How CTAs cope with the nearing end of a bond super cycle

Stockholm (HedgeNordic) – Systematic trend following futures strategies, formerly known as Commodity Trading Advisors or CTAs, have for the most part benefited from the sustained decline in global interest rates over the past few decades. As bond markets are approaching extreme valuations, and with implied yields trading at rock-bottom levels or even entering negative territory, how are quantitative strategies adapted, if at all, to cope with an interest rate environment never experienced before? HedgeNordic asked CTA managers, both Nordic and international, how they view the current environment and how they look upon the prospects for the strategy going forward.

To trend follow or not to trend follow?

Given the current extreme bond market valuations, are there still opportunities to extract trends fromthelongside? CTA managers seem to agree that fixed income markets still offer opportunities for disciplined trend following strategies although some point to having taken on a more defensive approach.

Christopher Reeve, Director of Product Management at Aspect Capital, says that their original approach was a more conservative one but that they have seen markets functioning in an orderly manner even with negative implied yields.

> ”We originally took the more conservative approach of avoiding markets where rates were at or below zero because we had never really seen this happen before and there were concerns that zero would act as some kind of barrier or that market functioning and liquidity levels would change. However, we have actually seen a number of fixed income markets continue to function completely normally with implied yields below zero, with trends continuing.”

Alexander Mende, senior researcher at Stockholm-based RPM, a provider of multi-manager CTA portfolios, says that the way their underlying managers approach fixed income markets in the current environment differ widely.

> ”Admittedly, the current zero-or- below-interest rate environment is unprecedented in financial history. Thus, our managers’ approaches differ from each other. Some managers have introduced caps on fixed income exposures other have not made any adjustments. Obviously, managers without any caps have performance better year-to-date.”

Niels Kaastrup-Larsen, Head of European Business of US-based CTA DUNN Capital Management, points to the fact that not only spot prices but also the so-called roll yield plays an important role in assesing the opportunities for trend following systems in global fixed income markets.

> ”There are two sources of returns on positions in futures contracts. The first and more obvious is the change in spot prices. The second is the so-called “roll yield,” which is the change in futures prices due to the necessary convergence of futures and spot prices when time approaches the contract expiration date. In the particular case of interest rates, we have realized gains in the last two years due mainly to the second source of returns. The roll yield will be positive in a long position on interest-rate futures if the expectation of raising rates is not realized. This behavior has been displaying a persistent trend, which has favored disciplined trend-following systems.”

Serge Houles, Head of Investment Strategy at Stockholm-based quant macro firm IPM, says that ”making investment decisions based on the rationale that interest rates cannot go lower as they are already too low can lead to sub-optimal decisions.”

According to Houles, the drivers that determine the position-taking in fixed income markets for IPM, including the mean reversion tendency of real interes rates, inflation expectations, the bond risk premium, and the shape of the yield curve are valid no matter the absolute level of interest rates.

The full discussion on how CTAs approach the current interest rate environment is to be found on pages 70-74 in HedgeNordics Fixed Income Report, to be downloaded here.

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