Hedge Funds

Macro

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Macro Strategy
Macro Environment

- Monitor the global economy and try to **identify imbalances** based on your assessment of:

    ▪ Macroeconomic conditions *vs* monetary policy and fiscal policy

- Perform the same **analysis for each economic block**

- Interconnect different regions to get the broad picture and assess what are the expected returns for each asset class (in light of their **correlations and relationships**)

Macro Strategy
Objective

- Try to **anticipate close future events** and **take positions accordingly**

- Steps:

    1. Assess Macro Environment *vs* Macro Economic Policies

    2. Choose those events that

        i. Seem **more predictable** (trends, self fulfilling prophecies) and/or

        ii. Seem to have **biased outcomes** (not properly discounted)

    3. Select efficient instruments to implement trades (**skewed**)

Macro Strategy
Reflexivity Theory
George Soros

One simple model to help you "tell the story", i.e. to identify imbalances and on-going trends

- **Equilibrium x Conundrum** (feedback loops pull mkts away from equilibrium)

- **Reality → Perception → Reaction → (new) Reality**

Observer's actions may affect the reality [approach from sociology] Ex: credit

1) Identify trends = f (**dominant themes**, major concerns, fashions)
2) Trend = **deviation from equilibrium** / economic logic
3) Identifying imbalances **does not mean** betting on a correction
4) Understand them (are there any **feedback loops** in place?) and
5) Try to identify possible **triggers for reversal**

"Don't fight the trend. Markets are reflexive. Positive feedback. That is why we need a supranational altruistic authority to stabilize things.", *George Soros*

Macro Strategy
Interest Rates
Models

- S/T rates - *Taylor* Rule

  - **Target S/T rates** = (Inf + Target real rate) + 0.5 x (Inf – Target Inf) + 0.5 x (GDP - GDP potential)

- L/T rates = f (expectations, Supply/Demand imbalances)

  - Expectations - expected <u>inflation</u> + expected <u>growth</u> + perceived <u>risks</u>

  - D x S Imbalances – QE, regulations, aging population, international reserves, investment Fashions

  - L/T r = 0.5 x S/T r + 0.5 x L/T GDP Nominal (*Maurice Allais*)

- Shape of the Yield Curve

  - Normal YC   – positive slope

  - Too steep Yield Curve   – inflation / strong growth expectations

  - Flat / inverted YC   – deflation / recession expectations

Macro Strategy
Skewed Trades

- Compare **your expectations** with **market expectations**

- Look for trades with the **most skewed possible outcome**

- I.e. trades that probably will

  - Win big, if you are right

  - Loose small, if you are wrong

- This is the most important part of a successful macro strategy (<u>you will not be right most of the time</u>! Accuracy ratios of 60% are already a good record, so the best way is to cut the left tail, diminishing extreme negative returns and/or to increase the right tail with large positive returns)

E.g. Brexit - volatility

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