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Extreme investing primer

Evan Lorenz writes:

Three simple figures ought to settle the question of whether the stock market is conducting business from the inside of a bubble: 1.3, 24.2 and 3.5.

In billions of dollars, these numbers represent the market cap of GameStop Corp. at the start of the year, at the Jan. 27 share-price peak and at press time on Tuesday. At a glance you might call it a round trip, but on closer inspection you'll see that the punters have managed to salvage a near three-bagger from the smoking ruins of the crash. Such things don't happen in every market cycle.

So, bubble it is, but what to do about it? Now in progress is a survey of hedges and investments to protect against (and/or to profit from) today's wide-ranging variances from the norms of price and value and volatility.

Maybe the Robinhood-cum-Reddit-cum-bitcoin-cum-SPAC pyrotechnics have you itching to sell everything you own and seek refuge in cash, but that stratagem poses risks of its own. Former Fed Chairman Alan Greenspan uttered the famous words "irrational exuberance" in a speech before the American Enterprise Institute in Washington, D.C. on Dec. 5, 1996. He meant them as a warning that the stock market might be getting ahead of itself. However, from the time he finished speaking until the March 24, 2000 market top, the S&P disobediently rallied by 115.5%.

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Bubble-protection approach No. 1 is not what you might expect, and maybe "protection" is the wrong word. The

course of action proposed is to buy—yes, buy—call options on the SPDR S&P 500 ETF (SPY on the NYSE Arca). Hear out our friend Harley Bassman, volatility expert extraordinaire and author of ConvexityMaven.com.

Bassman contends that the hunt for so-called black swans claims too many of the waking hours that investors devote to worry. It's not that there are no such unforeseen adverse events—the Great Recession and the Big Bug struck within a dozen years of each other—but there are other surprises in life. Garden-variety bullish events, or "white swans," as Bassman terms them, happen, too.

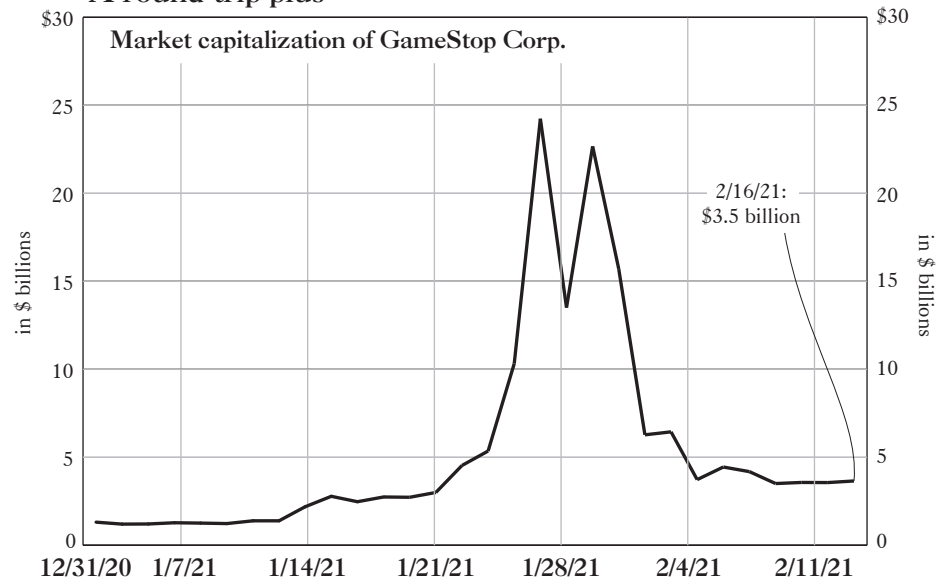
Between the Fed's buying of \$120 billion's worth of Treasuries and mort-

gages every month and the Biden administration's plan to mail \$1,400 in cash to each and every eligible American adult (on top of the \$600 federal checks that Congress approved in December), public policy can't be described as taut.

A portion of these funds surely will serve their intended humanitarian purpose, but not a small amount is likely to wind up in Robinhood accounts. In a survey conducted last week by Harris Poll for Yahoo! Finance, 9% of a representative sample size of 1,089 Americans admitted to buying at least one share of GameStop Corp. in January.

"What is clear is that a financial bubble is being inflated, and there is risk on both sides of the distribution," i.e., on the bullish side and on the bearish

A round-trip plus



source: The Bloomberg



source: The Bloomberg

side, Bassman observed on Feb. 3. “Ordinarily the bloviating pundits advise one to sell assets, or perhaps execute some sort of hedge such as buying puts or selling covered calls. They are looking in the wrong direction.”

To update Bassman’s analysis, the SPY trades at \$392.30, up 76% from its March 23, 2020 nadir. It’s a sign of the market’s acrophobia that puts on the S&P are so much costlier than calls.

Thus, the Feb. 18, 2022 calls, with a \$470 strike, change hands at \$5.09 for an implied volatility of 16.9%; they are 20% out of the money. Notably, their implied volatility is below the 20 at which the VIX, which measures the cost of one-month options on the S&P, currently trades.

In contrast, the puts, with a \$310 strike and the same expiry, are quoted at \$14.72 for an implied vol of 30.6%; they are 21% out of the money. “I will not quibble with the put price as it offers ‘earthquake’ insurance,” the bond quant concludes, “but within the context of current events, the call price is too cheap.”

For the record, the number of trading days between the “irrational exuberance” speech and the March 24, 2000 S&P top was 833. If you were bearish, it seemed like more.

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In the late 1990s, as Chris Cole, founder and CIO of Artemis Capital Manage-

ment, L.P., reminds us, stock prices and stock-price volatility climbed together. The pattern broke when the tech bubble burst, and for the next two decades the averages and the VIX tended to move inversely. But now we’re back to the future.

Thus, on Sept. 2, 2020, the S&P 500 soared to 3,580.8, taking out its pre-virus top. On the same day, the VIX closed at 26.6, well above its 31-year average of 19.5. “That was the highest VIX in history in the context of a new all-time [S&P] high,” Jim Bianco, eponym of Bianco Research, LLC, tells me.

For any who hate the cost of S&P puts even more than they hate the stock market, there may be a workaround. Tightening liquidity typically precedes—or, indeed, causes—stock market selloffs. And a symptom of tightening liquidity is that the difference between the bid and ask sides of the bond or loan market widens. It follows that you can lay down an indirect bet on falling stock prices with options and ETFs linked to the credit markets.

Today’s liquidity gusher may look like Old Faithful, but unlike the spout at Yellowstone National Park, the central bank-fed flood will certainly run dry one day. The GameStop affair itself—a tempest in a single stock—temporarily sucked liquidity out of the system, as the merry men of Sherwood Forest answered their multibillion-dollar margin call.

Something as obscure as a regulatory tweak—for instance, the reinstatement of the inside-baseball Supplementary Leverage Ratio—could likewise tighten monetary conditions. The SLR is a banking rule set in place after the Great Recession to assure a minimum level of capital relative to on- and off-balance-sheet exposure: 3%, along with an extra 2% or more for institutions that regulators deem too big to fail.

The Fed suspended SLR in April last year to quell the previous month’s pandemic-induced selloff. But that waiver is set to end on March 31, and there’s no move yet to extend it.

Restoration of SLR limits could prompt banks to shed assets—for instance, by reducing exposure to the repo market, in which government securities collateralize short-term loans. On its Jan. 15 earnings call, JPMorgan Chase & Co. speculated that the reimposition of SLR might lead it to turn away deposits.

Of course, as things stand, the hunger for yield rages, so much so that needy portfolio managers are petitioning operating companies to issue debt, instead of would-be borrowers soliciting the PMs to buy the debt that they determine they actually need to raise (“reverse inquiry” is the term for this Wall Street version of Saddle Hawkins Day).

When Carnival Corp., the now passenger-less cruise-ship operator, approached the bond market in February with \$600 million’s worth of six-year, senior unsecured notes, according to Bloomberg, the deal was upsized twice, the second time to \$3.5 billion, while the coupon was shaved to 5.75%, from around 6%. It’s a far cry from the 11.5% coupon that single-B-rated Carnival paid on a first-lien, three-year note issued last March.

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Junk bonds these days sport a three handle, if you please—3.96%, to be exact, on the Bloomberg Barclays U.S. Corporate High Yield Index. It’s a new low, down from the high of 11.7% a year ago. In consequence, junk trades 347 basis points wide to Treasuries, compared with the trailing 25-year average of 554 basis points. The 12-month forward non-energy default rate implied by such pricing is a mere 1%, according to Martin Fridson, the CIO of Lehmann Livian Fridson Advi-

sors, LLC. It's a far cry from the more than 5.4% speculative-grade default rate that Moody's Investors Service predicts for 2021.

Credit troubles could push corporate bond prices lower; an inflation problem could drive most bond prices lower. Today's moderate concern about the rising cost of living has already pushed the 10-year inflation breakeven rate to 2.21%, highest since 2014 (to calculate it, subtract the yield on Treasury Inflation-Protected Securities from that on standard-issue, fixed-coupon Treasuries).

Which brings us to the aforementioned opportunity to bet against the stock market through the cheaper portals of the credit market. We'll identify two such entryways: speculative-grade corporates and shorter-dated Treasuries.

Thus, the iShares iBoxx \$ High Yield Corporate Bond ETF (HYG on the NYSE Arca) trades at \$87.64, up from \$68.63 on March 23, 2020, and offers a dividend yield of 3.3%. The Jan. 21, 2022 puts on HYG, struck at \$79, trade at \$2.61, or at a 13.4% implied volatility; they are 10% out of the money. By comparison, puts on the iShares 20 Plus Year Treasury Bond ETF, with the same expiry, trade at an 19.4% implied vol; they are also 10% out of the money.

A liquidity drought or concerns about corporate solvency would ding both the S&P 500 and high-yield bonds. However, to sum up, the cost of 10% out-of-the-money puts on the HYG (a 13.4% implied vol) are less than half that of 20% out-of-the-money puts on the S&P 500 (with the aforementioned 30.6% implied vol).

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The reopening of the economy—has-ten the day!—poses its own investment risks. The bump in expected demand for travel, eating out, seeing a movie, etc. might shock already stretched supply lines and activate an inflation impulse that monetary policy long ago initiated. Higher yields, should they materialize, could threaten elevated equity valuations.

News on Nov. 9, 2020 of the 90%-plus efficacy of the vaccine developed by Pfizer, Inc. and BioNTech S.E. set the stage for a preview of the anticipated reopening trade. "It was a good

day for the market," Dean Curnutt, the CEO of Macro Risk Advisors, recalls. "It was an unbelievable factor rotation that I've never seen before, a 15-ish standard deviation move, stuff that's never supposed to happen in a gazillion years. The banks are up 15%, and the back-to-work stocks are up a ton. And the Amazons and the Apples were down considerably...of course, rates were up a lot.

"This was like the reflation impulse," Curnutt goes on. "And I just think that the market leadership is especially exposed to this, and I think we're supposed to pay attention to the top rung of the S&P because it's so dominated the performance."

While the cost of options on the long bond has risen, implied volatilities on shorter-duration Treasuries remain low. The ICE BofA MOVE Index, a sort of VIX for the Treasury yield curve, stands at 57 basis points, roughly half of its 30-year average.

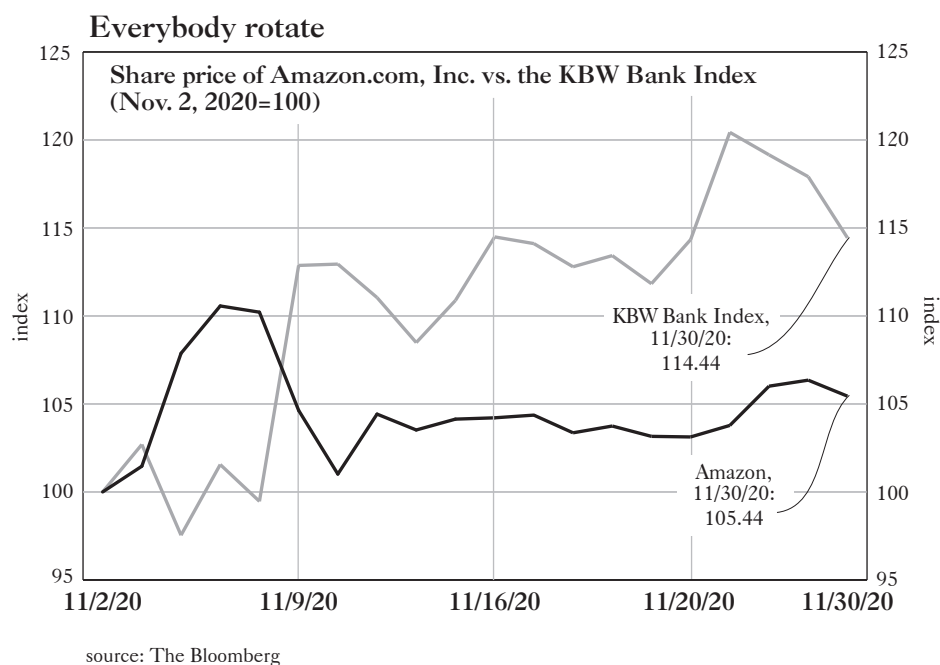
There are a host of rationales for the subdued volatility in shorter-dated Treasuries. For one, the Fed's continued QE program plus the Treasury's recently announced plan to run down its immense account at the Fed (in effect, taking hundreds of billions of dollars out of cold storage and releasing them into banking channels) could lead to a deluge of reserves entering the banking system; such a torrent would likely press down on short rates (*Grant's*, Feb. 5). For another, the monetary mandarins are doing their best to talk down

a rate hike. "We're going to be accommodative for a very long time because the economy just needs it to get back on its feet," the president of the Cleveland Fed, Loretta Mester, said at a virtual discussion for the Rotary Club of Toledo last week. "Patiently accommodative" was how Chair Jay Powell described the same idea, also last week.

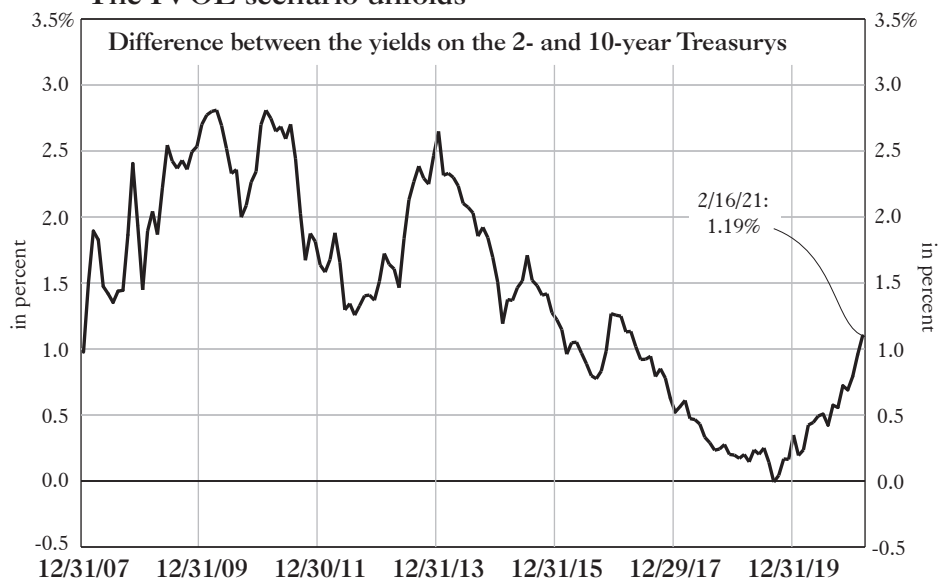
However, to judge from recent monetary pivots, the Fed is just as much in the dark about the start of the next tightening cycle as the rest of us are. Recall that two rate hikes and "autopilot" balance-sheet reduction were on the agenda of the Federal Open Market Committee meeting of Dec. 19, 2018. The sinking stock market led to a hasty rethink of that plan, and the tightening cycle ended with Powell's about-face of Jan. 4, 2019.

At the Jan. 29, 2020 meeting, the FOMC invoked a "strong" labor market and "moderate" economic growth as reasons to hold the funds rate steady, between 1.5% and 1.75%. But the pandemic-induced March liquidation scrambled those well-laid plans, too, and the Fed soon heaved its kitchen sink at the American economy.

"The point is, the last two policy changes have been market-driven," Bianco tells me. "The market takes a big right turn or left turn, and the Fed is forced to react to it. And, so, when the Fed says...we could let the average inflation rate run above 2%...we don't have to raise rates. I keep scream-



The IVOL scenario unfolds



source: The Bloomberg

ing, 'It's not your call. It's the market's call. If you let inflation go up to 2.5% and the markets are okay with it, you're okay with it. If inflation goes up to 2.5% and the market throws a fit, you're 10 days away from raising rates. You just don't know [that] you are yet.'

There are many ways to bet on a Fed rate hike, if one were of such a mind. The January 2023 Fed funds futures contract, for instance, has yet to price in a single tightening move; it trades at 19 basis points, right in the middle of the FOMC's target range of zero to 25.

Or one might sell short the two-year Treasury futures contract. "Because I'm doing it at such a low vol, there's a lot of convexity that comes from being able to do it at such a low price," Curnutt says. "So, I'm more in the camp of 'it is the trade to have on as a protection if the market starts to move ahead of the Fed.'"

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The Quadratic Interest Rate Volatility and Inflation ETF (IVOL on the NYSE Arca) is another vehicle with which to express a bearish monetary opinion. A

longtime pick-to-click in these pages, IVOL invests 84% of assets in TIPS with the balance in options that pay off as the yield curve widens between 2- and 10-year points (*Grant's*, May 17, 2019). The TIPS portfolio should catch the upside in a rise in the CPI. The options should become more valuable if interest rate volatility continues to increase and if longer-term interest rates climb in response to higher inflation. Despite its 1% annual fee, IVOL has compounded net asset value by 20.4% since its May 13, 2019 start date, beating the Bloomberg Barclays US Treasury Inflation-Linked Bond Index by four percentage points.

"I couldn't imagine a more perfect cocktail for IVOL," says Nancy Davis, the founder of Quadratic Capital Management, LLC and the portfolio manager of IVOL, about today's monetary and fiscal backdrop. "I'm scared for my children and my future grandchildren. We have [the Fed's] average inflation targeting, a blue wave and Yellen as the Treasury secretary. I feel like if there's ever a situation where we're going to have a correction and a normalization of inflation expectations, it's now."

Another option for monetary shelter is the Horizon Kinetics Inflation Beneficiaries ETF (INFL on the NYSE Arca), which was previewed in the issue of *Grant's* dated Nov. 27, 2020. To quote the fund managers: INFL is an "active ETF that seeks to provide positive real investment returns in an inflationary macroeconomic environment. The Fund seeks to achieve this by investing in the public equity securities of profitable businesses which we believe are also inflation beneficiaries with scalable, economically resilient business models."

INFL, which has scored \$34 million in assets (including a dollop of your editor's) since it began trading on Jan. 11, charges an annual fee of 0.85%. The top five holdings include a pair of royalty trusts (Texas Pacific Land Corp. and PrairieSky Royalty Ltd.), Charles River Laboratories International, Inc. (a laboratory services company for the pharma industry) and two exchanges (Deutsche Börse A.G. and ASX Ltd.).

I asked Andrew Parker, a managing director at Horizon Kinetics, "Why financial exchanges?"

"[Their] income is tied to the price of commodities," Parker replied. "As the value on which the future or option rises, their fee goes up. Trading goes up when volatility goes up."

Then, too, he said, when exchanges merge, "effectively half of the operations cost drops. If you look over time, the exchanges have done well in pretty much every environment. We think that will continue in a rising-price world."

While the Inflation Beneficiaries fund tries to protect its net assets from the ravages of a depreciating currency, it's intended to prosper even during periods of price stability. "The stocks we own, like Texas Pacific Land or the CME, are profitable companies," said Parker. "We just happen to think they will be more profitable if you have a rising-price world. The goal is to own something that will hedge you against inflation but won't hurt you if we don't get it."

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