LGIMA Multi-Asset Market Update

October 2017

Equity Market

Equity market price action has seemingly exhibited immunity to potential risk-off events—such as geopolitical tensions between the US and North Korea, Eurozone political risks around Catalonia and Brexit, US fiscal policy (tax reform) uncertainty, and ambiguity regarding central bank policy in the US and Europe. Stocks are up across the board over the past month, setting new records in many cases. On both a rolling one-year and YTD basis, equity returns have been in the range of +20%-30% across geographies, with EMEA and Latin America being the only regional exceptions. On a sector level, Energy and Financials outperformed while defensive sectors such as Healthcare and Utilities lagged. Small caps vastly outperformed large caps, returning +6.9%, while min-vol strategies lagged (US +0.6%, ACWI +0.6%). Together, these equity market developments seem to reflect a reinvigorated risk-on environment, perhaps even a sense of complacency.

Index	One month ago	Three months ago	One year ago
S&P 500	2.2%	4.3%	22.2%
Russell 2000	5.1%	5.5%	25.6%
Euro Stoxx 50 (LC)	2.6%	2.5%	22.2%
Nikkei 225 (LC)	6.9%	5.9%	27.8%
HK Hang Seng (LC)	2.6%	9.1%	27.6%

Source: Bloomberg

Source: Bloomberg

Rates Market

Mixed data and no real surprises from the September Fed meeting notes have kept rates in a +/- 5 basis points range for all of October. The 5-year and 30-year Treasury rates closed out September at 1.94 and 2.86, respectively, and are currently trading at 1.90 and 2.81. Although the change in nonfarm payrolls was -33k in September (first negative print since 2010), average hourly earnings surprised to the upside, growing 0.5% over the month compared to the 0.3% consensus. The remaining inflation data was not as stellar, with PPI coming in at consensus, followed by CPI coming in at 0.1% below expectations. The Fed has come as close as they are willing to essentially announcing that they will hike rates again at the December meeting, barring some catastrophic event in the interim. Fed funds futures price the likelihood of a December hike at 77%.

Index	10/13/2017	One month ago	Three months ago	One year ago
Fed Funds Rate	1.25	1.25	1.25	0.50
2y	1.49	1.38	1.36	0.83
5y	1.90	1.81	1.87	1.29
10y	2.27	2.20	2.33	1.80
30y	2.81	2.77	2.92	2.56

Source: Bloomberg

Source: Bloomberg

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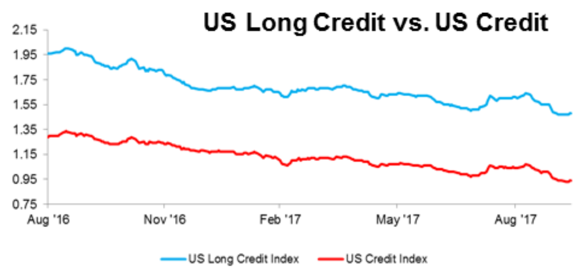
Credit Market

With investment grade credit markets at the post-crisis tights entering the week and roughly 15 basis points better over the last month, it was perhaps inevitable that the rally would take a pause as investors stopped to reassess valuations. In all likelihood, supply will also accelerate as banks come to market, but even so, the pace of issuance is slowing relative to earlier in the year. If there is a stumbling block for credit in the short-term, it's likely to come from either the rates market or tax reform. To some extent, the two are likely to be correlated. A failure to deliver a tax deal will probably send rates lower and credit spreads wider. The consensus is for the technicals to remain firm into December, but the continuation of this week's squishy market isn't out of the realm of possibility either.

Index (OAS)	One month ago	Three months ago	One year ago
US Long Credit	-6.3%	-3.9%	-20.4%
US Long Gov Credit	-5.3%	-3.3%	-21.2%
US Long Credit A+	-9.0%	-5.1%	-24.0%
US Credit	-8.7%	-6.9%	-24.2%
EM	-2.0%	-9.0%	-21.6%
HY	-4.4%	-4.7%	-25.2%

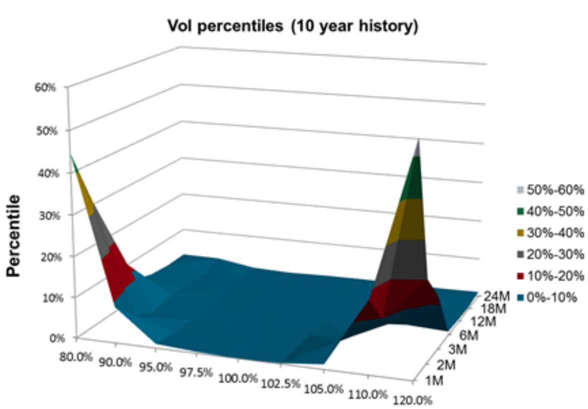
Source: Bloomberg



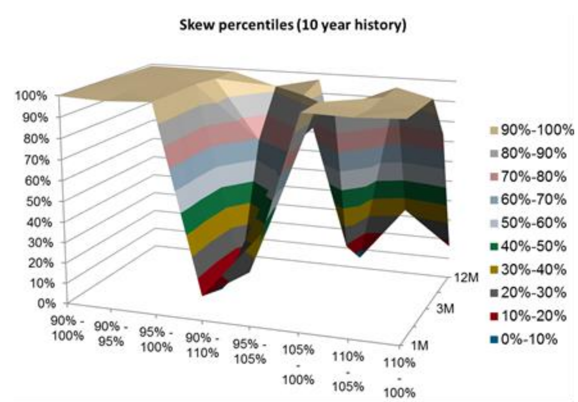
Source: Bloomberg

Equity Volatility

Equity vol has been extremely depressed on both implied and realized fronts, hovering near generational lows. The VIX Index hit at an all-time closing low of 9.19 on October 9th, while 1-month and 3-month realized vols hover near historic lows, at 3.75 and 6.96 respectively. This September was the least volatile for US equities since 1964, and this October-to-date is the least volatile on record. Certain measures of slope and skew, however, are elevated, reflecting that implieds, while depressed across strikes and tenors, are most depressed near the money and at shorter maturities. Put spread skews such as 85–100, 90–100, 95–100 are hovering around their 98th to 100th percentiles across tenors (1M to 12M), while call spread skews, such as 105–100 and 110–100, are at similar percentiles for shorter tenors (1M to 3M). On the VIX front, given historic low levels of implied volatility on the S&P 500, there seems to be a fair amount of VIX call buying (bets that implied volatility will rise in the future), which has bid up vol of vol (VVIX, or the VIX of VIX).



Source: Bloomberg



Source: Bloomberg

Rates Volatility

Rate vol continues getting pushed lower to multi-year or all-time lows – 3m30y is at 56abpv and 10y10y is at 70abpv. Program gamma sellers provide a constant supply of short dated options as realized vol is also at multi-year lows while the supply of longer dated options via overseas Formosa issuance keeps dragging vega lower. Deutsche Bank's Vega Index (a weighted average of volatility in the 1y5y-10y-20y sector) closed in late September at 70.0, just above the all-time low of 69.9 in Feb 2007.

Trailing 1y percentile
0-10%
10-20%
20-30%
30-70%
70-80%
80-90%
90-100%

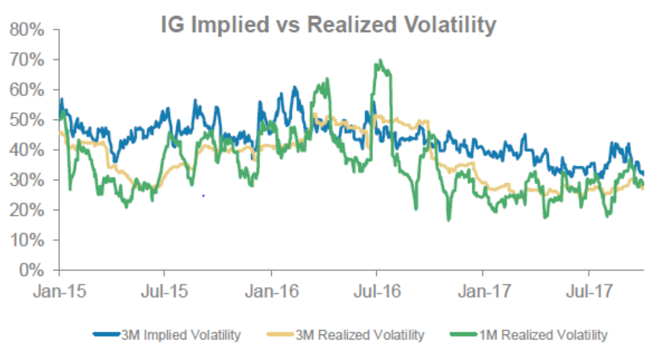
10/13/2017	2y	5y	7y	10y	30y
1m	23.5%	15.9%	13.9%	9.9%	2.3%
3m	14.7%	2.7%	0.7%	0.0%	0.0%
6m	21.1%	3.5%	2.7%	0.7%	1.1%
1y	8.7%	1.5%	1.5%	0.3%	0.0%
3y	2.3%	0.0%	0.0%	0.0%	0.0%
5y	5.5%	1.9%	1.1%	0.3%	0.3%

Source: Bloomberg

Source: Barclays Live

Credit Volatility

Over the last month, a strong risk-on tone picked up on the back of potential fiscal stimulus, which took credit spreads sharply tighter through the end of September and early October. However, implied volatility is back to all-time lows. Notably, implied CDX vol is now trading almost flat to realized, a level last seen in early July just before option hedging picked up. Additionally, there are attractive tactical trade opportunities in the market enabled by high skew levels in CDX relative to historic levels and ATM volatility.



Source: Morgan Stanley Research

Scenario Based Asset Allocation

SCENARIO SUMMARIES

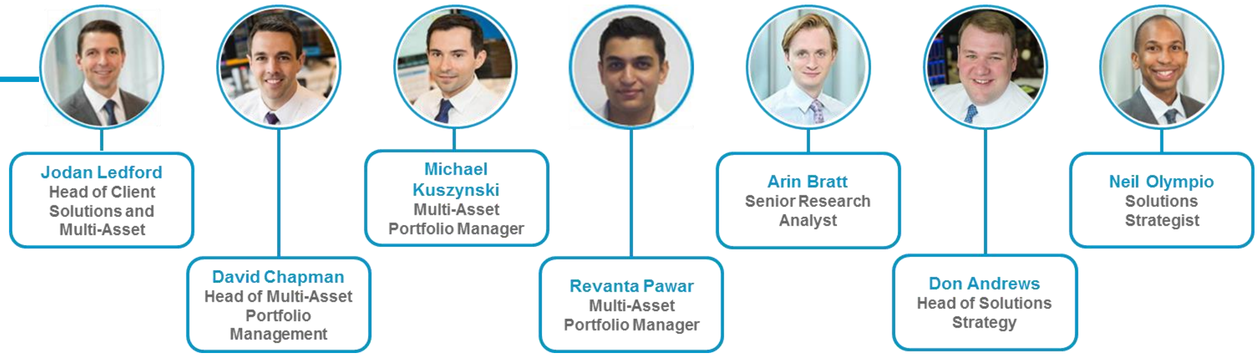
Name	Description	Risk Assets	Inflation	Rates	USD	Probability
Global Slowdown	• Dominated by fears of imminent recession, GDP growth trackers start to fall • US only manages 0-1 rate hikes in 12 months, UK cuts rates further toward 0% • Commodities drop, political uncertainty contributes to slowdown • US corporates under pressure, EM falters	▼	▼	▼	▼	10%
Longer Liquidity	• Inflation prints continue to disappoint • Despite falling unemployment and stable (if unimpressive) growth, the Fed raises rates slower than expectations • ECB limits tapering to the minimum politically acceptable level	▲	—	▼	▼ / —	15%
Roadmap Central Scenario	• Cyclical global recovery, but structural problems mean rates unlikely to fully normalize. • US overheating in 2019 prompted by tax cuts. • EM prospects brightening in absence of trade war • ECB to announce 2018 tapering in late 2017	▲	▲	▲	▲	30%
Global Growth	• Stronger growth environment driven by EM and EU, ahead of US. • Still some pick up in US inflation leading to some rate hikes. • Other economic data does not point to any overheating.	▲	▲	▲	▼ / —	15%
Rates Rebound Risk Off	• Central banks needs to counter looser monetary conditions by hiking more, which slows growth expectations • Global government bond yields rise fuelled by rising rate and future expectations • Equity markets sell off on the back of higher yields (similar market reaction expected for protectionism)	▼	▲ / —	▲	—	15%
Fed Found Out	• Inflation stays below trend, but the Fed presses on with planned rate hikes • Longer dated rates don't rise as investors bet on a Fed error • No significant slowdown of growth • New concern on the ineffectiveness of monetary policy	▼	—	—	▲	15%

MAIN TAIL RISKS

- China Hard Landing / Currency Devaluation
- Eurozone Malaise
- Escape Velocity

Source: LGIMA

Contributors



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