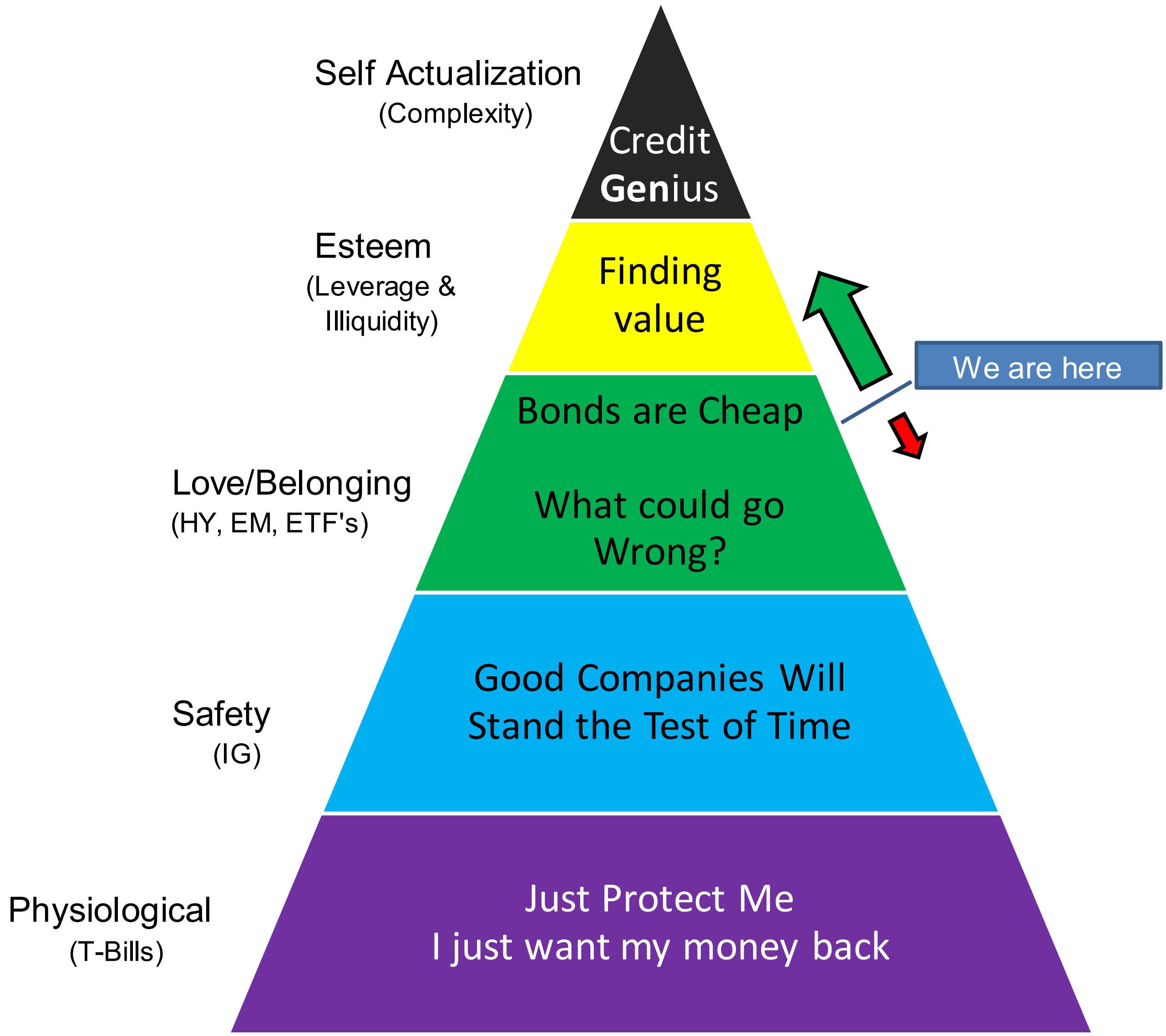
Maslow's Hierarchy of a Credit Bubble

Anyone who has had to sit through one of my presentations knows that I like to start with this slide. I think it does a very good job of encapsulating the emotional elements that impact markets.



In Maslow's hierarchy (in case you didn't take Psych 101 😊), a level needs to be fulfilled before the next level can be addressed.

I think in 2007, we hit the "Credit Genius" level. By the end of 2008 and early in 2009, we were way down to just wanting T-Bills. In my opinion, we've never made it close to "Credit Genius" since then, though we've gotten back to the "I can Find Value Anywhere" level, which we are approaching again (if we are not already there).

Back in March, you could see Investment Grade cracking, with even short-dated bonds and commercial paper struggling to find a bid. We were on the cusp of breaking back into the T-Bill only level, when the Fed and Treasury Department launched a series of new programs and ultimately D.C. pulled the CARES Act together.

At the risk of repeating myself, **credit is getting more aggressive (we are seeing more risk taking and more willingness to delve into structured and illiquid risk), and that trend is moving further up the scale**. That movement is supportive of credit spreads. Having said that, we are a long way from the excesses in the credit markets that we saw in 2007.

Let's call it heated, with the threat of froth, or in Maslow's terms, "Esteem", where we can all feel pretty good about our market.

Credit Bubbles Only Start with "Safe" Assets

I won't belabor the point, but this is one of my favorite topics of discussion. For all the worry about leveraged finance, distressed debt, private debt, you name it, **the risk to the credit market will almost certainly come from something that is currently deemed as "safe".**

Why would "safe" assets and not risky assets cause the problem?

- Investors put money they might need in "safe" assets. They have no expectation of loss, so any fear causes problems.
- Safe assets often attract leveraged investors, who prefer to heavily lever a safe asset, than go to riskier assets (longer out the maturity curve or lower down the credit spectrum).
- Banks tend to hold safe assets and to really be a bubble threat, banks need to be impaired when the problem starts.
- I am not sure how best to describe this phenomenon, but I've seen it repeatedly. It is at that moment when **investors go from trying to eke out a fraction of a bp here or there, to making the "Home Alone" face and realize just how many billions they have on the books (if something goes horribly wrong**.)

That is why I believe the risk is always from "safe" assets in credit. **Historically, there is evidence to support that**:

- **The S&L Crisis**. It was safe mortgages where the banks messed up the interest rate hedge that caused that massive problem.
- **The Russia & Long Term Capital Management Crisis**. Many investors viewed it as highly unlikely that a sovereign would default (restructure maybe, but not default.) Russia caught one set of participants offsides. Then LTCM had massive bets on 'tiny little things' like swap spreads. Few people outside the diehard industry experts paid much attention to swap spreads, until the 'mean reverting' strategy that was largely being employed by LTCM failed to revert (much like casinos put table limits on so that you can only double so many times). They also had massive bets on yield to call high yield/emerging market corporate issuers that got called just in the nick of time, to delay their problems by a few months. But the point is that these were not the markets people were scared of, but they were the ones that got us.
- **Let's call it Enron and WorldCom for lack of a better name.** It wasn't that IG went bad; it was a sudden fear that IG wasn't actually IG. That fraud caught people so much by surprise that it not only required massive portfolio shifts due to the losses, but also an entire change in mindset as investors evaluated companies and questioned rating agencies.
- **The AAA Mortgage Backed Crisis.** It wasn't just mortgages. It wasn't just the AAA tranche of a

typical collateralized mortgage obligation (CMO), it was the AAA tranche of the re-tranching of a bunch of BBB tranches of normal CMOs. Mistakes were made all over the place, both with the assumptions used to determine that something was BBB (those mistakes were amplified), and some new ones were added when getting to the AAA rating of the tranches of tranches (CDO squared). There was also Leveraged Super Senior (LSS), SIVs, and Constant Proportion Default Swap Obligations (CPDO), all of which either had high ratings or were deemed to be very safe. They turned out not to be (in some cases, because liquidity assumptions were built into the structure and those **liquidity assumptions weren't even close to accurate in times of stress.)**

- **European Sovereign Debt Crisis.** Italy was equal to Germany. Spain was equal to Italy. Greece was equal to Spain. Or, to complete the chain, Greece was equal to Germany (until it wasn't).

If I had to pick one area to worry about, it would be commercial real estate (CRE). I am not worried about it, especially as I expect stimulus and the defeat of COVID, but here is why it shows up on my radar screen:

- It is generally viewed as safe.
- Banks of all types, from your neighborhood bank to your global behemoth, all own it.
- **It hasn't crashed recently.** That may seem like an odd reason to be concerned, but if you believe, as I do, that the crashing cleanses a lot of the problems that build up over time, then you can see why this subset may have some risk of being overconfident (or, in Maslow's hierarchy, they might be a little closer to the apex than investors in other markets).

I am not worried about CRE, I just wanted to play devil's advocate. In fact, I own it and like it because of my views on stimulus and the battle against COVID, but it does catch my eye from time to time and I think highlights the type of thing we should be looking at to get ahead of any potential problems.

Bottom Line

Credit spreads will trade around, currently I'm looking for some spread widening, but I'm comfortable with credit risk here and think it is poised to do well.

Maslow's Hierarchy of an Equity Bubble…

I must admit, off the top of my head, I'd say that we might be in the "Equity" Genius phase of things.

Starting to read a lot of notes about structured products linked to the most successful equity ETFs. The various forms of private equity are all deemed to be "perfectly safe" (admittedly an exaggeration, but there is a bit of that feel.) The number of day traders trading factions of weekly call options seems "unique" to say the least.

When I think about "safe" I also always think about 1987 where "portfolio insurance" gave a perception of safety that failed, or all the people who said that the inverse VIX products "couldn't" blow up, in the weeks ahead of them blowing up.

Maslow's hierarchy of an equity bubble is outside my thought process, but…

Why I Hated the Big Short

I hated Michael Lewis's Big Short. I hated the book and I couldn't stomach the movie. Why?

Because I lived through the Big Short. I traded CDS indices with some of the characters. I occasionally traded the ABX indices themselves, but that isn't why I hate the book (a lot of the book got the trading and overall environment correct).

I hated the book because they made it sound like these were the only people who figured out that particular bubble. That no one else on Wall Street saw the risk or how fraught with problems the market was. People figured it out – in 2005, in early 2006, in late 2006, and even in early 2007, but they all got stopped out, or didn't have the stomach for a market that relentlessly ground against them.

The Big Short people got it right, and I'm still impressed how several of them stuck through the bounce in the spring of 2007 (I remember buying some BBB ABX tranche because every dealer was in the process of hosting calls on how good they were, and made some money, before going back to my knitting.) It was tough to stay short through some nasty bear market rallies and it was impressive that they did.

But I also remember having to close out the entire short CDX book of a trader who reported to me, because after small losses, management couldn't see how credit could ever go wider.

My takeaway is that lots of people "figured" out the problem, just far too early, which in this business, is the same as being wrong.

So even if something might be getting bubblish, which I don't think we are seeing in credit and probably not in equities, it can take a long time for that bubble to burst, as many of us learned the hard way back in 2005, and 2006, and 2007 😊.

More just things to think about rather than any investment recommendations.

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