Erik: Joining me now is Charlie McElligott, process and macro strategist at Nomura. Charlie has prepared a slide deck for anyone who's not familiar with Charlie's work. He's famous for his graphs and charts. So you're not going to want to miss that slide deck. Listeners, you'll find the download link in your research roundup email. If you don't have a research roundup email, just go to our homepage at macrovoices.com. Click 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 before even diving into the slides, I want to just start at the really high level big picture. Seems like there was lots of really good reasons for the stock market to be selling off through the middle of June as it was, all of a sudden it changed direction. It's been rallying ever since and most of us don't get it. It seems like the macro data is just getting worse. So does that mean this was just a dead cat bounce and we hit the 100 day moving average and it's all about to roll over or is there some big bullish catalysts that I've missed? What's going on here?

Charlie: Yeah, so first of all, always a pleasure to speak with you. Thank you for having me back. It's remarkable how many people I talk to around the street, on the institutional side that say at first, I first discovered you on MacroVoices. So thank you and obviously your platform is just wildly successful. I think what happened over the course of the summer and I think last time I was on, we spoke about what a clear trend market this had been. And that's why managed futures CTA trend is the foreign OA champion of the year to date kind of strategy performance. It's not based upon the traditional kind of bond-stock correlation that so much of the kind of modern investment asset allocation framework is and it works beautifully in times of tail type of an environment. And that trend dynamic over the course of the year, which was very much premised upon that inflation overshoot central banks forced to spastically tighten financial conditions theme was your big shorts and bonds, and then rates and in equities. And then on the long side, your long US dollar, right, as a central bank had to impulse tighten because they're behind the curve, they miscategorized inflation as transitory and it became something that's structurally persistent and then also to long commodities as your kind of inflation hedge.

In June, I would say is when that CPI shock, what was one of the most recent CPI shocks and other upside beat there. I think it saw the mentality from the market shift to, oh dear Lord, we don't have arms around this situation anymore. We do not know where this is going. High inflation tends to mean trending inflation. We've lost the ability to forecast this and where we're
going to borrow a line from Back to the Future where we’re going, there are no roads. The mentality shifted from that previous focus on inflation upside risk, now to growth downside risks which then kicked off a bunch of second order impact, and then that growth downside risk became this, this sudden corroboration with a lot of growth data as well as things that we mentioned last time we spoke, which were trends in the market that were telling you that markets were pricing increased probability of recession. You know, this immediately created something that looked like the equivalent to a dovish fed pivot. And you had this impulse easing in financial conditions. And I can go on from there as to those second order impacts what that then created and saw this kind of counterintuitive rally in equities that seemingly, as you said, from a top-down perspective had this perfect next leg down kind of story to go that then went completely awry over the last month and a half.

**Erik:** It seems to me that a big part of this picture is a whole lot of people have an embedded expectation that what's coming, it's almost like it's an immutable law of science that there has to be a deeply dovish fed pivot and it has to be coming soon and the only thing to be figured out is when it's coming. Almost nobody seems to question whether it's coming. Does there really have to be a dovish pivot or is there too much assumption built into those expectations?

**Charlie:** Well, we've certainly learned that, from the incredibly overly simplistic view as per the kind of 15 year back test let's say and honestly, to be fair, any tightening cycle, but much more so since we became you know, the Fed became this interventionist activist body in the post-financial crisis period is that you know liquidity on means, long risk assets, long duration, long speculative. And obviously in periods of tightening, you get the opposite. And the fact of the matter was that once the Fed capitulated to the markets this time around in a tightening fashion saying that we completely missed the plot on inflation. And we don't know where we're going with regards to, we don't know where the neutral rate is, we don't know where we're going with regards to running restrictive. And the inflation data continued to beat to the upside. It rightfully created a real panic that was then further amplified by the fact that policy is lagging. Policy accumulates, it's nonlinear and you started seeing a very sudden softening and survey data. A very sudden softening and housing. You know, stuff that's very credit sensitive started going the wrong way. And that allowed the market to pull forward this former conditioning that's was frankly been established over, certainly over the last decade plus in the post crisis period, but frankly, over a 30-year bond bull market, which is that okay growth slowdown, growth scare, Fed can begin cutting rates down to zero and in the more recent period Fed can begin large scale asset purchases, ie QE. The fact of the matter is we haven't had one of these growth scares when we have what has now been dictated by the Fed as the sole mandate, that being inflation. We haven't had an environment with 9.1% inflation where labor is running at a 3.5 year rate. And Atlanta Feds wage growth is an all time highs. That allows or that disallows that prior muscle memory, that prior conditioning that we can simply go back to an era of Fed pivot. That definition being cut rates to zero by assets, that we can't go back to that at least in any time in the realistic near future.

And that discussion as far as the speed and the definition of what is an ease, right is an ease going to be to the market, the move from 75 to 50. Is the ease going to be saying that we are at
our terminal rate where 50 through our terminal rate and we stop and pause. I think that in my mind is why we're still going to be and I've said this for the last month and a half, why we're going to be stuck in kind of this uncomfortable range trade. Because that old mentality, that old idea that you can shift back into QE, you can shift back into zero interest rate policy is not an option right now. So instead, the best that you're gonna get probably for the next year plus is after we get a few more hikes in and after we do a lot more quantitative tightening is that we just slow tightening early. We slow the the balance sheet run off and that we don't hike rates. And frankly, when you consider how much tightening has happened in the background both with the policy rate staying higher and the balance sheet run off. That's not a really great environment for risk.

Erik: Yeah, I noticed on page one of your slide deck, you say one of the best trades that you see is fading expectations of a spring of 23 rate cut. A Fed rate cut. It seems to me if what you're saying is you don't think the Fed is really going to pivot dovishly as everybody expects. Is the best trade really fading that or is the best trade anticipating what that's going to mean for the stock market, which I would think would be a lot of down from here.

Charlie: So the trade that you're talking about is something that I've been speaking to clients for the last, last three weeks I guess since I got back from summer family holiday. And that was this idea that you had almost an entire Fed cut priced in the Eurodollar curve. Eurodollars are just interest rate futures. Eurodollar futures, not the currency. And this is shown in EDZ2 which is the December 22 contract and EDH3 which is the march 23 contract, meaning it's covering that period of time between December to March of next year. And my view was for those very reasons that you're dealing with 9%+ headline with this impossibly strong labor market with these impossibly strong wage growth, that there is no way shape or form that the Fed is going to be able to signal anything close to a dovish pivot at that time because financial conditions will ease too much, which ultimately is counterproductive for what the Fed is trying to do. And the Fed is trying to destroy demand because that's the only lever they can pull. They can't address the supply side issues with regards to energy, with regards to refinery capacity with regards to very large container ships, with regards to US housing supply, with regards to rent options, all of these things are part of this backdrop that are completely tying their hands.

So the idea was, just a few weeks ago that Eurodollar curve was implying 25 bips. I said, there's no chance, that has to go to zero. So you put on a steepener here. Well, in the span frankly of the last week, this thing has gone almost to zero. And that is because this Non-Farm Payroll last week and the average hourly earnings upside surprises justify the Fed's aggressive hawkish messaging that they had to kick off a week and a half ago because that impulse easing of financial conditions and when we're talking about financial conditions, we're talking about things that kind of increase or decrease the access to money, the cost of money. Well, that's everything from equities, volatility to credit spreads to the level of the US dollar to real yields, right? Nominal yields less inflation. And all of those things over the course of this risk-on rally and the course of this duration rally as the market began to get more concerned about an imminent recession, kind of starting in mid-June from the implications of all this hiking, was that you would then see, this pivot back into this early Fed cutting cycle and I just said that's a non-
starter. Accordingly, that EDC2 and EDH3 spread has almost gone back to zero and that trade has worked.

What the trick here is that the market is still pricing in somewhere close to 60 bips of cuts just later in next year. So if you go from EDH3 which is, that same kind of March point to EDZ3 which is December of 23, you're 60 pips inverted, which is telling you that 60 bips worth of Fed cuts, and what that number has done is really grown because the market is telling you, the more hawkish you are now, the more you slam on the brakes now, the higher the terminal rate gets, the more that you know, September goes from 50 to 75 or February becomes a hike when people thought December would be the last hike. That's going to receive an equal and opposite impulse easing because you're going to slam the brakes on the economy just in that typical lagging policy fashion. So you've really just shifted the time horizon, into all of this big tightening and staying tighter for longer, staying higher for longer, staying restrictive for longer because of the inflation problem now is going to create down the road, what the market is telling you is a much bigger impulse easing on the way out of this thing. And that's why the markets telling yeah, we're gonna get somewhere between a 50 pips first cut and a 75 pips first cut, and they're still frankly targeting that for the end of 2023.

Erik: And what's your outlook? Can that happen by the end of 2023? It seems like inflation is a real deal here.

Charlie: Inflation is a real deal. And this is something that I've spoken with markets groups with central banks around the world in recent weeks and months, is that anytime and this goes to that idea of how reflexive the market is right? The market reacts to something in real time pulls forward kind of a future event, begins to price in a future event, before you even get there. I've spoken about the idea of kind of anticipating the anticipators and a lot of strategies kind of do something similar. Well, in this case, the market preemptively too early priced in easing start of next year. I don't think that's possible. We've since zapped that out of existence in that Q1 window, right? There is no more cuts priced in for Q1. I think what you're going to see and this is kind of the way I'm sequencing this right now is that we all know that the data is beginning to soften. We know that inflation expectations which are critical for the Fed are beginning to soften, which is largely a function of gas prices going down over the last month and a half as we've blown out half of the SPR. The fact of the matter is that accounts for a lot of the you know, some of that kind of headline type of relief and some of that inflation expectations relief that the consumer has felt, and frankly, why you're seeing democratic numbers begin to pick up again and actually take the senate back in some of the gambling markets simply as it's almost a pure input of gasoline prices. But I think the trick is this. I see no scope in a one year time horizon, it's almost mathematically impossible to get down to 2% target without running multiple months in a row of negative inflation. And I think what the reality is this, how quickly can we move down to that 6% inflation, 5% inflation, 4% inflation, that will allow the Fed over that period of time, it buys them time to kind of move the goalposts, shift the message. By that time, we will have seen job loss, job loss is something that the Fed tries not to talk about. But that is what they are trying to do with regards to demand destruction, because again, demand is the only lever they can pull here, they can't address the supply issues. So the fact is, they gotta slam on the
brakes, they're gonna slam on the brakes longer than people currently imagine. And you're gonna get a bigger ease when you get out of this thing.

I think the next trick becomes maybe it's sometime late this Q4. Maybe it's Q1 of next year, I think people are going to get some feel good relief in the next few months. They're going to see some of this data begin to soften and confirm that peak inflation is behind us. But at some point in Q4 or Q1, they're going to look around and say, we're not going to get back down below 4% maybe ever again because of some of these structural issues. And that goes with some of the inventory clearing issues that we've seen. They were a part of the problem with Walmart, part of the problem target, part of the problem with a lot of the earnings prints that haven't gone well, or inventory issues, that's the bullwhip effect of that COVID, you know, rush to preload and bring on all this capacity and then things normalize. And people are shocked that you can't sell NBA champion hats from the 2019 year in 2022. Because that stuff just gets off a container ship from China. So like, I think, in this case, you're gonna have another leg to another shoe to drop with this idea that, oh snap, we may have stopped hiking at a point, but inflation is still sitting four and a half percent, something like that, at some point start of next year. Now what? Because you're definitely going to have some accumulated slowing down in the growth data. And that's when I think people are going to get pretty uncomfortable again with where we go now. And at that point, you have to be on the lookout for the Fed to kind of move the goalposts on you. Whether that is begin talking about growth and labor, obviously growth is not a mandate but full employment is! Whether that's about moving the inflation target, which is a nonzero probability. All of those things will be in play next year, particularly if financial conditions do keep tightening and you do see job loss piling up and the political pressure will be pretty severe on them.

Right now, ironically, the market just caught a lot of slack from that Non-Farm Payroll number under the AG because I'm actually hearing some people some equity bowls beginning to rationalize it like this. We're seeing prices contract, right, the commodities roll over, the energy roll over, the gas will rollover. Inflation expectations are softening. We've seen that in regional Fed data, you're seeing that University of Michigan but then you have this big labor market strength and you're seeing through earnings so far that companies still have pricing power. We talk about the low-end consumer who's struggled and you've seen that with Target and Walmart, etc. But the middle class and the upper class for now because of the relative strength in the balance sheet, they've been able to digest the price increases. So what that gives you... It buys time, it gives you more rope to digest the forward state of the lagging impact of the tightening and that will ultimately get you then through that dangerous period and get you closer to that ultimate dovish Fed pivot that gives you as I said, what the market is pricing in to be somewhere between 50 bips and a 75 bips cut right out of the gates. So that's how people are trying to get comfortable taking their net exposure back up, taking up their equities allocations, which have been low single digit percentile over the past year. After being kind of hard down, gross down over the course of, frankly, since November of last year. That's the way I think people are trying to get comfortable with this is just in my mind, I think there's going to be one more hiccup, whether that's Q3 earnings that actually do begin to rollover on account of the implications of the top-down slowdown. Or if it's in my mind, it's about, you kind of hit this sticky point of inflation where we're stuck between 4 and 5% as we turn into next year, and the
market realizes we're out of gas and then the Fed is really in a bind there because it's persistently higher and we're not going to get it back down to target.

**Erik:** As we stand right here in the middle of August, we had a pretty brisk rally up to the 100-day moving average, then for the last week or so it's kind of been consolidating just above it is this where the next shoe is getting ready to drop, and we're about to head back down?

**Charlie:** So here's the deal on the kind of the setup, I'll go qualitatively and then I'll go a little more quantitative as far as some of the flows behind this rally that, look, we know that people were extensively bearishly positioned, and that sentiment was very bearish. And the thesis was kind of going into this earnings period, that earnings were going to be the next shoe to drop for equities. all of the equity sell off year-to-date So the first six months of the year was on the multiple, right? on the interest rate move on the Fed being behind the curve, the Fed having to spastically hike and tighten financial conditions. And then you got the multiple contraction, so almost all of the move was on the multiple side, it was on the interest rate side, it was not on the earning side. Earnings for equities from the bottoms up, we're actually going higher over the course of the year. That sounds counterintuitive, which is why so many from the macro community as we're heading into this kind of current, although wrapping up now earnings period, that they thought that that was the next shoe to drop for equities and for broad risk assets. You were finally going to get the earnings, the E-side to go lower, in light of kind of corroborating the top-down growth slowdown that we're seeing in macro economic data. What ended up happening however, was that expectations were so horrifically bad for earnings, people were so positioned short, were so historically underweight and were so high cash, CTA trend was so grossed up in their shorts. You know, vol control was completely deallocated. That prints came in less bad and the fact is earnings have continued to go higher. Almost 20% of the overall S&P earnings profile has been driven by energy, makes sense! Look at what crude has done right? Look at what gas has done. But it's in other sectors too, right? It's in everything from autos, to semiconductors, right? Those are also commodities. And the price gains in this earnings period, what we saw the price gains more than offset the macro volume slowdown, right, the sales slowdown and that caught people flat.

**Charlie McElligott**

So there was also simultaneously a view in the market that with regards to that next shoe to drop being earnings, a couple of prominent strategists in the street who really had to call from a macro level, you know, the pretty right call, but they were kind of both two guys in particular were both really kind of focusing on this potential scenario where S&P was gonna get that kind of clearing event, say down to like 3000 or 3400 at which case you could look at historical levels, historical multiples, historic earnings and make a justification where you could say that's a dip I want to buy. So everybody thought earnings were going to be the shoe to drop. You're gonna get this cleanse, you're gonna get this purge. That was going to be the time to buy. It was going to happen at the same time that growth was slowing and that the Fed will be nearing a pivot. And you ride off in the sunset, you buy that dip and there we go. Problem was the dip never came. Remember that week of you know, some of those really heavy mega-cap tech earnings and they just weren't bad enough relative to expectations. The market began to rally
and as spot began to rally and we got through the big earnings events which are volatility catalysts, vol started coming lower. And as those really grossed up shorts, right from the CTA side you know price their time series began to get away from them. Signals began to flip in the very shorter-dated stuff they began to cover. And that helped spot index move higher, vol began coming lower too. Some of that short gamma as vol rolled over. Some of that short gamma, the dealers were dealing with got longer. They had less of a short gamma problem. You're getting less violent range trades, vol control which was coming off of a three month realized volatility period that was sitting up at 100 percentile, mathematically was going to move lower simply because those high stress days in late April, early May period. We are gonna move out of that three month horizon. And that alone was going to lead to mechanical reallocation.

And look, over the course of the past month, CTA alone has been something close to 70 billion of almost predominantly covering flow. But that aggregate position in our CTA model is now basically back to flat. There are some components that are small, they're relatively dminimis. Vol control has bought almost 12 billion or something over that same period, and has another kind of 20 to 30 billion over the next month. And then this all goes down to as you can kind of see on slides 5, 6, 7, 8, 9 some outrageously underweight short position. Slide five is long short hedge fund beta S&P. As of last week, it was ninth percentile going back to 2003. Just completely not there for an equities rally. The next slide on page six macro fund beta 18th percentile, same deal, not there for rally. They were beared up, as I said, on the earnings story on that anticipated cleanse/purge that you were gonna get that never came. And now people are in a position have been in a position in recent weeks, force to become buyers higher. And then page seven you see that. It just shows the correlation of macro hedge fund to S&P, frankly at a level seen only two other times in the past decade. And then just from an overall kind of asset managers versus leverage perspective, like nobody was there. Asset manager S&P futures positioning has recovered up to 21st percentile, whereas levered right, so that hedge fund universe is 1.9 percentile. And that's actually point one percentile. That's how short they are going back to 2006. So then page nine, and just shows the kind of US equities, futures, aggregate positioning across, you know, for asset managers, for levered, and for non-comps across S&P, NASDAQ, and the Russell. This is a rally that nobody was there for. Once the systematics, just for mechanical purposes, for price purposes, for vol., for vol crunch purposes began to run with the ball, they just left the fundamental kind of macro bears in the dust. And it's been a really painful, really painful trade higher even though earnings by no means were fantastic. They were just less bad than expectations.

**Erik:** Charlie, let's move on and talk about volatility specifically. We had you in the show a few years ago, we talked about the volmageddon event back in 2018. We've got situations now where in energy particularly there are entire countries that are being brought to their knees by volatility and energy prices which frankly, I think is set to continue to the upside, maybe not till we get through this recession. But at some point, it's going to get really interesting. What does all of this mean systemically in terms of how the street is processing all this increased volatility?

**Charlie:** The kind of the largest talking point in my world for the last few months is that, again, from that same macro top down, very bearish outlook. Whether its global growth, whether it's
persistently sticky higher inflation, whether it's geopolitics, whether it's the energy-induced recession risk in Europe or our own, kind of tightening into a slowdown recession risk in the United States is that vol has just continued to bleed. And I think what's critical here. There's a bunch of different inputs, a couple I think are particularly relevant for the audience. The first is that we were coming from a really high place, right? Just about two weeks ago, three month realized volatility in the S&P was 100 percentile, right over the last year. Just meaning as far as the rank of the all of the volatility events over the past year, that three month window was sitting at the highs. You know, at the money implied vols, for the large part the most last few months if it had been sitting kind of in the 90 percentiles, vol was high for a reason. This was kind of one of those terms that I've used before as it pertained to the volmageadon stuff back in the days. This was a neon swan, right? We knew that the incredible cacophony of idiosyncratic events as it related to once in a lifetime COVID response with monetary policy, with fiscal policy with cash drops, with the bullwhip that that incurred with already a broken supply chain issues with Ukraine, Russia, and the impact that had on energy in a world where ESG was a religion, and the under investment there. There simply wasn't the infrastructure to get the stuff out. It was really a remarkable set of scenarios. And you had this just tectonic shift with regards to an inflation landscape which for the last 20+ years by and large had been written off for dead right?

We talked previously about, the three Ds of debt, demographics and tech disruption, all being disinflationary, structurally, secularly disinflationary. Well, it took these multiple acts of God all happening kind of the same time. And then the kind of the tiebreaker of unprecedented fiscal stimulus to catch a world who was defacto short inflation, flat and everybody got stopped out in their flat and inflation trades. And that's why I've always high and we knew that we couldn't create a spastic global central bank community, there's gonna have to hike, hike, hike, have to unwind balance sheet have to do all these things that markets don't like. Well, we got that! We got that and the fact of the matter is, if you go to page 12 you'll see what that led to. When we got that market shock starting in November, which was the month you know, it was like I think at the time was like the sixth consecutive CPI upside surprise, the market started getting the joke that the Fed was behind. The transitory was a scam and by the time December Fed meeting came around, the Fed too acknowledged it. So, in November of last year, you had cryptos start breaking down, you had all of those Cathie wood, ARKK unprofitable tech, perpetual hypergrowth, 100 times high multiple stocks start getting wrecked. And you started seeing these momentum shocks for all these trades that benefited from the duration proxies, right? They benefited from low interest rates in large scale asperges while they got all stopped out.

So on page 12, you'll see that we've been sitting in the midst of a six to a nine month rolling gross down, right? People because of the volatility because of the spot sell off, people who have had to sell Long's and either press shorts to make money in the downside or cover their shorts and get out of the market. And what do you see there is that you know, skew or put skew, which is just looking at like relative demand skew relative demand of a put versus a call. So relative demand for downside versus upside, or put skew is effectively kind of like the idea of winning skew like something in this case, like crashy put preference for, something that's really targeting a big market move, where you can see there in that five year percentile column. You know, low
single digits, there’s no demand for downside. And it’s been like this for months, there’s no demand for downside because clients don’t have any exposure to hedge anymore, right? Conversely, you see call skew there, which is kind of right tail, everybody was mortified after they slashed their positioning over the course of Q1 into Q2 and you kept getting more inflation, upside surprises. And you saw the Fed keep forward guiding us wrong way and having to hike by more. I mean, the June meeting was peak of absurdity, where they guided us to 50 bibs at the next two meetings and then, the Fed had to leak three days before the actual June meeting that they were going to hike by 75. I mean, just a clown show, everybody was mortified about missing a dovish pivot, about missing the rally because they didn’t have any exposure on.

So that’s part of this deal where like, downside began to bleed, because he just didn’t need any exposure on and frankly, against a very credible and rational macro bear case, which created this perversely, all of the fear was about the right tail, the fear was about missing upside. On slide 10 and 11, it just goes to show you how much vol continues to come off now from what was just really high up until recently, really high absolute levels of all that’s the one month that’s the one past month snapshot as of this Monday, just to show you collectively, what's happened across different equities classes, internationally, different kinds of sectors, and assets. It's just been a one way bleed in volatility. And page 11, frankly, refers to some of the stuff that I was talking about with regards to vol control funds. You know, very simple all control models, just looking at the absolute higher of one month realized versus three month realize, in this case, that's the orange line three month realize. Whereas I said just two weeks ago, that was 100 percentile, but in that three month window, all of that volatility of like the panicky days of April and May starts dropping out, that number is just going to crater lower, it's now as of today, somewhere in the mid 70 percentile. And perversely, that leads to more buying. Ultimately, you saw kind of similar effects here as far as the spill overs where that you know people were holding downside or were holding hedges, and the hedges weren't materializing because this was just a bleeding, exposure led out. It was a bleeding gross down so even people that had crashy downside hedges, they weren't getting paid out for that stuff. And at that point, it's like the Wargames quote, the only way to win the game is to not play.

And these hedges started getting purged and lo and behold, you've had this massive, massive, massive amount of covering of those hedges that dealers had on so page 17, that world that was positioned for kind of crashed, that world that was positioned for recession, that world there was positioned for all of these bad outcomes. What happens when a dealer is short downside to clients is they have to be short futures against that. And what's happened now as not only have puts been sold, right, because the markets getting away from you. So these puts are losing value, these puts are decaying. But people have also to the point I made about call skew have been buying upside because they're missing the rally. You know, they're chasing into upside and both selling puts and buying calls creates positive delta, meaning dealers have to go out and buy futures to hedge. So you can see there on slide 17, just across S&P, across spy across Qs and across IWM. Just over the past month alone, you've had almost 600 billion of implied futures to buy from dealers just in the option space looking at the US options, equity options landscape. It's just absolutely massive, how much force that that generates, which is why I always say dealer hedging, and dealer gamma are the most important flows in the market.
**Erik:** Charlie, on that note, let's hit the sequence of slides you've got beginning on page 19 because when you say that gamma is the most important flow in the market, not everybody completely understands what you're talking about. Please explain this, so that everyone can understand why is gamma the most important flow? What are we talking about here?

**Charlie:** Yeah I mean, I think it has a lot to do with, certainly in the post crisis world, this idea that volatility or selling volatility in that sense became an asset class. That it became a yield enhancement strategy. The growth of option strategies, the popularity of options now to this day, the deployment now it's not just an institutional tool, it's a retail tool as we see on a daily basis with the meme stocks. And the fact that these are so popular now. There are now expirations every day of the week and that creates incredible convexity in the market, where there's just a constant stream of forced hedging around these positions. And when dealers are in a long gamma regime where they're long optionality because clients have sold them options basically, or when we're in a short gamma regime, particularly, when there's grab or a fearful kind of market trade. And dealers are short downside, they're short hedges to clients, you get it, you get a short gamma environment and short gamma is the boogeyman for the last few years, but rightfully so sitting on one of the biggest wall desks in the world, the magnitude of the flows that go through as far as needing to hedge on the fly throughout the course of the day with buying or selling a yard. You know, a billion dollars worth of futures or 200 million here, 500 million there at times and certainly as it relates to those kinds of end of day periods where a lot of this hedging occurs, leave the general audience kind of scratching their heads like what is that all about? And I think now it's become well socialized, well democratized in the era of the socialization of trading and Robin Hood and things like that. You know, there's common sources of information now that aren't just for institutions.

**Charlie McElligott** But what's been very important over the past month of this rally, we're spot began to move higher, you didn't get the earnings disaster, positioning was short, sentiment was short, CTAs were very short. We began to see short term windows actually flip long. They began to cover and as spot rallied, vol softened and vol softening is dealers back some of that short gamma, kind of mechanically, they get longer gamma. And when you're in a long gamma regime, it's stabilizing. Long gamma is liquidity adding, like long gamma injects liquidity into the market. So a big part of like market stress and periods of periods of crisis is the fact that dealers typically at that point, there's a grab into protection, there is a grab at hedges. Dealers are short gamma so dealers are market makers instead of contributing liquidity, right? Where they can step in and offer futures, they can sell futures into a market that's ripping higher, right, where it's kind of counter cyclical, or they can even at a market that's collapsing, they can step in and buy, right? That would be a long gamma regime. It's stabilizing. It compresses ranges, it suppresses intraday swings. That's the world that we live in frankly in the post-financial crisis period. Really, with the exception of a few short months here and there mostly around Central bank taper tantrums. That was the world that we live where volatility was sold as an asset class. You know, it was a yield enhancement strategy, not just for sophisticated hedge funds for mom and pop investors. And that long gamma regime stabilized markets. Want a world of you know, fear of central bank tightening that will lead us into a recession. A world of energy shortages, and land
wars in continental Europe, etc. You know, this short gamma world that we're in, it feeds into volatility. Dealers have to sell the lower we go to stay hedged, they have to buy the higher we go to stay hedged. And it's a momentum force. It's an accelerate force, and it creates those much wider, much more dangerous moves.

So in the context of the last, say six weeks of rally has gotten us back into a long gamma regime, as you can see kind of on pages 19, 20, and 21. That is relative good news and for what it's worth, these slides were made a day ago. So they're relatively constant even though the market is selling off a touch. But we are now and this is why gamma is so important. Q's triple Qs, it's the ETF for NASDAQ, very, very deep liquid market. Qs are now nearing that point of gamma flip, where you go from stabilizing long gamma into that destabilizing accelerant flow feeds into momentum, short gamma regime. Because of where they are versus spot. And why this matters, on page 22, 23, and 24. You can see in just this most recent period, kind of going back to November of last year, that red box on the bottom, we've been really immersed in a persistent short gamma regime. And what that red arrow on top captures with those white lines above it, that's just the five day absolute return. So basically it's capturing that exact phenomenon, when you're in a short gamma regime, you get bigger ranges, you get bigger ranges because dealer, options dealer flows feed into moves, they don't offset moves. Recently used to be that small green box just over the last few weeks on the bottom there that we move back into a long gamma regime and S&P and lo and behold, those ranges get compressed because long gamma tends to buy weakness and sell strength. That's the same thing on 23. I mean, the first slide was one day high low range. The next day was a five day absolute return range. I think 24 best captures this and I think it's really interesting. Basically, if you just look where if you're starting the day in a negative gamma regime or a positive gamma regime, you can see that absolute the one day absolute return range and a negative gamma regime. It's almost, you know, it's over almost two and a half times that of a positive gamma regime. You have bigger ranges, you have higher VIX and that's what you see in that first plot there and long gamma regime, then the distribution is clustered it's compressed, right volatility, lower VIX, smaller absolute one-day range. And a short gamma negative gamma regime, those are the red dots. All over the place, both higher and lower, right with regards to you know, but outlier VIX moves outlier absolute ranges, the cut on the right is just another way to express that VIX versus absolute one day moves. Negative gamma, it takes off the insulation and that's a real problem and that's part of this backdrop that I'm looking at right now.

Which is as I said, the dealer CTA trades all those winning trades, when CTAs were up 35% earlier in the year over this kind of stop out, and they were monetizing winning trades over the course of the year. But over this stop out over the last month and a half, the fixed income short is now clean. That positioning can reset in either direction. Right now, the Fed told you, we're gonna have to be hawkish and run more restrictive with retire for longer. So you're seeing fixed income sell off again, and you're actually beginning to get away from that recession trade. Because the Fed is telling you, we're trying to induce a recession you fools. That's the point. We're trying to create job loss because it's the only way you can actually clobber demand to such an extent that it could actually have a negative inflation input. You know, the equity short has been stopped out. As I said 70 billion type magnitude over the last one month. And what
that's created on page 25 is that's just our estimate across all of our asset buckets in the CTA model. This trade has been stopped out all of that first six months of the year, the trend trades and the long commodities, the long dollar, short equity, short bonds. Almost every single one of those trades is now kind of in a net place. And that chart shows you that the gross exposure, the aggregate position size across all that is as low as we've been in 11 years 0.01 percentile.

For me, that's a signal that now this trade can potentially go to a new place. It's kind of like this. Look, we're clean, we got the stop out. Now some of those flows that have been squeezing, like say, for instance, the equities market higher now, yes, absolutely CTAs could now go from flat to outright long. But that's higher, that's 5% to 10%. higher by current levels in the market right now, we're not there. So CTAs are less of a buying story. This and vol control are still there. But bonds can sell off again because the Fed is telling you this critical CPI number tomorrow, which might still just be a little too sticky for that, for that segment of the market, which continues to pray for an early dovish pivot, as we get any sort of resumption of rate volatility, I do think that the equities market in this recent rally, we probably had some weak hands. We've seen how trashy it has been, but loaded popular, crowded shorts, buy meme stocks, buy low quality, no earnings types of companies, highly speculative stuff like SPACS. You can see all that stuff on page 28, you can see the call volumes trading and meme stocks on page 29. You know, all of these things are destabilizing. Typically, when you see the volume move higher, and like we did the last few days, you've seen spot up, vol. up. Typically a signal for coming volatility. In this case it's unstable, irrational behavior by kind of this Wallstreet Bets crowd or even institutional traders looking at high-short interest names buying 10, 20, 30, 40, 50% out of the money upside calls to try to create these gamma squeezes. Well, if the price does melt up to there, because dealers have to hedge and buy futures or buy stock on the way up to hedge what they're short on the upside, you can just as quickly melt down and turn lower on the way down.

You tend to see those spot vol up rallies collapse under the own weight of the implied expectations. And that's what we saw, certainly multiple times with the memes. So there's just a lot of stuff going on in the market right now. Whether it's the meme stock, irrational exuberance stuff, whether it's this speculative very short lead nature of this rally. whether it's the systematic flows that I spoke to that have been so much of the buying and particularly with the equities stuff that are now kind of tuckering out. Now back to flat against this idea that I do think that inflation is going to stay sticky higher for longer. You know, where you can get down to 6, 5, 4 percent, but you're not going to be able to get to 2% in that market that has been trained into thinking that the first sign of a growth panic, the Fed can ease. The Fed to buy assets, you know, is set up for disappointment and could be caught flat footed. Again, I think there probably is one more downtrend before we can really get that kind of full capitulation and get kind of full tilt, all in constructive at some point next year.

Erik: Well Charlie, I can't thank you enough for a terrific interview. As many of our listeners know one of the best pieces of institutional research that crosses my desk every day is your daily letter that is available to institutional clients of Nomura. So if you are an institutional investor listening to this program, reach out to your Nomura rep and be sure to get on the distribution list for Charlie's excellent letter. Unfortunately, it's not available to our retail
audience. Charlie is not in charge of making the compliance rules. Please don’t blame him. He just has to follow them. Patrick Ceresna and I will be back as MacroVoices continues right after this.