Charlie McElligott: Fear the Steepener
January 15th 2019

Erik: Joining me next on the program is Charlie McElligott, the man who both called the Christmas massacre event and was very outspoken in telling people that his CTA model was expecting a dramatic increase in the pace of selling if certain levels were hit, which they were. And, then right afterwards, called for there to be a relief rally, which is exactly what's happened.

So, Charlie, congratulations. You are knocking it out of the park with the calls you've been making lately.

I want to start with China, because that's what's on everybody's mind with the trade talks and so forth. Give us an update.

And also, we do have a chart deck from you. Listeners, you'll find the download link in your Research Roundup email – or next to Charlie's picture on our home page if you're not yet registered.

Why don't we jump into your chart book and talk about China? What is driving the situation, and how China is going to play into market action as this whole trade talk thing gets resolved in the next several weeks or months?

Charlie: I appreciate the opportunity to be on again and speak with you. I had a great time last time. And it expanded some of the folks that I interact with. So thank you for that.

I think, as we look to base this conversation out of the impulse that's originating out of China, and, last time we spoke, we did touch on that idea of the Chinese credit impulse – that credit impulse, of course, with regards to the government's forcing, pushing on a string of credit out through social financing, through new loan growth, through efforts to stimulate money supply, that has been the "past is prologue" playbook for Chinese responses to liquidity tightening in economic slowdown.

I think what the update is since maybe we last spoke, with regards to the continued degradation of the Chinese economy, has been twofold frankly.

You're dealing with a situation where policies have been very focused on preventing financial crisis and a credit freeze. Other policies, they're trying to support growth, but not enough to offset some of the negatives that are developing.

And it's both domestic demand issue and, from the folks that we have boots on the ground economic contact with there, I don't think a lot of folks in the West understand the incredible cynicism, skepticism, pessimism view from the ground within China.

I think that, also, risk markets, global markets, have been anticipating a more holistic BOOM-POW response from Chinese authorities, from the policy setters, from the PBOC, from the Ministry of Finance, more than what the Chinese authorities are able to provide – meaning there is no short-term QE solution, rate-cut solution that would give the market what it wants. Instead it's been these very piecemeal attempts.

I think we've had now four triple-R cuts since last January. We've had a number of value-added tax cuts and corporate income tax cuts.

The fact of the matter is – and certainly mandating putting more pressure on local authorities and banks to stimulate that loan growth, that credit impulse – they are now in a really tricky part of their process right now. And I think, generally speaking, it was consensus.

Folks understood that when you pile on the trade war and the impact that the tariffs are having on Chinese trade that you're in a situation where, because of the tariffs implementation, there was this potential relief by pulling forward much of the ordering from clients of Chinese counterpart corporations.

And you did see that to a certain extent – very limited extent – in some of the Q4 monthly data that's coming out.

I think what's happened in the last couple of days is that – you actually saw in the Chinese trade data yesterday export growth was down 4.4% year over year, which is a negative read on industrial production and employment on GDP.

And then import growth was down 7.6% year over year, which also speaks to this further domestic demand slowdown. It's highlighting that we've already hit the end of that tariff frontloading effect.

So you're really now dealing in the market – and we're going to talk on this very tactical, very positioning-driven risk rally that I've been making the case for since mid-December. But I think now you're at that point in the market where there is a lot of discomfort in owning this rally, because you are seeing this negative global growth impulse out of China really get picked up in the global data.

And our in-house view – Ting Lu, our Chinese economist, has been way more aggressively negative than the rest of the market and continues to be – is that it's only going to get worse in Q1 and Q2, especially now that that tariff frontloading effect is gone.

And I think we print the absolute lows in Q1 into Q2 2019, which then forces – as I referenced earlier, that escalation of Chinese stimulus responses of Chinese easing – that you can then begin to see some of the lagging impact of the fiscal stimulus of the easing to actually then start to see the global economic relief begin to register.

Erik: Now I want to ask a qualifying question. When you say that it gets worse into Q1, I'm assuming we're talking about the Chinese economic data getting worse. But I could imagine that translating to more accommodative policy. And, potentially, US markets could be rallying as the US Fed gets a little more accommodative because of what they're afraid of.

So are we necessarily expecting global markets to be worse? Or do you just mean the Chinese economic data gets worse in Q1?

Charlie: It's the right question to ask. It's a critical clarification. We're absolutely speaking with the Chinese economic data which, in turn, is having this dragging effect globally.

We saw the German GDP print yesterday confirm the slowdown fears. It's, of course, a known thing, right? Germany is the world's third largest exporter, the largest economy in Europe. It's very much representative of the flu that has originated out of China.

I think what this next wave is, with regards to that Q1–Q2 behavior in China, is that you're now going to see a situation where, instead of this growth deterioration or growth deceleration, it's now going to become – which has been due to this deleveraging campaign that began two years ago, so it's self-inflicted – you're now going to see the credit crunch in H1.

That's really where I think you're going to start seeing the narrowing impact and the smaller response that their economy is getting from these various piecemeal stimulus and easing efforts. They're smaller, they're more narrow, they're less effective than past policy stimulus.

Now you're going to see the payback for the frontloading of exports. You're going to see probably now the property market corrections, certainly in the lower-tier cities, is our house view. And probably more defaults and widening of credit spreads in China.

That, ultimately – which you are highlighting specifically here Erik – that is things getting worse to force that much more aggressive policy response from Chinese authorities that ultimately puts us back on track for a global economic pivot off of these H1 2019 lows is what we are anticipating.

Erik*:* Charlie, let's move on now to the bigger picture of where we are in the market. You've talked a lot about being late cycle and you've described a lot of things just impeccably well.

The way I assimilate all of this is it feels to me like the top is probably in for this equity market and we're into a bear market. The first wave is over and we're into that first significant bear market rally.

First question: Is that view consistent with your view? And, of course, the much bigger question is: If it is, how much further does that bear market rally have to go before it's done? When do you start to look at changing direction?

And something I've noticed that you are exceptionally good at is lining up the dominoes of what are the events that need to happen in order for the market to get to a certain resolution. So how do you see this whole thing unfolding? And how am I doing in terms of the view that I've assimilated from some of the things you've said in the past?

Charlie: When I was on the last time, I was really speaking to my two-speed year thesis for 2018, and specifically highlighting that we have transitioned into this new macro regime from quantitative easing to quantitative tightening and the impact that QT was going to have on financial conditions tightening from there.

Financial conditions tightening bleeds into the real economy. The behavior that we began to see and were highlighting on our last visit – specifically within the housing sector, the automobile sector, regional banks, super-cyclicals like semiconductors, chemicals, all of that price action that truly went remarkably recessionary.

If you look at the Q4, certainly the December price action, markets – and this time, may I add, it was equity markets, not fixed income, that priced in this growth scare and priced in ahead of other markets. Oftentimes, people take knocks on equities for being more the confirming agent instead of the leader.

Equities were way ahead on this overall downshift message. And my whole message has been that we are pushing into the end of the cycle and we've tightened ourselves into a slowdown. And that tightening ourselves into a slowdown was the key delta, as far as the market behavior in Q4 as well.

There was a period in Q3 (let's say September) where we made again new local highs – S&P high, right? And people thought we'd escaped the equity volatility regime shift that we experienced after the vol event in February of last year – but that wasn't the case.

And part of that thesis where I had a big October financial conditions tightening tantrum call, was that October was going to see a significant month of balance sheet inflection – meaning two very large Fed SOMA runoffs, so the SOMA account, the securities account at the Fed where there was going to be maturation of large notional US Treasuries and maturation of large notional mortgage-backed securities.

And George Goncalves, our rate strategist, was almost seven months ahead of anybody else in the Street when we worked with him on this. As far as highlighting last July, the quantitative fact that is large balance sheet runoffs within the Fed, particularly in mortgage-backed securities, you see a corresponding move lower in risk assets and, in particular, S&P.

So with that in mind, the fact that we had these two massive runoff days – we group these on a weekly basis – in October the Fed's balance sheet corresponded with the ECB's own tapering from $30 billion of purchases down to $15 billion of purchases.

At the same time, the Bank of Japan was conducting stealth tapering of their own bond-buying operations.

You ended up having this very volatile October trade momentum unwind across the equities long/short market neutral space cause huge performance decay. What we did – and I digress, going back to the original point – we transitioned from that early September idea that we were growing faster than we were tightening to this glass-half-empty view that we had tightened ourselves into a slowdown.

That match was lit by Jerome Powell on October 3 with his now infamous misstatement with regards to the far from neutral commentary which implied to the market that the Fed was setting us on a course for Fed policy error and that we were indeed going to tighten until something broke.

What has since transpired, of course, is a reversal. And that's the way that markets work in this day and age. The reaction function, unfortunately for the Fed, is kind of the market tail wagging the dog. So instead of Fed policy dictating asset behavior, markets now dictate Fed policy behavior.

So, as we in December hit the peak panic button – and a lot of that was due to year-end timing, a lot of that was due to multi-year highs in gross notional exposure within the leveraged hedge fund community needing to be unwound over the course of 2018 – you saw such terrible performance.

You saw such leverage removal precipitously in Q4 that we have just got that final purge of positioning. It was really just a value at risk (VAR) or a risk management event, that final impulse.

When markets got that bad, however, it forced the policy makers – specifically within the Fed as well as this also happening within China at the same time – it forced them to take more action.

So those were two critical sequences that needed to shift us into this kind of current stance which is this much more sympathetic, much more constructive kind of qualitative macro backdrop.

And the third was that, knowing that there were going to be these ongoing US/China trade negotiating talks, in a 90-day window – which actually wasn't 90 days, it was actually more like 60 days plus a week. That actually made us realize that there was going to be increased likelihood of positive leakage because both Presidents Trump and Xi needed market relief for their own purposes.

And that has allowed this very slashed positioning, slashed exposure, max short CTA behavior. As, certainly, the long-equities trade lost momentum and pivoted max short, we've seen an environment where with risk parity funds – our internal models have shown them positioning for a slow growth slow inflation backdrop which is adding massive fixed income, adding to their gold position, cutting equities, cutting credit, cutting risk commodities as well.

And you've effectively had this backdrop where people have purged their risk exposure right into the policy inflection. And that's more or less without getting into the systematic flows, what's set the table for where we are now at this current risk rally.

Erik: Now, let me make sure I'm not missing something. Because what I'm hearing is you've got the Fed threatening at one point last fall to tighten, tighten, tighten until something breaks. And people are panicking, and you've got these big Fed balance sheet roll-offs that are equivalent to a hike in many respects – and a lot of people have proven the numbers behind that.

Now what we seem to have is the Fed has blinked and it's saying, okay, the market is no longer pricing lots of hikes in 2019. We're down to either no hikes or, even, some people are talking about cuts. Everybody is breathing this huge sigh of relief. Okay it's better now.

Well, wait a minute. The Fed still has a whole bunch of balance sheet roll-offs in 2019. And Powell has been pretty darned adamant in saying that they're sticking with that.

So am I missing something? Or they're really, effectively, stealth hikes in the form of balance sheet roll-offs that maybe the market hasn't fully priced in yet?

Charlie: QT is unequivocally a financial conditions tightener. It saps dollar liquidity. And shrinking, contracting dollar liquidity is the reason that we've had rolling volatility events for the last year plus.

So, yes, unequivocally the balance sheet tightening, the balance sheet runoff is an ongoing negative risk asset impulse. It's an ongoing financial conditions tightener.

What the Fed did, from a very forward-guidance central-bank-speak perspective – think about Mario Draghi and "whatever it takes," that commentary – singlehandedly turned for a multiyear period the European crisis on its head without spending one penny of euros on their emergency bond-buying program.

In this sense, the Fed hasn't just capitulated with this code-speak for patience, which is equivalent to the Fed pause thesis – I think last summer when I was bringing up the concept of a Fed pause, 90% of the fixed income world was laughing at me saying no way, this thing is preset, autopilot, lights out. And my point was that the markets wouldn't allow it to get to that point because the impact was too massive. The perceived impact was too massive.

What they also did too was open up the possibility of decreasing or outright cessation of the balance sheet unwind over the last week and a half since this most recent Fed meeting. And what that has done has thrown a lifeline to folks that are concerned about this.

That said, you've got it exactly right. In the meantime, it's still going on at the same clip.

And that is part of my longer-term structural thesis why, if you are an investor, if you are an owner, and you are looking at this end of cycle trade – and remember, the catalyst for a US slowdown at a minimum, or a recession – whether it's late 2019, if you're on the bearish side, or a 2020 story, which I think would put you in the consensus – these are very much tangible and, frankly, accelerating.

So you have a still ongoing and lagging negative impact of Fed tightening.

So real yields, yes, have come off significantly. But they remain at multi-year highs while inflation expectations and break-evens have dropped to multi-year lows.

You have the fading US fiscal stimulus. The tax cut impact continues to diminish and half-life.

You have the dragging wealth effect of what happened last year with all assets in investor portfolios and people's retirement accounts and things that make them feel like they have paper wealth. At the end of the day, we have to acknowledge what a large part of quantitative easing was, and that was to create a wealth effect. That was to create a sense of wealth that will help stimulate discretionary spending. And that just took a wallop to the face.

And then I think the final reality, which is incredibly cyclical of course, is the corporate de-leveraging which inherently means lower CAPEX.

I referenced a bunch of times – I think it came out in late November or early December but, either way, the Fuqua school, the business school down in Fuqua, releases a corporate CFO survey on business environment expectations. And, in particular, they ask a number of questions with regards to recession, recession timing, CAPEX spending, environment, things like that.

And nearly 50% – I believe it was 48%, off the top of my head – saw recession hitting in calendar 2019. By 2020 that number went up to north of 90%.

The point being that these are the people that are – these are the C-Suite of corporate America – Fortune 500, S&P 500 type of companies – that have this late-days late-cycle view.

What are you going to do with your cash? Right? Are you going to go out and create organic growth? Or are you going to batten down the hatches? Are you going to hike compensation? Or are you going to sit tight on your cash stockpile and buyback shares?

That speaks very pessimistically. And that's a way that you can get a tracking – current tracking say 2.7% GDP – a .5 here and a .3 there and a 1% here, and all of sudden you could get to a recession and negative GDP growth type of a number in the coming quarters.

So that is very real, and I think that the market was pricing that type of environment in.

Pulling forward, understandably everybody sees the strength of the consumer, everybody sees the strength in labor markets, as per the most recent non-farm payroll, of course, with a very strong average hourly earnings print.

But I think, at the end of the day, equities markets know that the data is lagging and that the markets are real time. And that's why the Fed didn't just back away and transition to a coordinated pause message – which, again, was reiterated today from multiple Fed speakers.
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Taking a couple of quarters off, my view: June is the earliest they would possibly look at a Fed hike again.

And, frankly, the rates market continues to call that bluff, pricing in the end of the Fed cycle still to this point and almost a full cut again in 2020. That's what forced the Fed to not just go with the pause story but, I think, also the break-glass scenario, which would be then decreasing or even outright stopping the balance sheet unwind.

In the meantime, it's continuing until markets get sloppy again.

Erik: Let's bring the dollar into this discussion about the Fed balance sheet roll-off, because I think most people are kind of hugging the view that, okay, look, there's been a big run-up on the dollar, but that was to be expected. The Fed was hiking. And, of course, it's all about interest rate differentials, that's what drives everything.

Now that the Fed is pausing, then the dollar's got to go in the other direction. But from what you're saying, really, the balance sheet roll-offs are dollar-liquidity exacerbating. So are balance sheet roll-offs just as dollar-bullish as rate hikes are?

Charlie: I think in the scheme of things, at a minimum, equally important. I think the idea is this: people understand after the crisis, or into that crisis period and thereafter, how much dollar denominated that around the world, exploded – multiple trillions in the post-crisis environment.

So between that mix of rate hikes, between that mix of quantitative tightening which is pulling dollars out of the system, and then you add in a third point: not just the hikes and the quantitative tightening, but the massive uptick two years in a row of year-over-year doubling of expectations for Treasury issuance, to deficit funds.

You're just hoovering dollars that used to be there for anything in the world. Whether it was risky assets, whether it was for emerging markets credit, whether it was for industrial metals, these were all excesses of the QE regime that are now being reversed.

And look, I think part of this – and this is not something that I can quantify or point to – but I think part of the Fed's desire to talk dovishly with regards to willingness to touch, to modify, or to even halt QT, while in the background continuing on with it (as I said, it's their break-glass option), is that they know that in the case of the inevitable next recession or next crisis, that it is a very, very high likelihood that they're going to have to add to the balance sheet again.

I'm telling you right now, whether it's conversations with massive institutional investors or macro traders on the desk, they will all tell you to your face that if we do hit that panic button, and we do hit the slowdown into recession, Fed cuts alone don't mean squat to markets.

You don't care about a 25-bips cut when we've still barely gotten off the zero bound.

What matters are the purchases of assets, or the purchases of Treasuries, or the perpetual flattening of curves to ease financial conditions, or the purchases of mortgage-backed securities to help clear – which is a legacy construct of the prior crisis – but to help with that massively economic multiplier amplifier that is the housing industry in our country.

And ultimately, I think, in the next crisis we turn to look like the BOJ. And Janet Yellen has already outlined this years ago that we could in fact be buying ETFs. And I think that's just an inevitability of where we're going and that's a point for the future.

But it is clear to me that part of the reason they are so committed to maintaining this balance sheet runoff, say, over the next year to year and a half, is because they know they need to create room before they start adding again.

Erik: Charlie, I want to move on to your CTA model, which has become extremely popular with our listeners.

But, before we even get into the slides that you have, starting on Page 9 of the deck, I wonder if you could just explain the big picture of how this model works, what it predicts, and why the numbers that you use for thresholds are moving targets.

Last time we had you on, you mentioned gold, really, had a magic number around $1,245, which it was on the day that we spoke. Three or four weeks later we had people on Twitter saying, hey, we hit the number. Charlie said the magic number is $1,245. What's going to happen next?

And, of course, at that point your number in your daily note was up to $1,298 or something. Why is it a moving target? And what do we actually learn from this CTA model? How does it work?

Charlie: There's a number of proprietary signals of momentum that are everything from traditional classic technical measures as well as – because of the vol component to any sort of trend strategy, any sort of strategy that is levering onto lower realized volatility assets levering more, there is a negative convexity.

And, because of that realized volatility, are critical to sizing and scaling the long or the short position, meaning the size of the overall position within this large portfolio of 58 cross-asset futures contracts that our model replicates.

So what's important to note, and, to your point – our QIS team creates these, we have these outputs – what is important to note here is a number of things.

CTAs in general, trend models in general, are shorter-term in nature. And certainly CTAs got a ton of press last year because they got lit on fire, in all honesty. And that's the purest representation that last year was the anti-trend.

You had this huge macro regime shift. You had rolling volatility events. You had the unwind of systemic leverage accumulated over the 10-year post-crisis period in quantitative easing. And it forced a lot of positioning overshoots, positioning asymmetry as leverage blowouts bar events. You had this incredible shock, intra-day, across the days, different vibes from one day to another, from one week to another, month over month, quarter over quarter, complete reversals.

So that's why CTA models did so poorly last year. The fact of the matter remains that these are short-term in nature. And especially in a market where fundamentals tend to get pitched and people are trying to get their legs on what is the new macro regime? What is the policy backdrop? Where is growth going with this rapid deceleration in global data?

These types of strategies become that much more important in becoming the price setters. Because, one, there still is a massive amount of assets in them. And it's one of the most heavily leveraged strategies on top of that.

And with that the same confusion that I spoke to with regards to the fundamental backdrop, and where we are in the cycle, and all of these questions on policy, and all of these geopolitical issues that are still floating out notwithstanding as well, you're in a situation where the fundamental discretionary, active folks of the world are an even smaller part of the overall liquidity profile.

So the impact of these systematic strategies, whether it's a CTA trend model, or whether it's risk parity, or whether it's a target volatility variable annuity fund – all of these different strategies have an outsized impact because the liquidity deteriorates due to this tightening liquidity environment, the reduction of leverage in the environment – they're having an outsized impact.

So that's why the CTA model, I think, received so much notoriety and attention last year. And it's a really good model. This thing back-tests to the index on a three-year lookback within 50 bips of the actual index. This thing has been engineered brilliantly by our QIS team.

So with that said, you're dealing with a two-week window, you're dealing with a one-month window, a three-month window, a six-month window, and a 12-month window. And especially looking at the 2018 landscape, which was – say, within equities for instance – up 2% one day, down 1.5% the next day, down 2% the next day, and up 2.5% the next day after that – it's very important to understand which days are rolling into and rolling out of these various lookback windows across the different models.

We might touch on this later in the call, but day over day in our S&P 500 model – which per my call back in early December that we were going to see this major sell impulse when our models went almost consensually max short positioning across global equities futures – we've been sitting near this threshold to actually cover some of that short over the course of the rally over the last two weeks.

And this was a large part of my base case for this tactical rally call that I started making in December.

To capture this point with regards to the movement of the trigger levels, yesterday was still 100% max short in the S&P, and the trigger level to cover it down to just 82% short – so reduce roughly 20% of the scale of the outstanding notional short in S&P – was sitting at 2,595 in S&P futures.

So a close above that level, we would have triggered the cover. It would have been somewhere around $9.2 billion to cover. We closed right below that.

But then coming in today and rerunning the model, what happened was that you lost a particularly volatile day in the one-month window. So, basically, December 14 rolled out a sample. What that December 14 day rolling out a sample did to our trigger level was it dropped the S&P covering level down a full 50 handles to 2,545.

And that speaks to the movement. These are not static data points held constant in time. This is a daily reset based on the trailing realized volatility plus the price behavior.

And with that drop we were preordained, basically, today – ex the absence of a major risk selloff or some sort of a tape bomb and a noisy Brexit vote which people have just completely tuned out was not going to be that catalyst – we closed the day – currently S&P futures at 2,606 – nearly 60 handles above that deleveraging level. And, in fact, our S&P model estimates that there was $9.2 billion of S&P covering to reduce that short.

So that speaks to how these things are organic, how they are evolving, how they are constantly moving. And it's based off of the past performance windows across the two-week, one-month, three-month, six-month, and 12-month, as well as not just the price behavior but the realized volatility profile therein.

Because, again, these strategies need a trend. They will load more size, load more leverage onto something that is trending and creating positive P&L, which are why you get these brutal, unemotional reversals too.

That's the beauty of these strategies. They'll go from a max short, cover it to a long, and flip max long before you can blink. And that's why they are first movers. And that's why they're so important right now as far as giving me those incremental short-term directional leans that we've used to make a bunch of good calls in the last year.

Erik: Tell us a little bit more about the timing of these signals. Because when you first described it to me on your last interview, I thought that what you were saying was this is, effectively, if you see a daily close past this number that's going to cause the algorithmic trading systems the next day to start doing their buying or their selling.

But there have been a couple of occasions where in your daily note you said, okay folks, if we get to X level during the day and it goes past that, it's going to accelerate. Watch out. And you were just uncanny accurate with those calls. So, clearly, this does have an intra-day action reflex function.

How does that work? Who is making these decisions?

Charlie: That's a great point. There are two things there. We make assumptions as to how our strategy is set up to act. And that is off of a closing level. We are making assumptions based on the entirety of a universe that very well may trade intra-day let alone have different signals and different levels. Different inputs create different outputs.

So, for sure, there are certain strategies that I'm sure hit a threshold. And, BOOM, they're going long. BOOM, they're covering. BOOM, they're pressing their shorts.

I think the other component, though, that really captures what you're speaking to is the self-fulfilling nature of what these models have become. And that absence of a real fundamental view, especially – which is kind of a chicken or the egg impact of the performance environment – sees discretionary managers, active traders, fundamental folks, increasingly at the mercy of these levels.

And I am absolutely 100% certain that folks then build these levels into their psychology and into their framework. So not only are there folks that will try to front-run these levels for day trades – I know that for a fact. I talk with people that do it and they feel like it helps their cause. Just quick in- and out-of trades.

But, also, these things tend to self-fulfill where, clearly, over the course of the last two weeks my identification that this max short positioning was now established and now was a likely catalyst for a squeeze – especially once you got that Fed reversal towards easing of policy and talking about willingness to touch balance sheet, the escalation of China policy easing and capitulation there, and then this kind of this resolution progress positive leak stuff out of China trade negotiations.

All of that has created the backdrop by which you had this very much grabby behavior from people that frankly don't have – certainly within the equities complex, for instance – don't have the exposure on.

Their beta into the S&P is low. They've taken their grosses down. They've taken their nets down. They're high in cash. They've taken their portfolio beta down and are very defensive in posture. And they are missing this rally.

Now people know that these numbers are out there. They get itchy trigger fingers. And they think that the systematic strategies are going to be buying ahead of them – they buy ahead of the systematic strategies.

So there is this feedback loop impact as well, Erik. And I think that is – well, I know, frankly – that that's also part of the calculus.

Erik: Okay, Charlie, with that backdrop in place, let's go ahead and dive in at Slide 9 in your deck to the CTA model positioning estimates that you're showing now. What is this graph showing us? And why don't you walk us through the next couple of charts in the deck here?

Charlie: So I think really what I wanted to grab there was not simply just in regards to this capture of general risk sentiment, but also, too, capture this idea that the trend has been very much about a slowdown posture.

And of course a CTA model is not worrying about a macro output *per se*. There might be macro overlays, unequivocally. There could be humans that are kind of tilting the behavior to some extent with regards to exposures. But, generally speaking, that's against the point of the quantitative strategy.

What this is capturing though, against a backdrop of some other things that I'll bring up, is that you've really seen markets – whether it's these systematic trend models or a later risk parity or discretionary long-short – pivot into a very risk-off stance. Which is a huge part of the reason that we find ourselves now 270 handles in the S&P off the lows made two weeks ago.

What you're seeing (particularly here, in that top bucket), you see major markets. It just goes to some of the primary risk asset and key cross-asset securities that can give you a sense for this much more risk-off positioning.

You see the max short in the S&P 500 in Euro Stoxx, in Nikkei, the two G10 FX crosses there, eurodollar, euro/US dollar, and US dollar/yen – obviously, the dollar/yen short – both of those expressions are very risk-off there – short dollar/yen and short euro speak to that similar footing in the FX space.

And then that middle bucket is looking at rates. So Treasuries, 10-year Treasuries – and you have a max long.

Then you look at crude. Brent and WTI as global growth, consumption, the global economic engine, are also max short.

And then you look at gold – and this is, I believe two days old, this snapshot – but gold at basically 50% long position. You look back to the far right column versus a month ago, that was an incremental short.

And you see – again, looking in that month prior, that far right column, one month in parentheses – you see, generally speaking, the escalation of this kind of risk-off positioning over the last month.

The next bucket down goes just a little bit more granularity across the global equities bucket. And you see the extent, again, of the short positioning. A lot of max short, negative 100s.

However – again, as I highlighted, this was a snapshot, I believe, from Monday morning – you do see that Russell 2000 had begun covering.

You see that FTSE 100, Hang Seng, ASX, and KOSPI had all covered from that max short position, which was a precursor that told us that we were getting the ball rolling, that this max short bearish positioning had overshot.

And then the right side of the screen speaks to the fixed income side of the risk-off positioning. You recall, for almost the entirety of 2018, one of the most crowded trades on the board for sure was bearish fixed income, bearish Treasuries, bearish rates.

It was based upon above-trend growth, above-trend inflation, the tailwinds of fiscal stimulus, of the Phillips curve of labor impacting wage inflation. All of these very globally cyclical bullish phenomena. Plus the reality of Fed Treasury issuance, where supply – there was going to be this supply shock due to the deficit spend, realities that we touched on earlier – that it was just going to really lean on global fixed income.

And by the end of the year – this is always part of my thesis and it goes back to that Chinese credit impulse slide. Once you lose that credit impulse and commodities and inflation expectations and industrial metals and cyclicals versus defensives ratios – those all started coming off because you're unable to create the demand side into this tightening liquidity backdrop via the Fed's QT, via China's deleveraging efforts, via later the ECB slowing their bond purchases and even the BOJ tapering their bond assets.

What it ended up doing was create this very real slowdown in the back half of 2018 that got picked up in the very cyclical data, the very cyclical US data as well as global manufacturing data. I mean, the JP Morgan global manufacturing PMI index is down nine of the ten months.

Those types of things forced people into this much more defensive slowdown posture which was the opposite of the bearish rates, bearish Treasuries trade. It was instead max long Treasuries, max long European government bonds, and max long JGBs, and onward from there.

That's Slide 9 for you.

What I touch on in Slide 10 and 11 is something that I mentioned earlier too, which is that risk parity – which is a systematic long-only strategy to be fair, but it's obviously become quite a talking point over the last five years – and it's critical, right?

It's with regards to the assets deployed under the various iterations of the strategy or around the street, the leverage deployed in many versions of the strategy – and the strategy is this:

Instead of allocating assets, what you're allocating is your volatility of your portfolio. So in a 60/40 – the old line of thinking and the Bridgewater marketing pitch – in a 60/40 equities/bond allocation, 90% of your volatility is in the equities bucket. And what you should be doing instead is allocating your volatility.

So to grossly oversimplify – because oftentimes there is a macro overlay that I will touch on – but, to grossly oversimply, you lever up the historically low volatility asset class. And that historically low volatility asset class is, of course, fixed income.

Now, this is something I wrote about back in 2013, before the taper tantrum, saying, well, wait a second. What if the historically low volatility asset class – Treasuries or global fixed income – is a product of a 30-year bond bull market, and what if you actually had a rogue inflation print.

Or what if the market – who is already at that time hooked on quantitative easing and hooked on bond purchases via central banks – picked up wind that the central banks were going to stop buying bonds? (i.e. the taper tantrum.)

And BOOM-BOW, you had those massive risk parity unwinds that – due to, again, the assets under management, due to the leverage of the strategy – you had these huge cross-asset volatility blasts as these positions had to be deleveraged.

Well, fast forward to Slide 10. What you see is actually a very – from a macro perspective – a very kind of slowdown risk-off type of positioning here. And that is what a lot of, a number of risk parity strategies will actually look at.

If you look at a Punnett Square of four scenarios – with higher growth, higher inflation in one, higher growth, lower inflation in one, and the permutations therein all the way around – what this current positioning estimate as per our in-house model shows is that you've sharply reduced the US equities exposure. You're now just beginning to reduce the credit exposure.

So on a one-month basis, the largest single contract in our risk parity model sold is US investment-grade credit index.

And then also on Slide 11, you see the commodities, particularly the energy commodities – the largest part being oil, crude – coming off sharply as well, near five-year type lows. All against a huge buildup of length of leverage, again, in traditional fixed income products.

Particularly over the last month, we've seen large buying in US Treasuries but enormous buying in JGBs. And JGBs, understandably, in light of 25 years of QE from BOJ, are pretty much the lowest-volatility asset class out there in the global spectrum.

So the idea being, they are very much aligned with my end-of-cycle view with regards to this downshift into a slow-growth, slow-inflation, low-inflation environment.

Those are the key points that I wanted to bring up on Slides 10 and 11.

Erik: Charlie, I want to skip ahead in the interest of time to Page 20 in the deck because I want to revisit a topic we discussed in your last interview.

Where so many people fear an inversion or a flattening of the yield curve, you say we should actually fear the steepening of the curve. What do you mean by that? It seems counterintuitive to a lot of people.

What do you mean by it? And maybe talk us through the charts to explain your point.

Charlie: My long-time message has been that the key here with regards to the hyperventilation on curve inversions – The inversion obviously precipitates the steepening of the curve, but what really matters is that the curve-steepening side of the where-we-are-in-the-cycle indicator is telling us that – I have used the term in a number of my pieces, and maybe even on our last call – that the market has finally sniffed out the slowdown.

We've figured out that the policy tightening, the normalization, have impacted the real economy, that the lagging impact of tightening is starting to lead into financing and funding and the costs of capital. And it's causing behavioral shifts with corporate management, CAPEX discussion that we had before, and, ultimately, it's affecting the actual output in the real economy.

So when I say that what matters most is actually the steepening, as the cyclical risk-off signal, that's exactly what we've seen – over the last number of US recessions – is that you don't need to worry about trying to reverse engineer the timing of the inversion into when does the US recession start, just because there is no historical kind of signal there. It's incredibly noisy.

What does signal – because it's closer to the real event happening – is that, when you get this steepening, that's the market picking up the slowdown and confirming the slowdown.

The charts on Slide 20 show you the extent of the front end. We're looking at eurodollar spreads. And this shows you the extent by which the markets went pricing out the end of the Fed normalization cycle and pricing in the easing cycle.

And at the peak of early January, before the Fed's pivot (basically), before the Jerome Powell and Richard Clarida double whammy messaging that the markets had forced them to take a knee, we were at a point where we had priced in almost a full cut in the end of 2019.

There were times since July of last year that the eurodollar 2020 calendar spread was telling us that the Fed was on the margin looking to cut. That clearly escalated to a full cut over the course of the last couple of months.

What was still amazing in that real panicky December and then pre-Powell period in January was that we pulled forward that Fed easing, that Fed cut, from 2020 into the end of 2019. And that just captures the accuracy, frankly, by which the equities markets began pricing in this real recession risk. And that we spoke about in those deeply cyclical sectors.

So we have since moderated. The dovish Fed pivot has done enough right now to offset the policy error concerns. They are telling us they're going to be patient, meaning there is no pause probably for the next two – well, let's say this: There is probably going to be a pause through, at a minimum June. And that's why you've seen a modest steepening again in these curves, in these eurodollar short-term curves.

What I think is pretty important, though, is to get a little perspective (Slide 21) of the more traditional US Treasury curves and just get a grasp of where we have come on a larger lookback since, say, 2009 over the post-crisis period.

You're looking at 5s 30s, you're looking at 2s 10s, you're looking at 2s 30s – and you get a sense for the incredible flattening that has occurred, which has been by design. That has been by design because it eases financial conditions, it eases financing costs for corporates to do things that could stimulate growth. That's what the Fed has been doing with their balance sheet purchases, with their reinvestment plans. That's what they have been trying to create.

Now the market is seeing the impact of the reversal of these policies and we are just now beginning this very nascent steepening.

So that top panel there on Slide 21, that's the 5s 30s curve. In July of last year the 5s 30s curve traded down 19 basis points. And that's when people were – amongst many of these other curves that hit local lows at that time, kind of decade lows – people were really hyperventilating, getting very scared about the implications for what that's telling us with regards to the recession.

And since then, since July, 5s 30s have nearly tripled. There's another powerful steepening move today – I think 5s 30s closed at 54 bips. So it's chopped around a little bit.

But what that's telling us is, again this: The market has priced out further hikes in the front end and not just moved to a pause stance but moved to a view where within the next 12 months we're anticipating the beginning of a Fed easing cycle.

And that is hyper, hyper, hyper-critical because the shape of the yield curve impacts so many things across the asset spectrum. In particular, I've always focused on the impacts that this has within the equities space. Things like cyclicals versus defensives, and certainly a real talking point that I'm going to be focusing on (and I focused on it in my note today) in the months ahead – huge impact with regards to this value-versus-growth debate within the US equities space.

But, yes, the concern, and the trigger, and the more near-term tactical signal is the steepening of the curve. Because that's telling us the slowdown is here, the slowdown is real. And that, typically, at that point, even though the Fed can have some impact with regards to liquidity provision, as far as softening the impact on the depth of the recession, a slowdown is an inevitability and that's where we need to watch.

Because in prior examples – and that's what I go over on Slides 22 and 23 – a year before the ultimate risk-off events, you begin seeing the curve steeping begin. And sometimes it's less than a year. That's also important to note.

Erik: I think it's a really critical point, because there's a lot of people – I've seen this just reading around on the internet – people saying, boy, you know, that curve inversion was really scaring us. But we got some relief. It looks like it was a false alarm. It's all getting better now.

You're saying it's not getting better. We're getting to the point where the Fed is recognizing, or the market is recognizing that the Fed will need to recognize the need to take action because the shit's about to hit the fan.

Am I correct to interpret it that way?

Charlie: Absolutely. And look, I'll say it – and I referenced this earlier – the strength of the consumer, the strength of the labor section of the economy is no doubt maintaining and offsetting what's going on in housing and what's going on in manufacturing.

But there are – especially once you look at the disinflationary impulse that we're seeing globally right now – there are a lot of worrying signals. This is something that I think is very interesting. And from a timing perspective that – I call it my confirmation of quote "imminent Fed easing signal" – has been – and back to the eurodollar curve.

The eurodollar 2s 6 spread – that's the second eurodollar contract spread to the sixth contract – this spread is now inverted. It went almost negative – 25 bips I would say in the last couple of weeks. It's currently negative 14 basis points.

So with the eurodollar curve, you're dealing with the very, very front end of the curve, not looking out in the tenner or the year tenners of Treasury curves. And what this shows is something very interesting.

We've done some work here that shows over the past five easing cycles, the eurodollar 2/6 spread has inverted prior to each. So this thing has got a five for five track record over the last five. And it's inverted about six and a half months on average before the first Fed cut.

So if I look at this in a different way, and kind of broaden out the sample size to look back at the last nine eurodollar 2/6 inversions – and not including this current inversion because that would be number ten – but the past nine that we've had, the post-trade period, a Fed easing cycle has followed in seven. And the average length has come that easing cycle began 8.2 months after the inversion.

So, to me, this continues to corroborate that we are slowing. And that that slowing – for reasons that I brought up before: the lagging impact of Fed tightening, the ongoing QT, the fading fiscal stimulus, the dragging wealth effect on consumers due to the recent market shocks, and then the cyclical reality of corporate deleveraging, which inherently means lower CAPEX –

Which means from an economic amplification perspective you're going to continue to see that contraction and shrinkage, and capital is going to be used for non-growthy things like buybacks. That's how we get that slowdown impulse. And I think we are getting there.

And the Fed is trying to ease the things that they can ease. And that's the market volatility and that's the tightening of credit spreads. But that, ultimately ,the slowing is what bleeds through and the end of the cycle overrides all.

Erik: So, as we assimilate all of these signals that we've talked about today, let's come back to the original question: As we look at the S&P, it's very clear that we're in some kind of relief rally. I think it's a bear market rally that's not going to take us to new all-time highs.

How do you interpret these various different signals to tell you when it is time to actually be short and to look for this market to turn back down in the other direction?

Charlie: As I mentioned, in mid-December after I saw this complete overshoot and purging of exposure and max short positioning and trend and capitulation into Fed easing, Fed cut being pulled into a 2019 event, coming from a very different place, a diametrically opposite place just three months prior, it created this opportunity for this type of tactical rally.

And we've gone over those catalysts. And that is what we're seeing now. People are being forced back into the market as the systematic, unemotional first-mover quantitative strategies reduce their short exposure and cover.

And, obviously, we're going to keep getting this Fed dovishness which eases the financial conditions tightening. It helps the VIX settle back in. And it helps credit spreads normalize. It certainly helps crude bounce. Crude is critical because of its impact on inflation expectation. And inflation expectations are the most significant macro factor for everything from US equities to US rates.

You're seeing the same thing with Chinese policy. Capitulation. All of those pieces are in place.

I think, to me, the way that I'm envisioning this now, yes, we are beginning to reduce some of that underexposure drive of this tactical rally I've been calling for. The key here is this – and I've compared it to – we ran an analog on the desk that is just shockingly accurate thus far.

We just completed the 15th day of this analog, but the analog is looking at scenarios where the S&P sold off greater than 17.5% as a trigger in 67 days or fewer. The overall idea being prior scenarios where you had this just massive, violent de-risking in a very short period of time.

And the highest correlation, the highest R-square of this current trajectory versus one of those prior trigger dates in our sample set, is actually October 2007 through October 2008.

The analog is tracking to just a shocking degree of accuracy thus far – those slides are not in this deck in particular – but I'm using that in my background as kind of a triangulation point against what I see as this slow forcing in positioning.

To really oversimplify the way that the analog is projecting where we go from here, we're 15 days in, we are almost identical with regards to this current positioning analog on where the performance should be on this rally. We – per the analog – peak out on Friday of this week. And from there you would see then over the following almost two-week period a 5% decline.

And I think that's important because it actually does fit a lot of the qualitative discussions that I have with clients, where so many folks – and myself included, because I believe the analog – anticipate a squeeze. You know, this little bit of a force in – and then they want a fade in for the retest.

And that retest is going to be everything. I said in a note (I believe end of last week) that this next week and a half to two-week period is going to be so important because you're going to basically determine whether or not you squeeze in the people that have been waiting for the pullback in equities or whether or not they actually feel confident that it doesn't realize – they begin to short it, they begin to press it, and it completely resets the environment that we're looking at.

I personally feel – the timing is very interesting, because you're now just beginning to see people get very nervous that are underexposed. The tape held and the tape came back today that you're going to see this discretionary, active, fundamental investor adding back their exposure.

And then you also have in the backdrop the earnings call. And earnings is a volatility suppressor. And earnings also is important, because by February 6 you'll be through 75% of the S&P 500's buyback blackout.

And that's that next leg which corresponds, actually, with the local load that our analog predicts, that you then see a resumption in that trade higher.

And that would really correspond with the corporate buyback bid re-entering the market and being able to buy back their stock still at these much more attractive valuations than what they were looking at a year ago. And that's when corporates like to be in there buying their stock, defending their stock, and using their cash.

So I think that you're going to get a local high in the next couple of days and then you have basically two weeks to retest the low before you get that buyback resumption. And I think we probably start trading higher from there.

After that point, then it comes down to just how bad the data gets. How bad China gets, how bad the rhetoric around the structural issues with the Chinese trade negotiations go. You can't get much more dovish Fed-speak unless things get worse.

So I think we're going to be back in that chop thereafter.

But to summarize: near-term squeeze-out in the next, say, three to four sessions to localize. The next two weeks thereafter you get a, say, 5% pullback. And then that should correspond and put us on track for the return of the corporate buyback bid, which should see markets begin to get pretty constructive again. Especially if we get a really solid purge, a really solid retest of some of those recent lows.

That would be the perfect scenario for me to get a little bit more tactically constructive and play this from the long side again. I think right now this tactical rally is in the late stages before the next phase.

Erik: Charlie, these fantastic graphs and charts that we're looking at in this deck are representative of the content that you send out every single day to your institutional list. And that email is free for qualified institutional clients.

Please tell us a little bit more. And I'll apologize to our retail audience – Charlie doesn't make the rules that he is regulated by. He would love to share it with you but he can't.

So who is eligible for this? And who do they need to contact in order to get on this fantastic distribution list?

Charlie: I appreciate that, sir. The easiest route is to reach out to your Nomura Global Markets sales contact, whatever asset class, and we can put them in touch with the right people on our end. Typically, we do have a revenue threshold and there are certain regulatory dynamics with regards to domiciles which I can and cannot send into. But we can work all that out behind the scenes. The path of least resistance, as always: Call your salesperson and we can get the ball rolling to begin dialoging.

Erik: Well, I cannot recommend your daily letter strongly enough to those listeners who qualify for it, so I strongly encourage you to act on that.

Charlie, we really look forward to getting you back on the program again soon, you just give a fantastic interview.

We're going to have to leave it there in the interest of time. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.