

Alpha Exchange Podcast #229: Is US Stock Market Wealth a Reflexive Risk?

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In This Episode

Loyal listeners, I hope your recent days have gone well, even if they are becoming shorter. On my mind – and where I hope to engage your interest for 20 odd minutes – is the topic of risk and uncertainty.

The SPX is at an all time high and it is also highly concentrated with volatile and richly valued but uncorrelated tech behemoths. That's very unique. Whether you are an AI bull or bear, one thing we must acknowledge is the unique degree of index concentration and the risks that accompany it.

The exposure of both US households and foreign investors to the SPX is at an all-time high. There's a reflexive element here. The massive increase in market cap for corporates is the currency that funds the epic capex. For consumers, facing a tepid labor market and ongoing cost of living challenges, stock market wealth matters a great deal.

I also discuss the surge in volatility in gold and the advent of prediction markets. I hope you enjoy the discussion. Be well.

Transcript

Dean: Hello, this is Dean Curnutt and welcome to the Alpha Exchange where we explore topics in financial markets associated with managing risk, generating return and the deployment of capital in the alternative investment industry.

Lawyer listeners, I hope your recent days have gone well, even if they're becoming shorter. If you're in or near New York City, sunset is now before 6pm It's a far cry from when we peaked near 8:30 on June 21st and by fiat we'll lose an hour of precious daylight on November 2nd. It was Victor Burge who said, I don't mind going back to daylight savings time. With inflation, the hour will be the only thing I've saved all year. Come On Victor, the CPI is poised to pierce 3%. That is if we get another reading anytime soon. On my mind and where I hope to engage Your interest for 20 odd minutes is, as usual, the topic of risk and uncertainty. I've often said that risk management suffers from the failure of our imaginations. In the last Alpha Exchange podcast featuring Ben Hoff, the global head of commodity strategy at SocGen, we touched on the epic melt in crude prices in April 2020. The front or as they say in that corner of markets prompt contract plummeted to a who could have thunk it level of negative 40. My goodness. We did learn that interest rates could go negative.

The Swiss and Germans taught us that a decade ago, but just a little bit. But negative 40. And what about the volume impact? The OVX, the oil Vix surged to to 325 on April 21st, 2020. Can I get a second? My goodness. Just for fun, let's price a one month straddle on the S&P 500 using that fabulous volume put. The call alone costs 36.4% of spot with a 68 Delta. Add in the put premium and the straddle will cost you 72.7% of spot. But as Ben points out, it's really not as if one could have sold crude volume at 325 when markets break, as I think it's safe to say that the crude market did on its way to negative 40 on the front month prices, especially those that are calculated as per the VIX methodology that emphasize the tails need to be handled with care. But this is a good example of how risks materialize in ways that overwhelm our capacity to imagine them. This might be a good time to mention Shohei Ohtani's recent playoff game against the Brewers. Three home runs, six scoreless innings and 10 strikeouts before this mind bending feat.

If one were to imagine a single best performance by a player in a game. It might include a no hit perfect game by a pitcher or perhaps four home runs by a batter, but it would look nothing like what Ohtani just pulled off. We simply could not have imagined it. I think there are corollaries to markets and we've got to constantly press ourselves to entertain scenarios that challenge conventional thinking. There's much more on the recent podcast with Ben Hoff, with an emphasis on how commodity markets are structured to absorb volatility. I

encourage you to listen. Ben likens the commodity ecosystem to a CDO structure of risk absorption. The first loss tranche is optionality in time, where storage smooths shocks by shifting supply forward. The mez tranche cures through space and form, rerouting flows across geographies or substituting between products. Only when those defenses are depleted does the equity tranche financial volatility take over. This hierarchy explains why volume commodities is less persistent but often more explosive when it surfaces. Of course, who could forget James Cormier of optionsellers.com and his unfortunate foray into selling straddles on Nat Gas? Let me briefly preview our lineup of guests on the podcast.

I'm eager to share my discussion with Alex Kazan, partner and co head of the Geopolitical Risk Practice at the Brunswick Group. We explore a topic I think is very important, the notion that the us long considered a bastion of global stability, is now a source of market risk via its weaponization of sanctions, its negotiating style with tariffs, and the degree of partisanship in the US two party system. Kalshi now has an almost 1/3 chance that the shutdown will last more than 50 days. Also coming soon to the Alpha Exchange podcast is a conversation with Jordi Visser of Visser Labs. Jordy will lay out the promise of the AI revolution, arguing against the notion that we are in a bubble. His writing on Substack is really thought provoking and very much worth reading. I'll also chat with Todd Rapp, CEO of the Fortress Multimanager platform. In short order, a discussion that will focus on how Todd thinks about allocating capital to alternatives both internally and and externally. With that, let's get into the here and now. The S&P is at an all time high as I speak these words. Along with this, the index has several characteristics worth carefully considering.

First, it is remarkably top heavy. 38% of the market cap is in the top eight names. Notably, these eight names constitute a fifth of the global market equity cap. There is just a ton riding on the success of a few stocks. Next, this top heaviness comes from very high volatility names. The average third quarter option implied earnings move for the eight is 5.8%. This is versus the bottom 492 average move of just 4%. Next, these eight names and the index at large are substantially, and I will continue to argue, unsustainably uncorrelated s and P1 month realized correlation was recently 0.1month implied correlation is currently 9%. And lastly, valuation Factset tells us that the forward 12month P E ratio for the S&P is 22.4. This P E ratio is above the 5 year average of 19.9 and above the 10 year average of 18.6. Let's put all of this into a neat summary. The index is highly concentrated with volatile

and richly valued but uncorrelated tech behemoths. That's very unique. Now let's dive in. Google, Meta and Microsoft are the first to report on October 29th. Will their results have any implication for Apple coming on 10:30 and Amazon on October 31st?

The experience over the last two years has been no Market prices, including both volume and correlation, make perfect sense in light of recent experience. But is there a risk that some of the spectacular gains through this circular acquiring squad are the result of cash and market cap simply being recycled? There are plenty of opinions on this, with skeptics like Robert Knott from Research Affiliates citing the vendor financing arrangements that Cisco and Lucent utilized with weaker customers to prolong the cycle during the height of the dot com bubble a quarter century ago. Others like Jordy Visser are more sanguine in his recent substack entitled Edison's Lesson for the AI why the Capex Boom Isn't a Bubble, Jordy presents a thoughtful argument with much reference to history that puts today's creative destruction into context. We'll take this and more up on the podcast. Whether you are an AI bull or bear, one thing we must acknowledge is the unique degree of index concentration and the risks that accompany it. There's an old saying that quote, if your head is in the oven and your feet are in the freezer, on average you feel just fine. Today's economy would seem to present quite a quite a dilemma for the Fed.

And that's not just that it has been forced to operate in the fog of data war due the shutdown. There are surely signs that the labor market is slowing, but GDP growth is holding up. Jason Furman recently estimated that 92% of the increase in demand in the US economy was due to just two categories in GDP information processing equipment and software. Jita Gopinath, former chief economist at the imf, wrote a recent op ed in the Economist, highlighting her work on the impact of a capex bust on not just the US but the global economy. In financial media, fear certainly does sell, so the title of the piece on the crash that could torch 35 trillion of wealth might be a tad alarmist. That said, she makes some valuable points. Both households and foreign investors are as exposed as ever to the US Stock market. If you were Norges bank, would you be chomping at the bit to allocate to the CAC 40 38% of its nearly \$20 trillion portfolio is in the US stock market, essentially two times its allocation to all of European equities. Miskopenath estimates that a stock market correction on par with the.com crash could wipe out \$20 trillion of wealth for American households, the equivalent of 70% of GDP in 2024.

The consumption after shocks would be huge, translating to a 2% hit to overall GDP growth. Next, given how invested foreign entities are in the US stock market, she estimates losses for investors outside the US as high as 15,020,% of the rest of the world's GDP. It sure does sound like a lot. Now, using the.com crash as your modeling scenario is pretty extreme and in some ways may cause the reader to dismiss it as too bearish. But the point ought to be pretty clear. There is a ton of risk in a Mag 7 sell off. It feels like a very reflexive risk. The gains in market cap are the currency for more capex. They are also an increasingly valuable asset for US Consumers. The estimates of the propensity to spend stock market wealth are all over the map. When the richest come very quickly, we'd expect the spending beta to be lower. But this wealth has been building and building over time amidst a generally low volatility environment. As I've said over and over, the S&P may be composed of some volatile stocks, but because they are so uncorrelated, volume at the index level has been quite tame.

But for the unwelcome drawdown in April, my own work on the unsustainability of low correlation, along with what experts like Jason Furman and Jita Gopinath are saying form part of a cautionary mosaic on risk. If share price success underpins both the giant capex investment cycle and some portion of a wealth effect that keeps consumer spending even amidst an otherwise tepid economy, what happens should shares experience a correlated shock lower we have to force ourselves to entertain wayward scenarios. The S&P is up 17% in 2025 on a total return basis, that is after gains of 26% in 2023 and 27% in 2024, an 81% return altogether with just a 15 volume. These are sharp ratios that we can only dream about. No wonder the US Equity market is so well subscribed. Let's return now to market pricing as this critical earnings season gets underway. It's the super bowl of earnings this week with half the S&P 500 by market cap reporting. As I've discussed before, the CBO calculates a VIX for just about everything, including a weighted average of single stock fall on the names that comprise the S and P. They apply the same methodology used to calculate the VIX on Nvidia, Microsoft, Apple, etc.

And then weight all the names according to their weights in the S and P. The relationship between vixeq, the single stock constituent VIX and the actual VIX tells us something about how the market prices correlation among the stocks. Currently the spread of the VIXEQ to the Vix is 25, essentially a decade high. The spread nearly always widens during earnings

season, a reflection of the fact that a large degree of the expected moves in the S&P will result from the stock volatility that comes via corporate earnings results. Please do check out a cool chart I posted to make this point on X, that social media platform formerly known as Twitter. It shows the distinct seasonality of the spread of single stock fall to index fall as corporate earnings are released four times a year. The prominent spikes are the market paying for single stock options but that extra premium not really translating all that much to additional value in S&P options. That is low correlation in process. The spread is always there, but today's record spread is worth thinking about. The market is paying a lot for single stock volume ahead of earnings.

Bloomberg estimated that the average earnings implied move for the the companies in the S&P is the highest since 2022. The Vix EQ is in the 94th percentile over the last decade, but the VIX is in just the 67th percentile. The Vix trails the Vix EQ by so much because the market discounts the potential for CO movement among the super caps. At some point this record low correlation will break. I think this is incredibly important from a risk management standpoint. If you've got 25 minutes, please do go back and listen to my recent podcast. Low correlation is the defining risk in markets. Because the S&P is such a beast of a benchmark, I've suggested staying long it despite the correlation risks hiding in plain sight. But I do like playing defense through diversifying assets and the purchase of insurance. The Goat Great Opportunities and Threats portfolio I've been advocating for consists of 84% S&P, 10% Gold, 5% Bitcoin and a 1% allocation to three month 9580 put spreads on the S and P. This is vastly outperforming the S&P on a risk adjusted basis in 2025 and experienced only half the April drawdown.

Let me review some of what I was actively posting on Twitter in the run up to the dramatic gold online. Perhaps many did see this coming, but for me it was the behavior of gold implied volume that was the best tell that a sharp rally in gold was paving the way for a sharp, even if fleeting unwind. You may recall that one of my 35 sayings on volume risk is that, quote risk on and risk off are curious cousins. It's a nod to the way in which profits from a trade invariably draw attention and lure in fresh capital, eroding the margin of safety in the process. When the success of a risk on episode is significant enough, it paves the way for a spectacular unwind in the limit. Like a GME in January 21, it's a certainty that it will occur. Stock up Volup always ends in stock down volume down Gold has been a good case

in point. It's truly a FOMO asset with only a vague valuation framework. But that's mostly the point. It's dangerous to fade a price that is untethered to value. I argued that the strength of the recent gains in gold, paradoxically was doing two things at once.

First, the rising price was the advertisement compelling folks to buy. There's no Graham and Dodd valuation work to do. As Soros said, quote when I see a bubble forming, I rush in to buy further Adding fuel to the fire. The rising price was the fuel for new demand. The rate of change of upside moves recently accelerated. Since 2023, there were 19 days when the GLD move was up 2% or more in a single day. Thirteen of those 19 have occurred, seven since April 2. As the sky is the limit narrative was built through the ascending price. Implied volume rose sharply, reflecting the market's understanding that the risks were becoming more two way. That is for folks wanting to play the upside. Using call options became a consideration as the recent strong gains in spot could quickly prove to reverse the call option permits you the right to walk away if you are wrong. The GVZ the gold Vix went from 15 to 33 from August to October 16, even as one month realized volume on the GLD was just 21. This was simply about one way demand for optionality. You wind up in a situation where the strength of the risk on creates the vulnerability for the risk off as those investors in early take profits and those in late try to limit losses.

It's a sharp unwind that clears out positioning. On Twitter I said if history is some guide, further increases in both gold and its implied volume bring us closer to a sharp even if short lived unwind of some of the recent gains. Timing is impossible, but the GVZ is part of it. On the back of Fed independence concerns, the GVZ spiked to 28 on April 21 and it was back to 21 by May 1. Gold drew down 4.4% over that period. I suggested that it would be good for a 3 to 5% decline over a few days, noting that the option dynamics might accelerate it. If the buyers of all the calls that have traded in the GLD are outright and the sellers are hedging, you can conceivably get some feedback as these hedgers need to rebalance their deltas by selling into a falling market. It was also worth considering the overlay of leveraged ETFs on the gold miners including NUGT a 2x daily, JNUG also a 2x daily and GDXU a 3x daily. These would conceivably impose some short gamma into this asset class as the rebalancing at the end of a large down day would lead to more selling.

To be clear, I still think gold ought to be part of the portfolio, but what we ought to contemplate is that the volume profile of this asset might have structurally moved higher.

Two month realized volume was just 12 as of early October. It's now 25. Of course that incorporates the giant move lower of 6.4% on October 21st. I think gold still ought to be around 10% of the goat portfolio, but want to monitor it to see if that 25 volume roughly 1.5% per day daily move sustains itself. That's a bit too high for a 10% allocation from my perspective. With that, let me close this short pod with some thoughts on prediction markets. While some of the culture bets on these platforms are rather unimportant, how many times will Elon tweet in a week? Who will win best picture at The Oscars, for example. The language of prediction markets is actually quite clean. Most all of what we do in the land of investing includes some version of evaluating probabilities. When the market prices the odds differently than you do, there may be an opportunity to earn a favorable risk adjusted return. Everyone can quickly get their arms around a yes or no outcome.

Essentially, binary options that potentially pay a dollar if they hit vanilla option prices via strike prices give us a mapping of the implied probability of moving a certain distance. Event contracts can also help us estimate how far something will go. In addition, they can help us see a probability distribution of how long something might take. In this context, both polymarket and Kalshi are getting increasing attention from the likes of cnn, citing the odds placed on the duration of the shutdown. One interesting and valuable aspect of prediction markets is that in some instances they can be more effective at breaking news than news organizations can be at breaking news. This is especially the case in off the run bets where critical information can quickly make its way into pricing, moving the market sharply in the process. In this way, a big change in probability doesn't just reflect the news, but it is the news. A good example was July 2024 as Biden struggled to hold the line and stay in the race post the awful debate performance, the probabilities moved wildly. Sometimes intraday we'd see the prices move and only then get the specifics of why they had moved.

By watching the news, we were able to see a market price probability fluctuate in real time, about a pretty consequential issue. This is valuable price discovery. Through the event contracts, we also learned about correlations and conditional probabilities. Clearly, a plunge in Biden's probability would lead to a big rally in Harris's probability and vice versa. But that was only after Newsom's initial chances at times above Harris's died down. With respect to political prediction markets, there's a fascinating reflexive element. The contract isn't merely reflecting outcome probabilities. The odds themselves can conceivably impact the decisions

of those enmeshed in the situation. As the Biden vs Harris odds moved around in July, we saw in real time how that impacted Trump's odds. Thus, it became clear that the market thought Harris had a better shot at beating Trump than Biden did. And this information likely fed back into the course of action taken by Pelosi, etc. Furthering the view that Biden had to drop out. Well folks, that is it for me for now. I'm excited to continue to host conversations with deep thinkers on markets and policy and bring these conversations your way. Please keep the feedback coming.

It is both helpful and appreciated. I wish you a wonderful week.

You've been listening to the Alpha Exchange. If you've enjoyed the show, please do tell a friend. And before we leave, I wanted to invite you to drop us some feedback as we aim to utilize these conversations to contribute to the investment community's understanding of risk. Your input is valuable and provides direction on where we should focus. Please email us at feedback@alphaexchangepodcast.com thanks again and catch you next time.

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