Markets in Motion: The Return of Trend

Kathryn M. Kaminski, Ph.D., CAIA®
Chief Research Strategist,
Portfolio Manager

September 2019

Momentum: an object in motion will stay in motion until acted upon by an opposing force. – Newton's First Law of Motion

Introduction

Time series momentum, more commonly known as trend following, is an opportunistic strategy that follows both long and short trends across global markets over time. Fundamental investors tend to be skeptical of price-based strategies such as trend following, because they generally believe that markets are highly competitive and efficient. More specifically, they assume prices reflect all relevant available information. Yet, during certain scenarios, particularly during periods of stress or dislocation, markets move in unexpected directions and prices can temporarily exhibit momentum in one direction or another, while information is incorporated slowly into market prices. After a challenging 2018 for trend-following strategies, the slow and steady fall in global yields in 2019 has been a particularly good example of a strong momentum trade.[1] Given the steady move in yields, trend-following strategies were able to react and follow this trend. This note discusses key themes from 2018 into 2019 highlighting the race to negative yields and improved diversification in trend following.[2]

Markets in Motion

The race to negative yields: a strong momentum trade

In 2018, the outlook for bonds was drastically different from where we stand today. Trend-following signals indicated that the U.S. would raise rates while Europe and other developed countries seemed poised to be stuck in zero-to-negative territory. In Q4 2018, after a tumultuous year in equity markets, this all seemed to change. U.S. fixed income started on a long road towards lower and lower rates. Few fundamental investors believed that U.S. rates would go as low as they have gone; even fewer believed that European and other developed countries would move further into negative territory. In fact, on August 2nd, 2019, the German 30-year bond yield went negative, a feat most investors would have been unable to forecast.

Using the strength of a generic trend-following signal as an indication of direction for bond prices, Figure 1 plots the trajectory for U.S. and German 10-year futures contracts in 2018 and the first eight months of 2019.[3] For most of 2018 there were divergent expectations for the U.S. and Europe. The fourth quarter of 2018 marked a turning point as the U.S. Federal Reserve changed directions. From this point through the first eight months of 2019, all signals pointed to falling yields across the globe. This unexpected and steady move provided a momentum opportunity for trend-following strategies. After the fact, the trend is obvious, but there are few fundamental-based investors who would have predicted this exceptional move.

[1] Data through August 31, 2019. The first weeks of September have seen some reversals of this trade.
[2] Diversification does not assure a profit or protect against a loss.
[3] A generic trend-following strategy implemented with equal risk-weighting across futures markets spanning commodities, equity indices, fixed income, and currencies.

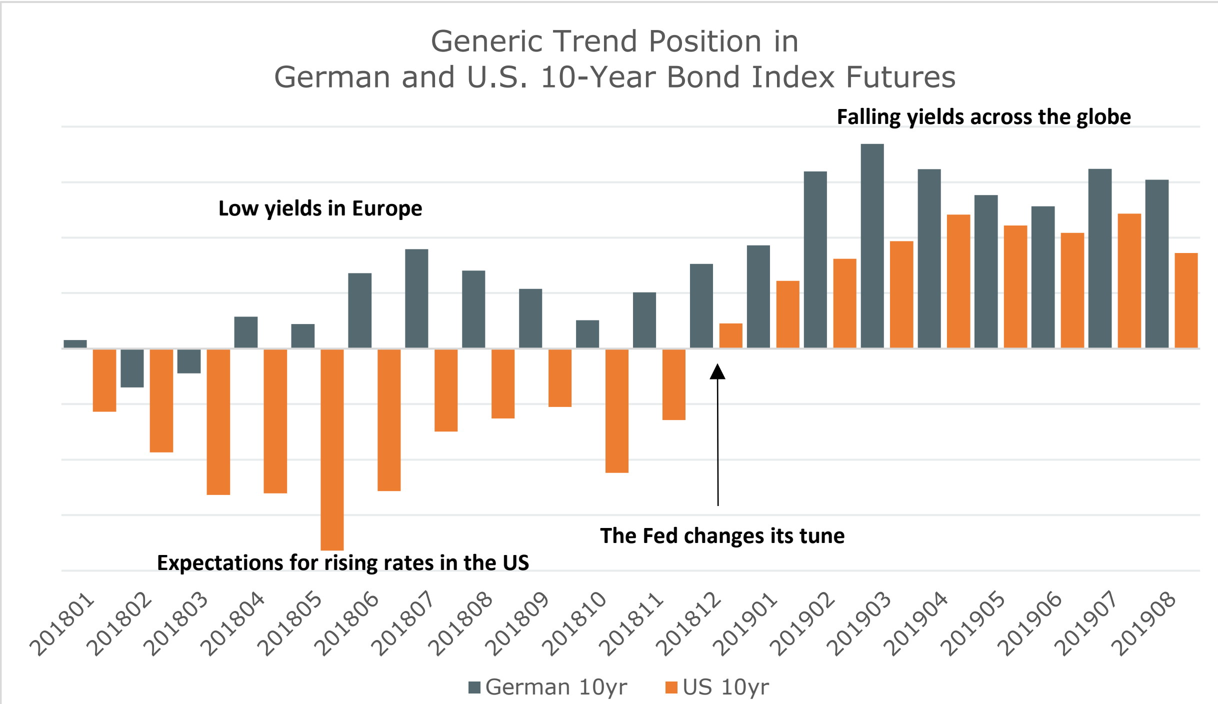

Figure 1: Positioning in German and U.S. 10-year bonds for a generic trend-following strategy implemented with equal risk-weighting across futures markets spanning commodities, equity indices, fixed income, and currencies. This analysis is intended to illustrate the evolution of a generic trend-following strategy's positioning over time and is not intended to represent results of a specific trading strategy. Source: AlphaSimplex.

In 2019, following global bond price momentum upwards has been an exceptional trade. Do bond yields do this often? Of course not. For a trend-following strategy to be successful, it needs to follow trends across a wide range of opportunities. This means that trend-following opportunities vary from year to year across different market environments. To demonstrate this, Figure 2 plots the returns of a generic trend-following strategy by asset class to demonstrate how these opportunities vary over time. For example, years like 2010, 2014, and 2019 were good years for bonds as bond prices followed discernable trends. In a difficult year for equity markets such as 2008, there were clear trends in all asset classes, although the momentum was downward for equities and commodities while being upward for bonds. Figure 2 highlights the importance of diversification across different asset classes for trend-following strategies.

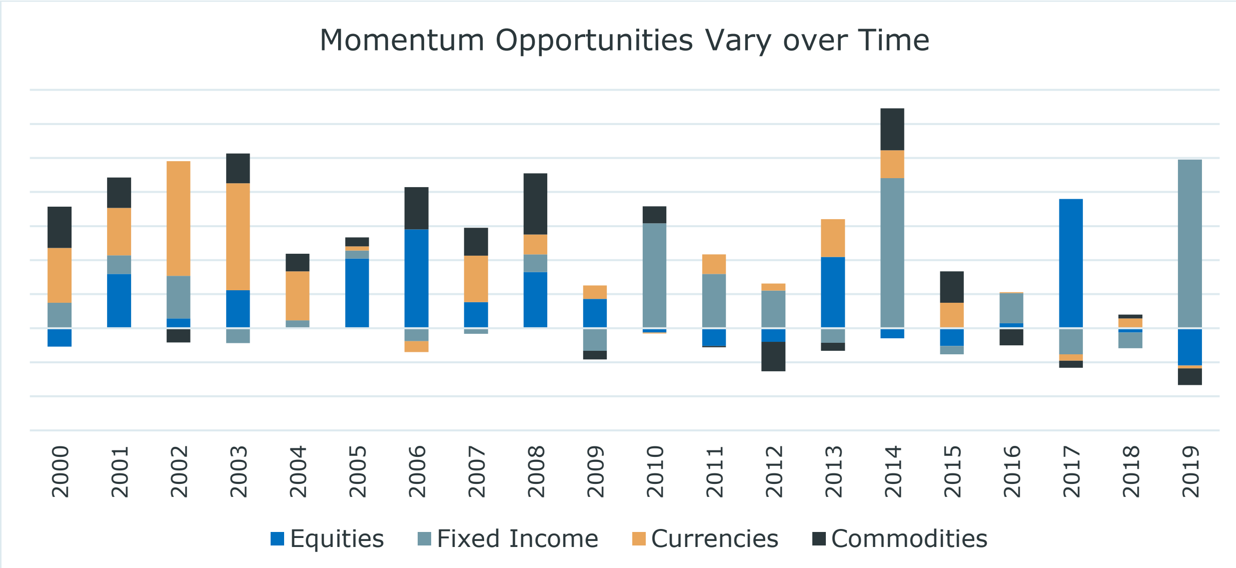

Figure 2: Returns for a generic trend-following strategy by asset class by year from 2000 to August 31, 2019. Source: Bloomberg, AlphaSimplex.

Diversification

The return of diversification in trend following

After a difficult 2018, diversification across global trends has improved in 2019. For trend-following strategies, diversification means that there are wide ranges of trends that move in different directions. More specifically, when some trends reverse, other trends may extend. In doing so, the strategy may be able to attenuate the impact of one specific trend reversal on the overall portfolio. To illustrate this, consider the most difficult type of trend reversal, a sell-off in equity markets. Figure 3 plots the performance of trend following (using the generic trend-following strategy as a proxy) during the ten worst days for the S&P 500 in 2018 and 2019.[4] In 2018, trend-following was positive on only three of the ten worst days for the S&P 500; in 2019, the trend-following has been positive for eight of the ten worst days. In 2019, when equity markets reversed, trend-following strategies found other opportunities.

[4] This analysis is intended to illustrate the behavior of prevailing trends during equity market reversals, not to compare the performance of a trading strategy to the S&P 500.

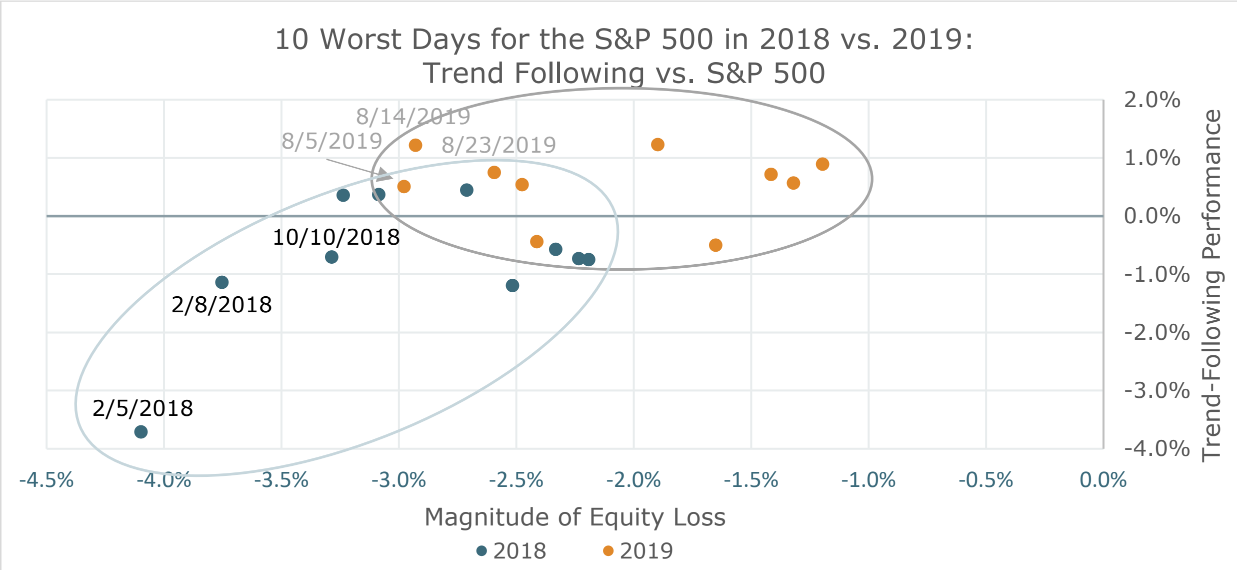

Figure 3: Generic trend-following strategy performance during the ten days of worst performance for the S&P 500 in 2018 and 2019 YTD. Data from 1/1/2018 – 8/31/2019. Source: Bloomberg, AlphaSimplex.

If we take a closer look at what is driving this effect, we can consider how other asset class trends moved in response to equity sell-offs. Figure 4 plots the percentage of days where trends extended or reversed in asset classes outside of equities for a generic trend-following strategy on the ten worst days for the S&P 500 in 2018 and 2019. From this figure, we can see that prevailing trends generally reversed simultaneously in 2018 when equities sold off. However, in 2019, when equities sold off prevailing trends in other asset classes have generally extended, particularly in fixed income.

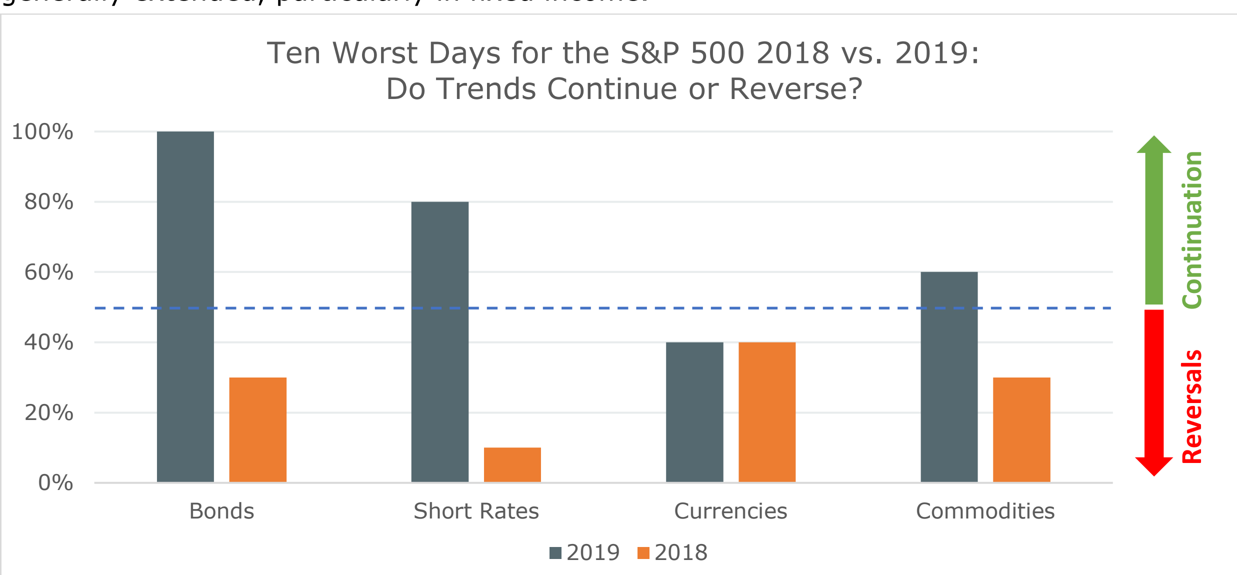

Figure 4: Using the S&P 500 as a proxy for equity markets, we consider the worst ten days in 2018 and 2019 and compute a generic trend-following return by asset class. For each asset class, if the return is positive on a sell-off day then the prevailing trend has continued; if the return is negative the prevailing trend reverses. The total percentage of continuation vs. reversal is denoted by

the percentage of positive returns on sell-off days for the S&P 500. Data from 1/1/2018 – 8/31/2019. Source: Bloomberg, AlphaSimplex.

Trend following moving differently than equities

As diversification across asset class trends improved in 2019, the portfolio-level benefit of investing in trend following has also improved. As-of the end of August 2019, both the S&P 500 and trend-following strategies (the SG Trend Index) have provided positive returns—with negative correlation. This is in contrast to 2018 where the correlation between the SG Trend Index and the S&P 500 was positive and both were down for the year. Figure 5 plots the returns for the SG Trend Index and the S&P 500 as well as their correlation in both 2018 and through August 2019.

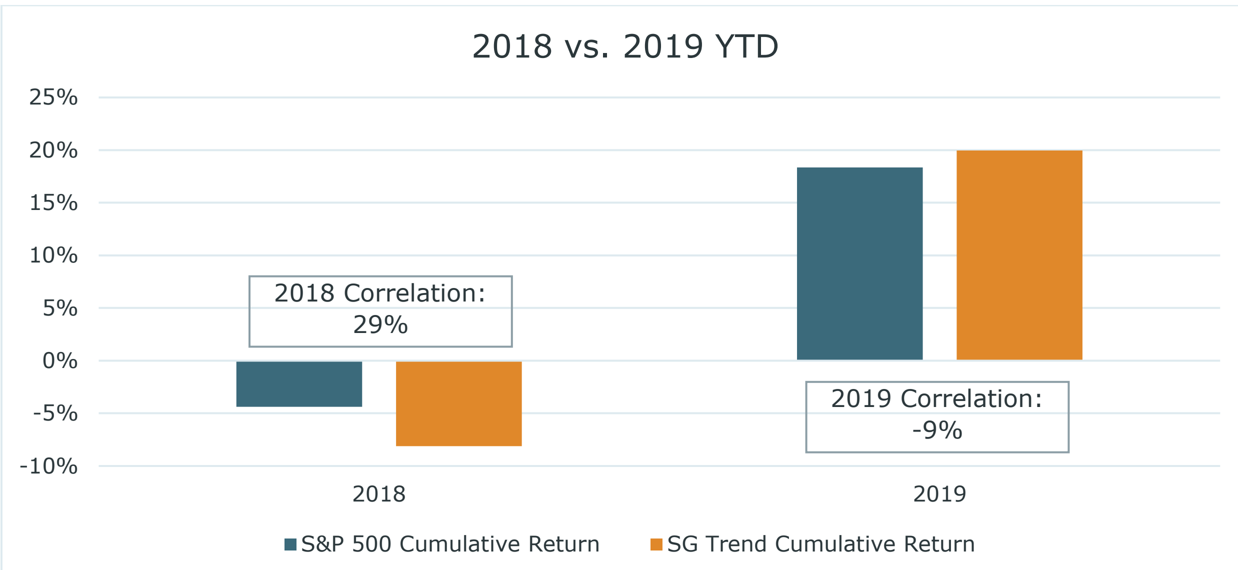

Figure 5: Performance and correlation for the SG Trend Index and S&P 500 for 2018 and 2019. Data from 1/1/2018 – 8/31/2019. Source: Bloomberg.

Opportunities Moving into Q4 2019

Through August, 2019 has been a year where markets have been in motion, diversification has returned to trend following, and the strategy has found persistent trend opportunities (particularly in bonds). Looking forward, there seem to be more and more fundamental data pointing to potential weakness in global economies. This may suggest continued momentum in bond prices with few opposing forces that may push yields higher in the short term. Given this, "flight to safety" trades may provide room for long trends to extend in assets like bonds, safe-haven currencies, and metals like gold. Despite some opposing forces in September, moving into the end of the year, markets certainly have the potential to keep moving in the same direction, providing opportunities for global trends going forward.

About the Author

Kathryn M. Kaminski, Ph.D., CAIA® is Chief Research Strategist and Portfolio Manager 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 joined AlphaSimplex in 2018. 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 is a Senior Lecturer at the MIT Sloan School of Management and has taught at the Stockholm School of Economics and the Swedish Royal Institute of Technology, KTH. Dr. Kaminski holds a B.S. in Electrical Engineering and Ph.D. in Operations Research from MIT. Dr. Kaminski is also a CAIA® Charterholder.

Contact Information

For more information, please contact:

Peter Martin, Director of Client Portfolio Management
clientservices@alphasimplex.com
617-475-7100

Disclosures

Past performance is not necessarily indicative of future results. Managed Futures strategies can be considered alternative investment strategies. Alternative investments involve unique risks that may be different from those associated with traditional investments, including illiquidity and the potential for amplified losses or gains. Investors should fully understand the risks associated with any investment prior to investing. Commodity-related investments, including derivatives, may be affected by a number of factors including commodity prices, world events, import controls, and economic conditions and therefore may involve substantial risk of loss.

This document has been prepared for informational purposes only and should not be construed as investment advice. The views and opinions expressed are as of 9/20/2019 and may change based on market and other conditions. There can be no assurance that developments will transpire as forecasted, and actual results may vary. All investments are subject to risk, including risk of loss.

The index information contained herein is derived from third parties and is provided on an "as is" basis. The user of this information assumes the entire risk of use of this information. Each of the third party entities involved in compiling, computing or creating index information disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to such information.

This material should not be considered a solicitation to buy or an offer to sell any product or service to any person in any jurisdiction where such activity would be unlawful.