MONTHLY MARKET INSIGHTS

December - 2021

KAI VOLATILITY'S PREDICTIONS FOR THE NEW YEAR, PART 1

As is customary on the turn of the calendar, we at Kai Volatility are taking stock of where we have been and looking forward to where we are going. When we opened the funds last year, we set out on a project not only to derive returns *from* insight for our investors, but also to continually return *to* insight. We feel immense gratitude to have the partnership that we do with our investors. The warm reception of the newsletter has been humbling and we're thrilled to be able to roll out new ways to share content in the new year. We've been hard at work preparing the first ever Kai Volatility Predictions for the New Year. Due to considerations of timing and length, we are including near term predictions in this newsletter. In the January newsletter, which will be released in the coming weeks, we will continue with broader macro predictions and positioning for the coming times.

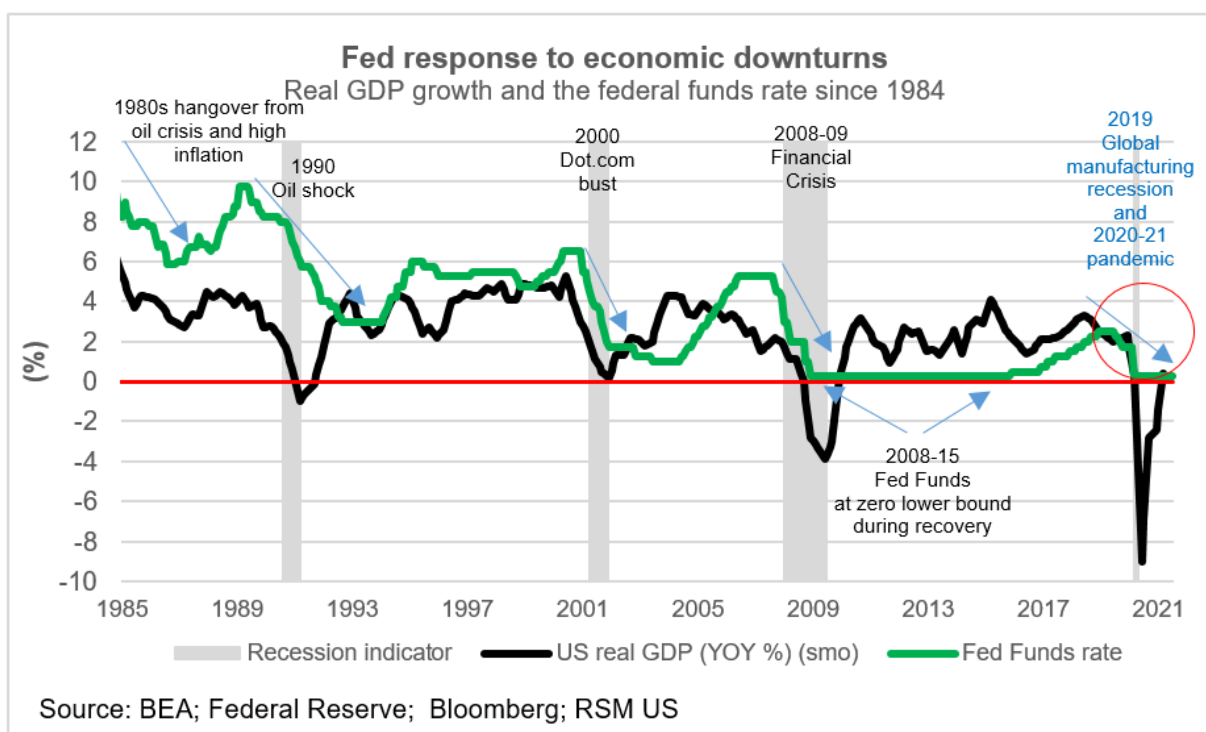
MONETARY POLICY OVER THE LAST 40 YEARS HAS LED TO ASSET INFLATION AND PRICE DEFLATION

We began in August writing about a concept that is so integral to what we do that the brand is on our door: liquidity. It has been readily apparent for some time that market valuations are an aggregate of equity supply and demand. What continues to be misunderstood is that prices are in no way tied to the underlying economy which, in fact, are in direct competition for the funds that drive equity supply and demand. Monetary stimulus alone leads to asset inflation. Money flows to the holders of assets who are more likely to invest those dollars than spend them. Capital reinvestment has led to greater corporate CapEx and more efficient technologies which in turn has largely eliminated jobs, lowered wages, and decreased demand. The much lauded "money-trickle" has always been the boondoggle of supply-side economics. This is the

age-old struggle between Capital and Labor; and Capital has been the recipient of most of the stimulus of the last 40 years.

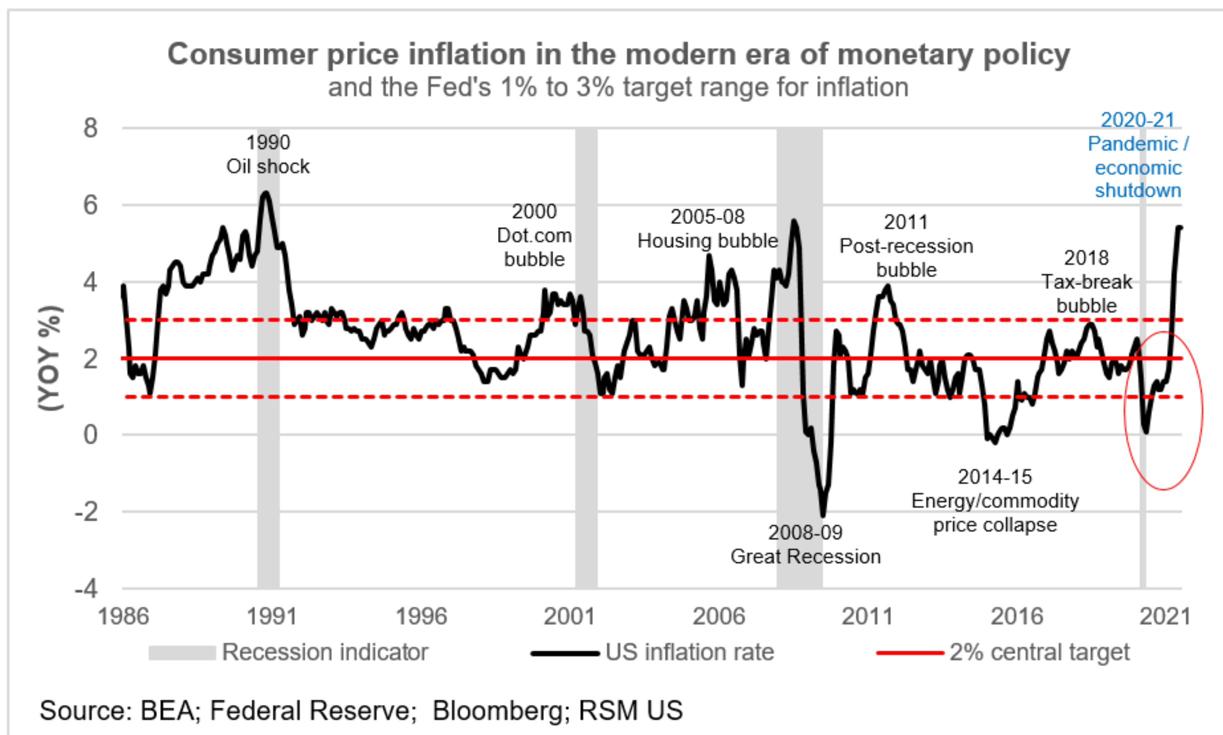
INEQUALITY HAS BEEN EXACERBATED BY LOOSE FED POLICY

This socio-economic backdrop has tended to result in working-class grievances that precipitates a considerable amount of social unrest. However, throughout this period policy makers in the US have indemnify the masses with the promise of broad access to the financialized economy. Defined benefits plans, stock-options, and easily attainable credit towards the American Dream of owning a home have been the purported bootstraps of upward mobility. From this vantage, it seems only natural that we end up with subprime mortgages, unprecedented household debt, gangrenous CDOs, and all the tinder for the Great Financial Crisis. In order to stave off a global financial meltdown, the Fed stepped in with, yes, MOAR monetary policy. Here we have our virtuous cycle of deflationary forces that has defined the regime of the last 4 decades. It has been an engine of substantial growth in GDP terms, but not without its cost of debilitating inequality, the clarion call of our current zeitgeist.



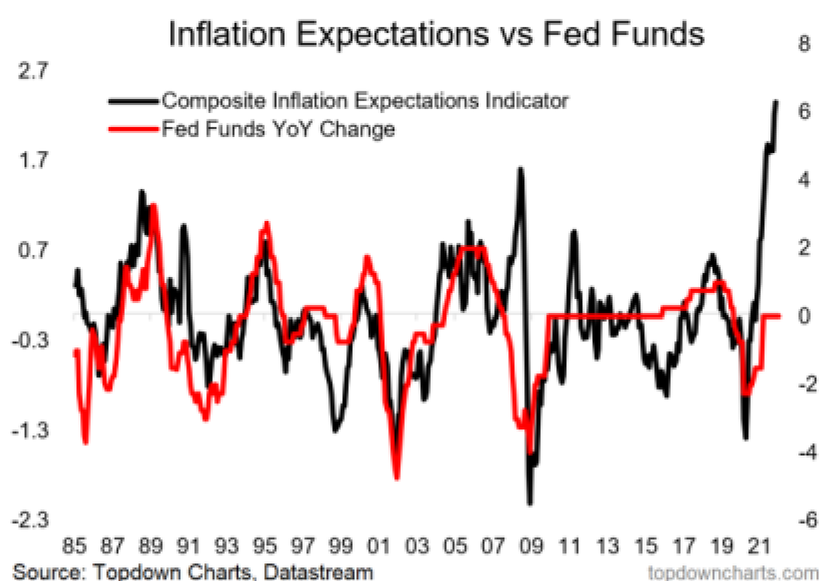
UNPRECEDENTED FISCAL POLICY WILL INCREASE INFLATIONARY PRESSURES IN THE NEAR TERM

The Covid pandemic has accelerated the effort to respond to growing inequality and policy makers have responded by enacting unprecedented fiscal policy. It is important to understand that this current policy not only dwarfs the Obama stimulus after the Great Financial Crisis by an order of magnitude, but also exceeds the size of the New Deal that filled a decade-sized hole in the economy. We have already started to see the effects of this. Over the course of the last year, wages for low income workers have climbed more than we have seen in the last 40 years, add labor shortages into the mix and, not surprisingly, we have an inflationary environment. It is also important to note that from the 12 trillion dollars in fiscal we have on the table, only a fraction of it has been deployed. As more of this capital gets injected into the economy as we anticipate in the spring, we will likely be led out of the lockdown/reopen-whipsaw by the omicron variant, which will unleash a deluge of pent up demand. Ultimately, we have considerable and non-trivial inflationary pressures. The Fed will be forced to confront inflation, which has already become politically unpalatable and promises to be the predominating theme in the first part this year.



QUANTITATIVE TIGHTENING CAN CURB INFLATION ONLY BY MEANS OF A RECESSION

Historically, monetary policy has been a blunt apparatus in creating downward pressure on inflation. Yet, and here's the rub, it is the only tool. The tightening of monetary policy has a more dramatic effect on liquidity than it does on inflation. Lower prices are a downstream effect of reduced liquidity only by proxy of an economic contraction. In fact, the majority of the recessions in the last 120 years were brought about by the tightening of financial conditions.



Reduced liquidity has several deleterious consequences for markets: less demand for risk assets, an unwinding of the TINA effect (TIA affectionately), and an unfavorable discount rate. Most pertinent to what we do here at Kai, volatility and risk premia will increase dramatically. As we discussed at length in the October newsletter, we are now in a burgeoning sumomarket. With the amount of leverage embedded in today's market, we will increasingly see extreme moves upon the reduction of liquidity and vol supply. As we have belabored here and elsewhere, these mechanics will yield a fat tailed leptokurtic distribution of outcomes.

THE DYING BULL MARKET: INVESTMENT STRATEGIES OF THE LAST 40 YEARS WILL UNDERPERFORM GOING FORWARD

The entire investment landscape since 1979 has not experienced inflation. The firms that have succeeded through this period have done so on the back of "buy and hold", passive investments, and risk parity—strategies that will begin to show their obsolesce moving forward. From where we sit at the precipice of this macro-economic cycle and the emergence of a new regime, here is what we forecast for the coming months:

Manifestly, we are in an important window of time for markets. Unlike in 2018 when the Fed did an about-face, Powell will be unable to walk back raising the federal funds rate in light of the current zeitgeist. In the near term, we see several possible market outcomes. As we have seen during past periods of tightening, the velocity of liquidity retraction is contingent on the reaction of capital markets rather than mere outcome of the Fed's directive.

THERE WILL BE A BLOW OFF TOP BEFORE A SECULAR DECLINE

Already we have experienced a 9% contraction on the S&P at the time of writing. Likely, the market will most become keen to the fact that monetary tightening is merely a trojan horse on the door of economic outcomes—that there is a considerable lag in its effects — and we will squeeze from the current zone. We could potentially move to new highs if we can maintain significant momentum from new buyers. Let's be clear, there is an impending terminus on this bull market, but the bubble could get considerably worse in the coming months making way for a secular decline after a massive blow-off top. However, if markets continue to swoon from the recent pullback, we could see another 5-6% taken out before we reach extreme oversold conditions. It is worth noting that we are in a weak seasonal period, sentiment is extremely poor, and if we begin to flirt with a 20% pullback we could cascade considerably lower as Brobdingnagian proportions of leverage and margin are unwound — there is a massive tail on this market, but participants have largely been hedged.

HEDGES WILL UNDERPERFORM INTO THE COMING DECLINE

Under the hood, we have seen a lot of rotation across sectors and single names. Yet, volatility has been largely compressed on the index level. The whole world is long, but the whole world is also spooked, and where do they tend to hedge? — on the index level. We anticipate that internals will continue to experience aggressive rotation of this sort, as indexes remain totteringly stable. The obvious pain-trade would be stair-steps down in the S&P with vol also underperforming. In recent weeks, we have seen declines on the index level with fixed strike vol broadly down day in and out — we anticipate this to be a

trend for the foreseeable future. As in December 2018, when investors began to fear a hawkish central bank and the S&P fell 9%, hedges also underperformed. Sustained Vol underperformance in these conditions can usher in further liquidation in the vol space, as fizzling hedges are unwound. Reflexively, this creates a negative feedback loop: dealers jettisoning vol off their books will be also forced to sell futures into a decline as we saw at the tail end of 2018.

RETAIL TRADERS' APPETITE FOR OPTION BETS COULD EXACERBATE THE DECLINE

To round out the downside risk we see in this window, we do not believe that retail traders' desire for putting on convex bets will wane over the coming year — and this does not necessarily mean upside call buying. There is considerable disillusionment and cynicism amongst this lot, many of whom view the dim prospects that have characterized their generation to be a direct result of Wall Street sins. Gamma works both ways. If the likes of r/wallstreetbets were to close ranks and buy short dated OTM puts into a decline in the same direction as institutional flow, as opposed to against it, the additional foot-pounds of pressure on the market would be catastrophic. For obvious reasons, it wasn't politically popular to punish retail traders when they were "short squeezing hedge funds" earlier in 2021. If the market economy were to be further damaged by a sardonic transposition of this retail trend, the backlash could be significantly larger, leading potentially to congressional action and further regulatory oversight of derivative markets.