RBC BlueBay
Asset Management

What is capturable volatility, and how can it deliver returns in an unstable world?

For professional investors only | Marketing communication

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"Policy and politics should be at the heart of every macro strategy – they drive macroeconomics, which drives price action."

There is always uncertainty in markets, and there will always be difficult asset allocation decisions that investors must make. However, process-driven macro strategies should be able to lean into this uncertainty to generate positive performance in any market environment.

Policy and politics should be at the heart of every macro strategy – they drive macroeconomics, which drives price action. And in 2024, we expect a lot of policy decision and political upheaval.

In the US, the presidential election will be contested by Democrat incumbent Joe Biden and the possible return of Donald Trump for the Republicans. Meanwhile, there have been growing concerns around fiscal policy, as US government budget deficits have ballooned in recent years.

There is also the potential for blow-ups in the corporate debt space. These events tend to happen more frequently at this point of the economic cycle. When policy becomes more restrictive, we see which companies are exposed.

Internationally, there are ongoing issues that will continue to impact global markets. China's retreat from the international financial system, a stalemate in Russia's war against Ukraine and the conflict between Israel and Hamas are just some of the geopolitical themes that could feature prominently in 2024.

Finally, the ongoing transition to renewable energy sources and progress toward net zero carbon emission targets will have a considerable, and possibly disruptive, impact on economies and energy infrastructure.

When combined with existing concerns about inflation, economic growth, and labour markets, the level of uncertainty in markets can seem overwhelming. At RBC BlueBay, we believe all this uncertainty creates 'capturable volatility' opportunities for alpha due to heightened volatility in credit markets.

Capturable volatility in the US Treasury market

Over the past few years, considerable volatility in the US Treasury market has resulted in a range of opportunities and attractive entry points for flexible macro investors.

Yields for 10-year US Treasuries have risen meaningfully over the past two years, as investors have dealt with unprecedented interest rate hikes from the Federal Reserve which have impacted the entire Treasury curve, most notably at the front-end.

The widening budget deficit and spending demands on the US government mean there will likely be more issuance in the coming months, albeit against a backdrop of falling demand. While this continues to push up yields, there is still considerable economic uncertainty, which is causing higher volatility in the Treasury market.

> **"A process-driven macro investor can capture more positive asymmetric risk-reward."**

Before the Covid-19 pandemic, volatility in US bond markets – as represented by the ICE BofA Merrill Lynch Option Volatility Estimate (MOVE) Index, the so-called 'fear gauge' for the US bond market and a measure of expected short-term volatility in US Treasuries – was typically low and in the range of 40-60 basis points. Since the pandemic, however, the higher inflation environment has resulted in a steep change in volatility for bond indices, and we think there are several reasons that it is here to stay.

Although headline inflation has been coming down as commodity prices have fallen, much of the inflation now embedded in the US economy is structural and will likely take some time before it starts falling, pushing back the start of any rate-cutting cycle by the Federal Reserve.

How to capture volatility

Trading interest rate risk, or duration, is one of the principal ways of exploiting the capturable volatility opportunity in US Treasury markets.

For example, at the start of 2023, sentiment in the market suggested that the Federal Reserve would embark on a rate-cutting agenda in the belief that the US economy would slow, and that inflation would drop. We took the opposite stance and increased our short-duration position just as Treasury yields started to rise and the economy strengthened, prompting the Fed to rethink its strategy.

Our tactical and nimble approach means we avoid running positions too long and take risk off when we need to, which was helpful when Silicon Valley Bank collapsed. Some of our peers lost money because of what happened at Silicon Valley Bank, but we waited again for the capturable volatility opportunity as a result of the dislocation in Treasury markets. It isn't just US markets where we can find opportunities. In the UK market, there have been opportunities too. In June, inflation figures surprised to the upside, and the Bank of England was forced to increase rates.

In the months to come, capturable volatility opportunities might be found in Japan, where, in our opinion, the Bank of Japan is behind the curve and bucking the trend of other global central banks and could hike rates two or three times in 2024. If that were to happen, we believe there could be opportunities on the short side in Japanese Government Bonds, which are currently trading at low yields.

By focusing on the fundamentals and waiting for markets to dislocate either to the upside or the downside, a process-driven macro investor can capture more positive asymmetric risk-reward.

Performing in an uncertain market

The world can be a very uncertain place, and an allocation to a process-driven macro credit strategy can play a crucial role in a diversified portfolio to help mitigate some of the risks in markets and generate returns in any market conditions.

The BlueBay Global Sovereign Opportunities Strategy was developed in 2015 and is overseen by a highly experienced team of macro analysts and portfolio managers focusing on global government bonds, rates and FX. The strategy was launched to provide an alternative to the traditional macro hedge fund strategies with three core components: simplicity, liquidity and transparency.

We don't believe a macro strategy should be a 'black box'; it should be easy to understand and transparent. Unlike other macro hedge funds, the team behind BlueBay Global Sovereign Opportunities Fund are investors rather than traders, positioning the portfolio for medium-term, structural opportunities.

Our top-down macro thematic convictions are based on deep fundamental country-level research and proprietary on-the-ground policy analysis. Indeed, research is crucial to our process and how we deliver performance.

We want to understand the fundamentals before taking a position; we aren't day trading. The investment strategy doesn't rely on short-term tactical or technical trading; holding periods for positions in the fund typically range between one week and several months, depending on the opportunity and the market dynamics.

> **"Research is crucial to our process and how we deliver performance."**

Some macro strategies have experienced difficulties in recent years because of the mismatch between the liquidity of the underlying portfolio and the liquidity demanded by investors. As a liquid alternative strategy, the BlueBay Global Sovereign Opportunities Fund aims to ensure our investors' money is not locked away. The portfolio maintains at least 50% of it's net asset value, at all times, in highly liquid investment grade government bonds or cash.

Investors will likely face a challenging macroeconomic environment, making asset allocation extremely difficult. However, allocating to a flexible, liquid macro strategy driven by a rigorous investment process can help spread risk and diversify your return profile.

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