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'A bell is ringing': A top-performing $8.5 billion hedge fund has sounded the alarm

RACHAEL LEVY
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Clint Carlson, the founder of Carlson Capital.

Screenshot via BloombergTV

A top-performing $8.5 billion hedge fund has sounded the alarm.

The markets are in a "historic" situation, according to Carlson Capital, an $8.5 billion Dallas-based hedge fund.

The hedge fund highlighted numerous concerns in a recent investor letter viewed by Business Insider.

These include:

- "US treasuries are the wrong price."
- Investors have "bypassed growth and moved to risk-parity, frankly a shameless abrogation of any equity-fundamental analysis replaced by the bond proxy."
- "The valuation of the stock market is being set by unreliable price indicators such as bonds."
- "We have witnessed mania around helicopter money, the recession, and the fatuous concept of negative rates."

The June letter was written by Richard Maraviglia and Matt Barkoff, who are portfolio managers on Carlson's Black Diamond Thematic fund.

The fund, which makes long and short stock bets, is beating competitors. The fund was up 9.9% net of fees in the second quarter, bringing year-to-date returns through June to 10.97%, according to the letter.

Other stock-focused hedge funds fell 0.09% on average through June, according to the Hedge Fund Intelligence US equity index. Carlson managed $8.5 billion firmwide at the start of the year, according to HFI's Billion Dollar Club ranking.

The firm, through a spokesman, declined to comment.

Here are some of the major takeaways from the letter (emphasis ours).

"US treasuries are the wrong price"

Over the last two quarters, we have hinted that we have seen poor risk reward in bonds. Now, we are saying it outright: US treasuries are the wrong price. Generally, being the cynics that we are, we have always had a problem with something or some type of bubble. Since 2013, when the momentum phase of the stock market kicked in, excess liquidity has found its way into a series of similar but ultimately end-game bubbles. If 2013 and 2014 was characterized by an insatiable appetite for ultra-growth predicated almost exclusively on concept versus reality in industries such as clean power and biotechnology, and 2015 was about mega-cap domination crowding and quantdriven price momentum (FANG), then 2016 has been the year when investors just bypassed growth and moved to risk-parity, frankly a shameless abrogation of any equity-fundamental analysis replaced by the bond proxy. The new acronym is now TINA – "there is no alternative" and more potently, STUD – "Staples, telecom, utilities, and defense." A bell is ringing.

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A "literally historic" situation

The Fed has typically hiked and should hike when one-third of the United States have unemployment below the NAIRU, when the ECI rises this much, two years after a trough in employment, or when Unit Labor Costs have risen sharply or when overtime hours rise or when job openings reach twenty-year highs.

Alas, not this time. Instead, we have witnessed mania around helicopter money, the recession, and the fatuous concept of negative rates. As investors, we look for anomalies and the above discussion seems literally historic in proportion.

Additionally, the Bank for International Settlements (BIS), the world's largest international financial organization owned by sixty of the world's central banks, recently produced a report on demography and inflation. In its opening abstract, it notes in its conclusion that "in particular, a larger share of dependents (i.e. young and old) is correlated with higher inflation, while a larger share of working age cohorts is correlated with lower inflation". Demography accounts for about one-third of the variation in inflation with the rest being other factors we have regularly discussed such as the Taylor Rule, the Phillips Curve, productivity, and other cost push factors such as oil. "Furthermore, our results suggest that ageing might eventually lead to higher, not lower, inflationary pressures – contradicting the prevailing view." In other words, there is a positive correlation between the dependency ratio which could be young and old. In this case, it is old, but the birth rate has also increased, so it is both. Interestingly, even the central banks comprehend that the prevailing view has a flaw. Prevailing views generally do. With the sixty-five and older cohort growing by a staggering thirty-seven percent over the next ten years and by seventy-five percent over the next thirty years, BIS concludes:

"Given that in the future the share of the very old is expected to grow fast, the predictions should be treated cautiously. In contrast, estimates for past inflationary pressures rely more on the cohorts in the middle of the distribution, where our estimates are the most stable. Taking our estimates at face value, the demographic pressure on inflation would be expected to reverse almost fully over the coming decades, from benign to more challenging."

More inflation to come

On the heels of massive monetary policy, Japan and Europe have introduced the idea of fiscal stimulus. As it relates to the US, after several years of austerity, the tide has turned. The Affordable Care Act has set the stage for a huge increase in fiscal spending for major healthcare programs (primarily Medicare) as well as Social Security.

Combining this with our assessment of the output gap and productivity about which we have written extensively and this current update on the US economy, we largely rest our case. The budget deficit has declined every year since its peak of nearly ten percent of GDP and the CBO expects it to begin an inexorable rise. Higher government spending is both inflationary and additive to GDP. Economic expansions do not die of old age like humans do. They come unstuck from excess investment imbalances or

> *from aggressive tightening.*
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> ...
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> *Higher inflation expectations or higher rates should cause a stronger dollar and a reversal in commodity stocks whose fundamentals remain tied to a disastrous China. Low volatility stocks have extreme tail risk. We have a barbell short across both styles and sectors.*

Consider gold in light of Trump

> *We noted that gold offered two ways to win at the end of last year; as the 2000's deflationary/fear hedge or the actual logical classical reason as a hedge: to inflation. Finally, the rise of anti-globalism and populism such as Brexit, Trump, and others supports the inflation cycle.*

Expect a big Fed impact

> *In spite of all of this, the Federal Reserve is expected to never hike. As the world goes anti-global, Yellen seems to pay ever more attention to potential exogenous world risks. A China devaluation, a small stock market correction, the US election and Brexit have offered a series of excuses to hold back. Her repeated hesitations have led to a view that the Fed is "constitutionally dovish." It will take three to six years to sort out a British exit from Europe, during which time its consequences will have been forgotten, remembered and forgotten again many times. It seems inappropriate for the Fed to wait until they know for sure especially in the context of sentiment that remains unscathed post-Brexit. Importantly, however, the constant delays mean the impact of a Fed Funds hike on financial conditions now will be much larger than before. The ultimate irony surely is to complain about hike-tightening conditions; is that not the point?*

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