MAI VIEW

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Weaponized Equity

Recent all-time highs in global equity markets are drawing popular attention away from an even more recent migration to safe assets. It is too early to be sure, but this budding migration to safety may be poised to take flight.

One thing of which we are sure is that global equities have been very well-sponsored across the world, implying confidence in economic growth, modest inflation, political stability, and strong corporate profits:

Graph 1: S&P Global 1200

Source: https://us.spindices.com/indices/equity/sp-global-1200.

As Virgil warned, however; "don't trust the horse, Trojans." Treasury prices, gold and Bitcoin have recently found renewed interest, suggesting global wealth holders are beginning to hedge their bets. We believe this was inevitable and is prudent now. Indeed, we have been long treasuries in the expectation of a global economic slowdown. As we wrote February 27 (Buy Bonds/Sell Junk):

> "One of the best trades for risk-adjusted capital appreciation today, in our view, is owning long duration treasuries in anticipation of much lower yields. A 100 basis point decline in thirty year Treasury yields would produce 18.2% capital appreciation, not including interest income or any currency impact foreign investors might experience. *We expect a minimum return of 25% (unlevered, in dollar terms) from Long Bonds by year-end 2018*."

Since then, long-bond yields have fallen from 2.98 percent to 2.81 percent (albeit not before rising a little in March). The bullish trend remains in place and we expect significantly lower yields…

Graph 2: Treasury 30-year Yield

Source: tradingeconomics.com; Federal Reserve.

…as US and global output growth trend lower. Equity investors seem to be ignoring the seven year-old decline in world GDP from 5 to 2 percent, and how that well-established trend may be extrapolated.

Graph 3: World GDP

Source: http://www.economist.com/news/economic-and-financial-indicators/21694998-world-gdp.

Gold has also found strength recently and may be on its way to test three year resistance levels:

Graph 4: Gold (in USD)

Source: tradingeconomics.com; OTC.

And as we noted in [Gold, Dollars & Bitcoin](), the recent meteoric rise in crypto currencies also suggests something untoward for risk assets may be afoot:

Graphs 4 & 5: Bitcoin/USD & Ethereum/USD

Source: coindesk.com

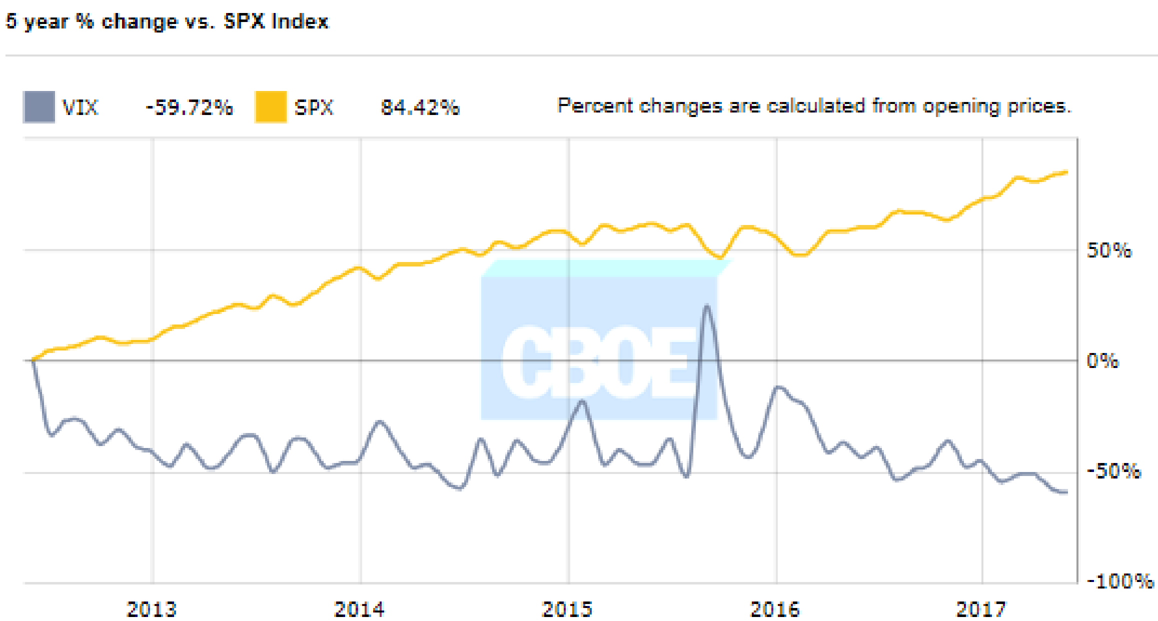
Finally, very recent weakness in the US dollar may further suggest all is not up to snuff:

Graph 6: DXY

Source: http://www.marketwatch.com/investing/index/dxy/charts.

Interestingly, the US equity market has been making new highs as market volatility is making new lows. In itself, this does not forewarn anything. However, the widening gap does suggest a dangerously asymmetric return setup should trends reverse. Small losses would be exacerbated.

Graph 7: VIX



Source: http://www.cboe.com/products/vix-index-volatility/vix-options-and-futures/vix-index/price-charts-on-vix.

As macro allocators, we seek to identify rationales and causes for prospective trends, both continuations and reversals. In this case, we are looking at contemporaneous cross market activity and matching it to macroeconomic rationales and causes we have identified. To a hammer, everything looks like a nail, and so we admit a bias towards trying to fit market action into our world view.

The reality is we spent most of our career as a bond and option trader/investor. We know that markets ultimately find their center – price points at which economics, funding, sentiment and valuations equilibrate. The macroeconomic discussion points we cite each week provide the foundation for further market, sector and asset exploration. We run the risk of being fooled when we see certain market "tells" begin to move in a direction we anticipated they would. But that is also what separates cognitive asset allocation from passive investing and investment programs defined solely by extrapolation that may no longer be relevant.

We think the reasonable course to take today for most investors is incremental action. Proportional re-weightings towards a more cautious outlook and/or new allocations that would benefit from an unexpected shift in sentiment and rising volatility.

We cannot know the timing or catalyst(s) that would bring unexpected change: a de-fanged White House that threatens the re-inflation scenario; a shooting war in the Middle East that would further threaten 70 year-old NATO doctrines; a poor economic or earnings report that would lead to significant technical price changes of critical, workhorse assets; a paradigm shift in the way wealth is measured that would leave financial asset investors questioning the soundness of their long-held investment beliefs; or a Black Swan we have not considered?

From a risk/reward context it pays to note all warnings and take action when we judge them to be reasonable threats. Our point is that the true threat today is not news and potential tail events per se, but rather that they have weaponized equity markets.

When (not if) market sponsorship shifts, the majority of participants will suffer relative to their expectations, fixed obligations or liabilities (though not necessarily relative to each other). Most will stay dormant and suffer. A few will profit handsomely.

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