Being sensible in a time of uncertainty

For professional investors only

David Gillard
CIO Insurance & Regulatory Strategies

Executive Summary

"Uncertainty is particularly large" resulting in increased interest rate volatility. However, risk premiums remain low at least in part because unconventional monetary policy liquidity remains abundant. Expectations are that tapering will likely return markets to more normal operations. What might this mean and what can institutional insurance investors do today to prepare?

Being sensible in a time of uncertainty

"Forecasting errors are nothing unusual. Neither central banks nor financial markets have been particularly good at forecasting inflation over the past decade. But when uncertainty is particularly large, as it is today, there are benefits in applying what Alan Greenspan once called a "risk-management approach" to monetary policy.

At its core, this approach builds on the notion that central banks should not only consider the most likely future path of the economy, but also the entire distribution of risks around that path with a view to keeping sufficient optionality to address all inflation contingencies."[1]

This extract is from a speech on Wednesday 17th November 2021 by Isabel Schnabel, Member of the Executive Board of the European Central Bank.

Indeed, interest rate markets are having a torrid time trying to understand the backdrop and make good forecasts. Even among some of the best advised macro hedge funds, 2021 losses are accumulating[2]. Why might this be the case?

Reaction functions to policy makers' pronouncements were confounded in the summer, when Fed dot plots indicated that rate increases were expected well before the completion of tapering. The markets had perhaps understandably expected QE to be removed before more traditional policy was employed, as needed, to manage economies. However, the expectations of policy rate increases, pushed higher by market speculation as inflation pressure persisted, did not result in a uniform upward move in longer dated yields. With policy rate expectations rising, the expectations for peak rates were bought forward and the terminal rate for this cycle's longer-term yields lowered.

Simultaneously the inflation debate is increasingly bifurcating into "Team Temporary" versus "Team Permanent". Whilst this of course sits within Schnabel's "distribution of risks" it does not give rise to a smooth (Gaussian) distribution. With the market only able to give assets one spot (mid) price we arguably see the effects of this uncertainty in the uptick in both realised and implied volatility in the rates markets.

Whilst the discomfort of market participants is understandable, and it is not clear whether the outcomes were expected or intended by policy makers, the rate moves will likely be welcomed. Both tapering and expectation of (or realised) rate hikes have not resulted in a market tantrum, with real yields remaining suppressed and financial repression (lower for even longer) still very much intact.

So far there has been little spill over of increased rates volatility (e.g. MOVE) to risk assets (e.g. VIX). Equity markets remain close to all-time highs and spreads at cyclical tights. QE driven liquidity remains dominant even though we know that the taps are being turned off. This could trigger a return of risk premiums and differentiation, allowing a rotation to "alpha" from "beta" to generate returns – a better environment for active management. Philosophically the removal of price-insensitive policy will be a healthy step for the process of capitalism.

What sensible steps can we recommend for portfolios in the prevailing conditions?

- Utilise low levels of "beta" (market directional) risk

  Uncertainty over economic outcomes and opaque policy drivers suggest that the information coefficient of directional views will be even lower in the near term than is normally the case.

- Use scenario analysis in risk management

  Ensure solvency outcomes are suitably robust to either Team Temporary or Team Permanent winning the inflation argument. Employ hedging strategies where needed.

- Re-visit bottom-up analysis

  If dispersion of outcomes increases, there will be winners and losers. Check the robustness of credit opinions and be sure that there is connectivity with potential ESG tail risks. Structure portfolios appropriately, managing idiosyncratic risk.

- Combine time and market-based triggers for capital deployment

  When moving capital into/out of an asset class manage point-in-time execution risk by scaling out gradually. However, set trigger levels to take advantage of unexpected realised volatility, to accelerate purchases or sales at attractive levels.

- Widen the opportunity set

  Ensure that a framework for the relative valuation of core and satellite allocations is refreshed and put in place with plans and pre-commitments to access opportunities should they arise. The dispersion of economic pathways of even major economies will likely result in valuation dislocations. This preparation helps offset our behavioural biases. Couple with the triggers above for implementation.

- Non-linear "risk control" strategies

  With implied volatilities of risk assets at low levels buying out-of-the-money protection is relatively low cost. For Insurers an option strategy overlay can offset the negative solvency capital implications of the underperformance of risk assets, giving a protected positive carry position.

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1 https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp211117~78f0a1f435.en.html

2 https://www.bloomberg.com/opinion/articles/2021-11-12/central-bankers-are-blowing-up-macro-hedge-funds

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