INTERMARKET VIEW: The Volatility Sellers

It's not often you read something that makes you almost spit out your coffee. That was our reaction to a recent IMF report, which estimated that the total amount of assets invested in "volatility targeting strategies" has risen to $500 billion, with a fifty percent increase just in the past few years alone.

What are "volatility targeting strategies?" They are basically put-selling strategies, ways to generate steady income when not much is happening. A market is gently drifting higher. If you assume it will keep drifting higher, and not fall, you can sell puts against it, which is kind of like selling crash insurance and collecting the premiums. The amount you collect is very small though. A few pennies on the dollar at best. To make it work you have to sell the puts "naked," meaning you forego the cost of protection. And if you really want to get a decent return out of the strategy, you step it up with some leverage, increasing your total size and exposure if things go wrong.

There is a phrase associated with naked put sellers: *"Eat like a bird, crap like an elephant."* That is because this strategy is a good way to make steady but small amounts of money for long periods of time – and then to give it back all at once in a violent dislocation. Another phrase associated with this play is *"picking up nickels in front of steamrollers."* Over the past twenty years there have been many famous blow-ups by way of this path. Long-Term Capital Management was a heavy vol seller in the late 1990s. The well-known money manager Vic Niederhoffer, who once traded for George Soros and wrote the book "Education of a Speculator," has blown up multiple times using strategies like this. (He seems to keep on coming back and doing it again. He may yet be on his fourth or fifth blow-up by this writing.) Probably the most dangerous and consequential blow-up of all time in this arena was that of AIG, the insurance company that sold credit default swaps (a kind of insurance contract which functions like a put option) and got bailed out for $80 billion in the 2008 financial crisis, for fear AIG's failure would blow apart the financial system.

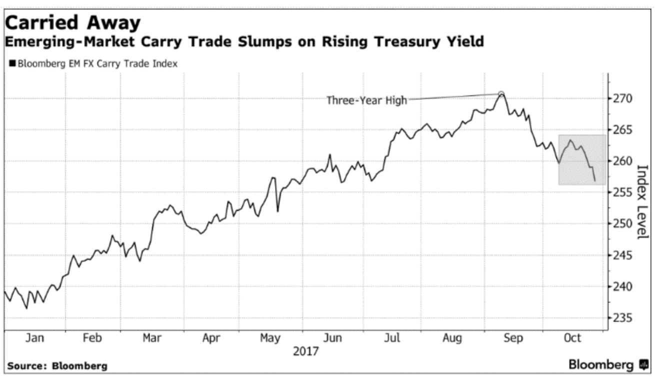
These "volatility targeting strategies" are not just sort of like selling naked puts. In many cases they are *literally* the selling of naked puts. A growing mass of retail investors has really leaned into this, their confidence increasing every time "buy the dip" proves itself yet again. But what is really worrisome is the fact that institutionals and pension funds are doing a lot of this. You don't get to $500 billion in "volatility targeting strategies" by way of mom-and-pop accounts. You need the Hawaii Employees Retirement System selling puts, and other multi-billion asset pools doing the same thing, to generate a stream of steady income in a low-return world. This further helps explain why volatility has been so weirdly suppressed. The vol-sellers absorb every dip, which creates a backdrop in which the market seems to have little to no volatility at all.

But you know how this story ends. As with most things, this goes back to stuff like math and the laws of physics. All that volatility being absorbed – stored up in the open exposures of institutionals and pension funds, now half a trillion worth – is like stored-up energy waiting to be unleashed. This is the same kind of thing that happened in 1987, and it is the same kind of thing that happened in 1994. The causes were varied, but in every case there was a build-up of deeply embedded risk within the system, as the result of extreme complacency.

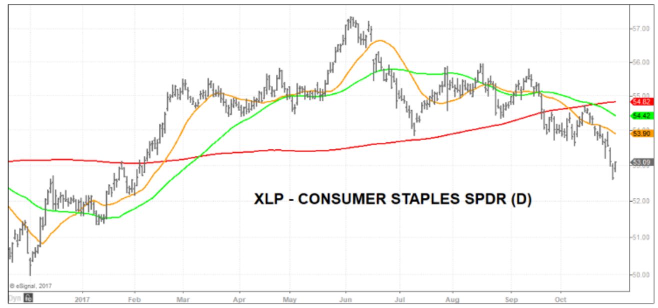
We can also clearly connect the dots as to why behaviors like this play out. Large institutional funds, and pension funds in particular, face extreme pressure to achieve their designated return targets. There are obligations to pay money to future retirees, and if the fund doesn't hit the seven percent target or whatever it is, there will be hell to pay, and potentially a budget crisis, and the manager likely gets fired. So you have this high external pressure to generate seven percent returns in a nosebleed valuation, low-interest-rate, low return world. As a result you have managers scrambling to do things that can make a little money, and then a consultant shows them how safe and smooth XYZ volatility targeting strategy is. The next thing you know, everybody is selling vol and waking up happy each day, as market volatility appears to go to zero, in part because the vol-sellers heroically absorb all the declines. This is like watching the conditions for the California wildfires develop. Massive amounts of dead dry underbrush following years of drought conditions, coupled with an increase of hot, dry crosswinds via global warming shifts. After a certain point all you need is a spark. Something "clicked" for us on reading the IMF $500 billion estimate, because it is not just a passive investing influence that accounts for bizarrely low volatility this year (the lowest on record since the 1960s). That super low volatility has occurred globally as well. It is undoubtedly also the rise of all these "volatility targeting strategies" that temporarily reduce volatility by absorbing it… but ultimately magnify the dislocation when volatility is finally unleashed.

We occasionally joke that markets are behaving in ways that make no sense. But actually the bizarre behavior of markets makes perfect sense, if you account for the non-mentioned factors like institutional fund managers sweating bullets to hit their mandated seven percent return targets, no matter what. And of course that is only one factor. The overall reality is that, in the bigger scheme of things – which almost nobody pays attention to – we are at the tail end of the tail end of a historic long-term debt cycle, in terms of leverage and rates and valuations and psychology the true polar opposite of the conditions of 1981, a year in which interest rates had climbed into the teens, with inflation conquered and leverage wiped by a brutal recession, setting the stage for the next 35 years.

The 2-year US treasury yield is at nine-year highs. It matters because, as a matter of market history, rising interest rates are one of the factors that end bull markets. There is even an old saying, “Three Steps and a Stumble,” meaning, if the Fed raises interest rates three times, watch out. This is because as interest rates go up, money gets tighter, and cheap credit provided in boom times stops flowing. This is also when you see the “tide go out,” as Warren Buffett has put it, to reveal who is swimming naked. Right now there is faith placed in a sense of synchronized global boom. But the source of growth is chicken and egg, as it is largely based on cheap credit and consumer borrowing, with large amounts of leverage built up in various assets. The whole thing is subject to implosion.



Credit markets still look “okay” as of this writing. There aren’t many visible signs of stress. Indeed you have the opposite, signs of dealmaking exuberance all over the place. But there are cracks in certain places, again tied to the slow steady rise of US interest rates. The Bloomberg EM Carry Trade index (as shown above) is now in a bona fide downtrend, having hit a three-year high in September 2017. This matters because a major build-up of USD denominated debt, dollars that were borrowed outside the United States, is a source of risk. There is a tendency to borrow hugely in dollars when the liquidity is flowing and credit is cheap. But those same dollars can be suddenly expensive when liquidity dries up, causing a “short squeeze” that makes the dollar rise. This is what created the Asian currency crisis of 1997. Dollar debt-loads in the Asian region became impossible to sustain. Interest rates going up, and the dollar rising, are self-reinforcing harbingers of an end to cheap money. The mood can potentially change quickly.



You can’t use valuations for market timing, as Druckenmiller said, and you can’t expect a macro crisis to develop on a time table. With that said, you can pay attention to the signs, and the point at which we get interested is when the signs start to confirm a problem. Like consumer staples for example, an area we are short which is sensitive to interest rate hikes. An obvious weakness in consumer staples is further indication that the market is starting to worry, just a little, about deeper implications of a tightening monetary policy environment. If it were just sporadic elements here and there, that’d be one thing. But there is a clear pattern here. Given the Fed’s desire to raise interest rates, we were already at a point where the low-interest-rate liquidity boom was likely to peak. Then we got a last blast of liquidity with a profoundly weakened dollar in 2017. And now the Fed is getting serious about hiking rates as egged on by strong USA economic data, like jobless claims at 44-year lows and a robust 3 percent reading on GDP.

Speaking of the dollar and its liquidity-giving ways: The great USD downtrend of 2017 is now over. The USD’s renewed rise is due to multiple factors, including new instability in Europe. But the dollar’s trajectory is worth watching regardless of the factors because, as the dollar gets stronger, the probability of a “risk-off” outcome increases. That is because a stronger USD, like rising US interest rates, is a harbinger of tightened monetary conditions and an end to the liquidity bonanza.

All told, US interest rates are creeping higher. Interest rate sensitive assets are transitioning to downtrends. The dollar, which has acted as a funding currency all through 2017, has gone back to rising. And the volatility sellers, Pavlovian in the willingness to absorb more exposure with each dip, have half a trillion worth of nitroglycerine stored up. The missing thing is a crisis catalyst. But there are plenty of those around too...

MACRO VIEW: Four-Dimensional Chess

During the 2016 presidential campaign, it was suggested that Donald Trump plays three-dimensional chess (later upgraded to four-dimensional chess). This was never true. If you want to see some real four-dimensional chess, think Bob Mueller.

This week, the Mueller investigation kicked into a whole new gear. It is not the beginning of the end, as Churchill put it, but the end of the beginning. The moves from Mueller's team were quietly devastating. For decades the gambit may serve as a lawschool example of prosecutorial chess, elegant in efficiency and punch. Trump has no idea what's hit him. The rest of the world, in turn, has no idea what the response will be when a full-on White House panic sets in. The destructive component of Trump's eruption – for markets, for civic and political norms, for the USA as a country, and possibly for the entire world – remains to be seen, and will further depend on what the Republican party chooses to do. Will there be a constitutional crisis? A bipartisan go-ahead for impeachment proceedings? A distracting military or trade war escalation? A tussle with the nuclear football? Nobody knows. But we're likely to find out. And as all of this unfolds, Republican hopes for tax reform are running into serious roadblocks, problems that experienced observers long expected (tax reform might be harder than healthcare, which is why it hasn't been done in decades). The risk to markets (which still, as of this writing, behave as if Washington is a sea of calm tranquility) is hard to overstate. Mueller's middle game may unfold at speed.

To understand why Mueller's opening moves against Trump are tactically brilliant, it helps to examine the players in this first round of indictments, the amount of trouble they're in, and the way a clear message has been presented. The player with top billing is Paul Manafort, caught dead to rights. The money laundering sums being alleged are enormous (tens of millions of dollars), and Mueller's case against Manafort is grounded in "paperwork" rather than testimony. It is almost impossible to beat an air-tight paperwork case, which comes down to disclosures on official forms. Did Manafort fail to fill out certain forms? Did he lie on other forms? If the answer is yes, and the amounts are serious (they are), and federal law is violated, Manafort faces a likelihood of decades in prison.

There is talk of Trump choosing to pardon Manafort, or even going so far as to blanket-pardon everyone. But this avenue is blocked by an inconvenient fact: Presidential pardons only cover federal crimes, not state crimes. If Trump goes ahead and pardons Manafort, the New York state AG could pursue Manafort for similar violations… and make reference to the acceptance of a pardon as further admission of guilt! So Paul Manafort is reduced to choosing between a federal prison or a state prison. Unless, of course, he keeps himself out of jail by giving up valuable information on a higher profile target...

The same logic, by the way, applies to members of the Trump family. Jared Kushner, Ivanka, Don Jr. and Eric are all in dire jeopardy from exposure to dirty business dealings and shady partnerships (as we explained in SIR 137). As with Manafort, in the event of presidential pardon, whatever federal crimes are uncovered here can be shared with the New York AG…

So the Trump inner circle is dangerously exposed. As we said in SIR 145, Trump world is a pile of bloody pork chops relative to Mueller's pack of dobermans. Paul Manafort meanwhile has incentive to share his best dirt, the alternative being to spend the closing decades of his life in jail. But Manafort isn't even the most interesting of Mueller's escalation salvo.

Rick Gates, the right-hand man and protégé of Manafort, was also indicted this week. Gates is only 45 years old (Manafort is 68) with a young family and a life ahead of him. Gates also had extended involvement with the Trump administration, staying involved with Trump political operations long after Manafort was forced out of the campaign. Gates maintained White House access and attended West Wing meetings. He almost certainly has interesting stories to tell, and a naturally intense incentive to keep himself out of prison at all costs.

And then you have George Popadapolous, the young Trump adviser (only thirty) who has already pled guilty and has been cooperating with the Mueller investigation for weeks, maybe for months. Popadopolous is a "little fish," but in some ways he was the true bombshell in Mueller's opening salvo. That's because not only did Popadopolous enter a guilty plea, his actions were directly indicative of attempted collusion, with email chains showing a direct attempt to coordinate with the Russians. Also devastating, professional observers believe it is highly likely that, if Popadopolous has been cooperating for months, he has also been wearing a body wire and playing "dial-a-crook," making incriminating phone calls to see what he can dredge up for Mueller (to reduce his own sentencing).

With these opening indictments, Mueller sent a message to remaining members of Trump world: *If you lie to me, you will face prison; your security may already be compromised by informants, so you'd better tell the truth; and if you want to volunteer information to reduce your own sentencing, you'd better do so quickly – no lenience for third or fourth in line.*

As explained in SIR 145, there are three overlapping worlds in play: Media World, Prosecutor World and Politics World. The center of gravity now moves to Prosecutor World, where media blather is irrelevant. The big risk here is that President Trump is a volatile and unstable object; Mueller has begun to apply relentless and intense pressure to that object. It isn't known how Trump will lash out, or what the fallout will be. There is no precedent for such a highly concentrated degree of political, geopolitical and financial risks all rolled into one.

TACTICAL VIEW: Nope, Still Not Different

"This time it's different." You hear that phrase over and over, and it always turns out to be wrong. The phrase is commonly deployed as a rationalization, and it typically surfaces in the extreme phase of a bull market. When a bullish run has gone for years, a few things always happen. The perpetual sight of rising prices, for years on end, programs the brain to always expect rising prices, through a psychological phenomenon known as recency bias. Daniel Kahneman wrote about this in his book *Thinking Fast and Slow*. Not in respect to markets per se, but the tendency of humans in general to assume that the conditions they've grown used to will last forever. After a few years of a bull run, there is also a layer of psychological reinforcement, in which rewards for certain behaviors apply over and over again, in a form of "operant conditioning." And because markets are big business, in terms of marketing and packaging and selling, after many years of bullish activity the marketing opportunity reaches its peak. This is often because the general public comes in on a lag, and their interest starts to peak as things get nutty, not before. Think of the individual who hears about Bitcoin as the price crosses $6,000, and is then overcome by FOMO – fear of missing out – after hearing predictions it could go to $400,000. This late marketing wave is a standard thing because marketing opportunity synchs to public awareness and public greed, nothing else. And so, in the latter stages, you have psychology and conditioning and marketing and late-stage public awareness all pointing in the same direction. And in those latter stages you also have a few cranky observers insisting on rationality and heeding lessons of market history, pointing out why things have gone nuts or saying *"this isn't going to end well."* Those voices are seen as killjoys and party spoilers. And so, in response to them, you get the arguments trotted out: *"No, this is why it will keep on going. This is why history doesn't apply. Because this time it's different..."* It is not an accident, in other words, that you get some version of *"this time is different"* at the extreme point in the cycle, every single time. It is a function of increasingly aggressive arguments being trotted out by those with strong incentive to maintain the frenzy of public buying interest.

Another factor of extreme environments is the way rational actors start to doubt their own sanity, or to wonder if they're the ones missing something. It is this extreme nagging feeling that even pulls in the doubters at the end. It's the reason why Isaac Newton took his money out of the South Sea bubble, then dove back in and went broke in the crash. It's the reason Stan Druckenmiller, one of the greatest money managers of all time, who made more money over the years being short in crashes than long in booms, got sucked into loading up on tech stocks just before the 2000 peak. The psychological pull at such times is like an almost irresistible gravitational force. We are sensitive to this pitfall having participated in markets since the mid-1990s, observing twenty years of cyclical high and low points, further having consumed volumes of market history dating back centuries or even millennia. (Speculative boom and bust episodes can be traced back to Roman times.)

It is from this vantage point we note that even the top value investors are complaining now, openly wondering if perhaps their whole approach to investing is dead. David Einhorn, the founder of Greenlight Capital, is one of the most prominent value investors of his time. His hedge fund at one point had assets under management above $12 billion, currently down to $7 billion. In a recent quarterly letter to investors, Einhorn openly wondered if maybe value investing no longer works:

The knee-jerk instinct is to respond that when a proven strategy is so exceedingly out of favor that its viability is questioned, the cycle must be about to turn around. Unfortunately, we lack such clarity. After years of running into the wind, we are left with no sense stronger than, "it will turn when it turns."

For a moment, let's consider the alternative. Might the cycle never turn? … Given the performance of certain stocks, we wonder if the market has adopted an alternative paradigm for calculating equity value. What if equity value has nothing to do with current or future profits and instead is derived from a company's ability to be disruptive, to provide social change, or to advance new beneficial technologies, even when doing so results in current and future economic loss? It's clear that a number of companies provide products and services to customers that come with a subsidy from equity holders. And yet, on a mark-to-market basis, the equity holders are doing just fine.

In the first paragraph, Einhorn essentially wonders whether value investing will ever work again. In the second paragraph Einhorn hypothesizes an alternative theory of investing: That maybe investors now choose to reward "disruption" even with a permanent absence of profits. It's notable Einhorn has been short some of the biggest winners of the cycle: Amazon, Tesla, and Netflix. He is proverbially throwing up his hands.

In our view this can all be explained with one word: Liquidity. Is value investing still a viable long-run strategy? Absolutely. It's just that, in the extreme phases of a liquidity bubble, all rational assessments of value go away. And disruption? No change here either. The long-run expectation is still that the disrupter will, eventually, earn good profits. Investors have a long history of throwing money at disruption plays with wild abandon: Railroads, cars, airplanes, etcetera. The difference is, once again, liquidity. At liquidity extremes the aggressive bid sets the price, and capital seems available without limit.

If you want to understand why value investing will return to the fore at some point, recall the conditions that represented the exact opposite of liquidity, in the immediate aftermath of the 2008 financial crisis. The violent market sell-off in late 2008 was the equivalent of a global margin call. It wasn't just fear, it was a complete absence of liquidity. Investors pulled their money out of mutual funds and hedge funds in a panic. Those same funds were getting margin calls from their prime broker as asset values fell. The net result was that trillions of dollars worth of equities were subjected to "forced selling," in which the seller had no choice but to get out. In result, the environment in the first quarter of 2009 showed some of the most bizarrely compelling values investors had ever seen. In that time window you could find small cap companies with solid business models and plenty of cash in the bank, trading at a market cap that was less than their cash on hand. You could buy established companies, in multiple industries, at a multiple of three or four times earnings. It was insane. Why did that happen? Because liquidity had evaporated. It was a polar opposite extreme versus liquidity conditions in 2017.

The point is not to expect that conditions will return to the drought extremes of first quarter 2009 (though it's possible). The point is that the liquidity pendulum will swing back. And when this happens, the marginal bid that doesn't care about value at all will recede. This has to happen, because blanket level valuation extremes generated by a liquidity boom have only two outcomes. They either grow up to the sky or revert to the long-term trend, with the amount of pain in the mean reversion process correlated to degree of wild irrationality and extremity of departure. And nothing grows up to the sky.

One of the shorts Einhorn complained about in his quarterly letter was Tesla (TSLA). He points out that Tesla had an awful quarter, that the company's business model is badly flawed on multiple fronts, that production ramp-up is going to prove next to impossible relative to expectations. We agree. Tesla is a poster-child liquidity bubble example. TSLA's disruption capacity is real. We've written of how Elon Musk has already succeeded in changing the auto market forever, by forcing the global auto industry to go all-in on electric cars. And yet Tesla is more a charitable enterprise than a profit machine. The share price is likely to tank, or crash, when reality sets in.

We did a short write-up on Tesla a while back. It pointed out the crazy valuation issues and serious flaws in the business model (which have only gotten worse). But the thrust of TSLA as a short, we argued back then, was that the shares would decline in the event of a credit crunch, as the marginal bid was withdrawn and Tesla found itself forced to either raise money on extremely harsh terms or issue lots more shares.

The credit crunch never came though. Instead the boom got even bigger. The 2016 presidential election ignited a frenzy of new speculative appetite (the Republicans-in-full-control-of-Washington idea), and then a declining USD and stabilized China extended the good times even further. When liquidity is flowing, the optimists have full control and set the tone. It doesn't matter what the flaws are. To reiterate our favorite Friedrich Nietzsche observation: *"All things are subject to interpretation. Whichever interpretation prevails is a matter of power and not truth."* In markets this is absolutely true.

We are now thinking, again, for the first time in a long time, of joining Einhorn by reshorting TSLA. Not because we're into pain, but because if you look at Tesla's chart (left column), you can see the price says something bearish. A great deal of "reverse value" exists in Tesla in that profit expectations are dramatically out of touch with likely reality: The fact that the Model 3 is an insanely great vehicle has no bearing on TSLA's ability, or not, to manufacture half a million units per year.

We also see signs that the great liquidity boom is nearing its final stages not because we want it to end, but because, well, signs are signs. If a doctor looks at the vital signs of a patient, and sees a whole confluence of factors which confirm a sense that something is wrong, the fact that the patient continues to say *"But I feel great doc, really!"* shouldn't matter. Along with a rising dollar, the extreme likelihood of yet another Fed rate hike in December, the extreme build-up of complacency and reliance on short volatility strategies, among still other factors, you have stocks like TSLA, which topped in June, now behaving bearishly. The reason we aren't yet disillusioned in our general big picture bearishness, or shaken by a lost sense of confidence a la Einhorn, is because the total picture, the market script if you will, still makes perfect sense when the impacts of liquidity and psychology and current events and cyclical behavior factor in. Like bizarre weather patterns that a meteorologist can completely understand by looking at the situational specifics and the underlying mechanics, the "weather" of markets can be understood as a system, even if the chaotic nature of the system means it isn't possible to pinpoint early exactly when a new storm front will form or how major its impact will be. Liquidity waxes and liquidity wanes: Nothing is "different" here at all. Even the aggressive temptation to question market realities, or even to question one's sanity at the wildest point, is part of the age-old script.

Strategic Intelligence Report

PENDING POSITIONS

Bull / Bear	Ticker(s)	Vehicle / Area / Industry Group	Description / Strategy	Analysis PDF Links
BEAR	GBPUSD	British pound / US dollar	The British pound likely has much further weakness ahead, as the market looks past a rate hike and the reality of Brexit penalties hits home.	**10-30-17**
BULL	EURGPB	euro currency / British pound	Similar thesis for Brexit weakness in the pound. Whereas GBPUSD declines when the pound weakens vs the dollar, EURGBP rises as the euro strengthens relative to the pound.	**SIR 156** **10-19-17**

CURRENT POSITIONS

Long/ Short	Ticker(s)	Vehicle / Area / Industry Group	Description / Strategy	Analysis PDF Links
LONG	USDJPY	US dollar / Japanese yen	The USD could gain a rate hike edge on the yen, or rocket higher against all comers on a short squeeze.	**SIR 156** **10-12-17**
LONG	AUDNZD CADNZD	Australian, Canadian v. NZD	Long-term breakout potential vs the New Zealand dollar on weekly charts, NZ populism issues, concerns over the new Labour government.	**09-26-17**
SHORT	XLP	Consumer Staples ETF	Moderate short position as consumer staples face threats on at least three different fronts.	**09-01-17**
LONG	TAN	Guggenheim solar ETF	Moderate long position from breakout with add-on. Boom-bust solar industry capturing imaginations as solar shows potential for waterfall expansion uptake.	**SIR 150** **06-23-17** **06-14-17**
LONG	EURJPY	Euro currency / Japanese yen forex pair	Sizable position, moderate starter plus multiple add-ons as Europe sees investor capital flows and yen is treated as a funding currency in a bullish backdrop. Took half profits on 10-30-17.	**10-30-17** **09-12-17** **08-24-17** **06-16-17** **06-09-17** **06-02-17**