MACRO Voices
with hedge fund manager Erik Townsend

Charlie McElligott Explains the Upside Catalyst for Equity Markets

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Erik: Joining me now is Charlie McElligott, Nomura's cross-asset macro strategist.

Charlie prepared a slide deck to accompany today's interview. I strongly encourage you to download it as we will be referring to the charts and graphs that it contains throughout today's interview.

Registered users will find the download link in your Research Roundup email. If you don't have a Research Roundup email, that means you're not yet registered at macrovoices.com. Just go to our home page and look for the red button that says Looking for the Downloads? just above Charlie's picture.

Charlie, it's great to have you back on the show. I recognize some of these charts and graphs because I so enjoy your daily letter, and I see that some of these charts and graphs in today's deck came from this morning's letter.

I want to start, though, before we dive into the slide deck with the big picture, which is, boy, we are facing one of the most difficult natural crises in generations. We've got a global pandemic threatening the entire world.

It looked like maybe the worst of the first wave was behind us, but in the last week or so we've seen a major escalation in the case counts around the world. Texas and California and the Deep South are all experiencing a great big resurgence in cases.

And that's international too.

Victoria, Australia just announced a lockdown. Chile has just a massive, massive growth in their cases. A lot of countries really getting into trouble.

The stock market not quite back to all-time highs, but really looking strong here.

How the heck do you reconcile that? A lot of people are saying it's expectations of more central bank stimulus. Does that explain the whole story? Or is there more to the picture?

Charlie: It's great to be back. You guys are fantastic supporters, so we appreciate the chance to be here again.

I think, coming out of that initial – because we're calling all parts of this experience phases – that February-March-April period, I think when speaking with clients over that period of time we started making a checklist when you had the sentiment shock-down, which, as we've spoken about so many times and I talk about in the Daily, you get a macro shock-down catalyst, you get those prior short-vol positions in the market that get disrupted, you have prices move through dealer Gamma levels. Dealer Gamma levels often coincide with trend and systematic vol control. Deleveraging levels.

And you get these shock-downs.

And then you get a shock-up once vol gets rich enough and attractive enough to sell. And you get intervention through central bankers and authorities.

Without question, the actions of the Fed and politicians around the world and central banks around the world were a huge part of allowing folks to get to feel supported, to feel like they could begin to get constructive again.

And the generic playbook of that period was, okay, let's start seeing the curve flatten with regards to case growth. Let's get some constructive positive feedback with regards to vaccine trials, Remdesivir in particular was a notable market sentiment swing.

Obviously, the liquidity operations from central banks were a big part of the deal. The truly unprecedented asset purchases with regards to – certainly just looking at the Fed as a microcosm – outright buying of risk assets.

All of those things were part of that market turn in that first Phase 1.

Everybody in the world has been anticipating that you were going to get a Phase 2 with regards to a resurgence. I think what a lot of people are realizing now is that has kind of come to fruition over these last few weeks is that (one) it's probably the Phase 1, it's just the extension as it pushes into the country.

I think right now – and this is very tactical and very recent within the last week – some of the stuff that we're getting from clients is that you're seeing, actually, some really optimistic interpretations of some very new data as it pertains to the virus.

And I will never claim to be an immunologist or an infectious disease expert, but speaking with clients who were paying experts to have these conversations, something that has really happened – so much of the public focus is on the bearish headline sentiment of the case growth – the equities tape over the last week or two is no longer responding to those new case records in Arizona or Texas or California.

Instead, there are two really interesting points. And I'll get granular into these before we turn

away.

But outside of the US – so particularly in Northern Italy and China – there is some focus being paid to hospital studies from infectious disease teams that are showing that the type of COVID patients that they are seeing now are very different from the ones they were seeing three months ago.

And that particularly speaks to much lower viral loads and fatality rates down significantly. Down 50% in some cases.

Which speaks to this potential of a mutation. You know, viral swabs now giving soft positives. Weak amounts of the virus versus that of Phase 1.

That is something that a lot of people in the market are really clinging to right now. And that makes a lot of sense. That would be a significant development.

The other is more US-centric.

Because China and Italy were ahead of us, we lagged them with regards to the growth the pandemic. The others in the US and the early data out of Texas, Florida, Arizona, California in particular, those are all showing the ages where the case growth is mainly concentrated in is actually downshifting to the young – 18 to 49 – which could go hand in hand with this steady to low hospitalization rate and a still declining mortality rate, despite the case growth trajectory.

I think both of those scenarios are leading to this belief that the virus had initial success – which is a really crude way of saying it was most deadly with those who were most vulnerable, the culling of the herd, basically.

And that sets up a less bad next phase, especially when taken into context with politicians on both sides of the aisle acknowledging that they will not go back to a full-stop quarantine unless things really devolve from here.

And that, I think, is keeping us static and steady higher – as opposed to the headline trajectory of the case growth, which looks worse and worse.

Erik: Okay, Charlie. To summarize all of that, it sounds like we've got reason to think that, even though the case growth really is getting worse and continuing to get worse, maybe it's happening in a younger demographic that is more able to tolerate those infections, go back to work, continue to open the economy, as you say.

Whether it is a good idea or a bad idea, it seems very clear now that government officials and public sentiment are leaning toward reopening the economy – good, bad, or indifferent. That's what they're going to do. And it sounds like you think the market is mostly discounting that kind of outcome.

How does that match up with what you're seeing in some of the CTA positioning and the various other things that you guys watch on a more tactical level as we get into the slide deck?

Charlie: I would say this. As that Phase 1 recovery off the March lows and the extreme overshoot of negative sentiment and pricing and depressionary type of outcomes, which were warranted to a certain extent, even though this – some would say that this situation parallels more of almost a natural disaster in some ways which could change the trajectory or shape of the curve on the comeback.

Once you have that initial volatility spike – and this is what we just touched on earlier – and you get the interventions from the authorities – and in this particular place, what really mattered was not just, again, the unprecedented monetary expansion – but what really needed to happen – and we've talked about this for years with regards to shaking and the lazy perpetual skepticism or cynicism around the idea of inflation or about trend growth and about trend inflation – was that you needed to see fiscal stimulus.

And the fiscal stimulus is a really big deal. The fiscal stimulus is a kind of a tie-breaker.

It's never before been experienced anywhere close to this magnitude, as authorities kind of pulled out all of the stops to stimulate future growth.

So I bring that up before I talk about CTAs because that has led to – after this initial shock-down, rich-vol, data collapsing – and with the extent and the scale of the misses – what that does too is it sets up an incredibly low bar with regards to beats on the reopen.

And the velocity of the beats on the reopen was even more high-Beta, in some senses, because of the itchy trigger fingers from the administration to get things reopened in the United States.

Obviously, there is a potential downside to that I think that we're feeling right now. But that same shock-down merited and elicited an even larger shock-up type of recovery.

So, as far as this slide has gone – actually, skip ahead to Slide 3, the economic surprise index, which, simply put, is a kinda sorta standard deviation of the average US economic data result. And in this case, if you just think about it assigning a positive one for a beat, versus net-to-zero for an inline and a negative one for a miss, what you're seeing here is that right now the index has just printed at an all-time high. Which speaks to the magnitude and the consistency and the scale of these beats that are coming in of the shock loads.

And that sort of impulse turn, impulse turn in sentiment, impulse turn in growth, impulse turn with regards to potential expectations, future expectations for inflation, which has a lot more

data points, that really worst-day macro-regime shock, that was felt in the vol space.

So to go then back to Slide 1, what you see here in the bonds space, it still is reflecting – and that's almost consensual long across the boards. Certainly, if you look at that fourth column in – that's the one month ago (in parentheses).

And still now to today, the first column in, you're getting a lot of max-long signal across the bond complex, which is capturing, certainly, the environment of this last three months of shock-down.

My thought here, though, is that, in conjunction with a pretty upbeat view on what vol can do as far as resetting and shocking out some of this legacy positioning, it matters then when we're talking about that bond long and the impact that it's had on equity behavior and equity cymatic behavior on the volatility complex, I do feel like there is a potential for this very large bond position to just reprice, even on incrementally better interpretation of the virus data.

Over the next two to three weeks – let's say we're not seeing those hospitalization rates spike in conjunction with the case growth, we're not seeing the mortality rates move off the lows – some of this premium that's been built into long in the bond space (as you see in Slide 1 with the CTA positioning giving that 100% long signal and most of the major G10 developed market bonds and then short-term money markets, eurodollar futures for instance) – some of that could bleed out into a less bad scenario. That's an additional sling shot for equities.

Erik: So, Charlie, when you talk about a sling shot for equity markets, I assume you mean an upside catalyst from here. But it's interesting – if I look at Slide 6, where you've got your CTA position estimates (not for bonds, but for equities), it looks like we had positive positioning on equities a week ago and a month ago.

But as of today and yesterday, it's showing negative as I see it on S&P and Russell.

So what's going on there? And what do you expect?

Charlie: Sure. That far left column was signaled today – to be crystal clear to listeners at home, that's actually through Tuesday morning. And what is important there is that (if you then skip over to that green box LevelToBuy), we triggered through those cover levels in the S&P, which is now back at 100% long.

If you take into context this whole time horizon (the fourth column in was one month ago, the third column in, one week ago) – you see that, obviously, this new case growth, oh, here goes Phase 2. Here we go again. They're going to have to unwind the reopening.

That got picked up with regards to – much of the global equities futures that we track in our basket have maintained this short framework, this short signal, throughout this experience. Because, again, the move down was just so powerful.

The fact of the matter was, though, a month ago, certainly due to the velocity of the US recovery, the S&P and Nasdaq were both 100% long and the Russell – which was obviously a very economically sensitive small-cap, very high-Beta, very financials-centric, yields-sensitive – that had even trimmed its short to capture some of that rally off of the lows.

The last one-week period shows this shifting back to a short, which is picking up that case-growth fear.

The news here, though, is that, as of today (which is not updated in this slide) that S&P position is back 100%. And it now makes it that the S&P and the Nasdaq are the only two longs. And across the equities portfolio is 13 different global futures, while 11 are still short.

And, to me, if you get this less bad behavior in the fixed-income market, this less bad interpretation of the virus, the less bad interpretation of pricing in a potential re-shutdown, you're going to get a yields-up trade.

You're going to get probably a bear-steepening trade. And the bear steepening really matters for equities behavior because then (if you go back to Slide 2) this is now picking up what's been happening over the last quarter in agitation. Everybody in the world – I've made a career out of talking about value versus growth, what is in US equity factors.

What has become value is basically the stuff that is cheap is going long the stuff that is cheap. And being short, the stuff that's expensive. Is it any wonder, then, that, for well over 10 years (certainly since the financial crisis and even a little bit before that), value has been destroyed.

Value has been destroyed because investors have been willing to pay for growth at any price. And growth at any price meant stuff that can grow profits or grow earnings, regardless of the economic cycle. So stuff like secular growth tech, right. The high fliers in tech. Nasdaq.

Those types of names have just gotten more and more crowded and they've become bond proxies. They end up trading – they need low yields to justify their expensive valuations. They look like bonds. They've benefited from this massive bond bull market. And that's where people have been headed.

So what was a pure momentum portfolio was basically a long-growth short-value.

When you look then at Slide 2 and see that quarter-to-date [QTD] column, second from the right, it shows you that there has been a real agitation going on. Not just in equities factors but from a cross-asset perspective, which is picking up a real agitation, a real regime change with regards to what people are thinking about going forward.

And, at the end of the day, that's what a dual left-tail shock does to markets.

It wasn't just the pandemic in March. It was also the crude price war. And the crude price war – which had an added kicker, of course, to the global growth picture and gasoline consumption and oil consumption and things like that – but when you see previously left-for-dead value, which is all the deeply cyclical, economically sensitive stuff that people have made perpetual underweights in shorts – really starting to rip and outperform the secular growth stuff that people have been crowded into for a long time, it's telling you that something important is going on.

And it hasn't just been an equities phenomenon. Cross-asset momentum was down kind of 6% last quarter. Multi-asset trend was down 4.5%. And just equities momentum, as you see here, was down almost 23% on the quarter.

So that, to me, is a signal that we are in the midst of a turn.

Erik: Okay, Charlie. So, big picture-wise, it seems like we've got some upside catalysts that could be constructive for equities.

But I want to touch on another topic, because a lot of the work that you guys have done at Nomura has been analyzing the impact of the short-vol trade and all of the volatility strategies in the marketplace.

You've done a lot of work in your Dailies, just talking about where the Gamma flip levels are in different asset classes, where options-driven buying and selling comes into play, and so forth.

What does the whole vol complex tell you? Does it contribute to this constructive story for equities? Or does it potentially suggest that maybe there is another side of the story?

Charlie: That is very much our bread and butter. I'm blessed to work on the best equity vol desk on the Street, which really provides me an incredible look under the hood at the market forces which matter most.

Long-time readers or clients know that I believe that Gamma is the largest force in the market, and all of that is a sub-header under the general Wall space.

And, as it relates to the shock of the past three- to four-month window, this most recent quarter that just ended, vol has remained sticky and high. Largely because – now out of discretionary, fundamental – buy-side investors have the willingness or VAR capacity after that type of a vol shock to be able to short vol again.

We've spoken *ad nauseam* about the perverse market structure that has been created since the financial crisis response and the Fed put, and the creating of volatility as an asset class as a yield-enhancement strategy, in a world without yield.

That has incentivized former buyers of volatility – real-money asset-liability managers like

pension funds, insurance companies – they used to buy hedges. Now they sell volatility. And that has created this tail-wagging-the dog phenomenon where the vol dictates to the underlying asset class.

When your VAR limits are based off of trailing realized windows – and we just went through a generational volatility shock, you had this dynamic where people haven't really been able to do as much short vol as their models would tell them they would like to be doing.

What is happening, though – and discretionary investors are sitting there watching this headline sentiment ping-pong on case growth – a lot of vol-sensitive systematic strategies have been reallocating into equities exposure or covering their shorts for the past three months –

As we just went over in the CTA, look at the 13 equities futures that we track in the model, 11 of which remain shorts, and what you're seeing is price and vol signals are beginning to turn.

This makes so much rational sense to folks, but they don't think about it all the time.

But, you know, let's look at what's just happened over this past three months. It is really important to realize that short-term trailing realized volatility has begun to collapse unto itself.

So, as of yesterday, S&P 60-day realized was at 65 on May 18. So a month and a half ago. And it's currently, let's say, 27-28. Something like that. S&P 10-day realized vol went from 41 two weeks ago to now low 20s in an even shorter window.

So the velocity of that repricing lower of volatility really, really matters. Especially, then, as it pertains to a trend or a vol-control model which uses volatility as the exposure toggle.

So if you think back about that 60-day window, three-month, 60-day window, over the past two weeks, something really important has occurred – and that is that much of the worst of March days, all those shock-down days – have dropped out of that 60-day window.

You had an S&P down 7.6% and down 4.9% and down 4% and down 9.5% and down 12% and down 5.5%, etc. – that are now no longer part of that three-month window.

So if you're talking about a vol-control strategy – and our model looks at either the max of the one-month realized or three-month realized vol – and then set (say) a 10% allocation target – it's a really big deal.

Because, as in the post-vol-spike surge, these types of strategies – this could look like a variable annuity product sold from a sleepy insurance company or asset manager – liquidated, their equities exposure to what was like a zero-percentile allocation three months ago, now they have a ton of room to add.

So, looking at Slide 4, if you look at that lower right-hand box – and these are just some of our

very baseline estimates of the implied notional allocation into the equities space in particular – you see that – and this is just historical context, looking back three years – but from peak of January, you almost had to sell $400 billion of implied notional equities, which is just now beginning to grind back.

That green box in the middle there is looking at hypothetical one-day changes – the -3% up to 2% band, we're adding anywhere from like a billion to two billion a day. On this particular day (which is a snapshot of yesterday), we estimated an add of $2 billion of equities exposure.

If you then actually skip ahead to Page 5, where we run based on these simple calculations an implied change for tomorrow or today plus tomorrow, you see in those green boxes at the top, these $2 billion to $4 billions all begin to add up.

If we were talking about an average daily market move of zero percent looking out over one week, that would be almost another $7 billion to add.

If the market was going nowhere at all for the next one month, that's almost $40 billion to add.

And, again, the lower left box – you'll see this, it's highlighted in red – the equities allocation on a 10-year lookback is still only a six percentile. But you look and see how much has been bought back over the last three months in the box next to that, the green highlights, in the last three months you're talking about $53.5 billion in equities exposure going back over the last two weeks. That's $18 billion in and of itself.

So this is mechanical. This is unemotional.

And if you look and see, even on a day where the market's not doing much today, kind of flattish S&Ps, VIX is continuing to trade under pressure.

And that is also another sling shot for this whole space of the universe – vol-control funds, CTA funds – that have taken down their exposure so low. Again, going back to that CTA estimate on Page 6, that's a lot of short base out there that is actually off the extreme.

We also estimate that aggregate short, max short notional position, was too almost negative 400 at the peak of the short. Now you're just back to flat. There is still a lot of room to cover. And, frankly, at this point, you're much closer to the cover levels than the additional sell levels.

And that's why I still think there is ample room to see the systematic universe as vol rebases to continue adding exposure and ultimately –

Then you look at a slide like Page 7 where you just look at S&P futures positioning, the orange lines are leveraged funds for the CFTC/TFF data. You just see in those little green highlight boxes, just last week you saw these tectonic covers out of that universe.

So your one-week purchase from leveraged funds, from hedge funds, in US equities futures was almost $24 billion in total across S&P, Nasdaq, and Russell. That's 100th percentile one-week buy to cover in Nasdaq futures at $5 billion.

$16 billion of that was S&P. And that's a 99th percentile – one-week buy the cover.

So there is still ample fuel to burn on a melt-up, which is obviously frustrating on a fundamental investor base – who remained skeptical with regards to the trajectory of the rally in conjunction or weighed against the economic outlook, the behavioral changes of people, the spending changes of people – that frankly caught them wrong-footed.

Because as soon as vol begins to reprice lower in this case, and we saw this into the last options expiration, systematic over-writers do begin to dip their toe back in the water and they start selling options again because their models say that small is rich and you're long the underlying, collect a little extra premium.

That develops unto itself and can start to snowball. And thus you've seen this big systematic reallocation, even just to get back to a very low total amount of exposure with still a lot of room to add.

Erik: Charlie, I just want to summarize, for the benefit of some of our listeners who don't have professional experience with these vol-targeting strategies, the gist of what we're saying here is a whole lot of the institutional investor universe makes their buying and selling decisions and their equity allocations not based on emotions and gut feelings but based on computer-driven models that are really driven by volatility in the marketplace.

And one of the reasons that we had those massive down days in March where there were 7% or 8% in a single day of downside in the S&P is because those models were telling those institutional investors SELL.

And they don't think about it, they don't get emotional, they just do what their model tells them.

What we're seeing now is those models are basically sending the message all systems are green to buy equities. It's time to get back in the market, because whatever happened to upset volatility is behind us now.

Is that the gist of it?

Charlie: It really is. I mean, at the end of the day, anything vol-control, vol-target, the trend, purely speaking systematically, is going to size each position set to be inversely proportional to the instrument's volatility.

So as volatility goes lower, that position sizing can then reverse and go higher.

And if you're thinking about – back to that slide about just the velocity of the data beats, which is a macro input into a number of models – it's not all just price or vol – or even just the idea of impulse and impulse turn or change of change or the rate of change – with vol, with price, with an economic data impulse – has a profound effect on these first mover short-term types of strategies.

The other point I would make, however, is that – and this is where we get so much of this crowding and amplification, certainly over the past decade, while we crash down and then we crash up – is that, although a lot of the systematic strategies might be the first movers, that the entire professional investor universe is, in my mind, basically a momentum trader themselves.

And that is because of the same dynamic.

All of their vol models, all of their risk management tools are still, frankly, at the end of the day, operating on that same framework. When you get a vol spike, you get a gross down.

Again, the size of each position is set to be inversely proportional to the instrument's volatility.

And so you end up having this amplification effect where everybody is a momentum trader. Everybody is a trend trader.

And, unfortunately, if you were rear-view-mirror driving – some of these crashes – as a fund, you would prefer to be deploying cash into the crashes. Instead, what ends up happening is you are forced to delever and gross down into the crashes and then you lever up into the rallies to match your exposure to volatility targets.

It's quite perverse. I don't see that changing as long as, frankly, central banks continue to backstop the market with their unspoken financial conditions mandate.

Erik: The point in any case is that right now what these messages are telling institutional investors is all indications are green. Challenger, you are GO for throttle up.

Guess what? That particular example didn't work out too well for the Challenger group. So I'll express my own skepticism about relying too much on these computer models.

But that is what is driving a lot of the institutional trade. And it makes a lot of sense to explain the tape action that we're seeing. And, as you say, it sounds like a setup for more upside in equities from here.

Charlie, I want to take a big step back. Now, we've talked about the big picture in equities. And we also talked about shorter term where some of the CTA positioning is in bonds.

But let's talk about the big picture in bonds.

We've had almost a forty-year bond bull market. And I'm going to say it's taken us all the way down to zero yield on the 10-year. Of course, we really only got down to whatever the low was – 30 basis points or something.

When you are coming from 1,500 basis points in the early '80s, I'm going to call 30 basis points close enough to zero that we've pretty much got to the end of the road.

My question is, is it really an end of the road? Or is zero just a stop along the way to negative rates? Do we have a secular end of a 40-year event in the bond market?

Or is it way too early to call that? How do you see the big picture for the whole bond market story?

Charlie: I'm skeptical. I continue to be skeptical of this long-term secular shift. I don't see a world of sustainable above-trend inflation and thus a reversal of the multi-decade bond bull market.

Somewhat – going back to the issue that the Fed encountered – and they still have clearly a ton of scar tissue from 2018, their own financial conditions mandate and the amount of leverage in the market in the financial system doesn't allow them to let rates move higher and move in their face, despite a personal view that low interest rates are actually part of the problem because they don't force productive investment decisions, from an individual or corporate level.

They tried – and they should have let it run longer but actually just paused and been more responsive to the market instead of so tone deaf in 2018 – to try to normalize the balance sheet and let the policy rate normalize. And we tantrumed. We tantrumed in 2013, as well, at the mere mention.

Jerome Powell got the joke back then. October 12 Fed minutes have him on the record as speaking and knowing that the Fed is running a massive (quote) short-volatility position. And that the market will continue wanting more and continue pressing more.

I think that that, in and of itself, will never allow for a true end to the bond bull market. I do think – and also, too, long term I believe in the three Ds – the long-term disinflationary implications of debt, of demographics, of tech disruption. Those are major headwinds.

Clearly, a short-term fiscal stimulus impulse is a big deal, though, from a tactical perspective.

In Germany, last month (within this last month), capitulating finally with regards to both domestic fiscal stimulus – and, more importantly, with regards to the Eurozone and the Eurozone economy, with regards to coronavirus bond and debt mutualization – is a huge deal. They've just been an empty socket for a decade plus with regards to the global growth picture.

That matters.

China continues to do a lot of stuff. Not as much as much – with a mix of fiscal and quantitative – and obviously the US – and this is going to be a big future input to the election – the election, frankly, is going to be a big future input to the direction of bonds.

What's happening here with regards to our own fiscal stimulus? And the potential for a Democratic takeover, speaking to universal living wages and things like that?

I think that there is potential in bits and starts to have the legacy decade-long, everything-duration slowflation goldilocks not-too-hot and not-too-cold positioning occasionally get shocked down.

We have crises a few times a year.

When growth is kind of 2%, and GDP for much of the last decade, and, of course, CPI is sub-2%, it allows them to keep rates really easy, policy pretty easy. And that incentivizes fixed-income long. And that incentivizes long in fixed income lookalikes and equities like tech as well as things like utilities.

And they you short stuff that is economically sensitive, like cyclicals.

When you have these periods of overshoot on the negativity around the crisis and you get some less-bad data or you get an actual inflationary impulse due to a big tax cut, due to a big money distribution (whatever that might be), you're going to have these positioning shocks and unwinds.

And I think that, in light of some of this positioning dynamic – you can see on Page 8 there, just looking at CTA exposures – with the equities positioned just kind of at 18 percentile going back to 2011 or bonds at 98 percentile –

This is where you start getting some of those extremes that can sharply reverse. And, again, since I even started talking about this three days ago with clients, S&P is up 130 points, Treasury 10-years sold off at almost 8 bips. And front VIX future is down 5 vol points.

I think all of this setup is out there. You get these sharp adjustments and then you kind of go back.

As it pertains, what could maybe turn some of this investor cynicism, and what I call the siren song of inflation, there is a little bit more of a credible case to be made with regards to inflation right now.

And that is the German capitulation away from austerity and fiscal stimulus there, the potential for a US new stimulus package, where I think an increasingly desperate President Trump is

going to be forced to move closer to the Pelosi $3 trillion kind and away from the GOP's $1 trillion kind.

Obviously, the potential for a Democratic sweep, where the Senate is potentially in play – and look for even more of a larger government-spending trajectory going forward, or permanent fiscal stimulus – is going to matter.

And, obviously, supply chain disruptions from COVID and global trade breakdown, tight inventories. All of those types of things matter.

And then, finally, the Fed and central banks globally, where just the monetary expansion of money supply and reserve balances, credit creation as companies draw down on their revolvers, that's fodder to get yourself more rebalanced.

And, frankly, at the end of the day, when you take it back to some of the things I talked about at the start were just trend and momentum strategies had just stopped working, that's what this is capturing.

Investors are realizing they were probably too far set up into too long of a bond position. They've got to start taking down some of that bond exposure. And occasionally, with a core CPI beat or a big jobs beat when nobody knows how to estimate the jobs numbers that make growth look like it's a little bit better than maybe we expected, you can get these positioning shock-downs. And I think that's probably where we are right now.

Erik: Charlie, we've got huge civil unrest across the country.

There has been a lot of talk about this potentially growing into the culminating (if you will) with the election –

And something I've been starting to follow is a lot of analysts are saying, hey, look, there is almost no way you could have a normal November 3, we find out the evening of election day who the winner is, because we know there is going to be a lot of mail-in ballots. We're not sure exactly how much yet.

But that stuff is going to have to be counted. So, unless it's an outright sweep where it is just super clear who won, it's very likely that we don't find out on election night.

And it's also likely that any election result, if it's at all close, is going to be contested by whoever didn't win and that's going to create some more turbulence and probably escalation of that civil unrest.

Half the country is going to be very upset with the election outcome, whatever it is.

How do you guys at Nomura think about that and model that into your thinking about markets?

Charlie: Certainly. On the equity-vol side, you have a kink-out around that election period, as there should be. A lot of clients over the past (say) month and a half, as the unrest was materializing, there was an element of the COVID anger built into that as well. There was a little bit of a multiplier there.

But you saw people doing calendar trades in vol, selling some near-term stuff to fund some stuff out around that election period, December-type of long-vol trades, just to kind of pay for the purchase of the long-vol stuff.

It still looks underpriced to us because of some of what you're talking about. I think the civil unrest stuff between now and then – which is an almost certainty – between now and then meaning the election – is going to matter because it's going to continue to impact election odds.

And, maybe overly simplistic – and we have to make generalizations here – but the general kind of playbook here is that, certainly in the case of (say) a blue sweep where the Dems have the House and they take the White House, and then potentially better odds to take the Senate than we've seen in quite some time, there is a train of thought that says this:

Look, it's going to be a large capital outflow dynamic in the United States. The potential dollar-shock type of a trade, due to this idea that higher corporate and individual tax rates and the loss of this US tax haven status since the tax cuts of the past four years, if those were to roll off and potentially get even more punitive, more punitive than they were before, is a growth shock.

It's a corporate shock, it's a consumer-spending shock. That is a large part of that thinking that leads most to believe that current straddles around the election aren't pricing in a big enough move.

I think that there is probably a more nuanced spin to that as to why it's not as big of a vol gap, even though it is certainly kinked out there, which is that, look, some of the swing-state senators that might be tilting blue are actually more middle-of-the-road types that will be more moderate types that will push back on substantial tax hikes.

And I think so.

The thought then is that you get that blue-sweep scenario, which, again, to line up all three of those things is like hitting a trifecta. It sounds easy. Its not easy to actually keep though.

That is a trade that I think people think the market gets shocked down and gets bought, probably off the back of that.

The other thing I would add, Erik, is that there is also a view that around that kind of

shock-down, if the market were to go vigilante, the Fed stands ready. And if you don't think that the mechanical processes that have been worked out over the course of the past month with the Fed now being a top-five holder in many credit ETFs – it was a test drive for equities purchases – you're wrong.

I do think that a lot of that logistical workflow has been dealt with. There have even been workarounds with regards to the language of the vehicle, of the special-purpose vehicle that's doing the purchases that potentially could create the workaround that previously made it something that needed to go to vote or have a law changed with regards to purchasing equities.

I think those thought are out there.

And also, part of that is the potential – not just something passive like yield-curve control, which the Fed has discussed, which means it's been discussed but they have said NO for now –

But certainly, too, in a real doomsday plan – say, the market tantrumming after a blue sweep, plus more COVID sickness out there and a lot of parents rushing their kids to the emergency room in the fall around the election time because they have a sniffle –

If we're really tense, it wouldn't take as much – and certainly I can say it's a non-zero potential that you could have a big enough shock where the Fed would do the seeming inevitable and do negative rates.

That's not a high-probability scenario. It would require a tremendous financial condition shock, but it's non-zero.

Erik: Charlie, I can't thank you enough for a terrific interview.

I've also become a huge fan of your Daily letter. Listeners, for anyone not familiar, all of the charts in today's slide deck came out of just one day's worth of Charlie's Daily newsletter. In fact, everything in today's slide deck came out of Wednesday's letter.

That letter is available free of charge to institutional investors who are clients of Nomura. Please don't blame Charlie. It's not his fault. Regulators and his employers control who can get that.

So you've got to be an institutional investor and have a relationship with Nomura. If you have that relationship, you are crazy if you have not yet contacted your Nomura rep and asked to be added to the distribution list for Charlie's excellent letter.

Charlie, I can't thank you enough. We look forward to getting you back on the show in a few months for another update.

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

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