Modern Macro: A New Approach to an Old Strategy

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Deep uncertainty and market volatility provide fertile ground for macro hedge funds that can monetize not just the trends, but the volatility around the trends.

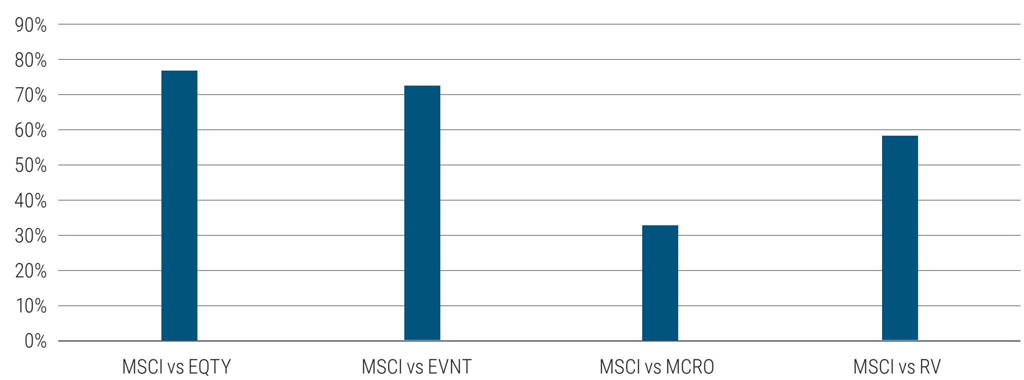
Macro investing is enjoying a renaissance. In 2022, as most asset prices sank amid sharply rising interest rates, macro hedge funds generated their strongest returns in several years.

This is not surprising: The macro style of investing – in which managers invest based on their outlook for the economy and geopolitical events – has historically performed well when markets, particularly equity markets, have experienced large moves. With this in mind, investors seeking diversification from equity portfolios (see Figure 1) have poured $7.3 billion in net inflows into macro funds[1] over the last three years.

We expect that gyrations across assets – ranging from the U.S. dollar to Treasuries to commodities – will continue to provide a fertile landscape for macro investing. Yet, we believe the increasingly uncertain and fragile market environment calls for a more dynamic, nimble approach to the strategy – one that seeks to monetize not just the trends, but the volatility around the trends, while defending against a widening range of outcomes. This more modern approach will, in our view, likely outperform its more traditional counterparts.

Figure 1: Macro strategies have been less correlated to equities than other hedge fund strategies

HFRI category correlations vs. MSCI World Index 1990 - 2022



Source: HFR, MSCI. Data from 01 January 1990 through 30 December 2022. EQTY: HFRI Equity Hedge Total Index (i.e. hedge funds that hold equity exposure); EVNT: HFRI Event Driven Total Index; RV: HFRI Relative Value Index; MCRO: HFRI Macro Total Index.

1 Hedge Fund Research (HFR), Inc.

TRADITIONAL MACRO STRATEGIES HAVE EVOLVED

To see why we advocate a more dynamic, nuanced approach to macro investing, it is important to understand how most macro funds operate. Contrary to the 1980s, when macro strategies first took hold, managers now use more than just a handful of trades to execute their views. All too often, however, trades remain highly correlated with each other, with only secondary consideration paid to trade expression (the choice of securities used to express the market theme in question), market timing, or tactical adjustments. In many cases, the result is a return stream with a higher proportions of returns exhibiting traditional betas, namely equities – even if macro as a category generally exhibits much less of this than other types of funds (see Figure 2).

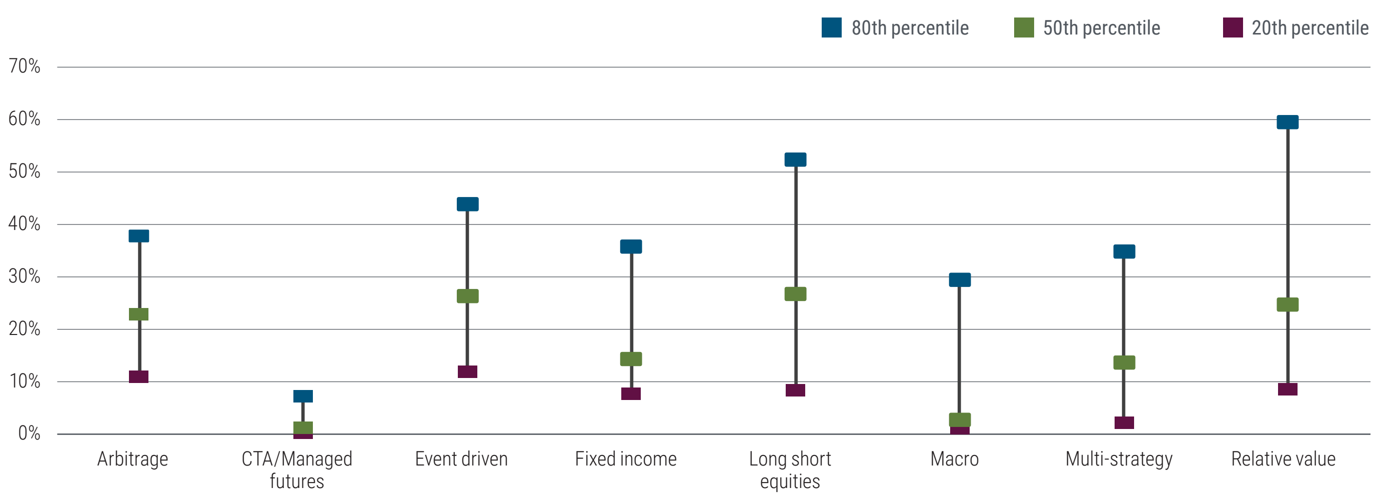
Going forward, while we expect the set of macro opportunities to remain rich, we believe heavy uncertainty, ongoing spikes in market volatility and recurring liquidity crises will challenge these approaches, especially on a risk-adjusted basis:

Heightened market uncertainty. A recent survey[2] showed the widest range of long-term inflation expectations in 30 years, and, in spite of the current high inflation environment, an all-time high percentage of respondents expected long-term deflation. An environment as uncertain as this requires true diversification, and heightens the need for asymmetric trade expressions (in which the potential upside is greater than the downside).

Higher short-term volatility. Central Bank tightening has drained market liquidity and heightened volatility. At the same time, post-global financial crisis regulations have limited broker-dealers' ability to step in and act as a backstop, leading to larger flow-driven asset price moves. And the rise of trend-following strategies is only compounding these price moves. Wild day-to-day volatility makes holding even ultimately winning positions difficult – underscoring the importance of overlaying a core macro view with tactical trading to defend against, and even profit from, the volatility around the core macro view.

Liquidity freezes. Episodes in which market liquidity rapidly and dramatically evaporates are becoming more frequent and severe. With many rushing for the exit, consensus positions, especially carry trades (which borrow at low rates and lend at higher rates in currencies or other instruments), can become significantly challenged. Historically, managers would often pair directional bets with low-frequency carry strategies (which trade less often). However, with carry strategies more frequently coming under pressure, managers will need to find alternative sources of diversified return.

Figure 2: Proportion of hedge fund risk explained by equity beta



Source: Eurekahedge and PIMCO. Based on returns from 30 September 2009 through 31 December 2022

2 University of Michigan Consumer Expectations Survey on 5-10 year ahead inflation as of July 2022.

PIMCO'S MODERN APPROACH TO MACRO INVESTING

At PIMCO, we have a differentiated approach. While our core macroeconomic views provide the "guardrails" for our portfolios, we couple those views with a robust three-pronged framework to help better monetize those views for our clients:

- **Trade around our core positions.** We use a range of positioning, flow-based and cross-asset indicators to tactically adjust our positions around our core macro views.
- **Mitigate downside risk.** We focus on developing asymmetric trade expressions to best capture our core macro views and protect portfolios should our base cases not materialize.
- **Use a range of complementary strategies.** We pair our core macro strategies with systematic and relative value strategies to provide a more diversified, consistent return stream.

As an example, consider our approach to the market moves we anticipated as the Fed began quantitative tightening last year. Although the 2-year interest rate soared from 1.5% to 4.5% in March through December 2022, the move was far from uniform, with multiple pullbacks, including an almost 100-basis-point countertrend move in July and August. Managers who used suboptimal trade expressions or who were unwilling or unable to tactically adjust their positions, were often forced to exit them during pullbacks.

In contrast, we were able to use our flow-based indicators to adjust our positions and buy cheap hedges as the global quantitative tightening trade became crowded. We also opted to express the theme via U.S. and Asian interest rate derivatives, including options, which were arguably more mispriced than, say, U.S. Treasuries. We were therefore able to generate more return per unit of risk taken, and at the same time be less exposed to drawdowns. Finally, we had a number of market neutral, systematic strategies running in the background, providing both diversification and potential positive return streams.

CONCLUSION

We believe today's more volatile, less liquid environment demands a more nimble, nuanced, and modern approach. Returns from traditional approaches could be buffeted by significant volatility in longer-term trends. More agile managers can monetize not just the trend, but the significant localized volatility around that trend. Managers will also need to give more consideration to the securities used in a trade in order to mitigate risks of an increasingly wider range of potential outcomes. Those adaptations should help managers pair macro-dependent returns with a more regular, recurring return stream.

Past performance is not a guarantee or a reliable indicator of future results.

All investments contain risk and may lose value. **Hedge fund and other alternatives strategies** involve a high degree of risk and prospective investors are advised that these strategies are suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk, including the possible complete loss, of their investment. Performance could be volatile; an investment in a fund may lose money.

There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

Correlation is a statistical measure of how two securities move in relation to each other. The correlation of various indexes or securities against one another or against inflation is based upon data over a certain time period. These correlations may vary substantially in the future or over different time periods that can result in greater volatility.

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