MACRO Voices

with hedge fund manager Erik Townsend

Charlie McElligott: Phase one is over. The easy money has already been made.

September 13th 2018

Erik: Joining me next on the program is Charlie McElligott who heads up cross-asset macro strategy at Nomura. Charlie has put together a fantastic slide deck to accompany this conversation, so please download it. Listeners, you'll find the download link in your Research Roundup email.

Charlie, for people who have been following your writing since you joined Nomura in January – I remember the first piece I saw that really got my attention was where you described this perfect storm after the VIX complex blew up. You said, look, if we get to certain levels on the S&P it's going to trigger the commodity trading advisors, they're going to start systematic selling, it's going to unleash a whole bunch of things.

Fortunately, we never got to that level. But I was very impressed with your analysis. As I followed your work since then, I noticed that, though you tend to be writing about the here and now – because that's the way institutional research is structured – I am able to assimilate a framework, if you will, that seems to guide your thinking, which I've pulled together from reading several of your pieces.

Can we try to present to our listeners a summary of that framework? How you think about markets and how this all fits together? And from there I want to go into much more detail on your slide deck and a number of other questions.

Charlie: Absolutely. I appreciate the opportunity to be here, Erik. It's a great program.

I would say that the way I approach the job with regards to assessing and the cross-asset macro landscape, from a high frequency, meaning more of a closer to the net-end user, the net-end trade idea-driven approach – as opposed to a research deep analytic dive, kind of slower moving – is that because in the post-financial-crisis world, trade time horizons, macro regime shifts, factor rotations, systematic leveraging, deleveraging, are a permanent part of our landscape.

So, I need to have a medium- to longer-term 6- to 12-month view on where we're looking, while still having a day-by-day kind of directional call. Favored trades, world view. Where are the pressure points? Where could things go wrong? Where is consensus? And where are the asymmetries there when crowding can tip over?

With that said, as I started here at Nomura back in late January – right before the vol, even – I kind of saw this framework and I called it a two-speed world thesis. Mind you, as I got back on my feet in January, after my non-compete gardening leave time, what I saw was immediate.

As I mentioned earlier, the importance of systematic strategies, vol control strategies, risk parity of course, following CTA's, those are a critical part of what I do on a daily basis, certainly based within a very vol-centric world. Because the changes, the inflections that are made happen unemotionally and happen with significant leverage behind them.

And what I saw immediately when I came in – I was reassessing the world at the time – was that the most crowded trade in the world, kind of ex-long-FAANG/ tech at that time, was that there was an implicit short-dollar trade in almost every macro trade that we look at across both our risk parity and CTA models.

Certainly, there was a max long equities world view. Obviously, large cap equities, certainly tech, Nasdaq, which benefit from those overseas revenues. But then, also, there was a huge bearish rates trade as people set into the year.

There was a massive blank in euro and yen on the view that policy was going to reconverge – this idea that we were heading [for] this dual growth. So, as opposed to the prior two years where it was just US economic escape velocity and rest of world behind, everybody got really bulled up on the prospects for Europe, for Japan, for emerging markets, for the rest of the world to play catch-up.

With the twin deficits within the US, this very bearish US dollar view began. People were max long crude, max long commodities. That was a pretty consistent theme.

And when I see something that consensually embraced, certainly within the systematic leveraged community, the trend community, coming off a year like 2017 where being long S&P was a 4 Sharpe ratio trade, my warning signs were up.

Promptly, we had the equity vol event. I joked to clients that we all knew what was happening within the leveraged to VIX ETN complex. We knew that those daily rebalancing, the daily vagary balancing at the end of day, was going to tip over at some point. And I called it a neon swan for a long time.

But something set that off. And in my mind what set that off was – if you went back to December, you had the first passage of the tax reform bill in the Senate. And shortly thereafter, at the start of December, you had the bottoming, the cyclical bottom in US Treasury term premium. Basically, interest rate volatility risk.

And I think what that spoke to was that we were at a late cycle and the economy was already at breakout speeds at that point.

Now we're adding gasoline to the fire. Effectively, within the next month we also got this dual fiscal stimulus of the deficit spend and what that did, when Treasury term premium bottomed, the entire crossed-assets volatility world also pivoted and broke higher after that point.

In my mind, that moment when the forward-looking path for interest rates became clouded for investors across the world, across multiple asset classes, you no longer knew that late in the cycle, adding on dual fiscal stimulus, what that was going to do with regards to central bank policy with regards to inflation. That's where the rolling volatility events of this new regime took place.

Within a week of that, you had the peak in S&P one-year forward earnings estimates. You had, that same week, the peak in cryptocurrencies. Within a few weeks you saw the tights in credit spreads.

In January you had a spot up VIX up environment across the equities complex where you had that massive risk rally within stocks. But at the same time, VIX was trading up. Which is a precursor, one of those moments where, sitting on a ball desk, you're anticipating some sort of crashy, wingy type of event.

There were a number of indicators in that two-month period that something had inflected. To take it back to that larger two-speed year thesis, the first phase was what I called the "Cyclical Melt-Up" phase. Which was classic late cycle, where the economy and its current shape with the enhanced expectations, the animal spirits of the tax cut, the animal spirits of the deficit spending, you typically see commodities and inflation-centric high-beta assets outperform.

My view at that time was if you want to be within the rate space you want to be long tips, short nominals, long break-evens. You want to be bearish fixed income in general, from the US Treasury side.

And on the equity side you want to be long cyclical. The stuff that works, that, frankly, some of which had been left for dead for a long period of time, the stuff that gears when you have interest rates moving higher from real growth.

So financials, materials, energy, industrials, the deep cyclical types of sectors.

And that's exactly what we got over those next six months. You had very consistent, pretty high Sharpe ratio, even with the volatility event in February and some disruptions thereafter in the coming months. These trades kept generating returns.

To fast forward, in May and June I started seeing some signals that there was this shift developing into my phase 2. And my phase 2 was what I called the "Financial Conditions Tightening Tantrum" phase.

This was basically a transition from a very directional, long risk, long inflation, long cyclicals, bearish fixed income type of view to a much more difficult tactical phase – where trading windows, time horizons on trade were going to be multi-week, every-month kind of powerful reversals market – neutral trades to protect yourself, seeing relative values, sector selection really take precedent.

And in mid-June I sent out a note talking about this downshift, that it was time to get tactical. And I think it makes sense probably to go over some of those indicators I saw at the time that, frankly, signaled to me that we were transitioning out of this smooth sailing phase into this very late cycle and, effectively, pre-recession phase.

Erik: As we are now recording this interview in September – I think of September as a very important month because, you know, the big boys are back from the Hamptons, the big decision makers on the desk. It's maybe time for something to happen.

I think you've written recently about two flavors of September, so I'm curious. What do you watch for? Where is September? What are the possibilities of where it might take us? And how does that fit in to your phase 2, everything is changing market tantrum scenario as far as what we might expect in Q4?

Charlie: When I speak to those things that started inflecting in June, what ended up really happening was that the status quo momentum types of trade that had been driving performance for the last one- to two-year period, frankly, started coming a little bit unglued. Whether it was bouts of extreme reversals in equities, growth versus value – where suddenly value would start ripping over growth. Or that period of cyclical outperformance over defenses would start reversing.

Those were generating signals of performance pain.

For the June–July–August window, some of the most acute drawdowns within the hedge fund communities – within the equities community but also parts of the macro community – were giving back an entire year's performance in a matter of weeks to months.

And that is a signal.

I watched my monitor performance very closely, the same way I monitor positioning and sentiment and where consensus is. And when you start seeing those types of reversals, where your crowded shorts are outperforming longs, momentum unwinds. You started seeing, from a macroeconomic perspective, Treasuries rallying on strong inflation data.

It told me that there was some sort of macro regime shift happening.

That big performance drawdown painfully set up a call that I made in the beginning of August that, looking at the seasonality of equity factor performance, there was going to be a huge momentum rally. Which is a perverse dynamic after you've had such a drawdown.

I mean, there was a number of very large funds that lost anywhere from 6 to 8, 9, even 10% in a few, say, five- to eight-week period there. Playing the seasonality of September – and September is, dating back to 1984, the second-best month of performance for a momentum factor strategy.

A momentum strategy is very simple. You look at the Russell 1000. You take the top decile of performance names over the last one-year period from a price return perspective. And you go short the bottom decile.

This is the Fama and French stuff that's been so documented with regards to what are the actual drivers of equities? You can rationalize: Why does September see such a momentum outperformance? Which, of course, would be the big, massive pain trade for so many funds that had grossed down their positions – meaning that all those macro regime signals that I was speaking about in the June–July–August period where crowded growth names, tech things, started coming unglued.

And the underweights, the shorts in value sectors, started squeezing higher. That means the funds were grossing downs. They were covering their shorts and selling down their longs. That's like a classic de-risking reality when you're – the shoulder tap.

You had an environment where people had grossed down and/or taken their net exposure down – either by selling their longs or growing their short books – thinking that the market was at risk.

And there was a lot of growing skepticism and pessimism over the course of the summer, obviously, around the rolling volatility events within the emerging market complex. Commodities were down 10%-plus from their earlier-in-the-year peak.

The developed markets within Europe around Italy. There was a lot of bearish stuff going on and a lot of it tied in to the escalating trade tensions. There was this kindling, basically, for a massive rally.

The September rationale is very simple. Momentum works as fund managers' window dress. So at the end of every quarter, what many fund managers have done is that you add to the stocks that have worked – when your investor letter goes out, your filing goes out to your investors – and you sell down on the names that haven't worked because you don't want to look like a clown.

Particularly in September, this phenomenon really escalates because in September you start getting a number of very prominent mutual fund year-ends. In both the September and October window are the vast majority of mutual fund year-ends. It's not actually calendar.

That accelerates that tax-loss selling component on the momentum short side. And on the momentum long side, people are window dressing. They're marking up, buying stuff that's worked.

Over the course of August exactly what I spoke about played out: massive rally, 10% rally in the long/short momentum market-neutral strategy, which just really crushed both the hedge fund and mutual fund communities.

September, now, has an incredibly distinct seasonality dating back well over 30 years – you actually see people get back to work. It's conference season. They're getting investors, PMs. CIOs are getting ready for the earnings season that kicks off in October. Kind of a refocusing. There's an optimism in the air. You see the first two weeks after Labor Day the markets slowly grind higher.

Then the back half of the month, almost the 15th to a tee, you begin to see risk come off. You begin to see defenses outperform cyclicals. Which of course, again, is a pain trade. That's not how people are set up in the current world view.

You have this dynamic where the back half of the month you fade. And, frankly, a lot of that is tied both into September expirations, where you have a lot of dealer gamma rolling off, and, as well, into the October earnings season you see two of the three biggest buyback sectors – being tech and being financials – those folks begin to enter their blackout windows.

So, we all understand the dynamic that the quantitative easing period that you've incentivized corporate malinvestment, bringing debt for free, basically, to buy back stock and strike your options. It makes your shareholders happy, it makes the C-Suite happy.

That buyback virtuous cycle has not stopped and, frankly, after the tax reform package, has only accelerated with the repatriation of those dollars. Most of that has gone to buying back stock. You hit the blackout window; you have a downdraft in the equities market in September.

So, we put the momentum trade on in August. It crushed it. Now I've taken off the long momentum side and I'm just keeping the short momentum trade on for the back half into what I expect to be another powerful rally starting in October, largely, again, driven by this performance chase phenomenon.

Because funds have just so massively underperformed index and benchmark over the last three months that now you're in career preservation mode as you push in through Q3 into Q4. People will start grabbing at the market again, especially around earnings season.

It's a well-documented phenomenon where managers put on their macro blinders. They tune out the emerging market stuff. They get very into the health of the balance sheet, the earnings growth story, the scale of the buyback. And typically, that's a constructive environment for equities.

From there, I can go in a lot of different directions. But what it speaks to is that, almost without a doubt, on a one-month basis, you have these entirely different trading environments, entirely different regime changes.

Just the same way as you went from this June–July downdraft in risk, and then you had this huge momentum re-risking in August ahead of the September seasonality. And September then has two different feels.

October is going to have a big risk melt-up move into, actually, a macro phenomenon that I think is going to be a very powerful negative force. A quantitative tightening impulse where the three largest central banks in the world (ex the PBOC) are all going to be quantitatively tightening. The US Fed SOMA account, the Fed balance sheet runoff escalates to the $50 billion a month max.

At that same time, the ECB's bond purchases taper in half, starting in October.

And then the BOJ, who recently moved their yield curve control range up, that's effectively going to create a further self-tapering, because you simply don't need to buy as many bonds and potentially as many equities, ETFs, because that yield range gives you more flexibility on volatility.

I think you could actually have the potential for another potential interest rate shock that risk assets obviously do not tend to like, as we experienced back in the January–February period.

Erik: Charlie, why don't we go ahead and jump into your slide deck? It's pretty darned clear here, from Slide 2 in the deck, that ED5-9 is almost at the low point in terms of where it's cyclical lows have been. That part is clear. What may not be clear to some of our listeners is what the heck is ED5-9?

Charlie: The Eurodollar's curve is a way to trade short-term interest rates. Or, Eurodollars, that is. And it's not the currency. It's talking about US interest rates, US interest rates futures.

What is important here with these – again, so often we quote the yield curve on a 2-year/10-year, or a 5-year/30-year basis, which has absolute value. There is a long-term view with regards to economic sentiment, inflation, Fed policy contained therein.

But what's so important about the short-term interest rates and these spreads, or these curves, is that it's giving us a much more real-time prognostication tool with regards to where the market thinks the Fed is nearing the end of this normalization cycle.

And the end of this normalization cycle is critical for the culmination of this phase 1 transition from the Cyclical Melt-Up phase into the phase 2 "Financial Conditions Tightening Tantrum" phase that is going to have major implications for the cross-asset universe and fund performance.

Erik: Moving on to Slide 3, what are we looking at here?

Charlie: Slide 3 is telling a story that is picking up within a macro factor PCA model that I use as part of my framework. What we are beginning to see is that same phenomenon that Slide 2 was showing, which is that, as that curve inverts – and that's looking out a year to two years from now – then inversion means that the market is now believing that somewhere within that time period – looking out one year to two years – the Fed is going to stop hiking and it's now more likely that there is a slight easing.

And why that's important – that that gives us a goalpost.

On Slide 3, my macro factor PCA model is showing that the equities complex is now registering that tighter financial conditions are now having a negative impact on S&P. Meaning stocks, US equities, are now picking up on this very late-cycle nature of where we are, picking up on this tighter financial conditions phenomenon that I'm speaking to.

In this particular slide, it's showing that the US dollar, which is maybe the most important financial conditions measure of them all, is now – a higher dollar is now a negative for stocks. That is important because, as you can see just recently as of this summer, we were at year-plus positive correlation between the dollar and US stocks.

My rationalization of that is because the US at that time was this lone beacon of growth in the world. So, investors wanted to be long US assets. Crudes bounced at that time. And the fact that the US is now on pace to be the largest exporter of crude in the world, long dollar is a very pro-cyclical, pro-US economic indication.

Now the data is showing us – and our macro factor PCA model – that a stronger dollar is now officially a headwind, because it tightens global financial conditions.

Erik: Now, is that a prognostication that the dollar rally is about to end? Or does it mean that it's going to continue but it's going to be bad for stocks and look out below for equity markets?

Charlie: Well, I think that there is – and, frankly, this touches on Slide 4 as well – where it's also the same tool that we use looking at the two other main indicators that I use to assess financial conditions.

You see both inflation expectations – which for the last two-year period have been massive positive US equities drivers – have now, too, inflected negative as well as global real rates. And real rates are nominal interest rates that you are actually including as well in inflation outlook.

Real rates are kind of the purest indication of financial conditions tightening. Right now we have all three of these things moving higher in unison. And that's why this is now confirming to me that incremental moves higher in the dollar from here are going to be perceived as pretty powerful risk asset negatives.

And, frankly, by the time that that affects what the Fed is going to end up doing, whether or not that means that they, say, sometime in 2019, reduce the number of hikes that they currently have planned, the curve will steepen. And by the time the US Treasury curve steepens, that's when equities begin to sell off.

Erik: As we move on to Slide 5, it looks like we can expect tightening conditions across the board in all sorts of different measures of short-term credit cost.

Charlie: Exactly. The key here is I just wanted to highlight those two boxes that were back in 2008 levels of tighter financial conditions.

That's looking at the 3-month T-bill, the ultimate cash equivalent. LIBOR as, obviously, the cost of money. US aggregate credit yield to worst grinding back to 2009 levels. Commercial paper – this is the stuff that lubricates the financial system. General collateral repo on the bottom.

That's the stuff that makes the system work, that funds businesses. It's critical to keep moving.

That simply higher yields on that stuff, higher interest rates on that stuff, slows down the velocity of money. And that's ultimately pure financial conditions tightening.

Erik: We've had a lot of conversations on this program about the risk that is created by the massive credit expansion that has occurred in China since 2009. What is Slide 6 telling us here?

Charlie: It's an interesting slide that I reference a lot. I have so many requests: Can I see the updated Chinese credit financial impulse framework? Because it tells a story. It flows down.

But what you can see in that top panel is that the Chinese credit impulse, which is basically the 12-month change in new credit as a percentage of GDP, has now moved sharply negative. And then back to levels last seen four-plus years ago.

What is key there is that this comes off the back of something that we're all very cognitive of right now, certainly as it pertains to these occasional global growth scares.

Certainly, the emerging markets wobble right now, is that over the last two-year period the Chinese, knowing that they have a debt bubble on their hands, a credit bubble on their hands – as they try to transition their economy to a service-based economy from a commodities-centric manufacturing one – have tried to rein in the aggregate social financing. They have tried to begin deleveraging, tried to begin controlling the shadow banking system.

Ultimately, what that's done is they've created tighter conditions there as well.

As that credit impulse – these new loans that are being forced out to banks per quota – those asks from the PBOC and from the central planners have eased. What ends up happening is that (in that second panel) all system liquidity then slows as well.

There is a seasonality. There is a very powerful seasonality with Chinese credit impulse, with Chinese credit financing. Certainly, into their New Year, at the start of the year, there is a huge impulse to feed that multi-week shutdown. Then you kind of taper off from there.
What ends up happening, though, is that you are seeing – under this deleveraging regime – a diminishing magnitude of these impulses. All of those middle panels and lower, show what the diminishing magnitude of that impulse has on Chinese financial conditions.

Meaning (in that fourth panel), Chinese financial conditions are moving lower. That means tighter financial conditions.

The next panel speaks to the Chinese inflation surprise index trailing lower. You see these peaks and then these fades. The yellow line is the global inflation surprises. Meaning: Is inflation data (CPI or CPI core data) around the world beating or missing?

On average, those are missing now. China is the engine that drives global inflation is what I'm communicating here.

From there, that blue line is the US economic surprise index. You see it correlates with those credit impulse dryings, those credit contractions.

You see our own economic surprise index contracts significantly where currently we are actually still negative. Meaning: We are missing more on average.

And the ultimate cyclical indication – industrial metals or equity cyclicals versus defensives – follow that exact same pattern.

Why this is all very important right now – obviously, there has been a ton of press on this, and I think it's a little bit noisy. But the scale within the leveraged fund community, certainly macro funds, absolutely the CPA side of things, trend followers, is that there is a huge short in Treasuries.

And the huge short in Treasuries is based on inflation escape velocity. But you have this drying of the Chinese credit impulse. It's actually creating a disinflationary impulse, especially with the yuan depreciation.

And that is risking, of course, potentially, a significant short squeeze in the US Treasuries base.

Erik: Moving on to Slide 7, I know because I have a home on the coast of Maine for sale and the realtor tells me it's past peak in the cycle, don't expect great prices for a while now. It looks like you're seeing both homes and autos telling you the same thing.

What's going on here?

Charlie: Again, I think context is important when you look at prior cycles, prior recessions.

What I want to communicate here is that by the time that the Fed has stopped hiking, in the months and one or two years prior, you've seen near-term peaks in the auto sector and the homebuilders' sector.

That makes sense, right? That is very rational. These are incredibly interest-rate-sensitive parts of the economy. And those sectors in particular begin to pick up on this fact.

I mean, it's simple. Say, after a Fed hike, there is an initial impulse that then creates the higher mortgage rates that then creates buyers to move market. I've got to get off the pot and transact on this house.

Well, you've got that and now you're fading. And, obviously, part of the story here is inflation. There is inflation in the tariffs and building products and things like that. And there's currently a steeper fade in the homebuilder space.

But these are large purchases: 30-year mortgages, large auto loans. They are very interest-rate-sensitive. Both of these sectors are incredibly cyclical and pick up on this late-cycle shift.

Back to that bottom panel, it's telling me that we are probably nearing the end of the Fed's hiking cycle. My major message here is that I think there is an increasing likelihood that 2019 – even though the Fed is currently telling us they are projecting three hikes, the market is only pricing in 44 bits of hikes versus the Fed's 75 bits – that there is an increasing likelihood that the Fed might have to pause if not ever to get to those three hikes.

And this is just another signal that we are very late in the process.

Erik: And I see on Slide 8 you are looking at a comparison going back to 2003 through 2008. What's the story on this particular chart?

Charlie: I think it's kind of a narrative clarification where – you see it every day in financial media and I've spoken about it too, how important the inversion is as a signal – the yield curve inversion as a signal.

But I think people are kind of missing a point there. This signal is telling us that we are transitioning. What you need to do as, say, an equities investor, is realize that it's when the curve steepens, that's the moment when equities come off.

You can see here in early 2007 the yield curve began to steepen. If you recall in early 2007, before the mortgage crisis was – that's just when you started seeing the signals.

I think in January or February, HSBC pre-announced on their mortgage portfolio. By the summer, you had the Bear Stearns structured leveraged credit hedge funds blow up.

You started seeing the yield curve steepen because you began to pick up on the fact that the Fed's hiking cycle had paused and was nearing an end. That top white line there.
The curve steepening accelerated, because what happened was the market began to remove hikes from their projections. And what that does is that the front-end rallies massively, yields move lower in the front-end.

The curve steepens, and that's when that blue line (the same time that the Fed began cutting) – it was too late, and equities sold off and equities were smoked while the curve continued to steepen.

It's when the curve steepens that equities investors need to be afraid. I think that's why one of the most popular trades we've done all year have been these curve cap options. They're constant maturity swaps. But, basically, it's a very simple tool that lets you bet on the direction of the curve.

And what people are doing, they're putting on these 1-year, 2-year expiry steepening trades via these options, with a defined PnL and timeline, that are huge risk-off hedges. We've been putting them on in massive size for macro funds, for credit cross-over funds, for equities funds, because, ultimately, the takeaway here is that the curve steepener is the risk-off move.

When the curve begins to steepen, that's when the market smells the slowdown, smells that the Fed is done, smells that the financial conditions tightening has negatively impacted or is beginning to negatively impact the real economy. And that's when you have the risk-off move.

Erik: Moving on to Slide 9, it looks like even more late-cycle indications.

Charlie: Yes, Slides 9 through 14 are just the number of metrics that I look for signals in. You can see the pressure building on the Fed with regards to – and I'm just looking at a couple of Dallas Fed metrics in particular here on Slide 9 – but with the idea of inflation is finally percolating.

And it's here. Whether it's wage inflation, wage outlook at 11-year highs, prices received at 7-year highs, prices paid for raw materials at 7-year highs, those are speaking to the really difficult position that the Fed is now in.

Tomorrow's CPI number is going to be massive in that sense, because it's either going to tie their hands or it's going to allow the Goldilocks environment to continue.

Slide 10 is similar. More of that prices paid. You're talking cycle highs since the financial crisis.

This is classic pre-recession behavior.

Slide 11 – the wage surveys, expectations for wages. You're at cycle highs. And then, frankly, you're back to secular highs at the current levels. Again, a useful indicator that we're entering that pre-recession phase.

Slide 12 – the U-rate. Obviously, with a three-handle now. These typically max out in late-cycle/pre-recession phases as the economy overheats and – we hear about it every day on the front of the newspaper – employers are having a difficult time hiring. That creates a drag. So that's very consistent.

Slide 13 actually goes back to that "Cyclical Melt-Up" phase. You have crude as a tell for late-cycle inflation when the economy is overheating. You see these significant crude rallies.

Back in the early '90s, a 131% move in crude. In the late '99 move into the internet bubble burst, you had a 120% move. And the pre-financial-crisis phase, a 230% move.

Right now, we're nearing a 90% move in crude. So that's also beginning to rhyme.

Slide 14 – this is a pretty unique one but one that I love. It's consumer confidence expectations minus the present conditions. It speaks to the tremendous overshoot of confidence. And you see these kinds of cycle lows where we currently sit as a great tell on a pre-recession period coming soon.

Erik: Now, since you mentioned tomorrow's CPI print, I should mention for our listeners we're recording this interview Wednesday afternoon, which means we don't know Thursday's CPI print or the outcome of the ECB press conference also scheduled for Thursday – just to make sure our listeners are aware of where we are.

Moving on to Slide 15, it says a lot of really, really rough times for equity hedge funds. What is causing this underperformance for equity hedge funds?

Charlie: Erik, I think it's the purest example of the regime change catching folks flatfooted. It goes back to that transition window. You can see where the drag really started in mid-July. This idea that we're moving from quantitative easing to quantitative tightening.

What that does is create – the term premium bottomed, you've had these rolling volatility events in emerging markets, you've had flash crashes in BTPs and US Treasuries. This is an environment where it began to then play out –

As I spoke to in June when I made that downshift note where I'd started taking off those very pro-inflation long directional risk trades and moved into defensives over cyclicals. Moved to value over growth. Which is a huge status quo or momentum reversal.

That's exactly what happened. Hedge funds got caught in legacy positioning and began to get crushed for it.

In mid-August, when I put on that long momentum kind of perverse rally that I spoke to earlier, that's exactly what you saw. You saw some relief because the growth stuff began to work again into that seasonal phenomenon of momentum performance in September.

Now, because that trade works so well – it returned 10% in a month – you're seeing performance fade again while the tape continues to hold.

So, it's just been an extraordinary period of reversal. And, most importantly, almost in a month-by-month or two-weeks-by-two-weeks kind of swinging from one side to the other. It has just made it very, very difficult for the average manager to perform.

Erik: Moving on to Slide 16, it looks like even more indications of reversals.

Charlie: Exactly, Erik. This is a US equities factor monitor that I look at. It captures these rolling reversals that are very performance-negative for folks, where you have all this stuff in that (on the far right, second to last column) – all the year-to-date performance sharply reversing in the short term.

That just speaks to – as you said – it's picking up quantitatively the phenomenon that is this macro regime shift to tighter financial conditions.

Slide 17 – you see hedge funds grabbing and market exposure, which speaks to their performance undershoot. It speaks to the fact they've had a hard time making money so now they're grabbing at the market. Which, again, makes me a little bit uncomfortable for the setup and I think sets up nicely for a pullback at the end of October.

Slide 18, same way. You see it's capturing some of these quant momentum unwinds.

And you can see on Slide 19 equities, long/short hedge funds, really struggling into what you capture on Slide 20 which is this kind of herky-jerky seasonality.

After that, it's more of the same. Crowded trades are at risk of tipping over. And, ultimately, the jewel trade is going to be 2019 when the yield curve steepens, and you begin to see US value stocks, which have suffered post-crisis period, begin to outperform growth. That's the trade that every fund in the world is scared of missing. But if you're early, it's killed your performance.

So a lot of stuff is really just capturing the current environment, and picking up on the fact that the game is real-time changing from where we've been the last 10 years.

Erik: Why don't we leave it there in terms of the slide deck? We've only got a couple of minutes left and I'd like to end with the big picture.

With all these things together it seems like just every place you look there is another sign that we are at the end of the cycle, that maybe it's not over yet but we're getting close.

Where does that leave you in terms of outlook? We've had some people say, look, this is it. The bull market is over. It's time to expect a major reversal.

Other people are saying, hey, wait a minute. Do not discount that possibility of one more melt-up to a blow-off top before it's finally over.

Where do you think we're headed? What is your best guess as to what we can expect for the rest of 2018 and into 2019?

Charlie: As per the message in that downshift note that I sent mid-June, it's the same view. You have to be completely tactical. You can't just be lazy long and, certainly, you can't be lazy short right now.

Yes, I do agree, I think that probably into the December Fed hike, which could be one of the final hikes – some people say it might be the last hike, in all honesty – I think we print probably cycle highs for stocks.

Incredibly, between now and then, I think there are probably three or four different directional trades, as I referenced earlier. I think right now you're getting ready for that September back half of September pullback in risk, which, again, is related very much to dealer gamma runoff around expiration, as well as the buyback blackout for financials and tech sectors.

And then, as that sets up into earnings season in the macro blinders trade, higher equities and probably a really powerful grab. Frankly, one that I'm interested in playing with, probably, in emerging markets long because it's been so distressed to this point.

We've started seeing some upside option trades going through (pretty good size), and EEM, EWZ, FXI. I think that people are getting ready for that potential upside move into October.

And then, as I mentioned, the potential for a risk-negative impulse in the end of October and the beginning of November – not related the US mid-term elections as much as some people talk about that. But more with regards to that quantitative tightening impulse that I spoke to earlier where the Fed, the ECB, and the BOJ are all tapering asset purchases or their balance sheets.

With that, I think you could have an unruly move higher in interest rates that the cross-asset or risk-asset universe doesn't like.

Again, almost on a monthly/biweekly basis, you're going to be in a different regime. Long, short, long, short again. And then long rip into the what I think will be highs into one of the last hikes of the cycle in December.

Erik: Charlie, I want to thank you for a fantastic interview. It is no surprise that you have gotten so much attention since joining Nomura in January. For our institutional listeners who do use institutional research, please tell them where they can contact you, where they can find out more about the work and the research that you have on offer.

Charlie: As it's a product of Global Markets, off the trading desk, if you are covered by Nomura within the Global Markets business – whether that's fixed income, rates credit, FX, or the equity derivatives space – just contact your salesperson and we're happy to begin that dialog. Use the daily piece as a conversation starter and go from there.

Erik: Fantastic. And for our retail audience, needless to say, Zero Hedge has been all over your writing since you joined Nomura and we look forward to having you back here on MacroVoices at some point in the future.

Meanwhile, Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.