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All of This is Worth Less than 2 Points in the VIX?

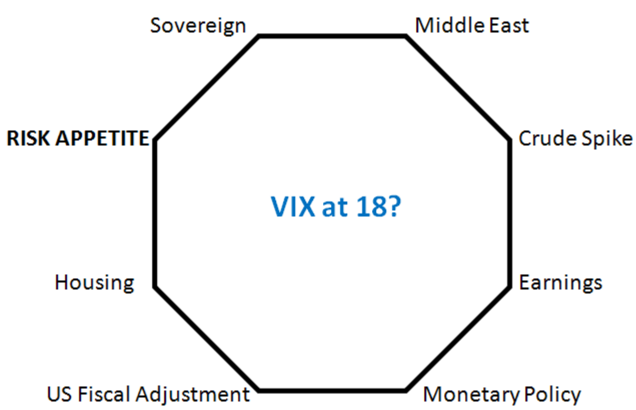
The VIX closed below 18 on Friday, less than 2 points above the lows posted in mid February. There are several potential reasons for the falling VIX – strong fund flows into equities, a deceleration of realized volatility, relief that the worst case fears in Japan seem to have been avoided, and dealer positioning which appears to have had to absorb large unwinding of long volatility positions.

Set against the backdrop of the global growth story, many argue the market has resumed its logical path higher, and that its ability to weather recent uncertainty speaks to the strength of the fundamentals. While the degree of stimulus offered by US monetary policy should not be underestimated, we believe recent events severely cloud the continued benign outlook for risk. **Simply put, we think the market is substantially mispricing the degree of uncertainty that has materialized over the recent time period. We believe risk appetite is vulnerable.**

Like everyone else, we have little capacity to foretell future events. We do, however, have conviction that short-dated hedges offer exceptional value versus the current landscape of uncertainty they are designed to protect against. **With the SPX just 2% below its cycle high and with the April expiration ATM implied volatility at 16%, we recommend that investors purchase April 130 puts in the SPY.** In the discussion that follows, we outline the increasingly unstable investment climate and tie these factors together in creating a higher degree of uncertainty. We believe the market's ability to absorb uncertainty, while impressive, may be tested given the multitude of cross-currents in play at the current time.

The Octagon of Uncertainty

Below we depict what we see as the multi-dimensional array of risks confronting the market. These risks are, of course, not new. However, the extent to which they are currently all quite active – with some clearly worsening – is troubling. The elements in the *Octagon of Uncertainty* are also highly interactive and to some extent circular. It is the uncertainty in the Middle East that creates the potential for a spike in the price of crude. This in turn can have a detrimental impact on earnings and lead to higher inflation and a disruption in the expected path of monetary policy.



On Bloomberg:

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1. **Sovereign –** Portugal drawing closer to needing funds with PM Socrates resigning after parliament failed to pass new austerity measures. Fitch Ratings on Thursday cut the nation's debt rating by two notches. Ten year yields are a cycle high of 7.9%.
2. **Middle East** – Demonstrations and violence in Tunisia, Algeria, Egypt, Yemen, Jordan, Bahrain, Iran, Libya, Oman, and Syria. For a timeline of recent events click here. In addition, renewed tensions along the Israeli-Gaza border after a bomb killed one and injured 30 in Jerusalem.
3. **Crude Spike** – Uncertainty in the Middle East has driven WTI up 13% this year and Brent up 22%. The pronounced upside volatility skew in crude indicates the degree of nervousness that prices could snap higher quickly.

4. **US Earnings –** Street expectations are for the SPX to print $22 in EPS for the quarter and $97 for 2011. This would represent 24%% earnings growth since last year. In a section that follows, we detail some of the recent comments from companies who have seen materially higher input costs as a result of rising commodity prices.
5. **Monetary Policy –** QE2 is more than half way through, and recent talk from Fed officials has been less than enthusiastic about continuing it. With global inflation pressures building, and with the potential for an energy shock, QE3 would be a difficult sell. In a recent speech, St. Louis Fed President Bullard suggested that it was important to begin to normalize policy and potentially end the QE2 program early.
6. **US Fiscal Adjustment –** The reality of the extent to which the US is over-indebted is sinking in and early attempts at even the most minor fiscal retrenchment are proving challenging. The OMB recently estimated a deficit of $1.7 trillion in 2011. Having printed deficits of $1.5 and $1.4 trillion in 2009 and 2010, Republicans and Democrats are at an impasse over how to cut something on the order of $50 billion in spending during fiscal 2011. A government shutdown may be in the offing as early as April 8th. Note also that the Treasury forecast that the US would reach its $14.29 trillion debt ceiling sometime between April 15 and May 31st.
7. **Housing** – After the homebuyer tax credit "sugar high" subsided, housing prices have started to head downward again. Negative equity and shadow inventory are rising. The recent data has been particularly alarming – new and existing home sales fell by 16.9% and 9.6%, respectively in February. Housing starts fell to 479k in February, just above the April 2009 low. In a section that follows, we provide further detail on the challenges facing the US housing market.
8. **Risk Appetite** – All of the preceding factors ultimately threaten to derail the risk appetite that has been so critical a component of the global asset reflation story. We believe that the uncertainty outlined above and discussed in the sections that follow may weigh on investor optimism and cloud the global growth story that has empowered risk profiles. All else equal, a decline in risk appetite will bring higher levels of volatility and hurt equities.

In the sections that follow, we detail these sources of uncertainty.

Uncertainty in Sovereign Risk[1]

To understand the slow-motion evolution of the financial crisis is to consider the following: on the eve of the Lehman bankruptcy, the average sovereign CDS level for Portugal, Ireland, Greece and Spain was 41bps(!). An entire year later - during which the VIX travelled from 20 to 80 back to 25, the same average CDS level was 100bps. Currently, this average stands at a staggering 600bps. As we discussed in a recent note, the tides have pulled the Eurozone into a hard place. With Greece and Ireland already recipients of EFSF/IMF bail-outs attention has shifted to Portugal, widely viewed as next in line for a bailout. Here, rising bond spreads and a push towards austerity are strangling any potential economic growth.

Portugal's problems are many. As we noted a year ago in "Debt Trap", the extent to which a country's cost of finance exceeds its growth rate creates a situation in which more and more debt is needed to support existing debt. Since then, growth has declined and borrowing costs are up. Portugal, along with Greece and Ireland, is now off the chart we included at the bottom of our note. While GDP growth in 2010 was 1.4%, forecasts for 2011 range from the Bank of Portugal's estimate of -1.3% to more optimistic market estimates as high as 0.8%.

At a Bloomberg conference in January, Portugal's Treasury Secretary Carlos Costa Pina said the government's average cost of financing was only 3.5%, as much of Portugal's debt was issued under lower rates. This is being refinanced at much higher rates – one- and ten-year yields are now 4.4% and 7.8%, respectively. Portugal has €22.3b of debt maturing for the balance of 2011 (€3.8b on Friday, most of which is funded) and will need another €7.9b to fill the budget deficit, assuming the (4.6%) guidance is achieved, for a total issuance of €30.2b or 17.6% of GDP over the next nine months. The added interest cost of just this debt will be over €750m annually at today's higher rates. Given Portugal's high debt-to-GDP ratio (83%), increasingly high cost of financing, and low growth, the standard of living is fast declining. Add in the unemployment rate at 11.2%, and this scenario does not encourage the animal spirits needed for growth.

Officials in Portugal have repeatedly denied the need for a bailout, instead stressing a preference for relying on public markets. Note that Greece and Ireland did not accept bailouts until funding in the public markets was no longer an option. Possible new flexibility for the EFSF to participate in primary auctions, announced recently, makes it more likely for Portugal to avoid a bailout for awhile longer. Indeed, the success of auctions since January for both Portugal and Spain suggest these have likely been prearranged sales to the banks and governments of stronger Eurozone members.

We find that the market is pricing Portugal's sovereign risk correctly as we discussed in a recent note. Possible catalysts pushing Portugal into a bailout or restructuring include bond yields continuing to increase, protests against austerity (several hundred thousand Portuguese marched recently in protest against the latest austerity cuts), a bad auction result, the bank stress tests over the coming months, and increasing private debt problems. Of course, the recent resignation of Socrates only exacerbates the situation and may be a tipping point from the bond market's perspective.

Amidst the worsening of financial conditions for Portugal, we must ask some tough questions of Spain. While the market has treated Spain better over the past two months, uncertainty remains. First, what exposure does Spain have to Portugal? To what extent are mortgages properly marked on Spanish bank balance sheets? How large are the recapitalization needs for the cajas? And to what extent will the Spanish sovereign be willing to play a role in the necessary recapitalization? Spain's credit rating was cut to Aa2 on March 10th by Moody's which said that Spanish banks may need up to $70bln to meet new capital requirements. Some economists estimate this number could be as large as $140bln.

Spanish banks that are short of capital have until March 28th to tell the Bank of Spain how they will raise new capital. The Bank of Spain has until April 14th to approve the plans. Given the awful experience Ireland has had in backstopping its banking system, there will be significant pushback against writing guarantees. This past weekend, the Eurozone attempted to structure its "Grand Bargain" by bolstering the capital of its present stability mechanism. However, on many counts, the agreement falls short. As Wolfgang Munchau of the FT details, while intended as a buffer against a future crisis, the capital structure of the EFSF is itself unstable. The question of "who will backstop the backstoppers?" comes to mind.

Ultimately, we care so much about European sovereign risk because the vast degree of financial inter-connectedness between a sovereign and its banking system may lead to a destabilizing feedback loop. This has most certainly occurred in Ireland. More broadly, there is the potential that contagion travels from one country to another as a result of banking system uncertainty. The BIS recently reported that banks have $2.5 trillion of aggregate exposure to Portugal, Ireland, Greece and Spain. Spanish banks had a total of $98.3bln of exposure to Portugal at the end of 2010.

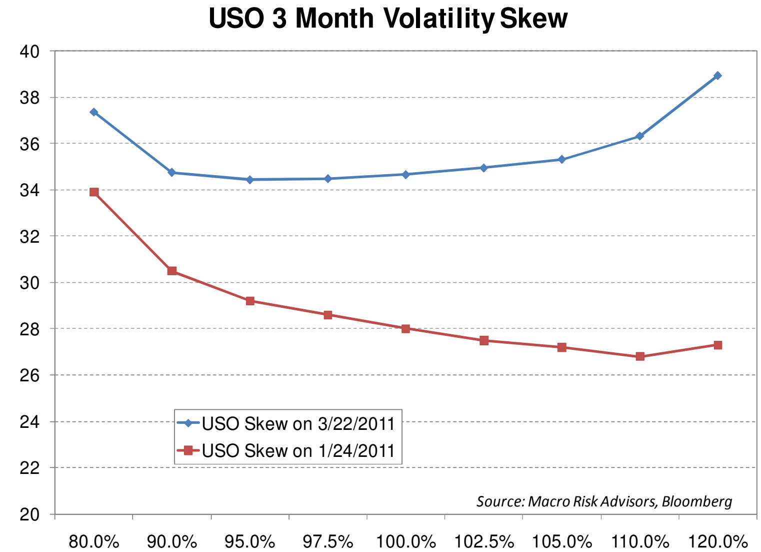
Uncertainty in the Middle East

We have no special knowledge of geopolitics, but are reading what we can. While markets have often shrugged off geopolitical uncertainty in the past, the situation in the Mideast appears is becoming more widespread and a cause for concern. There remains uncertainty surrounding the succession of leadership in Egypt, Tunisia, and Libya. There is continued unrest in Bahrain, Syria, Yemen, Saudi, Iran, Jordan, etc. The potential for a spike in the price of crude is very real, as evidenced by option volatility skews.

Israel is now also getting drawn into the fray. After a period of heightened rocket fire into Israel, and a retaliatory Israeli airstrike on Gaza last week, a bomb was detonated in Jerusalem. As Stratfor.com notes, this "raises the potential for another military campaign by Israel in the Palestinian territories. This not only could produce another crisis for Egypt [endangering the Israel-Egypt peace treaty], but could also play to Iranian interests in the region.… Israel is often the single unifying call for many on the Arab streets, and that is certainly something that a lot of Palestinian factions will be paying attention to right now. Watch for groups like Hamas, Hezbollah and others in the region to escalate attacks in an effort to provoke a military confrontation with Israeli forces"

Uncertainty in Crude

Related to the uncertainty in the Middle East, of course, is uncertainty in the price of crude. Here may be where the largest, most troubling shift in the systemic risk landscape has occurred. The substantial rise in crude has a dually negative effect. First, it is a real economic friction – the Economist provided a rule of thumb that a 10% increase in the price of oil will cut a quarter of a percentage point off global growth. Second, surging oil prices damage investor sentiment. Crude may rise to 120 or 130 or 150 and then stop – but the market cannot possibly know that. Thus, at each point, the derivatives markets are forced to price the uncomfortable upside tail with increasingly high probability. We are already seeing this in the crude volatility surface where the skew has gone decidedly upward sloping, as we show below using the USO.



Uncertainty in Earnings[2]

It is unclear whether today's commodity swings are transient "noise" or whether they will have a long term impact on prices. Currently, the negative output gap in the US seems to have kept inflationary pressures in check. However, at a recent speech, Jeffrey Lacker showed concern the economy was overheating: "I am not sure we can push unemployment that much further down or more rapidly without risking inflation picking up," he said.

The coming earnings season may provide a glimpse of the winners and losers in a world of rising input costs. Recent earnings calls for manufacturers of consumer goods show that commodity prices are a major concern. We list some interesting "sound bites" from recent conference calls as to how companies are thinking about margin compression, rising costs, and price increases.

- **3M:** "Raw material inflation was approximately 3% year-on-year…and we fully expect to offset raw material costs in 2011 with selling prices of our own."
- **Whirlpool:** "we expect raw material inflation to drive higher costs and therefore, have an unfavorable impact on operating results…As a result of inflationary environments and the unfavorable price mix, we have announced a significant price increase in the U.S. on most of our products and brands."
- **P&G:** "Higher year-on-year commodity costs reduced gross margin by 160 basis points. For perspective, on a weighted average basis, spot prices for our key materials and energy inputs are up more than 20% versus last year's levels."
- **Kraft:** "Q4 input costs in our base business were up nearly $0.5B and our margin suffered accordingly…Our current expectation is that input costs will remain high throughout 2011…As a result we're now in the process of implementing further pricing actions to reflect these higher input cost levels.
- **Cheesecake Factory:** "We expect y-over-y food cost pressures to be significantly heavier in the first and second quarters of 2011, and then to moderate on a comparative basis in Q4…As the year goes along, I would say we'll be in a better position to consider bigger menu price increases."
- **Nike:** "We're going to see input costs increase, notably cotton….Those are things that we see increasing for a short period of time, call it the next three or four quarters at this stage."
- **SYSCO:** "We experienced double-digit rates of product cost increases in three categories – meat, seafood, and dairy…it's difficult for [our customers] to absorb price increases in the short term. And so as a result, we've struggled to pass them along in the right way. So I expect that over time, generally and gradually, we'll be able to do that. But I think it will take a lot longer."
- **YUM Brands:** "We've taken very modest price increases at Taco Bell…in the first half of the year, the inflation's probably going to be out ahead of the pricing."
- **John Deere:** "We do anticipate price realizations to fully cover these cost increases."

- **Colgate Palmolive:** "The decline in gross margin of 40BPS in Q4 was due almost exclusively to the continued increase in commodity costs that we and others in the industry began to face in H2 2010…Going forward, we expect to be able to offset those cost increases….We have begun to implement price increases, particularly in the emerging markets."
- **Kellogg:** "In late 2010, we announced price increases on many products across our categories around the world to help offset the impact of rising input costs…I think from our perspective, we're seeing that broad-based grain inflation. We've taken broad-based pricing to help offset that. And we're seeing that work its way through the marketplace… all the food industry is going to be going up, including meat and poultry and so on."
- **Ethan Allen:** "Raw material cost inflation is likely to remain a challenge…"

Uncertainty in Monetary Policy[3]

The Federal Reserve has pointed to the relatively low CPI number (2.1% YoY as of February) and the stubbornly high unemployment rate for the extremely accommodative monetary policy over the past few years. While housing continues to search for a bottom, the rest of the economy has started to see prices increase, particularly in commodities and food. This recent article in the WSJ pointed to several troubling trends in the food industry. From the article:

- Restaurant chain Johnny Rockets, uses about eight million pounds of ground beef a year, and its prices have risen 20 cents a pound over the last two months
- MAR has been coping with higher prices for beef, fish and chicken over the past six months, says Brad Nelson, a vice president and the global corporate chef for the hotel chain. The company is also paying higher prices for sugar and Arabica coffee beans, which have both soared over the last year
- Norwegian Cruise Line began using e-auctioning last year to find better food prices as commodity costs rose, says Chief Executive Kevin Sheehan.

How much more room does Bernanke have? While the answer could be "enough", we are observing the disquieting trends of global inflation each day and believe it is at least time to start focusing on the forces at work that either enable or disable a continuation of ultra-stimulative monetary policy. A recent WSJ op-ed piece by Allan Meltzer provided a cautionary backdrop to the pitfalls of money printing and warned that higher inflation can occur even amidst an output gap. Meltzer, a former chair of the Shadow Open Market Committee, cites the hardships of the 1970's as evidence.

To review the recent goings-on in Fed policy, during the summer of 2010, Bernanke was faced with an economic slowdown, a flagging stock market and an unsettling decline in realized and implied inflation rates. This combination, along with the belief that fiscal policy was mired in legislative gridlock, empowered the Fed Chief to call for a bold redoubling of the monetary reflation campaign. QE2 was justified on the assertion that the Fed's dual mandate of achieving price stability and full employment both pointed in the same direction – further stimulus. Bernanke's highly direct communication with the markets on this front at Jackson Hole generally marked the low in risk asset pricing and inflation expectations.

In "Bernanke and the Stock Market", we explored the interaction between the SPX and Fed policy, suggesting that with housing wealth not coming back any time soon, the Fed's main driver of stimulus was the stock market itself. Bernanke has many times illustrated his belief in the strong impact of increased stock market wealth and at Jackson Hole said, "I the see the evidence…that such purchases work primarily through the so-called portfolio balance channel, which holds that once short-term interest rates have reached zero, the Federal Reserve's purchases of longer-term securities affect financial conditions by changing the quantity and mix of financial assets held by the public."

Recall that the three "pillars": Bernanke has used to justify the Fed's policy stance are realized CPI inflation (2.1% yoy and 0.8% yoy core), well anchored inflation expectations, and the output gap (read here as the unemployment rate). On the inflation expectations front, QE2 also appears to have made a material impact. From a low of 1.5% in late August 2010, 10-year break even inflation has risen to roughly 2.4% (USGGBE10 INDEX on Bloomberg). The move higher in the US is consistent with what has been observed globally, as can be observed globally on the ILBE page.

The bond markets have, of course, begun to price in the longer term impact of easy money, through higher inflation expectation and higher nominal bond yields. Some will argue that this is a healthy sign that naturally comes about when an economic recovery becomes more firmly entrenched. That said, we believe it is important to step back and recognize that we remain in unchartered territory with respect to global monetary imbalances.

We wonder if the Fed can operate within the vacuum it would prefer to, effectively ignoring the increasingly strong signals that inflation could reach US shores more quickly than forecast. To be sure, emerging market inflation is real. ECB and BoE comments point to concern that changing inflation rates may prompt a policy response. Commodity price rises threaten to become more entrenched in the production process and could conceivably be passed through to consumers by companies that are able to do so. To wit, the prices paid component of the ISM survey reached its highest level since just before the Lehman bust. While Bernanke's recent stance has remained dovish, it will be valuable to detect nuances in his comments that could portend a change, especially as the designated end to QE2 draws closer.

Uncertainty in US Fiscal Position[4]

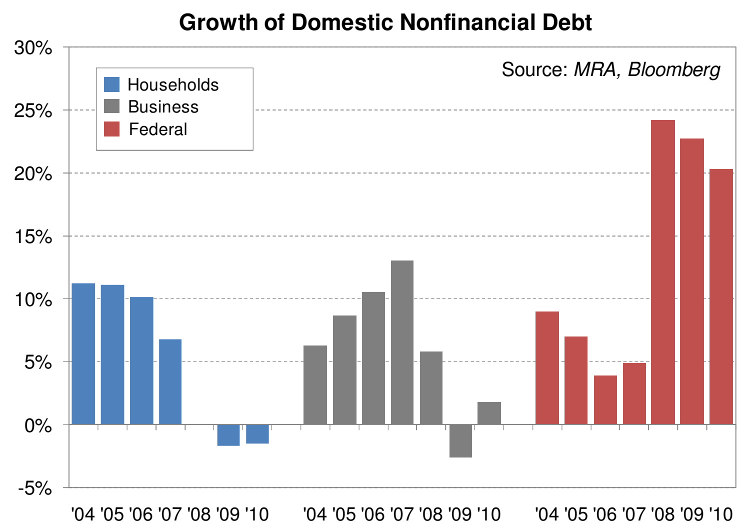
In the US, the magnitude of the debt problem at both the Federal and state level has become the subject of increasing focus. President Obama's budget, while portrayed as fiscally responsible, forecasts an average deficit of nearly $1 trillion per year over the next five years. These staggering numbers optimistically assume real GDP growth that averages just under 3.8% per annum over the same period. Two recent reports are worth summarizing:

The Little Hoover Commission issued a report in Feb'11 titled "Public Pensions for Retirement Security" examining California's underfunded public pension plans. The report finds that the 10 largest public pension funds in the state have a combined shortfall of $240b. This shortfall, amounting to a $21k future liability per household, is before any correction for aggressive asset return assumptions, commonly at 8%. As the report notes, "Today's benefit structure for public employees is unrecognizable from the design, funding structure and goals of the original 1932 version. Instead of retirement security, the public pension became a wealth generator."

Mary Meeker of Kleiner Perkins also published a notable report outlining the fiscal health of "USA, Inc.", viewing the federal government as if it were a business. On this basis, cash flow for F2010 was -$1.3 trillion and net worth -$44 trillion. The gorilla in the room is entitlement spending. Entitlement revenue (including Social Security, Medicare, Unemployment Insurance) was outstripped by entitlement spending by more than $1 trillion in 2010, 7.6% of GDP. According to the Congressional Budget Office, federal entitlement spending and interest payments alone should exceed total federal revenue by 2025, 35 years earlier than last projected in 1999. Medicaid, not included in the -$44 trillion net worth calculation as funding is appropriated on an as-needed basis annually, is the worst offender.

As the US Congress seeks to embark on some form of fiscal adjustment, it becomes clearer just how challenging the process will be. From our vantage point, corporate America has been a huge beneficiary not just of the Fed's zero interest rate policy and QE, but also from the outlandish deficits run by USA, Inc. The pushback within Congress is growing as concerns mount that a continuation of red ink of recent magnitude could push the US into a fiscal crisis. Alice Rivlin, former budget director under Clinton, said this week, "we could definitely have what's called a sovereign debt crisis…we used to think that only happened to small countries on other continents, but it could happen to us as well."

The chart below outlines the predicament. With the private sector deleveraging, the government has been the only source of credit growth over the past three years. If the austerity theme continues to catch on, this becomes much less feasible.



Uncertainty in US Housing[5]

At the center of the lack of private sector credit growth depicted in the previous chart is housing. At MRA, we have long held the belief that home prices demand attention owing to their strong transmission effects on both the real economy and markets. We have observed the virtuous cycle of rising home prices, bank lending, and job creation turn vicious in reverse. The reversal has yet to finish.

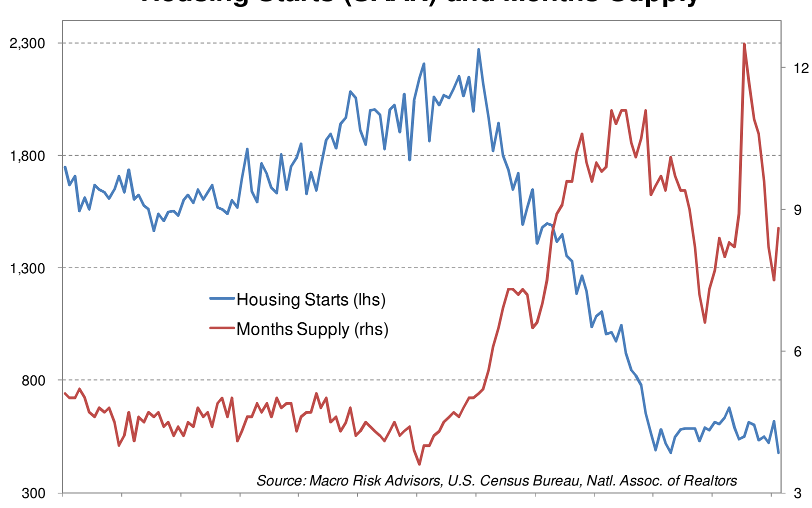
Home price indices and estimates for 2011 all point lower. The most recent data from S&P Case Schiller, the National Association of Realtors, CoreLogic and Federal Housing Finance Agency all show MoM declines, for the most part, of six or more months straight. CoreLogic reports negative and near-negative equity mortgages, defined as properties in negative equity or within 5% of being in a negative equity position, at 13.5mm or 27.9% of all residential properties with a mortgage at the end of Q4'10. This is down a just a hair from 13.6mm at the end of Q4'09. Zillow reports a similar negative equity rate at 27% for Q4'10, up from 23.2% in Q3'10.

With home prices headed to new lows, we may see this number deteriorate further. As we noted last year in "Barney's Frank on Second Liens," negative equity creates a situation in which banks are reluctant to realize losses on second liens. The reason is, as Barney Frank's letter noted, "Large numbers of these second liens have no real economic value – the first liens are well underwater, and the prospect for any real return on the seconds is negligible." The SCAP stress tests of May 2009 put second liens held by JPM, BAC, WFC, C at $477bln. Today's combined Tier 1 common equity for the Big 4 is $426bln. Granted some of these loans have rolled off, and a large portion is likely of high quality, but one cannot ignore the implications of these figures.

Investors require an honest evaluation of the risks of a further downturn in home prices. The recent CCAR stress tests by the Fed are unsatisfactory in this regard. The Fed's Comprehensive Capital Analysis and Review, released 3/18, is an overview of the latest stress tests performed by the Fed on the nation's 19 largest banks. The item worthy of note is the detail of the "Supervisory Stress Scenario" against which banks' capital levels were tested. The Fed's assumption for home prices in the stress scenario is only -6.2% for 2011, not nearly pessimistic enough. Market trust is eroded when regulators, together with the banks, are hesitant to recognize the extent of the problem.

The chart below illustrates the current state of the housing market, largely unchanged from two years ago. Housing starts have been bumping along an extremely low level as we work through excess inventory. A chart of new home sales over the same period looks almost identical. This supply overhang, depicted by the sharp jump in months supply, is still worse than it appears. Months supply (inventory of homes for sale divided by the monthly sales pace) is artificially low due to a likely slower sales pace than reported by the National Association of Realtors (the denominator should be smaller) and a larger inventory of homes for sale as shadow inventory, increasingly important, is not counted (the numerator should be larger). Shadow inventory is comprised of seriously delinquent properties, foreclosures, and bank-owned real estate (REOs) not listed for sale. The net result is CoreLogic reported Months Supply at 23 months for August 2010 (latest available data), versus 11.7 reported by NAR.

Housing Starts (SAAR) and Months Supply



Uncertainty in Risk Appetite[6]

One theme we keep close at hand is the degree to which markets are providing investors with feedback. No factor more decisively motivates the supply and demand of a financial asset than the real time profit and loss generated from being long or short said security. It was the powerful feedback of fast, breathtaking profits on Internet stocks that drove the NDX to a 75 P/E in the early part of this decade. A similarly self-reinforcing feedback cycle was in play during the credit bubble when selling insurance of any kind (and at increasingly lower prices) was a must, engendering a substantial carry trade that worked until it didn't.

Over the past two years, the equity market has provided investors with very powerful behavioral incentives. In a Strange Consistency, we showed that the market had risen on roughly 70% of the days over a period. Being short, or even under-invested, in such a decidedly trending market becomes painful. It has been the case for quite some time that SPX implied volatility has traded at a healthy premium to realized volatility. This creates substantial disincentives to hedge, even for those investors highly skeptical of a risk asset rally built on QE2. It also empowers risk appetite.

But risk appetite, while empowered by the success of carry (in all its forms), may become damaged when sources of uncertainty gather. While we cannot say what the future holds, we do believe that at current volatility levels, the market fails to sufficiently price the degree of uncertainty that exists. We think events that have materialized over the past two months are worth more than 2 points in the VIX. Recall that when the VIX was at 16 in late January, one month realized SPX volatility was roughly 7%. Currently, the VIX is equal to one month trailing realized volatility. While realized volatility could quickly reverse course, our discussion leads us to believe that there are sufficient unknowns to keep traders guessing and support a healthy level of daily swings in the market.

All of this leads us to have substantial interest in owning gamma at these levels. Earnings season is upon us, the Middle East is moving towards anarchy, crude is in flux, inflation is real, and sovereign risk is in full play. At MRA, we have often thought about market volatility events in the context of the urgency with which investors need to act. On a single stock basis, when a company's earnings differ widely from Street expectations, forceful selling may result, driving volatility higher. On a more macro basis, when broad assumptions about the investing environment are suddenly called into question, risk appetite is challenged and may result in wholesale unwinding of carry trades and risk assets. We cannot say if now is one of those times. We can, however, say that we believe the market underprices the potential that unwelcome events may soon transpire.

Conclusions…"Hedge When You Can, Not When You Have To"

We view the recent decline in short-dated SPX implied volatility as very supportive of owning hedges, especially against the backdrop of the landscape of uncertainty previously discussed. At current option premium levels and given sources of instability globally, we believe put protection has become increasingly important. The macro backdrop remains littered with unknowns: sovereign risk remains very high, the end of QE2 is a few months away, there is upward pressure on interest rates and commodity prices globally and there are growing geopolitical tensions.

Put together, we believe the market has become increasingly vulnerable to a "scare" – a bounce in risk premiums and decline in risk appetite that result from the inability to absorb the entirety of the uncertainty that currently plagues the investment landscape. Our recommendation is simple: with the VIX below 18 and with April ATM implied volatility at 16, "hedge when you can, not when you have to".

End Notes

1 Excerpted from MRA "*Man o' War*", 3/14/11
2 Excerpted from MRA "*Inflation Bites*", 2/18/11
3 Excerpted from MRA "*Bernanke and Inflation*", 2/7/11 and "*Food Friction*", 1/21/11
4 Excerpted from MRA "*Red (White and Blue) Ink*", 3/1/11
5 Excerpted from MRA "*Home Prices, the Forgotten Risk*", 3/23/11
6 Excerpted from MRA "*Hedging Ain't Fun…*" 2/16/11