HarborView Capital Management LLC

Global Investment Advisors

Market Note February 11, 2018

"There is nothing in the business situation to warrant the destruction of values that has taken place on the exchanges during the past week. It's a buying opportunity."
John D. Rockefeller October 30th, 1929

"Never before has American business been as firmly entrenched for prosperity as it is today"
Charles Schwab, President of Bethlehem Steel, December 10, 1929

The DOW was down 666 points last Friday, down 1,175 on Monday, up 567 points on Tuesday, down another 1,032 points on Thursday, and up 330 points on Friday! On a cumulative basis the DOW was up and down over 20,000 points this past week and is now down 9.11% over the last six trading days. The S&P 500 is now down 2.02% for the year.

HarborView Capital happens to agree with Mr. Rockefeller that the markets are indeed presenting us with a buying opportunity and this is not yet October 1929.

Fourth quarter 2017 earnings reports were the best since 2012. Thru Friday, with 68% of companies reporting so far, the S&P 500 operating earnings advanced by 22%. 76% of the companies exceeded their EPS projections and 67% beat revenue estimates.

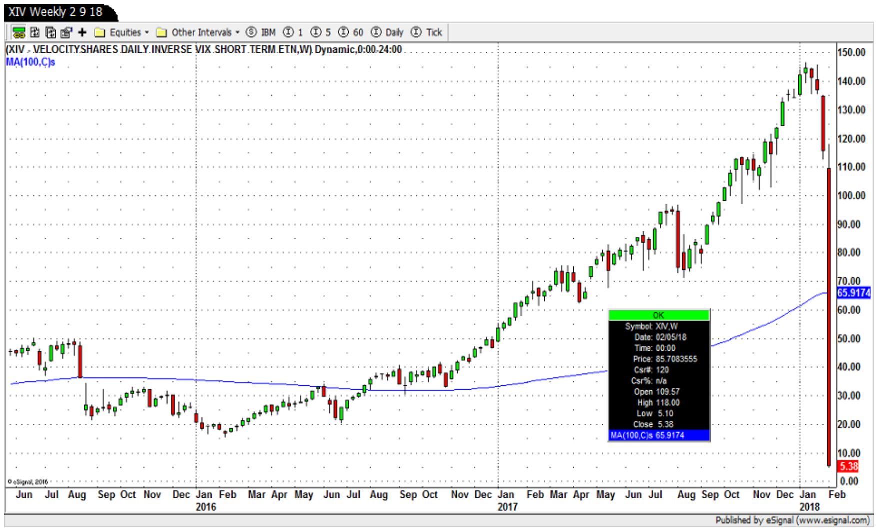
Earnings forecast for 2018 have been revised up to 20% ($155 of expected S&P earnings). Three months ago, consensus earnings growth for 2018 was 11%.

The S&P 500's forward Price Earnings (PE) ratio has now moved from 18.4X to 16.3X. The 25-year average PE ratio is 16.1X.

While a stock market correction has been long overdue what happened to make the last six trading days so volatile? On February 2nd, after January's payroll # was released, the stock market began selling off due to concerns about higher inflation and higher interest rates. Average hourly earnings came in at +2.9% YOY, the highest so far in the recovery, while Treasury announced in the afternoon it would be borrowing ~$1trillion annually for at least the next few years. With the Federal Reserve no longer buying Treasuries who exactly would be buying U.S. debt, and just as importantly, at what level of interest rates? Treasury needs to find $2trillion of additional funding just for 2018. Again, the stock market was beginning to ask, at what cost?

By the close of Friday's trading it was clear the algorithms were beginning to kick into high gear and the market closed on the days lows. Never a good sign. On Monday the markets opened down but rallied into mid-morning. From there the markets plummeted, with the DOW plunging 1000pts between 200pm and 300pm, and down over 1500pts at one point. Worse news was to come.

Short volatility (VIX) strategies and products, like XIV, shown below, essentially collapsed after the market close Monday. Theoretically volatility can go to infinity as there is no upper bound. Conversely a short VIX position can go to zero, as there is a lower bound, which is zero. And that is what happened.



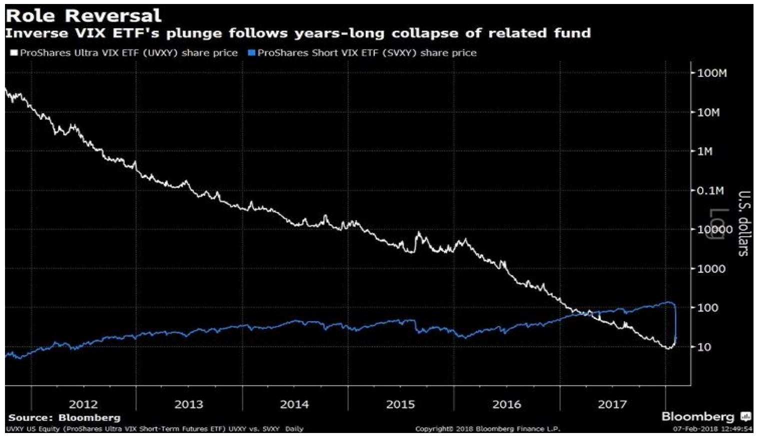
Stability sows the seeds for instability.

As volatility has declined over the last two years one of the biggest winners was to be short VIX. As volatility declines, strategies that short VIX sell even more volatility to maintain the same "risk" levels, with risk (or VAR) models not accounting for the eventual reversion to the mean.

Those short volatility were forced to buy volatility back, leading to the enormous move up in VIX, which in turn led to forced selling of the S&P/DOW, which the VIX is priced off of. Many sophisticated market participants were found to have short VIX positions in their portfolio's, including Bill Gross, the "Bond King".

Leverage hides in the darndest places, including this "conservative" sounding mutual fund.

As Hyman Minsky pointed out many decades ago "Stability sows the seeds of instability". How much risk portfolio's managers take is in many cases still dependent on Value at Risk (VAR) models that were developed in the 1990's. **As historical volatility declines VAR models (most VAR models "look back" 12-24 months) determine that taking even more risk is necessary to "keep" the same levels of exposure to risk.**

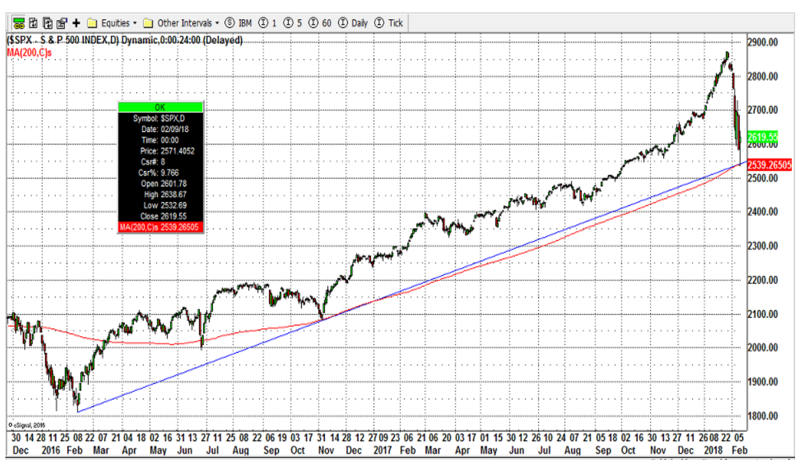


What risk?

Time and again, after long periods of low volatility, and this mispricing of risk, a reversion to the mean event reveals the true risk a portfolio has on board – and in many cases these strategies literally blow up. This is what happened to Long Term Capital Management in 1998, to AIG in the financial crisis, and this is what happened last week to the short VIX exposures around the world.

So we believe the volatility of the last 6 trading days was technical in nature, due mainly to positioning and rebalancing, and not based on economic or market fundamentals. Algorithmic trading (ie the machines). Rebalancing of Risk Parity strategies, which rely on "realized" historical volatility to determine leverage weightings. And perhaps most of all the aforementioned short volatility (VIX) positioning, which creates its own feedback loop.

When does volatility decline again? We are close. We believe Fridays retest of last Monday evening's low in the S&P (at 2530, also the 200-day moving average and the trend line from the February 2016 low) marks the short-term low, and perhaps the low for 2018.



The S&P 500 hit major support Friday after retesting the Monday nite low.

The markets have undergone a number of these violent selling episodes since the financial crisis of 2008. May 6, 2010/August 24, 2015 and January/February 2016 come to mind. **The correct action to take in all these episodes were either to 1) do nothing or 2) look for spots to buy.** Underpinning the positive outcomes from these episodic events were the fundamentals. While it is difficult & unnerving at times to sit thru these periods, it has proven the right thing to do. It is highly likely to prove the right thing to do this time around as well.

As we wrote in our Q1 Investor Letter we think 2018 will be a decent year for the stock market, and we continue to think that. But we also think as we head into 2019 and beyond the fundamentals will prove much less positive, with the likelihood of a recession increasing significantly as monetary tightening begins to "bite". Recession is a matter of when, not if.

Over $70trillion in debt has been added to the global balance sheet since 2008. The amount of leverage in the system is at historically high levels, and asset prices are getting bubbly. At the same time central banks are attempting raise rates and reduce the size of their balance sheets. **While this will not end well, for now the trend in risk remains higher, and the markets could easily see double digit returns in 2018.**

If you have any questions or comments regarding the markets or your accounts, please let us know.

Best Regards,

Paul Brian Gibson, Partner
HarborView Capital Management LLC