# Vauge Destination

**By Landon D Whaley**

I recently came across the word “coddiwomple,” which means to travel in a purposeful manner towards a vague destination. This word succinctly and effectively describes how to be a successful investor. Weather can’t be accurately predicted further than 72 hours out, so it makes no sense to forecast a system as complex as the global economy months into the future. I’ve been managing money professionally for almost two decades, and I can promise you that the destinations of the global economy and financial markets are always vague.

But there’s hope!

The key to successful investing is traveling in a purposeful manner, because it’s the one thing you can control. Being purposeful means evaluating markets using an articulated process that is data dependent and anchored in understanding what is happening right now.
Most investors don’t coddiwomple; they stagger, like a blind man in a room full of knee-high coffee tables.

Let’s coddiwomple through the gravitational forces impacting Treasuries, and better understand why strength in the Treasury market should be SHORTed until further notice.

## Theme Park

There are two things that allow me to travel in a purposeful manner. First, every decision I make is informed by my gravitational framework, which helps me understand the three most critical forces, or gravities, that impact the direction of asset prices: fundamental, quantitative, and humanness.
Second, my team and I develop and monitor investment themes. These themes, in conjunction with the gravitational framework, provide me with a wealth of context for the price action of a given market. This context allows me to routinely see market risks and opportunities that other investors miss or under appreciate.

One of the main themes I am monitoring and trading on right now is what I call the “Three-Headed U.S. Hydra.” This is the combo platter of accelerating U.S. growth, stronger U.S. yields, and a stronger U.S. dollar. The Hydra has implications for just about every market on earth, but it’s decidedly bearish for U.S. Treasuries.

## It’s FUN-damental

The two most important factors impacting financial markets are economic conditions and how central banks respond to those conditions. This is why my analysis of any market begins with understanding its fundamental gravity. I evaluate the market’s economic conditions, central bank policy, and political environment.

Right now, Fed policy and the U.S. political environment are heavily tilted to the bullish side for yields and the greenback. The Fed is unambiguously on the path toward interest rate normalization, and Trump’s policy wish list is entirely bearish for Treasuries, at least in the short term. This is true whether or not he is able to check off the entire list.

But this U.S. Hydra theme isn’t just about policy and politics, it’s about the data, too.

It's easy to get caught up in the narrative du jour that mainstream media and Wall Street try to sell you. Last week's release of the December retail sale figures was a prime example.

To hear the media's commentary on December's retail sales you would think the sales laid an egg. But remember, it doesn't matter how a particular data point compares to "expectations," which is code for "forecasts." Instead, the most critical aspect of any economic data series is what happens at the margin in terms of the year-over-year growth trend.

As it pertains to U.S. retail sales, the number to watch is the Control Group, which is the figure that represents retail sales in the GDP calculation. December's report confirmed that the Control Group's annual growth accelerated from Q3 to Q4 2016. So, contrary to Wall Street's reaction, this confirms what we've been seeing across the service and manufacturing sectors of the U.S. economy: growth is picking up.

We're still a couple of weeks away from the start of Q1 2017 data, but I'm expecting more acceleration. As long as economic data continues to improve, treat U.S. Treasuries like the plague. The bottom line is that when U.S. growth accelerates, U.S. Treasuries significantly underperform.

**I Love to Count**

Quantitatively, the gravity for the USD and U.S. yields is bullish — overbought to say the least, but bullish nonetheless. From a price action perspective, the USD would have to breach the $96 area for at least three consecutive days before I'd be inclined to reassess this head of the Hydra. Likewise, 10-year yields could fall as low as 1.91% before I'd be concerned.

Price action is just one of several quantitative components in my gravitational framework. I also monitor volume, volatility, and cross-asset relationships, to name just a few. All aspects of the quantitative gravity for the dollar and yields are signaling a bullish bias.

**Patience is a Virtue**

The final component is the humanness gravity, which is critical because human beings are innately flawed decision makers, and markets are driven by human beings making human errors.

To say that being SHORT Treasuries is a consensus trade idea right now is an understatement. Unless you've been stranded on an island with Wilson, you've heard that the 35-year bond bull market is officially dead. I've never seen a humanness gravity more bearish than Treasuries right now. Investors are massively SHORT all along the duration curve from 5 to 30 years, and what's more, they are still pressing their hands.

Just last week investors added another $8B of short exposure to 10-year Treasuries; there's now $100B of short exposure in 10-year Treasuries alone! In fact, as a percentage of all open interest, short positioning in futures is now four standard deviations away from the three-year average.

A two standard deviation event peaks my interest, but a four standard deviation event is freakin' epic! This market is coiled so tightly that the least bit of strength will catalyze a SHORT squeeze that'll make your head spin. It's going to be like the fake peanut can with a snake that springs out when the lid comes off. Only, instead of giving your Granny a mild heart attack, the SHORT squeeze snake is going to rip off Granny's face if she is SHORT Treasuries in size.

The interesting part is that the squeeze's primary catalyst is going to be Wall Street itself. It's a new year, and when the calendar turns from December to January, professional money managers reset their profit and loss calculation back to zero.

These guys constantly manage their career and bonus risk before market risks. There is nothing they hate more than a losing position, especially at the start of the year. If it's late in the year then a losing position means their P&L is less green, but if their P&L turns red at the beginning of the year they prioritize digging themselves out of a hole.

The pain trade will kick in around the $126 area for the 10-year (ZN), and the $156 level for 30-year Treasuries (ZB).

Be patient and wait for this market to come to you. We are just four weeks into this countertrend rally, and there is more upside to come. The longer this rally lasts in terms of both duration and magnitude, the more bullish Wall Street's U.S. Treasury narrative will become.

Don't be sucked in by these Sirens: continue to travel in a purposeful manner towards that vague destination. The last time the Three-Headed U.S. Hydra theme showed itself was during 2013, when long-dated Treasuries lost approximately 14% in nine months. As long as the U.S. Hydra theme remains intact, the most probable direction for Treasuries is lower.

Ignore the narrative. Stay process and data driven, my friends.

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