Notes from the Trading Desk

February 11, 2018

Tandem Investment Advisors

Market Movers & Shakers

Wow! What a week it has been. For months now the lack of volatility in the marketplace has been oft discussed. Well, if this past week is any indication, volatility has certainly made a splashy reappearance. Since the end of January, the CBOE Market Volatility Index (or VIX for short) is up 115%. The so-called fear gauge has more than doubled. During that same time, we have seen the S&P 500, the Dow Jones, and the tech-heavy Nasdaq all fall more than 7%. If the month ended today, it would be the 4th worst February in the S&P 500 since 1928. Only during the Great Depression, the Tech Bubble, and the Financial Crisis have we experienced a worse February. When painted with that brush, it sounds like this market has waded into some very choppy water. However, in markets like these, a little perspective is always necessary.

For starters, this whipsaw of a week is not unprecedented. In 2011, from August 4th to August 11th, the S&P printed the following daily moves: -4.78%, -0.06%, -6.66%, 4.72%, -4.42%, 4.63%. This past week pales in comparison, we saw price action of –2.12%, -4.10%, 1.74%, -.50%, -3.75%, 1.49%. The volatility in August of 2011 was certainly greater than it is now. The recent moves just feel extraordinary because the marketplace has been utterly devoid of any sort of volatility and pullbacks of late. The end of January marked the 15th consecutive month that the S&P 500 Total Return index closed higher. These 15 straight months of gains smashed the old record of 11 that dates all the way back to 1958-59. Only four times in 2017 did the S&P 500 even fall by 1%. Four times! The historical average, dating back to 1928, is 28 1% down days in year. One must go all the way back to the early 1960s to find a time the S&P was less volatile! Sentiment was also nearing record highs. Bullish sentiment in a recent Investors Intelligence report was 66% — the highest since 1986. For the past 15 months, the S&P 500 has been one directional and like Pavlov's dogs, we have all been trained to buy any and every dip. Lastly, January was the best start to the year that we have had in 21 years. The month was off to a very impressive start! At one point, the S&P 500's annualized return was well north of 100%. Yes, we are now 9% off our recent all-time highs, and yes the market briefly entered "correction" territory. At the end of the day though, the S&P 500 isn't even down 3% YTD.

Now that the backdrop has been set, what actually sparked the recent selloff? Well, pressure began last Friday off the back of the largest year-over-year increase in average hourly earnings since 2009. This nearly 3% growth in wages sparked fears that inflation would surely enter the economy, which in turn would cause the Fed to hastily quicken their tightening cycle. Our 10-Year Treasury jumped nearly 10 basis points in about 5 minutes — a dramatic move for sure. The sharp move higher in yields quickly caused markets to move lower as we closed down 2% with the VIX up 28% for the day. This initial inflation scare was the first domino to fall in hindsight, however, it was hardly the biggest problem.

The most crowded trade on the street for the past few months has been shorting volatility. Typically in the stock market, you buy a position low and then sell high. Well a short sale is the opposite, you first sell the position — which you do not own — high with the promise to buy it back at what is hopefully a lower price. Shorting volatility has been a favorite trade of managers throughout the industry. In fact, in Bank of America Merrill Lynch's January survey of global fund managers "Short Volatility" was deemed to be the most crowded trade. With volatility so low over the past few years, it was an easy trade, easy money. The XIV — an inverse VIX ETN, designed to sell volatility — has posted an average annual return of 84% over the last 6 years, before this year of course. In 2017, the product had an annual return of 187.57%. Like we said, it was easy money. Traders were selling volatility short — that is, betting that it would go lower — and in turn going long the market — betting that stocks would move higher. It was a great trade throughout all of last year. However, Friday's selloff sparked a considerable move in volatility as the VIX jumped a little over 28%. The trader's that were short volatility were now underwater on their trades and were forced in turn to sell their positions in the market in order to cover losses on their short. There's an old adage that "selling begets selling." Well this rang even truer this past week. On Monday, the VIX surged another 124% which caused the market selloff as the S&P dropped over 4%. The Dow at one point, lost nearly 1,600 points. So these traders, in order to cover their shorts were forced to buy back volatility at a higher price, this essentially created a rush of buyers that were in turn pushing volatility higher and higher. As volatility jumped higher, the markets were sold off in a risk-parity trade. Computer algorithmic trading has basically been programmed to sell the market as a whole when volatility goes higher and buy the market as volatility moves lower. Well the trader's short covering of volatility throughout the week, caused volatility to move higher which in essence forced the market to move lower in a sort of twisted self-fulfilling prophecy. There was a phrase coined to describe the hedge fund Long-Term Capital Management (LTCM) that infamously blew up in 1998, they were "picking up nickels in front of a steamroller." The short volatility trade was similar, and it too blew up — the previously mentioned XIV is down 96% this year and is being liquidated entirely by Credit Suisse. On Monday, we watched an entire asset class of inverse VIX products get completely wiped out. It was truly historic and spectacular to watch. I suspect over the next few days, weeks, or even months, we will begin to hear about a hedge fund or two that blew itself up just like LTCM did in the 90s. In fact, we already saw it happen to one mutual fund, LJMIX, as it fell over 80% this past week.

So what does this mean for the market going forward? In the short-term it is possible that we see a continuation of the choppy market as traders continue to unwind their shorts on volatility. The trading pattern for much of the week was a selloff into the close during the last 30 minutes of trading. This was typically viewed as traders unwinding their shorts. However, Friday showed a pleasant break from this trend. The S&P 500 ripped more than 3% over the last two and a half hours of trading. Some view this as the market having shaken out all of the short sellers, that were forcing the market lower during the last 4 closes. It's possible. It is also possible that the shorts haven't been completely unwound. However, we also saw a complete reversal in momentum in the S&P. The S&P went from record levels of being overbought to being oversold in just 7 trading sessions. On Friday we had fallen more than 10% from our January 26th highs in just 9 sessions. According to CNBC, this is the fastest "correction" ever. In the short-term, the selling appears to be a little overdone. In the long-term, little has really changed. Even accounting for this recent blip in the marketplace, the S&P 500 is still in its 97th percentile on its Cyclically Adjusted PE Ratio according to data compiled by Robert Shiller. The only time the market has been more expensive is during the tech bubble and the Great Depression. Price to Sales is at 1.98, off its recent December high of 2.14, but still well above its peak in 2007 and even north of where it was at the end of February in 2000. The point is, not much is different than it was a few weeks ago. The markets are still on the expensive end of the spectrum. Even though we are almost 9% off our January highs, we have just reverted back to price levels last seen at the start of December. However, here at Tandem we do not buy the market as a whole. We buy individual names when the opportunity arises. We buy low, and we sell high. This week we were able to take advantage of the selloff and put some cash to work in names that were sold off to attractive levels for a variety of reasons.

	WTD	MTD	QTD	YTD
Dow Jones	-5.2%	-7.5%	-2.1%	-2.1%
S&P 500	-5.2%	-7.2%	-2.0%	-2.0%
Nasdaq	-5.1%	-7.2%	-0.4%	-0.4%
Russell 2000	-4.5%	-6.2%	-3.8%	-3.8%
Consumer Discretionary	-4.6%	-6.5%	2.2%	2.2%
Consumer Staples	-5.1%	-7.2%	-5.9%	-5.9%
Energy	-8.5%	-11.3%	-7.9%	-7.9%
Financials	-5.8%	-7.0%	-1.1%	-1.1%
Health Care	-5.6%	-6.9%	-0.8%	-0.8%
Industrials	-5.4%	-7.5%	-2.7%	-2.7%
Information Technology	-4.4%	-7.3%	-0.3%	-0.3%
Materials	-3.4%	-7.2%	-3.4%	-3.4%
Utilities	-2.8%	-5.0%	-7.9%	-7.9%
REITs	-4.1%	-6.8%	-8.8%	-8.8%

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