September 2024

An August of Discontent

Market Volatility and Macroeconomic Uncertainty

Just a few weeks ago, global equity benchmarks were setting new record highs as optimism around AI drove torrid gains in technology stocks and an improving macro backdrop supported bullish investor sentiment. U.S. inflation figures resumed their downward trajectory after a series of higher-than-expected prints. Improvement in international growth data pointed toward broadening in the global expansion. Some major central banks began lowering rates, and the Fed suggested an initial cut could arrive soon. A year out from the last Fed hike, the clock appeared to be running out on a policy-induced recession, and many forecasters lowered their subjective recession risk assessments.

And yet just a few days later, equity markets were in a tailspin, with the MSCI World ultimately drawing down more than 8% by the time it bottomed on August 5th. Within and across asset classes, recent winners fared particularly poorly relative to recent underperformers, as investors fled from anything cyclical and/or tech oriented. The yen surged, high-carry currencies crashed, pro-cyclical commodities like energy and industrial metals sold off, and bond markets showed a classic flight-to-safety.

What transpired to engineer this abrupt market reversal?

Simply put, market participants were served a series of vivid reminders that the elevated macroeconomic uncertainty of the post-pandemic period has not faded.

Political risk reemerged as a tumultuous sequence of events rocked the U.S. election campaign, swinging betting market assessments of the race toward Trump and then toward his (new) opponent Vice President Harris. Meanwhile, news reports that the U.S. government might further tighten technology sales to China reminded holders of high-flying tech shares that political developments should not be ignored. Unexpected policy changes in Japan served to further unsettle markets, as official intervention to strengthen

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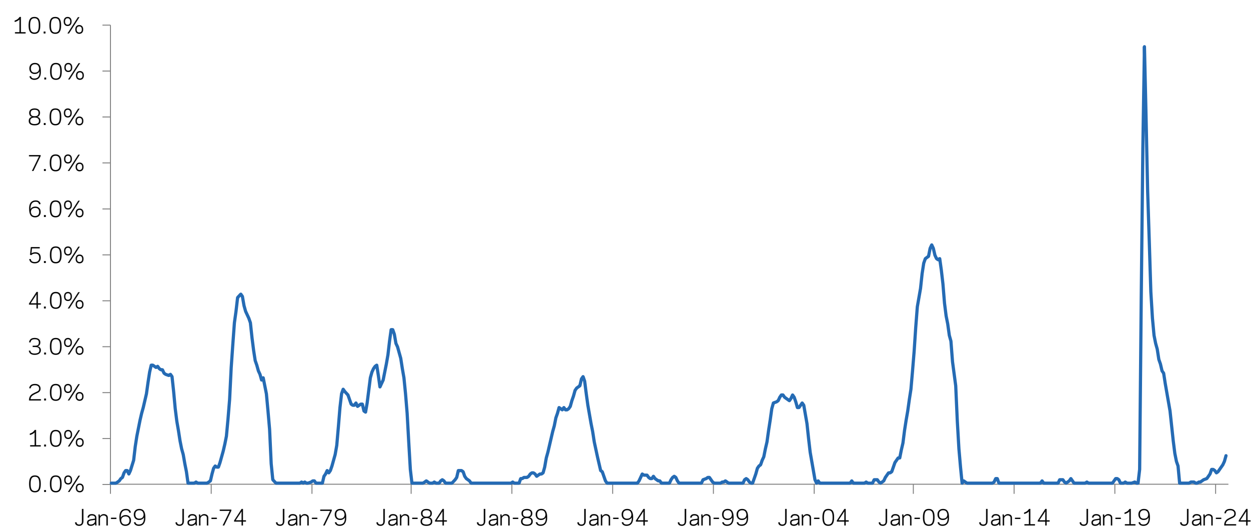
the yen and a surprise rate hike by the Bank of Japan late in the month propelled the currency to double-digit percentage gains. The strengthening yen proved to be a pressure point for global markets, sparking unwinds of carry and momentum trades across the macro space. Finally, a one-two punch of downside surprises on key U.S. data releases—the ISM Manufacturing PMI and the monthly employment report—prompted a sudden reassessment of whether recession risk had truly receded to the degree implied by asset prices. In other words, we saw an abrupt reminder that the world is still very much uncertain.

The Continued Rise in Unemployment Has Sparked a Reassessment of Recession Risk

U.S. Unemployment Rate, 3m Average, Increase from Trailing 2-Year Low
January 1969 – July 2024



Source: AQR, Bureau of Labor Statistics.

Each of these specific catalysts was unexpected. In a broader sense, however, this turbulence is not surprising. Global macroeconomic uncertainty remains extremely elevated as the aftershocks of the pandemic and the ensuing inflationary boom continue to play out. Couple that with rising political risk worldwide, and it seems clear we are still in a very uncertain place.

Soft landing, hard landing, and persistent inflation scenarios—each very different macroeconomic regimes—are all highly plausible near-term outcomes. An inflation revival in response to a renewed shock (simmering tensions between Israel and Iran come to mind as an all-too-plausible trigger for higher energy prices) remains a real possibility, but again with a lot of uncertainty.

While the Fed and other major central banks appear likely to ease in the near term, the speed and degree of easing is highly uncertain. Recall that only a few months ago many were questioning whether monetary policy was even appropriately contractionary.

Assuming monetary policymakers will "stick the landing" is far from a safe bet, especially with central banks facing risks to both their inflation and employment objectives.[1] Their recent record is far from stellar. Major central

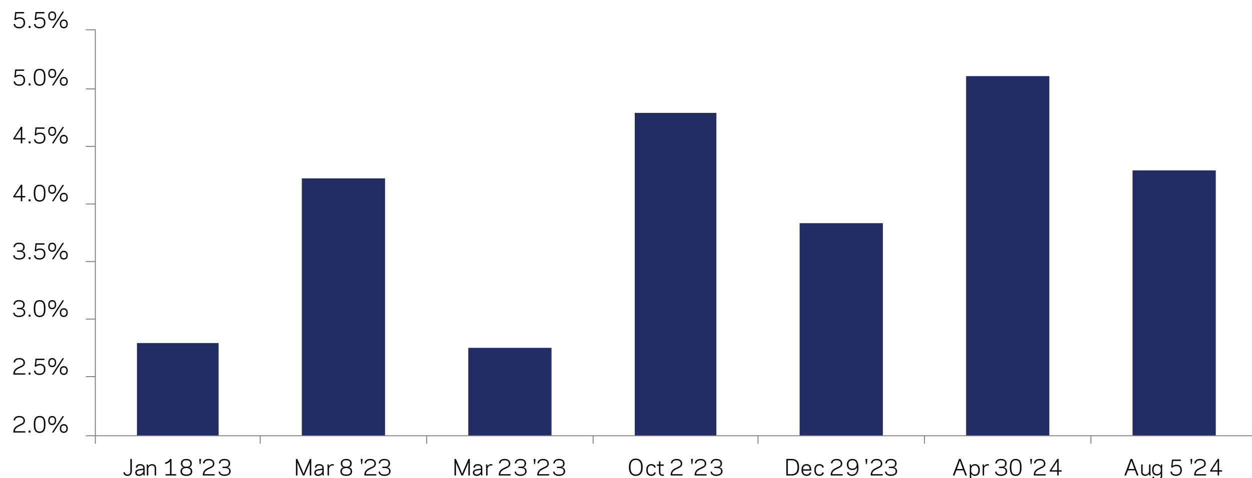
1 Brooks (2023) notes that macroeconomic uncertainty is meaningfully higher than average during periods in which the Federal Reserve faces tradeoffs between its inflation and maximum employment mandates (e.g., inflation and unemployment meaningfully higher than target levels).

banks allowed real interest rates to plummet at the onset of inflation, contributing both to its surge and persistence after initial inflationary catalysts wore off, before abruptly tightening monetary conditions in 2022 and early 2023. History tells us that such aggressive tightening leaves the economy in a vulnerable state.

Although financial markets have largely been calm until recently, there were telltale signs of heightened macroeconomic uncertainty. Futures-implied expectations for the path of interest rates have oscillated wildly over the last two years—from imminent and aggressive rate cuts (now, the beginning of this year, March 2023 post Silicon Valley Bank, December 2022 – January 2023) to higher-for-longer. Volatility at the front end of the yield curve in part reflects the inherent difficulty markets have in parsing central bank policy. But to an even larger extent it reflects true fundamental uncertainty about the path of employment and inflation, the appropriate longer-term level of interest rates, and the ability and willingness of central banks to preserve the two percent inflation target.

Market Expectations for the Path of Interest Rates Have Oscillated Wildly

Fed Funds Futures Pricing: December 2024 Contract



Source: AQR, Bloomberg.

As of this writing, in-line readings on various U.S. data releases have helped risky assets reverse much of the damage done in late July and early August.

Yet, investors would be well served not to be complacent and write the recent period off as an August blip. Macroeconomic uncertainty tends to be extremely persistent[2] and is a powder keg for financial markets.[3] As we just witnessed, markets can ignite rapidly, often sparked by fairly innocuous catalysts.

2 The Jurado, Ludvigson, and Ng (2015) macro uncertainty index ("JLN") has a monthly autocorrelation of 0.98, implying shocks to macro uncertainty have a half-life of around four years. See Brooks (2023) for more details.

3 As discussed in Brooks (2023), macro uncertainty has a strong association with financial market volatility. The JLN macro uncertainty index is 0.6 correlated, and realized volatility tends to be meaningfully higher than average when macro uncertainty is elevated (e.g., top tercile).

With this in mind, how should investors respond?

Against a backdrop of macroeconomic uncertainty, it is critical for investors to ensure their portfolios are well diversified. A recession or renewed inflation scenario would likely lead to significant tumult in equity markets. Private equity and credit investments are ultimately beholden to the same drivers as public equities (the ability of firms to generate cash flows and the amount investors are willing to pay for these uncertain cash flows) and would not be immune to the pain.

In contrast, liquid alternative strategies, which can make money *independent* of the direction of equity markets, are a valuable tool in constructing a well-diversified portfolio. They are even more critical, however, when macroeconomic uncertainty is high, as investors can't solely rely on equity risk to be the growth engine of their portfolio.

Some liquid alternative strategies, such as trend following, are not only resilient to economic volatility, but also tend to capitalize on it. Since trend-following strategies profit from asset prices underreacting to new information, large economic shocks are typically associated with a more attractive opportunity set.[4] Diversified approaches to trend investing that include a larger number of lowly correlated markets, and that better measure trends by explicitly modeling fundamental catalysts have historically provided even better performance against a backdrop of market tumult.[5]

Should we expect trend following and liquid alternatives in general to profit every time there is a spike in volatility? Certainly not. In this month's abrupt momentum crash, many categories posted losses.[6] But looking over quarters and years as opposed to weeks and months, liquid alternative strategies have performed exceptionally well against the recent highly volatile macroeconomic backdrop.

Of course, investors should not aim to "time diversification"—those that do will often find themselves a day late and a dollar short. This time around we are fortunate markets have fired a warning shot. We should heed the message.

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4 Babu et al (2020) links the performance of trend following strategies to the magnitude of risk-adjusted market moves.
5 See Brooks et al (2023) and Babu et al (2020).
6 Price-based trend following strategies tend to perform better in protracted, as opposed to short-lived, drawdowns. The performance of economic trend, which positions based on trends in fundamentals, is less dependent on the duration of market drawdowns. Economic trend tends to perform better in drawdowns that are preceded by deteriorating fundamentals, as opposed to those that lack an identifiable catalyst.

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