MacroVantage

Quant insight

Uncover price dislocations, trade opportunities, regime shifts and sensitivity across asset classes

1. **Current volatility & looking out into 2025**
2. **Re-pricing the Fed**
3. **US Materials – an efficient China long**
4. **Bullish bonds? Gilts offer best value**

1. Current Volatility & looking out into 2025

- **What happened**: The FED was distinctly more hawkish on inflation and more cautious on easing policy. The dot plot was significantly higher. At the same time, we saw the defeat of the bipartisan deal to avoid a government shutdown in the face of criticism from Trump and his allies

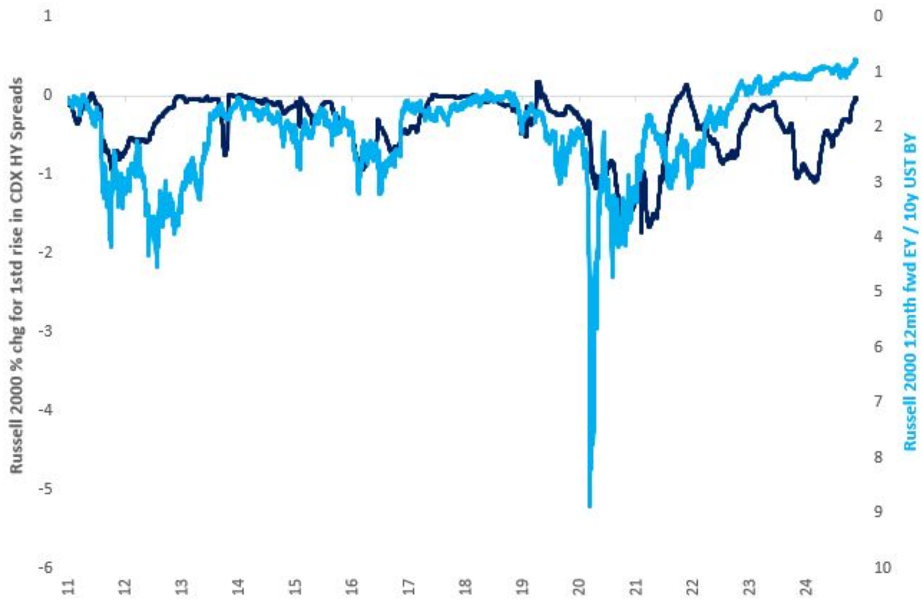
- **Market concerns**: The sharp response from the market is an expression of concern that the FED may not be there to save the market in the face of arguably the most volatile potential fiscal policy outlook since Reagan

- **Multiple sources of volatility**: The market will now have to contend with monetary, fiscal, trade/currency and industrial policy volatility going forward. A heady mix which requires a close eye on macro going into 2025 -- GDP, US$ and 10y/Term Premia, to mention but a few factors

So, what is Qi saying? What are the key messages coming from Qi:

Model confidence has dropped even on a short-term basis indicating a macro regime change is coming …

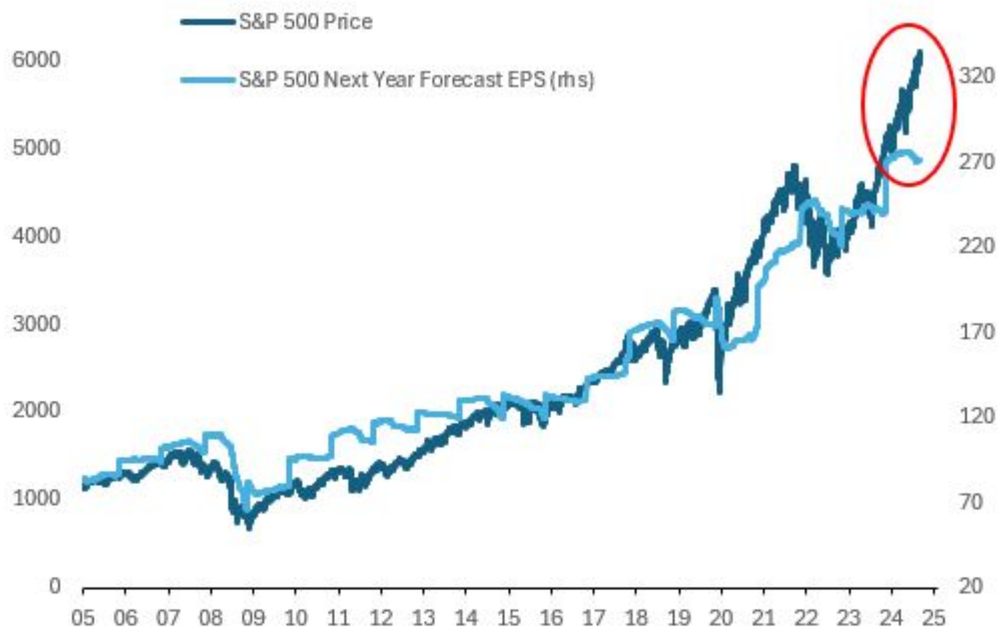
A large part of the market had become too complacent about Financial Conditions…a chart from two weeks ago…



The chart shows how the Russell 2000 had virtually stopped worrying about credit spreads and at how far the equity risk premium for the index had dropped. A clear and complacent setup for the near uninterrupted drop over the last half month.

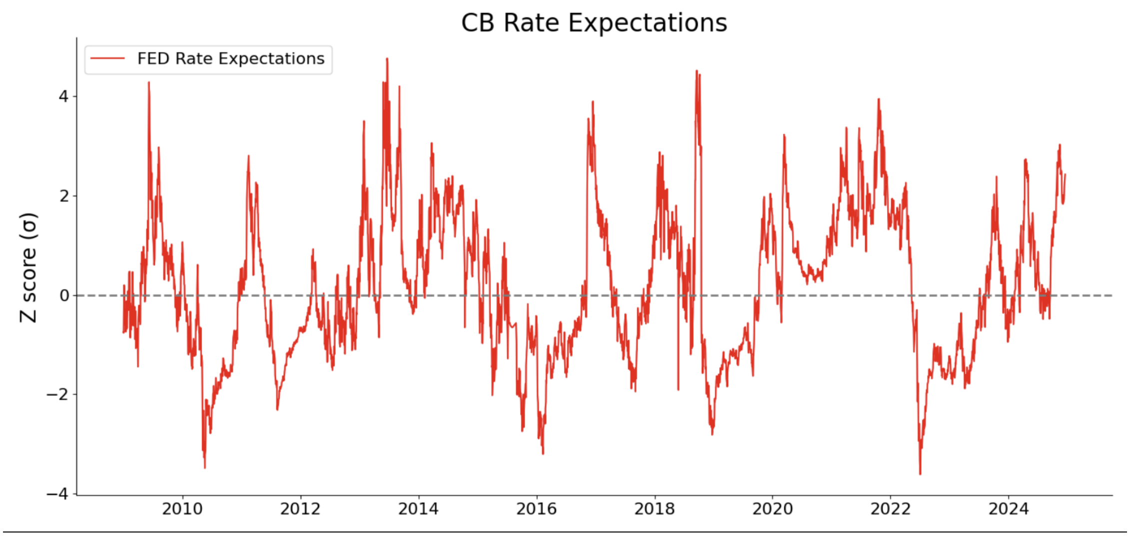
We know the market has bifurcated significantly over the last few years. Supernormal profits and ROIs at secular growth tech stocks have driven incredible stock returns driven principally by EPS growth though PEs are now also high on a historical range (below).

These have been concentrated in the Mag7 though we see a few new stocks enter the group (eg Broadcom recently). The size of this super group has interrupted and changed the normal "investment clock" for the major indices. However, as the move in the Russell 2000 illustrates, large parts of the market are still vulnerable to financial conditions.



2. Re-pricing the Fed

So the gunshot reaction is the Fed is no longer the market's friend. Is there any good news from last night's policy announcements? The one possible solace is that a fair degree of the re-pricing has already happened. The chart shows Qi's Fed rate expectations factor in z-score terms. We use the 1y1y forward - spot 1y spread in SOFR swap yields to capture the markets best guess on where policy rates will be 12-24 months' time.



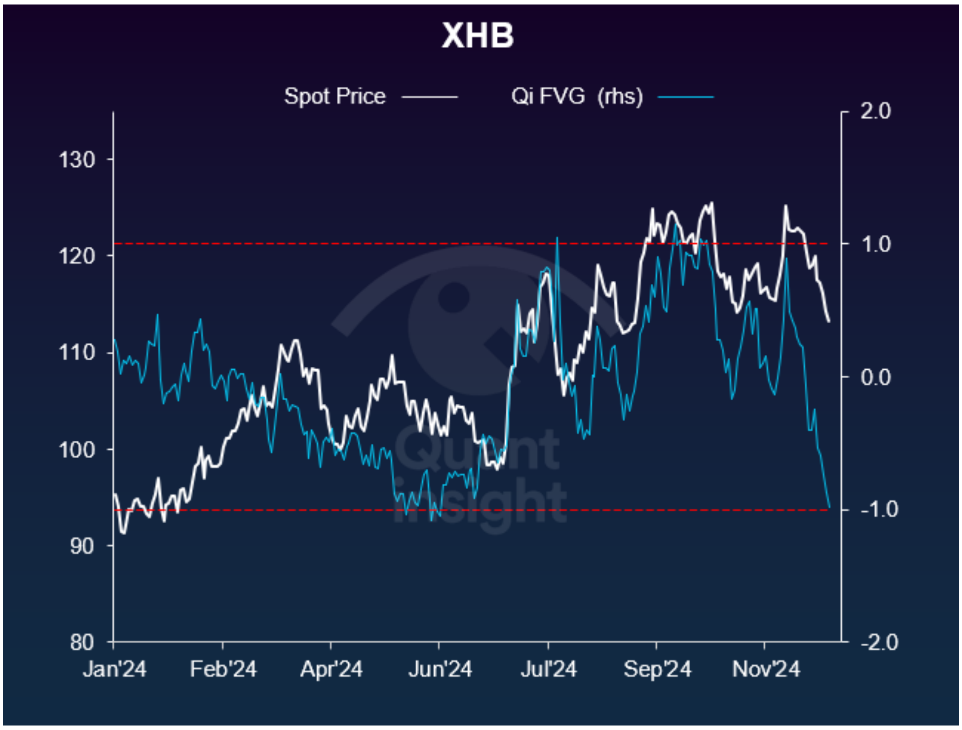
A move higher in this instance captures a hawkish shift in policy expectations - as the number of cuts has been reduced (i.e. the terminal rate has moved higher), this spread steepens. It is now nearly 2.5 standard deviations above trend which is towards the top end of ranges in terms of historical moves.

For context, it was at trend as recently as mid-September. This has been an aggressive move. There are historical precedents for bigger factor shifts, but they are comparatively rare. Finally, we would observe that the Fed Funds Target Rate and 2y UST yields have now converged. A crude proxy for the market expecting a neutral Fed in the near term.

3. US Materials – an efficient China long

The latest China bounce has followed the same path as September's with the initial excitement about a policy pivot petering out. Anecdotal evidence suggests there's been another wave of client deleveraging, this time with US Materials in particular experiencing heavy selling.

For those who think positioning in all Chinese plays is now heavily skewed short and a lot of bad news is in the price, note the US Materials ETF XHB sits 1.2 sigma (7.8%) cheap on Qi.

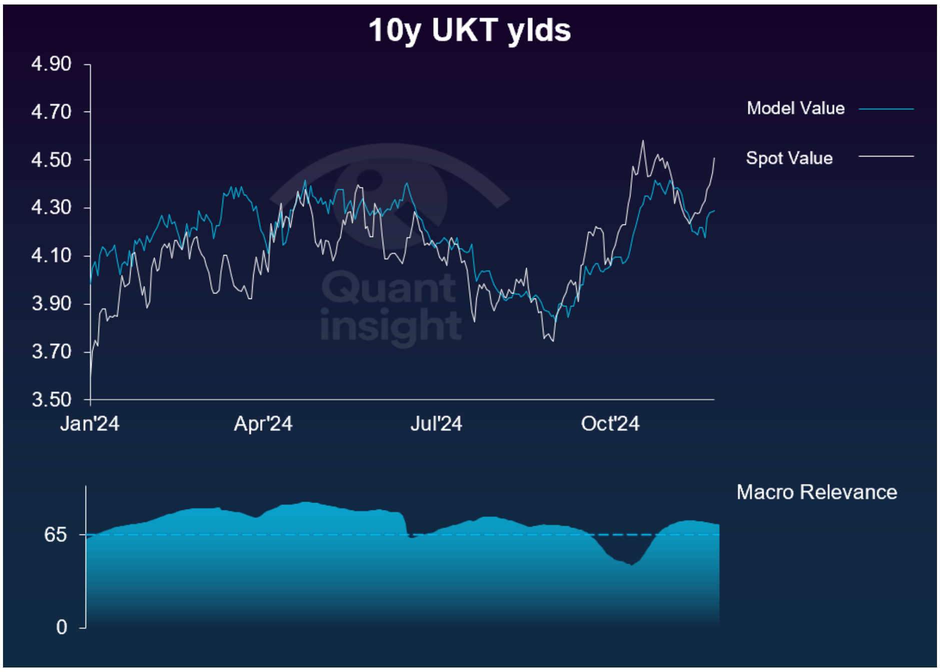


In the last few months Qi's Fair Value Gap has done a good job of capturing turning points. This could be an efficient entry level for contrarians with a more constructive outlook for China & the industrial cycle.

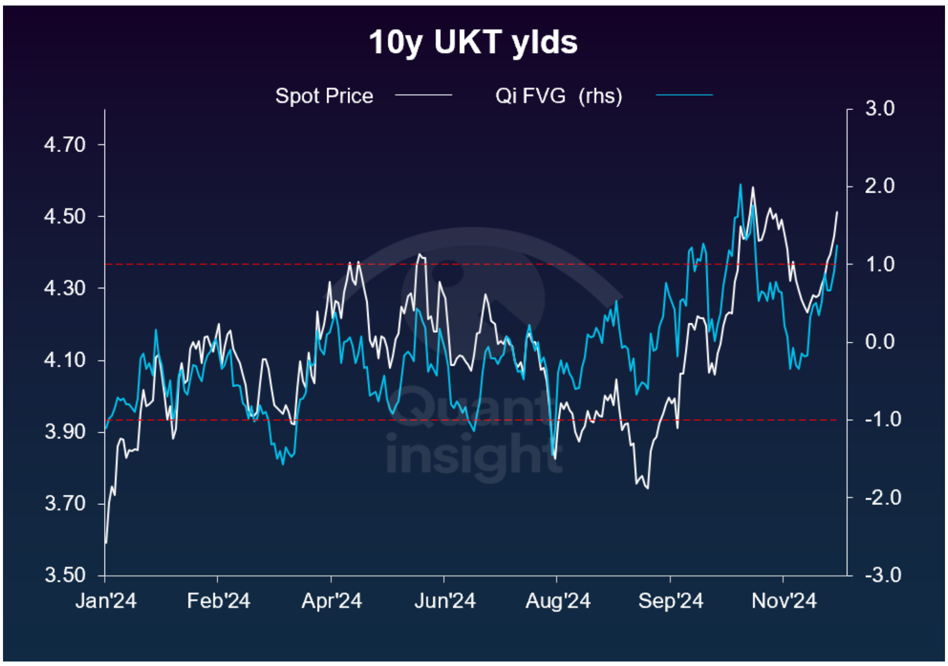
4. Bullish bonds? Gilts offer best value

This week has seen UK wage data and inflation pick-up; a combination that has the market believing the Bank of England will be restricted to just two or three rate cuts next year. Today's MPC meeting may offer more guidance but, thus far, the market has voted with its feet hitting gilts hard.

Qi model value has been pushed higher (now 4.29% versus 4.17% at the start of the week), but the market has moved even further. 10y gilt yields are now 1.2 sigma (22bp) above macro-warranted fair value.



Strong correlation between spot yields & Qi's Fair Value Gap suggests the recent pattern has seen the "right" kind of mean reversion, i.e. for gilts to mark-to-macro rather than the other way around.



This Macrobond chart shows just how big an outlier gilts are amongst G7 government bond markets. Most of its peers sit in the middle of recent Valuation Gap ranges. US Treasuries are modestly cheap but it is the UK that offers yield to any bond bulls.