36 South Views

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Liquidity is like experience Written 12/02/18

Liquidity is like experience… You want it just after you need it!

We have long argued at 36 South that the general market was cannibalising liquidity, correlation and volatility in order to obtain diminishing amounts of return.

This juggernaut comes to a shuddering halt when the bear presses the 'down' button once every bull is in the lift.

Last week liquidity showed signs of disappearing and disappeared completely in some short volatility products. Perhaps this is the first shot over the bow.

Liquidity is illusory at best, due to the absence of market makers and a preponderance of high frequency traders who turn their computers off at the first sign of trouble.

And, like experience, it will come back just AFTER you need it!

The correlation between bonds and equities has long served as the first port of call for diversification. When equities fall, bond prices rise. That is, until the fall of bond prices precipitates the fall in equities – then portfolio managers experience what happens when this correlation breaks down and the performance numbers start to look really ugly.

It was happy days when equity prices fell 10% and bond prices went up 10%. So in a standard 60/40 split portfolio one would be down only 2%.

When they are correlated, the losses are 10%! For pension funds who are severely underfunded and need the equity markets up AND non-correlated bonds, this is a nail-biting time. The market doesn't normally deal in wish fulfilment.

Correlations between stocks also start to move to one, i.e. together. This means a diversified portfolio of stocks starts behaving like one stock. Never a good thing, unless it is a melt-up.

In early February volatility finally jumped out of the stalls (in the short end at least). This is not a surprise as it was priced at perfection for months.

Volatility is what occurs when prices react to new information and move from A to B. It is healthy and should always be present in some form. When volatility gets artificially squashed by whatever means, e.g. the suppression of interest rates, buy backs, or the selling of volatility products to get yield, the resultant volatility – when it emerges – is a lot more sinister.

It is like having to jump down from a height of 10 inches a day. Done daily it is easy. Done weekly and a 5'10 jump is uncomfortable. Left a month, a jump down of 25 feet will probably hurt you and left a year it will kill you.

We are not sure what kind of jump we have left to face, but it is definitely more than uncomfortable.

January was buying spree of note as everybody suspended reality and bought the market; February is turning out to be the opposite.

This next phase of the market is yet to play out. We expect the other shoe to drop at time of writing but anything can happen – over the last few years the equity markets have defied gravity time after time.

From where we sit, the technical picture is ugly, fear has replaced greed and the market action is terrifying… even for a long volatility shop like ourselves.

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