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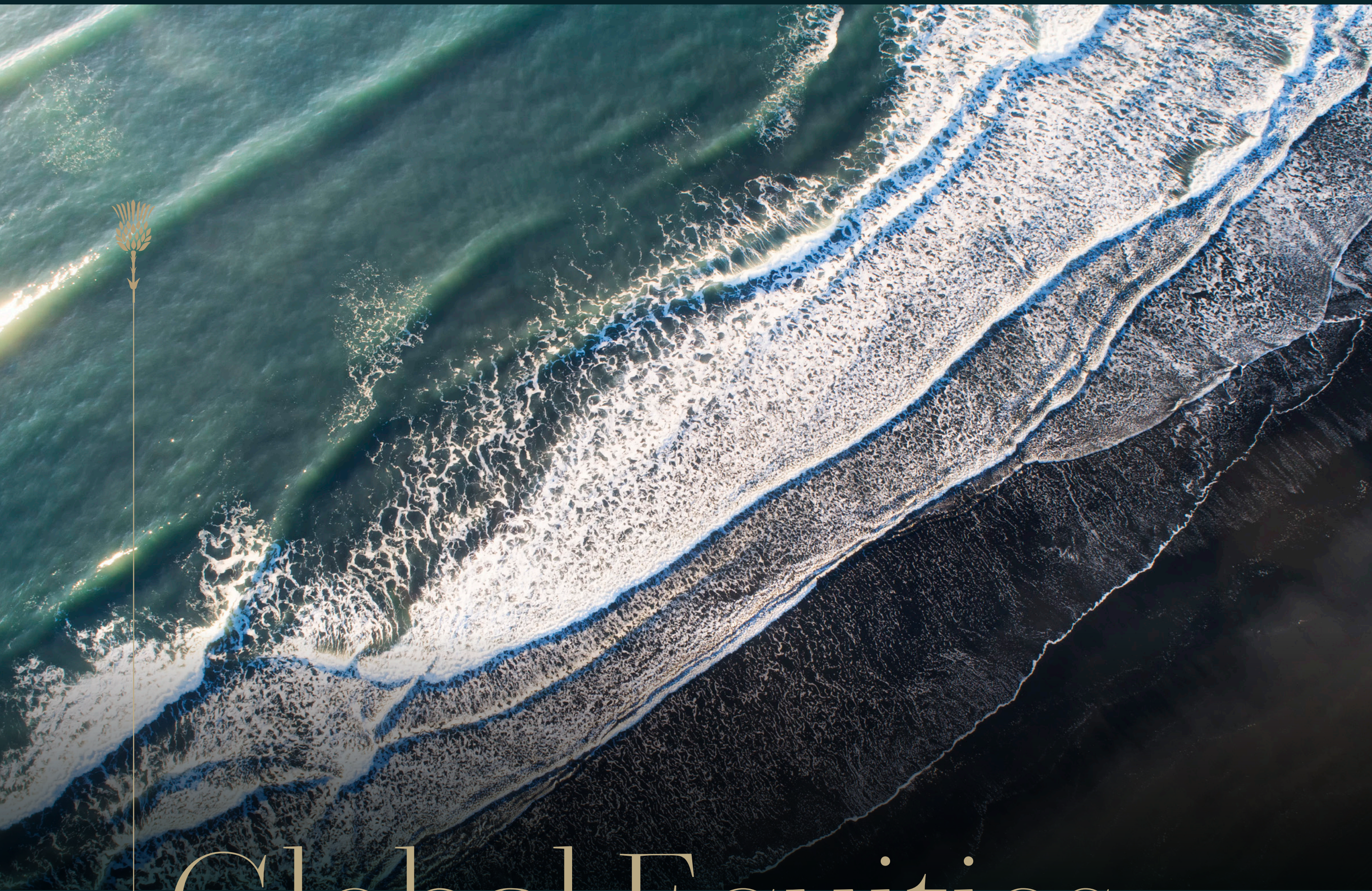
THE LONG AND SHORT OF IT

AUGUST 2024



Global Equities

Quick Take on the Latest Market Volatility

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Global Equities: Quick Take on the Latest Market Volatility

To investors' dismay, the start of the second half of 2024 has been the antithesis of the first half, with global markets enduring a significant sell-off. A confluence of factors has contributed to the recent shift, colliding at a time when liquidity is less abundant in the latter days of summer. **While investors continue to digest a number of macro-driven catalysts, we believe we have reached an inflection point in the macro narrative, moving from a fixation on inflation to the path for economic growth.**

In other words, the primary question investors are now trying to attempt to answer (and price accordingly) is: are we headed for an economic recession or not?

SENTIMENT AND POSITIONING INTO Q2 EARNINGS

In the past year and a half, market concentration in the U.S. equity market has reached new heights, spurred by economic uncertainty and an artificial intelligence (AI) driven sentiment frenzy. The markets vacillating between hard landing, soft landing, and "no landing" pushed incremental flows into insulated mega cap names, which acted as macro safe havens due to being viewed as "structural winners." In fact, at the recent local July peak, 62% of the S&P 500's 48% gain (from the start of 2023) came from the top 10 stocks in the index.[1] **However, with valuations stretched near extremes and earnings expectations lofty coming into the Q2 season, the gap between AI investment and monetization proved too wide for many of these companies.** While there were idiosyncratic growth stories to be had, many stocks sold off following earnings releases as expectations were too optimistic to overcome. From our perspective, it does make sense that the correction was borne in pockets of the equity market that were clearly the most overbought in which positioning got extremely one-sided. We believe that a reset in this part of the market was actually healthy, as the latest trajectory was unsustainable without a bubble forming. Indeed, sectors and companies that were among the best YTD performers and in the mega cap growth segment have seen the largest drawdowns of late, while defensives have fared the best (see table). **Despite the weakness, forward earnings estimates across the broad market and the aforementioned mega cap cohort have remained resilient, with almost the entirety of downside coming from multiple compression. From this perspective, it appears that angst on the economy's trajectory is not as concerning, and the correction is more of a recalibration of idealistic expectations.** To that end, the S&P 500's forward P/E ratio has retreated to 20.2x, which is still one standard deviation above the average since 1990[2], so there may still be some room to go on the downside.

S&P 500 SECTOR PERFORMANCE: YTD AND SINCE JULY 16 PEAK (PERCENT CHANGE)

Sector	YTD Change	Change Since July 16 Peak
Comm. Services	15.6%	-8.2%
Info Tech	14.0%	-14.6%
Utilities	14.0%	3.1%
Cons. Staples	9.4%	0.3%
Financials	8.5%	-6.0%
Health Care	7.5%	-2.1%
Industrials	5.8%	-5.9%
Energy	3.9%	-5.8%
Materials	2.8%	-4.3%
Real Estate	1.3%	0.1%
Cons. Discretionary	-3.4%	-12.8%

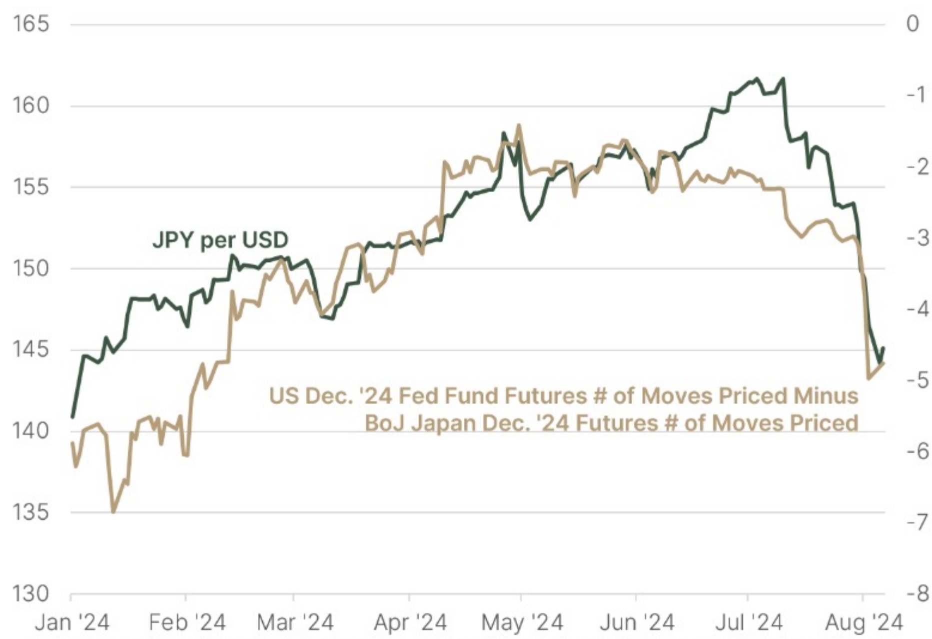
Source: Bloomberg, as of 8/5/2024.

[1] Source: Bloomberg, as of 7/16/2024.
[2] Source: Bloomberg, as of 8/6/2024.

JAPAN AND U.S. POLICY DIVERGENCE LEADS TO UNWIND OF YEN CARRY TRADE

While Q2 earnings may have been the initial culprit for market anxiety, policy divergence in the U.S. and Japan magnified it. At the July meeting, the Fed kept rates steady, as expected, but telegraphed a likely September cut. At the same time, **the Bank of Japan (BoJ) initiated a surprise rate hike to stymie inflation pressures, which significantly widened interest rate differentials between the two countries, leading to upward pressure on the JPY (see chart).**

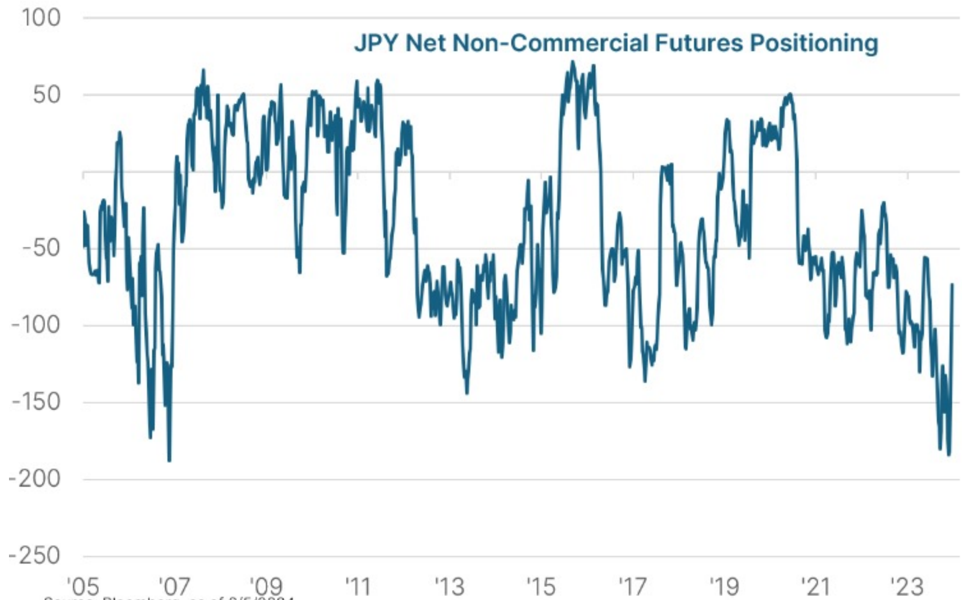
DIVERGENT CENTRAL BANK POLICIES PUT UPWARD PRESSURE ON THE YEN



Source: Bloomberg, as of 8/5/2024. Gold line represents the difference between the number of Fed cuts priced by December 2024 relative to the number of hikes priced by December 2024 from the Bank of Japan (BoJ).

This has important market implications because a very popular trade amongst hedge funds and other speculative investors is the yen carry trade – where an investor borrows in yen given Japan's very low interest rates, swaps that yen into another currency (most prominently USD), and invests the proceeds in other high-yielding assets (like stocks or fixed income (FI) instruments). However, the trade only functions properly in an environment where the yen is not appreciating versus other currencies, especially against the USD. **With the BoJ's hike surprising investors, traders were forced to unwind their trades (buy back yen, sell assets), further exasperating market moves.** What's more, short positioning in the yen had nearly reached record lows, as the trade became extremely crowded (see chart on next page). All in all, this became a case of unfortunate timing for markets, with headwinds from earnings and a weak payrolls report (see more on that below) further catalyzing a swift de-grossing across assets, with equities the primary casualty. While there will be violent rallies in a highly volatile backdrop, we believe the unwind has more to go, especially as positioning is far off neutral.

JPY FUTURES POSITIONING NEARLY REACHED ALL-TIME LOWS (FUTURES CONTRACTS, THOUSANDS)



Source: Bloomberg, as of 8/5/2024.

LABOR MARKETS CONFOUNDING SIGNALS

The transition from investors focusing more on the growth trajectory rather than inflation was front and center with the July payrolls report. On the surface, the report was disappointing and stoked recession fears as the unemployment rate rose to 4.3% (from 4.1%) while monthly payroll growth fell to 114,000.[3] While the underlying trend for unemployment is concerning and keeps us vigilant regarding further downside risks, we push back on the market's view of an imminent risk of a labor-driven spiral towards recession. **First, 70% of July's increase in unemployment was driven by temporary layoffs**, in contrast to permanent layoffs which have a greater correlation with consumer spending trends. Temporary layoffs could easily reverse next month and push the unemployment rate lower again before the next Fed meeting. Second, **the increase in unemployment from the cycle low of 3.4% has been largely driven by an increase in labor supply (i.e immigration), and not from a cyclical layoff cycle**. Indeed, job openings (or a proxy for labor demand) have moderated to pre-COVID levels, but that is normal in our view as the labor market works off an extremely overheated vantage point from prior years (see chart on next page). From that perspective, we think the fixed income markets' current pricing of 240 basis points of cuts by YE 2025 is a bit overdone, which prices in a recession-like cutting cycle. [4] Risks to our view include 1) a continued sell-off in equities causes companies to lay off workers, 2) temporary layoffs morph into permanent layoffs pushing the unemployment rate sustainably higher, and 3) companies and consumers pull back spending as the latest jobs report invokes a downshift in consumer and corporate sentiment. **In short, the probability of a labor-driven imminent recession is low, but a successively downbeat August employment report, which is not our base case, could be a real cause for concern.**

[3] Source: Bloomberg, Bureau of Labor Statistics, as of 7/31/2024

[4] Source: Bloomberg, as of 8/5/2024.

LABOR DEMAND HAS RETURNED TO A MORE NORMAL POSTURE

U.S. TOTAL JOB OPENINGS TO TOTAL UNEMPLOYED RATIO

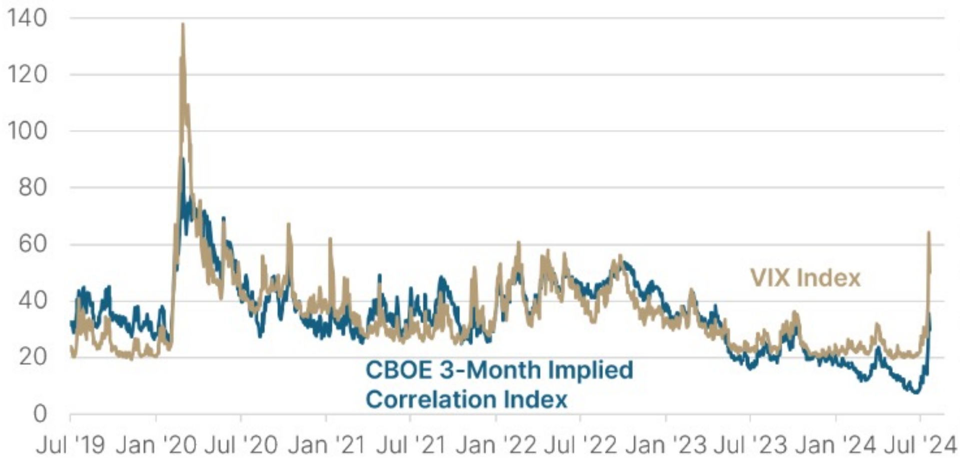
Source: Bloomberg, as of 6/30/2024.

THE DISPERSION TRADE

Another factor that has magnified market moves, particularly in the volatility space as we witnessed a CBOE Volatility Index (VIX) of 66 intraday on Monday, is the dispersion trade. Like the yen carry trade, it has gained popularity in recent years. Essentially, traders use options to short index volatility, while going long volatility with options on a basket of single stocks. **The strategy is a bet on individual stocks being more volatile than the overall index, which works well in environments with lower implied correlation between constituents and higher dispersion**. We can see this backdrop was prevalent for much of this year, with the VIX hovering near its lows in the teens, while 3-month implied correlation hit the lowest level on record (see chart on next page). As with many short volatility trades, they work until they don't, and macro-driven shocks usually upend them in a hurry. In this case, this rise of options trading post COVID (particularly zero-days to expirations) created more opportunities to earn premiums within short volatility strategies and has increased the presence of speculators who search for meme stock-like returns. A liquidation event, however, sends correlations back towards 1 as people rush for the exits - this is what markets experienced with the convergence of the JPY carry trade and labor market overreaction. As a result, VIX skyrocketed, which caused a domino effect on risk metrics like VaR (value at risk) that sent trading desks to cut any and all risk. Markets makers who are currently short gamma have also exasperated market moves. Short gamma means they are short (selling) either calls or puts, which forces them to hedge exposure the way the market is going to keep their delta positions neutral (sell when market declines and buy when it rallies). **Overall, with the vol complex completely repriced, we expect more extreme daily moves, and would prefer waiting until volatility comes back into more normal ranges (~20 on VIX) before putting cash to work.**

LOW IMPLIED VOLATILITY AND RECORD LOW CORRELATIONS MAGNIFIED MARKET MOVE

CBOE 3-MONTH IMPLIED CORRELATION INDEX (PERCENT) AND VIX INDEX (PERCENT)



Source: Bloomberg, as of 8/5/2024. The CBOE 3-month implied correlation index estimates expected correlation between the S&P 500 and the top 50 stocks in the S&P 500 using implied volatilties (options). The VIX Index measures expected volatility of the S&P 500 over the next 30 days using options.

WHAT'S NEXT

Fixed income markets seem to be pricing a shallow recession, but our view is the economy is still on decent footing. While growth may slow, there is no extreme over-investment or exogenous threats to the financial system. Corporate and consumer balance sheets remain quite healthy and the services industry remains in expansion. While the job market is cooling, it is not on the verge of collapse in our view.

In the current environment, we don't recommend reaching for the tails in the equity market. This means avoiding pure defensives and rate-sensitive plays given yield levels have already priced recession. In the right tail, steering clear of high beta-cyclicals and small caps that would benefit from a growth resurgence. **Rather, we prefer a barbell of high-quality cyclicals and less rate-sensitive defensives.**

This includes **mid-caps, which have much better fundamentals than their small cap counterparts** (two times higher profit margins and return on equity, less interest-rate sensitivity) but still have exposure to cyclical-oriented sectors that have sold off sharply in this correction. Mid-caps also have attractive valuations, at just 15.3x forward earnings, which is a 7% discount to the past 20-year average.[5]

At the broad index level, markets tend to overshoot both to the upside and downside, so we expect an oversold reading before this correction is over. From a risk-reward perspective, the 200-DMA (daily moving average) at ~5,000 and 50-week MA (moving average) at ~4,930 are decent levels for investors with elevated cash piles to consider putting money to work.[6] That said, given low liquidity and a seasonally difficult trading environment in August, a reversal may happen before we reach such levels.

[5] Source: Bloomberg, as of 8/5/2024.
[6] Source: Bloomberg, as of 8/6/2024.

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Disclosures

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