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Market Prices are Singing…But "There's No Reply at All"

- The considerable ink spilled on the bond market flare-ups across the globe over the past two weeks is grounded in broken promises.
- Bond market spasms reflect a confrontation with updated realities but there's a communication break-down with equities. "There's no reply at all".
- Equity volatility is derived from one of 4 places: 1) distance to default (Merton) 2) vol of earnings 3) vol of rates and 4) vol of the P/E multiple. Of these, #4 is currently most relevant, reflected in huge companies with high implied vols.
- The authorities typically don't respond to market declines led by falling multiples. A thematic trade for 2022 is a hedge program on the QQQ.

40 Years after Abacab…"There's No Reply at All"

Genesis is soon to hit the NY area live in concert and the electronic scalpers are poised to act as both agent and principal. On the wrong side of it, but a big fan, you buy the tickets, 4x the face value. You check out and see a 30% convenience charge kindly placed on the already pricey set. "We are after experiences," you convince yourself and while Phil Collins is no longer able play the drums (his son will in his place), the show will be a treat. It's been 40 years since Abacab, an album that peaked at #7 on the US Billboard 200. Of the hits on this album, "No Reply at All" is the topic of this note.

Rate Markets are Singing

The considerable ink spilled on the bond market flare-ups across the globe over the past two weeks is grounded in broken promises. Aggressive price movements are about the market's confrontation with updated realities. When an especially strongly held consensus is shattered, a market vol event is a likely outcome. In Australia, the RBAs abandonment of YCC is a strong case in point. We've characterized the Fed (and its CB brethren) as, primarily, in the business of crowd control, wielding command over market prices through heft. Sensing its compromised capacity to hold the line, the RBA allowed the dam to break. 3 turns of tightening were reflecting in 2-year yields in a matter of days. So much for the CBs guiding the markets along!

(But)…Is Anybody Listening?

"No Reply at All" is a song about miscommunication between two people in a relationship. And if that is between stocks and bonds, "I can hear my voice shouting out" might be the rate market admonishing the SPX that all is not well. "I've been trying but we cannot connect", added to reinforce the troubling break-down in communication. By mid-week, the discrepancy between an ascendant MOVE and a sagging VIX was well-flagged. Snapshotted on 11/3, the rate vol measure reached the 90th percentile (last 2 years), while its equity cousin sat in just the 12th. While these markets are populated by a segmented series of investors, that's quite an incongruity, worth keeping close at hand. Of the lessons imparted by risk events, one should be that markets incorporate information at different speeds. The SPX reached an all-time high Q3'07 while the credit markets were clearly cracking.

A Brief Accounting Class in Vol

Roughly, we can think of equity volatility as derived from one of 4 places: 1) distance to default (Merton) 2) vol of earnings 3) vol of rates and 4) vol of the P/E multiple. There's overlap in these. Vol in rates, for example, may be related to inflation which may lead to vol in the multiple. In 2008, it was #1, distance to default, in financials that sponsored vol. In 2020, it was #2, vol of earnings as the economy experienced a sudden stop. In 2013, it was #3, vol of rates, in the Taper Tantrum that hurt equities (briefly). In 2000, it was #4, vol of the P/E ratio (those stocks never had earnings to begin with). Amidst a middle of the road VIX, extremely tight credit spreads, pricey valuations and gyrations in risk-free bond prices, what insights can we develop on equity market risk?

Today's Vol...Not Like the Old Vol

The tech bubble and the GFC both saw exceptionally high realized volatility, but from different sources. The characteristics of today's equity market bear resemblance to the original tech bubble. Volatility in share prices today is not about credit risk, but about P/E ratio volatility. Consider that AMZN has 5-year CDS at just 34bps but 2-year implied vol at 28. MSFT has CDS of 24 and IV of 27. For GOOG, CDS is 28 and IV is 27. These stocks move quite a bit. Since June 2020, for example, AMZN has a move in excess of 3% up or down roughly once every two weeks. Default isn't a risk that comes to mind for a company worth almost 2T and with so much cash. Sure, these companies have vol in earnings. But it's also that their P/E's are quite volatile.

Some Comps

It is informative to look at the implied vol profile of stocks that comprise the lion's share of SPX market cap and compare this to a different time when the VIX was at 16. What can we learn? There are 93 companies with market cap > 100bln, 15 of which carry a 3m implied vol greater than 30. There are 6 with implied vol > 40. The simple average of implieds across these 93 companies is 26. How does this compare with 5 years back? This was just before 2016 election and the VIX was quickly ascending on concerns that a Trump win would destabilize markets (2017 was the lowest year for SPX realized since the 60's). Then, there were 38 companies worth more than 100bln. But the average 3m vol of them was 20.2, even though the front month VIX future was at the same level. There wasn't a stock among the 38 billion $ companies that had an implied vol north of 30, let alone 40 or 50. FB was top at 29. GOOG was 21, AAPL was 22 and MSFT was 20.

Single Stock Warning Signs Beneath the Surface of a Benign VIX

Some take-aways are in order. It's not healthy to have the top stocks in the index be among the most volatile. When TSLA adds 400bln of market cap in a hurry, its a sign. When firms like SHOP - 240bln in market cap - move on a 39 vol or PayPal at 272bln market cap moving at a 34 vol, it suggests an "easy come, easy go" loose poker game in markets.

Critically, P/E vol, which best explains current equity market fluctuations, is not the kind of risk that summons the financial authorities. They will ride to the rescue on #1 (default risk) and #2 (earnings risk) insofar as both often coincide with a deteriorating economy. An understatement would be to assert that they will do their best to suppress #3 (rate vol). But a broad re-rating of P/E ratios is not something they've proven to react to. The unwind of the original tech bubble is a great example. We gave back a lot of market cap, but there wasn't enough risk of systemic risk or an economic collapse for the Fed to try to counter it.

"But You're Lookin' Through Me...Like I Wasn't Here at All"

Optimistically, equity markets are saying to the bond markets, "we see you, and it's all good". The pull-forward of tightening cycles and the spasms in rate vol are simply part of the normalization process as the global economy recovers. We should cheer the stock market's capacity to bear these re-pricings. A less sanguine take would suggest a degree of cognitive dissonance. In this version, equity markets are simply behind, failing to appreciate the extent to which low rates have so empowered valuations. Is the ending in plain sight?

And equity vol markets are also singing. Voracious demand for upside calls is back. This is imparting almost outrageous skews on darlings like NVDA and TSLA up a tidy 45 and 57% in a month. Chris Cole of Artemis called the stock market a "derivative of the derivatives market". George Soros once said, "when I see a bubble forming, I rush in to buy it". Both of those statements should resonate. A thematic trade for 2022 should be an efficiently financed hedge program on the QQQ. More to follow.