

LGIMA's Multi-asset Market Update

July 2019



Equity market

Our last Multi-Asset report was a heavy metal take that shredded your inbox with a post-June Fed announcement riff. This month is more like the [inoffensive folk-pop stylings of Fed Vice Chair Richard Clarida](#). A cut at the upcoming meeting on July 31 is practically a foregone conclusion. So, the melodies and verses this month are quite familiar: parsing central bank announcements as finely as ever, mid-Summer (lack of) market depth and tension in the Middle East.

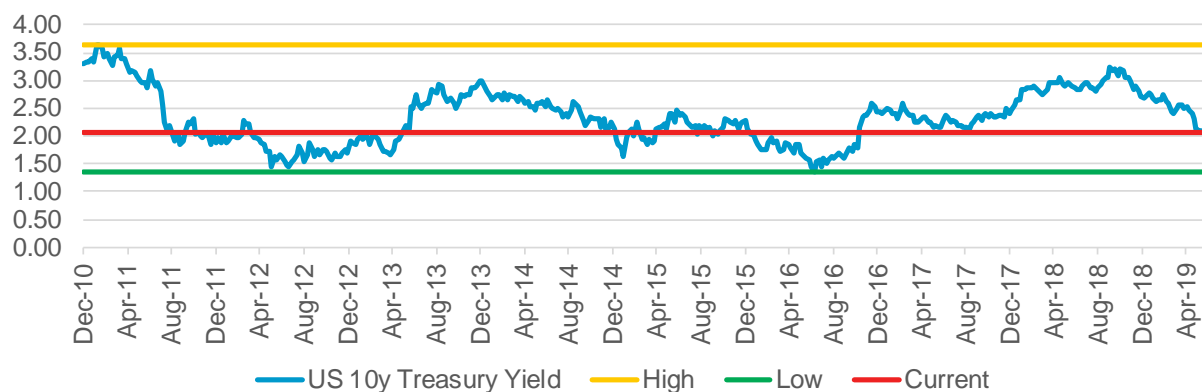


Meanwhile, the reluctant rally continues alongside the longest economic expansion in post-WWII history. We remain neutral on equity, although with a growing stable of bearishly-oriented tactical trades and still a bit of a buy-the-dip mentality. Our favorite market sentiment indicators remain somewhat cautious, and economic soft data has stopped underperforming hard data, which could assuage some of the growth fears that surfaced earlier this year. [Our economists expect a 25 basis point cut from the Fed, and see the US growing around potential through 2020.](#)

Our team is also very interested in the changing of Lagarde, as we expect the new ECB president to continue (or increase) the dovish bias and lean on her legal training for creative solutions to be able to ease further. The prospect of additional easing in Europe is truly remarkable when just last month Germany issued a zero-coupon, 10-year bond at a negative yield. *No coupons and a negative yield...for ten years.* Perhaps not coincidentally, our economists also recently took up debate on the prospect for negative yields in the US. We expect ideas of “helicopter money” and Modern Monetary Theory to become more mainstream in the next recession.

To put the potential of negative yields in context, we’ve been quite busy lately helping clients structure customized combinations of equity and interest rate options, driven by views of potential late cycle dynamics and the desire to avoid continued balance sheet volatility. Treasury yields are down ~65 basis points year-to-date, and our sense is that this move has created a tall psychological barrier for those clients utilizing rate options. It feels as though there is some implicit desire not to sell rates on the local lows as investors believe or hope rates are all but certain to go back up.

US 10-year Treasury Yield



Source: Bloomberg, LGIMA

But our current investigations are also focusing on a world with rates down another 200 basis points or more from here. A “helicopter money” environment would suppress bond yields and future expected returns, and make real assets more attractive. Corporate pension schemes would be particularly at risk in this environment, given their discount rate sensitivities.

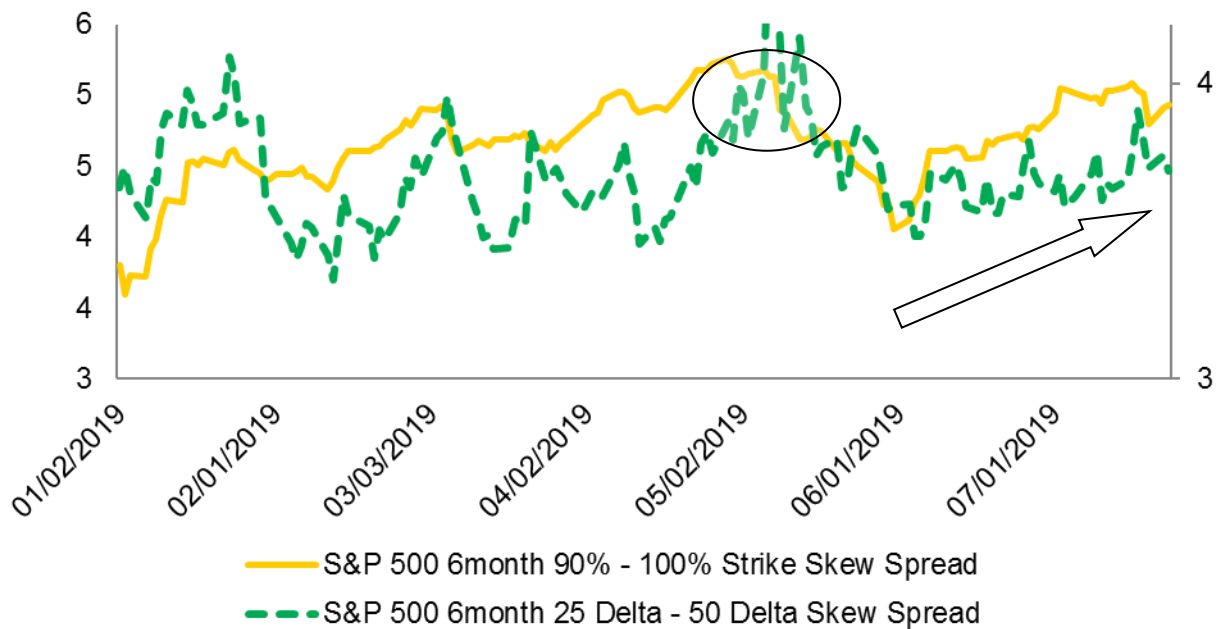
However, this is by no means a suggestion that pensions should panic sell their portfolios now (or ever). Rather, we reiterate our constructive medium-term view and emphasize that focusing explicitly on the institution’s goals can help objectively identify ways to rebalance, reallocate or hedge a portfolio efficiently. In other words, many institutions are well positioned to use this year’s strong returns to defray the cost of hedging and structuring. The purpose of hedging is to insure against truly damaging returns, and trying to time implementation with the next +20 basis points move in yields or +5% equity return is unlikely to have a material impact in those scenarios.

Equity volatility

Summer lethargy has taken over the US equity volatility space. The S&P 500 is up a humble 1% since last month and 20 day realized volatility is below 7% (which reflects average daily moves of about 0.4%). In last month’s commentary we highlighted that implied volatility had been elevated relative to an otherwise rising market. Recent dynamics illustrate that it is not strictly where the market goes that drives the cost of optionality, but how it goes there as well.

Skew has steepened moderately in the past month for what we would call “good reasons,” or the tendency for near-the-money implied volatility to decline at a greater rate than out-of-the-money implied volatility. Depending on which measure one chooses (by put strike percentage or 25 delta put versus at the money), this dynamic is not quite as steep as in late April. Then, the S&P 500 held a local high of ~2950 before taking a greater than 7% tumble to below 2750.

As we glide sideways on recovered equity prices, we don't ascribe predictive power to this skew dynamic, although dealer commentary has taken on both sides of sentiment. On the one hand, one could argue that the steepness of further out-of-the-money puts suggests demand for crash protection. On the other, one could suggest that market participants have taken on a risk-positive carry position and sold volatility, whereby dealers are overall long protection. If this prevails, calm begets calm, whereby trading desks' daily market exposure hedges away market divergences to either side.



Source: Bloomberg, LGIMA

Rates market

Despite the last month being one of the most volatile for rates over the past year, Treasury yields are almost unchanged from the levels right after the June FOMC meeting. Global slowdown, central bank accommodations, and weak domestic data have fueled these moves, and now the question is not *if* the Fed will cut at the July 31 meeting, but rather *how much* will the Fed cut – 25 basis points or 50 basis points. A few days after the June meeting, Minneapolis Fed President Kashkari stated that he had advocated for a 50 basis point cut during the meeting. Vice Chair Clarida said in an interview that same week that the argument for cutting has strengthened recently. The Fed's Bullard explained his dissent by stressing that the drops in PCE have been enough to warrant an insurance cut. This culminated in 2s30s steepening out to the local high of 81 basis points on the June 21 market close.

After ending the month at 2.53, 30-year Treasury yields moved to their local lows and closed at 2.47 (the first time closing below 2.50 since October 2016) on July 3 on the back of weak domestic data as factory orders, durable goods, and ISM services all came in lower than anticipated. After the brief holiday break, rates rebounded and gapped higher on the release of NFP printing 224k versus the expectation of 160k. This move was a bit of a surprise as the market chose to focus on this headline number rather than average hourly earnings coming in at 0.2%, below the

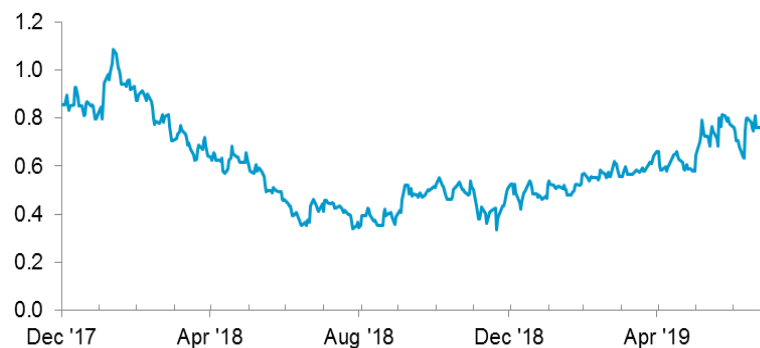
survey consensus of 0.3%. The 30-year rate close the week at 2.54 and 2s30s had flattened to 68 basis points. From there markets traded sideways until Chairman Powell’s two-day Humphrey Hawkins testimony before Congress. He voiced his concerns over trade issues, slowing global growth, and inflation continuing to trend below target. The June FOMC minutes, which were released on the first day of meetings with Congress, strongly hinted at impending policy cuts. By the end of the day 2s30s had twist-steepened 11 basis points as the 2-year Treasury rate rallied 8 basis points to 1.80 and the 30-year Treasury rate sold off 3 basis points to 2.57. Rates have moved little since then, but the next meeting is only a week away. Fed funds contracts are currently pricing in an 80% chance of a 25 basis point cut and a 20% chance of a 50 basis point cut. Although arguments can be made for 25 basis point vs 50 basis point cuts, the real surprise would be if the Fed stayed on hold. But with all the Fed rhetoric of the past month and several global central banks cutting policy rates already this year, cutting rates next week does seem like a foregone conclusion.

US Rate Environment

Index	07/22/2019	One month ago	Three months ago	One year ago
Fed Funds Rate	2.50	2.50	2.50	2.00
2y	1.81	1.77	2.39	2.59
5y	1.80	1.79	2.39	2.73
10y	2.05	2.05	2.59	2.84
30y	2.57	2.58	2.99	2.96

Source: Bloomberg, LGIMA

2s/30s



Source: Bloomberg, LGIMA

Rates volatility

Although delivered volatility has been up over the past month, implied volatility has been declining sharply after peaking last month, with the left-hand side of the volatility surface (options on shorter tails) dropping much more than the right-hand side. Since the end of June, short dated options on 2-year tails are down 6-20abpv in short dated options, down 3-6abpv in intermediate expiries, and 2-3abpv lower in longer dated expiries. Over the same period implied volatility on 30-year tails is down 1-7abpv in short dated options and virtually unchanged on intermediate and longer expiries. Normally imminent rate cuts and a steeper yield curve would be a signal for a higher rate volatility regime, but several factors seem to be impacting the path of rate vol. Program option sellers are still present in the market, looking to enhance yield in this low rate environment. The market is already pricing in at least a 25 basis point cut for the July meeting and 1-2 additional cuts by the end of the year. And with the increased Fed guidance and the dot plots (which weren’t introduced until 2011) the path should be better anticipated than the last round of rate cuts a decade ago. The curve is still much flatter than the last cutting cycle, which has led to the initiation of steepening trades in option space. This could richen the right-hand side versus the left-hand side going forward.

Current implied volatility levels and change over 1 month

EXP/TAIL	1Y	CHANGE	2Y	CHANGE	5Y	CHANGE	10Y	CHANGE	30Y	CHANGE
1M	70.5	-19.1	71.8	-21.3	69.6	-11.1	62.4	-7.1	56.8	-7.3
3M	66.3	-13.6	68.6	-16.8	66.2	-9.5	61.6	-5.2	56.5	-4.9
6M	66.2	-11.7	67.6	-12.1	66.3	-5.1	62.5	-1.9	57.2	-1.7
1Y	67.8	-7.8	68.2	-6.1	66.8	-2.2	63.1	-0.3	57.3	-0.1
2Y	67.8	-7.1	64.4	-9.3	66.2	-1.4	62.9	-0.3	56.6	-0.4
3Y	67.5	-4.4	67.6	-3.7	65.7	-1.3	62.7	-0.3	56.2	-0.3
4Y	67	-3.9	67.2	-3.5	65.6	-1.1	62.6	-0.3	55.9	-0.1
5Y	66.9	-3.6	66.3	-3.6	65.2	-1.3	62.3	-0.4	55.5	-0.3
7Y	66	-2.3	65.3	-2.3	64.4	-1	61.8	0.2	55.1	0.1
10Y	65.2	-0.1	64.5	-0.5	63.3	-0.7	61	0.4	54.4	0.4

Source: Citi, LGIMA as of 7/22/19

6m2y and 6m30y implied volatility



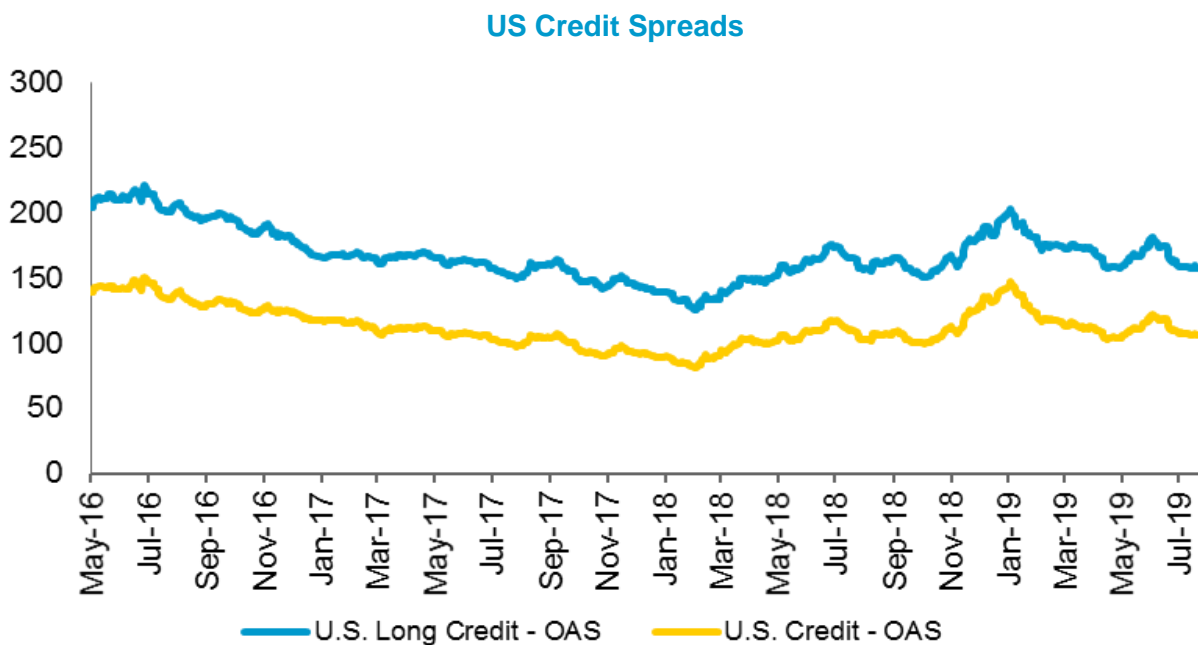
Source: Citi, LGIMA

Credit market

While risk-assets experienced a significant rally in May, investment grade credit has continued to trend in a positive direction throughout June, as the US Long Credit index has tightened to 158 basis points (3 basis points tighter MTD). Credit spreads have been range-bound over the past couple weeks as the market is currently uniquely positioned. Improved economic data with respect to retail sales and manufacturing surveys, in addition to a strong labor market and high consumer confidence, is positive for the macro outlook. However, the market has all but fully priced in a 25-50 basis points rate cut at the July FOMC meeting, even in the presence of strong fundamentals. Geopolitical risks further complicate the macroeconomic situation: a potential “No-Deal-Brexit” is on the horizon, the trade war with China looms on, and Iranian sanctions are still in place. Until there is further clarity on the direction of US/China trade developments, the market could remain in a holding pattern.

From a supply/ demand perspective, the corporate bond market has been operating in a positive technical environment. Month-to-date supply currently stands at \$49 billion, bringing year-to-date supply to \$623 billion, approximately 10% behind last year’s pace. The market saw less-than-expected issuance in the first two weeks of the month and technicals remain positive as foreign investor appetite has increased, mutual fund inflows remain elevated, and dealer inventory is relatively low to facilitate bond liquidity.

This week, a variety of data is scheduled to be released. The 2Q Real GDP reading, a plethora of corporate earnings, and UK elections all could potentially impact market sentiment moving forward.

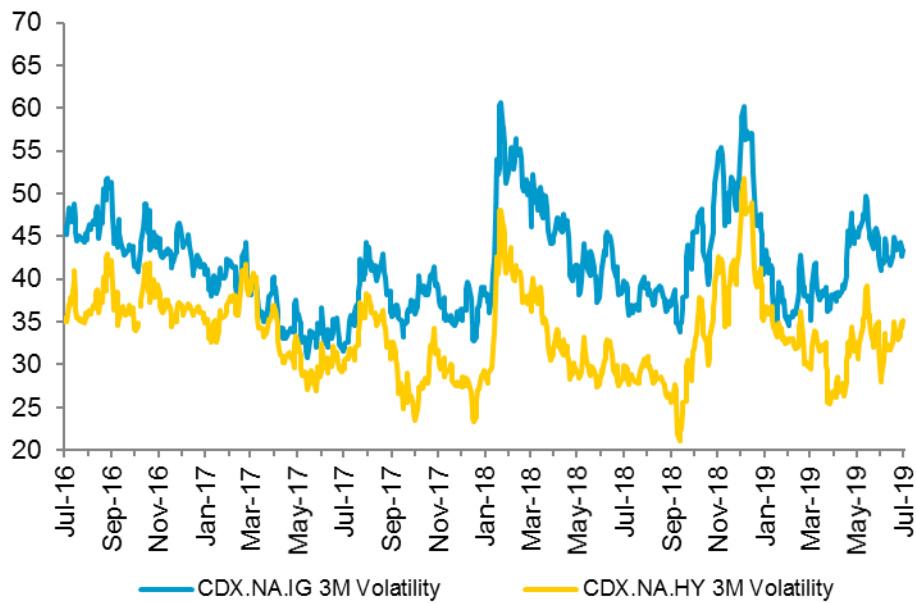


Source: Citi

Credit volatility

July has been an interesting month for volatility in the credit universe, as there is seemingly a disconnect between credit spreads and implied volatility. Since the end of May, CDX IG has tightened over 16 basis points – now ~9 basis points from post-crisis highs. CDX HY currently stands at 31 basis points wider than post-crisis highs; however, the tail risk is significantly elevated now in comparison to previous index tights. From a volatility standpoint, credit volatility is trading near the top end of its range compared to equity volatility. Investment Grade 3-month implied volatility has risen to ~47%, illustrating the fact that investors remain aware of the potential for upcoming market volatility. This could also be a result of investors lifting hedges to lock in gains, or absorbing the hedging costs now and expecting lower costs on the back of the potential Fed Cuts. Both strategies could contribute to the elevating implied volatility.

US Credit Volatility



Source: Citi

Scenario Based Asset Allocation

SCENARIO SUMMARIES

Name	Description	Risk Assets	Inflation	Rates	USD	Probability (last month)
Global Slowdown	<ul style="list-style-type: none"> • Dominated by fears of imminent recession, US growth below 1%, China faltering and below 5.5%, Europe flirting with recession • US & UK rate cuts • Commodities drop, political uncertainty contributes to slowdown 	▼	▼	▼	—	20% (15%)
Cycle Stands Still	<ul style="list-style-type: none"> • Inflation print stays below central bank targets • US unemployment similar to current level and growth follows trend. Central banks increase accommodation • Trade tensions simmer • 2-3 rate cuts in the US • China growth close to c.6% 	▲	▼ / —	▼	▼ / —	25% (30%)
Roadmap Central Scenario	<ul style="list-style-type: none"> • US gradually slows but is above trend for most of 2019 • Steady Europe growth and inflation • China stimulus helps stabilize growth given trade war uncertainty • Fed cuts once and inflation back to target 	▲	▲	▲	▲	30% (25%)
Global Growth	<ul style="list-style-type: none"> • US growth remains strong, buoyed by 2-3 early cuts, strong consumer consumption and no material trade war escalation • China stimulus leads to an overshoot of 6.5%+ • Europe rebounds with EM growth • Other economic data does not point to material overheating 	▲	▲	▲	▼ / —	15% (20%)
Rates Rebound Risk Off	<ul style="list-style-type: none"> • US inflation picks up rapidly, forcing the Fed to hike 2-3 times in the coming 12 months • Global government bond yields rise fuelled by rising rate and future expectations • Equity markets sell off on the back of higher yields 	▼	▲	▲	▲	10% (10%)
Recently considered scenarios	<ul style="list-style-type: none"> • Trade war escalation • China/US divergence • Credit led meltdown • 'Central Bank Impotence' 					

Contributors



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