A flash crash could cause the next market correction

The Thinking Man's Approach

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Ignacio Pakciarz, CEO
Eduardo Sensel, Analyst

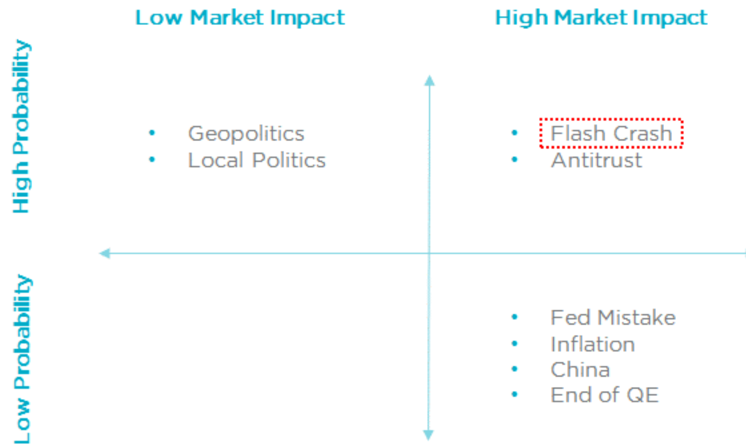
- Given the level of complacency in the market, it is reasonable to wonder what could jeopardize this bull market.
- A moment of fragility could trigger a Minsky moment. A Black Swan event might prompt a market selloff, which would be perpetuated by computer-driven strategies.
- Despite the severity of the crash, the effects will be short-lived. The Fed would probably intervene, and the drop would represent a buying opportunity.
- This bull market still has room to grow since fundamental factors that could prompt a downturn are not evident yet.
- This is not the time to be greedy. We believe clients should continue riding the bull market while protecting the downside. We reiterate the idea that volatility is currently the cheapest security.

For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com

In the Thinking Man #51, we addressed seven fundamental factors that could be the main catalysts of the next recession. Our probability and impact matrix has not changed. Some factors have become more relevant, but their probability and market impact remain the same. Antitrust concerns have increased and at least one of the four tech giants will see a $10 billion-plus fine, most likely coming out from Europe. Nevertheless, this will have repercussions only in the sector rather than in the whole market. The normalization and tapering picture is already clear for investors. The market will still need to see how this unfolds, but central banks globally have been careful in implementing and timing their policies. Finally, China has hinted it will attempt to start implementing measures to unwind a huge burden of leverage. Although this could prompt a global crash, Beijing could very well achieve this feat given the tight control it exercises over the Chinese economy.

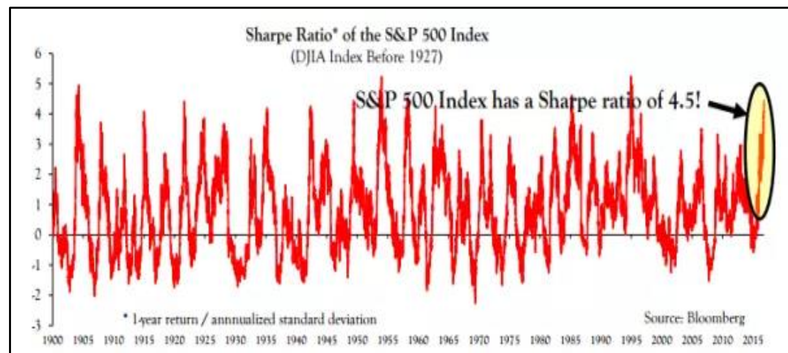
We have identified a new factor, this time a technical one, which we think could be a catalyst for the next market downturn. A flash crash, triggered by a Black Swan event[1], could cause a sharp correction in the 10%-20% range. However, we think that the consequences will be short-lived and that such an event would represent an opportunity to buy the dip. We still maintain our cautiously optimistic view that an inflection point is 12-18 months away. We continue to believe a recession and subsequent bear market are not imminent, as the conditions for a large sell-off are still not yet in place. Fundamentally speaking, this bull market still has room to grow. Nevertheless, given how good things have been, it is proper to evaluate the risks that investors can encounter in the current market. There are mounting concerns on the state of the economy, high valuations, earnings' growth continuity, and the approval of key economic policies. We stated that while the market is fragile and may be more vulnerable to short-term negative news and shocks, it is unlikely that events in the near-term will have a long-lasting impact – unless there is a drop accompanied by a recession. In this Thinking Man we will revisit what has occurred in the market, explain the new factor we have included in our market downturn matrix and how it could put this bull market at risk.

[1] A black swan event is a random event that deviates beyond what is normally expected of a situation and is extremely difficult to predict

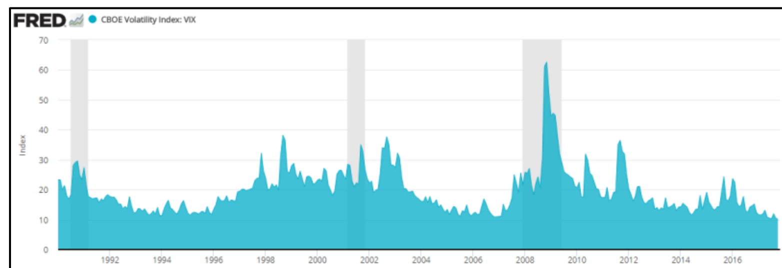


We expected a rocky October with a potential 5% correction. Surprisingly, the contrary has occurred. In October, the S&P 500 rose 2.2%, the DJIA climbed 4.3% and the Nasdaq Composite gained 3.6%. Since an inflection point could be 12-18 months away, we believe it is too soon to de-risk portfolios.

By using the Sharpe ratio -a measure of risk-adjusted return- it appears things have never been so good. Stocks in the U.S. have had a Sharpe ratio of 4.5 over the last 12 months, better than all but 99.7% of the time since 1900. Easy money, combined with the effects of TINY and TINA[2], is aiding the rise of asset valuations. Broad global growth and positive corporate earnings are also helping.



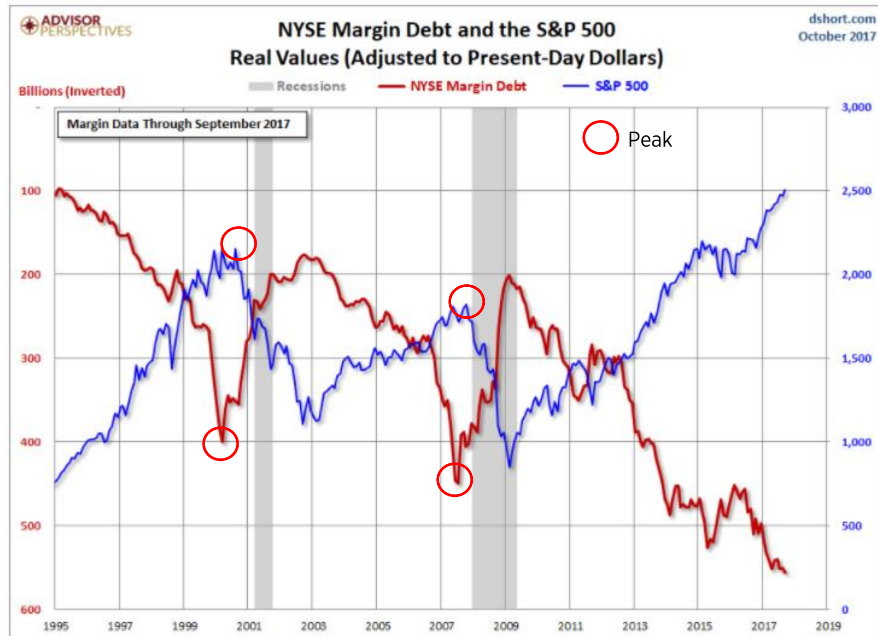
The levels of complacency are somewhat frightening amid significant local and global risks. Yet, volatility has been muted for most of the year and at historical lows. We believe the melt-up trade[3] is in its early stages, even



[2] TINY stands for "there is no yield" and TINA stands for "there is no alternative". TINY has been caused by central bank's aggressive monetary stimulus. In the search for yield, investors have no alternative but to remain invested in riskier assets, such as equities.

[3] A melt-up refers to the market stage where there is a rapid increase in valuation levels. This is caused by late investors rushing to allocate their capital into already prospering asset classes, as they wish not to miss out on a rising market. Melt up trades are said to be followed by melt downs.

though it has lasted more than 320 days with gains of 15% – compared to the average melt-up's 45 days and gains of 5%[4]. Signs of euphoria are starting to emerge, which is indicative of the early stages of a bull run's end. Shares of smaller companies and cyclical industries have outperformed lately, while stock correlations are continuing. However, we still need to see a significant rise in investors' enthusiasm. In a Bank of America Merrill Lynch poll referenced by the Financial Times, fund managers were the most underweight on U.S. stocks since November 2007. Given all this, and considering how good things are, it is reasonable to wonder what could jeopardize this bull run.



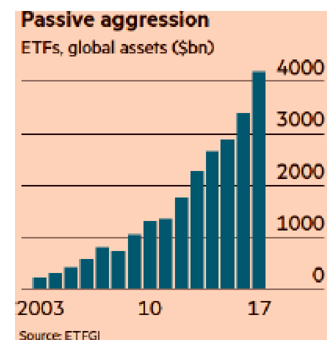
The current period of stability and growth should be worrying. A moment of fragility in any asset class could trigger a Minsky moment. Such moment, named after economist Hyman Minsky, refers to the occurrence of a crisis due to a market failure sparked by excess debt. Long periods of stability generate over-confidence in markets, which leads to increased leveraged speculation. This begets instability, as the system collapses due to the unsustainability of leveraged growth. The chart on the right demonstrates the divergence between margin debt, as a measure of leverage, and the S&P 500. The chart signals that stock market peaks often coincide with record levels of margin debt, but this does not necessarily imply causation. However, it should be important to consider and be wary of today's record margin debt levels. In the case of a fragility event, such levels of debt could have very negative implications.

Politicians and policymakers don't want to be responsible for prompting a bubble burst or the end of a bull market. The European Central Bank's recent decision on monetary policy is evidence of the relevance of such worries. Mario Draghi was expected to take a hawkish stance by announcing a QE tapering, but his announcement turned out to be dovish. Although the ECB halved the pace of purchases, it extended its asset-purchase program. Most likely, Draghi wanted to avoid a taper tantrum in German Bunds that could cause panic in the market. Another example is Trump's decision to nominate Jeremy Powell as the next chairman of the Fed. Powell is considered the right hand of Janet Yellen, who was severely criticized by Trump during his presidential campaign. However,

[4] INTL FCStone figures

Trump wants not only a monetary policy conducive of growth, but one where there can be no surprises or moments of fragility.

It is very hard to predict what exactly can give rise to a Minsky moment. Black Swan events usually tend to be the triggers of such type of crisis. An example of a Black Swan event is the 1998 crash caused by arbitrage hedge fund Long Term Capital Management. Highly leveraged, the fund sustained massive losses after an unexpected Russian default widened spreads. The unpredictable event led the Fed to intervene in order to avoid a global systematic meltdown.



We consider that a flash crash, triggered by the advent of a black swan event, could cause a sharp correction in the market. An unpredictable event could lead computer-driven, quantitative strategies to trigger a continuous market selloff. The rise of momentum and passive strategies has caused the replacement of human market makers by algorithms, which can recognize quicker changes in the market and react accordingly. The problem is that the latter provide less liquidity in a downturn than the former. This market fragmentation can make shares hard to find in case of dislocations. If there is a fragility event, a market selloff can occur. In such scenario, computer-driven strategies could cause further selling pressures; thus, creating a selling feedback loop. There are four strategies today that, given their magnitude, may be responsible of causing a flash crash that could prompt a Minsky moment. Risk parity, volatility targeting, leveraged ETFs and trend-following CTAs could cause severe liquidity disruptions – an event that would force the Fed to intervene to avoid the collapse of global markets.

BSP View

Given the current stage of the market cycle, this is not the time to be greedy – especially since our portfolios are continuing to exceed projected or targeted returns. This does not mean our clients should stop participating in this bull market. In fact, we believe this bull market will continue as there are no fundamental factors that indicate the contrary. Our clients should continue riding the market. However, since a downturn can happen anytime, our clients should protect the downside. As we have mentioned in the past, volatility is still the cheapest security. We should not wait until the peak of the bull run to start worrying about the downturn. Bull markets, as many other things in life, feel best just before the end.

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