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Market views and strategy

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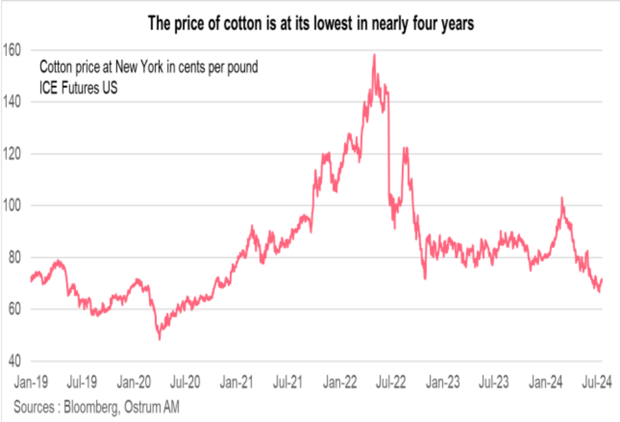
Topic of the week: US stocks: the dispersion trade, are tails wagging the dog?
by Axel Botte

- The US S&P 500 is up 15% with moderate levels of volatility so far this year;
- The stellar index performance is traceable to large cap stocks but a lot is happening under the surface, with unprecedented low correlation within stocks;
- The dispersion trade has been increasingly popular among market participants;
- Remember the Volmaggedon Krach in January 2018, the unwinding of crowded trades can always be painful;
- What breaks the dispersion trade is anyone's guess at this juncture.

Market review: The markets facing political uncertainty and global computer breakdown
by Aline Goupil-Raguénès

- The ECB maintains the status quo, leaving the door open for a rate cut in September;
- Divergence between the US and European bond markets;
- Decline in stock markets affected by technology stocks;
- The Vix index at its highest since April following political uncertainty and global computer breakdown.

Chart of the week



The price of cotton, listed in New York, reached a low not seen since October 2020. It settled at 71.4 cents per pound on the ICE Futures market on July 19, and even dropped to 67.3 cents on July 3.

This is a result of the sharp increase in production in Brazil, which has become the world's leading exporter, surpassing the United States. The decline in the price of corn over the past two years has prompted Brazilian producers to cultivate cotton.

At the same time, global demand for cotton has decreased since the Covid-19 crisis due to inflation and higher interest rates. Consumers are opting for textiles made from less expensive fibers, such as polyester.

Figure of the week

3.5

Business leaders in the eurozone anticipate a gradual slowdown in annual wage growth to 3.5% in 2025, after an expected 4.3% in 2024 and 5.4% in 2023, according to the ECB survey. This would bring them back to a pace more in line with the ECB's 2% inflation target by 2025.
Source: ECB

Topic of the week

US stocks : the dispersion trade, are tails wagging the dog?

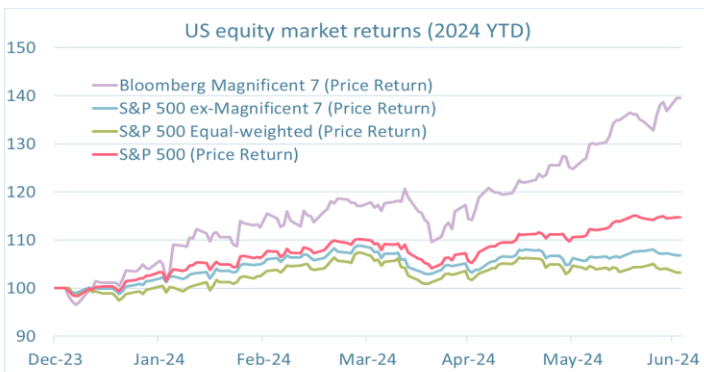
The S&P 500 has marched steadily higher while the VIX implied volatility measure stayed at low levels. However, a lot is going on at the individual stock level. The dispersion trade has attracted considerable attention and money. It is worth digging into the rationale for the trade and its consequences for the broader US equity market.

Extreme polarization of market returns

Nvidia vs. The rest of the market

There is a sense of calm in the US equity market. The S&P 500 gauge is up some 15% so far this year amid low volatility. The VIX implied volatility measure has remained moderate at around 12-14% for much of the year 2024. Such combination of high stock market return and low volatility makes the US equity market a relatively safe bet in the context of political uncertainty in Europe and growth concerns out of China.

That said, there is something brewing under the surface. The Magnificent 7 heavyweights in the S&P 500 move wildly out of synch with the rest of the US stock market. Nvidia, now a $3 trillion stock, is up some 150% whilst 40 % of the stocks included in the S&P 500 are down year-to-date. The equal-weighted S&P 500 is indeed underperforming the cap-weighted index by a considerable margin. In short, Nvidia moves the index quietly but not individual stocks.



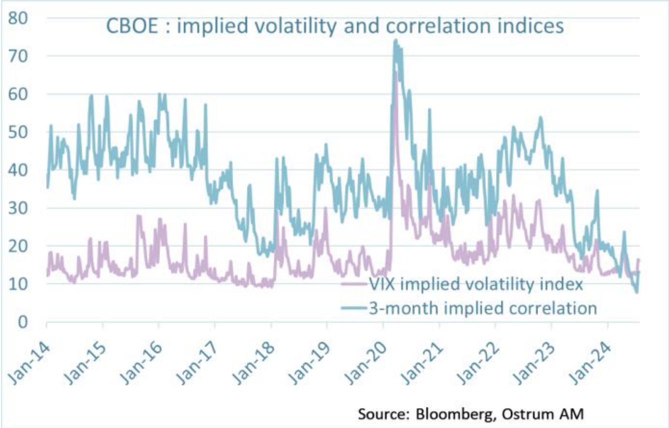
Source: Bloomberg, Ostrum AM

Too much dispersion for comfort?

The dispersion trade essentially represents a view on correlation. The CBOE-calculated implied correlation between the largest 50 stocks in the S&P 500 has fallen to unprecedented levels. In other words, the apparent calm reflects the behavior of a handful of stocks and a lack of investment themes outside artificial intelligence and anti-obesity drugs. This does not mean that the rest of the market moves as independently as the mega-caps leading the equity market.

The dispersion trade is usually implemented by betting on higher volatility in a few stocks via an option portfolio, for instance by buying call spreads on Magnificent 7 stocks, and selling volatility on a broad index, by, say, selling call spreads on S&P 500. This risk management trade has been around for some time (one can trace it back to the dotcom bubble) as it aims at managing the tail risks on technology stocks. It is hard to gauge the popularity of the trade (and we may never know it *before* market-wide liquidation) but correlation is one important indicator.

Using single-stock and index derivatives, the CBOE calculates implied correlation at several horizons. The low CBOE 1-month implied correlation has been depressing the VIX to levels unseen since 2017 when the Fed still maintained ample liquidity at near-zero interest rates.



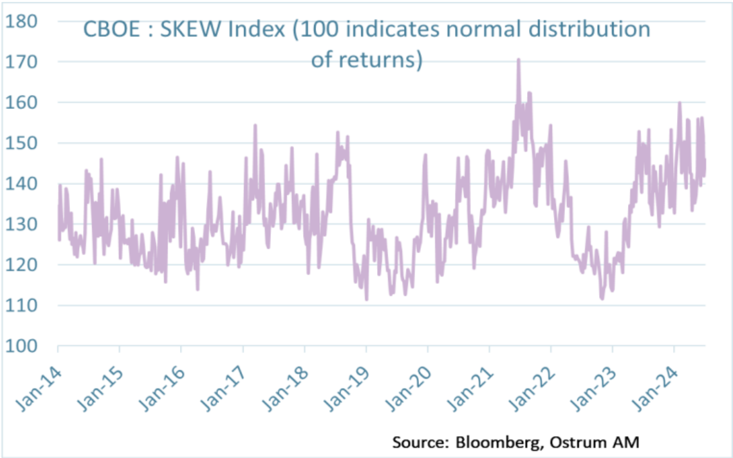
Volmaggedon wiped out $1 trillion dollars worth of short vol products

The stellar performance of the AI-powered Magnificent 7 created dispersion to the upside. Should heavyweights start to underdeliver on corporate earnings, sentiment among market participants could worsen (from near all-time high levels in AAII surveys) and investors ditch equity holdings. The longer-run consequence must be a rise in implied and realized volatility at the index level, should stock price correlations realign across the US equity market.

For the time being, systematic short volatility strategies still deliver outsized returns (chart below) thanks to the upward sloping term structure of at-the-money implied volatility.

A repeat of the 'Volmaggedon' Krach in January 2018 should send chills down traders' spines. As the bubble popped, roughly $1 trillion worth of structured volatility products was reportedly wiped out. It is therefore worth watching the amount of cash betting on lower volatility. A disorderly unwinding of short volatility derivative strategies would then magnify the pickup in volatility stemming from the correlation of large stocks to the rest of the market.

The catalyst for a volatility event could be the November Presidential elections in the United States or a monetary policy mistake from the Fed. Tail-risk hedging could be an early sign of stress. 'Margin call' pressure would certainly show up in a more pronounced asymmetry to the downside of implied volatility (i.e. a higher 'skew'). The Cboe SKEW Index measures perceived tail-risk in the distributions of S&P 500 investment returns over a 30-day horizon. A SKEW rating of 100 means the perceived distribution of S&P 500 returns is normal, and the probability of an outlier return is small.



Conclusion

The dispersion trade is another expression of the short volatility trade. It is a case of tail (risks) wagging the dog (market). Concentrated single-stock volatility creates a need for short volatility hedging at the index level. What breaks the dispersion trade and the bull market is anyone's guess at this juncture. There could be a takeaway from this observation. Taking the other side of the dispersion trade by going long VIX futures may be a more efficient downside hedging strategy than S&P put buying in this context.

Axel Botte

Market review

The markets are facing political uncertainty and a global computer breakdown

Bond markets experienced divergent developments on both sides of the Atlantic, while sector rotation continued in the stock markets.

The week was marked by J. Powell's interview and the ECB meeting, amidst a backdrop of political uncertainty and global computer outage. Jerome Powell expressed a bit more confidence in the continuation of disinflation with the latest 3 inflation figures (CPI). He also reiterated that the Fed's objectives in terms of price stability and maximum employment were more balanced. As expected, the ECB kept its rates unchanged after lowering them in June. Christine Lagarde did not provide indications on what the Central Bank would decide in September, stating that the question was "wide open" and would be dependent on the available data. Both the Fed and the ECB have thus left the door open for a rate cut in September. This was done in a context of continued political uncertainty. In the United States, the assassination attempt on Donald Trump led investors to anticipate a greater likelihood of his victory in the presidential election. Joe Biden, on the other hand, has been increasingly weakened following numerous calls, including from his own camp, for his withdrawal from the race to the White House for health reasons. On Sunday, July 21, he finally capitulated by announcing his withdrawal from the candidacy. In France, the government is in charge of current affairs for several weeks, at least during the time of the Olympics, while awaiting the nomination of a new Prime Minister.

In this context, US interest rates tightened over the week after having significantly dropped the previous week following lower-than-expected inflation. The 2-year and 10-year rates increased by 5 basis points to 4.51% and 4.24% respectively, putting an end to the steepening of the yield curve. This could partly be attributed to retail sales being much better than expected (+0.9% excluding volatile items in June, compared to the expected 0.2% and 0.4% in May) as well as industrial production (+0.6% in June, compared to the expected 0.3% and 0.9% in May). In the eurozone, rates decreased again: -5 basis points for the 2-year rate, at 2.78%, and -3 basis points for the 10-year rate, at 2.47%, notably due to expectations of a rate cut by the ECB. Spreads remained unchanged: 66 basis points for France and 130 basis points for Italy. In the euro credit market, spreads slightly widened: +3 basis points for IG and +5 basis points for HY. Expectations of rate cuts by the ECB resulted in a slight depreciation of the euro (at 1.088) while the yen appreciated again against the $. Gold reached a historic high with the expectations of rate cuts and Bitcoin surged significantly (nearly 9%) in anticipation of a victory by D. Trump, considered favorable to cryptocurrencies. On the stock markets, the rotation that had started after the US CPI continued. Investors shifted away from the technology stocks that had been widely favored, in favor of more traditional stocks more likely to benefit from central bank rate cuts. Furthermore, the Biden administration warned its allies that it could tighten the conditions for exporting electronic chips incorporating American technology to China. This was compounded by the global computer outage on Friday. As a result, the S&P fell by 2 %, the Nasdaq by 4 %, while the US small-cap index increased by 1.7%. The Euro Stoxx 50 lost 4.3% and the CAC 40, 2.5%. Luxury stocks were affected by the disappointing Chinese growth and the absence of measures to support demand during the Third Plenum. In this context, the VIX index reached its highest level since April (16 points).

Aline Goupil-Raguénès

Main market indicators

G4 Government Bonds	22-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.8%	+0	+1	+40
EUR Bunds 10y	2.47%	+0	+6	+45
EUR Bunds 2s10s	-33bp	+0	+6	+6
USD Treasuries 2y	4.52%	+7	-21	+27
USD Treasuries 10y	4.23%	+0	-2	+35
USD Treasuries 2s10s	-29.3bp	-6	+19	+8
GBP Gilt 10y	4.15%	+5	+7	+61
JPY JGB 10y	1.06%	-1	-2	-32
€ Sovereign Spreads (10y)	**22-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	67bp	+3	-13	+13
Italy	128bp	0	-30	-40
Spain	77bp	+1	-15	-20
Inflation Break-evens (10y)	**22-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.2%	0	-3	+7
USD 10y Inflation Swap	2.5%	+2	+1	+9
GBP 10y Inflation Swap	3.62%	0	-1	+9
EUR Credit Indices	**22-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	110bp	+1	-12	-28
EUR Agencies OAS	62bp	+0	-9	-8
EUR Securitized - Covered OAS	61bp	-1	-7	-18
EUR Pan-European High Yield OAS	364bp	+4	-7	-35
EUR/USD CDS Indices 5y	**22-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	53bp	+2	-7	-6
iTraxx Crossover	291bp	+7	-27	-22
CDX IG	51bp	+2	-2	-6
CDX High Yield	332bp	+11	-8	-24
Emerging Markets	**22-Jul-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	392bp	+4	-4	+8
Currencies	**22-Jul-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.089	-0.119	1.538	-1.3
GBP/USD	$1.293	-0.385	1.948	1.5
USD/JPY	JPY 157	0.619	1.908	-10.0
Commodity Futures	**22-Jul-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$82.6	-$2.3	-$1.7	8.9
Gold	$2 401.0	-$29.3	$69.2	16.4
Equity Market Indices	**22-Jul-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 505	-1.97	0.74	15.4
EuroStoxx 50	4 889	-1.90	-0.38	8.1
CAC 40	7 624	-0.12	-0.06	1.1
Nikkei 225	39 599	-3.86	2.60	18.3
Shanghai Composite	2 964	-0.33	-1.13	-0.4
VIX - Implied Volatility Index	16.55	26.14	25.38	32.9

Source: Bloomberg, Ostrum AM

Additional notes

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