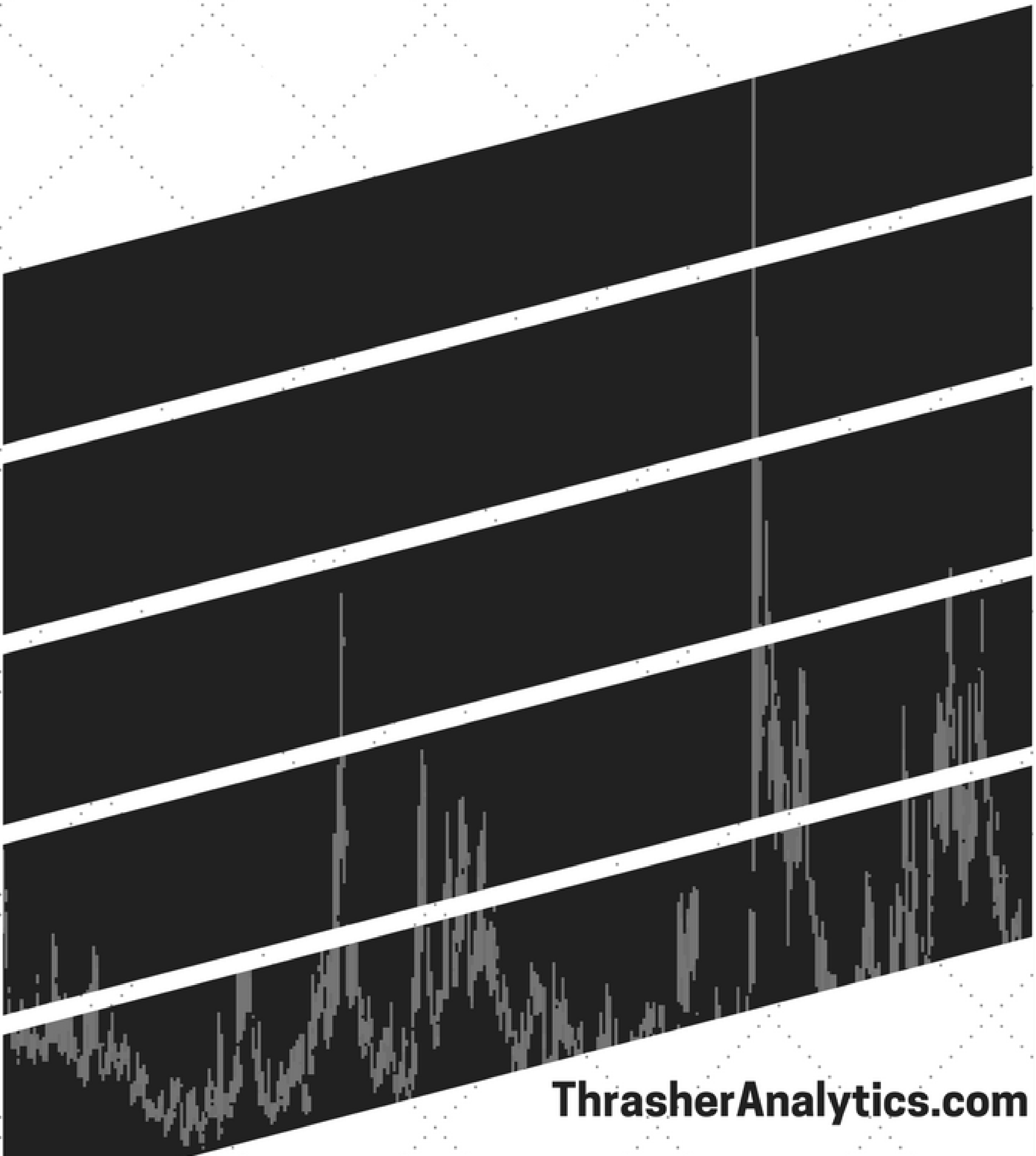
THRASHER ANALYTICS

BI-WEEKLY RESEARCH & ANALYSIS



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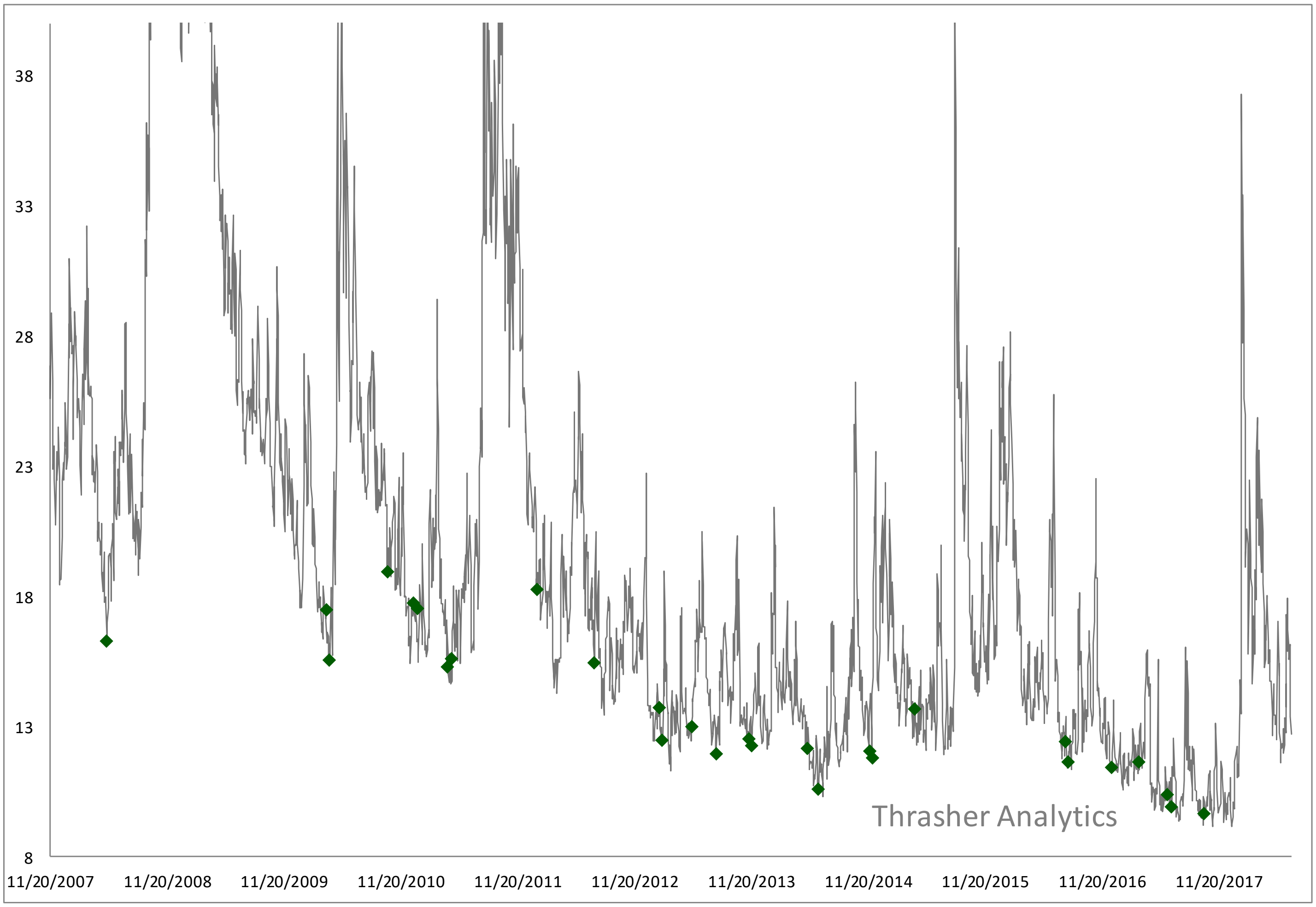
volatility Risk Trigger (VRT)

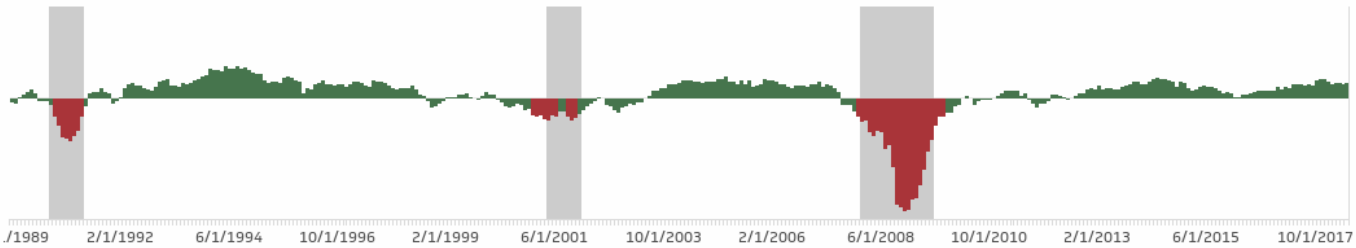


As I wrote in my last letter, we saw the volatility spike that I'd been looking for albeit it stayed subdued it still was a 20+% move in vol (forgive the percentage of a percentage usage). Spot VIX finished August just under its 1-year average and 100-day average, finishing the month as one of the least volatile Augusts in quite some time. I've begun noticing volatility dispersion narrowing in the data for the Russell 2000 and Nasdaq 100. While this is just a single input, it's still a notable development in the volatility market as over-confidence towards subdued vol has once again begun to perk its head.

I'll have some other volatility-related charts further into the letter but I will note the large changes in correlation within the vol space that's taking place right now. Could it be setting up for a change in environment for volatility in September? We'll see.

Economic Dashboard

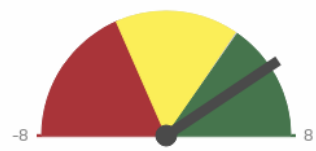
Leading Economic Indicator



Corporate Composite

2

Industrial Composite



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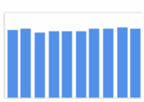
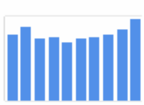
Corporate Indicators

Indicator	Value	Threshold	Trend
Corp. Operating Surplus	1,667,011	1,674,509 Less Than	
Corp. Disposal Income	592,366	527,122 Less Than	
Corp. Cash Flow	14.9	0 Less Than	

Industrial Indicators

Indicator	Value	Threshold	Trend
YoY Change in Manufacturing Sales	3.2	0 Less Than	
YoY Change in Industrial Production	3.8	0 Less Than	
YoY change in Non-Defense New Orders	8	0 Less Than	
YoY Change in Durable Goods New Orders	3.1	0 Less Than	

Economic Dashboard

Banking Composite

2

Consumer Composite

3

Banking Indicators

Indicator	Value	Threshold	Trend
% of Banks Tightening Standards	-11	0 Greater Than	
% of Banks Tightening Standards for Comercial & Industrial Loans	-3	0 Greater Than	
% of Banks Tightening Standards on Credit Cards	9.4	0 Greater Than	
Deliquency Rate on Credit Cards	2.5	2.5 Greater Than	
Deliquency Rate on Commerical & Industrial Loans	1.2	1.3 Greater Than	
Non-Financial Liabilities	459.8	433 Less Than	
Ratio of Non-Performing Loans	1.2	1.2 Greater Than	
% of Banks Increasing Willingness to Make Consumer Loans	9.2	0 Less Than	

Consumer Indicators

Indicator	Value	Threshold	Trend
YoY Change in Non-Farm Payroll	1.6	0 Less Than	
Avg. Weekly Hours Worked in Manufacturing	42.1	42 Less Than	
3Yr Change in Real Income	13.0	8 Less Than	
YoY Change in Retail Sales	6.5	5 Less Than	
Housing Building Permits	1,292	1,311 Less Than	
YoY Change in Consumer Sentiment	3.4	0 Less Than	
Barrel of Crude Oil	71.2	20% 6-month Change	
Shiller Home Price Index	203.0	197 Less Than	
Labor Slack	-0.8	0 Less Than	

Financial Stress Composite

-2.9

Headline Economic Indicators

Real GDP Growth	**2.8%**
Nominal GDP Growth	**5.4%**
YoY Change in Federal Debt-to-GDP	**1.6%**
Unemployment Rate	**3.9%**
Inflation (CPI)	**2.8%**
Core Inflation (CPI)	**2.2%**
Inflation (PCE)	**5.1%**
Core Inflation (PCE)	**1.9%**

Financial Stress Indicators

Indicator	Value	Threshold	Trend
St. Louis Stress Index	-1.1	-1.1 Greater Than	
Kansas City Stress Index	-0.6	-0.5 Greater Than	
Chicago Stress Index	-0.8	-0.8 Greater Than	

Broad Market Commentary

Two weeks ago I wrote how encouraging it was that the S&P 500 was holding above its July and March pivot points at 2800. Since then, the equity index has continued higher and eventually moved above the January high. Thursday and Friday of last week saw a bit of selling pressure but as we moved into the Labor Day weekend, the "real" trading will pick back up this week and bulls will want to see SPX hold above that January level as the last thing they will want to see is the creation of a false break out. I will note the small gap around 2875 price will most likely contend with. If selling does pick up I'll be looking for a gap fill there and a test of the January level, which will likely bring in some dip buyers initially. If 2875 doesn't hold then we could see a move back to the 50-day MA, currently at 2814.

The S&P Daily Sentiment Index (DSI) finished the week at 76% bullish, just off the intra-week high of 80%. This pairs well with what other sentiment gauges are showing as Conference Board Consumer Confidence Index hit its highest level since 2000. The spread between Conference Board's President Situation and Future Expectations has been extremely wide for most of this year, with the gap wider than in 2007 and only eclipsed by the pre-dotcom bubble era.

Stocks vs. Treasury Bonds

The above chart shows the ratio of the S&P 500 vs. the 30-year Treasury Bond. As to little surprise, the equity index has been outperforming bonds, sending the ratio to new highs. However it's important to point out that we now have a bearish divergence that's developed with the most recent higher high in the ratio. With the Relative Strength Index (RSI) making a lower low, the ratio has sense setup a possible false breakout with bonds strengthening late last week relative to stocks. If this bond strength continues this week then the ratio could begin to develop a new counter-trend lower, which would be a headwind for risky assets i.e. equities.

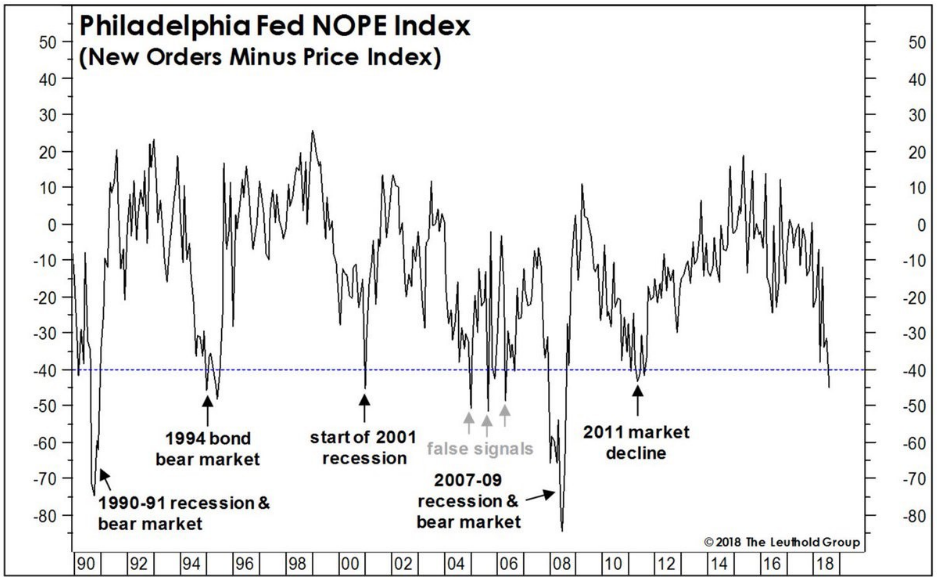
A Possible Surprise Miss in Manufacturing Data

I believe the largest near-term risk to the market right now is a slow down in economic data will cause the U.S. Federal Reserve to slow their base in rate hikes. While the September hike is all but certain, the market has large expectation for a hike in December as well but I'm not completely convinced yet. Tuesday we will get the Markit and ISM manufacturing data and I think we'll see a miss, as manufacturing continues to slow into year-end.

PMI data out of Europe has already begun to decline, Market noted on Italy, "Unless we see a pick-up in demand, the recent trends in the data raise the spectre of the [manufacturing] sector tipping into technical recession during the second half of 2018." Looking at other parts of Europe we have PMI data for the UK at a25-month low, Poland at a 22-month low, Switzerland at a 24-month low, Italy at a 24-month low and South Africa PMI is at a 13-month low.

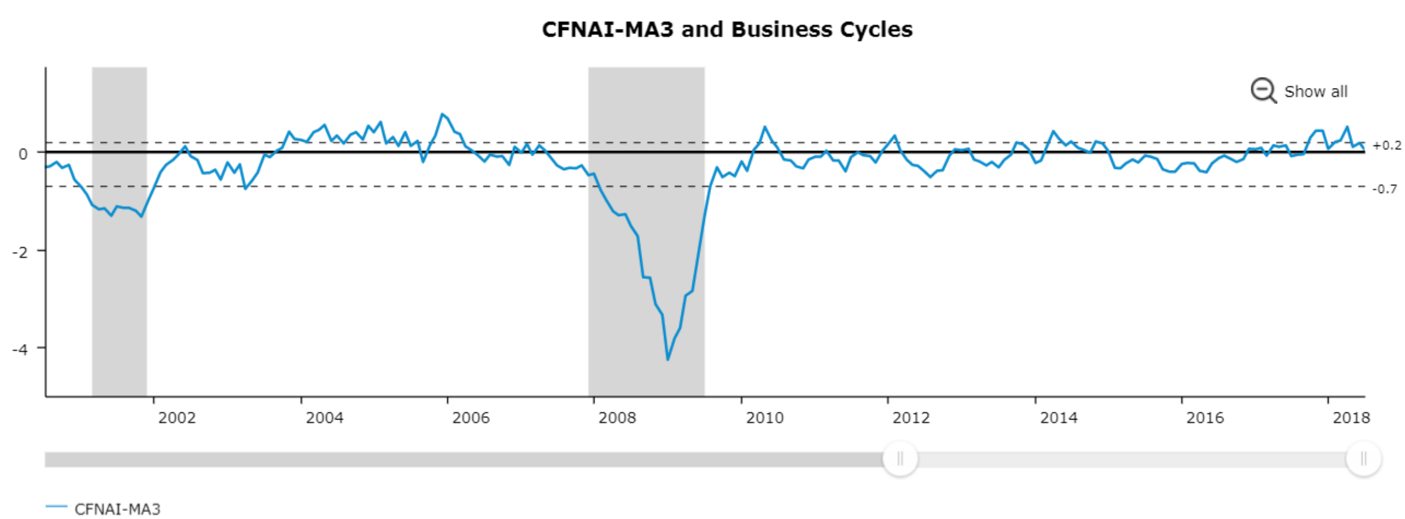
The above chart comes from Nordea, which shows that Phily Fed data leads the U.S. ISM report by 8-months and is currently signaling a continued down trend and eventual break of 50 by the ISM index. Over the next two pages I'll add to my reasoning why I think we see a slow in economic activity which coupled with the international developments (specifically emerging markets), I believe we'll see an easing off the gas by Powell as he takes a wait and see approach to December's rate decision.

Slowing in Economic Activity

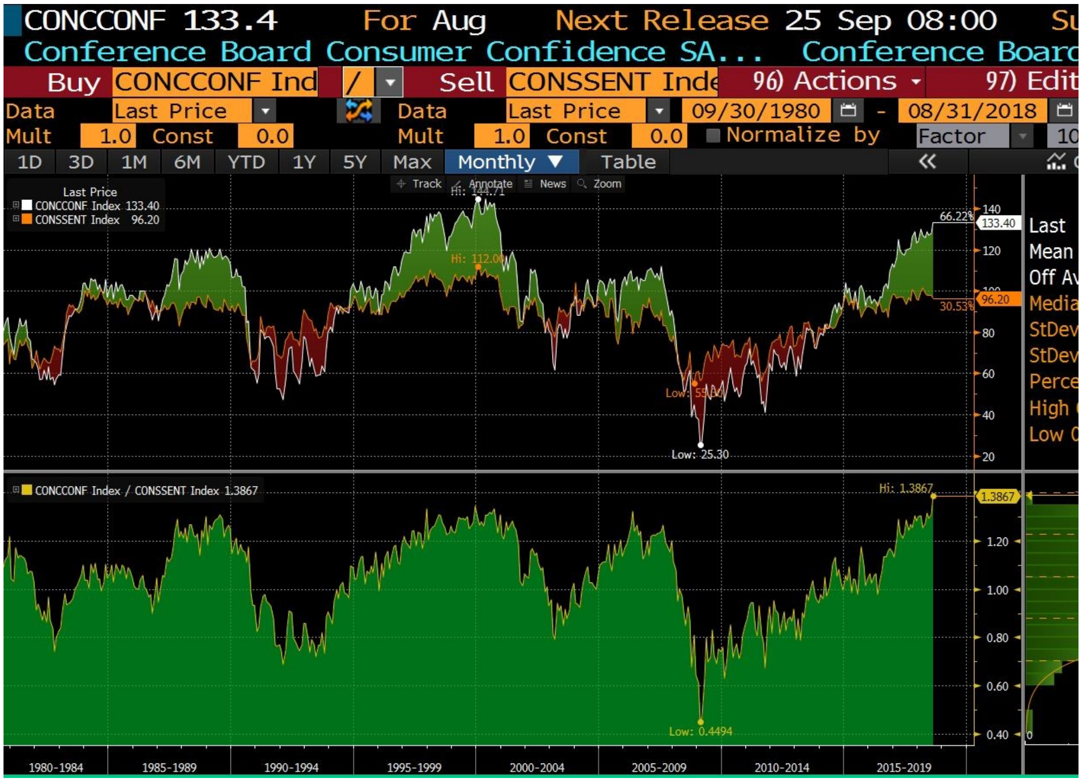


The Leuthold Group also notes the weakness in the Philadelphia Fed manufacturing report, specifically the spread between new orders and prices. Sharing on Twitter, "Sharp decline in new orders without drop in prices paid which usually accompanies such order weakness...result was that the Philly version of NOPE Index (New Orders minus Prices) fell below -40 threshold that frequently signaled trouble for stocks & economy."

Below is a chart of one of my favorite economic indicators, the Chicago Fed National Activity Index, smoothed by a 3-month average. the CFNAI remains positive. However, it peaked in April and has moved to near zero as of the July reading. Note, a move under -0.7 is the 'trigger' point for CFNAI to call for economic contractions, so we are still well above that level. Going into the mini-bear market of 2015 the CFNAI sent several months under the zero line, signaling weak economic growth but not one of full out recessionary-type contraction. If Nordea is right and we do see manufacturing data weaken further in the coming months, it's very possible we see CFNAI also begin spending more time under zero as well, creating an unfavorable environment for risky assets.



Growing Spread in Consumer Sentiment



There are many different survey's of consumer and investor sentiment. Two of them are the Conference Board Consumer Confidence Index and the Univ. of Michigan Consumer Sentiment Index. While you would think that these two would be highly correlated as they are both based on asking the general public how they feel. However, recently that's not been the case. In fact the spread between these two sentiment gauges has risen to the highest level in their history. You'll notice that the past instances of the spread increasing near today's level marked important points in market history (late 80s, late 90s, mid 2000s).

The difference in approach the survey's take gives us a clue into what this data is telling us. Conference Board focuses more on employment while UofM focuses on future expectations. Which is why it's believed that the UofM survey is more leading over the Conference Board. Based on the recent down shift in housing data while unemployment has stayed low, I would postulate there's been a downshift in consumer's confidence in their finances as they read the headlines of trade wars and rising interest and mortgage rates. That's why UofM is likely seeing a slower rise/slight decline in their data while Conference Board's sentiment index is hitting all-time highs. Chart courtesy of Otavio Costa.

Fortunately retail sales numbers have remained strong. I think we'll first see a breakdown in manufacturing data before weakness begins showing up in retail numbers. Which is a good sign for the economy as historically retail sales peak well before the economy as a whole, meaning we're not near a top in economic growth just yet.

Market Risk Appetite

Checking in once again on the risk appetite of the market we have a mixed bag. Over the last two weeks many of the risk ratios have begun to rise, confirming the latest advance in the S&P 500. However, the reason I've marked their arrows in yellow is because they are still well off their major highs. Meaning, while in the short-term they are improving, in the intermediate-term risk appetite is yet to confirm the new high in U.S. large cap indices. Notably, equal weigh vs. cap weight hit a fresh new 2018 low last week as the mega cap stocks continue to hold the reins for this market. High yield bonds improved, as did high beta (slightly) and small cap stocks.

This is a good initial sigh, but we aren't out of the woods yet as we need to start seeing new highs in these ratios in order to truly believe the 'risk on' mood of the market has returned.

Small Cap Relative Performance Driven By Global Yields

This is a chart you're unlikely to see anywhere else (at least I haven't) and I'd prefer to keep it that way, so please do not share it.

What we have here is a ratio between U.S. and Germany 10-year Treasury Yields and the ratio of U.S. small cap vs. large cap stocks, with momentum of the Treasury Yield ratio on top. Notice that when the Yield ratio is declining (German yields rising more or falling less than U.S. yields) and small caps are out-performing large caps, a trend change in relative performance for equities often fallows as shown by the red arrows and dotted lines. We saw this most recently in early-'18 when the ratio between small and large caps test the '17 low while the Yield ratio made a higher low, small caps then quickly began to outperform.

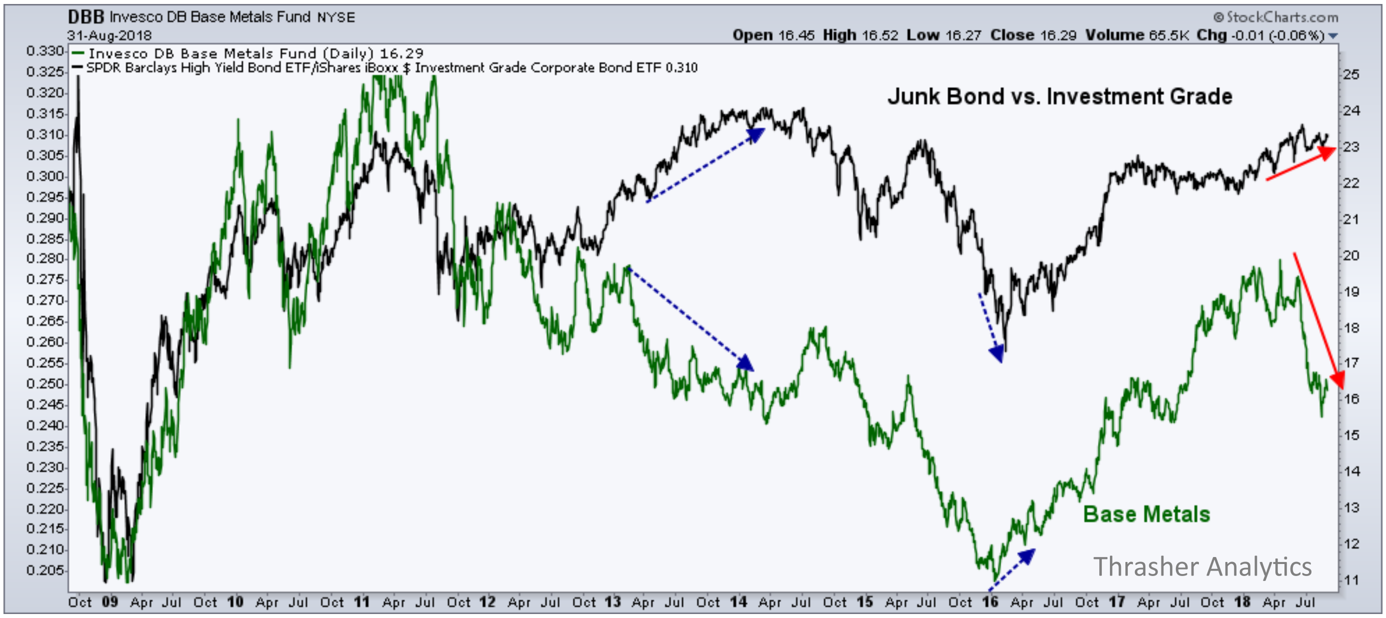
Focusing on the far right side of the chart we can see currently that the Yield ratio has begun to flatline after testing its prior high while momentum is making a lower high, a bearish divergence. If we start seeing German yields under-perform U.S. yields then that will put pressure on small cap stocks which will likely under-perform large cap. We saw something similar play out in 2015 with a momentum divergence signaling a shift in the Yield ratio and then a breakdown in small caps which was also the result of a macro trend change and mini-bear market.

If this chart continues to play out, I'll be updating you on it in the future but right now I just want to make you aware that we could start seeing weakness in small caps based on what could be shifting in the global fixed income market.

I'd also point out that if we see inflation data (specifically wage growth) pick up, that would also put pressure on small cap companies they see a greater impact by rising wages than larger firms due to a larger percentage of their revenue being eaten up by salaries and pay.

I know this is a somewhat complicated chart and commentary—as always be sure to email me if you have any questions.

Base Metals Diverge from Junk Bond Spread



Above is a rather unique chart for the high yield market. The black line shows the spread between junk bonds and investment grade bonds while the green line is the Invesco Base Metals ETF. The junk spread and base metals often move in lockstep with one another but when they begin to diverge, it's often the commodity that holds firm in the new trend direction. We saw this take place in 2013 as metals declined while the ratio between junk bonds and investment grade made a new high but then reversed lower. The low in 2016 also saw base metals bottom several weeks before the junk spread.

Once again we have base metals seeing weakness, likely due to the emerging market turmoil and economic slowing of several nations; meanwhile, junk bonds have been strengthening relative to investment grade. If base metals continue this move lower, we're likely to see the bond spread reverse as well. If this were to occur, that would paint a less than sunny picture for a risk-on environment as many equity charts have painted.

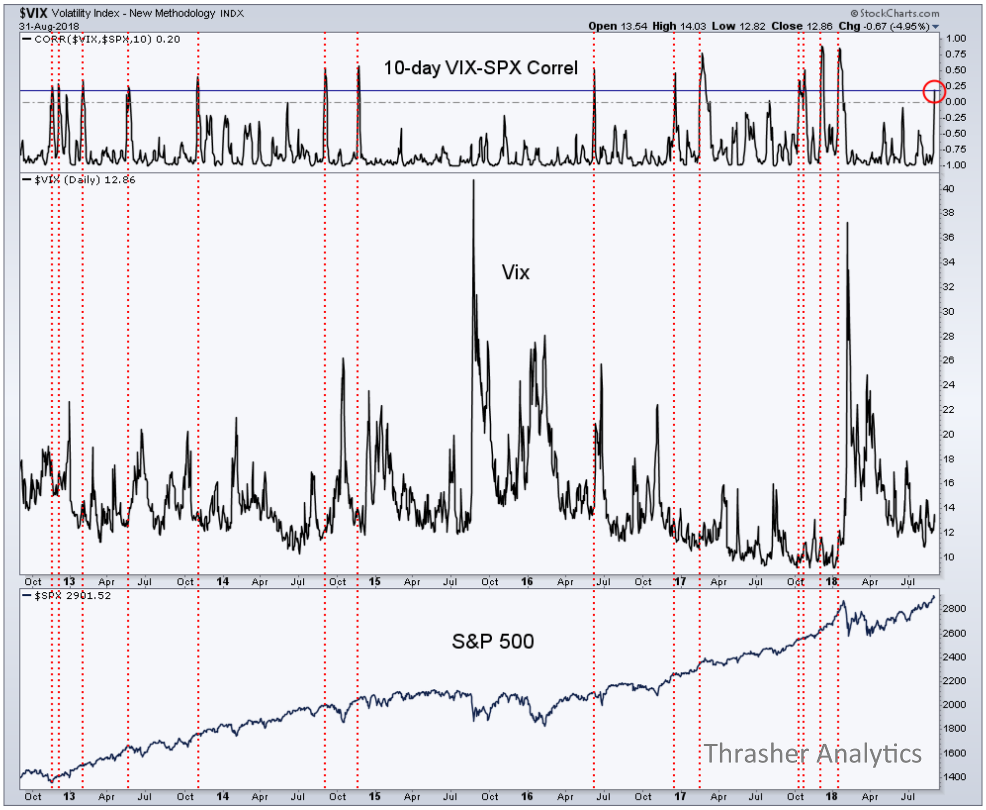
Emerging Market Currency Decline

While EM currencies are seeing a sharp rise in volatility, the dollar hasn't seen a material change, actually it has been weakening over the last week. Trump continues to tweet about Turkey, S. Africa, and Russia which keeps the pressure on the susceptible countries but it doesn't appear the dollar strengthening is the root cause of the latest weakening taking place in emerging market currencies. The Indonesia rupiah is the weakest its been against the dollar since the Asian Crisis in 1998, the Indian rupiee it's a new record low and the S. African rand is still declining. As a whole, the EM Currency Index has seen five consecutive months of declines, which is the most since 2015.

As far as the risks associated with the forex volatility, Nomura put together a nice yet brief summary:

"In Asia, there may be some short-term BOP-related contagion in [Indonesia, India and the Philippines] but from a fundamental standpoint, we believe the bigger vulnerability for Asia in coming months stems from domestic credit stress and evaporating market liquidity, not balance of payments or currency pressures", the bank wrote, in a note dated August 13. " A VaR shock, as experienced in previous instances of specific EM stress is possible. The concerns emanate from several fronts, including still relatively large positioning from real money in Turkey (tracking the JPM EMGBI) for which we have seen investors overweight on a geographical basis in eight of the past 12 months to June 2018. This is similar in other parts of EM, with overweights in Asia (except THB), LatAm (except COP) and EEMEA (except PLN; Figure 3). Like the Russia-led VaR shock, the contagion effect is driven by the need of real money investors to sell their holdings (even those with strong local fundamental stories) in other markets to fund redemptions, as indicated by discussions with EM real money investors, as well as by the strong historical relationship between global EM and specific EEMEA/LatAm/Asia dedicated funds' net flow data."

Rising Correlation Between Volatility & Equities

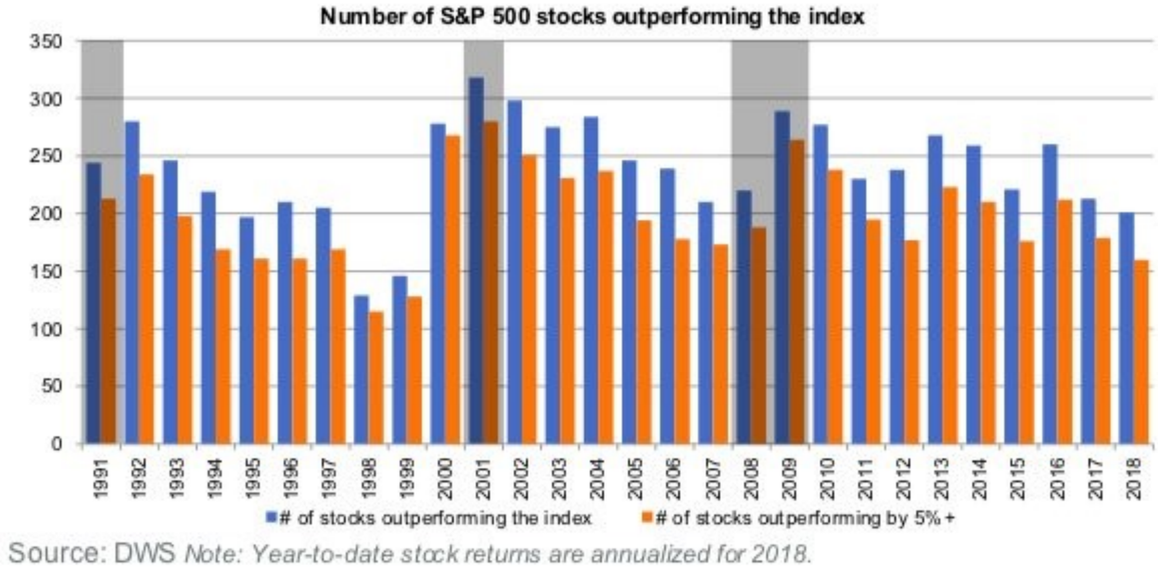


The recent rise in correlation between the S&P 500 and the Volatility Index has drawn some attention lately. This isn't a new concept, I've written about it on my blog and on Twitter numerous times, however each time correlations rise everyone's focus seems to go in the wrong direction.

A MarketWatch story has been getting passed around, calling for the correlation to bring down the stock market. And while we have seen periods of equity weakness follow a rise in vol-stock correlation, it's really the volatility market that should get the attention. We see much stronger moves come out of the VIX than we do in the broad equity indices.

As the chart above shows, with red dotted lines marking past occurrences of the 10-day correl getting to its current level, the equity market sometimes does drop a few point but look at some of the resulting moves in vol! If a trader was looking for a market to place a bet based on this correlation chart, it's in the vol pits not the equity market he or she should be looking.

Number of Stocks Outperforming the Market

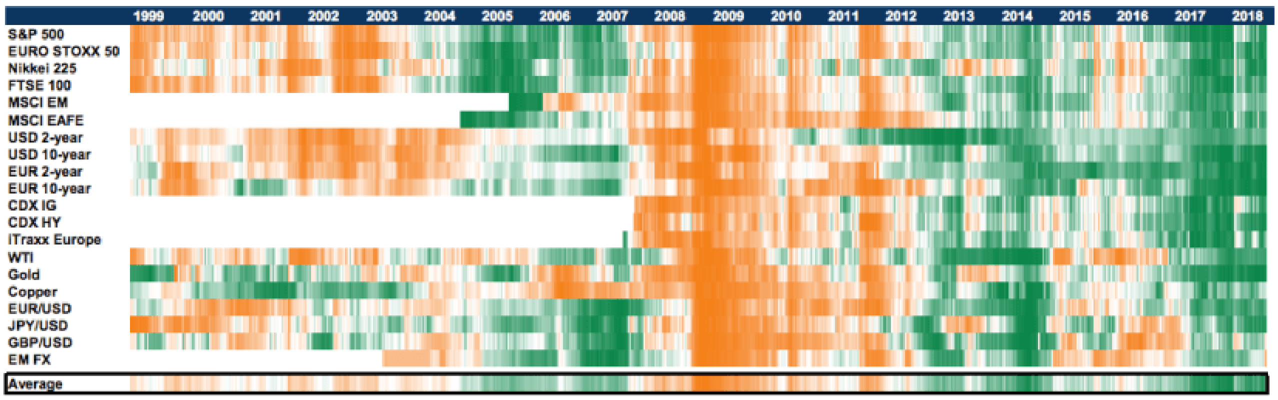


Sam Ro, Managing Editor or Yahoo Finance, recently shared this chart which displays the number of stocks each year that outperform the market as well as the number that outperform by at least 5%. You'll notice a slow down trend after each major market bottom, which is normal as market leaders emerge and rotation takes place to keep a bid under the broad index, you're likely to see a slight drop-off in the number of stocks outperforming. This also helps explain why so many asset managers themselves also under-perform the S&P 500.

What stands out to me with this chart though is this year's data. Currently both measures, total stocks outperforming and total stocks outperforming by at least 5% are at the lowest levels since 1999. I've been one of the few traders lamenting the lack of market breadth recently, noting the mathematical issue of the advance -decline line that many point to as their reason we have broad market participation. This chart shows once again that market leadership has narrowed. Even with the 2015 'reset' from the mini-bear market, we didn't really see a bounce back in stock strength like we did in 2009 or 2002.

Broad Asset Volatility Has Declined

Exhibit 1: Across assets vol remains anchored, with the pick-up in copper, GBP and EM FX more isolated
Percentile of 3-month ATM implied volatility for different assets since 1999. Green = low, Orange = high

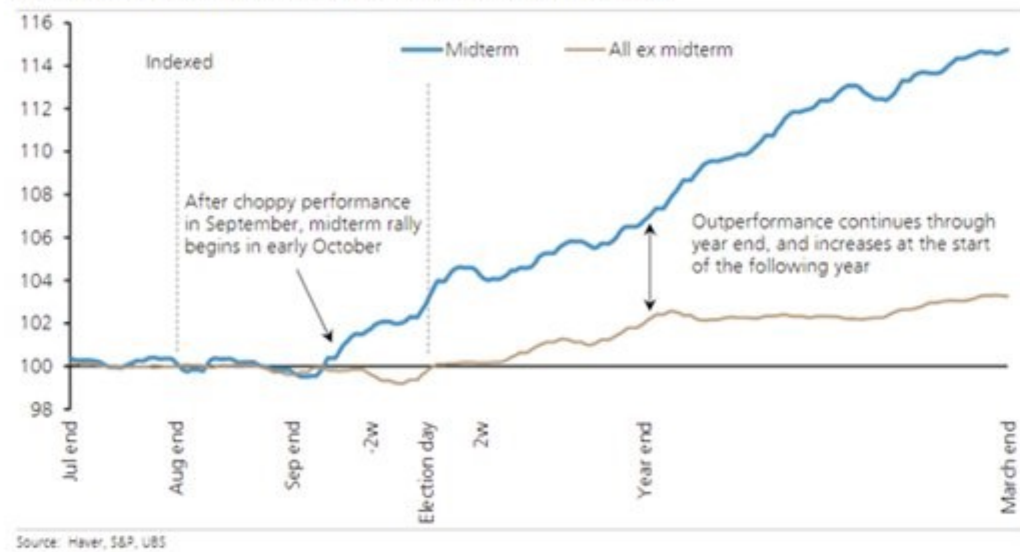


Source: Goldman Sachs, Goldman Sachs Global Investment Research

The above heatmap chart comes from Goldman Sachs and shows the implied volatility of various asset classes since 1999. Orange markings indicate high implied vol while green is when volatility is low. Typically most years see some degree of a mixture of green and orange, as market ebbs and flows. There are four years that stand out as being extremely low in cross-asset volatility: 2005, 2014, 2017, and 2018. Goldman notes, “cross-asset vol is quite depressed, with the increases related to the February VIX spike largely having faded – i.e., the market does not seem to be pricing much risk premia around any broad spillovers, for example, as S&P 500 1-month realized vol has drifted below 8% again, and implied vol and the VIX have followed.”

So once again we’re back to a point where volatility is being sold with both fists. If pressed for a reason I’d turn the main motive traders have in selling vol, and that’s yield generation. As fixed income markets are under pressure globally, traders I believe have become reluctant to seek yield in traditional assets like sovereign bonds and so are turning to the derivatives market, selling volatility just like they did in 2017….culminating in the February vol spike.

September Seasonality



Driehaus Capital prepared this chart of S&P 500 seasonality for September, which has historically seen more weakness in mid-term election years than non-mid-term years. Fortunately, this has led to nice rally into year-end based on historical seasonality back to 1950.

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