

» *Managed Futures:* *Outlook for 2022*

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Outlook for Managed Futures 2022: Ability to decouple is crucial in this environment

Executive summary:

- By virtue of extremely decisive monetary and fiscal policy, central banks and governments have succeeded in putting the world's economy back onto a growth trajectory. The price of these measures lies in record levels of government and corporate debt as well as significantly higher inflation.
- Central banks now face the tricky challenge of tightening the monetary reins, but without derailing the economic recovery. At the moment, it seems they still have the situation under control.
- However, there are growing indications that inflation will remain a dominant theme for some time to come. The supply chain issues and associated production shortfalls will clearly not be resolved in the short term. Yet, the longer inflation persists at this elevated level, the more likely it is that we will see second-round effects – which could fuel a dangerous wage-price spiral.
- Mounting inflation also means government bonds are increasingly viewed as risky. The correlation with equities has risen palpably, while the potential for investors to diversify has fallen accordingly.
- Whether, and in what form, the pent-up energy will be unleashed in 2022 is almost impossible to predict. Any scenario – from high inflation to stagflation – is a possibility. Against such a backdrop, the decoupling effect of managed futures – which have the flexibility to tap into new trends and have historically been reliable generators of “crisis alpha” – becomes even more attractive.

Review of 2021

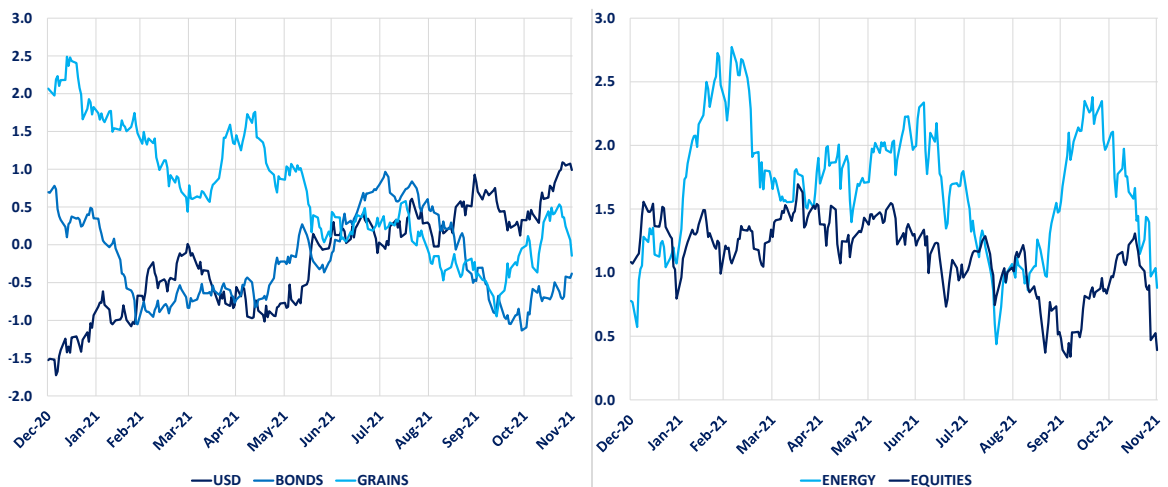
In last year's Outlook, we stated our belief that the world's economy was at a crossroads. Due to the need to impose measures to contain Covid-19, there was a risk of plunging into a deep recession. Central banks and governments around the world were responding to the pandemic with vigour by opening the monetary floodgates and putting together emergency support packages. It seemed unclear whether these measures would be sufficient to avert an economic slowdown, and whether central banks would succeed in maintaining price stability.

A year on, we can see that the labour market in the developed nations has largely stabilised. US unemployment had fallen from 6.7% at the end of 2020 to 4.2% by the end of November 2021, meaning it has almost returned to its pre-pandemic level (3.5% in January 2020). For quite some time, it seemed that inflation would not become a serious problem either. As the economy recovered, however, the upward pressure on prices increased noticeably – even if central banks initially described this as “transitory”. Although central banks still seem to be in control, the spectre of inflation is likely to hover over the economy for some time yet.

2021 turned out to be a fairly challenging year for trend followers. Fig. 1 below shows our trend signals for selected asset classes. The US dollar exhibited a highly negative trend signal when the year began. Trend followers therefore started the year with a short USD position and accumulated losses on this position in the period up to at least the end of June. Only then did the signal turn positive, enabling a profitable long position to be built up. Grains took almost the opposite track. There, the strongest trend signals could be seen at the start of the year, and trend followers were positioned correspondingly long. Here too, it was late summer before the trend signal turned negative. Due to the strong recovery towards the end of the year, however, the short positions built up in late summer failed to deliver much in the way of gains. Bonds proved to be the most difficult asset class. Here the trend signal calculated by Fisch switched between positive and negative territory a total of five times. As a result of this, trend

followers with a medium to long-term frequency were repeatedly caught on the wrong foot, with the much-heralded regime change towards rising interest rates being repeatedly delayed.

Figure 1: Trend signals for USD, bonds and grains (left), and energy and equities (right)



Note: The trend signals for various asset classes show how difficult 2021 was for trend followers.

Source: Fisch Asset Management

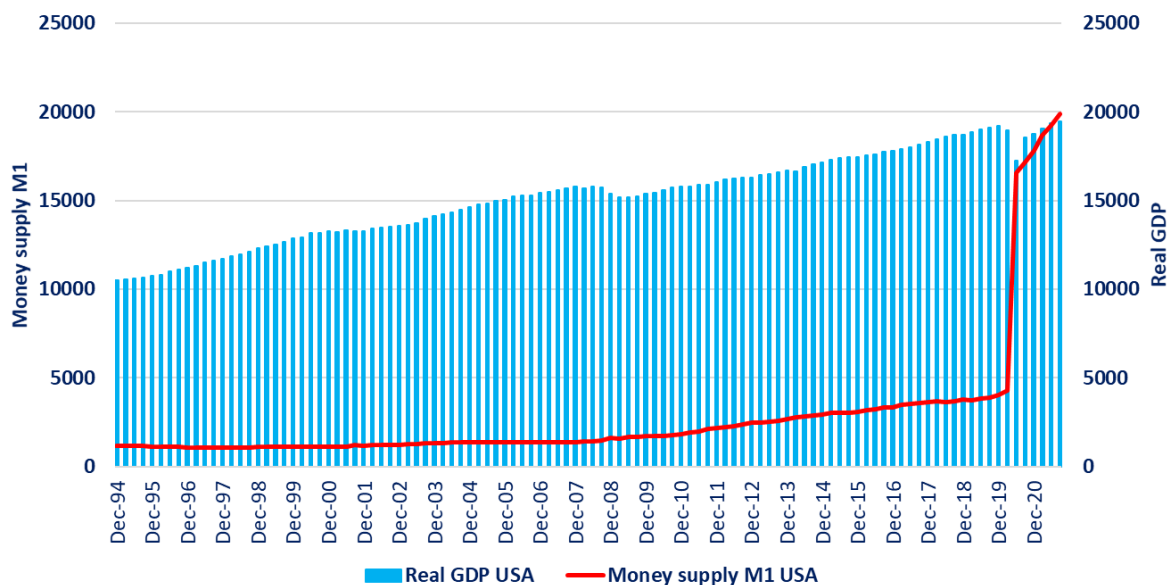
By the end of November, however, the industry succeeded in taking advantage of the persistently positive trends in equities as well as in the energy segment of the commodities sector. The right-hand section of Fig. 1 shows that the relevant trend signals remained continuously in positive territory, with the result that – despite more extensive fluctuations – a positive performance contribution was achievable. A sharp trend reversal began to take place in these asset classes on 26 November, resulting in considerable losses on the corresponding long positions. It is still too early to state categorically whether this marked the start of a bear market. The outlook for next year depends to a large extent on the following questions and answers, respectively.

Can economic growth be maintained in the absence of money supply growth?

In the wake of the 2008 financial crisis, central banks around the world pursued extremely expansive monetary policy. With the outbreak of the Covid-19 crisis, monetary expansion once again accelerated massively and central bank balance sheets expanded accordingly. The Fed's balance sheet now equates to 37.9% of US GDP. At 70.3% and 134% respectively, the figures for the ECB and the BoJ are significantly higher still.

Fig. 2 below shows that the US has therefore succeeded in stabilising real growth, despite all the restrictions imposed due to the Covid crisis. Given rising inflation, however, central banks are now under mounting pressure to gradually turn off the monetary taps again. Tapering is an extremely delicate tightrope walk: If central banks are too slow to implement more restrictive monetary policy, control of inflation could be lost. Conversely, if they overreact they could stifle the economy and cause it to go back into recession.

The Fed has so far managed to keep markets on side with its announcement that it will reduce asset purchases by USD 15 billion monthly. Long-term interest rates are already responding and signalling lower inflation expectations. While the Fed has succeeded in at least starting the tapering process, the ECB still faces a test of strength.

Figure 2: Growth in moneysupply and real GDP in the US

Note: The chart shows the trend in M1 money supply and real GDP in the US. The Covid crisis led to a dip in economic growth. The Fed increased money supply on an unprecedented scale. Combined with generous fiscal policy, it succeeded in steering the economy back onto a growth trajectory.

Source: Bloomberg

We anticipate that economic growth will now develop a strong dynamic of its own and will therefore not need any additional encouragement through loose monetary policy. However, the recovery could be jeopardised by a renewed tightening of measures to combat the pandemic and/or escalation of the dispute between the US and China. We expect central banks to start printing money again in the event of any signs of an economic slowdown. The exit from the prevailing extremely accommodative monetary policy is therefore likely to be a bumpy process that will take several years.

Is inflation really just “transitory”?

US inflation reached a figure of 6.8% (year-on-year) at the end of November 2021. That means it exceeds the eighth decile of the distribution of inflation since 1926, which is 5%¹.

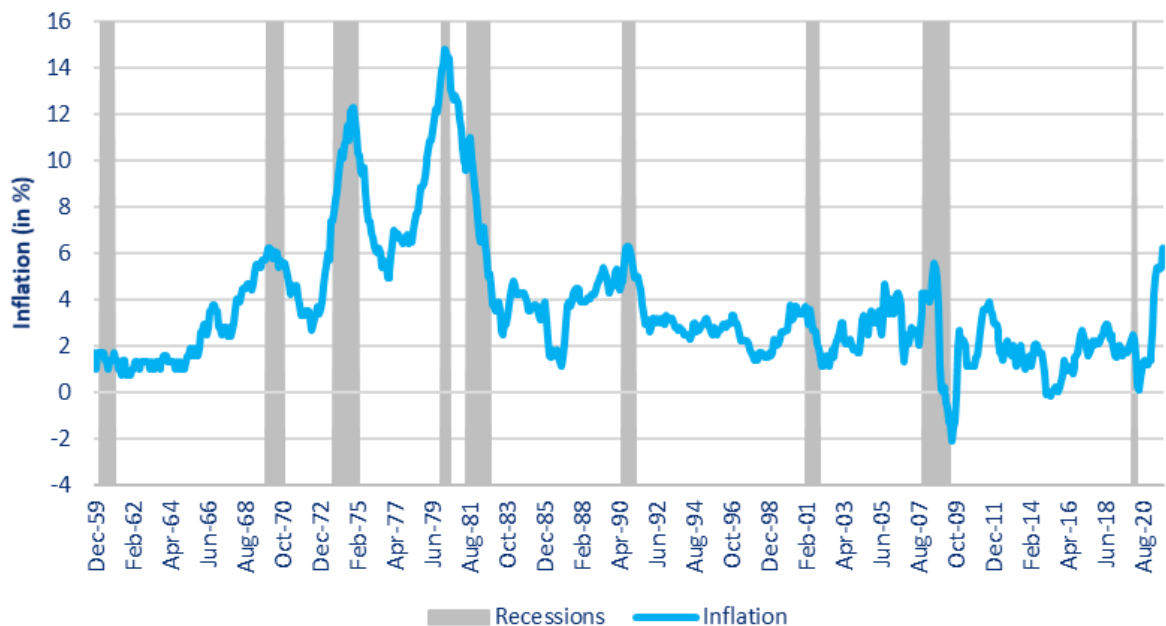
The jump in inflation was said by most experts to be “transitory” because it was initially caused by short-term catch-up effects on the demand side and secondly by short-term bottlenecks on the supply side. Central banks now acknowledge that these production issues will only be fixed in the medium term.

The longer inflation persists at this elevated level, the more likely it is that we will see second-round effects: Market participants will incorporate inflation into their expectations, which could lead to higher wage demands on the part of employees, for example. This could lead to further inflationary pressure, thereby unleashing a dangerous wage-price spiral.

The following graph illustrates the development of inflation and official recessions in the US. The comparison shows how difficult it is for central banks to get inflation under control again when the economy is overheating.

¹ See: *The Best Strategies for Inflationary Times*, H. Neville, T. Draaisma, B. Funnell, C.R. Harvey, and O. Van Hemert, 2021.
This version: April

Figure 3: Inflation and recessions



Note: The graph shows the development of inflation in the US and compares this with periods of official recession. It is notable that recessions often coincide with inflation overshooting the 5% mark.

Source Bloomberg (CPI YOY index) and Federal Reserve Bank of St. Louis (USREC)

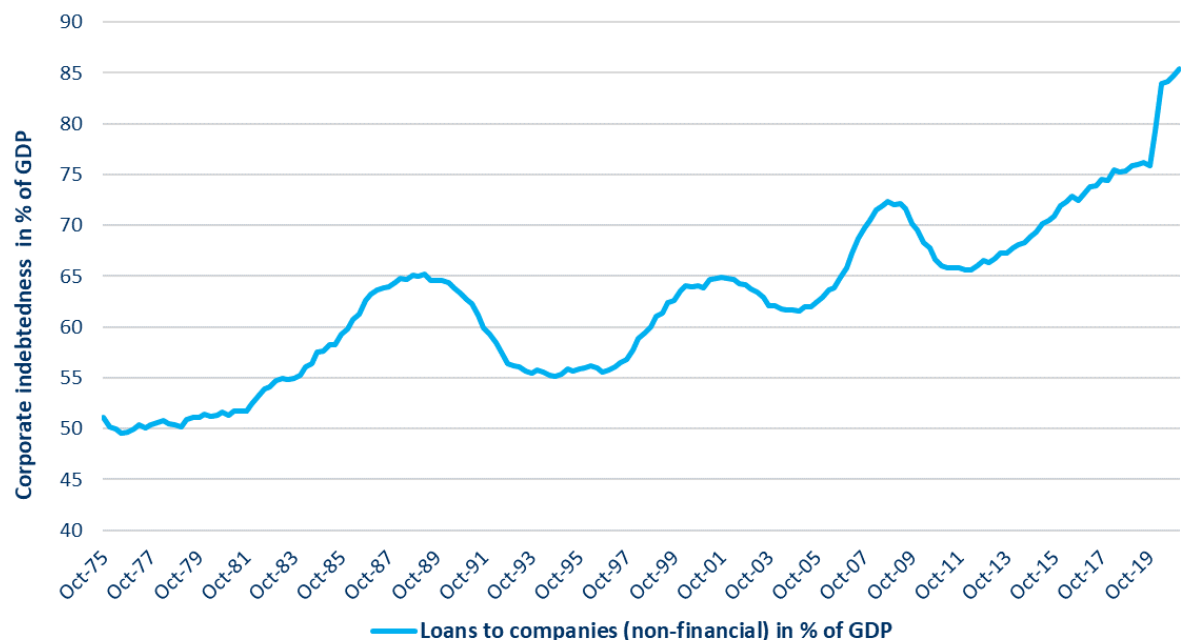
That the policy of cheap money has led to ever higher prices for physical and financial assets is not in dispute. The inflation in asset values is leading to a series of distortions and negative incentives that are in no way “transitory”:

- First, the price of a constant cash flow (dividends, rents, etc.) has risen sharply. This primarily affects pension funds, which have promised their members a certain level of income in retirement. To generate these pensions, they need to provide much more capital. It is also a very real form of inflation for private individuals wishing to invest in assets.
- Second, the pressure on profitable companies to keep their cash reserves low has increased. This is because, for the investor, it is not the official inflation number but the rise in market values that represents the opportunity cost of holding cash. Companies are responding to this development through share buyback programmes or returning cash to investors in the form of dividends. The resilience of these companies in times of crisis is likely to be reduced as a result.

Will corporate indebtedness become a problem?

The loose monetary policy operated by central banks has already led to a steady increase in corporate indebtedness. This development is illustrated by the US market: Fig. 4 shows that the debt levels of US companies have truly exploded in recent years and exceeded 85% of GDP in 2021.

Figure 4: Corporate indebtedness relative to GDP in the US



Note: The chart shows the development of corporate debt levels in the US. The easy monetary policy of recent years has again pushed corporate indebtedness upwards.

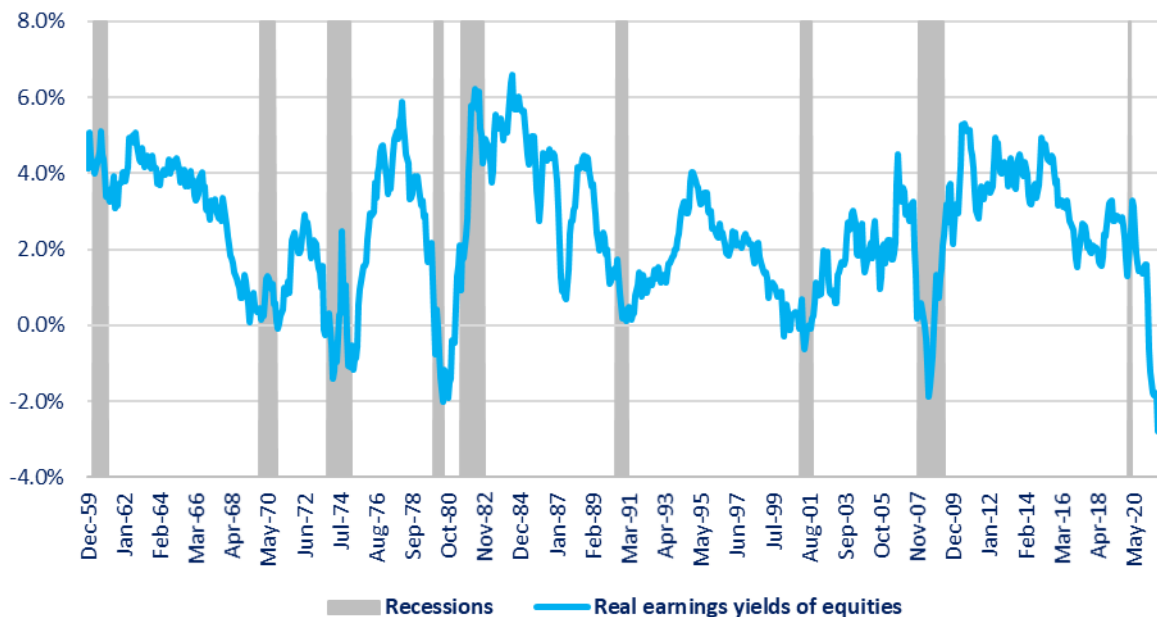
Source: Federal Reserve Bank of St. Louis (total credit to non-financial corporations, adjusted for breaks, for US, percentage of GDP, quarterly, not seasonally adjusted).

Debt is not a problem in itself, as long as it is used for financially sensible investments. However, the major share buyback programmes in the US are a cause for concern given that they are scarcely likely to boost corporate productivity. Furthermore, there is evidence of a constant deterioration in the average credit ratings of corporate bonds. The worry is, therefore, that the policy of cheap money on the part of central banks as well as the support measures implemented by governments have led to a situation where many companies with an unsustainable business model (aka zombie firms) are being kept alive artificially. As interest rates rise, we are likely to see a corresponding adjustment take place here.

Are financial market valuations sustainable?

As mentioned earlier, central bank monetary policy since the GFC in 2008 has led to higher prices for equities, corporate bonds, real estate, and other assets. What is important is that this increase in value does not reflect – or only partly reflects – higher future cash flows; instead, it reflects the fact that valuations (price of a given cash flow) have increased.

This development is already evident if we look at the earnings yield of equities (E/P). Company share prices have risen faster than their earnings in recent years, with the result that earnings yields have steadily declined. If we also take into account inflation, real earnings yields (E/P less inflation) have actually slipped into negative territory and are at their lowest level in 60 years (see Fig. 5). Equities are therefore no longer particularly attractive at these prices and with this degree of inflation.

Figure 5: S&P 500 earnings yields

Note: The graph shows the development of real earnings yields (E/P less inflation rate) in the US and compares this with official periods of recession. It is clear that negative real earnings yields often coincide with recessions.

Source: Standard & Poor's (current S&P 500 earnings yield), Bloomberg (CPI YOY index) and Federal Reserve Bank of St. Louis (USREC)

A normalisation of this development requires either a massive increase in corporate profits (on constant share prices) or a correction in the valuation of these profits in equity prices. Unfortunately, the coincidence of negative real earnings yields and recessions in the chart above would tend to point to the second scenario.

Diversification: The significance of managed futures

Central banks and governments last year succeeded in stabilising the world's economy and sparking new growth momentum. In the absence of negative external events, this development is likely to continue next year with an attendant continuation of the recovery of the labour market. We are fundamentally more positive than we were at this point last year.

In light of rising inflation, however, we are alarmed by the inconceivably high level of government and corporate debt. The task faced by central banks is akin to a difficult balancing act where any mistake can result in a tumble. Recession, inflation, or even stagflation: Virtually no scenario can be ruled out.

Diversification would seem to be paramount against such a market backdrop. The bad news, however, is that correlations between asset classes increase at a time of crisis and diversification potential is lowest precisely when the investor is most in need of it. In recent decades, long-only positions have always been able to count on the decoupling properties of government bonds. With rising inflation, however, an increase can be seen in the correlation between equities and government bonds. As interest rates are still at record lows, and in an environment characterised by inflation fears, the investor can only count on the protective benefits of government bonds to a limited extent.

Historically speaking, managed futures have repeatedly proved their ability to deliver "crisis alpha" – that is, to generate positive performance in a period of crisis. The flexibility of this asset class in terms of exploiting positive trends – e.g. in commodities in the event of accelerating inflation – as well as play

on negative trends, such as in the case of bonds when interest rates are rising, or equities in the event of a slowdown in the economy — in our view makes it an indispensable component of long-only portfolios. Timing is virtually impossible with this asset class because it is too difficult to forecast the persistence of these trends. We nevertheless expect the pent-up energy in financial and commodity markets to be released in the coming years and, at this point in time, that strong trends will materialise.

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