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The Great Fiscal Experiment: What could be next?

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Introduction

As a trend-following manager, we watch and follow where the market moves. The markets sure have moved since last year, particularly after the COVID-19 crisis. A few interesting themes stick out, leading us to wonder where the world may be going next. First, we discuss some of the recent trends: the potential demise of the long bond trend, a powerful reflation trade, and the shift from monetary to fiscal policy. Then, we review how the use of massive government stimulus, or what we term “*the great fiscal experiment,*” may provide new opportunities going forward.

RIP Long Bond Trend?

Few investors remember a rising rate environment. In fact, the bond market hit its bottom in 1981–1982, long before many of the current money managers were involved in the market. Since then we have seen a long and steady ride to almost negative rates, in an almost 40-year bull market for bonds. Through this period, there have been some indications the tide would turn, but there was no yield bottom in sight. To put this into context, Figure 1 plots trend strength for fixed income since 1981. This chart shows that short bond signals have not been common since 1981, and have become even more uncommon in the period of quantitative easing post-2008. It is also notable that bond trends moved to net short in February of 2021.

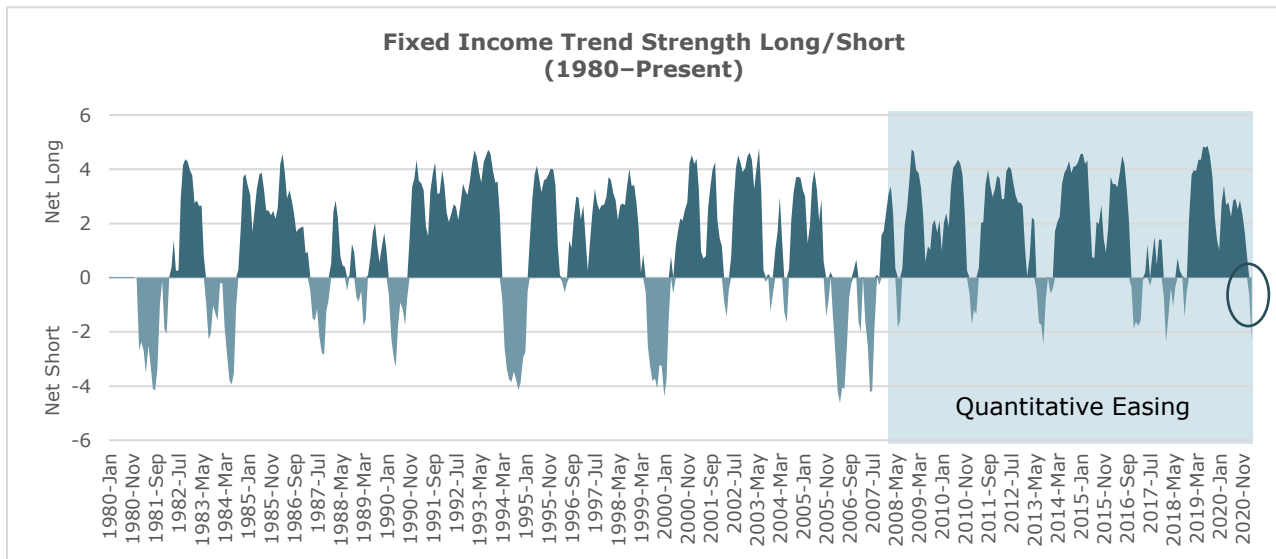


Figure 1: Trend strength using a representative trend-following system for fixed income since 1980. Trend strength is defined as the average trend signal across a basket of available bond futures. Trend strength is calculated daily and then aggregated to a monthly mean. Data is from January 1980 to March 2021. Past performance is not necessarily indicative of future results. Source: Bloomberg, AlphaSimplex.

Figure 2 plots trend strength in fixed income from January 2019 to March 2021. Bond yields fell substantially in 2019, creating a strong long bond trend. This trend waned late 2019 into 2020 but it picked up steam again in 2020 as the COVID-19 crisis hit. Finally, towards the end of 2020, the bond trend began to weaken substantially and finally turned net short in February 2021 as markets grew more concerned over rising longer-term rates.

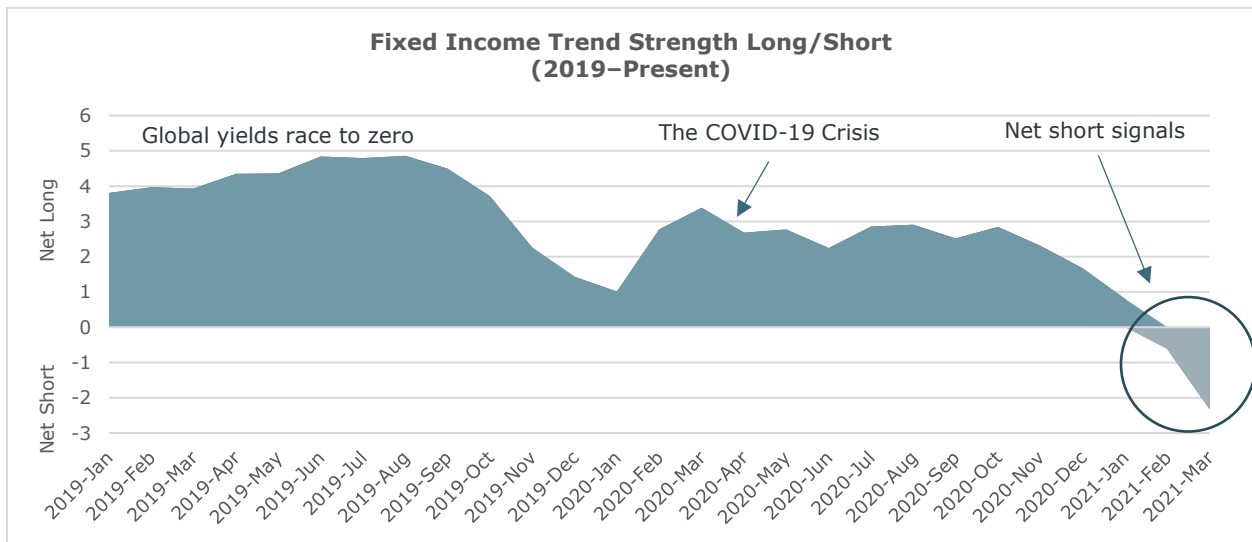


Figure 2: Trend strength using a representative trend-following system for fixed income from January 2019 to March 2021. Trend strength is defined as the average trend signal across a basket of available bond futures. Trend strength is calculated daily and then aggregated to a monthly mean. Past performance is not necessarily indicative of future results. Source: Bloomberg, AlphaSimplex.

Since trend followers trade across asset classes, both the absolute level of a trend signal and the relative contribution of any particular asset class is important. From this perspective, something else stood out in 2020 for fixed income. Despite being the strongest trend in 2019, fixed income hit some of its lowest relative weights in the last 10 years by the end of 2020 and going into 2021. To demonstrate this, Figure 3 plots the risk allocation by asset class from January 2019 to present. Fixed income took up a larger amount of risk in 2019 and eventually dwindled down to a small risk allocation in the beginning of 2021.

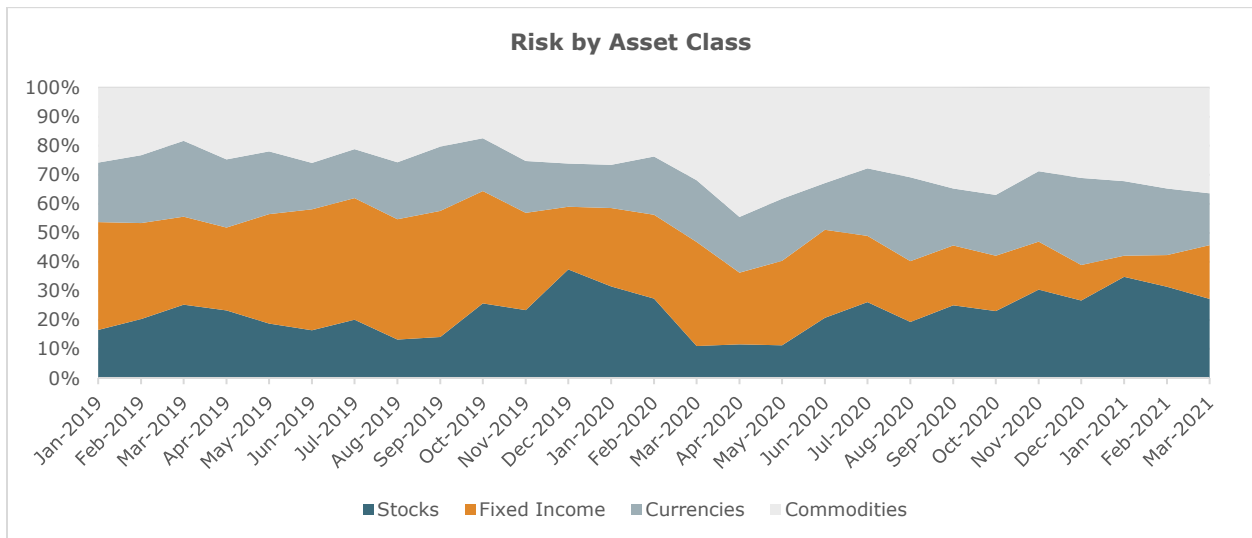


Figure 3: The risk budget information shown above represents the asset-class risk budget of a representative account of the AlphaSimplex Managed Futures Strategy. These risk budget estimates reflect positions in derivatives (such as futures and forward contracts), but exclude cash investments in money market instruments. Percent of risk budget estimates are based on trailing 1-month volatilities (standard deviation) of daily instrument returns as of month-end. Data from January 2019 to March 2021. Past characteristics of asset-class returns are not necessarily indicative of future results. There is no assurance that the composite will be able to achieve its objectives. Source: AlphaSimplex.

Given how strong the fixed income trends have been over the past ten years, particularly long bond trends, this smaller risk allocation has been a somewhat infrequent occurrence. To demonstrate this, Figure 4 plots the risk allocation for fixed income since 2010. Note that in January 2021, the risk allocation in fixed income was 7%, which is in the bottom 3–5% of all months over the last ten years. These last few months have made us pause. With signals turning to net short and the relative risk allocation at all-time lows, could we finally see the demise of the 40-year long bond trend?

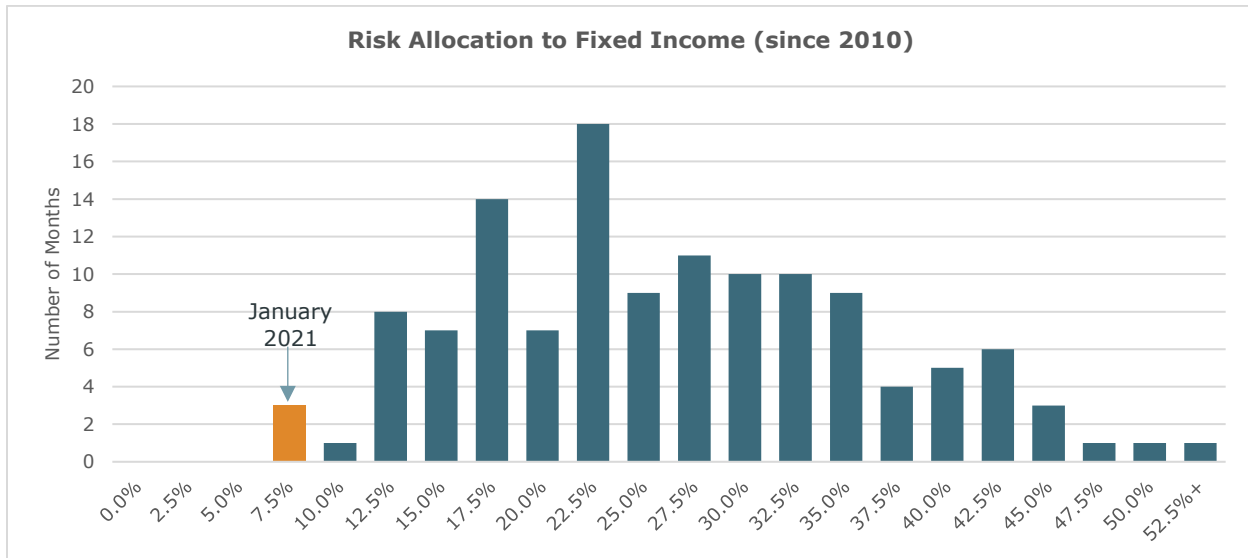


Figure 4: Histogram based on the asset-class risk budget of a representative account of the AlphaSimplex Managed Futures Strategy. The orange column includes January 2021. These risk budget estimates reflect positions in derivatives (such as futures and forward contracts), but exclude cash investments in money market instruments. Percent of risk budget estimates are based on trailing 1-month volatilities (standard deviation) of daily instrument returns as of month-end. Data from August 2010 to March 2021. Past characteristics of asset-class returns are not necessarily indicative of future results. There is no assurance that the composite will be able to achieve its objectives. Source: AlphaSimplex.

A Powerful Reflation Trade

In the wake of faltering bonds in 2020, a new powerful cross-asset trend emerged: the reflation trade. Reflation is defined as the expansion of an economy’s output by either monetary or fiscal policy. In practical terms, this has meant the act of pumping money into the system has generally sent prices roaring upwards. In simple terms, we have seen equity markets come back to surpass pre-spending and pre-COVID-19 levels; commodity prices experienced serious momentum and continued spending put pressure on the U.S. dollar, weakening its relative purchasing power. It is not necessarily the act of reflation that has sounded some alarms, but the speed of reflation that has caused us to consider what this may mean. To demonstrate this point, Figure 5 plots the price of corn futures from 2020 to present. This graph alone could make someone pause. If you needed to buy corn during the “reflation” period, this was certainly disconcerting, but from a trend-following perspective, that period offered spectacular and highly profitable opportunities.

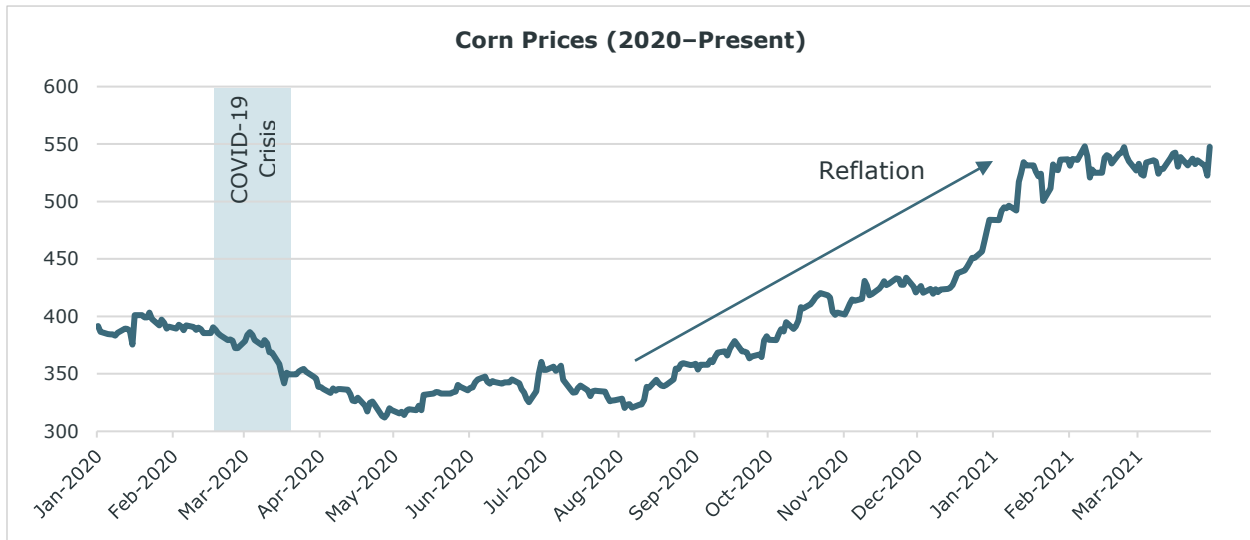


Figure 5: Corn prices from January 2020 to March 2021. Source: Bloomberg.

Taking a closer look at reflation, we consider a simple reflation factor: long equities, long commodities, and short the U.S. dollar. Figure 6 plots the return of the reflation factor both with and without equity market returns. We note that without equity returns the reflation factor is even more pronounced across different time periods. In the post-COVID-19 crisis recovery, the factor has been particularly strong.

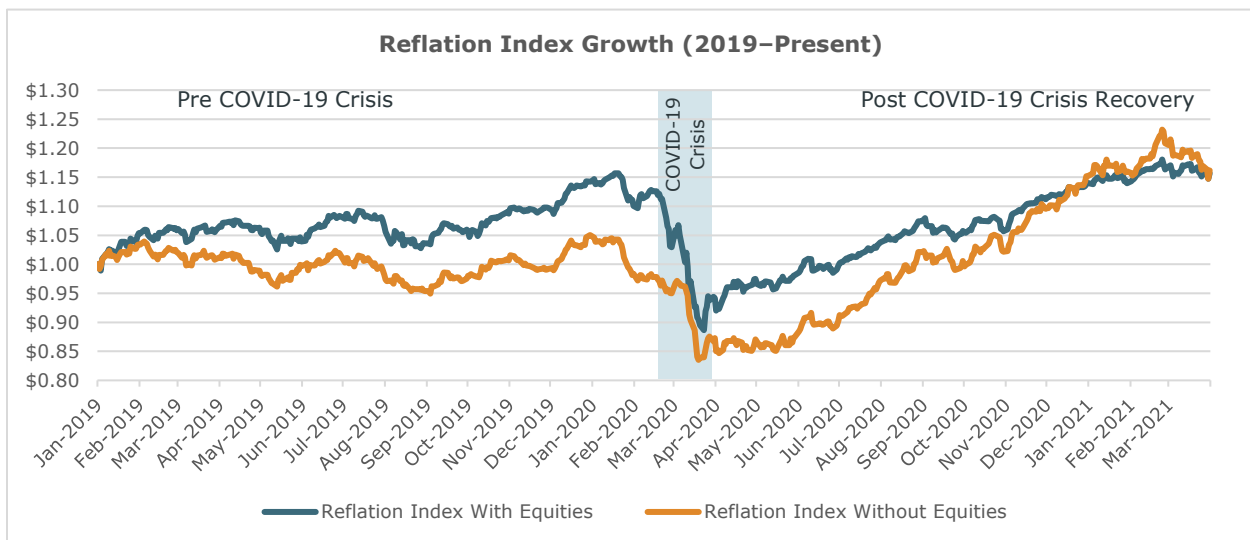


Figure 6: This chart shows two versions of a "Reflation Index," a sample index that can be used to demonstrate the growth of \$1 invested in a selection of assets that are likely to be affected by reflation. Reflation Index With Equities is equally weighted between long S&P 500, short U.S. dollar, and long commodities. Reflation Index Without Equities is equally weighted between short U.S. dollar and long commodities. The commodities positions are an equally weighted basket of industrial metals and agricultural commodities. Both indices are risk targeted to 10%. Data is from January 2019 to March 2021. Past performance is not necessarily indicative of future results. Source: AlphaSimplex, Bloomberg.

A Shift From Monetary To Fiscal Policy

Post-2008, markets have turned to the Fed and other central banks to ease their pain with quantitative easing. Rates simply continued their march down to zero or below. In this environment, the negative correlation between bonds and stocks has been a portfolio diversifier. When equities were down, bonds were there to cushion the fall. After the COVID-19 crisis, markets have begun to sing a different tune. From a trend perspective, this means that bonds seem to exhibit less negative correlation to equities and seem to cushion the downside in equities less than in previous years. To demonstrate this, Figure 7 plots the downside capture ratio for classic defensive assets: bonds (the U.S. 10-Year Note), gold, and safe-haven currencies (the Japanese yen and Swiss franc). This graph shows downside capture for three distinct periods: pre-COVID-19, the COVID-19 crisis, and post-COVID-19, with the periods defined by the peak-to-trough drawdown for the S&P 500 during the COVID-19 crisis. Downside capture gives a measure of how much cushion you may have from an asset when the equity market is down.¹

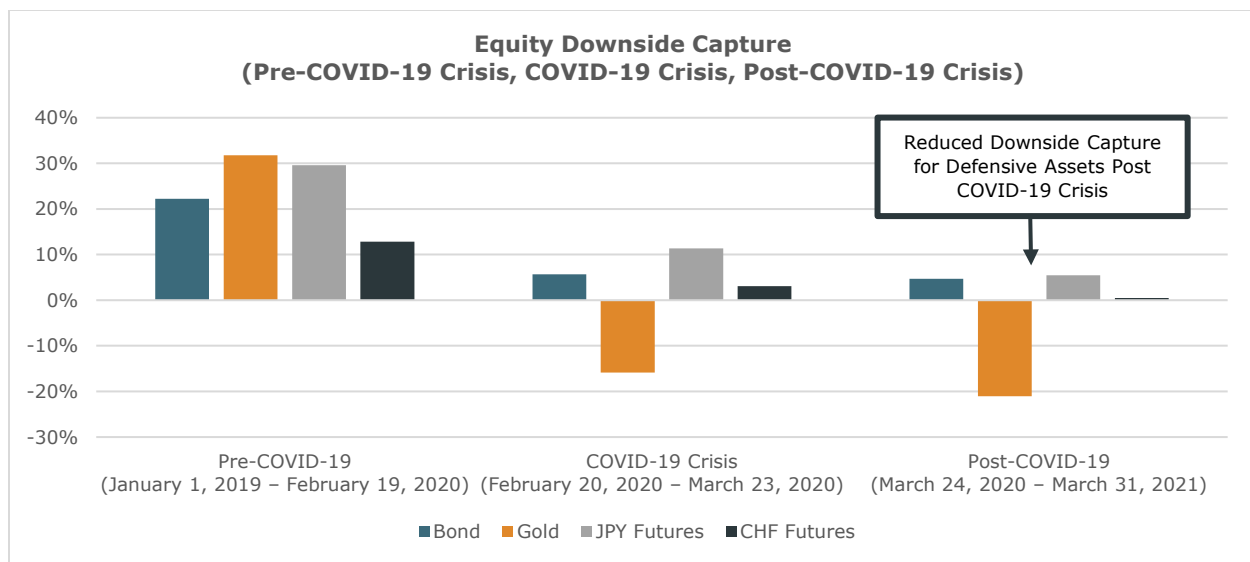


Figure 7: Downside capture for defensive assets: U.S. 10-Year Bonds, gold, and safe haven currencies (the Japanese yen and Swiss franc) during three periods: pre-COVID-19, the COVID-19 crisis, and the post-COVID-19 crisis period. Past performance is not necessarily indicative of future results. Source: Bloomberg, AlphaSimplex.

¹ We calculate the Down Side Ratio (**DSR**) capture as a ratio of mean bond returns on the n-worst stock return days compared to the mean stock return on those days. Keeping things simple, we do it for the worst ten days for pre-COVID-19 period (January 1, 2019 – February 19, 2020), the COVID-19 crisis period (February 20, 2020 – March 23, 2020), and post-COVID-19 period (March 24, 2020 – March 31, 2021). Note that ten worst days for stocks are typically expected to be negative by design. However, the bond returns on those days can be either positive or negative. For a simple definition see also: <https://www.investopedia.com/terms/d/down-market-capture-ratio.asp>.

The Great Fiscal Experiment

After the Great Financial Crisis in 2008, there was a period of monetary policy and quantitative easing, with monetary policy in focus for market prices. Central banks had two key tools: setting the level of benchmark rates (such as the Fed Funds rate) and purchasing plans meant to boost market prices by providing demand. From a monetary policy perspective, rates began to creep down to lower and lower levels, with the entire German yield curve going negative in the summer of 2019. When the COVID-19 crisis hit, rates were at all-time lows with little room to move. At this point, the world turned to fiscal policy in hopes that stimulus would alleviate the potential value destruction created by a global pandemic. In simple terms, pumping tons of capital into the system would keep us from going into a recession and might eventually slow value destruction and unemployment and support the economy. To demonstrate this, Figure 8 plots the total government expenditures since 1960. Unfortunately, it looks a bit like the price of corn in 2020. Note that this plot ends in Q4 2020 and there is much more stimulus to come, hence the orange arrow for 2021.

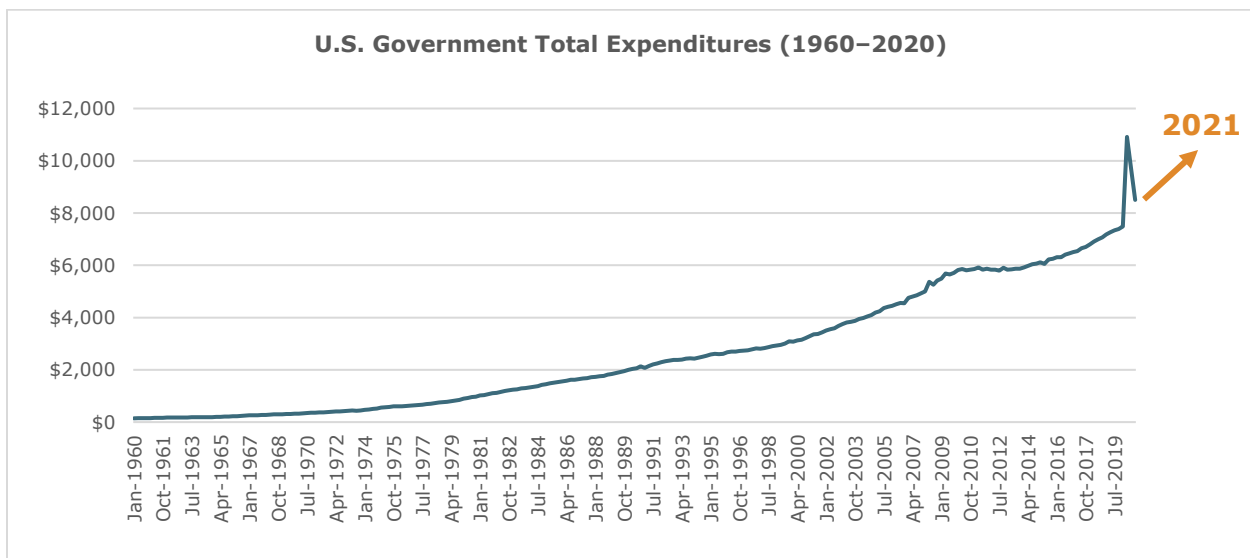


Figure 8: Plot of fiscal spending in the United States. Source: U.S. Bureau of Economic Analysis, Government total expenditures [W068RCQ027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis. Amount given in USD billions. Data is from January 1960 to December 31, 2020.

As trend-following managers, we focus on where the market is going, not why it is going there. Yet given the graphs in this paper, it is hard for anyone not to wonder why and what will happen next in this Great Fiscal Experiment? To begin to understand, we take a detour into a controversial way to think about value, money, and the way markets and economies may work: Modern Monetary Theory. This approach certainly wasn't taught in our M.B.A. or Ph.D. programs, but it is gaining popularity and may lead us to some answers.

Modern Monetary Theory

Money is defined as something that has value and is accepted as payment for goods and services. When a government can issue its own money, often termed a “fiat currency,” it creates a monopoly on that currency. According to Modern Monetary Theory (MMT), a controversial economic theory, this in turn allows a government the power to manage the supply, the power to create new money, and the power to use more money to pay off debts in its own currency. Figure 8 certainly makes us think of the second point. In traditional economics, printing money is generally viewed as dangerous, as it may lead to inflation and adverse consequences. Proponents of MMT suggest that money creation is just another tool that doesn’t necessarily lead to adverse economic situations. In fact, money printing has been going on significantly since the Great Financial Crisis but so far has not led to inflation.²

Still, there are several key concerns. The biggest one is inflation. If money creation gets out of hand and money gets pumped into goods we need to purchase, the prices for goods may skyrocket. Inflation means the assets we currently own and our own cash would be worth less in terms of purchasing power, which is also concerning. In addition, given that countries are not islands, if a government decides to create excessive money it may see massive pressure on its currency. In today’s world with massive fiscal stimulus this could mean there are two key risks:

1. Inflation
2. Bond rates could either stay at zero or experience inflationary pressure

To many traditional economists, this view sounds like a game of monopoly where you get to do whatever you want with the cash and even add more to your pocket when it suits you. You would certainly win the game, but at what cost? Even more complex, if there are many different bankers, each with their own money, all playing this game of monopoly with each other. How would that turn out? It certainly sounds complicated. One might even wonder how long before someone gets up and throws the board at another player.

Thankfully for us, we are trend-followers, not economists. The current trends are providing a few signals that these risks may not be unfounded. Unlike most investors, we are not overly concerned. If inflation were to occur, commodities and other assets would likely experience big trends. In fact, using longer-term historical data, Greyserman and Kaminski (2014) showed that trends were stronger in inflationary and rising inflation environments. Commodity markets in particular tend to demonstrate bigger price moves with inflation. Finally, if bonds are no longer a defensive trade, we could see bonds providing little-to-no return with low-to-zero rates; or if inflation hits, we could see longer-term bonds devalue, causing serious concerns for investors who hold long-term bonds. From a trend-following perspective, if bonds

² Edwards and Mohamed 2020.

do not move, their trends will be weaker; if bonds devalue with inflation risk, short-bond trends may be an opportunity going forward.

To demonstrate this, we consider a historical perspective. Figure 9 plots inflation as defined by the changes in the CPI index since 1970. The horizontal lines divide different inflationary regimes: low (<2%), moderate (2–4%), and high (>4%). It has been almost four decades with very low inflation.

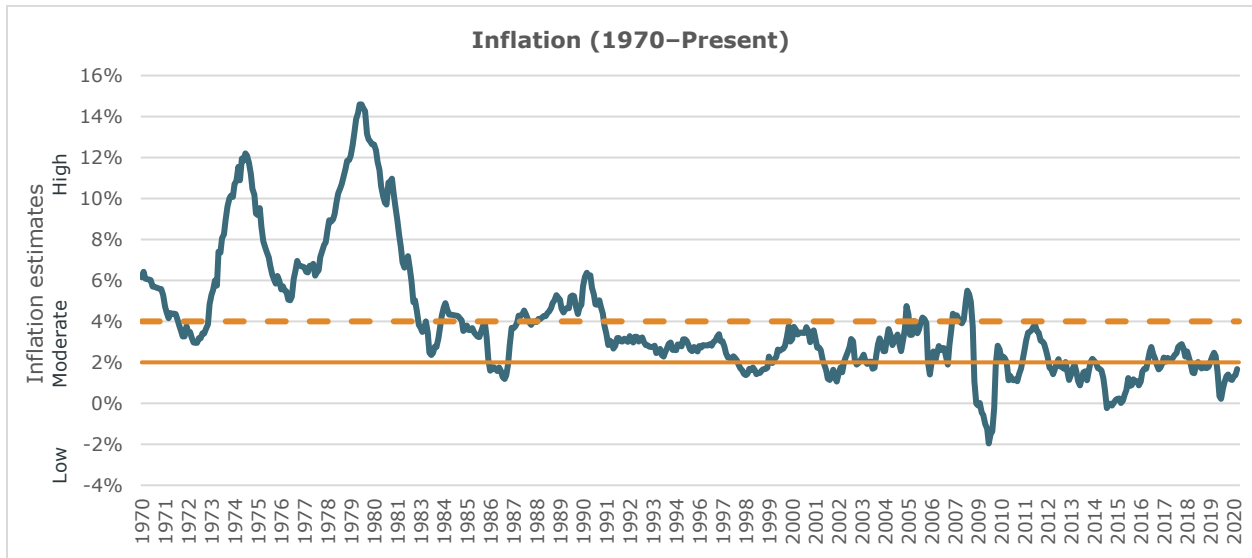


Figure 9: Inflation calculated as the change in the CPI index from January 1970 to March 2021. Past performance is not necessarily indicative of future results. Source: FRED.

2020 has sounded alarms for some investors as forward estimates are starting to tick higher. To demonstrate this, Figure 10 plots inflation estimates using changes in the CPI and a real-time daily estimate from State Street.³ The real-time estimates for inflation are moving into moderate territory, with estimates ranging from 1.6% (based on CPI) to 3.4% (based on State Street’s PriceStats).

³ State Street PriceStats provides high-frequency measures of inflation and exchange rates drawn from prices on millions of prices sold from online retail.

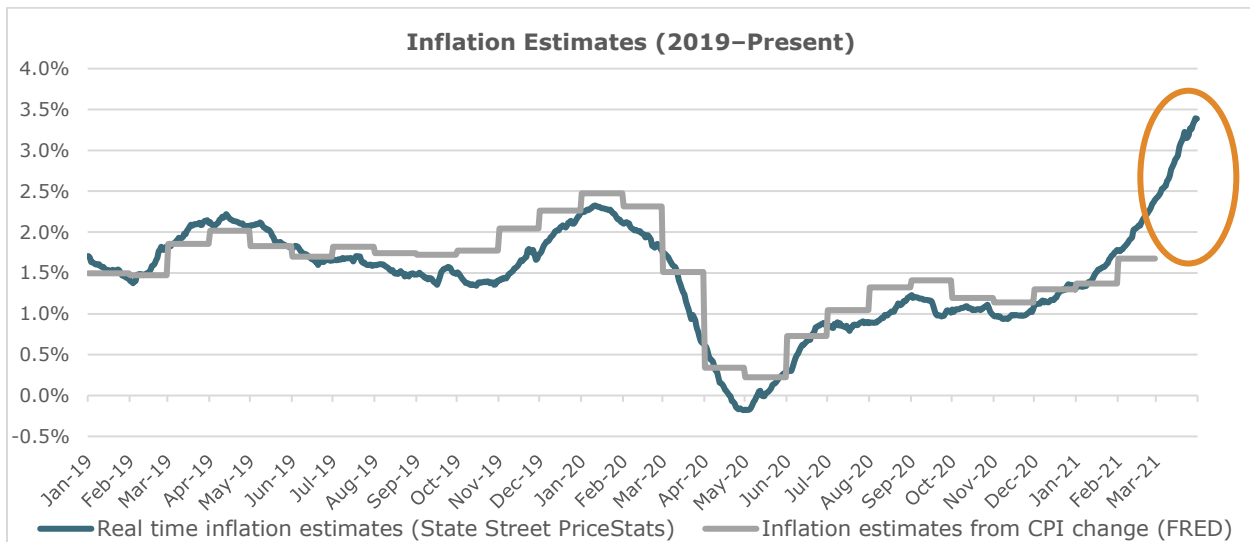


Figure 10: Inflation estimates for January 2019 to March 2021. Past performance is not necessarily indicative of future results. Source: Bloomberg, FRED, State Street PriceStats.

If inflation were to come back, even at moderate levels, what would this entail? Certainly inflation would affect cash flows and real assets such as bonds and commodities. To consider the impact of inflation, Figure 11 plots the average return for bonds and commodities over different inflationary regimes (as described above) using the U.S. 10-Year bond and the GSCI Index as proxies for investments in bonds and commodities. In Figure 11, it is clear that commodities seem to provide larger returns during higher-inflation periods, whereas bonds struggle more with higher inflation. This is because bonds face two opposing forces: the positive impact of a weaker dollar versus the headwinds of rising rates. Either way, consistent with Greyserman and Kaminski (2014), higher inflation tends to mean more trends, which can provide opportunities for trend-following strategies.

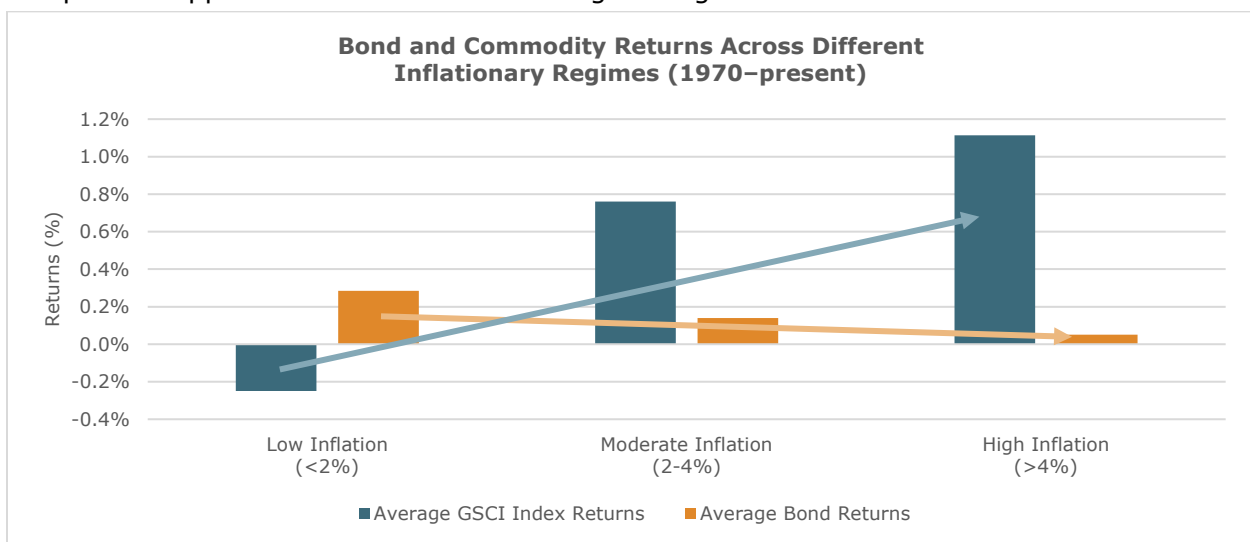


Figure 11: Average bond and commodity returns using the GSCI Index as a proxy for commodity returns and a price series from the U.S. 10-Year Bond for estimated bond returns. Data from January 1970 to March 2021. Past performance is not necessarily indicative of future results. Source: FRED, Bloomberg, AlphaSimplex.

Summary

Over the last few months post-COVID-19, there have been substantial trends in global markets. Recent themes have put into question the future of what has been an almost 40-year bond bull market. In the wake of increased fiscal stimulus, markets have shifted focus from monetary policy to fiscal policy, giving way to what has been deemed the reflation trade. Recent selloffs in the bond market, particularly in longer-duration bonds, have shown the shift in utility of bonds as a cushion for equity drawdowns. As trend-followers, we have been watching these themes unfold, leading to questions that do not yet have answers. Instead, with the backdrop of MMT, there are certain risks for inflation and the potential for a very different period for fixed income. Both of these may create new and potentially disruptive trends for traditional investment portfolios. To the trend-follower, this shift can signal opportunity instead of challenge, and we are ready.

References

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