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Swimming with Whales

“The purpose of the margin of safety is to render the forecast unnecessary”
— Benjamin Graham

Extreme levels of options SKEW coupled with inflation, booming equities, and the presence of a big “whale” player in the markets is creating a unique recipe for a potentially extreme event.

The problem is, no one knows exactly when this event will happen or how it will all play out. It could happen tomorrow or years from now. If we had to guess, we would say it will happen sooner rather than later.

We believe that markets tend to “punish” the biggest players. That is, those participants who have an outsized position or influence tend to end up on the wrong side of the trade.

Currently, many stock market pundits are focusing on the whales in meme stocks and how a new generation of retail investors are crushing the institutional shorts as markets push higher.

This type of “big player” squeeze historically has occurred to both the longs and shorts, causing markets to move significantly in either direction. The Hunt Brothers in the 1970’s, portfolio insurers in the 1980’s, LTCM in the 1990’s, subprime lenders in the 2000’s, the Japanese Central Bank (who is still playing at the table) are all examples from an endless list of people, organizations, governments or products that simply got too big or gained outsized influence in the markets. These are the ones to keep your eye on.

It is analogous to the big player at the card table. He is the big whale, the mark, the one to bet against. Pay attention to this player. Bet conservatively because he has lots of chips and can outlast you. Ultimately, his betting and pushing things around will wreak havoc at the table and upon the whole system. Be prepared, take advantage or you will get destroyed when this happens.

This whale, like all the others, thinks he has discovered a can’t-lose system and a sure path to profitably. This market impacting player is a real entity and has been around for a while but recently been emboldened by his newfound success and prominence. That is, his seemingly endless supply of chips is empowering him to push the other players around.

Like all the others, this big player will be "punished". His run absolutely will end, and it will create mayhem and stress. We just don't know exactly how or when.

Who is this big player at the table now? It is the U.S. Government together with The Fed. The infinite asset purchases, the money printing, and the spending. It is unconstrained monetary and fiscal stimulus combined. The player believes he has discovered a new system that works.

We are not predicting doom and gloom or the collapse of western civilization. We just are saying that when one player is too big, things start to get interesting. While we do not want to "bet against The Fed", we also realize that The Fed and the U.S. Government have never intervened to this extent before.

Practically this means: Be long equities since the player is printing chips to push the market higher BUT, also hedge the downside so that when the inevitable occurs one can both profit and preserve wealth. We want to sail along with the upside but minimize the risk of the downside. This is especially important today since we think the downside risk due to a combination of various fundamental and technical factors are uniquely aligned generating extreme risk vs return.

The key to implementation is to have a focused, disciplined process that applies advanced technology and uses options and futures to both hedge the downside and allow for the upside. Be prepared.

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