Legal & General
INVESTMENT MANAGEMENT
AMERICA

September 2020

Multi-asset market update

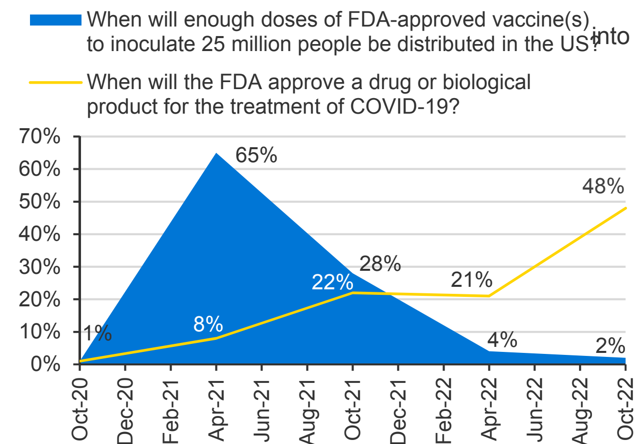
Equity market

We maintain our neutral view on equities. The myriad of event risks so far and yet to come in 2020, as well as our focus on managing return distributions, have been well-documented in recent months. And these experiences make holding a neutral stance nearly as difficult as shifting away from it. It's an obvious statement that efforts to identify opportunities in either direction require that we have a handle on what the markets have already priced. And although we probably wouldn't say it – and we certainly wouldn't put it in writing – "we don't know" is likely the fairest assessment right now.

Why is this such a difficult task? It may be related not only to difficulties identifying "consensus" views, but also that consensus is characterized by logically inconsistent views. We frequently use and cite The Good Judgement Project ("GJP") internally. The GJP is a website that promotes egalitarian forecasting of events and markets. It was founded by Phil Tetlock, author of *Superforecasting: The Art and Science of Prediction* and professor at the University of Pennsylvania. A great deal is staked on the timing and efficacy of a COVID-19 vaccine, and what GJP reveals about this in *Figure 1* is telling.

Nearly 70% of people believe we will use an FDA-approved vaccine by April 1, 2021, and nearly 70% of people also believe the FDA will approve a vaccine after April 1, 2022.[1] By extension, though, this impossibility is somehow priced into markets if you assume markets reflect some probability weighted average of virus outcomes and resultant impacts on economic activity.

Figure 1: Vaccine forecasts

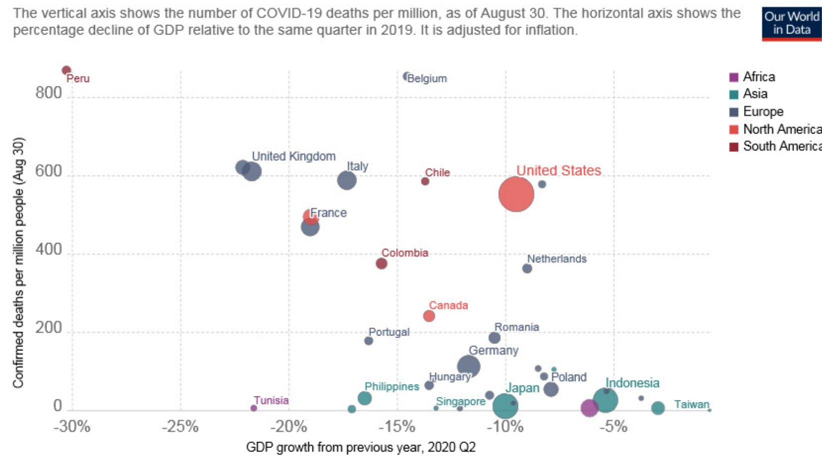


Source: Good Judgment Project, data as of September 15, 2020

This prediction is important because some of what is at stake with a vaccine is economic activity and investment performance. For much of the early pandemic experience, it was assumed that there was a trade-off between economic activity and public safety (and that may still be the case, wholly or partially). Yet *Figure 2* offers some evidence that the opposite may be true.

1 We assume that the populations of people who go to that particular website to make forecasts for multiple questions on the same topic would not be sufficiently independent to explain the inconsistency. However, we also acknowledge the subtle difference between "vaccine" and "treatment" in the two questions and recognize that could explain some of the apparent inconsistency.

Figure 2: Economic decline in the second quarter of 2020 vs. rate of confirmed deaths due to COVID-19



Source: Our World in Data

Weighing this evidence is an entirely depressing task, though. It rekindles debate and inspires second guessing about what the consequences could have been if lockdowns hadn't been implemented and healthcare systems became completely overwhelmed. It also reminds us of data showing increased frequency of at-home deaths, including a sharp uptick in overdose fatalities, and the staggering prevalence of self-reported symptoms of anxiety and depression. Like last month, though, we set aside the humanity of these issues to focus on unfeeling mathematics. Or, perhaps with less sheepishness, weighing this evidence does not lead us to any better understanding of current market pricing, but it does make obvious another conundrum.

The US, the world's largest economy, is in a miserable quagmire of politics and pandemic. Certainly, there is much economic and social healing ahead of us, but we do not know if more damage will be done first. China, the world's second largest economy, has returned to pre-pandemic levels of activity and growth by all but one economic measure (retail sales), assuming we quell the nagging doubts about the veracity of their official economic and virus data. The S&P 500 has had a truly remarkable recovery already yet trails a broad Chinese equity index by almost 13% year-to-date.[2] If future waves of the virus prove manageable and returns to school and work are largely successful, then the US can get on with the economic recovery, presenting us with more early cycle-like opportunities and the potential for a continued rally such as what China has experienced. However, the economic impact of any future virus setbacks also hinges on policy responses. We are approaching peak uncertainty for the next phase of the virus (i.e., during colder months and flu season) and peak election uncertainty simultaneously. The US track record for leadership during the pandemic is quite poor, and we may find ourselves in a scenario where it's not certain who the elected leader should be.

Equity volatility

Implied volatility remains elevated, although closer to the bottom of the range over the past few months. Term structure of implied volatility has normalized such that at-the-money implied volatility is relatively flat between 23-24%. This implies +/-1.5% daily moves on average.[2]

Without rehashing the well-documented, recent commentary about historically elevated volumes of call buying in technology related equities and the commensurate elevation in short-term market dynamics, recent historical realized volatility has picked up substantially in tandem. Historical volatility over a 10-day window is over 30%.[2]

Figure 3: 2nd month VIX futures price

Source: Bloomberg, data as of September 15, 2020

For general sentiment in the volatility space, however, it is worthwhile to refer to the two-month VIX futures price. VIX futures interpolate a fuller measure of skew across a particular maturity, and therefore incorporate risk pricing for a broader range of scenarios. The most recent level peaking near 40 expressed option market pricing consistent with an environment like the brief, but intense, equity sell-off in June, or that of early April when markets were just beginning to recover from the March bottom.

2 Source: Bloomberg, LGIMA calculations as of September 15, 2020

We have had an increase in inquiries for equity option-based hedging solutions and a broader appetite for considering alternative structures besides outright put buying. For continuity, the vanilla one-year 80/95 put spread can be part of a costless structure from the sale of a 111% call.

There are a variety of defensive approaches that indicate favorable relative-value trade-offs due to today's skew and volatility dynamics. Depending on a client's specific objective and, importantly, horizon, there may be a variety of possible hedging strategies to accomplish that objective.

Rates market

With the past few weeks being relatively quiet for rates, we are (essentially) at the exact same levels we were at one month ago. The front end remains firmly anchored and expectations for the Fed remaining on hold continue to get extended out further and further.

Positive data and Fed policy revisions led to some bear steepening in the back end, but these moves quickly reversed course. At the end of August, PMI rose to its highest level in 18 months and existing home sales grew 24.7%, the best pace since July 2006 (although some of this is attributed to a build up from the spring that was delayed for COVID).[2]

At the annual Jackson Hole summit, Chair Powell announced that the Fed had concluded their policy framework review. They have shifted their focus to "long-run goals" and will be targeting 2% *average* inflation, echoing previous statements from other Fed governors that they would be comfortable letting inflation run above 2%, shifting their policy from "stabilization to accommodation."[3]

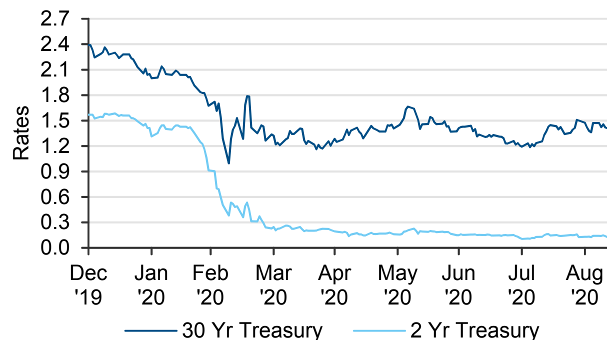
Figure 4: US rate environment

Index (%)	9/15/2020	One month ago	Three months ago	One year ago
Fed Funds Rate	0.25	0.25	0.25	2.25
2-year	0.14	0.15	0.19	1.72
5-year	0.27	0.29	0.34	1.63
10-year	0.68	0.71	0.72	1.77
30-year	1.43	1.45	1.46	2.26

Source: Bloomberg, data as of September 15, 2020

Powell also emphasized that low unemployment absent inflation would not be a reason to shift to a hawkish policy and start raising rates. Long-end rates spiked in the wake of Jackson Hole, with the 30-year Treasury rate reaching 1.57 overnight. Rates then rallied into month end on light volumes and the long end closed out August at 1.47.

Figure 5: Treasury rates



Source: Bloomberg, data as of September 15, 2020

The first few days of September all followed a similar pattern: long-end rates would have a small selloff overnight during Asia trading hours, strong macro data would be released during US hours, and rates would rally 5 basis points. By September 3rd, the 30-year rate had hit 1.32 despite chain store sales continuing to climb, ISM surprising to the upside, and the US Treasury announcing another round of record-breaking debt issuance.[2]

The August employment numbers continued to outpace even the most optimistic expectations and shattered any thoughts that the recovery had stalled in July or August. NFP showed a gain of 1.37 million jobs (vs 1.35 million estimate), unemployment dropped to 8.4% from 10.2% one month earlier and average hourly earnings grew by 0.4% on the month. Long-end rates had climbed back up to 1.48 by the end of the day going into the holiday weekend. Since then, rates have moved lower on equity weakness with the 30-year rate holding steady at 1.42 for the past few trading days.[2]

Rates volatility

Volatility on the right-hand side of the surface remained well bid while volatility on the left continued a slow grind downwards. With the market not pricing in any Fed hikes until well into 2023, sellers of volatility on 1y and 2y tails have gone from "picking up nickels in front of a steamroller" to "picking up pennies" as implied volatility is below 1.5 basis points/day.

3 Source: The Federal Reserve.

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

P/Tail	1y	Change	2y	Change	5y	Change	10y	Change	30y	Change
1M	17.1	1.2	18.2	-0.7	29.8	-3.6	52.3	-2.2	71.5	0.2
3M	19.0	-1.5	21.8	-1.6	40.0	-0.5	66.0	2.4	84.9	3.3
6M	17.4	-3.2	21.1	-2.9	41.1	0.5	64.8	4.0	79.1	4.7
1Y	20.9	-3.7	25.7	-3.0	43.4	-2.0	63.7	2.3	73.7	2.4
2Y	32.1	-3.0	37.8	-2.2	50.6	-1.5	63.9	1.4	70.6	1.2
3Y	43.0	-2.6	45.3	-3.2	55.3	-0.9	64.2	1.0	67.9	0.9
4Y	50.6	-1.2	52.1	-1.5	58.6	0.1	64.5	1.2	66.0	0.6
5Y	56.0	0.3	57.4	0.2	61.1	0.8	64.2	1.4	64.2	1.0
7Y	61.2	0.6	62.0	0.8	63.2	0.7	63.7	1.3	61.5	1.8
10Y	63.7	1.1	63.7	0.9	63.0	0.6	62.4	1.3	58.5	1.6

Source: Citibank, data as of September 15, 2020.

Volatility on 10y and 30y tails have had more life in them and generally have been trading directionally with rates – volatility goes up as rates go up.

Expiries around the election continue to be the most well bid point on the surface, as Bank of America points out that 3m30y volatility traded 9abpv above both the 1m and the 6m expiries for the first time on record. Fears of a drawn-out election - either from COVID-19 related mail-in delays that need to be counted in a close race or Trump fighting unfavorable results – persist, which should keep that volatility well bid.

Figure 7: 3m implied volatility

Source: Citibank, data as of September 15, 2020.

Figure 8: Payer skew

Source: Citibank, data as of September 15, 2020.

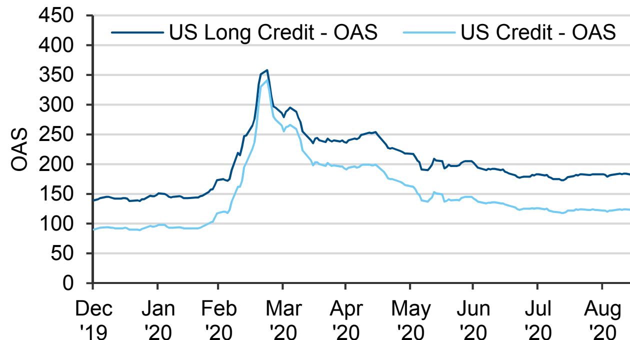
Some RV traders have started using this as an opportunity to enter into calendar trades, selling 3m30y vs buying longer dated options. Conditional bear steepeners in intermediate expiries remain popular as well as the front-end stays anchored and volatility on longer tails has been rising in selloffs. The notable exception to that has been unwinds in 1m bear steepeners, where fast money has been closing out positions as the sustained selloffs have failed to materialize. Curve volatility on 2s5s steepeners has been a popular sell as well as the Fed shifts their focus to average inflation targeting, which should put a cap on how much 5-year yields can rise. Longer dated volatility has remained well bid as Formosa issuance has been light over the past month.

Credit market

Throughout September, credit spreads have remained relatively rangebound, as the US Long Credit Index closed at 182 basis points, 1 tighter on the month. At 122 basis points, the spread on the US Credit Index continues to hover near the post-COVID lows. A large portion of the index trades at a spread similar to a year ago if not tighter, particularly if one adjusts for the higher dollar price of bonds today. However, much as was the case coming out of the GFC, sovereign debt crisis, and energy crisis, the investment grade market has bifurcated with about 10-15% of the market lagging the recovery. Monetary policy remains exceptionally accommodative in the United States. Chair Powell's speech at Jackson Hole marked the completion of the Fed's long anticipated framework review and pivot to average inflation targeting (AIT). However, as

the Fed did not define “average” there is still ambiguity around the Fed’s reaction function.[4]

Figure 9: US credit spreads



Source: Bloomberg, data as of September 15, 2020

The August jobs report slightly beat consensus as payrolls rose 1.37 million. The strength of the August jobs report has called into question the need for another fiscal stimulus bill. Republicans and Democrats appear far apart on the size and composition of any relief package and negotiations appear to have stalled in the last month. As election night quickly approaches, former Vice President Biden remains ahead in the polls, with the September 15th data indicating his lead ranges between 6-9% relative to President Trump. With that being said, Trump continues to see polling tighten in key battleground states, such as Florida.[4]

Although 2Q earnings were objectively horrible, an unusually high number of companies beat analysts’ expectations by an unusually large amount. Gross and net leverage both increased over the quarter, but at a lower level than expected. The initial estimations of a full-turn increase over the year are now unlikely to occur, as gross leverage only increased by 0.5x (3.24x) and net leverage increased by a modest 0.25x (2.42x). Downgrade volumes have also subsided, with very little activity in recent months. The primary market has brought $89.2 billion to market month-to-date, already surpassing the $150 billion expected in September. US issuance is currently 70.2% ahead of 2019’s pace. Robust demand from mutual funds, ETFs and foreign buyers has helped to digest the plethora of supply. ■

4 Source: Bloomberg

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