Life in a Video Game

No, I'm not talking about virtual reality or our efforts to use and understand AI chatbots. I'm talking about markets.

Video games let you do things extremely fast. You can conquer the world or play a single NFL season in a couple of days. Anything is possible and it happens quickly so you can do it over and over again.

This week saw two such examples:

- We started with the **recession** theme gaining traction and ended up believing in the "soft landing" scenario. WTI was the poster child of this fast paced "game" dropping from $77 to $68 (and finishing at $71).
- Apparently, **we had (and fixed) a banking crisis this week**. We did that in a week for the second time this year! While banking stocks ended the week down, there were some eye-popping moves to the upside on Friday.

I'm not incredibly bearish. I've been moderately bearish and despite Friday's strength, the S&P 500 closed down almost 1% and the Nasdaq 100 was fractionally positive**. I'm loath to bring up this next topic, but I feel obligated to do so.**

I HATE the Big Short

This is ground that we've covered before, but between what is going on and my thoughts on Mommy, Where Do Bond Losses Come From, I felt that it was time to reiterate some long-running themes. The bond loss piece we published on Thursday is worth a read if you missed it.

I HATED the Big Short. I like Michael Lewis a lot. *Liar's Poker* is still my first recommendation for anyone thinking about working on Wall Street (with the number of veterans reaching out to Academy Securities, we've likely bumped up sales). This has nothing to do with Michael Lewis, but everything to do with how the story was told.

It took me a few years to even crack the book open. I lived through the crisis trading CDS indices at the time (IG, HY, XO (what a beast), and LCDX). We traded with many in the mortgage market as people were trading ABX ("blowing up the world" fame) against the other markets. Some of the biggest mortgage players were big components in the CDS indices (WAMU, Countrywide Financial, etc.). So, the tickers and the trading were forever seared in my mind (not in a good way) and I was reluctant to read the book.

I finally fought my way through the book and have only one complaint, but it is **a big complaint. The book made it sound like only a couple of people figured out the "problem"**. For the record, I still cannot bring myself to watch the movie despite being told it is really good.

Very few identified the problem, found the best way to execute the bet (AAA ABX), had the staying power to be in the trade when it started to crack, **AND** had the conviction to stay in the trade throughout various powerful rallies.

The story took years to play out. Investors had been bearish on this segment of the market as early as 2005 and there was no better example of "**early equals wrong"** in financial markets than those trades. 2006 saw more people get bearish. Early 2007 created even more bears (and an inordinate number of "why ABX is cheap" teach-ins by Wall Street). **So it wasn't that only one or two people figured something out, many figured it out too early, which I think is a useful lesson in this "video game"**

environment that we are trading in!

The first big cracks in the mortgage backed market started in 2007. Yet, after some serious Fed intervention, stocks hit new highs in October. Then things cracked again, with CDX IG almost breaking 200 in the days before Bear was bought by JPM. And yes, you guessed it, we went back to very tight levels on credit in the summer of 2008. Lehman was in the autumn of 2008 and was just one of many pivotal events that fall. The stock market didn't bottom until March 2009!

While the "**Lehman Moment**" might be useful (Lehman Was NOT a Moment), the process was long and created plenty of opportunities to make and lose money in every direction.

The main takeaway is that the market treated things as "solved" multiple times during those years, only to find out that they really weren't solved (or that we had moved on to some other issue, more often than not triggered by one of the earlier problems).

I'm Not as Bearish as the Paragraph Might Make It Seem

I've been sitting at a -4 (on a scale of -10 to 10) on equities for about a month (S&P 500 up 0.76% in that time, Nasdaq 100 up 1.5%) and only this week did I downgrade credit risk from neutral to -4.

If anything, despite the prior section, I'm tempted to nudge my risk appetite closer to neutral (or even positive).

The **two things that I liked about this week**:

- **Good news was good on Friday**. The Jobs data was "good news" from an economic standpoint as discussed on Friday. The 2-year yield jumped 13 bps (from 3.79% to 3.92%, which used to be a big move in 2-year yields). The market, rightfully so, believed that the data could push the Fed to think about a hike in June rather than being done or cutting.
- **Earnings are almost done and discretionary buybacks are ramping up**. The buybacks are one very powerful tool against the headwinds of QT. With many stocks well off their highs, there should be strong use of buybacks, even in this higher-yield environment.

I did not like the fact that chatter about investigating short trading in bank stocks on Thursday/Friday contributed to the strength. My experience through the GFC and the European Debt Crisis is that banning shorts tended to have very limited impact and made things worse if and when there was another round of weakness (as there would be no "short covering" bid).

Bottom Line

I'm being stubborn by not budging on my equity/credit rating. I probably should be nudging it closer to neutral, but I cannot bring myself there.

Beyond that, some "vague notion" that I have is percolating into something that could be a plausible tail risk event. I'm still toying with how it could play out, but "bond losses" due to forced selling, the over eagerness to claim victory over each crisis, and the increasingly dismissive attitude towards the uber bears (who have had a few recent victories) are crystalizing into some sort of tail risk.

That tail risk, while still nebulous, is lurking somewhere in the bond market. As discussed in "where do bond losses come from", the debt ceiling (however chaotic it becomes, including the risk of failing to pay some debt on time) has the potential to be a catalyst. We could see, for a variety of reasons, bond selling outpacing bond demand too quickly, which could cascade into other assets. Again, I haven't latched onto that scenario, but it is what I'm thinking about a lot right now. Also, at least so

far, the chatbots haven't identified it, so there might still be the need for human thought😊.

On rates, we are rangebound for now. 3.55% on 10s seems to be a buy, while 3.30% seems like a sell. There might be some tail risk to either side, but it isn't obvious to me unless some geopolitical event occurs, which would more likely create a flight to safety trade.

On the front-end, the market got ahead of itself and continues to be too optimistic that the Fed will enter cutting mode. I don't like the 2-year here, as it should be yielding more, and therefore believe that 2s vs 10s will get more inverted**. However, that trade was briefly crushed this week (before the recession was avoided on Friday).**

With a high degree of certainty, I'd advise issuers to issue sooner rather than later. Summer is fast approaching on what has been a tiring start to the year for most asset managers and the debt ceiling (amongst other things) creates some uncertainty.

And while both the issues facing the banking system and recession risk were "resolved" this week, we don't live in a video game or a book. This is why I am unchanged on my risk outlook. This weekend, maybe I will guide the Bills to a Super Bowl in Madden or I'll enjoy the nice weather and play golf (something chatbots can't do by the way).

Enjoy the rest of this weekend and if you missed the China focused Academy webinar on Tuesday, it is also worth watching. While it is a bit concerning in some respects as **Generals Walsh and Marks** pull no punches about the current geopolitical atmosphere, it ends on a positive note!

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