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Timely thoughts & musings on the financial markets

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THE UNWINDING OF GLOBALIZATION, FALLEN ANGELS & BEHAVIORAL ALPHA

By Jordi Visser, President & CIO

Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone
If your time to you is worth savin'
Then you better start swimmin' or you'll sink like a stone
For the times they are a-changin'
-Bob Dylan

During my career, I cannot remember a year quite like 2018 that ended so vastly different from the expectations set in January. 2018 surprised almost everyone and many investors are searching for answers. The facts are that asset prices are lower and visibility for investors and corporations going into 2019 are more uncertain than they appeared to be at the beginning of 2018. Confusion creates anxiety but importantly offers opportunities for those able to control their emotions. This paper is my perspective on what happened this past year and why, in my opinion, this is an inflection point similar to 2008 where investors will need to once

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again check their cognitive biases at the front door and be ready for a new environment going forward. It will start as a long term macro view but finish hopefully with some useful ideas to help navigate what is certain to be another volatile year. More importantly, using the Bob Dylan lyrics, I will make the argument that the "times are a–changing… so you better start swimming or you will sink like a stone" or, in Moneyball terms, adapt or die.

The Unwinding of Globalization

The long term macro story is the unwinding of globalization and a movement towards regionalism. Exponential technology and the trade of digital information, ideas and innovation has grown rapidly while the world moved away from the industrial world built around trading of finance and physical goods. The resulting distribution of wealth gap and job obsolescence from this transition has helped contribute to the rise of populism. 2008 forced the banking system into regionalism. Quantitative easing ("QE") helped with this transition and now with this monetary experiment ending, we are seeing what most expected - a rise in asset volatility. Tax cuts gave investors a brief fundamentally driven hope to ignore the beginning of the global central bank balance sheet unwind. As the tariffs started and the ultimate reality of an intellectual property battle between China and the United States hit, investors were tossed into a state of asset turbulence. Despite what some want to believe, the US & China dispute was never over something as simple and easily solvable as trade dollars.

Behind the intellectual property battle is an AI arms race. In May, The White House established the "Select Committee on Artificial Intelligence" to advise the President and coordinate AI policies among executive branch agencies. In January, when President Xi gave his annual speech from his office, there were two AI books on the wall behind his desk: The Master Algorithm: How the Quest for the Ultimate Learning Machine Will Remake Our World by Pedro Domingo and Augmented: Life in the Smart Lane by Brett King. In 2017, Vladimir Putin said, "Artificial intelligence is the future, not only for Russia, but for all humankind. It comes with colossal opportunities, but also threats that are difficult to predict. Whoever becomes the leader in this sphere will become the ruler of the world."

This global race for AI supremacy accelerated in recent years with the growth in data storage and the big data revolution. As was mentioned at Singularity University during my 2017 trip, AI is the engine and data is the fuel. To emphasize the speed of this race, in 2015 the Gartner group unexpectedly removed big data from its hype cycle because it had become reality more quickly than they could have imagined. The unexpected speed of these advancements has helped China's acceleration in its technological competitiveness which has forced the United States to recognize that the China 2025 plan was no longer a dream. As Eric Schmidt of Google said in November 2017, "By 2020 they (the Chinese) will have caught up. By 2025 they will be better than us. And by 2030 they will dominate the industries of AI." To summarize the status of the relationship, it is ok for a superpower with a large military to make our hobby horses and cabbage patch kids but not our iPhones, computers, and anything with a chip in it, which now is almost everything.

This is why intellectual property is the most important part of this trade war. As the battle over IP has heated up in 2018, the trust between China and the US has fractured. All good relationships are based on trust and the parents of the economic world no longer trust each other and with it, I believe we have hit another important inflection point in globalization similar to the years after Lehman. Post the Great Financial Crisis, the rules of investing were driven by quantitative easing. Now this relationship, once affectionately termed "Chimerica", involving the two largest economic powerhouses on the planet, has reached a point where trust is lost and leaves us in an environment which can be described as eggshell investing. My parents got divorced when I was in high school and the best way to describe the experience in the house was living on eggshells. I believe years like 2017 with no volatility and high asset Sharpe ratios will become a distant memory. It will take time for investors and CEOs to adjust to living on eggshells and during that period we are likely to see continued stock market multiple compression and credit spread widening.

Over the next 10 years, the winners at all levels of the capitalist system will be focused on advancements in artificial intelligence, robotics, 3D printing, nanotechnology, and the blockchain. It is not about shipping goods with parts from seven countries that are put together in another and then shipped on a diesel-fueled hotel-sized tanker. It is not about academic ideologies like the Philips Curve, Taylor Rule, or policy normalization. The market is a discounting mechanism and in my narrative, it is currently discounting the unwinding of globalization and the disruption to the global supply and demand chain. Like all industries in recent years, the world is being disrupted by exponential technology and now forced to adapt just like after Lehman due to the rise of populist nationalism. All year, the markets have been sending warning signs but as of yet, central bankers and governments have not been worried about the structural economic consequences to the attack on globalization.

In February of last year, I wrote a paper titled A Regime Shift: Neuroplasticity and The Global Optimization Unwind which talked about a regime shift due to a breakdown in the historical relationships between assets and regions due to a world where globalization was under attack and the implications for the quantitative space which are dependent on covariance matrices for risk optimization. At the time, we did not know how the tariff and IP battle would play out but the pace and intensity of this confrontation and subsequent eggshell relationship has clearly surprised market participants. Now, in the same way that global optimized portfolios dependent on covariance matrices were disrupted, investors, CEOs, governments, and central bankers will need to adapt to the global supply and demand chain disruptions.

It is not surprising that quant strategies' will have trouble with this outcome because of their inherent dependence on the past for forecasting the future and the breakdown in underlying covariance matrices. I say all the time that computers are incredibly efficient but also incredibly stupid. The majority of money being managed by computers today focuses on waiting for data or price to change before their positioning changes. There is still very little in forward thinking with computer driven investing. If the relationships of the past are no longer relevant for future, we should expect these complex tools to bleed in the coming years the same way simple trend following systems have had trouble since 2009, while trying to recalibrate these models. In the future when AI is more advanced, this could change. In the meantime, liquidity takers, trend followers, or back testers dominate decision-making in the markets today leading to trouble when the turns are sharp.

For humans though, who can take a Bayesian approach and connect the dots and adjust risk ahead of the reality of the turn in earnings and economic data, it was surprising to me how long it took for US assets to acknowledge the risks in 2018. Throughout the year, we had quotes like those below from the leaders of the US & China.

"I am a Tariff Man. When people or countries come in to raid the great wealth of our Nation, I want them to pay for the privilege of doing so. It will always be the best way to max out our economic power. We are right now taking in $billions in Tariffs. MAKE AMERICA RICH AGAIN"
-President Trump

"when a country (USA) is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good, and easy to win."
-President Trump

"To push forward reform and opening up in a country with 5,000 years of civilization and a population of 1.3 billion, there are no textbooks containing golden rules or teachers who can be arrogant to the Chinese people..."
-President Xi

"we must oppose the practices of imposing one's will upon others, interfering in others' internal affairs or the strong bullying the weak"
-President Xi

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Until “the Truce” passed in early December at the G20 meeting and the Fed continued their academically driven tightening campaign two weeks later, investors seemed to be hopeful the stable environment of 2017 would come back eventually. They were still holding pocket red aces while there were four clubs showing. The only explanation to me is the difficulty of highly educated people to get around the concept in the game theory of prisoner’s dilemma. It is obvious that nobody wins in a trade war so educated people seemed to believe it could not happen. Part of this decision to ignore the risks is also likely from the training of the last 10 years of QE - where worrying led to the crystallization of losses at the bottoms before the next buy the dip appeared. A recent article in the Financial Times, titled Corporate elites are overlooking deglobalization”, directly addresses this point:

“All of us, no matter how wise, have our cognitive biases. Indeed, there’s research to show that elites are less likely to part with their biases than the ordinary person. This is probably because they believe themselves to be better educated and informed than the masses, which may well be true.”

After “the truce” passed, the market reminded investors what Mike Tyson said. “Everyone has a plan until they get punched in the mouth.”

Fallen Angels

Normally, an outlook paper would not spend this much time on the prior year but I feel going in to the New Year, sentiment is still hopeful of some sort of simple resolution and not accepting of a structural change in the investing environment, so this story of last year in my opinion will still be the driving force to early 2019. On the back of the continued unwind of globalization and the impact from the need to rethink the global supply and demand chain, a spotlight will be on the “Fallen Angels”. A fallen angel is a term that refers to investment grade companies whose debt gets downgraded to junk status. All year there have been warnings from the IMF, World Economic Forum, BIS, Mckinsey, Ray Dalio, Paul Tudor Jones, Howard Marks, Scott Minerd, Jeff Gundlach and others on the risk in the corporate credit markets. I could write a whole paper on the statistics supporting these fears but the two must read reports in my opinion to get up to speed are Rising Corporate Debt Peril or

Promise by Mckinsey and The Rise of Zombie Firms: Causes and Consequences by the BIS. Just remember as you read these reports, these were written before the China US tariffs went into effect and before the SPX fell 20% from late September to Christmas Eve. The focal point in credit is on the lowest rated part of the IG rating, BBB, where the likely fallen angels currently live.

"Corporate indebtedness is now quite high and I think it's a danger that if there's something else that causes a downturn, that high levels of corporate leverage could prolong the downturn and lead to lots of bankruptcies in the non-financial corporate sector,"
-Janet Yellen

This quote from Janet Yellen last month is what should be worrying people about 2019. The “something else that causes a downturn” which investors should think about is the unwind of globalization and the global supply and demand chain.General Electric has been the most talked about BBB-rated company in 2018 and that was also before the tariffs and SPX decline. Multi-national companies with an extensive global footprint are going to be impacted the most by a reworking of globalization and GE, like the many other multi-national companies with BBB ratings will have a new worry. These excerpts from Michael Milken’s WSJ article titled Why Capital Structure Matters just after the lows of the Great Financial Crisis in April 2009 is a great look at why these fallen angels are so important to global assets and the outlook for 2019.

“My belief -- first stated 40 years ago in a graduate thesis and later confirmed by experience -- is that capital structure significantly affects both value and risk. The optimal capital structure evolves constantly, and successful corporate leaders must constantly consider six factors -- the company and its management, industry dynamics, the state of capital markets, the economy, government regulation and social trends. When these six factors indicate rising business risk, even a dollar of debt may be too much for some companies.”
-Michael Milken (“Why Capital Structure Matters”, WSJ April 2009)

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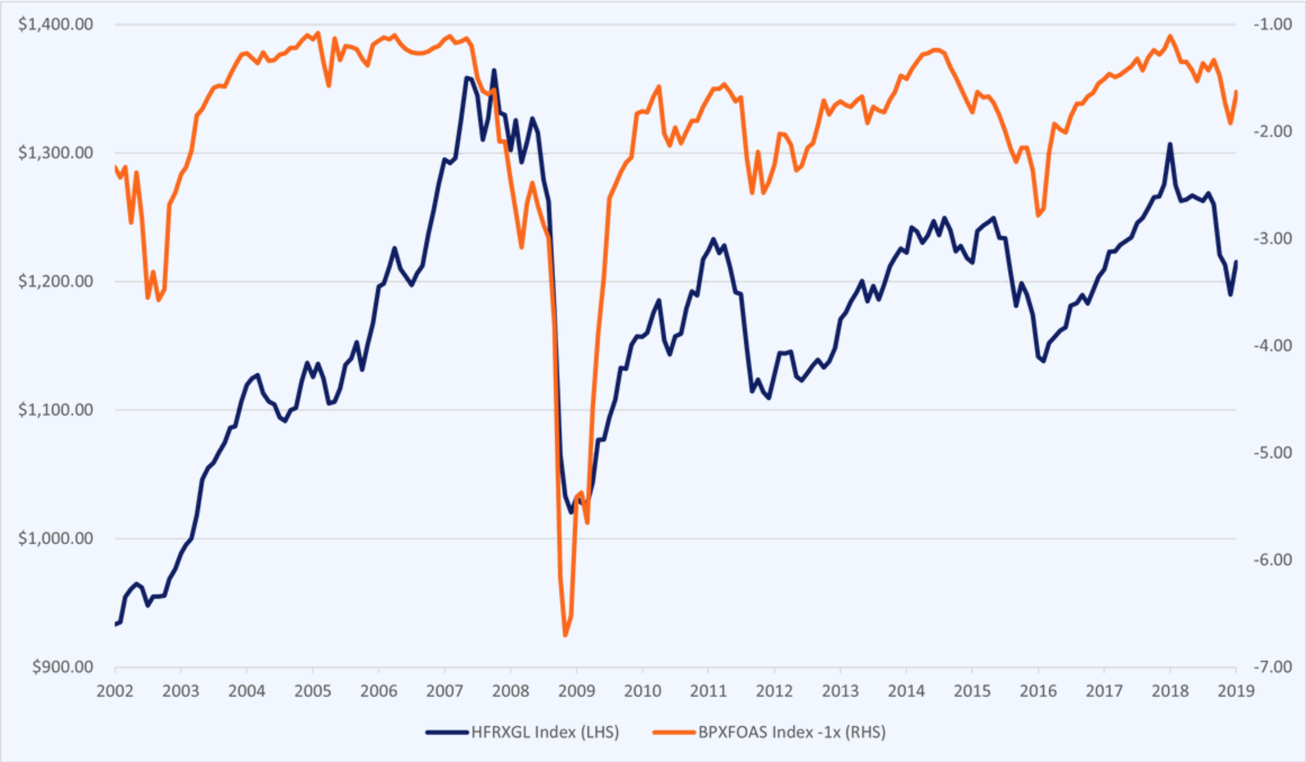
"Without stock buybacks, many such companies would have little debt and would have greater flexibility during this period of increased credit constraints. In other words, their current financial problems are self-imposed. Instead of entering the recession with adequate liquidity and less debt with long maturities, they had the wrong capital structure for the time."
-Michael Milken ("Why Capital Structure Matters", WSJ April 2009)

If you take these BBB companies and think about the impact of exponential technology, the rise of populism, the shift from QE to quantitative tightening, growing pension liabilities due to demographics and now the attack on globalization, you have a situation where corporate leaders are facing a historic capital structure battle particularly after buybacks and acquisitions funded by leverage during the QE period. They all made a long-term bet on globalization.

I expect the credit markets to be volatile which may be an issue for the equity markets in 2019 as investors are reminded of what Michael Milken meant when writing, Why Capital Structure Matters. To be clear, I do not see the corporate bond market risk as something systemic like in 2008 post-Lehman. The bank's balance sheets are in a much safer place due to regulations since the GFC and corporates are still flush with cash. Also, with negative yields around the globe and rising pension yield needs, there will be a natural bid to credit at certain yields. My view is this will be a structural change to credit with spreads being structurally wider and more volatile due to the uncertainty going forward over globalization, the end of QE, and the structural change in liquidity in the credit markets.

This type of shift would have major implications for assets but also for active managers. The chart below is an overlay of the HFRX Global Hedge Fund Index [see disclosures] on the inverted BBB ex-financials spread. Basically, since the quant unwind in August 2007 and not coincidentally the launch of the iPhone which fueled the growth over value trade, hedge fund returns have been driven by the moves in credit spreads. Going forward, I expect to see more abrupt shifts in credit spreads in shorter time periods without the traditional smooth cycles usually associated with the business cycle. With a belief that credit spreads will be wider and more volatile as we adjust to regionalism, I expect liquidity providing asset managers to have a tremendous opportunity for trading and generating what we call “Behavioral Alpha”.



Source: Bloomberg

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Behavioral Alpha

Behavioral alpha to us is taking advantage of a more uncertain investing environment which requires faster decisions. Behavioral alpha is the alpha created from folding, trading, sizing, patience, a willingness to be a contrarian, being early and not chasing, taking a Bayesian approach to new data, increasing and decreasing gross and remaining flexible, and most importantly an ability to accept being wrong and moving on. What used to happen in a year should be expected to happen in a quarter as the pace picks up. If you want to compete with a computer, you must use your emotional intelligence to create behavioral alpha. The inefficiencies and smooth cycle days are over and the edge going forward will be your ability to be mentally tough. Like poker, behavioral alpha is a test of mental endurance. It is a test of emotional endurance. It is a test of true Bayesian thinking to constantly update your risk-reward so you can adjust positioning before the turns. To ensure you are embracing uncertainty we should all follow Annie Duke's advice.

"A hand of poker takes about two minutes," she writes. "Over the course of that hand, I could be involved in up to twenty decisions. And each hand ends with a concrete result: I win money or I lose money. The result of each hand provides immediate feedback on how your decisions are faring."
-The New Yorker, Annie Duke Will Beat You at Your Own Game

"Wrap your arms around uncertainty. It's going to make you a better decision maker, because when you acknowledge 'I'm not sure,' you naturally view your beliefs as under construction."
-Annie Duke

"We can get better at separating outcome quality from decision quality, discover the power of saying, "I'm not sure," learn strategies to map out the future, become less reactive decision-makers, build and sustain pods of fellow truthseekers to improve our decision process, and recruit our past and future selves to make fewer emotional decisions. I didn't become an always-rational, emotion-free decision-

maker from thinking in bets. I still made (and make) plenty of mistakes. Mistakes, emotions, losing—those things are all inevitable because we are human. The approach of thinking in bets moved me toward objectivity, accuracy, and open-mindedness. That movement compounds over time"
-Annie Duke, Thinking in Bets

The first step to creating behavioral alpha is self-awareness. We all have biases and these biases are built by our brains desire to simplify information processing. Our brains want to reduce uncertainty and be at ease in a comfort zone. Investors' comfort zone is built on the math of the markets and fundamental alpha but as we transition from a world of inefficiencies and arbitrages (blackjack) and into a world of efficiency and incomplete information (poker) behavioral alpha will be the key to success. Albert Einstein's famous quote "As far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality" becomes more important in a world of uncertainty.

2019 will be a year of opportunity. In a world transitioning to regionalism, I believe the biggest winners will be emerging markets. As the global race for AI by the world's superpowers continues, rates will remain low and those countries that have not yet benefitted from technology and are not military threats will gain in the reworking of the global supply and demand chain. Despite a belief that BBB credit will be a major theme this year, it should also be noted that it is likely due to supply and demand for yields that there is a global backstop in yields up around 8% which is close to where high yield is today.Yes, there will be defaults in the coming years but the demand from global pensions, sovereign wealth funds and insurance companies will continue to be enormous as the demographics drive liabilities higher. In terms of equities for this year, my gut tells me the lows will be in the first quarter.I expect the dollar to be weaker this year against EM currencies but don't have a strong view vs Europe or Japan.I do expect US rates to move lower than what almost anyone will predict for 2019. Most importantly, I think the fallen angel reality will lead to what Henry McVey at KKR wrote about in 2017, "Deconglomeratization", which will help drive a large outperformance of value vs growth. However, for all these thoughts, given the uncertainty, I am prepared to be an excerpt from a book for those curious on uncertainty and gaining the strength in admitting we don't know.

I look forward to conversations with many of you in the year ahead. All the best in 2019.

Jordi

"The mind state caused by ambiguity is called uncertainty, and it's an emotional amplifier. It makes anxiety more agonizing, and pleasure especially enjoyable. The delight of crossword puzzles, for example, comes from pondering and resolving ambiguous clues. Detective stories, among the most successful literary genres of all time, concoct their suspense by sustaining uncertainty about hints and culprits. Mind-bending modern art, the multiplicities of poetry, Lewis Carroll's riddles, Márquez's magical realism, Kafka's existential satire—ambiguity saturates our art forms and masterpieces, suggesting its deeply emotional nature. Goethe once said that "what we agree with leaves us inactive, but contradiction makes us productive." So it is with ambiguity."
-Nonsense: The Power of Not Knowing, Jamie Holmes

Disclosures:

The HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event-driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry. The HFRX Global Hedge Fund Index is being used under license from Hedge Fund Research, Inc., which does not approve of or endorse any of the products discussed in this presentation. Source for HFRI data: Hedge Fund Research, Inc. www.hedgefundresearch.com.

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