Investment INSIGHTS

SYSTEMATIC GLOBAL MACRO STRATEGIES ARE A TIMELY DIVERSIFIER

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Institutional investors face a slew of challenging market signals arising from recent inflation spikes, the potential of reduced fiscal and monetary support, continuing low interest rates and high equity valuations. In addition, the recent shift to a positive correlation between bond and equity performance has challenged the negative-correlation regime of the past decade.

"It's important for investors to assess what returns they should expect from bond and equity portfolios going forward. And whatever is next may not offer the same diversification that has worked for them in the past," said Adam Rej, head of macro research at Capital Fund Management (CFM). "This is a good time to diversify your portfolio away from buy-and-hold strategies, and systematic global macro strategies can be a great source of diversification."

Systematic global macro (SGM) "strategies could offer excellent low correlations with bond and equity markets. They can potentially offer solid long-term returns, and they also offer exposure to other asset classes, such as commodities and foreign exchange," said Rej, noting that CFM is a fully quantitative and systematic fund manager.

"At CFM, our strategies are informed by a slew of leading-edge data sets, many of which require substantial computing power in order to become useful. This allows us to glean insights that the more traditional active managers might struggle to identify."

DECIPHERING INFLATION SIGNALS

With the recent breakthrough of the Consumer Price Index above the low levels of the past decade, investors are trying to read the inflation tea leaves, as well as the Federal Reserve's intentions around the tapering of its asset purchase program to support the economy.

"There are several factors pointing to higher-price appreciation — there are monetary and fiscal policies, supply chain disruptions and appreciation in the housing market," Rej said. "There's also the base effect due to the drop in prices in the early months of the pandemic. All of those factors cause current inflation readings to be strong by recent standards."

But "for inflation to be back, long-term inflation expectations would have to shoot up. A commodity super-cycle, for example, could be a trigger. We do not see a sign of a substantial shift in long-term inflation expectations just yet," he said. However, "there are definitely risks to the upside," he added.

REVERSAL IN CORRELATIONS

While bond and equity valuations are relatively rich by historical standards and have, thus far, provided strong returns for core portfolios, Rej said he is not as sanguine about their future performance. "We still don't know how the Fed will respond to inflationary risk over the mid-term," he said. "The withdrawal of fiscal and monetary support could challenge, or be the litmus test of, those valuations."

> *For a wide group of investors, systematic global macro strategies provide a good alternative that is uncorrelated from bond and equity markets and is, thus, not affected by the current rich valuations.*

In addition, investors have relied on the negative correlation between bond and equity performance of recent years as a hedge against each other. However, the duration and magnitude of the positive correlation between stocks and bonds in 2021 could suggest a potential return to the pre-2000 positive bond-equity correlation regime, he warned. "If that's the case, it is bad news for portfolios concentrated in bonds and equities. The benefit of investing in those two traditional asset classes rests in their negative correlation," he said. "The lower it is, the better."

WATCH COMMODITIES

As the traditional opportunities to hedge become more scarce, systematic global macro may offer good returns, uncorrelated from traditional assets, that make them a particularly interesting proposition for investors to add to their portfolios, Rej said. One of the strategies uses the trend-following, or momentum, approach across different markets. "We have been able to back-test this strategy over a period of up to two centuries for all major asset classes," he noted. "Momentum is just one of our strategies, many of which are proprietary systematic alpha ideas and, as such, not publicized."

Rej pointed to commodities as being at a potential inflection point for a commodity super-cycle, supported by the shift toward decarbonization that requires more raw materials for infrastructure-related investment, together with an underinvestment in certain commodities needed to build a new green economy. "One of the reasons that commodities are relatively under-appreciated is partly because it's difficult to buy commodities. One approach is through the use of futures."

In addition, "the dollar has weakened and there's pent-up consumer demand for certain goods, so if we're in the beginning of another commodity super-cycle, trend strategies will naturally pick this up. In fact, we have seen relatively solid performance of both fast and slow momentum strategies and commodities in 2020 and 2021, and a commodity super-cycle may allow those gains to run much higher."

CFM looks holistically at the asset class to find opportunities. "We trade a broad basket of commodities, and have a preference for strategies that work across the entire basket of commodities. We generally believe that strategies that work across many products are more robust for the longer term."

"Commodities are not the only source of diversification that we have found," Rej added. "The foreign exchange markets are another one. Currencies like the euro, Japanese yen or emerging market currencies are said to be notoriously hard to forecast and, indeed, they require a prudent and more tailored approach," he said. "But you don't want to miss out on this market either, as it is diversifying and very liquid."

TAP INTO LEADING-EDGE DATA

CFM uses multiple alternative data sources when devising investment strategies across all the asset classes, Rej said. "For example, for commodities, we use weather data, satellite crop imagery and shipping data, along with more common data sources. More common data sources may still give you an edge if you're able to aggregate a very large number of them, which could be difficult for the more traditional or discretionary global macro managers."

Rej emphasized the strict scientific discipline of the firm's investment philosophy. "All of our investment strategies are developed using data and are grounded in the scientific method. We combine those strategies using robust, cutting-edge portfolio construction techniques, and we do not override decision-making by our models, as this would contradict our scientific approach." Another key aspect of the approach is maintaining a "state-of-the-art execution platform in order to keep the trading costs as low as possible [and] so we're really fully systematic," he added.

"When you overlay an investors' core strategy with the strategies gleaned from alternative data sources, you end up with an interesting proposition in terms of not only expected returns, but also low correlations with pretty much any other strategy," Rej said. "For a wide group of investors, systematic global macro strategies provide a good alternative that is uncorrelated from bond and equity markets and is, thus, not affected by the current rich valuations." ■

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