



MacroVantage

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

1. Small Cap rotation is hostage to inflation
2. Rate Volatility - the Blind Spot in Equity Risk
3. Rising Rate Vol - the Achilles Heel of IBB

1. Small Cap rotation is hostage to inflation

Last week's *MacroVantage* highlighted the S&P500's growing negative sensitivity to inflation and easier financial conditions.

That pattern is even more acute for the Russell 2000. IWM sensitivity to 5y US inflation expectations is at record lows; and IWM is noticeably more reliant on benign inflation than either SPY or QQQ.

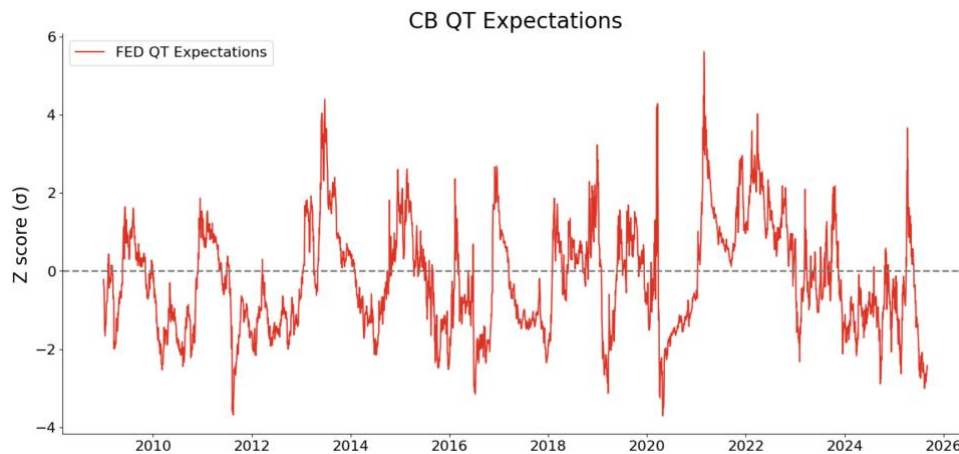
Rotation trades into small caps are popular for a variety of fundamental and positional reasons. Qi observes that to work, we need to see inflation behave. Further hawkish re-pricing of inflation would be a big headwind to R2k performance relative to both Large Caps and Technology.



2. Rate Volatility - the Blind Spot in Equity Risk

Interest rate volatility is effectively Ground Zero of financial markets right now. This is a good way to track the key themes of fiscal dominance and the mood of the bond vigilantes.

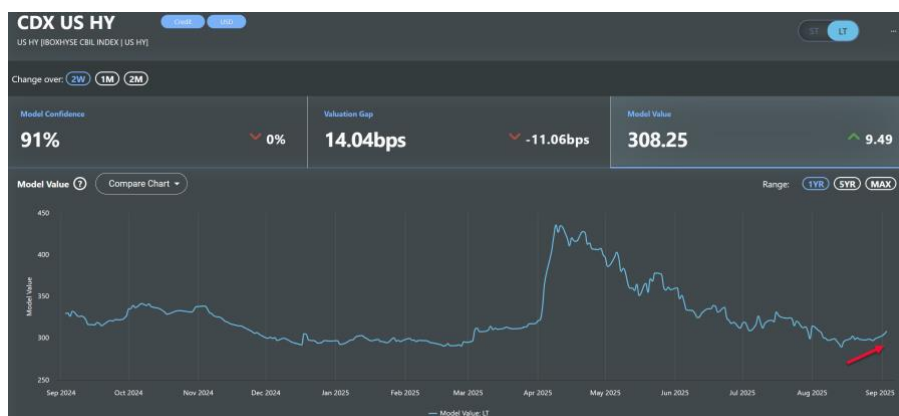
We have observed before how swaption vol - our Fed QT expectations factor - has fallen to extreme lows suggesting the bond market is not worried about inflation, deficits, Fed independence or data integrity. But risky assets live in fear of a disorderly bond market so this is a key tail risk to monitor.



An increasing number of equity models (see IBB below) are displaying greater vulnerability to any possible spike in interest rate volatility. That vulnerability would be compounded if the Fixed Income market provoked credit spreads to widen as well.

It is notable therefore that Qi's macro-warranted model value for US High Yield spreads troughed at 290bp on August 14th and has subsequently risen to 308bp today. The biggest driver of that move wider in Qi model value? Rising interest rate volatility.

Understanding the impact of Fixed Income markets is going to be critical for equity investors in the weeks ahead.



3. Rising Rate Vol - the Achilles Heel of IBB

Fears over long-term debt sustainability will feed into the durability of longer duration, more speculative risky assets. On Qi's valuation mode, IBB (biotechnology ETF) is stand-out where rising rate vol and real rates account for the largest share of macro explanatory power. Indeed, more broadly across the technology sector, one would think that higher AI infrastructure capex implies a high duration risk attached to the future return on investment. The ARK suite of ETFs also fall into this category.

IBB is trading 1.2 sigma above Qi's model fair value, close to 5yr highs. See the first chart below. Running a backtest since 2009 on prior signals where IBB is trading at this fair value gap and well explained by macro, reveals 13 events. 10 out of these 13 events proved to be a profitable short opportunity.



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FVG_Back_Test(['IBB'],1.2,0.25,65,'2009-01-01','2025-09-02',['Short'],'Long Term')
```

✓ 5.7s

Results	
Hit Rate	76.923077
Avg. Rtrn	2.867827
Ann. Rtrn	34.186088
Median Rtrn	2.322379
Avg. Max Gain	4.501515
Avg. Max loss	-2.538509
Avg. Holding Period	24.230769
Median Holding Period	19.000000
No. of Trades	13.000000
Avg. Win	4.534865
Avg. Loss	-2.688964
Win/Loss	1.686473

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