Monthly Commentary

March 5th, 2018

About this note

ReDefine provides clients and business partners with a differentiated suite of services and products. The monthly note from our Capital Management division encapsulates, in a succinct manner, how our team is looking at the world and the practical implications of that approach. The note is designed to illuminate the process behind the implementation of investment decisions within ReDefine Wealth Management portfolios.

Macro Fund Process

At ReDefine, our investment process consists of three main components. Firstly, we undertake a thorough analysis of the fundamental macro backdrop. We look at where our research differs substantially from consensus growth and inflation prognoses, region by region. We also look at distributions of risk around those expectations which might lead to a positive or negative surprise. Secondly, we look at flow of funds and technical analysis which combine to provide the basis for attractive reward versus risk investment opportunities. Lastly, we look at the liquidity characteristics of markets or subsets of markets in order to calibrate whether a defensive or offensive approach to risk is appropriate. Unexpected changes in liquidity characteristics can often turbo charge profits or losses and needs to be considered carefully.

Fundamental Macro Backdrop

Jerome Powell took over as the new Chair of the Federal Reserve as US data continued to improve. Bond yields rose on the back of strong Non-Farm Payroll data and stocks sold off. He negotiated his first FOMC meeting and statement without telling us very much. His twin testimonies to Congress and the ensuing Q&A hinted at a more hawkish approach to a US economy running close to full capacity. This would suggest higher interest rates moving forward. The prospect of fiscal stimulus goosing growth further will also need to be considered as the staff and board fine tune their economic forecasts, "dot-plot" assumptions about the appropriate level for terminal Fed Funds rates. The Minutes from the inaugural Powell FOMC meeting will also be keenly awaited during March to help assess any change of focus.

President Trump's foray into protectionism holds the prospect of significant disruption. Equity sectors could respond in a challenging fashion but it is too early to draw detailed conclusions. It is, however, clearly a net negative for global equity.

Other data out during the month leant broadly in the direction that our research had suggested and the thrust of last month's analysis remains intact.

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The Portfolio Month in Review

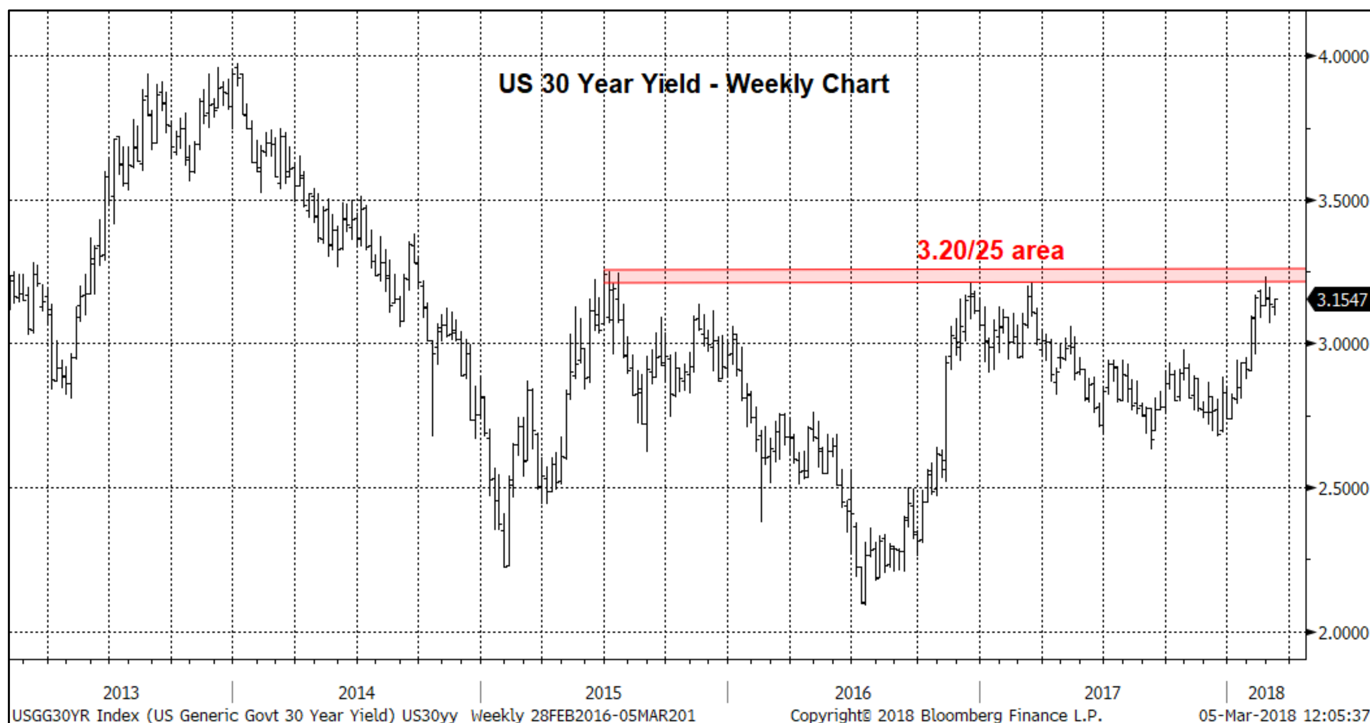
We concluded the inaugural February Monthly as follows: “This is a time to take money out of equity *and* bond markets to preserve capital and look for the inevitable opportunity that market volatility provides.”

We observed that flows into risk assets (equities and lower-quality bonds) in January had been extreme and were suggestive of a “Fear of Missing Out” (FOMO) stretch for risk. Market participants seemed optimistic about GDP growth and therefore likely misinterpreted future equity returns. In fact, it was exactly this strength of data which would lead to higher interest rates and wages. Continued increases in both will increase corporate expenses and challenge growth. They will also lead to greater economic and market volatility, and likely downside risk.

The degree of risk asset buying had caused just the sort of high volume price spikes often associated with market tops. It wasn’t clear at the time that this was sufficient to call a top. The missing component was higher bond yields. After the release of the Non-Farm Payroll numbers at the beginning of February, the associated increase in bond yields became sufficient to trigger the ensuing price dynamics.

February Conclusion No1. “US bonds below 3% are yielding too little, fundamentally speaking.”

March Status Update: Since the start of the year, US 10-year yields have risen around .50% to a peak of 2.95% just a few days ago. Now, however, positioning is heavily short in 10-year futures, suggesting yields will head back down. Price action started to look a little tired as we approached the huge 3.00/3.05% in 10 years and 3.20/3.25% in 30 years resistance area. Since we expect a more volatile market in the near-term as the powerful, but extended, move runs into these big levels, we continued to reduce duration in existing bond positions. We will look for either better re-entry opportunities or more confirmation of the bear market in bonds to take a short position.



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February Conclusion No2. "There is a yield level in bonds that equities won't like."
February Conclusion No3. "Buy downside protection."

March Status Update: The Non-Farm Payroll data in early February was sufficiently strong to push bonds down (yields up) and that in turn upset the equity market. There ensued a violent sell-off in almost all global equities. However, our flow of funds analysis strongly suggests that this was insufficient to change behavioural biases. Leveraged, short term traders were quick to sell. Short volatility structures (ETFs, etc.) were badly affected and forced to cover. However, the bulk of real money and retail flows were quick to buy the dip. These positions are likely to be challenged. We have continued to reduce equity exposure in the sectors most likely to sell-off.

Conclusion No4. "European bonds are also mispriced."

March Status Update: This idea remains fundamentally central to our case for higher growth and inflation in Europe. However, European bonds have remained supported by fund flows from European Central Bank (ECB) money printing and it is premature to become over-extended on this idea. We are keeping both German 10 year Governments (Bund) and their Italian counterparts (BTPs) very much in our sights.

Conclusion No5. "From a technical perspective the better expression of this expectation in Europe is a short position in Equities which are particularly sensitive to higher yield expectations and are heavily over-owned by foreign investors looking for the European growth dividend. Here, our flow of funds and technical analysis marry to generate a very attractive risk/reward opportunity to the downside."

March Status Update: EuroStoxx tried to rally back but fell short. We have exited all European equity positions for the time being until the market shows some strength.

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New or Developing Themes:

FX: USD

In the currency market, the US dollar has shown some initial signs of a rally. But so far, its strength has been uneven and narrow. We will continue to monitor the currency markets and enter to either hedge other positions or for upside opportunity if the risk/reward metrics are in our favour.

Conclusion

Since behavioural biases in the markets have barely begun to adjust and only the most aggressive, active trading portfolios have made material adjustments to their investment profile, this period of heightened volatility is very much in its infancy. We anticipate an extended period of higher volatility to force the market to de-leverage. Higher volatility will generate much less attractive risk-adjusted returns and strategies that rely of long-only diversification as their sole source of defence will be challenged. We demonstrated how both volatility and correlation metrics have allowed excessive risk-taking in last month's Monthly and we now expect that to unwind.

Correlation assumptions and modelling are most often informed by relatively recent. Assessing the probabilities of a significant change or paradigm shift, it is our core contention that the pattern of the last 30+ years is coming to an end. Greenspan's "Great Moderation" is behind us and the correlation between bonds and equities associated with both that Great Moderation and the Greenspan Put (since 1998) has already started to break down. This is an environment that plays well for the ReDefine process and one that we expect to be able to exploit to our clients' advantage.

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