

# The Evolving Process



**Darius Dale**

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***“I agree you shouldn’t be in the business of using macro – most macro research does more harm than good.”***

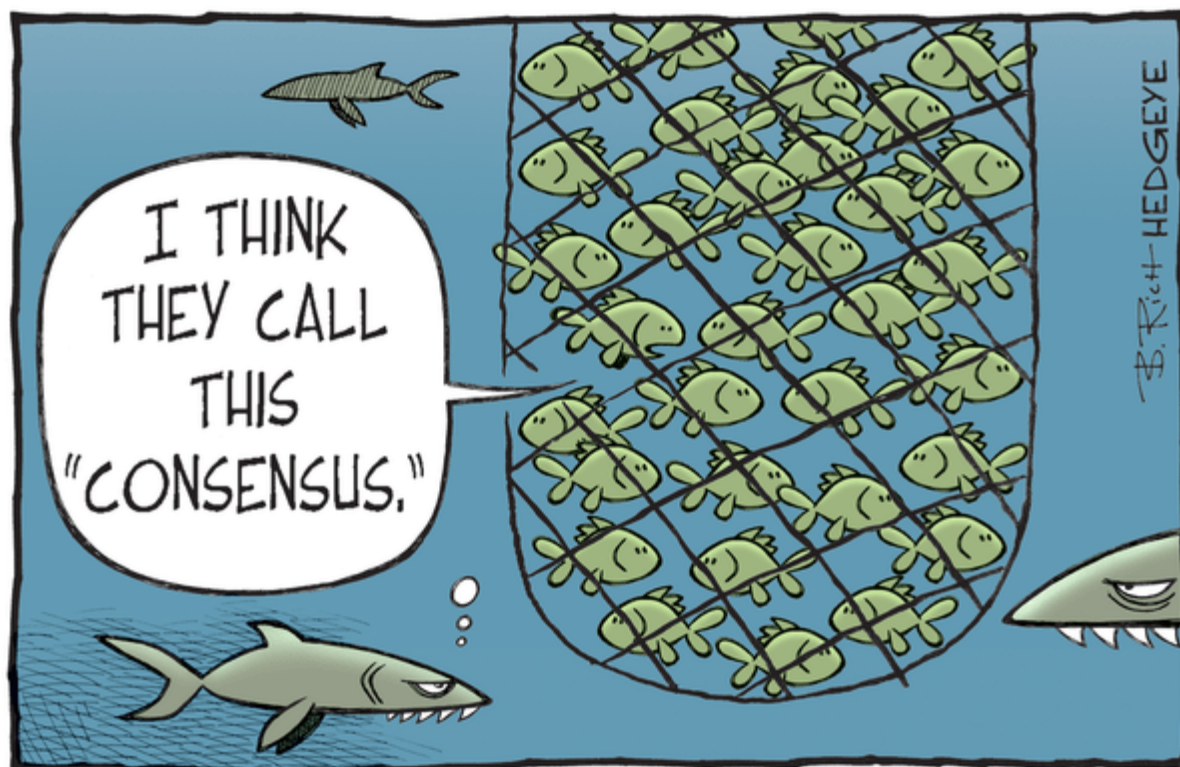
**-Keith McCullough**

It’s a bit awkward to quote one’s boss in their own widely disseminated research note, but I’m sure that many of you that have met with Keith and I over the years would attest to my [potentially biased] view that he’s got some pretty darn good one-liners.

That one often comes out in response to a prospective client at an equity or credit fund telling us that macroeconomic research is purposefully not a factor in their investment decision-making process – usually because they humbly submit that they do not yet understand how best to apply it, or are being honest about how an overreliance upon macro has blown them up in the past.

Indeed, most bottom-up investors would rather stick to what they know and we don’t blame them – we live in an era of peak macro tourism and pretty charts. The former tricks investors to hop haphazardly from one topic de jour to the next consensus macro risk. The latter creates a false sense of hope or despair about the future by relying upon [usually-contrived] linear relationships that most often fail to capture the full breadth of economic history.

Both are dangerous in that they force investors to constantly cede options premium and/or potential alpha in the process of improbable events failing to materialize.



Back to the *Global Macro Grind*...

If there is one thing that most differentiates our macro research from the click-bait feed on *Zero Edge* and/or our competition in the legacy macro research provider space, it's that we strive to avoid being macro tourists and producing pretty charts – almost to a fault.

That's not to say neither source adds value. When I started in this business “way back” in mid-2009 the former was an exceptional resource for learning about how complex financial intermediation systems and derivatives worked.

Fortunately for everyone involved, we never experienced that MASSIVE collapse they were calling for throughout the first ~half of my career (at least).

The latter can be a great resource as well. Unlike Keith, I've never consumed their research as a buy-side portfolio manager, so I can't attest to their respective track records. From what I can glean from the hundreds of client and prospective client meetings we do each year, however, they are a decent tool for aggregating investor consensus on whatever the macro topics de jour are.

We also get pushed a chart or two of theirs on occasion from a mutual client who is seeking more color on our likely differentiated take on said topic(s). As an honest competitor and the guy on our team most responsible for producing

“counter-analysis”, said pretty charts are usually quite hard to refute at face value. That being said, however, I almost always find one of three key faults with the underlying premises that support their analytical conclusions:

1. The charts don’t go back far enough to respect economic cycles. I mean, what does a 5-7 year chart depicting a relationship between two or more monthly or quarterly indicators *really* tell you?
2. Not only do the charts fail to consistently fully respect economic and financial market history, they generally assume the linear relationship highlighted in the analysis is likely to continue – perfectly on whatever awkward and/or unexplained lag they settled upon to make the chart look prettiest. That’s fine and I see no fault with that – other than the fact that markets and economies are constantly evolving in ways that introduce nonlinearity into what were previously the most stable of relationships. It’s our job as investors to anticipate what those catalysts might be.
3. The very nature of the analytics themselves fails to depict a consistent process. Sure, we have competitors that rely heavily upon key survey-based indicators such as PMIs and economic surprise indices and others that rely upon their valuation opinions, but what I don’t see is a *consistent* framework that tells investors exactly how financial markets are likely to respond to changes across their key indicators. Some don’t even consider why readings across their primary indicators might *change* in the first place; instead opting for an overreliance upon what the current level portends for some other indicator(s) in the future.

Since our industry tends to breed arrogance more than most, it’s worth mentioning that I don’t write this to be trite or condescending in the least bit. Everyone who has a seat at a major sellside or buy-side firm is some version of “really smart”, likely has a degree(s) from a highly reputable university and/or institute and consistently interacts and learns from other really smart colleagues and clients.

Indeed, there are a thousand ways to “skin the [investing] cat”, and I’m far from young and dumb enough to think our macro team has it all figured out ([we get things wrong all the time](#)). In fact, the truth is quite the opposite – we’re constantly evolving and learning more about what we didn’t/don’t know daily.

In that light, my favorite part about attending client meetings is the critical and occasionally contentious pushback we receive from someone with an opposing

view. It is through the process of producing research that refutes said pushback (or alters our own view) where I learn and expand upon our fundamental research processes most.

In recent client meetings, there have been two core areas of pushback that have prompted me to further expound upon our differentiated forecasting process:

1. Our bullish bias on domestic consumption and service-oriented growth and all the factor exposures we like on the long side that benefit from that; and
2. Our bearish bias on domestic and global inflationary pressures coinciding with a slowdown in European and Chinese growth that portend a recovery in the U.S. dollar, another leg down in commodity-based reflation and a reversal of the capital flows currently perpetuating EM outperformance.

We've obviously nailed the first view, across asset classes, so there's not much to discuss beyond the process points we reiterated in two notes this past Friday:

- [Early Look: #BuyMoreStocks](#)
- [RE: Q2 GDP: Not Your Average Recap Note](#)

Regarding the second view, however, it's worth re-contextualizing its key premise in the context of our fractal fundamental modeling process:

- **Backward-looking cyclical view:** Real GDP growth in the Eurozone accelerated to a 6.5-year high of +2.1% YoY in Q2, but all the leading data we've seen reported for Q3-to-date (PMIs, consumer confidence and business confidence to be specific) is suggestive of a negative inflection off those highs. Moreover, YoY core inflation has yet to breach the top end of the +0.6% to +1.2% range it's been stuck in for the last four years.
- **Forward-looking cyclical view:** Base effects for Eurozone GDP growth are incredibly challenging over the NTM, while base effects for Eurozone CPI continue to steepen.
- **Key secular forces:** Demographic headwinds get considerably more difficult throughout the Eurozone over the next 3+ years, while other key structural indicators suggest that Europe is still, well, Europe.

[CLICK HERE](#) to download the associated charts.

All told, the confluence of these three fundamental factors leads us to believe that our euro-inspired CORNHOLIO is likely to be relieved, at least in large part, over the intermediate-term.

It's worth noting that we've held a long-term TAIL bullish bias on the U.S. Dollar since the early part of 2013 and the DXY is up around +16% since then – inclusive of the -12% decline from its early-January high. “What have you done for me lately?” questions notwithstanding, we recognize that we've been explicitly wrong on the EUR/USD cross since it troughed on January 3<sup>rd</sup> – by +14.5% to be exact.

To be fair, Keith has shorted the FXE ETF in our Real-Time Alerts signaling product eight times since we introduced our intermediate-term TREND bullish bias on the dollar back in mid-November and only lost money once out of seven closed positions. Trading around core positions when they're moving against you is really difficult, but he's done so admirably, IMO.

Lastly and with respect to emerging markets, it's worth noting that the average YTD performance of the EM exposures we've liked on the long side (i.e. South Korea +31.8% and Taiwan +26.0% = an average of +28.9%) is far outpacing the average YTD performance of those we've liked on the short side (i.e. Brazil +15.6%, China +23.7%, Indonesia +11.1%, Mexico +28.2%, Russia -5.4% and Turkey +35.2% = an average of +18.1%).

So in the context of being heinously wrong on the direction of the asset class YTD (largely as a function of being wrong on the dollar), we're hopefully still helping investors find ways to generate alpha therein. That's something to build upon in our continual process of evolving.

Our immediate-term ***Global Macro Risk Ranges*** are now:

UST 10yr Yield 2.22-2.35% (neutral)

SPX 2467-2483 (bullish)

EUR/USD 1.15-1.18 (neutral)

YEN 110.04-112.40 (bearish)

Oil (WTI) 45.41-51.08 (bearish)

Gold 1241-1287 (bullish)

Keep your head on a swivel,

DD

Darius Dale  
Managing Director

## TIME BETTER BE DIFFERENT IN EUROPE

THIS TIME DARN WELL BETTER BE DIFFERENT IF YOU'RE BETTING ON A SUSTAINED RECOVERY IN THE EUROZONE **FROM HERE.**



DATA SOURCE: BLOOMBERG

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