MACRO VIEW: Schrodinger's Cat

Erwin Schrödinger, an Austrian quantum physicist, devised a famous thought experiment in 1935. Imagine a cat, placed in a sealed box with a hammer and a vial of poison. There is also a geiger counter and a small amount of radioactive material in the box. Over the course of an hour, there is about a 50/50 chance that the radioactive material will decay, thus emitting random particles. If the geiger counter detects a particle, the hammer then smashes the vial and the poison kills the cat. Given the unknowns – and without opening the box – we cannot say with certainty whether the cat is alive or dead.

Greece, in respect to whether or not it will default, is like Schrodinger's Cat. Is Greek eurozone membership alive… or is it dead? It is simply impossible to tell. And what about the possibility of default and "Grexit," i.e. return of the drachma? We don't know what that would mean either. Those who say with confidence that everything will be "fine" in the event of a Greek exit are merely expressing their hopes or wishes. But those who say Grexit would be guaranteed <u>disaster</u> are also falsely confident and whistling in the dark. Grexit could turn out to be catastrophe… a "nothing" event wholly ignored by markets… or even a positive, with winners including Greece!

The Greek finance minister, Yanis Varoufakis, has proposed a "debt swap" as this issue goes to press. Europe's bailout arm could lend Greece 27 billion euros with which to buy back Greek bonds, Varoufakis suggests, and structure it as "a 30-year loan with a relatively low [rate]" like 1.5%. In other words: Lend us a huge amount of dough, for a very long time, at a near zero rate – and we will then use the funds to pay off the old loans we can't afford. So what is this exactly? A last minute nonsense proposal that will be laughed out of the room? Or something the powers that be will genuinely take seriously? Again, this is Europe. The stakes are too high and the game is too bizarre… so we just don't know what happens next. There is no such thing as a fixed deadline and the goalposts are constantly moving. This is quite intentional.

In the beloved comic strip "Calvin & Hobbes," the two main characters played a game called "Calvinball," defined by the ability to make up zany rules on the spot. To play Calvinball is to engage in absolute chaos because the rules can change any second. The "rules" for Greece have a strong Calvinball element: Deadlines are not real deadlines. A final ultimatum is not truly an ultimatum. This is deliberate because Europe has to juggle a roster of impossible expectations. Think of a birthday party gone badly wrong, where the six-year-olds are divided into opposing camps. That is Europe and Greece…

There are a ridiculous number of angles here. You have the moral hazard angle, in which Greece must be taught a lesson lest other deadbeat euro members get the wrong idea. You have the geopolitical angle, in which Greek stability is crucial as a member of NATO and a Russia buffer. You have the euro tail risk angle, in which the risks of breaking up a currency union that was supposed to be "forever" are unknown. You have the fiscal transfer angle, in which other member states could take additional huge hits to the wallet whether Greece stays or goes. And then throw in populist uprising, youth unemployment, political contagion risk (to much larger Spain or Italy), fiscal backlash, on and on it goes…

Here is an example of how nutty the game is. Some argue that Greece actually <u>wants</u> a default, and have been buying time to prepare for one. The logic runs like this: If Greece defaults, then the tens of billions in Greek debt held by various eurozone banks and the ESM (Europe's bailout arm) would become useless as collateral. This would "force" the Greek government to issue a sort of "proto-currency" that would, in essence, be a return of the drachma or something leading to it. The Greek government could then loudly claim that it WANTED to stay in the euro… that it didn't WANT to issue new drachmas… but its hand was forced. And here is the gimmick: An estimated 30 billion euros worth of currency have left Greece just since February, to be parked in assets and banks <u>outside</u> Greece. Were Greece to default, that 30-billion-plus (and billions more) could flow BACK into Greece and convert from euros into "new drachmas" at the post-default exchange rate. Call it the "hard currency switcheroo."

With the "hard currency switcheroo," we have a situation where Greece defaults and wins! They get their old drachma back, which in turn allows for a mass influx of tourism by way of incredibly favorable exchange rates. They are shed of their crippling eurozone debts. And the economy is bolstered by tens of billions in hard currency, temporarily stashed in euros outside the Greek system, that comes back home after the switcheroo is pulled off. Oh, and export competitiveness is now massively stronger, thanks to a suddenly super-cheap currency. There might be a funky inflation problem to wrestle with, but who cares in comparison to those benefits? Imagine Alexis Tsipras and Yanis Varoufakis like Dan Aykroyd and Eddie Murphy at the end of the movie "Trading Places," toasting victory on their yacht in azure-blue waters, while Merkel and Schauble look like the busted Duke brothers as they get booted from office by ragingly angry German voters.

That's one way it could go. But there are darker ways. No one can be sure that a Greek default would be smooth sailing, for Greece or for anyone. There is no rulebook for exit from a "permanent" currency union of the euro's size and scope. There are also no reliable assessments of what hidden technical issues might arise. Those who think that a Greek default would be "fine" in the big scheme of things, if honest, will remember that the whole Lehman brothers meltdown was born of an odd technicality that resulted in a freeze-up of assets, in turn triggering financial panic. It is exactly the same possibility of an unknown cross-border "freeze-up" of some kind, where a major artery of trade or debt issuance or financial transaction capability gets jammed up, that could wind up producing a Lehman-style result from a Grexit.

Then, too, there are the risks of Greece becoming a failed state on Europe's doorstep… a plaything of Russia… a launch pad for a resurgence of right-wing (Nazi) populism… a touch point for angry populism now brewing in Italy and Spain… or some noxious combination of all the above. The implications of losing Greece as a NATO member give the United States a keen interest in this whole situation. It is not just economists and traders and historians watching Greece. The US Joint Chiefs of Staff and the Pentagon are watching closely too.

One can only imagine what is going through the minds of Tsipras and Varoufakis, the principal Greek players in this multi-way high stakes poker game. They could be on the cusp of a gigantic victory, whether by forcing last-minute bailout terms or snatching victory from the jaws of default. Or they could be headed for disaster and defeat, via humiliation at the hands of Germany and Brussels in accepting harsh terms… or even chaos and fiscal doom on the other side of Grexit. Merkel and Schauble, the German players, are also laying in bed awake at night. Chancellor Merkel's political legacy is at stake – but so too is the stability of Europe…

The German populace is frustrated and disgusted. As far as German voters are concerned, Greece can fall into the ocean (and perhaps should). Multiple other eurozone members have come around to this view also. "People are really fed up with this," says Erik Nielsen, Chief Global Economist with UniCredit SpA. "They've never seen anything so completely ridiculous, frankly speaking, from a debtor country." Germany is now crafting contingency plans for a default, including possible capital controls on Greek banks. Angela Merkel is facing increasingly heavy political pressure from her own party to let the Greeks go ahead and jump.

But it simply isn't that simple… because Merkel has to think like a statesman as well as a politician. The risk of Greece becoming a failed state… or a Putin satellite… or possibly just as bad, a country that managed to exit the euro on successful terms, is not something Merkel can take lightly. Were Greece to quit the eurozone and come out the better for it, or even turn out simply "okay," populist leaders in Italy and Spain would begin to pound the table: *"Greece did it – what are we waiting for? There is nothing to lose but our fiscal chains!"* So along with the geopolitical dangers of losing a strategically placed NATO member, "Grexit" would invite the possibility of unraveling the entire euro project. The dangers put Angela Merkel in a particularly tough spot. From a risk management perspective, Germany cannot let Greece depart that easily, even if the German populace is deeply in favor. Yet Merkel also has to account for political risk on the home front. If she is seen as being too soft on Greece, or giving them too many concessions, she could face a political uprising. There are growing rumors of an internal split between the dovish Chancellor Merkel and the hawkish Wolfgang Schauble, the 73-year-old German finance minister who first entered politics when Merkel was still in high school. But some think the split is more showmanship than anything, as Schauble maintains the role of hardliner in order to give Merkel cover.

Alexis Tsipras, the Prime Minister of Greece, is locked in a similar battle with the hardliners of Syriza, his own party, who are deeply opposed to any kind of Greek compromise… and who would welcome the risks (and potential rewards) of Grexit, endorsing default rather than further humiliation. As with the German populace, Syriza is driven more by emotion and ideals than cold hard logic. And thus if Alexis Tsipras authorizes a painful last-ditch compromise to keep Greece in the eurozone – if he and Varoufakis blink first – then they can expect to be political outcasts at home. The *Financial Times* has compared the Tsipras-Varoufakis duo to Lenin and Trotsky in the Brest-Litovsk peace treaty of 1918. Lenin capitulated to extremely harsh German demands to maintain the Bolshevik hold on power; Trotsky held out until the very last second, preaching rebellion until the moment he gave in.

TREND VIEW: The Grand Slam Business

What happens to the euro after Greece defaults? Or doesn't default? Does EURUSD push sharply higher? Or fall sharply lower? We can describe plausible scenarios for default or non-default, heading in both directions. If Greece capitulates at the last moment, as Lenin did in 1918, it could be seen as a victory for fiscal hardliners, causing the euro to strengthen. Alternatively, if Greece stays in the euro because a major bailout pushes through, giving Tsipras-Varoufakis a win and the perception that the hardliners are soft, the euro could weaken dramatically. So the "Greece stays in" outcome hinges on perception of deal terms and who "won" the final outcome of the hand – Greece or its opponents.

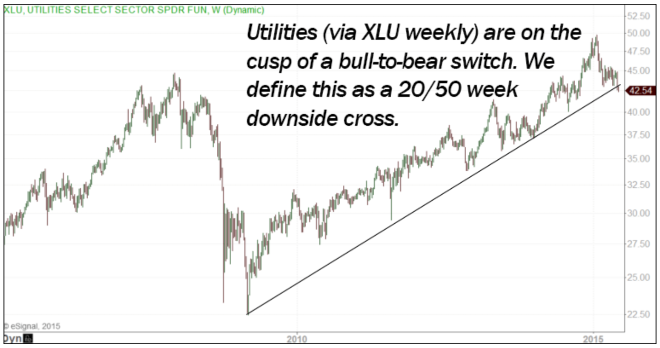
Similarly, if Greece defaults, there are possibilities of a strong run higher or lower. The bullish EURUSD scenario would be a perception of strength and discipline: The notion that kicking out Greece, without any major blowback, has made the euro stronger (and its remaining members more disciplined). On the other hand, a "successful" Greek default could accelerate questions of "Who's next, Italy or Spain, and how long until France…" which could then lead to a loss-of-confidence spiral that sends EURUSD below $1.00, and eventually below its all time low of 86 cents. Then too you have the question of trillions worth of European sovereign debt recently trading at negative interest rates… now subject to further volatility as government bonds world-wide show sign of topping out.

Speaking of bonds… barring a near-term US recession, or a return to global crisis that sparks a violent flight to safety, US treasury bonds continue to confirm a generational cycle top.

As we all know, US equities have been teflon these past few years. But the cracks are finally starting to show… it makes sense that real estate (as shown via IYR above) would be one of the first areas to crack, given extreme orientation to high valuations and low interest rates. As we have noted in these pages and elsewhere, real estate values had progressed from frothy to beyond "insane"… think 500K apartments in Hong Kong barely larger than a regulation-sized US parking space, and a spec real estate compound in Beverly Hills going for $500 million. (Half a billion for residential real estate!)

Of course, as the old saying goes, "the market can remain irrational longer than you can remain solvent"… which is very true, and the reason we don't fight price. Except, we would argue, in respect to real estate and IYR, it is no longer bears fighting price, but bulls. At least on the daily timeframe (which is shown above)… on the true "big trend" timeframe, IYR is still bull neutral (but now showing signs of a turn).

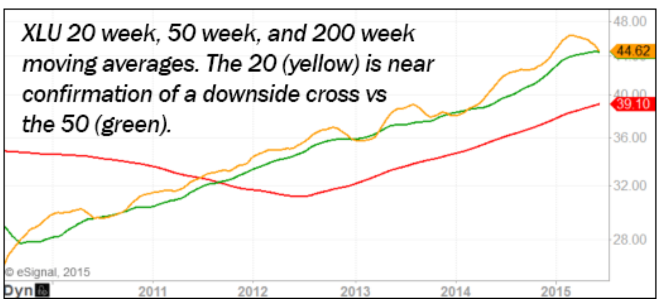
You can see it is still "early days" for IYR by observing the big picture time-frame. We classify the current long-term trend for IYR as "bull neutral," meaning it is no longer bull trending, but not yet turned bearish. Attractive patterns take longer to develop tban most traders realize. There is often a mismatch between "human time" and "trend time." A truly powerful trend with the ability to haul a lot of freight – i.e absorb a lot of capital and deliver a powerful ROI in absolute dollar terms – can take months to develop and years to play out. This is why top traders rarely hurry – except at key inflection points.



Utilities – as shown via XLU weekly above – are on the cusp of a true bull-to-bear switch. We actually define this based on moving average levels. By our parameters, there are only four "states" in which a market can exist:

- Bull Trending
- Bull Neutral
- Bear Trending
- Bear Neutral

The "neutral" zones incorporate all kinds of chop, sideways action, lack of clarity and so on… yet still reflect an overall bias one way or the other. Trending classifications require less explanation. We deliberately classify trends with these four slices only because, by the time you layer other factors on top, you have all the complexity one could want. Start simply and clearly, then seek to add layers of capability, and you will have plenty o' complexity to handle no matter what.



Major turns in the macro environment will often have the stateliness of a cruise ship. Think of the Queen Elizabeth II doing a slow and massive 180 degree turn, as opposed to a fast speedboat with a tight turn radius. The long-term trend, as defined by us via the 20 week / 50 week moving average relationship (in conjunction with three-month high and low parameters), is deliberately a "slow" signal. We can see that XLU has either been "bull trend" or "bull neutral" since late 2009, with only three cross attempts (20 below 50) that turned out to be false signals. Keep in mind too that one does not trade off the weekly timeframe, but instead uses it for strategic positioning purposes. We booked solid gains from a utilities short in 2013, in which the price action appeared quite dramatic on the daily charts, before going sideways and resolving bullish again from '14 onward. So will this fourth cross setup be another fakeout? Possibly. And yet, and yet…

The current fundamental positioning for utilities, relative to valuation, interest rate sensitivity, solar competition, and general long-term outlook (think Elon and his batteries) has only grown worse and worse. Even the "melt-up" equity case is somewhat bearish for utes, as a true last-ditch melt-up would likely involve a rotation out of "safe haven" equity positions… and into the sexy stuff making a parabolic run (even as continued yield creep hurt utes all the more).

Speaking of sexy, the bigger the trend, the sexier the prospects... and the long-range upside breakout developing in dollar/yen (USDJPY) is one of the biggest trends around. Bill Gurley, a prominent Silicon Valley venture capitalist, is on record saying "The venture capital business is not even a home run business, it's a grand slam business" – meaning the point and purpose of being a venture capitalist, when one looks back at a track record developed by deploying capital over multi-decade periods, is capturing those huge, HUGE opportunities that dwarfed all others.

Trading, poker and investing are very much similar. There are plenty of opportunities to book modest profits or otherwise "cover costs" with incremental gains. But the reason you are there -- the reason why you play the game -- is to crush the mega-opportunities when they come. Dollar/yen continues to strike us as one such "mega-opportunity" in the making. There are various scenarios, quite plausible, in which USDJPY could run to 150 or even 200. That is the type of move which can generate a fortune. And while no one has a crystal ball, there are many "odds and probability" factors in favor:

- further deterioration of China's economy
- growing threat of China / Japan conflict
- blowback from "USD carry trade unwind"
- potential panic response to stalled Abenomics
- increasingly favorable US / Japan positioning
- likelihood of Asia capital flight into USTs in a crisis event
- And more…

At the end of the day, it is not just about the trends, but the big, BIG trends. That is an easy thing to miss, and thus a truly important thing to emphasize and revisit. As our processes evolve and capabilities enhance behind the scenes, we will find more effective ways to emphasize and articulate this...

FOUNDER'S NOTE: Evolution, Morpheus, Evolution…

Jack here. The "Spotlight" feature will resume as normal next week. This week, I want to give you a quick heads up as to all that is happening with *Mercenary Trader*… and the major benefits you will see as a *Strategic Intelligence Report* reader. We can start by addressing the elephant in the room – SIR delivery times. Many of you may be wondering things like:

"Why am I seeing this issue on a Sunday? And are these guys ever going to pick a set time? They've seemed to go through all the days of the week… what's going on over there?"

Completely fair to wonder. So let me give you the lay of the land. The short answer is that the SIR is still a young product (less than two years old)… and more importantly, Mercenary Trader is still a young organization. We are now transitioning through an explosive period of evolutionary growth. This has meant temporary chaos behind the scenes, but all to a very powerful end (which will benefit the entire MT community).

Mercenary Trader (MT) revealed itself to the world in May 2010. I remember the time period vividly, because the May 2010 "flash crash" was one of the very first things we blogged about. In the beginning, MT was two founders. Now there is one founder – Mike stepped away to spend more time with his growing family – and a team of four analysts, quite soon to become five. In the beginning, MT headquarters was a converted master bedroom in a condo in Reno/Tahoe. Now our headquarters is a 4,600 square foot penthouse in Las Vegas, with four large balconies, event capacity for 50 to 100 people, and room for 15 to 20 full-time employees. We now have "team dinners," with food prepared Google-style, by a professional-level outside chef. And we are developing new systems and processes to run the entire organization on cloud-based production management software, equipped with 21st century sharing and collaboration tools.

That is only the beginning. Within six months, MT is likely to have a full-time London office. We are going global. We have also upgraded our internal organizational structure. We now have a Pattern Division – focused on quantitative market analysis and the development of pattern-based algorithms – and a Research Division, focused on traditional fundamental analysis and the development of conviction-based themes. We are now taking our already formidable capabilities on the fundamental analysis side, and underlying the whole thing with a powerful quantitative analysis structure. The Pattern Division and Research Divisions, meanwhile, are not separate entities but instead overlapping circles of competence that work closely with each other. Our vision for MT, as recently described to *Driver's Manual* subscribers, can be described as "Bridgewater with a Quantum Fund Overlay."

Oh, and that's not all. Within four to six weeks' time, we will reveal a completely relaunched MT website structure, along with a sister site, TradingWisdom.com (if you type "Trading Wisdom" into Google, we are already the top result). We are also going to be revealing an MT message board forum with incredible features – including the ability to create your own profile, avatar image, personal description, and more – and also unveiling a "2.0" level subscription-level interface (no more "monthly passwords" to access your SIR subscription).

And still this is not all of it… we will soon be introducing a suite of "trend algorithm" tools, possibly more powerful (and useful) than anything made available to any retail trader, ever, anywhere. And those trend algorithm tools will only be our first foray into true "augmented intelligence" as we make forward strides toward the development of AVA, short for "Automated Virtual Assistant." As Ava's capabilities evolve, you will eventually be able to ask for her opinion on a stock, industry or asset class – and receive a detailed response. But still this is not all…there is even more I am leaving out…

What does all of this have to do with the SIR, and benefits to you as a SIR reader? A few key things. **First, the chaotic nature of delivery times is temporary... and a normal delivery window will stabilize.** Along with rapid iterative development of team capabilities, we are also getting "settled in" to various systems and processes that will allow for regular SIR delivery in more of a clockwork-style fashion. Second, the quality of SIR research is only going to become better and stronger. There are many legacy newsletters out there -- some of them quite good -- that have nonetheless hit a stagnant local maximum. They aren't getting any better, in other words. That is not us. We are developing new and deep capabilities at an astonishingly rapid pace. The SIR is already known, as many of you have attested, for institutional quality insight and content. Well I am here to tell you we have only just begun on that front. We will not stop evolving and growing, expanding our capabilities and knowledge sets and delivery mechanisms, until we are simply delivering the best research available anywhere. And third, SIR is going to go global. For the initial stretch we have focused on US equities because, well, you have to start somewhere. But our mandate is global, not local. We want to find the most compelling risk-reward opportunities that we can, regardless of the exchanges they trade on. As our manpower and coverage capabilities expand, so too will our global reach… Let me close with a heartfelt "thank you." We are deeply grateful for your support as a *Strategic Intelligence Report* reader, and hope to raise a glass with you at some point in future. The adventure, and the journey, has only just begun…