



While Some Assets Are Pricing In A Recession, Others Remain Oblivious: Here's How To Trade The Schizophrenia With A 10x Payout



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Is a recession coming... and when? That is the \$64 trillion question. And if one has the answer, they can make 10x on their invested capital.

While rates, "safe havens", long-dated equity vol, and even the Fed are sending very clear warnings about an approaching US recession, some pockets of the market are still underpricing - or outright ignoring - the likelihood of a downturn, according to the BofA equity derivatives team led by Benjamin Bowler.

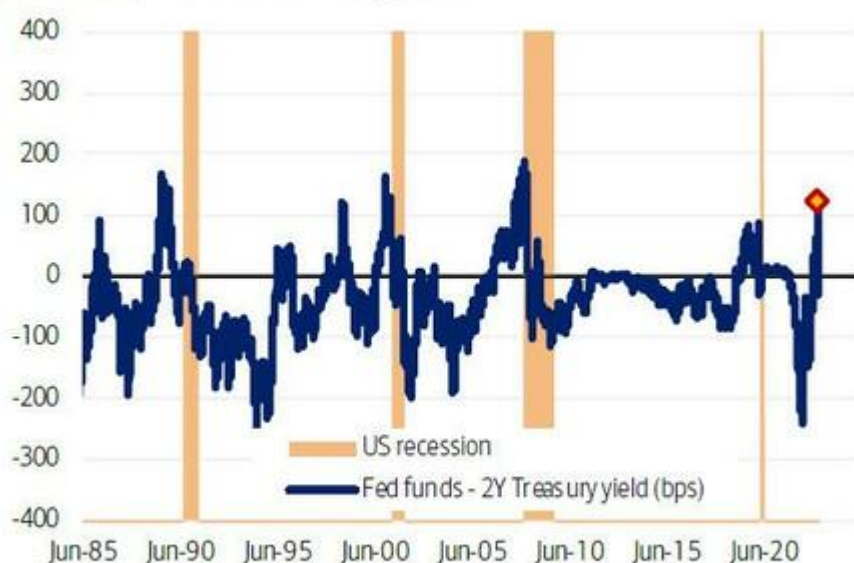
- First, US equities seem to be looking past the type of financial or economic shock that would get the Fed to cut rates, and yet seem to be paradoxically trading on expectations of future rate cuts.
- Second, cross-asset correlations are still heavily influenced by the inflationary environment of the last 18m ("safe havens" and risk-assets moving together) and are not in line with recessionary price action (like the bid to "safe havens" triggered by this month's banking crisis).

But before we get ahead of ourselves, let's take a more detailed look at the two camps. We start with the assets where there is growing consensus that a recession is coming to US shores. We can see this in:

- **Rates markets:** The sharp rally in Treasury bonds this month, particularly at the 2yr point, has created a historically large spread between Fed funds and 2-year yields. It has also caused a sharp steepening of the 2s10s yield curve from inverted territory. **Both dynamics have long histories of reliably predicting recessions.**

Exhibit 8: The market is pricing in sharply lower rates in the next two years, a historically reliable predictor of recession

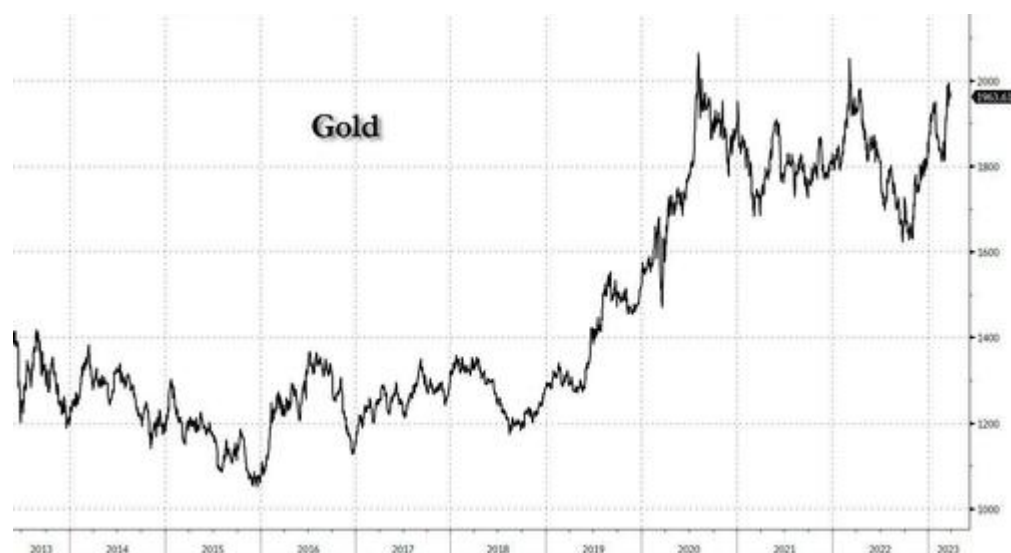
Fed funds spread over 2Y Treasury yields



Source: BofA Global Research. Data from Jun-85 to 24-Mar-23.

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- **"Safe havens":** The "safe haven" trade (Treasuries, Gold, and JPY rallying on equity weakness) has awakened in the last couple of weeks – a marked change from the inflationary dynamics of the last 18m.

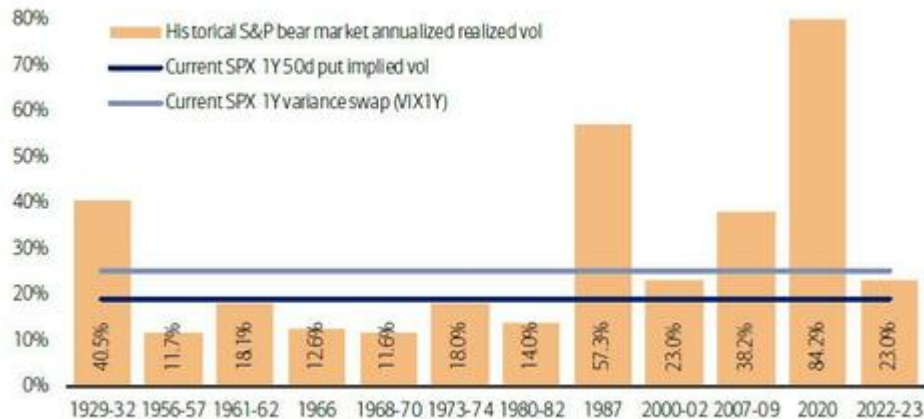


- **The Fed:** The FOMC's forecasts for growth and unemployment are already consistent with milder recessions like the early 2000s, according to our Economics team...

... with each new forecast they keep lowering their forecast for 4Q/4Q 2023 GDP growth. The last four median forecasts are, respectively: 1.7, 1.2, 0.5 and 0.4%. Keep in mind that there have been two recessions in the modern era where yoy GDP growth bottomed out at just above or just below zero: 1970 (-0.2%) and 2000 (+0.2%). The Fed is one revision away from the 2000 recession. Meanwhile they expect the unemployment rate to jump to 4.5% by 4Q (from a 3.5% average so far this year). There has never been more than a 0.5% rise in the unemployment rate absent a recession

- **Even equity vol (to some extent):** Longer-dated measures of equity vol are not an obvious buy into a garden-variety recession (e.g. 1Y 50d vol is now priced for a 1973-74 repeat while 1Y variance is priced for a Tech Bubble repeat; Exhibit 9). And longer-dated skew has re-steepened to historically elevated levels, **pricing in more severe downside risks to equities over the medium to long run.**

Exhibit 9: Longer-dated measures of implied equity vol are not too low for a garden-variety recession (1Y 50d vol is now priced for a 1973-74 repeat and 1Y variance for a Tech Bubble repeat)
Current SPX 1Y implied vol & variance vs. the realized volatility generated historically in S&P bear markets



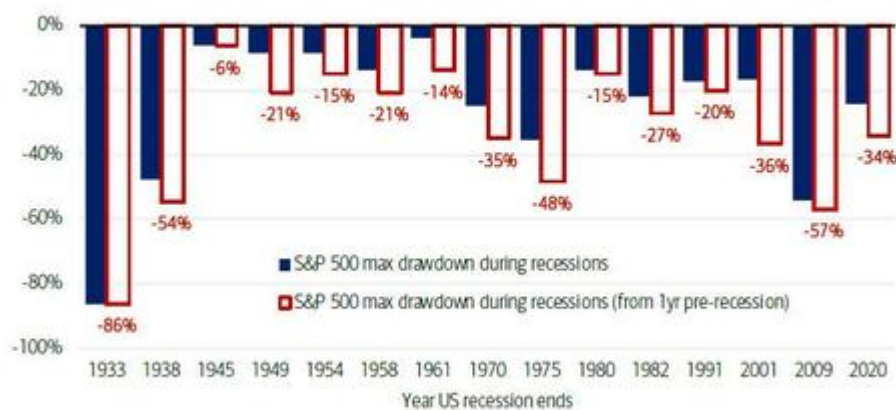
Source: BofA Global Research. Data as of 27-Mar-23. Bear markets are defined as peak-to-trough drawdowns in the S&P exceeding -20%. BofA GLOBAL RESEARCH

But some pockets of the market aren't priced for a recession yet:

- **US equities:** The major US equity indices seem to be looking past the type of shock or economic slowdown that would get the Fed to cut rates, and yet are trading on expectations of a lower (eventually) discount factor. This is despite two important facts: (i) recessions are reliably negative for equities throughout history and not discounted in advance (Exhibit 10), and (ii) the FOMC projections and dots imply no rate cuts even if we get a mild recession this year.

Exhibit 10: Recessions are painful for equities and hardly discounted in advance, suggesting plenty of room for more S&P downside from here

The S&P saw drawdowns of over 20% around 7 of the last 8 recessions. And in almost all recessions since 1929, most of the max drawdown (67%) took place during the actual recession, and not in the 12m prior.



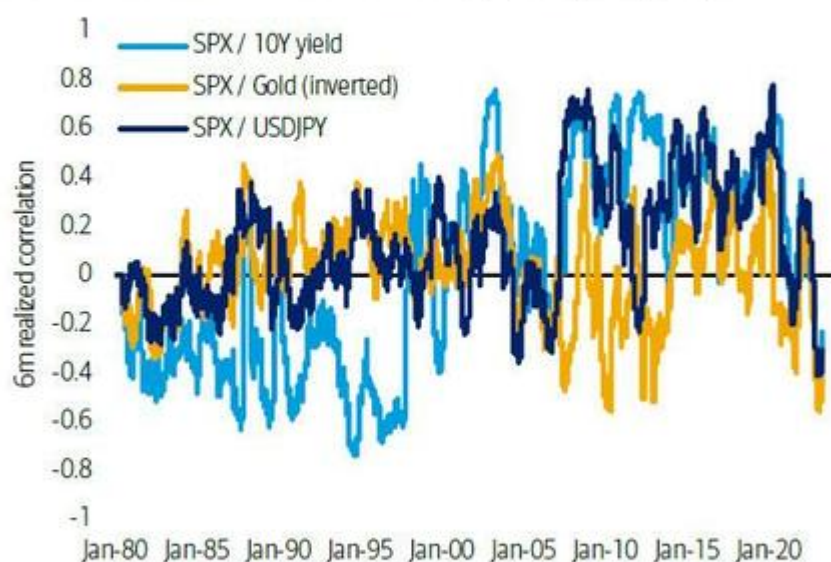
Source: BofA Global Research. Data from 1927 to Mar-2023.

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- **Cross-asset correlations:** Despite having moved sharply in recent weeks, cross-asset correlations are still heavily influenced by the inflationary environment of the last 18m, which was characterized by "safe havens" and risk assets falling in tandem. Hence, **they are underpricing a recessionary environment in which equities sell off and bonds rally.**

Exhibit 11: Cross-asset correlations are still heavily influenced by the Inflationary environment of the last 18m, which was characterized by "safe havens" and risk assets falling in tandem

Realized correlation between the S&P and gold, 10Y yields, USDJPY



Source: BofA Global Research. Data from Jan-1980 to 27-Mar-23. Correlation of daily returns, except daily changes for 10Y yields.

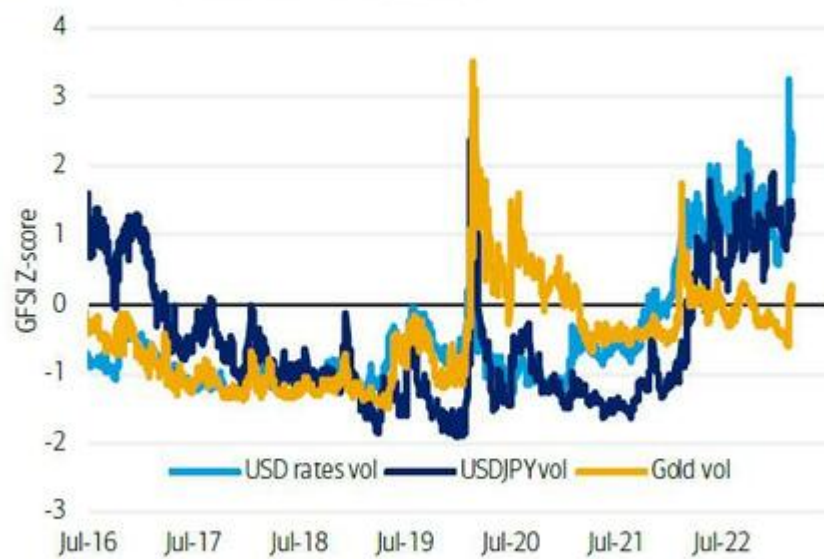
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As a result of this schizophrenic landscape, when looking for how to best hedge a recession the BofA derivatives team finds value leaning short US equities and selling the correlation between S&P and “safe havens”, e.g. through structures that pay out when SPX falls and a “safe haven” rallies. One such trade BofA has been recommending is **SPX puts contingent on 10Y lower**. But currently the entry point is more attractive to own SPX lower, gold higher structures.

Recession hedge: Buy Sep SPX < 92% GLD > 103.5% dual digital for 10% (10x max payout; 0 correl bid, ref. 3982.24, 181.92). Risk limited to upfront premium spent. - (call your nearest BofA salesman for more details)

The trade, which offers 10x payouts, benefits from historically high correlation and from gold vol near all-time lows vs other “safe havens”. The entry point also benefits from S&P/gold implied correlation at 0 (vs slightly positive for S&P v. rates and S&P v. USDJPY) and gold vol still clearly lagging cross-asset vols (1st %ile vs both rates vol and USDJPY vol).

Exhibit 12: Gold vol is still a clear laggard vs vol in other “safe havens” like rates and USDJPY, which makes it a more attractive asset to pair with SPX lower in dual digitals to hedge a recession
Rates, Gold, USDJPY implied volatility (GFSI)



Source: BofA Global Research. Data from Jul-2016 to 24-Mar-23.

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Furthermore, while gold has been less reliable than Treasuries in equity bear markets, stickier inflation expectations today and the challenges faced by Treasuries post-COVID might drive demand for gold in the next slowdown.

Fundamentally, stickier inflation expectations and the challenges faced by Treasuries post-COVID might drive demand for gold in the next slowdown.

More in the full BofA note [available to pro subs](#).

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