36 South Views

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Viruses respect maths…

“Life is not a wish granting factory.” *- John Green, The Fault in Our Stars*

Whilst viruses are busy obeying the laws of probability, governments are unwittingly aiding them by reacting too little too late to contain their spread, almost ensuring the pandemic will reach the farthest corners of the globe.

It gives investors an unpleasant dilemma, the viruses will do what they do and follow their in-built maths. We however will, in the face of the unimagined, construct any number of alternate realities which will hopefully end up keeping the asset markets high, everybody at work, and social cost to a minimum.

But life is not a wish granting factory…

I imagine there will be a continual shedding of delusion as this “not a pandemic” continues.

A swan of this nature is the epitome of uncertainty, yet investors still hang on the view that this will be short term and minimal in impact. I disagree and fortunately, at the time of writing, the price of volatility in many assets is still low enough to be wrong and not be punished unmercifully.

I believe this “not a pandemic” will prove to be much longer lasting and more difficult to contain. The tragedy in the making is the economic fallout especially in the services sector where the majority of people work. People need products but have a much diminished need for services in this kind of environment. Then the multiplier effect works its concomitant destruction. One cancelled conference for instance takes business away from many other businesses: travel agents, airlines, hotels, event planners, and caterers to just name a few.

I sincerely hope to be wrong on all of this! Governments will respond like seemingly responsible parents by throwing massive amounts of money at the problem via fiscal stimulus financing with debt, i.e. using their “credit card” with payback on the “never never”. It has worked for the longest time but I sense that we are fast approaching the point when investors would rather put their money in gold, silver or crypto than lend to a debt burdened government with an inability to pay it back at a “nothing” or negative yield!

This brings into play the correlation between bonds and equities. Bonds have long been relied on as a diversifier in portfolios…until they aren’t. A “risk parity” blow-up is now a distinct possibility. Equities too look vulnerable. The poster child for the top of the bull market, if indeed it is, must be the purchase of E*Trade by Morgan Stanley. Valued at 8.4 billion[1] in October 2019, Morgan Stanley bought it, admittedly for stock, at around 13 billion[2] a few months later. Let me get this straight, E*Trade charges zero commissions after joining the ultimate discount pricing war and ends up being bought at the highest valuation ever? Robinhood, also a zero commissions broker but a private company is currently valued at $7.6 billion[3] according to research firm CB Insights, this is now worth almost as much as E*Trade.

Finally, February was a very volatile month, volatility in the equity markets was brutal with the short term VIX spot reaching a high of 49.48[4]. VIX futures, even those with a few weeks to run, didn’t really follow it up reaching about 30. I suppose the players in this space remember the last three years where, after a spike like we have just seen last month, nearly every time the VIX tended to collapse in short order and so it is at the time of writing.

Volatility on currencies remain near decade lows, it’s interesting that the collective market perception is so complacent in the face of a “not a pandemic”, the mother of all swans.

[1]https://ycharts.com/companies/ETFC/market_cap
[2]https://www.morganstanley.com/press-releases/morgan-stanley-to-acquire-e-trade
[3]https://edition.cnn.com/2019/10/02/investing/etrade-zero-commissions/index.html
[4]https://finance.yahoo.com/quote/%5EVIX/history/

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