May 2021

Multi-asset Market Update

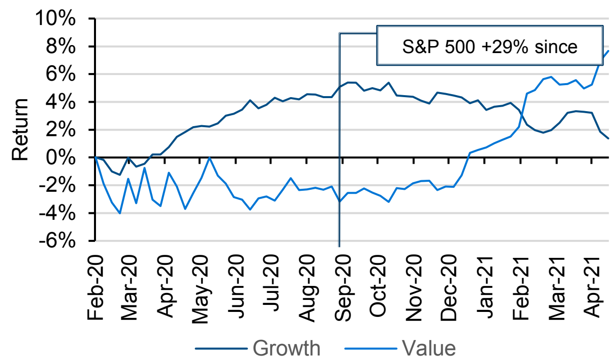
Equity market

Asset allocation is essentially a balancing of exposure to growth and inflation. We say this not to feign profundity by trotting out a truism, but rather to highlight its contrast with our day-to-day preoccupations—over short horizons, we spend so much of our time parsing minutiae and nuances in order to deliver alpha. And when it comes to beta, it's really just exposure to equities and duration that will determine the preponderance of total returns. Few variables and few tools imply that macro decisions have limited breadth in the terms of Grinold and Kahn's Fundamental Law of Active Management. A great mentor and large institution CIO made this point much more plainly—long-term shifts don't happen often, so it's really just one or two decisions that can define a career. It is understandable, then, that recent economic surprises are generating a great deal of apprehension.

Last month, we passed on the opportunity to offer our inflation views just as things were heating up. However, remarkable developments across both growth and inflation dynamics continue to move markets, and the quiet questioning of the potential for high inflation has morphed into a din. Nevertheless, we do not believe these shifts are seismic yet (and therefore unlikely to be career-defining in the moment). So, this month we offer a few observations on both growth and inflation and why the environment is still supportive of our current views: positive on equities, negative on duration, neutral on inflation.

The resurgence of the equity value factor over the past six months has variously been celebrated or dismissed depending on the commentators' disposition to shifts in the global economy (e.g., less globalization, supply chain disruptions), rates and inflation, or the prevalence of exponential growth businesses. However, what we find more compelling is not that there is a true resurgence in value but rather that investors are simply rotating away from restrictively-defined access to growth. One of our counterparties summarized this succinctly by pointing out that growth opportunities in the late-cycle environment prior to the pandemic were scarce, but after the pandemic reset and accompanying fiscal and monetary stimulus, growth is abundant. Access to growth, therefore, is now available via a much broader segment of the stock market, and so any vaunted rotation into value may be better explained as a loosening of narrow growth leadership. Further support for that idea is evidenced not only by the change in factor leadership but also by the fact that broad markets continue to rise as this occurs (i.e., rather than factor rotation suppressing realized returns and volatility at the index level). Therefore, we believe this remains consistent with our constructive equity view based on the view that we are early- to mid-cycle and that the policy backdrop is still overwhelmingly supportive.

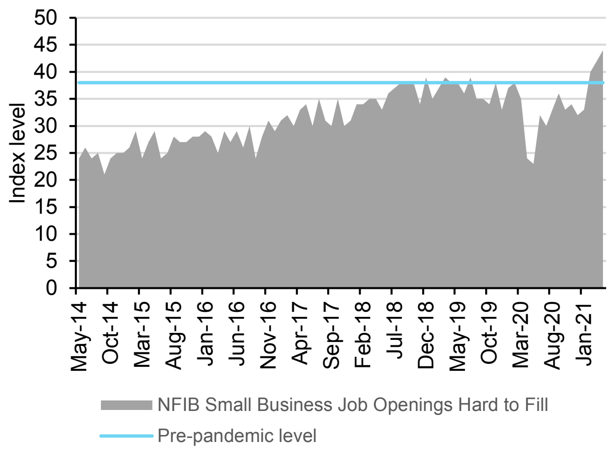
Figure 1: US equities: Growth vs Value



Source: Bloomberg, data as of May 18, 2021.

On the inflation and rates side, the crux seems to be whether recent price increases will be transitory, and the consensus view is that markets will determine that likely by the end of this year. Many aspects of goods inflation have been rationalized, and our internal debate recently focused on services inflation, particularly with respect to labor shortages. For example, even though we believe that economically we are still early- to mid-cycle, there are more businesses reporting that open jobs are harder to fill than during the pre-pandemic, late-cycle environment.

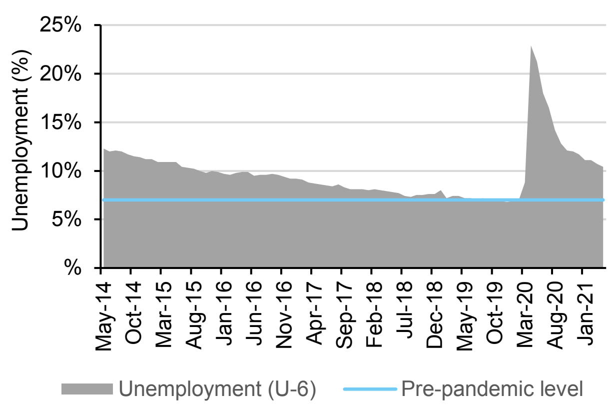
Figure 2: US labor shortages



Source: Bloomberg, data as of May 18, 2021.

This is despite broad unemployment not fully retracing its pre-pandemic level. Commonly cited reasons for this paradox include frictions related to family care and transit or other worries remaining from the pandemic, as well as potential distortions between pre-pandemic prevailing wages and the current amount of economic stimulus. The latter is evidenced by the myriad of large employers (e.g., Amazon or Walmart) announcing wage increases and/or signing bonuses to attract workers.

Figure 3: US unemployment



Source: Bloomberg, data as of May 18, 2021.

We don't have an answer (yet) as to whether wage inflation will be transitory, nor whether that even matters to equity markets (yet). However, the dull roar of the inflation debate is overwhelmingly one-sided—not whether inflation will be higher, but how much higher. Importantly, positioning and pricing in markets, particularly in rates markets, already reflects this. With higher inflation priced in, we believe upside remains for equities. In fact, while inflation is topical, it might be an easier time for businesses to protect margins by passing through cost increases to consumers (who arguably now have the stronger aggregate balance sheet), thereby protecting one of the significant risks to valuations.

Taken in aggregate, economics, policy, positioning and sentiment all remain quite favorable to equities, and for now we are happy to fade any inflation hysteria. The primary risk to our view may likely be rising inflation expectations and the potential for a self-fulfilling prophecy. With growth pulled forward by policy, subsequent persistently high inflation creates a very challenging environment, particularly when starting from elevated valuations.

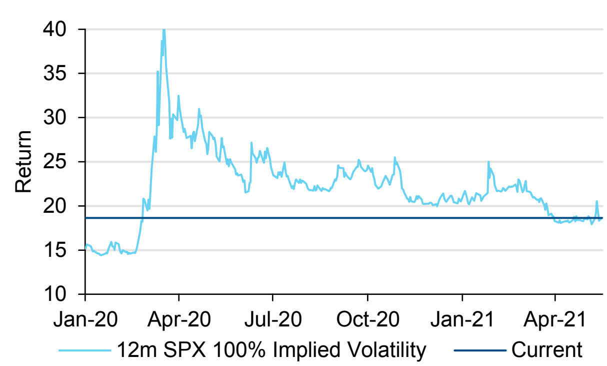
Equity volatility

Overall, a snapshot of the equity volatility space today closely resembles last month's. Term structure remains upward sloping with one-month at-the-money implieds at 16%, three-month at 18%, and all the way out in the listed maturities space through to three years around 19-20%. Realized volatility across a variety of shorter dated observation windows remains moderately below implied, such that carry programs and trading books have remained orderly.[1]

Nonetheless, there was a remarkably short-lived panic last week. In the depths of the near week-long mini rout of a 5% intra-day high-to-low drawdown, implied volatility spiked and term structure completely flattened, meaning that short-dated options rose incrementally even more than longer-dated ones. In the depths of the sell-offs, the entire VIX futures curve was above 26. Nonetheless, the S&P 500 staged an impressive recovery, and the near entirety of that stress evaporated.[1]

Longer-term measures of equity volatility remain cyclically elevated. Last month, we highlighted six-month VIX futures prevailing at 24, which is where the contracts are still currently anchored. For another measure to contextualize today's conditions, it is worthwhile to consider that one-year at-the-money implied volatility, at just under 19%, hovers near the lows of the COVID-19 era, but ranks at the 94th percentile for the seven-year period preceding the lows of March 2020. Although forecasting is a tough business, it is reasonable to conclude that the option space is not complacent and is priced to withstand a reasonable amount of ongoing stress.[1]

Figure 4: S&P 500 Implied Volatility



Source: Bloomberg, data as of May 18, 2021.

Rates market

Over the past month, rates are slightly higher and the yield curve is steeper, but all the attention recently has been on inflation. How much of it is actually transitory, and what it will take to make the Fed budge from their long-standing position of continued accommodation? Rates traded sideways to close out April, with the April 28 FOMC meeting essentially being a non-event. Consensus was that the meeting was slightly optimistic, as the Fed described risks to the economic outlook as "considerable", but there was no mention of tapering. Chair Powell went as far as saying the Fed is "not even thinking about thinking about raising rates." He emphasized that they interpret high inflation prints as transitory, stemming from base effects and disruptions to the supply chain. Powell elaborated, stating that the recovery is "uneven, far from complete", despite progress on the vaccine front. There was a small belly led selloff leading into month end as the 7-year auction tailed 0.1 bps, a much better showing than the previous two auctions, tailing 4.5 bps and 2.6 bps. There was some standard month end buying from real money accounts and the 5-year treasury rate closed out April at 0.85 while the 30-year rate ended the month at 2.30.

Figure 5: US rate environment

Index (%)	5/18/2021	One month ago	Three months ago	One year ago
Fed Funds Rate	0.25	0.25	0.25	0.25
2-year	0.15	0.16	0.10	0.17
5-year	0.82	0.83	0.55	0.33
10-year	1.64	1.60	1.30	0.69
30-year	2.36	2.30	2.08	1.41

Source: Bloomberg, data as of May 18, 2021.

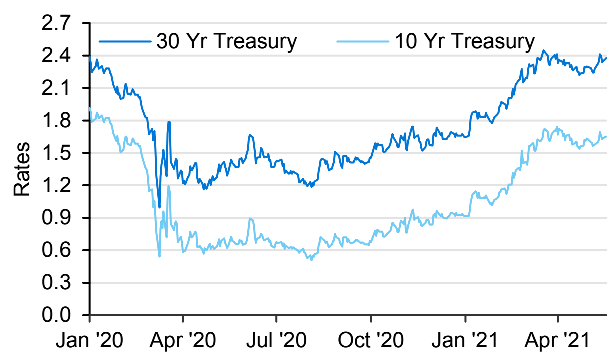
May started with a front-end rally on the back of weak data prints in ISM and US manufacturing PMI. There were high hopes for the April jobs report, but expectations were quickly dashed, as the print came in at +266k job growth and a nearly -150k downward revision to the prior month. Unemployment ticked up 0.1% to 6.1%, as the labor force participation rate came in higher than expected. The immediate reaction to the data was a front-end and belly rally. Some of this flash rally was exacerbated by hedge funds covering shorts they had set up at month-end in anticipation of a blowout NFP number.

The market quickly shrugged off this low print and the 10-year rate rose back to unchanged on the day. The 5-year rate remained 3 basis points lower at 0.77 and the long bond rate sold off 4 bps to 2.28. This brought the 5s30s curve to its steepest level since March.

The following week, everything centered around the CPI print that surpassed even the highest expectations, coming in at +4.2% year-over-year (+3.0% core). The curve immediately bear-flattened, as green and blue Eurodollar strips sold off 10 basis points on the belief that inflation could force the Fed's hand and persuade them to pull their rate hike expectations forward. In a speech later that morning, Fed Vice Chair Clarida continued to push the "inflation is transitory" rhetoric of the Fed. The largest contributors to the CPI increase were from used cars (up 10%) along with air travel and hotels, which both are certainly a product of base effects. However, there have been supply side constraints that could be structural and longer-lasting, particularly given all the chatter around commodities potentially entering a "super cycle" and dramatically increasing the cost of inputs. There have also been reports of shortages of labor, which are unexpected for a reopening economy. The additional unemployment benefits are scheduled to expire in September, which may help ease some of these labor constraints.

Despite the recent strength of consumer spending, US household savings have increased dramatically. This provides ample opportunity to pass rising costs onto them. In the rates market, breakevens have hit multi-year highs, while real yields are in negative territory, likely a result of the continued purchasing program from the Fed. Last month, Clarida stated (perhaps arbitrarily) that if inflation is still running hot at the end of the year, he would no longer consider it transitory. If we continue to see numbers like this, they may need to reconsider what they classify as transitory.

Figure 6: Treasury rates



Source: Bloomberg, data as of May 18, 2021.

Rates volatility

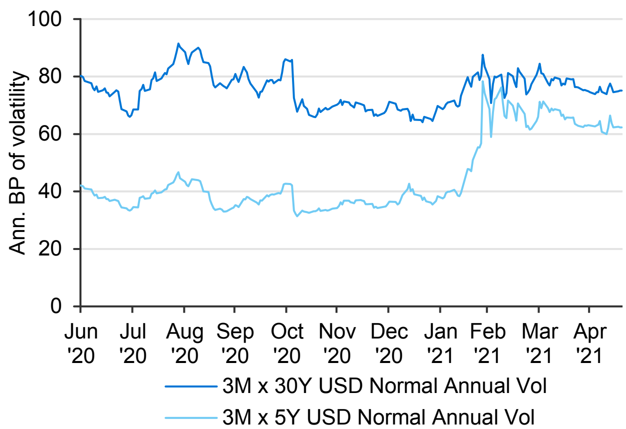
Through 2021, we have seen rate volatility trade directionally with rates – rates go up, volatility goes up and vice versa. This is particularly true in low rate regimes, and especially pronounced on short tails close to the presumed lower bound level of 0. As rates peaked in March and the selloff subsided, rate volatility grinded lower across the surface. The exception to this is intermediate expiries on short tails, which have remained elevated. The graph of the forward rate on these structures versus the implied volatility had virtually been indistinguishable. However, recently we have seen a small divergence as the left-hand side of the surface remains bid as the market tries to time the next Fed hiking cycle.

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

P/Tail	1Y	Change	2Y	Change	5Y	Change	10Y	Change	30Y	Change
1M	11.3	-0.4	19.6	-2.6	59.2	-7.3	72.0	-9.3	71.9	-10.2
3M	13.9	3.4	23.2	0.4	62.6	-3.2	74.7	-4.3	75.0	-4.2
6M	17.1	1.8	30.0	0.0	65.2	-3.8	75.9	-4.0	74.8	-4.3
1Y	28.0	-0.7	42.9	-2.1	69.8	-2.2	76.9	-2.8	73.9	-3.9
2Y	58.8	-0.9	69.1	0.1	76.8	-0.5	77.7	-0.9	71.9	-2.0
3Y	76.3	1.7	80.5	2.4	79.7	0.5	77.7	0.1	70.8	-0.6
4Y	82.3	1.4	81.5	1.8	80.0	1.1	76.6	0.6	68.8	-0.1
5Y	81.6	1.0	80.5	0.7	78.9	1.2	75.2	1.0	67.1	0.8
7Y	78.9	1.6	77.7	0.4	76.3	1.1	71.9	1.2	63.8	1.3
10Y	73.5	1.2	71.8	1.2	70.0	1.3	66.6	1.7	58.9	1.6

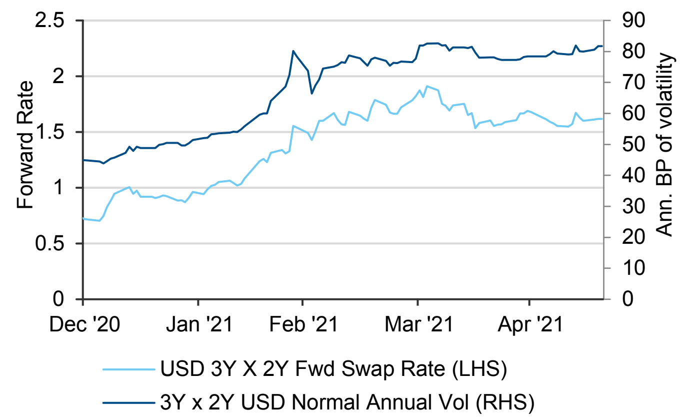
Source: Citibank, data as of May 18, 2021.

Figure 8: Annual volatility



Source: Citibank, data as of May 18, 2021.

Figure 9: Forward rate vs. Implied volatility



Source: Citibank, data as of May 18, 2021.

This jump in volatility is reminiscent of the taper tantrum of 2013, and the lead up to the 2nd rate hike of the cycle at the end of 2016. The CPI print last week further fueled interest on the left-hand side of the surface. After the number 1y1y and 2y2y gapped higher, the rest of the volatility surface followed suit. This rally in rate volatility was short lived, as fast money accounts and program gamma sellers quickly came in to hit any prevailing bids.

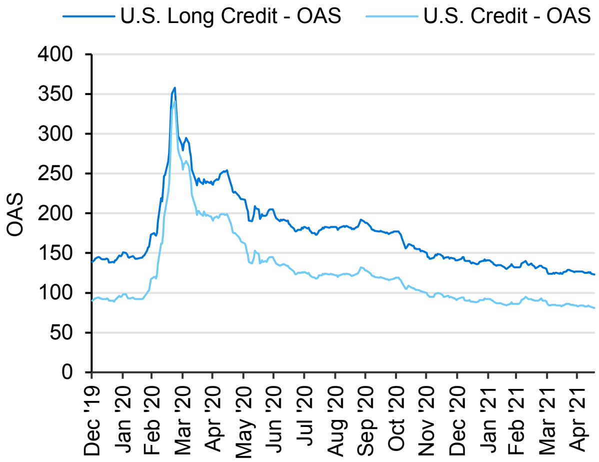
In shorter dated gamma, there has been some interest in low strike protection from cross asset accounts looking to mitigate downside risk, while some fast money accounts have been selling high strikes via distribution trades (a bet that rates will move higher but not significantly higher). This has helped cheapen high strike payers versus low strike receivers, but generally, there is still a strong demand for high strikes. Overall implied vol on 1-month and 3-month expiries has continued to trend lower, primarily due to low delivered vol and dwindling expectations for Fed action in the near term. OTC options with SOFR (the LIBOR replacement) as the underlying index have become more liquid in the past month throughout the interdealer market. In longer dated vega, the bottom right of the expiry surface has remained well bid, as forward vol carry trades remain popular and a slowing Formosa issuance has limited supply.

Credit market

Throughout the month of May, the US Investment Grade Credit market has been relatively range bound. Both US Market Credit and Long Credit spreads are near historical tights, with current spreads hovering around the 1st percentile over a 5-year lookback. Nominal yields are slightly lower, but real yields have seen a noticeable decline, and have become more negative since mid-March. Further, President Biden’s recent infrastructure and jobs proposals (which amount to over $4 trillion in spending), have elicited additional cause for concern amongst investors as the funding will reportedly be sourced from tax increases. Despite these headwinds, as of May 18th, the Long Credit Index is at 124 basis points, 3 tighter on the month and 17 tighter on the year.

Issuance has continued to surprise to the upside. For the month of May, we’ve seen $97 billion come to market and expect an additional $35-45 billion. This trend of higher supply will likely continue, as M&A demand remains robust and share buybacks are gaining traction. From the demand perspective, US IG Bond Fund and ETF inflows have slightly weakened, but we continue to see elevated

Figure 10: US credit spreads



Source: Bloomberg, data as of May 18, 2021.

overnight demand, where inflows are likely due to attractive currency hedged yields.

Inflation continues to be top of mind for all investors. Last week's CPI reading placed increased focus on the Fed's relaxed stance, drawing concern from critics. US CPI jumped 4.2% YoY in April, the fastest growth since 2008. Fed Chair Powell has held steadfast in his views, repeatedly stressing that the lessons learned from the last cycle imply that structural disinflation should allow the Fed to be ultra-accommodative as the labor market continues to heal. Vice Chair Richard Clarida voiced a similar sentiment, arguing that high inflation readings are temporary. Such rhetoric reaffirmed the Fed's efforts to support the labor market and hinted that there will be no QE Tapering in the immediate future.[1]

Earnings for the first quarter have come in much stronger than anticipated, even after accounting for the post-pandemic trend. Heading into earnings season, most anticipated beats of around 10%. However, as earnings season draws to a close, beats have been closer to 22% higher than initial forecasts. This equates to one of the largest beats on record. However, given the relatively muted equity market response, it seems that the majority of these gains were already baked into market prices. Notably, views from research analysts for subsequent quarters have remained relatively static as well. Given the current level of valuations, as well as inflation concerns and less corporate friendly fiscal policy, our IG Credit views remain slightly bearish for the foreseeable future. ■

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