

# 36 South Views

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## Judging snow stability

There is a reality in today's equity markets: if you haven't got tech stocks in your portfolio you are behind the eight ball. Asset managers around the world are being asked why they haven't got more tech stocks in their portfolio and less traditional defensive assets like gold etc.

We sympathise with them. The classic narrowing of the leadership in a mature bull market and these leaders' frankly unbelievable momentum is sucking the lifeblood out of all kinds of defensive strategies and so it must be. The bear presses the basement button only when the lift is full.

Bull market cheerleader Warren Buffet is wading into Apple still - even at these lofty valuations...

ETFs have proliferated as a passive, low-cost alternative. I hear that a fund of ETF funds using AI has been launched - this is vaguely similar to CDO squared in 2008 and the pyramid of investment trusts in 1929 (read the chapter "In Goldman Sachs We Trust" in *The Great Crash of 1929* by John Kenneth Galbraith).

The difference between this and other bull markets is that this a global bull market. Before now it was relatively difficult to move capital cross border to make strategic investment decisions, not any more. Thus it is entirely possible that this bull market will surpass even the wildest bull's imagination.

Anecdotal evidence suggests that publically listed corporate treasuries are selling puts on their own stock. If they expire worthless they simply take the premium and add it to earnings. If the put is exercised they simply call it a buy back. Again this seems vaguely similar to the indiscriminate selling of long dated Japanese Nikkei put warrants in the early 90s when the Nikkei was in the high 30k range.

Bonds holders are also being corralled. With 10-year US yields around 3%, investors have less inclination to be long emerging bond risk with their concomitant currency risk at 8% or so.

Currencies ditto. Why be long anything but the US dollar in this environment?

It reminds me of a tidal wave which, just prior to its appearance, sucks the water from the beach in the opposite direction, confounding observers.

As a central banker I would be concerned that low interest rates appear to have spawned hyper financial asset inflation. The mispricing of capital has effectively benefited those with access to it, i.e. investors who can borrow thus exaggerating the divide between rich and poor. It is probably a good thing that GDP as a measure of prosperity totally masks this phenomenon.

We have opined on these topics often in the past. The signs are all there; the potential for a financial avalanche is there. Skiers won't get off the slopes until they see an avalanche bearing down on them and by that stage it will be too late. They have simply had too many false alarms in the last few years.

Yes, the avalanche has started in emerging markets. Will it be contained?

If it is, it will only embolden the bulls and it is then entirely possible that a melt-up will ensue.

But we suspect that the Fed will probably look to try and take the punchbowl away by raising rates further before valuations get totally out of hand. This will further distress all peripheral markets however.

The canary in the gold mine (intended) still has to be the level of complacency shown in the global options markets, especially the low probability options.

This record remains stuck... the risks are too great and growing more imminent by the day whilst the cost of protection continues to get cheaper.

*“Judging snow stability is a lot more like playing the Wheel of Fortune than using any rules of thumb or equations. In other words, you never, ever get all the pieces of the puzzle in front of you at one time—there’s always missing pieces that you have to fill in with your imagination. The more knowledge and skill you have, the easier the game becomes. In other words, stability evaluation means INTEGRATING lots of different pieces of information—putting the pieces of the puzzle together in an organized way. It’s a very serious mistake to latch onto just one test or observation and base your whole opinion on that one test—kind of like deciding to get married on the first date. Bad mistake. No, you need to shop around, do some homework, put them through a rigorous series of stress tests, travel for a month in a third world country, meet the in-laws, remodel the kitchen together. Then you’ll have a lot better idea whether to invest your life in this person—or, in this case, invest your life in the slope you are about to cross.”<sup>1</sup>*

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<sup>1</sup> <https://avalanche.org/avalanche-encyclopedia/stability/>