



# Kass: The Market Continues To Underprice Risk.

*"Most valuation parameters are either the richest ever (Buffett ratio of stock market capitalization to GDP, price-to-sales ratio, the VIX, bond yields, private equity transaction multiples, real estate capitalization ratios) or among the highest in history (p/e ratios, Shiller cycle-adjusted p/e ratio). In the past, levels like these were followed by downturns. Thus a decision to invest today has to rely on the belief that "it is different this time." • Howard Marks, "[Latest Thinking](#)"*

For several years we have lived in an investment world, dominated by passive strategies -- that has underpriced risk and has ignored a number of potential headwinds and adverse outcomes. Importantly, clear and seemingly dangerous structural market issues have also been disregarded. To be sure, the demand/supply conditions over the last 10 years were supportive and provided a tailwind to stocks.

- The number of publicly held companies listed on the exchange had contracted from 7800 in 1999 to only 3850 today -- as mergers, delistings, takeovers, etc. diminished the ranks.

- *Of the remaining 3850 companies, over 17% of the shares had been repurchased -- serving to contract the available float.*
- *Meanwhile, active investing took a back seat to passive investing (which have a tendency to steadily accumulate stocks). ETFs gained popularity -- to the point that the number of exchange traded funds have eclipsed individual equities traded on the New York Stock Exchange. Leveraged quant strategies, like volatility trending and risk parity -- which are agnostic to balance sheets, income statements, have little understanding of private value or intrinsic value and depend on the "normal" and historic correlations between asset classes -- gained more traction as active management lost ground.*
- *With interest rates low (contributed by enabling global central bankers), T.I.N.A. ("there is no alternative") became a dominant market theme and format of investor behavior.*
- *In this reduced supply relative to rising demand, trading volume slipped -- further goosing stocks and providing a buy the dip mentality that conditioned most active and passive investors.*

Concerns that I have expressed, of an October, 1987- like drawdown caused by a structural shift in markets (similar to that era's growing use of *"Portfolio Insurance"* back 20 years ago) diminished in weight as time moved forward, as volatility became a "hat size" and as the global bubble in short vol surfaced and was ignited. Indeed, accommodative central bankers made traders feel like Nobel Laureates by making a host of short volatility strategies (and risk parity) an easy way to incrementally add to investment returns and yields. The ursine crowd looked increasingly foolish -- worry warts were considered Cassandras, resembling an endangered species like the Dodo Bird.

**Worries? Hardly any existed as seen in the bullish prism of optimism.** Bullish investor sentiment grew to an extreme (captured in the record retail inflows into equity funds last month), as did valuation (seen in Warren Buffett's market capitalization to GDP metric, mentioned above in my Howard Marks reference, which hit a record high) and so did the self confidence of many talking heads in the business media -- many of whom explicitly worship at the altar of price momentum and rarely confront an investment or market that they didn't admire. Much like during the dot.com boom in the late 1990s, strategists began to compete for the highest S&P price targets -- shouting from the rooftops and CNBC that their forecasts were higher than their peers, oddly reminiscent of the dot.com era 18 years ago when my pal Henry Blodgett made his bones by producing a Ludacris price target for Amazon.com ([AMZN](#))! Fear and doubt became noticeably absent in most market commentary -- adverse outcomes were ignored. *"Get rich quick"* trading schemes multiplied -- I won't mention which strategies because my criticism understandably pisses off their practitioners, so I prefer to criticize by category and not by individual strategy. Most of these strategies possessed the toxic cocktail and constant of greed and simplicity. With the trend in charts clearly higher, momentum trading was embraced to the fare thee well -- scorning yet another Buffett quote (*"If past history was all there was to the game, the richest people would be librarians."*) As I observed lately, even some of the most skeptical began to play the game -- and why not, in a rapidly rising stock market, these strategies were working. Rising stock prices also became rationalized by The Oracle of Omaha (Buffett) and other thoughtful, sober and enormously successful oracles -- like my pals Lee Cooperman and Byron Wien, and others like David Tepper -- who expressed the strange notion (at least to me!) that [stocks](#) were not expensive against an (admittedly) overvalued bond market (in which interest rates remained subdued relative to history). And, why not be bullish with such a clear and advancing trend in equities? Aided by the generosity of global central bankers, stocks have steadily risen (with few interruptions) since I called *The Generational Bottom* in the first week of March, 2009 on CNBC's "The Kudlow Report." Stated simply (as Marty Zweig famously professed) -- *"the trend was your friend"* -- at least up to a week ago! **The Tax Bill Provided the Last Goose to Investor Optimism (and The Virtuous Cycle) in January**

*"So call it a gift to the corporate sector if you want, but I think it's unlikely to be much of a job-creator or long-term boon for the American middle class. There will be pluses from the law, and there will be minuses. For me, the bottom line was captured best in a January 11 speech by William Dudley, the long-term and highly respected president of the New York Fed: While the recently passed Tax Cuts and Jobs Act of 2017 likely will provide additional support to growth over the near term, it will come at a cost. After all, there is no such thing as a free lunch. The legislation will increase the nation's longer-term fiscal burden, which is already facing other pressures, such as higher debt service costs and entitlement spending as the baby-boom generation retires. While this does not seem to be a great concern to market participants today, the current fiscal path is unsustainable. In the long run, ignoring the budget math risks driving up longer-term interest rates, crowding out private sector investment and diminishing the country's creditworthiness. These dynamics could counteract any favorable direct effects the tax package might have on capital spending and potential output. Of all the possibilities, I find myself agreeing with Dudley's take on the likely consequences. **All else equal, the tax law is likely to result over time in higher deficits, higher national debt, higher economic growth, higher inflation, higher interest rates, higher federal debt service requirements, and thus still-higher deficits and debt. These things tend to go together, and together they constitute the fiscal path Dudley describes as unsustainable. The outlook was troubling before; the tax cuts will make it worse.** The reward from the tax law is pretty clear: it's likely that in the short run the economy will strengthen, corporate profits will increase and take-home pay will rise for most Americans. But the long-term benefits are less certain, and meaningful hidden risks exist."• Howard Marks, *Latest Thinking**

With the relationship between demand and supply favorable for rising stock prices, nearly unbridled enthusiasm surrounding fiscal policy (abetted by the passage of the tax bill) prompted investors to contribute over \$50 billion into the coffers of domestic equity funds in January -- serving to prompt even higher prices over the last month. However, my analysis, as described in my many Diary opening missives, is that the tax bill will likely add far less than (the consensus) \$10/share to 2018 S&P earnings -- half that seems closer to what can become reality, hardly enough to support the magnitude of the climb and the great thrust recently in stock prices. Moreover, the consequences of a loss of fiscal discipline (in the implementation of the lowering of corporate tax rates) which has accompanied the tax bill's passage has been under appreciated and, surprisingly, has garnered little attention or criticism. The continuation of the virtuous [cycle](#) -- of rising demand and lower supply and less market activity -- seemed to have gotten even stronger in the past two months. But that virtuous cycle has its limitations -- particularly when nearly everyone is in bullish agreement and retail investors (in January) came in droves to the market party after years of rapid price appreciation in the major indices. John Templeton expressed the nature of markets in this quote -- which many bullish market participants have quoted to support their continued optimism:

*"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."*

After all, to many, optimism was in place and not euphoria. However, (in reality) euphoria is only one factor of many that may contribute to a market top, and, ultimately a recession. Rather, asset value declines (in dot.com stocks and home prices) previously served to establish a market top, undermine growth and put us in a recession in early 2000 and late 2007. (In 1987 and 1994 other, non-economic factors also contributed to sharp market downturns). Significantly, in our brave new investment world, the nature and structure of markets can also be contributing factors. And, as previously mentioned, when too many are found on the same side of the boat (and are leveraged in short vol or risk parity strategies), a drowning may follow. In other words, Sir John Templeton's adage may have been true in the past but could be a tired investment saw today. **Investment**

## Vision is Always 20/20 When Viewed in the Rear View Mirror

*"The potential catalysts for decline that we have to worry about most may be the unknown ones. And although I read recently that bull markets don't die of old age or collapse of their own weight, I think sometimes they do (a dollar for anyone who can identify the catalyst for the collapse of the bull market and tech bubble in 2000 -- it's not easy)." • Howard Marks, Latest Thinking*

The above commentary explains how I believe we got to a serious level of overvaluation in late January but not where we are going in the future. I have long been of the view, expressed in this Diary, that:

1. *Rising interest rates is the most significant potential headwind to the US Stock Market -- in our leveraged financial system this statement stands taller than before. Today, as previously written, the two year US note yield stands at 2.17% compared to only 1.78% dividend yield on the S&P Index. Moreover, every dividend discount model has, at its core, "the risk free rate of return" in making the valuation calculus. (Note: I am quite bearish on bonds and have held a large short TLT position since I perceived "A Generational Low in Bond Yields" 1 1/2 years ago).*
2. *Global central bankers have begun to reverse their largesse of the last decade.*
3. *Especially at inflection points, bear markets are borne out of good news and bull markets emerge from bad news. (e.g, March, 2009)*
4. *Market tops are almost accompanied by the perception of a new paradigm (of uninterrupted economic growth and no meaningful market corrections) and speculation (i.e., crypto currencies, which peaks a few months ago)*
5. *Market tops are associated with extreme investor optimism, large retail inflows and high valuations. These factors are all in place now.*
6. *In a market dominated by ETFs, short volatility strategies and Quant strategies (risk parity and volatility trending, etc.) -- buyers live higher and sellers live lower! Be forewarned -- as we may start to resemble October 1987 when portfolio insurance was the catalyst to a large market dive.*

**Cracks in the market began to appear in the last two weeks -- actually in some asset classes a few months ago -- most conspicuously in the speculative rise in price of bitcoin and crypto currencies and in marijuana-related stocks** (who's values ultimately declined by -50% to -75%). I, and some others, waxed enthusiastically (and aggressively shorted) the recent rise in cryptocurrency prices as well as in equities -- the former being a signpost, to those that recognize that history often rhymes and that speculation was getting out of hand. This, too was ignored until recently -- in fact the business media (as it is wont to do) devoted a disproportionate amount of its time (including the both infamous and conspicuous bitcoin price bug) in the promotion of bitcoin and other crypto currencies, just as the asset class was concluding its parabolic rise and making what appears to be a significant top. In essence, as with the dot.com boom and the era of flipping houses -- many in the business media became enablers, once again -- and the late to the crowd retail community "bought the top" in bitcoin and, as retail inflows surged into equity funds last month, bought what also could be a top in equities.

## On Interest Rates and Markets

*"How did you go bankrupt?" • Two ways. Gradually, then suddenly." - Ernest Hemingway, The Sun Also Rises*

Slowly but predictably, interest rates began to rise and debate over what level might impair stocks unfolded. Given the still historically low term structure of rates, most market participants felt that we were far from the level that would adversely impact equities -- stocks continued to rise and the



bullish cabal sang out loud and clear the Zweigian chant that "the trend (higher) was your friend." That optimism changed swiftly in the last two weeks -- even though relative to historic moves interest rates remained low and the trajectory of the rate rise (the ten year US note yield rose from about 2.4% to 2.8%) was relatively modest. To me, Friday's abrupt move lower (-2%, -700 DJIA and -60 S&P handles) could be testimony to the fact that:

1. *Aggregate risk has been underpriced.*
2. *High valuations have made the upside/downside reward vs. risk potentially more vulnerable than many had assumed.*
3. *The market structure (discussed at the beginning of this missive, Part I), like in October, 1987, is more leveraged to interest rates than many believe.*
4. *Too many are (leveraged) in the same trade -- long stocks and short volatility.*

## Where Do We Go From Here?

*"The simple explanation is that because of the involvement of people, economies and markets -- as well as other cyclical phenomena -- tend first to overshoot in one direction (and given how people are wired, usually to the upside) and then they are bound to correct in the opposite direction. I think that description is highly relevant to the two topics discussed above. \* When markets do too well for a while -- that is, when equity returns far exceed the growth rate of companies' profits, and when bonds return more than their promised yield to maturity -- it usually means they've become overpriced and will correct sooner or later. \* And when an economy expands faster than the potential growth rate determined by its population growth and increases in productivity -- usually because companies or consumers borrow, invest or spend to excess -- it's likely to contract eventually. This happens either because the excesses are unsustainable in and of themselves or because central bankers take steps to cool things off in order to avert hyperinflation. That's the common thread here: markets that may have been doing too well, and an economy that may be in the process of being overstimulated. Both feel good right now, but each has potential negative consequences."* —Howard Marks, *Latest Thinking*

I will start by expressing a much repeated statement I have made over the years: the only certainty is the lack of certainty and that opinions are like asses, every one has one! In a flat and interconnected world, hubris and cockiness are much undesired investment features -- hide your children and portfolio from the cockiness too often seen in the business media as, quite often, it has undesirable outcomes. As [expressed](#) a week ago, I am short bonds in the belief that the 10 year US note yield's "intrinsic value" is about 3.325% -- well above the current 2.86% yield close on Friday. It is my continued view that anything fixed income related (*Treasuries, high grade corporate bonds, junk bonds, etc.*) should be avoided. If correct in my rate view, there is likely much more weakness ahead for the markets. **If, by contrast, the rate rise is contained, the markets could stabilize probably about where we are now.** However, an equal concern, as expressed in my Surprise Lists in both 2017 and 2018, involves the changing market structure and a potential change in asset class relationships which could produce the possibility of "Portfolio Insurance (Part Deux)" in which the very leveraged short volatility bubble and risk parity/volatility trending strategies begin to be unwound, much like was the case of forced selling in October, 1987. In it's extreme I worry that days like Friday could foreshadow another "flash crash" -- a domino-like impact in which levered quant strategies, somewhat like a movie in reverse, are forced to de-risk, taking markets much lower:

## Surprise #9: Volatility Spikes, Causing a Major Flash Crash

*"We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping. I admit to not understanding it."*•Dr. Richard Thaler, Nobel Prize winner  
In 2018, the global volatility bubble bursts in a spectacular fashion, with stocks falling by 15% in one session. In [an interview with Bloomberg](#) a few weeks ago, University of Chicago economics professor Richard Thaler went on to say in response to the market's low volatility and continued investor optimism, *"It's certainly puzzling... and it's puzzles that attract my attention."* He added that he is nervous, and when investors get nervous *"they are prone to being spooked."* **A World Without Risk?** These observations and, specifically, the above quote are much like what I have been saying in my Diary -- namely, that never in history have there been so many potentially adverse political, geopolitical, economic and market outcomes. I am not alone in this view, as Macquarie's Viktor Shvetz recently wrote:

*"Investors are probably suffering extreme mental exhaustion. Historically low volatilities and risks, coinciding with high valuations, would make anyone nervous."*

According to the brokerage, the reason for this underlying dysphoria is that "investors understand that there is nothing normal in the current environment of unprecedented financialization and economic disruption. The deadweight of US\$400 trillion 'cloud' of financial instruments (*backing into assets that are either worthless or are declining in value*) must be supported by ongoing financialization." In a world seemingly without risk and with spreads at all-time tights, Bank of America's•David Woo writes in a similar vein that the market is more complacent than it was in the summer of 2007:

*"This implies that liquidity must continue to grow, volatilities must be controlled and neither demand nor supply can yield higher cost of capital. Thus, risks facing investors are that either CBs and/or China misjudge extent to which reflation is dependent on inflating asset values and China's fixed investment. If the market is underpricing the uncertainty with respect to the outlook of US monetary policy, we are even more concerned that it seems totally impervious to the risk of two potentially disruptive, if not dangerous, Games of Chicken likely to unfold in the summer and the beginning of the fall.... We find it difficult to reconcile the record low volatility in financial markets at the moment with growing political risk in Washington and geopolitical risk in Asia. There are many reasons why we are living in a different world than the one we used to know and we would caution against relying too much on history for forecasting the likely outcome of these risks."*

I recently observed the volatility records being made recently:

*"Month to date, the annualized realized volatility of the S&P Index is 5.2% -- that's the lowest vol in an October in over 90 years. By means of perspective, the average October volatility since it has been recorded is 17.0%. It is interesting that the four other low volatility Octobers all occurred in the 1960s -- a period that preceded a sharp acceleration in inflation and rise in interest rates over the next decade."*

So, with volatility at record lows, the S&P 500 climbing to new heights and such consistency of dip buying and advances, why do I think the risks associated with a "flash crash" are multiplying? It is market positioning -- something I and others rarely consider in our market analysis. Today, speculators have breathtakingly large short positions in volatility futures, so that a relatively small spike lower in the averages, for any reason, of 3% or so could drive volatility much higher and demand (covering) of VIX futures. (The largest S&P selloff when the VIX was under 12 was 3.5% in February 2007.) **Let me explain how a short volatility unwind might develop and what its implications are.** If Markets Spike Lower and the VIX Goes Bananas It is tautological that as volatility moves lower and stock prices move higher, risks rise. Several buy- and sell-side analysts have done a great deal of work as to what current positioning in the market may have if an

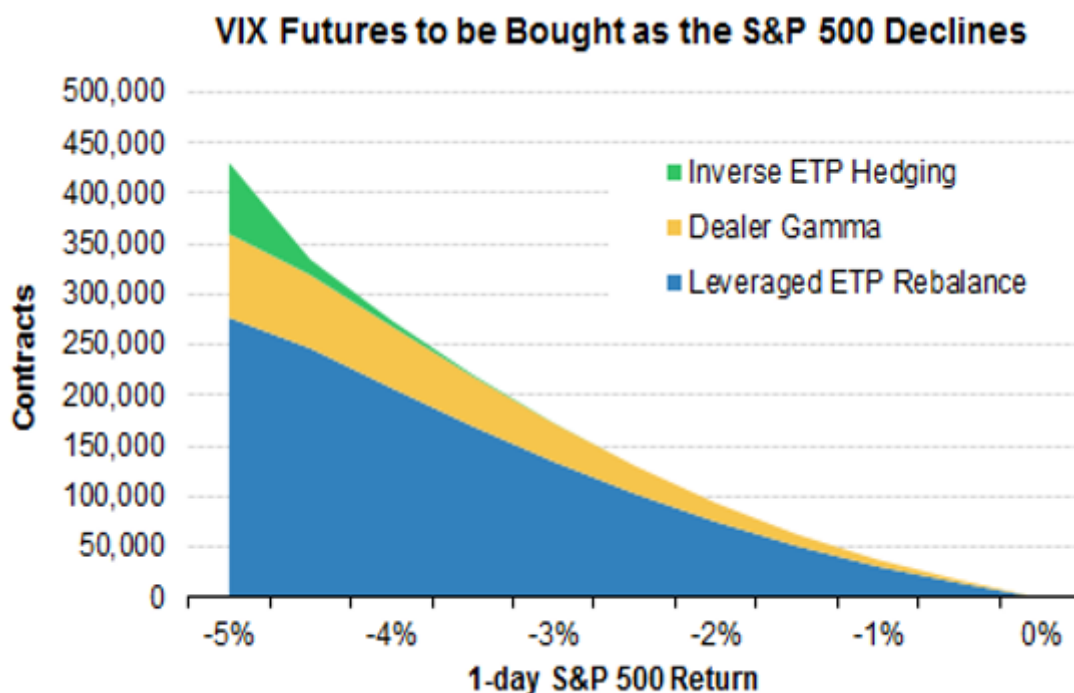
exogenous event (from any Black or "Orange" Swan) produces a quick woosh lower in the averages and a spike in volatility. *From Morgan Stanley's Chris Metli:*

*"It's easy to become numb to the low volatility environment and the risks it presents. While trying to pick a trough in vol has been a fool's errand, focusing on the risks resulting from vol being so low is not. Low volatility has produced a regime where the risks are asymmetric and negatively convex, so being prepared for an unwind is critical. This is not a call that vol is almost to spike, but you need a plan if it does."*

The pain of an unwind in VIX futures could be exacerbated in the days following a woosh lower by the dominance of passive investors (quant strategies and ETFs). The deleveraging of highly leveraged risk-parity funds, in particular, represents a risk that may not be easily repaired or reversed after the initial market drop. Here is a further explanation from Morgan Stanley [by way of Zero Hedge](#) of the positioning risks that were in place in July. Since then, as volatility has declined and the S&P index continued to climb, the risks have grown greater with an even larger base of short volatility futures Francesco Filia of Fasanara Capital [writes about the potential damage](#) delivered by the possible covering of short volatility futures:

*"Market fragility must surely be a concern in the current investing environment. Yet, the psychological damage on investors and their behavioral reaction function to a sudden risk-off environment can never be as certain and direct as a wipe-out risk to a whole cluster of them. That is the nature of the risk that short-vol vehicles are facing today."*

And consider this important update on positioning from Morgan Stanley's Metli -- specifically, that more than 400,000 VIX futures would likely needed to be bought if the S&P Index falls by 5% in one day, nearly double what it was in July!



Source: Morgan Stanley QDS

## Bottom Line

Though large daily drops in the markets [are rare](#), the factors that could contribute to a quick drop have increased. Investors have been concerned about the VIX for years, but the positioning has now moved to an extreme. Such positioning could accelerate a market drop as the chances of a flash crash have escalated. Hyman Minsky has warned about the [risks of becoming numb](#) to the

risks associated with a period of stability amid rising asset prices; it is not only inevitably followed by instability, it inevitably creates it. In a world in which the chances of an external market shock are rising and at a time when volatility is cratering and stock prices never decline, the risks of a flash crash caused by the one-sided market positioning in VIX futures is increasing and are at a higher probability of occurring than at any time in history.

## Strategy

*"It appears many investment decisions are being made today on the basis of relative return, the unacceptability of the returns on cash and Treasuries, the belief that the overpriced market may have further to go, and FOMO. That is, they're not being based on absolute returns or the fairness of price relative to intrinsic value. Thus, as my colleague Julio Herrera said the other day, 'valuation is a lost art; today it's all about momentum.'"* ♣ Howard Marks, *Latest Thinking*

Most investors should consider an above average exposure to cash and consider what Howard Marks recently wrote... *"moving forward with caution."* Prospective returns are likely to be well below average in almost every asset class. Adverse outcomes -- including a quick ramp in interest rates, possible monetary fiscal and trade policy errors, a disappointing trajectory of domestic economic growth, developing market structure risks (and the reversal of past asset class interrelationships), political risks, geopolitical risks, etc. -- should be better appreciated and more considered. On my earlier point of the virtuous cycle caused in part by a shrinking amount of available shares, record retail inflows into domestic equity funds and lower trading activity -- we should remember that it works both ways, as it won't take much selling pressure to cause a problem to the downside just as it was easy to get a rally to the upside in 2017 and during the month of January, 2018. Moreover, the view that stocks are not expensive vis-a-vis interest rates (and an admittedly very over priced asset class, bonds) still seems foolish to me. So, with interest rates now climbing and global central bankers less accommodative, risks are rising and may be underappreciated: **The mantra of T.I.N.A. ("there is no alternative") may soon be replaced by C.I.T.A. ("cash is the alternative").** In summary, I remain of the view that the downside in the S&P Index is approximately 3.5x to 4.0x relative to upside over the next 12 months. As expressed in my *15 Surprises for 2018* -- I anticipated a year high in the S&P Index of about 2800 (*in January we overshot that by about 60 handles*) and a potential low of 2200. I see nothing to change these expectations. While I took off a number of shorts at or near the close of trading on Friday, I remain net short in exposure.