SPECTRA MARKETS

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am
FX

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Puzzle: How do you cut a standard cake into eight equal pieces, using just three cuts.

Current Views

Flat

It’s still sell rallies

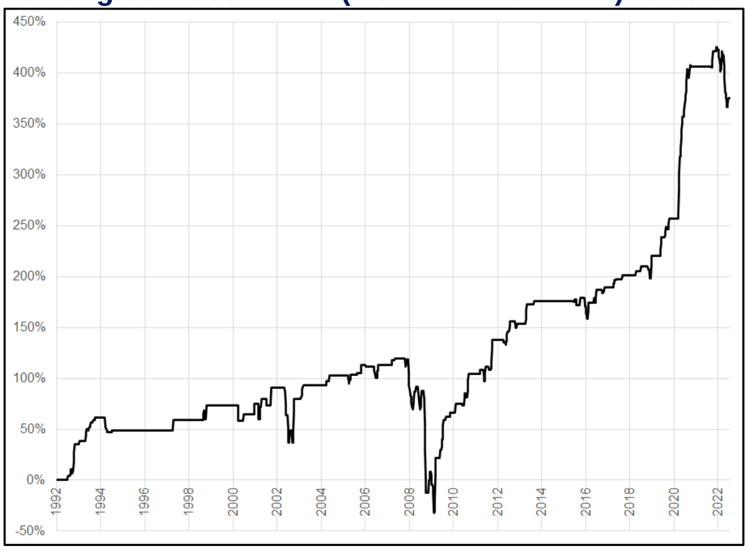
I am back after a week off. Looks like a lot of bad news / good price type of stuff going on in the market since CPI as we have this continuing phenomenon where everyone thinks that everyone is short equities, so everyone wants to be long. It reminds me of the old Yogi Berra quote: “Nobody goes to that restaurant anymore, it’s too crowded.”

This is how the entire bear market has been: Most people are structurally bearish but frequently square up or turn tactically bullish because of sentiment and positioning readings. My feeling is that this is mostly a product of a Pavlovian buy the dip mentality that has worked for the past 13 years. The problem is, sentiment and positioning are directional in bear markets, not contrarian.

AAII is the best data series for equity sentiment because CFTC positioning data doesn’t go back all that far (plus, if you backtest it, CFTC data tends to be more trend following than contrarian.) AAII is a survey of retail investors that produces a BULL, BEAR and NEUTRAL score. If you take bulls minus bears, a reading of -10 or lower occurs about 16.5% of the time. The current scores are: Bulls 27, Bears 47 for a net of minus 20. That’s in the 93rd percentile of most bearish outlook in the series.

A simple contrarian strategy is to buy stocks when the reading is below minus 10. Here is the P&L of doing that strategy with a 1-month holding period (back to 1992).

P&L of long S&P 500 if AAII (BULL minus BEAR) is below -10



Using weekly data, holding the position for one month

The main takeaway is: QE is very conducive to buy the dips strategies. This is obvious! All the positive returns are from **2009 to 2013** and **2020 to 2021**, the two main periods of raging QE. The strategy did not work from 1993 to 2009 and it got rekt in 2008 as you might have guessed. It was decent 2016 to 2020, even though QE was not in play.

Sentiment and positioning indicators are not particularly useful in bear markets and the reflexive buy the dip mentality is a product of a long, long period where it worked. I continue to believe that the buy the dip mentality that has pervaded all the way down continues to be misguided. Slowing growth and sticky inflation are more important than CFTC or AAII data.

What about the bad news / good price from last week's CPI?

I am a big believer in bad news / good price as an indicator (I wrote a piece about it here, for example). The thing is: bad news/good price is a short-term indicator that generally reflects excessive positioning into or after an event. That is, if the market was max long USD and short equities into CPI and added after the 9.1 dropped, the subsequent price action can be counterintuitive (bullish) but only for a bit. It doesn't mean we need to go back to 4300 in SPX. In other words, the bad news/good price story is probably played out for now and the weak positions with bad entry points have likely been rinsed.

The table here shows the CPI surprise dates since the Fed dropped "transitory" last year, along with SPX change on the day of the release (t) and then 3, 5, 10 and 20 days after the release. You can see the bad news/good price rebounds after strong CPI in NOV2021, APR2022, and MAY2022 were all short-lived. My guess is the situation here is similar.

Date (GMT)	SPX	core suprise	t	t+3	t+5	t+10	t+20
11/10/2021	4,642	0.20%	-0.8%	0.8%	1.0%	1.2%	0.5%
1/12/2022	4,716	0.10%	0.2%	-3.1%	-5.1%	-8.4%	-4.6%
2/10/2022	4,498	0.10%	-1.8%	-0.7%	-2.7%	-2.6%	-6.6%
4/12/2022	4,393	0.20%	-0.4%	-0.1%	1.4%	-4.8%	-10.5%
5/11/2022	3,930	0.20%	-1.7%	1.9%	-0.2%	1.2%	2.2%
6/10/2022	3,899	0.10%	-3.0%	-2.7%	-5.7%	0.1%	-1.9%
7/13/2022	3,805	0.20%	-0.5%	2.4%			

So… Get short stocks and long dollars again? Meh, not yet. My feeling is that there is nothing special about this exact moment in time that suggests any tactical reason to fade the rebounds. This is not an urgent call to action to reload equity shorts or dollar longs. The point is more:

1. If I was long equities or short USD for a reversal play, I would be getting out here as I think we enter a choppy and random consolidation for a bit.
2. Sentiment and positioning are not that useful if we are still in a bear market. I believe we are going to do another big leg lower in stocks at some point as earnings pressure, global recession fears, curve inversion, demand weakness, and sticky inflation are still the main story. Dreams of Fed cuts or a Jackson Hole pivot are premature.

That said, the rejection of 1.00 in EURUSD (the epicenter of the EURUSD strikes, and a key round number) along with the bullish price action in crypto and NFTs, as discussed in my last crypto piece "MacroTactical Crypto: Intriguing Resilience") makes me think that two-way action is the play, and there is no huge rush to get aggressively short right away. 3940 and 4140 are the two levels to sell SPX, depending on the depth of your reservoir of patience.

Housekeeping

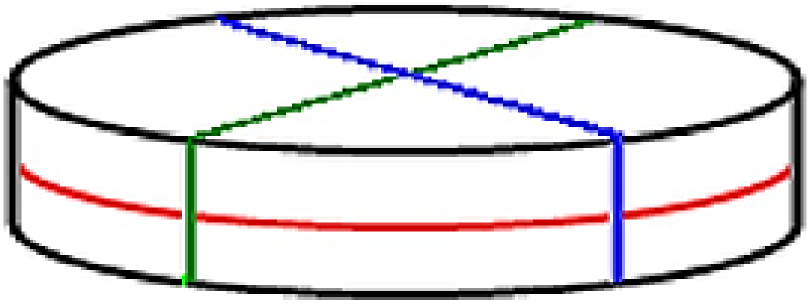
I cut the short EURJPY. My JPY view for the past few weeks has been wrong as I expected the cooldown in rates and commodities to lead to a cooldown in JPY flows. While Japan stopped buying USDJPY around the time rates and oil peaked, other time zones continue to go *nom nom nom*, gobbling up USDJPY for reasons I don't fully understand. I was just out for a week, and I don't want to get stuck with a stale view. I think I'm better off getting to flat and proceeding with an open mind from here.

Final thought

I spoke to a few friends and relatives involved in real estate in the Toronto area and they are saying bidding wars are gone and some listings are lowering prices by as much as 20% in an effort to transact. Volumes are way down, and buyers are in control. But there is no panic.

Have a sweet day.

good luck ⇅ be nimble



Cut one, red
Cut two, blue
Cut three, green

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