Charlie McElligott: The reflation that reversed course in April will reverse course again

April 29th, 2021

Erik: Joining me now is Charlie McElligott who heads up the cross asset macro strategy team for Nomura securities and is very well known for his daily newsletter which is available to institutional investors. Charlie is well known for the quality of his graphs and charts and he's prepared a slide deck for today's interview. Registered users will find the download link in your research roundup email. If you don't have a research roundup email, it means you're not registered yet. Just go to our homepage macrovoices.com, click the red button that says looking for the downloads right above Charlie's picture. Charlie, it's been way too long. Great to have you back on the program. As we get started, I want to start with a trend we're seeing which is all of our favorite deflationists have defected and become inflationists. What do you make of this trend where suddenly everybody's an inflationist?

Charlie: It's great to be back and speak with you all again. Look, this is something that I think for the last two years to three years worth of our visits, we've spoken about. Which was this decade plus regime that I call the everything duration trade, the everything duration narrative, where, you know, that post great financial crisis QE response had facilitated this kind of perpetually low yields and flat curves type of a trade. And what benefited of course then were things that had, you know, high sensitivity to low interest rates. And that was, you know, again, certainly everything from US Treasuries of course, to mega-cap tech and secular growth which is a two fold dynamic.

One, you know, secular growth stuff is stuff that doesn't need a hot cycle to grow and in the past decade, we have not operated in a hot cycle. Thus, you know, the bull flattening in interest rates and curves. And further secular growth stocks, you know, which can grow profits, grow earnings in the absence of a hot economic cycle, also then to can have their valuations justified by such, you know, impossibly low interest rates and negative real rates, things like that. So that's that kind of double whammy that facilitated what was momentum over the past, you know, 5-10 year period. Which was frankly, looked like long bond proxies, long duration, long interest rate sensitives, short cyclicals. And the short cyclical stuff was almost just a funding short, and financials and energy and basic materials, industrials, to a certain extent.

All those kind of, you know, formerly known as deep value sectors that we'd spoken about. It was going to take some sort of shock catalysts to pivot that construct, and that lazy momentum positioning that had accumulated, frankly, over the course of a decade. And that shock came in

the form of this impossible left tail last year, you know, this global growth crisis and this global growth, Black Swan, you know, in the form of the pandemic. And the disinflationary impulse that followed, then forced not just, you know, a resumption of full throttle QE and that full throttle QE has been unprecedented QE, unprecedented asset purchases, unprecedented lending programs, but then to ultimately the real tiebreaker here, this brought the old deflation uses into the new, you know, inflationista camp was, of course, the fiscal stimulus, right.

You know, this step closer to an MMT world to a world where government debt is, you know, effectively being monetized. Helicopter drops, you know, stimulus checks, and, you know, we've seen over the course of the past year that gasoline to the fire on the recovery, and once we then knew that, you know, both with a democratic administration being elected and this, you know, understanding that that meant larger government deficit spending, the fiscal stimulus checks, jobs programs, things like that. Plus, you know, this new world of anticipating the vaccine pull forward, you're gonna have this real double whammy. And the double whammy is what shocked us out of that legacy, everything duration trade into the reflation trade.

And obviously, you know, from November of last year, certainly the Georgia senate run offs, which evened out the Senate to help allow some of the administration policy to push through with regards to spending and stimulus when you add that with the vaccine reflation and the renormalization of the economy, everything just flipped on its head. So it's been a cyclicals over seculars. And obviously, it goes without saying a value over growth trade that is really, you know, caught, as I said, a decade of legacy positioning, flat footed, because people just took it for granted that you know, this was a perpetual deflationary phenomenon based on debt, demographics, and tech disruption.

Erik: Something that fascinates me Charlie is just a couple of years ago, a few years ago. A 2% yield on the US 10-year would have been considered an inconceivably low number. It couldn't possibly go up that low. That's impossible. That's what people would tell you. Now we've come full circle to the point where a lot of people are panicking, saying if the US 10-year yield goes over 1.75 and certainly if it gets as bad as 2%, Oh, my God, the sky is falling, the world's gonna come to an end. How do we get here? and what I know you do a lot of work there in terms of looking at where we are in the cycle with reflation and the reflation narrative and the overshoot. Where do you factor in the trend in Treasury yields? Is this just the beginning of something? Or was that just a false alarm? How do you look at this?

Charlie: Well, I think that, you know, to be candid, the easy part of this cycle pivot, certainly from, you know, moving rapidly from, you know, still, frankly, expansive economy last January or in February when we were printing just markable economic numbers, jobs numbers, labor, and unemployment. You know, really shocking stuff into this hard, hard, shock recession. You know, within a month thereafter as the global economy was forced shutdown that everything that has happened thereafter is part of the playbook, right.

It's that recession into recovery phase, you get such, obviously, you would expect once the markets begin pricing in, you know, the monetary policy, you know, forward repercussions once

the market, certainly in this case began pricing in the fiscal stimulus repercussions, you got that, you know, short bonds, higher yields, long inflation type of a trade to a tee. that's what the backtest show up from a factor perspective. But it's the pivot out of the recession, that you kind of counter intuitively, to a certain extent, because people would say, you know, do I really want to be, you know long banks and things of that nature. You know, as we're sitting in this economic quagmire, but that's exactly the time because they are clearly so sensitive to interest rates on this trade out as the market pulls forward all this future growth.

And now, the thing is that we've actually, in some of our Quadrant work that we update on a weekly basis, has shown this pivot into the harder part, which again, might seem backwards to some folks on the base level where we're actually five weeks in a row now of our larger metric considering the expansion phase, and the expansion phase is a win. You know, the expansion phase is where you want to get as an economy, the expansion phase is what helps us digest that idea that, you know, higher rates in a black and white world are financially, you know, restrictive. Higher interest rates are a headwind if you're not still growing, right. If you're not still seeing, you know, healthy reflation and not punitive inflation, you know, that context matters. If we're seeing higher interest rates on a taper tantrum, when growth is still low, and inflation is, you know, counterproductive, say, a stagflationary environment, it's a very different risk asset response.

In this case, if you're still getting reflation, plus higher growth, it makes those higher interest rates far more palatable. And that's why I think, you know, these scenarios that are trying to look for an absolute level and nominal yields that are saying, you know, this is where the stock market will take it, you know, I think is grossly oversimplified. It's far more nuanced than that. But to my point about the Quadrant turn, and as you see, you know, and that slide one where the expansion is now five weeks in a row of our metric. Slide two actually tells a pretty interesting story kind of thematically, because you move out of that really high, you know, highly cyclical, highly indebted, leveraged, high beta, yield sensitive regime that we've been living in, frankly, this past year. Certainly, from January to March, as reflation was just skyrocketing, you know that that was the world that we live in, so that you know that that long cyclical, value, short secular growth type of a trade.

And this corroborated exactly with what we've seen in April, which is, you know, pretty fascinating. A lot of people have kind of been caught flat footed by this. But April was, you know, a glimpse of kind of the opposite world where, you know, you really had a situation that ran contra to kind of everybody's you know, positioning. You know, growth factors up 3%, right, secular growth is up 3%. The stuff that the likes lower interest rates and flat curves. And you've had this tech outperformance relative to cyclical value and cyclicals are the high fliers, the gear stuff, the economically sensitive stuff is down actually three and a half percent month-to-date. And that, you know, again, so this runs contrary to what we've seen January through March, April has been this big reversal month. This big, kind of reverse dispersion month, that's gone into the face of, you know, this whole last year's worth of reflation trade.

And that's what these, you know, slide two is showing you there, that as we transition into expansion from recovery, recovery is the juice. Now you're in the harder part where again, much more nuanced story, you see, you know, the one month forward returns and this is back testing to 2006. You know, when you're looking at the quadrant terms, the one month forward returns is pivoting into expansion are, you know, low risk factor, right, that's a bond proxy. That's kind of defensive, long defensive, short, high beta type stuff. Leverage factors still works to a certain extent but there you see, you know, hedge fund crowding, which is really still long secular growth. Size, which is like the mega-cap type stuff outperforms small cap, which is the cyclical value type stuff. it's counterintuitive.

And then if you look all the way down at the bottom what doesn't work. The 10-year yield sensitive factor. 10-year yield sensitive factor has been the proxy for reflation. If you look at our risk premia suite, when our 10-year yield sensitive factor is up over the past one year. This is as a market neutral strategy, something 96%. But over the course of, you know, the month-to-date, it's down, you know, 2.6%. So, I think we are currently capturing this transition into a much more kind of diversified return story. It's not as easy now as just being short bonds, long inflation, long cyclicals. You're really going to get some chop. And that, you know, we can speak to that later as far as kind of my more medium term, you know, one to three months view. A lot of these backtests tell us that there's some some chop coming with regards to themes, you know, between assets, sectors, and industries.

Erik: Charlie, I'm looking at your newsletter from yesterday where you write a handful of recent back tests of macro sentiment and vol factors makes a case that a view for US equities continues for the next one to three months to risk a chop with thematic reversal risk, ie. April month-to-date, which has run contra to January to March based upon a number of studies which you outlined in the newsletter. We can't send everybody the newsletter. But give us a quick overview, Charlie, of what you guys are looking at there and what the implications are for markets?

Charlie: Of course. So the first one that I spoke to, is what we just discussed, right? So the economic quadrant analysis that looks at this transition. This phase pivot from recovery to expansion, you know, really captures, right this is what we just spoke about. It's this reversal that we're seeing over the course of April looks to probably continue to a certain extent into May and potentially even in June to a certain extent where we've moved from this very high beta cyclical value, short secular growth into now this expansion phase.

So what it does I mean, it's counterintuitive, you're thinking the economy is humming now. But what you see are duration sensitives like low risk, like hedge fund crowding, like mega caps over small caps that outperforms and then the economically sensitive stuff like ISM manufacturing PMI factor, which you know, again is long stuff that outperforms and trending higher ISM manufacturing regimes and short stuff that reacts negatively to that. 10-year yield sensitive factor, WTI crude factor, all that stuff actually become laggards as the cycle evolves. So that's part of this chop, right? It's a thematic chop, you're through the easy money of reflation.

So that's the first part and if you and even you know that's on the one month but even the three months factor for returns. They make the case for modest further reversal and extension of this secular growth recovery to a certain extent, right? The tech mega cap thing type stuff that does begin to stabilize and get its legs. I would probably contextualize this, as you know, more of a consolidation, in this case, just looking at this economic quadrant backtest. But then from there, if you start getting into some of our other analysis. So we do a if you turn to slide three, the sentiment index testing. So what we look at right now is the sentiment index that looks at a number of metrics from, you know, momentum, credit spreads, vol indicators, technicals. We have currently are running a score that since 2004, this US sentiment index is 99.6 percentile. Extreme, extreme, extreme, high, high sentiment across all of these various metrics, right.

And what we wanted to do is then kind of contextualize that or then look at forward returns. If you make contingent coming from a really kind of a low volatility regime that we've been kind of operating within. And what ends up happening is that you look at the median returns, the one month S&P return on the back test, you see kind of more of this chop, right. The one month forward return is just like 70 bps, and no excess return. And excess return, we're just saying we're comping it, versus what you would typically expect a normal market to do. This does exactly what the market always does. So it's just kind of like this grinding 70 bips expected return when sentiment is this high.

But what we did then were to look at such a sustained period of high sentiment. So we tested the 50-day rolling score of our sentiment index, when it was higher than 99.2 percentile, which just gave us more data points as you widen kind of the band. And what it showed was, you know, pretty remarkable. When you've sat in such a high extreme sentiment view for, you know, this 50-day period, kind of approximately, two and a half months of a trading month. The S&P three months median return is down 2.1% and there's actually a negative excess return. So it actually underperformed where you would typically expect the market to do by a significant amount, which again, looking at this sentiment index, it tells us that we are probably going to go through this period of consolidation, maybe even a slight pullback on kind of a one month, three month window, just because we're so overshot with regards to sentiment.

And then if you turn to slide four, it's this final study that we did, where it's from the vol space, right and speaking with a lot of folks, a lot of clients who are asking about kind of the ratio of the V-VIX, which is kind of known as the volatility of volatility versus VIX versus, you know, implied vol, and the ratio of the two is something that a number of people like to look at. And if you were talking about, you know, two Fridays ago, I believe you printed a, like a 96 percentile, you know, looking back well over kind of a 15 year period. You printed a 96 percentile rank, which basically says to me, it's the study of really rich tails. You know, I think kind of generically speaking, when I see V-VIX, it's going to tell me that tails are being bid up, or tails are being kind of offered, you know, tails, meaning, you know, crash up or crash down types of scenarios.

And what this high ratio is telling me that we have really rich tails versus low kind of base volatility. Because, our VIX 12-month rank is just 2.8 percentile. So, what I wanted to do was

then look at the forward returns when we have you seen prior examples, right. This high V-VIX/VIX ratio, this rich tails versus low vol, but then make it contingent on this 12-month trailing VIX being really low vol, which is again, just 2.8 percentile. And what we ended up getting were a number of points there. And what it showed, it was again, confirming right. The forward returns, you know, looking out three months, the average return S&P return was down 2.2%. The median return which is kind of my preferred metric was down to 1%. And there's a, you know, a low hit rate. So if when I say hit rate, it's percentage of the time that it's hire kind of, you know, 50 is a break even in that sense, it's only 38%.

But almost more importantly, what you end up seeing too. And we did the same analysis with regards to VIX forward returns as well. But I think maybe even more just important than the simple S&P forward return is that you actually see larger drawdowns on average, over the next three months. So when you do get those down S&P scenarios. They're down much more substantially than kind of the standard month. Plus, you also see higher base vol, if you were to look at the you know, the VIX study, meaning just higher VIX out one month, or out three months. So this is, you know, all of these kind of separate, you know, there's macro study, this sentiment study, this vol study that we're looking at, are really telling me that there's a kind of rotationally consolidation period as we transition the economic cycle and that makes sense to me.

Again, fits within this idea that, you know, a lot of the reflation easy money has been made. And even though the economy is now in the expensive phase, which is a good thing, and can help us digest, you know, financial conditions tightening, that it makes sense now, as the conversation with the Fed itself, in the next few months is going to pivot to removing some of this emergency liquidity. And that is going to begin not with rate hikes, of course, but with the tapering of quantitative easing. And I believe that they will start messaging that probably some time, just to begin socializing, and then the mind of traders and markets. Begin probably starting to talk about the economic data coming in, hot in looking better, you know, even in tomorrow's fed meeting. You know, I think for for reader purposes, that's Wednesday, and then in the months ahead probably around the June meeting, you know, I think they're going to begin to really start talking about beginning tapering the asset purchases, both with regards to the purchase of treasuries and mortgages.

Erik: I should have mentioned that we're taping this interview on Tuesday, this week, our listeners will hear it Thursday. So it'll be yesterday's Fed meeting by the time they hear you say that. Moving on to page five, Charlie, the title here is no more as vol control model anticipates the potential for buy flows into end of week. Tell us what the Nomura vol control model is first, for any listeners who are not familiar with it, and then tell us what this chart means.

Charlie: So very simply, there's a number of strategies, you know, anything from, you know, variable annuity products, that kind of will model driven in this case, you know, target a volatility level, that will allocate your investment into cash or lower beta or treasuries. It'll toggle that exposure, you know, your risk asset exposure, in this case, just like a pure stock exposure, based on the kind of the volatility regime that we're operating within. And we run a vol control

model assuming a target volatility of 10 that I think best captures and you can save all control kind of sits over, you know, a number of strategies, variable annuities, number of CTA trend, risk parity in some ways. All of these, you know, go back to this general idea that in the kind of post crisis, market structure that we live in, where the Fed in central bank response has been suppression of volatility and suppression of interest rates and maximizing, you know, financial conditions easiness. That that has created an entire world of negative convexity strategies or short volatility strategies.

And in a market environment, where volatility is low, it allows you to deploy more leverage to hit your kind of, you know, target returns to your allocations. You deploy more leverage on to trending trades, until there is a catalyst for higher volatility. And that then will cause you to reduce that exposure, remove that leverage, deleverage. You know, anybody who's been in the market in the last, you know, five years, to say the very least, knows that we've had these, you know, handful of times a year, these massive de-grossing experiences, you know, for a number of idiosyncratic you know, macro reasons. Anything from the quantitative tightening experiment, which I think still weighs heavy, frankly, in Jerome Powell's mind. You know, having blood on his hands for the very poor communication of the tapering which led, then kind of started kicking off the Volmageddon experience in February 2018.

So then, you know, the Trump-China tariff tweets we experienced over 2019. You know, you had these volatility catalysts that would cause these kind of convexity shocks. These negative convexity shocks, the short gamma shock and ultimately, all of these strategies that are built on, you know, this concept of volatility is your exposure toggle, that has to force de-risk. You know, by shrinking books, by cutting longs and covering shorts. So we've just had a number of these de-grossing or deleveraging events happen. You know, with that you've had a number of momentum shocks. This has been a, you know, this most recent world that we've lived in, as far as a very trend environment, you know, the macro narrative holding true, right. You know, long equities, short bonds, long inflation, long commodities, all of those trades have trended really well, it's why kind of CTAs as an alternative strategies have done quite well, you know, year-to-date and recently.

But of all control model, in this case, you know, the way that we model it. We look at, you know, the higher of either one month or three months S&P realized volatility. So right now, that would mean that the three month realize, which is, you know, somewhere around 16 vols is the kind of the trigger that we're looking at. And you can, you know, estimate or extrapolate. And we use this as kind of part of our toolkit with regards to, you know, potential flows, catalysts.

If you look at, you know, this last month and a half of volatility and base volatility repricing lower. You've generally seen a significant amount of exposure adding, because, you know, real trailing realized vol has calmed, from some of those concerns seen earlier in the year with regards to, you know, an inflation shock, with regards to the implications that could have on Fed policy. Obviously, the last few months, you've had a couple of like headline shocks, but generally speaking, it's been a low volatility environment, stocks making all time highs, you know, the

bond sell off stabilizing, right. There was a lot of interest rate concerns that were driving some of the higher vol that we saw, you know, January, February, that is too calm.

So you've seen an accumulation in vol. control strategies, where they've been adding back exposure, that is kind of stalled out of weight. Because you've lost that catalyst, you've kind of had vol, you know, trading a little bit sideways. But now what we're looking at, if I'm looking at that three months look back period. There's actually two over the next week, there's two really big days that are dropping out of sample. And that's what slide five is showing you. Those highlighted green boxes there on the kind of the lower, lower right. The January 27 down 2.6% S&P day, and the January 29, down 1.9% day drop out of sample. And that matters because in this case, if you were talking about kind of tame daily S&P returns over the course of this week. So even just like up 1% or down 1%, if the daily returns in that band, for the week, the model estimates $15 billion of buying from vol control this week.

If that, you know, consolidated even further. If the daily change were just up or down 50 bips, you know, we'd estimate kind of dictate an additional like 21 billion or so of equities buying and that stuff matters, those flows matter. And when, you know, you're still kind of, you know, halfway through the earnings period, you know, where, obviously, volatility is calm, but so too is trading volumes, those flows can have an outsized impact, even though we're sitting here at all time highs. That type of a flow can be a catalyst later in the week, to be, you know, help us break out to a new all time high. Even though the back tests you spoke about earlier, still should continue to kind of capture some of this chop, where again today you're seeing some, you know, the secular growth stuff that people were using as their source of funds to move into cyclical value.

You know, big tech is again, you know, stabilizing to a certain extent. And, you know, it still matters because it's still a really substantial part of the index. So, you know, I think the tape can hold steady, but you're going to keep getting these days of reverse dispersion where the last year dispersion meant value was outperforming and tech and secular growth were the source of funds now for the last month and I think probably for, you know, another month or two months. You can see the opposite of that. And that doesn't mean the index is going to sell off either. It just means you're going to get these movements under the hood.

Erik: So the graph on page six is basically showing us for a given change in the market, given size market move in one day, how much buying or selling systematic traders are going to do as a result of that and it's very insightful just to look at that chart. Let's move on to page seven, which is the combined gamma per 1% of spot. Give us a little bit of perspective, I know this is kind of a complex subject, but our own Patrick Ceresna has prepared many of our listeners for the gamma concept. Tell us what this model shows and and what this gamma flip point is that is so important where the game kind of changes at a certain price level.

Charlie: For sure. So, you know obviously, this is something that's it's bread and butter in a world of negative convexity that I've spoken about in a market structure where exposure is added on low volatility, and deleveraged on up volatility. You know, dealer gamma matters,

right. And what this chart is simply telling you is that right now, S&P futures spot is $4172. That's basically stuck dead solid between the two largest dollar gamma strikes on the board. Like at $4150, there's approximately $3 billion of dollar gamma. And at the 4200 strike, there's like $4.25 or so billions of dollar gamma.

And looking at that chart on the left, you see kind of the peaking out in the aggregate dollar gamma just above 40, you know, $4200. But those two biggest strikes have us, you know, somewhat pinned to a certain extent. So I'm not surprised that, you know, on top of earnings, which are almost by definition, you know, dispersion events. You know, there's going to be kind of, you know, winners and losers based on positioning and obviously the fundamental output. You have a low volatility environment that is being further suppressed by dealers being long gamma, which means that to remain hedged, they tend to sell strength and buy weakness. This is all based on options that they are long and short to clients.

So you see by that dotted line, right, there, we are, you know, pretty much near like, peak of the long gamma number, where things get interesting, of course. When dealers do get, you know, relative to the move in spot are found to be your short gamma, which means that instead of this insulating force that kind of stabilizes, and buffers sell strength, buys weakness, which is, you know, Vol suppressing in its own right. You actually have this accelerant dynamic, and that's where, you know, the fireworks happen. You get a macro shock causing spot to move, you know, maybe some sort of deleveraging event, or maybe that's associated with a trend reversal, a short term trend, metric breaks and reverses. And you can see, you know, some sort of systematic selling. When dealers get caught in a short gamma dynamic, they're pressing moves. So they're buying the market, the higher it goes, or they're selling, the lower it goes to remain hedged.

And that's where you get, you know, these massive kind of one, two day moves of the past few years because we've frankly, had, you know, a pretty remarkable number of macro catalysts into what has been generally speaking, kind of a low volatility exposure adding type of an environment because then you get these stop outs, you get these deleveraging events, you get these, you know, Vol events, and you get the opposite. Oftentimes, it does so it has happened, where you get a gamma flip level that corroborates with like a CTA trend, deleveraging level. You know, whether it's, you know, a short-term time horizon, signal flipping from buy to sell, you know, two weeks, one month, three months, something like that. When those two points when a CTA, deleveraging level hits, or a releveraging level hits, when that also occurs alongside a gamma flip level. That's where stuff gets really hot and heavy.

Right now, in this case, we are still in a pretty, you know, comfortably long gamma dynamic, which is why it doesn't feel like the tape is moving. And yes, we're sitting near all time highs, but you're getting kind of 20-30 bip, you know, 10, 20, 30 bips moves a day. And most of the movement to kind of the point of everything we've spoken about is really about thematic and dispersion sector versus sector, factor versus factor, risk premia versus risk premia. That's where so much happen because it's been a macro regime pivot from this old world of everything duration and disinflation to footing change towards a more reflationary world. Obviously right

now, the message of the earlier conversation was that cycle is beginning to pivot to something more mature into this expansion phase. But then that too has implications for risk premia, for themes, for sectors, for factors.

Erik: And for the benefit of any of our listeners who may not be familiar with this Gamma flip concept. Patrick Ceresna has done a couple of webinars on that. We will tell you where to find them in the postgame segment. Let's move on to page eight now where you're applying this concept, or I should say, where you are using this concept to look at specific data here. Tell us what's going on. You're looking at the gamma on the left and the Delta on the right, as of 4/26, which is now basically. What's going on with these charts, what do the charts tell us?

Charlie: So this is just another way of kind of contextualizing and ranking the magnitude of this current long Gamma, positive Delta, you know, Options take that we're talking about. So there's about 13.5 billion of Gamma here, which is substantial. Again, the peak of that is somewhere around like 40 to 25 in the S&P, but it's holding steady. You know that 67th percentile since 2014 is a pretty substantial gamma position. It's not crazy extreme meaning if we for whatever reason soft spot breaks sharply lower and do a Gamma flip level, the bigger that dollar Gamma rank would be would mean that we're going to have a bigger move, you know, a bigger shock reversal move in the opposite direction, most likely. In this case, it's big enough to matter and it's big enough to keep us pinned.

The dollar delta is from a rank perspective, it is a bit more extreme. You know, at 89th percentile there is you see there's $342 billion. But that, you know, that tells you two things. One, that the market is long via options and two, that is pretty rational in the sense that we're at all time highs. The trick is, if you do see a lot of Gamma come off, say as a product of options expiration. You know, this is something that we talked about a ton in the note or OPEC cycles and flows around OPEC cycles. Where, especially with the growth of like, weekly options. And certainly the growth of even though this is more of a single stock phenomenon over the course of the past year, but the growth of you know, daily weekly options usage from, you know, retail right? Where they're almost intentionally trying to create these Gamma events to get dealers or market makers short Gamma by buying deep out of the money, you know, options on short expiration. So there's a ton of convexity there, it can really accelerate moves.

But in this case, if we were to have kind of, let's say, you know, some sort of macro catalyst, spot moves down a bunch, it's a pretty big dollar Gamma, you know, notional that we're talking about 13.5 billion, 67th percentile. If we were to get some sort of a shock where we traded down through that Gamma neutral level and what short Gamma, then that dollar Delta would matter. Because, you know, that's a lot to de-risk, is what that's telling you. So it's just giving you some like dimensional context to positioning and where inflection points are in the options market.

Erik: Moving on to slide nine, the title is thematic and factor risk premium performance trends. I love your titles for the sound so efficient. Charlie, tell us what's really going on here. What does this mean, what does it tell us?

Charlie: You know, I wanted to include this because it gives you time snapshots and particularly. I love this monitor, Prashant Sundararajan built this with our Delta One team and they give you a real hard capture at both the duration to reflation trade that we've been in right. So, if you look at kind of the far right and I sorted this by the year-to-date returns which are the orange header there, second from the right. But, you know if you just look at index returns like there you go like Russell is up 16.4% going into today's trade year-to-date, which is you know, basically 2x you know Q's, teaser secular growth. Russell is cyclical value, right? Small cap versus mega cap, small cap value, you know, cyclicals versus mega cap secular growth tech. That makes total sense, right? On the one year, look back, you know, Russell's up nearly 80%.

So it's capturing like the market picking up the fact that and getting ready for the next move. Even at the peak of the pandemic slowdown, your people knew we would, we were going to have this, you know, artificial recession. And what happens when you emerge from a recession due to fiscal stimulus plus monetary policy plus, you know, unprecedented lending, asset purchases, all that stuff. Then you get this, you know, huge economic release and that's why the cyclical value stuff, and that's why short bonds, that's why long inflation, all of that stuff has worked. And that's captured in that small cap, cyclical value outperformance of secular growth tech.

You see that too, just in that next section the factor pairs on a year-to-date basis, you know, leverage factor, which again is, you know, highly leveraged balance sheets. So it's kind of like high beta, long high beta, short quality. You know, you're seeing an 80%, one-year return in that factor. I mean, it's just massive. And that's generally speaking continues to be the case year-to-date. More, though, about January through March, right? Because I have spoken earlier about how April was kind of a reversal of the reversal. And similar to that cyclical value factor, you know, long economically sensitive, short duration sensitives basically. That strategy is up 47% over the one year and 29% year-to-date. This stuff that has lagged, the red boxes below on the year-to-date is stuff that was frankly bond proxy, long bond proxies. Stuff that's been long bonds, short cyclicals, stuff that's been long mega cap, long big cap, short small cap. You know, long defensives, short high beta. All that stuff has been a loser for the, you know, the same reasons we just went over.

Further down, I mean, the middle section there pneumatics, as you zoom into this, you'll see I mean, this just captures some of the speculative frenzy that, you know, could be discussed as a case study forever frankly. But of what happens when you add unprecedented monetary response plus fiscal, you know, in the form of "stimmy" checks. You know, with people that have too much screen time, had no sports to watch, and we're kind of sick of dealing with, you know, spouses and kids learning virtually from home. This is, you know, led to the returns that we see here, which, you know, spin-offs up 111% in the year, recent IPOs 109%, liquidity beneficiaries 99%, post-SPAC merger basket 87% return over the past one year. You know, everything, all of these are, these are long, only strategies. But all of these kind of juicy themes, you know, that have just seen outrageous returns.

If you look further in though, and that more recent history, you do pick up some of that de-grossing, some of that monetization that we've seen, certainly over and to a lesser extent, we just see smaller magnitudes of these returns. As you know, those retail high flyers have, of course, you know, encountered a little bit of turbulence. Certainly, we are well off the highs of the SPAC bubble. And some of that stuff has really slowed down too. But that really just captures the Zeitgeist of the past year, and a lot of these very speculative themes. After that, you just kind of dropped down to the bottom, the macro pairs, one that I highlighted is that 10-year yield sensitive factor that I spoke to, you know, long, the most extremely economically sensitive, short the most bond proxy sensitive, and that factor is up 96% over the past year and 27% year-to-date. Even though, as you know, creep in on the month-to-date is down three and a half percent. Because, you know, generally speaking, you've seen the bond sell off stabilize too.

And that ultimately has been a very healthy thing, right? I mean, you want higher interest rates, as we said at the start. The Fed is seeking higher interest rates, if it's reflective of higher growth and inflation expectations and we've checked that box. What you don't want are rate tantrums. What you don't want are rate moves that are so fast and so violent, that it causes financial conditions to tighten. That it tightens lending. And then it causes, you know, huge fixed income deleveraging events, which you know, is you know, we've said many times over the years of the show. Inflation is the ultimate volatility catalyst.

Because, you know, in a world of, frankly, decades of disinflation, we have built this legacy positioning where we've only just reversed over the past year, you know, a part of that. But if you saw fixed income as a core part of most portfolios, where it's been immersed in a 30 to 40 year bond bull market, if you saw that kind of core 60/40 you know, where your bonds or your low volatility asset class was certainly within the world of risk parity. And we remember risk parity, what happened to it last year under this macro regime change. Remember what happened with risk parity in 2013 during the taper tantrum, where bonds are your leverage low volatility asset class to counteract the higher volatility of equities, then you have real problems. Just considering the magnitude of fixed income, fixed income assets out there. Particularly with the amount of leverage deployed in them by a number of strategies these days.

So that's been the difference or think over the course of April, the fixed income has stabilized. The rally even flattened a little bit and that has allowed too, to see, you know, realized volatility, once again, compress. And, you know, that's what has helped the market, the equities market, those under the hood changes where again secular growth, instead of being a source of funds, has to stabilized. And that's why over the course of April, you've seen that kind of reversal, where duration sensitives, bond proxies, secular growth can actually again at least short-term began to outperform cyclical value again.

I think for the next one to three months, that can be perpetuated as the index chops its feet. And then after that, it ultimately comes down to how the market responds to the Fed socializing, that ultimately, a lot of this emergency liquidity will begin to erode in a very controlled, communicated

fashion. But you know, and that's going to begin with the tapering of QE purchases. You know, potentially as soon as Q4 of this year, or you know, probably the start of Q1 next year.

Erik: Charlie, I can't thank you enough for a terrific interview. But before I let you go, I want to talk about where all these slides, and graphs, and charts came from. Almost everything we discussed in this slide deck was taken just out of one day's worth of your daily letter, which is only available to institutional investors. Now if you're an institutional investor, you already have a relationship with Nomura securities and you haven't yet told your sales rep. that you want a free subscription to Charlie's newsletter. Do that immediately.

It's free, you can't lose. It's guaranteed win. Retail listeners unfortunately, sorry, you can't have it. Please don't blame us for that. Don't blame Charlie. He doesn't make the compliance rules. He just lives under them like everybody else does sending repeated emails to macrovoices saying Nomura won't give it to me, macrovoices should instead won't help you. Please don't do that. Okay? Charlie, anything else that you want to add for our listeners before we close?

Charlie: Always appreciate the support. You guys have been tremendous to me and my career. And it's been really nice to make some individual contacts grow off of the platform and your loyal listeners. So looking forward to our next visit. Hopefully, as the Fed language pivot begins to pick up here into the summer months. That means more volatility. That means more trading opportunities that we can circle back in a few months from here and go over some of those changes.

Erik: We will definitely get you back on this summer Charlie and talk about what's going on. Patrick Ceresna and I will be back right after this message from our sponsor.