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April 7, 2025

Beware of Greeks bearing gifts

There's something happening here
But what it is ain't exactly clear[1]

The stock market has collapsed. This is widely blamed on the forecast of negative effects of a harsh tariff regime proposed this week. Many people claim to be economic experts. The consensus of their informed" opinions is that this will at once cause inflation at the same time drive a worldwide recession. The large and rapid stock market decline is considered validation of this reasoning. Never mind that these are contrary outcomes, there can be little inflation if the demand side of the economy collapses.

The markets seem to be focusing on a future that is hardly determined. Investors will be better served by focusing on the current data and the more likely near-term outcomes,

Economic data suggest that the economy is slowing, inflation is well controlled, and employment is softening but still healthy. Policy changes include:

[1] For What It's Worth
Song by Buffalo Springfield · 1966
Password

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- Government spending cuts, instead of an increases
- Regulatory relief versus increasing strictures
- Deemphasizing industrial policy,
- Rooting out waste and fraud, and
- Reducing the size of government.

Federal Reserve Policy

One thing that hasn't changed is the Federal Reserve Board's creating policy based on their future economic forecasts - despite their abysmal record of recent past.

The inflation rate has fallen close to the Fed's proclaimed 2% goal.

Powell and company claim to be data dependent, but that is hard to match the data with their behavior. Interest rates have diverged from the Fed's policy of maintaining restraint, dropping precipitously over the last few weeks. The bond market is sending a starkly different message from the Fed. The yield curve is again extremely distorted, short rates exceed intermediate rates, the ten-year note is under 4%, while the overnight policy rate is 4.25-4.5%. Even more significant, the 90-day/thirty-year rate differential is once again nearing an inversion, consistent with a recession.

Powell and company are creating a policy based on their feelings about the future, acting on possible outcomes, instead of market indications. During Trump's first term, they acted to preempt inflation that never appeared, nearly creating a recession ins 2019, aborted by easing to alleviate a stock market plunge. During the Biden term, they facilitated deficit spending long after the self-inflicted Covid economic emergency, purposefully ignoring the obvious and persistent inflation caused by their lack of even a modicum of restraint. They then slammed on the monetary brakes, leading to a significant market correction in stock and bonds in 2022.

You would think they would recognize their overconfidence. Parsing the recent Powell speeches suggest not. I add emphasis,

"We have stressed that it will be **very difficult to assess the likely economic effects of higher tariffs** until there is greater certainty about the details, such as what will be tariffed, at what level and for what duration, and the extent of retaliation from our trading partners. While uncertainty remains elevated, it is now becoming clear that the tariff increases will be significantly larger than expected. The same is likely to be true of the economic effects, which will include higher inflation and slower growth**. The size and duration of these effects remain uncertain**. While tariffs are highly likely to generate at least a temporary rise in inflation, it is also possible that the effects could be more persistent." [2]

"Very difficult to assess", and "these effects remain uncertain" should guide policy. Instead, they are maintaining high short-term interest rates. This is a gamble on the self-confessed unknown and unknowable future. I worry that the reserve Board fears of the inflationary pulses from the tariff policy may promote an unnecessary recession.

[2] https://www.forexlive.com/centralbank/the-full-text-from-fed-chair-powells-speech-20250404/

Reality Check

The US economy is the largest, strongest and most self-sufficient in the world. It is the most desirable trading partner. There is no similar market. In my opinion, prolonged trade disruption is the less likely outcome, it is far more painful for other nations. Economic imperatives should drive reforms and eventually much lower trade barriers. Chicken little should be ignored.

Lower interest rates and falling oil prices are disinflationary. These reflect a recognition of the real economy – as opposed to the Fed's data independent view. Investors should resist selective data interpretation focused exclusively on the effects of tariffs. Their view should encompass all the current data: slowing wage inflation, lower interest rates, lower energy prices, stable employment, and the benefits of cutting waste and fraud in government, and deregulation.

The benefits of reorienting growth to the private sector could far outweigh the potential impact of tariff negotiations.

Why has the market reacted dramatically to an ambivalent outlook?

There may be more than meets the eye to the current market price collapse since the news background is far less dire than those which accompanied other significant market declines.[3]

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[3] The "Trump Thump" will go down alongside 1987's Black Monday, 1929's Black Thursday, the dotcom crash and the pandemic as one of the worst times ever to be in the stock market.

I think there may be a structural problem in the market arising out of lax regulation and excess leverage. In 1987 the market plunged as "portfolio insurance" and "program trading" led to automated trading and cascading sell orders. Hugely popular, short term, seemingly sure thing trading strategies were the tail that wagged the dog. Again in 1998 the market plunged when another popular, high-level strategy failed. Long term Credit Management's sure thing arbitrage strategy unwound spectacularly. Certainly, there were other factors involved, but these investing methodologies were significant in magnifying the market reactions to investment events.

I think much of the current market volatility may be directly related to the massive expansion in option markets. The size of those markets has soared, facilitating rampant speculation and a structured investment industry.

Average daily options volume has grown from 20 million contracts in 2019 to 58 million contracts in January 2025. In notional terms, today's options flow exceeds $3 trillion in value — more than five times the daily turnover of the 5,700 underlying stocks and Exchange Traded Funds (ETFs). Dominant trends in recent years have involved growing retail adoption and short-dated options (0DTE) trading, a significant increase in the number of ETFs that

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The two-day fall of 10.5% makes it into fourth place in the worst two-day drops since the S&P 500 was created in 1957. Worse were the outbreak of the pandemic in 2020, the aftermath of the collapse of Lehman Brothers in 2008, and the 1987 crash. ….We can go back to the 1920s using the S&P 90, the predecessor to the S&P 500, where the Trump Thump is beaten for two-day falls only by some legendary disasters: The 1929 crash, the success of the Nazi Blitzkreig in 1940, and a couple of dives near the bottom of the Great Depression in 1932 and 1933. https://www.wsj.com/livecoverage/trump-tariffs-trade-war-markets-04-05-25/card/the-trump-thump-market-swoon-was-historic-9Ge9LuW0bo AAEsaNOkUB *use options, and the increasing use of FLEX options to customize exposure and implement securities-financing operations.*[4]

The structured investment market is substantial and continues to grow. In 2024, the global structured finance market was valued at $1.53 trillion dollars. [5]

Options contracts are a transaction between a buyer and a seller. These trades are facilitated by market makers, highly leveraged, high frequency trading firms.[6]

Market makers are constantly seeking to maintain a neutral posture, hedging their outstanding options liabilities with a position in the underlying security. Hedges require two sides, a party and a counter party.

In the most basic terms, a put option is an obligation to purchase shares, the hedge is shorting the underlying security. A call option is the opposite, requiring a purchase of the underlying security to offset the obligation to deliver the underlying security. The actual hedging operation is continuous and based on complex analysis of many variables, referred to as the "Greeks."

[4] Options Activity Review and Preview
[5] Structured Finance Market Size & Trend [2033]
[6] The largest option market makers, such as Citadel Securities, Virtu Financial, Jane Street, Optiver, and Susquehanna International Group (SIG), typically receive financing from a mix of sources, including:
Prime Brokers – Large investment banks like Goldman Sachs, Morgan Stanley, and J.P. Morgan provide financing and clearing services to market makers. https://copilot.microsoft.com/chats/LYR5E962cTibdKGgaih7Z

The "Greeks" is a complex subject beyond the scope of this piece.[7] What is important is that trillions of dollars (notational value) of securities change hands throughout the trading day, as market makers continually seek to maintain a neutral position on their books while exacting tiny amounts of profit on the trades. These continuous hedging offsets create the potential for cascading waves of selling or buying. (The consequence dynamic hedging and the use of "Greeks" of Delta and Gamma .)

The amount and speed of the transactions are mind boggling. It is a real-world use of artificial intelligence and data processing capacity, automated trading systems that drive markets, unrelated to fundamentals.

The WSJ briefly noted this phenomenon when the DJI dropped over 2000 points recently:

"Meanwhile, traders piled into the options market on Friday, in another sign of just how wild the session was. The total options volume on Friday was 101 million contracts, about 77% above recent average levels, according to Cboe Global Markets.[8]

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[7] In options investing, the Greeks are values that estimate the various risk characteristics of an options position. They tell traders how an option is likely to react to changes in the market, such as a change in the price of the underlying asset. The Greeks include delta, gamma, vega, and theta, and they provide a way to measure the sensitivity of an option's price to quantifiable factors.

[8] **Market Carnage Worsens**
Dow plunges 2,200, Nasdaq enters bear territory after China counters U. S. tariffs.
By Vicky Ge Huang, Krystal Hur and Gunjan Banerji WSJ 4/5/2005

One may properly ask, "what has this to do with the fundamental purpose of equity markets, accumulating and allocating capital to support economic activity?" I think the answer is little or nothing. Rather it has transformed the equity exchanges into the largest casinos in the world, as the house – the market makers and lenders reap profit from this trading frenzy.

Wait for the magic.

Markets are continually changing. The current explosion of option trading is unlike anything seen previously. It has increased volatility enormously. It will have to run its course. In the absence of regulatory reform, volatility will likely remain elevated – in both directions.

I refer to the peaks of negative sentiment and trading frenzy as magic moments. These are infrequent and heretofore reliable buy signals for the markets. I use the term "magic" to mean that regardless of the economic environment, once the signal has been generated equity bear markets are close to or reversing trend. Some of these indicators are technical, other sentiment based, and some fundamental.

The signals in 1998, 2008, 2016, 2020, and 2022 occurred at or near important lows. Another signal is at hand. Further price declines will validate the signal.

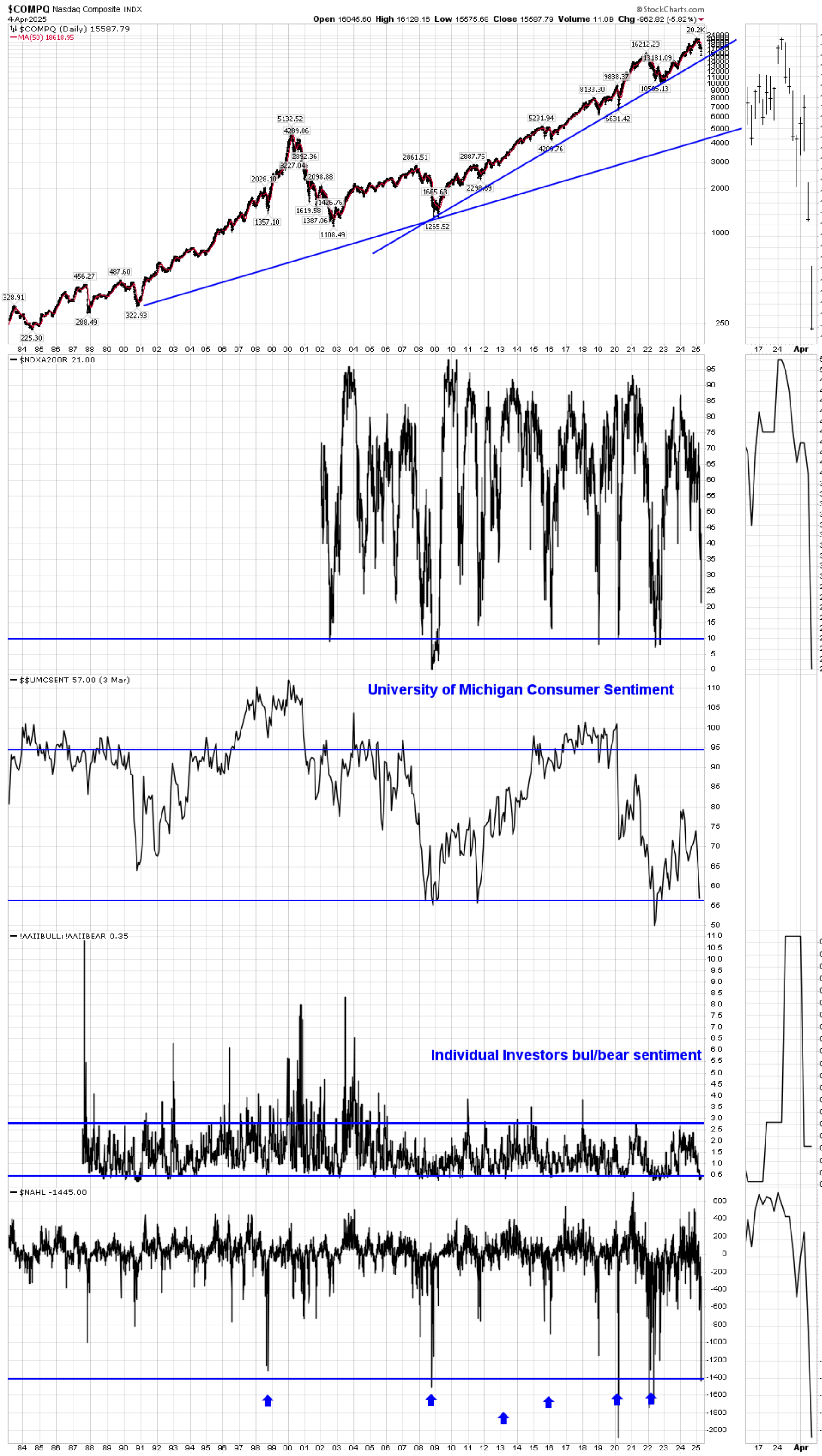
If the magic is still potent, it is probably too late to sell and time soon to think about buying.

I remain concerned about a cathartic, market clearing event, as the amount of leverage in large, loosely regulated or unregulated financing sectors is probably under considerable strain.

A FED put is still in reserve, notwithstanding the taciturn Powell, a series of interest rate reductions which the yield curve is anticipating. The roaring 20's ended in an economic disaster, risking another debacle when interest rate cuts are on the table and appropriate seems highly unlikely.

Conclusion

Current market conditions may present buying opportunities, despite potential risks of a market-clearing event due to high leverage in unregulated sectors. Previous rapid and large market declines have generated buy signals in similar circumstances. Magic implies the willful suspension of disbelief – a difficult leap for informed investors.



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