Goldman Sachs The Markets
Why investors should "expect the chop to continue"
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Sam Grobart: How are investors responding to a big earnings week but a smaller than expected GDP number? This is The Markets.

Hi, I'm Sam Grobart. Today I'm joined by Brian Garrett who leads the equity execution team on the cross assets' sales desk in Global Banking & Markets. Brian, thanks so much for joining us today.

Brian Garrett: Sam, thanks for having me.

Sam Grobart: So, we've been seeing some big moves in indices in the past week. And you recently wrote that we should, quote, "expect the chop to continue." What's leading you to that conclusion?

Brian Garrett: I think it's important to take a step back and remember what the market has done since the Fed pivot in late October through the end of the first quarter. We had one of the highest sharp ratio rallies in the last 30 years over the last six or seven months, where you've got an extremely powerful rally in equity markets with very little give back along the way. Market participants got lulled into this low volatility, high return environment over the last week and a half/two weeks. We saw a sell off in markets. And unfortunately, that has started to pull liquidity out of the equity market. So, you now have multiple opposing factors that are at odds.

The first, you've got a systematic community that was running extremely long equity indices across the globe where momentum thresholds start to get triggered when you have a relatively sturdy, high, durable rally in equities with a quick sell off. So, you've got that supply hitting the market at a time when futures liquidity is at the lowest level of, call it, six to eight months.

And then you've also a dynamic where effectively there's systemic options selling that has market makers long gamma. In which case, they kind of trade against the one- or two-day momentum of whatever the S&P is doing. So, as we rally, they sell. As we sell off, they buy. So, it dampens volatility in the market.

Sam Grobart: Right. So, there's no countervailing force?

Brian Garrett: Correct.

Sam Grobart: To the systemic movements that you were describing.

Brian Garrett: Correct. So, you've got increased supply, lower liquidity, and no dealer footprint to protect the market. So, you can see an expansion in kind of intraday volatility.

But on the other side you've got positive fundamentals, positive consumer data, spending data continues to be strong. Delinquencies are low. So, at this exact point in time you've got a push and a pull from multiple factors.

Sam Grobart: Gotcha. This has been a huge week for earnings. What are you seeing out of all the big reports coming from the major corporates?

Brian Garrett: Yeah, totally. There's a lot of unrealized P&L, especially in the kind of blistering AI tech piece of the market. And I think the average stock in our AI basket is up 15 percent year to date versus the average stock in the S&P's only up 4 percent.

Sam Grobart: That's a pretty big gap, yeah.

Brian Garrett: Yeah. So, you've got a high bar on earnings. And I think that we're starting to see even good prints get faded because you're in an environment where overall volatility's higher. There is a lot of kind of unrealized P&L in these names. And if you don't, you know, knock the cover off the ball, the market is going to size their positions. And I think we're seeing an earnings report that could have led to a name down 3 or 4 percent is now trading down 5 or 6 percent as a function of just people managing their risk.

Sam Grobart: So, I just want to sit with this one for a second. Is what you're saying that you've got this sort of, almost, incredibly bright, shiny object, which is AI earnings, and that is somewhat, not distorting, but changing the expectations that investors have on non-AI companies?

Brian Garrett: Through the beginning of the year there were the have and the have nots, right? Like, AI, GLP-1, etcetera, those names have all rallied. Where the rest of the market has been left behind. So, I think that you've got the year-to-date winners have an extremely high bar that has been set for them that if they can't overcome, their stocks could potentially see a little bit more aggressive sell off than otherwise would have been.

Sam Grobart: Got it.

Brian Garrett: And then you've got names that were massive underperformers where the bar is much lower. And you could have negative momentum trends following these things that are short where now they beat that low bar and you see an outsized rally on earning.

Sam Grobart: Got it. Brian, we've been seeing an uptick in ten-year treasury yields lately. What does that mean for markets? And how are investors responding to it?

Brian Garrett: So, I think there are two things that can take treasury yields higher. One of those is stronger growth for the economy. And the other is, unfortunately, inflation readings, which can be at odds with the Fed's 2 percent target and soft-landing narrative.

If you get higher yields as a function of stronger growth and stronger job data, I think the equity market can certainly handle a ten year in the high 4s, low 5s. But where we see the apprehension in the market is when you get blistering hot inflation prints, which muddy the outlook for fiscal policy and financial conditions for the US as a whole.

I think one other thing to piece in that question is that there's also a function of absolute level of rate and velocity of rate. The equity market can handle higher interest rate environments, again, assuming growth is good. But what they can't handle is when you have extremely choppy moves within the interest rate environment over short periods of time.

So, when the ten year yield is averaging a 15 basis point intraday band, the VIX trades about 25. Last night, the VIX closed at 16. So, you're talking about if the bands in the fixed income market expand, you could expect the equity market to be about 1.5 times as volatile as it has been.

Sam Grobart: Interesting. Brian, we just got GDP data as we sat down to record this. And I was wondering if you can talk a little bit about the relationship between markets and economic data. And has that relationship changed in the past few weeks?

Brian Garrett: We need to bifurcate economic data in two camps. I think the first camp is inflation data and the second camp is everything else. GDP data came in unfortunately low this morning. The market has responded. But I think that overall, jobs and consumer are the most imp the thing. And both of which continue to be quite strong. The market is also extremely focused on when the Fed is going to have their first cut.

Sam Grobart: Of course.

Brian Garrett: And so, I think that during the Fed pivot in late 2023, and in subsequent interviews, Jerome Powell has made it very clear that the Fed is not afraid to cut in a high growth environment. But it is very reticent to cut if they haven't, quote/unquote, "beaten back inflation." So, again, I think that's why you need to bifurcate economic data between inflation and everything else, just because they're two very different kinds of outcomes for the market.

Sam Grobart: They can move in very different directions.

Brian Garrett: Correct.

Sam Grobart: And Brian, last question, what's going to be on your radar for next week?

Brian Garrett: As an equity derivatives guy, I can't hear that question without looking at what the implied move is between now and the end of next week, which for the S&P is 2 percent, which is actually pretty high all things considered. Unfortunately, I've got three things that are on my mind, none of which are the FOMC.

Sam Grobart: Okay.

Brian Garrett: It's earnings, jobs, and Janet. First is earnings. You have multiple mega caps that will all be reporting. Realized moves so far in this earning season have been quite large. And so, many market participants will be focused on that.

The second thing on my radar is obviously nonfarm payrolls on Friday. I've done this job for almost 20 years. And I've never missed an NFP report on the desk. Bottom line is, as I mentioned, a lot of the predications for soft landing, positive economy, positive equity hinges on strong jobs. So, if you aren't watching NFP every month and jobless claims every Thursday, you should either be well hedged or in cash.

Sam Grobart: Okay. Good to know. And your third one, you were saying Janet.

Brian Garrett: And the third one is Janet Yellen. So, the Treasury is going to issue their QRA next week.

Sam Grobart: What's QRA?

Brian Garrett: QRA stands for quarterly refunding announcement where they'll dictate the amount of issuance that they will have in either bills or bonds. This actually has a very large implication for liquidity in the fixed-income market. And so, that's definitely something that's going to be in my radar as well.

Sam Grobart: Brian Garrett, thank you so much.

Brian Garrett: Thanks, Sam. Appreciate it.

Sam Grobart: That does it for another episode of The Markets. Be sure to find us on Apple Podcasts, Spotify, or wherever you get your podcasts.

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