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MARKET CALLS

Positioning for the Fiscal Cliff

Wednesday, October 3, 2012
Donald Luskin

Markets aren't pricing the coming volatility, but protection from it is eminently feasible.

We continue to get pushback from clients as we discuss the intense volatility event we expect at year-end -- negotiating the fiscal cliff and the debt ceiling after the re-election of President Obama (see, most recently, "Step by Step, Toward the Cliff" September 25, 2012).

- We most often hear some version of "yes, but… I'm sure it will all somehow work out just fine." It probably *will*. But there is *much* more than a fat-tail probability that it *won't*. Even if it *does*, the political brinksmanship involved will create a major volatility event like last year's debt ceiling fiasco (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). And if it *doesn't* work out fine, there will be an instantaneous double-dip Great Recession.
- The worst-case scenarios flow from Obama winning the election, and becoming a lame duck president who feels he has a mandate to raise taxes. Many clients (and it seems we have a great number of politically conservative ones) can't bring themselves to believe Obama could be re-elected. At this time we think he *will* (see "TrendMacro's Election Model" September 28, 2012).
- Even among clients who accept our view of the coming risks, there is an apparent lack of interest in taking action. Some clients maintain that the risks are already discounted in markets, and thus can't effectively be protected against. Others maintain that with so many complexities ahead -- in the election itself, and then after -- it would be precipitous to act now by significantly de-risking.

We must therefore conclude from this very strong anecdotal evidence that -- even though the fiscal cliff is discussed endlessly -- *the risk is not adequately appreciated by investors.* That makes it all the more dangerous, because when it happens it will come as a surprise.

- At the simplest level, we find it difficult to believe that the risks we see are adequately priced with the stock market hovering at four-year highs, and all-time highs on a total return basis (see "New High, Fat Tail" August 22, 2012).
- Observed volatility is very low by historical standards (see "On Ryan at the RNC" August 30, 2012), and has fallen over the last

Update to strategic view

US STOCKS, GOLD: From talking to clients and from observing market prices, we conclude that the intense volatility event we expect for year-end -- as the fiscal cliff and the debt ceiling negotiations start -- is not being priced in markets. This means the reaction to the inevitable shock of recognition will be all the more intense. With stocks at four-year highs, why not at least take a little off the table. But with so much that remains indeterminate about this politically-driven event, various active and passive dynamic strategies that respond to a changing terrain can be put in place. Gold could be a safe haven play here. It is all the more attractive, perhaps even headed for all-time highs, with the Fed flooding the market with new liquidity before the year-end crisis even begins.

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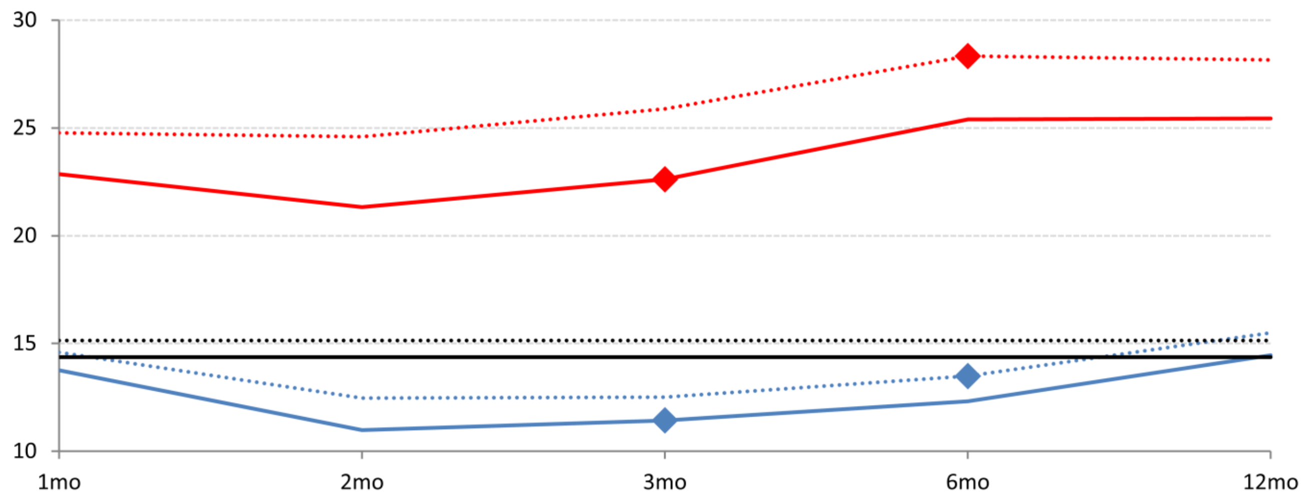
three months, even though talk about the fiscal cliff has become commonplace (please see the chart below).

- If stocks were discounting these risks, prices would be much more sensitive to news flow, and that would show up as higher volatility.
- Option-implied volatility for all tenors -- including year-end -- has also been falling, both for out-of-the-money puts and out-of-the-money calls (again please see the chart below).

S&P 500 OTM implied vol — Puts Q3 end --- Q2 end — Calls Q3 end --- Q2 end ♦ Year-end tenor
S&P 500 actual 90-day standard deviation — Q3 end --- Q2 end



Source: Bloomberg, TrendMacro calculations

- This wouldn't be happening if investors were scrambling to insure themselves against the risks of the fiscal cliff.

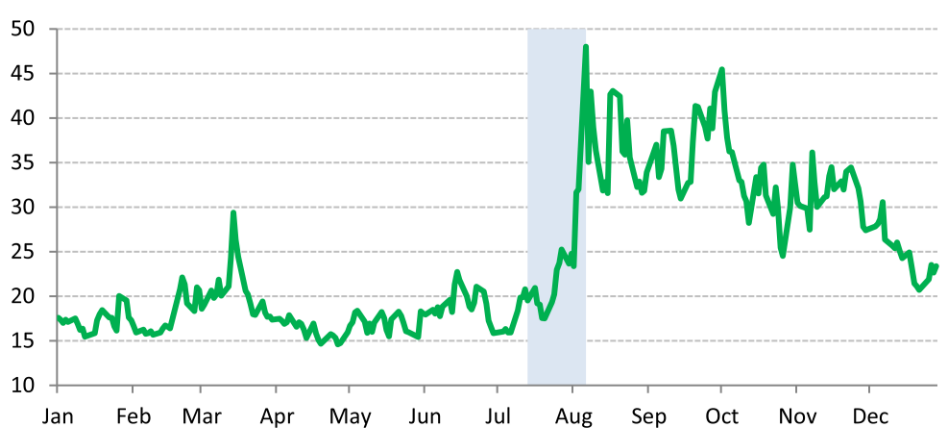
If the risks we are highlighting are not priced, then it there is the opportunity to effectively hedge against them or exploit them.

- For starters, indeed there is no need to significantly de-risk right now, with so much still unknown. But with stocks at four-year highs, it would seem to be sensible to at least take a little off the table. We already made *that* call two weeks ago (see "On the September FOMC" September 13, 2012).
- Yes, stocks are still objectively cheap according to our equity risk premium model, But they're nowhere near the bargain they were a year ago when we called the bottom (see "Europe Fails, US Stocks Flail" October 4, 2011) -- the S&P 500 is up 31.4% since then, while forward earnings have risen only 4.1% and long-term interest rates are unchanged. Sadly, it seems to be human nature that they were difficult to buy *then* when they were really cheap, and are difficult to sell *now* when they are so much less so.
- Be that as it may, the risks we face toward year-end will evolve between now and then, and will be very event-driven. There will be opportunities to adjust exposures as the election outcomes become clearer, and as the various players in the year-end political

confrontation first launch trial balloons and then eventually crystallize into negotiating positions. Our mission is to discover, interpret and suggest how to act on these events.

- That is an "active management" approach to the challenge. There are "passive management" approaches as well -- driven not by qualitative interpretation of events, but by quantitative responses to changes in markets as events unfold.
- One passive approach is dynamic hedging, or what used to be called "portfolio insurance." By this we mean adjusting risk exposure pro-cyclically -- that is, selling risky assets when their prices fall, and buying them when their prices rise. This creates a pattern of returns similar to owning a protective put option, with similar costs. We have deep battleground experience in such strategies, dating back to the heyday of "portfolio insurance" in the Crash of 1987; we would be happy to talk privately with any clients who are interested in pursuing something along these lines.
- Another passive approach would be actually buying puts -- possibly deep out-of-the-money puts, which would seem most appropriate for clients who are skeptical about the dangers ahead, but nevertheless might wish to have at least some hedge. Such puts would involve modest expense, especially as implied volatilities have been falling.
- Implied volatilities of calls are lower than those of puts (this is typically the case). This differential can be exploited by creating low-cost "synthetic puts" -- by simultaneously selling stock and buying calls in an appropriate ratio.
- Yet another passive approach would be to hedge by betting on volatility itself -- through the various new instruments tracking the VIX Index -- not the direction of stock prices. Remember, even if ultimately the coming fiscal cliff and debt ceiling crisis turns out just fine, along the way the brinksmanship involved will surely raise volatility sharply above its present quiescent level.
- Consider what happened in July and August of last year when we faced *only* a debt ceiling crisis. It turned out fine (again, see "Debt Ceiling Crisis Over -- Now What?"). But from Standard & Poors' first

VIX Volatility Index 2011
Debt ceiling crisis, from S&P warning to BCA to S&P downgrade



Source: Bloomberg, TrendMacro calculations

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[About us]

Recommended Reading

Toppling Off The Fiscal Cliff: Whose Taxes Rise and How Much?
Roberton Williams, Eric Toder, Donald Marron, and Hang Nguyen
Urban Institute and Urban-Brookings Tax Policy Center
October 1, 2012

A Circular Relationship Between Political and Economic Views
Nate Silver
New York Times
FiveThirtyEight
September 29, 2012

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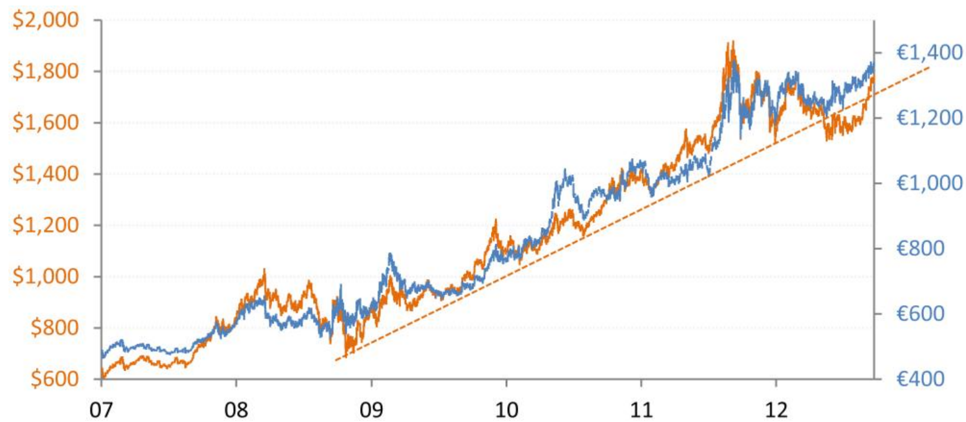
warning, through the chaotic White House negotiations and the Budget Control Act, and finally to the S&P downgrade -- over just three weeks -- volatility tripled (please see the chart on the previous page).

- Another possible response here is gold. If the fiscal cliff and debt ceiling crisis plays out as we expect, gold could function as a safe haven in a time of panic.
- To be sure, gold did not successfully serve that function in the panic following the fall of Lehman Brothers in September, 2008. But that's because the post-Lehman environment was one of intense liquidity-shortage, in which no asset -- including gold -- was as precious or scarce as cash.
- A crisis at year-end probably wouldn't have that characteristic -- indeed, quite the opposite. We think this is one of the reasons the Fed announced QE3 when it did, and in the form that it did -- to create a liquidity reserve so that the post-Lehman squeeze wouldn't be repeated. The flexible and unlimited nature of QE3 is in some ways problematic (see "Rethinking QE3" September 18, 2012), but it is just what the Fed would do if it were expecting another panic.
- If a panic comes, the Fed will have created a great deal of liquidity -- and we can be sure it will add more. Gold is already at all-time highs priced in euros, where the ECB has announced unlimited bond purchases if Spain or Italy need bailouts (please see the chart below, and "On the September ECB Policy Decision" September 6, 2012). With the Fed similarly preparing for a crisis that seems just as inevitable as a Spanish bailout, why shouldn't gold make all-time highs in dollars, too?

Gold — USD — EUR



Source: Bloomberg TrendMacro calculations

Bottom line

From talking to clients and from observing market prices, we conclude that the intense volatility event we expect for year-end -- as the fiscal cliff and the debt ceiling negotiations start -- is not being priced in markets. This means the reaction to the inevitable shock of recognition will be all the more intense. With stocks at four-year highs, why not at least take a little off the table. But with so much that remains indeterminate about this politically-driven event, various active and passive dynamic strategies that respond to a changing terrain can be put in place. Gold could be a safe haven play here. It is all the more attractive, perhaps even headed for all-time highs, with the Fed flooding the market with new liquidity before the year-end crisis even begins.