RPM investments
DIFFERENT MOVES.

Stockholm 2021-06-11

The Big Picture

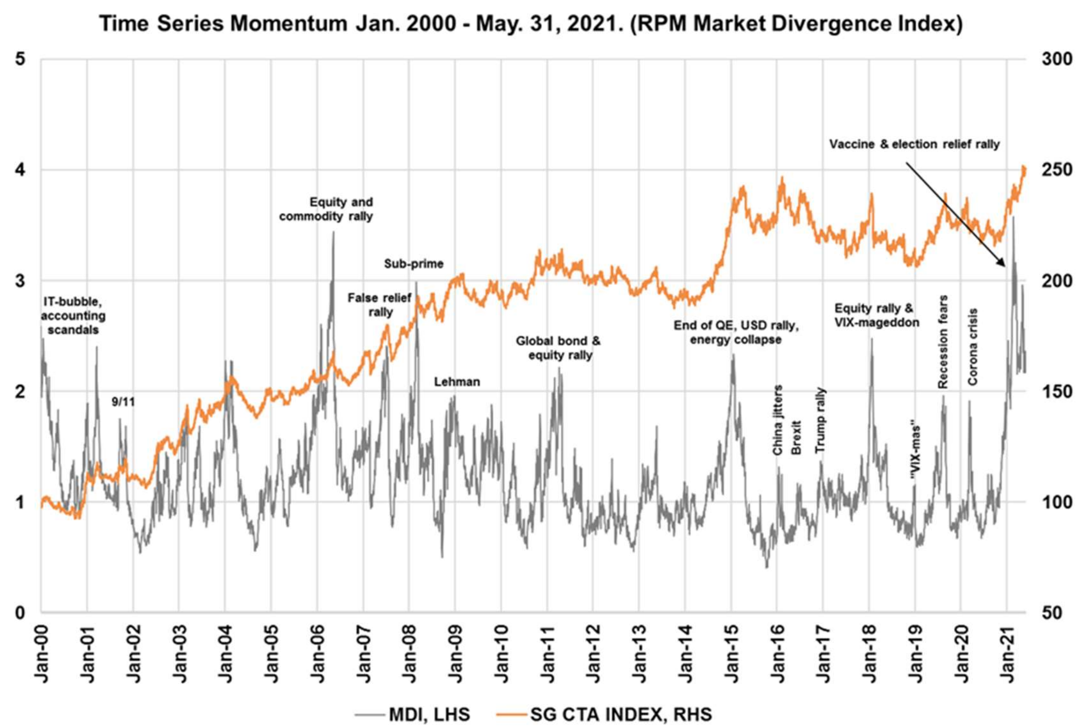
The SocGen CTA Index has returned 15.1% over the seven months since the end of October last year. RPM's Evolving CTA Fund and Galaxy Fund (both in USD) were up 17.1% and 29.8% respectively, during the same period. This kind of performance has not been seen since late 2014. What has changed? The short answer: Markets have changed. Commodity markets have changed the most. And there are reasons to believe we have entered a new market regime.

The Risk Factor: TSMOM

The CTA industry's principal risk factor – Time Series Momentum (TSMOM) – is shown below together with the SocGen CTA Index. Both TSMOM and CTAs reached all-time highs earlier this year.

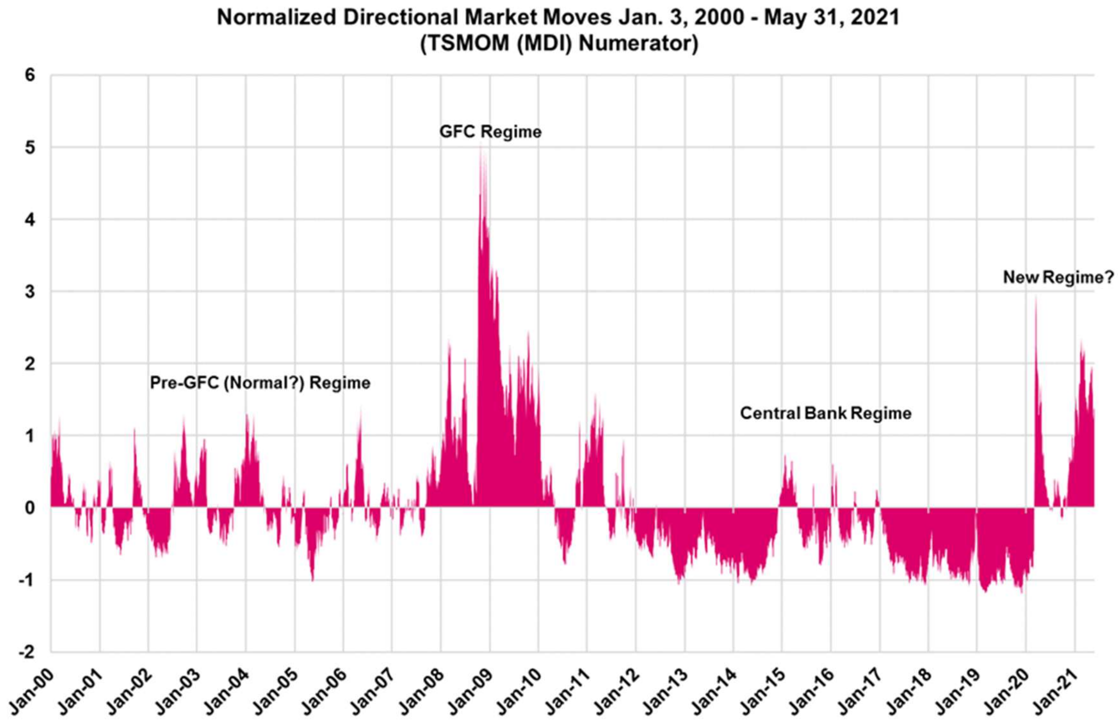
RPM's measure of TSMOM is essentially the ratio of absolute price moves over volatility – a kind of absolute Sharpe-ratio. This is calculated for 50 different time-horizons for 70+ futures markets and averaged into one number for each trading day.

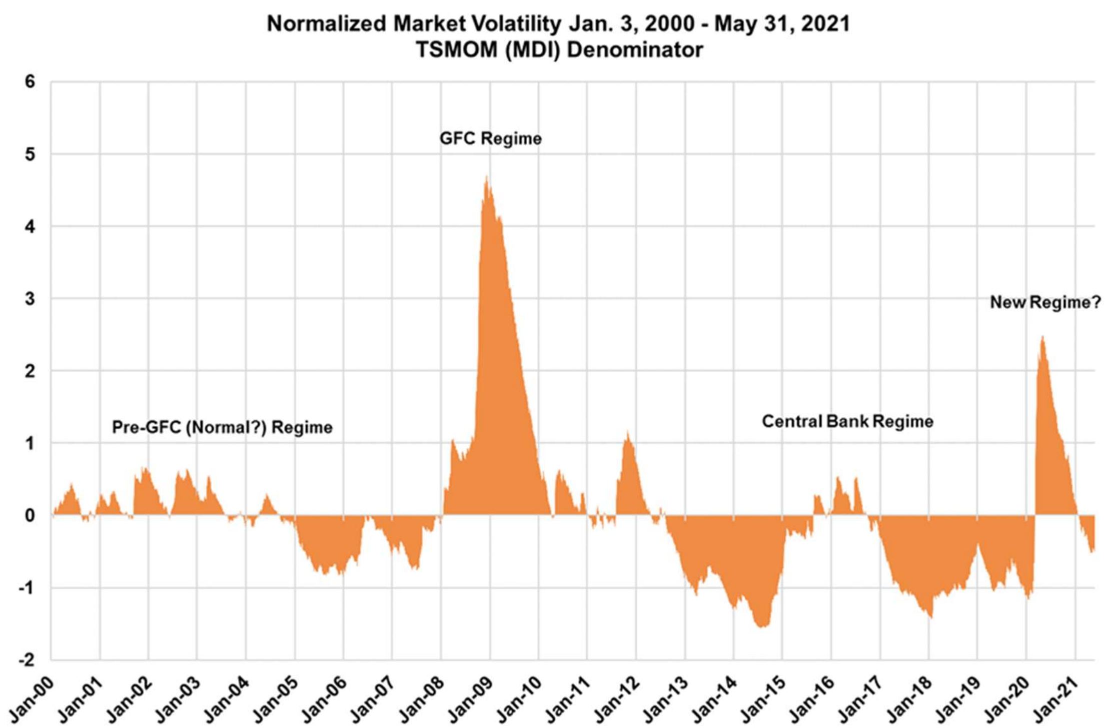
In recent months, markets have moved quite a lot while at the same time volatility – measured as standard deviation - has been decreasing, resulting in levels of TSMOM never seen before. In other words, price trends have been unusually strong, and CTAs have benefited.



Price changes and volatility in markets

Let us look at the components of the TSMOM calculation individually. The first chart focuses on price change*; the numerator in the TSMOM factor above. The chart shows how the markets have moved in terms of absolute price change, up or down, since 2000. The second chart shows market volatility, the denominator in the TSMOM above.**





Markets were unusually quiet for long stretches of time since 2011 up until last year, when the pandemic hit. Since then, the size of the directional price moves has not been seen since the financial crisis in 2008.

Market regimes from a CTA perspective

Viewed from this perspective, since 2000, four different market regimes can be identified. The first regime ranges from 2000 up until the Great Financial Crisis. General directionality in markets went up and down, almost like a sinus curve. Volatility was somewhat high in the early years; the IT-bubble, accounting scandals and 9/11 contributed. Volatility then decreased during the bull market period preceding the GFC. Let us call this the Pre-GFC Regime.

The second regime – the GFC Regime itself – was characterized by very large price moves in many markets. Some were positive like bond markets and soft commodities while others were negative, like equities. Volatility exploded across not only equity markets; commodities, foreign exchange, energy, fixed income all moved violently up and down.

Then followed what we might call the Central Bank Regime: markets were on average subdued, volatility was generally very low, kept in check by central bank talk and activism, low inflation, low interest rates, and mediocre growth. Volatility started to pick up when the Fed started tapering and finally ending QE, but subsided in the years that followed.

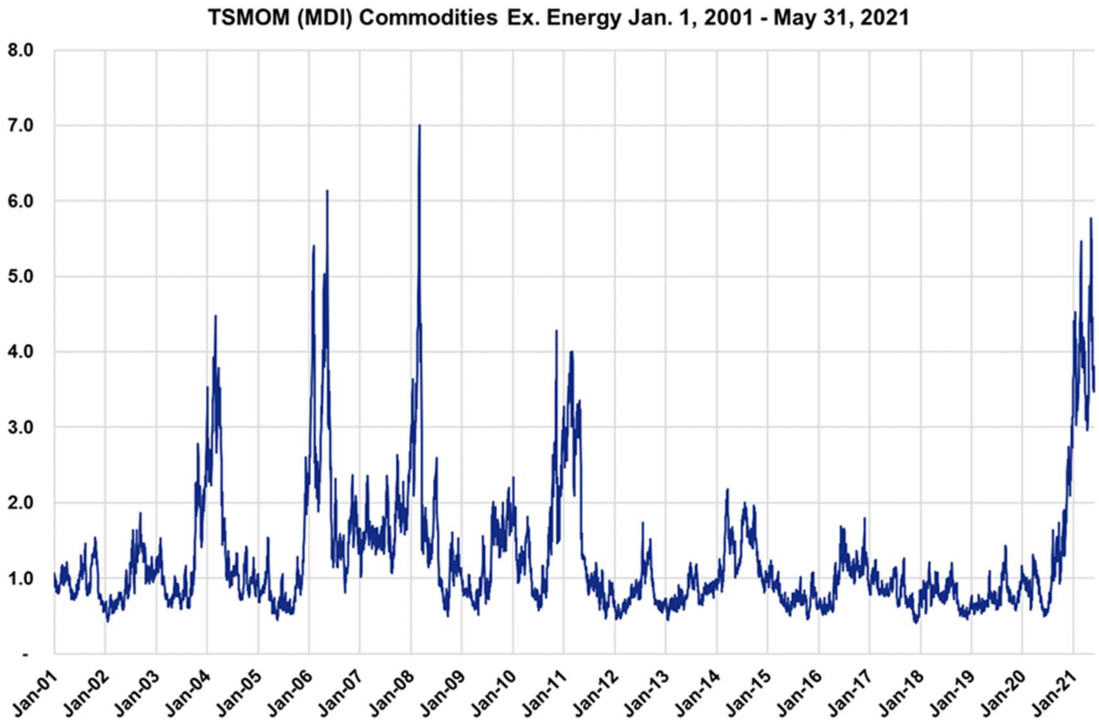
It is too early to baptize the current regime as we do not yet fully understand what is driving it. Notably, there are bullish market moves across almost all sectors. Volatility has picked up dramatically after the GCC, only to fall below normal levels in 2021.

Right now, we are in the unusual situation of having strong directionality in markets combined with low and falling volatility.

Now what?

A significant factor behind the strong CTA performance and the high levels of TSMOM since last fall, is the spectacular bull market in commodities. Precious metals, industrial metals, grains, soft commodities, and meats have with few exceptions been trending upwards.

The next chart shows TSMOM calculated on commodities only – energy markets excluded.



Interestingly, the upward TSMOM move started already in early spring last year and gained further speed around the US presidential election. The trending market environment has largely remained intact since then.

This is quite surprising considering that the sector, with few exceptions, behaved sluggishly since mid-2011. The "Commodity Supercycle" narrative has gained traction but has yet to reach consensus status among analysts and investors.

There are, however, strong arguments in favor of the idea that we are at the beginning of a new market environment quite different from the long period when Central Banks largely controlled market volatility and price dynamics. Commodities may well be the trumpet that signals that change.

Here are a few observations and arguments that would support such a change of regime. The arguments are in no way exhaustive:

Short- to medium-term:

Vaccine relief

The generally successful roll-out of Covid-19 vaccines in the developed world has helped create an atmosphere of optimism and positive expectations of economic growth. Risk is on.

Supply chain bottlenecks

Lingering supply disturbances create pockets of under-supply that drive prices up.

Pent-up demand

The drop in consumption during the pandemic paired with the high savings rate has created a close-to-perfect fundament for consumption spending, adding momentum to economic growth.

US election relief

Investors and other actors around the globe are most likely viewing the new US administration as guarantors of policy stability, reducing growth- and investment-hampering uncertainty.

Droughts and floods in agriculture

The fierce weather situation in Central and South America is likely to have a strong impact on grain and soft commodity prices for the foreseeable future.

Long-term:

Limited room for maneuver for central banks

Inflation rates and expectations have jumped recently with the US and the UK even breaching the 2% target. While central banks are likely to keep policy rates on hold (at least) for this year expecting these inflationary effects to be transitory, nevertheless, there is not much room left for further monetary policy accommodations. The end of central banks suppressing market volatility is nigh.

Energy transition investments

The transition from fossil fuels to renewables involves investments of gigantic size. Goldman Sachs estimates 1-2 trillion USD annually going forward.

Reintroduction of fiscal stimulus

As monetary stimulus is losing its effectiveness, fiscal austerity is on its way out. Huge infrastructure investments are on its way in the US, paving the way for European nations to follow. Keynes is in, Friedman is out.

Changed status of bonds

The outlook for bonds has become gloomy and the asset class has begun to lose its status as a haven. Commodities as an inflation hedge are growing in popularity.

Trend towards regional and national self-sufficiency, de-globalization, regionalization

The pandemic put the spotlight on nations' vulnerability of global supply chains and in secure deliveries of essential goods. The western world is moving fast towards increased self-sufficiency. Regionalization replaces globalization.

The next regime

All the above are arguments in favour of continued growth, changing market dynamics, and de-synchronization of growth between major regions and nations – all of which could be expected to be beneficial to CTAs. And we have barely mentioned inflation.

In terms of market regimes identified above; we believe markets will soon enter a regime that may look like the Pre-GFC Regime. After a slowdown of the current "bull market of everything", markets will develop new dynamics, trends will come and go, as will volatility. Such a regime would be much appreciated by CTAs.

But what if we are wrong? What if, for whatever reasons, there will be no investment boom, no fiscal stimulus, no regionalization, no energy transition. The most likely new regime would then be something like the GFC Regime: a forceful reversal of the current trends and yet another crisis. After a painful couple of weeks following the turning point, CTAs will adapt to, and profit from, new trends when TSMOM starts to build, driven by falling prices across market sectors.

The least likely scenario would be a return to the Central Bank Regime as central bank measures have lost a lot of their effectiveness. Although the monetary stimulus was essential in averting a depression during the GFC, in the years that followed it has benefited Wall Street far more than Main Street while growth remained sluggish. Some central banks have openly passed the ball to politicians: "it is your job now; we can't do much more".

Summing up, CTAs and their investors have good reasons for optimism! RPM's Evolving CTA Fund and Galaxy Fund (both in USD) were up 9.2% and 20.3%, respectively YTD as of May 31, 2021.

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*** The calculations behind the directional move are somewhat lengthy. In essence, it is the average of how much each of the 70+ markets have moved in one direction, up or down, averaged over 50 timeframes ranging from 5 days up to one year. The trick is that the price changes for each market for each timeframe are related to what has been the average for each market and timeframe since 2000.**

****The volatility is calculated using the same methodology as in the directional price move chart above: 70+ markets, 50 timeframes, each market normalized to itself over the whole period, then averaged into one number for each day.**

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