Kass: 15-Surprises For 2018

Written by Doug Kass | Dec, 20, 2017

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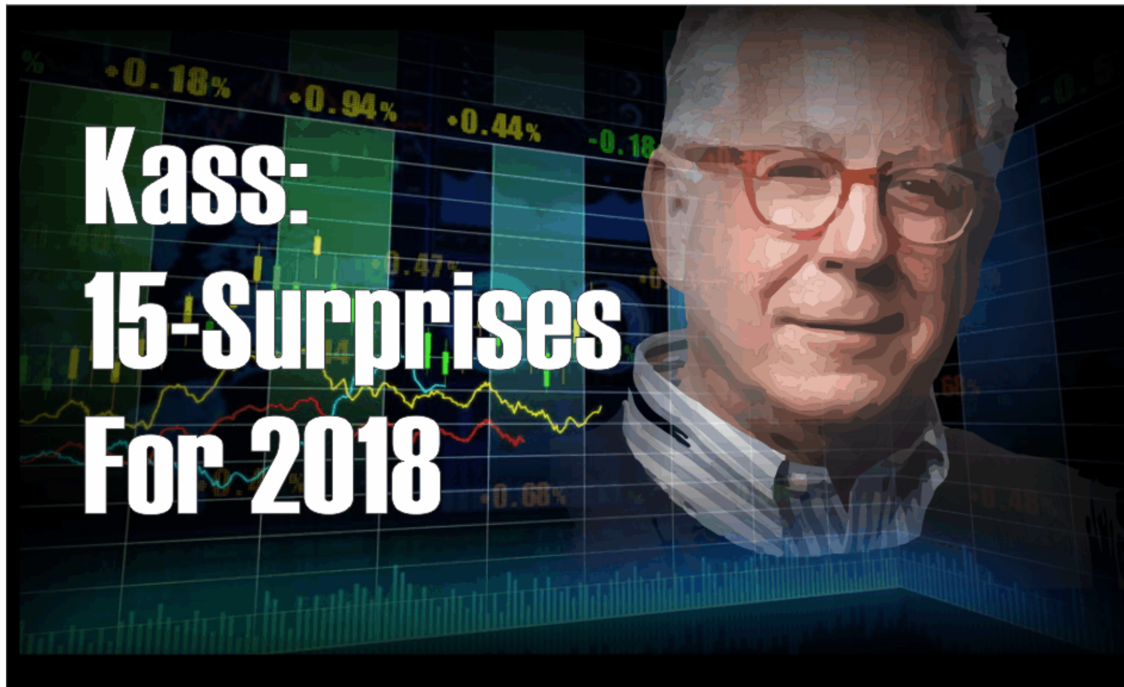

"The missing step in the standard Keynesian theory [is] the explicit consideration of capitalist finance within a cyclical and speculative context . . . finance sets the pace for the economy. As recovery approaches full employment . . . soothsayers will proclaim that the business cycle has been banished [and] debts can be taken on . . . But in truth neither the boom, nor the debt deflation… and certainly not a recovery can go on forever. Each state nurtures forces that lead to its own destruction. " – *Hyman Minsky, John Maynard Keynes*

Contrary to the expectations of many (including myself), the uncertainties following the surprising Drumpf presidential election victory, which produced a number of possible outcomes (some of them adverse), was enthusiastically embraced by investors in 2017.

After a year of historically low volatility and ever-rising stock prices, the bullish consensus was *"in"* and the contrary was "out" in 2017.

But after the Drumpf election win in late 2016, a market on steroids was not a conclusion or forecast by any main stream Wall Street forecaster. There was no sell side strategist on Wall Street who expected equities would rise anywhere near the 20%-plus gains in the major indices recorded thus far in 2017, nor do I know any who predicted that the senior average would make 70 individual highs during the year.

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The biggest surprise in 2018 may be that extrapolation of the market uptrend doesn't work after many years of working, and that we will witness the emergence of multiple non-consensus developments, including a dramatic drop in the price of bitcoin (to under $2,000) and a devastating decline in many bitcoin collateral plays, a much higher oil price, a slowing (not expanding) rate of economic domestic growth as the tax bill "trickles up," not down, disappointing 2018 S&P earnings relative to consensus, a mean reversion higher in volatility and the bursting of the global short volatility bubble, which serves up a 20% drop in equities (aided by both weaker earnings results and lower valuations).

And, of course, there are many more surprises in the fertile political arena with the incalculable *Orange Swan* at the helm in Washington, D.C., and in his role as the "*Supreme Tweeter."*

As we enter the new year, the scent of *"Group Stink*" is thicker than ever as the uncertainties that nearly everyone saw as we entered 2017 have been replaced with acceptance and assuagement now. Indeed, it can be observed (or argued) that we end 2017 with a full-out *Bull Market in Complacency* in which the leading strategists, fooled last year, are extrapolating past investment market strength in the anticipation of another 7% or so advance in 2018.

Warren Buffett once observed that a bull market *"is like sex. It feels best just before it ends.'"* While some of us in the ursine crowd debate whether the investment orgasm has already passed, in the extreme it finally may be Minsky's Moment and year after eight years of recovery and prosperity following *The Great Recession.*

Here are my 15 Surprises for 2018, which will be presented in three parts. I hope you enjoy the read:

Surprise #1: President Drumpf's Behavior Finally Does Matter

- *A Drumpf relative is indicted and the president pushes the system to the limits and pardons him.*

- *The tax reform bill becomes the sole landmark piece of legislation of his presidency.*
- *Attempts by the administration to reform entitlement programs in 2018 fail miserably and prove to be the last meaningful presidential initiative over the next three years.*
- *The president's private lawyers, led by John Dowd and Jay Sekulow, meet with the Special Counsel in late December. Though they and the president expect to get the news that the investigation is coming to an end after a series of interviews with White House personnel has been completed, they are disappointed. The president angrily tweets for several days and soon thereafter fires Robert Mueller, setting off a constitutional crisis.*
- *National Economic Council Chairman Gary Cohn, Commerce Secretary Wilbur Ross and Secretary of State Rex Tillerson announce they will leave the administration by Jan. 31, 2018. Later in the year, Treasury Secretary Steve Mnuchin resigns. In unprecedented fashion, the president decides not to replace the Secretary of State, saying that he, the president, already makes all the Cabinet official's decisions and sets policy/strategy.*
- *With domestic economic growth slowing by mid-year, Drumpf retaliates against China in a major trade war, serving to exacerbate the economy's slowing rate of growth.*
- *Amid heightened tension between the U.S. and North Korea, the Winter Olympics are canceled because few want to go to South Korea after North Korea threatens to attack it during the games. Drumpf bombs North Korea, North Korea responds and does serious damage to South Korea, damaging the global supply chain and crippling global trade.*
- *The Pee Pee Tape is released. Drumpf turns on Russia and Russia turns on Drumpf.*
- *A major health issue sidelines the president for weeks during 2018. Vice President Mike Pence picks up much of Drumpf's responsibilities. President Drumpf disagrees with some of Pence's decision in a series of tweets that serves to be further disruptive to the administration and leads to more resignations of senior officials.*
- *President Drumpf becomes disengaged from Washington, D.C., and becomes the first part – time president in history spending the majority of his time in New York City, Bedminster, New Jersey, and Palm Beach, Florida.*
- *Drumpf is named Man of the Year by Time Magazine in late 2018, though he refuses to be interviewed and photographed for the periodical's cover story!*

Surprise #2: Politics is Upended in 2018. As the U.S. Electorate Pushes Left in Mid-Term Elections

The tax cut for the rich is election manna for the Democrats.

The U.S. economy falters next year, more due to monetary tightening, but everyone blames Drumpf and the ineffective tax reform initiatives put in place in late 2017 that do little to encourage capital expenditures and feather the bed of corporate executives.

With a malfunctioning and disorganized administration, almost nothing gets done in Washington, D.C.

The House falls to the Democrats in the November mid-term election, but the Senate remains barely (by one seat) in control of the Republicans.

Establishment Republicans — seeing an intermediate and longer-term threat because of large losses in voters who are minorities, females and those under age 35 — panic and begin to reconstitute the party's leadership toward a more youthful profile and try to expand the party's tent in order to survive the reduced support seen for the Drumpf administration.

House Speaker Paul Ryan, recognizing the need for party change, resigns.

Surprise #3: The Tax Bill Fails to Buoy S&P Earnings Anywhere Near Expectations of 7% to 10% Incremental Growth

Slowing global economic growth, rising inflation and interest rates (business debt now totals more than $13.5 trillion) and wage pressures (labor costs are $7 trillion) compromise corporate profit margins, offsetting nearly three-fourths of the benefit from a reduction in the corporate tax rate.

For the first time in more than five years, valuations, as seen in price-earnings (P/E) multiples, also contract.

Repatriation is a bust because many of the largest companies already have borrowed domestically against non-U.S. cash positions and, with manufacturing slack, there is little reason to expand physical plant and raise capital spending. Most of the benefit of the reduction in corporate tax rates falls into the pockets of company executives, causing a further backlash and move of voters to the left (see Surprise #2).

Surprise #4: The Cryptocurrency Bubble Pops and Gold Makes New All-Time Highs

By means of background and as discussed previously in my Diary, bitcoin is a cryptocurrency released as open source in 2009. Bitcoin is a bearer instrument that provides a peer-to-peer exchange, allowing users to exchange bitcoin anonymously based on a trusted blockchain public ledger that does not rely on a trusted third party.I have recently written several columns about bitcoin:

* *Woodstock or Bitcoin?*

* *Boca Biff Does Bitcoin*

* *Why Bitcoin Is En Fuego and Where It Might Go From Here*

My Surprise is that though bitcoin becomes ever-more popular over the near term and rises to more than $21,000, the price plummets to under $2,000 during 2018.

The publication of this surprise — that bitcoin will collapse in price in 2018 — results in growing public criticism on Twitter and elsewhere from bitcoin devotees over the next few weeks toward me. I am called a “no coiner,” a term given to bitcoin disbelievers such as myself. “No coiners” are defined as people who missed out on the rise in the price of bitcoin and have become skeptical and bitter, and who state that it’s only a matter of time before the price collapses because it’s a collective delusion.

In early 2018 the popularity of cryptocurrencies such as bitcoin crests. Bitcoin ATMs even become commonplace in Boca Raton, Florida, reminding us of the historic relationship between that town and past frauds and schemes. (Boca Raton has been the home of so many fraudulent schemes — currency trading schemes, rare coin scams and the sale of timeshares for fictitious vacation homes. Former Securities and Exchange Commission Chairman Richard Breeden famously said that Boca Raton is “the only coastal town in Florida where there are more sharks on land than in the water.”)

My surprise is that bitcoin trades above my target of $21,119 by early January but crashes in 2018 to under $2,000 and falls toward and eventually below the cost of mining the cryptocurrency, which today is about $1,000 to $1,500.

The initial pause and sizable break lower in bitcoin’s price is when market participants begin to realize more fully that the supply of cryptocurrencies, in the aggregate, is unlimited with low entry barriers. The threat and realization of this risk is prompted by Apple Inc. (AAPL) and Amazon.com Inc. (AMZN) , which introduce their own easy-to-use and faster cryptocurrency blockchains. (Note: Amazon already has received a patent for its own blockchain technology — 8,719,131 — see here and here.)

JPMorgan Chase & Co. (JPM) causes a stir after CEO Jamie Dimon’s previously negative comments on bitcoin by introducing *“*JPMorgan E-cash,” its own cryptocurrency. Soon thereafter, other banks follow suit. As well, several governments (including the U.S.) introduce their own government-based cryptocurrencies based on their desire to continue to control policy levers such as money supply and fiscal policy.

The eventual demise for bitcoin commences in earnest when it is revealed in a New York Times expose that less than 10 entities, mostly residing in China and Japan, are found to have manipulated the price of bitcoins higher in Ponzi-scheme fashion over the last two years. The cryptocurrency bubble finally collapses in dramatic fashion and falls in value by 90% as a result of direct government intervention and a successful hacking where thieves penetrate the blockchain code and steal a large amount of coins.

Several large, well-known hedge funds desperate for *“alpha”* are caught with their pants and portfolios down and with a large weighting in bitcoins and other

cryptocurrencies; they lose more than 30% of their funds' assets and value and are forced to liquidate their cryptocurrency holdings and close their funds.

Bitcoin will ultimately assume a permanent place in the Speculative Hall of Fame*,* along with tulips (1636-37), the dot.com bust (1999-2000), the housing bubble (2005-07) and the South Sea Bubble (1711-20), as traders and investors learn the lesson, once again, that an asset class founded on the notion that there is a greater fool who will be willing to buy that asset for more than the previous fool paid, almost always ends in disaster.

The year 2018 will be one in which investors come to understand that blockchain technology — a distributed database of records of transactions that are executed and shared among participating parties and are validated by a network of users, called "miners," who contribute computing power in exchange for the chance to garner coins using a shared database and distributed processing — is real (each transaction is encrypted and can't be replicated or altered), but that bitcoin is a mirage and becomes, like many past schemes, a byword for *Ponzi-like* nostalgia.

Interest in gold, which has been sidelined for months amid the cryptocurrency frenzy, regains popularity, reverses direction from the lower left to the upper right and moves higher in price.

In an abrupt and swift flight to *alternative* safety, gold makes new all-time highs and becomes the single best-performing asset class in 2018.

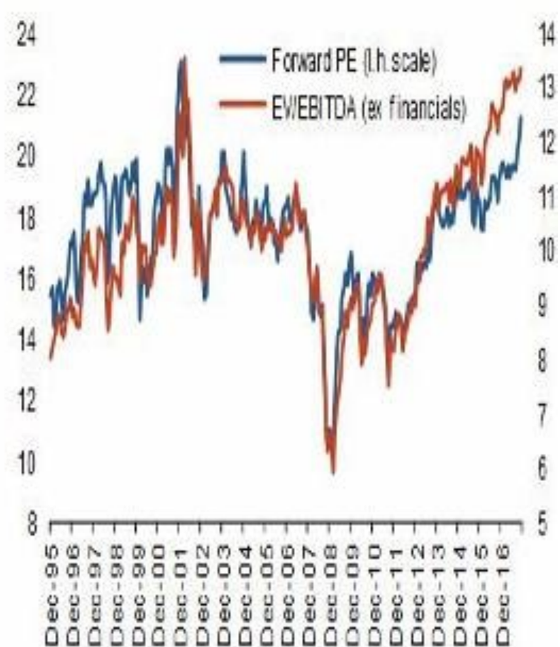
Surprise #5: The S&P Index Roars Into the 2017 Close and Makes a 2018 High on Jan. 2, 2018

Optimism about the U.S. economy and 2018 S&P earnings result in an all-time high in the MSCI World Stock Index by the close of 2017. For the first time ever the index posts a total return in every single month in 2017, hitting a remarkable sequence of 14 months of positive returns.

However, at the same time, the European markets mid-September stall continues and Europe begins to perform poorly both in an absolute and relative sense late in December, 2017. This geographic divergence initially is ignored but proves to be an important signpost of a January market top in the U.S.

Despite reducing the corporate tax rate from 35% to 21%, the benefit from the new tax bill is not anywhere near expected because actual corporate tax rates are significantly below the 35% statutory rate and already under 25%.

Because median stock valuations rarely have been higher both on a GAAP basis and on a forward P/E and enterprise value to EBITDA (EV/EBITDA) basis, it turns out the late 2017 stock surge overshoots and more than discounts the benefit of the tax bill.



Equities steadily decline in 2018.

Dip buying is not rewarded, but shorting the rips is rewarded next year.

Surprise #6: A Congressional Subcommittee Meeting Called by Sen. Dianne Feinstein Leads to a Regulatory Attack on Google and Facebook That Slows Their Expansion Plans and Market Share Gains

U.S. Sen. Diane Feinstein announces that her staff has been researching the possible adverse ramifications (real estate, employment, etc.) of Amazon's (AMZN) disruptive business strategy and Alphabet's (GOOGL) (aka Google's) dominance in search for nearly one year.

After publishing her findings that the lower product prices delivered by Amazon to the consumer are materially offset by the disruptions along many industries and that Google's search pre-eminence is anti-competitive, she calls for a Senate investigation. For the first time since the 2016 election, the Democrats and Republicans finally agree on something — the dominance of Amazon and Google must be reined in!

The president's antipathy towards Jeff Bezos, head of Amazon and The Washington Post, intensifies in a series of tweets after hostile stories in The Washington Post follow Drumpf's pardon of a family member and Robert Mueller's firing.

Amazon's share price halves as its ability to expand into different industries is halted by regulatory bodies and Alphabet' shares fall 30% as this existential threat intensifies.

Surprise #7: Stagflation Emerges in the Last Half of 2018 and the Fed Tightens Four Times

Though economic growth slows, wage growth begins to spike.

When unemployment falls to 3.5% a labor shortage develops and unit labor costs rise by 4% by the end of 2018.

Oil spikes to $80 a barrel as underinvestment meets geopolitics meets some kind of nature-driven problem in the oil supply chain.

The Fed sees itself behind the curve and tightens four times. The 2s/10s curve inverts and the vision of a stagflation-driven recession becomes clearer.

Meanwhile the Fed no longer is a liquidity provider. Netting out just Fed and European Central Bank (ECB) liquidity, January will see a net addition of $15 billion compared to $50 billion this past September thru December. By the second quarter it's just $5 billion per month and by the third quarter it goes negative. Investors fail to appreciate how chaotic this central bank unwind will be at the same time we have historic valuations.

With everyone on the same side of the boat as retail and institutional investors become fully invested and the levered risk parity funds take on maximum risk in response to ever-lower volatility, the above yields a sudden market correction of more than 15% in a single week as a major levered player implodes. Said players call the unexpected spike in volatility a once in 10,000-year event (see Surprise #9)>

Japan and Europe begin seeing the inflation that the Bank of Japan (BOJ) and ECB desperately want.

Surprise #8: The 2020 Presidential Front Runners Are Mike Pence and Howard Schultz, but Many Shadows Remain

With the tax bill again failing to "trickle down," the wealth and income gap widens and the electorate moves to the left.

Starbucks (SBUX) founder Howard Schultz announces a Democratic presidential exploratory committee. Facebook's (FB) Marc Zuckerberg and Mark Cuban become Schultz's largest and most vocal supporters.

Disney's (DIS) Bob Iger resigns after the Disney/Fox merger is rejected by the regulatory authorities. He, too, considers throwing his hat in the 2020 presidential contest but decides instead to run for a statewide office in California.

Hillary Clinton leaves open the possibility of running for president in 2020. So does Bernie Sanders.

Mitt Romney resurfaces as a force in the Republican Party and appears to begin preparation for another presidential run.

Surprise #9: Volatility Spikes, Causing a Major Flash Crash

"We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping. I admit to not understanding it.' -Dr. Richard Thaler, Nobel Prize winner
In 2018, the global volatility bubble bursts in a spectacular fashion, with stocks falling by 15% in one session.

In an interview with Bloomberg a few weeks ago, University of Chicago economics professor Richard Thaler went on to say in response to the market's low volatility and continued investor optimism, "It's certainly puzzling… and it's puzzles that attract my attention." He added that he is nervous, and when investors get nervous "they are prone to being spooked."

A World Without Risk?

These observations and, specifically, the above quote are much like what I have been saying in my Diary — namely, that never in history have there been so many potentially adverse political, geopolitical, economic and market outcomes.

I am not alone in this view, as Macquarie's Viktor Shvetz recently wrote:

"Investors are probably suffering extreme mental exhaustion. Historically low volatilities and risks, coinciding with high valuations, would make anyone nervous."
According to the brokerage, the reason for this underlying dysphoria is that *"investors understand that there is nothing normal in the current environment of unprecedented financialization and economic disruption. The deadweight of US$400 trillion 'cloud' of financial instruments (backing into assets that are either worthless or are declining in value) must be supported by ongoing financialization."*

In a world seemingly without risk and with spreads at all-time tights, Bank of America's David Woo writes in a similar vein that the market is more complacent than it was in the summer of 2007:

"This implies that liquidity must continue to grow, volatilities must be controlled and neither demand nor supply can yield higher cost of capital. Thus, risks facing investors are that either CBs and/or China misjudge extent to which reflation is dependent on inflating asset values and China's fixed investment.

If the market is underpricing the uncertainty with respect to the outlook of US monetary policy, we are even more concerned that it seems totally impervious to the risk of two potentially disruptive, if not dangerous, Games of Chicken likely to unfold in the summer and the beginning of the fall….

"We find it difficult to reconcile the record low volatility in financial markets at the moment with growing political risk in Washington and geopolitical risk in Asia. There are many reasons why we are living in a different world than the one we used to know and we would caution against relying too much on history for forecasting the likely outcome of these risks."
I recently observed the volatility records being made recently:

"Month to date, the annualized realized volatility of the S&P Index is 5.2% — that's the lowest vol in an October in over 90 years.

By means of perspective, the average October volatility since it has been recorded is 17.0%.

It is interesting that the four other low volatility Octobers all occurred in the 1960s — a period that preceded a sharp acceleration in inflation and rise in interest rates over the next decade."
So, with volatility at record lows, the S&P 500 climbing to new heights and such consistency of dip buying and advances, why do I think the risks associated with a "flash crash" are multiplying?

It is market positioning — something I and others rarely consider in our market analysis.

Today, speculators have breathtakingly large short positions in volatility futures, so that a relatively small spike lower in the averages, for any reason, of 3% or so could drive volatility much higher and demand (covering) of VIX futures. (The largest S&P selloff when the VIX was under 12 was 3.5% in February 2007).

Let me explain how a short volatility unwind might develop and what its implications are.

If Markets Spike Lower and the VIX Goes Bananas

It is tautological that as volatility moves lower and stock prices move higher, risks rise.

Several buy- and sell-side analysts have done a great deal of work as to what current positioning in the market may have if an exogenous event (from any Black or "Orange" Swan) produces a quick woosh lower in the averages and a spike in volatility.

From Morgan Stanley's Chris Metli:

"It's easy to become numb to the low volatility environment and the risks it presents. While trying to pick a trough in vol has been a fool's errand, focusing on the risks resulting from vol being so low is not. Low volatility has produced a regime where the risks are asymmetric and negatively convex, so

being prepared for an unwind is critical. This is not a call that vol is almost to spike, but you need a plan if it does."

The pain of an unwind in VIX futures could be exacerbated in the days following a woosh lower by the dominance of passive investors (quant strategies and ETFs). The deleveraging of highly leveraged risk-parity funds, in particular, represents a risk that may not be easily repaired or reversed after the initial market drop.

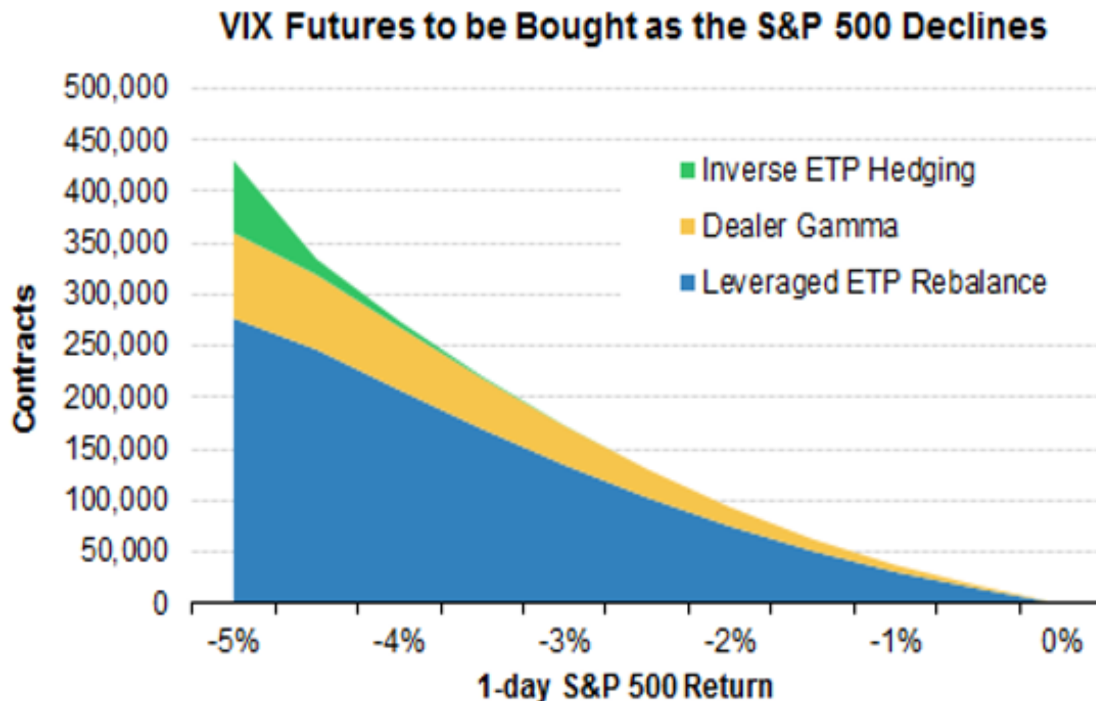
Here is a further explanation from Morgan Stanley by way of Zero Hedge of the positioning risks that were in place in July.

Since then, as volatility has declined and the S&P index continued to climb, the risks have grown greater with an even larger base of short volatility futures

Francesco Filia of Fasanara Capital writes about the potential damage delivered by the possible covering of short volatility futures:

"Market fragility must surely be a concern in the current investing environment. Yet, the psychological damage on investors and their behavioral reaction function to a sudden risk-off environment can never be as certain and direct as a wipe-out risk to a whole cluster of them. That is the nature of the risk that short-vol vehicles are facing today."

And consider this important update on positioning from Morgan Stanley's Metli — specifically, that more than 400,000 VIX futures would likely needed to be bought if the S&P Index falls by 5% in one day, nearly double what it was in July!



Bottom Line

Though large daily drops in the markets are rare, the factors that could contribute to a quick drop have increased.

Investors have been concerned about the VIX for years, but the positioning has now moved to an extreme. Such positioning could accelerate a market drop as the chances of a flash crash have escalated.

Hyman Minsky has warned about the risks of becoming numb to the risks associated with a period of stability amid rising asset prices; it is not only inevitably followed by instability, it inevitably creates it.

In a world in which the chances of an external market shock are rising and at a time when volatility is cratering and stock prices never decline, the risks of a flash crash caused by the one-sided market positioning in VIX futures is increasing and are at a higher probability of occurring than at any time in history.

Surprise #10: The Athens Stock Market Is the Best International Performer in 2018

Alexis Tsipras loses a snap election to Konstantinos Mitsotakis and the Athens stock market is the best performer in 2018.

Surprise #11: Company Share Buybacks Drop Dramatically

Contrary to the consensus, slowing domestic economic growth, rising interest rates, contracting corporate profit margins, disappointing S&P profit growth and political uncertainty weigh on buybacks, which plummet to a three-year low despite the tax bill's cash repatriation provision and a sharp drop in the corporate tax rate.

Surprise #12: European Bonds Sour

The European Central Bank (ECB) announces late in 2018 that Germany's Jens Weidmann will head the ECB in 2019 when Mario Draghi steps down as president. The European bond market gets hammered because that spells the end of NIRP (no interest rate policy) soon after the 2018 end to quantitative easing (QE). The global markets, both stocks and bonds, re-rate lower as an unprecedented loss in EU fixed income spins the markets lower.

Surprise #13: Twitter Is Acquired

Twitter (TWTR) becomes a more accessible access point to news, sports and video content in 2018.

Twitter is acquired at $30 a share in a bidding war with two different technology companies and a media company.

Surprise #14: Berkshire Hathaway Makes a $75 Billion Acquisition in Early 2018

Shortly after announcing the deal — the eighth-largest in the last decade — health concerns cause Warren Buffett to announce his replacement in 2018 and preclude him from attending Berkshire Hathaway's (BRK.B) annual meeting in early May in Omaha, Nebraska.

After a four-year hiatus, Warren Buffett invites me to grill Charlie Munger at the 2018 annual meeting.

Surprise #15: Tesla Stalls Out

Tesla (TSLA) isn't able to successfully manufacture the Model 3 at scale. The company loses access to the capital markets and becomes the next Valeant (VRX) .

Elon Musk retires and leaves the planet, headed toward Mars with a harem of supermodels.

FANG stocks fall in sympathy.

And that, as they say, is that.

Doug Kass

Since 2004 Doug Kass has served as President of Seabreeze Partners Management, Inc. He runs a hedge fund and individual managed accounts, co-authored "Citibank: The Ralph Nader Report" with Ralph Nader and the Center for the Study of Responsive Law in the 1970s and wrote "Doug Kass: A Life on the Street" two years ago (John Wiley). Since 2003 Mr. Kass served as a guest host on CNBC's "Squawk Box" and has guest hosted Bloomberg's "Market Surveillance" for the last five years. Along with Jim Cramer, Doug is the principal contributor to Real Money Pro.

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