Investment and Trading Strategy Amidst Virtually Untradeable Volatility

Markets have been volatile and political and economic news from across the globe have been very confusing. How do we make sense of this?

Europe:

It is useful to understand that Greece cannot remain in the Euro. It can only do so if its economy can deflate and withstand a deflation of 30-40% in an abridged time frame. This is not going to happen. With their own currency they could do a one time devaluation. Any reorganization of debt without addressing the currency is a waste of resources and scarce capital. The Eurozone core will not allow Greece out of the Euro easily. 60 over years of history and cultural baggage make it very hard for Germany to even allow any weakness in the Euro experiment. As a result markets will continue to be buffetted by hope, whenever the Eurozone leaders meet to discuss bailouts, restructurings and other fantasies, and despair, as when they realize that the Eurozone governments have no clear solution. This makes for a lot of extreme and often times untradeable volatility but it can at times establish a trading rhythm. Sell into hope and cover into reality.

US:

The US economy is in worse shape today than it was a year ago, yet the Fed's response was weaker, not stronger, medicine. One has to suspect that the Fed has simply run out of viable policy tools. Ex-debt, the US economy is well in recession. The housing market weakness needs to be stemmed once and for all. It is the largest repository of wealth in the economy and falling house prices simply create a negative wealth effect. That said, note that last year 75% of the profits of the S&P

companies came from outside the US.

China:

The real estate market and the local governments are heavily levered. The SIV lite like structures (LGFVs and trust firms) used to channel this leverage is unstable. As long as growth remains on track these structured credit vehicles should pose little problem. Given that the government is aware of this problem, it is unlikely that they will allow the economy to slow to a degree that will impact these structures. Be that as it may, land prices have fallen precipitously as inflation fighting policies reduce the availability of credit which is the life blood of real estate. One bright spot is that inflation is likely to recede, possibly below 5% by year end on base effects. This could create a year end rally, although selectively since most of the listed companies are banks, insurers, resources and exporters.

The global investment approach:

For the last 2 over years it has been profitable to invest globally, buying companies with emerging market revenue sources and shorting those with developed market exposure. This approach still holds in the long term but current levels and valuations make even this approach vulnerable. Typically one would establish a portfolio gradually, buying long as the market dips and selling short as it rises to accumulate gross exposure in a low market beta fashion. As profits rise, gross risk is increased and as losses increase, gross risk is decreased. If the market is also rising, a gradual increase in net market beta can be taken, but not too aggressively. If the market is trending down, a net negative beta can be accumulated. Gross risk should be a function of the underlying stock’s volatility, so that target fund volatility (or VaR) is kept relatively constant. Given the current high volatility, this implies a very low gross exposure. Given valuations of the bull trending stocks, the long book is getting hard to justify. The short book remains opportunity rich. This allows the bottom up stock picking to drive the net exposure into a slight net short positioning. Shorting is tricky business. The banks are an obvious long term fundamental short since they are being regulated as utilities and ROEs will fall in line with utilities in the long run. In the short run they are short of capital and many are insolvent. That said, shorting bans, bailouts and unilateral government action can confound the most fundamentally justified short. It is time for guerrilla trading and stock picking. In stocks, unfortunately, there is no arbitrage. The opportunities in credit are getting very interesting. For example, in some Asian names you can buy a convert wide of the straight bond, short the bond and gamma trade the equity option. The option is cheaper than free… In the vol space, the implied curves are inverted meaning that you can buy the long dated vol and fund it with short dated written options.,,