Looking Back, Looking Ahead

By Vineer Bhansali| January 09, 2023

A Happy New Year to All! While 2022 turned out to be one of the worst years for financial assets, it turned out to be one of the best years for common sense. A decade of macro distortions caused by central banks were unwound, as central bankers realized that they were working with the wrong theories, wrong approach, and wrong forecasts. It also showed the risks of trusting non-elected officials to make the right calls when it comes to your own wealth.

Fortunately for us, we anticipated this problem, along with many others, and over the last three years, have positioned for a world of rising volatility, illiquidity and lack of financial market support from the government. As I wrote about a year and a half ago (here), inflation came and crushed the gods of money printing. And as of this writing, inflation is still running high, interest rates are still relatively low, and assets purchased as part of quantitative easing are still in the trillions. Of note, there is one central bank, the Bank of Japan, which is still fighting fundamentals by pinning the level of yields.

I see three great opportunities for investors in the year(s) ahead:

1. **Inversion of Yield Curves**
   The US government yield curve is the most inverted in over four decades. With the Fed trapped fighting inflation even at the cost of tanking the economy, the front end of the yield curve today provides the highest yield anywhere, along with a built-in "option" against a stock market crash. Typically as short rates rise and the curve inverts, things start to break. Last year we saw the UK almost break, the digital asset industry break, and I have no doubt that there are other skeletons in the closet that we have not

yet discovered. When things break, yield curves steepen, or maybe a steepening of the yield curves makes things break. The causality is not that important. What is more important is that long-term rates are too low relative to short-term rates, and odds are that the yield curves globally are ready to start re-steepening. These trends can take multiple years to work themselves out.

2. An Implosion in Japan

The yield curve control (YCC) of the Bank of Japan has been sticking out like a sore thumb. Japan was not only the first one to try out quantitative easing many years ago, but has also been the one central bank who has so far defied the rest of the world by keeping short-term rates negative and ten-year yields pegged. A few weeks ago, without any announcement, they let the ten-year yield jump from 0.25% to 0.50%. When one looks at the Japanese yield curve, we find that the BOJ owns almost all the bonds in the 10-year sector, because they have had to print money to keep these yields pegged. In other words, this is a poker game between one man (Kuroda) and the global financial markets. But Kuroda is ready to leave, and who knows what the next ("non-lawyer"?) central bank head decides to do. Odds are that any rational person would let yields drift up. But more importantly, the asymmetry from shorting Japanese government bonds is obvious. With yields at 0.50% and inflation running over 2%, there is a lot more room for yields to rise than to fall.

3. Say no to Negative

One simple rule of thumb that has worked has been to "say no to negative". This started with shorting negatively yielding bonds in Europe, which resulted in some healthy profits, as well as shorting negatively yielding TIPS in the US (negative real yields). As many of you know, I put out a monograph titled "The Incredible Upside-Down Fixed Income Market: Negative Interest Rates and Their Implications" (free download from the CFA Institute website here). What's next? In my view,

negative swap spreads in the long end of the US yield curve are next. For those who don't follow this market, interest rate swaps have recently migrated from LIBOR to SOFR (Secured Overnight Funding Rate). For investors who are looking to hedge their liabilities for a long term, the simplest way to "buy duration" has been to receive fixed in a long maturity swap versus paying some version of SOFR. Since swaps do not require putting up the full value of the bonds, these investments are done on margin. As interest rates rise, the curve inverts, the financing cost of these strategies at some point will become more expensive than the liability hedging benefit they confer. Since as of this writing, long-term swap spreads (the difference between government bond yields and swap levels) is deeply negative, shorting long-term swaps vs government bonds is a "long-option" on this swap unwind dynamic, while earning positive carry! After three decades of trading in the fixed income markets, I have come to appreciate the value of owning options and getting paid for them!

So far, I have not said much about non-fixed income markets. There are two reasons for this. The first reason is that all the "action" is in the bond markets today, because that is where the distortions got to be so enormous, both in terms of magnitude and direction. When non-economic players, like central banks, trample financial markets like elephants and then begin to reverse course, great opportunities arise. Over the last few years I have begun to be more and more convinced that central banks have become the "opponents" of financial market participants; and to use an analogy from poker (which, thankfully, I am really bad at so don't play at all), most of the money that one wins comes not from the brilliance of one's own play, but from the ineptitude of your opponents.

If I extend the fixed income themes to other asset classes, I suspect that equity markets don't do much in aggregate. However, within the market, some types of investments will likely do really well and many others will likely do very badly. Due to the size of the index fund market, a new dynamic has emerged. When index funds or ETFs sell assets, they also force the good to be thrown out with the bad. A great example is the ARKK ETF that is the poster child of the recent bubble and bust in tech stocks. Our research shows that the ETF has lost close to 10 billion dollars for its investors since its inception. And yes, the compounded returns from

inception still show a slight positive return since when the fund had positive performance its size was very small. As the liquidity cycle has reversed, the ETF has had to sell its underlying assets. Since throwing the baby out with the bathwater is never a great idea, it creates interesting opportunities for investors who are looking to buy great companies at the right price.

I also think that for now the US dollar is the only place to be. First, in periods of market upheaval, there are very few places where you can get liquidity to park money and take out to invest at your whim. And when such parked liquidity provides the highest yield in the developed markets, it is hard to justify moving assets to more risky domains. Yes, the time will indeed come when the US dollar is not the reserve currency of the world, but we are probably a few years away from that point. I simply cannot justify a lot of negative carry betting on this rather remote probability. Maybe a small toe-dip into emerging market currencies and equities for now.

Finally, gold. For the last few years we have believed that until real yields stop rising, gold is probably not going to do much. Real yields have risen a lot and in the middle of 2022, we flipped from being short TIPS to long TIPS, as real yields went from minus 2% to plus 2%! At this point, TIPS provide a real yield of 1.5% and they guarantee a contractual protection against inflation. So if inflation stays above 4% in 2023, which is my central forecast, then we pick up a yield of 5-5.5%, in government securities. If the financial markets keel over and the economy falls into a recession, we probably get an additional price appreciation from yields falling. So all else being equal, the right time to buy gold will likely be when a recession becomes inevitable.

Conclusion

As option traders, we always look for asymmetries. Our approach has always been to try to implement large, asymmetric positions using either options or the proper structures. With so much distortion in the financial markets today as a consequence of years of unchecked central bank activism, the opportunities looking out appear enormous.

Important Disclosures

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