Charlie McElligott: Banking Crisis, FOMC, 0DTE, CTAs & more

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Erik: Joining me now is Charlie McElligott, Nomura's cross asset macro strategist. Charlie, what a perfect week to get you back on the show because your team is really good at looking at market internals and the flows and so forth. Here's my question. If Bear Stearns just happened and I contend it did, it's called SVB. And you're not sure if Lehman is about to happen next. How do you tell because the Fed and other government officials have a strong incentive to lie in order to shore up confidence? What can we look at in the market to tell whether this banking crisis is a flash in the pan that's already over or if it's something that's just getting started?

Charlie: Appreciate being here. Great to speak with you again. Look, this is one of those rare opportunities where I get to kind of step back from very tactical flows, and look at some actually larger structural, strategic stories. And, you know, that is exactly what's happened over these past few weeks with regards to you know, both the US regional bank dynamic as well as the, you know, the EU bank story, with SIVB, and Signature, and SI, and Credit Suisse. You know, all of those fails are idiosyncratic symptoms of this larger bank profitability crisis becoming a solvency crisis. And, you know, as it relates to your question, these are long term structural dynamics for banks, whose kind of profitability models were built for an era of 0% interest rates and an era of large scale asset purchases, and an era of slowflation. And we're seeing, you know, the emperor has no clothes pretty clearly here. And, you know, as it relates to, you know, too flat yield curves, as it relates to higher cost of capital, wider credit spreads for banks, and all that means negative carry. So, you know, NIM compression, you know, it's a future state of enhanced regulation and forced capital raises.

And all of that is against this, you know, huge headwind. That's really the catalyst here, which is this continued deposit flight story. Too low deposit rates, versus customers who are then being incentivized to continue shifting money out and into money market funds that sit at the RRP or direct into bills that are offering magnitudes higher premium. So it's that two-tiered US banking system. You know, Janet Yellen got absolutely pinched on her testimony two weeks ago, and that clip that went viral. And basically, it's telling you that there's like a structural long term placeholder trade here. It's like long the major banks versus short regional banks, and the implications of it from the big picture is that, you know, this profitability and solvency crisis becomes a massive financial conditions tightener. And ultimately, you know, in a fractional reserve banking system, where, you know, this is the transmission mechanism for US economic growth. The global economy is going to get toasted, because these banks are going to go into zombie mode, at best and at worst, it means that, you know, credit and lending doesn't flow out into the economy. So it's a really big story. It's a really significant story. And it's where this cycle that's kind of been on this, you know, slow autopilot for the last while, as you know, fed hiked rates and without a lot of market impact. Now, it's really taking a turn.

Erik: It seems to me that the biggest risk here is what I'm calling the why not too big to fail trade where a lot of people look at this and say. Look, I can't tell whether or not my bank is encumbered or if it's in trouble, maybe they're hiding the whatever duration risk, they're taking a loss on, they're hiding it because they've marked all of those securities as hold-to-maturity. So they don't have to report where their losses are, you know, screw it, I'm going to get out of this. And I'm going to go to one of the big four banks, because I know the Fed is going to bail them out, no matter what happens. If the whole world does that, it results in a complete collapse of the smaller banks. And that wouldn't be good. But you know, I look at this and I think, why wouldn't a rational actor say, I can't tell what's going on with my regional bank. I'll just take everything to Citibank or you know, to one of the other really big banks is that a risk of the entire... It seems like once that starts that that it gets it's a form of a safety trade, you know, a flight to safety or a flight to too big to fail. Once it gets going, it seems to me that that's self reinforcing and I'm not sure what anybody could do to unwind it.

Charlie: I could not agree more. There is honest to god no justification at this point. There is no edge that they provide, like think about SIVB right. I mean, if the thesis was like you have access to this network of like-minded venture cap, seed founders, you know, at preferable terms, and we're the smartest guys in the room. Well look with that guy, you right? It was this massive, absurd concentration risk, not just, you know, from the nature of kind of the demographic of the, you know, the client that they're dealing with. But all of those assets were basically a leverage long bond position, right? All those things are a function of easy money policy era. And they're under tremendous pressure. I mean, that was the thing, right? The deposit outflows happen, because one, their deposits were burning cash, because of the nature of their business being, you know, very duration sensitive, very interest rate sensitive, but then two, you know, obviously they created kind of their own run on this thing. But that's the exact picture like there is no edge, there is no rationale, to not continue that flight. And again, particularly when you have these massive headwinds against you that we just went over, you know, higher funding costs, tougher regulation, forced capital raises, and lower deposits, which was just means that in, you know, we could turn this into, you know, or the recent liquidity actions, QE or not conversation. You know, it's those types of banks don't work anymore. And I'll say this, the problem is that they are incredibly important from a lending perspective. You know, just like some stats, this is Federal Reserve data. But if you're looking at banks, outside of the top 25 U.S. lenders and their share of all outstanding loans in the US, it's absolutely wild, their percentage of all loans overall, for small and medium lenders is 38%. 28% of all commercial and industrial loans to small and medium lenders. 37% of all residential real estate. This is the big one, obviously, the markets focused on 67% of all commercial real estate loans. 27% of credit cards, 50% of auto loans, 48% of other consumer loans. You know, this is at the core of exactly what we're talking about.

Like the Fed tightening that began last year that began to wreck all of these duration, long duration assets was that, you know, the emperor has no clothes and the tide goes out dynamic, right? Anything that was really just a function of a decade of keeping rates at zero, and a decade of large scale asset purchases, and a decade of forward guidance that suppressed volatility, all that stuff was built for an era of no inflation. And it was inconceivable that you could ever see a tightening cycle, this short and violent and here we are. And now we're finding out all of these structures, whether it's private equity, which is just you know, which looks a lot like, frankly, you know, profit was tech, which looks a lot like venture cap, which looks a lot like, you know, we repeat, repeat, repeat, commercial real estate, right? You know, when you don't have access to perpetual funding at zero, these models don't work. And that's where we are and that's why, you know now if you're talking about these banks that have no structural edge, and are kind of a terminal short in some ways. If they're touching this much of the of the lending and the money flow and the credit flow in the United States economy. You know, we just accelerated into a pretty substantial hard landing.

Erik: What would it mean to the financial system if we see this flight from regional banks into too big to fail banks, just because people are afraid of this exposure? As you say it's going to knock out a whole bunch of lending. How does that cycle end? Does it end up with the too big to fails getting even bigger by acquiring those regional banks? I mean, that's just making the too big to fail problem worse. But at the same time, it would be hard for regulators to stand in the way of an acquisition that's designed to essentially catch a failing bank before it fails. You know, what would we do in that situation?

Charlie: Yeah, I mean, there's obviously a lot of market desire for some quick headlines with regards to you know, private investors stepping up, you know, the everybody tracking private jet flights into Omaha that first weekend, you know, things like that, you know, obviously, there still are a fair bit of questions with regards to the quality of the assets and those loan books of many of these banks. You know, I do think that, you know, one thing that we saw that was pretty underwhelming from a market response perspective is when you got those initial headlines, let's say with FRC, that you know a consortium of banks were going to step up and you know, kind of backstop or whatever. Well all they were doing was taking deposits that had inflows to those larger city banks. And basically just redirecting them back. The story here and the bigger issue here. And this is why, you know, I referenced earlier that none of these vehicles, none of these liquidity vehicles absorb a form of backdoor QE is that none of this stuff is going back into the real economy right? You know, people are saying, like, look at the balance sheet growing over the past two weeks from the usage of these, you know, lending facilities. Well, first of all, they're interbank lending facilities right there, which just tells you, the stuff is, you know, in this type of a cycle, and where we are, is kind of stuck interbank, but it's not QE, right? The Fed balance sheet is growing because banks are borrowing funds, via pledging collateral back to these facilities. And again, as I said, it's extremely unlikely in this phase of the economic cycle, that this quote, money ends up anywhere, but replacing the lost deposits, right? And in that case, it will end up back in the RRP, or in a money market fund or in bills, right? It's not being lent back out, or transmitted into the real economy through credit creation. People are taking on risk, they're tightening lending standards as they have to shrink their balance sheet right in this type of environment. So there's no impulsive net liquidity injection, there's no meaningful stimulative impact.

You know, the big banks, they don't want these assets sitting on their books. You know, there's obvious political dynamics at play now. We just actually, during the Fed meeting, as we were watching this before, you know, we recorded, you know, there was a headline snuck in there, you know, actually from Janet Yellen, which, you know, I think, really caught the market flat footed on top of some of the Powell commentary that was, you know, relatively dismissive of the bank's issue for now. And Janet Yellen said, we're not considering broad increase in deposit insurance. That's because it would require an act of Congress to do that. And due to the bipartisanship, that is currently running at full tilt, as you know, most, most folks are aware. That's dead on arrival, it's not going to happen. So at some point, if you do see the big folks have to step up and buy some of these assets, they're going to have a lot of leverage, because at that point even if there is political pushback, and, you know, from the Elizabeth Warren's of the world. The fact is, you don't have a lot of other options at that point. So it's just all of this is, is negative for sentiment, it's negative for any of this money or liquidity to move back into kind of growth positive, economically constructive, you know, lending and credit creation. it almost reminds me to a certain extent of what we used to say kind of about China, and that after that post massive growth era, in the early 2000s like at some point, you're pushing on a string, and in this type of economic environment, where it's this most anticipated recession ever, and we've been all been waiting and waiting and waiting, and the economy just stays. So coiled, labor stays so coiled, services inflation staying so robust. You know wages sticking near near highs. There are all these positives. There's all these supportive catalysts out there, but at the same time, sentiment is so fickle.

And when a lot of these, you know, loans, and a lot of this lending has been concentrated into these key growth drivers for the past 10 years, that really look a lot like, you know, kind of a long bonds position. Again, we keep focusing on commercial real estate, but like, look what office REITs have been doing, they've been making, you know, kind of pre-crisis lows. I'm talking great financial crisis lows during this whole period, because this is going to be a massive dead weight on bank balance sheets and that is a lot to overcome. In light of this still relatively buoyant economy. Once you start losing jobs, once corporate margins start getting hit and they start laying people off. The whole story you know, really unravels and the consumer cracks. And then you know, there's just a massive disinflationary impulse, which is why the market is, you know, keeps conflicting with kind of the Fed's dots message, you know, when you're looking at futures curves that they're telling a very different story, because once you do eventually have to cut here, you're going to have to cut large and cut pretty fast.

Erik: Let's move on to the monetary policy implications of this banking crisis or formative banking crisis. Seems to me, we finally reached the point where the Fed is damned if they do damned if they don't. If they were to really try to fight inflation as much as they want to, they would probably be hiking rates more than the 25 basis points we got on Wednesday afternoon. But if they went more, they would probably exacerbate the banking crisis. So it seems like they can't do any of the policy objectives that they want to do because they're stuck in this damned if you do, damned if you don't. Is that going to get worse and if so, are we at the beginning of a process where the Fed loses control over the markets or is it not that bad?

Charlie: Well, the damned if you do damned if you don't observation is bang on. I mean that's clearly where there's going to have to be a trade off. And I think the market does feel that simply just buying time, as the economy slows and you do begin to tilt closer to that earnings recession environment, that there are some positives there that would allow the Fed to take the foot off the gas the tightening, and that's why, really, at this point, the Fed just tipped their hat to say, we probably got one more hike at best, and then we're done. The trick is that the market wants cuts and wants cuts fast, and what's it going to take to get cuts? You're going to have to see either, labor turn and crater fast, right? You know, a quick string of some negative nonfarm payrolls that confirm that all of that lag and variable tightening from last year has caught up to us. The problem is, that's going to happen and at the same time, as a function of margins really being crunched, and from corporate America, and that's when you get the earnings recession. So it doesn't, it doesn't feel very good, obviously, the Fed will tell you, they're not super concerned about equities, per se. The thing that we have to watch is credit. And, when you start seeing this type of environment where, bank spreads are widening now, because of all of the dynamics that we spoke about with regards to these structural impediments to profitability, as well as idiosyncratic like, this very foggy interpretation of 81 Cocoa bonds with the Credit Suisse stuff, but it all leads into a dynamic where the cost of money, the cost of funding is going higher. And that clogs up the mechanism that really drives this economy. And only when that happens, you kind of have to sit here and wait for bad stuff to happen before you can take action in this environment, because as it currently stands, there is still this inflation backdrop, and there still is this very robust full employment backdrop that is almost too strong for the Fed.

So you're sitting here waiting for bad things to happen. And, that's why I like to say, you know, markets, we've just been running to standstill for a while. It's a race against time, the Fed is buying time, right now at this point and hoping that inflation solves for itself in the next kind of three months. At that point, we start losing jobs, and it's a lot easier for the Fed to begin needing to cut. But the one point I'll make about cuts, is that the way that this cycle went, jumping from 25s into 50s into 75s. There still is a lot of thought that if we hit the fan, or hiking that much that then it needs to cut on the way coming out because it was such a violent cycle. And I think that's going to be the real challenge here is that, they're not going to be cutting 25 bps if we run into the brick wall and start seeing negative nonfarm payrolls.

Erik: It seems to me that the material change here is that the Fed is no longer able to fight inflation as hard as they might have liked to previously. In other words, before if they thought they needed to fight inflation hard, they just raise more. Now they figured out if they raise more, they're going to break something else. So how do we translate that to a trade opportunity? Is it long gold because they can't raise rates to fight inflation? So gold is going to benefit or is it something else? What do we do to make money on this?

Charlie: Well, you've definitely been seeing, you know, once the bank stuff really accelerated in the past two weeks. People started looking for stuff that has beta to, you know, a dovish tilt as beta to lower treasury yields. And, one of the clearest expressions was gold, and one of the clearest expressions was to a certain extent, Bitcoin. We saw upside buyers, and these things upside optionality buyers and these things, just under the under the belief that you kind of win in either direction, but particularly if the Fed has to slam the brakes on their tightening and start to ease. There's that kind of speculative dynamic there more so in the Bitcoin sign that really benefits. At the same time gold gives you a little bit more risk off flight to quality, flight to safety type of a trade. I think the bigger story of the past two weeks really has just been a super clear kind of cross asset recession escalation. You had this blast The US Treasury curveball steepening. That's always... we talked about that man five years ago, I think on some old podcasts, right? That's always the true recession signal. It's the steepening, as front end, as those massive shorts at the front end and STIRs market got stopped out. As we went from hikes, turning into sooner cuts. Crude oil got wrecked, crude oil was kind of down 15% month-to-date something like that. And then equities thematically, it was clear as day to! Just a massive down shift. Whereas a lot of the year-to-date rally kind of prior to March had been in all those very crowded shorts from last year. There was the unprofitable tech stuff that was getting wrecked appropriately, because of the hiking cycle. Well, that was everybody's Alpha last year. So they were crowded shorts. Everybody had to start unwinding their shorts that we ripped in January out of the gates. And there was that belief that we were approaching disinflation.

Well now, in the last two weeks, there's just been a walloping impulse, that is very much kind of like a safety, safety kind of slowdown type of a trade where cyclical-value right. The stuff that's geared to a hot economy or leverage factor, which are kind of high default probability types of companies, leveraged balance sheets, that stuff down kind of 8 to 10% month-to-date as market neutral strategies. But what is working is low risk factor right? You know kind of classic, like long defensive, short high-beta. And then, just sector wise, it's been this kind of duration barbell, I like to say. It's almost like, it looks a lot like the QE era of the 20 teens, right? From the easy money period there were, you know, you hide in the liquidity and high cash flow of mega cap tech is your high beta, but then you pair it with defensives and bond proxies as your low beta durations exposure. And that's all against a short or an underweight in those very growth sensitive cyclicals as the economic cycle turns the page now there is a higher probability of a hard landing and that's, on a month-to-date basis, that's almost exactly what we're looking at from like S&P sector performance where the top five sectors are comm services, Infotech, Staples, Utils, and Healthcare. I mean, that's pure secular growth as your you know, the one side of your barbell and pure defensives is the other side. And the bottom five of the bottom six sectors are all cyclicals, it's industrials, energy, materials, financials and all that good stuff that's going to run into a wall as we hit the hard landing.

And so the market has already identified those trades. And it's this kind of flight to quality, up in quality type of a trade and out of stuff that needs, that has financing needs. Like I said, the leverage balance sheet and all those things that are really going to hit a tough patch here when, with the stuff that the Fed cares about, which is, do the credit markets remain open. Do high yield issuance come to a dead stop. That's typically the pain point for them, whether it's on spread, or if that's actually like an issuance dynamic, where we started seeing a week straight of no high yield bond deals getting done and things like that. That's really what they care about, because that tells you that the economy is going to stop working.

Erik: Charlie, I'm glad you brought up that podcast we did a few years ago talking about how to trade going into a recession cycle and the steepener and so forth. I just want to let our listeners know, that is probably just as relevant today as the day it was recorded several years ago. Just put Charlie's name in the search box at macrovoices.com. Look for an interview titled Charlie McElligott, fear the steepener. It was a great interview, I remember it. Well Charlie, let's move on or actually come back to the banking crisis before the bank situation blew up, there had been a turn up in the VIX, which is the broader stock market volatility index, but it's not at all specific to banking. You guys look at a lot of these internals. And you know how these things really work. Was the VIX smelling out what was coming in the banking crisis or was that unrelated?

Charlie: Well, there's a chicken or the egg dynamic here. Right. So I think that a lot of folks saw that the way VIX acted last year and this has been a talking point for effectively a full year now. You know, where it was this crash list sell off. I think we discussed that maybe the last time we spoke. This idea that in that post-everything duration era where anything that worked for over 10 years looked like a long bond. You know, secular growth tech FAANG, unprofitable tech, venture cap, private equity, commercial real estate, a lot of stuff that…When you finally had this inflation overshoot in this violent tightening cycle, that stuff is going to go wrong way. Well, that's exactly what happened and, the fact of the matter was, it was this is a Neon Swan. We knew that was the scenario that was going to take so you just had this grinding deleveraging out of exposure last year out of all those legacy trades and what that meant, or there's so many questions like, look at the look at the market every day... You know, it just grinds lower, it doesn't gap down, it doesn't crash, but what's the deal? That was the problem, right? You didn't have exposure on so you didn't need to grab into kind of new downside protection into new crash. Your net exposures were single digit historicals on 5 or 10 year basis, right. So like barely any length on if not short, and you had all time high cash. So you didn't really need downside edge. That's why skew, that relative kind of measure of demand for a put versus a call was like zero percentile for large parts of last year, put skew more, which is kind of a measure of really kind of wingy downside versus something that's closer to at the money was also zero percentile just because you didn't have the exposure on, you didn't need to hedge anything that might pay away even more performance. If anything cash was your hedge right? Cash is an at the money put. The only demand for crash was for crash up because you didn't have exposure on you're scared to death of missing a rally, missing a dovish Fed meeting, missing that big first CPI miss. Missing that big first NFP, right? You didn't really get those. But we saw that in the back part of last year. I think November and October, the average S&P up day was 2x that of the average S&P down day, right? We saw at various times, spot up, fall up right as the market went up, vol went up because people were kind of grabbing into upside. Well, we turned into this year, and people started adding back exposure in January. So you saw skew begin to turn. You saw actually need for hedges again.

But the real big thing that mattered. And this is that idea of the chicken or the egg is that, we knew the market sense the market got the joke that the lag and variable tightening, there was going to be a come to Jesus moment and we saw signs of opaque parts of credit starting to starting to get squirrely. You saw financial conditions get pretty tight and you started seeing these problems begin to appear ie like what's happened with banks last few weeks. And there has been for the last kind of two months, some really kind of pervasive, consistent upside buying in VIX. And the thing that was important about that upside buying is that VIX isn't the same kind of market that it was a few years ago prior to March of 2020. Prior to volmageddon in February of 2018. It's skinny, and to a certain extent it can be cornered. And it was the first real kind of short convexity or negative convexity or negative gamma problem that you've seen in VIX for a few years from a dealer positioning perspective and that contend to sell fulfill. In this case, knowing that we were closer to an accident, as accidents were increasingly occurring. You know, it put us closer to some of these dynamics realizing and that short convexity catching dealers in a spot where kind of the higher vol went, the more they needed to buy to stay hedged. And we finally got that over the past two weeks where you finally got this big vol outperformance versus spot after the prior year where you basically hit one percentile, I think looking back 20 years on vol underperformance versus spot so you're actually in a more normalized state of kind of the traditional VIX relationship and, and that, frankly has been healthy and much needed. You know, for what it's worth, as of the day of recording this. There was a lot of that VIX upside that expired. And that was part of the big rally that we saw on the 21st going in as a lot of these were sliding away from those call strikes. And that actually forced dealers to sell Vega and buy Delta. That was part of the rally up into this and then you got this kind of lackluster, not quite dovish Fed plus you got the Janet Yellen comments with regards to deposit guarantees and here we are people started buying that upside again, further out in the months ahead. So VIX is going to stay tense. And that means, bigger market moves, which you know I'm here for.

Erik: Speaking of volatility, let's move on to the subject that was the subject of a lot of conversations before the banking crisis took over the headlines, which was zero day to expiration options. Now, Charlie, as you know, since there's been options, every option has a last day of trading where it has only one day left. But we've actually suddenly reached a point. And it used to be nobody traded them on the last day, you know, it was like, nobody goes and tries to cash in their life insurance, you know, one day before it would expire otherwise, but all of a sudden, they're being traded. So actively, that exchanges are actually listing more option contracts in order to make sure there'll be more zero day to expiration options every single day of the week, there's some option that's expiring today that you can trade. And this is not crazy, Wall Street silver Guys Gone Wild. This is institutional risk managers that are using one day options to hedge real institutional risk. What's going on here? Why are people doing this in the first place and what effect is it having on market volatility?

Charlie: I think the first blush was that as we finally mid last year, tilted towards actually having an expiration every day, for the first time. And these products were kind of created from the exchange, there was this initial field, and okay, these are lottery tickets. And it's kind of, it's very similar to what we saw with the meme stock, Wall Street Bets stuff back in 2021, where they were means of creating gamma squeezes. They were, again, cheap ways to play for big outcomes, big moves, and you can help kind of bully the market in either direction. You know, what was interesting about our analysis is these have grown into clearly now, not a retail tool, even though yes, very popular with retail, I mean over one out of every two SPY options on a daily basis is now zero DTE option. But it's also a big S&P contract dynamic. You know, it's like 49% is kind of like the high day and this is generally speaking, it's like, basically one out of two there also. There's a couple of different ways we look at this. So one of the things that our work has done was to identify this idea that, what is the usage of these things, right? It just talking about volume, just talking about increased open interest doesn't tell you anything, you need to know if these are calls bought, or calls sold, or puts bought or put sold. And what we did then was that when you talk about the exchange itself, the CBOE tags, that kind of for end user types, there's like broker dealer, there's broker-dealer pot prop, which is somewhat antiquated, I think, from a different era of obviously Prop. There is customer and then there's market maker. So you can separate out the kind of net end users. In the case of what we were trying to do, which is identify how are people using is we want to isolate customers. On the other side, what was very clear was that it was market makers and I differentiate market makers from broker dealers, is because by and large, this is a pure product of electronic options market makers. And I think, folks at home can kind of determine that that is not really a banks thing. That's the electronic market makers, a lot of these big securities firms that used to be into the high frequency trading game, frankly. And those folks are basically on a kind of a day by day basis. They're basically selling gamma, right? They're either short straddle or short a strangle when we look at the moneyness buckets of all the options that trade on a day.

But if you look at kind of in that, generally speaking, out of the money upside, so like 101% to 103% calls, or you look in the out of the money, you know, put stuff like 97 to 99% puts. Customers are net buyers. What we do is we run an imbalance, we look at the time and sales to create kind of a buy pressure analysis. If something trades below the midpoint, it was somebody hitting a bid, right? It was a seller, the trades above it was somebody lifting an offer. And what we see almost on an everyday basis, there have been a handful of days where it hasn't been this definitive, but generally speaking, customers are buying these options. And that's customers that's generally speaking, this is kind of like institutional plus, smaller amount of retail and they're trying to create gamma squeezes. Also, though, at the same time, look at the nature of all risk in the past year. It's been one day phenomenon. It's been, this week's CPI, this month CPI print, this month NFP, this month FOMC, this month is Humphrey Hawkins or Jackson Hole or ECB meeting, etc. You want hedge products that are going to be very sensitive to, just as sensitive as kind of the risk that you're trying to protect. And honestly one of the big lessons of last year was no longer dated options didn't pay, they didn't protect, they didn't, you know, tail hedge, you know, that was puts and that was long puts, that was long gamma that just didn't work. So you want something that's really convex and can do the job for that day of risk. So these things are used to hedge as well.

I would say that even though it's this very clear delineation of market makers or sellers. By the way, running short a straddle, short strangle on a daily basis is a great Sharpe ratio, like there's a reason they want to do this, and they're taking their pound of flesh. You know on the trade, the vast majority of these things are going to expire worthless. But the fact of the matter is, generally speaking, customers are buyers of these things, and they try to push the market around, there are days without a doubt, where I'm quite convinced that, some funds are going to be willing to sell out of the money tails on a down move, sell and out of the money put on a down move, because there's a regulatory arbitrage in these things where they're gone by the end of the day, right? So you don't need to post collateral with your prime broker, they're not on your book, right? So you can kind of do that, and generate a credit to go buy an out of the money call. And that way, you get some like free convexity. Those are attractive trades for people. But by and large, it's very clear cut. And the reason I'm bringing all this up is that, regulators are calling and asking, like, what's the deal with these things? Well, I'm actually very comfortable with this kind of framework. Because one, they mean revert, right? You buy, you create this gamma squeeze, but guess what, you have to monetize that if it comes in your favor, right? So you're kind of taking it off. And that's a little bit of what we saw, you actually saw higher intraday movement as the gamma was hedge. But on a close to close all basis, you actually compress, you actually compress volatility, because you're not, you're not kind of exploding out of a range most days.

So I want the risk held by people who are short the gamma, I want the risk held by the practitioners that have risk management that have large balance sheets. I don't want to see customers randomly, without thinking shorting tails for yield, that's the pennies in front of a steamroller trade where I can't trust how they're going to respond, when you do get that big headline, or you do get that big shock print that creates a real inconsistency. So I'm okay with this current market structure and the way they're currently being used. It does not mean that it's always going to be, it's always going to be this kind of tidy. But right now, it actually is where it's an accelerant flow intraday, but because these are very convex instruments with a lifespan of six and a half hours max. But by the end of the day, generally speaking, these things are either going to mean revert because you got to monetize them and take them off, or they're going to expire worthless.

Erik: Charlie, the group that you lead at Nomura is semi-famous for the work that you do on modeling. What trend following CTAs are going to do next essentially. Your daily note actually gives institutional traders a list of levels basically saying, you know, if the S&P gets here, that's where the CTAs are going to start buying or selling and so forth. And that's been very popular with institutional traders. It seems to me like I don't know what's going on but it's it feels to me like the Gods of markets have stopped being nice to trend followers. It seems like these guys just keep getting whipsawed out of their trend trades. Is there some underlying technical reason? Is it something to do with dealer gamma? What is driving this and why is it that all of a sudden the CTA and it's usually a very reliable strategy? Seems like they get nailed lately.

Charlie: It's a great thought look, the last year was a generational tail environment. CTA trend is a phenomenal tail hedge. The back test proves it. It's because it can be kind of short, the kind of traditional bond stock, bond is your hedge correlation. That’s what happened last year. That's why 60/40 got crunched. That's why risk parity type of exposure gotten crunched. In this case, the ability to be short assets and long dollar. Alright, long cash was the only trade that worked last year and it worked all year. It was the most definitively clear trend trade that I've probably seen in my career. And what that meant, this remarkable environment for CTA is where they finished the year kind of up somewhere in the mid 30% range. Right and the thing was, too as fundamental investors were kind of stopped out of the market last year, it further empowered and activated and amplified the flows of CTA trend into the feedback loop which was just kind of like long dollar short assets. Well, the problem was, the cycle began to turn. The end of tightening was pulled forward as we thought that there was going to be this disinflationary trade and to start the year, and because the Fed said so, right I mean Jerome Powell and his 21 mentions of disinflation, I think in January Fed, when you started seeing the data softened a little bit, and all of a sudden, everybody was really into this short dollar, anti-dollar, long rest of world trade. It worked magnificently. And in January, part of that was kind of China reopen. Obviously, part of that was Europe not going into a hard landing because the energy crisis, and the kind of, quote 100 Delta certainty of a hard landing there didn't materialize because of the Ukraine-Russia war state contained. People got their gas stockpiles up and had a really mild winter. Well, then Europe was much less bad than feared. Europe is leveraged to China's economy, through luxury and things like that. So there was this symbiotic feedback loop into all of these kinds of reversals of last year's trends. And that's brutal for CTA, right? They want clear runway and every other month this year, and you know, in the case of some every other week, you've had this incredible chop. This incredible theme chop obviously what happened January got reversed in February, because of that less bad than feared dynamic saw growth surprised to the upside, and that reinstituted got everybody worried about higher terminal rates and fed accelerating hiking, when part of the assumption coming into the year that was so wrong, was an H1, the first half of the year, you're going to get this imminent recession. In H2, you're gonna get the slowdown and the Fed was going to be begin easing.

Part of that was then this view that you are going to get one or two more hikes, pause and cut. Well, my big note in January was like, the worst, the biggest mispricing in the market was saying well what if that's not the case? What if prematurely easing from the Fed meant that financial conditions loosened, and the economy was able to re-accelerate and that's exactly what happened in January as per the January data release in February, we got that huge rates move. That huge FCI tightening. We added like 100 bps of terminal rate. And guess what that meant, that meant that financial conditions tightened all of a sudden, and you reverse the trend, again, and it was this potential headwind for data, but then you add on the legacy lagged variable impacts of last year's tightening you started having these accidents. Well, that's been the story of March, you reverse the other direction, big FCI easing, in light of the banks and people now ending the tightening cycle and pricing and cuts. And here we are CTAs have been absolutely chopped up and you saw it in these double digit standard deviation shock moves and these legacy front end shorts, that both for macro pods. And trend followers are by far the largest driver of alpha, hence the largest trade on their books for the past year period. And, you just went from this banking crisis escalation, VaR shock and crowded rate shorts, and then a full reset of global central bank monetary policy paths from what was just a few weeks ago, Jerome Powell buying back his 50 bps hike option to now suddenly implied cuts, so they just got ripped. And what it did was that anything trend momentum, and any strategy running short gamma, just got torched. You just had two-way overshoot price action. And, I mean, think about the Fed today is lower volatility likes compressed distribution of outcomes. Think about into the Fed today, there was delta on a hike, a pause, and even a cut. So, all of that very kind of wide path that developed into today was big part of that rate vol explosion. Was a big part two of this big stop out in the most crowded, most profitable trade of the past year. And it's been a disaster for CTAs and systematic trend followers as well as macro funds these past two weeks, just some acute losses. And you've seen it with liquidity, and you've seen it with the market trading, wildly overshooting in both directions.

Erik: Charlie, I can't thank you enough for a terrific interview today. But before I let you go, I want to talk about the daily letter that you publish for institutional investors. First, I'm just going to break the bad news to our retail audience. Unfortunately, Charlie's hands are tied. Don't hate Charlie. He's a good guy. His compliance department is not nearly as nice as he is. And they don't let him do what he wants to do. So unfortunately, if you're a retail trader, you cannot get Charlie's letter but for our institutional audience, people who do have worked for an organization that has an institutional relationship with Nomura. Your letter is just incredibly popular, a lot of people are really excited about it. So please tell us both what listeners need to do in order to get your letter if they already have an institutional relationship with Nomura, which they would need in order to get it, and what they can expect to find in it when they subscribe.

Charlie: Well I appreciate the opportunity to discuss it my friend. Look, we're in the content game and resourcing and payment for content is, you know, the ugly truth here. It is thought to be pretty valuable in the fact that it has a top-down view. But it is tactical, it does hit on some of the more opaque parts of the market, with positioning and systematic flows and crowded narratives and how things kind of go wrong, being my overall framework, looking for asymmetries, and I do think it provides a valuable, kind of blind spot filler for a lot of folks. Look, if you are an institutional client of the firm, obviously make contact with your salesperson, there is a revenue threshold to make sure that the content is not diluted. We can't give it away for free but you know, that's why you're a client and we appreciate the opportunity to add value.

Erik: Well for people who are qualified, I very highly recommend it. You've got some terrific content there and it is every single day. It's one of the most interesting reads that comes across my desk. So Charlie, I look forward to seeing you again soon. We'll get you back for another update in a few months. Patrick Ceresna, Nick Galarnyk, and I will be back as MacroVoices continues right here at macrovoices.com