THE DAILY CHECK-IN WITH GOLDMAN SACHS

GUEST: MORAN FORMAN, CO-RUNS THE INDEX FRANCHISE TRADING DESK, EQUITY DERIVATIVES, GLOBAL MARKETS DIVISION

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RECORDED: FEBRUARY 4, 2021

Liz Bowyer: Hi Moran.

Moran Forman: Hey, Liz.

Liz Bowyer: You help our institutional clients trade macro derivative products. Just given all of the activity that we've seen in the markets in recent weeks, what are you focused on most with clients right now?

Moran Forman: I think most of our clients are focused currently on the retail inflows that we've seen over the past few weeks. And in particular, the large de-grossing that's happened last week. We had an environment where single name shorts were getting covered in really large size. And that led to huge performance difference between the hedge fund VIP basket, which comprises the most popular hedge fund names, compared to the most short basket. And that divergence is really what everybody's focused on at the moment. So, the flows that with saw in the back of that with people short covering single stock names. And on the back of that, moving into shorts in the ETF space. So, the ETF shorts now make up more than 20 percent of our short [UNINTEL], which is the highest level on record.

Liz Bowyer: So, talk more about the kinds of volumes that you're seeing.

Moran Forman: Yeah, so it's really been off the charts at this point, both on the cash space, so the cash equity side, as well as on the derivative side. We've seen record volumes to start the year in equities.

And just to give you a sense, in the call option volumes, seven of the ten largest volume days in history have occurred in 2021. And we're only in January of this year. And January was a short month. And so, we're really seeing these trades dominate the market. And in particular, when we look at the small order size trades, so these are when we break out the order size of the

volume that we see in the market, we see that about 25 percent of trades currently comprise of small order size. And that compares to only about 10 percent in 2019. So, it's really been a huge increase in the retail inflows in January.

Liz Bowyer: So, these higher volumes are translating into higher levels of market volatility. How long do you expect that to last?

Moran Forman: Yeah. You know, I think we've experienced a year of really high macro economic volatility in the data itself, which has led to higher equity volatility in the past year. One thing that we're seeing in the equity market now is a much lower sensitivity to data. Equities are being quite forward looking at the moment. And essentially ignoring some of the weak data that has come in, such as the weak payroll parents, the increase in the COVID variants, and the slower vaccine rollout.

So, in terms of volatility from here, what we're really experiencing right now is a supply/demand imbalance. So, on the supply side, usually it was the volatility sellers that had provided the offset to the buyers in the market. But since March of last year when we experienced really high level of volatility and a lot of these strategies were taken out of the market, it's been very slow to come back into the US index space. And so, we're seeing a lack of supply coming in. And at the same time, we're seeing a really large increase in demand, particularly from the institutional players on the downside. And from the retail investors on the upside. So, that's kept the implied to realized spreads in the S & P much wider than it is usual.

People kind of expected volatility to come in after the US elections and then after Georgia and then after the inauguration. And once that didn't really happen, I think it kind of indicated a lack of liquidity that was forming in the market as volatility failed to normalize. I think going forward, a lot of our investors do believe that we're now in a regime that will have some lower index volatility and that will be mostly result of larger sector dispersion. So, as these sectors move in opposite directions, it keeps a lid on where the volatility of the index, as a whole, can go.

Liz Bowyer: And elaborate on the volatility you're seeing in indexes versus single stocks.

Moran Forman: Yeah. So, I think the way to really see this is in something we call skew. Skew basically measures how much

demand there is for upside versus how much demand there is for downside. And the reason I bring this up and what can seem like a technical term, is it's really a divergence between index and single stocks. So, on the index side we've been demand from institutional players for protection from downside or wanting to hedge against equity market drawdown. But on the single stock side, that's been really where retail has dominated. And that's caused the single stocks skew to trade very flat. And the index skew to trade very high. And so, the divergence between those two is actually at some of the widest levels we've seen in history.

One other thing I should just mention in terms of the volumes we're talking about when we talk about the retail investor is the nature of the options that have been bought. Most of these options are very short dated in nature. So, we're talking one-to-two-week options. So, these aren't people typically that are playing these names for a one year, two year, three year timeframe. It's a much shorter time horizon. And that the primary flow that's intermediating these retail investors typically comes from market makers as opposed to the larger banks and institutional players.

Liz Bowyer: And Moran, against this backdrop there's a big focus on Washington as the fiscal stimulus package makes its way through Congress. What does the prospect of more fiscal stimulus from the US economy mean for equities?

Moran Forman: Yeah. You know, I think equities, we're expecting around a $1 trillion package, which is about half of what President Biden had initially proposed. Now that it seems to be going through the reconciliation process, which does not require bipartisan support, the size of the package could potentially be larger. And that would be a positive for the equity market. It would be viewed as positive to growth. And something that equities will probably view quite favorably.

The one nuance here and the one thing to kind of watch out for is the correlation between rates and equities. So, on the rate side, nominal yields moving higher is good as long as it comes with positive growth. But once equities have factored in the positive growth, if nominal yields continue to [UNINTEL], that's a problem for equities, because a lot of the equity inflows were really predicated on this concept of there is no alternative. Like, where else can you possibly put your money in a world where interest rates are so low? So, if that equation changes as a result of the larger fiscal stimulus, I think that's where the

risk could come for the equity market. But by and large, equities will view a large fiscal package as positive for growth.

Liz Bowyer: And what about the risk of inflation and the prospect of the equity market moving into bubble territory just given all of the stimulus?

Moran Forman: Yeah, I think that's really the number one question right now. The base effects for the middle of this year coupled with this concept of revenge spending as people have been cooped up in their house could definitely mean a recipe for higher inflation. I should mention equities are a nominal asset, meaning based on company revenues. So, some inflation is generally okay when it comes to the equity market. But if we do get, for instance, runway wage growth, that could be an issue for a bottom-line profitability for the equity markets in general. And in my mind, that runway inflation without significant growth could become an issue as people start to look at the debt sustainability and the situation that the government finds itself in with the amount of debt that's being issued. Recently, that hasn't clearly been the focus. The number one focus is getting the economy out of the pandemic.

I think, you know, the Fed is clearly important here. They've shifted their framework to what is an average inflation target framework. What that means is that they are targeting higher rates of inflation during the good times to offset the lower rates of inflation during the bad times. And so, that's a very pro-cyclical policy that if tested and if they do hold with [UNINTEL] as you get inflation moving higher, that will be quite positive for the equity market.

Liz Bowyer: Thanks, Moran.

Moran Forman: Thank you, Liz.

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