Market Note

Bubbles, Bonds, and Diversification

2/6/2018

Aaron Dirlam, CFA®, CAIA®
Chief Investment Officer

Paul Courtney, CFA®, CAIA®
Director of Research

Summary

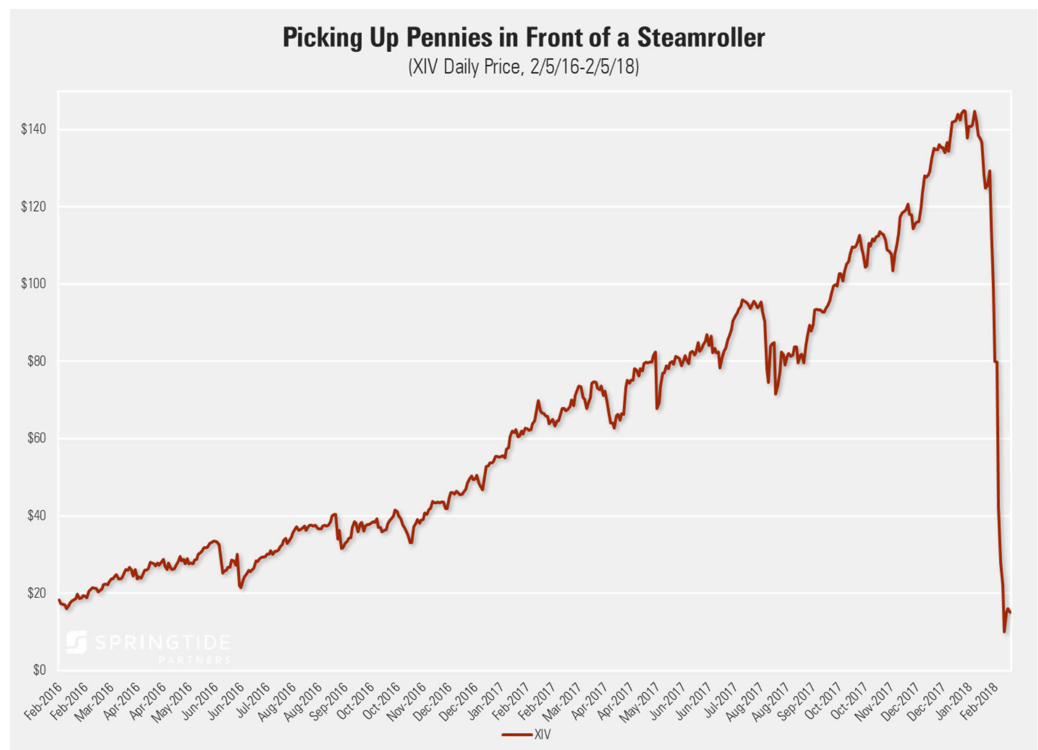
- On February 5th, two bubbles burst. The first was the tulip bubble, and the second was the bubble in complacency (low volatility).
- The real carnage was focused in funds that sell ‘volatility’, with one fund losing over 80% yesterday.
- We also briefly discuss the ramp in Treasury supply that is going to be concentrated in just two months—February and March.
- This increased supply will place pressure on interest rates (lower prices) and will serve to reduce liquidity in the market which, in turn, can negatively affect riskier assets.

396 Days & Counting

On February 5th two bubbles burst: the first was the tulip bubble and the second was the bubble in complacency (low volatility). As fate would have it, yesterday was the 381st anniversary of the peak of the tulip bubble in the Dutch Republic.

No one knows, least of all us, if this is the start of something larger.

What a day it was. Stocks were down over 4%. The largest drop of that magnitude since August 2011. The Dow experienced its largest point decline in history. Volatility, as measured by the “VIX”, had the single largest percentage jump ever (+115%) and the volatility of volatility (“VVIX”) closed at the highest reading ever.

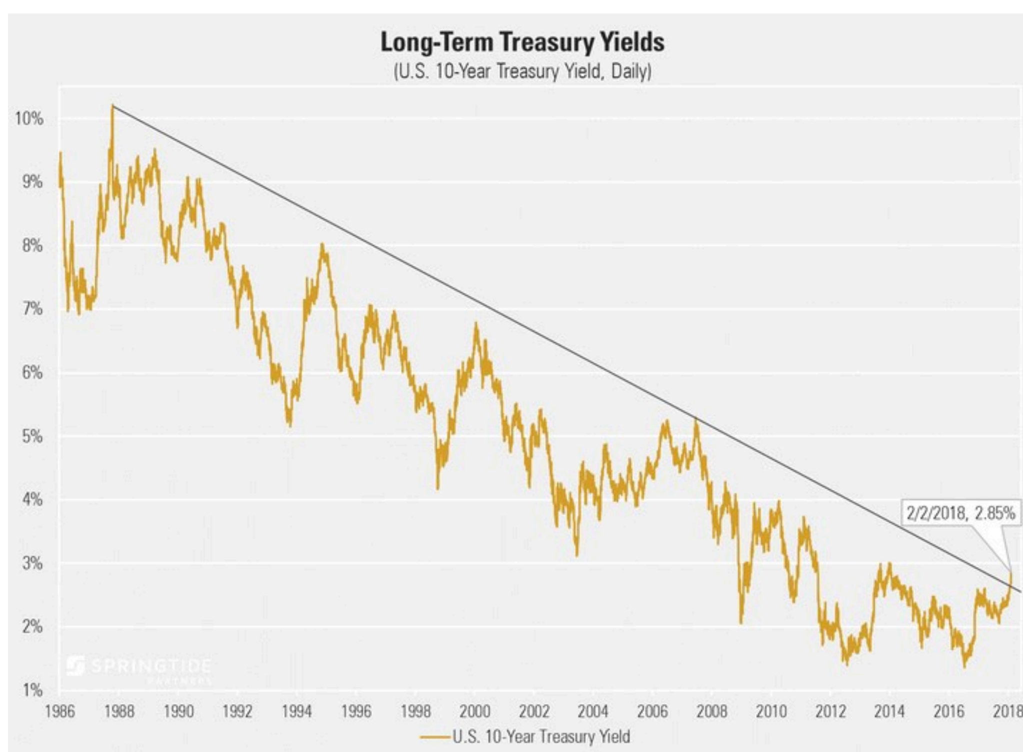


The real carnage was focused in funds that sell "volatility", which is to say they make money by effectively harvesting equity insurance premiums. This works until it doesn't. Some of these funds were leveraged 2x, which means a spike in the VIX of 50% in any given day will theoretically wipe them out. So they got wiped out. The fund pictured above lost over 80% yesterday (through after hours trading) and is going to formally unwind later this month.

Despite the spike in volatility, the carnage seemed relatively contained in a few asset classes. But that doesn't mean it wasn't a significant day.

Here are some things we have been watching leading up to today and some thoughts on the day.

Let's go back to last week. Long-term bond yields (which move inversely to prices) appear to have broken out to the upside. Even though the absolute level doesn't seem like a concern, a 35-year trend line breaking is worrisome. Also, we believe higher debt levels vs. prior cycles means rate rises will start to bite sooner.

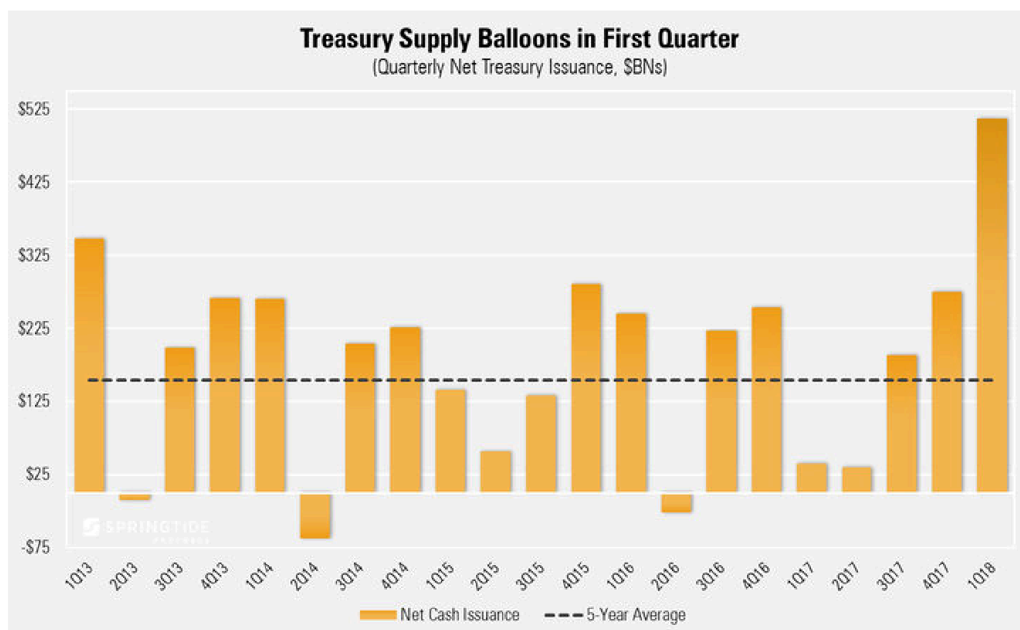


Our view is that rates were the proximate cause for the decline. Higher rates are linked to the dramatic increase in Treasury issuance (supply) expected this year, wage growth and labor market data suggesting higher inflation will force the Fed to continue hiking and the Fed unwinding its balance sheet ("quantitative tightening").

But everything is linked, so pinning a decline on a specific trigger is impossible. Markets can go down simply because buying stops. That's how markets function.

That said, we have been discussing the ramp in Treasury supply for months because so much of it is going to be concentrated in just two months – February and March. The

U.S. Treasury expects to borrow $441 billion in the first quarter (of which it has already borrowed $40 billion). This is a massive amount of supply – nearly the total for all last year.



However, the supply cannot be issued until the debt ceiling is raised. The Treasury has stated it will extend the debt issuance suspension period into February to keep using extraordinary measures to stay below the debt ceiling. Congress needs to act to raise the debt limit with the Congressional Budget Office believing the debt ceiling needs to be raised by mid-March.

We believe this is an important development for markets. This increased supply pressures interest rates (lower prices) and serves to reduce liquidity in the market which, in turn, can negatively affect riskier assets such as stocks. The lack of issuance recently, may have been a contributing factor to the melt-up in equity prices in January.

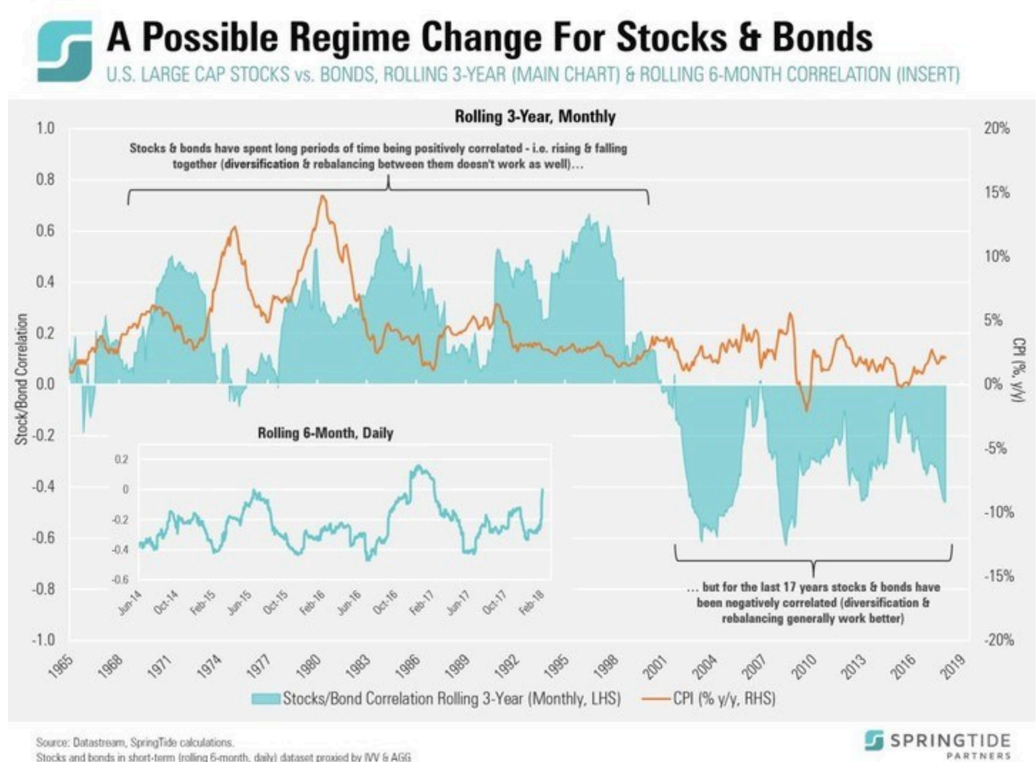
The Fed's gradual unwinding of its balance sheet also removes a price-agnostic buyer of Treasuries. For the first time in many years, markets must find a balance with not just less support from the Fed, but with the Fed heading in the other direction and draining liquidity. Inflation expectations have also been driven higher by strong economic activity in the first quarter (Atlanta Fed GDPNow is up over 5%), rising commodity prices and signs that wage growth may finally be picking up. Both 2-year Treasuries and 10-year US Breakeven Inflation rates are now securely above 2% after rising persistently over the last three months.

We are paying special attention to how these factors come together in the context of a diversified portfolio. If inflation is driving bond prices down, and higher inflation is met with tightening by the Fed, we may be entering a regime change for stocks and bonds. We need to consider that if rates rise meaningfully, the tail-wind of lower rates that drove bond prices and equity prices higher likely ends, and with it, the negative relationship between stocks and bonds.

That negative relationship has persisted for most of the last 17 years, but looking back through history it is a dynamic number. A dynamic that is a function of the inflation and policy regime.

Our chart of the week, shown below, looks at rolling 3-year correlations between stocks and bonds alongside a shorter-term rolling 6-month correlation (daily prices). Correlations have recently spiked higher.

We think this is a really important topic to keep an eye on.



Sincerely,

The SpringTide Investment Team

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Disclaimer and Terms of Use

DISCLAIMER

Past performance is no guarantee of future performance. Any opinions expressed are current only as of the time made and are subject to change without notice. This report may include estimates, projections or other forward-looking statements, however, due to numerous factors, actual events may differ substantially from those presented. The graphs and tables making up this report have been based on unaudited, third-party data and performance information provided to us by one or more commercial databases. Additionally, please be aware that past performance is not a guide to the future performance of any manager or strategy, and that the performance results and historical information provided displayed herein may have been adversely or favorably impacted by events and economic conditions that will not prevail in the future. Therefore, it should not be inferred that these results are indicative of the future performance of any strategy, index, fund, manager or group of managers. While we believe this information to be reliable, SpringTide Partners LLC ("SpringTide") bears no responsibility whatsoever for any errors or omissions. Index benchmarks contained in this report are provided so that performance can be compared with the performance of well-known and widely recognized indices. Index results assume the re-investment of all dividends and interest. Moreover, the information provided is not intended to be, and should not be construed as, investment, legal or tax advice. Nothing contained herein should be construed as a recommendation or advice to purchase or sell any security, investment, or portfolio allocation. This presentation is not meant as a general guide to investing, or as a source of any specific investment recommendations, and makes no implied or express recommendations concerning the manner in which any client's accounts should or would be handled, as appropriate investment decisions depend upon the client's specific investment objectives.

TERMS OF USE

This report is intended solely for the use of its recipient. There is a fee associated with the access to this report and the information and materials presented herein. Re-distribution or republication of this report and its contents are prohibited. Expert use is implied. For more detail please refer to the appropriate sections of the SpringTide Partners Terms of Use and Disclosures at: https://www.springtide-partners.com/disclosures