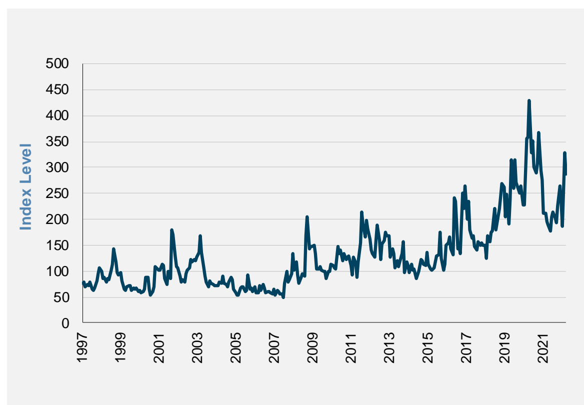
Here Be Dragons

June 2022

Having been used by early mapmakers to symbolise uncharted and yet-to-be discovered territory, the phrase '*Here be Dragons'* has entered the lexicon in reference to the basic human fear of the unknown. The current seismic shift in economic, social and political themes has made the macro investment landscape feel like uncharted waters, with the lure of riches and fear of doom in equal measure. Several significant macro forces have gone into reverse: globalisation to nationalism and reshoring, deflation to inflation, quantitative easing to quantitative tightening, energy and food security to insecurity, global cooperation to sanctions and fragmentation. In keeping with the analogy, we will show where portfolio stresses have gone 'off-the-charts', what the new economic paradigm looks like and why we feel that trend following strategies are best placed to navigate this enduring period of heightened uncertainty.

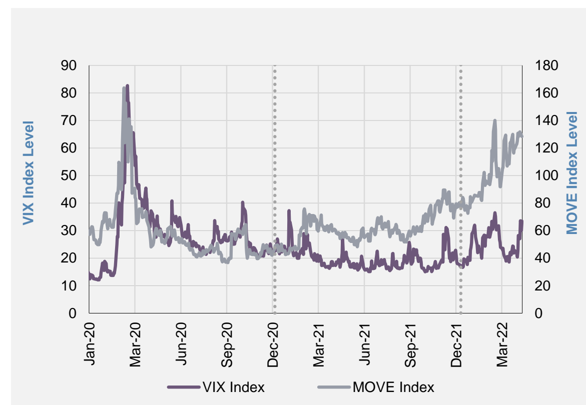
Let's begin with uncertainty. First up, in Figure 1, is an index of global economic policy uncertainty, which is a GDP-weighted average of Economic Policy Uncertainty across approximately two thirds of the world market cap, measured by the frequency of EPU mentioned in own country newspapers, appropriately normalised. With the exception of the spike caused by the outbreak of the pandemic, we see that uncertainty has been generally rising, with the Brexit vote, Trump Presidency, US-China trade wars, Covid and post-pandemic implications gradually making the macro landscape more uncertain.

Figure 1: Global Economic Policy Uncertainty Index: Jan 1997 to Apr 2022



Source: https://www.policyuncertainty.com/index.html

Figure 2: Stocks and Bonds Implied Volatility: Jan 2020 to Apr 2022



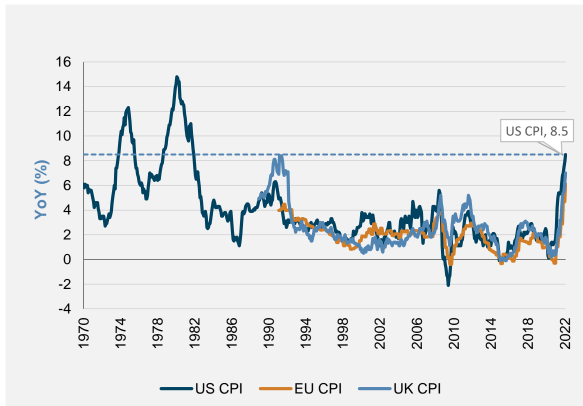
Source: Bloomberg.

A more recent and immediate marker of unusual uncertainty has come from the bond markets. In Figure 2, we show implied volatilities of both stocks and bonds measured by the VIX and MOVE indices. These are the two most prevalent asset classes in investors' portfolios and therefore are of greatest significance economically. The systemic shock induced by the outbreak of Covid is clearly represented by the dual spike in volatility of both asset classes. Uncertainty was understandably high due to the widespread and synchronised global response to the pandemic. Two years on, the equity shock has mostly dissipated - but bonds have become three times as risky in the space of a year and are presently almost as uncertain as they were at the height of the pandemic-induced market panic. Something has certainly changed…

One thing that's markedly different about the world today, compared to the last four decades, is the return of inflation. No longer 'transitory', the US CPI print of 8.5% in April 2022 is the highest since 1982, when Paul Volcker was chairing the Fed, and the US was recovering from a decade-long stagflationary environment. Figure 3 shows the speed and extent of the mounting inflationary pressures and Figure 4 highlights how slow the Fed has been to react

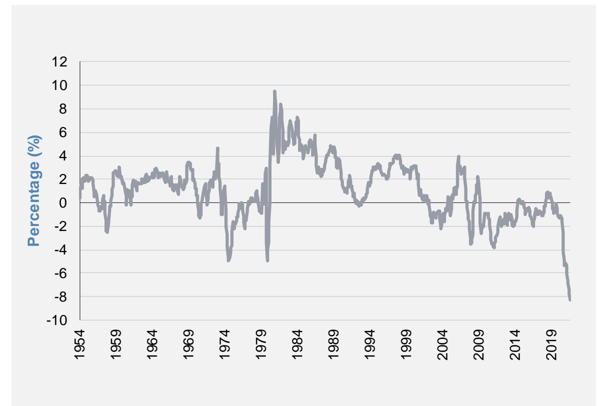
to rising costs in the economy. The real fed funds rate has truly gone off exploring uncharted waters and it's anyone's guess now what the resultant knock-on effects will be.

Figure 3: Inflation in the US, the UK and the EU: Jan 1970 to Apr 2022



Source: Bloomberg.

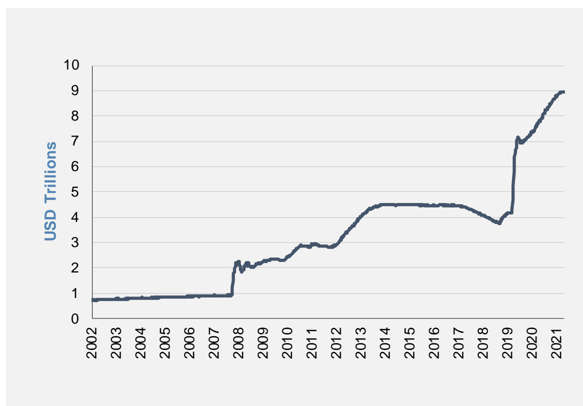
Figure 4: Real Fed Funds Rate: Jul 1954 to Apr 2022



Source: Bloomberg. Real Fed Funds Rate calculated using effective federal funds rate minus year-on-year CPI.

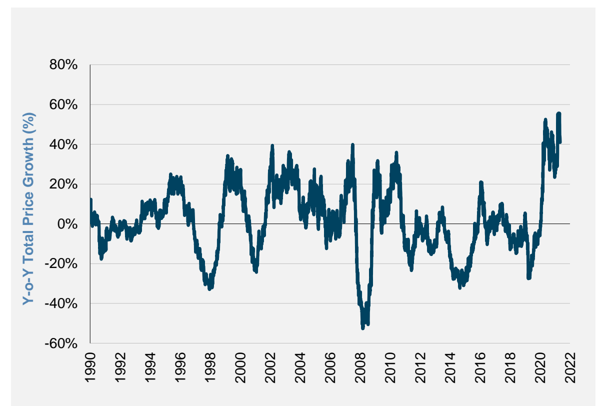
There are several global macro themes that together serve to entrench inflation and weaken demand, presenting a stagflationary challenge for the global economy. Two of the more significant ones are the effects of unwinding bloated central bank balance sheets, or quantitative tightening, and the broad and significant rise in the cost of commodities, ushering in a new commodity supercycle era. The Fed balance sheet, shown in Figure 5, has rapidly increased in size, especially as a way to mitigate the deflationary effects of the pandemic response. However, the saying, "the bigger they are the harder they fall" feels apt when it comes to the ramifications of the Fed's attempts to unwind its balance sheet.

Figure 5: US Federal Reserve Balance Sheet Expansion: Dec 2002 to Apr 2022



Source: St Louis Fed.

Figure 6: Bloomberg Commodities Index Y-o-Y Total Return: 1990 to Apr 2022



Source: Bloomberg.

By contrast, as we see in Figure 6, commodities have been surging in price, driven by factors that are mostly external to the Fed or any other central bank. Despite a plethora of hawkish central bank actions of late, waning fiscal support as we emerge from the pandemic, and anaemic growth in China as it maintains an aggressive zero-Covid policy in the face of the highly contagious Omicron variant, commodities are rallying and showing no respite.

To understand the driving forces affecting commodity markets it helps to distinguish real assets from financial assets. Financial assets, like stocks and bonds, are driven by growth expectations. Consequently, changes to the level of interest rates or earnings growth have a material impact on the performance of the spot financial markets.

By contrast, commodities are real assets, that react to changes in the level of demand relative to supply. Of late, supplies of commodities have been significantly impaired, disrupted or outright restricted depending on the region and commodity in question. The effects of pandemic related shutdowns or reduced activity over the last two years have resulted in mining and manufacturing disruptions, shipping delays and generally significantly impaired global supply chains. Additionally, the tragedy of war in Ukraine and associated sanctions on Russia have resulted in significant drops in supplies of grains, fertiliser, hydrocarbon-based energy products and many industrial metals. Yet the level of demand for commodities, in particular sources of energy as well as food, remains as high as ever. The combination of significant near-term supply shocks, low inventories and longer-term global ambitions to reduce reliance on carbon-based energy sources provides an environment that will keep energy prices elevated and at risk of further price spikes.

In the simplest of terms, high and rising energy prices are inflationary, as all economic activity is effectively a conversion of energy into goods and services. Central banks will attempt to tackle inflation by hiking rates and stifling demand. However, in the short-term there is very little they can do to improve the supply side of many commodities. Financial assets are most sensitive to changing growth expectations and we have already seen evidence of declining global growth forecasts. Low growth and high inflation once entrenched is the definition of stagflation – a subject we have discussed at length in a previous paper[1]. We argued that during stagflationary environments, traditional portfolios comprised of stocks and bonds erode in value as real rates of return turn negative, yet trend following strategies potentially have the attributes to ably navigate such a macro environment. We also wrote last year about the factors contributing to the commodity supercycle[2] and how that plays positively into the hands of commodity-heavy trend following programmes.

What do we know so far?

- Inflation is back with a vengeance after a 40-year hiatus and central banks have turned to hiking rates and quantitative tightening
- A commodity supercycle is in its early stages, fuelled by structural underinvestment, post-pandemic demand resurgence, the drive to decarbonise and war
- Policy uncertainty and market instability is on the rise
- Peak globalisation is behind us and geopolitical tensions are exacerbating the disruption in an already disrupted world

Given the significance of each of the themes above and the low likelihood of a quick resolution, we spend the remainder of the paper looking at the impact so far on traditional assets and we show how trend following strategies may be well placed to provide diversification and risk mitigation in these uncharted waters.

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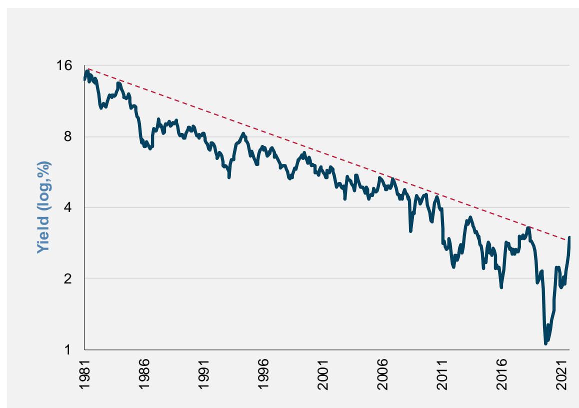
1 Stagflation Implications for Asset Owners.

2 Let's talk about the 'C' in CTA.

Papers available on request.

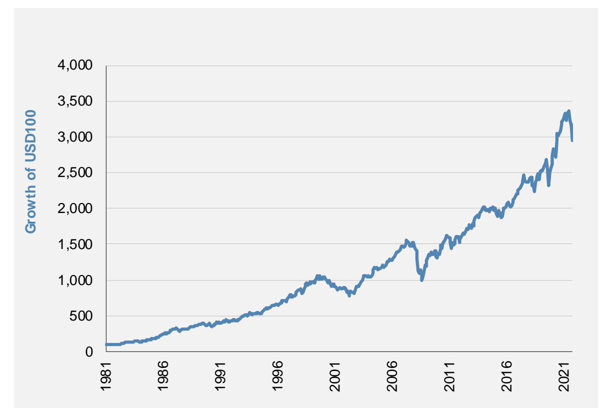
Let's begin by looking at the traditional portfolio of equities and bonds. The last four decades have seen declining bond yields as shown in Figure 7 and this, coupled with negative correlation to equity markets, has meant that a passive portfolio made up of a 60% allocation to developed market equities and 40% to global bonds would have averaged returns of 9% per annum with volatility of only 10%.

Figure 7: 10Y Treasury Yields: Jul 1981 to Apr 2022



Source: Bloomberg.

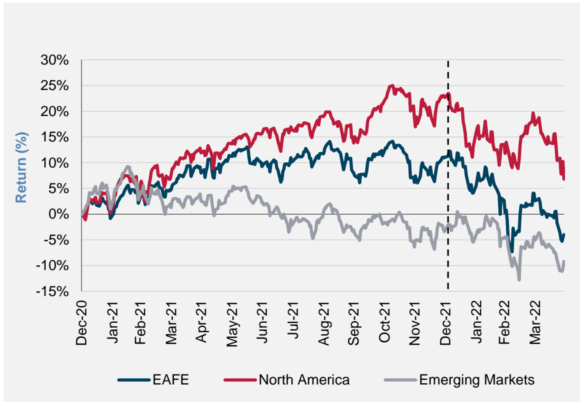
Figure 8: Performance of 60/40 Portfolio: Jul 1981 to Apr 2022



Source: Bloomberg.

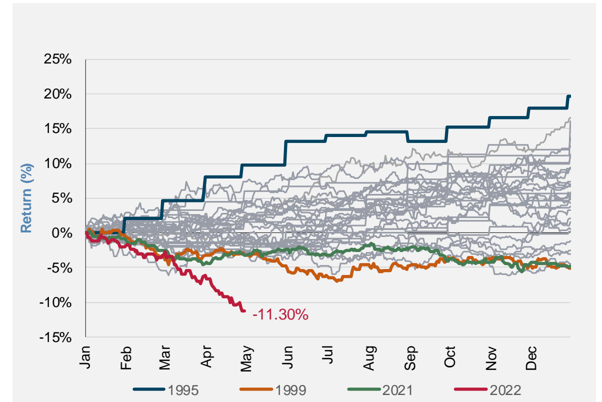
But that benign scenario has changed dramatically and the traditional portfolio has had an extremely challenging start to 2022 as we can see in Figure 9 and Figure 10. Equity markets are down near bear market territory after just four months. The war in Ukraine has had a significant impact on European and other EM markets. China's zero-Covid policy together with sweeping reforms aimed at curbing excesses further impacted emerging markets. US technology stocks, particularly the pandemic winners, have met their reckoning as the prospect of higher interest rates drove a stake through previously astronomic growth projections. Yet stock markets do that, corrections, pullbacks, fads to fades – it's all part of the stock market cycle.

Figure 9: Global Stock Indices Performance by Region*: Jan 2021 to Apr 2022



Source: Bloomberg. Note: See important disclaimer at the end of this paper.

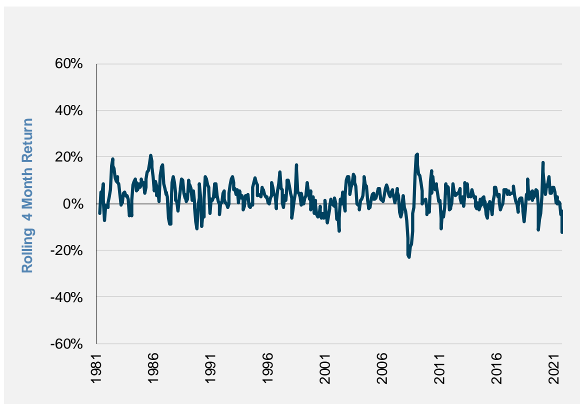
Figure 10: Bloomberg Global Aggregate Bond Total Return Index Performance: 1990-Apr 2022



Source: Bloomberg. Note: See important disclaimer at the end of this paper.

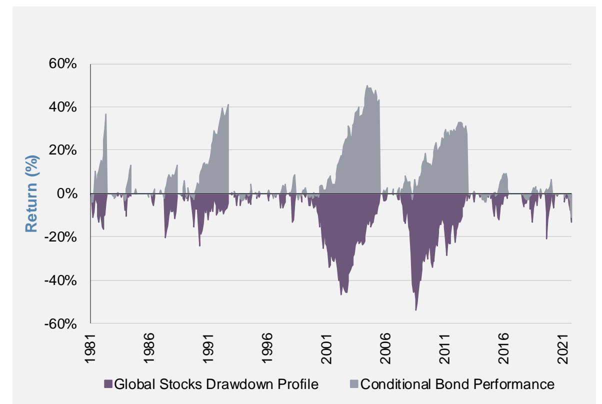
What used to make this equity market behaviour tolerable was the risk mitigation cushion offered by bonds. Only as we see from Figure 10, and further explore in Figure 12, bonds have had their weakest start to the year in decades. The Bloomberg Global Aggregate Bond Index represents nearly $70 trillion worth of bonds from nearly 28,000 issuers. It fell by more than 10% in just 4 months, the worst such loss since inception of the index. Bonds should not do that.

Figure 11: Rolling Returns of a 60/40 Portfolio: Jan 1981 to Apr 2022



Source: Bloomberg.

Figure 12: Conditional Bond Performance During Equity Drawdowns: Jan 1981 to Apr 2022



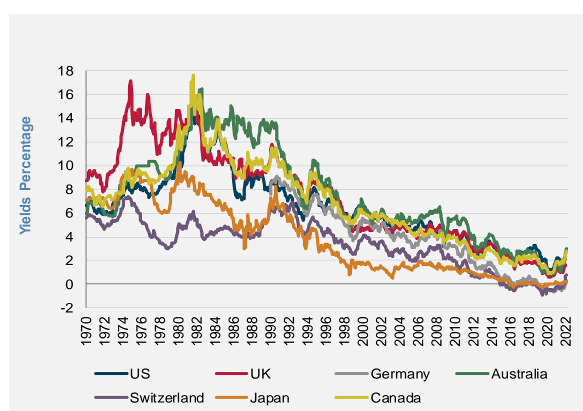
Source: Bloomberg.

Let's look at the passive 60/40 portfolio and try to see what this four-month period looks like in a longer-term context. Figure 11, shows us that this current 4 month return period is the second worst in 40 years, only the teeth of the Global Financial Crisis was worse in 2008. But the striking thing to note is the breakdown in the equity risk mitigation

property of bonds. Figure 12, showing bond returns when equities are in a drawdown, illustrates clearly how, in the past, when equity markets struggled, investors found protection from their bond allocations. But not this time. For anyone that started their investing career in the last 40 years, this is unprecedented. Here be Dragons!

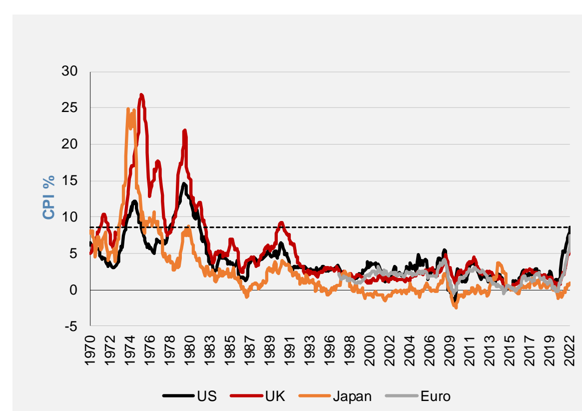
Are we truly in uncharted waters? Well, it depends where you've been before. If we look back just one more decade, and go back 50 years, as we show in Figures 13 and 14, we notice that the 1970s was characterised by high inflation, rising interest rates and a period of widespread wealth destruction through stagflationary conditions, echoes of which are starting to mount.

Figure 13: 10Y Bond Yields in Major Developed Economies: Last 50 Years



Source: St. Louis Fed, Bloomberg.

Figure 14: Inflation in Major Developed Economies: Last 50 Years

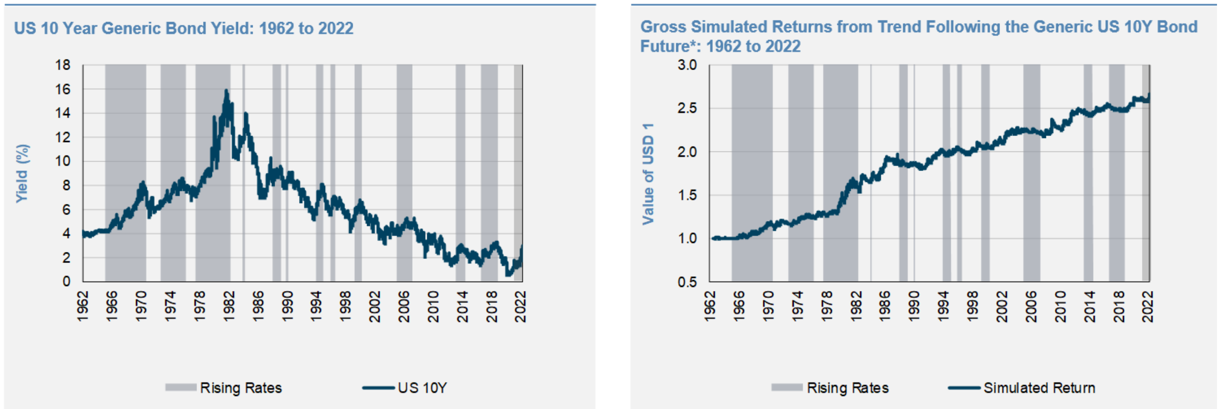


Source: St. Louis Fed, Bloomberg.

Unfortunately, back in the 1970s there were no financial futures so any empirical study on strategies trading futures is biased by only considering the declining yields and stable inflation period post 1981. Trend following strategies have the ability to capture trends in both rising and falling markets and in an environment as we have just witnessed this year, with stock and bonds falling together, trend strategies have generated useful risk mitigating returns. This return profile is entirely consistent with the strategy features of trend. We will have to resort to simulations for the next few charts in order to demonstrate the ability of trend strategies to generate returns in rising rate environments (a feature most relevant given where we are in the rate cycle).

Figure 15 illustrates the results of a generic trend following strategy being applied on a single market, in this case the US 10Y Treasury future. We have had to synthetically extend the history of the future price from its inception in the early 80s all the way to 1962 to allow us to span the era of significant rate rises of the 1960s and 1970s. We utilised other maturities on the US yield curve to proxy the carry element of the futures return, thus giving us a suitable representation of how the 10Y bond future would have behaved had it been in existence. The results are clear to see, risk adjusted returns are similar in both rising and falling interest rate regimes.

Figure 15: Trend Capture in a Rising Rate Environment

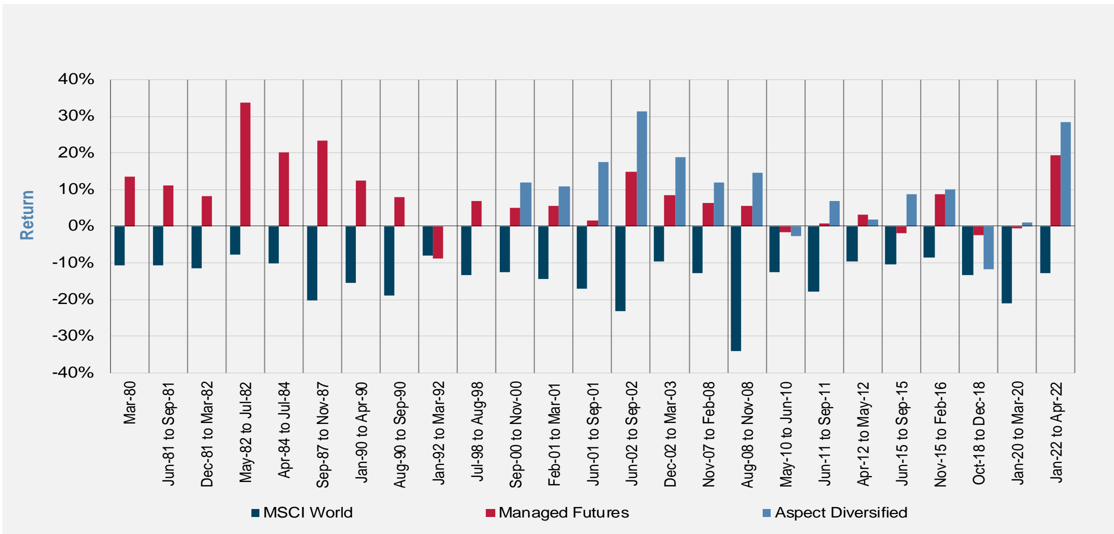


	All Periods	Rising Rates	Falling Rates
Annualised Return	2.7%	3.3%	2.5%
Annualised Volatility	5.0%	5.2%	4.9%
Information Ratio	0.54	0.63	0.51

Source: Bloomberg. Note: Simulated data, please see important disclaimer at the end of this paper. *The Generic US 10Y Future refers to the synthetic extension of the data prior to the existence of the 10Y futures contract using US Treasury yields data.

Restricting ourselves to live strategy data, we note that despite the breakdown in relationship between stocks and bonds illustrated in Figure 12, trend following strategies retain their risk mitigation properties. For example, we see below in Figure 16, that over the last 40 years, Managed Futures strategies deliver a very high hit-rate of providing diversifying returns during periods of considerable equity market declines.

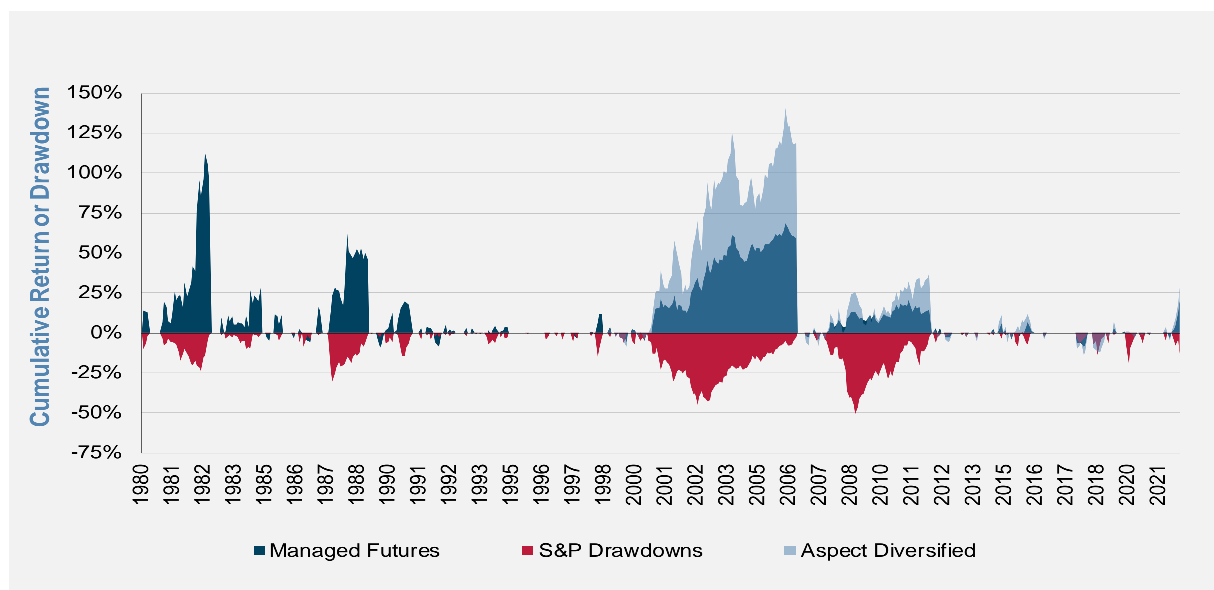
Figure 16: Managed Futures Performance During Equity Drawdowns: Jan 1980 to Apr 2022



Source: Aspect Capital, CISDM, Bloomberg. The data used for Managed Futures is comprised of CISDM data from 1980 to end of 1999, SG Trend Index from 2000 onwards. Note: Please see important disclaimer at the end of this paper.

Revisiting the conditional equity drawdown chart of Figure 12, we now ask the same question but replace bonds with managed futures. What is the cumulative performance of managed futures during equity market drawdowns? Figure 17 shows us the result. No dragons here. But there are some useful observations.

Figure 17: Cumulative Returns Conditional on S&P 500 Drawdowns: Jan 1980 to Apr 2022



Source: Bloomberg. Note: The data used for Managed Futures is comprised of CISDM data from 1980 to end of 1999, SG Trend Index from 2000 onwards. Please see important disclaimer at the end of this paper.

In the last 40 years, we have had two decades containing significant equity market declines and two with remarkably benign conditions. We seem to be emerging from one such period of equity market tranquillity. Post GFC, equity market corrections were infrequent, short-lived and bonds delivered protection. Inflation was negligible and the world was awash with liquidity and easy money as central banks kept rates low, flooding the system with their various quantitative easing programmes. Commodity markets had peaked in 2008 and, with the wind of globalisation in their sails, the 20 largest OECD economies grew in synchronised unison to late 2017. This goldilocks environment for growth and prosperity was shattered, slowly at first with the US-China trade wars and then suddenly and significantly by the pandemic and war in Ukraine. We now find ourselves with tight commodity markets, fragile, stretched and impaired supply chains, negative real yields, a record debt overhang, entrenched inflation, rising interest rates and significant disruption to global trade.

As Figure 17 reminds us though, trend following has the ability and opportunity to generate significant risk mitigation against the threat of persistent erosion of capital in challenging periods for the global economy. During periods of significant macro instability, such as right now, the GFC, the Tech Wreck, and the oil embargo shock of the stagflationary 1970s, trend following strategies have generally generated strong performance over a sustained period of time. The recent strong performance of trend strategies is by no means unprecedented in size or timing.

Key take away: In an inflationary environment, aggravated by a commodity supercycle, with rising rates and heightened geopolitical tensions against a record debt overhang, the outlook for traditional passive portfolios of

equities and bonds is challenging. Trend following strategies are well placed to deliver diversifying and risk mitigating returns though dynamic, directionally unbiased models in a multitude of asset classes. In practice this means that trend is potentially able to generate returns from shorting bonds in a rising rate environment and to participate in the many opportunities that emanate from commodity markets as the world adapts to the current inflationary supply-led shock and continues the slow march to a greener future.

Although it may feel at times as if we are navigating uncharted waters, trend following strategies are designed to cope with unseen events and flourish when price divergence is abundant and persistent. Given the extent of the disruption in the global economy, driven by all the enduring factors we have earlier described, our expectation is that it will take a long time for markets to find a new equilibrium. As we have shown in Figure 17, trend following tends to excel during multi-year periods of asset price divergence, and it is likely that we find ourselves only at the early stages of such a period.

Chart Disclaimers

Figure 1 to 15: The data used with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used are available from Aspect upon request.

Figure 9: This is an equally weighted USD price composite of various global stock indices performance. The stock indices used are those traded at Aspect.

Figure 10: This chart shows data for Bloomberg US Treasury Total Return Index and the S&P 500 Index.

Figure 15: THESE RESULTS ARE BASED ON SIMULATED OR HYPOTHETICAL PERFORMANCE RESULTS THAT HAVE CERTAIN LIMITATIONS. UNLIKE THE RESULTS SHOWN IN AN ACTUAL PERFORMANCE RECORD, THESE RESULTS DO NOT REPRESENT ACTUAL TRADING.

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Simulated results presented in this presentation for any Aspect Product are calculated by taking the historical market information available at the relevant point in time. Hypothetical trades relevant to each current strategy are generated on the basis of this information. Positions are valued using the prevailing market prices at each point in time. Performance is calculated using these valuations and subtracting the relevant management and performance fees (where applicable) of the Aspect Product, using standard methodology. Simulations are relevant to show the pattern of returns, but are not a forecast of future performance. There are many assumptions made, many of which may not prove to be accurate in actual trading. These figures are based on information believed to be accurate but have not been audited by a third party. Information is for illustrative purposes only.

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