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Daily Commentary

The Price of Overcrowding

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The Price of Overcrowding

Looking at the indices, yesterday seemed like an almost boring session, with the S&P 500 index +**0.33**% at 7,744, the Dow Jones +**1.08**% and the Nasdaq almost unchanged at +0.08%, after having fallen by almost 2.0% in the morning.

Beneath the surface, however, **hedge funds experienced one of their worst days of the year**.

During the U.S. morning, the three major families of equity strategies, long/short funds, systematic or quantitative funds and multi-strategy funds, were all losing more than **0.8**%.

It seems like little, but it is not.

According to prime brokerage data, the banking service that finances and monitors speculative funds, from a leading U.S. investment bank, from COVID through the end of 2025 it had never happened that all three lost more than 80 basis points in the same session.

In 2026, it has already happened three times, on February 4, July 28 and yesterday.

Let us stop here, because this is the real news.

A rare event cannot occur three times in one year without a reason.

If its frequency were really once every five years, the probability of seeing it three times in ten months would be about one in 1,500.

So, either we have been very unlucky or the managers' risk models are wrong.

The second hypothesis is by far the most likely.

In February, the momentum factor had already made a **4** standard deviation

Source: Bloomberg, Reuters, Yahoo Finance, Financial Times, ECB, CNBC, The White House

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move, on paper, one every 126 years.

Why are the models wrong?
Because Value at Risk, the measure of maximum probable loss that managers use to calibrate their positions, looks at past volatility and correlations, but when everyone buys the same things, risks stop being independent and become the same risk, multiplied by the number of funds holding it.
It is overcrowding, that is, a full theater with only one exit.

How does the theater empty out?
All it takes is for someone to start selling.
Selling increases portfolio volatility, volatility triggers risk limits, and those limits force positions to be reduced.
Since everyone holds the same stocks, everyone sells the same stocks at the same time.
In multi-strategy funds, with leverage on the equity portfolio of around **4.5** times and tight loss limits for each internal manager, the spiral moves even faster.
Yesterday, the signature was clear.
At 10:30 a.m. in New York, the momentum factor was down **3.4** standard deviations and the stocks most widely held by funds were down **1.8**, while the most heavily shorted stocks were up **1.2**.
When what everyone owns falls and what everyone is short rises, no one is making a bet, they are simply closing both legs of the portfolio.
It is a reduction in gross exposure.
Quantitative funds paid the highest price, **−1.4**% at the close, a **−3.7** standard deviation session, the worst since August

Source: Bloomberg, Reuters, Yahoo Finance, Financial Times, ECB, CNBC, The White House
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19.
The day before, they were the only ones in positive territory.

And this is where the difference that matters lies.
On July 28, the dynamic was similar, but the cause was different.
The selling came from a forced seller, a leveraged fund overwhelmed by margin calls, together with the liquidation of Korean memory stocks.
It was a matter of positioning, not fundamentals.
In fact, once the seller was out of the picture, memory stocks rebounded by **15-22%** in a single session.
Yesterday, the thesis itself was called into question, namely the possibility of financing the race for Artificial Intelligence computing capacity.
Demand for computing power can grow exponentially, the capital to finance it cannot.
Even the desks of the major investment banks acknowledge this.
In July, the unwinding was "technical"; this time, it raises questions about earnings, rates, credit and return on capital.
Excess positioning is absorbed once positions have been reduced.
A doubt about fundamentals requires someone to resolve it, with the numbers.

Yesterday, someone tried to resolve it with words.
From Stockholm, **Jensen Huang** said that CoreWeave's financial strength "improves every day" and that its cost of capital "is coming down".

Source: Bloomberg, Reuters, Yahoo Finance, Financial Times, ECB, CNBC, The White House
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Unfortunately, at the same time, CoreWeave's bonds were yielding between **14** and **16**%, with the five-year CDS contract coming off a record **1,117** basis points, in addition to the fact that Nvidia holds a stake in CoreWeave estimated at around $**2** billion, a rather obvious conflict of interest.
The market, however, liked it: CoreWeave closed +**5.9**%, after having fallen as much as 9.5%, and short covering began in the most heavily shorted neocloud stocks.

How long can it last?

Short covering is fuel that is quickly consumed.
Once the stocks have been bought, those who were short no longer need to buy.
Even a German investment bank, which remains positive on CoreWeave, estimates around $**10** billion in operating cash flows over the next twelve months against $**45** billion in investments.
Words can tighten the spread for a day, but they cannot fill a $**35** billion gap.

So far, the reduction in overcrowding has been visible in the dispersion within the index, but not in the indices themselves.
A reduction in gross exposure ends when gross exposure has fallen, but funds' gross leverage stands at **310**%, at the **94**th percentile of the past five years, and gross exposure to Taiwan is at the **99**th percentile.
The entire load is still on board.

Today, moreover, monthly options expire.
Until now, dealers had a hedging position that dampened movements in the index,

Source: Bloomberg, Reuters, Yahoo Finance, Financial Times, ECB, CNBC, The White House
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meaning they sold on rallies and bought on declines, and yesterday the S&P 500 index rebounded precisely off its 50 day moving average.
With the expiration, part of this cushion disappears.
The desks point out that exposure to Artificial Intelligence is cleaner than in June, that the Nasdaq 100 price-to-earnings ratio has returned toward **21** times, and that the rebound in Treasuries (10-year yield at **5.09**%) helps.
However, these were the same arguments made in early August, shortly before the collapse of quantitative funds on August 19.

Meanwhile, the bond market is asking another question, who is next?
Because CoreWeave is not just a borrower, it is also the tenant paying the rent on a significant portion of the high-yield bonds issued by others to build data centers, **7** issuances out of **20**, for $**14.1** billion.
Credit has already begun to distinguish between one tenant and another and, once again, it noticed before equities did.
The price of overcrowding is not paid in a single day.
Those who think that, as in July, it is enough to wait for it to pass risk being disappointed.
Better to continue hedging.

Source: Bloomberg, Reuters, Yahoo Finance, Financial Times, ECB, CNBC, The White House
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