THE STRAIGHT FLUSH CRASH

AN ILLUSION OF SIMPLICITY, AN ENTANGLEMENT OF COMPLEXITY

A white paper by Dr. George Sokoloff and Ted Parkhill

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Lately, there has been talk of so-called "elevated" markets. Equity markets, real estate markets and bond markets are indeed reaching new highs regularly. But how long will this last? Can it last indefinitely? Or as is often said, "It's different this time,"; is it really? We posit that it is not different this time. In fact, there are very real parallels that should concern every investor. What could catalyze the next global financial crisis ("GFC II")? We suggest that it won't be a "Flash Crash." Instead it will be a flash flood that could be caused by very real systemic risk. In other words, the system will flush itself of the market detritus accumulated over the last 8-9 years. We are calling it The Straight Flush Crash. This paper will explain why.

For anyone that has studied the sequence of events leading up to the Global Financial Crisis ("GFC") of 2008-09, it would not be hard to put together the shape of the new crisis. The first GFC began with the New Century Financial bankruptcy that caused the first market hiccup on February 27, 2007 (when the VIX indicator jumped a record 60% in one day) and escalated to Bear Stearns, to Lehman Brothers, then to the whole GFC debacle. In our opinion, the market blip on August 24, 2015 (affectionately known as the ETF Flash Crash) was the first indication of the shape of things to come. During each crisis, a flashpoint has ignited the existing structure, which then toppled and in turn caused enormous losses for investors. For example, in the GFC of 2008-09, subprime lending was a small fraction of lending which ignited the whole structured finance pyramid and caused the liquidity crisis that bankrupted multiple banks.

Potential Catalysts

Let us start by posing some simple questions about potential catalysts. We believe that the risks in China are far greater than investors may realize. China's banking system (total, including shadow) is a $40 trillion asset monster on top of a $2 trillion of equity in a $11 trillion economy and the level of non-performing loans in this asset base is extraordinarily high. Naturally, a question comes up, "Who will be the four horsemen of the Chinese financial apocalypse?" Who will be the AIG, Bear Stearns, Lehman, and Countrywide of the next crash? The top candidates so far are Anbang, HNA, China Evergrande, and Dalian Wanda. These conglomerates are overloaded with bad debt and went on an acquisition binge in an attempt to escape from China with whatever assets they could. But now the government is cracking down on conglomerates' acquisition sprees, creating the need for liquidity at whatever cost. There are enough rumors which indicate that big banks, such as HSBC and BofA, are explicitly stopping their lending business with HNA. Additionally, an HNA subsidiary is selling 1-year USD-denominated notes at a 9% rate. Any of these companies going under would be the Bear Stearns moment of the GFC II.

Blockchain technology came to the rescue allowing Chinese investors to push billions of dollars through the cryptographically verified ledger. In our view, the cryptocurrency rush (BTC, LTC, Ripple, ETH) is an indication of the need for companies to "borrow mainland, hide offshore" and the exceptional need for ordinary investors to expatriate financially. It feels as if mainland investors are being pushed into cryptocurrencies on purpose.

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Blockchain exists as long as most nodes communicate with each other. How hard would it be to creatively apply The Great Firewall to temporarily disrupt the synchronization process on the mainland nodes to create panic and 'de-anonymize' or punish participants? The Indian demonetization scheme of 2016 is infinitely cruder in comparison. On January 2, 2018 the news about China's desire to regulate mainland cryptocurrency miners was published. A coincidence? Not likely.

We are no Sinologists, but one of us has lived in a communist country and this feels eerily similar to the undertones in the news flow in Soviet Russia. China's President Xi has significantly strengthened his positions at the party during the last congress. Some say he has now become the next Great Leader. With so many problems objectively facing the Chinese political and economic system, the leadership may rely on the tried and tested Communist method—the Great Purge. As an eastern philosopher might have said, "When the ants that built the great Red house turned into termites, it's time to cleanse the system." Xi has at least five years to right his ship.

Straight Flush Draw — Already on the Table

Alright, we've identified China as the ace of spades in the reaper's hand. What about the king, queen, jack and ten of spades to round out our theory of the Straight Flush?

The rest of the lucky hand is a group of liquidity and volatility-entangled strategies with gross exposure in the range of tens to hundreds of billions. There is plenty of kindling for this fire in the form of explicit and implicit short volatility bets that will unravel in a convex fashion—each position's liquidation will cause the next position's risk parameters to flash red and demand action. Other market commentators have succinctly elaborated on the possible elements of the great negative convexity pyramid, ranging from the explicit short VIX futures positions to large risk premium parity portfolios. We believe ETFs are also an important part of the picture. The allure of simplicity in buying just one symbol to get a desired exposure in a market, sector or smart beta factor conceals a liquidity mismatch and massive constituent entanglement problem. Akin to close coupling in a complex machine, it's the unintended consequence of design, which places sensitive elements next to each other creating fragility. Stock weights in an ETF aren't matched to the liquidity of components, creating a skew in returns when the need arises to move the underlying portfolio. Additionally, the set of links from a world of ETFs to the universe of stocks is a mesmerizing web of connections not readily tested in a market stress environment, except for the early hours of August 24, 2015 and during the flash crash of May 6, 2010. One ETF pulls on tens or hundreds of others, so to speak. While the majority of money still sits in liquid ETFs such as SPY, we are most concerned with large positions in ETFs that deal with less liquid products like investment-grade corporates and junk bonds and of course, levered and inverse volatility products. It is possible that the entire ETF market is as stable as a house of cards...

What about Central Banks? Can't they stop it? From the looks of it, no. They are effectively out of 'monetary bullets.' The central banks have already herded investors into a narrow canyon of short volatility strategies. By suppressing volatility, the Central Banks made investors all feel like Nobel laureates by making explicit (short VIX, option writing) and implicit (risk parity) short volatility strategies excellent yield generators. Too bad these investors are now running LTCM clones—generating a positive yield while things are normal, and an extreme downside when they aren't. In terms of correctional "macroprudential" actions that Central Banks could do, they are limited by inflation risks that would be hard to contain by simply raising rates. In fact, the Fed has already hiked multiple times, only to see the financial conditions index loosen on one hand, and the yield curve rapidly flatten, indicating incoming recession, on the other.

What's the direct connection between events in China and our markets? We have a 10-J-Q-K straight draw, but would it be a straight flush with the ace added? Well, how did the Chinese market crash and the RMB revaluation cause ETF trading on the US exchanges to lose connection to underlying instruments, albeit briefly, in late August of 2015? What market conditions caused the VIX indicator to stop pricing at all with its sibling VXST index trading around 80? If one can find this connection, one can estimate the way the crisis of tomorrow will propagate. This exact mechanism will work similarly but on a larger scale next time around as China can reliably produce more than just a 2015-style hiccup and local strategies are wound much tighter with record gross exposures.

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The Flush begins when these triggers are pulled. It starts small and then begins to gain momentum. At first, it could be just a few of the leveraged short VIX ETFs that get hammered when the VIX spikes. This would ultimately cause flight from other ETF strategies, thereby causing a potential run on ETFs in general, and eventually triggering the beginning of the great Flush. It all seems so simple; just buy the index and go home. But there are more ETFs today than individually listed equities. If there is a loss of faith in ETFs, it could cause a self-induced spiral out of these funds. But this simplicity may just be an illusion of strength. Any spike in volatility could be pulling back the curtain and exposing the structural weakness created by these multitudes of ETFs.

The Flash Flood that will Flush the Market...

The picture we have painted is very painfully clear. It is a perfect mirror image of the 2008 crisis with all components already in place, cocked and ready to fire. With news about HNA's woes appearing almost weekly, the Bear Stearns moment is imminent. Yet, as students of the market, we must admit to the existence of unknown unknowns that will likely come into play and radically change the course of future events. The 2008 crisis has dramatically expanded our frame of reference regarding possible paths that a crisis could take. We have seen the impossible happen—Merrill Lynch? Lehman?! People called the 2008 crisis a black swan not because it was unpredictable in principle (although several investors predicted and profited from it)—it was the propagation path of the crisis that really opened up doors to the new world that we live in now. The prescient, now famous investors shorted subprime and bought CDS contracts but didn't short Lehman Brothers shares or trade Eurodollar futures, anticipating 0.25% Fed Funds rate for 7 years straight. The next crisis will be a black swan in the same exact fashion. We won't know where it'll strike the hardest or how exactly floodwater would navigate around hastily constructed dams of preventive measures. But it seems clear that now is much likelier than in the past nine years.

Note that China might not necessarily be the culprit that sets things rolling. This straight flush draw can also be completed with a nine of spades. We don't know which player has it or when she chooses to play it. We have some thoughts about who on the economic and geopolitical map could hold this card, but we are sure we would be fooled again. After all, these unknowns are in fact, unknown.

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