Eric Peters: Systemic Risks are Mounting
February 15, 2018

Erik: Joining me next on the program is Eric Peters, CIO at One River Asset Management. I want to let our listeners know that we are taping this interview on Wednesday afternoon, so our conversation will not reflect anything that happens on Thursday. Normally we don't need to tell you that, but things are happening so quickly in the market I wanted to make that point.

Eric, I think that the question on everybody's mind is – we're looking at the tape on Wednesday afternoon just before the close – it looks like we're going to get back above 2,700.

Is a relatively small market dislocation just ending now? Is this all over? Or is it more the case that a really big event is only just beginning, and we're looking only at the appetizer in a bigger story here?

Eric: I think it depends on your time horizon. If you step back, what we're seeing is another what I would call trail marker on the path to what seems, quite obviously to me, to be a changing macro environment. I think the things that we look for most often, that are most meaningful to markets, are moves that happen, seemingly out of the blue, that lack really good explanations. This is exactly the type of move that you see when you're in a transition phase for markets.

In other words, it's fine for people to look at this move and say a point three increase in average hourly earnings precipitated it at 10 plus percent decline in the market out of the blue.

But I think that there's a lot of backfitting going on. There's no specific and good reason for this move. I think it's reflective of some major forces changing underneath the market. That's not to say that there aren't buyers of the dip. There clearly are.

I think that there are still an awful lot of people in the market that are conditioned to sell volatility and to buy the dip, and I think we're seeing that happen. But this, I think, was a very important move.

Erik: In terms of what actually happened here, there seem to be several competing theories. Some people say this is entirely about the backing up of Treasury rates and the pressure that that creates on equities.

Other people have said that's where it started, but, really, it was the vol complex blowing up and the VIX ETF situation that occurred that exacerbated that equity selloff.

And then, just this week, Zero Hedge has been pushing a story that actually describes the possibility of an intentional malicious attack where someone spoofing option quotes intentionally blew up the vol complex, and that's what caused all of this.

How do you see it? Is it possible to tell which of those things – or maybe something else – caused this? And what do you see next in terms of how this resolves? Do you think we're headed back to yet again more all-time highs? Or are we maybe looking at a failed rally in the making?

Eric: Those are all good questions. They're difficult to answer. I think people in our industry are often keen to explain why things happened in pretty precise ways because it gives them comfort that they're in control of their destiny.

The truth is often that, particularly in moves like this, they have many contributing factors that lead to them. But it's difficult to assign any of the specific things that you came up with as the real drivers of moves.

There's no question that, in an economy and in a financial system where there's the level of debt that we have and the sensitivity to interest rates, rising rates are kind of a pre-condition to equity market disruptions and selloffs. I think that the level of volatility selling and its integration into risk models across virtually every type of investment strategy are contributors.

And, having gone through such a long period with very, very little movement, I'd say that many people's trading books were robust for relatively small moves. But once you've passed a certain move – and I think in this case it was probably the S&P down 3-ish% that triggered a whole series of different adjustments that people needed to make to their books and their option books – that then amplified the move in volatility and led to this blowup in the VIX product.

But you have to remember that these VIX products were extremely ill-designed. And they were very vulnerable to this. They're a rare thing that you see in our industry, which is they had a predefined stop loss. And markets are pretty good at finding stop losses and triggering them.

I started my career in the commodity pits, and I witnessed firsthand how the commodity pit is built around finding stop losses on the top side of the bottom side of markets. So I think the market did a great job of finding the stops – and in this case finding the weakest ones, which were in the VIX complex – and hitting them.

But I don't think that that really explains why this move happened. Why did we get the first leg down, and why are markets starting to move with very little news flow? And, again, that's something that's difficult to explain for a lot of people that are trying to do it.

My strong opinion is that it's really meaningful, simply because there is not a very good explanation. We are entering this last phase of the economic cycle, and markets are in the processes of starting to move in ways that anticipate larger moves ahead.

Erik: I'm curious, when you say that these are very poorly designed products, I mean, even the XIV did what it was designed to do. Obviously, there were a lot of retail investors who didn't really understand the risks that they were taking.

What do you mean when you say they were poorly designed? Do you just mean that it's a product that probably didn't make a lot of sense for a lot of people who were holding it? What specifically do you mean when you say they were poorly designed?

Eric: Number one, I think they were very likely inappropriate for a lot of people that bought them. They're classic late-cycle type products that, in many respects, are designed to try to create returns in a world where it's difficult to find returns. And late cycle you tend to see these things pop up that provide enhanced levels of carry, or some type of return that looks safe and is a lot less so.

They were likely inappropriate for people. But I assume that people had a sense for that.

I think the design flaw, specifically, is to have a large retail product that has the ability to fall to zero in a day, provided there are a number of conditions met. But, principally, the front month VIX future has to go up 100% for it to lose 100% of its value – means that product, by design, the bigger it gets, the more likely it is that as the VIX moves up in a rapid way the market is able to anticipate that there is a very, very large fire.

And they know exactly where to stop losses. And the market will tend to suck itself up, or the VIX market will tend to suck itself up to that level, because it knows that it has a forest fire at that level.

It's a very ill-conceived product. If you have a stop loss that's that big, it is reckless to show the market where it is. And these products were designed so that the market always knew where that stop loss was.

Erik: That's an excellent point.

Let's come back to rates, which, clearly, were a driver, at least in starting this. The version of increasing interest rates that we want to believe is that it's an indication of a strengthening economy. Everything is getting better, the future is so bright I gotta wear shades and turn the interest rate up a little bit.

Of course, that's not the only reason. A lot of people have speculated that deficit spending and President Trump's budget may have been what's behind this recent move up in rates. I'm personally having a really hard time reconciling (regardless of what's driving it) we've got really strong weakness in the US dollar.

And the normal macro function of better Treasury rates attract more capital – the dollar goes

up as Treasury rates go up – it's not happening here. So what do you think the driver has been behind this increase in rates? And how do you reconcile the fact that the US dollar is not moving up as these rates move up?

Eric: There are a few questions in there. And they are questions that we think about a lot.

The rates, it's a tricky – and I say it's tricky because we can all recognize that we have extremely low nominal interest rates relative to history. And we're not far above 5,000-year lows. We still have major central banks in the world with severely negative interest rates. And there's still an awful lot of bonds that are trading at negative interest rates globally.

So interest rates, just generally speaking, are very low. Debt is extremely high. And inflation has remained low. So we're somewhat caught in a dynamic where it's extremely difficult for rates to go up very high without raising a significant burden on economies. The only way to alleviate that burden is to create more inflation.

But I think, as everyone looks at the world as they see it today, they go, well, it's going to be difficult for inflation to go up very far. Consequently rates can't go up very far, because if they do they'll, essentially, bankrupt economies. And obviously they won't bankrupt the whole economy. They'll pressure it enough that the economy will tip into a significant recession.

People's mental model is, roughly speaking, that. And so they look at it, and they go, well, rates are very low, but they can't really go much higher without sinking economies and recession – consequently, they're going to be around the same unless inflation moves up substantially.

That last part I think is what's necessary. And, ironically, it's what the major economies in the world are really seeking to deliver right now. They're not looking to deliver a 1970s-type inflation.

We've reached that tipping point within society where income inequality has become sufficiently large that we're seeing political shifts, whether it's here in the US, in the UK, in Germany – certainly in those three places – where there's clear pushback by the mid-skill worker against low wages, low wage growth.

As these things happen, as political winds shift, we're seeing some of the natural consequences. Which is, let's call it de-globalization. I don't think it's going to be a radical de-globalization. But it's pretty clear that we're seeing policies in these various countries that, on balance, are going to lead to less globalization.

Those factors, combined with already very low unemployment, should lead to higher levels of inflation. I think we're starting to see that right now. And that's the thing that's going to allow interest rates to move higher.

I think it's probably good for society overall, although it's certainly not going to be good for

financial assets ultimately. We're looking at the bond markets, the rate markets. Embedded within that incidentally is an awful lot of supply, both through lower levels of QE (or the unwinding of balance sheets), but also just very, very large deficit spending.

So it seems that there are a number of forces that are going to be pushing rates higher. That's the lens through which we see higher rates.

I think your second question, which is: Despite higher rates, why is the dollar performing so poorly? That's really a fascinating question. And I say that because it's exactly the type of thing that we really look for when we either seek out opportunities or we look for confirmation of our investment views or theses.

One of our strongest investment views is that we are transitioning from a reflationary economy here in the US toward a stagflationary economy. Stagflation brings up in people's minds visions of the 1970s. And I think it's highly unlikely that we see something that looks like the 1970s.

Every period has different dynamics. And the '70s had very different demographic dynamics, amongst other things. But we do think that we are shifting toward an environment where there are significant numbers of capacity constraints in the US economy, one of which is our labor force. Obviously, unemployment is very low – 4.1% right now – lowest levels that we've seen, roughly speaking, since the 1960s. Which, incidentally, is when inflation was also extremely low and then started moving materially higher.

But we think that the de-globalization that we're starting to see will combine with some of these capacity constraints to shift us into a stagflationary world where growth is constrained by only modest increases in productivity combined with relatively anemic levels of labor supply. And we'll end up in a position where growth doesn't expand a whole lot faster than it is right now, but inflation starts creeping up.

And in that world, what you inevitably see is a very equity-unfriendly environment. Because you see input costs going up, labor costs going up, so your margin's shrinking. That's a difficult environment.

What needs to happen in order to accommodate the difficulties that you're seeing in the economy is you need to see a weaker dollar. One of the things that I think is lost in a lot of macro analysis right now is that human labor cost in the US, relative to its trading partners – it's not been moving up in an explosive way, but it's been steadily trending higher.

And the consequences of that is the dollar is becoming more and more expensive on a relative basis. So we think that a stagflationary environment, characterized by rising rates and declining US competitiveness, demands a weaker dollar. That's why we think the dollar has been weakening.

I guess the last thing I would say is the reason we get so excited about seeing market

movements that's so counterintuitive is because it tells you that most market participants are kind of on the wrong side of the trade and they have the wrong mental framework.

Last year, for instance, people were excited about the dollar because they thought "Trump Trade" was going to work, Trump was going to stimulate, Trump was going to introduce border taxes, and these various things that would push up the dollar.

And the dollar started weakening because people lost faith in Trump's ability to get anything done throughout the year. And that all made sense as a mental construct around how markets were moving.

Where it broke down was this year, where Trump got the tax reform and tax cuts through and yet the dollar continued to fall. And that was the signal to us that this stagflationary dynamic is beginning to manifest itself in such a material way that markets are moving in spite of the fact that people don't understand it and are fighting it.

Erik: On the topic of inflation, Eric, you said that you see a lot of forces that are going to cause inflation to come back. Now, you also said that you don't see it getting to 1970s-style inflation. So I assume by that you mean you don't see it getting that high.

It seems to me that, as you also said, we've got a problem here. Which is, rates can't go too much higher, because it would bankrupt the US government if they did.

So it seems to me that, in terms of monetary policy tools, if inflation were to start to run away, the Fed's ability to contain it by aggressively raising interest rates is kind of broken. Or I would see it as broken. I think that their hands would be tied and it would be difficult for them to very aggressively raise rates.

So you must see, for some reason, that this inflation kind of contains itself and doesn't require any monetary policy in order to prevent it from running away. Is that right? And, if so, why do you see it that way?

Eric: I think that your insight is absolutely correct in that the world that I'm framing is one where monetary policy and its ability to interact with financial markets and the economy is going to look awfully different from what we've grown accustomed to. And that's going to create a really interesting market.

Incidentally, I think that you're seeing clear confirmation of this in the way the Fed is speaking. So, unlike 10% correction out of the blue that I've seen over many years, this time around we haven't seen a Fed member come out and say we're going to be really supportive of the markets.

In fact, every single Fed governor who's spoken in – there have probably been five in the past couple of weeks. And then there was Yellen a couple of Fridays ago on her way out. They all

said that it is rather capable of dealing with the decline in equity markets and asset prices, and you should do just fine, and we're not really worried.

I think that what they are in the process of doing is they are beginning to shift the way they communicate with the markets and they're signaling that they're no longer going be there the way that they have been.

And there are a few reasons for that. I think number one is because they recognize that, at 4.1% unemployment, and a trillion-and-a-half-dollar tax cut, and a 300-billion-dollar budget boost, and a 90-billion-dollar hurricane recovery spend, and then something that amplifies it with infrastructure spending – they're looking at this and saying, there's just literally no way this is not going to lead to higher levels of inflation.

Again, I'm not saying 1970s inflation, but higher levels of inflation in an economy that is capacity-constrained.

We're not really in a position to boost it by doing QE. QE is not really meant to be a recession fighter. It's meant to be a financial market implosion insurance program, where you can take different economic actors – in some cases even governments – and you can buy their debt and make them solvent again, or at least appear solvent for a period of time so they can heal.

These are not tools that are going to be appropriate to fight the next recession. And I think you're seeing really smart guys like Ray Dalio come out and signal that as well.

So I think the people who really understand how economies work and how monetary policy interacts with it recognize that the next cycle is going to look awfully different. The only question is when does the next cycle come?

I don't think that high rates will bankrupt the US government. I actually don't think that you can bankrupt the US government, simply because we have the reserve currency and we can print as much as we want. But I do think that significantly higher rates will make it very difficult for corporates, and just for the economy to function well.

So there's a natural limit in the absence of inflation where higher rates will really start to hurt economic activity. And that will be a reflexive process. So it's difficult for rates to go a lot higher unless inflation starts picking up.

Erik: I want to pick up on that idea of corporates going higher. One of the views that I've had is that a whole lot of this really massive rally that we've seen in equities has been driven by corporate buybacks. And a lot of those are financed with junk bonds.

So it seems to me that as rates pick up, eventually you get to a point where it's no longer economic to engage in these share buybacks. And it seems to me that that potentially starts a vicious cycle where you can't do the buybacks anymore, rates are going up, and it leads to a

major change in direction for equities.

Am I right to think that that's a risk? And how do you see that in terms of how substantial of a risk it might be?

Eric: I think it's a risk. The process will probably be gradual – until it is not gradual. I guess that's not saying a whole lot. Other than I don't think that we're on the cusp of buybacks all of a sudden just stopping.

I do think that we're in a period, however, where we've had this massive financialization of the US economy that's been driven by QE. It was one of the unintended side effects of QE and one of the great weaknesses of QE.

And I think that the folks who implemented QE and have sustained it were hopeful that low rates would lead to more economic activity. And, ultimately, that would be self-sustaining.

What they discovered was an awful lot of that money went into some of the activities that you just described like buybacks and debt issuance at low yields. What it distinctly did not go into was capital investment. And that's one of the reasons that we have many of the capacity constraints that I described earlier.

What I think is highly likely to happen – and I think we're in the beginning stages of this happening – is that corporate CFOs, they don't think in six months or even necessarily one year terms when they think about these buybacks. They're looking out at issuing debt over five years or seven years or whatever it might be and saying, well, we can issue debt at such and such a yield, and we can buy our stock back, and that makes a whole lot of sense, and that seems like a pretty good investment.

I think what's beginning to happen is that, as they're seeing rates rise, and they're seeing the prospect for sustained rate rises in the coming five years or so, they're saying we're not going to want to have to roll that debt at potentially much higher levels. And the levels are already starting to go up.

And, oh, by the way, we haven't really made a lot of CapEx investment, or replaced some of our aging equipment, so why don't we start shifting that mix? And, again, that's the type of mix that leads to hotter economic growth.

All of which is being compounded by tax policy, amplified, compounded – they're going to look at it by tax policy.

And these are the types of things that I think will lead to higher inflation, higher rates. And that's what I think is going to hit the equity market toward the latter part of this cycle. We may or may not be there right now. But I think that's the end game for this cycle.

Somewhere along that path, by the way, it makes sense to me that these CFOs will engage in even fewer share buybacks. And that will remove another level of support for the market. But I don't think the market is going to fall just because they're gradually doing fewer buybacks.

That's how I see it all connected.

Erik: It seems like we're getting a different tone out of the Fed, out of the Powell Fed as opposed to the Yellen Fed. It seems like the message is pretty clear that, hey, we're on our path toward tightening, hiking rates in the front end of the curve, shrinking the balance sheet in terms of beginning to unwind what happened from QE. And, by the way, if that disturbs markets, markets can take care of themselves. We're not in the business of bailing out the stock market.

I would contend that they are in that business. It just depends on how bad it gets. But they're saying that they're not in that business.

So what do you see on the horizon in terms of how the Powell Fed will differ from the Yellen Fed? And do you think they're serious about not bailing out the stock market? Or does it just have to get really bad before they start to look at more easing and more accommodation?

Eric: Easing and accommodation right now is something that they know that they simply cannot do, even if the equity market were to fall 20% from here. Which is, incidentally, one of the reasons why I think the equity market is more fragile than people think.

And the reason I say that is the following: Every central bank in the world post-QE has grown very concerned about not only financial stability – and that has to do with this financialization of the economy and buybacks and high asset prices etc. – but they're also really worried about what to do in the next recession. We all know that, right?

But the question is: What is their reaction function to that. And the Fed is clearly trying to buy itself enough space through rate hikes and balance sheet normalization or reduction so that they have some tools in the next recession.

They really don't know when that is. I think that they generally expect it to be somewhere out anywhere from 12 to 30 months from now, something like that. Whether they admit that or not, I think everyone recognizes that that's a real risk. So the question is what do they do about it?

I think that one of their greatest fears right now is the prospect that we go into recession at the tail end of this enormous stimulus – through taxes, through increased budget, through infrastructure, through hurricane rebuild. Their greatest fear is that we go into the end of this cycle with a P/E of something like 25 on the S&P. And, relatively speaking, modest rates. And all this stimulus just having hit the economy. And then we go into recession.

And their fear is that at that point we actually will have pretty material inflation and we'll have a very limited ability by the politicians to do some type of fiscal stimulus. If that happens, they really have extremely limited tools. QE will be completely inappropriate for that. Rate cuts on the margin may be helpful.

But there is a case to be made that in that type of environment there's very little the Fed can do. And these are smart people. I know that people like to make fun of them. I certainly do at times. But they're smart people. I think that they are trying to think out over the next year to two years. And they see that scenario as being a very scary one.

So I think some of the reasons you're seeing them signaling or sending a different tone right now in their statements about this recent volatilities – I think they actually want volatility.

They do not want people to be extremely short of vol after the stimulus is through. They'd rather see a stock market correction, even a bear market, sooner rather than later, so that the starting point for asset prices is not extremely high at the point where they're most vulnerable to an economic recession. And policy makers can't do another big one-and-a-half-trillion-dollar tax cut.

Erik: You made a really excellent point earlier about the blowup in the vol complex, describing how everybody knew where the stress point was and what would happen if it got there. And the market basically seeks those things out.

I think you just made a really excellent argument for why the Fed is going to be out of bullets and not really able to respond to solving a market crash. Does that mean that the market kind of smells that out, realizes that the Fed put is gone, and that that dramatically increases a risk of exactly that outcome occurring?

Eric: The most likely market path, at the end of this economic cycle – and remember, we're in one of the longest economic cycles in history. If we make it out to mid-2019 without a recession, I think that it's the longest economic cycle since the mid-1800s. We're talking about a long cycle.

I think the most likely market outcome is something that does not look anything remotely similar to 2008. I think that the most likely market outcome looks a lot more like a 1987 or a 2000 dot com type crush. It's a much steeper path.

And I think that, for similar reasons to that ETF example, I think the market does a very good job of finding the Achilles heel of a financial system. Or, in the case of the ETFs, the Achilles heel of a particular product. And that's what it's most ultimately vulnerable to.

And in this case, given how intricately volatility-based risk management systems have been embedded in portfolio construction, and the way people take risk – whether it's at a bank, or a pension fund, or an endowment, or a hedge fund, or even in a whole host of retail products and

retail portfolios – Given how volatility has become intricately embedded in these things, it has been the case, and I think it will continue to be the case, that the lower the volatility the more risk that economic actors throughout the financial industry take.

And the consequence of that is that what all of those models and those portfolio constructions are most subject to is a dramatic, swift reversal in the market. And we got a glimpse of that just now in February.

That is something that is going to be with us until people look at portfolio risk in a very different way. And I don't think that's going to happen anytime soon. So I think when this market turn comes and the Fed is not there to catch it, I think that we'll have a very swift and very deep correction.

There are other potential inputs and reasons that I could go into for that, but it would take a lot longer. But I think that it's very clear that that's the greatest pain point for this market: A discontinuous move or a very rapid move down.

Erik: A week ago when we were at 10% off of the highs, a lot of people were saying, oh my gosh, this is the Lehman moment. It seems to me, if I had to draw an analogy to 2008, that market cycle, it's not the Lehman moment. Maybe it's more like the Bear Stearns moment where we just had a really clear message that not everything is perfect, but the big one is probably not here yet.

Now, Bear Stearns was more than a year before everything really, really got scary. Is it that far off? Am I wrong to think that Bear Stearns is a good analogy? Is this maybe closer to – I think in '87 the vol spikes that preceded the really big move were only by a month or so.

So are we looking at more of that scenario, where something really gets ugly a month from now? Or a year from now? Something in between, or something different? How do you see it?

Eric: When this happened – and we've been anticipating a shift to a higher-vol environment, thankfully, as a firm – but when this happened my first instinct was that this is a Bear Stearns moment. What I mean by that is that it's just a tremor.

In this case, an ill-constructed product blew up. Investors throughout the industry who engage in various forms of vol selling, of which there are an almost innumerable number of types. Those people look at this product and they go, oh, you know what, it was a very poorly constructed product. You had to have been an idiot to have been involved in that. But the behavior that we're engaging in is much more sophisticated and we should just keep doing it.

And it's in no one's interest, by the way, to have a bear market or to call into question these strategies that they're employing. Because just no one wants to do it; it's been too lucrative. And if it were that scenario, then, yeah, it would be more likely that we would have a big market move sometime in a year or something.

And I think that, basically, the most logical time to have a big move is when we're on the cusp of the next recession. That's when it makes the most sense. That's when you would look at the market and you would say, okay, you know what, we're really close to recession – incidentally, very few people ever really know when that point is.

But I would suggest that with this much stimulus coming down the pipe it's not in the next couple of months. So the most logical time would be closer to the next recession, once the ECB and the BOJ are really engaging in tightening behavior.

So that's the most logical time. Obviously, I don't know. No one knows when a big market down move will happen. I would tell you that, given the prevalence of very large vol selling throughout the industry and the reflexivity of vol selling – meaning that as vol goes lower people take more risk, which pushes vol down, which tells their risk models that they have less risk, which means that they can take more risk, and it's just a reflexive process. That process works in reverse in a very ferocious way.

And so given the prevalence and the level of vol selling, I suspect that the next material correction could happen much sooner than just a few months ahead of the next recession. I have a pretty open mind about that.

One of the things that's interesting – you mentioned 1987 and vol around 1987 – one of the things that is really interesting around that period was that volatility and some of the other asset classes didn't really go up very much. It was really centered around equity markets.

And we're talking about a very long time ago. People don't have a lot of data on that. But, as we've looked at that period in time, rates vol moved up a bit, currency vol moved a little bit, but it really was an equity-centric market.

And what's interesting is that this time around that's been exactly what's happened so far. Equity vol has moved dramatically, but you have not seen any other material change – obviously vol has gone up a little bit, and the other asset classes, but not by a whole lot.

Anyway, I don't know when it will be. But I think the clock started ticking as soon as the Fed started unwinding its balance sheet.

Erik: I guess the question that that begs is – it sounds like we are on the same page – this is analogous to Bear Stearns in the sense that it's pretty darn clear that something is wrong here. But it's not time for it to all fall apart yet.

So I don't want to just pile in to being short the equity market, that was the wrong thing to do in reaction to Bear Stearns. I know that, because that's what I did. At the same time, I don't think it's time to put new money to work in a buy-and-hold strategy, hold stocks for the long term. That's not it.

I guess the question is what do you do in this environment? Is it carry trades?

You wrote an excellent paper back in August, "The Case for Long Volatility." Congratulations, you obviously aced that call. But now that we've been through what we've been through in the last couple of weeks, is it too late for that trade? Is long vol still a strategy people should consider? And what other strategies do you look at when we're in this – it's not time to panic yet, but it's not time to think that we're starting a new bull market either.

Eric: There's a short answer and a long answer to that. Maybe I'll try for a medium answer. The biggest problem in the investment industry today, the portfolio construct that investors have come to rely on, which is a brilliant construct really pioneered by Ray Dalio – he naturally has done incredibly well from this, and it's been a fantastic strategy – this risk parity strategy. And, while there's certainly more complexity to it that just being long equities and leveraged funds, let's just view it as that strategy for a moment.

It's essentially what the dominant portfolio has become at all the major investors, pensions, endowments, etc. in the industry. And the beauty of that portfolio has been that you've been able to own risk assets and then you've been able to own a hedge, which is a leveraged bond portfolio, and that hedge has actually paid you a positive return.

The problem is when equity valuations become very high and interest rates get very low it's difficult for that strategy to continue to perform very well. All else being equal. Now, however, if you add modest inflation into the formula, that portfolio actually becomes pretty toxic.

That's the environment I think we're entering into. And that's why, ultimately, I see some of these shocks like this most recent market shock as just being trail markers on this path to a much more difficult investment environment.

So the question is what can investors do? By the way, there is no big scalable solution to that. The scalable portfolio construct that worked so well was risk parity. There's no other risk parity. Kind of like when you looked at China as a driver of growth, there's no "next China." There's just one risk parity. And we've really milked that for a couple of decades.

So now what do people do? What they're going to be staring at are really sub-standard or sub-par returns, some negative returns in certain years, as we look out over the next five years. I'm not sure which year, but there are going to be some material negatives for some of these portfolios.

Now I think that there are some things to do in a more limited way. From our perspective, we see great opportunity in the challenges that some of these big investors face. We think that a really thoughtful macro firm can capitalize on those opportunities.

It's ironic that so many macro firms have closed recently. I think that it's kind of classic market

timing that that's happened right as the opportunity set really opens up. But I think the remaining macro firms, you're starting to see them do really quite well in this environment.

I think having someone focus on inflation trading – they are a whole class of securities that have been really unremarkable for lots of years that are going to become much more interesting – TIPS (Treasury Inflation-Protected Securities) products and talented inflation managers.

And then, in a niche-y way, a long-volatility product is something that is going to be able to capitalize on rising volatility levels.

But, again, none of these are going to be big enough to solve an industry-wide problem. The industry is just facing a very difficult period over the next five years. There's nothing to do about it.

Erik: I want to come back to the risk in risk parity specifically. Until a couple of weeks ago, a whole lot of people were telling themselves that stock prices and bond prices are inversely correlated and they can never both go down together at the same time. You can look that rule up right next to housing prices never go down across the board. It seems like we just got some pretty darn clear proof that stock and bond prices can go down at the same time.

Does that potentially create a panic out of reinforcing a vicious cycle where people start to move away from the risk parity trade because they see that the risk of both assets selling off at the same time is much greater than they previously perceived? And, of course, as they do that it becomes self-fulfilling – more and more people start to panic as the selling continues. Is that a risk that we need to be worried about?

Eric: If you'd asked me when I was a 25-year-old or a 30-year-old, as opposed to a 51-year-old, I would have said, yes, that's a risk of some type of wholesale and cascading panic.

Through all these years I've learned a lot more about how big investment committees act and how they make decisions and how they shift strategies. There have been a couple of decades of analysis and decision-making that have gone into deploying huge amounts of capital in various forms of risk parity strategies. That's not going to change overnight.

But I think that these portfolios are growing increasingly vulnerable and fragile. And, as these big firms encounter lawsuits through not a month, but let's say over a few quarters or a year or half a year, the dynamic will be that they will start to question how robust these strategies are for, let's say, a rising inflation paradigm.

Their consultants will interact with them and then they will start reducing. And that will create more supply of risk assets to the marketplace. So it will become part of the fabric of the market.

As these strategies have been deployed, they've been vol suppressors. So into every decline, in many respects, there has been more and more buying of risk assets. And that suppressed

volatility. And now, I think, due to the decisions that we've made, over the coming five years or so, into rallies there will just be more supply of risk assets. And that will amplify volatility. It won't buffer it.

Erik: Your office was kind enough to give us permission to share some of your excellent writings with our listeners. One of them I just mentioned is "The Case for Long Volatility," which you wrote back in August.

There's another paper that you wrote called "The Interplay Between Trend Following and Volatility in an Evolving 'Crisis Alpha' Industry." There's also some Weekend Notes. Our listeners can find download links for those in their Research Roundup email that accompanies this interview.

But, Eric, you also run a hedge fund. I know that for compliance reasons you're not at liberty to make any particular representations about that fund on a public podcast, but we do have a large institutional and accredited investor audience. For those people who are accredited and qualified to invest in hedge funds, how can they contact you to find out more about your fund offerings?

Eric: They can go to our website which is oneriveram.com. You can easily find me on LinkedIn. Those are the two easiest ways to get in touch with us. We're based in Greenwich, Connecticut.

Erik: Well, Eric, I can't thank you enough for a fantastic interview Stay tuned, folks, Patrick Ceresna and I will be back for our post game segment as MacroVoices continues right here at macrovoices.com.