SPECTRA MARKETS

April 28, 2022

am/FX

Brent Donnelly

bdonnelly@spectramarkets.com
(212) 398-6230

Jared's car

Current Views

Flat

Dirtcon: Day 1

Hello from South Carolina. I am attending Jared Dillian's annual conference called: Dirtcon. It gets its name from Jared's daily letter "The Daily Dirtnap." I have known Jared since the 2006 days when we both worked at LEH and I am an avid reader of his daily. It's one of the few things I make sure to read every day. If you would like a taste, email dillian@dailydirtnap.com and ask him for a 1-month trial. He writes about stocks, commodities, sentiment, and sometimes cats.

The conference is a great mix of speakers so far; in today's am/FX I will give you a few of my takeaways from each speaker. This is actually pm/FX, of course, due to me being in the conference all day. Same thing tomorrow and then back to regularly scheduled programming on Monday.

I realize I'm missing some huge moves in FX but sometimes you gotta rip yourself away from the desk and accumulate the growth and learnings. Without further ado, some conference takeaways so far.

Speaker 1
Devin Andersen
Founder of Convexitas, ex Managing Director and head of structuring at DB

Devin's presentation was about derivatives and why many of the most accessible and well-known derivative products don't do what most people think they do. Specifically, he spoke about ETFs, ETNs, hedged equity mutual funds, and tail risk funds. While I was aware of the inherent basis, rolldown, and carry issues endemic to ETFs that run (for example) VIX and other futures strategies, my main takeaway is that when I am thinking or talking about any index, ETF or derivative, I will do more work to make sure I understand it and how it actually works.

The gist is that creators/issuers of these products optimize for: simple, easy to explain, easy to sell, scalable, and cheap to operate. Investors, on the other hand, are looking for outcomes that mitigate or add risk in a tax optimal way. Very often, these objectives conflict and are resolved, almost without exception, in favor of the issuer.

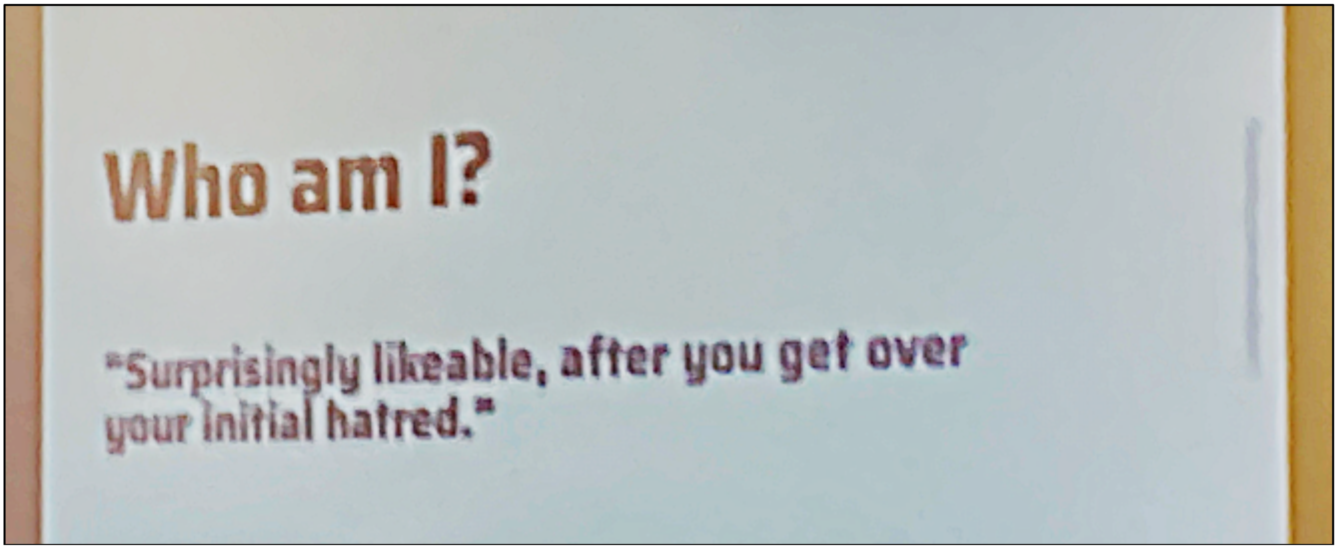
Devin spent a good portion of his presentation breaking down the extremely complex nature of the VIX calculation and the long and the short of it is:

- VIX is mostly a reflection of spot moves and skew, not changes in volatility. VIX is riding the skew, not telling you what's going on in vol.
- The way that the VIX is calculated leads to idiosyncratic drops and rises that have nothing to do with volatility and everything to do with ongoing changes in which contracts are used and how they are weighted.
- VIX is the very front of the options market and very rarely represents options that hedgers actually own. The actual options people own don't perform very well, even when VIX is shooting higher. Skew has not performed in 10 years as options market structure changed radically after the GFC.
- 2/3 of VIX ETN returns are from term structure and 1/3 is from the level of volatility.

Basically, VIX is an esoteric index of front-month vol and not a good proxy for equity volatility. The final takeaway is that if you buy tail hedges to mitigate equity risk in your portfolio, you should systematically rebalance out of the hedges as they make money. This forces you to buy dips at opportune moments. Monthly rebalancing kinda thing.

Speaker 2
Brian Venturo
CTO of CoreWeave, a cloud provider serving AI/ML and other high performance compute markets.

Great intro slide:



This presentation was insane. Brian is a fast and loose personality, seems like the kind of guy that just tries stuff and sees what happens. His company, CoreWeave, was born out of a huge early-stage investment in ETH mining rigs and eventually turned into a major cloud service provider. Brian learned the computing infrastructure ropes setting up ETH farms in his grandfather's garage at a time that ETH mining margins were so huge, computers he bought that were forecast to pay off in ten months were paying off in **as little as three days**.

Brian started out as an NG trader and was the lead PM at a natgas fund when he randomly got interested in ETH mining. Slowly, he saw a bigger and more interesting opportunity there and raised money to do a big build out in 2017. Then, Crypto Winter happened. They had to decide whether to shut down, or double down. They concluded that this was a binary bet on whether or not crypto goes to zero and managed to raise a bunch more money from investors to buy as much computing power as possible from failing and liquidating crypto miners.

They bought a massive project in Canada that had cost $100 million to build, but was in a bad state of disrepair. 27,000 rigs that didn't work mostly due to non-functioning fans. They bought the whole setup for **$500,000**, shipped it all to North Carolina, and hired 100 people to work full-time on replacing the 27,000 fans. They also bought a pristine chunk of computing infrastructure in Chicago for pennies on the dollar as it was in bankruptcy liquidation as BTC crashed.

Then, when prices rebounded, many of these investments paid off 50:1 or 100:1. Brian was 1.5% of all ETH mining at one point. Over time, as margins have shrunk, the company transitioned away from mining crypto and into providing compute power for AI/ML systems, visual FX companies and so on. They compete directly with AWS and Google Cloud. When asked how this is possible, he said that there is not enough supply of computing power out there so even though these competitors are huge, there is so much demand that there is room for more than just the three main companies. He thinks cloud computing is very, very early still.

His view on crypto mining now is that there is way too much money coming into crypto mining and especially bitcoin mining. Bitcoin miners at current prices have a 929-day payback (approx.) His interactions with the ETH developers and the never-ending but never-happening move from PoW to PoS has soured him on ETH as he feels it's not decentralized or subject to the idea of "code is law". Bitcoin, on the other hand, has shown that it's resilient to outside pressures and social engineering whereas ETH is not.

Speaker 3
Alan Kurtz
Lead Portfolio Manager for The Lord Abbett Convertible Bond Trading Strategy

The last time I thought about or heard about a convertible bond, I was in university! This was an interesting view into a market that I completely forgot existed. Some bullet points:

- Data shows converts give you 72% of equity upside with 44% of the downside
- The 2019 TSLA convert went up 20X. A bond. That went up 20X. Holy.
- In contrast, the PTON convert issued when the stock was at the ding dong highs still trades at 80.
- Teladoc stock was down 40% today and the convert was only down 3 points.
- The average convert usually has a delta of around 60/70 but that drops when the market falls. It's currently sub-60. Buying converts when the overall convert delta is below 60 has had a higher Sharpe than buying SPX or Russell at the same moment. Converts become more bondlike and more optionlike after big equity selloffs (i.e., further from delta one). This makes them a good way to play any bombed out stocks that you don't think are going bankrupt. He gave examples such as Smile Direct and Draft Kings (this is NOT a buy recommendation!).
- Main takeaway: **Buying converts is the best risk-adjusted way to buy the dip**.
- Obviously, there is an inherent bias as he's a convert guy so do your own research!

Speaker 4
Perth Tolle
Founder, Life and Liberty Indexes

Perth was born in China and moved to the US when she was 9. Her experiences with women's rights and other observations about China have led her to believe that investors should put their money in countries that have the most civil, political, and economic freedom. There is a moral and a fiduciary reason to avoid autocracies and countries with low freedom scores.

Most EM indexes are massively overweight China because of its size. She believes this is suboptimal from every point of view as you are buying an autocracy with tremendous **past** growth and the worst demographics in the world. Also, the MSCI China Index average annual return since 1992 has been… Less than 2%! Yuck. If that happened in a period of epic growth, what will happen as China moves from the old model of increasing economic freedom to a model of "common prosperity" where companies are zeroed overnight if they don't fit ever-changing state policy? She showed a chart of TAL and EDU (private education stocks) as an example. They were hugely profitable companies pretty much deleted overnight. Turned into non-profits by the government.

China is 35/50% of many EM indexes and EM ETFs. The war in Ukraine and the collapse of the value of Russian asset prices is an example of why investing in autocracies can be a terrible idea. Her thesis is not specifically anti-China, though. The thesis is that **political, economic, and civil freedom create the conditions for innovation, growth, and prosperity.** I found her thesis very convincing… Like, now that you say it… Of course it does!

Perth developed an ETF based on her thesis and it trades under the symbol FRDM. The methodology is rules-based and seems clean, smart and logical to me. They use the Cato and Fraser Institute freedom scores to assess emerging markets, rank them based on the freedom scores, and then buy more of the freer countries and less of the less free countries. Out of 27 possible countries, they buy 18. The thing launched in 2019 and has massively outperformed as China stocks dirtnapped.

Speaker 5
Thompson Clark
Writer and Editor of High Conviction Investor

Thompson presented his thesis on three small-cap single names: RILY, ZD, and CRGY. RILY has a nice big dividend. I'm not a single names guy so I don't feel I can really evaluate this content very well. Thompson's approach is: Cheap, high insider ownership, strong growth. These three stocks all fit that description very well.

Speaker 6
Tony Greer
Owner of TG Macro, author of the Morning Navigator, all around cool dude

Tony's presentation was definitely the funniest and got the crowd the most riled up. His hour was split into two parts:

1. Bullish oil and E&P companies. I have been following Tony for a while and he has nailed this call; it's not a new view. He's been bullish for ages and in January he wrote a trades of the year piece called: The Three Horses of 2022. They are XOP, IGE, and XME. All three have gone to the moon. His thesis is that US energy policy is driving US production lower and this will not change soon as ESG and other motivations have broken the normal "The best cure for high prices is high prices" feedback loop. There is an attack on supply.

   Normally, when prices go up, supply increases. Now, the government (and banks and investors) are disincentivizing drilling and there is not much spare capacity. US crude production peaked above 13.2 million barrels and is now below 12 million. While supply has lost its elasticity, demand remains robust and is also rather inelastic. As such, Tony thinks oil will stay up here and eventually go to $200. That will benefit the E&P companies and all related stuff.

2. The second part of the presentation was about sentiment and how to use it in trading. This was an explanation of various sentiment bell ringers such as magazine covers, large IPOs and various other what he calls "WTF" moments like Giselle asking to be paid in euros in 2007. The final slide of that section showed Elon Musk on the cover of Time Magazine with a cage full of Twitter birds. Tony keeps a file of crazy sentiment moments and this is the most recent addition to that file. People are starting to wonder if the TWTR buy is peak TSLA and whether it adds downside convexity to TSLA stock if Elon could get margin called. It will be fun to see how it all plays out.

Thanks for reading… I hope you found this useful. Let me know either way. Tomorrow, speakers include me, Turney Duff and others. Turney Duff = Tough guy to follow.

Super quick FX comment to end: Extremely aggressive moves in the USD, in either direction, tend to lose steam at the turn of the month. If you've been dying to fade this and sell dollars, tomorrow is a good day to try.

I am now off to see the Pelicans play minor league baseball.

good luck ⇅ be nimble


A small section of The Litchfield Resort where we're staying

Myrtle Beach is affectionately known as "The Dirty Myrtle"
There's even a beer here called that.


View out my balcony

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