# 36 South Views

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## Money for nothing and VIX for free

February was interesting.

The volatility spike, which retraced pretty rapidly, is reminiscent of all beginnings of a long term rising volatility cycle. Pretty much all rising volatility cycles start like this, like the jolt of a train when it first overcomes inertia as it pulls out the station – then a seemingly long pause until we feel that the train is actually in motion as it accelerates out the station.

Not all volatility spikes transmute into a longer term rise in volatility but pretty much all long term volatility cycles start with a spike!

As someone once said, you can't predict but you can prepare! There are very few hedges against a correlated downward spiral in equities especially, and being long volatility is the most reliable and consistent hedge.

We note the current interrelatedness of asset prices as all assets have become proxy yield plays. Complexity coupled with systemic complacency?

We wonder if the next bit of news is the straw that breaks the camel's back and gets the volatility cycle going in earnest.

We are living more and more in a 'power law world'; a world where the winner takes the lion's share and the rest take the hindmost. Nowhere is this more apparent than in finance (except maybe the internet). Social systems too are obeying power laws – any social inequality stats will bear this out.

This is exacerbated by the fact that we are also living in a world supersaturated with debt due to low interest rates. Leverage magnifies this power law phenomenon. Power law up also can transmute into power law down. Yahoo was trading at 250 in 1999 and at 10 two years later! Unfortunately most finance theory is predicated on a linear(ish) mean reverting world which suits the elegant maths which describes it, but hardly the real world. A power law system is more characterised by chaos theory than mean reversion or mean variance theories.

Debt has accumulated to enable consumerism and growth. This has gone on for 30 years unabated, consuming for its own sake or growth for growth's sake is the current pervasive ideology. (Same ideology as locusts and cancer cells incidentally!)

Eventually as Maggie Thatcher commented about socialism, we run out of "other people's money" or worse, we destroy the faith in the fiat system and the value of paper money.

We are the financial Titanic sailing at full speed in what looks like calm waters. Our beliefs regarding the robustness of this state of affairs have led us to be cognitively blind to the growing risks.

Magicians are impressive because we have innate cognitive blindness. We just don't have enough brain power to have full awareness all the time. The more we believe something to be true, the more cognitive blindness we have. That is why we can drive a car for miles and miles without awareness.

Chaos theory describes systems as being scale free, i.e. the object being described can get a lot bigger or a lot smaller than we have the capacity to realise. E.g. FANGS?

Whilst this is not necessarily a bad thing, chaos can ensue in these systems when perturbed…

It starts with TIES (tiny initiating events) and their consequences are determined mostly by how closely coupled the underlying system is i.e. how correlated. The more closely coupled, the more at risk of TIES disturbing the whole system. E.g. the closer trees grow together, the more risk of a huge forest fire and the more unstable the snow on the slope, the easier it is for one small innocuous snowflake to cause an avalanche.

We see a multiple power laws world in finance, closely coupled. Why?

Low interest rates, high government deficits, increasing social inequality, massive global debt creation, huge trend into self-similar low cost ETF's, low volatility, narrowing of the equity market leadership, corporate borrowing to affect buybacks, to name a few.

The TIES are incubating, the seeds of a crisis are sown and the last 9 years have been a blessing to the world economy rescuing from the brink in 2009 but at what future cost?

TIES are difficult to identify with certainty but interest rates rising is definitely one which could throw the literal spanner in the global financial engine. Others might include multiple frauds, manipulations, geopolitical events, trade tariffs and technology disruption.

We believe we are witnessing a 'smouldering crisis'. I.e. chaotic systems getting increasingly closely coupled and the valence for disturbance accumulate unnoticed.

We are cognitively blind to the risks and it just needs a match or a snowflake….

Everybody is on the same bus and has been for a while.

This system is undoubtedly fragile and all it now needs is a TIE turning into a trigger event.

Unfortunately for us crises are not predictable as to timing or impact.

It is our belief that the biggest fear of central banks now is a runaway equity market which will force their interest rate hand. They are mindful that rapidly rising interest rates would hurt their government's ability to fund themselves, the wealth effect of consumers and their propensity to spend and corporates' ability to fund themselves at reasonable rates. A pedestrian equity market with low stable rates and a robust underlying economy is surely their preference.

But despite best intentions, interest rates rising in the USA could be that trigger event.

Only time will tell…

If not, another TIE will eventually turn into a trigger event and there will be a wholesale rush for the exit door. And due to passive investing, risk parity, narrowing of the equity leadership etc., we are all in the same proverbial movie theatre with a catastrophic risk of getting crushed in the ensuing stampede should a fire occur.

We are truly astounded in the widely held belief that a portfolio should seek yield at the expense of robustness.

History tells us otherwise.