LGIM
America

October 2020

Multi-asset Market Update

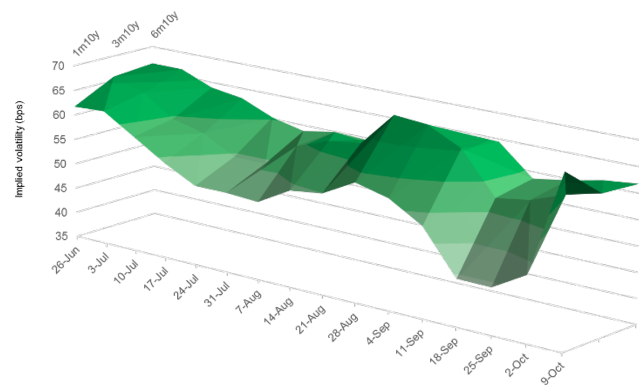
Equity market

Despite my own strong desire to think or write about anything not related to the election, this is our last monthly update before such a significant event, and near-term market implications seemingly rest heavily on the results. We maintain our neutral stance on equity, albeit with an inclination to tilt positively. As we mentioned last month, though, it is equally difficult to maintain a neutral position as it is to drift from it. Because, like politics, many markets seem to be of two minds.

In our experience and analysis, political risk premia are frequently inflated and subsequent outcomes in corresponding markets are typically much more placid than anticipated. To be fair, the dangerous tails of political events are often more difficult to interpret or anticipate than economic events (and the latter can certainly be influenced by the former). However, it is possible that we are now overly conditioned to this sequence with the 2016 US Presidential election and Brexit vote adding some recency bias. We think this is evident in volatility markets—both rates and equity—where pricing seems to indicate high anxiety about outcomes that survey data indicate would be quite benign.

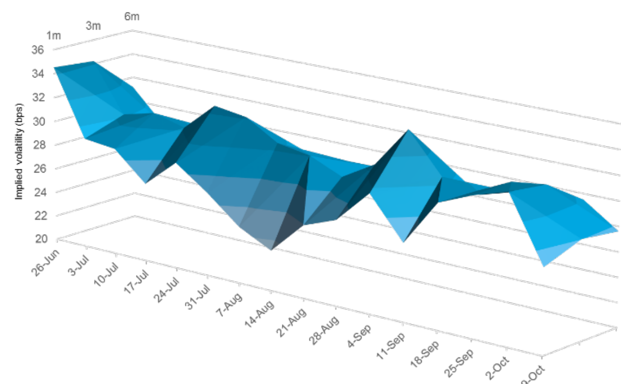
Figure 1 and Figure 2 are charts of the implied volatility term structure for US 10-year Treasury swaptions and VIX futures through time. The charts tell a knotty story, so bear with us. As an example, note that the surfaces as of late June were both elevated on an absolute basis and relatively flat (1-, 3- and 6-month constant maturities are along the Z-axis). This occurred coming out of the March drawdown and subsequent 2Q20 rapid recovery—an extended period of elevated realized volatility with much uncertainty remaining in the year. On the other hand, while levels declined into September, the term structure created a peak around the election date. This was just ahead of the first Presidential debate and early in the current political dogfight over additional fiscal stimulus.

Figure 1: Swaption implied volatilities (annualized move in basis points)



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

Figure 2: VIX Index futures



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

Currently, rate and equity implied volatilities are similar in that peak uncertainty occurs after the election. According to a Bank of America survey, 61% of institutional asset managers have a contested election as their base case, so the current term structures are consistent with that view (or

at least a delayed result).[1] Interestingly, though, both markets have attracted sellers of very short-dated (i.e., up to the election) volatility recently. Yet, overall, volatility remains stubbornly elevated.

So, what are the inconsistencies? And how might you position for them in the short term?

Historically, a government of opposing parties in the executive and legislative branches results in more gridlock, which can reduce uncertainty (i.e., more likely that nothing happens than something adverse does) and markets often respond favorably. Several senior portfolio managers in our organization and a prominent counterparty have fairly argued that a Democratic sweep results in more total stimulus and is therefore bullish. (Equity markets seem to rely on stimulus as their primary reaction function, so it's harder to deny this.) And while the same institutional asset manager survey and betting markets assign a trivial probability to a Republican sweep, the likely policy outcomes (e.g., corporate taxes remaining low) are still market friendly. So, we are left with few scenarios that would typically challenge markets, even if the winner of the Presidential race isn't immediately known.

Perhaps the market is concerned that a divided government delays or limits stimulus, but a colleague insightfully commented, "What politician wouldn't want to spend money right now?" Our US Economist is concerned about a consumer stall in Q4 given the lack of additional stimulus so far but remains above consensus on 2021 growth nevertheless. Further, the same fund manager survey also indicates a precipitous drop in participants expecting a near-term recession, and, in fact, nearly 60% believe that we are now early cycle. Recent consumer confidence and small business optimism metrics corroborate this; they have rebounded sharply to historically strong levels.[2]

We're left with a market that seems to care less about the risk of upending the most likely election scenarios (i.e., selling very short-dated volatility), while also being quite concerned about a post-election environment that tilts favorably for markets. Mentions of the virus are conspicuously missing this month, and risks certainly remain there, which contributes to our restraint. We also still favor selling medium-term volatility and put spread collars continue to offer attractive payout structures precisely because they sell that medium-term volatility. So, clients who wish to maintain or increase return-seeking allocations may find this an attractive way to balance a constructive view with some additional downside protection.

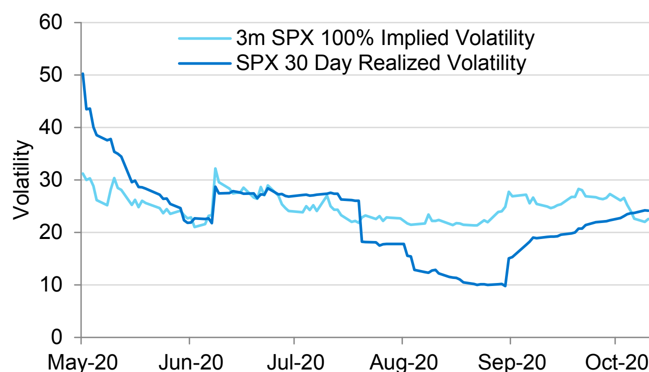
Equity volatility

Implied volatility remains elevated, although the measures continue to normalize. At the money implied volatility term structure remains flat at around 22% compared to 23-24% highlighted last month. VIX futures have broken down below 30. These measures imply daily spot moves of approximately +/-1.5% a day. Some of this normalization is simply a function of the rise in equities, which naturally causes the option market to reset at lower implied volatility for higher strikes (i.e., "rolling down the skew").[2]

Realized volatility also remains elevated, although the variety of daily observation windows from ten days to six months have converged to approximately 20%. We interpret this to mean that the option market is trading at a moderate premium compared to the underlying and attempting to balance further anticipated stress versus normalization. Despite elevated volatility risk premia, many of carry strategies are likely to have only performed modestly. For example, many short volatility programs sell implied volatility and are subject to the risk of subsequent higher realized volatility. Throughout 2020 that premium has been quite narrow.

After steadily growing interest in equity structures during the past 2-3 years of episodic volatility, we continue to see clients more confidently roll or modify their plan derivatives overlays and establish action plans across a variety of allocation circumstances.

Figure 3: Implied vs realized volatility



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

Rates market

Since our last publication, rates traded sideways through September before the long end sold off into the upper end of the COVID-19 range. Rate moves over the past few weeks have been largely driven by speculation over a second stimulus bill and inflation trades coming back in vogue.

The last FOMC meeting before the 2020 election went as expected. The Fed continued the messaging they've had since Jackson Hole: Rates will be on hold through at least 2023, they are now targeting long term average inflation (which would mean letting inflation run above the 2% target), and the conditions for raising rates have a high hurdle to clear – it's not just a matter of unemployment getting back below 5%. The only small surprise was that there was no discussion to extend the QE program or the weighted average maturity of the Fed's portfolio.

Figure 4: US rate environment

Index (%)	10/14/2020	One month ago	Three months ago	One year ago
Fed Funds Rate	0.25	0.25	0.25	2.00
2-year	0.14	0.14	0.16	1.59
5-year	0.30	0.26	0.29	1.55
10-year	0.73	0.67	0.62	1.73
30-year	1.51	1.41	1.31	2.19

Source: Bloomberg, data as of October 14, 2020

The long end closed out September at 1.46, having sold off at month-end on comments from Treasury Secretary Mnuchin that he expects to come to an agreement with Speaker Pelosi on a second round of stimulus, although this sentiment was tempered by Senator McConnell announcing later in the day that the two are still far apart from each other.[2]

Figure 5: Treasury rate

Source: Bloomberg, data as of October 14, 2020

Rates got a further push higher with the release of another positive (albeit below consensus for the first time in several months) employment report. NFP added 661,000 jobs in September and the unemployment rate dropped from 8.4% to 7.2%, although some of this was attributed to a decline in the labor participation rate. Pelosi also echoed Mnuchin's comments from earlier in the week that a middle ground would be found on a second stimulus. Despite the President and several other White House officials and Republican Senators being diagnosed with COVID-19, optimism around another stimulus plan (along with the President being released from the hospital in good health) further buoyed rates as the 30-year Treasury traded at 1.61 intraday on October 5.[2]

Rates traded sideways in a tight range the following day up until 30 minutes before the rates close, at which point the President sent an unexpected tweet saying that there would be no further stimulus negotiations until after the election.

He also emphasized Republicans, McConnell in particular, should focus on fast tracking the confirmation of Amy Coney Barrett to fill the Supreme Court vacancy created by the passing of Justice Ginsburg in September. The long end rate dropped 6 basis points in less than ten minutes into the close. Rates bounced back the following day as the President was quick to walk back on his hard-line negotiation stance, instead saying that he would consider some stand-alone stimulus for airlines, small businesses, and individuals.

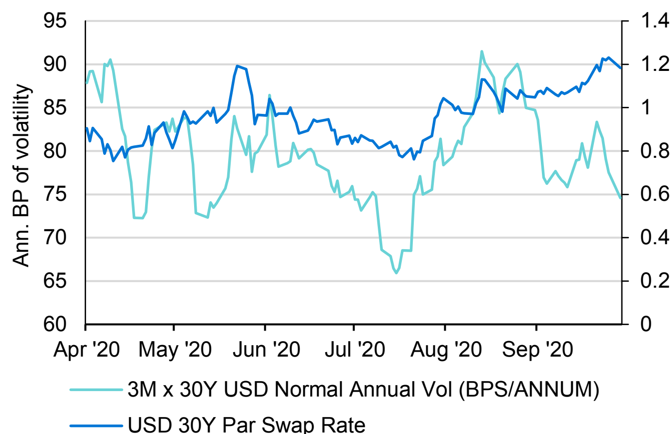
The accommodative Fed policy coupled with the potential for tremendous government spending via the stimulus has led to many participants initiating inflation trades, either through 30-year breakeven purchases - the long end break even rate hit an 18 month high this month - or via steepeners, as the front-end is firmly anchored for the foreseeable future.

This holiday shortened week has had a risk-off tone as Johnson & Johnson announced over the weekend that they were pausing their COVID-19 vaccine study due to an unexplained patient illness. The 30-year Treasury rate closed out Tuesday at 1.52.[2]

Rates volatility

Despite some large up and down delivered moves in rates and the long end getting back to local highs, interest rate volatility was hammered lower across all expiries and tenors, particularly on longer tails. The notable exception to this are 1-month expiries, which now contain the election event risk. Upper left volatility is now trading at an implied volatility of 1 basis point per day in 1-year and 2-year tails, so it seems like it would be tough to have it move lower from here. Shorter dated options on longer tails had been moving with rates (higher rates led to higher implied volatility and vice versa) but this trend has started to break.

Figure 6: 3m30y implied volatility



Source: Citibank, data as of October 14, 2020.

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

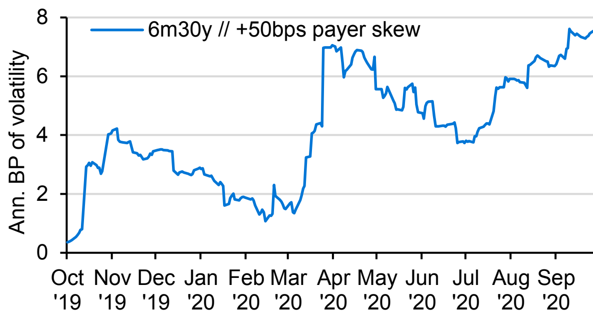
P/Tail	1Y	Change	2Y	Change	5Y	Change	10Y	Change	30Y	Change
1M	19.8	*3.1*	21.7	*4.0*	40.1	*10.9*	67.8	*16.4*	88.2	*18.1*
3M	17.4	*-1.6*	18.7	*-3.2*	36.3	*-3.9*	60.1	*-6.0*	74.8	*-10.4*
6M	16.7	*-0.6*	19.1	*-2.0*	37.6	*-3.9*	59.9	*-4.8*	71.9	*-7.7*
1Y	19.0	*-1.9*	22.8	*-2.9*	40.6	*-3.1*	60.0	*-3.5*	69.7	*-4.2*
2Y	28.4	*-3.7*	33.7	*-4.0*	46.8	*-3.9*	60.5	*-3.5*	66.4	*-4.3*
3Y	38.3	*-4.6*	41.8	*-5.0*	52.2	*-3.4*	61.5	*-2.7*	64.5	*-3.3*
4Y	46.2	*-4.3*	48.6	*-4.3*	55.9	*-2.8*	62.0	*-2.4*	63.2	*-2.8*
5Y	52.0	*-3.9*	53.8	*-3.5*	58.7	*-2.4*	62.0	*-2.2*	61.8	*-2.5*
7Y	58.1	*-3.2*	59.0	*-3.0*	61.2	*-2.0*	62.0	*-1.7*	59.4	*-2.1*
10Y	61.2	*-2.5*	61.4	*-2.2*	61.4	*-1.6*	61.1	*-1.3*	56.9	*-1.6*

Source: Citibank, data as of October 14, 2020.

Program sellers have been fading any pop up in short dated volatility lately. This has led to a steepening of the expiry curve on 30-year tails, leading to the unwinding of forward volatility trades over the past month as they richen from this steepening.

Interest in high strike payers continues to persist, particularly from mortgage and insurance accounts, or those interested in putting on curve steepening or long end inflation views.

Figure 8: Payer skew



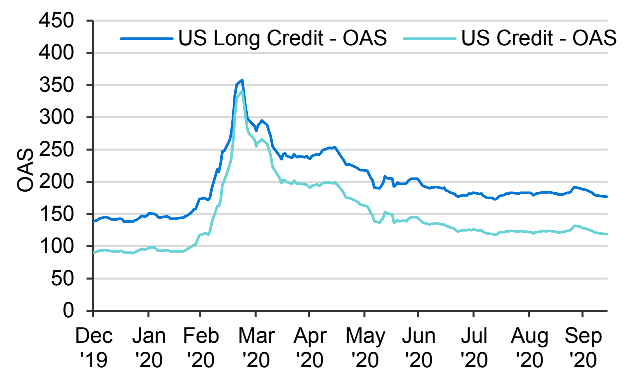
Source: Citibank, data as of October 14, 2020.

Along with this theme, dealers have noted that interest in curve caps has persisted as well. The US election is less than 3 weeks away, and while volatility around that date have come down from their previous highs, it still has the potential to be a major market mover, particularly if the election results get drawn out and delayed like in 2000 and the election has to be voted on by President's newly nominated Supreme Court Justice.

Credit market

Over the past month, the Bloomberg Barclays US Credit Index has traded in a 13-basis point range and is currently 2 basis points tighter at 119. The index is now just a hair away from the post COVID-19 crisis tight of 118, which was reached in early August. It is notable that yields are nearly 20 basis points higher since then, which can be interpreted as a supportive factor for spreads.

Figure 9: US credit spreads



Source: Bloomberg, data as of October 14, 2020

These higher yields have re-energized foreign demand, with overnight activity showing the strongest net client buying since late August. Furthermore, inflows from bond funds and ETFs into investment grade credit hit $8.7 billion, the highest in six weeks, on the back of a more favorable return profile. Combining the strong demand trends, we are seeing with supply that is expected to remain contained through earnings season and the election, it is no surprise that spreads have quickly retraced their recent widening.

Infection rates, which were at one point as high as 70,000 cases per day, halved at the start of September. This number has since climbed back to around 50,000; however, the uptick has been mostly driven by Midwestern states and localized outbreaks. Daily testing is also up substantially, with the US closing in on 1 million tests per day. Some believe this increase could be the main reason for the rise in recorded cases.

On the economic front, private-sector hours worked for September saw an increase of 13.5% (annualized), which was in-line with July and August figures. The unemployment rate also dropped to 7.9%. However, the drop was accompanied by a decline in labor force participation. We also saw the September jobs report come in weaker than expected, suggesting that payroll growth might be slowing as the economic recovery decelerates. Going forward, we do not anticipate the Fed to increase

bond purchases, barring any sizable sell-offs. Based on their actions throughout September, when the credit market saw softening, the Fed's appetite to add risk remained weak.[2]

During 3Q, the stronger than expected economic rebound, combined with supportive market technicals, have more than offset a slowdown in fiscal stimulus and a resurgence of COVID-19. Over the coming weeks, earnings season and the election are expected to keep supply subdued, which is supportive of spreads. Furthermore, the backup of yields should attract the overseas buyer. That being said, spreads remain volatile due to a weakening macro environment, which makes credit selection even more important than usual at this time. Although national polls have been the most stable on record for a presidential election over the past few months, the idea that the outcome could be contested, specifically in regard to mail-in voting, shouldn't be overlooked. All things considered, with favorable market technicals expected over the next few weeks, we remain cautiously optimistic on the direction of credit spreads in the near-term.

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1 Source: Bank of America
2 Source: Bloomberg

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