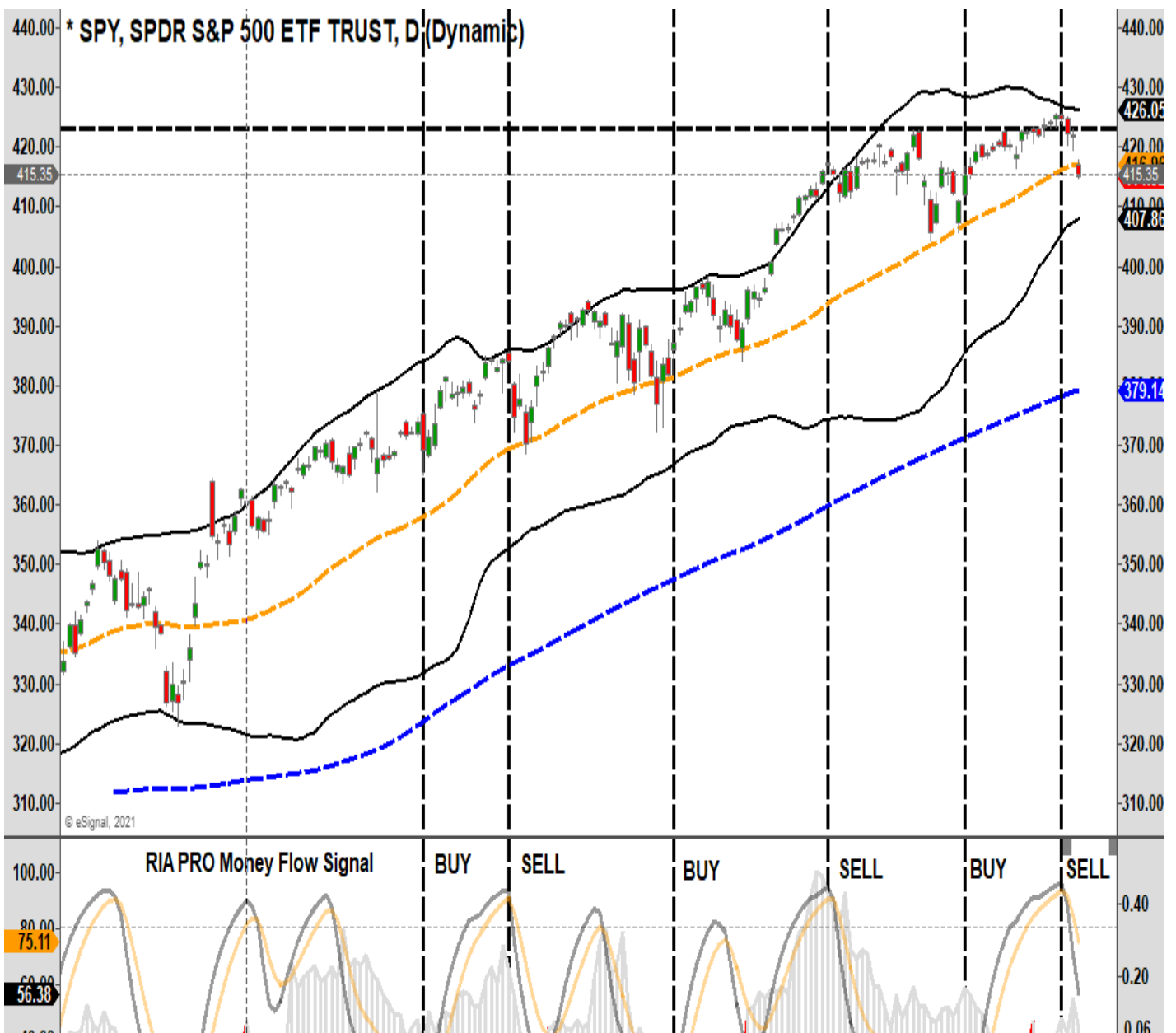


A couple of weeks ago, in "[Warning Signs A Correction Is Ahead,](#)" we said quite a few indicators set the stage for a pick-up in volatility. A review of the latest Commitment Of Traders (COT) report suggests the same.

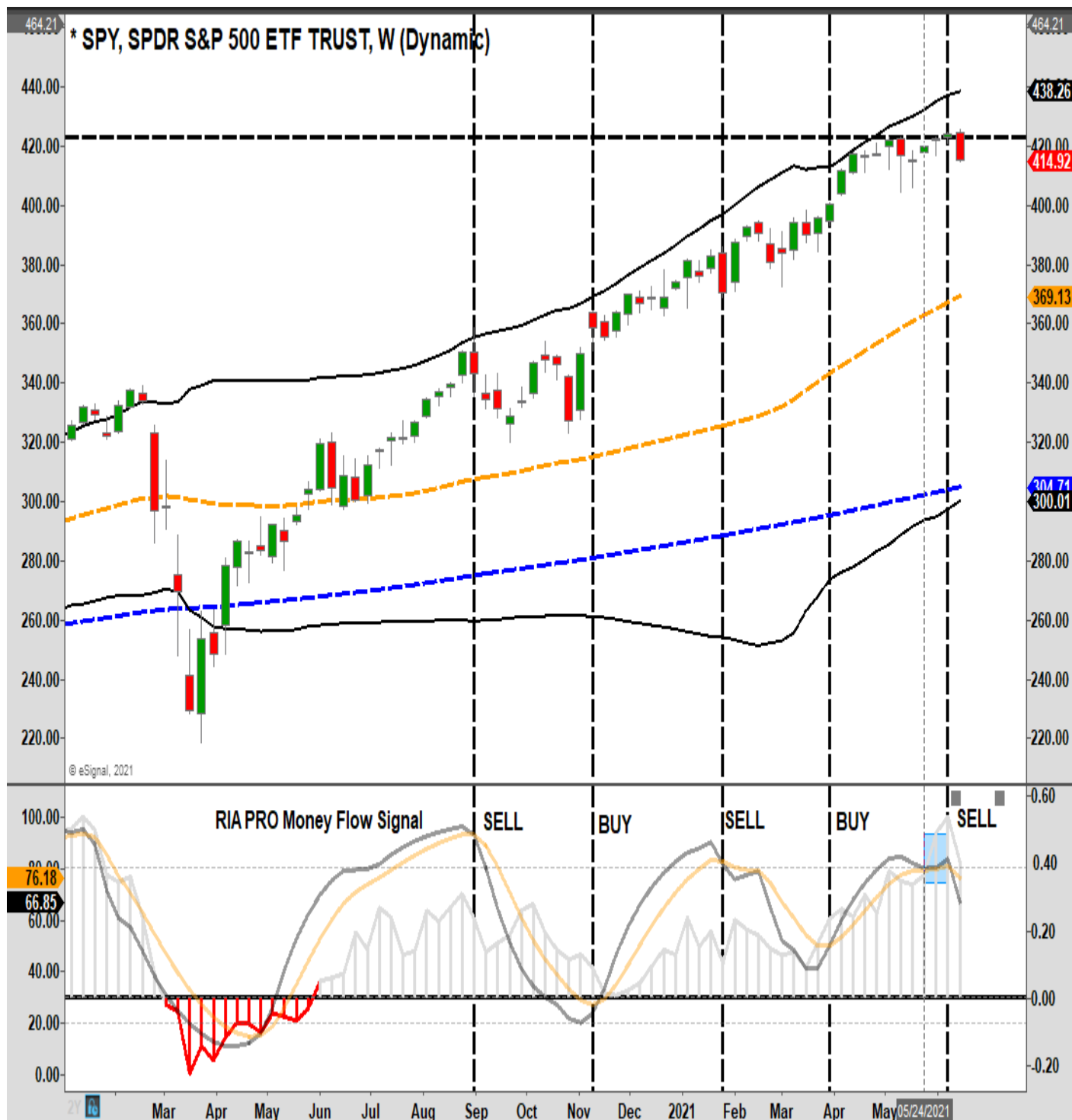
"During a 'bullish advance,' investors become incredibly complacent. That 'complacency' leads to excessive speculative risk-taking. We see clear evidence of that activity in various 'risk-on' asset classes from Cryptocurrencies, to SPAC?s, to 'Meme Stocks.'"

Last week, the market broke down as our "sell signals" triggered. As noted in this past weekend's newsletter, "[Fed Signals Taper,](#)" I stated:

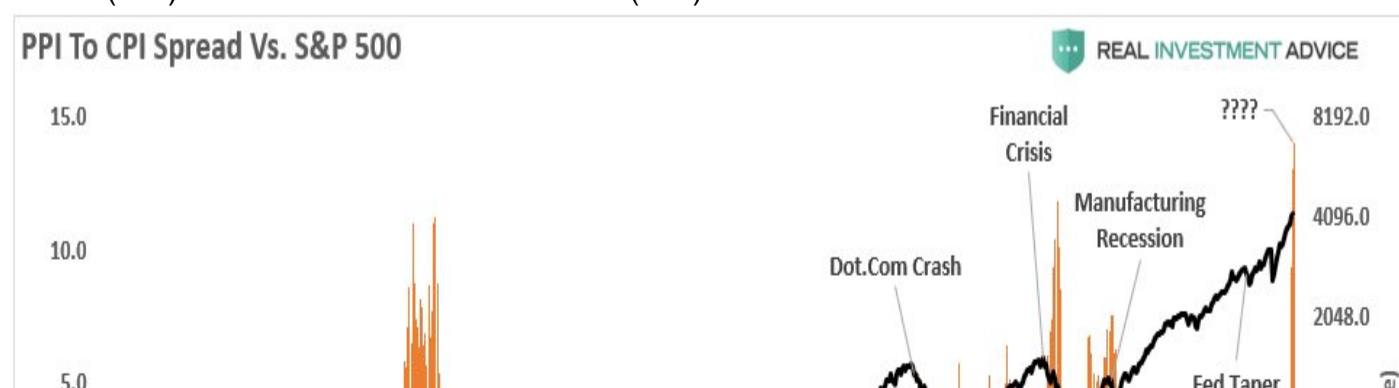
"Well, not only did the highs not stick, but the 50-dma failed during Friday?s sell-off. The market closing at its lows suggests we could see some more selling early next week. The 'good news,' if you want to call it that, is the 'sell signal' is moving quickly through its cycle. Such suggests that selling pressure may remain limited and may resolve itself by the end of June."



"The 'not-so-good' news is on the weekly chart. Our previous discussions warned that if the daily and weekly 'sell signals' align, such has often coincided with more 'corrective' rather than 'consolidative' actions. Importantly, weekly signals are only valid at the close of the week. On Friday, the weekly 'sell signal' triggered suggests a period of correction/consolidation is probable."



The more critical point in the newsletter concerns the massive spread between the Producer Price Index (PPI) and the Consumer Price Index (CPI).



"Please pay attention to this spread as it shows producers cannot pass along inflation to their customers. Therefore, the retained inflation, and by this measure, a lot of it, will erode profit margins and earnings in the future."

Such is severely problematic given current valuations.

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Positioning Review

The COT (*Commitment Of Traders*) data, which is exceptionally important, is the **sole source of the actual holdings of the three critical commodity-trading groups, namely:**

- **Commercial Traders:** *this group consists of traders that use futures contracts for hedging purposes. Their positions exceed the reporting levels of the CFTC. These traders are usually involved with the production and processing of the underlying commodity.*
- **Non-Commercial Traders:** *this group consists of traders that don't use futures contracts for hedging and whose positions exceed the CFTC reporting levels. They are typically large traders such as clearinghouses, futures commission merchants, foreign brokers, etc.*
- **Small Traders:** *the positions of these traders do not exceed the CFTC reporting levels, and as the name implies, these are usually small traders.*

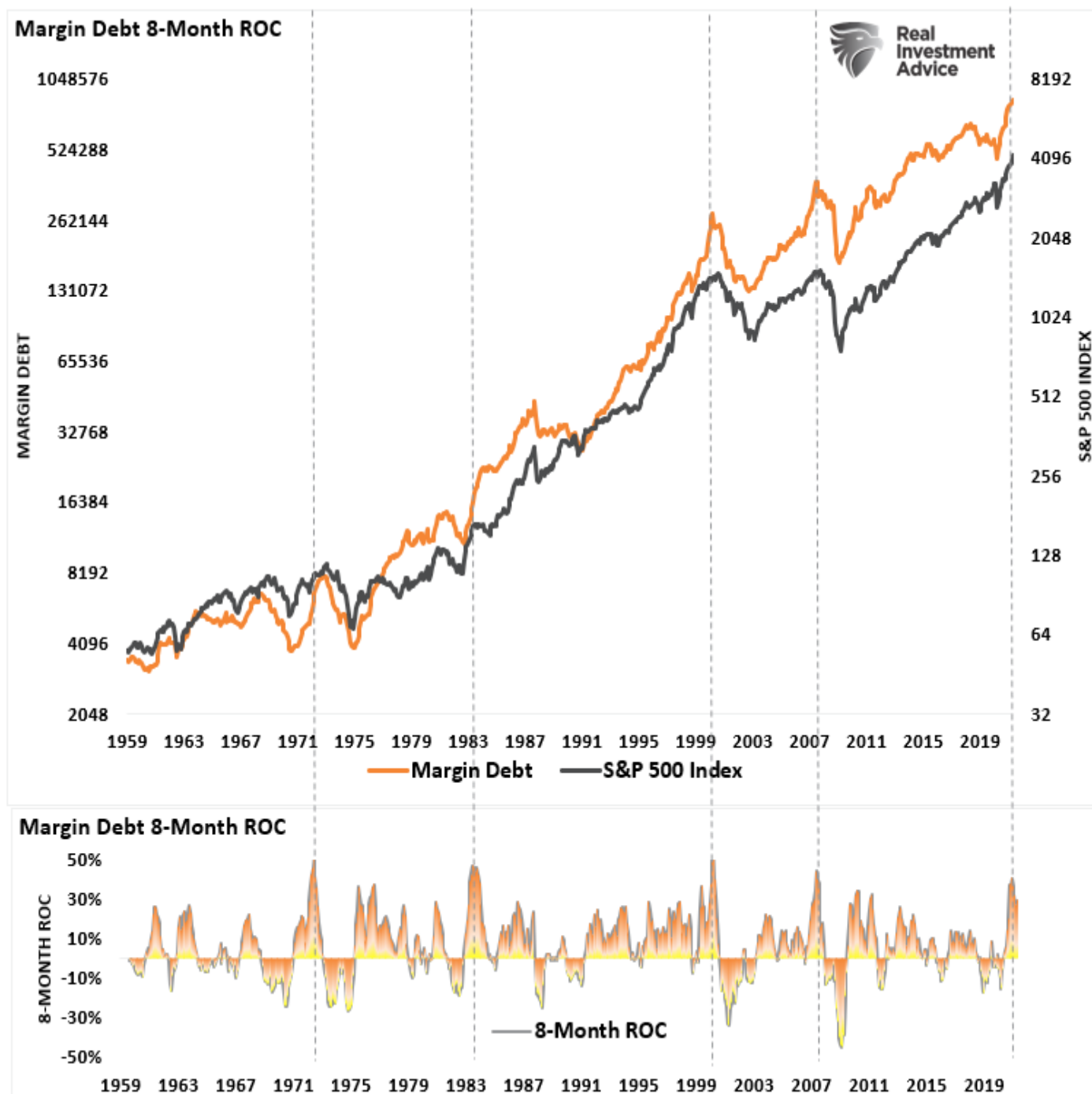
The data we are interested in is the second group of **Non-Commercial Traders (NCTs.)** NCT's are the group that speculates on where they believe the market will head. **While you would expect these individuals to be *?smarter?* than retail investors, we find they are just as subject to "human fallacy" and *?herd mentality?* as everyone else.** Therefore, as shown in the charts below, we can look at their current net positioning (*long contracts minus short contracts*) to gauge excessive bullishness or bearishness.

Volatility

Since 2012, the favorite trade of bullish speculators has been to "short the VIX." Shorting the volatility index (VIX) remains an extraordinarily bullish and profitable trade due to the inherent leverage in options. Leverage is one of those things that works great until it doesn't. One of the more astonishing data points is that retail investors have increased risk markedly since the March lows. (Chart courtesy of Sentiment Trader)

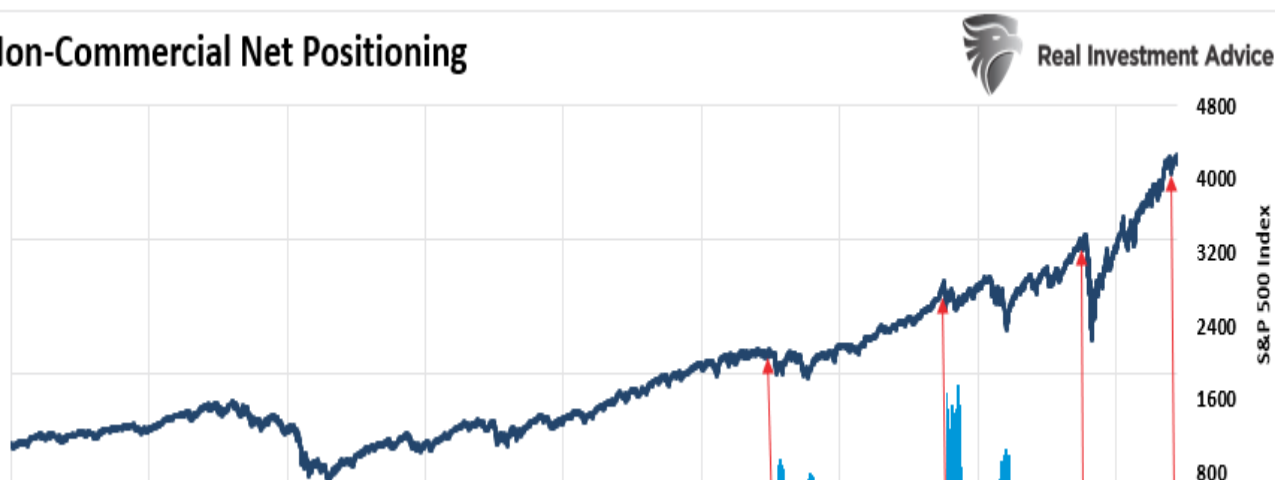


Furthermore, while investors took on record levels of risk via speculative call buying, they also increased margin debt to record levels.



Currently, net shorts on the VIX are still very elevated. However, they have begun to reverse this past week which has typically preceded more significant volatility swings in the short term. **While current levels are not as significant as seen in January 2018 or February 2020, the positioning is large enough to fuel a more substantial correction.** The only question is the catalyst.

VIX - Non-Commercial Net Positioning





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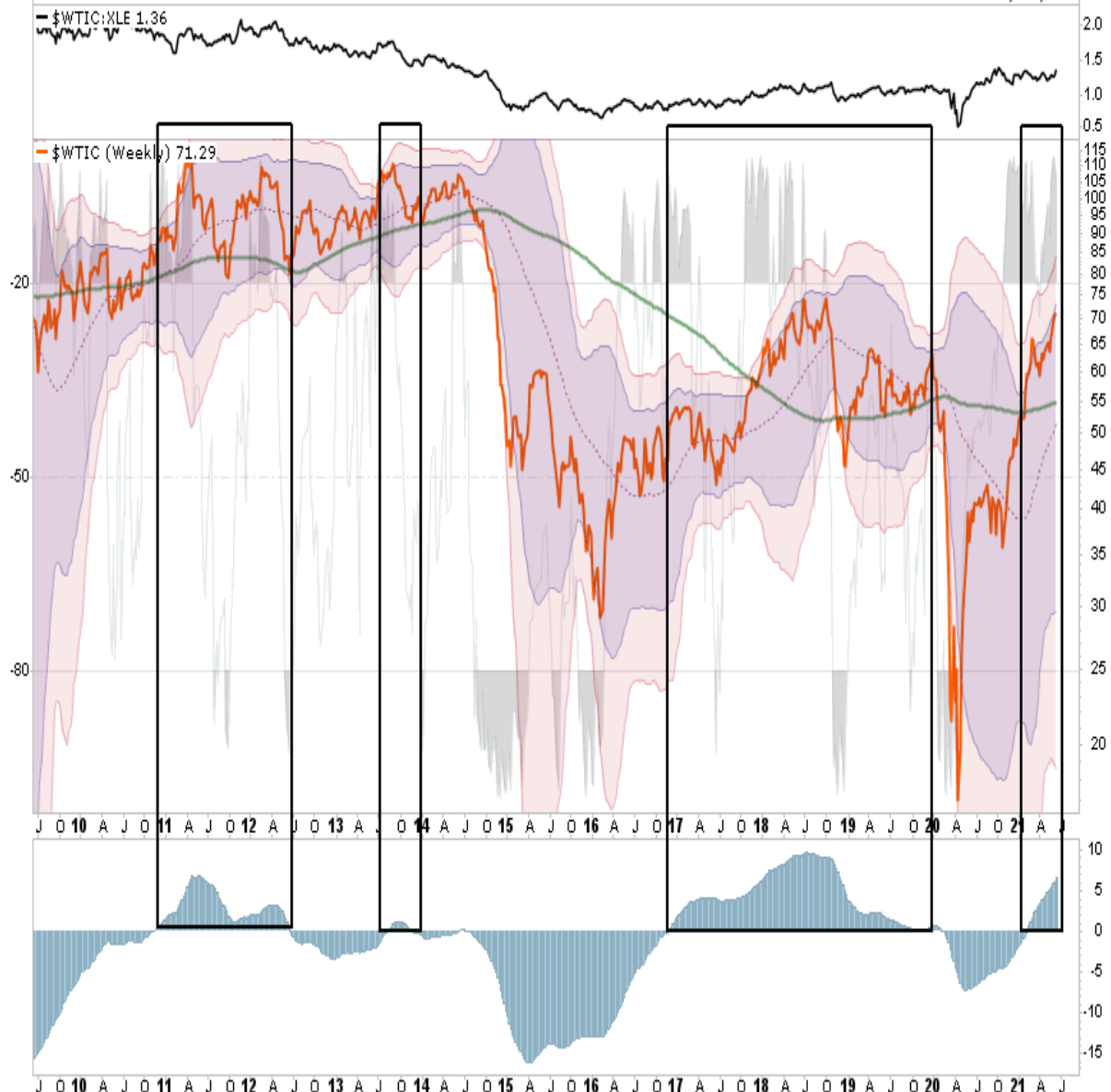
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Crude Oil Extreme

Crude oil has gotten a lot more interesting as of late. After a brutal 2020, the price of oil futures going negative at one point, oil is now pushing \$70/bbl. Given current expectations for a surge in *"inflation"* from the massive liquidity infusions, the focus on highly speculative positions is not surprising. Despite the massive surge in oil prices since March 2020, *"energy"* stocks, as noted by the correlation of crude to XLE, have underperformed. Such is because the leverage in options increases speculative returns. **It is worth noting that *"expectations"* of economic recovery are likely well ahead of reality. As such, the extreme overbought, extended, and deviated positioning in crude will likely lead to a rather sharp correction.** *(The boxes denote previous periods of exceptional deviations from long-term trends.)*

Open: **70.65** Ask: P/E: Options: **no** Friday 18-Jun-2021
 High: **72.99** Ask Size: EPS: Annual Dividend: **N/A** Chg: **+0.54%**
 Low: **69.77** Bid: Mkt Cap: Yield: **N/A** Last: **71.29**
 Prev Close: **70.91** Bid Size: Last Size: SCTR: Volume: **182,865,792**



The speculative long-positioning is driving the dichotomy in crude oil by *NCTs*. While levels fell from previous 2018 highs during a series of oil price crashes, they remain more extreme at 510,499 net-long contracts. While not the highest level on record, it is definitely on the "extremely bullish" side. The good news is that oil did finally break above the long-term downtrend. However, it is too soon to know if these prices will "stick," or as the economy decelerates towards the end of the year, oil prices will decline.

Crude Oil Net Positioning



Real Investment Advice



The supply of oil, and lack of global demand, remain a longer-term problem for oil prices. **Furthermore, due to a deflationary push, a dollar rally will likely derail the oil prices later in the year.**

U.S. Dollar Rally Likely

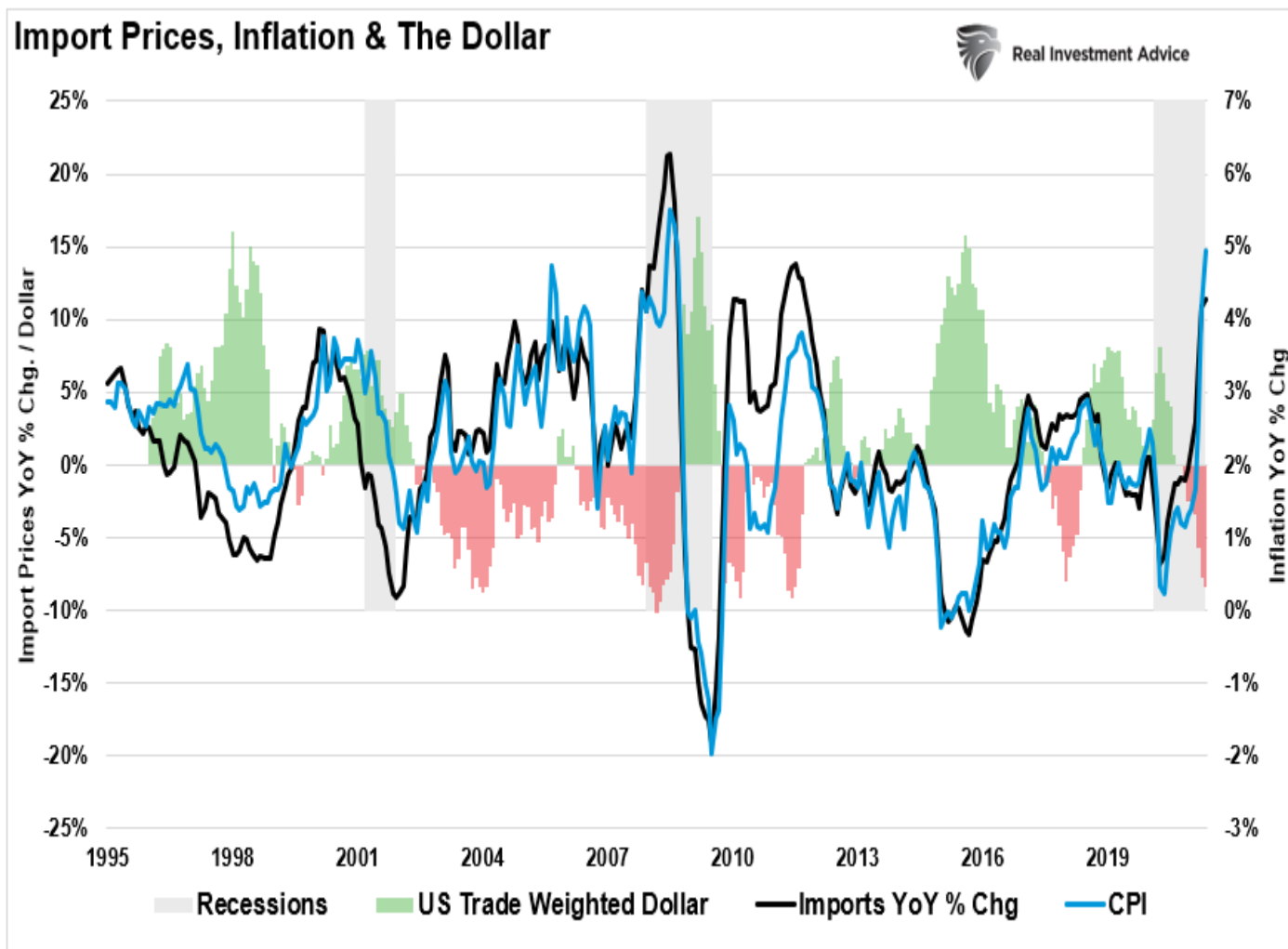
There are two significant risks to the entire *"bull market"* thesis: [interest rates and the dollar](#). For the bulls, the underlying rationalization for high valuations has been low inflation and rates. In February, we stated:

"Given an economy that is pushing \$87 trillion in debt, higher rates and inflation will have immediate and adverse effects:

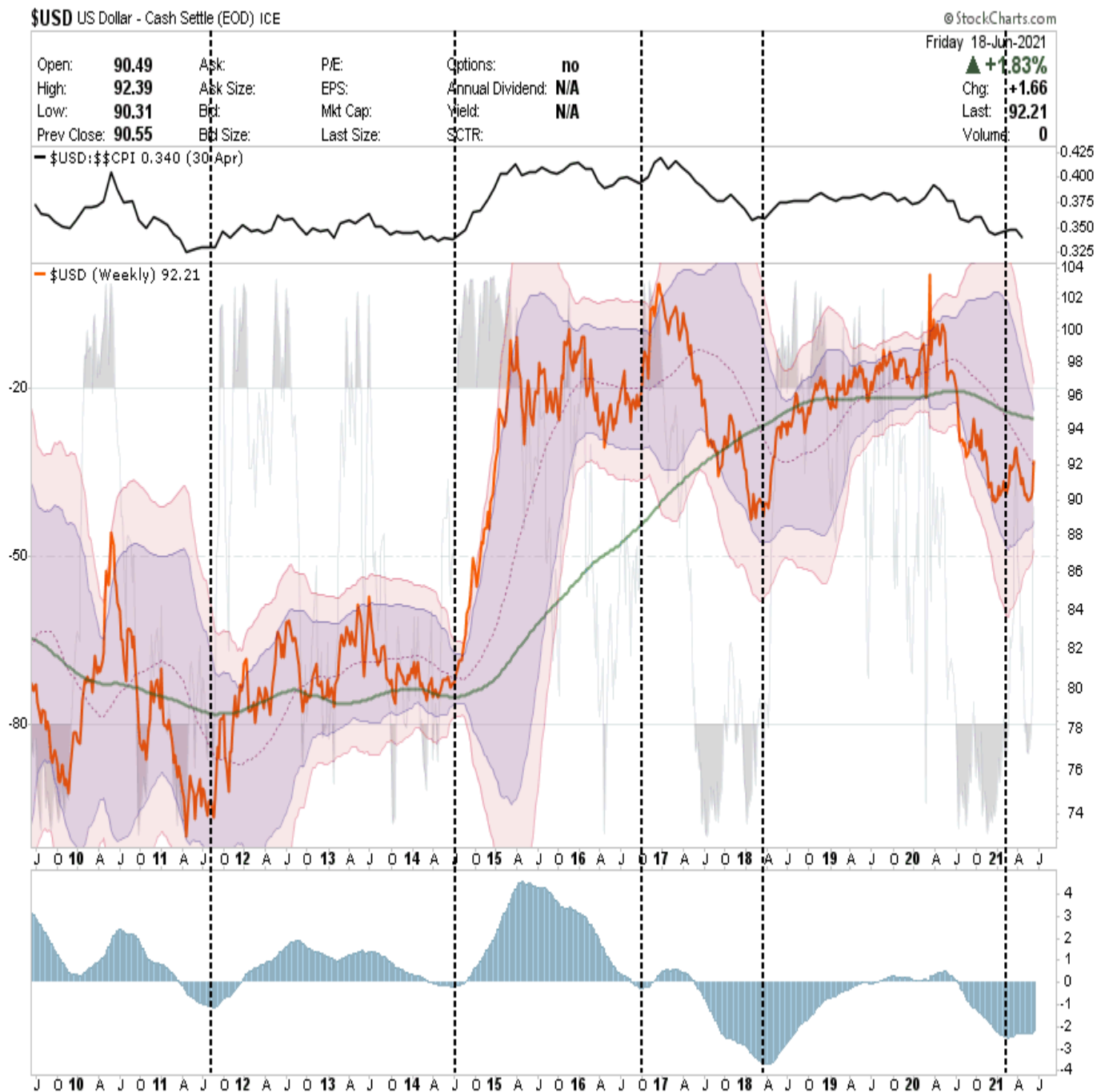
- 1. The Federal Reserve gets forced to begin talking tapering QE, and reducing accommodation; and,*
- 2. The consumer will begin to contract consumption as higher costs pass through from producers.*

Given that personal consumption expenditures comprise roughly 70% of economic growth, higher inflation and rates will quickly curtail the "reflation" story."

A few months later, the Fed started to talk about tapering their balance sheet purchases. With the market currently priced for perfection, **a disappointment of economic growth caused by a rising dollar, rates, or a contraction in consumer spending will lead to a repricing of risk.** The weakness in the U.S. dollar contributes to the inflationary push in the economy as it increases the costs of imported goods.



The one thing that always trips the market is what no one is paying attention to. For me, that risk lies with the US Dollar. As noted previously, everyone expects the dollar to continue to decline, and the falling dollar has been the tailwind for the emerging market, commodity, and equity 'risk-on trade. Whatever causes the dollar to reverse will likely bring the equity market down with it.

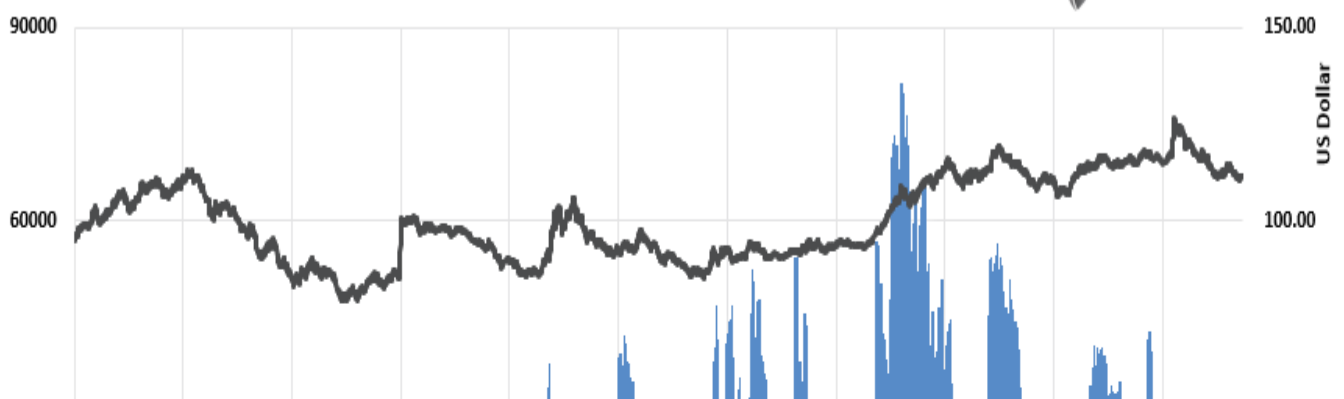


Very quietly, the dollar has been rising and recently broke above both the 50- and 200-dma. The short-covering in the dollar has fueled that rise. Such also suggests there is still significant room to rise.

USD Non-Commercial Net Positioning



Real Investment Advice



Interest Rate Conundrum

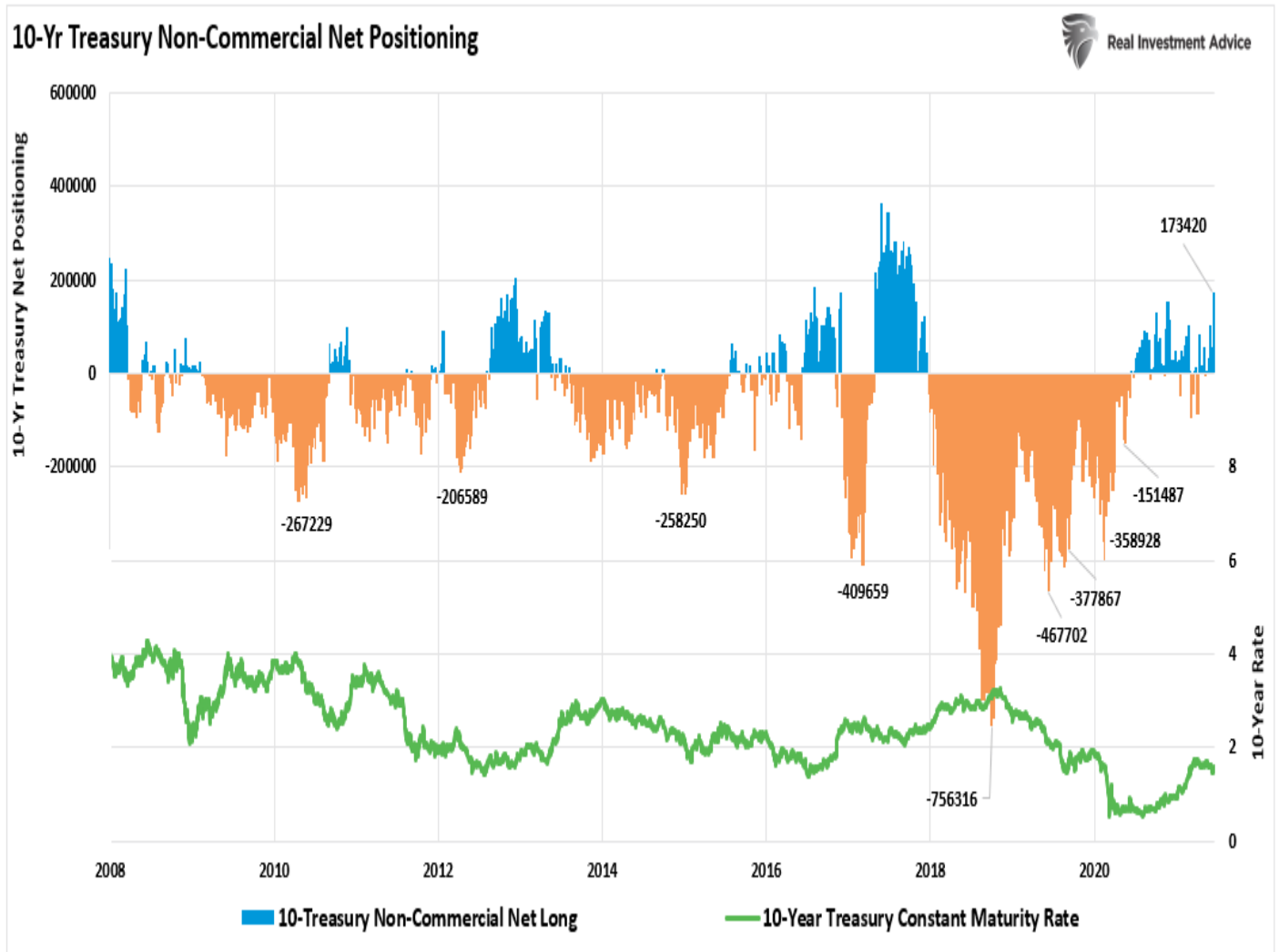
Over the latest several years, I have repeatedly addressed why financial market *?experts?* have been confounded by why **interest rates fail to rise**. In March 2019, I wrote: ["The Bond Bull Market,"](#) which followed up our earlier calls for a sharp drop in rates as the economy slowed. At that time, the call was a function of the extreme *"net-short positioning"* in bonds, which suggested a counter-trend rally was likely. **Then, in March 2020, unsurprisingly, rates fell to the lowest levels in history as economic growth collapsed.** Notably, while the Federal Reserve turned back on the *"liquidity pumps,"* juicing markets to all-time highs, bonds continue to attract money for *"safety"* over *"risk."* Despite the repeated calls by *"bond bears"* this year, rates have remained range-bound below 2%. Such is interesting given the calls for explosive economic growth. **However, as noted above, such is unlikely as higher inflation, a rising dollar, and rates all harm a debt-laden economy.** Such remains the case currently as rates continue to predict much slower economic growth later this year as the stimulus, and not potentially liquidity, leaves the system.



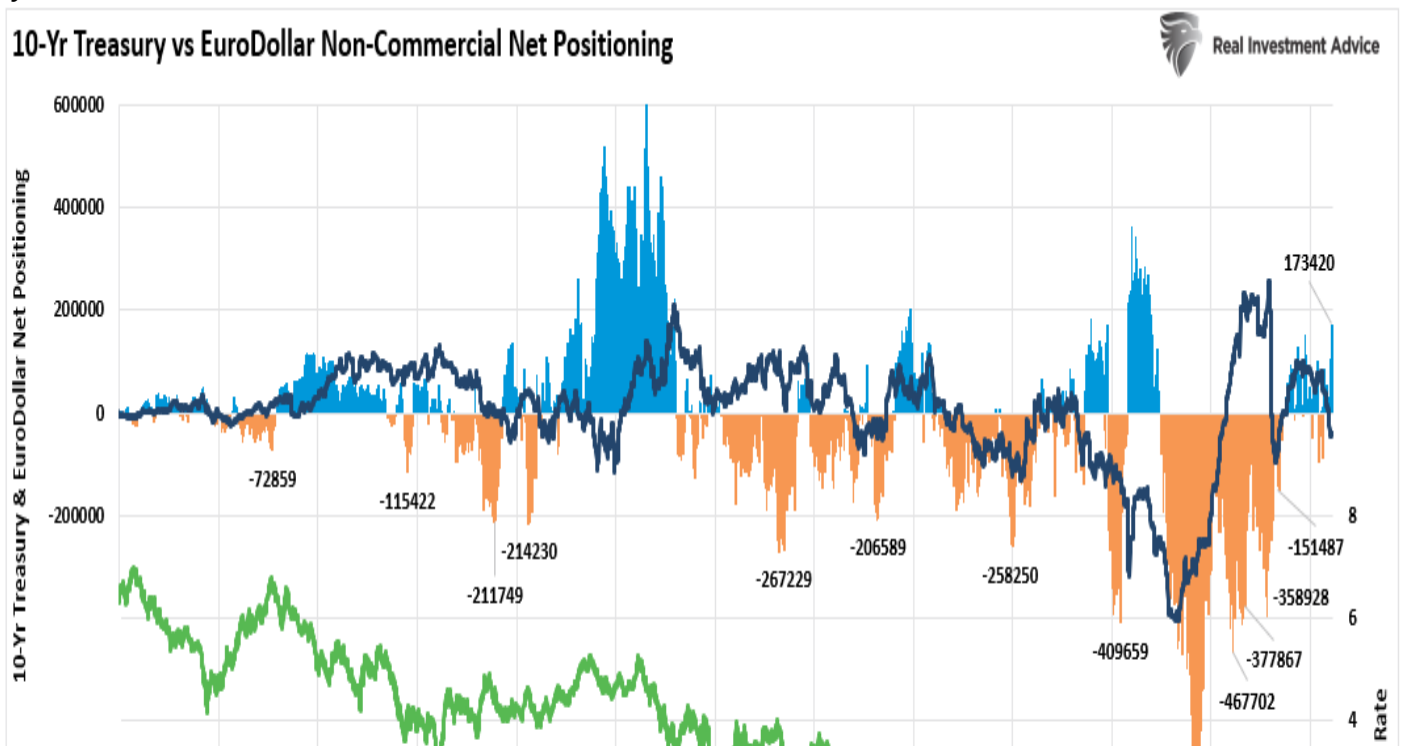
As we said in February:

"The number of contracts 'net-long' the 10-year Treasury already suggests the recent uptick in rates, while barely noticeable, maybe near its peak."


Such remains the case currently.



We also noted in that same report the reason rates failed to rise was due to increasing levels of **Eurodollar positioning** as foreign banks push reserves into U.S. Treasuries for "safety" and "yield."



With the number of bonds with "negative yields" rising globally, the U.S. Treasury bond's positive yield and liquidity will likely keep it a preference for storage of reserves for now. Such will increase further if economic growth fails to appear as expected.



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Conclusion

In today's market, the majority of investors are simply chasing performance. The biggest problem is that technical indicators do not distinguish between a consolidation, a correction, or an outright bear market. As such, if you ignore the signals as they occur, by the time you realize it's a deep correction, it is too late to do much about it. **Therefore, we must treat each signal with the same respect and adjust risk accordingly. The opportunity costs of doing so are minimal.** If we reduce risk and the market continues to rise, we can quickly increase our exposures. Yes, we sacrifice some short-term performance. However, if we reduce risk and the market declines sharply, we not only protect our capital during the decline but have the cash to deploy at lower price levels. **Such is the biggest problem with ?buy and hold? strategies.** Yes, you will perform in line with the market, but given that you didn't ?sell high,? there is no cash available with which to ?buy low? in the future. **I suggest that with our ?sell signals? triggered, taking some action could be beneficial.**

- Trim back winning positions to original portfolio weights: **Investment Rule: Let Winners Run**
- Sell positions that simply are not working (if the position was not working in a rising market, it likely won't in a declining market.) **Investment Rule: Cut Losers Short**
- Hold the cash raised from these activities until the next buying opportunity occurs.
Investment Rule: Buy Low

There is minimal risk in ?risk management.? In the long term, the results of avoiding periods of severe capital loss will outweigh missed short-term gains.