



## Five Themes for 2012

Heading into a new year of trading, markets are in a period of significant uncertainty. To generate profits this year, traders will have to adapt to change quickly, and make decisions based on imperfect information.



Across the globe, many important variables are in flux.

Economically, we continue to deal with seemingly insurmountable sovereign debt issues that ultimately affect the livelihoods of millions... Socially, the world is watching to see how political structures in the Middle East continue to evolve, and the death of Kim Jong-il raises many questions for North Korea's future effect on the rest of the world.

Politically, this is an election year in the US – complete with a clash of perspectives on how to grow the US economy, create jobs, and achieve a more level playing field for the middle class.

As traders, **we're very skeptical of "predictions,"** finding little value in analyst price targets for the major markets, or revisions to GDP expectations for the coming year.

These reports may carry some relevance if they lay out alternative scenarios that could cause market sentiment to shift one way or another. But the actual "predictions" themselves are usually less valuable for a flexible trader. After all, there's a big difference between *being right and making money*.

Turning the page on the calendar and looking at the year ahead, I see five significant themes that will affect market action. I'm not going to make a "prediction" on any of these themes – but rather lay out some scenarios that could cause price movement (and profit opportunities). As we trade our way through the coming year, I expect the following areas to be particularly relevant for traders:

- 1. Europe's adjustment to overwhelming debt**
- 2. China's growth engine misfiring**
- 3. Social media "investor market saturation"**
- 4. Homebuilder sentiment shifting**
- 5. Retail adjustment to no middle class**

*We'll break out each of these themes below the jump...*



## **Europe's Adjustment to Overwhelming Debt**

I know at this point you must be saying "well duh! of COURSE Europe is a major theme for 2012." For the majority of 2011, we saw markets react to European headlines on a daily basis. The environment was extremely difficult to trade because of the "risk on / risk off" dynamics that were impossible to predict ahead of time.

This year, markets will certainly be influenced by headlines concerning bond issuances, austerity votes, and civilian reactions to political decisions. But the trader sentiment is much different heading into this year after having a year to adjust to the dynamics.

The EURUSD currency pair has come full circle over the past year – now sitting at the key 1.30 mark. This is a critical juncture and from a technical perspective, a break of this level could trigger massive liquidation and seriously undermine confidence in the European currency.

While our trading book has relatively light exposure at this point, one of our largest positions is a short EURUSD trade. We recently doubled our exposure when EURUSD crossed below 1.30 – while simultaneously tightening our risk point to lock in a net profitable trade on the entire position. *~All trades are time stamped and reported in real-time via the [Mercenary Live Feed](#).*



Our view is that the reward to risk ratio is favorable for a sudden move lower. Of course there is a chance that EURUSD finds support at this critical level, but if this happens, our risk is minimal. On the other hand, if EURUSD breaks down, our potential profit will be many multiples of the amount of capital we put at risk.



This is what we mean when we talk about “*ignoring the predictions*” and “*making money versus being 'right.'*” In every trade, there is an element of uncertainty. But understanding the scenario – trader sentiment – technical levels – fundamental shifts – all of these come into play when determining where to enter a trade and how much capital to put at risk.

The action in Europe has a direct affect on the financial sector – which is why we have seen so much weakness in the major banks this year. But given the negative level of sentiment, and the action over the last two quarters, there are reasons to consider being bullish on this sector in the coming year.

**Traders are already well aware of the risk that Europe poses to the financial sector.** By the same token, banks have worked hard to raise capital levels and reduce their sovereign debt exposure. With the worst-case scenario already well researched and in many cases expected, there is now strong potential for sentiment to shift back to more bullish levels.

It wouldn't take a major bullish event to turn this sector higher. Traders could cover short positions and asset allocators could bump up their positions just based on a “less than horrible” perspective on the sector. So any positive news – or lack of new negative catalysts out of Europe could actually propel a bullish move for major financials.



Speaking of Europe and shifting sentiment, let's take a look at another major economic development that has been flying under the radar...



## **China's Growth Engine Misfiring**

The Chinese economy has been one of the strongest growth stories over the last several years. Investors have allocated capital to this area because China has continued to grow even while developed nations stumble.

But recent data points have indicated deceleration in that growth rate – leading to concern over valuations for Chinese equities. Remember, equities trade (*or are theoretically supposed to trade based on long-term expectations of earnings*). When investors believe that earnings will continue to grow at an exponential rate for a long time, they are willing to pay a premium price.

What happens when those growth expectations are called into question? Even if China's economy is still expanding, a slower rate will still lead to lower prices as investors adjust their models and premium price points become harder to justify.

If austerity measures are successfully implemented in Europe, it will have a profound effect on China's export-driven economy. Bulls hope that the US recovery will drive demand, but this recovery is uncertain at best. Recent manufacturing statistics out of China indicate growth is slowing, and housing costs have also come in below expectations.

This is good news for China's inflation problem, but bad news for economic growth. The developments are taking a back seat to Europe's crisis, but as the media begins to pay more attention to the developments in China, we could see optimism wane – valuations contract – and stock prices continue to drop.





The chart above shows Chinese equities in a truly bearish trend. But the media attention has focused much more on the crisis in Europe, leaving China's bear market as a "page two" event.

If more attention is given to China in 2012, it could significantly affect the trading environment for these stocks, and a climactic event could ultimately give bearish traders an excellent opportunity for profits. We will be looking for good reward-to-risk scenarios to lay out short positions in both the ETFs that cover this area, as well as individual equities with speculative price multiples.

### **Social Media "Investor Market Saturation"**

Price action is all about supply and demand. Prices rise when demand outstrips supply, and drop when there is ample supply and less demand. This is true about commodities, services, and even financial securities.

In early 2011, there was plenty of buzz about the new wave of social media companies coming public. Investors were excited about participating in this high-growth industry, and well-connected investors were able to gain access to companies like Facebook and Twitter well before the lower-tier companies priced their IPOs.

The IPO transactions ended up with mixed success over the year. To begin with, **LinkedIn Corporation (LNKD)** saw a triple digit percentage gain after offering its stock to investors at \$45 and seeing the stock eclipse \$120 on the first day of trading. Since then the stock has backed off significantly, but still carries a healthy premium to its initial price.

Part of the reason LinkedIn was so successful was because there were few other social media stocks available to invest in. But as companies like **Groupon Inc. (GRPN)**, **Pandora Media (P)**, and **Angie's List Inc. (ANGI)** were brought to market, investors had more choices for participation in this area. In fact, Global X even [launched a social media ETF](#) to give traders a diversified option for investing in the industry...

As more supply (of stock choices) hit the market, the hype premium began to wear off. Couple that with [competitive challenges for many of the most well-known names](#), and stock prices began to drop.

In 2012, we're expecting Facebook and Twitter to come public, along with Yelp and a handful of other tier-two players. The opportunity for diversification should allow traders



to separate companies with good prospects from the “also ran” names – leading to significant divergences between stocks in this industry.

Option prices point to high levels of expected volatility and lead to spread opportunities like the bear put spread we recently traded for LinkedIn. Expect to see plenty of volatility in social media stock prices this year – with the potential for trading profits through pairs trades or option spreads.

### **Homebuilder Sentiment Shifting**

Another area where we are likely to see shifts in trader sentiment is the homebuilding area...

Right now, “conventional wisdom” tells us that there is plenty of supply on the market (*foreclosed homes held by banks and the FDIC*) with little demand left to drive business for home construction companies. But what investors don’t seem to understand is that **there is a huge difference between prospective buyers of foreclosed homes versus new home buyers.**

Purchasers of foreclosed homes are typically either retail buyers looking to pick up a “good deal” – and willing to make their own improvements to the property – or investors buying the foreclosed homes at a discount with the intention of renting or flipping the home.

But new home buyers are now much less worried about price, and much more focused on location, style, and convenience. These new home buyers want a new home because they don’t want to deal with the hassles of owning a foreclosed property that may have significant improvements that need to be made.

So while the “shadow inventory” of existing homes continues to be a drag on the market, builders are beginning to see a rise in demand for brand new units – and we have seen the economic data point to unexpected rises in both housing starts and new permits over the last two months.

Trader sentiment for this area has been negative for so long, that it is actually hard to imagine being bullish on homebuilders. But the stock prices for many of these companies have rebounded sharply over recent months, and the [luxury homebuilders are seeing more demand](#) as wealthy consumer sign contracts.

Early last year, we took a close look at the [differences between the two major homebuilder ETFs](#). The **SPDR S&P Homebuilders (XHB)** has a lot of exposure to



retailers serving new home buyers, while the **iShares DJ USHome Construction (ITB)** is more heavily focused on the companies that actually *construct* the homes. The conclusion we came to at the time was that ITB was a better trading candidate for homebuilders.

But today, that role may be reversed... New home buyers are typically motivated shoppers as well. Companies like **Pier 1 Imports (PIR)**, **Williams-Sonoma (WSM)**, and even **Home Depot Inc. (HD)** are benefiting from the rise in new home purchases. So a bullish trade in XHB might offer a better return this year as home buyers embrace the entire experience of buying – *and furnishing* – a new luxury home.

You can see this dynamic in play by looking at the relative return for XHB (red line) versus ITB (blue line) over the last 15 months:



Speaking of retail dynamics, let's take a look at that sector for the coming year...

### **Retail Adjustments to No Middle Class**

If 2011 was the year the middle class disappeared, then 2012 will be the year retailers adjust to the new environment.

Despite a challenging economic environment, luxury retailers continued to grow earnings in 2011. This is because the truly affluent consumers didn't face the same sort of challenges that "normal" people had to deal with. The unemployment rate for workers



used to a six figure salary was significantly lower than the unemployment rate for blue-collar workers, and this dynamic is likely to continue in the coming year.

With the retail environment largely being split into two camps (*the "haves" and the "have-nots"*), companies catering to the upper or the lower end of the retail spectrum have fared well. Companies like **Lululemon Athletica (LULU)** have continued to see year-over-year earnings growth at or above 50%.

At the same time, investors piled into deep discount retailers like **Dollar General Corporation (DG)** because of their success in capturing market share for "the 99%" consumer.



This year, we will see even more adjustments being made by middle of the road retailers like **Kohl's Corp. (KSS)** and **JC Penny (JCP)**. Just like a high-stakes game of **Omaha hi-low**, retailers need to cater to one side or the other in terms of consumer classes.

This means that established players on both ends of the spectrum will be dealing with more competition. Expect significant price swings from retail equities as traders adjust to the new environment and company-specific market advantages are challenged by new entrants trading up or down the food chain line.

### **Traders With Flexibility Win...**

It is clear that this coming year will favor traders who are able to adjust their style and their area of focus based on the changing dynamics of the market...

This year we will continue to look for attractive swing trading opportunities, while also adding new strategies to the mix. Covered calls may help to capture option premiums,



while pairs trades give us a chance to collect relative value from different securities.

We're beefing up our research capabilities to cover more *industries, groups and themes*, and we're excited about the expanding trade opportunities.

While certain principles like [risk-control](#) and [selectivity & spread](#) are overarching concepts, individual components of a trading program must adjust to meet the market dynamics.

*Here's to a flexible and profitable 2012!*

*MM*

