36 South Views

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How long is a piece of string?

"(colloquial, often humorous, rhetoric question) Used as a response to a question such as "How long will it take?" or "How big is it?" when the length or size is unknown, infinite, variable, or relative." – Wiktionary

The equity market is defying all rational explanations to rise in the face of potentially regime-changing fundamentals.

Hence the question: how long is a piece of string?

This term says that it is impossible or unreasonable to predict the object at hand, in this case the equity market.

I lay the blame for this intellectual myopia directly at the feet of zero or near-zero interest rates.

An equity price at its core is a discounting machine, the rate being applied is whatever the current yield curve is indicating.

At zero, the theoretical price of an asset approaches infinity. There are no relative markers to constrain an asset price, much like travelling at 100 or 500 kilometres per hour in an aeroplane where there is no vegetation or horizon to get a sense of how fast you are travelling.

Once you arrive at this point, you are rudderless and any forecast on the length of that piece of string is extremely difficult.

We do know a couple of things however…

Personal income in the US has gone up despite COVID-19 due to government bailouts.

There is no yield available in safe assets. The Fed has perpetuated the myth of the "Greenspan put".

The Fed/Government is relying on the "wealth effect" i.e. keeping asset prices high to keep people feeling wealthy and therefore spending at a high level to drive GDP. The bond vigilantes are seemingly on sabbatical. There are no impediments to borrowing an infinite amount from the future.

Brokerage is now effectively zero – there is no cost to going in or out of the market.

It is now understandable why the market can effectively discount fundamentals and why retail investors feel empowered to buy any stock at any price….nobody knows!

"There is no hitching post in the universe" as Einstein famously quipped speaking on how everything in the universe is relative.

The closest hitching post we can find in the financial universe is currencies and I include precious metals and proxy currencies here.

In ten years' time, it won't help a retiree in the US if the S&P 500 is at 10,000, but the dollar is at 1/10 of its value today. What is important is real value. What can I buy in the real world in ten years' time once I sell my financial stuff?

Governments can borrow an infinite amount of money in the future to spend today, they can reduce taxes to zero, they can send cheques every month to everyone, they can boost the bond and equity markets to any price they want, but they will ultimately pay the price in their currencies. There is no free lunch, no perpetual motion machine, no money tree.

Therefore the biggest risk roosting on the roof for portfolio managers is not asset price risk but currency risk. Interestingly, it is one of the only risks that portfolio managers DON'T report to their clients.

It is our belief that currencies may start to become more volatile as they have become the last risk vector through which prices can reflect reality.

Counterintuitively, hedging using currency volatility is, for the most part, at decade lows i.e. cheap, setting the stage for a once in a decade opportunity for volatility buyers which believe, as I do, that currencies are going to start to get more volatile.

It might be impossible to guess how long the piece of string is i.e. the equity and bond market asset prices, but there still a way to protect real wealth by hedging with volatility, in particular currency volatility.

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