36 South views by Richard "Jerry" Haworth

Reflecting on 2014

The first week of the year is a time of intense reflection for us. The purpose is clear: to do a post-mortem on the previous year in order to get a realistic base upon which to plan the next.

In general, when looking at the macroeconomic climate, it is safe to say that we are looking at, in the words of George Soros, "far from equilibrium conditions".

The global credit bubble, started over 30 years ago, is humongous and growing like a tumour.

Nobody is overly worried because central banks keep it inflated with an ever-increasing amount of intrinsically worthless paper. As long as they don't ask us directly for money to "pay the piper" we seem to implicitly accept the status quo.

The result of all the 2008 fixes is that stagflation seems to be the order of the day: financial asset inflation combined with real economy deflation. This seems to help no one except the top 10% of global net worthers.

Second-order consequences include a rise in social inequality, geopolitical tension and commodity deflation.

The most astounding event to happen last year, which happened with very little media fanfare, was the halving of the oil price. Perhaps even more astounding was the press this did receive was negative when, in reality, it is the best thing to happen to the global economy since sliced bread. Imagine the furore should the oil price have doubled?

We can only assume the negative press was because the talking heads assumed the precipitous drop came from rapidly slowing global demand. Any other reason is a cause to celebrate – i.e. increased supply, Saudi refusal to cut output, etc., etc.

This leads us on to another point – how murky must the economic waters be if we have to wait for an event like this to divine that global demand is on the wane?

Anyway, there is an alternative reality that is theoretically possible which is that the oil price was manipulated down by certain governments for political and economic reasons.

Certainly it would make economic sense to flood the market with oil in order to drop the price in an attempt to restart the world economy, primarily driven by distribution and consumption. Financial QE had issues and had lost its goosing power.

Another astounding thing to happen last year was the start, in earnest, of the currency wars. Japan has thrown down the gauntlet by indirectly creating a situation which makes currency depreciation pretty much inevitable, i.e. take long dated interest rates to zero by "encouraging" the BOJ to buy all new bond issuance and then some. This is direct monetisation and if it doesn't lead to currency depreciation then either of two things are possible: first, the currency it is paired with is depreciating faster (i.e. if it is also monetising its currency and is thus engaged in a currency war), or second, that some central bank has decided buying Japanese long term bonds with a yield very close to zero is a safe and prudent thing to do. If the latter is the case the author will immediately become an earnest doomsday prepper!

Volatility has remained subdued for the better half of the year, with the odd episodic venture of the VIX over 20 only to be flattened by the volatility "whack-a-VIX" speculators who now fundamentally believe that central banks have our back and volatility will never rise much above 25% for more than a day or two.

It is true; central banks have adopted the mantle of High Priests of Finance and believe they can "ordain" financial integrity to any financial structure smaller than them with a wave of their QE wand. Hence credit risk and volatility is unnaturally low given their hubris in spite of the fragile nature of the global financial system.

We are inherently long volatility in our funds, we pay-off when volatility rises. Volatility rises only when something previously unknown hits the wires (otherwise it would already be discounted in prices). Of course, it is impossible to predict in advance what that "thing" is that will cause volatility to rise and for us to make handsome returns in the funds. All we can do is determine if the implicit insurance cost of buying volatility is under or overvalued and invest appropriately.

We consider the current price of volatility to be undervalued given the global macroeconomic climate and are confident that we have the "house" odds in our portfolios.

Given our two-sided payoff, it is not critical whether our global macroeconomic view is right or not. What is critical is the WAY we implement our views using undervalued, preferably long dated options which, despite being negative carry, have enormous benefits including positive asymmetry of returns.