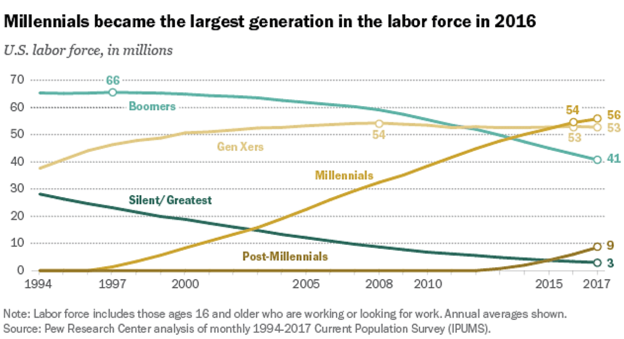
June 2021

Multi-asset Market Update

Equity market

Summer seems to have started a bit earlier this year. Market chatter and liquidity have declined. Comments across all our trading desks in our morning calls are repeating that most asset classes already have a mid-summer vibe. And it makes sense: many of us accrued a lot of unused vacation leading into this clement reopening. However, the summer lull coincides with a period of highly anticipated economic data as we wait for more pieces of the recovery and economic cycle puzzles to be revealed. For now, our views are essentially unchanged: underweight duration and credit with a preference for equities over credit. However, our active risk levels have been reduced to avoid any short-term surprises or liquidity traps.

Figure 1: Millennial labor force

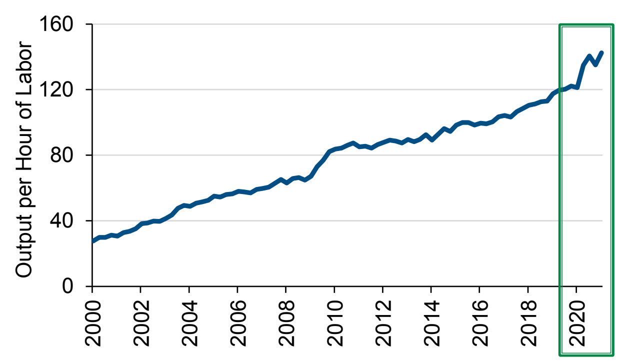


Source: Pew Research Center.

We are acutely focused on the supply dynamics in both labor and goods. Last month we touched on the paradox of a higher unemployment rate than pre-pandemic while also having more businesses report that positions are harder to fill than pre-pandemic. Since then, our economists have also noted persistent price increases in a few categories that stand out—sporting goods and home furnishings, for example. Those are notable because—recalling last year's rush to create home offices, redecorate, and stock home gyms—we would have otherwise expected base effects to put downward pressure on those CPI components. We believe that there are persistent bottlenecks for many goods (microchips and lumber are two recent, prominent examples), so part of this wait-and-see period relates to exploring how manufacturers and supply chains will continue to adapt and evolve.

In Chicago where we're headquartered, summer brings (ever so briefly) warm, pleasant and consistent weather. So, return-to-office plans have supplanted the weather as the preferred small talk for opening meetings, as those plans are more varied and dynamic. And it is a truly interesting topic because it reveals part of the back-and-forth narrative regarding labor force composition, labor force turnover and productivity. The narrative seems to pit older generations of workers (e.g., Morgan Stanley CEO James Gorman) who on average seek more time in the office against younger workers who seek more flexibility.[1] Importantly, those younger generations who grew up and tend to be more adept with technology now dominate the workforce, and they are thriving in the remote environment.[2] Many workers—not exclusively younger ones—are also reevaluating work-life balance in a way that may be disruptive to firms seeking to fill jobs. The balance between employers' and employees' demands for flexibility will create a new clearing price for labor, which will in turn affect how the labor bottleneck may resolve.

Figure 2: US labor productivity



Source: Bloomberg, data as of June 17, 2021.

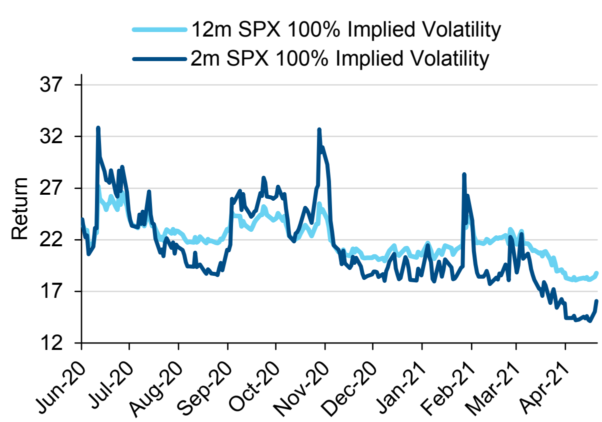
However, productivity can be an offset to labor shortages. The pandemic period saw one of the most rapid increases in productivity (measured as output per hour of labor) in several decades. This likely owes largely to that very majority of the workforce that are younger, more comfortable with technology and happier professionally in a remote environment. If these productivity gains can be maintained, it could help reduce inflationary pressures, adding to the risk of our short duration view. In the meantime, the only thing we are certain is transitory is summer itself. We will remain vigilant, and, as the last state-level mobility restrictions are removed, wish you all healthy, happy and safe months ahead.

Equity volatility

While there is more collective attention following rates- and inflation-related markets, equities and equity volatility have entered a summer lull and are exhibiting expected and actual calm. Term structure has steepened dramatically with one-month at-the-money implieds at 12% (from 16%), three-month at 15% (from 18%), and smoothing slightly upward out to three years around 19% (from 20%).[3]

Realized volatility across a variety of shorter-dated observation windows has fallen about as low as it can, and, for now, sits at pre-COVID-19 levels. For example, 20-day realized volatility is approximately 6%, or an average daily move in the underlying spot price of less than +/-0.4%. That said, there is broad dealer consensus that the option market has been carrying what amounts to a long position in short-dated optionality, which tends to have a stabilizing effect on market volatility. These dynamics are set to potentially roll off with the June quarterly option and futures expiry.[3]

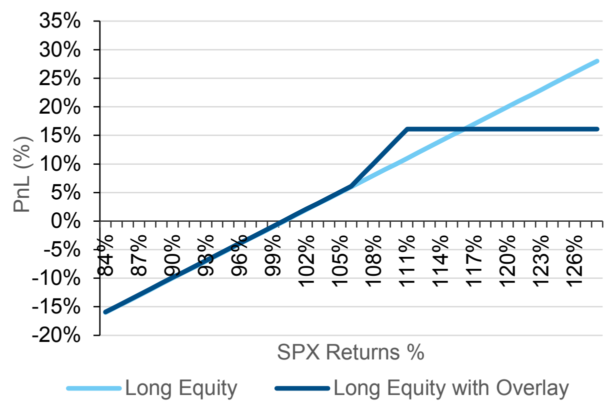
Figure 3: S&P 500 implied volatility



Source: Bloomberg, data as of June 17, 2021.

Consistent with our views described in previous notes and above, we've implemented upside overlay exposure that seeks to accelerate further equity market returns in some limited upside range. For example, a client can add a "1x2 call spread" to an existing equity portfolio: buy a one-year 105% call and sell 2x notional of a 110% call for zero upfront premium. This combined structure will deliver 15% overall returns when the equity market is +10%, with the tradeoff of capped further performance.[3]

Figure 4: 1x2 Call spread profit & loss



Source: Bloomberg, data as of June 17, 2021.

Rates market

From mid-May to mid-June, rates rallied and the curve flattened despite inflation numbers coming in above expectations. However, a surprisingly hawkish June FOMC meeting seems to have changed the tone of the market, at least for the time being. The latter half of May saw rates trading fairly range bound as competing forces kept them in check. On the one-year anniversary of its introduction, the 20-year treasury auction tailed 1.1 basis points as that sector continues to trade weak on the curve, helping push rates higher. Further, the Fed minutes showed that they were in fact talking about talking about tapering, while still emphasizing data dependence. Vice Chair Clarida noted in a speech a few days before the release of the minutes that the Fed will "have to be attuned and attentive to incoming data." Mixed data (strong manufacturing and PMI prints, weak housing starts) coupled with escalation related to the Israel-Palestine conflict contributed to some of the rally in the back end of the month, as did month-end buying from real money accounts on the shortened pre-Memorial Day session. The 5-year treasury rate closed out May at 0.80, while the 30-year rate ended the month at 2.28.[3]

Figure 5: US rate environment

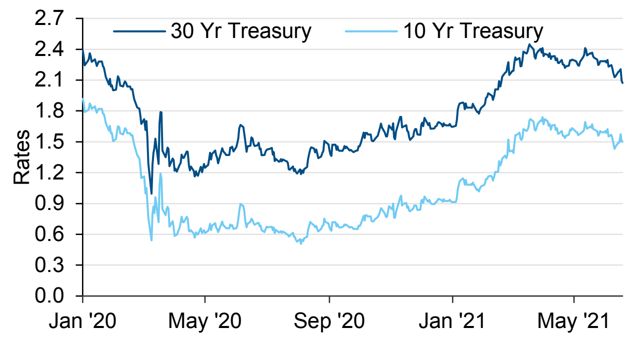
Index (%)	6/17/2021	One month ago	Three months ago	One year ago
Fed Funds Rate	0.25	0.25	0.25	0.25
2-year	0.21	0.15	0.13	0.19
5-year	0.88	0.82	0.80	0.33
10-year	1.50	1.64	1.64	0.71
30-year	2.09	2.36	2.42	1.48

Source: Bloomberg, data as of June 17, 2021.

Rates traded sideways the first few days of June until the May payroll numbers were released. While the data showed that +559k new jobs were created in the month, it still fell short of the consensus expectation of +675k. The unemployment rate dropped to 5.8% from last month's 6.1% print, although this was partially due to a decrease in the labor force participation rate. Rates grinded lower the following week as bull flattening flows out of Asia permeated into the London and New York trading sessions despite a steady supply from the 3, 10, and 30-year treasury auctions. CPI had another solid beat, coming in 0.6% month-over-month growth versus the 0.5% expectation and a 5.0% year-over-year core print – the highest in nearly 30 years. Even with these above-consensus and above-Fed-target prints, the market rallied. This rally was very puzzling and most attributed it to crowded short positions that were closed out as a sell off failed to materialize. The following Monday, the post CPI rally reversed quickly reversed itself.[3]

As previously mentioned, the June FOMC meeting was more hawkish than anticipated. While the target rate remained the same, IOER and RRP were raised by 5 basis points. But the big surprise was in the dot plot. The median dot now shows two rate hikes by 2023 (median showed zero hikes though 2023 at the March meeting – six dots had upward revisions) and now seven committee members expect a hike by the end of 2022, compared to just four members at the March meeting. At the accompanying press conference Chair Powell said this was the meeting that the Fed was "talking about talking about [tapering]." Furthermore, he said that "at coming meetings… [it] will be appropriate to announce a [tapering] plan" provided that enough economic progress and recovery has been made. The PCE inflation expectations for 2021 were revised up 1.0% to 3.4% while the 2022 and 2023 expectations were raised only 0.1% to 2.1% and 2.2%, respectively. Some are interpreting this as the Fed thinks that overshooting their inflation target in 2021 will be enough to hit their averaging target, which may mean that once liftoff occurs, any sustained inflation above 2% could warrant a hike. The belly of the curve sold off on the release of the dot plot and continued selling off during the press conference, with the green and blue Eurodollar packs moving 15-17 basis points higher. The 5-year treasury rate sold off 12 basis points to 0.90 while the long end treasury rate sold off two basis points to end the day at 2.21.[3]

Figure 6: Treasury rates



Source: Bloomberg, data as of June 17, 2021.

Rates volatility

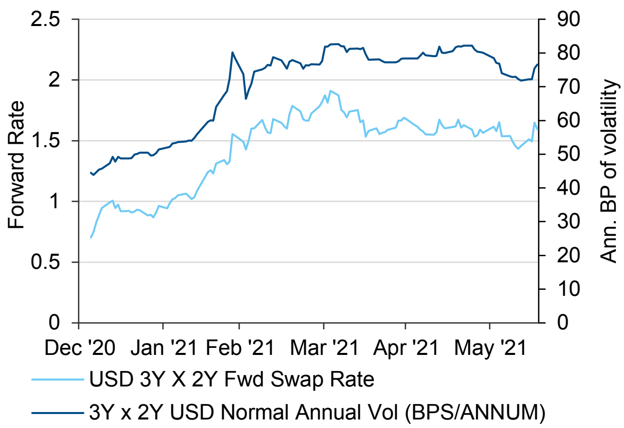
At the start of the month, a combination of low delivered volatility and rates staying range bound brought out the profit taking and systematic gamma sellers, as rate volatility grinded lower. There was a small pop up in gamma on the release of the Fed minutes. However, this was quickly faded, particularly in longer tails, as 3m10y and 3m30y cheapened to their lowest levels of the year. The selling in gamma on longer tails intensified once the 10-year treasury rate dropped below 1.60 the last week of May. Even the seemingly endless bid to intermediate left hand options waned as implied volatility in structures like 3y2y fell to be more in line with the forward rates. The first week of June implied volatility was down 2-6abpv across the surface, mostly in the wake of the weaker than expected payroll print which left many in the market thinking the Fed could comfortably stay the course and lead to an uneventful June FOMC meeting.[3]

Figure 7: Current implied volatility levels and change over one-month

P/Tail	1Y	Change	2Y	Change	5Y	Change	10Y	Change	30Y	Change
1M	12.7	*1.3*	20.9	*1.2*	57.0	*-2.4*	65.8	*-6.3*	67.1	*-5.4*
3M	20.1	*6.1*	27.9	*4.6*	63.4	*0.9*	73.3	*-1.2*	73.9	*-1.4*
6M	23.7	*6.5*	35.5	*5.1*	65.8	*0.2*	73.4	*-2.6*	73.1	*-2.1*
1Y	31.9	*3.1*	45.8	*1.1*	68.2	*-2.3*	72.8	*-4.1*	70.5	*-3.5*
2Y	58.2	*-1.9*	66.9	*-3.2*	73.0	*-4.0*	73.3	*-4.2*	68.9	*-3.0*
3Y	74.8	*-3.0*	76.6	*-5.2*	74.9	*-4.7*	73.1	*-4.4*	67.6	*-3.0*
4Y	78.7	*-4.3*	77.5	*-4.6*	75.0	*-4.9*	72.5	*-4.1*	66.2	*-2.6*
5Y	77.4	*-4.3*	77.0	*-3.5*	74.7	*-4.3*	71.5	*-3.8*	64.9	*-2.3*
7Y	75.6	*-3.3*	75.0	*-2.7*	72.6	*-3.7*	68.7	*-3.3*	61.8	*-2.1*
10Y	70.7	*-2.8*	69.9	*-1.9*	68.4	*-1.7*	64.6	*-2.1*	57.5	*-1.4*

Source: Citibank, data as of June 17, 2021.

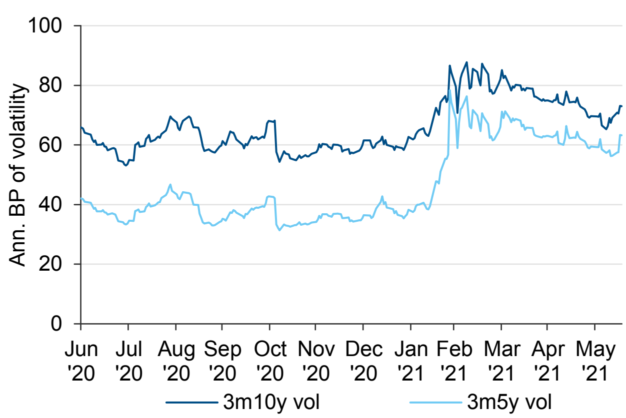
Figure 8: Forward rate vs. implied volatility



Source: Citibank, data as of June 17, 2021.

Gamma on longer tails did find some support at their local lows just ahead of the CPI print. Even as rates continued to rally after the print, gamma on 10y and 30y tails continued to move higher. Reflation trades regained some popularity as the moves lower in volatility and rates provided better entry points. But many of these high strike payer buys were done via distribution spread trades, indicating that the volatility market thinks rates will go higher, but will be tough to move more than 30 basis points higher. Flows on 5y tails and shorter were much more mixed as dealers saw two-way flows in those markets. Vol sellers interpreted the post CPI rally as evidence the Fed doesn't need to move early while buyers saw lower rates as a better opportunity to initiate new positions on structures like 2y2y.[3]

Figure 9: Annual volatility



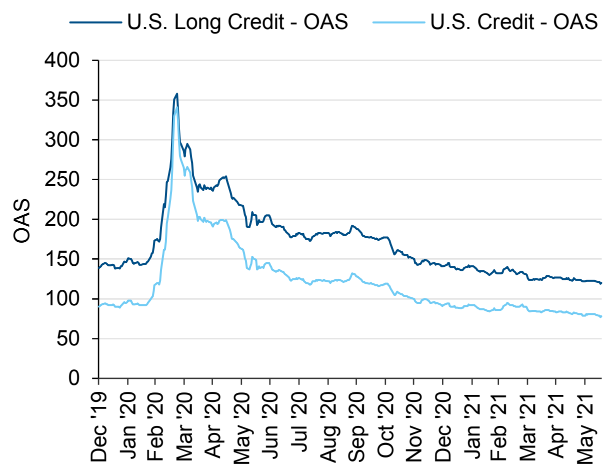
Source: Citibank, data as of June 17, 2021.

The June FOMC meeting injected some life into the rate volatility market. Implied volatility took their cues from rate movements. Long end tails saw a modest increase as the statement and dot plot were released. Intermediates on the left were up 4-5abpv, very much in line with the 14-17 basis point sell off in the green and blue Eurodollar futures. The following day the yield curve bull flattened with the front end roughly unchanged but the back end of the treasury curve, rallying 15 basis points intraday. Volatility on the left-hand side has remained bid while volatility on longer tails has given up most of its gains post FOMC. Dealers have already seen insurance companies step in to buy low strike receivers versus selling high strike payers.

Credit market

June began with modest widening in the US IG Credit market, followed by spreads resuming its tightening trend. US Credit spreads continue to hover around historical tights, remaining at the 1st percentile on a 5-year lookback. Investor's concerns have unequivocally shifted to inflation and interest rates, leaving COVID-19 concerns in the rearview mirror. Government spending is also top-of-mind, as consensus around the Build Back Better proposal anticipates nearly $4.4 trillion in costs. As of June 17, the Long Credit Index is at 119 basis points, 3 tighter on the month and 21 tighter on the year.[3]

Figure 10: US credit spreads



Source: Bloomberg, data as of June 17, 2021.

In the last few weeks, dealer inventory has come off the lows, while supply has remained robust. Month to date, we have seen around $80 billion come to market, and anticipate an additional $5-15 billion for the remainder of the month. This brings supply to just under $753 billion on the year. Although the pace of supply is 30% below 2020's pace, it is roughly 30% ahead of 2019 and on track to surpass the issuance record prior to last year. On the demand front, mutual fund inflows are positive, but have recently slowed to a pace of around $2 billion per week. However, pension demand continues to benefit from the improvement in funding ratios.

Leading up to the June FOMC meeting, the market seemed to be growing comfortable with the Fed's approach, as financial conditions continued to ease even with strong economic readings. However, the meeting was slightly more hawkish than anticipated, as Fed officials signaled they expect two increases by the end of 2023, pulling forward the start of the hiking cycle from the previous 2024 guidance. There was no mention of when QE tapering will begin, but the market consensus remains that the Fed will begin to outline plans to do so by the fourth quarter of this year and begin actual tapering in early 2022.

After a blockbuster first quarter earnings season, companies are showing no signs of slowing down. Over the last year, most companies significantly increased the amount of cash on their balance sheets; however, cash balances now appear to be gradually declining. Firms do not appear to be using the cash to pay down debt. Rather, there has been an uptick in share buybacks and M&A. With respect to ratings, we're starting to see positive momentum. Although there have been more aggressive uses of cash, it is not quite at a level that looks concerning. With that said, given the richness of the market, elevated government spending and continued inflation concerns, we remain slightly bearish on US Investment grade credit market for the foreseeable future. ■

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1. Financial Times: https://www.ft.com/content/ffd6033f-e8fc-4289-85b2-42bc4ddddd16
2. Gallup: https://www.gallup.com/workplace/324218/millennials-finally-workplace.aspx
3. Bloomberg

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