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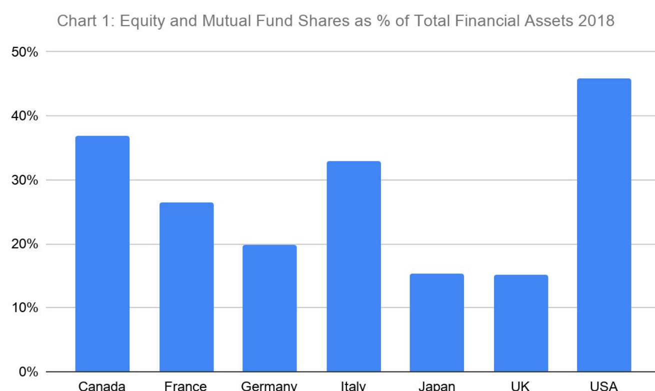
Recent Observations - April 2020

"Since all models are wrong the scientist must be alert to what is importantly wrong. It is inappropriate to be concerned about mice when there are tigers abroad" **George Box**

As a quantitative asset manager, we constantly challenge the assumptions behind our models to try to figure out where they might go wrong. We don't always succeed but if models were infallible then you wouldn't need a manager. Study of historical data and patterns is obviously at the heart of designing systematic strategies but sometimes it is important to step back and analyse circumstances where historical relationships might break. One such example is the actions of large players like central banks that can have potentially a large impact on asset prices and can significantly change sentiment. Below we outline few of our recent observations on this topic:

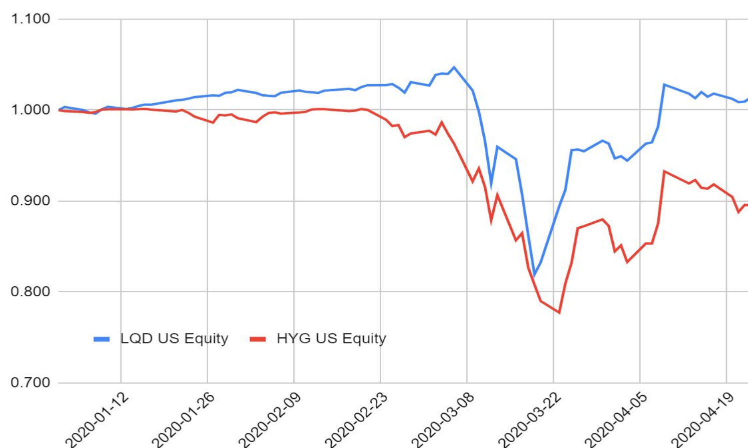
1) There is little doubt that central bank actions can influence directly and indirectly a wide range of asset prices. In the case of government bonds, the mechanics are pretty clear where central banks can directly influence bond yields in specific parts of the curve. For more risky assets like equities, the transmission mechanism is not clear even though loose monetary conditions for a long period of time can encourage a variety of risk taking behaviours.

2) There is also little doubt that risky assets, in particular equities and credit, have an influence on monetary policy even if it's not in the central bank's mandate to support risky asset prices [1][2]. This is particularly true in the US where equity market investment represents a large portion of savings and where negative shocks have a significant effect on consumer confidence (Chart 1)[3]. Historically, central bank interventions in risky assets have usually happened after a major drop in equities and credit markets and a significant deterioration in sentiment [4]. This has become widely accepted as the central bank put.



3) Incorporating these observations in a systematic investment process is difficult because a large part of what a central bank does has to do with sentiment which is very difficult to measure and can change rapidly. As well as sentiment, consumer confidence itself influences monetary policy.

Having said that running strategies which may be structurally short assets that can be greatly influenced by central bank actions could be very dangerous. For those reasons and over the past 30 years shorting Japanese Government Bonds (JGBs), as a bet on raising interest rates in Japan, has time and again been labelled as the “widowmaker trade” by market practitioners.



In the most recent market correction, central banks have been more aggressive in their response. The Fed for example has for the first time planned to intervene directly in the Investment Grade and High Yield credit markets [5] filling the liquidity gap and causing the prices of the Investment Grade and High Yield market to quickly reverse from their mid March lows (Chart 2).

4) Thus the natural question is should investors try to position their portfolio to benefit from central bank actions after a market dislocation? Or should they take a more cautious stance late in the cycle when restrictive monetary policy prevails? When answering this and following a dislocation in risky assets prices investors have to also ask themselves: has the central bank done enough and are they ahead or behind the curve?

Only in hindsight are the answers to these questions clear. For example, in the 2008 crisis it took the S&P 500 5 months from the time the TARP program was announced in October 2008 to finally hit the bottom.

5) Ultimately taking central bank decisions into account when positioning a portfolio is a question of calibration. In the early stages of a recession the balance of risk would suggest to be cautious in respect of central banks ability to support asset prices because there is still a high level of uncertainty on whether or not they have done enough. In the late stages of a recession or in the recovery phase it pays to take a more aggressive stance

because not only would the central banks' actions have fed through already but the fundamentals would have also started to adjust.

For individual mean reversion strategies, which benefit from reversal effects in asset price movements, there is also the question of where to set the triggers to play the mean reversion. If they are set too far they are never triggered and if they are set too tight then you run the risk of getting in too early. Some mean reversion strategies, for example, have worked extremely well since the financial crisis but broke up more recently because the trigger to go long was too early and before the impact of central banks interventions.

6) Regardless of the assessment of how much influence central bank actions can have it is very difficult for an investment manager to ignore. We believe that around economic cycle turning points it is particularly important to remain vigilant of monetary conditions and how they might impact portfolios.

References :

[1] "The Stock Market's Wild Ride | St. Louis Fed - Economic ...." 10 Apr. 2020,

[2] "The Economics of the Fed Put by Anna Cieslak, Annette ...." 14 Apr. 2017,

[3] "Household accounts - Household financial assets - OECD Data."

[4] "When Does the Fed Care About Stock Prices? by ... - SSRN." 29 Aug. 2018

[5] "Primary Market Corporate Credit Facility - Federal Reserve Bank." 9 Apr. 2020,

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