Seeking Balanced Excess Returns through Economic Turbulence

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The Federal Reserve's anticipated cycle of interest rate hikes is now front and center for markets, and heightened anxiety among many investors has led to a widespread selling of financial assets. These dynamics have increased volatility to levels not seen since the onset of the COVID pandemic, and uncertainty over the trajectory for economic policy remains a key feature of the current environment.

In this research note, our goal is to provide a broader context for the dislocations that have resulted while assessing new risks and the broader opportunity set for investors to seek excess returns as markets recalibrate.

The beginning of 2022 featured an abrupt market transition driven by a shift in expectations for central bank policies and the economy. These dynamics combined with rising geopolitical risks and a changing shape of the pandemic to create uncertainty, volatility, and widescale deleveraging across asset classes. While this environment resulted in short-term pain for many investors, the market shakeup has in turn created opportunities for systematic strategies that seek to monetize market dislocations through a framework balanced to potential outcomes for the economy.

Impact of Changing Policy Expectations

Key Takeaways

- A meaningful shift in expectations for central bank policies resulted in sharp selling pressure on financial assets to start the new year
- While the sweeping reset of prices produced negative results for both stocks and bonds in January, it has created dislocations among assets that ultimately expand the long-term opportunity set for systematic investing

Expectations for central bank policies are constantly in flux, and they are regularly reflected both directly and indirectly in market pricing. In recent weeks, however, the shift in policy expectations has been notable. Persistently high inflation data and commentary from FOMC Committee Members have combined to pull forward the timeline for the upcoming hiking cycle and increase the number of potential interest rate hikes now priced into futures markets.

Figure 1: Futures Implied Policy Rate

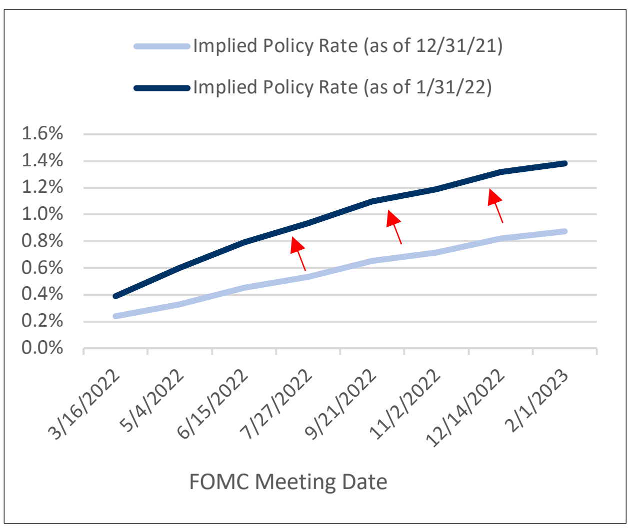
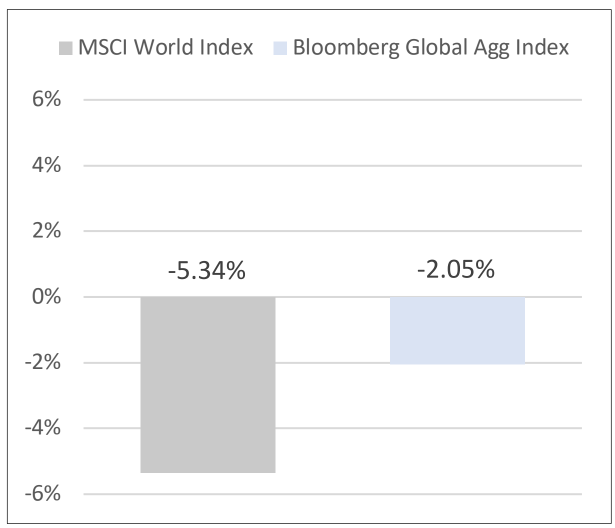


Figure 2: Stock & Bond Market Returns, Jan. 2022



Source: Bloomberg

The meaningful shift in the expected future path of interest rates highlighted above drove an uptick in volatility across markets. The ICE/BofA MOVE Index – which monitors the volatility of US Treasuries implied by options – reached its highest level since March 2020, and in this context both global stock and bond markets suffered losses. For the month of January 2022, the Bloomberg Global Agg and MSCI World Indices were down -2.1% and -5.3%, respectively, as a broad-based move out of financial assets left substantial market dislocations in its wake.

Trajectory of Returns After Prior Market Dislocations

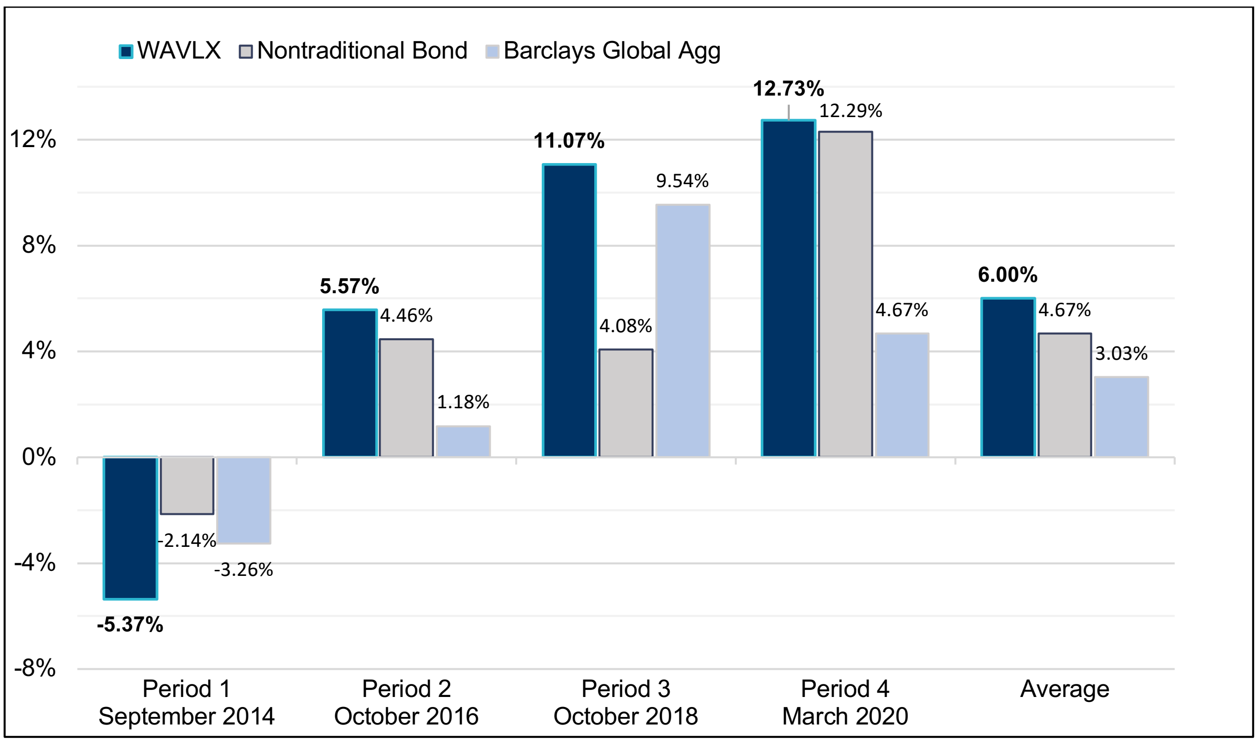
Key Takeaways

- Since WAVLX's inception on 9/30/2013, there have been four calendar months when both the Bloomberg Global Agg Bond and MSCI World Indices each suffered losses greater than -1%
- In the 12 months following these instances, WAVLX has, on average, outperformed both the Bloomberg Global Agg Bond Index and its Morningstar Nontraditional Bond Peer Group

Past performance does not guarantee future results and there is no assurance that the Fund will achieve its investment objective.

As challenging as this period has been for many investors, it is not the first time that markets have exhibited these dynamics where selling pressure overwhelmed long-term economic drivers. Since our strategy's inception on September 30, 2013, there have been four monthly instances where global stocks and bonds have simultaneously registered losses in excess of -1%. While each of scenario has its own idiosyncrasies, observing these dislocation events with the 12-month periods that have followed can offer helpful perspective for long-term investors.

Figure 3: 12-Month Forward Returns Following Prior Market Dislocation Events



Source: Morningstar and Bloomberg, see notes for indexes & definitions

The set of outcomes following dislocation events is varied and features a wide range of underlying conditions that have driven returns. On the whole, however, markets have been resilient in the past, and we see no reason why they would not recalibrate to a new environment coming out of the recent turbulence. As the path for policy becomes clear and uncertainty subsides, we expect cash to broadly move back into markets based on the principle that investors naturally invest to outperform cash over the long-term.

Opportunity Set as Policymakers Shift Gears

Key Takeaways

- Increased friction across financial assets leading up to the Fed raising rates is not without precedent, and uncertainty over the policy transition's impact is naturally embedded in markets
- We believe that seeking to monetize the market dislocations created through these dynamics while maintaining a balance to potential economic outcomes is a prudent investment approach in an environment of heightened uncertainty

The Federal Reserve will embark on its upcoming hiking cycle with the goal of balancing its mandate for stable prices with maintaining maximum employment and moderate long-term interest rates. An environment where inflation is at its highest level in decades creates a unique challenge for policymakers, and the risk of a policy error on either side is considerable.

In this context, we believe our approach is also differentiated in that we do not seek to forecast any specific economic conditions that result from these policies. We are instead positioned with a targeted balanced to growth and inflation, with a goal of maintaining an equal balance to potential outcomes for interest rates and the economy. In an environment of heightened uncertainty, we believe this is a prudent approach to investing that lets us attempt to limit exposure to large-scale directional risks and focus on monetizing the dislocations that may result from changing policy expectations across fixed income markets.

INDEXES:

Global stock market returns are represented by the MSCI World Index
Global bond market returns are represented by the Bloomberg Global-Aggregate Total Return Index
Nontraditional bond category is represented by the Morningstar Nontraditional Bond Category

TIME PERIOD DEFINITIONS:

Period 1 – September 2014
Period 2 – October 2016
Period 3 – October 2018
Period 4 – March 2020

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