BNY MELLON

The Aerial View
Morning Briefing

September 15, 2020

Macro Investors in Limbo

- **Volatility traders worry about the coming two weeks**
- **Stagflation is a disconnect between core and headline CPI**
- **AUD and NZD reflect macro community outperformance**

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Doldrums Worries

The other side of seasonality effects on market behavior is now hitting market participants. Normally, in the absence of event risk, volatility would collapse well into November.

In the chart below we show the evolution of FX volatility throughout the year. The top line is the weekly highest point in FX volatility for each week of the year since 1999, the bottom line represents the lowest FX reading for the same week, and the middle line is the median reading for the period studied.

FX volatility often shows a spike between summer doldrums and early fall. Median volatility readings usually picked up by about 1 vol, but for the lowest readings, summer jumps would be sharper. Using the minimum reading suggests FX volatility could rise as much as 2.3 vol – following the usual summer spike, FX volatility remained near the same levels for the remainder of 2019.

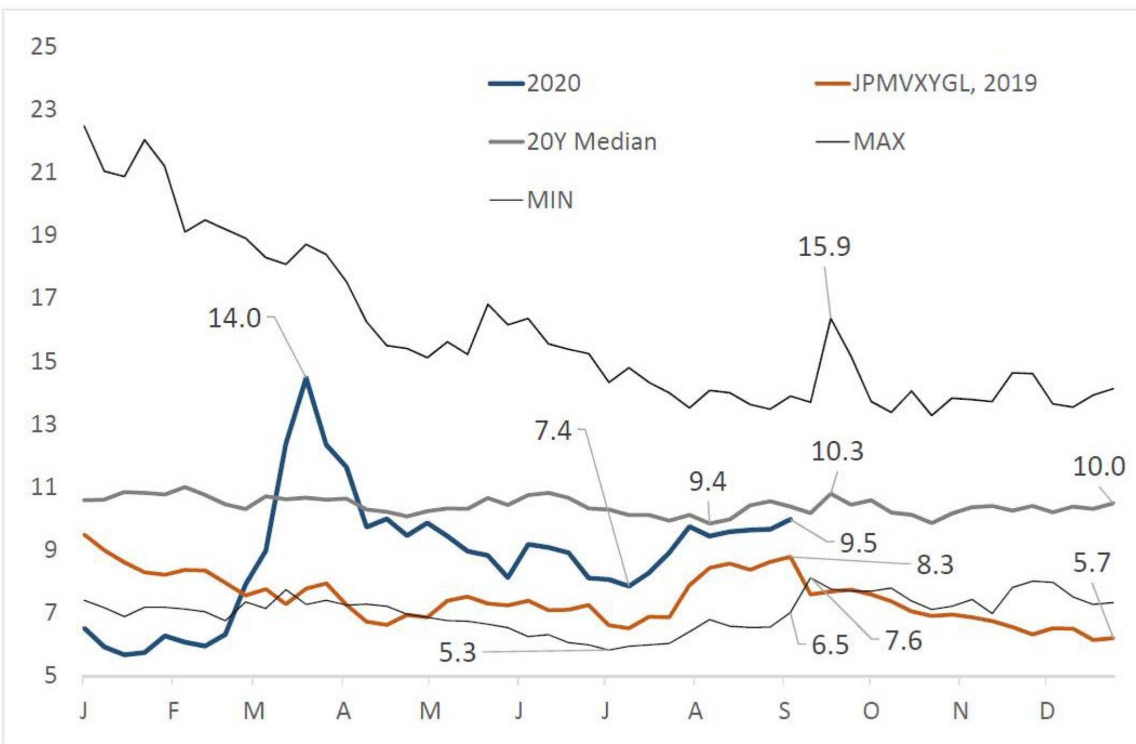
For 2020, FX volatility increased from 7.4% to 9.5%, which still is below historical medians but well above the doldrums observed last year. In fact, the main concern for market participants would be a collapse in volatility similar to that observed exactly a year ago.

Last year around this exact same week, FX volatility peaked at 8.3%. It subsequently declined to well below the lowest readings recorded until through Q4 2019. FX volatility remained below historical minimums until late February, when COVID-19 woke markets up.

In our view, the main driver of uncharacteristically low FX volatility points between September 2019 and February 2020 was excessive easing. Financial repression as a result of balance sheet expansion was already in motion well before COVID-19. The Federal Reserve's balance sheet increased from $3.6tn in September 2019 to $4tn in March before the Fed stepped up its easing pace. In addition, the Fed cut interest rates three times last year in July, September and October.

Going forward, we believe event risk remains significant into the US election period, which will likely expose uncertainty with regards to fiscal policy in 2021. Additional US Treasury issuance would be a key driver of higher market volatility, particularly assuming inflation remains around 1.5%.

Implied FX Volatility (Against 20y Seasonality)



Source: BNY Mellon and Bloomberg L.P.

> ***COVID-19, along with heightened protectionism observed since 2018, imposed higher replacement costs***

Another Stagflation Spin

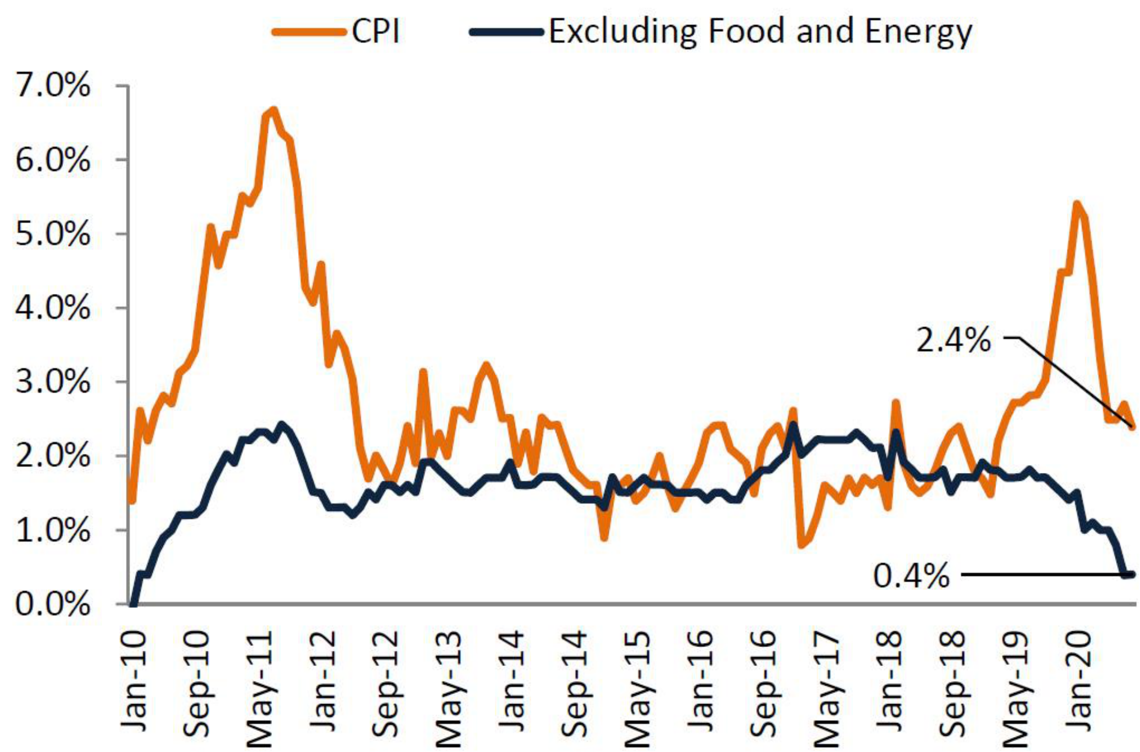
At the risk of oversimplifying, stagflation is an environment where output remained stagnant while inflation increased. Between 1973 and 1975 annual headline inflation in the US increased from 3.4% to 12.3% while GDP growth dropped from +7.6% to -2.3%. Between 1978 and 1980 a similar pattern reappeared.

A smaller version of this same combination reappeared between 1989 and 1991. For the past 30 years however, investors have grown less weary about stagflation. Trade agreements along with a transition from net oil importer to net oil exporter reduced concerns of supply bottlenecks. As a result the correlation between demand and inflation increased. US headline inflation was running at 4.9% in September 2009, dropping to -1.4% in June 2009.

So far during COVID-19, GDP growth declined from 2.3% to -9.1% while inflation dropped from 2.3% to 0.6%. COVID-19, along with heightened protectionism observed since 2018, imposed higher replacement costs. One excellent example is container shipping costs, which have increased 116% since December 2017.

In the chart below we show the breakdown between headline and core inflation in China. During the last inflation outburst seen ten years ago, both increased and dropped in tandem. This time the breakdown seems evident due to the implementation of tariffs on China and US exports to each other in 2018.

China Headline and Core CPI



Source: National Bureau of Statistics of China

> ***We observed large underheld exposures in the Australian dollar well into the crisis***

Macro Investor Outperformance, Explained

The Bloomberg All Hedge Fund index is up 1.74% year-to-date with a drawdown of 11% in March. The macro slice of this group is up 4.6% with a drawdown of 8.24%. Inflation uncertainty will likely be an important contributor of macro funds' outperformance going forward, in our opinion.

This performance gap is being noticed by investors and should be explained by a noticeable breakdown in bond-equity correlation around the peak of the COVID-19 crisis. Risk parity funds seeking to keep portfolio volatility at 10% using equity and bond allocations is up 1.3% year to date with a 24% drawdown.

Even 60-40 portfolios would not have performed as well as macro hedge funds. An index carrying such equity-to-bond allocation would be up 7.4% year-to-date but with a meaningful 22% drawdown. The key for macro hedge funds will be their ability to sustain market gyrations while keeping strong conviction trades. Investor commitment to the strategy will therefore be an important component going forward.

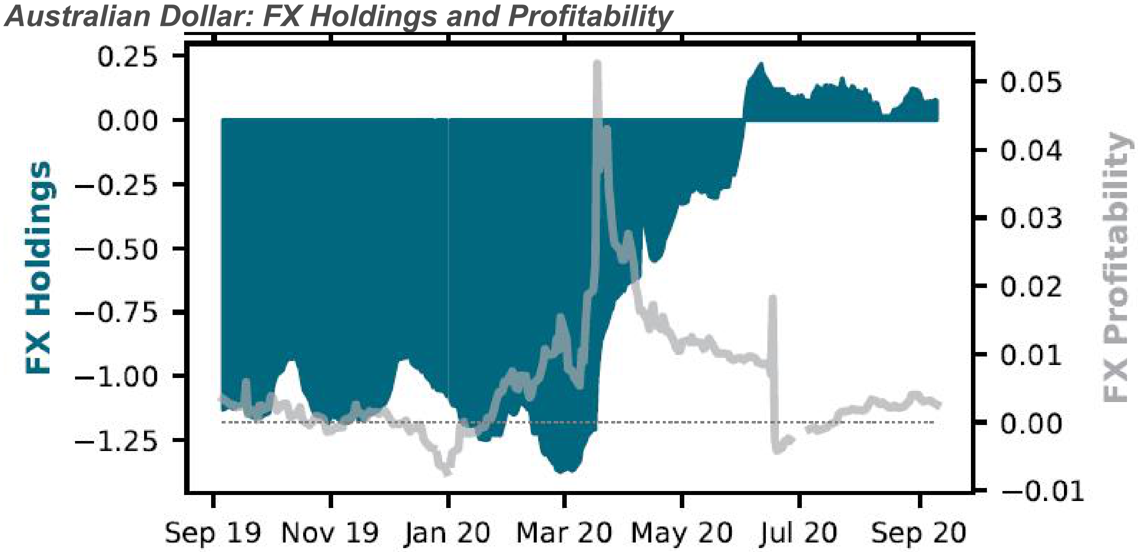
One popular trade we have observed through our own tools has been short AUD. We observed large underheld exposures in the Australian dollar well into the crisis, which was a key source of profitability into the event. In the chart below we calculated AUD holdings, which were at historical lows into March 2020 but have now been significantly paired.

The right axis represents profitability in these same holdings. Macro investors have now largely locked in earnings and are holding relatively small AUD longs.

We believe the other side of this trade is short NZD. Similar to the AUD, investors were very short the New Zealand dollar into March and subsequently paired exposure. However, since early August, we have observed a significant build up of short NZD exposures.

See the iFlow Cloud picture for September 11 here.

Australian Dollar: FX Holdings and Profitability



Source: BNY Mellon, WM/Reuters, Bloomberg LP

Please direct questions or comments to:

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