Charlie McElligott: Bond rally correction appears to be over

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Erik: Joining me now is Charlie McElligott head of US cross-asset macro strategy for Nomura.

Charlie, it's great to have you back on the program. Listeners, we do have a small chart deck that Charlie prepared that will accompany this interview. You'll find the download link in your Research Roundup email. [If you're not yet registered, go to our home page at macrovoices.com and look for the red button that says Looking for the Downloads?]

Charlie, I want to start with the really big broad-stroke big picture, and then we'll get into some of the details that you've been writing about in some of your daily notes.

When I first interviewed you more than a year ago, you were talking about late-cycle dynamics, the end of the economic cycle. And I don't think you got anything wrong. I think you were spot on.

But now we are more than a year later and I think we are seeing that the economic cycle really is ending. But, boy, the stock market has just got this persistent bid.

What is going on here? And is it telling us that that late-cycle analysis was wrong? Or is it just that the dynamics have changed and the market can melt up no matter what the economy is doing?

Charlie: It's a pleasure to be back. And I appreciate the conversation as always.

Look, I think that initial conversation a little over a year ago was and remains still very consistent with what we're seeing now, which was that, at the time I think people were really – you know, this is probably closer to last summer – people were still very much believing in this idea that, look, we were late cycle. Well, we were above trend growth, above trend inflation, we were just so many months into the actual fiscal stimulus.

And, at that point, a slowdown or a recession seemed, was very unlikely, I would say, per most people's beliefs. But there was a lot of consternation with regards to what was happening with the shape of the yield curve. And at that time we were seeing this powerful flattening.

And that message (I think, went on one of our first podcasts a year to a year and a half ago) was that, actually, the signal with regards to the actual recession is the steepening of the curve.

The flattening happens when the market sees this kind of slowdown building, sees financial conditions tightening. The steepening begins to happen once the market begins to price in Fed easing, the front end moves lower.

And then, ultimately, you hope that the long end moves higher in conjunction with that, under the easing of financial conditions and the stimulus added from the Fed.

The idea was that, typically, traditionally, per back-testing analogues, that you see curves steepen in those final moments before the recession. And that's the actual signal there.

And as that relates, say, back to equities, it's really a thematic – it's less about directional equities at that time. It's more about the thematic change.

Typically, a flat curve is associated with slow growth, low inflation, or just what I'd call this muddle-through of the last umpteen years of what it feels like in a post-crisis period, which is this 2%-ish, 1-1/2% to 2% GDP growth, sub-2% core CPI, which has grown this very crowded and of everything duration trade over the last few years.

Generally speaking, you're long the bond proxies, which is everything from typical minimum volatility defensive sectors – you know, the way that Utes and REITs and staples have really been the best-performing S&P sectors over the past year, in addition to those secular growth names like the high-flying SAT software types of names, the FAANG tech type stuff, which actually acts like a bond because of valuation – it benefits from the lower yields justify the expensive valuations.

And they return – they grow earnings, they grow as in this world of low yield and low growth.

On the flip side, people have been short cyclicals.

So that is a product of this slowing growth kind of grinding, muddling-through world that we've come to expect.

The thing that started happening last year was that the curve began to steepen because the market began sniffing the slowdown. And the market sniffs the slowdown, then you price in that Fed action.

We got all that. That steepener call that we made last year, and then the catalyst for some of this momentum unwind that comes with that, and then the momentum unwind of trend trades has very much been the theme of the past year. You know, these very stark sharp kind of shock-down periods where prior carry-type trade, prior momentum trades really, really come unglued.

Now we are at this point again where – in the last two months specifically – where I've been talking about the implications of the bond market rally over the course of 2019 having overshot. That people were potentially misinterpreting that absolute level in interest rates as this kind of signal of imminent recession.

When, instead, we were actually still kind of holding that muddle-through.

So my message over the last two months has been, look, if bonds unwind some of this overshoot rally, you're really going to get another shock-down because the market is underweight cyclicals, overweight the bond proxies, and underweight anything growth-related. And that has also been this very tactical story. And that's been bang on too.

So now I think everybody is trying to readjust for a world where they are starting to get rid of that probability of the now recession and now beginning to push it back into a 2020-2021 story.

Erik: For the benefit of any new listeners, I want to draw their attention to your earlier interviews, Charlie. Listeners, if you type Charlie's name into the search box at macrovoices.com, look for an interview that was titled "Fear the Steepener." And there's a lot of really great content that is just as relevant right now today as when it was recorded several months ago.

Let's come back to that theory again. As I look at the 2s10s chart now, as we're speaking Charlie, we've got down to the point where the 2s10s went negative very briefly. Looks like a bottom. And, you know, it's bounced back to about where it had been trading for about the first half of 2019, kind of muddling through there.

Is that the steepener that you said to fear? Or are you talking about a much bigger steepener still to come that we need to fear? And where do you see this going and playing up from here?

Charlie: So, the steepener that I was focused on last year was 5s30s, just because I want to truly capture that long-term growth in inflation view that only the very duration-sensitive part of the curve (meaning the long end) captures.

So the 5s30s was the place that I was really advocating a significant steepening in the 5s30s cash curve from last summer. And I was pushing it. Ultimately, it ended up almost quadrupling. You know, less than 20 bips to 80 bips, say from Q3 last year into summer of this year.

That was that first signal that, okay, market has adjusted. They've smelled the slowdown, as I said. They're now pricing in Fed activity. Then we began to realize that things were not quite so bad as all of this permanent, almost constant recession talk that we've seen over the course of 2019, in these last two months.

And with that, bonds have sold off. And actually it was the front end that was sold. And thus you've had a little bit of a flattening here as the market began to price out so much Fed activity.

So that is a big part of this where I think people went from one side of the boat to, okay, fiscal stimulus, late cycle, already hot economy, up, up and away. You know, this view at one point last year into this oh, my gosh, imminent recession, look – from one extreme to the other.

And now I think we're being a little bit more adult here with regards to saying, look, the mid-cycle adjustments undertaken by the Fed probably have extended this cycle because they've (once again) eased all of that financial conditions tightening that was at the core of the cross-asset bounce in volatility that we saw all year in 2018. You know, specifically as it related to the balance sheet unwind on top of the Fed hikes.

We've reversed some of that damage. Now I think people can be in a little more pragmatic, neutral spot, that the world is not ending imminently.

That said, these steepenings come before the recessions do tend to hit on that kind of six to nine months lag.

So people are by no means capitulating on that view that the recession is an inevitability, that the business cycle is coming to an end. I think they're really more about adjusting the positioning and the sizing of some of these trades. And certainly, based on the timing of those trades where, in their minds, it's now been pushed off a year, probably because of that Fed liquidity injection.

Erik: Now, in your daily note on Wednesday of this week, you wrote that the momentum reversal of the past few months was the easy trade. That was the easy one to see coming. But the hard part is where we are right now.

What did you mean by that? Why is it the hard part? And what is it that we should be looking at here?

Charlie: I mean, whether it was just speaking with clients about how crowded in a qualitative sense the narrative became with regards to this end-of-cycle skepticism and the trade war had thus pushed this already end-of-cycle slowdown view into an outright imminent recession view. That overshot.

There were two big bond rallies over the course of 2019. The first was March, where we had just a vapor move lower in Treasury yields. And the most recent power bond rally was in August. Both of those were very much convexity related in my mind, meaning mechanical buying.

The March episode was due to big bank dealer desks that have been shorting options to clients for, frankly, the last two years, who were buying these big crash recession hedges. And those trades were – the curve-cap trades that I started advocating last year on the podcast were basically bets on the curve going steeper and bets that the Fed was going to have to cut rates into a slowdown.

Big banks had sold tons of these options structures to large clients, from asset managers to family offices to hedge funds, for the past two year and were just collecting premium. And they were expiring worthless. It was a great trade.

Well, in March you had a really significant global growth scare, a slowdown scare, you started seeing some bad data come out of China, especially as it related to some of the rhetoric around the trade wars.

And all of these dealers that were short these options, they were basically tied to low strike receivers, which were calls that Treasuries were going to go higher, or short options that the curve was going to steepen, which were basically bets that the Fed was going to ease in the front end and the market was going to have to price in more Fed cuts in the front end. They just got lit on fire.

So that was the first part of the rally, where it was very much just about dealers having to hedge in the short-options exposures.

The most recent one in August was convexity hedging of another sort, which was really from the mortgage space. We had another large global growth scare over the course of August and July. Frankly, the European data was absolute garbage and the Asian data was really accelerating worse. And from there you ended up having a situation where mortgages are inherently negatively convex.

So as bonds rally, those that play in the mortgage base, whether it's MBS accounts or bank portfolios or bank treasuries or mortgage REITs which are heavily leveraged, 7 to 10 times type of entities – they had to go out and buy more and more TY – more 10-year futures – to stay hedged, the lower that yields went.

So in both of those cases the point I'm making is that it was a mechanical feature, not necessarily though a view of this imminent recession. And that was at risk of being misinterpreted.

My whole point, then, over the last two months has been that, specifically in August, there was this false optic that the world was ending. And all it took was a little bit of a less bad outcome on China trade, a little bit less bad data, something constructive to hang your hat on that was going to see the same mechanical rally have to reverse. Especially as positioning had grown so extreme.

So you were seeing, whether it was bonds, whether it was record buys in duration across Treasury futures, or eurodollar positioning in 95th percentile extremes to equities, where there also was this end-of-world, end-of-cycle slowdown trade that I just spoke about earlier, along with the bond proxies, both secular growth and the defensive min vol stuff, and you're short cyclicals, which are the growthy stuff, the inflation stuff.

We saw that with prime brokerage data, where tech was 99th percentile owned by hedge funds and, conversely, energy financials materials are kind of 10th percentile down to zero percentile (if that actually is a word) with regards to historical ownership.

So everybody had this trade on. It was very crowded. It was levered. We saw the hedge-fund data show that funds had low net exposure. So they had a very low directional lean long, by historic measures. But they had big grosses on.

Because both sides of the trade, from the long side, being long secular growth and long defensives, it worked so well, and they were very short the cyclicals that kept going down every day over the course of the year.

My point was in August that the moment that we get some positivity injected into this market, you're going to have a way outsized market response as we've overshot. And now this positioning would have to unwind, and probably painfully so. And that was at the core of this cross-asset momentum reversal that we've seen.

In today's note, in Wednesday's note, I spoke about that. Since the end of August, you had a 43 basis point cheapening in 10-years. You know, the zero-coupon ETF is down 11%. A cross-asset momentum strategy, quantitative strategy on Bill Barrett QIS group down 14% since that start of September, an equities price momentum factor – you know, long the top decile of Russell 1,000 performers versus short the bottom decile of Russell 1,000 performers over the past 20 years – down 15% over that time. Value over growth. Cyclicals over defensives. Everything reversed.

The hard part is now. We've got the overshoot. We've got the positioning cleanse. We've gotten the deleveraging in a lot of these positions. Now this momentum, too, this momentum unwind is past.

And now I think the whole world is set up for this yields higher, stocks higher trade into year end, which is partially based on fear of missing out, just the psychological nature of it. A very positive Q4 seasonality for S&P, which is just a fact of nature for the past 90 years. And then expectations, too, around this Phase 1 of the China/US deal signing.

My concern now is that investors have the potential to get caught flat-footed by another rally in the US Treasuries, another rally in US rates, just as everybody has now shifted to the other side of the boat and is now short Treasuries, short rates. And that stocks are susceptible because there is so much new, fresh long added into this rally that we've seen off the back of some of this China/US trade deal positivity.

Erik: I want to pick up on that point about stocks, because you did write about equities in your Wednesday note as well. You reference your CTA model. And I know that that's something that you've gotten a huge amount of press attention for.

We'll often see, you know, a piece on Zero Hedge that says, okay, Nomura's Charlie McElligott says the magic line in the sand on the S&P is blankety-blank number. If we get a daily close below that number, it's all over.

I've had the opportunity to interview an expert on these CTA systems and how they work. And the information I'm getting, Charlie, really – now, maybe 30 years ago it worked that way, but the most sophisticated traders, the people who are running most of the money these days, are the RenTechs and the D.E. Shaws, these big quant shops that have incredibly sophisticated models that are reacting in real time.

And, from everything I understand, they really don't have any magic line in the sand that gets crossed. Their models are processing data on a continuous basis.

So help me understand exactly what your Nomura CTA position estimating model is. How does it work? What does it do?

And help us reconcile how it works with this idea that I'm getting that, you know, it seems like maybe the way these quant trading systems work is very real-time and it seems like it's hard to understand how there could be a magic line in the sand, so to speak.

Charlie: Sure. So I think there's a couple of points here.

One, I think, is simply the way that information is exchanged these days. Where a snapshot in time is then extrapolated or passed around as (as you said) some sort of line-in-the-sand magical trigger, that in actuality, in reality is dealing with so many moving targets and moving inputs in this case, that those levels that we release on a daily basis –reverse engineering this model with our QIS group – are constantly moving.

And they are constantly moving because of the volatility inputs to the various underlying instruments.

We're talking about a very complicated portfolio with four asset classes, five time horizons, 20 different strategies, where this aggregate portfolio and the volatility inputs and the price inputs and the fact that there's five different tenor windows (short-term being two weeks, one month, three months and then longer-term six months, 12 months) and the loading of each of those.

There never is just a static point where we are buying and/or selling. And that's the first point that I would make.

At the end of the day, yes, it's incredibly complicated, because you're dealing with five windows of a time series momentum construct and the sizing is inversely proportional to the instrument's volatility. It's pure risk control, which is the way that CTAs manage their exposures and manage their risk.

So that speaks to the fact that the number of inputs are incredibly complicated and that you can't have something that is a snapshot in time at some level be anywhere close to telling the same story the next day. It's a new slate almost every day.

And the other point that I would actually make here, too – and this is almost more of a qualitative observation or a philosophical conversation point of discussion, but I have felt this way for the longest time – I view the world from the lens of volatility.

You know, I think the most powerful and most meaningful flow in the market is gamma, which, in some ways, is saying that the tail wags the dog with regards to what people think moves the markets actually does not move markets.

I spend a lot of time working with our vol teams. And we have a tremendous look under the hood with regards to what investors are doing and, particularly, what dealer desks are doing with regards to hedging of their risks.

And this is very important because I think the CTA is such a hot topic, not simply because we're talking about this actual universe, where BarclayHedge estimates that the actual size of the AUM – they update this monthly on their website via reporting CTAs into them, up $360 billion.

And it's clearly one of the most heavily leveraged strategies out there on top of that. Which matters because then we're talking about, ultimately, trillions of dollars of notional exposures being managed and moving around (not necessarily sloshing around, but with the potential to slosh around) – is more on this idea that (certainly in the post-crisis world) desks, whether a long/short equities or a long-only real money account or a relative-value 10-times-levered fixed-income arb shop or a 20-times levered market-neutral strategy, quant strategy, generally speaking are all under kind of a VaR constraint.

That is the world of risk management in the post-crisis world. And specifically with the buy side, as it relates to investor expectations for managing that risk. Investors and their consultants expect certain risk parameters met, certain institutionalized risk management structures built.

And the point is that volatility is the trigger. Volatility is the toggle by which positions are grown or reduced. And volatility is that tail that wags the dog.

The other is that, in the post-crisis period, banks, through regulatory oversight, now manage their risk very differently. And have to manage their risk very actively on a daily dynamic fashion.

So CTAs are important because what they are is picking up a very unemotional reversal of a trend.

And when you get a reversal of a trend and, as I said, these are the size of the positions are inversely proportional to the instruments ex-ante volatility – that is picking up a shift in positioning, a shift in volatility that then ripples out across all types of strategies that are not pure momentum.

And the point is that everything – when you're allocated in this current real-life 2019 into 2020 market structure, volatility is the toggle. And everybody becomes a de facto momentum trader.

So that's the thing.

I mean, people have said, do you really think – when we knock one of these calls that, at this level, the signal flips from long to short or something of the like – and that has happened a number of times over the past two years – do you really think this is ticking the generalized CTA community in their behavior?

And I think, look, there is something to it. Absolutely.

I mean, we regressed this to the index and it tracks. It replicates the benchmark index for years going back. We continue to track those key modes of returns. So we know we're doing it right. We regress it on a weekly basis to see where the slippage is and make the according changes on that basis. So it fits.

I also think that, because people know that they're so volatility sensitive – and I'm talking about discretionary traders, fundamental traders – that there is an element of front running at these levels.

There is an element of self-fulfillment of these levels where people try to trade ahead of these levels – kind of a game of telephone of these levels – that enhances the feedback loop, enhances the echo chamber.

And I think that is also part of why the story has grown bigger than what I'm actually trying to capture, which is simply these critical reversal levels. These critical inflection levels that then start that larger snowballing across all strategies.

Erik: Let's go ahead and move on to the signals that you're getting now and what you've written about equities. Because it sounds like you think, with a little bit of good news recently, maybe we're in kind of an overbought situation that makes us vulnerable to a reversal in equities.

What are your models telling you? What do you see on the horizon? What are the numbers to watch for?

Charlie: I think there's an interesting dynamic where, in this most recent tactical view in the Wednesday note, where I'm saying that the bond selloff is tired, positioning has been cleansed, and there's no next sell levels at this point because positions are established and the duration position has been taken down – with that, a lot of these cross-asset momentum trades that have really accelerated, these momentum reversal trades that have accelerated over the last two months are probably fatigued too.

That thematically matters, then, at this point, if I think the bond selloff is largely lost for now. Because you probably won't be seeing that cyclicals over defensives trade, that old tech over new tech trade – as I said, all the software names that were up 80% year to date have lost 20% in a couple of weeks.

I think on the micro level that's where it matters. I think, though, with regards to the macro story, the macro takes a little bit of a back seat here.

And now, to me, the short-term risk is purely just about positioning, with regards to investors who have either directly or indirectly become very long equities over the course of this recent rally escalation, which was generally attributed to positive news, not as bad global growth data. A couple of nice US data beats on top of this general positivity around China trade.

So, if I'm talking about very long equities, what am I talking about? Well, if you look at the net dollar absolute position in S&P futures for asset managers, we're looking at a 98-1/2 percentile position, dating back to 2006. I mean very long equities in that sense, from real money.

If I'm talking about our CTA model's estimated positions, we're now back to plus 100% long signal in 12 of the 13 global equities futures that we track, versus a month ago where a number of those had deleveraged and a couple of them looked short.

And then specifically – and this is one near and dear to my heart because, again, I look at the world through this volatility lens, this vol lens – if I look at S&P index options, if I look at SPY ETF options and look at their consolidated Greeks, we see that the net long dollar delta is 98th percentile since 2013.

Which means that, frankly, you have a market that protected themselves on an upside rip via options. They don't have the big net exposures right now. They're, generally speaking – and that's why the momentum unwind has been so profound, the momentum factor down 15% in two months – they've been in the more bond-sensitive stuff and have been short the high-beta stuff.

So they haven't performed the same way that the market has to the upside. They've slacked on positioning into this rally. They've slacked on performance into this rally. Which has made it a not-feel-so-good rally. They're not losing money, but they're not capturing the actual extent of the move.

So what now that means is that through all this options upside exposure, to hedge themselves on a melt-up, they are now long what I call like soft delta. They're not long in their underlying single stock names.

And there are probably, when you get 98th-percentile-plus type of options positioning, options dollar delta, they are more prone to begin to take profits. They are very long. The market has moved up significantly.

Now it makes sense to monetize them and stuff. Especially just if you're looking at where we stand over the course of the year and the fact that they haven't performed quite as well as the index has over the last two months.

So I ran a really interesting study last week and I think it's important to talk about. I just talked about the 98th percentile net dollar delta across S&P and SPY equity options positioning. Again, it's this length that has been added via those options structures, via the upside strikes.

Well, if you test at 98th percentile dollar delta in conjunction with, basically, a 95th percentile (let's say) dollar gamma position, and that is a net dollar gamma position, I'm actually capturing in the dollar gamma position the fact that the market is ground amid this power move, grinding higher to such an extent that over-writers – sellers of volatility – are now short a fair bit of optionality. And they have dealers very long gamma.

Right now that's the reason that we're stuck at this 3,100 level. There is $1,600 billion of dollar gamma at the 3,100 strike. That is just a massive number.

I actually can't think back off the top of my head the last time we had absolute dollar gamma at one strike of that size. That's why we're kind of stuck here.

But the interesting thing about this analogue, this back-test that I ran, is that when you look at that extreme dollar delta and that extreme dollar gamma in conjunction, you actually show potential for near- to median-term equities downside and really significant VIX upside over the next X number of months.

So what does that actually look like for the S&P? It looks like over the next two weeks you see a pause to a pullback, down let's say 30 bips over the next two weeks median return. Over six months that looks like an almost down 4% median return.

But really where you see it is in the VIX complex. The median return over a number of these samples that we've tracked previously, a 55% VIX return over a three-month window. So that iterates to me that this positioning has overshot a little.

And now, if you do get a scenario where, look, the market has really baked in a significant amount of positivity with regards to these Phase 1 talks, and if you look at Donald Trump's speech to the Economic Club yesterday, and a market that, I think, was telling us that people wanted to short that mid-December finger-in-the-air Phase 1 deal signing – because everybody knows that Phase 2 is the hard part that we'll probably never get to – that now you're probably further incentivized to take profits because he didn't back down on tariffs.

And now they've adjusted – himself and Kudlow – over the last few days, backing away from a hard date on signing it. It feels like the easy money has been made there.

And if you're long all this market upside via options and you're kind of soft delta, I'm going to start taking some of that off. If I'm an asset manager – and, collectively, that universe is 98th percentile long the S&P futures, you know $130 billion of length – I'm going to start taking some of that off.

So, to me, it's about this positioning. And now this macro, oh, wow, we've priced in best case all of a sudden on this China trade stuff, it maybe is a little murkier than we thought. I'm probably going to take some of that off. And why you do tend to see this kind of two-week/one-month window for a pullback when you look at some of these analogues of the options positioning.

Erik: Charlie, I want to stay on this topic of volatility and the VIX in particular. As you remember, about 18 months ago there was this widely reported just blowup of the vol complex after a whole bunch of retail traders who literally had no idea what they were doing were all short the VIX.

Now, there's an old saying that the hardest-learned lessons are the longest-remembered. But it seems like that may not be the case here. Because some analysts that I've been reading are saying that the COT reports are now suggesting that they're at it again, that we've got that record speculative level of short interest in the VIX futures contract, people trying to pick up that contango yield, that sets them up for that same kind of blowup risk that happened at the beginning of 2018.

Now, you just said a few minutes ago you see significant upside in VIX. That could be the next blowup event.

So is it accurate so say that they're at it again? Or is the picture maybe a little bit more complicated than that?

Charlie: That's a great capture of the dynamic, Erik.

I mean, I think the challenge is this – and I know we've spoken about this previously – the dynamic of February 2018 will never be seen again. And I don't like saying this, but, unless a bomb goes off in the middle of downtown Manhattan in the middle of a trading day, point being, that we will never see that amount of short vol need to be rebalanced at the end of the day.

And why is that?

Because February of 2018 was the extinction event of the leveraged short vol complex. Those products don't exist anymore. And that just created an impossible amount of rebalancing into a tiny window at the end of the day where, God forbid, you had this filing – filing meaning a bankruptcy event for some of these products – where there was a macro catalyst over the month of that prior January where, all of a sudden, inflation became a thing and the market had to suddenly shock-adjust to the possibility of the Fed power-tightening.

Which is exactly what happened over the course of last year.

Now the reality is this. Those products are gone. And if those products are gone, we can never have that kind of squeeze.

More importantly, I think, right now, you're seeing this discussion where people are taking in isolation a snapshot of the CFTC non-com, meaning spec, spec position in VIX futures. And they are hyperventilating on the fact that the net position is the most short it's ever been.

The trick, to me, is this. A lot of folks don't realize that the VIX ETN complex on the other side actually more than offsets that short vega position in the CFTC futures because it is the other side of the trade.

So the short-term VIX ETNs, which, if you back-test this type of extreme long that they have, which, again, more than offsets the net vega short in the non-com futures position, the ETNs tend to have the near-term forward returns. They are long vol. And you actually tend to see higher near-term volatility when you see this type of extreme.

Right now, the net vega position for ETNs is 99.7 percentile since 2011. If you look at that non-coms spec hedge-fund mixed-futures net vega position, yes, it is extreme. It is 0.2 percentile since 2011.

But, again, the point is there is the other side of that trade. And it's the VIX ETNs, which, to me, a lot of people aren't advertising the full story here. So that's why I appreciate the opportunity to clarify it.

I am of the view that equities are going to pull back in the next two weeks to one month – it might be down 2%, it might be down 5% – because of this extreme positioning. And, yes, VIX is low on an absolutely level, let's say. Kind of like a 13 handle in the index, not necessarily front-month future.

But one other point that I'd like to make on the non-com VIX futures position is that it's so short right now because systematic roll-down players who play the shape of the VIX curve are massively into that trade because of the shape of the curve right now. The curve is so steep.

And that is part of what's happening right now is they get a signal due to the steepness of the curve, where the front month's vol has been smashed, partially because of the VIX ETNs just had to rebalance.

And for seven months in a row, when VIX ETNs rebalance, you've seen the VIX trade down multiple vol points one week into the event. They have to sell the front month to buy the second month. That is an inherent steepener of the VIX curve. That is then a signal for systematic VIX roll-down guys to come in and try to trade the shape of the curve, with such a steep roll-down.

And, to me, they actually end up getting run over on this trade.

Why I think there is VIX upside in this next two weeks to one month, I think that type of roll-down, systematic roll-down, they hedge indiscriminately in some ways.

So I think that's a big story to me. But you can't talk about vol without really going into the larger offsetting other side from the VIX ETNs.

Erik: Finally, I want to move on to gold, a subject we haven't talked about since the breakout occurred that surprised a lot of people, myself included – past $1,350, which had been a key resistance level for almost five years.

First of all, how do you interpret that?

A lot of people think, okay, this is a clear signal that we're now in a new secular gold bull market.

Do you agree with that? And, if so, does that mean it's time to buy? Or does that mean it's time to wait for a more significant pullback before getting back in?

Charlie: To me, gold is a shapeshifter. Gold at times – I think a lot of people probably incorrectly associate it with some sort of a risk-off hedge in and of itself, which is not always the case, because other times gold acts like an emerging markets risk currency.

To me, the story of gold over this past year rally – and we started getting pretty bullish on gold late December last year – was core to my steepener thesis.

And my steepener thesis was that front-end yields were going to probably be collapsing as the market sniffed the slowdown, forced the Fed into a much more aggressive easing cycle than many people believed was possible.

So the trick then, to me, is that gold began to trade off of lower real yields. It began to move higher opposite – correlated, right? So indirectly correlated to lower real yields.

Now I think that markets have seen this dynamic where you're instead looking at a normalization of yields over the last two months. Gold has given back. Yields – it wasn't this end-of-days scenario. It wasn't this imminent recession scenario. So, with that, I think that was pretty important because you ended up seeing gold get pretty hard hit.

And actually it's funny. So, like a week ago, on the 5th where you had a huge purge, our CTA model had the gold position reducing from 100% to 38%. And that still is where we sit right now.

We had been pretty much over the course of the year long, 100% long in the trend signal. That has now been reduced on account of – come from a macro indicator, the fact that real yields stopped going lower and, frankly, began going higher again.

So I think now the trick is that – my view here going forward is that the bond rally can actually continue. We've washed out that excess positioning. We had that big 40-plus basis point selloff in 10-years.

I think now that, as we pivot towards the more likely deterioration in the China trade story – again, as we look past this Phase 1 and into the tougher Phase 2 – that bonds can rally again. And bonds rallying again means lower real yields means higher gold.

Erik: So it may be that right now is the time to be getting into that long gold position as we see what looks like maybe a reversal point in the bond market, which you think is probably the driving factor here.

Charlie: Yeah, I think that bonds have scoped to rally again here, especially as it's tied into the potential for stocks to fall back. And, with that, lower real yields should mean higher gold.

Erik: Well, Charlie. I can't thank you enough for another fantastic interview.

You write an absolutely terrific daily note, and it's only available to institutional listeners who have a business relationship with Nomura. Folks, please understand. Charlie's not trying to be a jerk. His hands are tied. There are regulatory issues here, so he can't send it out to our retail audience.

But, for the benefit of our institutional audience, people who do have an institutional relationship with Nomura, how do they get your daily note? Because it really is one of the best pieces of reading that comes across my desk every day.

Charlie: I appreciate those kind words, Erik.

If you are an institutional trading partner and client of Nomura Securities, you can reach out to your sales person. And that includes the instant side or the cash equities side of our business. Reach out to your sales person and [indicate] certain revenue threshold expectations. We'd be more than happy to add you to the dailies and have further dialogue from there as it relates to the more tactical intraday conversations.

Erik: Well, Charlie, we look forward to getting you back in a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.