Notes From the Rabbit Hole ©

Alice and the characters of Wonderland; illustration by Jessie Wilcox Smith

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NFTRH 606 excerpt explaining some keys to NFTRH analysis and the origins and orientations of its author

In June 2020 with market participants being whipsawed between fear and greed, deflationary signaling and inflationary signaling, deplorable economic data and improved economic data amid a backdrop of the ongoing COVID-19 pandemic and America's cultural struggle with racism it was time on June 7th for a conversational report. Time to stop the bus for a week for the sake of clarity. To get this market right, you need to understand the basics.

Below are the opening items from NFTRH 606, which abbreviated or omitted the usual full docket of market analysis segments (weekly reports include in-depth analysis on US and global stock markets, stock charts of companies in key areas of interest, precious metals, including extensive charting of the miners, currencies, commodities, market internals, sentiment and more).

It is important for readers to know and understand who they are consuming services from and #606 goes into those details after a few subscribers asked for clarification of some NFTRH tools/indicators, wording and interpretations about the macro backdrop. The macro has made sense every step of the way since the March crash, so it is important to be able to consistently convey the important signposts to readers.

Opening Notes: Clarifying Terms (Market Nerds 101)

I have now had a fair amount of years in the markets (about 22), 16 years writing about markets and going on 12 years providing this market service. A wealth of experience? Maybe not, but certainly enough to learn a lot of lessons.

I was never a very good student in high school or college because I never found what interested me back then (finance was the furthest thing from my mind and I found those economics classes to be dirge-like). I was disassociated from the material most of the time, as it seemed like an abstraction, like it was not grounded in anything real.

My learning in the markets came hands-on, losing and increasing my own money. That is something I take personally, and in fact when my financial advisor lost half of my wife's retirement account and 40% of mine in 2002 after assuring us that the managers of the mutual funds he put us into (on pure commission, not performance) would never allow the kind of losses that I, a mere retail trader would, I yanked everything from him and began my journey. I realized that all he did was collect fat commissions, put people at risk and hope (consciously or not) that the Fed would repeatedly bail the markets out.

There had to be a better way and I was going to find it. What works for me is market timing. Not like a day trader watching 15 minute chart squiggles, but timing the macro swings where using the all-too clear 2020 experience as an example, we got the warnings, successfully managed the decline (my accounts were down 5% in 2020 at the worst of it but that was due to the fact that I consciously decided to not puke out of three gold stocks, WDO.TO, GBR.V and MAI.V), which then enthusiastically joined the crash.

During the crash NFTRH analysis was cool, calm, even brave while the hysteria grew. I bought and wrote about sectors like software enabling remote work/collaboration/communication/commerce/living and of course the ultimate counter-cyclical sector, gold mining. My accounts are very well green in 2020 and I look forward to leaning into my market views more heavily as the macro clears. But first I see signs that the inflation instigated reflation that the FOMOs (that's 'fear of missing out', I am trying to clean up some lingo per request) are piling into is approaching a high risk zone, on an interim basis at least.

In the above paragraph are a couple of the words (inflation & reflation) that confuse a few people, especially when used together or even alternately as if they are very different things. I am a home made market manager and analyst. I can't say that the way I write is the best or the way I describe my tools is the clearest. I can say (and I would not if I did not believe it) that this stuff works and the macro shifts and changes usually make sense to me. That is because as a student, I *finally* found what it is that interests me.

So welcome to **Market Nerds 101**.

Clarity of Writing

I want to start with this one first, because it will be the most difficult subject to tackle. There is a reason I write differently than the average newsletter writer. Simply put, I am trying to provide the highest quality, most on-point service I can. The newsletter industry has many rules of thumb and one of them is to write in a way that *everyone* will 'get you'. Voila, that spells increased subscriptions, and that's what it's all about, right?

Wrong. I am here to get the markets right. Period. Not to excessively use (!) in my writing as if you are a child that needs to be called to action. I try to keep it real about my own mistakes, limitations and other failings rather than trying to attain the exalted newsletter writer status of 'guru'. That's another rule of thumb you know; if you get to 'guru' status you've got it made. Richard Russell rode tragically poor performance for much of his career after having attained guru-hood, and in the gold "community", virtual knighthood (I remember a gold website/writer calling him "Sir Richard the Good").

This is not to slam dear departed Richard. I've expressed a personal issue I had with him in the past because he did what I considered to be a vile disservice to me as a new public writer in 2005. But I also witnessed something from him in black and white that told me all I need to know about the subject **Newsletter Guru 101**: Just before a big decline in gold stocks and the best of the post-2009 stock bull market Richard issued this simple, clear and easy to understand message to his herd (and the public at large) from on high:

"Instructions: Sell all stocks, except mining stocks."

Instructions? Well that is clear enough. Public: 'A guru told me to sell my stocks and hold my miners and I am a mere (retail) human. So what am I to do? Follow instructions!' Tragic. Newsletter writers tend to speak with authoritative clarity. No thank you.

As I look around the landscape of the financial writing community I see a lot of people doing it right; providing clear answers, solutions and clear, unambiguous writing. I see certain indicators highlighted, I see a lot of nominal technical analysis warning of doom or spreading the good word of stock gains to come. I see a lot of opinions, and in some quarters I see way too many (!)!!!!!

One gentleman who emailed asks for a glossary of terms. I told my wife about that and she thinks it's a good idea. I think it is a good idea too. But here is my problem; I am maxed with the work I do, especially after having altered the updating system in a way that allows me to be much more hands on during the day (with Tier 2 & 3 updates, usually in-day). I see something (like Friday's big drop in the CDNX/TSX ratio), I get on it and note it for you along with brief thoughts about it.

I work a full 7 days a week and the issue is capacity. I feel almost limitless in my ability to do the work required to keep right with the markets. I love it, actually. I am enthusiastic about it. But getting back to the second paragraph on page 3 I tend to flounder with 'make work' or things I am disassociated from. That college Economics class for example. The 'Wrap Up' segment (which may return soon, because it was of value) in NFTRH that I used to really bum out about having to write after putting in a full 50-70 pages all weekend. Sitting and writing a glossary of terms.

In short, I like action. I like what works. I hate 'make work' and I hate crap that pretends to be important that really is not (like 60-80% of what you Wharton alums probably learned in Economics classes IMO). I like what works, and what works is what I've developed and refined during nearly two decades of hands-on management.

People may not readily know what the 'Continuum' is or why I nicknamed the indicator.

Well, it is the most bedrock tool I have. The 30yr Treasury bond yield, which has *continued* on its downward path over decades of deflationary pressure. It's as simple as authorities have license to inflate the system when it is at a low extreme (as it has been in 2020) and an implied mandate to toughen up when inflation expectations run too hot, as happened when the yield broke through the (red-dashed) 100 month EMA limiter in late 2018. We were well prepared in both of those instances because I used a cartoon with a nickname in order to "*be* prepared" (lesson from Boy Scouts well learned).

What I am saying is, to put it in really clear terms "this shit ain't easy". If I am going to be like a lot of other newsletter writers I'll write clearly, tell you what is going to happen (yet another newsletter writer rule of thumb is to always sound authoritative, even when you don't really know you are talking about) and later issue new proclamations while soft serving the previous screw ups. Always. Be. Authoritative. Again, no thanks.

I will and do admit to you my screw ups. You are adults, not children. You must see through and realize that it's just a faulty service provider trying his best, using his tools and keeping honesty front and center. But for me to be honest, it takes words (not proclamations or instructions) and more than that, it takes a lot more words than simple instructions when trying to convey all of the risks, rewards and probabilities in play at any given time. There is a lot going on out there, and it just is not simple to manage it.

Now ironically, the gentleman who emailed about clarity and adding a glossary also noted that perhaps instead of saying what I say in two sentences I can say it in three sentences, for the sake of clarity. But again I ask you, how much is too much? We have a job to do here and I am doing it as fast as I can and it still takes all weekend and much of the work week. There is so much in motion at any given time in the markets and I am trying to cover all of it that is material to our needs.

I am not here to sell newsletters (well, I am, but work with me in this case) so much as I am here to be the best I can be. Adding a glossary of terms or adding additional words of clarification of the way I naturally write are good ideas. I don't dispute that, and I will try my best. But speaking personally, I have found what works best for myself and I think a good portion of the subscriber base. The gentleman who emailed surmised that most NFTRH subscribers are 'retail' and in the general newsletter industry I think that is the case. But I have been amazed how many CFAs, fund managers, hedgies, ex-hedgies and newsletter writers are or have been in the subscriber base over the years. I'd wager a bet that the proportion of professionals in the NFTRH base is significantly higher than the average. Not bad for some self-taught guy who had no interest whatsoever in college.

All of the above is too many words to ask you to bear with me. I am trying. But I write how I write and while I can try to minimize my confusing 'word salad' moments and try to keep in mind the first rule of Newsletter writing (write so that *everyone* will get you), but to quote an old website I used to know a little about, "it is what it is" to a large degree.

I welcome your suggestions and indeed, the reason I put a sentence in every Sunday report email asking for your feedback, questions and critiques/corrections is so that I can clear up anything you may not have grasped fully. Some writers don't reply reliably to emails. With the rare exception of a forgetful mind, I do. You are my customers and I value you. I want to be sure you are getting the most out of the service. But also there is a possibility that NFTRH is not right for everyone, and I cannot make it otherwise.

Inflation & Reflation

Okay, finally we can do some work today as we get into the wheel house of some terms and concepts that have been at the forefront especially prominently in 2020.

A couple people are thrown by the terms inflation and reflation, and what I see as the differences between them. First of all, inflation is the very thing that has sustained the Keynesian economic and financial system for decades. Reflation is more of a buzz word related to the economy, as in the Treasury/Taxpayer backed Fed is trying to reflate the economy through inflationary monetary *policy*.

But these are my interpretations. I see inflation as what policymakers are doing (via the printing press and other manipulative means) and I see economic reflation as a potential and desired result. So when I write about the reflation trades I am talking about the thus-far ongoing bounces in stocks (esp. financials, materials, industrials, etc.), commodities, long-term yields and all of the things that would go with an inflation-fueled cyclical economic recovery. Costs would also push higher if they are successful.

So let's define it this way: Inflation is the attempt and reflation is the would-be result.

In the attempt to define the prospects that this inflationary operation will succeed in reflating the US and global economy we first noted the explosion upward in the CNDX/TSX ratio (in a real-time update on May 12), which we have shown to be historically in line with both US inflation expectations and the CRB commodity index. Then on Friday, we noted its negative divergence to the big party atmosphere hitting the headlines and emanating from the orifice of Trump's Twitter mouth.

But that is an isolated signal, as it was when it burst positive (above the SMA 200) on May 12. So we call in other indicators like the now consolidating Silver/Gold ratio in order to confirm whether the inflationary reflation attempt is ending, interrupted or ongoing. But it is all about processes. Logical deductions happen in our minds much faster than they do in the macro markets. That is why the Newsletter industry makes a point to be so clear, authoritative and on point all the time. Because this stuff is hard and people are looking for answers. Well, I will not give you answers until I get them. Otherwise I'm making shit up to suit my bias, and that is simply not going to happen.

What do I think is going on? I am glad to tell you that at any given time as the analysis evolves. I *think* that the inflation/reflation indicators are stretched and I think that the drop in CDNX/TSX on Friday may be an early warning on that just as it was an early signal on the happy stuff that followed it upward after the May 12 signal.

I also think that it has a good chance of changing trend to up, having taken out the SMA 200. But the indicator was stretched to an extreme and could use a breather at least.

Deflation & Liquidity Crises

The conditions noted above are what are happening now. The markets and associated sentiment/psychology have exited the utter fear of deflation so prevalent in March, sentiment is swinging from fearfully clinging to liquidity (and the reserve currency, USD) to following the Fed's implicit instructions to abandon cash and own assets.

It's how today's modern, over-managed/manipulated markets work. It is as clear as the nose on your face. You and I have witnessed it yet again just in the 2020 microcosm. More than that, we have managed it rather than being in awe of it or worse, dumbstruck or forced into poor decisions by it. Those who've been around NFTRH for a while have been through and observed this wash-rinse-repeat cycle work logically* for us on multiple occasions.

A liquidity crisis came about amid the pandemic as herds sold assets and rushed to cash liquidity. Funny thing, in the middle of this page my wife returned from a walk with her friend asking me to attend to a pile of dog poop in the driveway (he's a good boy, but at 13+ he's slipping lately). Ever dutiful, I got the poop out of there and said hi to her friend. We talked a little about the times and she told me that her husband liquidated to cash in March and was very pissed at Friday's upside market action. FOMOus Angstus Extremis.

And there you can see why I time the market on its larger swings but always try to do so at contrary points rather than at points where the herd is reacting. With long-term yields in the toilet and deflation in the air in early 2020 bond players should have sold (just as they should have been buying in Q4 2018 amid the ***BOND BEAR MARKET!!*** hysteria promoted far and wide by 'experts' like Gundlach, Dalio, Gross, etc.).

To me deflation is the natural *attempt* by the markets to clear the previous inflationary distortions through liquidation (i.e. herds rush to cash). It is the need for savings that a real economy runs on. But this is not a real economy, is it? This is a late-stage Keynesian economy. It tries to deflate, they inflate. Wash, rinse until some day it does not repeat.

We are in a Wonderland economy, where anything is possible. Tens of Trillions in national debt? No problem. The Fed tells us it has limitless ability to print more FRNs with the Treasury (Taxpayer) standing behind it. It's all good… until the next deflationary episode and flight to liquidity. As long as confidence in this system of (funny) munny creation remains intact we can repeat the absurd exercise over and over along the Continuum (page 5) until something breaks. It almost broke in Q4 2018, but the now dovish Powell was hawkish then and it made 100% sense to us.

** Again, they are not necessarily going to teach this stuff at Wharton, which is why so many herds so often follow well-educated economic intellectuals right off the cliff every damn time the Continuum hits an extreme.*

Yield Curve, Risk 'on', Risk 'off', etc.

Questions about the yield curve are more common than most others I receive. In response to something I wrote recently…

"On this reflationary global market bounce and threatened USD breakdown the steepening is inflationary at this time. But if the reflation fails the curve is likely to continue and/or accelerate steepening, in that case under deflationary pressure."

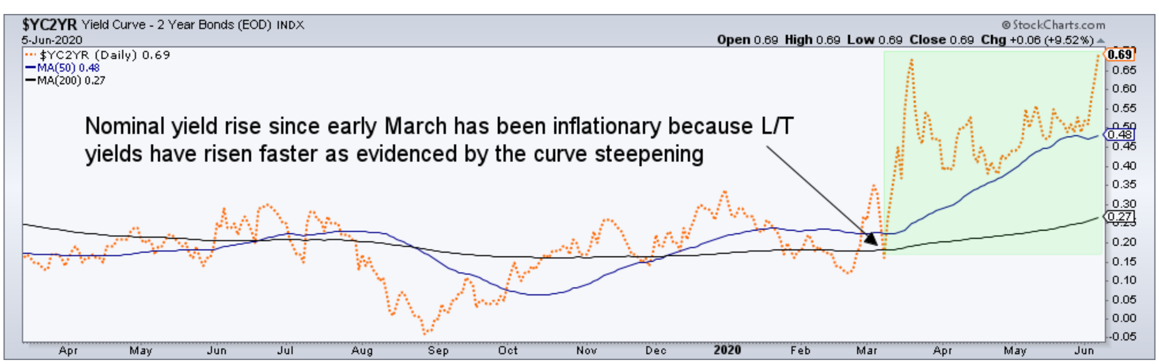
…a subscriber asks: *"I don't understand this! How can the curve steepen under both inflationary and deflationary scenarios? Can you elaborate?"*

I would be happy to. Again, this gets to the heart of the piece I wrote about clarity of writing, because to do market management right you are going to confuse the hell out of some people because it is just not simple. I do the work and you too need to do some work because the work is not readily understandable and cannot be put forth in normal Newsletter 'rule of thumb' language.

How else to explain a concept like a flattening (declining) curve is not inflationary or deflationary and indeed signals an economic 'boom' because short-term yields are higher *relative* (a super important word when discussing the YC) to long-term yields, regardless if they are dropping or rising?

The key is whether the herds are seeking liquidity or not. When they pile into liquidity (e.g. USD) short-term yields (cash equivalents) are driven down. When they move to risk-asset speculation mode they'll go further out on the bond yield curve and take more risk that the government will not inflate away their long-term bonds. That is especially the case during a curve flattening where both long and short-term yields are declining. That is the blessed Goldilocks backdrop.

But using the situation currently in play (a still early curve steepener) let's answer the subscriber's question. The yield curve is a thing of different moving parts. It is the spread between a longer-term bond yield (let's use the 10yr) and a short-term bond yield (2yr). Nominal yields have been bouncing since making a violent low in early March.



The chart of the Yield Curve is simply a view of what long-term yields are doing relative to short-term yields. Currently with nominal interest rates rising and the fact that long-term interest rates are rising faster, the rising Yield Curve signal is inflationary (yields tend to rise during inflation as bond holders begin to fear what the government is doing to their investments).

Bond investors start shimmying down the curve to the short end, where their principal will not be inflated away as readily due to these bonds' shorter duration (this is why I have calmly held the SHY 2-3yr Treasury bond fund through the current inflation attempt but would never have held the 20+ year TLT, for example). Its distributions would not have kept up with its principal destruction in any convenient timeframe.

That's the mechanics of an inflationary steepener. What about a deflationary steepener?

Well, during a deflationary liquidity event yields will drop as herds jerk out of assets and into bonds. But during a systemic crisis short-term Treasury bonds are favored again because the risk is lower. Both from the future inflation that a Keynesian system of money printing is sure to promote and also real or perceived insolvency of said government. In short, at such times people are not so much worried about making gains in the bond market as preserving their capital. Short-term Treasury cash equivalents (T Bills and very short-term bonds) are best for that.

The yield curve, which is more a seesaw than a firm messenger of any single condition, will steepen during a deflationary episode because the flight to short-term bonds during a liquidity crisis will send short-term bond yields lower *relative* to long-term bond yields, which may also be dropping (as bonds rise).

So the bottom line is that a flattening Yield Curve indicates a boom (whether cooked up by previous policy or not) and a steepening can be very bad (deflation, with a rising USD) or indicative of an inflationary time to be discriminating in what assets you own (reflation trades tend to begin with precious metals and eventually fan out to commodities, global markets that benefit from stronger commodities, sectors like Banks/Financials, Materials, Industrials, etc. with a declining USD).

The Yield Curve rocketed in 2008 with a liquidity crisis. I believe that is the more common driver of a steepening curve. But there are phases where it's inflationary by the dynamics noted above. A microcosm of that has been from early March to today. I don't know if they taught you this stuff at Wharton or not. They sure did not in my state university Economics class, at least the parts I stayed awake for.

For this indicator, unlike for example the 30yr yield Continuum things are not at all black and white. You've got to look into the moving parts driving the Yield Curve indicator itself in order to correctly interpret the macro backdrop.

As for Risk 'on' and Risk 'off', Thing 1 is what the Fed has tried to promote since going full frontal dovish on monetary policy. The cheap trick they use is simply to cheapen the money units that denominate assets. By doing this they tell the herd - as Bernanke did for an ungodly long 7 years with ZIRP - to get into asset markets or we are going inflate away your ability to keep up with rising assets and other costs.

At least that is what they are attempting and it will last until the next deflationary liquidation ends the racket (ref. 2001, 2008 and in a microcosm, Q1 2020). The market's natural forces want people in cash and out of the inflated rackets so that savings could be rebuilt and a normal economy could eventually recover after much pain. But that is not how the modern system works. It's not normal to anything pre-Greenspan.

Every time the herds rush risk off (like my friend noted above who went all cash in March) there is policy response. It's not just Trump and Powell. It was Obama and Bernanke. It was Bush and Greenspan. Politicians and Fed Chairpeople are all on the same team when the Continuum says it's okay to be. Go… TEAM! Pump, baby, pump.

Hearkening back to the Continuum chart on page 5 yet again, in Q4 2018 the noise about the hawkish Fed chief was deafening and I put a lot of effort, both in NFTRH and publicly, to explain why he was hawkish despite a then tantrum throwing stock market. The yield Continuum (30yr yield) had broken the monthly EMA 100 'limiter' on the upside and that was not play time, it was not time to coddle asset markets.

I noted at the time that if given the choice between an asset market crash and a breakout in yields that would blow up the Fed's 'inflation *on*Demand' racket, they would choose an asset market crash. Indeed, a market correction is exactly what put the herds back into the long bond, pulling its yield back out of danger and beginning the journey toward Q1 2020's hysterical low in yields (high in bonds).

And let's not blame COVID-19 for all of this. The economy was decelerating before the acute pandemic phase and yields had been in hard decline for over a year before anyone had even heard of the damn virus. We were on the journey to the opposite end of the Continuum well before COVID-19 rammed it home with a **(!)**.

So the herds rushed risk 'off' in Q1 2020. In March, early birds like us began to position for the rebound to risk 'on', the most overt expression of which came on Friday's Jobs report. 'Yay!' thinks the herd, 'the economy is reopening, let's we market participants (and machines) focus on something other than the angst-ridden social backdrop after all that Corona-worry. Happy days are here again, or at least I hope the hell they are because I just chased this mess because I could not hold out with FOMO anymore.'

That's what the market does to people. Risk of a reversal to 'off' is as I've been writing every week for quite a while now a lot higher than it was in mid-March.