingly susceptible to its "baser" tendencies.

Take these laws and combine them with our knowledge of debt cycles and you get a powerful framework to help understand history and present day geopolitics.



The long-term debt cycle (75-100 years) is where debt accumulation over a generation drives consumption and quickly raises living standards. At its zenith, a large chasm forms between debtors (those saddled with a mountain of debt) and their prosperous creditors (those with all the capital).

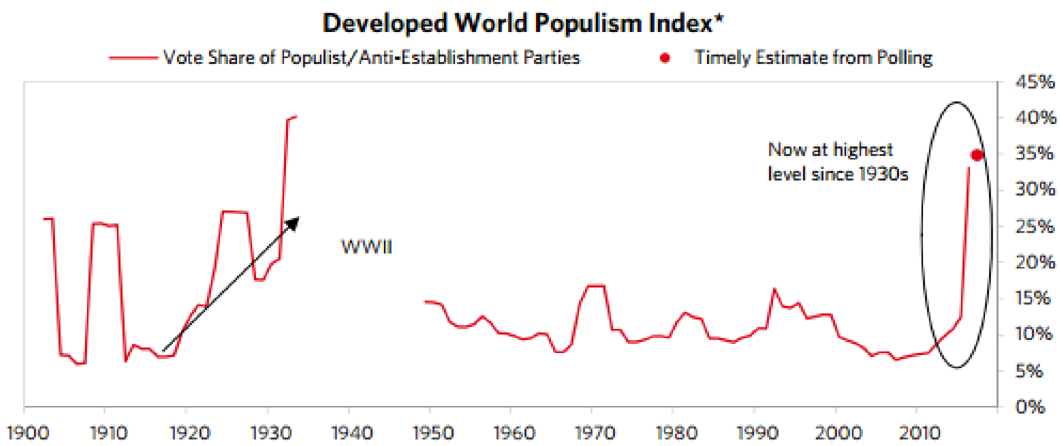
This long-term debt cycle inevitably leads to a society of Haves and Have-nots. As stated in our laws of social history, this relative prosperity gap leads to a closed and vengeful society.

Through this lens, it’s clear that the rise of populist leaders across the Western world in the 1930’s was not some historical anomaly, but something completely expected, as was the world war that followed. When people feel their standard of living is getting worse, they become angry. They elect someone to “fix” it regardless of the means. This is par for the course during the turning of the secular debt cycle (which last occurred in the 30’s).

Now, nearly 90 years later, we once again find ourselves in another secular deleveraging. And we’re currently in the early stages of attempting to rectify the gap between the Haves and Have-nots.

This clear relationship between the long-term debt cycle and populist policies can be seen in the two charts below.

The first is from Bridgewater — the most successful hedge fund of all time. It shows their index that tracks populist votes throughout the developed world.

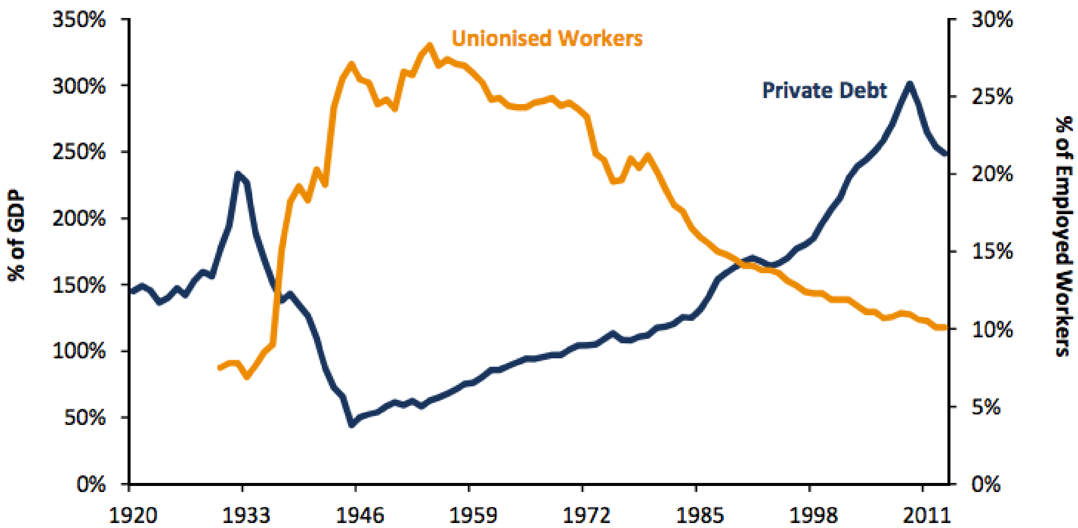


**The latest point includes cases like Trump, UKIP in the UK, AfD in Germany, National Front in France, Podemos in Spain, and Five Star Movement in Italy. It doesn't include major emerging country populists, like Erdogan in Turkey or Duterte in the Philippines. In the rest of the study, we look at populists of the past rather than those now in office in order to study the phenomenon because the stories of ones in power or possibly coming to power are still being written. For example, while we consider Donald Trump to be a populist, we have more questions than answers about him and are using these other cases to assess him against by seeing if he follows a more archetypical path or if he deviates from it significantly.*

The chart has gone vertical since the Great Financial Crisis. The last time we saw these levels was during the Great Depression and the destructive two decades that followed.

Now compare that chart to the following from GMO. It shows that private debt levels peaked at the height of the Great Depression alongside the percentage of unionized workers in the workforce.

Exhibit 19: US Private Debt Ratio and Trade Union Density



Source: GMO

There's a virtuous cycle at work here.

The start of the long-term debt cycle sees rising living standards that create acceptance and complacency across a society. This complacency allows power to concentrate among those who have capital, while shifting it away from those who don't (ie, labor).

This goes on until a saturation point is reached. Eventually, increased debt can no longer add to productive means. At this point laborers' living standards start to stagnate or fall, creating an increasing level of wealth disparity. This is when the debt cycle kicks into reverse.

Labor unifies and the Have-nots battle the Haves for more power. At the same time, a debt deleveraging occurs and then the whole cycle starts anew.

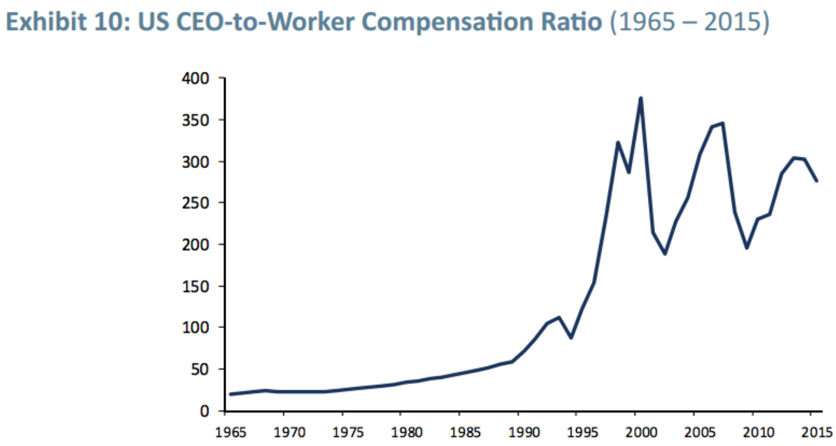
Bridgewater describes this populism as:

> *A political and social phenomenon that arises from the common man, typically not well-educated, being fed up with* ***1)*** *wealth and opportunity gaps,* ***2)*** *perceived cultural threats from those with different values in the country and from outsiders,* ***3)*** *the "establishment elites" in positions of power, and* ***4)*** *government not working effectively for them.*
>
> *These sentiments lead that constituency to put strong leaders in power. Populist leaders are typically confrontational rather than collaborative and exclusive rather than inclusive. As a result, conflicts typically occur between opposing factions (usually the economic and socially left versus the right), both within the country and between countries.* ***These conflicts typically become progressively more forceful in self-reinforcing ways.***

While very few populist movements have a history of producing positive outcomes for those behind them, populism will still remain a predictable human response to societies that produce large gaps between the wealthy and middle class… which itself is an inevitable outcome of a credit-based economic system.

Remember, it's all about the three laws of socio-economics. And just like in the 1930's, we're once again in clear violation. Just look at the chart to the right via GMO. It shows the average US CEO-to-worker compensation ratio. In 1965 this ratio was 20x. By 2000 it peaked at 383x!

This is wholly unsustainable.



Source: EPI

It's because of this fragile socio-economic environment that Bridgewater noted in their recent letter that "over the next year populism will certainly play a greater role in shaping economic policies. **In fact, we believe that populism's role in shaping economic conditions will probably be more powerful than classic monetary and fiscal policies (as well as a big influence on fiscal policies).**"

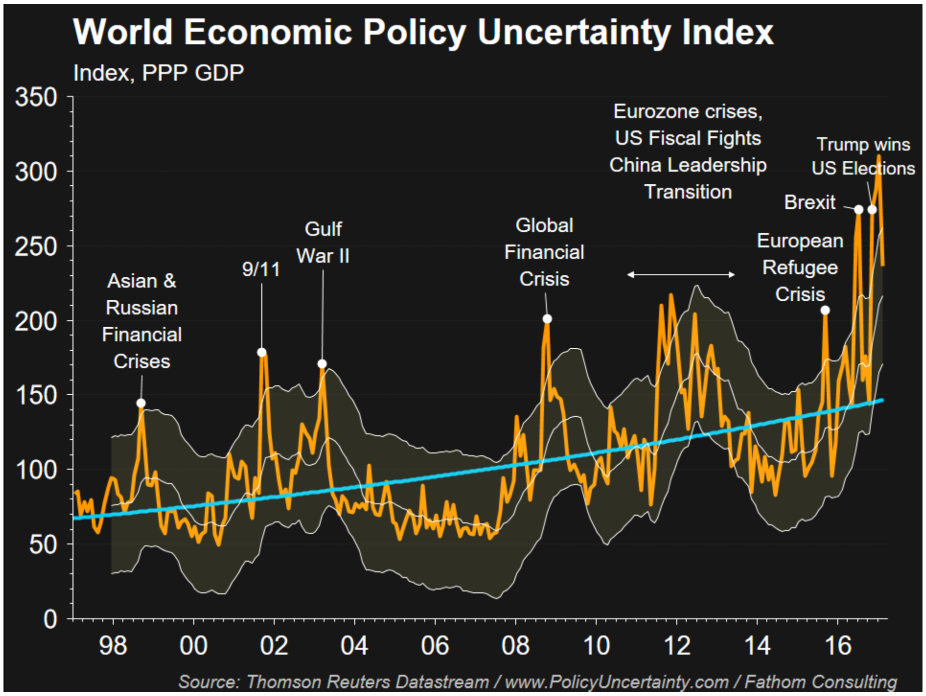
With our "psychohistorical" framework, it's safe to assume that populism, as a political movement, is in its early stages of a secular uptrend. Over the next decade or two there will be less global cooperation, more protectionism, and greater proclivity for global conflict.

With that said, just like short-term debt cycles oscillate around long-term debt cycles, populist movements oscillate around secular trend lines as well.

The Economic Policy Uncertainty Index to the right shows this short-term political cycle at work.

We can see that the trend-line, as noted in blue, started moving upwards at the turn of the millennium — right around the time debt and income disparity peaked.

The yellow line shows the cycling overtime; meaning uncertainty progresses in waves, not linearly.



This makes logical sense. We can break down the progression of a populist political movement like this:

- Income disparity causes growing populist sentiment
- As it grows, the populist movement and its leaders push the limits of what's considered socially acceptable
- This sets precedence, but at the same time stirs backlash, which causes the movement and its leaders to take a few steps back
- During this time enthusiasm and support for the movement wanes
- But eventually deteriorating broader fundamentals (ie, debt cycle) re-energizes the populist movement, prompting its leaders to push the line a bit more. This causes the precedence for what's "acceptable" to be pushed a little further down the line once again
- This cyclic progression of social precedence occurs over a long period of time until the populist hysteria becomes full blown. This forces a reset of the system through either destruction or mass change

Consider Mussolini's Blackshirts or Germany's Nazi Party. Many today make the mistake of thinking those societies were comprised of people who were fundamentally different than us. They think we could never repeat their violent hysteria and atrocities.

<u>They are wrong.</u>

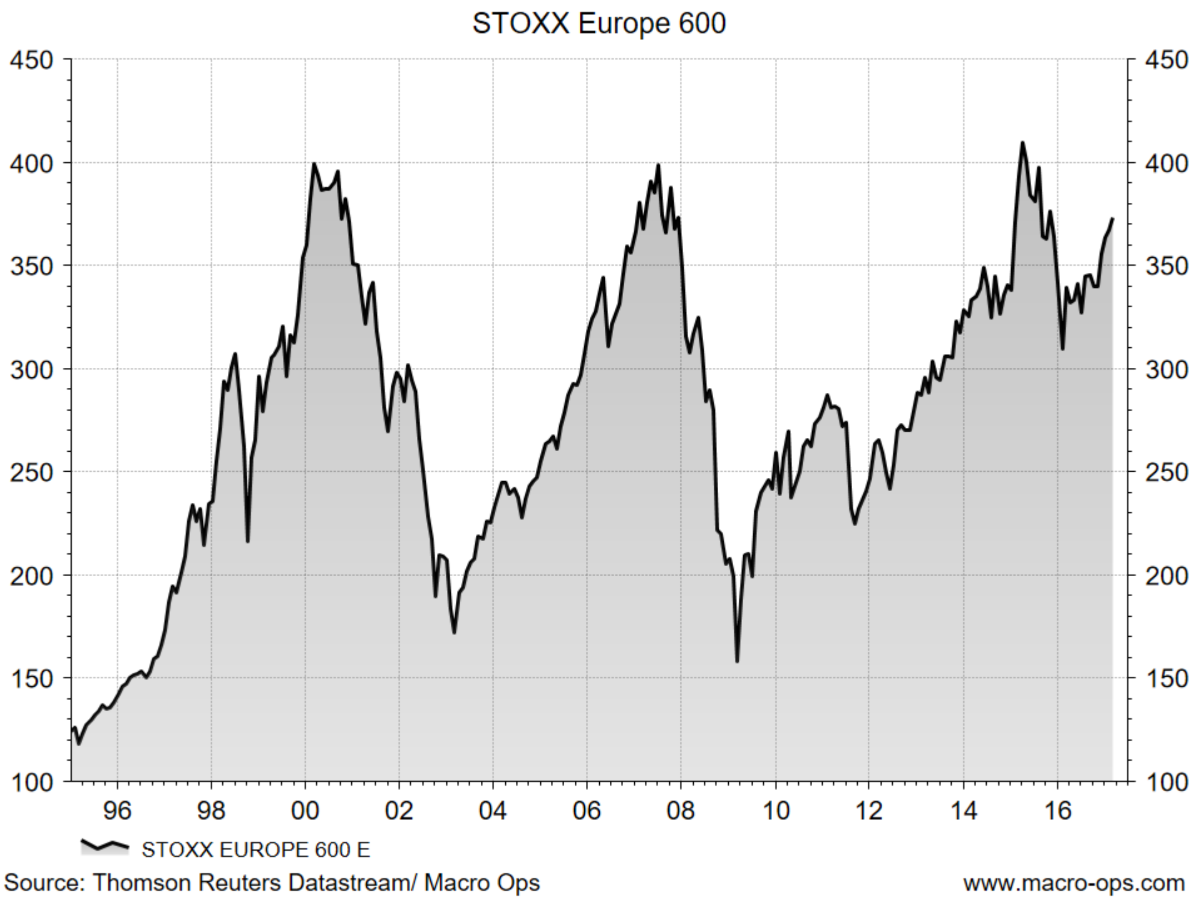
To quote Einstein again, "Two things are infinite: the universe and human stupidity; and I'm not sure about the universe!"

The fact is, human behavior is a predictable constant throughout history. Our technology changes, but our propensity to repeat the grand mistakes of the past is assured, especially when put under certain economic conditions.

The Nazis didn't transition from a normal society of European people to a destructive and vile political group in just a week. That change happened over years and under dire economic conditions. Over time, precedence was pushed further, bit by bit… almost imperceptibly… until what was considered socially reprehensible a decade earlier became the norm. And so began a movement all its own…

And with that, let's turn to Europe.

Europe: A Budding Soros-Style False Trend?



Charts of a number of European ETFs and indices look constructive.

The bullish narrative here is simple.

Relative to the US, European stocks are cheap. The US stock market is trading at a CAPE of 29x (the second highest reading in history) while Europe is trading at 18x. This isn't cheap, but it's a bargain compared to the US.

There's also the case of diverging monetary policy.

The Fed is tightening rates with two more hikes planned this year. There's serious talk of reducing the balance sheet following the third hike as well.

This is in stark contrast with Europe, where the deposit rate is -0.4% and the ECB is still conducting large scale quantitative easing. They're buying €60B worth of bonds every month…

In fact, the ECB is *so* concerned about the market interpreting its actions as anything but dovish, that it leaked a note last week (which happened to be on the same day the UK triggered Article 50) that stated markets had grossly misinterpreted its last meeting as too hawkish.

The ECB wanted to "reassure investors that their easy-money policy is far from ending" and that the slight hawkish tone of their last meeting was "way overinterpreted".

Combining this accommodative monetary policy with better relative valuations and an uptick in sentiment raises the probability that the European equity rally will continue.

This is why fund managers have been jumping into the trade since the end of last year.

Figure 6: Long Exposure to European Equities at High Among American HFs

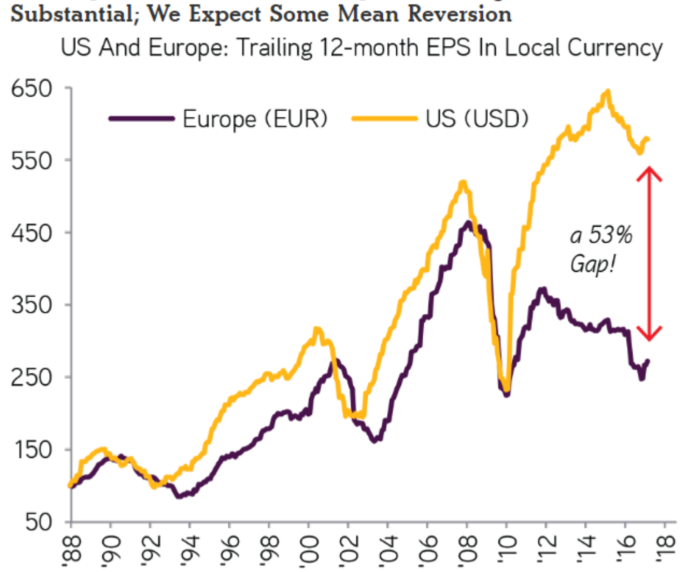
They're working off the assumption that the large EPS gap between US and European stocks will mean revert, with Europe doing most of the work to move its EPS higher.

There's already signs that the power of mean reversion is starting to work.

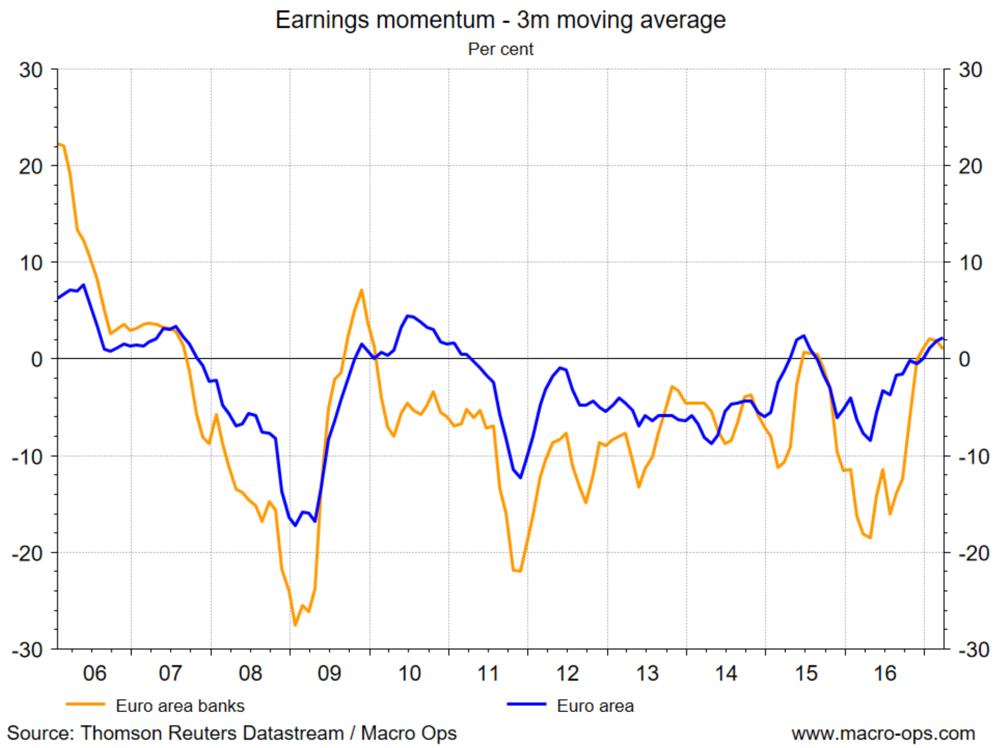
European earnings momentum, as shown by our chart below, recently trended positive for the first time since 2015. How long this trend lasts remains to be seen, but it's at least a positive for European stocks over the next few months.

EXHIBIT 28

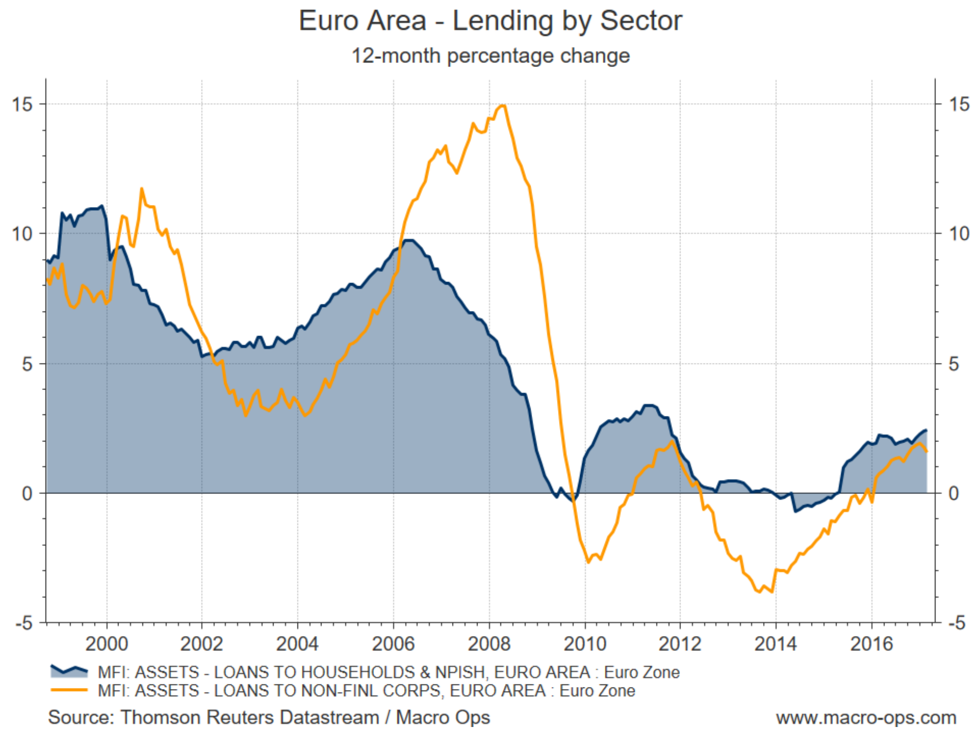
The Gap Between U.S. and European Earnings Is Now Substantial; We Expect Some Mean Reversion



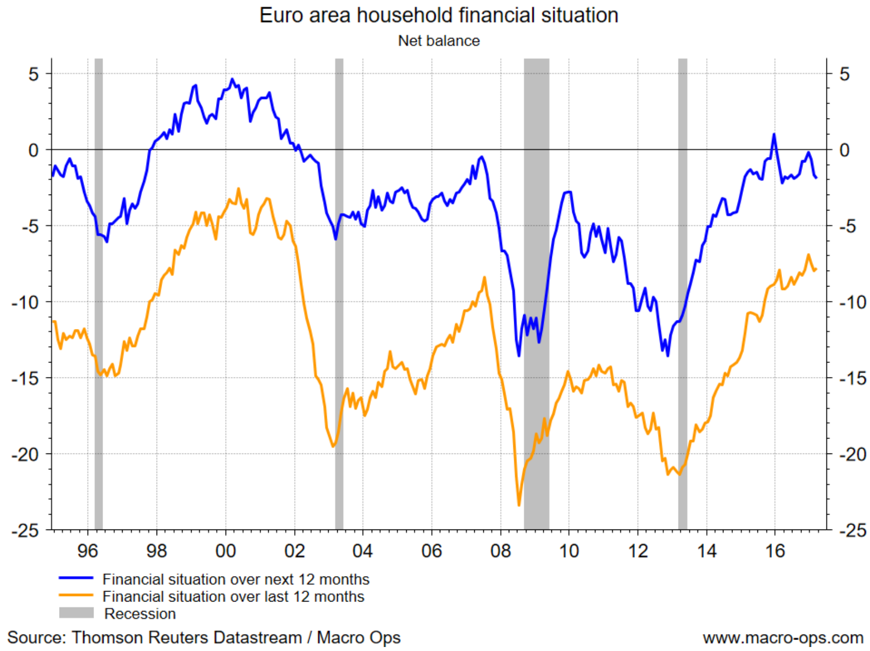
Indexed to 100 in 12/31/1987. Data as at February 28, 2017. Source: BofA Merrill Lynch Global Investment Strategy, MSCI.



Meanwhile, lending to both euro area households and businesses has picked up over the last year. It's still historically low, but if the trend continues, it'll gives credence to the bull case. Lending growth needs to coincide with any broader move in stocks or the sustainability of the move becomes questionable.



On the back of these improving economic numbers, European household sentiment began a steady uptrend in early 2014. The chart to the right shows survey data of households' views on their financial situation over the next 12-months (blue line) and past 12-months (yellow line). The data is extremely cyclic and serves as a reliable early warning signal for when the cycle begins to turn. You can see that a downward trend in the data has preceded the last four recessions. The current trend higher has slowed down in recent months. This is something we'll need to keep an eye on.



That's the basis of the European bull case: relative valuations, diverging monetary policy, and mean reversion in both EPS and shifting sentiment sets the stage for a run in European stocks.

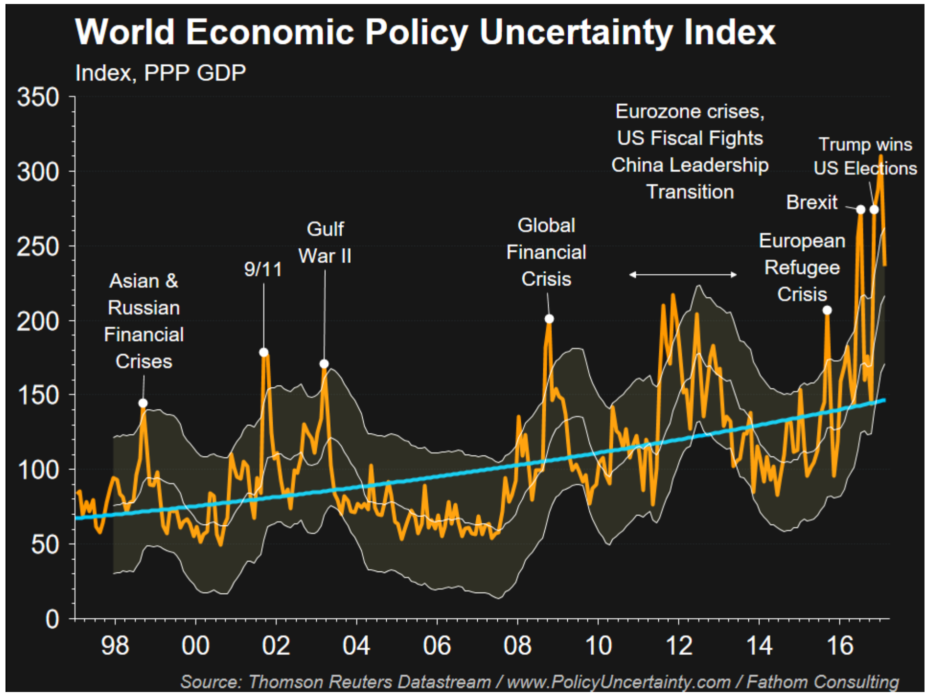
A catalyst that would ignite this positive trend further would be the defeat (or the perception of the inevitable defeat) of presidential candidate Marine Le Pen in the upcoming French elections.

Le Pen is the populist leader of the right wing National Front. The National Front is an anti-euro, anti-immigration party. A Le Pen win would send shockwaves across Europe… signaling the demise of the European project as we know it.

She's currently not projected to win. But we all know how well the polls have performed in the last two major political events…

We should add that even if her opponent Macron (a clear favorite) wins, he's still an outsider. He's not from one of the traditional parties. This would be the first-time traditional parties cede the presidency to an outsider since the *founding* of the Fifth Republic in 1958. Just another sign of the times.

Going back to our earlier discussion of short-term political cycles within longer ones, we're of the mind that we're near the peak of the current short-term uncertainty cycle. We expect political events to swing back towards more predictable outcomes for a while. Precedence has been set, the line has been moved forward, but now we think the population needs a breather from pushing politics. **Le Pen will likely lose.**



This thought is bolstered by the outcome in the Dutch elections where firebrand Geert Wilders was handily defeated.

Le Pen losing would be a positive (however short-lived) for Europe because after France comes Germany with a big election in September.

It could be a boon to markets if Europe can blanket the flames of populism for the rest of the year. This is also why the ECB is so keen to play it loose. They *are* an offspring of the EU experiment after all.

2017	April	France (23/04) & (7/05)	Presidential
		Finland	Local
	May	Germany (07/05)	State (Schleswig-Holstein)
		Germany (14/05)	State (North-Rhine Westphalia)
		Hungary (May-June)	Presidential
	June	France	Parliamentary (National Assembly)
	September	Germany	General
		France	Parliamentary (Senate)
		Spain	Potential Referendum (Catalonia Secession)
		Portugal	Local
	October	Czech Republic	General
	November	Denmark (21/11)	Local
2018	January	Finland (28/01) & (11/02)	Presidential
		Czech Republic	Presidential
	March	Netherlands (21/03)	Local
	April	Hungary	General
	May	Italy	General
	September	Austria	General
		Sweden (09/09)	General & Local
	October	Ireland	Presidential
		Belgium (14/11)	Local
		Hungary	Local
		Czech Republic	Local
	November	Poland	Local

Based on the data, it looks like the coast is clear for Europe and we should pile in on the trend right?

Well… not exactly.

The bullish case for Europe is a classic Soros-style false trend.

George Soros, a hedge fund legend, said the following about false trends:

> *Let me briefly recapitulate my theory for those who are not familiar with it. It can be summed up in two propositions. First, financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. This is the principle of fallibility. The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times it is quite pronounced. When there is a significant divergence between market prices and the underlying reality I speak of far from equilibrium conditions.*
>
> *Second, financial markets do not play a purely passive role; they can also affect the so-called fundamentals they are supposed to reflect. These two functions that financial markets perform work in opposite directions. In the passive or cognitive function, the fundamentals are supposed to determine market prices. In the active or manipulative function market, prices find ways of influencing the fundamentals. When both functions operate at the same time, they interfere with each other. The supposedly independent variable of one function is the dependent variable of the other, so that neither function has a truly independent variable. As a result, neither market prices nor the underlying reality is fully determined.*

Here it is in English: A false trend develops when a narrative is founded on untrue assumptions, and yet is *so* compelling, that price moves in its favor anyway. The positive price action further enhances belief in the narrative and creates a positive feedback loop between market and narrative strength. This loop continues driving price further away from the truth, creating more instability. Eventually this loop breaks when belief in the narrative falters and price corrects.

Soros would often buy into false trends knowing they were false, but while also being well aware that like normal trends, they can be very profitable.

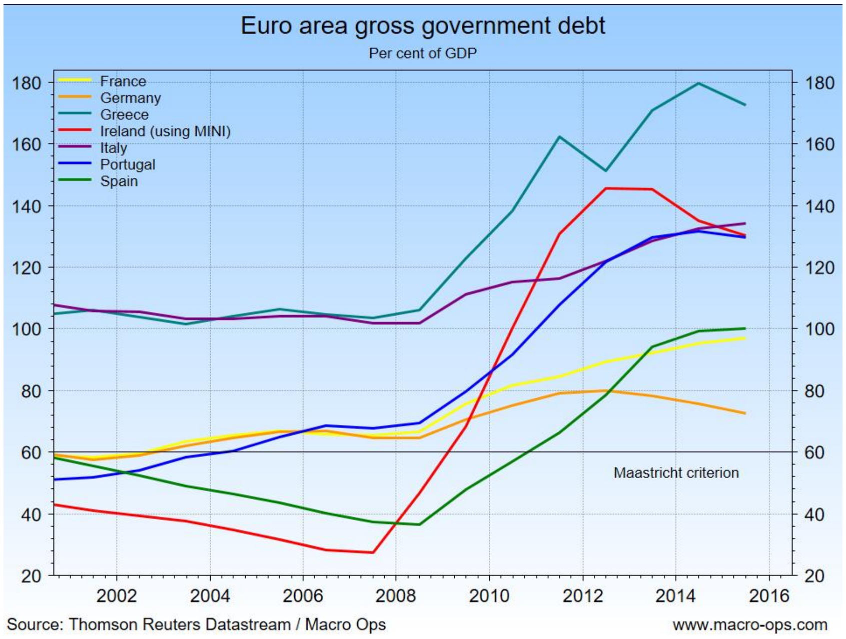
The reason this European rally is a false trend is because none of the original reasons to be bearish on Europe have been settled. None of them.

The can of radioactive economic worms has simply been kicked down the road, over and over again.

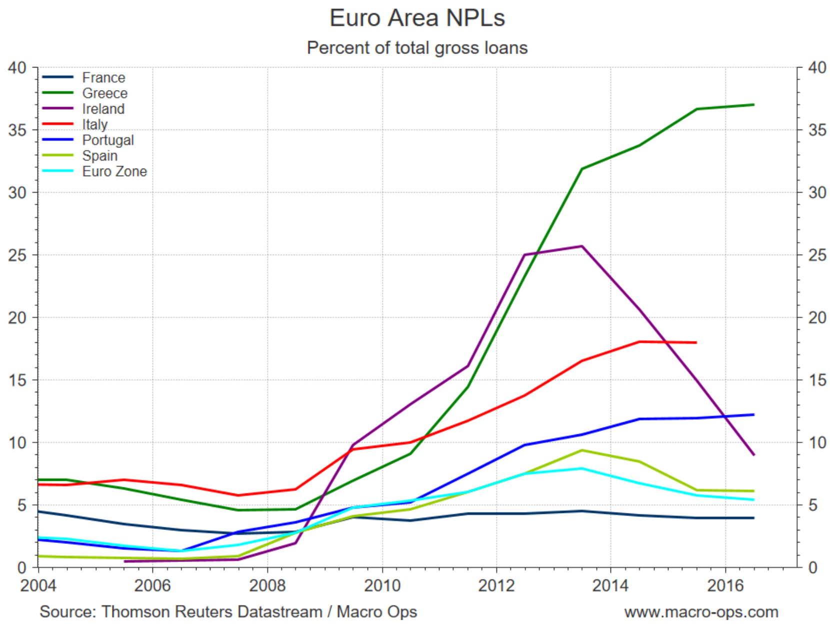
Here's the following from KKR, a global investment firm (emphasis ours).

> *Europe continues to barrel down the path of a two-tiered economy, which is likely long-term unsustainable, in our view. Specifically, there is a large and growing dichotomy between Germany, with its strong growth, and the rest of Europe, Italy in particular…* ***Italian GDP is now seven percent below its 2008 level in real terms****; by comparison,* ***Germany is a full eight percent above its 2008 level in real terms.***

Italian real GDP contracted 7% over the last decade. That's insane! And all while Germany steadily grew… talk about an insurmountable divide between the Haves and Have-nots. That kind of disparity in growth will lead to terrible outcomes for the European continent, not to mention the union.



There's also the persistently high debt which remains near record levels. European consumers, though showing a few signs of life, are still saddled with debt and without a plausible catalyst in their future to alleviate it.



Non-performing loans remain disgustingly high and that's despite having negative interest rates. Think, what would happen to the number of NPLs if interest rates were to climb just 1% on the belief of newfound economic growth? Things would get ugly… fast.

The reality is that Europe is just behind Japan on their transition along the long-term debt cycle. They have structural problems that include inflexible and uncompetitive labor markets, dwindling demographics, a misguided currency union, and an increasingly troubling immigration problem that's pulling at the seams of their already fragile political union.

Europe's recent "recovery" isn't so much a recovery as it is another dead cat bounce on its long road of decline.

But Soros-style false trends can be powerful moves. And if the French election plays out how we think it will, with Le Pen losing, then the false narrative can continue. We're willing to surf long with the true-believers, but we'll be quick to jump ship when things turn.

In the end, the populism trend is only growing stronger. And Europe and the Western world are barely in the middle of this long-term deleveraging. Remember, there's no escaping the dead hand of social inevitability.

Deep Dive: European Equities

To play this false trend, we wanted to select a basket of some of the highest-performing, most-undervalued European companies. As the European markets get bid higher, these stocks have the best shot at moving multiples more than the broader indices.

Fiat Chrysler Automobiles (FCAU)

> *[The company] looked just mind-blowing. The month I spent drilling down… has to be perhaps the most exciting month in my 22-year journey thus far as a value investor. I read more than twenty books on various facets of the… industry, several annual reports, etc. I listened to many archived conference calls, saw many videos. I read many transcripts. I was up till nearly 3 or 4 AM every night. And then I'd resume the next day. It was the only time I collaborated with three other close friends and investors to make sure I wasn't missing anything obvious. I kept sending them materials to read, books to order, etc. They had a hard time keeping up. Eventually all four of us invested. The whole thing was an incredible orgasmic experience. If I can have the same experience even just once a decade, it would be incredible. - **Mohnish Pabrai***

So what company got famed value investor Mohnish Pabrai all hot and bothered?

It's none other than Fiat Chrysler Automobiles (FCAU).

Whoa, whoa, whoa… a car company? Really?

Yes.

We're talking about the auto industry? With its low margins, cutthroat competition, and high fixed costs? The same industry whose dinosaur incumbents are about to be destroyed by Uber and Google?

Again… yes.

The share prices of the majors (Ford, GM) have done a whole lot of nothing these past few years. Regardless of their improving fundamentals, the market hasn't paid them any notice.

Yet big name investors like Pabrai and others like David Einhorn and Ted Weschler at Berkshire Hathaway have been taking huge positions in the industry. Clearly there's a discrepancy here.

The two popular market narratives surrounding the auto industry are **1)** self-driving cars are revolutionizing the autos and destroying incumbent business models and **2)** US automobile sales have peaked.

This begs the question of why Pabrai has 28% of his fund in Fiat Chrysler — a company that's invested the least amount of cash into autonomous vehicles compared to its peers and that also has a majority of its revenues tied to the North American market. Seems contrarian to say the least.

The reason is, both these market narratives are wrong.

First off, we're nowhere *near* the utopian auto future people love talking about. The common narrative in which no one owns a car, everything is rented, and cars operate themselves is far off.

Yes, we *do* have cars that successfully drive themselves on freeways and some local streets. It can even be argued that 90% of autonomous driving has been figured out. But even so, it's the last 10% that's most difficult and which will take the longest.

We're talking about programming all the fringe cases that come with standard driving — unpredictable weather conditions, crazy pedestrians, other *human* drivers. The variables at play here are almost endless. Coding it all is no simple task! Chris Urmson, who used to run the Google autonomous car project, estimated it could be another 30 years before we get **fully** autonomous cars.

In this case, the market is discounting these car companies' shares too far into the future. Self-driving cars will not have a serious impact over the next 5 years, yet the market is pricing these stocks like the end of human drivers is tomorrow.

As we explained before, FCAU is the furthest behind in the autonomous "race". Ask CEO Sergio Marchionne and he'll say Ford and GM are wasting their time and money. Marchionne is instead focused on the here and now. And he's absolutely right to do so.

The second popular concern with the auto industry is that US auto sales have peaked. Investors believe the seasonally adjusted annual rate (SAAR) has reached a high of 18 million units per year and will only head lower from here. This is a major problem because most car companies, including FCAU, make a majority of their money from US sales. And low margin, high fixed costs businesses like autos need consistent high volumes to stay profitable.

It's true that auto volumes are unlikely to increase this cycle. But they probably won't fall much either. The U.S. auto fleet is old. The average car's age is 11.6 years. And with 264 million cars registered, even at 18M new units purchased per year, the fleet will not be replaced quickly. Considering this alongside natural population growth, US auto volumes should stabilize for a while going forward.

The market is clearly mispricing the “dinosaur” auto companies. But the most mispriced of them all is Fiat Chrysler. This makes it the best play for a few reasons.

First, CEO Sergio Marchionne is a genius operator. As Pabrai explains:

If one had invested $1 million in Alusuisse when [Marchionne] became CEO in 1996 and then kept moving those funds as Sergio moved, that $1 million would be worth north of $30 million today. And that includes twelve of those twenty years spent in the lousy car business – with zero prior experience in the auto industry. By 2019, when he intends to hang up his boots and study Theoretical Physics (yes, that’s right!), that $1 million will likely have grown to over $100 million.

Marchionne knows how to run a company.

Back in 2013 he launched an extremely ambitious 5-year plan to be completed by 2018. It involved a 59% increase in vehicles sold, higher margins, increased revenue, and vastly reduced debt. The goal was to swing from almost $10B in debt to $5B in net cash. Of course the market didn’t believe a word of it. Yet Marchionne and his team have continued to exceed expectations year after year. 2016 results were stellar:

- Earnings before interest and tax were up 26% over the year before to €6.06 billion
- Margins were up 120 basis points to 5.5%
- Adjusted net profit was up 47% to €2.5 billion
- Net industrial debt dropped from €6.5 billion to €4.6 billion

The company's products and brand have in turn greatly benefited.

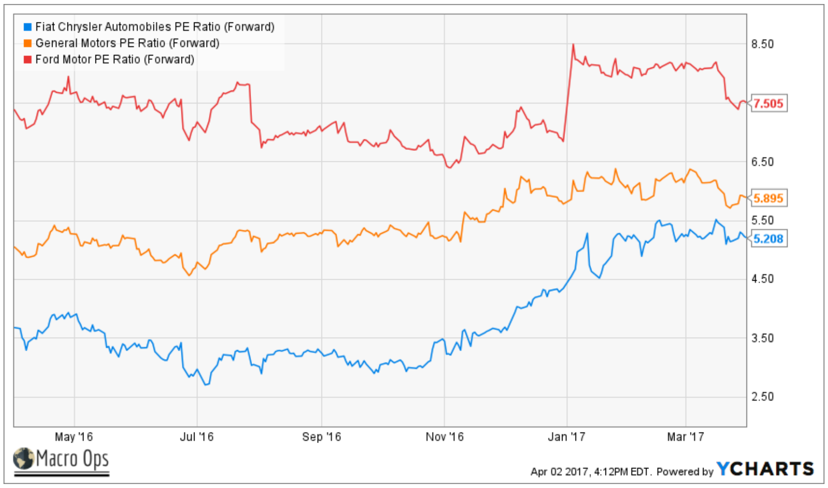
In 2009 there were only 250,000 Jeeps sold in the world. In 2016, Jeep sales hit 1.5 million, and they are now well on their way to reach 2 million by 2018. Jeep's image and brand are both rock solid. Those who buy Jeeps don't want anything to do with other SUVs. In China, the term for SUV is actually *Jeep* itself — they're synonymous. Jeeps are high margin vehicles too. FCAU makes a good chunk of change from every sale. And in the even higher margin truck business, RAM has continued to steal market share from Ford and GM. Since 2009, RAM's US market share has doubled from 11% to 22%!

In line with our current focus on stocks that'll benefit from the European false trend, we want a company that's also popular with Europeans. FCAU once again checks all our boxes. The company's full year 2016 European sales rose 14.1% compared to 6.5% for the industry as a whole. Jeep sales were up 19%, Alfa Romeo 16.5%, Fiat 13.6%, Lancia 9% and Maserati 29.8%. FCAU is also dominating the small car sector. In the "European A" category, the Fiat 500 and Fiat Panda have 29.4% market share. And in the "Small MPV" category, the Fiat 500L has a 25.5% market share. Lastly, the Fiat 500X, in the "Small SUV" category, is the current market leader.

The chart below from the *Economist* shows that Europe has some of the highest levels of new car registrations. This was the third consecutive year of growth for Europe and the trend is forecasted to continue.

The market is completely missing the magic happening at Fiat Chrysler.

The company is currently trading at 5x forward earnings. The entire industry is undervalued, but FCAU in particular is mispriced. Eventually, investors will realize the massive positive effects of Marchionne's management in an industry that's NOT about to be destroyed by driverless cars and whose volumes are NOT going to plummet.



We're currently waiting for FCAU to hold above its highs before considering a position. A sustained break above $11.45 would pique our interest.

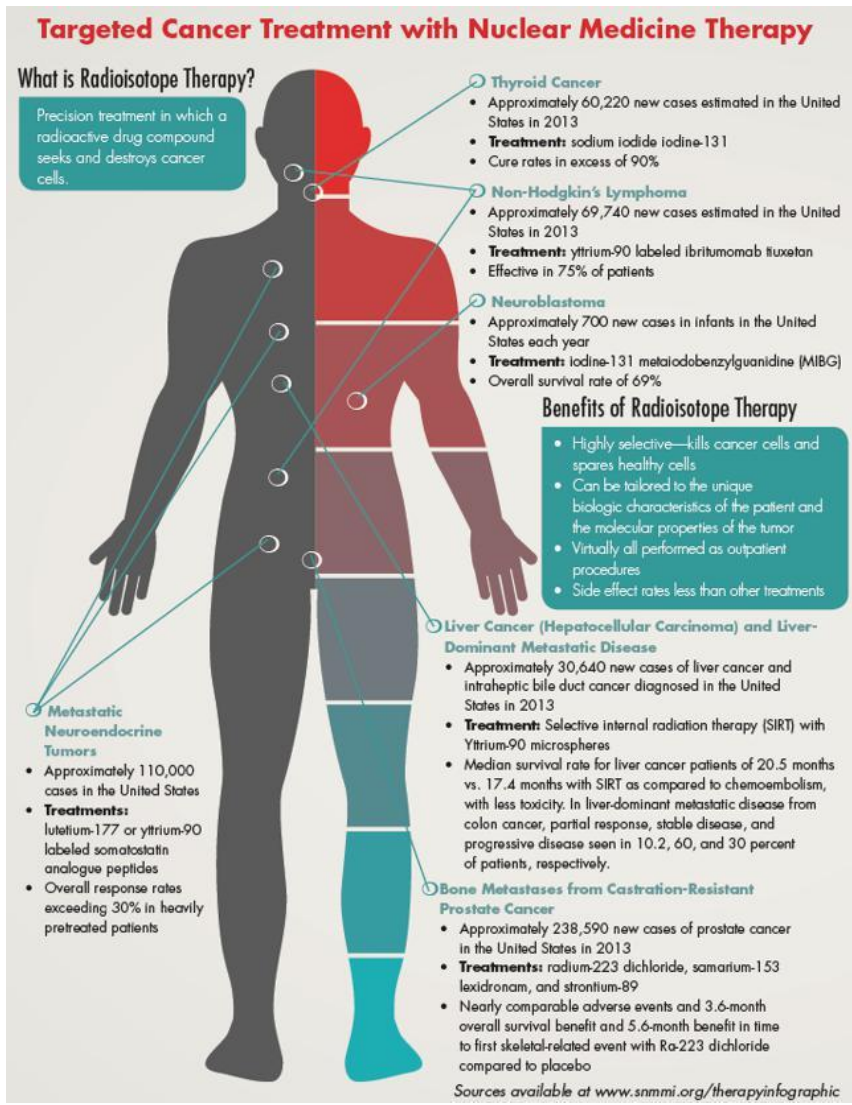
Trade Idea: Buy FCAU On Weekly Close Above $11.45

Advanced Accelerator Applications (AAAP)

When it comes to medical procedures, we want quick, efficient, and with little to no side-effects — a luxury we didn't have back in the day. Back then if you broke your leg, it got amputated... and that meant biting down on a piece of wood while you watched the doctor dismember you with a hacksaw.

Thankfully medicine has come a *long* way since then.

Doctors are now able to perform heart surgery with no more than an inch-wide incision. But what's even more spectacular is what they've learned to do with no incision at all…



On the forefront of the non-invasive trend is molecular nuclear medicine (MNM). MNM procedures use trace amounts of radioactive substances called radiopharmaceuticals to diagnose, treat, and monitor diseases.

You can think of radiopharmaceuticals as heat-seeking cancer missiles. A physician only needs to inject a patient with a cocktail of the stuff and the radioactive drugs surf the bloodstream until they lock onto tumors. From there they attach to the cancerous cells and can do one or both of the following:

- Emit energy that screams "look at me!" for physicians trying to find the tumors with a PET scanner and/or

- Use their energy to slice through the tumor and destroy it.

The drugs that do both, track the tumor AND kill it, fall under the category of theranostic treatment. This type of treatment is a huge improvement in a few ways.

First off, it provides more detailed, unique information regarding the cancer compared to normal detection methods. This allows physicians to spot and terminate tumors much earlier in the cancer's life cycle, which of course leads to more saved lives.

Second, this treatment is non-invasive. No more surgeons playing *Operation* with your innards.

The drug cocktail is just as targeted as a scalpel, but without the huge procedure. It's also a big improvement over chemotherapy which is the equivalent of dropping a carpet bomb over your entire body. Chemo attacks all cells instead of just the cancerous ones. Radiopharmaceuticals on the other hand are like drones — tactical and focused on killing just the cancer. I'm sure you've seen people on chemo and the terrible side effects they're forced to deal with. Well with radiopharmaceuticals there are none… patients are back to business in only a few days. You can learn more about this breakthrough medicine in this *awesome* 80's-style video here.

As you would expect, the global MNM market is growing rapidly. It's currently worth more than $4.3 billion and by 2030 it's expected to grow to over $24 billion. The market can be split into two segments: diagnostics (finding tumors) and therapy (destroying tumors). Right now diagnostics accounts for 90% of the total market. But the therapy segment is expected to grow at 30% per year and make up 61% of the market by 2030.

So if we were to make a play on this industry, we'd want a company that has a solid footing in diagnostics with the potential to capitalize on the growing therapy segment.

This is exactly what we get with Advanced Accelerator Applications (AAAP).

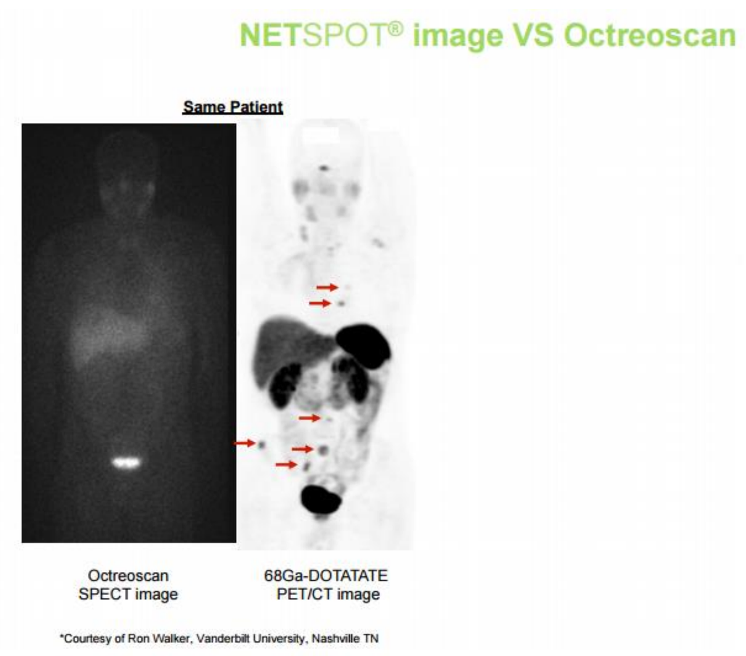
AAAP is a European radiopharmaceutical company that makes a number of drugs for the MNM industry. It's main focus at the moment is diagnostics — the radioactive cocktails that help physicians spot tumors. It's the leader in the European market with seven of these products. It also recently launched a new diagnostic drug in the US, its first foray overseas.

But that's not all. AAAP is working on the therapy side of the market too. They have a drug in the works that's well on its way through the FDA and EMA (Europe's equivalent) approval process. The company is well positioned to capitalize on the industry's shift towards therapeutics.

On the diagnostic side of things, AAAP has a brand-new blockbuster product called NETSPOT.

NETSPOT is a radiopharmaceutical kit that tracks neuroendocrine tumors (NETs). So far it's received orphan status from both the FDA and EMA, which means AAAP gets tax benefits and exclusive rights to develop this class of product for the next seven years, a significant moat against competitors.

NETSPOT is vastly superior to the previously approved NET diagnostic product on the market — Octreoscan.



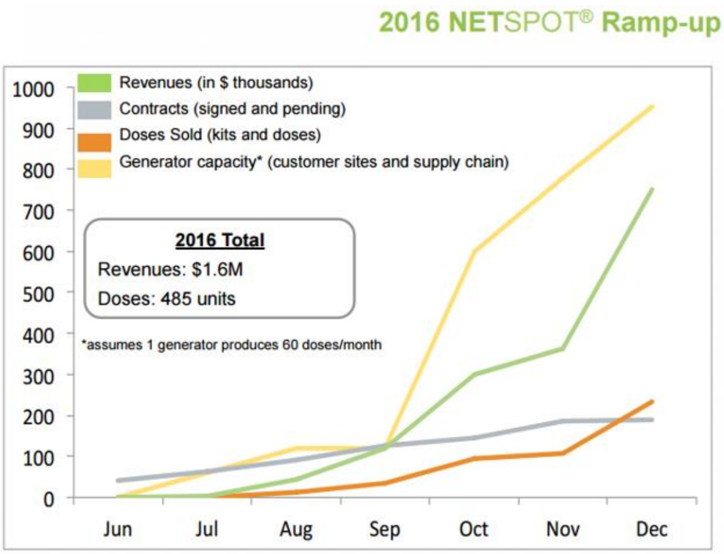
Source: Advanced Accelerated Applications Investor Presentation

The main advantage is that it pinpoints **30% more** lesions in patients. But not only is it more effective, it also uses a lower dose as well, which is an important factor when considering the radiation exposure involved with using radiopharmaceuticals.

Hospitals love it too. Instead of the normal 48-hour protocol that most radiopharmaceuticals need, NETSPOT's process only takes 2 hours with no pre-bowel cleanse necessary! This means fewer examinations for the patient, saving hospitals both time and money.

The quality of NETSPOT has propelled its adoption by the medical community. At the beginning of the year AAAP managed to negotiate reimbursement for NETSPOT from all the major healthcare payers in the US. And on March 1st, NETSPOT was included by the National Comprehensive Cancer Network in its guidelines for the evaluation of NETs. Both of these are major milestones that will boost confidence in the product and greatly increase its adoption and distribution.

You can see on the graph to the right how rapid NETSPOT's growth has already been in 2016. And it's only accelerating.



Source: Advanced Accelerated Applications Investor Presentation

At the end of September 2016, the company was supplying 80 patient-ready doses of the drug on a monthly basis. By the end of February 2017, this number increased to more than 400 monthly doses. In March they hit 500+ doses. By the middle of this year the company plans to increase its partner radiopharmacies (the guys who actually make the stuff and distribute it) from 20 to approximately 40.

And as we said, AAAP isn't stopping with just diagnostics. They're going for the 1-2 punch with the therapy drug they're currently developing called Lutathera. NETSPOT identifies the NETs and Lutathera destroys them.

Lutathera has received orphan drug designations from the EMA and FDA just like NETSPOT. And while it's still going through the lengthy approval process, 2017 looks to be the year when it'll finally be approved. Phase 3 trials were highly statistically significant — a major step. Lutathera resulted in a 79% reduction in the risk of disease progression or death compared to patients treated with similar products.

AAAP's strong positioning in the MNM market is already showing up in their earnings. Their latest Q4 2016 report surprised to the upside. EPS came in at a loss of 18 cents per share, an improvement over the expected loss of 20 cents per share. Losses are to be expected with biotechs in their development stages. What we need to focus on is growth. And in that area AAAP is stellar. Total sales for 2016 came in at $115.4 million, a 23% increase over the $93.5 million made in 2015. These results added to their compounded annual growth rate of 28% between 2012 - 2016.

AAAP's stock recently broke to new highs on above average volume. But the price action on the breakout wasn't ideal. We want a strong thrust above the resistance which hasn't happened yet. We'll continue to monitor this stock and may initiate a starter position when price has more follow through.

Trade Idea: Buy AAAP On Strong Weekly Close Above $40.00

GasLog Partners (GLOP)

We last wrote about master limited partnerships (MLPs) a little over a year ago when the sector was trampled alongside everything else energy related.

It was a classic case of the baby being thrown out with the bath water. MLPs for the most part either store or transport energy products. They're essentially toll-road operators that collect a fee regardless of energy prices. But even so, their shares were hammered. Now in the aftermath of the carnage there are many undervalued MLP's that look attractive. One in particular that caught our eye is the Monaco-based GasLog Partners (GLOP).

GasLog Partners is a European MLP operating a fleet of ships that transport liquefied natural gas (LNG) around the world.

The thesis here is simple. GLOP was unrightfully sold off in the MLP purge and now with the general shipping environment improving alongside better prospects for the LNG market, GLOP should make a solid run.

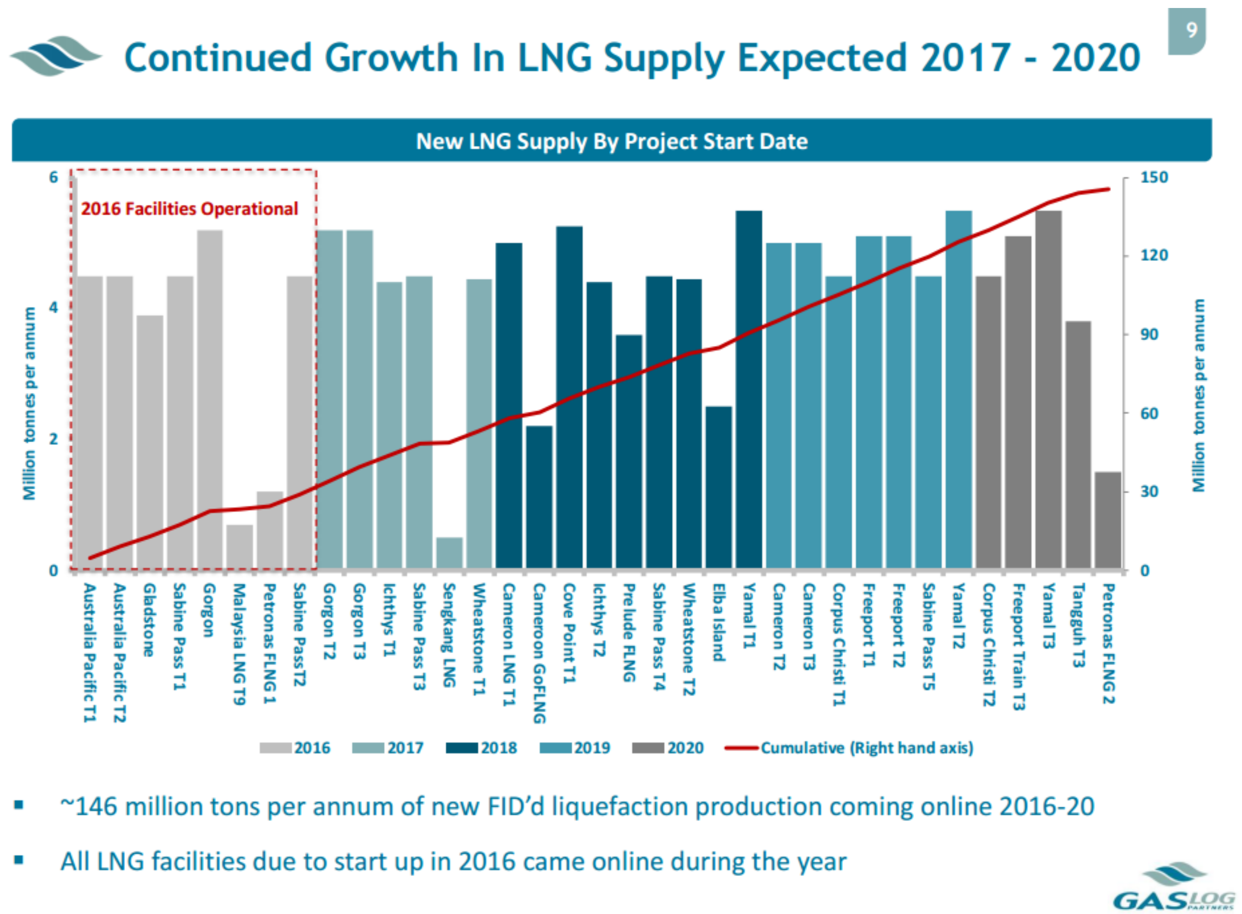
The Baltic Dry Index, which provides an assessment of the price of moving raw materials by sea, recently hit a two year high. A number of analysts are starting to come around to the idea that the shipping industry has bottomed. Recently, Morgan Stanley analyst Fotis Giannakoulis upped his outlook for several shipping stocks, sending their prices higher.

The recovery in the LNG shipping market looks particularly promising. In their latest earnings call, GLOP's management was upbeat about their prospects:

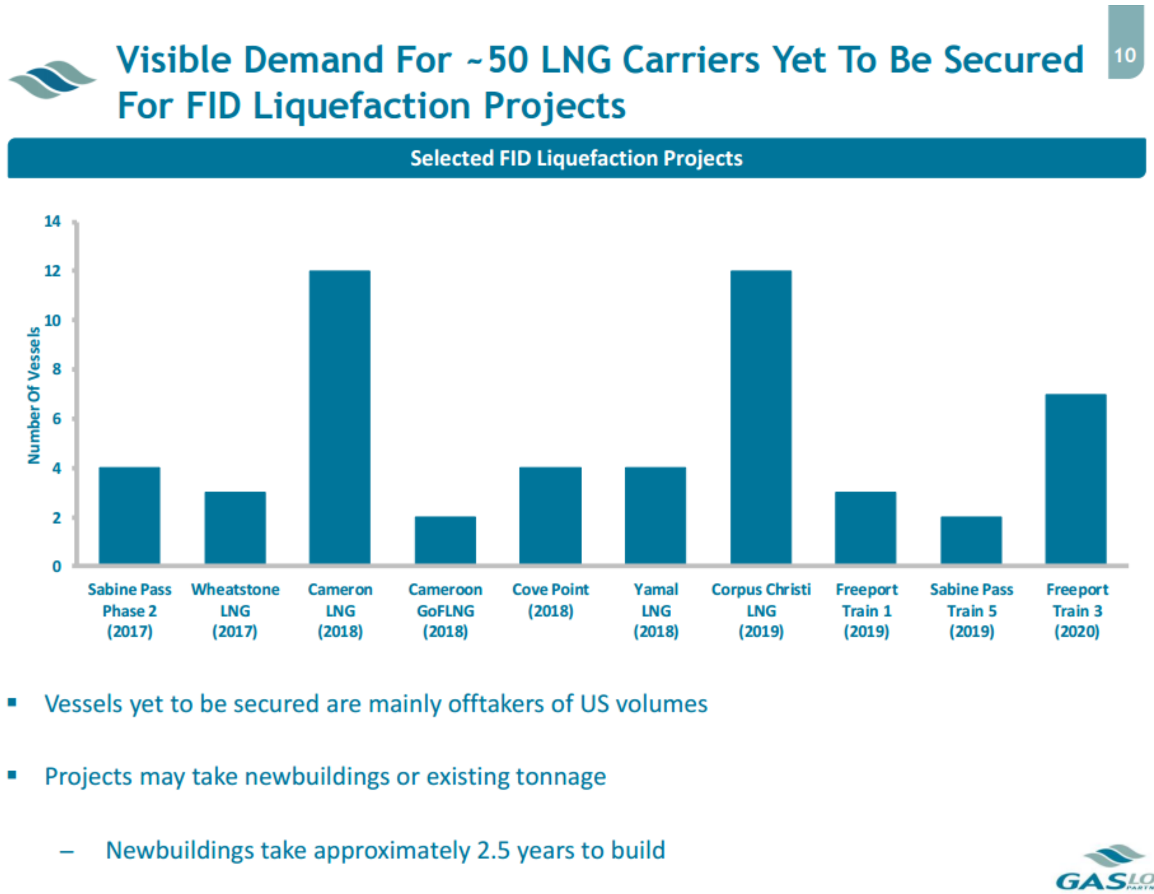
> *Every large scale project that was due to come online in 2016 started up as planned and is now producing. These new sources of LNG supply should increase demand for shipping, and we continue to see tenders for long-term charters of vessels needed to transport volumes from these facilities.*

On the demand side, in 2016, we saw a 9% year-over-year increase in global LNG imports. China and India were the two primary drivers of this increase with China's import increasing over 30% and India's 29%. We've also seen several promising FSRU developments with seven new contracts awarded in 2016, demonstrating the growing demand for offshore re-gasification.

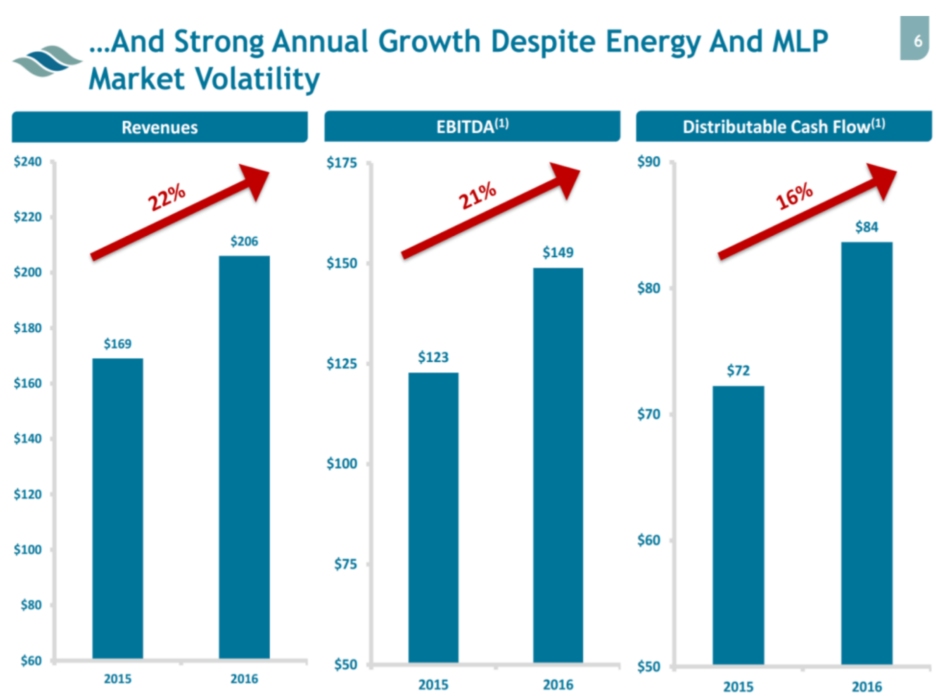
Given significant increase in LNG listings expected through year end 2019, we feel confident there will be strong demand for our vessels and charters in 2018 and 2019.



What's even better for GLOP is the fact that the global fleet isn't expanding fast enough to carry all this future supply. Shipping vessels take roughly 2.5 years to build, which means there should be a 50-vessel shortfall should this supply trend continue. This squeeze will provide a windfall for GLOP in the form of higher prices and profits on each ship.



GLOP's financial performance has been spectacular within the improving market. The company reported record revenues, EBITDA, and distributable cash flow in Q4 2016. Each of these areas is growing at double digit rates.



And what's more, the company currently has a solid distribution yield of **8.7%**, which management is dead set on increasing. They've already achieved a 10%

distribution growth rate since the company’s 2014 IPO and are on track to increase it into 2017.

In Q4 2016 alone GLOP increased their cash distribution to $0.49 per unit, or $1.96 annualized, 3% higher than the third quarter of 2016 and the fourth quarter of 2015. Management plans to increase that number again from $0.49 to $0.50 in Q1 2017 — a 5% increase over Q3 2016.

The company also has a strong distribution coverage to ensure it continues to meet these payouts. The coverage ratio has stayed near 1.22x since GLOP’s IPO, consistently exceeding management's 1.125x target. The company expects to sustain this level well throughout 2017.

GLOP is a high-dividend, high-growth stock — something you don’t find too often. You’ll have both income *and* growth investors piling in with numbers like this, creating a great opportunity for us to ride the trend higher. We’re considering a position on a weekly close above the $24.85 level.

Trade Idea: Buy GLOP On A Weekly Close Above $24.85

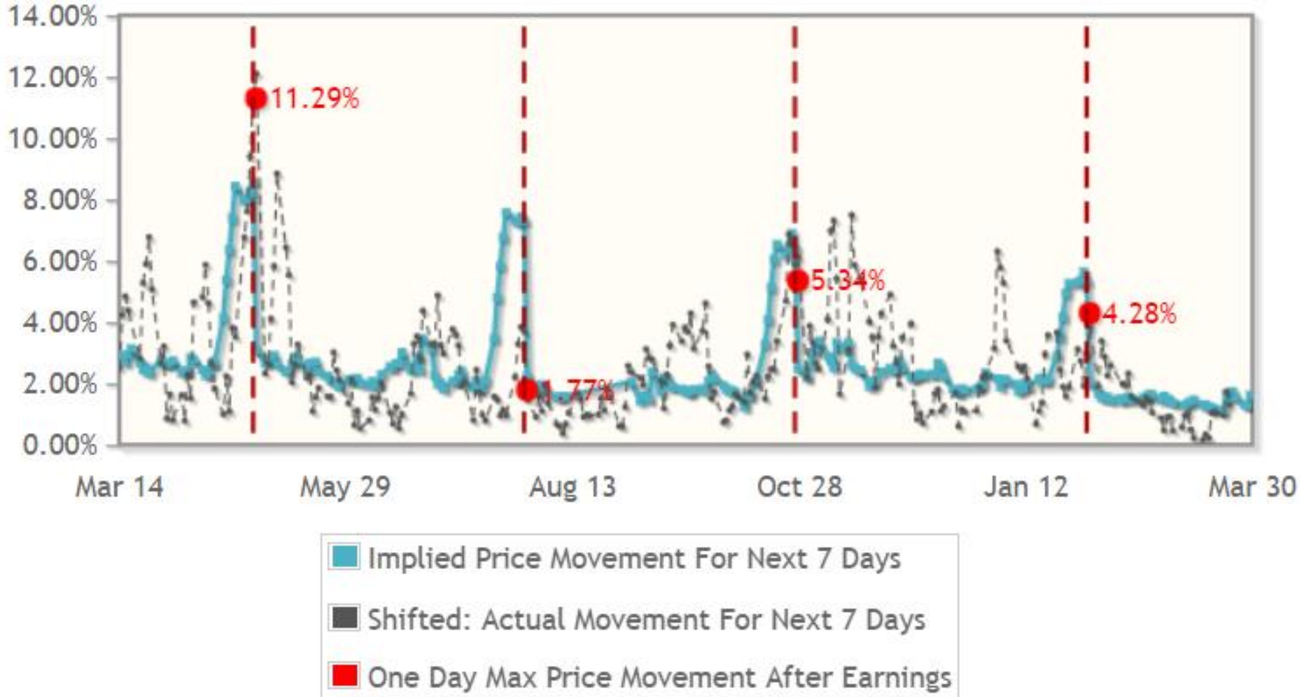
Quant: Election Volatility & FX Options

We like to cover all our bases. Along with our directional bets, we make sure to take some trades that are likely to win regardless of where European markets trend.

French Election Playbook

If you were with us in November, you'll remember how we played the U.S. elections through the volatility market. We'll dip back into that toolbox in preparation for French elections.

The way we play volatility heading into macro events is based off how vol behaves around equity earnings. Take a look at Amazon's option volatility below:



The red dotted lines denote earnings announcements, and the blue line is the implied volatility of the weekly options. The pattern is obvious. As earnings approach, traders bid up implied volatility. This reflects the increased uncertainty that comes with a new data release. After earnings are announced, implied volatility plummets as pent up uncertainty is resolved. You can see this in the chart. The blue line crashes to normal levels after each earnings date.

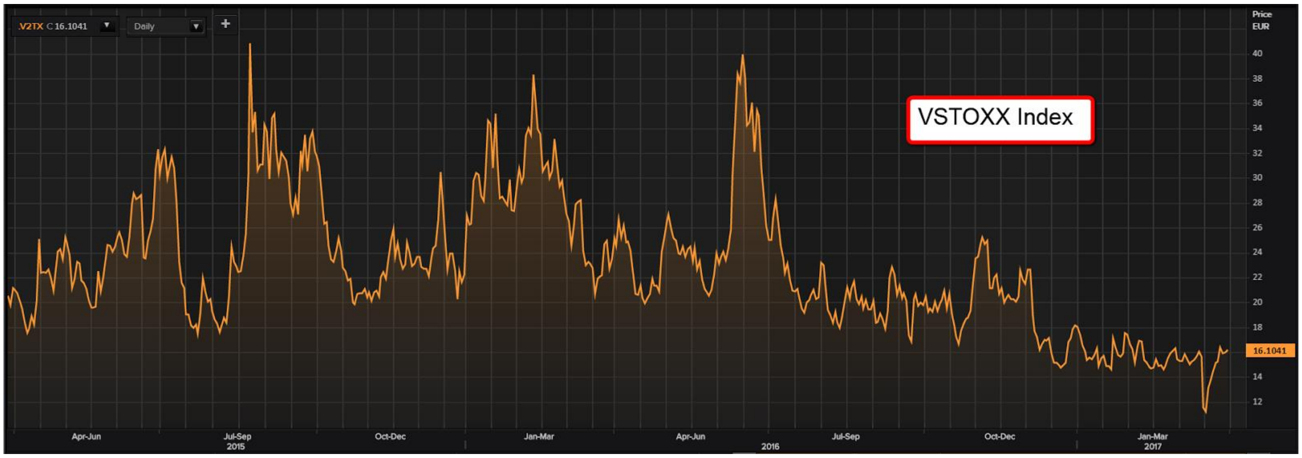
Extrapolating this pattern into macro land means being long vol into uncertain events. And then being short vol over the event in order to benefit from the vol crush that takes place after the uncertainty is resolved.

We executed this exact strategy during the U.S. elections. It played out perfectly. VIX ran up before the event and sold off hard afterwards.

The VIX puts we traded post U.S. elections were some of our biggest winners in 2016.

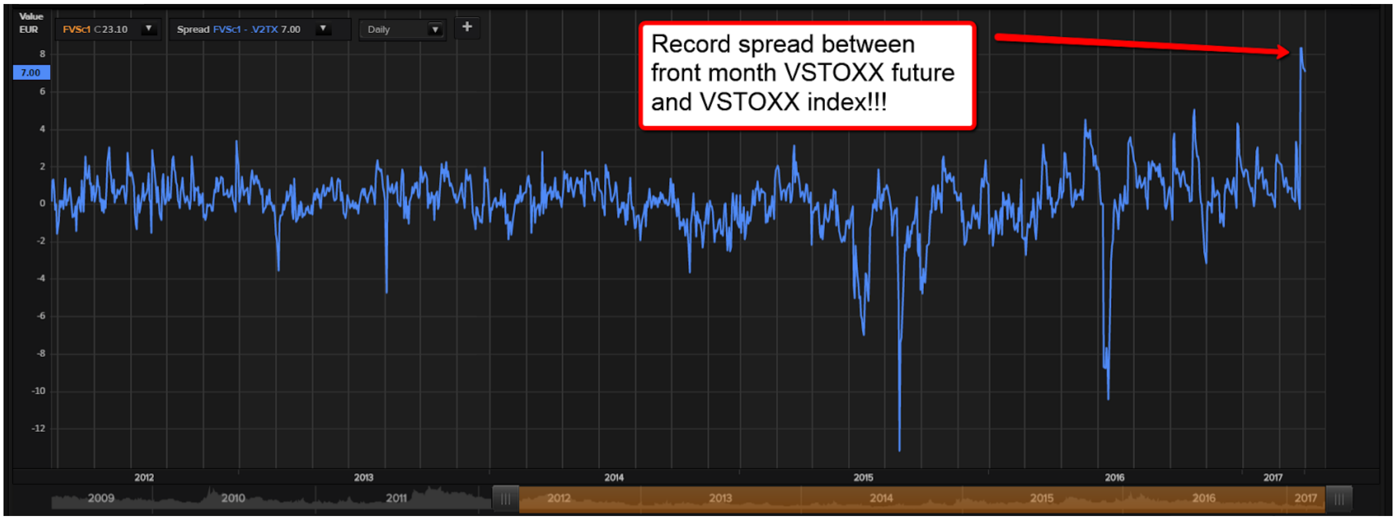
For the French elections we'll repeat the process — buy vol into the election and sell it over the election.

European equity markets have their own volatility index called VSTOXX. It's their version of the VIX.



They also have futures on VSTOXX, so just like the U.S. markets, it's possible to bet directly on vol.

But there's a problem with VSTOXX futures. They've already priced in the election move. The VSTOXX index is trading around 18 but the April futures are all the way at 23.50 already. Buying the April future leaves little reward for the trade. VSTOXX needs to spike 7 points before longs in the April future start making money.



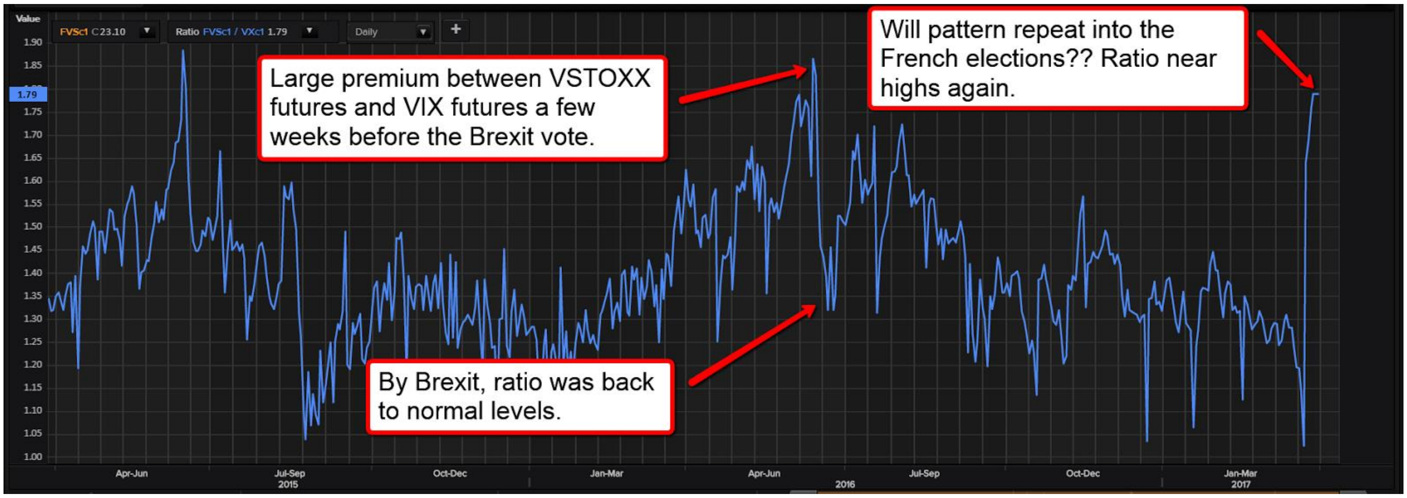
We can't bring ourselves to buy European vol into the elections with that type of setup. Too many things have to go right to win.

But the good news is that the trade is still playable through U.S. vol.

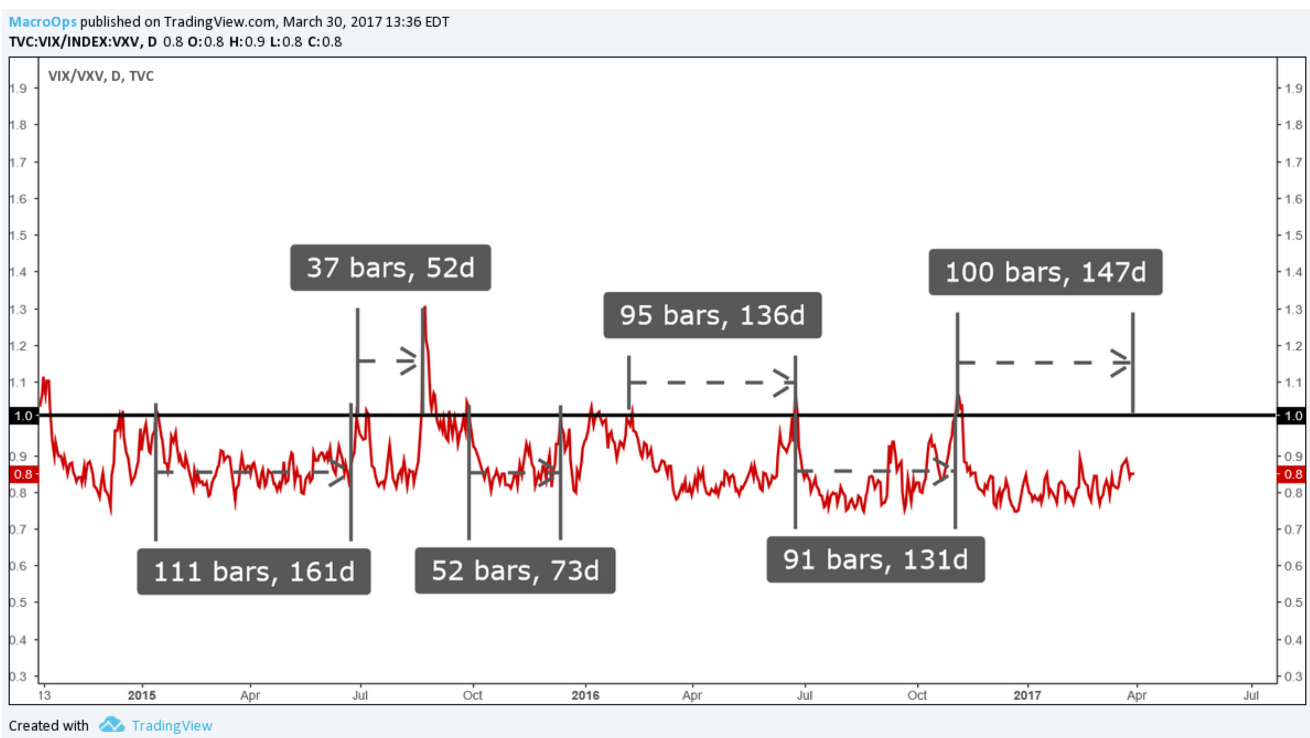
Even though this is a European macro event, the US VIX should move up as traders pay for cheap protection. Global markets are now connected to the point that a vol event in one area of the world usually spills over into the others. Buying VIX gives you long vol exposure to a French macro event at a much cheaper price.

Before Brexit, markets followed this exact logic.

European vol was extremely expensive prior to the vote so traders hedged using VIX derivatives instead. You can see this behavior play out in the chart below which shows the ratio between the price of VSTOXX front month futures and VIX front month futures. Back before Brexit, VSTOXX futures were really expensive relative to VIX futures. But then into the event the ratio collapsed. We're expecting the exact same thing to happen with French elections.



On top of the French elections catalyst, we've gone a long time without the VIX term structure inverting (represented by a value over 1.0 in the chart). You can see below that we're due for an equity market "scare" where stocks sell off and the VIX rips into the 20s, inverting the term structure.



We're considering playing this trade by buying UVXY. It has some of the best liquidity of any VIX product.

Historically it's best to buy vol about two weeks before an event. We're looking to execute this trade on April 7th.

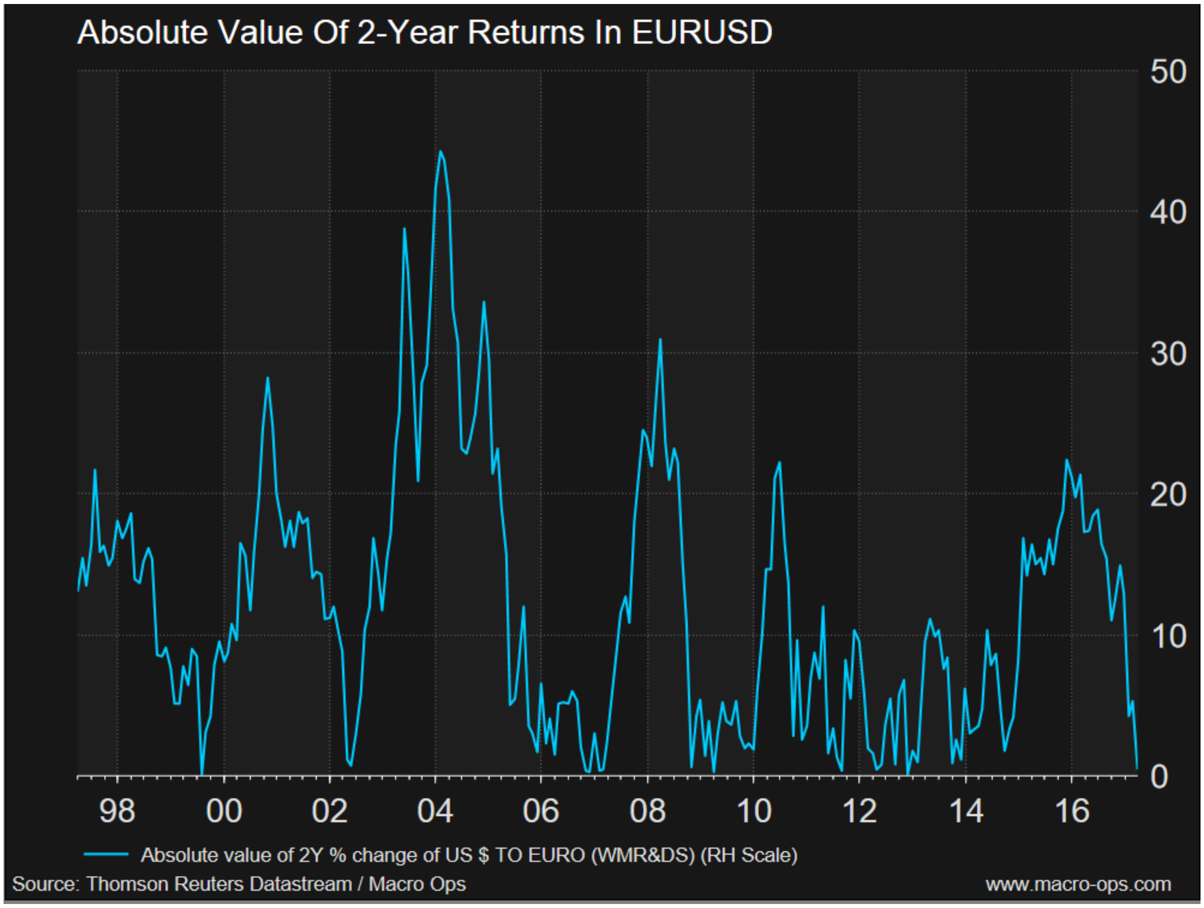
Trade Idea: Buy UVXY by April 7th, Sell Before Elections on April 23rd

EUR/USD: Going Nowhere

If you've spent any time trading EURUSD over the last two years then you know how much of a killing field the currency has been for trend traders. The cross rate has done absolutely nothing since 2015.

But the biggest moves come from markets that've gone sideways for long periods of time. You see this cycle across every asset class. Nothing perpetually trends and nothing gets stuck in a range forever.

This cycle is evident in the chart below that plots the absolute value of 2-year returns on the euro currency since its inception.



There's an obvious reversion function at play here. Whenever the graph touches the 0 line, it tends to bounce hard, meaning the EURUSD has a large move (up or down). Once the large move occurs, the EURUSD starts to range again, causing the line to collapse back towards 0.

The graph above spiked back down to 0 this April due to EURUSD's tight 2-year range. This pattern implies that a big move is on the horizon. This makes sense given the Eurozone's political backdrop. There are plenty of macro catalysts this year that could push the currency out of this range.

The best part about this setup is that we can bet on it while remaining directionally agnostic. Buying an at-the-money straddle (where you purchase both the put and call at the same strike) on the EURUSD ensures that we win as long as the currency has a big move up OR down.

The key with FX options is to only purchase those that are set to expire far out in time. If you read our recent article on Jim Leitner, he talks about this in more detail. Short-term options (those expiring under 90 days) are always overpriced. Long-term options on the other hand are a good value. Price usually trends enough within a year to overcome theta costs.

To test this setup we went back and examined the return for a 1-Yr ATM straddle in EURUSD after a two year range. The results of the study are below:

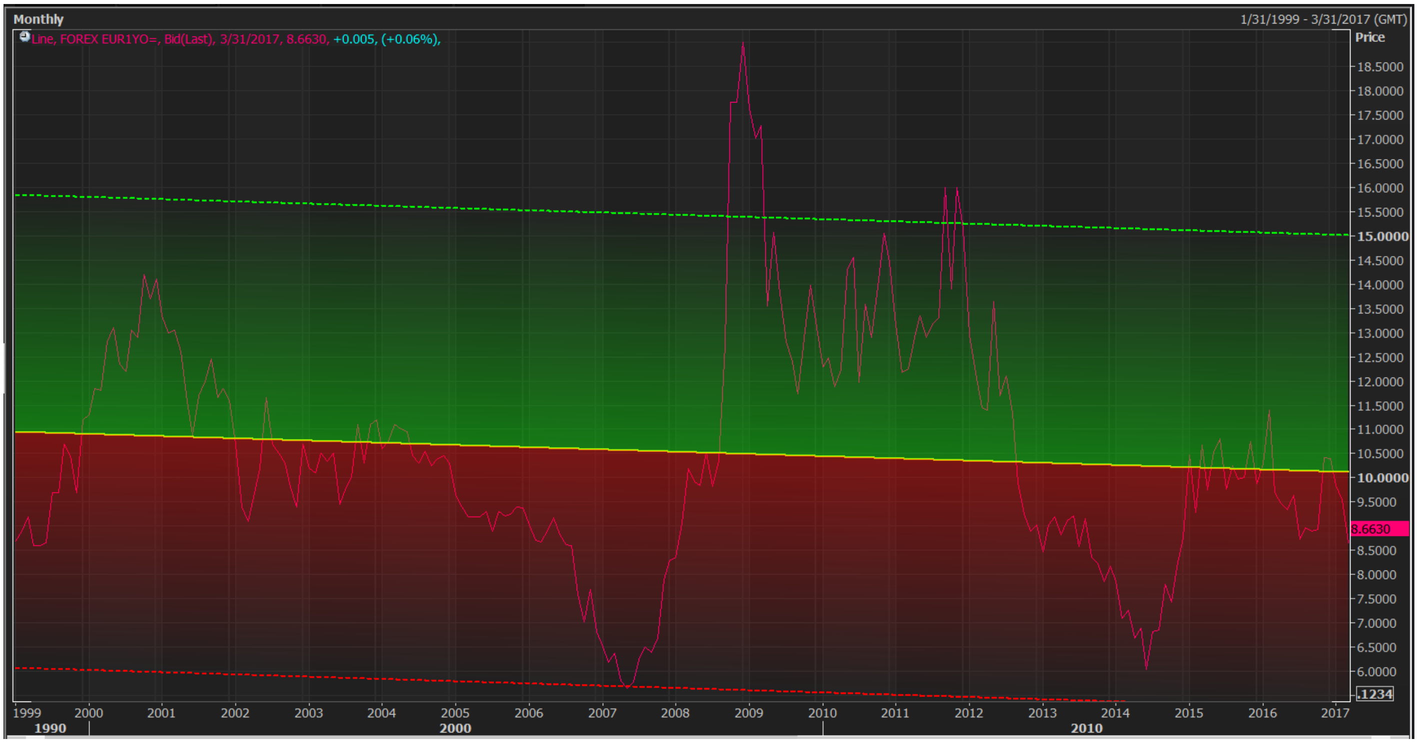
EUR 2-Yr Return at 0%	Price	Price 1-Yr Later	1-Yr Return	EUR 1-Yr Implied Vol	Difference	Straddle P&L
July 1999	1.0703	0.9268	-13.41%	9.70%	3.71%	38%
April 2002	0.9002	1.1172	24.11%	9.60%	14.51%	151%
November 2005	1.1787	1.3241	12.34%	9.40%	2.94%	31%
November 2006	1.3241	1.463	10.49%	7.70%	2.79%	36%
Oct 2008	1.2738	1.4712	15.50%	17.75%	-2.25%	-13%
November 2009	1.5005	1.2982	-13.48%	13.98%	-0.50%	-4%
November 2010	1.2982	1.3445	3.57%	15.05%	-11.48%	-76%
April 2012	1.3238	1.3166	-0.54%	11.40%	-10.86%	-95%
September 2013	1.3525	1.2626	-6.65%	8.35%	-1.70%	-20%
September 2014	1.2626	1.1175	-11.49%	7.80%	3.69%	47%
March 2017	1.0666	???	???	8.65%	???	???

The dates on the left are when the signal triggered. If you took every straddle and held for the entire year without trade management, the total return was 96%. There's clearly an edge here.

The stretch of losers after the 2008 crisis are because implied vol (IV) rose substantially higher. This caused ATM straddles to become expensive which made it tough for the currency move to overcome the high IV cost.

This is why it's important to make sure you buy options at a relatively low IV value. If you buy high IV, the probability of the trade working plummets.

The graph below shows 1-Yr ATM IV for Euro options since 1999. The yellow line in the middle is the average value. Any reading in the green area indicates that IV is rich relative to the long-term average. And any reading in the red indicates that IV is cheap.



All the losses in our backtest, except for the September 2013 trade, took place while the ATM IV was trading in the green zone. We want to avoid buying options if IV is within that zone.

Lucky for us, 1-Yr ATM IV is reasonably priced right now at 8.66%. Going long EURUSD straddles is attractive.

There's an ETF available to play this trade — FXE. The Jan 19th 2018 103 straddle is trading for around $6.59. If you buy the straddle, you need FXE to move more than that amount either way to turn a profit.

The quant data supports this trade and the deal is sweetened by potential political surprises in Europe.

This trade will also act as a cheap hedge against a basic stock portfolio. Equity volatility tends to spill into FX markets when things get really bad. Having a position in your book that benefits from extreme moves will alleviate the pain of a large market drawdown.

Trade Idea: Buy FXE Jan 19th 2018 103 Straddle for $6.59

Portfolio Snapshot

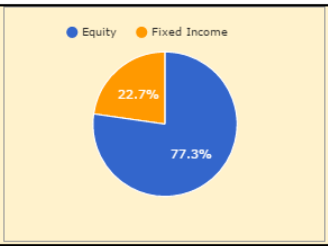
Strategic Ops

NAV $1,148,813

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Notional
Equity	Goldfield GV	1,000	$3.89	$2.52	$1,370.00	$4.50	$7,000
Equity	Century Aluminum CENX	400	$11.11	$7.55	$1,424.00	$16.55	$26,860
Equity	GAIA	7,600	$9.88	$8.50	$10,488.00	$13.75	$48,500
Equity	Videocon VDTH	2,900	$11.27	$9.26	$5,829.00	$17.45	$32,625
Fixed Income	30 Yr-Bond Futures (ZBM7)	6	$146.69	$145.75	$5,625.00	$153.00	$890,952

Metrics

Exposure Breakdown	
Equity	$19,111.00
Commodity	$0.00
Fixed Income	$5,625.00
Forex	$0.00



Total Open Risk

$24,736.00

2.15%

**Updated 4/4

Volatility Ops

NAV $1,231,000

Asset Class	Position	Size	Cost Basis	Notional
Volatility	June 21st VIX Future	-36	$15.00	-$543,600
Commodity	Crude Oil May 2017 48.5 P	11	$1.06	~

Scenario Analysis/Stress Tests

Max Loss -$350,000

**Updated on 4/4

Asset Allocation Weightings

Asset Allocation Weightings	Underweight	Neutral	Overweight
EQUITIES			
Large Cap Growth		x	
Large Cap Value			x
Small Cap		x	
Mid-Cap		x	
International Equity			x
Emerging Market Equity			x
Cyclical			
Materials		x	
Gold		x	
Commodities		x	
Consumer Discretionary			x
Financial Services			x
Real Estate, Domestic		x	
Real Estate, Global		x	
Sensitive			
Energy		x	
Industrials			x
Technology			x
Telecom		x	
Defensive			x
Consumer Staples	x		
Healthcare			x
Biotech		x	
Utilities	x		
FIXED INCOME			
Preferreds		x	
Government Bonds		x	
Corporates	x		
Munis	x		
Long Duration		x	
Intermediate Duration		x	
Short Duration	x		
High Yield	x		
TIPS			x
Emerging Credit	x		

For more information about real time portfolio updates please email alex@macro-ops.com