INVESTMENT NOTES: WEEK OF OCTOBER 21-28, 2018
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I am re-sending these investment notes as I believe they are important in the context of the recent weakness in the equity markets.

There is also not much new news out- China's income tax cut is not a surprise and was mentioned in last week's notes, speculation about mid-term elections is just that- let's see what Trump promises or if he says- getting a Republican Congress elected is 'not my job', Theresa May's Brexit is on the knife edge- but probably something will be worked out as the stakes are too high for all concerned.

Europe is the place to watch. Italy missed the fate of being downgraded to junk but we are one step closer. More importantly, it appears Angela Merkel's days might be numbered. If she is no longer leader of her party (the convention is the first week of December) the stability of the EU will be shaken- just at a time when it needs to be strong. Brexit, Italy, Populist movements in other EU countries, France's unions- all to a certain extent depended upon a stable and conciliatory Germany to 'make everyone play nicely'. Without that influence, the EU not only will miss its major funder but also its 'raison d'etre'.

Last week the fund cut its holdings of Amazon and Alibaba in half. We are still positioned very conservatively and believe there is too much uncertainty coming up for investors to take big positions before the end of the year. The only potential buyer would be corporate share buy-backs as they are once again outside the blackout period after reporting. These buybacks are predicated on low interest rates. It will be interesting to see if the C-Suite of the USA believes Fed tightening is temporary or will continue- if they believe it will continue- they will probably look at December to be perhaps the last time to increase their share prices (and their bonuses) with buy-backs.

Investment Notes- Week of August 12-19th, 2018 (The Week Amber Opportunities Launches!)

Two short volatility products imploded in early February this year when the VIX spiked (the CBOE Volatility Index spiked up 95% in one day) and equity markets dropped fast. VIX is now back to its pre-spike days and the S&P is close to its all-time high. We are going long VIX in our new fund since we remember that two Bear Stearns hedge funds collapsed in mid-2007 raising the awareness of potential problems in the mortgage markets although it took the best part of a year for equity markets to begin reflecting the extent of the problem. Do the February implosions of the VIX short funds forecast ugly events as the Bear Stearns funds did?
We think they might. Here are the facts: 1. The two funds that imploded were a miniscule part (approximately $3B) of the estimated US $1.5-2.0 Trillion worth of short-volatility exposure in the market.
2. Share buybacks reduce volatility and are now running at an all-time record high.
3. Buybacks have been funded by corporate debt. Non-financial corporate sector debt has risen by 48% from a low of US$6.04 trillion at the end of 2010 to US$8.95 trillion at the end of 2017. 4. This corporate debt has been issued at increasing advantageous terms (covenant-lite) to the borrower as investors chase yield. 5. A large slice of this debt is held in Bond ETFs- which can be called to liquefy daily (or moment to moment) whereas the underlying bonds cannot be sold so easily- therefore a liquidity mismatch. 6. There is a potential credit time bomb approaching with rates rising and maturities approaching.
Investors are only looking at the explicit volatility products- the VIX ETPs and say it is only 5 billion dollars and the total of explicit products is estimated at $60 billion. However, implicit short-volatility strategies-

strategies that may not be directly shorting options, but use financial engineering to mimic the components of a short-option portfolio is equal to about $1.5 trillion. If stocks and bonds sell off together- there will be a disorderly withdrawal of liquidity which will result in increased volatility and a very quick deleveraging of the implicit short-volatility strategies. (these numbers are only for the US although the short volatility trade is widely practiced across all major countries and asset classes). Shorting volatility has become an alternative to fixed income.

Here's how the Explicit Short Volatility trade and the Implicit Short Volatility trade breakdown:
Explicit Short Volatility: $60 billion
VIX ETPs: $2 billion
Speculative VIX: $3 billion
Pension Overwriting: $45 billion
Option Funds: $8 billion
Implicit Short Volatility: $1.4 trillion
Risk Premia: $250 billion
Long equity trend following strategies: $175 billion
Volatility Targeting: $400 billion
Risk Parity: $600 billion

Share buybacks are a major contributor to the low volatility environment because a large price insensitive buyer is always ready to purchase the market on price weakness. There is no coincidence that the largest equity drawdowns of the past few years have both occurred during the share buyback blackout period (the SEC prohibits buybacks during/after earnings announcements- this is known as the blackout period). 6 of the top 10 multi-day declines of the VIX have occurred when buybacks have had record days. Buybacks result in lower volatility, lower liquidity- which incentivizes more share buybacks and therefore more short volatility strategies.

But the biggest problem is the credit that has fueled these buybacks. The planet has never had this much debt (244.4% Global debt to GDP (excluding the financial sector). Notice that the financial sector that was the source of the last debt problem is excluded (they have actually de-leveraged). US Corporate bond issuance was $711 billion in 2008 and is now $1.6 trillion in 2017.

We also need to remember that corporate debt is not liquid. There has been a collapse in corporate bonds owned by brokers/dealers relative to the surge in such bonds owned by mutual funds and ETFs. The ratio of US mutual funds' and ETFs' holdings of corporate bonds owned by brokers/dealers has gone from 1.7x in 2Q07 to 37x at the end of 1Q18. Mutual funds and ETFs holdings of corporate bonds have increased 240% from US$708bn in 2Q07 to US$2.41 trillion in 1Q18.
Also- nearly half of US investment grade companies are rated BBB- or a notch away from junk. Covenant-lite loans are now 75% of total issuance and 74% are leveraged loans. Jim Grant, of Grant's Interest letter- points out that the S&P reports a record 22% of M&A related loans issued in the first half of 2018 contained add-backs to adjusted EBITDA greater than 50% of EBITDA- double the 11.3% of such loans issued in 2005 (pre-2008 high). This is another sign of senior corporate debt corruption. (Hence the fund does not hold any corporate debt).
Another factor in liquidity of corporate debt is the amount that needs to be rolled over. In 2018- $36 billion of speculative grade bonds will need to be rolled over (according to Moody's), in 2019- $104 billion, in 2020

$182 billion and in 2021 $285 billion. What if this roll over happens with higher interest rates as the Fed is telling us?

There is $600 Billion in bond ETFs in the US. How will these ETFs replicate a debt market in a liquidity panic? Equities are quoted on an exchange- debt isn't. What about loan ETFs- where is their liquidity? Are investment managers taking this into account or have they been blinded by the 30 year bull market in fixed income?

Another curiosity to us is: if so much money is going into passive investments (ETFs are now $4 trillion), why would the players with the biggest market share cut their fees? Do they need volumes to keep the game going? Are there hidden liquidity and leverage problems that require more and more trading so people can dig themselves out of a hole? Did the SEC turn a blind eye to the problem when they made mutual funds manage and report on liquidity risk but exempted many ETFs? Where do these ETFs find buyers for their over-weighted, highly appreciated holdings if they need to sell in a crunch? Should index fund holdings in an equity be excluded from float? (Excluding index funds and insider ownership, for example, Amazon's free float is reduced by 54%).

These notes are longer than normal and we apologize. We just wanted to make sure that our fund holders know why we are as liquid and risk averse as we are right now (not the typical pitch to invest in a fund!).

As always, call us if you have any questions- we enjoy hearing from you.