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INVESTMENT MANAGEMENT

Managed Futures As a Potential Solution to Market Volatility

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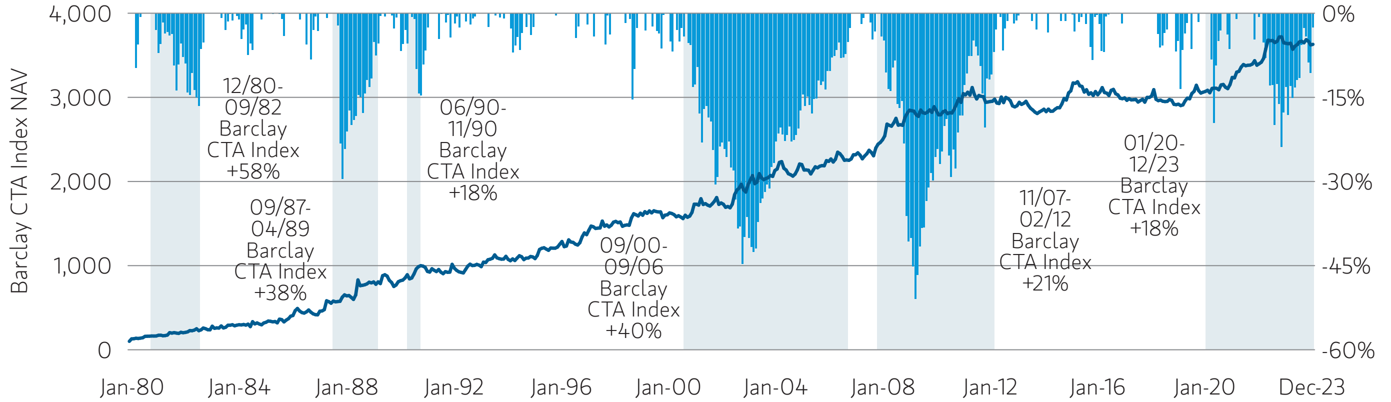
For more than a decade, global market volatility was generally constrained, largely attributed to the quantitative easing and low-to-negative interest rate policies of most central banks around the world. Combined with a bearish cycle across the broad spectrum of commodity markets, the global investment marketplace experienced one of the most prolonged equity bull markets ever. As happened many times before, this period of buoyancy ultimately resulted in higher inflation, being tackled now by governments and central banks globally. Investors are experiencing further uncertainties as geopolitics are combining with fundamental forces to keep elevated volatility across a wide array of market sectors. In periods of such volatility, particularly coinciding with a period of exceedingly high equity/bond correlation, clients may be looking for an alternative investment which may not only provide diversification and potential portfolio protection to market fluctuations, but also potentially capitalize on increases in volatility.

Historically, managed futures investments have offered low correlation not only to traditional portfolio investments such as stocks and bonds, but to other alternative hedge fund investment strategies as well. Viewed as an absolute return alternative investment strategy, managed futures investments typically have a low beta to risky assets and are uncorrelated to long-biased hedge funds, private equity, and other alternatives. Moreover, managed futures have no inherent long bias to any asset class, and at periods may be short any number of markets. That could make managed futures an important part of a retail or institutional investor's portfolio in the current environment which may continue for some time.

Managed futures investments have also historically performed well in periods of extended equity drawdowns. This "crisis alpha," as it is often referred to, can offer a key component of portfolio insurance in such a period. This is represented by *Display 1* which plots the performance of the Barclay CTA Index during periods of

DISPLAY 1

Barclay CTA Index vs. S&P 500 TR Drawdown



Data: January 1980- December 2023 Barclay CTA Index and S&P 500 TR Index. Data for Indices were provided by EurekaHedge. **Past performance is not indicative of future results.**

stock market drawdowns, as represented by the performance of the S&P 500 Total Return Index. Importantly, the periods of strong performance for the Barclay CTA Index coincide with S&P 500 bear markets, including recoveries to new "high water marks."

Why the Current Macro Environment May Favor Managed Futures

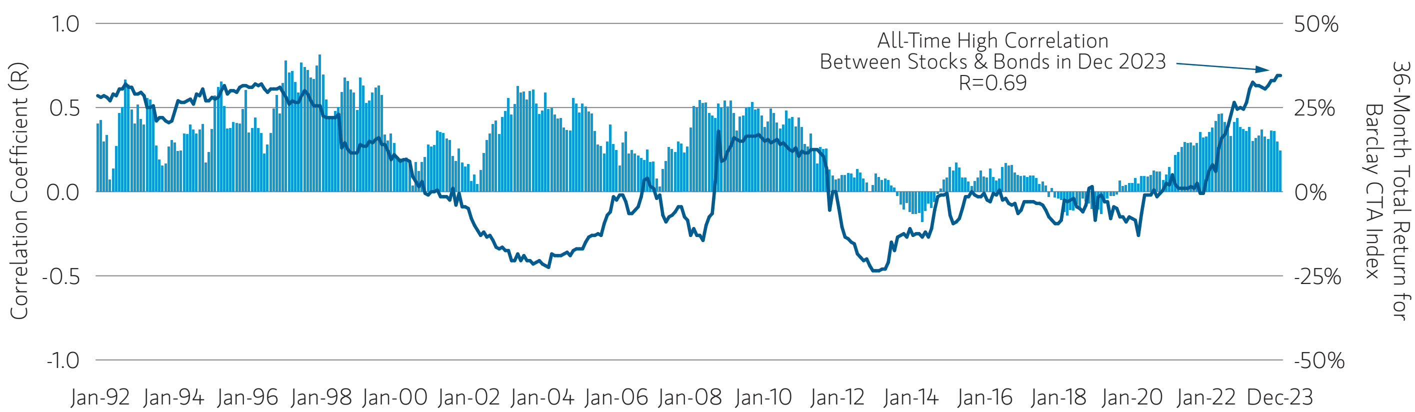
The current global economic environment is exhibiting widespread volatility which has not been experienced in many years. Many of the current macro and micro impacts experienced by investors may not be transitory and, in fact, could persist for an extended period of time. Below is a partial list of some of the major fundamental drivers of the volatility we are currently witnessing.

While certain volatility can be a potential danger to a traditional portfolio, it may also provide trading opportunities for the "right" investment vehicle. Looking forward into the remainder of the year and beyond, there are a number of factors that could point to longer-term volatility that managed futures investments have historically been able to profitably capture.

Since the COVID pandemic, the interplay between inflation and central bank reaction has dominated market focus, pushing the correlation between equities and bonds to historical highs. As of December 31, 2023, the 36-month correlation between S&P 500 Index (TR) and Bloomberg U.S. Aggregate Bond Index (TR) was at its highest level since 1992, as represented by *Display 2*.

DISPLAY 2

Barclay CTA Index vs. Stock / Bond Correlation



Source: January 1992 - December 2023. Barclay CTA Index, S&P 500 Index, and Bloomberg U.S. Aggregate Bond Index. **Past performance is not indicative of future results.**

When monetary policy is the primary source of uncertainty, markets focus on liquidity. As market expectations of monetary policy direction change, whether tighter or looser, it has the same directional impact on all financial asset pricing. Conversely, when global growth is the primary driver of uncertainty amidst stable monetary conditions, we would expect to see negatively correlated price action. For example, strong growth expectations driving equities higher, and bond yields up.

We believe that the market preoccupation with monetary policy globally is likely to remain for some time. Further, if the market remains primarily focused on monetary uncertainty, we believe the bond/equity correlation is likely to remain positive. Given this, we also believe that managed futures can potentially provide diversification to other assets and strategies as shown by *Display 2*.

Of course, if the market shifts its focus toward real growth as the monetary policy turns consistently and transparently looser, then a reversion lower in the correlation between stocks and bonds is possible. In that case, managed futures as an investment strategy can still have the potential to capture alpha.

Currently, we see drivers of inflation volatility still arising from a tight labor market, deficiency of housing supply and solid overall economic growth, at least in the U.S., while the interest rate policy remains uncertain and lacking a significant degree of transparency. In terms of the global real growth outlook, a combination of risk around election cycles and their fiscal implications, geopolitical risk, more frequent trade and industrial policy interventions should all serve to keep volatility elevated, including occasional regime shifts.

In short, the combination of high bond/equity correlation, a high and volatile cost of capital, and ongoing policymaker-induced volatility should bode well for dynamic, diversified, multifactor, liquid trading approaches like those employed by the managers in managed futures investments.

INFLATION UNCERTAINTY STILL HIGH

- Are we in a disinflationary, deflationary or even a reflationary environment in the U.S. and globally? Market expectation of coming rate cuts, especially in the U.S., may be overly optimistic.
- Increasing growth dispersion between the U.S. vs. elsewhere around the world:
  - Japan and India may outperform, Europe seems likely to underperform, with the U.S. probably somewhere in between.
  - What is poison for some may be a cure elsewhere: reflation may drive Japan to a sustained recovery, while Europe is suffering under even slower deflation. With the most recent negative GDP growth print in Germany, the European Central Bank (ECB) may cut rates sooner and more aggressively than the Federal Reserve. At the same time, it is possible that Bank of Japan starts changing its decades long monetary policy, and possibly even hikes rates later this year.
- Difference in reported inflation vs. reality for consumers and its potential economic impact as consumer spending, still resilient in the U.S., may turn for worse.

RECESSION EXPECTATIONS HAVE SUBSIDED BUT UNCERTAINTY STAYS

- While markets are increasingly expecting a relatively "soft landing" for the U.S. economy, the potential for an economic slowdown is still a measurable risk for global equities and other risky assets. Managed futures is one of the few alternative investment strategies that have the ability for global equity exposures to go 100% short. For example, we saw Commodity Trading Advisors' (CTAs) short exposures in equity indices emerge throughout 2022 as global equity prices overwhelmingly moved lower.

GLOBAL GEOPOLITICAL INSTABILITY

- Current conflicts in Europe and the Middle East involving several nuclear powers: the U.S. and Russia, as well as Israel and Iran. Global polarization and deglobalization increase the chance of further spread of conflicts.
- While energy market turmoil comes first to mind, trade and transportation bottlenecks, as we are currently witnessing in the Red Sea, currency wars and accelerating de-dollarization are some of the possible scenarios.
- In the U.S., we may be facing an even more antagonistic Presidential election later this year. In the last few elections, no matter the outcome, risky assets benefitted from continued loose monetary policy and ever-increasing liquidity. This time around we may face sharp reversal of such policies, especially if Donald Trump wins. Despite his general pro-business stance, chances are he would have to respond to his caucus' calls to stop and reverse increasing government spending and money printing, thus likely impacting U.S. growth.

GLOBAL CONUNDRUM ACROSS ENERGIES AND OTHER COMMODITIES

- **GROWING DEMAND VS. SHRINKING SUPPLIES:** Many commodity traders believe that the underlying fundamental supply/demand equation in commodities has no real short-term fix. It is not just demand that is driving the volatility in commodity markets. The primary reason we may see the current commodity cycle being prolonged is the widespread weakness of the global supply chain and how it has been brought on by a decade of underinvestment in capital expenditures at nearly every level. Moreover, current higher working capital costs have fueled an inventory destocking cycle that has held back spot pricing. Both these dynamics may make prices less elastic on the supply side than in previous cycles. Given this, more volatility in the commodity markets could possibly lie ahead and there is still a meaningful probability of a "commodity supercycle" dynamic unfolding over time. This could offer some strong trading opportunities for commodity trading advisors.

- **WEATHER IMPACT:** Weather impact on crops in the U.S. Midwest, South America, West Africa, and other geographies has arguably been more pronounced with climate change. As reported by the NOAA, 2023 was the hottest year on record since 1850. 2024 may bring even more weather havoc, and with it, reignited food inflation. Weather also affects power production and consumption as energy sourcing, transmission and demand are going through potentially revolutionary change. As a shift toward sustainable energy sources is taking place, electricity pricing may suffer extreme peak volatility due to inadequate energy storage and peak power gas turbines capacity. Moreover, electric vehicle (EV) participation, primarily in the U.S. and Europe, is increasing while artificial intelligence (AI) computing drives electricity consumption higher. All of it will require a significant metals production increase while a capacity increase has been severely curtailed by chronic underinvestment.

- **CONTINUED GROWTH OF "GREEN" INITIATIVES, REGULATIONS, AND FINANCING:** Also of growing significance is the ESG movement and governments' actions to fight climate change. This has the potential to greatly impact markets in profound ways for years to come. Energy transitions, infrastructure upgrades and EV conversions are just a few examples for this to create new investment opportunities, sometimes in unique commodity markets, such as in global carbon allowance futures. Carbon capture has been our investment theme for years and will likely be creating further investment opportunities as COP28 resulted in a global agreement to transition away from fossil fuels in energy systems. The growing global climate issue may also affect the energy markets in other significant ways. Increasingly, the efforts to move away from hydrocarbon energy to sustainable energy sources, which thus far have not been able to reliably provide for demand volatility, run up against the underlying fact that demand for energy will remain constant in the least and is most likely to grow. These imbalances have the potential to inject a considerable amount of volatility into the energy complex.

- **DEGLOBALIZATION NOT LIMITED TO MANUFACTURING:** Many of the themes listed above can be seen in terms of a reversal of the "one-world" globalization trend which has emerged over the last 20 years. Any profound change to this trend could also potentially have a dramatic impact across the globe and add even more volatility to the current global situation.

These are just a few of the themes that can potentially create investment opportunities for a strategy like managed futures. Uncertainties, whether economic, political, social, or weather-related, will continue to support heightened volatility. Historically, managed futures investment strategies have capitalized on such environments which feature prolonged volatility, adding diversification to a portfolio in different market environments.

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MSIM's Managed Futures team, which has roots dating back 40-plus years, specializes in providing high net worth and institutional investors access to multimanager investment solutions. In our view, an allocation to managed futures is an essential component of a well-diversified portfolio. Over the long term, we believe these strategies provide important diversification benefits versus other traditional and alternative asset classes.

For more information, please contact the MSIM Alternative Investments Hotline at (212) 296-7676.

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