FIRST QUADRANT

# MARKET INSIGHT

## How Market Participants Shape the Macro Environment

February 2019

Even in this historically-long bull market, we have seen (not-infrequent) shifts in investors' risk sensitivity, ranging in both magnitude and duration. The past several months have been a particularly obvious reminder that risk appetite can shift abruptly, with volatility oscillating as market participants assessed global growth prospects, Brexit developments, trade uncertainty, and the US government shutdown. At First Quadrant, we believe the best way to understand how changes in the market environment will influence asset prices is to first understand how they will influence market participants. Because of these insights, for our GTAA and Global Macro views, we rotated into net-short positioning in stocks and net-long positioning in bonds in mid-October, increased our bearish stance throughout the fourth quarter, and shifted back to a more growth-oriented stance mid-January.

Our first indication that macro opportunities were shifting came through our view on how portfolio investors would assess the excess return associated with equities. When the interest rate environment improves, we expect profit-seeking investors to more heavily discount the future earnings or dividends associated with equities. Consequently, we had identified headwinds for equities for some time, with our conviction strengthening during the lead-up to the equity selloff in October. We also started to see more favorable opportunity for bonds due to the wealth effect: We expect investors to be more sensitive to risk when their portfolios have lost value. Put differently, the less money you have, the higher the marginal cost of losing an additional dollar. As a result, we anticipated that investors' loss of wealth would lead to a preference for lower-risk assets, such as bonds. Based on both of these views, in mid-October, we shifted our allocations to favor bonds and disfavor stocks.

This adjustment to our overall stock and bond exposures significantly benefited our macro-related strategies. And as risk appetite continued to fluctuate, we began to see diminishing opportunity to capitalize from defensive positioning. Investors' flight-to-safety behavior during the late-2018 selloffs resulted in depressed bond yields, improving the relative attractiveness of expected equity returns. This shift (and others) prompted us to neutralize our bearish positioning mid-January, locking in significant gains from our bet. Since then, we have returned to a more pro-growth stance, increasing our overall exposure to stocks and decreasing our exposure to bonds.

**Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.**

While our now-bullish stance has also been of value, we are beginning to detect another shift in macro opportunities, and have been again moderating our view. In the coming months, we believe there will be further changes to the risk environment, as investors continue to gauge Brexit prospects, the US-China trade relationship, and monetary policy – and these are just examples of known potential risks. But for the prepared investor, a change in the macro environment can be an opportunity for potential profit. Predicting when and how political uncertainties will resolve can, of course, feel as daunting as prognosticating the weather. We believe, however, that the best way to try to protect your portfolio is to instead form active views on how market participants will adjust when the winds do change.



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