Short is the New Long

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2018 has been a turbulent year in financial markets and a difficult year for trend following. Trend following strategies use technical and mathematical methods to measure the direction of trends across the globe—that is, to try to determine where markets are going. In the wake of trade war concerns, political uncertainty, and general angst regarding the direction of global equity markets, it is not that surprising that it has been hard to determine where markets are going. Markets seem to have been at an inflection point, bouncing back and forth between old and new trends. More simply put, the global economy seems to be trying to decide if this is the beginning of the end or the end of a new beginning. This perspective resonates across multiple aspects of global markets.

- **Rising rates vs. low interest rates.** In 2018, short positions in U.S. bonds were profitable for the first time in a while. Europe and the U.S. diverged substantially with the U.S. moving towards higher rates and Europe remaining in a very low yield environment.
- **Nationalism vs. globalism.** Discussions of trade wars between China and the U.S. occurred on and off all year. In Europe, political tensions in France, Sweden, and elsewhere continued to demonstrate the push and pull between nationalist and globalist perspectives. The Brexit decision continued to affect European markets as well.
- **Rising equity markets vs. recessionary pressures.** U.S. equities were down for the year with major reversals in February, October, and December; European and Asian markets lost even more over the year.
- **The United States vs. the rest of the world.** Correlations between the U.S. and the rest of the world have gone down in equities and fixed income. The U.S. dollar remains strong, which potentially puts additional pressure on markets moving into 2019.

Is this time different?

Investors have found 2018 challenging as they try to determine if things have changed for good. They often ask if v-shaped recoveries (or a swift drawdown immediately followed by a recovery period) in equities are the new normal, or if they should begin to expect more divergence in global markets. For trend following managers, this environment is not easy. But it is also not new. In fact, there are several times in history when we saw similar trends and positioning. As we often say, history does not necessarily repeat itself, but it certainly can rhyme.

Figure 1 plots the MSCI World Index for eleven months in 2007 (February – December) and 2018 (January – November). In both years, markets experienced significant retractions, although of course for different reasons. Given that both 2007 and 2018 brought "rhyming" reversals in equity markets, one might wonder how trend following strategies performed. This question is especially pertinent given managed futures strategies' potential ability to provide "crisis alpha," or positive returns when markets struggle.

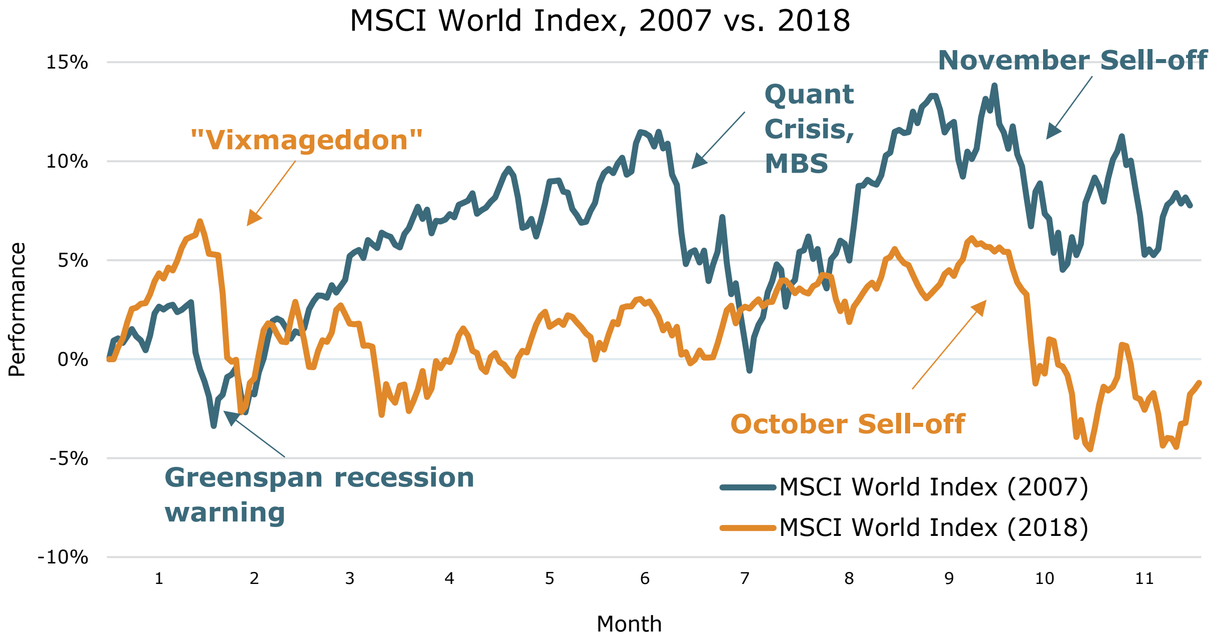

Figure 1: MSCI World Index during 2007 (Feb. 2007-Dec. 2007) and 2018 (Jan. 2018-Nov. 2018). Key global events and equity drawdowns are highlighted in their corresponding colors. Past performance is not necessarily indicative of future results. Source: Bloomberg.

How did trend navigate 2007 and 2018?

Going into both 2007 and 2018, consistent with their approach to measuring market direction, trend following strategies held positions that reflected sustained trends in global markets coming out of 2005–2006 and 2016–2017. These trends included sustained positive returns in many traditional assets like equities, which led to trend following strategies having long positions in those asset classes. In both 2007 and 2018, markets reversed, which hurt both equity markets and trend following strategies simultaneously. Figure 2 plots the performance of global equity markets and trend following strategies in both 2007 and 2018. In both periods, equity markets suddenly declined; trend following strategies declined more. However, during 2018 European, Asian, and Emerging Markets did not recover as strongly as they did in 2007. The impact was less pronounced in U.S. equity markets until December 2018.

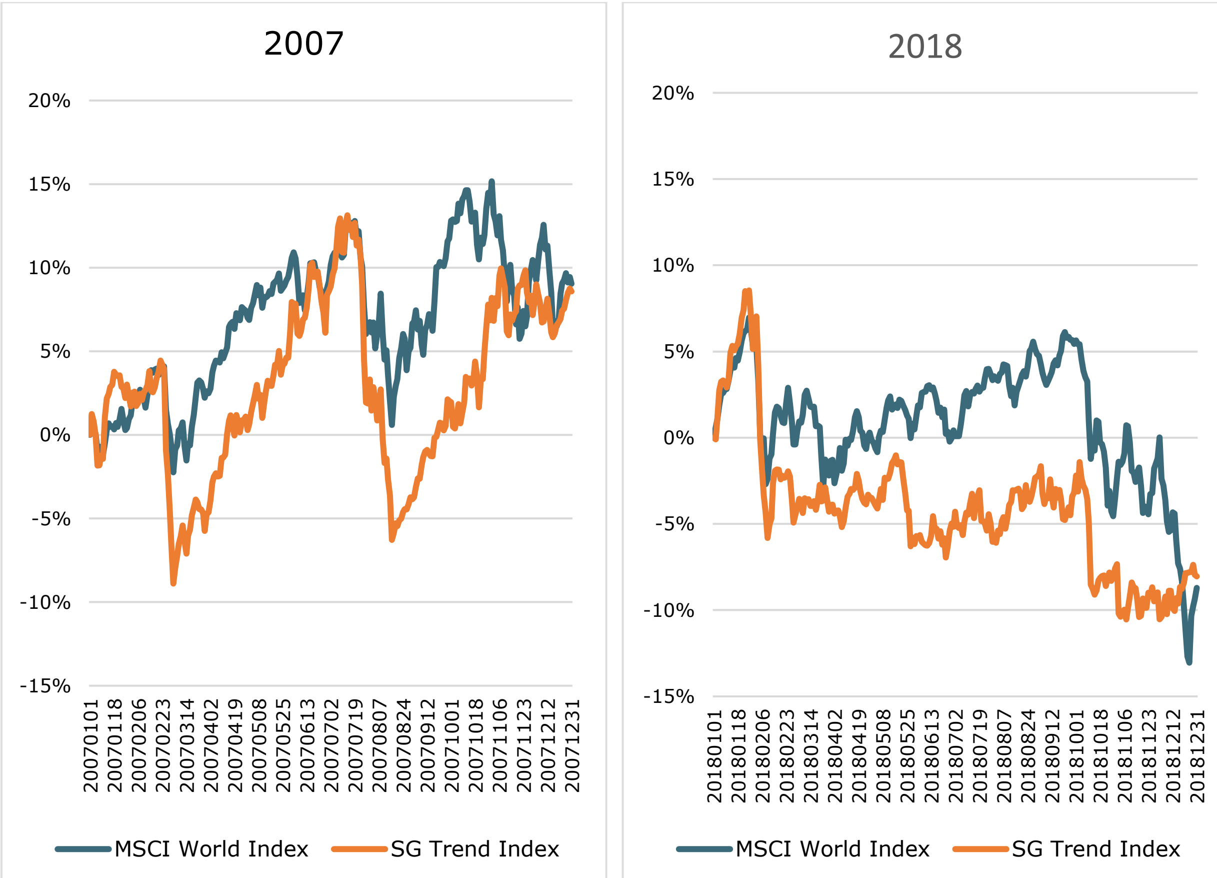

Figure 2: Cumulative performance of the MSCI World Index and Managed Futures (SG Trend Index) in 2007 (1/1/2007-12/31/2007) and 2018 (1/1/2018-12/31/2018). Past performance is not necessarily indicative of future results. Source: Bloomberg.

How do market reversals impact trend positioning?

As global trends change, particularly when they reverse, trend following strategies adjust their positions as markets move in new directions. In a year like 2007 or 2018, new trends may emerge and trend following strategies may pivot their positions to follow emerging new trends. Figure 3 plots net long and short positioning of a generic trend following strategy by asset class in 2007 and 2008 and in 2017 and 2018. In both periods, but particularly in 2018, trend following shifted from primarily long positions to primarily short positions. From the current net positioning in 2018, we can clearly see that in 2018 “short is the new long” for trend following.

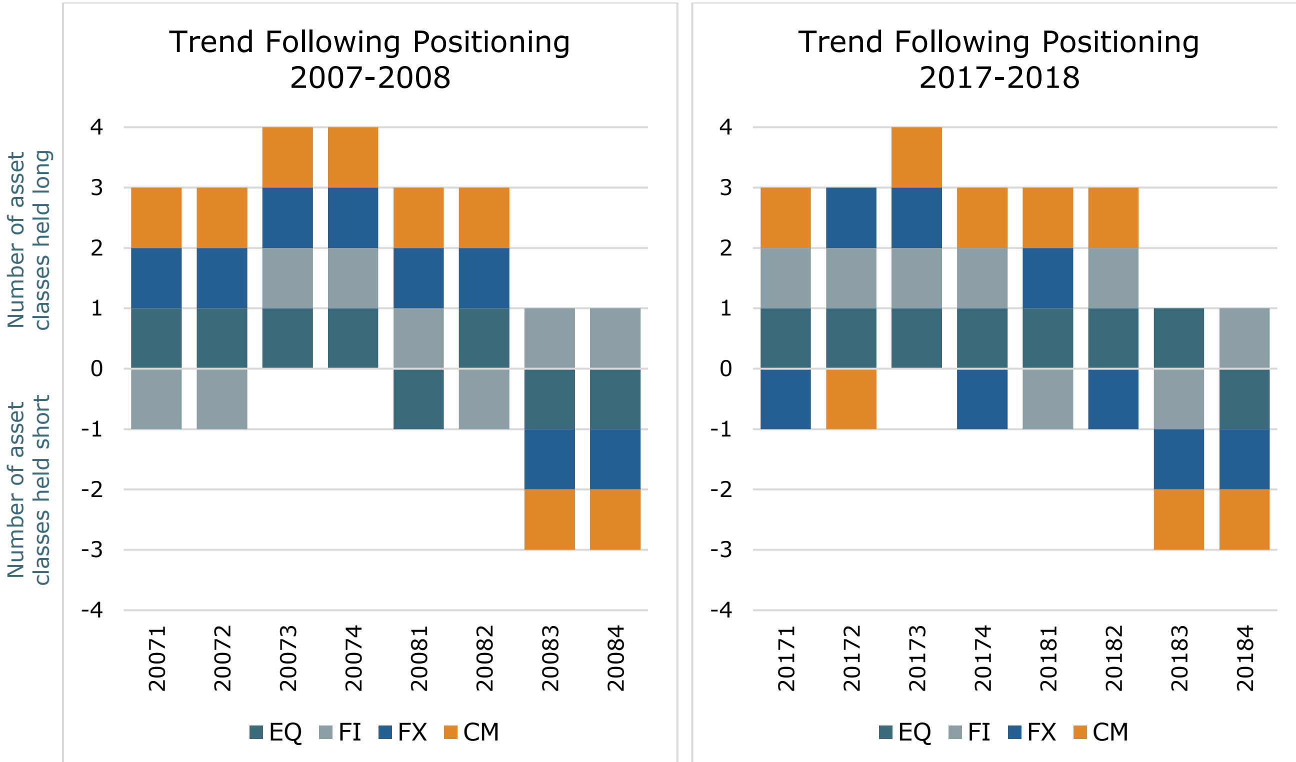

Figure 3: Quarterly positioning of a trend following strategy implemented with equal risk-weighting across futures markets spanning commodities, equity indices, fixed income, and currencies during 2007 and 2008 (1/1/2007-12/31/2008) and 2017 to 2018 (1/1/2017-12/31/2018). This analysis is intended to illustrate the evolution of a generic trend following strategy's positioning over time and is not intended to represent results of a specific trading strategy.

	2007-2008	2017-2018
Equity Markets	Net Long to Net Short (Q1 2008)	Net Long to Net Short (Q4 2018)
Bond Markets	Mixed between Long/Short	Mixed between Long/Short (Q1 2018)
Currencies	Net Long to Net Short (Q3 2008)	Mixed to Net Short (Q3 2018)
Commodities	Net Long to Net Short (Q3 2008)	Net Long to Net Short (Q3 2018)

Table 1: Summary of trends in trend following positioning in 2007 to 2008 and 2017 to 2018, as indicated in Figure 3.

From Figure 3, we can see that the reversal environment in 2007 and in 2018 was followed by shifts in positions in many asset classes, often from long to short. Are these two environments the same? Clearly not. However, there are some similarities. The reversal environment in both 2007 and 2018 was followed by shifts in many asset classes from long positions to short positions. As of December 2018, trend following is net short in currencies, commodities, and equities. Hence, "short is the new long." Similar to Q2/Q3 2008, fixed income positioning in Q3/Q4 2018 switched from net short to net long in response to equity drawdowns.

To put current trend following positioning into perspective, Figure 4 plots the cumulative net long and short positioning by asset class since late 1990. Note that Q4 2018 is one of the few periods in history with mostly net short positions.

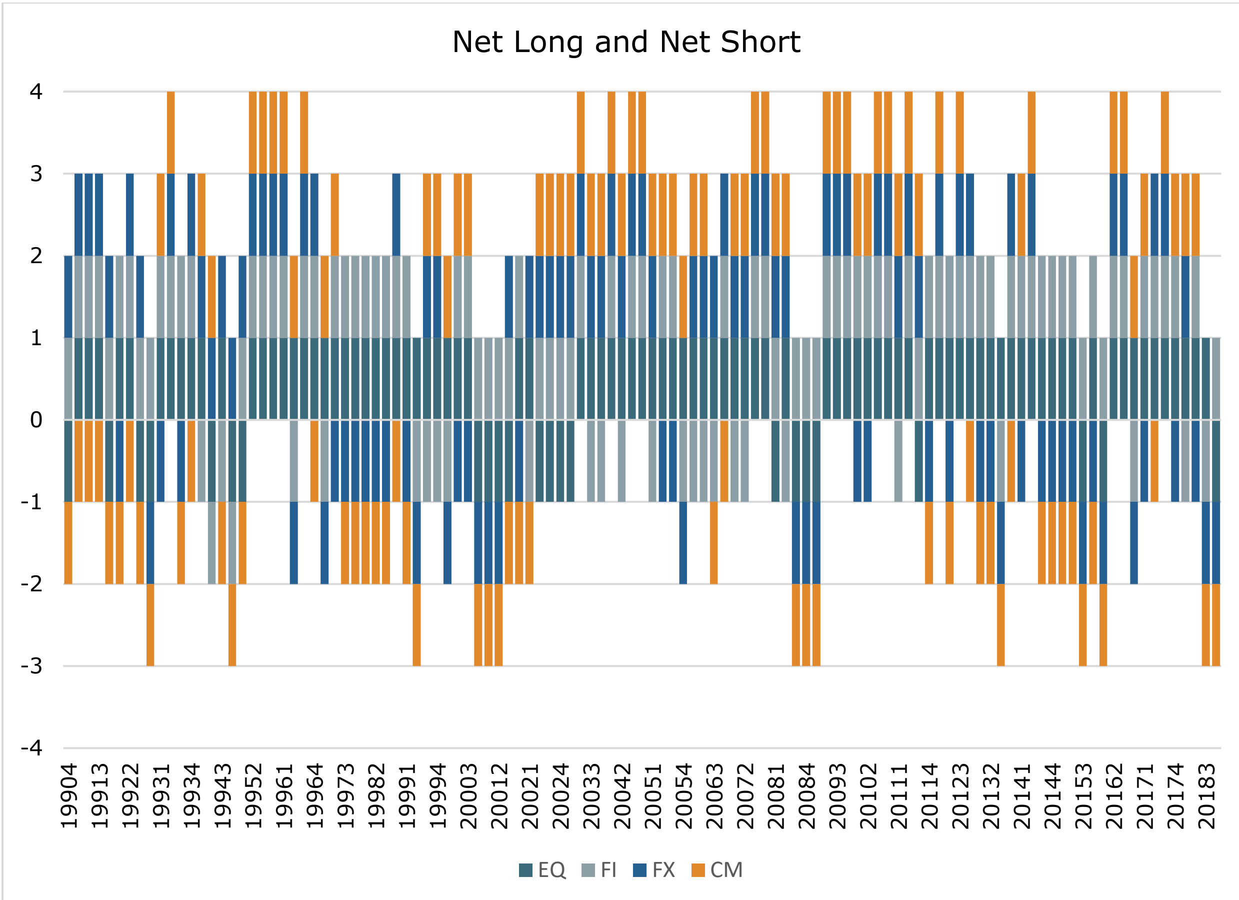

Figure 4: Quarterly positioning of a trend following strategy implemented with equal risk-weighting across futures markets spanning commodities, equity indices, fixed income, and currencies (10/1/1990-12/31/2018). This analysis is intended to illustrate the evolution of a generic trend following strategy's positioning over time and is not intended to represent results of a specific trading strategy.

What can we expect going forward?

Trend following strategies add diversification to traditional portfolios by being able to go long and short a wide range of assets across the globe and across asset classes. This profile allows the strategy to add diversification and potentially mitigate risk during periods when the positions have low or negative correlation to traditional asset classes. Although trend following has had a difficult ride in 2018, with large reversals in equity markets, trend following positioning is poised for something different—with the potential to add diversification. In 2007, we saw the same pattern, with trend following strategies reflecting equity positioning until the end of the year, and then moving to markedly different positioning. In 2008, this was a useful strategy for trend followers. To illustrate this, Figure 5 plots the MSCI World Index and trend following strategies (SG Trend Index) in 2007-2008.

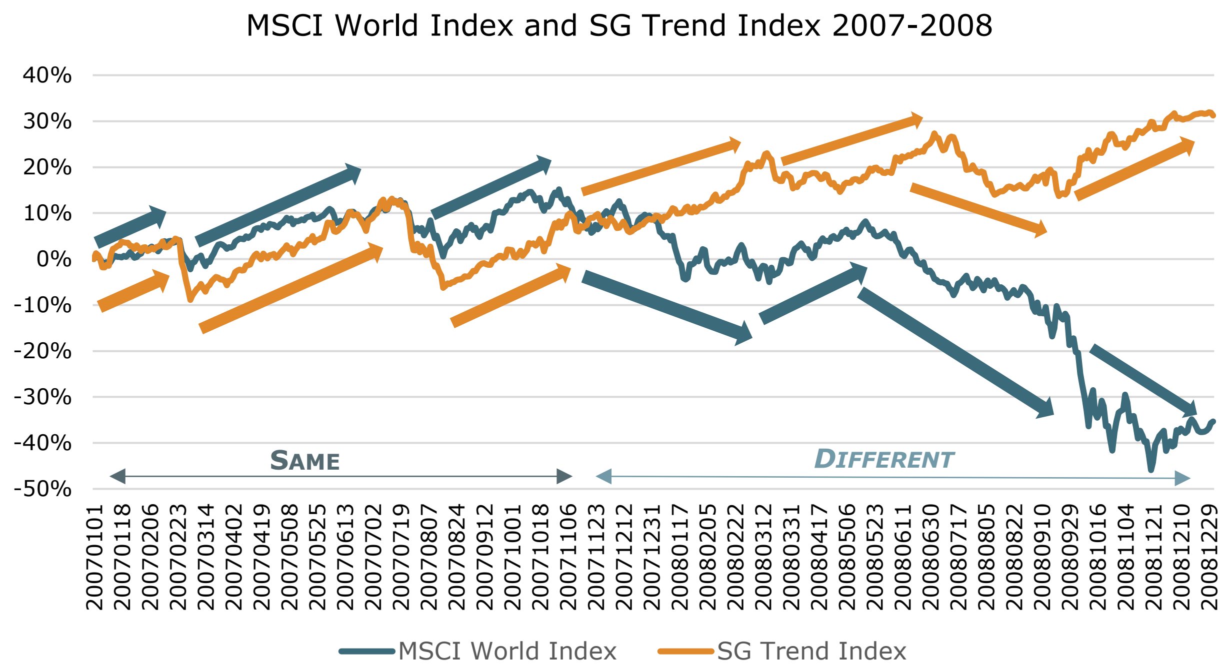

Figure 5: Cumulative performance of MSCI World Index and Managed Futures (SG Trend Index) from January 2007 to December 2008. Past performance is not necessarily indicative of future results. Source: Bloomberg.

In a world where short is the new long, there is potential for markets to do something different. Going into 2019, trend following strategies are positioned for potential change.

About the Author

Kathryn M. Kaminski, Ph.D., CAIA® is the Chief Research Strategist at AlphaSimplex Group. As Chief Research Strategist, Dr. Kaminski conducts applied research, leads strategic research initiatives, focuses on portfolio construction and risk management, and engages in product development. She also serves as a co-portfolio manager for the AlphaSimplex Managed Futures Strategy. Dr. Kaminski's research and industry commentary have been published in a wide range of industry publications as well as academic journals. She is the co-author of the book *Trend Following with Managed Futures: The Search for Crisis Alpha* (2014). Dr. Kaminski holds a B.S. in Electrical Engineering and Ph.D. in Operations Research from MIT.

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