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MacroVoices: Reference Matterials

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Excerpts from "The Next Perfect Trade: A Magic Sword of Necessity"

Chapter 11, Pages 98-101

One of the things they teach in the beginning class on logic is the meaning of implication. "Every salmon is a fish, but not every fish is a salmon." In other words, being a salmon implies being a fish, but being a fish does not imply being a salmon. Conversely, not being a fish implies not being a salmon, but not being a salmon does not imply not being a fish. And yet another way to express this: being a salmon is sufficient for being a fish, but being a fish is necessary for being a salmon.

All of the above are equivalent variations of the same logical statement:

salmon >>>>implies>>>> fish

Given a random animal you would rather bet on it being a fish than on it specifically being a salmon. As with the basketball example, we would rather bet on a broader class of events.

winning >>>>implies>>>> not losing by more than 10 points

This seems fairly straight forward; but on the abstract level, the conclusion is not so intuitive. If

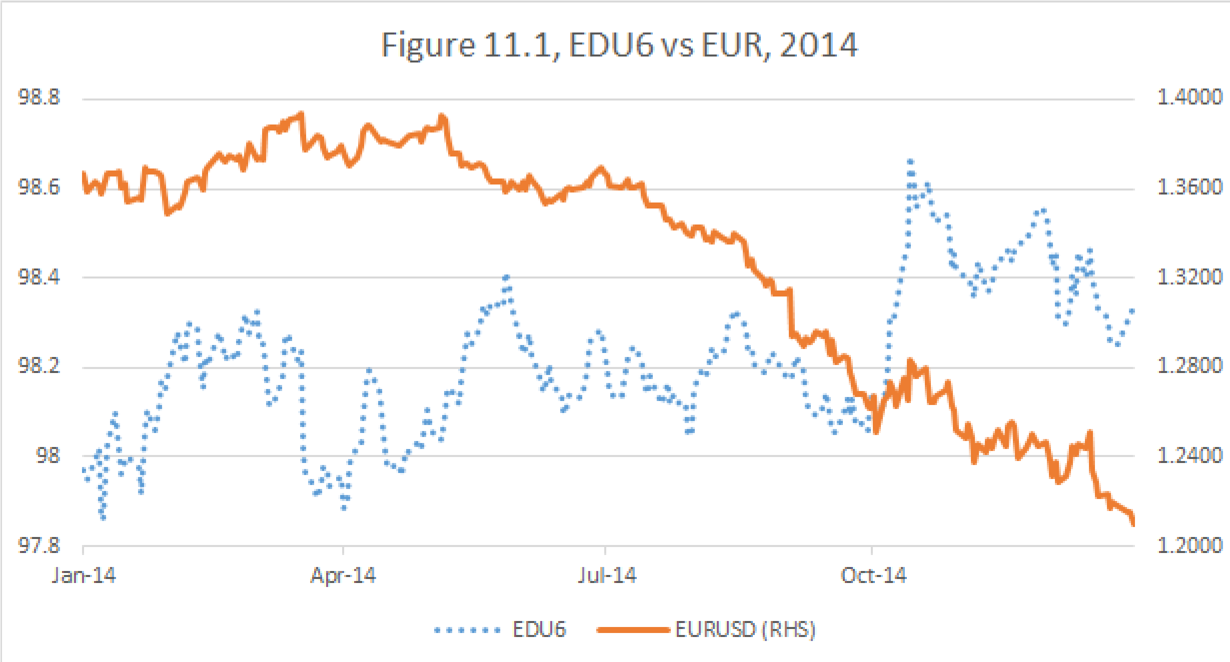
A >>>>implies>>>> B,
then A is the sufficient, and B is the necessary, and B is the dominant trade.

Let's consider two macro trades of 2014. Both were related to expressing the idea that the US economy was doing well, and the job growth was picking up.

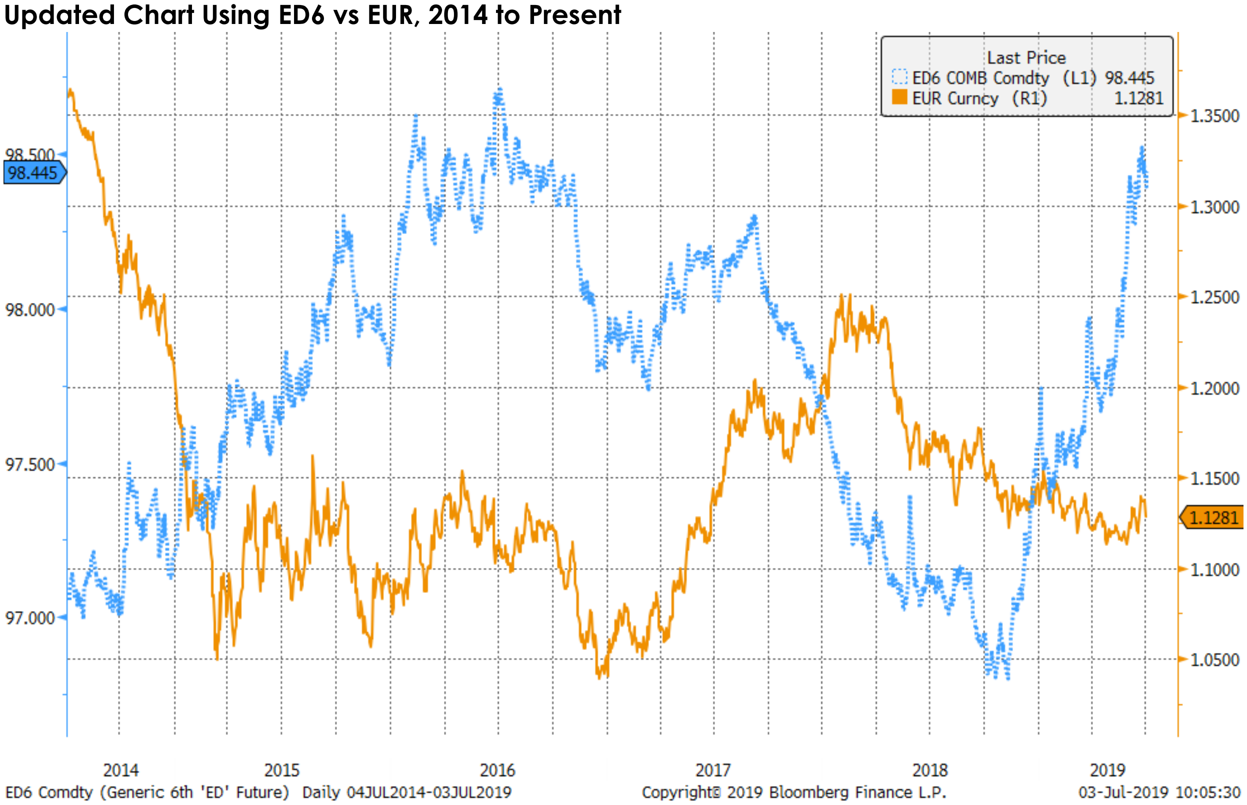
A. Short the front end of the US interest rate curve. Many people (including the consensus of the Fed Reserve governors), believed that the path of tightening the market had priced in was too benign.
B. Short Euro vs. Dollar. With divergent economics and central bank policies, some economists were calling for Euro to go down to parity within three years.

You might guess which I thought was a better trade given that I previously recommended avoiding shorting the US interest rates markets. We also know what happened. (Both trades win if the corresponding line goes down.)

Original Chart, 2014



Updated Chart Using ED6 vs EUR, 2014 to Present



But let's set aside retroactive thinking and go over scenarios.

Despite its lack of success, Position A might have had a positive expectation — a fact I don't dare or care to dispute.

On the other hand, it was reasonable to assume that if the Fed had tightened at a faster pace than anticipated by the market, the dollar was likely to outperform the euro.

Thus,

A >>>>implied>>>> B

On occasion, the logical implication works both ways, making the two statements equivalent. Let's check if

B >>>>implies>>>> A

Did lower euro imply higher US interest rates? I didn't think so. And Fig 11.1 confirms my assumption: the dollar dramatically outperformed the euro without the benefit of higher-than-projected US interest rates.

It is important to understand that the assumptions above are not permanent, but rather a function of an economic environment. In particular, this logic was predicated on the fact that European interest rates were not at all likely to go up, given the dramatically-below-target inflation.

I am confident that in 2014 most experts would have agreed with this line of reasoning. Then they would have to admit that B (long dollar) was a strictly dominant trade. Which in turn meant that everyone short the US interest rates market in 2014 was in a strictly dominated inferior trade.

This logic can be taken further. We have discussed how 10-year notes yielding 3% and funding at 0% at the beginning of 2014 were offering an extremely lucrative carry. It was reasonable to assume that it was difficult to make money being short, unless the Fed started to raise rates.

So if you were to consider three trades:
A. Short short-end interest rates
B. Long US dollar
C. Short 10-year notes

You get:

C >>>>implies>>>> A >>>>implies>>>> B

Thus Trade C was the most inferior one and Trade B, the most superior. It is worth reiterating here that I am not calling everyone who got involved in Trade C in 2014 incompetent. On that one particular year, my strategy and understanding gave me an enormous advantage; but on a different year, others might have shined.

I have been fortunate to intuitively follow these logical implication lines from early on in my career, but my first attempts to explain this approach lacked clarity. Only in the process of writing this book was I able to identify the source of consternation. Our common sense associates implication with causality. (I have no such problem, because as a former mathematician, I am not burdened with common sense.)

Saying A causes B, is very different than saying A implies B. To arrive at a logical implication we have to be more precise. "A is sufficient to cause B" signifies "A implies B." But "A is necessary to cause B," leads to the opposite direction of implication.

Let's analyze our A-B-C example in this light.

As we have said before from an economic perspective, it was easy to assume that higher short-term interest rates in the USA would be sufficient to cause a stronger dollar in 2014. My deduction also was that this economic causality, while sufficient, was not necessary.

Given that Japan was in the middle of ramping up their QE program and Europe was only about to start one, it turned out that all the Fed had to do to allow the dollar to rally was to stop actively debasing it.

So in this case, the logic went in the intuitive direction:

Higher short-term rates <<<<economic cause of>>>> stronger dollar and

Higher short-term rates >>>>imply>>>> stronger dollar

In the relationship between A and C, the causality also starts with A: Higher short-term rates <<<<cause>>>> higher 10-year yields. But this causality is necessary, rather than sufficient. As I have explained earlier, I deemed aggressive tightening to be necessary to cause higher yields in the long end. However, the analysis of historical yield curve patterns shows that rate hikes are not sufficient to cause long-dated Treasuries to sell off.

Hence,

A <<<<causes>>>> C
but
C >>>>implies>>>> A

Chapter 15, Pages 141-145

"A perfect trade is a combination of two superior trades, of which neither may fail without the other one succeeding."

It would have been reasonable to expect that only one of them would perform, while the other meandered, but the amazing power of concurrent necessity delivered on both sides beyond the wildest dream.

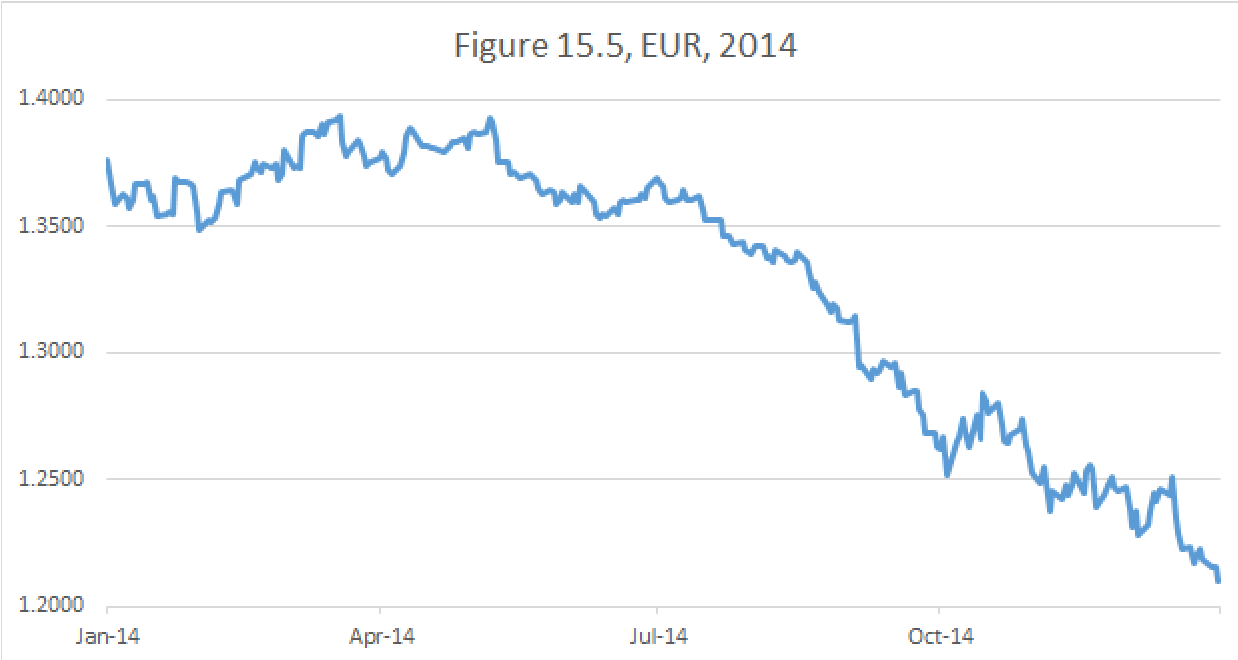
On any given day, or month, or even year a trade may be profitable based on the success of its underlying view. But dominant trades make money over a wider range of scenarios. Over a very long horizon, concurrent necessity is the vampire that sucks profits out of inferior trades and relentlessly transfers them to dominant strategies.

I have been continuously looking to replicate and expand the success of my 2002 strategy. I constantly look to lock in an undefeatable "grid" of superior trades linked to each other by the relation of dominating each other's respective failures. Such constructions have not always been successful: my logic had not been precise until the last few years and even if it were, the assumptions about economic causality and concurrent necessity are just that — assumptions. Also, on occasion, like in 2007, the attempt to construct a perfect portfolio led to complexity and less liquid trades.

It took me twelve years to find another truly perfect strategic opportunity. Only in 2014 was I able to repeat and surpass my volatility-adjusted performance of 2002.

You may have already guessed some of my 2014 logic: the opposite of the worst trade ever (short bonds) is not necessarily a perfect trade in itself, but it's a good start.

So we had the long bonds trade of 2014 that was an "even if" trade supported by historical pattern. The other side of the strategy was the long dollar trade, easiest expressed via short Euro. While the yen had depreciated considerably by 2014, the euro was at the cyclical highs. Given the deflation crisis in the eurozone and the "whatever it takes" rhetoric from the central bank, weaker euro was a no-brainer.



So short Euro was a great "even if' trade based on the pattern that if a central bank wants to weaken their own currency, they usually have tools to succeed. Also from the perspective of a positive view on the US growth, the broader long dollar was dominant with respect to betting on rising rates.

On the other hand, going long bonds was clearly a dominant bet on weaker growth, with respect to betting on a weaker dollar. Indeed, if weaker domestic economic data were to start undermining the dollar, lower rates would have been a concurrent necessity. Meanwhile the opposite is not at all true: weaker dollar was not at all a necessity with respect to lower rates and weaker growth in the USA.

Let's review the 2014 portfolio:

Trade A: Long bond futures:

- Aligned with a multi-decade secular trend
- Positive carry
- Aligned with terminal value
- An "even if" trade according to the historical pattern

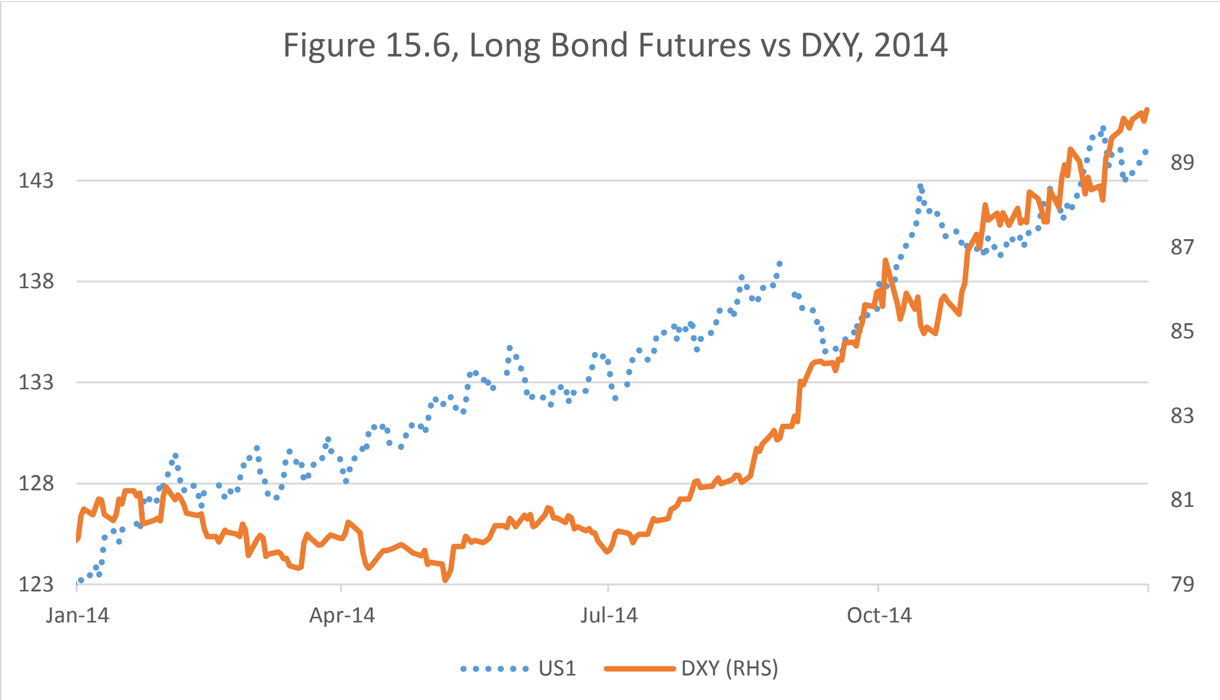
Trade B: Short EURUSD

- Positive carry
- Aligned with valuation
- Aligned with positive growth outlook
- An "even if" trade based on the historical pattern of central bank policies

Trade A is dominant with respect to B (the opposite of B) and B is dominant with respect to A. Both trades were simple, liquid and infinitely scalable.

We had a perfect trade!

And, as it had happened in 2002, the power of concurrent necessity drove the profitability beyond the boldest expectations. US job growth made a strong showing in 2014, and the stock market continued upwards. The dollar rallied broadly (with Euro being one of the worst performing currencies). At the same the bonds staged an enormous rally.



I would like now to loop back to something I said earlier:

Concurrency is everything.

Any trade, good or bad, can be made profitable with fortuitous timing. Yet, I don't rely on my ability to time market or economic events consistently. For example, my first attempts to time the Fed raising interest rates in 2010-2011 failed miserably. And it was back then, when I was still only in the USDJPY trade, I realized that instead of trying to guess the timing, I had to understand the concurrency.

It didn't matter to me when the Fed actually hiked, because by then the strengthening of the dollar would have been a necessity. And for a long as the Fed didn't hike, I could make money by earning carry on being long interest rate products. To reiterate, the beauty of it was that I could keep earning the carry indefinitely and still earn the full benefit whenever the rates outlook shifted.

By 2014, this general philosophical understanding morphed into the second perfect trade of my career. In the very first chapter of this book, I have referred to the fact that 2014 was a difficult year even for some macro traders with exceptional experience and credentials. During that year, as in 2002, I have reached dramatic outperformance not through having a superior economic view, but by utilizing very reasonable assumptions to construct a superior portfolio.

Diverse individual investment styles accord advantages in varying market environments, so it only makes sense that different traders find different years to be most profitable. But I am convinced that any experienced macro trader presented with the system of arguments outlined in this book would at the very least have avoided being caught short bonds in 2014. And if that is so, what I am sharing offers value in augmenting long-term portfolio success.

It is important to understand that the logic of concurrency and dominance on the intuitive level is not unfamiliar to most elite traders. Many speak of the most efficient (dominant, superior?) way to express a given view. But without spelling out the logic of concurrent necessity, it is possible to overlook the trap of an inferior trade. Writing this book is helping me, above all else, to maintain this intellectual rigor.

It is 2015. The market levels have shifted, and a lot of value has been realized; the long dollar/long bonds strategy still looks promising, but no longer satisfies the "perfect trade criteria." I am contemplating strategies, based on more than two positions, all interlocked in the relationships of superiority and dominance. But as I have learned over years, as you add more components, it is harder to retain simplicity and guard against the "idiot factor."

There are many superior trades and strategies and many ways to make money. But whatever I do, I want to leave some chips on the table for the moment I discover

the next perfect trade

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