Illiquidity and Contamination are Leading to Fast Spikes in Volatility

There's a huge stockpile of liquidity in the world, created by the unorthodox global accommodative monetary policies. However, we are seeing illiquidity in the markets. How is this possible? We need to understand the difference between STOCK and FLOW. There's clearly an abundance of money in the system, i.e. STOCK of liquidity, as corporations and households are sitting on unprecedented levels of cash. What is more relevant, however, is the FLOW, or the degree to which assets can be traded. For cash to translate into liquidity, the mechanisms or "pipelines" for cash to flow through to the markets must be wide open and free flowing. Thanks to structural risks created as a consequence of monetary policy, these pipelines have become narrow and bottlenecked, creating illiquidity and large gaps down (or up) in prices. Furthermore, we are seeing crowded trades in this "risk on, risk off" environment, where niche and risky markets are suffering because of a lack of liquidity. When there are wild price gyrations in these markets, there is a "contamination" effect in other markets for a short window of time- creating a fast spikes of volatility. We believe these fast spikes of volatility are opportunities for clients to trade.

New Regulations Limit Security Inventory, Create Illiquidity

Regulatory changes are a principal contributor to the narrowing the pipeline that connect buyers and sellers in the market. Before the 2008 financial crisis, large investment banks matched buyers and sellers by holding large inventories of risky securities. With increasingly stricter regulations after the crisis, these banks were forced to sell off massive inventories of securities as part of their balance sheet cleanse to shore up their percentage of "core" assets (in particular "Tier 1" assets). They were pushed into holding less risky, liquid, large, securities, like Treasuries, and forced to sell-off spread products (including corporate bonds, high yield bonds, emerging market bonds). This sell off was significant- some estimate that since 2008, these investment banks have cut back on security inventories by 30-80% (the amount cut depending upon the specific asset class).[1] This heavy cutback of inventory has crippled these banks in their ability to act as market makers, a once integral role they played in facilitating a wide pipeline between buyers and sellers in the market.

The Thinking Man's Approach

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Ignacio Pakciarz | CEO
Ilina Dutt | Research Analyst

The week of October 13th the markets were riddled with high levels of volatility: abruptly shaking investors who have been complacent over the last few years, living in a world where volatility was sitting at a 15 year low. It's our belief that volatility is here to stay: we will continue to see fast spikes in volatility like we did on October 15th, and see this as an opportunity for clients to trade. In this month's Thinking Man's Approach, we discuss some of the contributing factors to volatility: structural risk caused by illiquidity and contamination in the financial system and questions around global growth and how financial markets will fare after the US ends QE.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

ideas@bigsurpartners.com

Crowded Trades

Over the last few years, we have seen extreme consensus amongst investors, who have shown a herd mentality, trading in a "risk on" or "risk off" mode, many times with investors on the same side of the trade. This dynamic is characterized by everyone in the investment community chasing after crowded trades or dumping securities. Technology contributes to this dynamic- electronic trading programs mean that the herd is larger and moves faster. This lopsided dynamic causes volatility, but this is exacerbated in a world where market makers have limited inventory of securities. For riskier or niche markets, market makers no long keep positions on their balance sheets when others are selling- they are joining the fray and also selling these securities. There is no one on the other side of trade, creating sharp spikes in volatility. Even if this initially happens in niche or risky markets, this contaminates other asset classes, and everyone takes a hit. The contamination is short lived, usually characterized by a brief sharp drop that normalizes after a few hours.

An Example of Contamination Across Markets

An illustration of this happened October 15th, during one of the most volatile trading days in recent memory. AbbVie, a pharmaceutical company had been very near closing an acquisition of Shire, a UK based pharmaceutical company. They announced the previous night that they were reconsidering the deal after analyzing the Obama Administration's new tax inversion laws. Most risk arbitrage hedge funds were building long positions in Shire, as they were confident of the deal's success. Everyone was on the same side of the trade, and then when the deal was put into question, everyone went on the same side of selling the trade. Liquidity in the trade was hammered because there were not market makers, and risk arbitrage players had some of the great losses in their history. When funds like these take such large hits, they have margin calls and are forced to sell off their other assets- so the bleeding of the niche and risky market affects other larger, more stable asset classes. We saw this in practice, as US equity markets were trading down 460 points at the lowest part of the day, while the 10 year US Treasury yield undershot and moved within a 35 bps range! However, the contamination was short lived, recovery started the same day, and at the end of last week, US equity markets were only down 1%.

Transition Period: More Volatility Ahead

Both illiquidity and contamination are two factors which will contribute to volatility in markets going forward. We live in a new world - with divergent monetary policies, as the US ends quantitative easing and branches away from other global central banks who continue their accommodative monetary policy. We were previously in a period where there was a continuous buyer of Treasuries, which boosted asset prices across markets. As markets and "risk on" types of trades trended upwards and volatility was sitting at lows, there was a lot of complacency and we didn't see the negative effects of illiquidity and contamination. This transition period is also coming at a time where we have a strong US dollar and where there are many unknowns- most fundamentally, what global economic growth will look like. There are concerns about the US being able to sustain itself as a growth engine and concern as to how leading US corporations with global operations will fare in the face of a global economic slowdown In addition to this fundamental unknown- there is noise around Ebola and potential geopolitical conflicts which are adding to investors' nervousness. We're in a world where volatility is no longer sitting at its 15 year low, but it is now back to "normal" levels. We consider this an opportunity for our partner-clients!

Conclusion: How to Position in Face of this Illiquidity

The heavy amount of cash on the sidelines, at some point, should provide some protection on the downside, as some of it should be put to work. It's important for investors to understand, however, that it is not necessarily a bull signal to the markets that there is a lot of cash in the system. Illiquidity and contamination will create fast spurts of volatilities which can translate into tradable situations as we saw last week. The nervousness in the markets, relating to the fundamental unknowns and also the herd "risk off" behavior relating to noise such as Ebola or geopolitical risks, will contribute to heightened volatility as well.

- There will be fast spurts of volatility even in the large and mature markets like US equities and US Treasuries. But these will likely revert quickly and rally back. We can see these times as opportunities to trade- as was the case October 15th when in a short period of 15 or 20 minutes, the market came down about 250 points. In the end, contamination cleared and as the forced sellers were cleaned up from the market, things normalized.

- In niche or risky asset classes, there is risk associated with illiquidity and contamination. For these types of markets, we will be careful to analyze the liquidity, bid/ask spread of securities we would potentially buy or sell for our clients. It's very important for investors to understand the dynamic of liquidity for the specific security, asset type and asset class. Prices may gap down very quickly in these markets, because everyone is on the same side of the trade, there is limited inventory, and bid offer spreads widen tremendously.

- The opportunity to trade volatility: Spikes in volatility are here to stay, we are unlikely going back to a world where the VIX (*) is at 10. We'll be looking to buy volatility when it trades on the low range of our expected spectrum, and sell it when it hits the higher end. We also think investors should consider the volatility as a hedge (when volatility is low and thus cheap) or to generate income (when volatility spikes and thus gets expensive).

(*) VIX is the Chicago Board Options Exchange Volatility Index and is widely used as an indicator of future volatility. VIX reflect the market expectations of US stock market volatility over the next 30 days. The index is based on implied volatility, which is ultimately determined by the price of option contracts. VIX is calculated by taking the weighted average of all of the options prices in the S&P 500 index.

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