

November 2011 Alvine Newsletter

Why volatility is not new, but extreme correlations across asset classes are.

Key issues—Investors have been increasingly paralysed by the appearance of extreme volatility. While the almost perfect correlation between multi -asset classes is the real new story.

Key recommendation---stable markets are products of gentle rising cycles, and hence are few and far between. Sometime violent movements are natural occurrences and should not put off patient long term risk taking. The increasing over correlation of markets will throw up excellent investment opportunities.

The great moderation theory seems like a distant memory. But our position of hindsight should not obscure how it can still cast a shadow.

'Recessions were once as frequent and as regular as World Cups or general elections. Now,....they hardly ever happen' wrote Mark Thoma from his comfortable 2007 world (source Economists view.com.) The triumph over inflation, and hence improved Central Bank policy making, came with all the advantages of technological progress and globalisation. Deregulation of financial markets and hence the proliferation of sophisticated products gave Banks, consumers and even governments the ability to offset risk and hence dampen volatility. Interest rates, inflation, growth, unemployment all seemed to suddenly break free from the wild gyrations of the 70's and all behave moderately.

'Economists have coined a term for this remarkable period of stability. Taking their cue from the great Depression of the 1930's and the great Inflation of the 1970's and 80's, they have called the current era *the Great Moderation*' so explained Thoma.

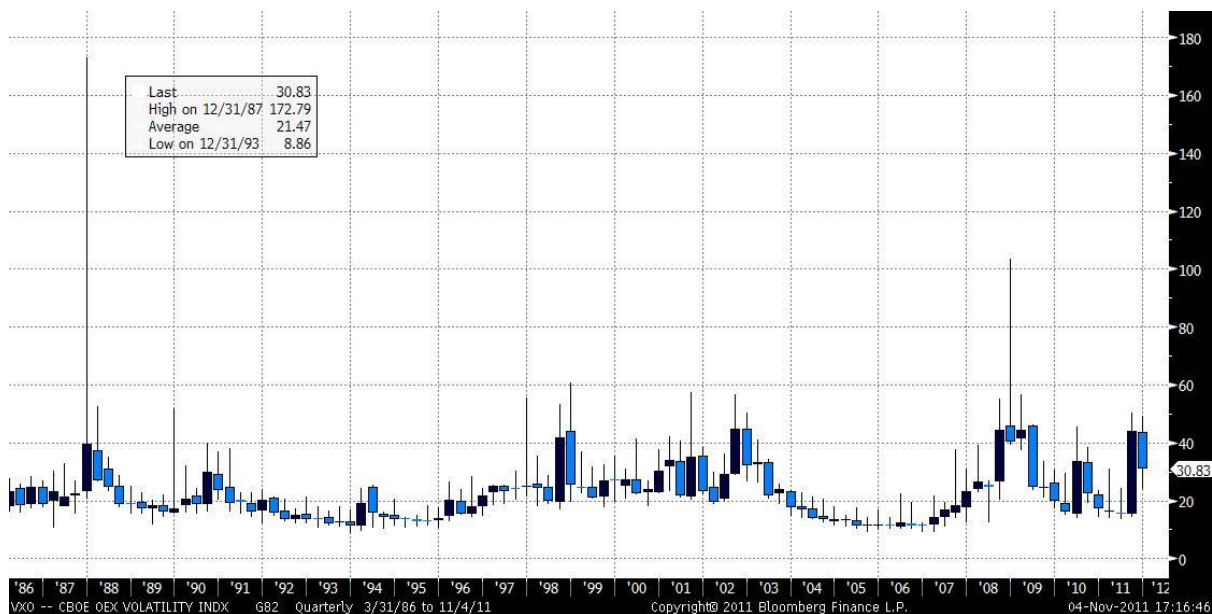
From our vantage point of late 2011, with even the Governments of major western nations at an existential point, this view seems so obviously naive. Any critique needs to take in the context of what had been long term bull markets, as well as all the other realities of low inflation etc.

Whether human nature is always going to drown out this happy time with an orgy of greed and speculation is another serious question, but before we get drawn into theorising about the psychology of people and markets we need to look at more serious critiques of this era.

Economic growth since the 1970's has been ever concentrated into 'capital' hands, a trend exacerbated by globalisation. This tended to lead to mass pools of savers, and to asset price rather than consumer inflation. Central bankers then have less to do, with smaller movements in official rates enough to propel policy. However **as real incomes stagnated in the period of apparent prosperity, middle and working class consumption was sustained by increasing reliance on borrowing through a myriad of complex financial products.** The rest is surely history as this system led to its own demise.

However, a further analysis of this period was the apparent **back stopping of risk** by an ever increasing interventionist government. Bailout after bailout from the S&L crisis, through Mexico's peso problems, LTCM, the dot.com bubble etc created a sort of 'moral hazard' that sat over the apparent success of these policies. Rising markets, moderation etc gave ample incentive to use leverage while the system would be back stopped by Greenspan and the worlds governments.

As Larry Summers put it 'the success in battling inflation will prolong an economic expansion only to lead to overconfidence and a financial crisis' (source www.newyorker.com 12/09/10.)



Old VIX long term chart of volatility (source Bloomberg)

So the true evidence of volatility is that it is a historic reality and is 'basically a function of uncertainty' John Bollinger (source USA today 10/8/11.)

What are the current reasons for uncertainty?

Markets had been reasonably sanguine going into the summer. Apart from the hiccup over the Japanese earthquake in March, the never ending European debt crisis had seemed to lose some of its immediacy while the data around the world demonstrated a further, albeit slow, recovery from the 2009 economic nadir. However, the US wrangles over the Federal debt ceiling seemed to explode that myth. Markets since the summer have been trending down, punctuated by brief violent rallies. These worries may be part of human nature, but they are certainly tangible.

Computer driven programmes

'In the crash, many analysts blame the use of computer trading (also known as program trading)...computers were programmed to automatically order large stock trades when certain market trends prevailed' (source History News Network). This quote is not in response to the 2010 'flash crash', or even the 2008 melt down. In fact this comment refers to **the 1987 crash**, and shows how worries about automated trading are hardly new.

However, the prevalence of algorithmic and CTA based trading funds have proliferated especially as traditional long biased strategies have failed to perform. The sheer size of funds such as Winton Futures (\$27bn), Lynx (\$5bn), Aspect (\$6bn) and others has raised concerns about complimentary strategies driving extreme price moves. Multiply these funds with some serious leverage and you can see how large these system trades can be. Once a trend is established these trend followers will continue to push it to the limit, irrespective of arcane measures of value or price.

Algorithms run by computers that can make calculations in a thousandth of a second then try and exploit tiny differences in prices. It all sound perfectly innocent, in fact probably enhancing liquidity for the rest of us. But what happens when things go wrong? In the so-called Flash Crash of 2.45pm on May 6th 2010 a five minute sell off in the main US stock markets caused chaos.



A big blow out May 2010 (source Bloomberg)

Allegedly it was precisely this sort of programme trade that caused the problem the algorithm sold over 75,000 stocks with a value of £2.6bn in just 20 minutes, causing other super-fast trading algorithms to follow suit' (Jane Wakefield bbc.co.uk 23/8/11.) The worry is that these decisions can now be made by a machine that is pre-programmed, and difficult to switch off. Jane Wakefield goes on to describe in another example of these computer wars how Amazon's price setting code went to war with itself this year. An eventual price of \$23.6m for a simple book occurs 'after the algorithms used by Amazon to set and update prices started outbidding each other.'

Volatility is an issue in investor minds—but only the downside really hurts

It is not a difficult concept to understand that the return to more normal, and hence real, volatility has spooked investors. We all hanker after the days of a long term bull market, where you would always be bailed out by the next bull run. Investment news reported 'among the 206 registered investment advisers surveyed in September, Cogent found that 70% cited market volatility as the top concern amongst their client' (source WSJ 17/11/11.)

The reality is that it is the failure of most traditional asset classes to perform, over what is now more than a decade that has sapped investor confidence. When similar swings took place in the 80's and 90's they were in the context of a bull market. Hence the down phases would be fairly soon overcome.

‘Two savage bear markets in a decade appear to have stripped retail investors of their faith. It would be wise to treat this as a secular shift; a generation’s worth of good news could be needed before spirits recover’ (FT Markets column 26/7th 11/11.) This is the issue more than a return to more normal levels of volatility.

Correlation rules---risk on and risk off

Perhaps as a corollary of just how beaten up investors are, the markets are increasingly trading as one. While it may be fair that if the stock market plummets this may affect future activity levels in the economy, but links with currencies and even precious metals seem more difficult to make.



Chart Commodity Index vs. S&P 500 (source Bloomberg)

In the early part of the decade as commodity prices moved up investors, and indeed some Central Bankers, worried about the onset of inflation. For equity investors the onset of rate tightening would have been a negative. This meant that commodities and equity prices tended to move in opposite directions.

By 2008/9 this process had been reversed. Maybe market participants had become more sensitive to the effect of overall levels of economic activity, but as likely an explanation has been the increasingly financialisation of all asset classes. From 09 onwards these highly different asset classes have moved in tandem.



Euro/\$ exchange rate vs S&P 500 (source Bloomberg.)

For foreign exchange rates the trend is even more pronounced. From an inverse relationship, the euro rate has now come to symbolise the vagaries of risk appetite. During a New York afternoon, anyone trading currency might as well trade equity futures.

Conclusion—volatility is not new extreme correlation is

For weary market participants struggling to stay alive as 2011 draws to a close, it is worth reminding that the biggest ever move in the S&P 500 was not 1929 but in fact October the 19th 1987 when the fall was nearly 25%. This would be equivalent to a drop of over 280 pts or 2000pts on the Dow! Veterans of that day do not have much sympathy for today's stressed out traders.

However as we enter a second decade bear market it is true to point out that no one active in western financial markets has had to deal with the consequences (albeit they are in Japan.) The old 'buy and hold' models do not go down well with your clients.

Something different is going on with the increasing correlation between asset classes that even a few years ago might have given a portfolio genuine diversity. As the FT summarised 'correlations between asset classes are higher than before, making it harder to diversify risk' (John Authers 26/7th 11/11.)

It is here that we sense a chance to take an opportunity in such troubled times. If all assets are getting trashed in today's volatility then some juicy ones will become very cheap.

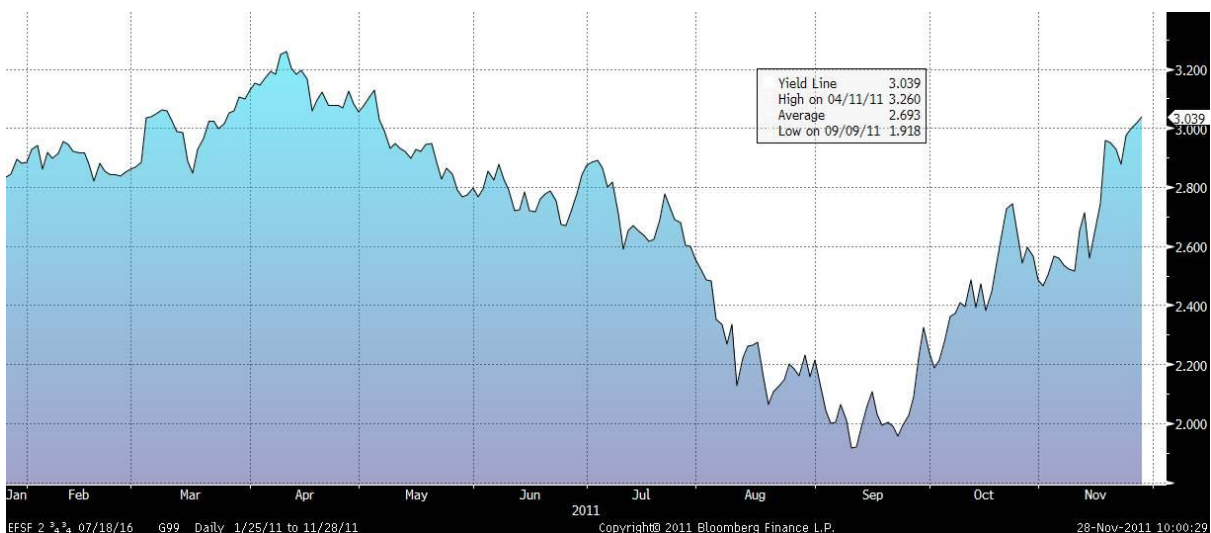


Unilever---buying opportunity in August risk off moment (source Bloomberg)

Investors can pick up preferred assets during these blow-off phases.

Market summary

November was the turn for the bears to reassert themselves after October's violent bounce. Market themes for this sell off were hardly new, Euro zone worries combined by lacklustre US growth and fears of a hard landing in China. Political attempts to come up with ever more exotic mechanisms to hold in the Euro zone government debt.



EFSF 2.25% 2016 (source Bloomberg) 100 bp back up in yields

The above chart documents just how difficult the concept of issuing large amounts of debt has now become for this so-called 'rescue vehicle'. The EFSF has only had four tranches with a total of 16bn euro raised, a very long way from the 250e (or 440e) that this is expected to generate.

Investors have clearly become sceptical about buying ANY Euro zone bonds, let alone novel super-national structures. With this route looking questionable, and the market increasingly focussing on the lack of growth within Europe, only full scale monetisation seems to promise salvation.

Article 123 Treaty of Lisbon

'I do not think this is really within the remit of the ECB. The remit of the ECB is maintaining price stability over the medium term' Mario Draghi in response to a question at his first press conference concerning the purchasing of greater quantities of Euro zone government bonds (source CNBC.com 21/11/11.) He is right.

'Overdraft facilities or any type of credit facility with the ECB....shall be prohibited'
(Article 123 source www.lisbon-treaty.org)

As it became clear the sell-off in Euro zone bonds was moving well beyond Greece, the ECB has been engaged in frequent forays to make these very purchases. The exemption used to correct what would appear an anomaly is to 'smooth' the orderly functioning of markets. But obviously this has its limitations. With a virtual buyers strike already on the cards, and the needs for Italy to rollover in 2012 are an astonishing e300bn alone. If the Central bank is going to pick up the slack some sort of wholesale amendment of Article 123 is required.

Game of chicken---blow out crisis low required

It's hard to be an optimist right now. However the big shred of hope we have been concentrating on ever since we constructed our model portfolio was the monetary stimulation available, and being deployed.

Of course we know that the western world has been going through a painful, and necessary, de-leveraging process. Those halcyon days of the 'great moderation' will not be repeated. However, the level of pain has been circumvented by extraordinary levels of fiscal and monetary governmental support. It is worth recounting that this has extended to the SNB making unsterilized intervention, the BOE with a further round of QE, the BOJ printing, the Fed's operation twist, the Chinese undertaking a massive fiscal stimulus during the 2008 crisis and we can go on.

Only German politics has dictated the ECB to follow the mandate. While it is quite likely that Angela Merkel would long ago have given the go ahead for the ECB mass purchases, this monetary printing is still anathema to the majority of Germans.

However the consequences of doing nothing are growing daily as each of the various schemes falls by the wayside. If Germany continues then disaster is surely upon us. The end of the euro, perhaps the EU?

So we believe the ECB will be forced to waive in some way Article 123, or make some other manoeuvre perhaps by lending the to EFSF or IMF what is needed. This will be a big number, certainly north of 1trn Euros.

'The reason is simple: it's because it's what they *have* to do, because there is no other way out of this mess. The notion of leveraging the EFSF has failed; there will be no additional money from the IMF without US approval, which won't come without Europe putting up substantial funds of its own, which won't come without the approval of all 17 nations, which won't come' (Steve Liesman CNBC.COM 21/11/11.)

Timing is everything

Our prediction is that Germany will have to give up its much cherished fiscal discipline and agree to a mass monetising of all EU sovereign debt (Greece is not likely to be included). But the German nation is only likely to agree to this during an out and out crisis. While things are not that good right now, we feel that this existential moment will be needed to during an all holds bar moment.

1st quarter blow out, a run on several Banks including US and UK, Italian BTPs yielding over 10%, a continued collapse in Chinese and Indian stocks....all of these events are coming. **The big print** QE3, take a number and then double it. ECB buys over 1 trn sovereign debt. The BOE comes in again and buy's another £100bn gilts, and expands the direct loans to SMEs. Both the BOJ and SNB reload, while those Chinese huge foreign exchange reserves are deployed. <http://bloom.bg/sAh3ax> (Central Banks ease most since 2009 Bloomberg.com) this is a good summary.

However for our portfolio we prefer to waiting until we are in the eye of the storm before we increase our holdings of Gold and equities, our preferred way of playing this egregious policy. The policy will work in the sense that it will back stop the world economy, and prevent the natural depression that was overdue. But the price will be paid in double digit inflation.

This material is confidential and is intended solely for the use of the person or persons to whom it is given or sent and may not be reproduced, copied or given, in whole or in part, to any other person. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision.

The information and opinions presented here are for background purposes only and do not purport to be full or complete. No reliance may be placed for any purpose on the information or opinions contained in this document or their accuracy or completeness. No representation, warranty or undertaking, express or implied, is given by Alvine Capital as to the accuracy or completeness of the information or opinions contained here and no liability is accepted by Alvine Capital for the accuracy or completeness of any such information or opinions.

No information provided herein shall constitute, or be construed as, an offer to sell or a solicitation of an offer to acquire any security, investment product or service, nor shall any such security, product or service be offered or sold in any jurisdiction where such offer or solicitation is prohibited by law or regulation.

UK Residents: Alvine Capital Management Limited is regulated in the conduct of investment business by the Financial Services Authority, ("FSA").