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Let's not normalize what's not normal

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Let's not normalize what's not normal

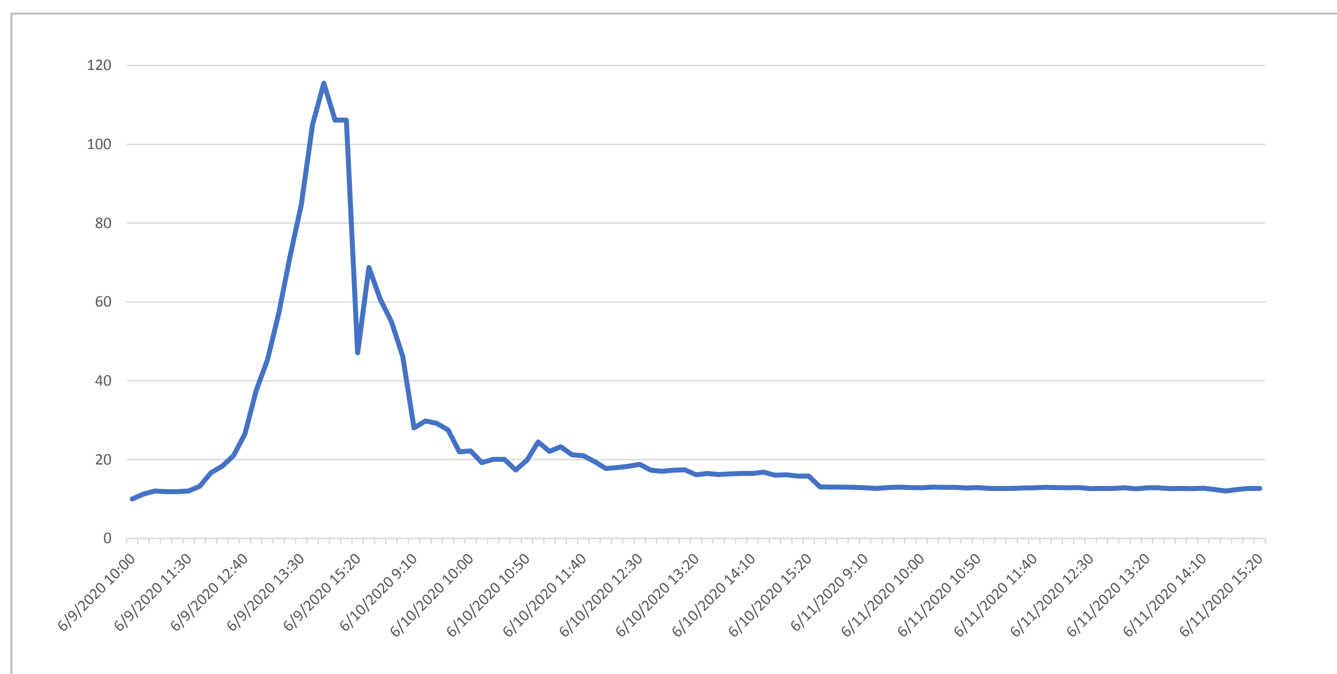
In a recent speech, Dutch King Willem Alexander raised an important point as to the unprecedented times we find ourselves in. Let's not normalize what's not normal. In our view, this could also apply to how we look at the current markets.

Last Thursday's (June 11th) downward move marked the first significant decline since the troughs of March, which despite being fairly recent, seem all but forgotten judging by the recent performance of stock markets around the world. As if the largest job-loss since the Great Depression of 1929 is normal. Or the increase of US debt by over one trillion dollars within five weeks. It took the US from Independence through 1981 to accumulate its first trillion of debt.

Wondering whether this is normal begs the question as to whether a market decline would constitute just one more of these buy-the-dip moments, or something more structural. From our perspective as volatility traders, while our strategy is quantitatively focused, the market backdrop is relevant in our daily trading. Therefore, we'd like to share our thoughts on markets and volatility looking forward, to frame what is or isn't normal.

At first glance, the theme of a 'healthy correction' makes sense, given the well documented excesses of early June. A range of data suggests links to an "army" of daytraders that came into being from a combination of being stuck at home because of the COVID-19 lockdown in the US, additional stimulus checks during the same period, and nowadays being able to trade on zero-transaction cost platforms such as Robin Hood or Charles Schwab. For example, while the Chinese real estate developer FANGDD might have been a great prospect by itself, in all likelihood it was confusion with the FANG basket that has been the standard bearer of the tech rally which caused the share price to catapult from USD 10 to USD 120 (and back to USD 10) in a matter of days, creating and then removing billions of dollars of market cap in the process.

FANGDD Stock price between 9 June 2020 and 11 June 2020



Similarly, price explosions in companies which had already filed for Chapter 11 bankruptcy protection caused some sniffles with self-proclaimed seasoned investors. The headline on the Hertz issuance of shares during bankruptcy proceedings captures the mood: *"Hertz wins approval to offer potentially worthless stock."* This would not be the first time that the allure of quick riches has captured many, including the brightest minds, as Isaac Newton's ill-fated investment in the South Sea Company in the 18th century, the hottest stock at that time, made clear. Newton famously said he "*could calculate the motions of the heavenly bodies, but not the madness of the people.*"

But any Schadenfreude of the implosion of the names on the Robintrack.net stock leader board might obscure a more general point: What if the recent excesses are merely the most eye-popping symptoms of a far more general complacency? Where maybe the phoenix-like rise of American Airlines or LiveNation stock has sprung out of a much more broadly held belief that, as Dave Portnoy, one of the prominent Robin Hood daytraders, aptly put it, "Stocks can only go up!" Is that materially different from the presumably more studied acronym TINA (There Is No Alternative)? FOMO (Fear of Missing Out) similarly haunts newly minted daytraders and established professional investors alike.

In a zero interest-rate world, with central banks ever more explicitly stepping in to accommodate the markets, stocks do smell like a one-way bet. And last Wednesday Fed Chairman Jerome Powell emphasized the Fed would not hold back even if it would be of the opinion asset prices are too high. Are they? Calling market frothiness or even a market bubble is far less difficult than timing the unwinding of it, as many smart investors found in 1999. But the volatility of recent days is a reminder that Powell has also said that monetary policy can restore liquidity, but not solvency. Perhaps the aftermath of the dot com boom is also worth bearing in mind.

That there are plenty of reasons to be worried about the economic future is not necessarily new. Even prior to COVID-19 doubts lingered on the market valuation's viability, doubts on whether a 'new normal' had arisen. Economists are famed for having predicted 'eight out of the last three recessions'. But at this moment, one aspect does stand out compared to the past. The potential storm clouds which are currently on our horizon do so with a specific timing involved. This summer appears to be a critical moment of time, for various reasons:

• Some key US stimulus programs will expire soon...

The various programs enacted around the world have been able to mitigate the initial impact of mass job losses following the COVID-19 lockdowns. Many were crafted in a hurry and with an implicit understanding that the economic impact, while sizeable, would be short-lived. One of the specific aspects in the US approach is the finite end dates. The weekly supplement unemployment benefits from the Coronavirus Aid, Relief, and Economic Security (CARES) Act will cease as of July 31st. The Payroll Protection Program (PPP) expires even earlier, on June 30th.

These programs have been instrumental in lessening the economic shock of COVID-19. Analysis[1] even suggests that a notable number of the unemployed were financially better off under the program than in their jobs, a factor that may have been instrumental in the relative robustness of consumer spending, which is of overarching importance to the US economy. But following the positive surprises on the unemployment report (both the ADP survey and the non-farm payroll data) potential extension of the programs remains uncertain at best.

[1] *Elle Koeze. "The $600 Unemployment Booster Shot, State by State". The New York Times, April 23rd 2020*

Other programs, such as the forbearance on mortgage payments or student loans will expire in the near future as well. All these programs have temporarily put additional cash in the hand of the US consumer, but the supplemental unemployment benefits will cease. And a forbearance implies that the money remains due, albeit later. Thus with these end-dates approaching, it remains to be seen this Summer whether the US economy will be able to swim by itself once the life vest comes off and whether enough employment will be created to compensate for those sectors of the economy which appear structurally upended by the post-COVID reality. Until there is a vaccine or herd immunity, the travel, hospitality and entertainment industries might not bounce back.

• A less forgiving earnings cycle...

The Q1 2020 earnings season was mostly remembered for what did not happen: forward guidance. Smack into a global pandemic, companies could be forgiven for not being able to provide clarity on the near future. But now that a quarter has passed, "because COVID-19" may not pass muster anymore. Are the profound changes in how we work, live and learn a zero-sum game with both winners and losers, or will the overall pie be negatively impacted?

It is not that expectations are low, as the sharp market recovery from the lows of March has propelled the earnings multiples at which markets trade. When a V-shaped recovery appears priced in, some evidence supporting this thesis ought to be present in corporate results and expectations. Particularly for those companies where the current situation is a tail wind. If the Grubhubs of this world do not have a bumper quarter now, when will they ever?

• The US election cycle heating up...

Whereas the Presidential race is front and center in the media, for markets the most interesting one might prove to be the battle for control of Congress. Prior to the pandemic the House was deemed to stay Democratic and the Senate was deemed to stay Republican, leaving the status quo in place. Even if Democrats would capture the White House, a Republican controlled Senate would prevent meaningful policy changes (similar to what the Obama administration experienced throughout most of its tenure).

Multiple crises currently engulfing the US have put the Senate firmly in play, with the odds of a Republican majority sinking to 40% on betting sites (however, given that some Democratic leaning senators formally caucus as Independents, this does not mean the Democrat majority is quoted above 50%). With the primary process in full swing, developments might crystalize quite ahead of the November election date. Just as an example for political wonks, a wildcard could be the ruby red state of Kansas where a primary win by the divisive Chris Kobach could put one of that state's Senate seats in play. For similar reasons, the races in Arizona or Georgia (where both Senate seats are on the ballot) carry importance quite beyond the presidential ticket.

A full Democratic sweep would open the door to policies which might not be market-friendly, in the areas of healthcare, environmental and other regulation and anti-trust legislation. Also in the cards would be a reversal of the 2017 tax cuts which are said to have been a key driver of the equity rally. Elizabeth Warren, whose brief rise spooked markets earlier in the election cycle is still in the running as Biden's running mate and in order to keep the progressive Bernie Sanders wing of the party motivated, Biden cannot pull an 'etch-a-sketch' and move to the center on economic policy approaching November.

•...as well as COVID-19

In the US, the tragic death of George Floyd, and the outpouring of frustrations and desires for meaningful change has shifted the media focus away from COVID-19. As the virus numbers out of the hotspots New York and New Jersey have improved, it appears markets have bought into the optimism on reopening. But such optimism, shared by governors of states such as Texas, Florida and Arizona, may be misguided. The virus did not disappear over the Spring as hoped, and conventional wisdom suggests a risk of a second wave come Autumn.

The escalation in Latin America does not bode well from that perspective, nor does the experience in Iran where a second wave followed an early reopening.

Given the incubation period involved, a potential second wave as the result of reopening (or hopefully the lack of such wave) would start to be visible over the coming months. The best news for the world and for the markets would be the silver bullet of a vaccine. With unprecedented efforts all over the world, a positive surprise could also spring up over the Summer. (Being volatility traders doesn't make us pessimists per se.)

FROM TUG OF WAR TO VOLATILITY

Where does all this put our outlook on volatility? In mid-April, we wrote in our March monthly newsletter about the proverbial tug of war between two extreme forces: (1) potential negative outcomes with COVID-19 and the economic impact and (2) the unprecedented fiscal and

monetary stimulus applied the world over. A tug of war typically starts with an equilibrium with two equal opposing forces, but when one side starts to prevail it typically ends in a rapid collapse of this equilibrium. In the markets the potential for severe movement either way did support elevated volatility levels, despite briefly in a rangebound equilibrium. Since then, the stimulus appears to have won for now as is visible in the markets' stellar performance (the fastest and sharpest recovery from a bear market in history) as well as in the declined levels of market volatility. Markets could race on higher still, but even in bullish scenarios we do not foresee an imminent return to the extreme volatility suppression we have seen in recent years.

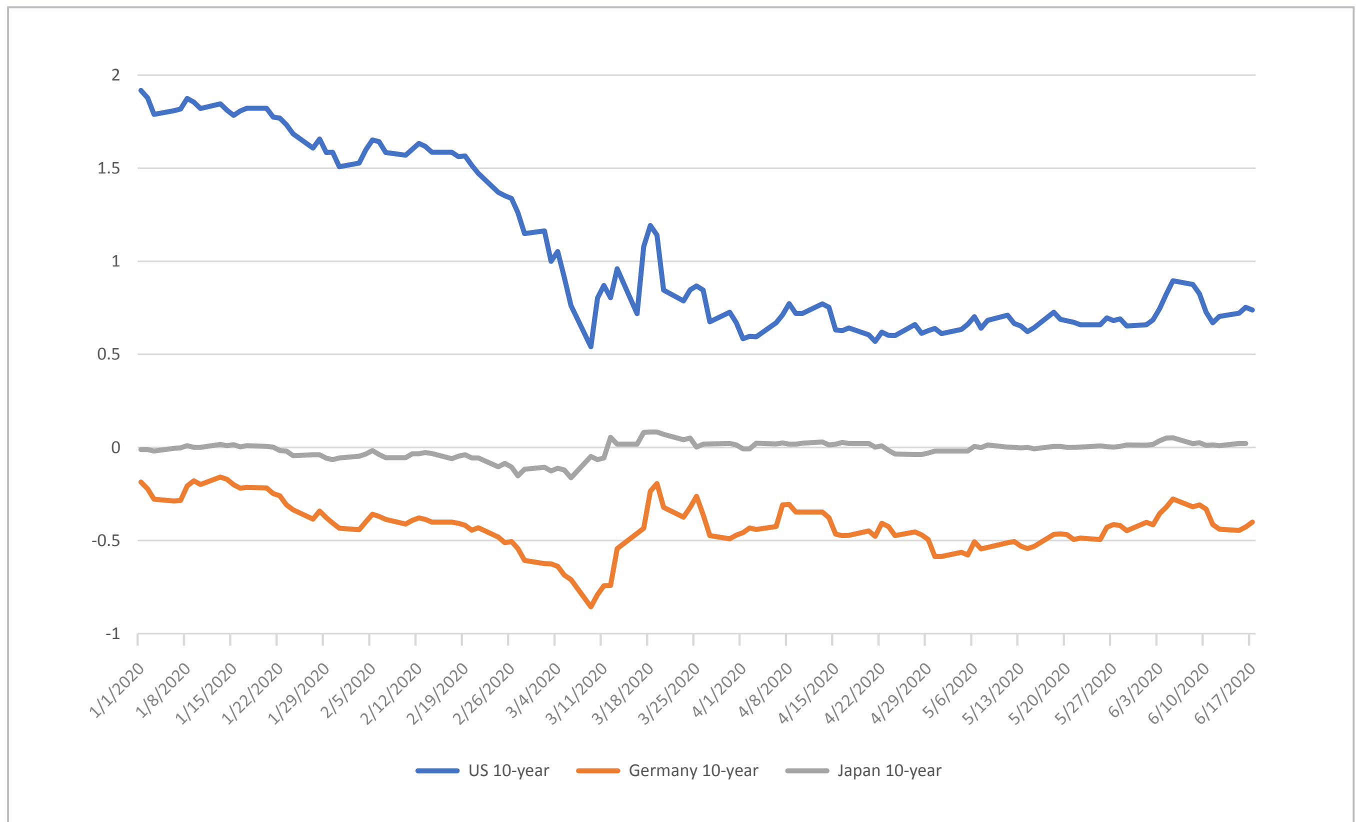
Yes, markets are cyclical and memories are short, but some of the technical reasons that encouraged leveraged volatility selling now suggest more cautious sizing. VaR-based risk measures that focus on recent history will likely limit many investors' ability to take on large short volatility positions in the near-term. With the peak in equity volatility in March similar to the peaks in 2008, stress tests will likely get renewed focus too.

But will it be 'party like it's 1999' as the retail fueled surge in some household names has been likened to the dot-com craze at the end of the last millennium? Markets can move higher and even sharp upward moves cannot be ruled out. However, downside risks seem more prevalent to us at current levels. It is the expectation of movement either side that ought to keep volatility levels relatively elevated in our view. Markets have started to price in a small premium for the US elections in a developing bump in the curve around November implied volatility, but we believe that a number of risks could also play out in the nearer future.

WHAT IS NORMAL?

Normally, a balanced portfolio containing both equities and bonds (for example the traditional 60-40 portfolio) would have a degree of cushioning in times of market stress, as the rush to safety would raise the bond component while the equity component falters. But with bond yields globally encroaching on zero if not negative rates, that cushioning becomes ever more uncertain going forward. Whereas US treasuries did rally in the flight to safety of the COVID-19 crisis, holders of German Bunds or Japanese JGB's were less fortunate, as depicted in the graph on the next page.

US, German and Japanese 10-year yields over 2020



With the Fed already arguably all in on easing, could the muted reaction of JGBs and Bunds be a signal for the behavior of US Treasuries in the next crisis? Despite initially rallying, the Japanese and German government bond total return indices actually finished March negative for the month as the dash for cash unfolded. JGB total returns remain negative YTD. What will happen if fiscal and monetary policy succeeds in returning economies to more normal levels of inflation and central banks need to start tightening again? "Normality" looks like a stress scenario for bonds at the moment. Perhaps the performance of volatility in the first quarter of 2020 may mean that volatility itself comes back into focus as a diversifying asset class, one where, given the high volatility that volatility itself has, we believe there are strong benefits from active management.

Remember the storm clouds we described previously. The Summer is generally perceived to be a quiet time for markets, thus reactions when a shock does occur tend to be larger. In nearly ten years since the inception of the True Partner Fund, the month of August has been one of the more favorable ones for the Fund and this looks like another Summer where the trading screen could be more exciting than the "socially distanced" beach.

Regardless of the market direction, we will strive to provide our investors with the positive alpha and negatively correlated returns we have generated throughout the past decade and wish all our readers good health and profitable markets.

About the authors

Mr. Govert Heijboer, Co-CIO of True Partner, has been active as a market maker trading in the European and Asian derivatives markets as well as positional trading since 2003. Govert started as a trader/researcher at Saen Options in Amsterdam and rose to become the director of derivatives trading and a member of the executive team in 2007. In 2008 he moved to Hong Kong to set up and assume responsibility for all trading activities in the new Saen Options Hong Kong branch office. Govert holds a PhD in Management Science and an MSc in Applied Physics from the University of Twente, Netherlands. He is a founding partner and has worked on the launch of the True Partner Fund since March 2010.

Mr. Tobias Hekster, Co-CIO of True Partner, has been actively trading for the past 21 years in various different roles in several markets across the globe. Starting at IMC in 1998 as a pit trader in Amsterdam, Tobias has established the off-floor arbitrage desk, headed the Chicago office in the transition from floor trading to electronic trading and set up the Asian volatility arbitrage desk in Hong Kong. Tobias holds an MSc in Economics from University of Groningen, Netherlands. Next to his role as Senior Strategist, he taught as an Adjunct Associate Professor at the Chinese University of Hong Kong and as an Adjunct Professor of Financial Practice at National Taiwan University.

Mr. Robert Kavanagh, CFA, Head of Investment Solutions of True Partner, has been in the hedge fund industry since 2004 and joined True Partner in 2019. Prior to joining True Partner he was an Executive Director at Goldman Sachs Asset Management where he spent 15 years within the Alternative Investments & Manager Selection (AIMS) group. Robert has extensive experience investing in hedge funds and working with a wide range of hedge fund investors. Robert is a CFA charterholder and holds a First Class (Honours) BSc in Philosophy and Politics from the University of Bristol, UK, where he was awarded a Social Sciences Scholarship.

About True Partner Capital

True Partner Capital is a team of former market makers and IT specialists that have been working together for more than 15 years.

Their combined expertise on trading, execution and risk management as well as the proprietary trading technology, allows the team to identify and capitalize on trading opportunities.

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