Janus Henderson INVESTORS

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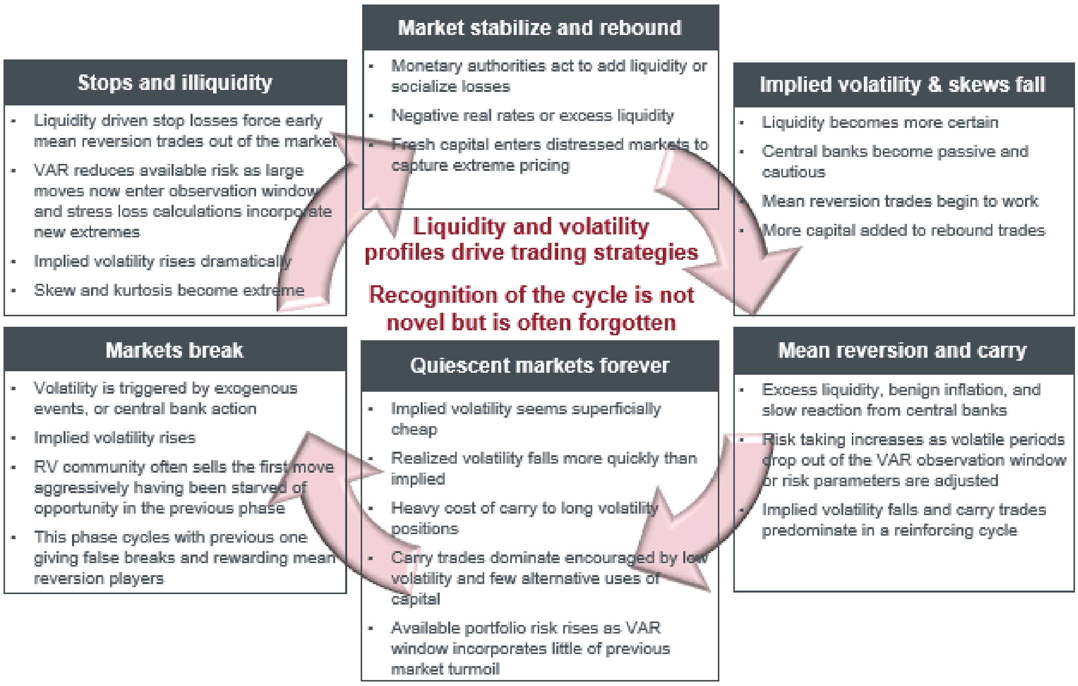
View from the Multi Strategy Team

The first three months of 2020 saw one of the most significant market collapses in history. When markets fracture, investors are left with many questions about the road ahead, and the options available to them.

In this letter, I discuss our long-standing cyclical road map, observations on some of the more significant factors we saw unfolding, current views on the COVID-19 crisis, and our thoughts on what may lie ahead.

Our Volatility Road Map serves as a useful reminder of the phases of market cyclicality. In this millennium alone we have seen this cycle at least three complete revolutions – 2000, 2008 and now again in 2020.

The inherent cyclicality of markets



In each cycle the key components are comprised of periods of highly compressed volatility which in turn lead to extreme narrowing of risk spreads and most importantly the build-up of leverage in multiple sectors of the economy. Benign inflation, either through hedonic manipulation and/or as a consequence of globalization, technological advances and demographic shifts have encouraged policy makers to keep real and nominal rates low, encouraging asset prices to inflate, and to encourage the belief that the market cycle has been conquered and we shall see quiescent markets forever. When markets break, it appears shocking and yet, whatever the catalyst, the breakdown is always familiar in its characteristics and the pattern of unwind and extreme market volatility is inevitable.

Our approach to risk and protection exposures is driven by the market's location within the cycle. We build our downside volatility exposures and our discretionary macro long convexity exposures when volatility is low and falling and liquidate them in the unwind phase. The core of our Protection strategy is to balance its cost and scale throughout the cycle with strategies that benefit from more benign environments and falling volatility regimes. We do not believe we are so skillful that we can see the catalyst or time our protection exposures, but we do believe there is an enormous benefit in tilting appropriately between these exposures depending on our current location in the volatility cycle.

The first quarter of 2020 was not only a period in which market risk spread compression reached a nadir (volatility was also compressed to new historical lows in many markets) but in the second half of Q1 we saw a sequential rapid unwind in leverage across markets and a rapid rise to upside extremes in implied and historical short-term volatility measures. These measures peaked in the latter part of March, and asset markets bounced once again in the wake of unprecedented monetary and fiscal intervention around the world. The challenge from here is to establish whether the unwind phase is complete and effectively arrested by the authorities or if further unwinds are to come after an ephemeral bounce.

First some observations:

1. The speed and ferocity of the unwind was record breaking. This appears to be a consequence of the lack of market depth as much as it was in the volume of unwinds. This is an issue we have been very focused upon – ETFs offering unrealistic liquidity expectations, peak leverage at the volatility cycle lows, and algorithmic market infrastructure that steps back as volatility rises in a self-reinforcing circle
2. Many measures of market dislocation were similar to those in 2008 – risk spreads, index sell-offs, volatility measures – but the speed of these moves were considerably quicker and so was the response from many central banks and governments in implementing policies to counteract the market panic. The US Federal Reserve instituted as much QE per day as they executed in 2009 per month. The scale of intervention has been truly epic.
3. Mid panic, once again, the market began to build in a European fragmentation premium with a primary focus on Italy. While this has been temporarily arrested, the BTP market continues to be fragile despite continual support from the ECB.
4. Perhaps unique to this cycle is the simultaneous supply and demand shock in the economy. Payment chains have essentially been shattered; solvency issues will mean many businesses have laid off vast numbers of employees who may never be rehired. Our view is the supply shocks will be far more impactful and take more time to counter than the aggregate demand shock.
5. The impact of COVID-19 is truly global in scale (and the reaction too has been global), but the scale of that reaction and its locus and speed has varied tremendously.
6. Global central banks will be the buyers of most global sovereign bonds for the foreseeable future and with a determination to keep real rates as negative as possible for many years.

Supply shock

1. The last major supply shock for the global economy was OPEC 1 and OPEC 2. We must not forget supply shocks are inherently inflationary.
2. It is likely that the combination of the massive deflationary demand shock and global supply disruptions will not resolve themselves simultaneously. In our view the focus from authorities on the demand side of the economy will mean the supply chain will remain fragmented far longer.
3. Geopolitics, which was in flux before the virus, will now become massively disruptive in the coming years. In our view it is now likely that China's behavior around the virus and its actions in the financial markets mid-crisis will drive a huge effort by US authorities to permanently alter supply chains. This change is unlikely to be a smooth process. We remain extremely wary of China's actions around Taiwan in the years to come while the rest of the world is distracted.
4. The reshoring of US production will add cost in both the short and medium term. History tells us that pandemics are usually associated with a tilt toward labor and away from capital in terms of rewards. As US politics focuses ever more inwardly, we expect gradually increasing upward pressure on wages. This is likely to be a huge positive for Mexico on a strategic basis and will be an enormous headache for the Fed in monetizing the deficit.
5. We should not overlook the enormous damage in the oil markets. My only observation for now is that the US has the best bankruptcy process in the world. Moving assets from current owners to new stronger hands is exactly what the bankruptcy process is for. Shale oil is more easily turned on and off relative to other suppliers, but significant damage has been done to medium term supply at any given price. With the consequential medium-term impact on inflation.

What does all this mean?

1. The Fed appears to have been focused and effective in heading off the usual shortage of US$ in the global economy that we associate with financial downturns. Current policy in isolation is incredibly negative for the dollar and if the rush to safe assets abates then the currency world may become very interesting going forward.
2. Sovereign bond markets look set to be dominated by QE for many years. This facilitation of massive new credit creation is inherently inflationary. We remain cautious of duration exposures but recognize this is likely a slow-moving car crash, not one for 2020.
3. Credit in a micro and macro sense is the near-term economic battle ground – a world of highly illiquid assets, and deteriorating fundamentals offset by enormous fiscal stimulus. Opportunities, for the nimble, will be many but maybe dominated by negative real yields and a march to Japanification in many sectors.
4. Active equity management face a target rich environment. Winner and losers in each industry, an unprecedented domination in many sectors by those winners, and a lack of government desire to arrest that monopolization process in the near term.

Multi Strategy Outlook

1. Our cautious approach over the last 12 months has rewarded our investors as the volatility cycle transitioned into dislocation and unwinds.
2. We have reaped significant benefits and profits from all three elements of the protection strategy, each providing returns in different phases of the sell-off. We now adopt a more appropriate and cost-effective approach to tail hedges in this high volatility environment.
3. The Price Pressure strategies have seen strong returns as we would expect from the rapid resetting of liquidity risk premia across markets. We hope, and expect that to continue, but will now have to incorporate QE into our assessment in the fixed income sub strategy.
4. We believe that both Event Driven and Market Neutral Equity strategies are target rich environments and the opportunities will be many. Over time we will seek to increase our risk in these areas.
5. In general, higher risk premia across all our risk on strategies raises our return expectations. Our job as portfolio managers is to allocate nimbly and efficiently between competing demands for capital.
6. We have not seen this type of environment in several years. We are excited by the prospect, while never losing sight of the tail risk we take on and remain wary that the entirety of the unwind phase of the cycle may be incomplete.

Best Regards,

Steve Cain
Portfolio Manager, Diversified Alternatives

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