November 2020

Multi-asset Market Update

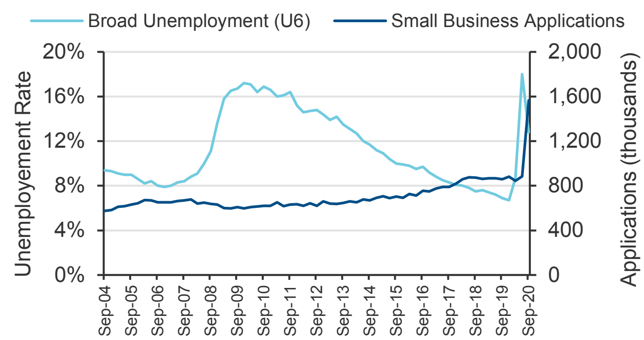
Equity market

The recent debate across our global asset allocation team is whether the market is pricing potentially stricter virus-related lockdowns in the US. The view from abroad of Americans' behavior regarding the virus doesn't seem to be particularly flattering. Recent surveys from Gallup[1] showing a declining willingness to comply with restrictions and another from The Ohio State University[2] suggesting a very large proportion of Americans still planning large holiday gatherings don't cast our collective approach to shared sacrifice and communal accountability in any more favorable light. So, the conflict between our desire to be with friends and loved ones (especially during holidays amidst a long, difficult year) and the precautions necessary to reduce viral spread seems set to propagate current case trends.

Yet, for markets there may be a cornucopia of optimism. A recent article in Nature[3] suggests that most coronavirus spread comes from a very small number of places. Specifically, 5% of points-of-interest account for 75% of virus spread. Those places include bars, restaurants, fitness centers and hotels. So, relatively limited restrictions may still be able to significantly limit spread. Meanwhile, American resilience and adaptability has shown strong. Schools, offices, grocers and other essential businesses have largely adapted to new protocols. The situation is far from optimal, and I'm not alone where the situation with a remote learning child feels closer to dire. But on the whole, particularly for the US economy, the pictures are quite constructive.

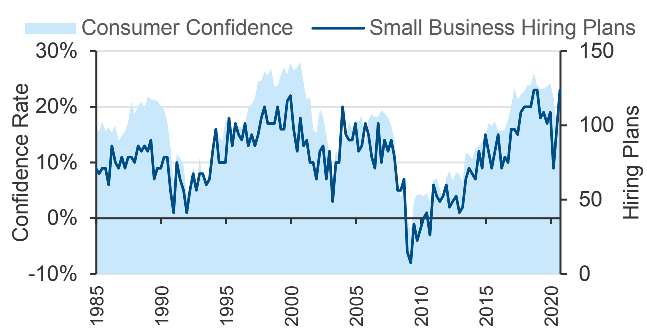
Figure 1 shows that we have already retraced much of the spike in unemployment, even using a broader measure that includes those who are under-employed. Alongside that is a massive spike in applications for new small businesses. The 3Q20 jump is certainly remarkable, but even 2Q20 had a respectable gain. Now, a majority of small businesses are formed as home-based businesses and/or sole proprietorships,[4] so it's possible that many of us have registered a new tax ID to report income earned via Etsy thanks to this year's abundance of crafting time. On the other hand, as shown in *Figure 2*, small businesses surveyed indicate strong hiring intentions—either your tchotchkes are much more popular than mine or there is something more substantial to this. Meanwhile, consumers are also still reasonably confident; perhaps not at the level prior to the onset of the pandemic, but *Figure 2* also exhibits that consumer confidence lags the hiring intentions data (intuitively).

Figure 1: Unemployment rate vs. small business applications



Source: Bloomberg, data as of November 14, 2020.

Figure 2: Consumer confidence vs. small business hiring plans



Source: Bloomberg, data as of November 14, 2020.

Our 2021 outlook for equities reflects these optimistic data points. Valuations are a bit inflated historically, but less extreme than many other asset classes. Consistent with the data in the *Figure 1 and 2*, an early cycle environment is generally very equity friendly. However, we have not yet moved away from our neutral stance. Why not?

Sentiment is more stretched than valuations. Fund flows data, cash allocations, sentiment surveys and Wall Street equity strategist return targets are all skewing very bullishly, which tends to be a contrarian signal. Economists at Oxford and Goldman Sachs both commented this week[4] on the "pent-up" or "excess" savings by Americans, yet this is at odds with our economists' views on the more urgent need for another stimulus package to bridge this wave of the virus. So, at face value the data seems quite supportive, but, particularly where there is limited underlying detail available, there may be some contradictions. As we note throughout this month's piece, the market is already looking past this wave of the virus. Yet that rests precariously on whether there is indeed enough cushion to persevere without more significant disruption or unexpected second-order effects (and whether those newly formed businesses will survive such a daunting infancy).

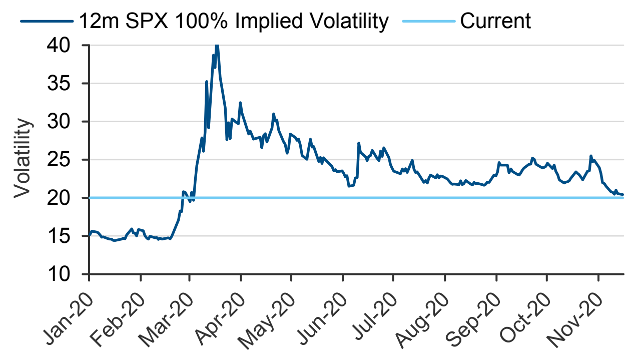
Equity volatility

With the election past and COVID-19 vaccines on the way, implied volatility has fallen to a post-crash low. At the money implied volatility term structure is now uniformly upward sloping. This means that the implied volatility for every longer dated maturity is higher than the previous shorter dated one (i.e., exhibits progressively greater uncertainty about the future). Furthermore, longer dated implied volatility, such as the 12-month at-the-money, has reset lower to nearly 20%. Such levels were last observed in February.[5]

We think the phrase often heard since March of the market "looking through" the crisis applies to this implied volatility normalization. Realized historical volatility observed on actual market movements remains stubbornly elevated. Whereas the one-, two- and three- month historical realized volatility measures are in the 21-23% range, the option market is willing to underwrite expectations of greater calm going forward.[5]

With all the above normalization, and the additional calming in both put and call skew, various spread structures may appear less attractive in percentile terms. It is important to note, however, that for plans which are preparing for their 2021 risk management objectives, it is not simply the upside-downside range tradeoffs that apply, but also the actual dollar strike levels at which they open hedges. In those terms, elevated underlying equity markets offer favorable entry points for risk management overlays.

Figure 3: Implied vs current volatility



Source: Bloomberg, data as of November 17, 2020.

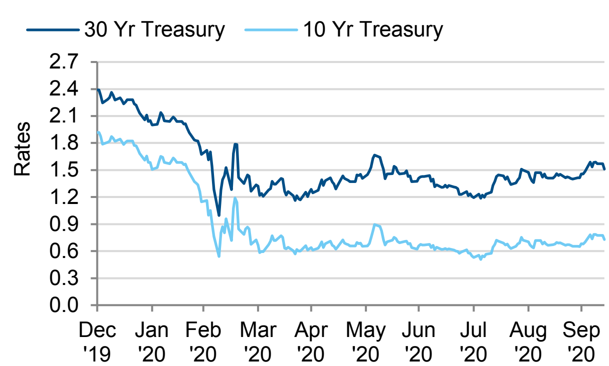
Rates market

Over the past month, rates have moved higher, and the curve has flattened on the back of the US elections, spikes in COVID-19 cases, and promising results from two different pharmaceutical vaccines.

Rates rallied in mid-October despite strong retail sales and ISM numbers as inflation numbers continued to track lower than expectations. They reversed course later in the month on two separate headlines - polls suggested a "blue wave" Democratic sweep of the White House, Senate, and House was more and more likely, and rumors circled of Mnuchin and Speaker Pelosi getting closer to a new stimulus deal.

The 30-year Treasury rate closed out October at 1.66, a 20 basis point sell off over the month, while the 10-year Treasury rate closed at 0.87, its first time above the 200-day moving average since the end of 2018.[5]

Figure 4: Treasury rates



Source: Bloomberg, data as of November 17, 2020

The US elections were expected to bring a tremendous amount of volatility to the market, and they did not disappoint. In just one day, the long end rate went from 1.75 on the assumption of a Democratic sweep to 1.48 as it looked like the polls were wrong (once again) and the outcome was far from certain. On election day, the betting markets had Biden as a 60% favorite in the morning, which dropped to 20% in the evening as Trump won Florida and was ahead in many key battleground states. This jumped back up to 80% by the opening bell the next day as a record number of mail-in and absentee ballots began to get counted.

The November 5 FOMC meeting was a non-event with no surprises, taking a backseat to the breaking election updates. The Fed said they would continue to adjust as appropriate while taking into account risk to public health, the labor market and inflation. There was a hint of bullishness in the press conference as Chair Powell mentioned a discussion of purchase "scenarios" during the meeting, which some interpreted as the Fed extending the duration of their asset purchases.[5]

Figure 5: US rate environment

Index (%)	11/17/2020	One month ago	Three months ago	One year ago
Fed Funds Rate	0.25	0.25	0.25	1.75
2-year	0.17	0.14	0.15	1.59
5-year	0.38	0.32	0.29	1.63
10-year	0.86	0.75	0.69	1.82
30-year	1.61	1.53	1.43	2.30

Source: Bloomberg, data as of November 17, 2020

Following the weekend during which Biden was named the winner by several news outlets, Pfizer released the results of their phase 3 trials showing a 90% efficacy of their vaccine with no major side effects (although the need for the vaccine to be stored at sub-zero temperatures does create some logistics and distribution issues). This good news helped push the 30-year Treasury rate to 1.765 intraday, the highest level since March. After the Veteran's Day mid-week break in the markets, heavy buying in the long end out of Asian commenced as the long end hit new local highs and pushed the long end back down in a bull flattening move.

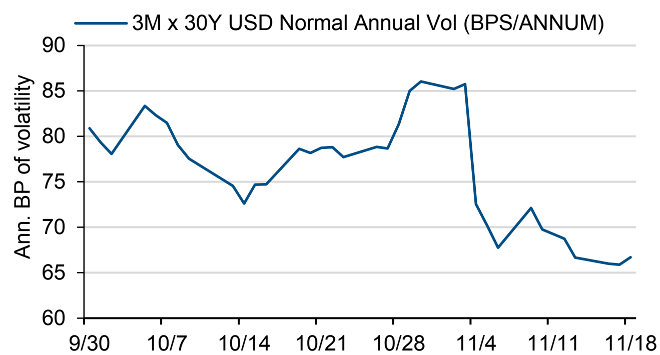
Even with Moderna announcing their vaccine has shown a 94% efficacy, rates still rallied as COVID-19 cases spike across the entire country - NYC has considered re-shutting down public schools, Chicago re-implemented some of the restrictions that had previously been lifted and hospitals in rural and urban areas hit their full capacity. Biden's COVID-19 adviser – immunologist Rick Bright – has also floated out the idea of putting the entire country on a 4-6 week lockdown. Additionally, Mitch McConnell has continued to push a $500 billion stimulus package, well short of the $1-2 trillion Democrats are trying to pass.

So, even with promising news on the vaccine front, it will still take months before it can be mass produced and deployed, and it's unclear how the economy will cope until then. This will most likely keep rates depressed for the foreseeable future.

Rates volatility

Volatility across the entire surface is down over the past month, from the top left to the bottom right. Much like rates, their movement was driven by COVID-19 news and the election.

Figure 7: 3m30y implied volatility



Source: Citibank, data as of November 17, 2020.

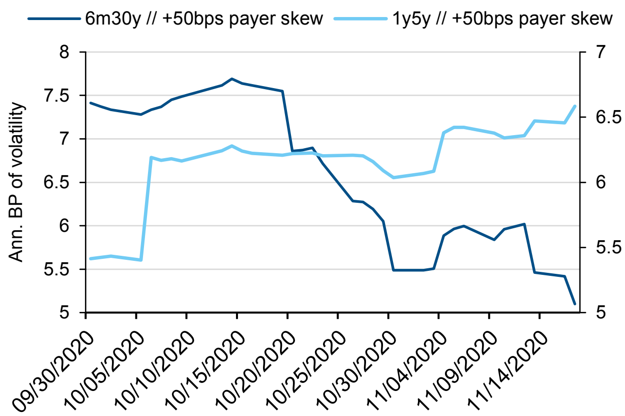
Figure 6: Current implied volatility levels and change over one-month

P/Tail	1Y	Change	2Y	Change	5Y	Change	10Y	Change	30Y	Change
1M	12.3	-7.3	13.3	-9.1	31.5	-13.1	55.8	-19.1	67.2	-28.6
3M	12.5	-4.9	15.3	-4.0	33.6	-5.2	55.7	-7.3	67.0	-11.9
6M	12.9	-3.7	17.1	-2.3	35.9	-2.9	56.0	-4.7	66.4	-6.8
1Y	15.3	-3.5	20.2	-2.4	39.1	-2.1	55.8	-4.4	63.8	-5.8
2Y	24.3	-3.0	31.9	-0.7	46.0	-0.7	57.4	-2.7	61.2	-4.6
3Y	36.8	-0.6	41.1	0.3	50.8	-0.9	58.8	-2.1	60.2	-3.6
4Y	45.5	-0.4	48.3	0.3	54.5	-1.1	59.6	-1.9	59.2	-3.1
5Y	51.5	-0.7	53.4	-0.1	57.0	-1.3	59.6	-1.9	58.0	-2.8
7Y	57.3	-0.5	57.2	-1.2	58.5	-2.0	59.4	-2.0	56.1	-2.3
10Y	59.5	-2.3	59.4	-1.8	59.0	-2.2	58.7	-2.1	53.3	-2.9

Source: Citibank, data as of November 17, 2020.

Volatility on 30-year tails moved steadily higher through the end of October as polls continued showing the "blue wave" Democrat sweep as the most likely outcome, leading to expectations of a large stimulus package, further government spending, devaluation of the dollar and long end steepening. It should be noted this volatility rose even as program sellers emerged assuming the election results would be known quickly and uncontested.

Figure 8: Payer skew



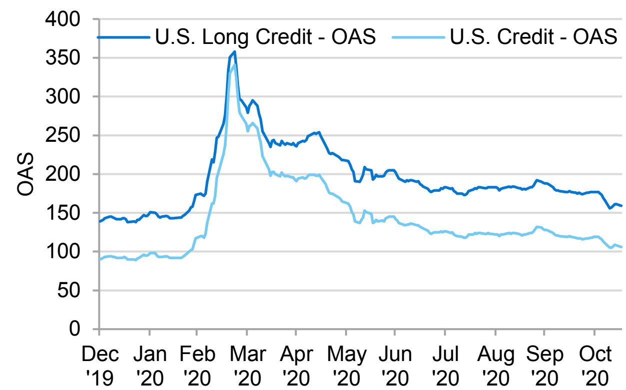
Source: Citibank, data as of November 17, 2020.

Some fast money accounts also sold high strike 30-year payers as a way to fade this sentiment going into the election. Volatility plummeted after the election, but it was not just to the event risk passing - the outcome of Democrats controlling the Presidency and the House while Republicans retain control of the Senate is a perfect recipe for gridlock, putting the brakes on any expectations of reflation and long end steepening in the short term. With rates drifting back into their previous range, program sellers have re-emerged, further depressing volatility across the surface. The positive vaccine move did give a small uptick to volatility on 5 to 10-year tails as this part of the curve realized outsized moves in the bear flattening reaction to the Pfizer news, leading to buying of high strike payers on 5-year tails. In longer dated volatility, there was a large amount of Formosa issuance (mostly from one issuer in Japan) just before the election, which sent lower right volatility back near their all-time lows. But that seems to have stabilized as outright buyers and relative value buyers coming in via forward volatility structures have absorbed this supply to the market.

Credit market

Throughout November, news cycles have revolved around promising vaccine trials, election results and stronger-than-expected earnings. As a result, the Bloomberg Barclays US Long Credit Index currently sits at 161 basis points, 16 basis points tighter over the month. The November 5th FOMC kept policy unchanged as expected; however, there was discussion of various ways to enhance QE, if needed. Given the positive response to the Pfizer and Moderna studies, central bankers across the world will likely prove reluctant to act in the immediate future.

Figure 9: US credit spreads



Source: Bloomberg, data as of November 17, 2020.

Foreign overnight buying showed a noticeable uptick at the beginning of the month, seemingly coincident with the rise in US Treasury yields. That trend has continued, although the pace has slowed. November supply was anticipated to be below the 5-year average, with estimates ranging from $65 to $75 million. So far, issuance is generally on pace with that expectation, as $54 million has come to market. We are currently 61% ahead of last year's pace. However, this figure has slowed, and issuance is expected to further dampen as we approach the end of the year. Given the record borrowing in 2020 amid the diminished rates and pandemic uncertainty, various strategists are anticipating a 30-50% reduction in supply next year. Demand is expected to remain steady, pointing to a potential catalyst for further spread tightening.[5]

Heading into earnings season, expectations were that EPS would fall around 22% YoY. With the majority of companies having reported, EPS is on track to fall only 7.6%. Of those that have reported, 83% beat their projections. However, not all news is positive news. The US is currently in the midst of a third COVID-19 outbreak as infection rates have risen to as high as 181,000 per day. The latest surge began in more rural areas throughout the US but is now spreading across the country. This dynamic could potentially result in some short-term volatility due to mandated business closures and hospital capacity concerns. However, a realistic rollout of the vaccines could mean that the US is able to achieve "herd immunity" by mid-year 2021, boosting growth from 2Q21 onward. Given the positive market technicals as a tailwind to credit spreads grinding tighter into year-end, we are cautiously optimistic in the short-term.[5]

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1 Source: Gallup
2 Source: The Ohio State University
3 Source: Nature
4 Source: SBA.gov
5 Source: Bloomberg
6 Source: Citibank

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