April 30, 2014

Long duration T-Bonds – You’re about to get Lucky!

Strong performance of Quality Bonds defy expectations & excessive

Strong performance in long-dated, high-quality bonds runs counter to market consensus, and confirms our Elliott analysis; see our previous assessment in January 2014. Yields, which move inversely to bond prices, were supposed to be moving steadily higher, driven by increased demand for money from the expanding economy. As you see, recovery remains a hallucination, the green shoots have long turned brown, and the Goldilocks’ “not too hot not too cold” economy remains frigid.

Since January, it’s been precisely the opposite: longer-dated, 30-year bonds have had the best performance. Year to date, high-grade bonds are up 7.48% vs. 3.3% for junk. Although this is a true “preview” of the capital gains in longer-term quality bonds, concurrent with the reassessment of risk in junk, for now it’s a false start. The Elliott pattern has not yet completed the wave 2 correction required before the subsequent wave 3 impulse in bonds can begin. Markets intensified by computer algorithms, have once again jumped the gun, and must double back to the starting blocks, before a sustainable rise can begin.

The more volatility threatens US equity returns, the more attractive higher-grade debt becomes, and its demand expands. All of a sudden, “duration exposure” which the fundamentally-driven experts warned against, no longer concerns investment managers. Meanwhile, each 1% drop in interest rates results in 10% capital gains for 10-year Treasuries; the appreciation in 30-year Govies approximates 2.5x as much.
The abundance of Swing Trade opportunities prove the pervasiveness of *mindless* program trading

The abundance of Swing Trade opportunities attest to the pervasiveness of the barrage of algorithmic orders, fired-off in the absence of human veto. The consequences of such massive trend-following, rapid-fire orders will have catastrophic consequences in a panic ahead. These computer programs, like most investment managers, have a built-in bullish bias, that will soon lead to their self-destruction. They are no match for the decisive & pattern recognition capabilities of a good *human computer*. Opposite the immediate larger trend, & consistent with the behavior of nearly every asset class, bonds have jumped the gun in a false break-out. They have gone up *too far* as a *sucker’s rally*.

*Program trading: the Fast-track to a Flash Crash*

The pervasiveness of *trend-following*, program trading, currently estimated to comprise 70% of market volume, accounts for the extremes achieved in these *ongoing, false breakouts*. Cumulatively, these *rapid-fire* order torrents will become the market’s *Achilles heel*. Reminiscent of the Bear Stearns & Lehman fiascos, high-frequency trading profits are prone to vanish in a flash, to destabilize markets & cross-contaminate the entire financial system with *counter-party risk*. Program trading is the *fast-track to the market’s flash crash*.

*We’re about to get Lucky!*

When you’ve done your homework, *or I have done it for you*, & realize that markets are out of whack, and make your move *against the herd, you are most definitely going to get very lucky*. “Lucky is what they’ll call you”, brush off such assertions, *we make our own luck*...I was “up all night to get lucky”. Rather than waiting for T-bonds to drop back, we will opportuisitcally *short them* via the inverse ETF *TMV*, until they drop back to *just above* to our buying range. Analogous to *utilizing a shorter yardstick* to measure the British coastline, we continue to compound profits at an accelerating rate by remaining *flexible*, on the look-out for *valuation extremes* of the ever swinging market pendulum.
Background: *interest rate risk vs. credit risk*

At the beginning of the year, a chorus of Bond experts, including Bill Gross, *Mr. Big* at PIMCO, and Morgan Stanley’s Chief Market strategist, promoted shortening bond maturities to side-step interest-rate risk, concurrent with conventional wisdom asserting that “rising interest rates” were all but assured. In sharp contrast, I countered that *credit risk*, the risk of default by debt issuers, was the *real threat*, still unrecognized, as is the impending economic contraction. In other words, the risk lays in *junk of any duration*, going belly-up. The money-making opportunities are to be found *swing-trading* the longer-dated, quality T-bonds. Long US T-bonds, suitable for *widows & orphans*, remain the safest asset in the world. In a panic, as in 2009 & 2012, US T-bonds will realize out-sized capital gains, in a knee-jerk flight to safety & quality.

In December, we bought long *TLT* at an average price of *102.5* and sold it for *109* a scant two months later. Since overvalued assets tend to go to extremes, the danger of shorting bonds at *109* was considerably higher than it is now at *112*, after the solid black candlestick indicates a bullish reversal; the risk is now in *TLT*. In a situation such as this, Mastery of the Wave Principle provides a material advantage over the
fundamental crowd, and the vast majority of market technicians. In simple terms, until wave 2 completes, the apparent wave 3 is a sucker’s rally.

So instead of waiting for the price of TLT to drop back within buying range, we will short it via inverse bond ETF, TMV. Backing-out half of the leverage, by utilizing just half the capital, and leaving the rest in cash. (as usual, TMV, plus the cash must be aggregately considered a single position). To reiterate: if you total invested is $500,000, $250,000 is currently in cash to back-out the leverage. We split the $250,000 again between the XAD and TLT.

When we go against the trend, we decrease the amount by 50%. So rather than $125,000, we will invest $62,500 additional in TMV, total in two scales of $31,250. Consistent with minimizing risk, we consider this allocation to TMV separately, simply looking to trade the high-momentum middle ground of the trajectory, intent on bailing-out earlier - just looking to capture the easy profit.

Buy 1/2 pos TMV limit?

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**benefits of subscribing are ongoing – this is no “one trick pony”!**  For the majority of you, getting this one trade right would defray the cost of several years subscription. The limits will be posted once they are substantially out of reach in a month or so.

As you see below, Inverse bonds, **TMV**, are tracing out a **Diag >** to indicate a bounce to the minimum dashed line, in the area of min 67.5 - our first scale-out. A high near 74 is likely, and 78 is possible, at higher risk obviously.
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Exceptional Bear

"Opportunistically timed investments that maximize wealth"