"History doesn't repeat itself, but it does rhyme" -- Mark Twain

The quote above has been indelibly etched in my mind and I have thought about Mark Twain's observation often during my career of over four decades in the investment business. So, too, have I been influenced by George Soros -- arguably the greatest speculator in modern investment history. Both have taught me that markets don't necessarily change when fundamentals change; markets often change when beliefs change. **Back to the Future and Soros' "*Theory of Reflexivity*"** When Warren Buffett was once asked about the key to success, he pointed to a stack of nearby books and said, *"Read five hundred pages like this every day. That's how knowledge works. It builds up, like compound interest. All of you can do it, but I guarantee not many of you will do it."* Of all the investment books I have read in my life (and I have read many), George Soros' The Alchemy of Finance: Reading the Mind of the Market stands out. In his seminal book, George Soros describes his *theory of reflexivity*. It was what he attempted to write his PhD on, but the theory was tested in the way he applied it to the financial markets. The central thrust of the theory is that market participants are biased. As opposed to making consistently rational investment decisions, market participants jump on trends in a self-reinforcing and self-fulfilling manner. As opposed to trending towards equilibrium, the financial markets perform in line with the biased expectations of the participants. Such has been the case of the markets over the last few years and, particularly, during the month of January when volatility was squashed and a fear of missing out ("FOMO) was the prevailing sentiment/emotion -- in a market overshoot that took the S&P Index to close to 2900. Soros goes on to argue that the more people who believe in the efficient markets hypothesis, the less stable financial markets will actually be. Some of his comments with respect to what I call " groupstink"•are very prescient when we think about what happened in the sub-prime mortgage boom and in today's shifting and dangerous market structure (and the adverse impact it has recently had on share prices and increased volatility). Soros disagrees with the idea that markets trend towards equilibrium. He rails against the theory of perfect competition, arguing that imperfect knowledge is almost always the case. In fact, he argues that based on his observations in the financial markets that they tend towards excess as opposed to any form of reality-based valuation. He uses the rise of conglomerates in the 1970's to illustrate that executives started creating conglomerates simply because other companies were and because the price/earnings multiples for conglomerates were rising faster than other categories of stock. By jumping on the trend they could raise their share price and earn higher performance bonuses. (1970's executive earnings were several standard deviations below the obscenities of today). Eventually the conglomerates over-extended and suffered major losses. Up until that point no one took a step back and thought about things. They merely jumped on the trend. Finally, in his book, Soros argues that regulators are always one step behind the private sector. (And this is certainly the case of the SEC -- who fell asleep during the mortgage crisis in the mid-2000s as financial weapons of mass destruction were marketed around the world and today, with regard to volatility-linked products, that seem to be a distant cousin of those levered mortgage products). **The Current State of the Markets - Short Term Bullish/Intermediate Term Bearish** After the market closed on Thursday I wrote that I was turning more positive on the markets and I began to accumulate a trading long rental in Spyders at about $258 based on my belief that we were following history as a guide. (Here was my logic as expressed in that column in my Diary. Specifically, the last structural market liquidity event, the *Portfolio Insurance* -- inspired decline in October, 1987 exhibited a pattern that could be repeated in 2018's liquidity event which was importantly influenced by the breakdown in volatility linked products (which had accumulated to over $1.5 trillion in invested assets) -- a concern I held on to for the last several months. That October, 1987 pattern of a Monday waterfall decline, followed by a "Turnaround Tuesday" and then a quick retest later in the week of the early morning Tuesday low -- may, I suggested, be repeated again in February, 2018. The early Tuesday morning (premarket) low of 2545 on the S&P futures (and $254.50 on Spyders) also coincided with an important moving average for the S&P Index:

Source: The Divine Ms M.

In Friday's tumultuous trading session, the S&P Index had more moves than a shortstop batting .110. First up, then down dramatically, then a rally, then another drop, followed by a remarkable rally in the last hour -- the markets indeed tested (and fell slightly) below the critical Tuesday futures low and stopped at the moving average (see the chart above). **It is my view that, at 2535 (at about 1:40 pm on Friday) we hit a capitulation trading low.** Following the first retest in late October, 1987 -- the markets rose by about +11%.•A similar move would take the S&P back to about 2800 -- but I believe that is too optimistic. Given current headwinds, a gain of closer to +7% to +8% from Friday's bottom seems more probable (2725 S&P). So, if the historical relationship holds, we will rally some more over the near term and then have another retest in about 5-6 weeks from last Monday's waterfall decline. The balance of the year will likely be challenging as described ahead in this post.•

Markets Often Change When Beliefs Change, Part II

Panic equals opportunity -- at least for the near term. Early (6:00 am) on Friday morning I was interviewed by Tom Keene and Jonathan Ferro on Bloomberg's *Market Surveillance* to discuss my changing view that the past week's market drop has provided the opportunity for a "tradeable rally." Here is an excerpt of that interview. Before my interview, Tom had asked another guest what would be an exogenous shock to the markets. I mentioned that it was my view that we are already seeing the exogenous shock in a vol inspired unwind... and I began to explain why the market pressure could be over shortly, perhaps even before pitchers and catchers meet in Spring Training in 3 days 17 hours and 58 minutes! For a perspective, I asked Tom for two minutes to give some historical perspective and summarize my more optimistic view. Here is basically what I said:

> *"I could parade my mistakes down Fifth Avenue but some of the things that I have learned about the history of the markets over the last few decades provide a lesson and a blueprint for how to act in the present in order to deliver good returns in the future. As you might recall back a few years ago Warren Buffett asked me to be Berkshire's credentialed bear and spray him and Charlie Munger with a bunch of tough but respectful questions about Berkshire Hathaway's future prospects in Omaha at his Annual Meeting. With the help of three of my analysts -- Scott, Nick and Kelley -- I did a lot of research in the formulation of those questions. In doing so I learned some important lessons from the Oracle -- that I carry today and that have relevance to the last six trading sessions. When I think about the pernicious impact of volatility linked strategies on the markets -- which has resulted in a devastating 160 point decline in the S&P since 3:30 pm in the afternoon on Wednesday (that is in only one trading day plus 30 minutes) I am reminded of Warren's quote: "In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497." And at the core of his investment tenets was the notion "to be fearful when others are greedy and greedy when others are fearful." British banker Nathan Mayer Rothschild put it another way, "Buy at the sound of cannons, sell at the sound of trumpets." In other words, in trading and investing Warren has taught us that we should pay attention to history, that it pays to be emotionless and we should impassively move on opportunities that represent themselves -- when market prices adjust and represent a reasonable discount to intrinsic value. Three things have happened in the few weeks, last week and yesterday that has caught my attention -- First, for the first time in a long while over the last few weeks, stocks and bonds have declined together -- precipitating the delevering*

of volatility linked strategies and products. Secondly, according to my friend Rev Shark in three of the last five days 90% of the stocks, on a daily basis, have declined. This is the second time in 80 years that this has happened. The last time was May 17, 1947, ending a 28% decline in the DJIA. At that time soldiers were returning from war and there was concerns that factories which had been producing war supplies would be idled. Stocks then turned around a bit. Thirdly, look at the CNN Fear and Greed Index -- it hit a level of 8/100 at the close yesterday, that's extreme fear -- it was at 90-95/100 a few weeks ago, extreme greed. I want to be clear how large the vol problem is. A competitive network last night discussed the small amount of ETF vol products (say $2 billion) that are the tail that is waging the markets dog. But there is much more behind this. There is $1.5 trillion of risk parity, vol target, vol trending and CTAs employing vol related strategies! ***That said, in the absence of any apparent change in fundamentals or any profound further rise in interest rates (which were contained yesterday and are unchanged this morning), we must be reactive to changes in sentiment and valuation and use some history as a guide."***

So to quote Marvin Gaye:

> ***"You know I've got to finda way/to bring some loving here today."*** *•-What's Going On?*

Markets Often Change When Beliefs Change, Part III

A Troubling Intermediate Term -- The Top Nine Reasons for Concern

> *"We are seeing the beginning of the end of the post-crisis monetary regime. Many people believed it would continue forever, but it was unsustainable. The new world is going to be far less hospitable to those who don't understand how to manage risk or who are unschooled in financial history. And those who looked like Olympic swimmers in a bathtub are now swimming in the ocean in the middle of a hurricane."* • Michael Lewitt, *The Credit Strategist*

I remain concerned that, after the rally I expect over the near term, that markets will retest and likely undercut the previous lows made last Tuesday sometime in the next month or so. I hold to the view that the following headwinds would result in a down year for the S&P Index:

1. ***Policy Risks (Already Put In Place) Abound and There Is An "Orange Swan" In the White House:*** *Deficit -- financed tax cuts (which will likely trickle up and not down) and now government spending increases in a full employment economy is poor economic policy. With $20.5 trillion in debt, (among the largest countries in the world) the U.S. is now only behind Greece and Italy as a percent of total debt to GDP. When President Reagan was cutting taxes, debt was was 30% of GDP -- now the U.S. debt is 104% of GDP. With the recent budget deals (see here and here) all the proposed infrastructure and military spending, borrowing needs will explode this year and next. Goldman Sachs estimates at least $1 trillion of new net debt issuance, even with GDP growing over 3%. The U.S. savings rate is the lowest on record (2.4% and dropping), so we will need to beg foreign nations (especially China) to lend us money at a time our currency is weakening.•The Administration's dysfunction, disorganization and personnel turnover is worrisome. Potential risks of trade wars and other unforeseen policy mistakes abound.*
2. ***Strategies and Products Have Inflated Markets****: Investors have underestimated the cumulative impact of a fundamental change in market structure -- with buying associated with*

the popularity of exchange traded funds and quant strategies (e.g. vol targeting, risk parity) buoying stocks since 2013. We are likely in a "regime change."

3. ***The Changing Market Structure is Dangerous***: *It took nearly a decade for the number of ETFs and ETNs to outnumber the amount of publicly traded companies on the exchanges. It took nearly a decade for the quant strategies (short vol, risk parity, volatility trending, etc.) -- who worship at the altar of price momentum and slam vol at 3:00 pm every day -- to dominate over active investing. Though inverse volatility related ETFs (e.g. XIV and SVXY) stood at only about $3.5 billion (at its height in January), volatility linked strategies are estimated to total over $1.5 trillion Something makes me think that this seismic shift in the market structure that took approximately 10 years in the making to develop -- is not going to end in several trading sessions.*
4. ***The Era of P/E Mutliple Expansion Is Likely Over:*** *Despite protestations from some quarters, the market rise over the last few years has been materially driven by an expansion in valuations -- precipitating a distorted and delusional reality and a Bull Market in [Complacency].*
5. ***Bonds Remain Bubblicious***: *Rising interest rates is the most significant potential headwind to the US Stock Market -- in our leveraged financial system this statement stands taller than before. Today, as previously written, the two year US note yield stands at 2.17% compared to only 1.78% dividend yield on the S&P Index. Moreover, every dividend discount model has, at its core, "the risk free rate of return" in making the valuation calculus. (Note: I am quite bearish on bonds and have held a large short position since I perceived "A Generational Low in Bond Yields" 1 1/2 years ago). Interest rates are moving higher -- perhaps much higher. With wage inflation rising, a huge treasury supply at the same time the US Dollar is moving lower and with the Federal Reserve reducing its balance sheet -- the yield on the ten year US note will likely approach 3.5% in 2018, with risk to the upside.*
6. ***More History Lessons:*** *Especially at inflection points, bear markets are borne out of good news (September, 2007) and bull markets emerge from bad news (March, 2009).*
7. ***Another Long Boom of Uninterrupted Economic Growth? Unlikely!:*** *Market tops are almost accompanied by the perception of a new paradigm (of uninterrupted economic growth and no meaningful market corrections) and speculation (i.e. crypto currencies, which peaks a few months ago). The outlook for global economic growth in 2019 is deteriorating -- especially as I suspect, financial conditions erode as the year progresses.*
8. ***A January "Minsky Moment" in Volatility and a Top in Euphoria:*** *Market tops are associated with extreme investor optimism, large retail inflows and high valuations. These factors were all in place when we had a a record $55 billion of retail inflows into domestic equity funds coupled with a flush to new all time lows in volatility*
9. ***Volatility Is At a Crossroads***: *In a market dominated by ETFs, short volatility strategies and Quant strategies (risk parity and volatility trending, etc.) -- buyers live higher and sellers live lower! Be forewarned -- as we may start to resemble October 1987 when portfolio insurance was the catalyst to a large market dive. At the extreme, volatility will continue to represent a challenge to many investors.*

The Bottom Line

Here are my major investment conclusions:

- *Look to History As A Guide to Our Markets*
- *A Short TermTradeable Rally May Have Emerged Following a Capitulation at 1:40 pm on Friday and a Retest of the Tuesday Morning Futures Bottom*
- *But The Current Market Rally Is Likely A Continued Part of the Topping Process and, At Some Point, Should Be Sold in Preparation for a Turbulent 2018 That Will Be Filled With*

Opportunity

- *Risk Parity Remains A Continued Threat To Our Markets -- Not Inverse VIX ETFs (Which Have Been Obliterated in Price)*
- *I Am Near Term Bullish and Intermediate Term Bearish on Stocks*
- *I Remain Very Bearish of Bonds -- On any Timeframe*

I bought Spyders on Thursday evening and during Friday -- and I have moved into a net long exposure in equities based on history and a successful test of the Tuesday morning futures low and of a major moving average (of about 2450 on the S&P Index). I have also based my tactical move on a sharp reversal in investor optimism (seen in an abrupt move from record retail inflows to record retail outflows from domestic equity funds) as well as other indicators like the CNN Fear and Greed Index, among others. It is my view that the S&P Index is no longer materially overpriced, just somewhat or less overpriced at the close on Friday than it was in late January. The Bull wont likely *"Die As Easily"* as bears hope. Dip buyers may have disappeared for a week, but I suspect with Thursday and Friday's successful tests we can rally over the near term. Following the first retest in late October, 1987 -- the markets rose by about +11%. A similar move would take the S&P back to about 2800 -- but I believe that is too optimistic. A gain of closer to +7% to +8% -- off of Friday's bottom -- seems more probable (2725 S&P). It also means that some individual stocks finally meet my criteria -- as we don't have to be index confined. Though many should wait until the ground hardens, given my risk profile, I have a tendency to be more bold and anticipatory -- shorting into ramps and buying/covering into dips. For now, large cash reserves are still in order -- but maybe not as aggressively as two weeks ago, depending on one's time frame and risk profile. Instead, it might be time to consider some prudent, opportunistic buying (especially on any further dips). I certainly did last week. Despite my near term optimism (based on technicals, sentiment and history), it is important to understand that the popularity of exchange traded funds, risk parity and volatility linked strategies has elevated stocks over the last several years. And it is even more important to understand the many challenges -- of a continued risk parity unwind, higher interest rates, etc. -- facing the markets over the intermediate term. These factors substantially could decrease the ultimate market upside this year to levels that may be well below consensus expectations of 2900-3100. The S&P Index closed Friday at 2620. For the balance of the year I expect the S&P Index to range between 2200 and 2800 -- with a year end price target of about 2400 (representing a decline of nearly 10%) from current levels.