MACRO Voices
with hedge fund manager Erik Townsend

Charlie McElligott: Tightening Cycle Is A Headwind Until It Becomes A Tailwind

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Erik: Joining me now is Charlie McElligott who heads up the cross-asset Macro Strategy Group at Nomura. Charlie and his team assembled a short slide deck to accompany today's interview. Listeners will find the download link in your research roundup email. If you don't have a research roundup email, just go to our homepage macrovoices.com, look for the red button that says looking for the downloads. We'll be focusing most of today's interview on the first two charts, but I recommend perusing the remainder of the short deck at your convenience.

Charlie, it's great to have you back on the show. It's been too long, I want to start by just going way back out high level, big picture here. We've got this fed tightening cycle. A lot of people are saying hey, the Fed has no way to get out of this at this point. The markets gonna crash. It's just got to be you know 20, 30, 40% down before the Fed put will kick in and the Fed will change its stance. Is that the right way to think about this and what does history teach us about what happens in these tightening cycles?

Charlie: Well, it's certainly good to be back and speak with you guys. It has been too long, fully agreed. Look, inflation has been this macro regime change catalyst. Inflation, as I've said, I think prior meetings with you folks years ago, is the driver of cross-asset volatility. Simply on account of what it does with regards to a forced capitulation from global central bank's away from the persistent easy money policy, large scale asset purchases dynamic of the past, you know, decade plus since the financial crisis. And what that led to and why the last year, you know, last half year to a year has been so tumultuous is that almost all legacy cross-asset leadership and positioning and performance has been tied to that dynamic where it was all about Goldilocks economic environment, not too hot, not too cold with growth and inflation. And that inflation skepticism or cynicism then allowed for outperformance of duration sensitive assets and stuff that's sensitive to interest rates.

And investors parked in long duration assets. They parked in stuff from the equity side that could grow profits in earnings without a hot cycle. And in you know, the treasuries or rates side that meant long treasuries, bull flattening and curves, negative real yields. So, which is a very highly speculative environment which meant persistently low volatility and long gamma, short skew, all of these dynamics really crowded us into trades that were proxies of the same thing. Long secular growth, expensive, high multiple equities are equivalent to long, you know 10 year

or 30 year Treasury type of dynamic and ultimately created to the fact that US is this secular growth engine versus rest of the world being very cyclical, very value. We created this US exceptionalism trade, and that shift over the past, you know two years frankly right that from the COVID double whammy of the monetary policy and the fiscal policy response, and then the exit from that period, really supercharged and unanchored inflation and that's where we are right now.

Erik: You mentioned that inflation is the driver. I know that as you said, you've been talking to us about inflation for years where everybody else seemed to be in denial. Most of the institutional guys I talked to say they believe the Fed that it really is transitory and they don't think that we have a new secular inflation. How do you feel about that? Do you think that there is really evidence that it's not secular? Seems to me like all the signs are there.

Charlie: I do think that this is been a perfect storm of idiosyncratic and cyclical that has aligned, as we've said previously before, I mean just maximum perversion, that the kind of tiebreaker was this global growth shock in the form of COVID that forced authorities to, you know go over the top with regards to fiscal policy. In addition to of course, and running alongside unprecedented monetary easing. But what that did create too, and the sequencing of the kind of escape from COVID over the past, you know, very staggered escape from COVID is that there have been both supply and demand inputs here that have complicated that picture. I am actually of the view and I think we'll probably speak to this a little bit later, but that we are pushing into peak inflation territory over these next few months. You are seeing potential signs of inflection across some of those supply snarls. There's major CPI inputs such as the Manheim used vehicles which are now seemingly turning lower. LA Long Beach Each port congestion backlog is now declining in pretty substantial fashion over the past few weeks. Baltic Dry freight index down 62% from highs and even, you know the kind of the lagging impact of China's cooling inflation through the global supply chain, you know where you've had three consecutive declines in factory gate PPI, a recent CPI roll over too. All of that is coming into an upcoming period where you get easier year over year comps.

And just kind of the monthly versus the real jump risk that we saw last year at this time, the real escape velocity inflation prints. So the danger here is that, you know, the world has really set up for this hawkish trade. And it's been the right trade and a tremendous bear flattening as you priced in more Fed policy having to be responsive and react to these persistent inflation upside prints. In December of 2021, obviously, you kind of had the final nail in the coffin and this true Fed pivot towards inflation hawks with that that meant tighter FCI, tighter financial conditions becomes the pure focus of the Fed. And with that, you know, this creates an environment where they had to really respond and price in and add in a lot of hiking. Well, the fact of the matter is, you're going to get some of this kind of after Q1 softening in inflation. And I think too from the demand side, that's when you're also going to begin seeing some of the impact of not just getting the first few hikes under our belts, which will help slow some of that demand in theory, but also to I do believe that a fair bit of that current kind of strong corporate, strong consumer demand story that's out there right now. And we could certainly see it. Things like retail sales and consumption is that you're actually experiencing too maybe a false optic, where there has

been a pull forward of purchases into higher inflation expectations certainly as it relates to surveys of, you know, kind of the consumer, as well as dynamics right where there's double booking and double ordering out of this persistent inflation pressure.

And both of those two should seemingly see mean reversion in H2 right? I mean, that's the whole old idea of you know, what cures high prices is high prices. And I think that would really catch some people flat footed as we've now established such a good conceptual, kind of, you know, persistent higher inflation positioning in the market, short duration, you know, as I said bear flattening in curves, value over growth, you know as it pertains to kind of traditional late cycle winners, which are you know the inflation sensitives, like energy and materials, and then short the stuff that always goes down at the end of the cycle and at the beginning of a tightening cycle, which is the expensive stuff. And we've certainly seen that. The risk now as I'm saying is that you get this kind of growth is actually a little bit slower, because that demand has been pulled forward. And this is all kind of projecting out into the second half of the year, as well as this natural kind of organic softening of some of these other inflation inputs that have been previous tailwinds that could actually become headwinds.

Certainly, without question, there is a risk to this observation with issues like energy, right crude supply, Ukraine-Russia impact on natural gas, and obviously to this wage price spiral challenge, which could be kind of the next leg of inflation. But if you really do see this path now, where H2, you know, or second half inflation could derail meaningfully or it simply just slows to the point which is maybe the worst pain trait of all where the economic Goldilocks of the US returns. And nobody is really positioned for that I think. You know, if we went back to this world of not too hot, not too cold, just right. And you saw, you know fixed income or you know, yield sensitive type of assets began to outperform again when everybody is kind of geared up for the inflation overshoot. That would be, you know, certainly a painful environment for many.

Erik: Surely this issue of the tightening cycle is obviously got everybody's attention, some thing I noticed is so many people in the world of macro launched into these pontifications, where they posit their hypothesis for what this means and how it was likely to play out according to their personal, you know, view of the macro world. Some of the guys in your group did something a little different. They said, why don't we instead of doing that just go back and look at the data look at history of when these significant tightening cycles have started in the past, and they put together two charts. The first one is what markets look like two months after the hiking cycle. Started with second chart is what did the markets look like 12 months after the hiking cycle started? And what I find most fascinating about this, Charlie, if any listeners are not sure which one is which, the one that's a sea of red, that's the two months after, but the one that's 12 months after almost looks like a sea of green, what's going on here? And what can we learn about these two charts?

Charlie: Absolutely. Look, we wanted to we think there's a lot of nuance with regards to, you know, all hiking cycles, and the Fed has said the same thing, right. This is a particularly, you know, idiosyncratic as we previously stated, you know cycle and that this was steroidal almost right, the accelerated economic cycle, this Supercharged inflation overshoot, you know, thanks

to this unprecedented monetary and fiscal thanks to the growth, suppression of COVID and lock downs, and then the growth in demand release of the vaccine. And the dropping of you know, a lot of these mandates is just created this very high speed, high velocity economic cycle, that you need to differentiate between all kinds of prior tightening all prior fed lift offs. So all we did was knowing that this is a, you know, a front-loaded aggressive lift off. And even though that, you know, 50 basis point March commencement has seen, you know those odds decline. I think most you're still somewhat in the ballpark of seven hikes this year, and another, you know, three or four next year currently on the sell side.

What we did was we kind of screened them for prior fed hiking cycles which saw four more hikes in the initial 12 month period. And that does give you I think, a few surprising outcomes. Right? and I think the general takeaways here are that after that initial two months following lift off, yes there is a trade down. There is a negative trade down, that's the peak drawdown that we see within equities that kind of post two month window. So in theory, if we're, you know, fixed and locked and loaded now that March is going to be the height right? I think it's 16 days away that you know, kind of pushing out into May, is somewhere in that peak draw down and I'll circle back to this later because without question, we are doing some pull forward of this trade. We're doing some major pull forward of the tightening cycle without having it tighten yet.

But what the data showed is that after those first two months, the S&P was down 3.6% median return with just a 25% hit rate. So across those, you know, prior examples where we've seen, you know, the four hikes plus in the first year. You know only 25% of those were higher, saw higher stocks after the first two months. The tape has a certainly a defensive posture, along with late cycle outperformance from energy and commodities, which goes hand in hand with the reason that the Fed is having to go pretty aggressive with a tightening cycle, you're getting an inflation overshoot. And of course, that goes higher in conjunction with with Treasury yields. The thing that ends up happening though if you then start to move out, and we go through this on the, you know, on the 12 month slide, the 12 month forward return slide, but frankly, this starts at the six month point, you begin seeing markets stabilize while yields stay higher and commodities continue to work, but ultimately out 12 months it's a very stable regime and almost higher across the board with multiple themes, sectors factors working. You know that 12 month median return after these four hikes in the first 12 month hiking cycles is up five and a half percent S&P, 80% hit rate. The Russell is up nearly 10% with the 63% hit rate. Growth factor is up 11%, Value is up 5.5% and you know yields are higher, commodities are higher, gold and US dollar are all up too.

You know, I do think that there is a notable worth going over. If you go back to the 12 month forward return slide. There's one outlier there where the lift off is a notable downtrade and it's the January 1973 path this occurred. And the reason this is notable because it occurred during an inflation shock. The CPI trajectory was exploding, persistent upside surprises. There was the oil crisis with the Arab oil embargo that happened actually in conjunction with this massive new source of government deficit spending in the Great Society on top of the Vietnam War and that really saw stocks get hammered. And gold and commodities you know exploded higher. So I think that is important to note. The other thing, if you go back to the peak drawdown slide right.

If you're talking about the two months after, the most bullish instance was the 1980 scenario. And that's where Volcker began a series of multi-year hikes right? And actually saw equities markets believe that the Fed would stop hiking as the unemployment rate would eventually move higher. But what ended up happening. So equities traded higher over the course of that 1980 scenario as Volker began this pretty aggressive hiking cycle, but thinking that he was going to stop. What ended up happening is he kept hiking and because inflation kept going, so by 1981, a recession hit and actually the following year, the S&P finished down 10%.

So I wanted to kind of contextualize these scenarios where yes, there are outliers. But as we try to find, you know consistent themes and look at the median returns of these, you know, different aggressive, front-loaded hiking cycles, that it actually on the margin paints, you know, a pretty constructive environment. I would actually to like to add one final scenario here which is if we even take this a step further, where if I'm looking at the scenarios where you actually kind of look most alike where we stand now. Meaning that we have had a significant pulling forward of the Fed tightening and kind of snapshotted basically half a month out from the first hike. The one that most looks most like today is the 2004 scenario. And it looks most like today because excess liquidity rollover, US growth was still at higher absolute levels. There was a big rally in gold and crude going into the tightening cycle. And there was even a big flattening of yield curves into it right, the front end sold off. And you know, the long end saw this more aggressive hiking cycle meaning depressed longer term growth. That's the flattening.

And what ended up happening is that you had a, you know, again, a big sell off right into the the the peak drawdown out a few months, as we talked about kind of about two months. But it is worth noting then that three months forward. Three months afterthe trough, that you did end up seeing a really significant risk/return in that 2004 example. So three months after the trough, you had Russell up 20%, EM up 18%, S&P up 11%, value and growth up 13 and 10%, respectively. It was a real risk on. So this is just the final example and even further clarification that I think that this particular one has been pre-traded. There has been a lot of consternation that we've seen in the market, we feel it in the market daily. But I think the fact that we have seemingly pulled forward so much of this tightening without yet having even stock purchases of assets and yet to see the first hike still half a month away. That actually portends to a pretty good, I think kind of t plus three months out forward return scenario.

Erik: Okay, so let me see if I'm assimilating all of this correctly, it sounds like the hiking cycle, which technically hasn't even started yet, is likely to provide a headwind to markets initially. We might expect a bottoming of markets sometime around May or so. But there's also an argument to say this particular cycle maybe is happening at a little bit faster speed than historical ones. A very interesting outlier, though, is if you believe that we are on the cusp of a 1970 size secular inflation, then that outlier, where the January 1973 on the second chart really shows us that would be the case. If this inflation turns out not to be peaking. And it really is developing into a big secular inflation. That would be the outlier that says we're much lower a year from now as opposed to recovering a year from now. Is that a fair summary of these two slides?

Charlie: Absolutely. Yeah, that's spot on. And that's why I want to note it, there is absolutely still a part of the universe that believes that not only is the Fed behind the curve, but they're not going to have a choice with regards to this now very politicized into midterm elections this now politicized inflation issue. And that even, you know, you try to control the demand side with with policy hikes and balance sheet runoff, but still this persistent, inefficient start-stop of supply side issues. As well as you know, some of the background noise with regards to what's happening in the energy space, for instance, and the inability to kind of flip on more energy supplies. Certainly, as it pertains to the Nat. Gas geopolitical situation, but also to just the global crude supply and OPEC really not being able to do much more of themselves, that it does stay sticky. And it does stay tense and it continues to trend higher and create more snarls, bleed into supply chains, lean on earnings and that outlier matters. That outlier is by far without question the left tail because the Fed will indeed then be forced to, you know, hike us into an accident.

Erik: Let's come back to that question of secular inflation then because something that, to me seems like it's a little misleading is I think a lot of very smart people are right when they look at this, and they say, look, you got so many COVID related pandemic forces that have affected supply chains. A lot of this inflation is coming from that, that inflation, according to a lot of analysts should peak sometime in the spring some say February, some say March, you know, in the next few months. It ought to peak and I agree with that. But here's my contention, I think that those transient temporary forces are indeed going to peak and you're going to see those big prints of seven and a half percent or something come way down but not back to where they were. Because I think there is a secular inflation trend underlying all of this. I just think it's not as big as the big inflation spike that's been created by the pandemic effects. What do you think about that? I have to admit, I don't have a lot of data to back it up. It's just the way I kind of feel about this market. Does that jibe with what you guys are saying?

Charlie: It's similar to the debate surrounding the first kind of balance sheet runoff. it's a stock versus a flow issue. I'm a big Delta guy, I'm a big rate of change guy. And for me, what is more similar to credit impulse discussions, right? Where there are inflections and those turns matter. In this case, the fact that you're still dealing with absolutely higher levels of leading economic indicators. Absolutely higher levels of base inflation, you know, that matters. You're still in clearly a disruptive environment. You still have, you know, places like China, which is, you know, the world's supply source, you know, attempting a zero COVID policy. Things like that will continue to snarl and make this a lot thornier and it's not going to be a linear path.

There are clear signs of easing, as I said earlier to, you know, with the Trump tariffs, right? A lot of corporates had already done a lot of work with regards to supply chain and improving efficiencies there and alternatives and workaround paths and look input prices or input prices. And you see what's happening daily in commodities across the board from you know, industrial metals to precious metals to energy, but there is going to be very uneven softening in this data simply on kind of the reverse base effect. And that change in direction will to then matter because I think, as it happens alongside slowing growth, and that point I made earlier on some of the demand being a little bit of an optical illusion. With the pre-ordering and the pull-forward of ordering, the double booking, and things like that. That could eventually give you a double

whammy. The market can handle one thing at a time. But you know, the occasional death by paper cuts certainly as a phenomenon. And I do think that if you get this expected, anticipated softening in data and you know, again, things like, you know, owner rents are staying really sticky and don't see those coming down anytime soon. But used vehicles which were, you know, a freakishly large part of the CPI inflation are softening. Things like that will matter, it's going to be uneven. But if you get that kind of demand slowdown story and that slowing growth story at the same time that you have, you know, some of these supply dynamics softening. I think that change of change meaning just projecting lower will feed into a little bit of questioning of such extremely extensive hawkish positioning in the market.

And as we know, over the years, you know, the positioning is built off of narrative crowding. And I think that'll cause some people to reassess their risk/rewards in a lot of these trades. And simply taking profit alone. Simply monetizing bear flatteners alone, simply monetizing some of your late cycle, Longs in cyclicals alone or value trades will create potentially as much crowding as there is into those trades right now. Create, you know, a larger impact than then folks would expect.

The third thing that I would say is that and this goes back to this idea of an earlier resumption of Goldilocks then I think the market is positioned for. Say you're getting this inflation softening. Say you're getting this demand softening dynamic in the second half in a world set up with, you know, so much kind of long inflation perspective now and short duration. You know, that sounds like a really dicey situation. What could end up actually softening that and helping to mitigate that is the fact that, you know, as we can see right now, out of China is that there are social financing cramdown that they've been conducting as they've been forced to accelerate their easing impulse. And we think that is going to even accelerate further in March at the National People's Congress. But you're getting some of that Chinese credit impulse turn. And that really matters, you know, kind of on a six month lag, a six month change that is the social financing, that's the impulse. If you look at it, just like a three month lead, so not that far in advance that's turning up a lot higher. And when you look at that relative to PMI is that's kind of a 12 month lead but you're seeing a real turn higher in the credit impulse that will ultimately be supportive of global PMI. And that is this idea that maybe the most painful trade of them all isn't just a, you know, a full one side of the boat to the other with regards to, you know, this current, you know, long inflation, short duration trade. But instead, it's actually going to a place that's Goldilocks, which is somewhere in between, because again Goldilocks these people and assets work and assets lead that are more sensitive to duration and more sensitive to slowing. And frankly, with central banks it gives them a lot of slack to ultimately look more dovish than what the markets have currently priced in, which is, you know, a rather aggressive tightening cycle.

Erik: I want to touch on what the right tail risks are going to look like. But while we're still on the left tail, let's just talk about this war risk escalation of the Ukraine and Russia situation. Now we're recording this midday on Wednesday, I'm sure everything will have changed yet again by the time our listeners hear this on Thursday evening. But you know, something that just strikes me Charlie. Every war, I can remember has gone the same way, which is all investors panic and say, oh my God, it's a war, sell everything quick. And then a couple weeks later, they kind of

come to their senses and say, wait a minute, if you look at history wars are usually bullish for the stock market. Why did I sell my stuff? Let's buy it back. In my right to that's off the top of my head, you're the guy with the data. Is it right to think that that's how history works? And if so, should we really be thinking about this Russia-Ukraine situation as a downside left tail risk? Or is it actually longer term more likely to be a right tail event?

Charlie: It's a good question. You know, certainly folks who've been looking at analogs from the recent spate of Russian military invasions where there have been a number over the past decade. That have been, you know, relatively short incursions. I think you make a good point in that, you know, this has been this at one point background dynamic. And it's still, you know, the larger market gyration, the larger macro regime shift from a decade of long duration assets to now a very quick reversal of and puke out of those legacy assets into those that are tied to inflation has been this forced capitulation from central banks into a hawkish posture into a need where they have to tighten financial conditions. That is the larger dynamic that has created, you know, this vol regime shift to over the last over the last few years easy financial conditions regime, but for a decade was you know, very long Delta, right long underlying exposure, high nets, high grosses, you know your books kept going up persistently. So there was a long skew trade, right? You needed to be well ahead.

Well, what this tightening FCI, tightening financial conditions regime has meant, as the Fed became inflation hawks, kind of officially in December of last year. Is that you've basically been able to make some money in a short Delta, short skew environment. You don't need as much hedging per se, because your book is smaller, right? The intraday moves have been so remarkable and stunning. And I'm going to speak to why that is, and in a second here as it relates to your question, but that you don't frankly, need as much hedging. You don't need to have on as much protection just because you've been forced to size down as anybody who has a VaR risk management model knows these. You're blowing through your risk limits, sometimes in up days, sometimes in down days. And that just forces a mechanical shrinking of your gross exposure. So the hedging needs are different. The one thing and back to your point about Ukraine-Russia though is this has become a new something to deal with. It's obviously there's a risk negative connotation there that it turn into something much larger. But the larger options, the larger growth in the options market, in and of itself in the background, and the incredible intraday volatility which the options market is feeding into is creating behaviors where people are using options using, you know, zero days till expiration or one day till expiration options institutionally right? Doing kind of some of that stuff that we've seen out of the retail YOLO crowd for the last, you know, year or two, even dating back to summer of 2020 where you had that, you know, the first kind of gamma, weaponized gamma trade.

And now are trading these headlines. You know, where we gapped down overnight, people are buying, you know, zero DTE, zero days till expiration puts that are creating a ton of convexity and getting dealers short. You know, dealers are short gamma. And with that they're very short Delta because they're having to sell futures to stay hedged and you're closing on extreme lows. But at the same time and this is back to your idea, as in when there is a resolution to Ukraine-Russia and that might be after war, that might be you know, we've just more posturing and it

kind of fades out and out of existence. That all of this had all of this kind of trading hedging. Where again, generally speaking people's exposures are lower, but people are now using puts. People are now trading puts. Retail and institutions are using options to kind of accelerate moves, same day, press shorts, and on the same time, when we do get these squeezes, they buy calls, and that squeezes us to the upside too.

But these flows are created and have so much convexity in them. So much hedging requirement in them that it then ends up setting the tables, certainly with how much, you know, put downside has been trading. That stuff becomes squeezed fodder as I like to say. You know as in when you do get a sustained relief rally, as in when you do get, you know, Spot equities beginning to rally away from some of those downside strikes. Some of those trades that people have put on with a lot of convexity, you know, buying downside optionality. Those puts are going to lose delta. And that means that dealers who have been short futures to hedge their exposure end up covering as we rally away. We move away from those strikes, they end up covering their short futures. And that's how you get this really steroidal, you know, kind of, you know, accelerant type flows from dealer hedging that have been contributing to this larger intraday volatility because effectively since the Fed pivot in December. And we started seeing signs of the market picking that up in November when really the the expensive secular growth tech stuff began to first wobble and crypto began to wobble and that's all kind of the same trade.

That you've seen a real sticky environment where dealers have consistently been short gamma short optionality and that flow at the end of the day without getting too complex it just means that into down moves, dealers contribute to further down moves, we contribute to trend where we have to sell more the lower it goes. And on rallies, we have to buy more, the higher it goes. That's why we're closing on such extremes. That's why you're seeing such remarkable intraday ranges and why it's been such a brutal hiking environment. But to your question, ultimately, all of this bearishness, all of this fear ends up setting the table for the big relief rally as those downside puts begin to bleed and volatility softens. There's a real slingshot of dealer hedging dynamics that can send us markedly higher.

Erik: Let's talk about that next then. Is this scenario basically, it sounds like the headwind would be strongest sometime around May. Let's move beyond that out to the middle of the summer, second half of 2022. Let's imagine that we don't see 1973 sized secular inflation prints continuing inflation is coming back down under control. Maybe the worst situations under control. What could that set up in terms of the second half?

Charlie: Yeah that's a scenario that I think would you know, give some folks the willies. Look, you're already seeing it now. You know even on Monday night, the Monday you know, Presidents Day holiday with futures reopened after the Putin speech, and S&P immediately gapped down 2%. Front VIX, second VIX were only up like 50 cents. And what that speaks to for me is that there have been a lot of people in renting VIX futures trying to hedge their convexity risk. A lot of tourists as I like to say, and that we are largely in position now where vol feels tired. Sitting at very high absolute levels. And if you get that situation where you know, vol is fatigued without a new catalyst and at this point the new catalysts are either outright war

which will certainly get vol going again to higher highs but it actually might be a right tail that is required right? Some sort of diplomatic breakthrough, some sort of stepping down, you know from the Russian side who knows if that's even possible. I'm not going to get into you know, the geopolitical game theory.

But if you do get that stabilizing relief rally and you have these vol. mechanical drivers in the background that then see dealer hedging forces you know, negative gamma, you get vana, you get charm, all of these forces in play that could slingshot us higher. Well above there, you have two of the largest sources of deleveraging flows over the last few months right? Vol. sensitive strategies like CTA Trend which have gone into the you know, outright short side in equities. As well as vol. control strategies which over the last three months have sold almost $100 billion of US equities on a lagging impact those turn buyers as vol. resets lower. Vol. is a mean reverting asset. It's going to take sustained volatility to support you know vix at 28-29. Kind of in the range of you know, 1.6 to 1.8% daily S&P changes. If you can't hold that, you know, if you can't hold that you're gonna see real slingshot type flows and ultimately CTA trend. Ultimately Vol. control, they become a source of synthetic short gamma where their buyers higher and that then would meld into the macro story that you just talked about. The macro story that we just talked about, which is market is really positioned for incredible persistent hawkishness and persistent inflationary pressures. Well guess what? Maybe inflation isn't as bad as we thought. It does begin to normalize. Plus, that demand squeeze was a little bit of pull forward and you get a little bit of slowing there. All of a sudden the market has to dovishly reprice rates. And all of a sudden duration sensitive assets like you know, defensives and tech begin to work again and all of a sudden those longs in cyclical value start getting cratered. You know, those types of scenarios where it's a, you know, an equities higher type of a trade but you're in the wrong stuff.

You know, we still know how much of the index weight you know a lot of these secular growth names have, that could be a really remarkable environment especially if the macro kind of softens in the back half. Back into that Goldilocks of the past 10 years, and people will go back to their muscle memory. And if bonds stabilized, you're going to have a real whipsawed position there too with that, you know, short treasuries paying in rates, you know, bear flattening trade, you know, going to get stopped out if you begin to remove hikes. And frankly, it's important to note that the last hikes are really already priced in, you know, the Euro dollar curve in the first half of next year. And by 2024, you're beginning to press in the first easing. So I think the market is starting to get that joke, where, okay, we've had a great run, these trades have made me you know, a fair bit of money for the macro side. You know, paying in rates and bearish global bonds and long value and things of that nature and long commodities. But this is getting long in the tooth, maybe I start to monetize. In that moment, you start seeing the data soften out 2, 3, 4, 5, 6 months, you're gonna get, you know, that real longer term turning in in positioning that would actually be an equities positive type of scenario. And I think, frankly, just very kind of anecdotally, people are really bearish right now. And that's kind of the final, you know, spike of the football.

Erik: Charlie, this is a fantastic conversation, we're not going to be able to get to all of the slides in your deck individually. But I want to really focus on what I took away from the rest of

the deck in terms of the theme that really speaks to me, and it's about liquidity. You talked earlier about what really drives markets, is it stock or flow and so forth. And I'm very much of the opinion that, you know, as much as people love to talk about economic fundamentals and all that stuff that they study in universities. At the end of the day, what it comes down to is when there's more buyers than sellers, and it's about liquidity. And some people think that that liquidity has been mostly provided as a result of monetary policy, other people don't believe that that's what's driving it. But one thing that does seem to be clear, is we don't have as much liquidity in markets as we used to and a lot of your slides reflect that. What's going on here? What does it mean and how should we interpret all of this.

Charlie: Yeah, so this is super relevant because it's been a major talking point in recent weeks and months. And I think there is a kind of amorphous understanding of this relationship between vol. of volatility and liquidity. But specifically as it pertains to, you know, this larger discussion of the Feds hawkish pivot right? In this 10 plus year regime change that we've been living under. Easy financial conditions, loose financial conditions, almost the primary Fed mandate, right? That since they had to capitulate, because of the inflation overshoot and move into inflation hawks, the equities market has been embedded for one of the longest periods I can remember in my career in a short gamma versus spot territory for dealers on account of this persistent short dated hedging demand from clients. And really, what that means is that, you know, this demand for downside hedges, this demand for this new regime, this demand into a tightening cycle into higher real yields tighter financial conditions, which are going to bleed really high valuation assets, both within equities and fixed income, and have caused this you know, substantial netting down substantial slashing of longs and substantial de-grossing at times or, you know, de-grossing of longs and grossing up of short books has been you know, this grab into short-dated downside protection.

And short gamma creates accelerant flows as we've spoken about previously, right? Dealers end up needing to sell into moves lower, they need to buy into moves higher to remain neutral in their hedging. But also to, and that amplifies volatility. That makes sense. And it's a two directional thing. It's not just when we trade lower, but it also magnifies this deteriorating market liquidity phenomenon. Because it is the primary driver of it. When dealers earn a long gamma regime, which was that short vol. world that we lived in for the, you know, the 10 years prior, the decade prior where you know, clients are selling options to dealers, and we're stuffed with options, and we're then long gamma. What that actually does is provide liquidity. We can post offers into market rallies. Or conversely, we can bid into market sell offs, that insulates the market against large swings. That suppresses volatility, it's insulation. It's vol stabilizer. But in a short gamma regime, dealers become liquidity takers, we're on the same side of the trade.

So we're moving in the same direction with market momentum, we're selling into weakness, we're buying into strength, and that in turn exacerbates volatility. And that in turn becomes a huge notional source of liquidity removal from the market. And you know, ultimately, when you are supposed to play this role of market maker, there are other matters in play here, too. You cannot just simply be the liquidity provider of last resort, if you're risk management, if your P&L,

if you're hedging obviously comes primary. And that is the largest input in my mind why the market trades so broken and why liquidity or illiquidity is what it is right now.

Erik: Charlie, I can't thank you enough for a terrific interview. Before I let you go, I want to ask you a little bit about your daily letter, because I'll tell you, it's one of the most interesting things that crosses my desk every morning. Retail listeners, I'm sorry to be the bearer of bad news. Charlie does not make the compliance rules, but he does have to live by them. And Charlie's letter is only available to qualified institutional investors who have a relationship with Nomura. If you're an institutional investor, and you have a relationship with Nomura, you're crazy if you are eligible and have not yet signed up for Charlie's free letter, which is every single morning and is always full of fascinating graphs and charts. Charlie, for people who are eligible, what do they need to do in order to get signed up?

Charlie: Sure, and appreciate it. Just make sure you reach out to your Nomura securities sales contact and we can get something worked out with regards to being added to the distribution.

Erik: Charlie, I really appreciate the interview and we look forward to getting you back in coming months for another update. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.