BlueBay
Asset Management

Macro: Thinking ideas, trading in the real world

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Alternatives to core fixed income

"They're like us," I said. "For in the first place, do you suppose such men would have seen anything of themselves and one another other than the shadows cast by the fire on the side of the cave facing them?"

Plato, The Republic

Generating alpha as a macro investor requires a thorough understanding of how economies work and intersect with policy and politics, a robust risk management framework and a firm grasp of market supply-demand mechanics. The critical differentiator, however, is often the ability to identify and time inflexion points in market structures. Generating alpha requires a different type of thinking, one which in its purest form is a return on judgement and insight, not the mere accumulation of numbers, facts and knowledge.

The macro toolkit

Macroeconomic (macro) investment strategies typically adopt an opportunistic approach, be it either long-standing or tactical, with positioning dependent on the manager's views on prevailing macro trends and current asset prices.

Let's begin with the tools at the disposal of a macro investor. As we move from analysing a single security to a single company, to a country and then aggregate securities, we face a macro environment where we can buy and sell securities in a more seamless manner. This can be done through indices and sovereigns – where borrowing, credit default swaps (CDS) and other derivatives are more readily available, or via other easily tradeable assets such as short-term interest rates and currencies. Asset prices depend on general macroeconomic trends, supply-demand mechanics, market sentiment and politics and monetary policy, and investors can use them to take advantage of large macro shifts as well as short-term market dislocations.

The well-rounded skillset

Macro investing requires a different skill set to that of corporate long-short strategies (equities or credit), or at least to deploy these skills differently. In general, for long-short corporate strategies, where bottom-up analysis is critical, the manager must understand the mechanics of the underlying business, the indenture of the parts of the capital structure, the quality of the management, and the underlying market. It involves levers at a singular (company, business model, management) and aggregate (sector, market for the asset class) level.

Conversely, in macro strategies, top-down factors predominantly drive prices. Market sentiment, supply-demand trends and the demographics of buyers and sellers in the securities play a more important role. Nevertheless, managers should not be confounding themselves to trade through charts and volumes – at the end of the day, computers are much better at doing that. Where macro managers have a potential edge is in analysing the 'human' nature of decision making, which is vital in understanding the fundamental drivers of asset movements. Macro investors need to understand the incentives and train of thought of two sets of agents:

- There are smaller sets of **individuals**, such as policymakers, central bankers and regulators, where decisions have broader implications. It is essential to know their motivations and way of thinking: taking the time to interact with them, to read their publications and to understand their intellectual references.

- Then there are **aggregated** sets of agents of which there are two primary dimensions: the political dimension and the economic dimension. Take for instance the electorate of a nation, which can propel to power a candidate of a particular economic bias, or the employers of a country, who have the power to drive payroll numbers and impact growth and inflation. Understanding the thinking processes of the aggregates in those two contexts and their interplay is fundamental to understanding the digestion of the policy measures and the newsflow (and ultimately the direction of asset prices).

Questions a macro investor might ask:

Will this policy package of measures reactivate the economy? Will this stimulus generate inflation, or is there enough slack to digest it? How will this change in banking regulation affect the equilibrium state of a financial institutions balance sheet and lending to the economy as a whole? Does this news item mean anything in the context of the key movers of the economic policy of the country, or it is just a politician pandering to the audience? Is the conventional wisdom right or wrong when assuming a specific electoral result?

Forming views

In the 'Allegory of the Cave', contained in The Republic, Greek philosopher Plato reflects on the limitations of human perception as a way to access reality through the representation of a group of prisoners who, since infancy, have had their exposure to the world reduced to shadows reflected on the cell wall with accompanying sounds. As prisoners are eventually freed they gain access to a higher degree of knowledge – for instance, they can finally see the figures which projected the shadows, the fire behind them, the area outside the cave, and ultimately the sun – a metaphor, alongside other concepts, of enlightenment. According to Plato, whereas our sensory experience only gives us an image of reality, only thought and reason were the routes to

the ultimate levels of reality, that he called Forms (ideas).

Plato's work is an inspiration for countless artworks, among them the Wachowskis' *The Matrix*, or Weir's *The Truman Show.*

These concepts are very present in our age, where the way we access information has radically changed since the arrival of the internet and social media. We are currently subject to an enormous amount of informational stimulus and distinguishing noise from signal is a critical skill in order for managers to spot inflexion points in macro structures. Some examples of the challenges investment managers face include:

- Despite the sea of information on the internet, the quality is often disputable. The way we access the internet – through social networks, phone devices and summary screens – leads us to obtain information in a way that distorts the reality of the relevance of situations or perpetuates intermediary biases.
- We receive more updated information on a limited number of items, but not more information (just type "TOP" in your Bloomberg screen).
- The lifespan of individual topics has become quite limited due to the media always being eager to move on to the next issue to keep our attention once an item has been registered. This, in turn, prompts a more reactive, less reflective way of handling emotions with respect to the news.

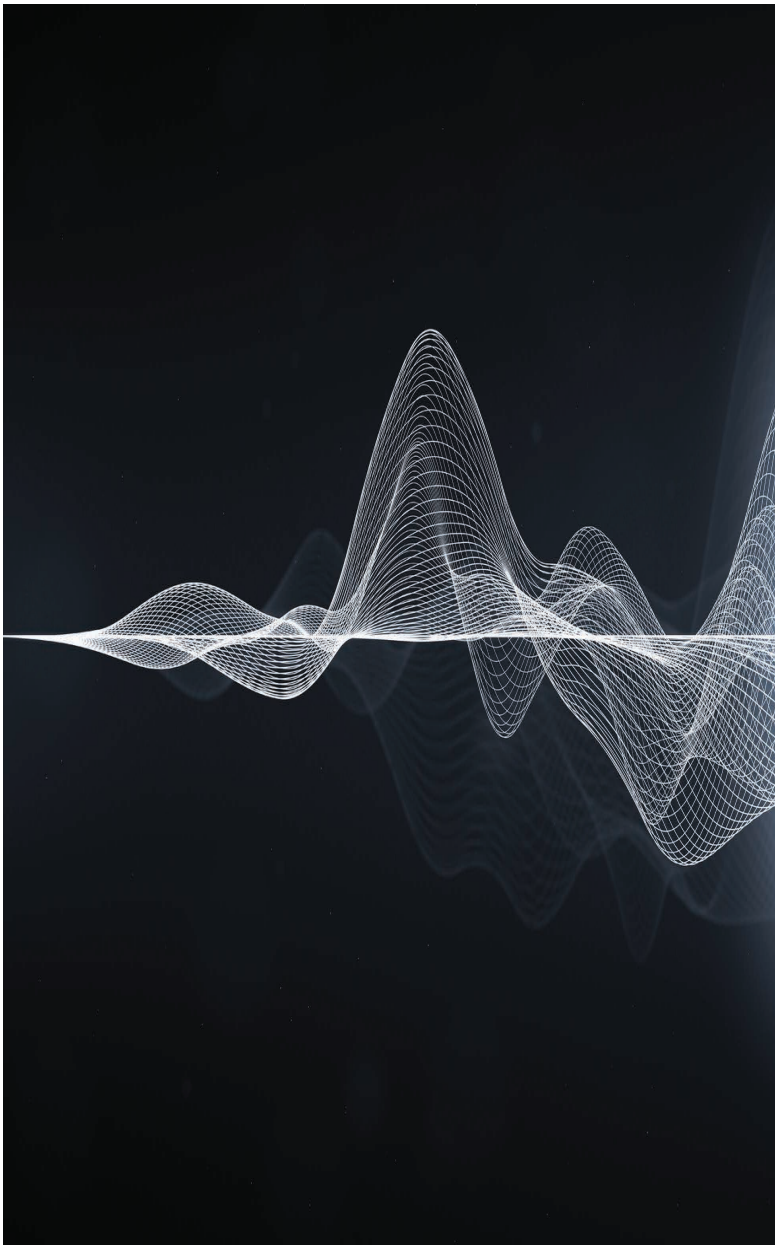
The delivery of the news, especially in social media, must be interpreted keeping in mind the intention of the issuer of the communication. The language, intensity and reiteration of the message are an essential part of the message itself, as that bundle is intended to create an opinion. It therefore requires a sharp focus on the key stakeholders, how they communicate and the legislative and political processes around them. Politics, for example, by its nature has a larger reporter base, hence taking biased voices or 'fake' news at face value can be expensive.

Above all, it is essential that we anchor the considerations that we see spiking the public debate to the facts, that we get the testimony from the horse's mouth, and that we understand why the speaker is delivering the message in such a manner. Only in that way, would we be able to filter the news items that are important and breakdown the intentions of the different actors.

Execution

Once the manager has analysed the facts, the macro figures, fit the models, talked to the relevant actors, understood their thoughts and motivations and projected the scenarios, only then does he or she go to the market to execute the final view.

In the same way that a high yield corporate bond analyst values a security by measuring the risk of default, the loss given default and general market sentiment, the macro manager analyses asset prices according to the projected scenarios based on their view. He or she then looks for those assets with the lowest basis risk between his or her view and the price movements with the most attractive asymmetry. At this point it is essential to understand what the market is discounting as scenarios,



how they differ in severity and probability with respect to the manager's scenarios and what should prompt the general market perception to shift. In macro, it can be as harmful to be early as to be wrong, and the same can be said for selecting the wrong instrument in the right scenario.

But the market is also technical and often driven by sentiment. We have to understand who is buying and who is selling, how these investors are funded, what their commitment is to the strategy and their staying power. Obviously, we cannot survey each buyer, but we can see whether the flow is coming from institutional money, speculators or retail. We must also take into account the operations of central banks. We must see how volumes underpin a position, or whether there is a gap risk emanating from the lack of market participants. The manager's reading on how a certain macro scenario will impact asset prices and which the best assets to exploit that scenario is vital. It would not be the first time a manager gets the scenario right but fails in the transmission of that scenario to asset prices. This requires a superior understanding of the drivers of these assets and their holders/traders.

Finally, we have the holistic view of a portfolio. A disconnected group of trades is not a portfolio. Adequate risk management is crucial, especially in the macro space, where we can be long or short a number of themes, but will always be long the portfolio manager's view of the world. Taking risk-aware decisions, knowing how the different building blocks in the portfolio interact with each other, and when the environment is simply not interested in our thesis and it is time to get the chips off the table are of paramount importance. Trading discipline and maintaining level-headedness is crucial, but the ex-ante work on portfolio robustness is equally important, as there will be situations where we will be less in a position to de-risk than in others. It is, therefore, also critical to run a portfolio being aware of where the liquidity can go the structure of investors' liquidity and other funding, and the moves that we may have left at our disposal in an adverse scenario.

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