CION INVESTMENTS

Time to Position Defensively?

A good horror movie never starts with the monster. The shark in Jaws, the Tyrannosaurus Rex in Jurassic Park, and the alien in, of course, Alien—none of them appear until an hour into the movie. Horror starts with a hint. It's only in Act Two when the scary stuff appears.

So too as we enter the late-stage business cycle and the market starts hinting at horrors of its own.

THE STATE OF PLAY: LATE STAGE BUSINESS CYCLE WITH CRACKS STARTING TO APPEAR

A large global asset manager recently speculated that the next recession could start as soon as late-2019. Still, he acknowledged that predicting recessions is "notoriously difficult." As this business cycle continues to age, it's not too early to think about becoming more defensive in advance of an economic contraction.

But for now, fundamentals have maintained 2017's favorable trends.

Overall headline numbers remained strong throughout the first quarter, giving investors reason for a positive short-term outlook. And other signs of strength during Q1 were robust corporate earnings growth, continued low unemployment, and the tailwind of large fiscal stimulus.

Still, there were signs of approaching difficulties. For investors, uncertainty is what lies beneath signs of rising inflation, an increasingly volatile stock market, interest rate hikes, and a turn toward trade protectionism. The Goldilocks market environment of 2017, marked by low volatility and high global equity market returns may, in hindsight, be the calm, red dawn before the storm.

A VIX SPIKE LEADS TO NEW VOLATILITY EXPECTATIONS

"The long, smooth ride is over. And it doesn't feel good."

– Stocks Plunge as Market Enters 'Correction Territory,' The New York Times, February 8, 2018

In 2017, the VIX, an index of equity market volatility, had not only its lowest daily close in history but also its lowest annual average on record, registering 11.1. These numbers are especially low as compared to the all-time historical average of 19. Put side by side with recent years, 2017's

calm markets were the possible tail end of a multi-year trend in the volatility investment sector.

Owing to several years of low volatility since 2008, investor interest in VIX-linked securities has grown rapidly. Trading in VIX futures increased over 6,000% from 2009 to 2017. By the end of 2017, over thirty different VIX investments options (short, long, leveraged, etc.) were created. Capital flooded into the space. The result: VIX investments became some of the most actively traded securities on US exchanges. The most popular of these trades was betting on the decline of, or shorting, the VIX.

The short VIX bet was simple: Investors would profit if the VIX either remained steady or declined. Years of low volatility provided reassurance that the trade was a safe one. Of course, traders assumed a small risk of massive losses if volatility quickly reverted to historical norms. And on February 5, 2018 that is exactly what happened.

THE VIX SPIKES, PAIN FOLLOWS

On that day the US equity markets stumbled. It was the worst fall in over six years, with the DJIA and S&P 500 both suffering their largest daily point losses in history.

This turmoil caused one of the most violent VIX spikes ever, rocketing the index from 18.44 at open to finally peaking at 38.8. It was a catastrophic affair for short volatility traders.

Two popular VIX products are representative. The *ProShares Short VIX Short-Term Futures ETF* declined nearly 80 percent and the *VelocityShares Daily Inverse VIX Short-Term ETN* plummeted 93 percent, then shutdown.

A VIX EPOCH

Since then the volatility world has changed. Following the February spike, the VIX has maintained a persistently higher state. From the start of 2017 through February 4, 2018 volatility averaged 11.1. After the spike it has averaged 20.8.

It is estimated that over $2 trillion in investment strategies are, in fact, implicit bets on volatility. This increase will impact all of them.

Moreover, a long-term state of higher VIX has important implications for equity investors. Specifically, greater volatility leads to higher risk premiums. Higher risk premiums, in turn, lead to equity market declines, all other things being equal. Year-to-date equity performance suggests that increased volatility has already started to be priced in.

After a roaring 2017, domestic equity market returns for 2018 have been, so far, underwhelming. As of March 31 the S&P 500 had declined two percent, and the index has declined nearly 10% from its January peak.

Even so, the S&P 500 has experienced large gains since the 2008 financial crisis. This large run up in equity valuations since 2008 suggests an asymmetrical return profile going forward. That is, the equity market is more likely to mean-revert than to continue to expand.

The equity market looks risky, but as interest rates continue to rise, the fixed-rate bond markets have their own troubles. In a low yield environment small rate increases have an outsized impact on bond values. For example, a 15-year bond yielding 2% and trading at par would decline 12% from a mere 1% rise in rates. Investors should look to uncorrelated and low volatility investments with floating rates to ride out the storm and prepare for Act Two.

INFLATION IS BACK. RATE HIKES WILL FOLLOW

In early March, the Federal Reserve published its Beige Book, a summary of commentary on the economy. It showed growing employment, persistent labor market tightness, and—driven by a shortage of qualified workers—a moderate increase in wage growth. Altogether the anecdotal survey showed prime conditions for labor market inflation pressures.

Other Q1 data showed that inflation is not confined to the labor market.

The Consumer Price Index, a monthly inflation survey published by the Bureau of Labor Statistics, showed inflation rising at a 2.4% annual rate (before seasonal adjustment). This was the highest reading in twelve months and significantly higher than the average 1.6% 10-year average annual rate.

But consumers are not the only ones feeling the pinch of higher prices. The Producer Price Index for the same period registered 3.0% year-over-year (ex. food and energy), its highest reading since 2011.

Although it may take more data to confirm that March was not just an outlier, the direction of the trend is clear: After a long period of non-existent inflation (except in asset prices), inflation is back.

THE HAWKISH FED IS IN NEW TERRITORY

Signs of inflation and a general hawkish stance by the Fed suggest that the pace of interest rate increases will be at the upper end of expectations.

In a February speech, Fed Chair Powell hinted that the Fed could raise rates three times or more this year. Or at least that's how the markets interpreted his talk in real time: As he spoke stocks declined, the dollar got stronger, and bond yields increased.

These are uncharted waters for the Fed. Fiscal stimulus is infrequent outside of a recession. Also, the Fed is raising rates at the same time that it implements quantitative tightening, something no central bank has yet had to navigate.

Higher volatility, higher inflation, and higher interest rates are scary enough, but in 2018 investors now have to deal with a new source of geopolitical tension.

NEW TARIFFS IN TOWN

During the first quarter of 2018 the United States imposed tariffs on imported solar panels, steel, washing machines, and aluminum. These tariffs were estimated by Morgan Stanley to cover over four percent of U.S. imports.

When the tariffs were first announced the DJIA dropped 2%. Heavy users of steel, e.g., car manufacturers, experienced even greater declines.

Retaliation was swift, but modest. On April 2, China imposed tariffs on 120 American products. The following day the U.S. proposed a 25% tax on certain Chinese goods. China responded in turn with further tariff proposals. The tit-for-tat rattled US markets and escalated protectionist rhetoric.

There is no red line that determines when a trade war starts. Very few investors have experience planning an investment strategy that accounts for tariffs. In fact, most Americans have only ever experienced low tariffs and minimal restrictions on trade. The average tariff rate for dutiable imports (the sub-set of total imports subject to custom duties) has been under 10% since 1970. Further, since 1945, tariffs on total imports have slowly trended toward zero. But if trade restrictions move beyond symbolic measures, that decades-long trend could be set to reverse.

As business supply chains and revenue sources have become increasingly globalized, the effect of trade restrictions is hard to predict. Investors fear that a trade skirmish escalates into a full out war—a small, but devastating risk that is hard to quantify.

THERE IS STILL TIME TO POSITION DEFENSIVELY

The US financial market has survived volatility before, it has triumphed over rising rates, it has beat inflation, and it has excelled in the face of tariffs. But it has never had to do them all at the same time.

Volatility and inflation can spike to new highs, trade wars can heat up, and markets can start to price in much higher risk premiums. Investors who diversify early and shift to low volatility, uncorrelated assets will be ready for Act Two.

And that's when the real horror begins.

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