

The New Skinny Bitch

If you bump into someone who has lost 10 pounds, maybe you notice it, maybe you do not. If you meet ten such people, you might catch on to five's improved health or changed looks. However, if you meet someone who has lost 50 pounds, you almost certainly notice. If you meet ten such people, you would catch onto eight, maybe all ten. What happens? The magnitude of change raises the pace of diffusion of information.

Apply this idea to the equity market. The changes in valuation have been so significant that everyone is watching everything, and higher volatility implies that the diffusion of information is much faster and the market is hyper efficient. The equity market is the new Skinny Bitch, and everyone is noticing. This explains the recent rally, which left quite a few hedgies, in equities and fixed income, wondering what the long only types were up to. The macro economy remains terrible, individual earnings are cliffhangers or worse, what's to celebrate?

Starting in early January, the Skinny Bitch phenomenon led to a downward re-pricing of stocks in eight weeks of a magnitude that would normally occur over the course of six to nine months, the usual horizon of valuation efficiency in the US market. Many levered stocks converged towards 0 because current trends would not allow for refinancing. This process was already over by early March, when the market started looking at the next quarter. Hence Citi's 'leak' that its ongoing business was stabilizing lit a match. Every positive pre-announcement was then treated with the possibility that the entire sector would stabilize at that level. In terms of statistical projection, this takes away the left tail of the distribution of changes in future revenues. Consequently, if costs are under control, the discount rate collapses, to say 5%. Even without growth, the market became willing to pay a multiple of 20 for normalized cash flows. The 'smart' money was short biased, and the caution which paid off until early March bloodied them since then. Long / short strategies absorb brief rallies in shorts here and there, but the size and the pace of this one left everyone befuddled, and few wealthier.

Since the market is, even if temporarily, hyper efficient, the potential for stability lowered the risk premium immediately and led to a ferocious rally which presumably lasts until 'Which companies are truly stabilizing?' becomes the big question for the next quarter. At that point, the multiples for companies that can reignite the top line will hold up, while others will collapse. The pre-requisite is that the macro economy stabilizes as well. If it does not, and currently neither housing nor employment is helpful, the market could revisit lower lows quite quickly, because now you have continuing top line damage without the belief that near term stability is possible. From current heights, an outright collapse would occur. When the next signs of stability appear, another vicious rally would materialize. This could go on for months or years.

If the economy does stabilize here, or when it does, the next risk becomes the withdrawal of stimulus in response to the rise of inflation, which can lead to a 'double dip' recession, and led to the slowdown in the late thirties which was eventually solved by WWII. Assuming the Fed manages the withdrawal well, all this still leaves us with the problem that equity risk premiums will rise again as expectations normalize around lower consumption led growth, so the market will struggle to provide significant returns for a while. If the Fed accepts inflation, we are back to the seventies – single digit multiples coupled with supply shocks in energy and materials.