Equity markets remain sensitive to growth and macro factors, and technical factors are also having an impact. This means equity and bond markets are issuing different signals about global trends.

We remain in an environment of very low growth and low inflation. Against that background, markets have proved extremely sensitive to small changes to the growth outlook, central bank policy changes and other macro factors such as the oil price.

This growth sensitivity has been exacerbated by the structure of market participation. Regulation has forced investment banks to limit market making, while growth in high frequency algorithmic and momentum-following strategies, among other factors, has left markets more prone to sudden gyrations or rotations in performance trends. At times, price moves can appear disconnected from underlying stock fundamentals as active investors reduce risk exposure in the face of macro uncertainty or outflows.

Performance within markets since the beginning of 2016 has reflected these themes. It has been a complicated picture, with surprise central bank action, commodity price rises and contradictory news flow from China resulting in some counterintuitive market and share price moves. It has been all the more difficult for active managers to outperform, whether they use long/short or long-only strategies.

Since January, the weak U.S. dollar (USD) led to a rotation away from well-established trends. USD weakness fed through to rallies in commodities, which in turn led to strength in emerging markets. Procyclical stocks, in particular, have rallied hard.

If we were viewing the equity market in isolation, the logical conclusion would be either that global growth prospects have suddenly improved...
or a resurgence of inflation was in the offing. A weak USD, and sharply rallying emerging markets and commodity prices, give the impression of an inflationary backdrop.

However, bond markets have barely reacted — yields have fallen at longer maturities, and implied levels of inflation have barely moved, although bond market signals are themselves distorted by the chase for yield as large sections of developed bond markets move into negative yield territory. Our inclination is that the bond market is right, and any equity market moves that anticipate a marked acceleration in global growth and sustained pick up in inflation will be short-lived.

We have witnessed a period of very low equity market volatility, but high levels of macro uncertainty with large moves in many currencies, commodities and bond markets. A weak USD has been helpful to emerging markets and to the Chinese economy in the short term. Nonetheless, while currency reserve outflows have slowed, there is increased concern around debt levels, and potential impairments. This simply illustrates the degree to which policymakers are boxed in — while weakening the USD takes the pressure off emerging market currencies, growth and stability concerns in the emerging markets remain. Again, equity markets have been telling a different story, with all things emerging market-related performing well through the rotation. Actively managed funds have adjusted positions and reduced exposure in response to market
risks and uncertainties, and also to investor outflows. These position adjustments, broadly unrelated to stock-specific fundamentals, have exacerbated currency and commodity-related share price moves this year. Long-running positions in consumer stocks and defensives have been trimmed while established underweights and shorts in inflation-sensitive parts of the market have been reduced. This has led to the rotation from growth to value and the recent rollover in momentum, which has lasted longer than the rotation in late September and early October last year.

Another macro factor complicating the picture has been the vote on the UK’s membership of the European Union. Up to the referendum, the polls were generally evenly split, but the bookmakers broadly favored a “remain” outcome. For many actively managed funds, the only real protection from the investment impact of a “leave” outcome was to reduce gross exposure or active position sizes and to wait for the event to pass.

Against this background, we have spent considerable time trying to minimize exposure to macro factors through tighter hedging and reduced gross exposure in our long/short equity strategies.

Like other active managers, the trends year-to-date have led to some negative performance in our portfolios. But, we do not see anything that unusual in recent price moves: for now, they seem to be temporary reversals in a longer-term trend. At the margin, we have reduced some industrial short positions linked to the commodities food chain, reflecting our conviction that now is the time to minimize losses and preserve capital.

If our view that the underlying global environment remains one of weak growth and subdued inflation is correct, we would expect the rotation we have seen to unwind as share prices refocus on those fundamentals. In that scenario, the positions in place should start to improve and we would look to dynamically increase either these or other positions.

Figure 1: Popular shorts in the equity markets spiked as investors unwound their positions

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Source: Bloomberg, as of April 29, 2016