

FRM Early view - Markets

Stockholm (HedgeNordic) – After damping risk since the end of Q1 2015 we are now considering a shift in the balance towards more market exposure. The structural imbalances in the world economy persist, most notably excess capacity and debt. However, history has shown big bear markets can be as dangerous on the rebound as on the way down. We may now be at the point where the cumulative impact of worldwide rate cuts over the last year, modest but persistent developed market economic growth and recent big falls in risk asset valuations has shifted the balance of probabilities confronting investors.

True, reasons to be negative abound. We believe emerging markets, notably Brazil, face severe economic headwinds and tough financial choices, while Saudi Arabia has cut equity market exposure and redeemed over \$70 billion to bolster domestic and military spending. And, at last, there is meaningful spread widening in the US corporate bond market in response to rising leverage and strong net debt issuance, which among other things will gradually reign in stock buybacks. It is worth recalling that the move up since the financial crisis has been huge, so we believe a proportionate correction could have further to run. But managing hedge fund portfolios imposes a challenging requirement to anticipate developments quite some time before the actual price action happens in markets. We need to consider now what November and December might bring.

The first thing to note is the complete triumph of the bear market case. Sentiment indices are at extreme lows and declining. The sense of despair in commodities markets is palpable amid forecasts that a 20-year 'bear super-cycle' is in its early stages with much worse to come. The bear case being articulated around the problems linking China and emerging markets to overcapacity and deflation is now being told with supreme confidence even though the story is not a new one. The owl of Minerva flies at dusk....

Moreover, we believe the life cycle of this bear move looks to be at an advanced stage. Investors initially sold speculative positions, but now higher conviction positions are being abandoned. Among hedge funds, particularly Event managers, capitulation is under way, notably in healthcare stocks. Democratic Party presidential front runner Hillary Clinton's plan to battle drug companies over prescription costs has turned a correction in biotech into a rout. Another sign of the advanced stage of the bear life cycle is that position risk is tumbling. Daily selling by hedge funds reached a yearly high during September. Data from our own managed account platform supports this. CTAs, for example, have now closed out long positions in equities and are net short, which leads us to believe that the bulk of the volatility targeting funds will have finished making position adjustments. The downwards move has been painful, particularly for investors in China, Germany and some frothy sectors in the US. Finally, while implied volatility is obviously higher, it is less sensitive than when markets first turned down. All in all, we believe a sharp technical bounce is possible.

Additionally, some developed market macro elements are constructive, while central banks everywhere outside of the US are easing to refuel economic activity. China has been particularly active with the PBOC cutting rates five times since November 2014. We believe these changes should soon begin to impact the data and couple with growth in developed markets, which may be modest but is far from disastrous. Meanwhile, rates keep falling. India, Canada and Australia have made multiple cuts, while Norway, Taiwan (and India again) cut in recent days. With QE being pushed in Japan and the Eurozone, the monetary conditions of the US' main trading partners is highly supportive.

We believe the trend looks pretty clear. Even the Fed has stayed rate hikes. But what happens next?

If the combination of monetary loosening leads to a pick-up, first in PMIs and then in GDP data, decisions to take down risk now threaten being painful, especially if a technical bounce finds fundamental support. We believe since most currencies have fallen against the dollar, an uptick in PMIs can be substantially trade driven and support a rally in risk assets lasting perhaps two or three quarters. In such a move, it is expected that cyclical and industrial stocks would outperform, while high growth and defensive stocks will lag. In this scenario, we believe today's capitulation stocks would appear attractive.

From our vantage point as hedge fund investors we sometimes see how rather different approaches can end up in an aligned market outlook. In this case, a macro strategist (who anticipated the current problematic conditions) has articulated the top-down view sketched above. At the same time, one of our leading trading managers (with proven instincts and a propensity to be early) has started to go long on mining stocks, arguing on a bottom-up basis in a way that is curiously consistent with the top-down view.

Their consensus viewpoint has two further implications, one top-down, the other bottom-up. The first is that Europe, despite longer and larger QE, is no longer expected to outperform other equities markets. Instead, with Q3 earnings expectations in the US quite weak and the PMI still over 50 despite the collapse of capex in oil and gas, we believe there is potential for an earnings upside surprise. The second implication is that though this is really a developed market story, the dollar's strong run has tilted the terms of trade in favor of emerging market exporters. We believe this could bring a period of relief to those markets, before the structural downside pressures resume.

In sum, the balance of probability on the next big move looks to have shifted as a result of recent developments. We believe a technical bounce is likely, and better news about growth may support it, notwithstanding the structural dislocations that dog the world economy. As a result, after trimming most of the credit risk from our book since late 2014, and reducing equities in the spring and summer, we are now closing tail hedges and looking at some selective risk-on strategies. We are likely to implement the first moves in this as October unfolds.

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