MARCH 2021

JORDI'S JOURNAL

Timely thoughts & musings on the financial markets

LESSON LEARNING IS A NEVER-ENDING PROCESS

By Jordi Visser, President & CIO

The question I am most frequently asked so far in 2021 has been "what lessons were learned in 2020?"

Because of the shock and despair of 2020, the conversation can go in many directions but when it comes to what lessons were learned about the forecasting of markets, there are two things that stand out to me. The first being that there are many potential outcomes that are missed on the probability distribution. The second lesson is that we are in uncharted experimental territory as it relates to a monetary and fiscal policy, so history may be an inadequate guide to forecast the future.

The second lesson is worth unpacking as we near the end of Q1. Currently, the consensus is that the monetary and fiscal stimulus measures will propel economic growth and inflation to levels we have not seen in decades and earnings are going to be explosive. Despite these uniquely bullish expectations, it is also expected that the Federal Reserve and U.S. Government will continue to support the market regardless of the strength of the data and, in turn, that the market will continue to act the same way.

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Having just finished a year where the unthinkable happened each day, I find it surprising that the forecasts for 2021 look so certain. This seems naïve to me and yet people sound so confident in the outcome. In fact, it is hard to find anyone disagreeing with the consensus thoughts. The only refrain comes from the familiar phrase: "This will end badly." This may not be wrong, but this is often based on uneasiness than a reasoned view. Still, I will raise my hand as someone who is worried about the lack of discourse amongst market participants. The lesson the market has taught us many times over is that whenever there is consensus, be ready for surprises. And that brings us back to the first lesson we should have learned in 2020 about missing potential outcomes in the probability distribution. With leverage and net exposure within the hedge fund community at high levels, and optimism everywhere, we should be worried if things do not go according to plan and there is a new deleveraging event.

Assuming you were not trying to cover a short position, I do not believe that the GameStop saga in January was important enough to be considered the deleveraging event for this year. Even if the rotation out of growth to value is causing some difficult reassessments of portfolios, this is still low on the pain meter, so to speak. In searching for something of greater magnitude, the question everyone should be asking is which part of the probability distribution are we ignoring given that we have never seen this amount of stimulus in combination with a synchronized reopening of the economy.

Unless there is a similar unexpected shock like a pandemic, I agree with the consensus that the economic data will reflect the novel combination of seasonality, government stimulus, pent-up demand, and the desire for some much-needed catharsis this summer. It very well may be a Gatsby-like summer. On the other hand, I also believe investors are underestimating the potential for inflation to exceed estimates. To that end, I agree that the Fed is committed to letting inflation run hot before taking away the punch bowl.

In listening to podcasts, reading research pieces, and participating in investor meetings, I think the problem for this year is that investors sound too dogmatic in terms of their trust in the Fed. It is important to remember that 2020 was a year of speed chess—a lightning-fast year with unprecedented conditions and extreme fear, leaving many advisors, institutions, and central banks in a state of confusion.

I simply do not expect an orderly transition from speed chess to being able to ride the Fed and government to market utopia.

During the worst of the market fears over the pandemic in March 2020, investment-grade credit spreads got up to the widest levels since the financial crisis. The SPX fell approximately 35% from the February peak. Within six months, both had retraced the moves at unprecedented speed. People did not have enough time to process what was happening since the news was not getting better. Therefore, we cannot forget that despite what will be a historic economic year and a Fed allowing the party to continue, when playing speed chess, you must make your move quickly because the cycles will not allow you the time to think about it. There has been unexpected news at the end of 2020. For example, the Georgia Senate runoff and the speed of the vaccine rollout have changed the economic calculus at a time when spring is approaching and there is a desire to experience life again. This grand reopening with extra money and pent-up demand comes at a time when all leading inflation signals are already high and there are bottlenecks.

What worries me most about this is not necessarily that the Fed will respond by changing rates or even the message soon, it is that people are not thinking about other potential risks on the probability distribution. It reminds me of this Sherlock Holmes line I have used before.

> *Sherlock Holmes and Dr. Watson are going camping. They pitch their tent under the stars and go to sleep. In the middle of the night Holmes wakes Watson up: "Watson, look up at the stars, and tell me what you deduce."*
>
> *Watson: "I see millions of stars and even if a few of those have planets, it's quite likely there are some planets like Earth, and if there are a few planets like Earth out there, there might also be life."*
>
> *Holmes: "Watson, you idiot, somebody's stolen our tent!"*

Given that investors seem so dogmatic in their views that the Fed will not move regardless of the coming economic strength, I wonder if, instead, the real risk is the Fed does not move despite record economic strength and the market decides this is a mistake.

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This would not be the first time the market told the Fed or a government that they were making a policy mistake. For example, in December 2015, the Fed raised rates despite oil having fallen almost 40% in the prior 6 months and the S&P 500 proceeded to fall 12% in the following 8 weeks. The Fed took note and did not raise rates again until December 2016.

This sounds simple, but the pressure point to watch is the unemployment rate. Remember that it peaked during the Great Financial Crisis at roughly 10%. When the Fed first warned about tapering, the unemployment rate was around 7.5% and it was near 5% when the Fed first raised rates in 2015. Comparatively, the unemployment rate peaked at 14.8%, though it is already down to 6.2%. If it continues downward to 4% over the summer—and I think this is likely—there is a risk that we are underestimating how the market may react. In this scenario, my guess is that rate volatility would rise significantly on the uncertainty of the Fed's potential response. In turn, the rate volatility would have an impact on credit spreads and equity risk premium. I leave you with the famous quote from Mike Tyson, who said that everyone has a plan until they get punched in the mouth. There are unknown outcomes on the probability distribution and, from my experience, if the consensus is all agreeing, prepare for a punch to the mouth.

More than a market neutral pioneer, Weiss invests in people, partnerships, and a purposeful future. Our mission is to make our expertise in alternatives universally accessible. Jordi Visser is the President and CIO of Weiss. He joined the firm in 2005. Previously, Jordi was the founding Managing Partner of Anchor Point Asset Management, a global macro fund. A former Managing Director at Morgan Stanley, he traded various global equity derivative books for nine years. He opened the Morgan Stanley office in Sao Paulo, Brazil, and managed the derivative sales and trading effort there during the 1997–1998 emerging market crisis. Upon his return to New York in 1999, he managed index derivatives and ETF trading and was a member of the Equity Division Risk Committee. Jordi is a magna cum laude graduate of Manhattan College and a board member of the School of Business at Manhattan College. *through its affiliates

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