

Volatility in the Age of Trump

The world changed the night of November 8th when Donald Trump rode a wave of populist anger to become the president elect of the United States of America. Many readers of our investor letters know that Trump's victory was not a surprise to Artemis... as I observed with fascination how many of friends and family from my birth state of Michigan, most of whom voted for Obama the last two elections, reluctantly admitted in private they were supporting Trump. I cautioned, both in writing and during a speaking engagement at the EQDerivatives Conference in May, that the market was dramatically underestimating the probability of a Trump victory given socio-economic factors and age demographics in swing states like Michigan and Florida. What the consensus failed to see is that the election was not between a Democrat and Republican, but rather a Globalist and a Populist. America wanted a populist of one vintage or the other. The Democratic party didn't lose the election in November, but in the summer, when they suppressed their alternative populist candidate in favor of an oligarch. This is just the beginning--- I'll double down this a passage from my June 2016 Letter to Investors.

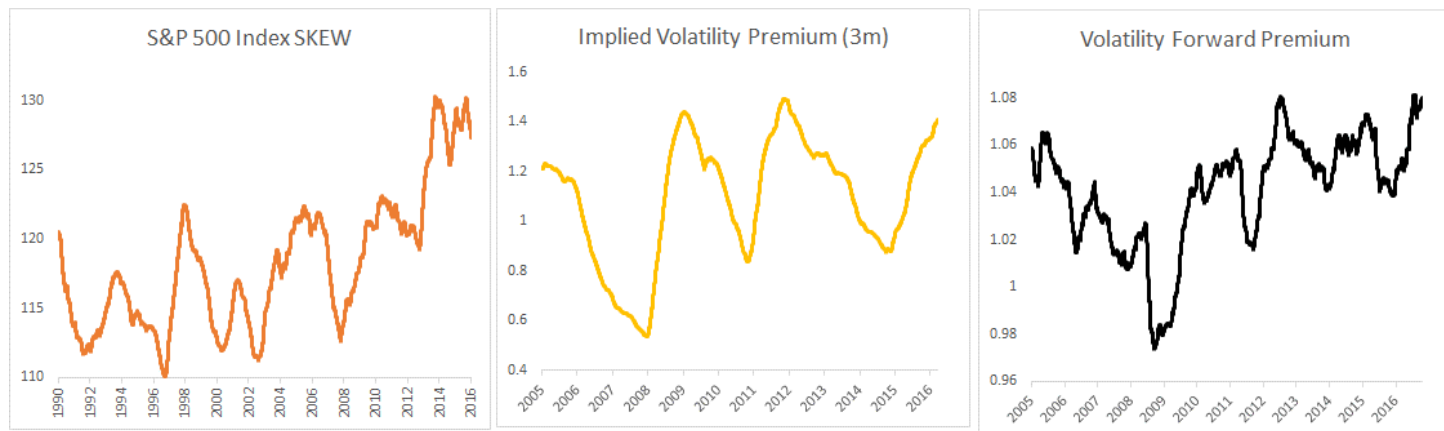
"Brexit is nothing less than the Bear Stearns of populism, a shocking rejection of globalization that has many technocrats now openly questioning the very wisdom of democracy itself. If I am correct, a Trump presidency and/or breakup of the European Union will be the "Lehman Brothers". This is only the beginning of a rising anti-political establishment movement in the US and Europe that will have major ramifications for asset price stability going forward. Winston Churchill once said that the more you look backward the more you will see forward. To this effect, the 1930s provides a template for today, whereby a period of competitive devaluations (UK, US, and then France), class war, alternative politics, and economic isolationism led the world down a very dark path."

Artemis Capital Management June 2016 Investment Letter

What Trump Means for Volatility Trading

Trump is a boost to volatility traders (but not traditional hedging or tail risk) because of his inherent unpredictability. Never before in history has a president been so able and willing to shift a policy debate with a tweet. In a world where we have gotten used to parsing Fed statements for methodically planned hints on policy shifts, **Trump is a protectionist bull in a china shop.** Trump will keep the price of uncertainty high, and high uncertainty is very good for the business of dynamic volatility trading, but oddly poses a challenge for traditional hedging and tail risk funds.

Uncertainty and volatility are not the same thing. 2016 was a year of **low volatility** but historically **high uncertainty**. For example, although the VIX index averaged only 15.82 in 2016 (36th percentile of observations) investor hedging drove the expectation of vol to historic highs as measured by skew, implied volatility premium, and volatility forward premium.



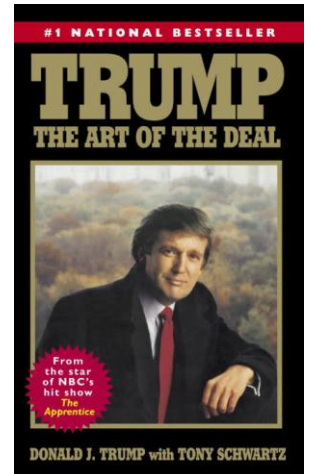
Traditional hedging and tail risk will struggle in an environment where markets remain calm and the cost of uncertainty remains high. Dynamic volatility traders can perform because we can recycle higher priced uncertainty to achieve a better return profile on long optionality. For example, this year Artemis found value by recycling overpriced skew and term premium into volatility-of-volatility and vol-of-vol-convexity.



Trump is the start of Global Regime Change

Trump is the first “populist” US president since Andrew Jackson in 1829 and takes office with a mandate to reverse the course of globalization. Denial is not a strategy and it’s time to face the reality that is coming... the good, the bad, and the ugly. First off, stop underestimating this man – you don’t become leader of the free world through stupidity and luck. The rants and twitter storms are part of a strategy of media control and distraction. Trump knows that if you can’t win, then you change the rules of the game – this is what he has already done with American politics – and what he is about to do to the entire Post-Bretton Woods World Order. If you really want to know a person, watch what they do, and not what they say... or what they tweet.

Trump’s business career was largely comprised of three core strategies **1) Leverage 2) Restructure 3) Brand...** in that order. Throughout the late 1970s and 1980s Trump rode a generational decline in interest rates and debt binge to purchase a range of high profile real estate projects including the Grand Hyatt (1978). Trump Tower (1983), the Plaza Hotel (1988) and the Taj Mahal (1988). In the 1990s he went through a total of 6 bankruptcies due to over-leveraged hotel and casino businesses in Atlantic City and New York. In the 2000s he pivoted to move away from debt-driven property investments to building a global brand through the “Apprentice” TV show. Trump will run the country as he ran his businesses.... He will lever, and lever, and lever, and lever... and lever... and then restructure his way to success, or whatever success is defined as by the broadest measure of popularity at any given time. Trumponomics, if it delivers, will be a supply side free for all: massive tax cuts, deficit spending to create jobs, financial and energy deregulation, business creation, and trade protectionism all driving inflation. More importantly, Trump sees bankruptcy as a tool and not an obligation and will have no problem pushing the US to the limits of debt expansion.



“I do play with bankruptcy laws, they’re very good to me!” he once said. Trump may be willing to bring the US to the brink of default if it produces middle class jobs and popularity, and what he understands is that nobody can stop him, not Europe, not China. In a Trump mindset, the US national debt and deficits, or prior commitments (e.g. NATO), are not to be taken seriously as long as we hold all the cards... namely the biggest military in the world, energy independence, world reserve currency, and the world’s largest buyer of consumer goods. He is dangerously right, these geo-political solvency tools are far more powerful than the bankruptcy laws he used to protect his casino assets... the US is just another, bigger, badder, more bankrupt casino with air craft carriers. The media doesn’t seem to understand that Trump’s overtures to Russia and Taiwan are not diplomatic gaffes but rather forms of economic leverage. He is reminding Europe that NATO is **nothing** without the US, and reminding China that creditor nations lose trade wars. As a negotiating tactic, it may work ... or may drive the world to a hot war... or both.

Like it or not --- the old rules are gone. Diplomacy has been replaced by Twitter, and the unexpected is now to be expected. Trump’s world is a zero-sum game – and this means a shock doctrine of US centric re-positioning in trade in a dramatic change from the post-World War II order. The US has the largest military, the best geography, best technology innovation, the largest economy, best demographics in the developed world, and shale-driven energy independence to boot.

Trump won the election by funneling the frustrations of the marginalized white middle class voter humiliated after three decades of wage stagnation... he is the “super-ego” of the American Middle Class... and Trump will restructure the global order to make that voter happy if that is what it takes to get him re-elected.

Trump’s biggest and newest brand is the U.S.A., and he will use **nationalism** and every **publicity stunt** possible to create spectacles of economic and military success.

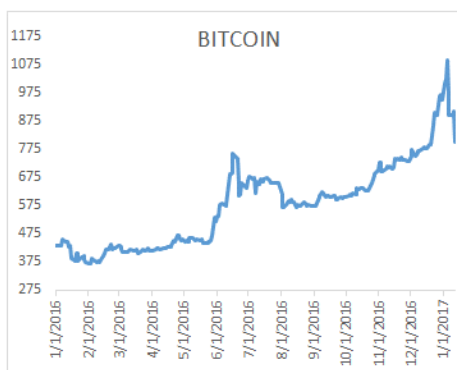
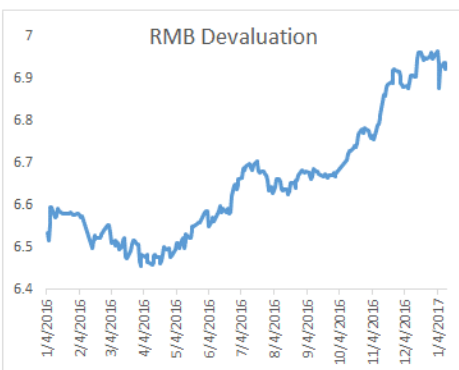
All bets are off, and that is very good for volatility... but potentially very turbulent for the world.



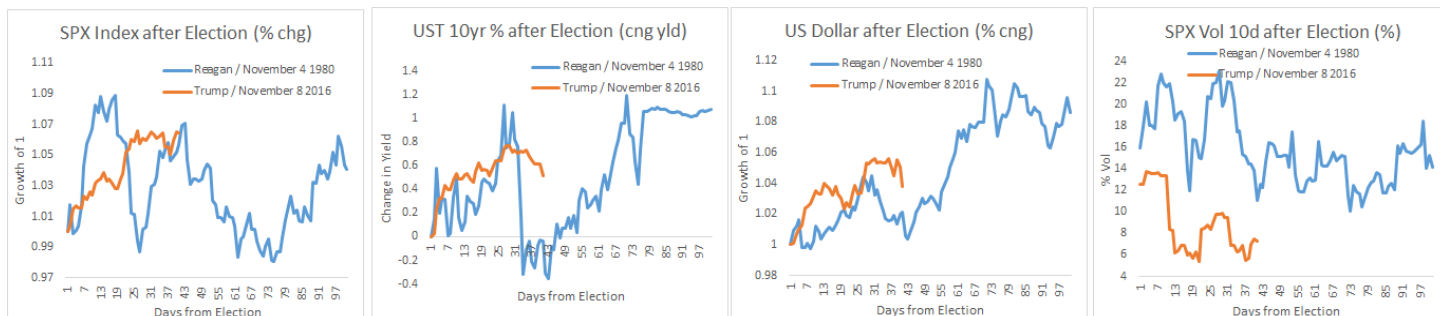
The Trump presidency will mark the reversal of the Post-Bretton Woods World Order ending a multi-decade regime of reflexive globalism. Ever since the 1970s the world been dominated by a self-reinforcing arrangement between Developed-Debtor and Emerging-Creditor nations driving generational trends in currencies, commodities, interest rates, and stocks (see chart). The US provides the largest consumer base in the world, military protection of global trade routes, developed financial markets, and willingness to take on debt -- and the developed world produces cheap goods and in turn buys debt and dollars reinforcing the monetary-military reflexivity. Asset prices rise, debt expands, commodities rise, developed world inflation stays tame, and interest rates drop. The net effect is that the US exports its middle class and inflation abroad and the emerging world absorbs that inflation creating a new consumer class and social stability for authoritarian regimes (China). The financiers, technologists, and emerging world industrialists get richer and richer, while the developed world middle class is marginalized.



Trump marks a populist rejection of this global arrangement, which is going to send the entire world order down a very unpredictable path. Do not underestimate the probability that Trump will not serve out his full term – you do not threaten a multi-decade system empowering a transnational class of global elites without a bloody fight. The rally in the USD is more than just trade protectionism, it is about security and capital flight in anticipation of the new world order. For the US, Trump may be good in the short term but drive **stagflation** in the long term. For Europe and China, he will be a disaster. Volatility will be forthcoming, but it will be worse internationally than in the US. Markets are dramatically underpricing the three-year forward probability of a European Union breakup, and China’s debt bubble collapse, both of which have been probabilistically amplified by the Trump victory. For evidence of the later consider the current USD funding crisis that is causing inter-bank lending to spike in China, stealth devaluation of the RMB, and surges in Bitcoin. History serves as a guide to periods whereby globalism turned into isolationism, namely the 1910s and 1930s... and the lessons we can apply from those eras to today are further financial crises and higher probabilities of armed conflict between Russia vs. Europe, Iran vs. Saudi Arabia, and China vs. Japan in the next decade. Fourth turnings do not happen quietly.

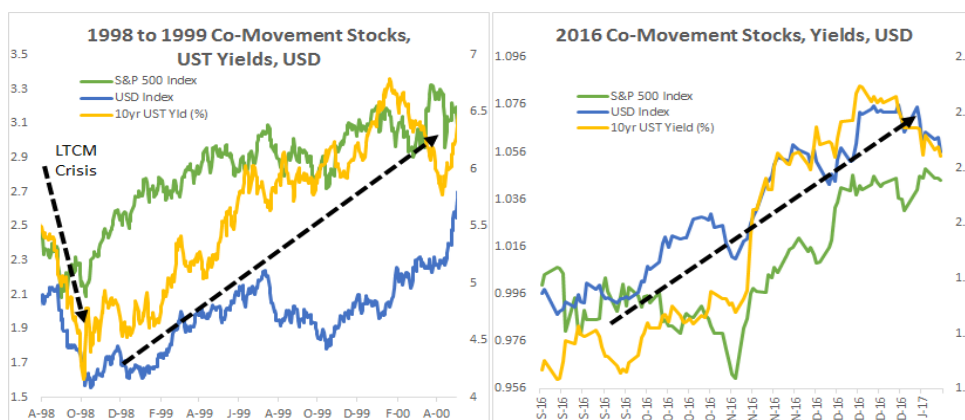


The Trump promise of fiscal stimulus, de-regulation, and trade barriers has sent the USD soaring, the stock market higher, market sentiment to all-time highs, and nominal yields back to their highest levels in three years. All-in-all the rally appears a little overdone. It's eerily similar to the rally that occurred after Reagan was elected in 1980, but the comparison should stop right there. In 1980 the S&P 500 index sported a PE ratio of 9x compared to 21x today, the 10yr UST yield was over 1100 basis points higher at 13.56%, US Debt to GDP was at 30% versus 105% today (not including off balance sheet liabilities and social security) and the top marginal tax rate was 70% vs. 39.6% today. The idea that Trump's election somehow changes world demographics and deflation overnight, is about as naive as giving Obama the Nobel Peace Prize in 2009 for his role in ushering in a new era of global peace.



When looking at the effect of Trump, I don't see a return to the 1980s, but rather the late 1990s. The aftermath of the Trump election resulted in an unusual positive correlation between the USD, Yields, and the S&P 500 Index. The last time the USD, Stocks, and UST yields both rose and fell simultaneously was at the height of the dot-com era in 1997-1999 (2008-2009 also experienced periods where all fell). During the late-1990s all three assets rose and declined in concert as the market gyrated between irrationally exuberant growth and international crises (Asia and Russia Default). High volatility and a bull-market co-existed during this time as the VIX averaged 25 between 1997 and 1999 (compared to 15.8 in 2016) as the S&P 500 index rose +98%. If supply side stimulus and animal spirits released by Trump amplify the current bull-market and lead to inflation, expect the second order effects of his policies to cause violent bouts of international turbulence and drawdowns reminiscent of the Asia (1997) and Russia (1998) crises two decades ago. The extent which international turbulence causes significant US equity volatility will depend on contagion effects. For example, in 1998 it took several months for the effects of Russia's sovereign default to spread, eventually threatening the US financial system via the contagion vehicle of Long Term Capital Management. Expect a similar pattern for a banking crash in China, EU breakup, or regional war.

In the late-1990s overvaluation was concentrated to one asset class with ample room for policy response. Today there are historically high valuations in equities and fixed income coupled with high sovereign debt, unprecedented central bank balance sheets, and poor world demographics. Low beta and high dividend index stocks are the new dot-coms. According to S&P Capital IQ, Russell 2000 index stocks carried a 62 percent valuation premium over non-index stocks in 2015, rising from just 12% in 2006. This time around it may not be possible to print our way out of the next crisis... so mechanisms are already being put in place to "freeze" the assets inside the system... essentially a global version of the Cyprus "Bail-in"... but that is a different story for a different investment letter.



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