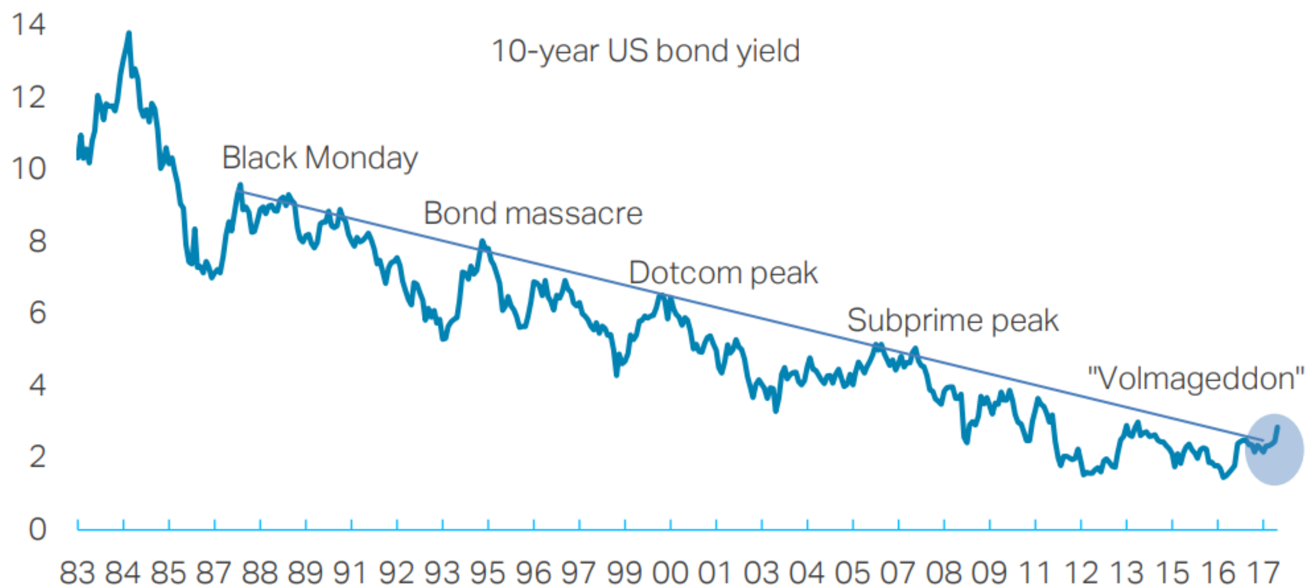
KARMIN CAPITAL

February 2018: Who Shot JR?

March 21st. Put that date in your calendar as it is the first Federal Open Markets Committee ("FOMC") meeting for Jerome Powell as chairman of the Federal Reserve. The FOMC sets interest rate policies and Chairman Powell will be able to send an important signal to investors as to what they can expect for monetary policy under his guidance. But before turning to the near future, some thoughts on the turbulence in markets over the recent past.

The sharp selloff in the equity and bond markets that began on Friday, February 2nd and accelerated last week raises the question if both markets are undergoing a correction (generally described as a selloff between 10%-20%) or whether a larger secular or even a generational shift is underway. Ever since the 2008-2009 global financial crisis, investors have worried about "secular stagnation," which is an environment characterized by low growth, low inflation and low interest rates. But with global growth and inflation at their highest levels in many years, secular stagnation may have finally ended. At the very least, this may conclude the era of negative and extremely low interest rates that started with the 2008 crisis. Far more significantly, however, some investors are worried that the 30-year bull market in interest rates has now ended. In other words, investors fear higher bond yields which savers will celebrate.

The Trend is No Longer Your Friend[1]



The above chart is key for many investors who use "technical" indicators to base their investment decisions. While we do not do this, the graph is alarming to some bond investors because the technical resistance, or cap, for 10-year bond yields has now been broken. This downward trend line in bond yields has been in place since the 1987 stock market crash. Investors fear bond yields could increase from their current 2.85% to 4% or 5%. For stock investors, this would have significant ramifications for valuing companies. For savers and bond investors, this would be generally welcomed news. Retirees could see their bond income almost double! This, of course, ignores the mark-to-market losses some investors

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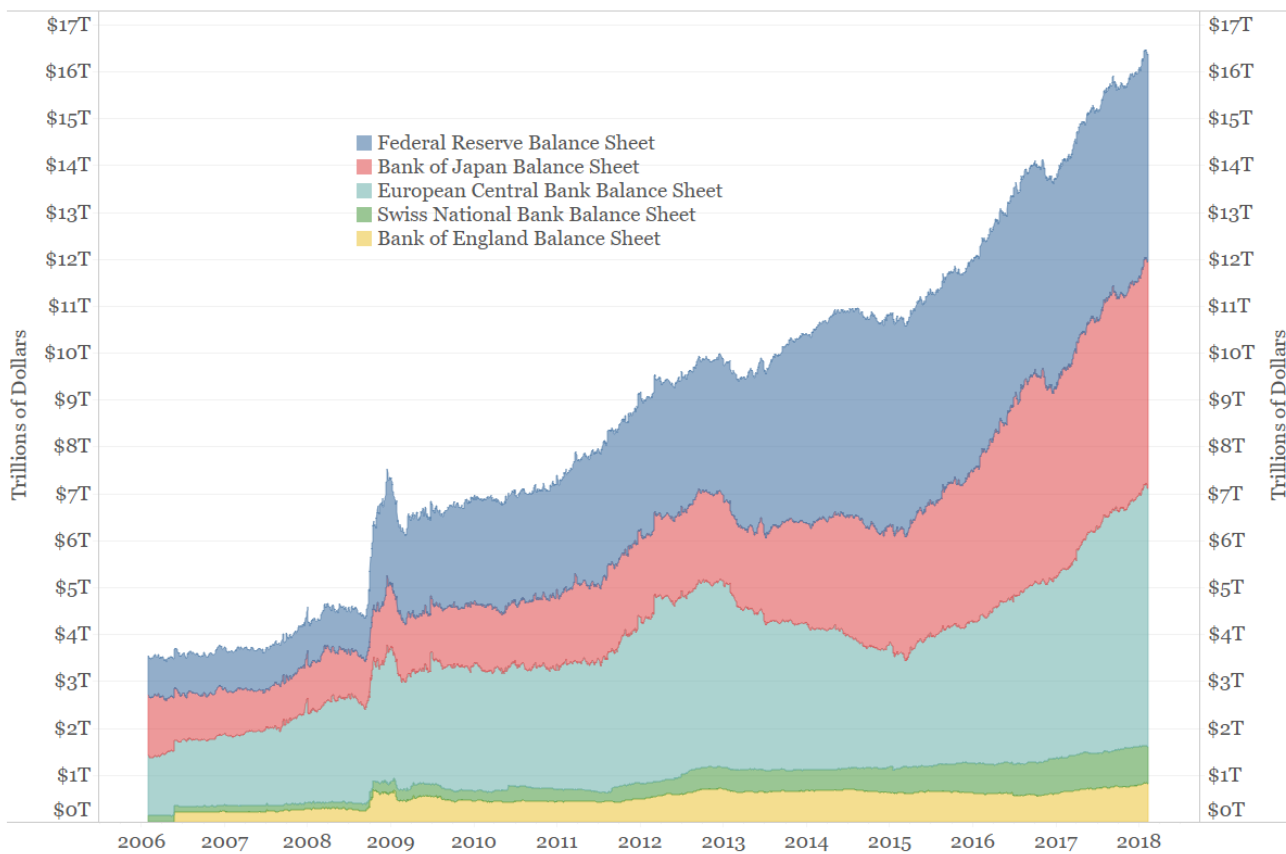
would have on their current bond holdings. As a reminder, the price and yield of bonds move inversely. As interest rates move higher, the price of a bond moves lower.

For the past decade, we have been in what some would describe as a "bull market for everything." Bond and stock prices have risen as global central banks have lowered both short and long-term interest rates. The Federal Reserve and others, such as the Bank of Japan and the European Central Bank, have done this in two different ways. The first and most conventional has been to lower short-term interest rates, such as the overnight rate. The second and far more unconventional method has been to buy bonds and other assets such as stocks. Did you know that the Swiss National Bank (Switzerland's equivalent of the Federal Reserve) owns over $90 billion (yes billions, not millions) of U.S. stocks? Its largest holdings are Apple ($3 billion worth), Microsoft ($2.4 billion), Amazon ($2 billion) and Facebook ($1.6 billion).[2] Or what about Norway's Central bank, which is known as the Norges Bank? According to its website, the mandate for the Norges bank is to "promote economic stability in Norway."[3] It owns $260 billion of U.S. securities including $7.6 billion of Apple stock, $6.2 billion of Microsoft and $4.9 billion of Amazon shares.[4] This makes it the 12th largest holder of Apple and the 16th largest shareholder in both Amazon and Microsoft (Bill Gates is 9th).[5] How this promotes stability in Norway is for a different occasion.



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As the above graph shows, global central banks (Norway is not included) have increased the size of their balance sheets by **5x** during the past ten years.[6] As we mentioned, this growth is largely the result of buying bonds and stocks. The question becomes who will buy when the central banks change their policies, stop buying and heaven forbid even sell?

That is why March 21st is such an important date. Back on March 21, 1980, JR Ewing was famously shot on the TV show "Dallas."[7] Will Jerome Powell shoot this "everything bubble" by aggressively raising interest rates and changing the policy of how many and what type of assets the Federal Reserve buys? As the global economy grows, will other central banks follow and end their asset buying programs?

Global central banks are clearly trying to reverse their policies in the most non-disruptive manner possible. This secular change spells the ending of quantitative easing and the expansion of central bank balance sheets. The generational shift, however, would be the increase in interest rates to a more "normal level." We can establish a clear correlation between the rise in global trade and disinflation or deflation. Now, the reverse may come into effect: less trade and more inflation. The Trump administration is the most mercantilist (i.e., focused on trade and manufacturing) that the U.S. has had in many decades. Also of significance, the Chinese also may be reversing their long-standing emphasis on trade. For the last several decades, the Chinese have exported deflation through their economic and trade policies, which have emphasized increasing manufacturing output to grow the economy. As we have written in the past, though, their pursuit of "Quantity over Quality" changed at the 19th Communist Party meeting in October 2017. President Xi declared that he is now pursuing "Quality, not Quantity," in order to achieve a more sustainable economic model.[8] As an aside, we note that Facebook CEO Mark Zuckerberg sounded a similar mantra on Facebook's most recent quarterly earnings call. The company wants users to experience more quality time on Facebook rather than simply spend a large quantity of time on the site; presumably, like China, in order to achieve a more sustainable model for the platform.

After the U.S. stock market experienced its best January since 1987, the "melt up" in equities took a breather. Comparisons to 1987 can be haunting. Seven years after JR Ewing was shot, the U.S. Federal Reserve had a new chairman in Alan Greenspan, a Secretary of the Treasury (James Baker) who was talking down the dollar and then of course the stock market crash in October 1987. As of February 1st, we had a new Federal Reserve Chairman and Treasury Secretary Mnuchin was quoted a few weeks ago as saying, "Obviously a weaker dollar is good for us as it relates to trade and opportunities."[9] Foreign investors – including the Norges Bank and Swiss National Bank – like a strong (or stable) dollar when they invest in the U.S. If the dollar weakens, it means that the foreigners' U.S. assets will have a lesser value when converted back into their domestic currencies. As an example, if a Japanese investor owns $100 million of U.S. stocks at the current exchange rate of 109 Japanese Yen per dollar, that means they own JPY10.9 billion of U.S. stocks. However, if the exchange rate drops to 90 and the U.S. stock market is unchanged, the $100 million of holdings is now worth only JPY9 billion, or a drop of 17% in value when converted into Yen. Thus, if foreigners think the U.S. government wants a weaker dollar, it will behoove these investors to sell their U.S. assets today rather than waiting for the exchange rate to drop.

Not to sound too alarming, but there is one other similarity to 1987. Back then portfolio insurance was employed by investors to hedge against a selloff in the U.S. stock market. Unfortunately, as the market sold off on Black Monday, portfolio insurance caused more selling of stocks. More selling led to more selling and the snowball effect continued.

A similar occurrence happened this past Monday (February 5th). For nearly two years, investors had grown accustomed to historically low levels of volatility in the stock market. As a strategy to generate extra yield in a low interest

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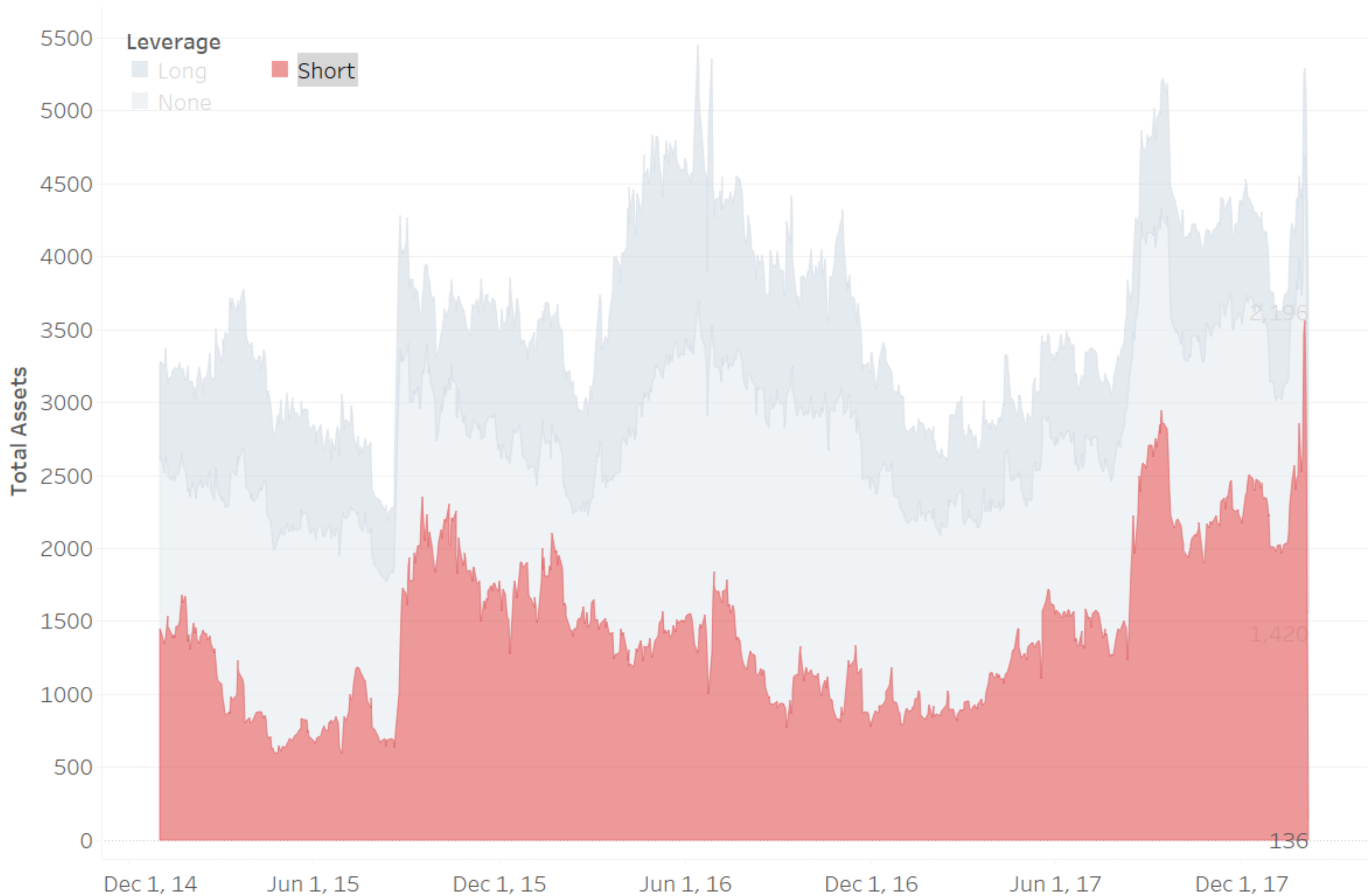
rate environment, investors sold volatility through various products including exchange-traded notes ("ETNs") where the value of the note was tied to the underlying volatility of the U.S. stock market. The growth of this "asset class" is seen in the chart below. So long as realized and implied volatility remained low or went down, investors who were short volatility profited.

Growth in ETFs Dedicated to Selling Volatility[10]



These volatility assets were tied to a benchmark known as the VIX (short for the CBOE Volatility Index), which is a measure of expected variance in the price of the S&P 500.[11] Investors betting on lower expected volatility (or a lower value of the VIX) through these products created a real-world feedback loop that actually resulted in lower realized volatility in the stock market. While only several billion dollars in assets were involved in ETNs that directly shorted VIX futures contracts, far more money was tied to the level of the VIX via various algorithmic (or computer model-based) trading strategies that invest more aggressively in stocks as the level of the VIX declines. As volatility declined over the last year,

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more money steadily flowed into shorting volatility as well as into the stock market itself, which further reduced expectations of volatility – as a steady flow of buyers theoretically would limit the potential extent of any selloff. However, as volatility materially increased throughout the day on Monday, February 5th and the following morning, products and traders who had bet against or had hedged with the VIX needed to begin buying back the billions in VIX futures contracts that they had sold short, which exacerbated the movement in the VIX to the upside. Per an estimate from Barclays, "some $500 billion of assets are tied to funds that target a given level of volatility -- two-thirds of which are traded by algorithms."[12] Thus, as volatility surged, these funds wound down significant equity exposure through algorithmic trading. In the absence of any fundamental-based buyers stepping into the market, the wave of technical selling caused a mini "flash crash" on Monday afternoon that saw the Dow plunge nearly 900 points in a matter of minutes.

In other words, the explosion in volatility resulting from the unwind of the short volatility trade caused an avalanche of programmatic, technical sellers at a time when few buyers were willing to step into the market – hence the extreme fall in stocks. The one positive thing about this selloff is that it blew up the ETN products – at least temporarily –that traders had used to bet on volatility, such as the VelocityShares Daily Inverse VIX Short-Term ETN (ticker XIV), an ETN issued by Credit Suisse that allowed investors to make money so long as volatility stayed low. As the below chart shows, investors in XIV profited from this low volatility environment for many years – until one day they effectively lost it all:

The Implosion of XIV – The Most Popular Inverse Volatility ETN[13]

In our view, the SEC should never have allowed these products to come to market. While sophisticated traders can bet on volatility via futures contracts, these VIX-related ETNs were especially popular amongst retail traders who likely

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lacked an understanding of the risks inherent in owning these instruments. We doubt that most holders of XIV had read the prospectus which stated that Credit Suisse could "accelerate" the maturity of this note if the net asset value (NAV) of the XIV dropped 80% in a day.[14] Well that is exactly what happened on Monday, February 5th. Following the unemployment report on Friday, February 2nd, the VIX soared from 17 to 37 – an increase of 116%.[15]

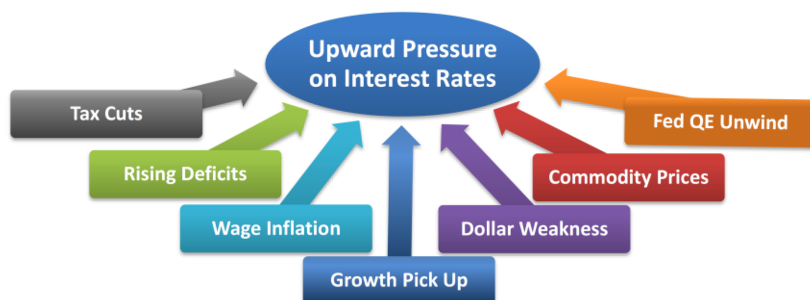
Date	VIX Index	% Change	XIV Share	% Change
2/1/2018	13.47		$ 129.35	
2/2/2018	17.31	29%	$ 115.55	-11%
2/5/2018	37.32	116%	$ 99.00	-14%
2/6/2018	29.98	-20%	$ 7.35	-93%
2/7/2018	27.73	-8%	$ 6.23	-15%
2/8/2018	33.46	21%	$ 5.10	-18%

As a result of this, the price of the XIV has dropped 96% in one week and investors in XIV permanently lost approximately $1.9 billion in a matter of days.[16] Now that most VIX-related ETNs have been halted or terminated by their fund custodians, we are hopeful that market turbulence declines over the coming weeks.

While volatility may remain elevated compared to its low levels over the last year as investors re-assess inflation risks and algorithmic-based funds that use volatility as an input in their models rebalance, we do not think there are fundamental problems in the economy that pose significant near-term risks for investors. If anything, markets are safer now that many of the toxic volatility-linked products have imploded. If you liked stocks a week ago, prior to the selloff, then you should especially like stocks right now, given that they went on about a 10% sale from the recent highs.[17]

If the market and economy aren't "broken," why did the explosion of volatility and the implosion of volatility products come to a head over the last week of trading? Since hitting a post-2016 election low of 2.04% in September, the yield on 10-year U.S. government bonds has risen sharply by 81 basis points to 2.85%, with an increase of approximately 40 basis points this year alone.[18] The higher interest rates are reflective of several factors: (1) improving economic data; (2) concerns that deficit-financed tax cuts and infrastructure spending will have an inflationary impact on the U.S. economy, which by measures including the unemployment rate and industrial/manufacturing activity is already running close to peak strength; (3) expectations that the Federal Reserve, along with other major central banks, will raise interest rates and begin winding down asset purchases; and (4) fears that the Federal Reserve is actually "behind the curve" as inflation is rising.[19]

Upward Pressure on Interest Rates



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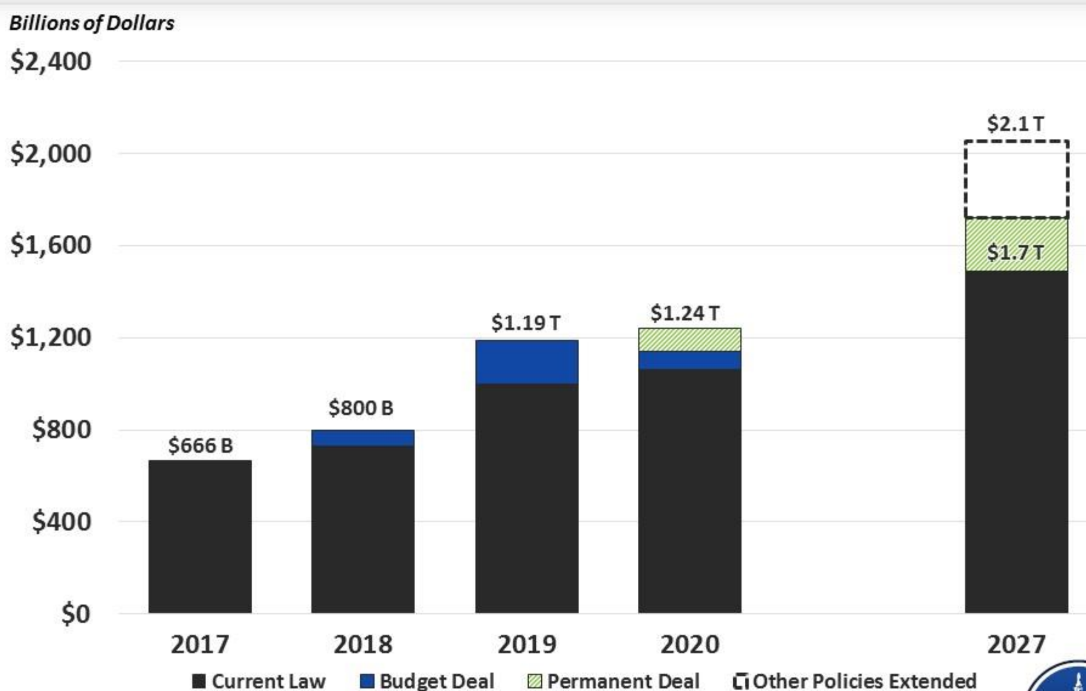
Following the release of U.S. monthly employment data on February 2nd, which reported higher than anticipated January private sector wage gains of 2.9% year-over-year, rates on the 10-year Treasury spiked nearly 14 basis points from 2.7% to 2.84%.[20] The clear break above the long-term bond yield trend line (discussed on page 1), coupled with concerns over rising inflation as indicated by January wage gains, caused a spike in volatility that ignited the long-simmering volatility storm.

Just as the volatility markets had mutually dependent factors exacerbate underlying volatility, some investors fear the bond market **MAY** be entering a similar scenario. As the economy is already running strong and central banks are expected to wind down and end their purchases of government debt (and perhaps equities), it is natural to expect interest rates to rise when a material buyer of U.S. government debt is ending its purchase program. Additionally, foreign buyers may be scared with talk of a weaker U.S. Dollar. But when one then considers that the Trump Administration and Congress have agreed to a large budget deficit with increased infrastructure spending, this is only adding fire to the strong economy. Fiscal stimulus is being applied at a time of full employment, which hasn't occurred in many decades. Just yesterday on Fox News Sunday with Chris Wallace, the White House Budget Director Mick Mulvaney said, "Certainly, there's a risk that interest rates will spike."[21]



As hopefully we have made clear, the catalysts for the dramatic selloff during the past week were far more technical in nature than fundamental. And to reiterate, despite the severity of last week's selloff, we do **NOT** think markets are at risk of crashing further. While unpleasant, this most recent correction was not abnormal relative to the market's long-term

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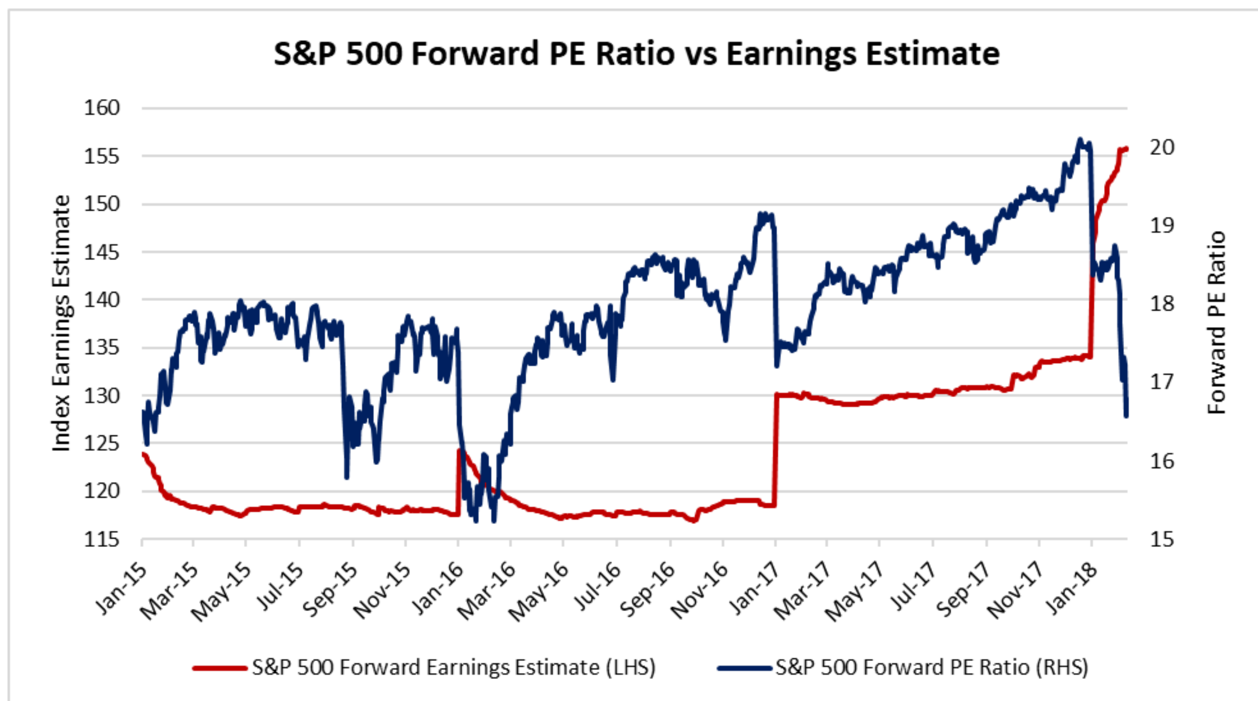
history. What was abnormal was the prolonged period of low volatility that preceded it. At its peak on January 26th, the S&P 500 had increased over 34% since the November 2016 election of Donald Trump, with seemingly no down days in between.[22] In fact, through the end of January, the S&P 500 had gone 112 trading days without a correction of more than 1% and over 400 trading days without a correction of 5%.[23] To put that in perspective, this was the longest such period without a 5% correction since the 1920s![24]

With this latest correction, valuations have come down to levels last seen in early-2016. The combination of surging earnings estimates due to improving economic growth and tax reform, coupled with the selloff, has reduced the price to expected 2018 earnings ratio of the S&P 500 from 20 down to 16.8.[25] Per the below chart, this is roughly the average valuation over the last three years.[26] And, as we highlighted last month, on a free cash flow basis (a measure of operating cash flows minus capital investments) the S&P 500 is now trading around its 30 year-average (4.4% free cash flow yield vs. 4.8% average).[27] Put another way, valuations based on companies' cash flow generation relative to their market cap sizes suggest that stocks are not overvalued compared to their historic trading range.



Following this selloff, our primary concerns right now in the market are four-fold: (1) will inflation increase faster than markets anticipate, causing a further jump in interest rates which will in turn pressure stock market valuations; (2) will a geopolitical shock, such as the abandonment of international trade agreements or increasing tensions on the Korean Peninsula, weigh on economic growth and/or world peace; (3) will China engineer an economic slowdown that impacts the global economy as it focuses on reforms ranging from improving environmental standards to reducing excessive debt in its economy; and (4) are earnings expectations too high? While we cannot plan for geopolitical shocks, we can monitor inflation and earnings and recommend portfolios adjustments if inflation does in fact pick up or earnings disappoint. As discussed, the U.S. is beginning to experience signs of faster wage inflation that newly appointed Fed Chairman Powell will need to monitor as the year develops.

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If inflation picks up and the Fed raises interest rates faster than the market anticipates (three times this year), while at the same time global central banks also reduce their purchases of sovereign bonds, then we would expect fundamental volatility – as opposed to technical volatility – to impact markets. For now, however, interest rates still remain close to historically low levels (with the U.S. 10-year Treasury yielding 2.85%),[28] financial conditions are still accommodative to growth and the world is experiencing synchronized economic expansion. Despite the recent bout of volatility, we still believe it is a good time to invest in select stocks, sectors and global markets that will benefit from company-specific opportunities, positive sector trends or continued global/regional growth. So long as economic data remains positive and earnings continue to grow, stocks should generally perform well, providing superior returns than fixed income alternatives – though perhaps with a bit more turbulence than we have grown accustomed to the last two years. In regard to bonds, we continue to buy preferred securities where the coupon or interest one receives adjusts to the market level of short-term interest rates. Ultimately, the yield on bonds will remain capped as fixed income investors will flock to low-risk government debt paying higher coupons. Certainly a 5% yield with 2% inflation (or a 3% real yield) will appeal to a myriad of investors.

Lastly, we would like to mention that one way to take advantage of the recent volatility and improve the yield on one's investments is by selling covered call options against portfolio holdings. The recent surge in volatility has increased the amount of premium that option sellers receive. To refresh, a call option contract provides a call buyer the right, but not the obligation, to buy a stock at a predetermined price (the "strike price") on a certain date (the "expiration date"). The cost of this right is known as the option "premium" – an amount in excess of the strike price that is determined in part by the value of the underlying stock, time remaining to the expiration date, interest rates, dividend yield and, most importantly for our purposes, the volatility of the underlying stock. The higher the volatility, the higher the call premium will be. In contrast to a call option buyer, the seller of a call option has the obligation to sell his/her stock to the call buyer should it exceed the strike price on the expiration date. In return for assuming this obligation, the call seller receives the premium upon selling a call option. The call seller bears two risks, assuming he/she owns shares of the underlying stock:

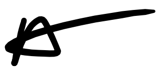
- That the stock will rally in excess of the value of the strike price and that he/she will be required to sell the stock to the call buyer below the market price.

- The underlying stock sells off and the investor's investment in the stock loses money. However, this is a risk the owner has when purchasing the stock.

For many stocks that have recently experienced elevated levels of volatility, call premiums are close to two-year highs. These elevated premiums offer call sellers the opportunity to enhance their returns. This is a particularly attractive strategy for IRAs and other tax-free accounts. Please let us know if you would like to discuss this strategy for your portfolio.

We look forward to discussing the markets and investment strategy with you – please, as always, feel free to reach out with any questions.

Sincerely,



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Citations and Disclosures

[1] TS Lombard, "Melt-Up-Down" (Feb. 8, 2018).
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