True Partner Capital

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# Icarus versus Goldilocks: the myth versus the fairytale

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Ever since the Great Financial Crisis a decade ago, the main recourse Western nations took to restart their economies has been Quantitative Easing ("QE"). While the term has quite a scientific ring to it, it was an untested theory to avoid the mistakes which exacerbated the Great Depression of last century: keep the financial system awash in liquidity and prevent a collapse of the banking system. Desperate situations require desperate measures and few would dispute that an untold calamity had been avoided.

After the excesses of the prior decade, restraint was the new game in town. In the United States, the fiscal restraint was politically driven as the Tea Party intended to stifle the Obama recovery. In Europe, especially in the northern economies, there was simply no political capital available for bailing out Southern Europe after bailing out the highly unpopular financial sector just before. Quantitative Easing was a more palatable way to prop up the faltering recovery. Contrary to the public works programs which helped solve the Great Depression, fiscal policy was lacking, leaving all the heavy lifting to monetary stimuli.

The direct impact of central bank liquidity was to lift asset prices. If the equity markets would represent the overall economy, recovery was bearing fruit. However, the proverbial disparity between 'Wall Street' and 'Main Street' became visible as buoyant equity markets did not seem to translate into rising wages and prosperity outside of the major metropolitan areas. The rising markets were not a tide that lifted all boats, but instead more accelerated the growth of inequality. The surge in populism across the globe can at least partly be attributed to this uneven recovery and resulting inequality.

## To QE infinity and beyond...

In 2013, while the banking system across the globe was out of the woods, the economic recovery finally appeared to pick up outside of merely the capital markets. Realizing limits in efficacy of monetary stimuli and underscoring these were temporary measures, the Federal Reserve started to telegraph an end to the operations in order to limit any unintended consequences of the unprecedented operation and preserve a Goldilocks economy. But the markets wanted none of that and thus the Taper Tantrum erupted. The Federal Reserve blinked first and QE Infinity was born. The Taper Tantrum will likely be seen as a watershed moment, the birth of an explicit Central Bank "put option" supporting the equity markets with on-demand interventions. The term *tantrum* was well chosen, as most parents know that giving in to tantrums might not be the best way to raise a child.

Let's fast forward six years to now and take stock of where we stand. The Central banks through QE have provided the market with Icarus like wings: equity markets in the United States are at the all-time highs. Valuations across the globe are at levels seen at prior market peaks, not for the exuberant expectations associated with prior peaks, but as a direct consequence of the monetary reflation as the true action has occurred in the debt markets. Yields have cratered and over 17 trillion dollars' worth of bonds even trade at negative yields. Old investment wisdoms have been turned upside-down with shares being held for dividend yield and bonds for appreciation in a high stakes game of pass the hot (negative yielding) potato. A world where a 100-year bond issued at a 2% coupon can yield a 100% return in one year as its yield to maturity declines to 1%. A world where yield starved investors pile into Argentinian century bonds. That gambit did not end well - Argentina appears on path to do what it has done seven times before in the past 100 years: default.

It is this scarcity of yield that defines many aspects of today's economy. Pensioners and savers are deprived of income unless they engage in ever larger risks. Lack of follow-through to the real economy results in a scarcity of investment opportunities for companies who thus resort to near continuous share repurchases (there is a bit of a conflict of interest here) and acquisitions which tend to concentrate market power, further exacerbating inequality. (the 'Moat' that Warren Buffet speaks of so highly). Most macro-economic knowledge from our university years has been rendered useless in a zero-interest rate world. Oddly enough, one chart from that past springs to mind: there is a concept of a liquidity trap where lower interest rates no longer have a positive effect on economic output. In study books, the level was set at 2%. Coincidentally the level to which the Federal Reserve has just lowered its key benchmark rate. Capital Asset Pricing Mode (CAPM) has been replaced by There Is No Alternative (TINA). Markov's efficient frontier is now a straight-line market sensitivity, known as beta. And after umpteenth successful instances of buy-the-dip, the concept of Downside Risk has devolved into Fear of Missing Out (the Bottom).

## Goldilocks or Icarus economy?

Pundits tend to describe the economy as 'Goldilocks'; not too hot, not too cold and keeping the 'bears' at bay (as originally coined by David Shulman from Salomon Brothers in 1992). One has to keep in mind though, that in the end Goldilocks is a fairytale. One can just as easily make the analogy with the Greek myth of Icarus, who escaped his imprisonment by King Minos by flying away over sea on wings of feathers and wax. His escape started off in a Goldilocks kind of way, flying not too high and not too low. Not too low as the seawater would dampen his feathers. Too exhilarated and empowered by his ability to fly, however, he ignored his father's other warning of not flying too close to the sun as that would melt his wings, resulting in the catastrophic consequence of his drowning.

## Imperial skin...

For us volatility traders, current market dynamics are not the most conducive to say the least. But of course volatility traders are known as glass half empty types and maybe as party poopers. All the vested interests are married to the current status quo of ever decreasing yields and rising markets. All is thus well and the emperor has beautiful clothes. We would like to share our observations not only as to why we doubt the current trajectory will not end in tears, but also more importantly how to protect one's portfolio should you start to see some glimpses of uncovered imperial skin in the markets.

## OBSERVATION 1: Buy-the-dip strategy is self-reinforcing until...

Market swoons are getting more and more short-lived. The anxiety is more focused on missing the low than on what drives the market downdraft to begin with. In the past 2 years, we have witnessed no less than five months which were characterized as volatile in the media. However, as the below table depicts, the actual degree of volatility increases as expressed by the VIX index and the front month VIX futures has declined over time. Compared to February 2018, the VIX Futures severely lagged in December, which indicated that the market was confident the burst of volatility was short-lived, effectively ending prior to the expiry of the VIX futures contract. Furthermore, in this year's May and August, the VIX index spikes were more muted as well. In other words, banking on an ever more explicit 'put option' under the markets any downward movement must be quickly harvested through selling volatility and as a result volatility no longer 'pops'. Therefore, the water looks tranquil beckoning more swimmers to come in the next time around. The increased competition mandates selling volatility even earlier into the decline in order to avoid missing out further reducing volatility and therewith yield of the strategy, a self-reinforcing increasingly crowded strategy.

***Table 1: Peak closing levels in VIX spot and VIX future in recent volatile months***

| | Highest VIX spot close | Date | VIX futures close |
|---|---|---|---|
| February 2018 | 37.32 | February 5th 2018 | 33.225 |
| October 2018 | 25.23 | October 24th 2018 | 20.625 |
| December 2018 | 36.07 | December 24th 2018 | 25.90 |
| May 2019 | 20.55 | May 13th 2019 | 19.525 |
| August 2019 | 24.59 | August 5th 2019 | 21.625 |

*Source: Bloomberg data*

## OBSERVATION 2: Low interest rate leverage is a two-way street.

In a low interest rate world, vast multiples are paid for earnings growth. Expansion of multiples such as price/earnings is in fact a leverage which has the power to magnify low growth rates into high valuation as long as yields and thus discount rates are low. Profits growing at 3% can carry a hefty valuation when your discount rate is 2%. But there is little margin for error as either a small decline in revenues or increase in costs can twist the pendulum into growth below the discount rate, a profit decline or even a loss. It is this dynamic that has caught many 'boring' stocks in recent earnings cycles with double digit percentage declines.

## OBSERVATION 3: Trends are great until they ain't

Volatility traders are not the only ones complaining. On the next barstool likely sits a stock picker lamenting the fact that all trends appear self-reinforcing and move away from their valuation logic. Some of these trends are driven by quants and algos. As in the fairy tale of the Pied Piper of Hamelin, profitable patterns attract more quants whose piling in further reinforces the trend, this way causing an extremely crowded trade. The ending to this movie we have already seen in the Quant Blowout of August 2007. This episode was overshadowed by the crisis shortly thereafter, but during a few memorable weeks, all the profits of year long following a popular trend were wiped out in a disorderly unwind. Perhaps it was the foreshadow of the GFC, a starting decrease in liquidity, which took the juice out of the trade. As ample liquidity spawns crowded trades, yet another painful unwind could be in the cards if the unprecedented current liquidity would get withdrawn.

## OBSERVATION 4: ETF's look liquid on the surface, but it is just an inch deep

One aspect of the above trends is the ease at which one can latch onto trends using ETF's. The unprecedented migration from active to passive investing over the last decade has had the effect of more investors doing exactly the same. Equity index ETF's have been mostly been extremely liquid, but this level of liquidity might not be present in the stock component of which the ETF consists. ETF's tend to be market cap weighted, but for quite a number of components the degree of market cap vastly exceeds the degree of traded volumes. For those who want to practice, try trading Alphabet (GOOG) shares for size. In times of distress, when it really matters, liquidity is actually just an inch deep.

To illustrate with an example, let's look at the MSCI Emerging Markets ETF ('EEM') during the 'Taper Tantrum' period in 2013. The market could not sustain the sudden larger outflows in EEM and during US trading hours the ETF traded at a significant discount to its Asian closing NAV. At the opening of Asian markets (where the vast majority of EEM component stocks were listed) this became a self-fulfilling prophecy as market participants would offload the underlying stocks at that discount, causing further declines and thus a negative feedback loop.

Another extreme example is that on May 6$^{th}$ 2010 (the Flash Crash) when basket traders ended up selling Accenture shares below USD 1, they earned money in that trade: they did so because their algorithm spotted a profit between buying the S&P500 ETF at a discount and selling the basket at the bid prices. The power of discounts in mainstream ETF's cannot be underestimated. Since these two examples, the ETF market caps and therefore the stakes have significantly risen.

## OBSERVATION 5: Volatility reducing strategies potentially create volatility

Markets are cyclical and people never learn. It is astonishing to see that renaming a product or strategy that failed in the past allows for the same mistake to be made again. Strategies which gear position size up and down along with market moves are effectively the same as Portfolio Insurance, which is widely believed to have exacerbated, if not caused, the 1987 market crash: increasing exposure in rising markets and low volatility is easy, but reducing exposure in declining markets and high volatility is not. This is especially the case if a strategy is leveraged and popular, hence 'crowded'.

## Buyers beware...

The above observations more concern the structure or even microstructure of the markets. We have not addressed the reasons or triggers for markets to decline to begin with. Economically and politically the world is changing more so than in the last 20 years, with many uncertainties on the near-term horizon: US-China trade tensions, Southern Europe, slowing growth (the dreaded 'R' word), Brexit and Iran, and from our office window, Hong Kong.

The picture we intend to sketch is not one of imminent doom. However, we do want to make the point that below the tranquil surface of the current low volatility markets risks and imbalances lurk. Unfortunately, the current configuration is increasingly digital. Future market declines might very well smother, as have the past ones, until something does pull the rug out under it. This can be reduced efficacy of central bank interventions, foreboded perhaps by the underwhelming reception of the Fed rate cut in July and Draghi's last hurrah in September. But it can also simply be a policy error in general or for that matter maybe the President of the United States realizing that if he continuously retracts his bravado towards China after every small down move in the S&P500, his tough image might be at stake. If the explicit and implicit safety nets were to suddenly disappear, it remains to be seen how brave the volatility selling crowd would be facing such absence. After all, contrary to popular belief assuming risk is not alchemy yielding returns. It is taking a calculated bet and if parameters of the calculation change, so will the outcome.

## There-Is-No-Alternative...

So what can an investor to do in a There-Is-No-Alternative world? The problem with staying on the sidelines is opportunity costs. In most markets these costs are in the economic sense of missed opportunity, but in absolute sense in Europe given the negative interest rates.

For those who see signs of trouble near-term, these costs might be worth it, as in the above described 'digital world', events will likely come fast and furious. Exiting when the event hits might very well be too late. Especially given the structural aspects hampering market liquidity.

For all other investors, if there is no alternative to staying invested it would be ill advised not to have any protection. When Icarus flew towards the sun in ancient times he only had his wings. Nowadays you can protect yourself by having a parachute on your back. And the costs of one has been coming down consistently. Similarly, the price of protection in the equity markets is under pressure in the ever-continuing quest for yield. Volatility exists in both directions and as long as market movements exceed the implied price paid for such movement, the protection is worthwhile. With the S&P500 up almost 20% for 2019, this move is of much larger magnitude than the implied movement currently embedded in options contracts.

In a way, the prevalence of yield seekers and volatility sellers does provide subsidized insurance, which allows investors to retain exposure whilst being protected should the markets rise too close to the sun. Whether applying stand-alone options hedges or investing in volatility strategies, unless you believe the negative interest rate world is the new normal, we are of the opinion There Is No Alternative to such protections.

## 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 and he teaches as an Adjunct Associate Professor at the Chinese University of Hong Kong and as an Adjunct Professor of Financial Practice at National Taiwan University.

## 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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