RCM Alternatives

Choppy Currents or
Smooth Sailing?

Managed Futures
Outlook 2017

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Managed Futures 2017 Outlook

This non correlated investment stuff sure can be frustrating, can't it? There you are in mid-February of last year thanking your lucky stars for diversifying into non correlated managed futures investments as they sat up 5% on the year while stocks were down -5%; only to finish the year like this: See fig. 1

Fig. 1: Asset Class Performance 2016

ASSET CLASS	2016
U.S. Stocks	11.81%
Commodities	9.94%
U.S. Real Estate	7.02%
World Stocks	4.31%
Bonds	2.45%
Hedge Funds	0.70%
Cash	0.15%
Managed Futures	-2.66%

Past performance is not indicative of future results.
*Source information can be found on pg. 18

Yes, after a flat year in '15, and despite some real value provided to start the year - '16 was pretty much a fail... with the SG Managed Futures Index down -2.66% after starting out so strongly. Beyond the index, bellwethers such as AQR – Managed Futures Strategy Fund (-8.43%) and Aspect – Diversified Fund (-9.16%) couldn't escape the down year, although there were winners in the alternative space, both amongst established names such as Quantitative Investment MGMT (GIM) Global Program QIM (+16%) and in the emerging space with funds such as the Attain Relative Value Fund (+16%). And while the absolute value wasn't so bad, anyone can live with a small single digit loss every now and then, it sure felt a lot worse alongside other asset classes which were having a resurgence of sorts.

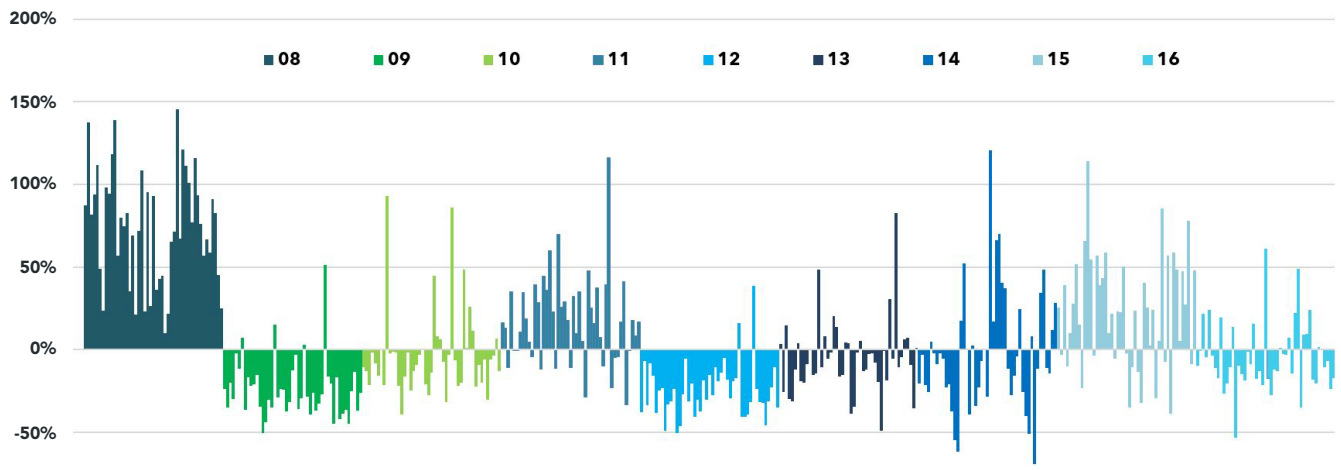
So why the down performance in 2016 and what can we expect in 2017? Well, we won't pretend that we can forecast with any accuracy where managed futures and global macro strategies will end up over the next 11 months, but we are interested in analyzing the conditions which caused these alternative investment styles to perform the way it did in the year gone by and discuss whether those conditions will persist, reverse course, or yield to different conditions in the New Year.

Source: cnbc.com

To start that discussion, we look in the engine room of managed futures/global macro programs, we look at volatility in the global markets the asset class tracks – and specifically, whether volatility is expanding or contracting. Managed futures and global macro funds are often referred to as a "long volatility investment," simply meaning that they are expected to do well when volatility is on the rise. So what was volatility doing?

If you're looking for a simplistic answer to the poor Managed Futures performance, look no further than an overall volatility contraction in the basket of futures markets we use as a proxy for the typical managed futures portfolio. Per our simple year-over-year look at the difference in each market's average daily range, 68% of markets saw their ranges contract in 2016, with 32 markets contracting and 15 markets expanding. Here's what the 2016 volatility contraction/expansion looks like compared to previous years.

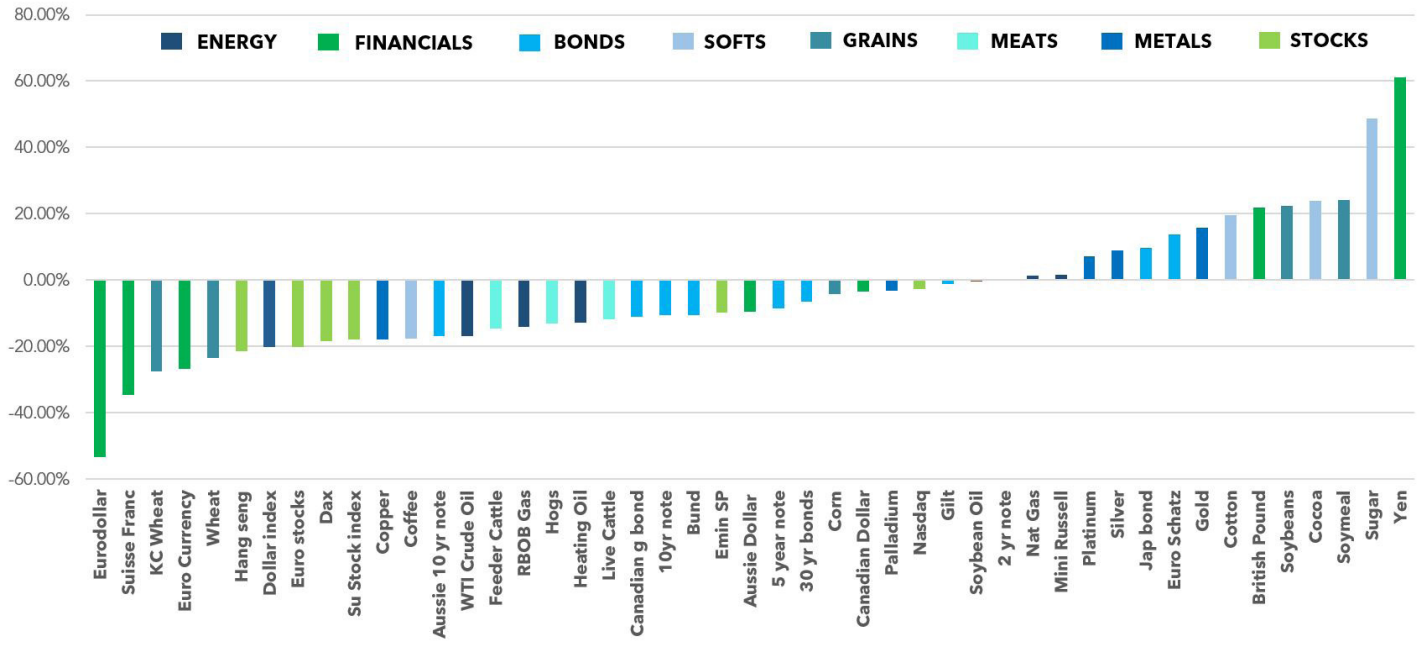
Fig. 2: Volatility Increase/Decrease Across 47 Futures Markets



As measured by the difference in **'Average Daily True Range'** using each calendar year as the lookback period

This certainly helps explain the overall Managed Futures performance and a closer look drives that home even further. We know volatility contraction doesn't bode well for traditional systematic strategies, as less volatility means less price movement, meaning less opportunities for profit (and more whipsaws and false breakouts). Sure, we did see some rather strong moves in various markets, such as the British Pound after Brexit and Copper after the US election, but those moves happened over the course of a couple hours or days, not weeks or months. In addition, despite the big move in the U.S. Dollar post-election, the market experienced a contraction in volatility of 20% year over year. Likewise, Copper experienced a volatility contraction of 17% year-over-year, and this was the first year since 2014 where Crude Oil stayed within a price range, with a volatility contraction of 17%. Here's a look at the various markets from the most contraction to the most expansion.

Fig. 3: Contraction to Expansion Comparison 2016



Suffice to say, there was volatility, but it wasn't the volatility most systematic programs enjoy, existing within an overall contraction regime and displaying seemingly ever shorter half-lives where the moves were either too quick for longer term programs to get involved in, and too short-lived for those programs who did take a shot at participating. (you can see how 6 different managed futures strategy types performed in our recent "Managed Futures 2016 Strategy Review" whitepaper)

But enough about 2016, what could 2017 look like??

What Could 2017 Look Like?

The easy, stock answer, making the rounds between both investors and managers at the recent Managed Funds Association conference was that managed futures and global macro styles should expect a rebound in '17 behind increased volatility thanks to the newly elected 45th President of the United States, one Donald J. Trump.

But it's rarely that easy, is it? The reality of 2017 is sure to be a bit more nuanced and complicated than just Trump = unpredictable = volatility = good. For one, that view is a bit Americentrist. There's plenty of other things happening in the world to pay attention to, from the Chinese economy to European elections to Syria to negative interest rates. And second, these are the known unknowns. The true black swan, outlier producing events come from the unknown unknowns.

So while we're only too eager to say things are looking great for 2017 - there's a few headwinds as well; like the cost of carry being short bonds. At the end of the day, there's enough uncertainty, unknowns, and unrest to go around – and that dynamic is what will drive performance in 2017.

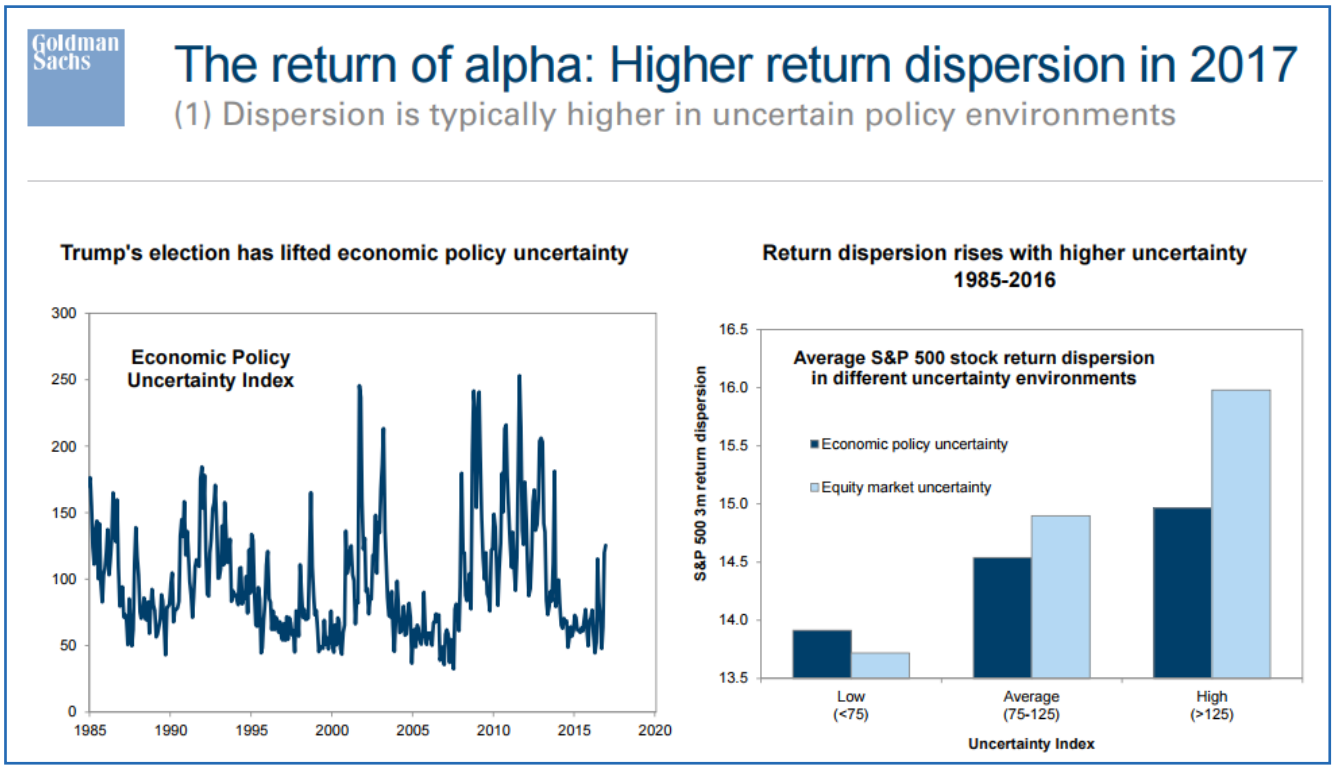
Possibly Helping Managed Futures/Macro

1. **Unpredictability** of Trump

Before we go down this rather thorny rabbit hole, we can point at the incredible rally in equities since the election as evidence that political uncertainty does not necessarily equal market uncertainty. That being said, there's really three "market/economy" camps right now. One, those scared to death of what's going to happen. Two, those hoping Mr. Trump can make "it" happen and breathe further growth and profits into the US economy. And three, those who have no idea what's going to happen.

No matter which of those three camps you pitch your tent in, the common denominator is the uncertainty in how and when it will happen. Can he push it through congress? Will his bluster cause trade wars? Can useful policy

be crafted? There's no doubt the end result (much less what might happen tomorrow or next week) is far from certain and that economic policy uncertainty in the US, and by extension elsewhere, is on the rise. Right on cue, Goldman Sachs was out with a piece analyzing this dynamic and its effects on return dispersions in the S&P 500.



It's not too surprising to see that the higher the economic policy uncertainty, the higher the equity market "dispersion" (chart on the right); and managed futures and global macro traders are looking at that rise into 'high' territory (over 125) in hopes of a more lasting expansion in market volatility; although it's a bit surprising the reading is still well under the 2010-2013 levels. What does Trump need to say/do/undo to get that index to blow past those levels? Your guess is as good as ours, but whatever it is, it's easy to imagine him saying/doing/undoing it…

The US exports 1 billion bushels of Soybeans to China every year, for example. What happens if a trade war puts that demand in jeopardy? Or if labelling China a currency manipulator causes them to stop buying US Treasuries? Speaking of currencies, check out a chart of the Mexican Peso lately to see what Trump can do to a foreign currency.

The idea is that Trump's unpredictability is likely to lead to increased dispersion in returns across not just equities, but a whole host of markets spanning commodities, currencies, and interest rates. So what if dispersion rises? Who cares?

Well, we care because managed futures and global macro trading models appreciate greater market swings (and over longer time periods – notice the Goldman charts are tracking 3 month S&P

return dispersion). Just look at what managed futures did when oil was range bound between $100 and $120 in 2012 and 2013 (flattish performance), versus what they did when Oil saw its "dispersion" in returns increase three-fold in 2014 (double digit performance) to get a feeling for what this looks like.

1a) We're due for some volatility expansion, anyway.

Whether or not Trump fuels equity uncertainty or not – we expect to see some volatility expansion in 2017 anyway. Volatility expansion tends to be somewhat cyclical (although there's no shortage of good arguments for how the market is now setup to dampen volatility at every chance it gets) and last year was the lowest volatility expansion in the futures markets since 2012. Just take a look at the percentage of markets in volatility expansion over the last eight years.

While not quite the volatility contraction seen in 2009 and 2012, it's not too hard to imagine multiple markets (like the entire energy and interest rate complexes) seeing an uptick in volatility after a year of contraction. Of course, this doesn't always work. Managed Futures best year over the last eight years was in 2014, for example, a year where more markets than not saw volatility contract {Disclaimer: Past performance is not necessarily indicative of future results}.

In the end, the general view heading into 2017 and beyond is that Trump will be good for volatility; as evidenced by this line heard at a recent hedge fund conference, "I don't know if Trump can 'Make America Great Again,' but he could 'Make Global Macro / Managed Futures Great Again.'"

Fig. 4: The Cycle of Volatility

% of 47 Futures Market Volatility Expansion	
2009	9%
2010	23%
2011	70%
2012	4%
2013	34%
2014	38%
2015	70%
2016	32%

Past performance is not indicative of future results.

2) Fed tightening cycle (aka Short Bond trade)

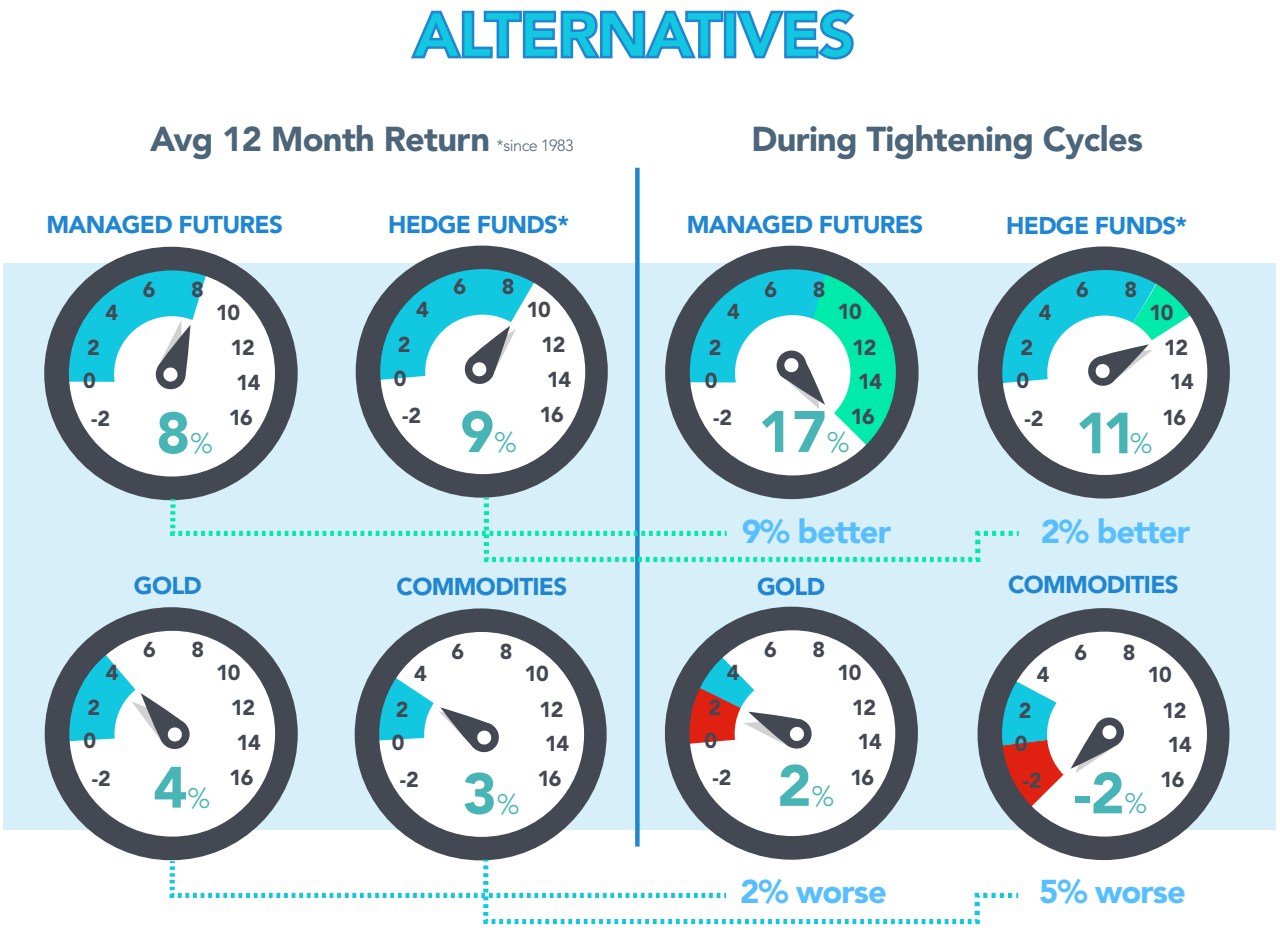
While 2016 was supposed to be when the Fed's tightening cycle finally kicked in, it was anything but, with the late 2015 rate hike followed by just a single additional hike to 0.50%. For markets which used to be raised by that much, not to that amount, it didn't add a lot of excitement and was surely not the sort of cycle which creates extended movement in interest rate futures markets. It's no secret that managed futures has tended to outperform most other asset classes during Fed tightening cycles (see the graphic here from our infographic on rate cycles), and luckily the expectations for 2017 are for a much more active fed rate cycle environment.

How does that happen? Well imagine expectations for future rates in a scenario when the date of the next hike is unknown, versus an environment where the Fed telegraphs their intentions to hike every quarter, or even every other quarter. The telegraphing part is key, as that creates a trending type move, with hike 1 providing the first catalyst, the expectation for hike 2 the next catalyst, expectation for hike 3 the next catalyst, and so on. The greater the expectations of those next hikes, the more conviction traders and hedgers will have in structuring trades at lower and lower bond prices (higher rates), creating a down trend.

Beyond the trend in bond prices alone, a tightening cycle can dampen global demand, shift cost of productions,

and change the flow of capital into different sectors and asset classes. The result of all those machinations in the past has been lower equity and bond returns, and higher returns in alternative investments such as managed futures and hedge funds (although not all alternatives react as well, with Gold and Commodities seeing lower than usual returns).

Fig. 5: Performance During Fed Tightening



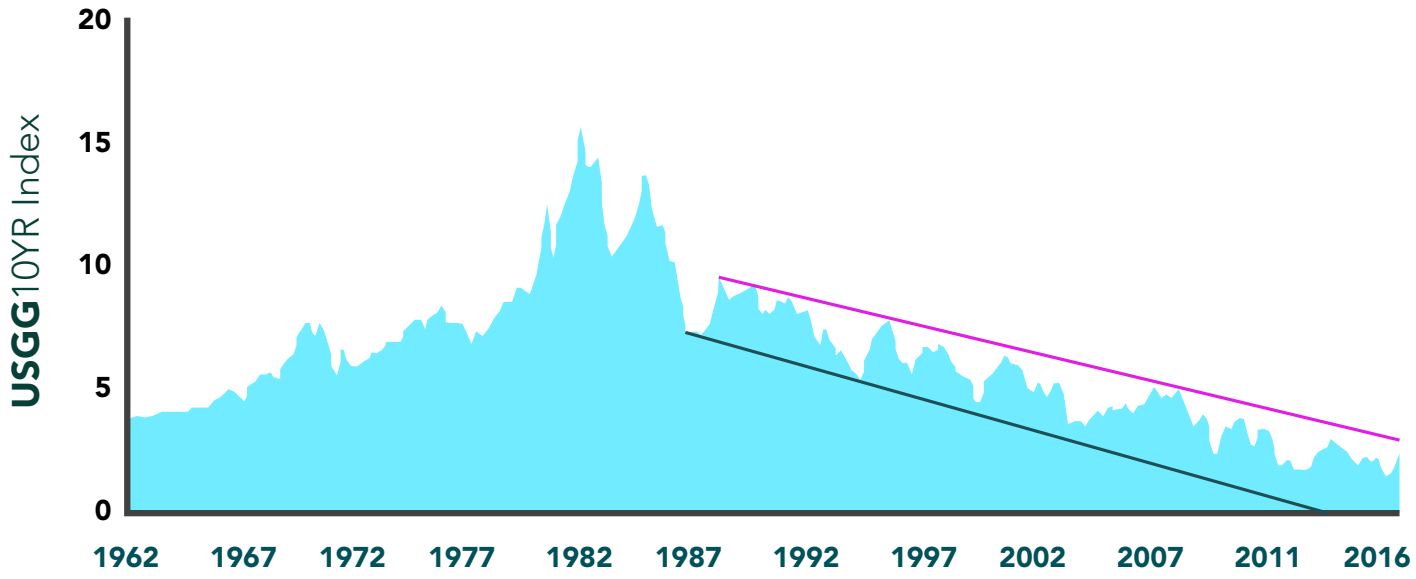
*Data starting from 1994

Managed Futures: Barclayhedge CTA Index | Stocks: S&P 500 | Bonds: U.S. Aggregate Bond Index | Gold: Spot Price
Commodities: Reserve Bank of Australia | Hedge Funds: Dow Jones Credit Suisse Hedge Fund Index

In the end, this could be just what the doctor ordered for managed futures investors, where visions of another 30 year bond trend dance in their heads. Of course, this one would be a down trend in prices (rates higher), while the last one was a historic uptrend (rates lower). But Managed futures models don't care which way bonds are moving – they just want them to move – and the common belief is that an extended down move in bond prices could produce a managed futures tailwind of sorts. Just as happened (in reverse) for much of the past 30 years.

So just how big could that down move (in prices, rates higher) be? We turn to none other than the Bond King himself, Bill Gross, who provided the following chart along with one of his recent market letters. Quite the trend! And anyone can see there's a whole lot of room to the upside when and if that trend line gets broken.

Fig. 6: Down-trend in 10YR Yields



So when will this downtrend be broken if at all in 2017? What is the moment we should all be watching for? Gross says the US 10 Yr. Note yield breaking above 2.60% is the key level:

> Now, however this super strong, frequently tested downward trend line is at risk of being broken. 2.55% to 2.60% is the current "top" of this trend line, and over the past few weeks it has held and reversed lower by 15 basis points or so. BUT----------. And this is my only forecast for the 10-year in 2017. If 2.60% is broken on the upside – if yields move higher than 2.60% – a secular bear bond market has begun. Watch the 2.6% level. Much more important than Dow 20,000. Much more important than $60-a-barrel oil. Much more important that the Dollar/Euro parity at 1.00. It is the key to interest rate levels and perhaps stock price levels in 2017.

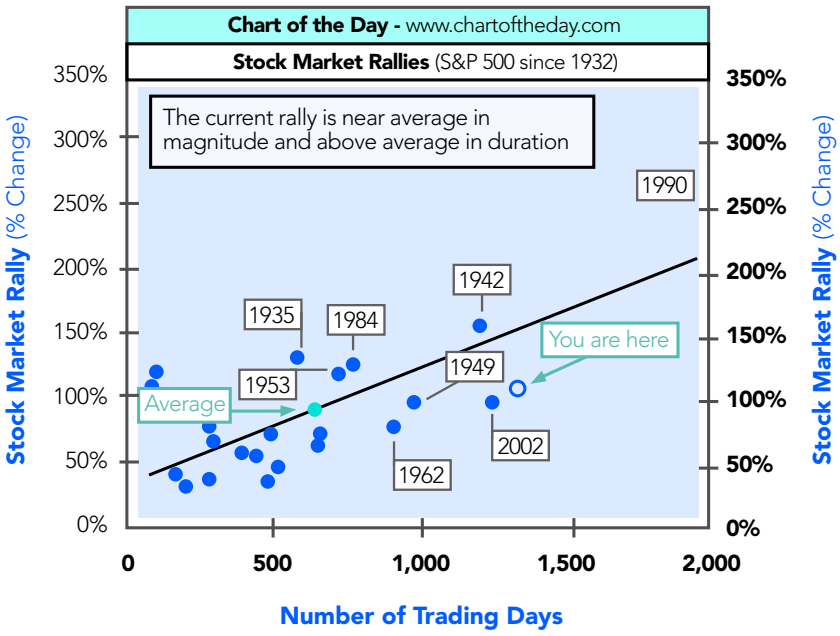
Did you read that last part correctly? Bigger than Dow 20k, bigger than crude at $60 a barrel, and bigger than the breakeven point of the Euro/Dollar exchange. We couldn't agree more. This is the story for many managed futures programs with very heavy portions of their exposure in interest rate futures of all shapes and sizes. A breakout move by the US 10 year can be just the catalyst for sending other markets on their own outlier adventures. And wouldn't it be nice to have that tailwind again, after managed futures has seemingly been tacking into a nor'easter for the better part of 8 years now. Let's gibe and sail with the wind for a while.

3) The 2nd longest stock market rally (basically ever) without a correction…

Since the beginning, people have called this the most hated bull run in history. And just as many people have been calling for its downfall since the beginning with the bad trades or missed entries (or both) to prove it. Maybe this "wall of hate," to coin a new phrase, is the reason we're currently witnessing the second longest stock market rally since the Great Depression. Here's Horan Capital Advisors with the facts:

> *"With the S&P 500 once again in record high territory, today's chart provides some perspective on the current rally by plotting all major S&P 500 rallies of the last 86 years. With the S&P 500 up 107% since*

Fig. 7: Stock Market Rallies



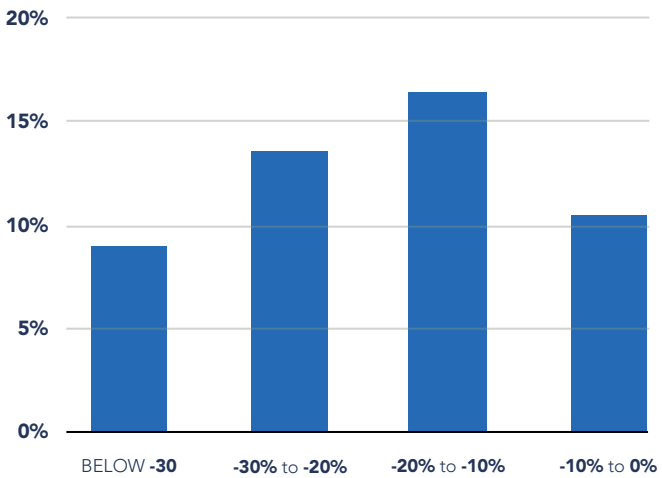
its October 2011 lows (the 2011 correction resulted in a significant 19.4% decline), the current rally is above average in magnitude and the second longest rally since the Great Depression."

Of course, just because something's been going up for a very long time doesn't mean it's bound to come down, tomorrow. This rally is proof enough of that. But surely we're closer to the next correction than we were at this time last year, with every day of further rally bringing us a day closer to the next correction in a sort of market Catch 22.

So what does this mean for Managed Futures? Well, technically their non-correlation to equity markets means it shouldn't matter, Stocks will do what they do and managed futures will do what they do. Managed futures doesn't need a stock market sell off to make money (although it's sure seemed like that since 2008). But sell offs sure seem to help. For one, they can go short those very markets and make money during the selloff. But more importantly is what a stock market sell off does to other asset classes – causing correlations to rise, selling to beget more selling in other assets, and buying in flight to safety assets. In short, it creates volatility expansion. It creates trends and movement out of consolidation areas as investors rush to raise cash or lighten exposure.

We all know what managed futures did in 2008-2009 during an epic stock market sell off (Barclayhedge CTA index up +16.50% while S&P was down -47.74%), but that was an extraordinary event and not one likely to happen again any time soon. We'd be more than happy to just have a run of the mill correction and see what managed futures do with the resulting market movement. After all, there's returns across the down spectrum for stocks, not just at the extreme levels, as seen on our managed futures education page on our new website analyzing managed futures returns during different magnitudes of 12 month equity down periods.

Fig. 8: Average Managed Futures Performance Based on Stocks

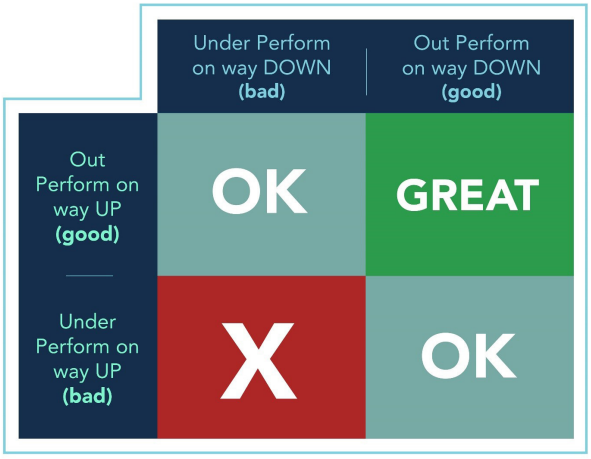


Past performance is not indicative of future results

PS - beware the managed futures programs who have 'cheated' a little over the past few years to get additional return by adding mostly long stock market exposure to their models. They've been smarter than their peers for doing so the past few years, but won't have the same crisis period performance profile when that rooster comes home to roost. They'll likely fall into the

bottom right of our simplistic peer review matrix laid out below – having out performed on the way down (for managed futures performance), but underperforming on the way up. We find the underperformance excuses are typically only valid on one side of the equation.

Fig. 9: Peer Review Matrix



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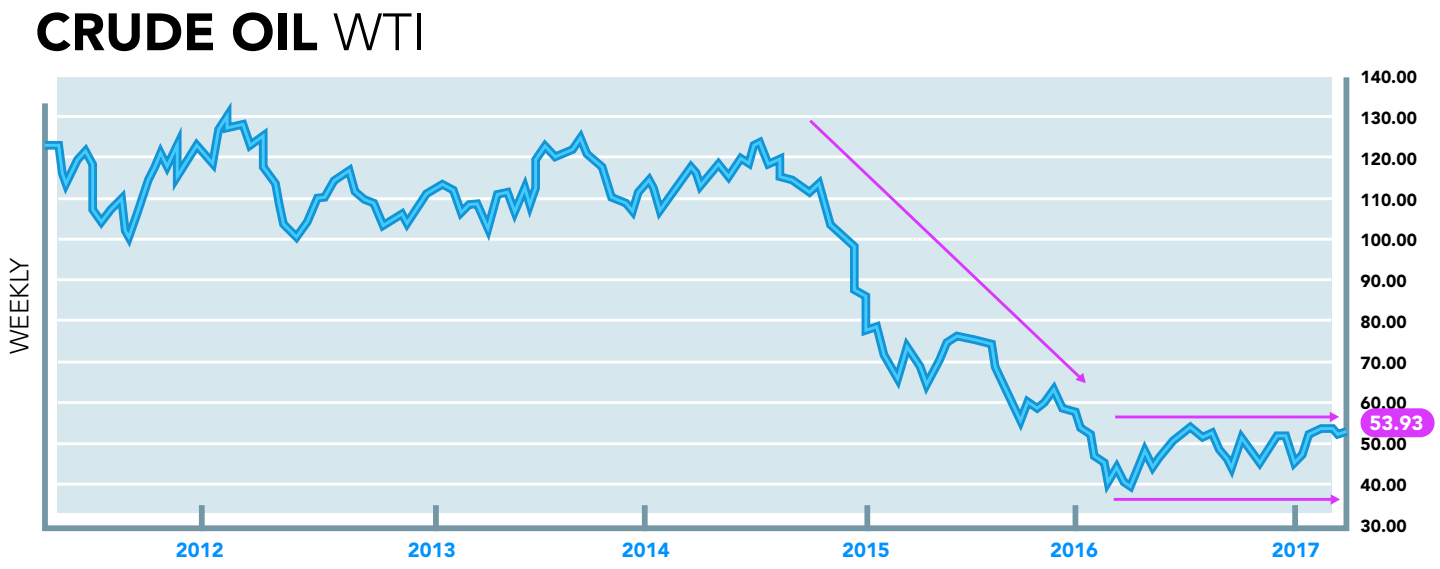
4) **Energy Price** Consolidation

Part of the problem for managed futures and macro in 2016 was missing the 50% rally in Oil markets. That's a hard pill to swallow for an asset class built on capturing such trends, but the problem was that most of that rally from the high $30s to high $50s was not an uptrend, but the end of the down trend. They may seem like the same thing, for most, but the models designed to track and profit from such trends are not designed to buy bottoms. They have to somehow identify when a trend ends, much in the same way they have to identify when one begins. Typically, they consider a trend as ending when prices cross back above a longer term moving average of prices – like the 80 day, 100 day, or 200 day moving average of prices. The sharp drop in oil prices meant it took a long while for the longer term moving averages to come down within sight of near term prices, meaning prices had further to go up before triggering an "end" to the down trend for many longer term models.

What's more, for those with shorter term models which may have identified the end of the down trend and beginning of an up trend sooner – the move higher didn't see much of a follow through. What's changed in 2017? Well, with prices hovering mostly in an $8 range between $46 and $54 – it has opened the market back up to a two-way trade after having some punch removed from it after such a tremendous down trend. Crude oil now has room to move in either direction, with managed futures/macro traders able to capture profits in either direction. Managed futures models don't much care which way a trend moves; they just want to be involved in capturing it.



Having said that, all of us in the space would much prefer a breakout to the upside - as there's always more opportunity in long trends (prices can theoretically go up an infinite amount) than short trends (which have the zero bound). And that's just what many analysts are calling for, not to mention those flooding into the "commodity" space based mainly on Oil's rise last year.

Here's Bloomberg to get you thinking about how that Oil rally could come about:

> *"It should come as no surprise that Trump's pledge to dismantle the Iran nuclear deal ranks as one of the most significantly bullish risks towards oil markets this year," it said. Still, "we think his approach will moderate from campaign rhetoric."*

A possible default by Venezuela would cause creditors and business partners to step back and banks to freeze accounts for Petroleos de Venezuela SA, according to the report. The ensuing liquidity crunch could prevent the state oil company from making payments to partners that are necessary to facilitate day-to-day operations, hurting production.

What's more, a breakout could apply across the energy complex and markets like Natural Gas, which has been hammered so low the past few years it sometimes trades as a flight to safety market. Nicholas Potter of Barclays explains that there are multiple potential supply demand issues with Natural Gas throughout 2017. Specifically, he says exporting Natural Gas to Mexico has driven prices lower, but with the new Trump Administration already at ends with Mexico and Trump considering renegotiating NAFTA, and news of using the word "tariffs," we could see some price shock coming our way. Again, we don't much care about the why, we just want the move, but such catalysts for new price regimes paired with price compression coming into the catalyst are just the sort of thing which allows managed futures/macro traders to systematically capture such moves.

So, with higher rates, a stock market sell off, energy markets breaking out, and added volatility expanding trading ranges as the likely positive catalysts in 2017, what about the downside? What possible pitfalls await the asset class?

Possibly Hurting Managed Futures/Macro

1) **Donald** Trump

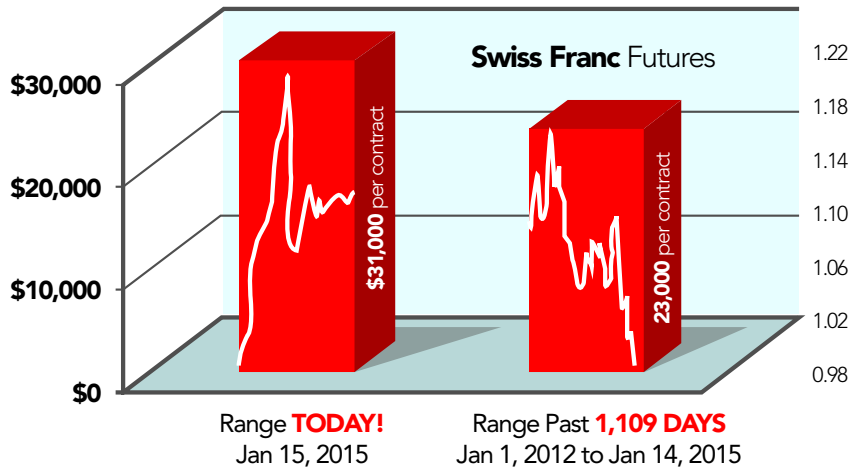
Wait! Didn't you say he could be helping? We sure did, we're cheating. But this is the king of quick tweets and unfiltered language, and that volatility producing style could just as easily produce the 'bad' kind of volatility (more on that in the next section) as the good kind. He could say he's banning all cocoa imports because he bit into the wrong piece in a box of chocolate; then announce a new chocolate statue initiative a few days later; whipsawing prices down then up and injuring systematic models which look to capture extensions of the initial moves.

But more seriously, Trump's penchant for panache could easily (and unwittingly) create more of what we call binary events. We're talking winner take all sort of market events like Brexit, the Trump

vote, Swiss Frank depeg, and so forth which have plagued systematic trading models for much of the past few years. We're talking ultimatums, deadlines, out of the blue directives, and so on which can spike markets quickly – with that spike not necessarily being the beginning of a secular move higher/lower.

Just go back to the Swiss Franc depeg event from the Euro as an example. The Swiss Franc moved more in just a few hours than it had in weeks.

Fig. 10: Swiss Franc Depeg from Euro



This is the pinnacle of frustration for systematic programs which are designed to capture outlier moves. Here was the mother of all moves, but it wasn't the type of outlier move they like. It's easy to say, "hey, don't be so picky." But they're designed to measure averages and ranges and model risk and reward based on previous patterns and data to identify potential outlier moves being generated over time. Oddly enough, they aren't looking for the outlier move to happen all at once. The type of outlier moves they look for are more like combinations of normal moves pushing prices to new highs or lows.

Imagine flipping a coin. Systematic models are setup to capitalize on an outlier event such as the coin being flipped heads 20 times in a row, risking, say… $0.25 to earn $5.00 in profit (a quarter for every correct flip). The binary events are like changing the game, saying we're going to risk $20 on the next coin flip, and then not play anymore.

The more ultimatums and deadlines we see out of Mr. Trump, the more binary market movement could become – with prices moving quickly to meet the new reality instead of building into a new reality over time. There's also the unscientific contrarian take on this… if everybody's expecting Trump to add "good volatility," will it really happen that way?

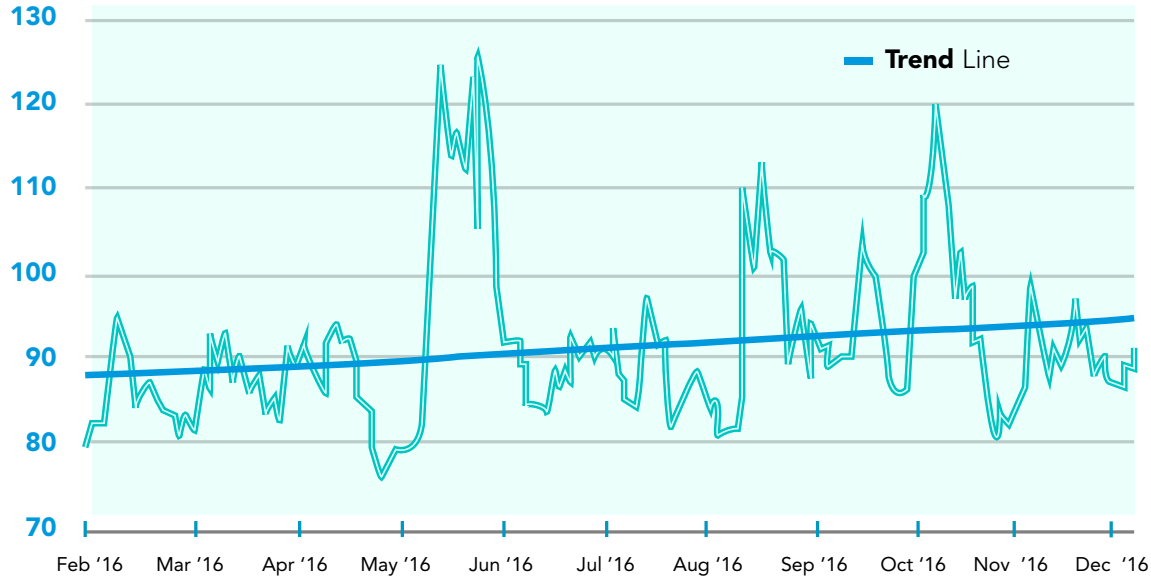
2) A continued rise in the volatility of volatility

Heavily related to the above, but slightly different, is a pattern we've been watching for a while which is a seeming increase in the "volatility of volatility." We're going to get into the weeds a bit here, but while volatility expansion can be good for managed futures – an increase in the volatility of that volatility can be bad. Volatility of volatility… what? Are we talking about a derivative of a derivative, which is an index of a derivative in the first place? Yes, traders call it, "the vol of vol" and the CBOE even has an index on it, called the VVIX.

> *"Every asset class deserves its own volatility index, including volatility itself. The VVIX Index is an indicator of the expected volatility of the 30-day forward price of the VIX. This volatility drives nearby VIX option prices. CBOE also calculates a term structure of VVIX for different VIX expirations. The VVIX or any*

point on its term structure is calculated from a portfolio of VIX options (VVIX portfolio) using the same algorithm used to calculate the VIX. Approximate fair values of VIX futures prices and their standard deviations are derived from the VVIX term structure. Selling a VVIX portfolio on a consistent basis can capture a volatility risk premium."

Fig. 11: Volatility of VIX



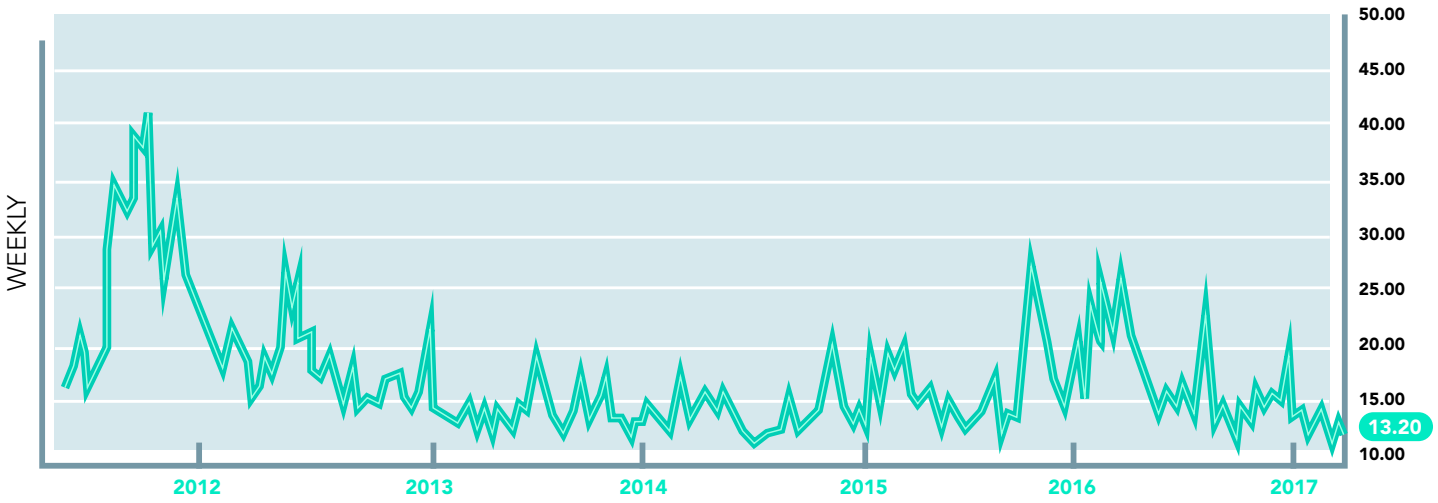
Past performance is not indicative of future results

What kills systematic programs is moves like the type described in the previous section (binary), where the volatility increases dramatically, and then disappears very quickly, as the move which caused the volatility increase either quickly snaps back in a V shaped reversal, or sits at the newly established level without the spike being the catalyst for further movement. This on again, off again, volatility can be described as volatility of volatility, which starts to make our head fell like is going to explode a little bit. This isn't easy stuff.

To simplify and show why this is bad for systematic programs, what if we think of volatility as the speed limit? When its higher, we can go faster, and make more time (money in managed futures case). Now think of the volatility of volatility as the number of times the speed limit changes. A new 100mph speed limit may decrease your commute time dramatically, but not if it only lasts for 200yds and is spanned on both sides by 25mph zones. In short, when there's an increasing number of changes, you'll get people speeding up, slamming on breaks, speeding up again, and more crashes. It's better to have one change, then another one in the same direction, then another, to create a streak of changes all in the same direction. There's less whiplash that way.

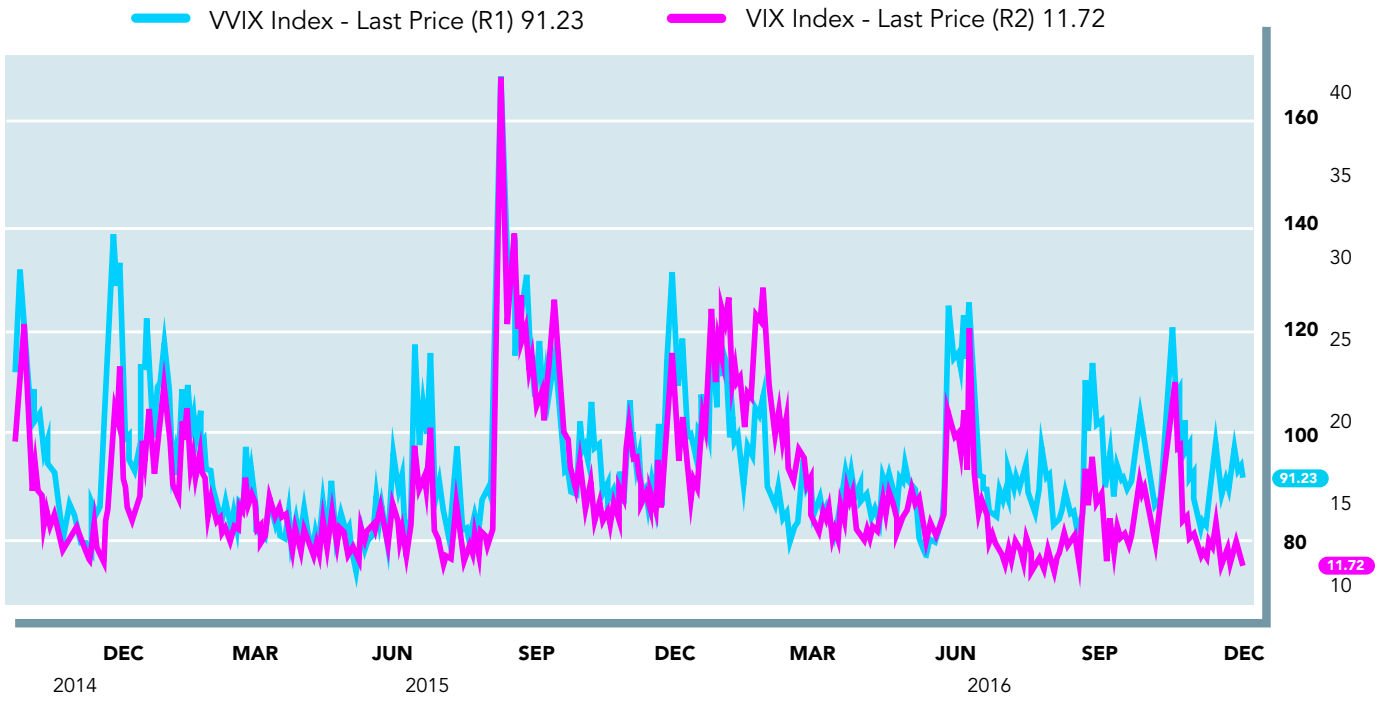
But the markets aren't your local highway. The whiplash has become a quite popular trade amongst hedge funds and even individual investors of late – buying (or selling VIX futures) into volatility spikes instead of panicking, selling (or buying VIX futures), and adding fuel to the spikes. The mantra of the 09-17 stock market rally has been BTFD (buy the dip for the politer amongst you), and much of that has been driven by this new "VIX smash" mentality. Just take a look at the VIX chart over the past few years, where you can see each spike quickly giving way to lower VIX levels, and those snap backs in volatility becoming quicker and quicker of late. There's no movement to new volatility regimes, just quick excursions outside of the low vol castle walls before heading back inside before dark.

VIX



What used to be a few weeks of worry has become days, if not hours. What used to be conversations about whether the VIX would hold over such and such level, has become "when will the VIX return lower?" What used to be a conversation about volatility has become a conversation about the volatility of volatility. Case in point, Bloomberg Editor, Joe Weisenthal tweeting not about VIX, but the price gap between the VIX and VVIX (the volatility of volatility).

VIX & VVIX PRICE GAP



Of course, there's a bevy of new managers who have modeled their strategies around just this sort of thing and analyze all angles of volatility. We'll leave their explanation of trading the vol of vol market to them.

3) Rising Rates / Rising Dollar

The U.S. Dollar Index has shown its muscle over the past couple of months, with one of its quickest run ups in recent history. Typically, a trending dollar – and specifically a rally in the U.S. Dollar index - has been very beneficial for Managed Futures. Part of the reason managed futures tends to do well when the US Dollar is trending, is because the U.S. Dollar index impacts almost all commodity futures markets simply because those markets are priced in the dollar. That means, for example, a falling U.S. Dollar can translate to falling prices in dollar denominated futures markets (all else being equal).

But here's where things get interesting. There's one dollar denominated market that doesn't tend to fall when the dollar's rising – Bonds. We've seen a rallying dollar before. We've seen falling commodity prices before. But it's harder to remember an extended period of time we've seen both a rising dollar AND falling bond prices (yields rising). Mainly because there haven't been many recent periods where bond prices were falling (rates rising).

Here's a quick and dirty look at the recent history of the Dollar and Bonds as compared to managed futures performance (see fig. 12).

Fig. 12: Prior Periods

UP DOWN SIDEWAYS

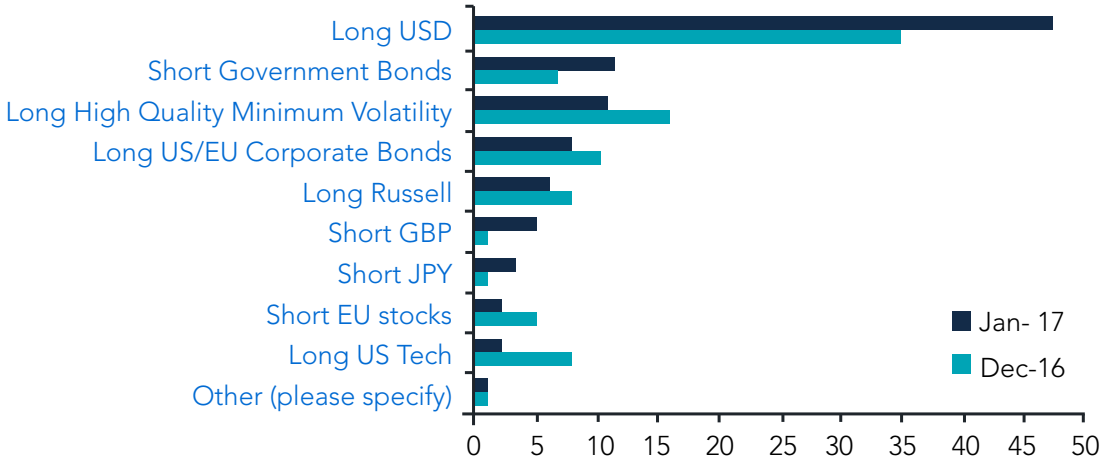
	DOLLAR	BONDS	MANAGED FUTURES
2000 – 2002:	↑	↑	↑
2002 – 2004:	↓	↑	↑
2004 – 2006:	–	↑	–
2006 – 2008:	↓	–	↑
2008 – 2009:	↑	↑	↑
2009 – 2010:	↓	↓ –	↓
2010 – 2014:	↓ –	↑	↓

Past performance is not indicative of future results

Basically, this is as unscientific as it gets... but our spidey sense is tingling and we're not sure an extended up-trend in the US Dollar can coexist with an extended down trend in bonds in a nice way, having really never seen a secular bear market in bond prices over the past 30 years. In the end, only time will tell if this will be beneficial to Managed Futures.

Of course, given the popularity of the long dollar trade, it's also more than possible that things reverse course; with the market always liking to inflict the max amount of pain on max amount of people. And look at who's second on the most crowded trade list – short bonds.

Fig. 13: What do you think is currently the most crowded today?



Past performance is not indicative of future results

Source: Bloomberg

4) **Managed Futures** Negative Carry Problem:

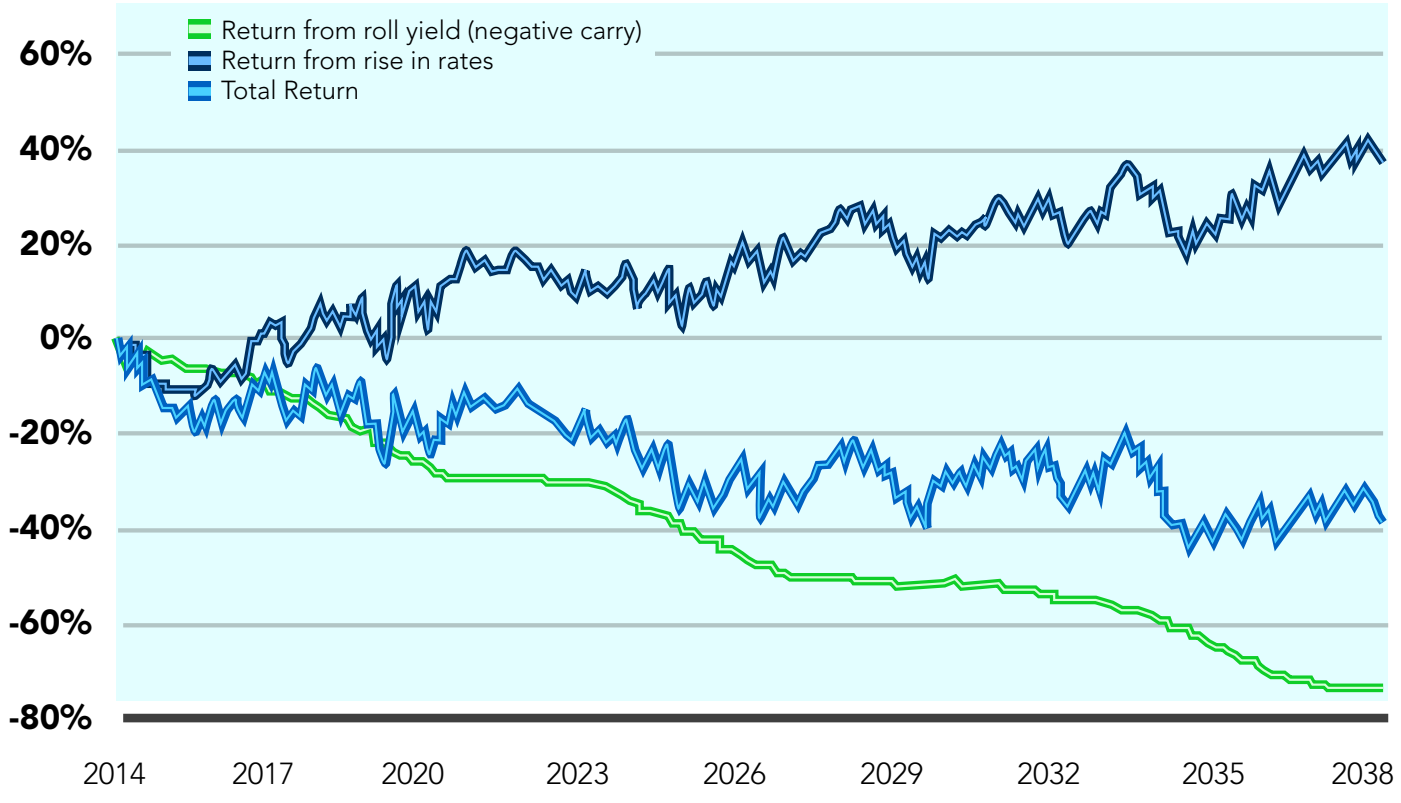
There are two camps in the Managed Futures space on whether falling bond prices (an uptrend in rates) will be beneficial to Managed Futures. The first is the generally accepted view that managed futures is a long/short strategy, and is just as profitable and capable of capturing big down trends in bonds (rates up) as it was in capturing the big up trend in bonds (rates down). This makes sense from a theoretical standpoint, and is intuitively correct. Managed futures models don't much care which way a trend moves, they just want to be involved in capturing it.

The second, more nuanced view, however, is that bonds' price structure might look much different on the way down (rates up), than they did on the way up. We turn to Roy Niederhoffer for this view, who argues that a downtrend in bonds/rise in yields would not be as profitable as the previous bond rally because of the negative carry associated with the trade. His modelling shows roughly two thirds of the return trend followers extracted from the bond markets during the 30 year bull run was due to the roll yield, and that if bonds remain in backwardation while interest rates go up – managed futures managers could lose that roll yield.

> *"[a short bond in modelling] yields a return of 36% from the rise in interest rates. The return from the negative roll yield, shown in green, is -73%. Obviously this vastly exceeds the 36% profit from being correct on the direction of interest rates. The blue line in Figure 3 shows the total return of a sell-and-hold strategy. Obviously, the -36% total return is not particularly attractive."*

The bottom line, says Niederhoffer, is: "An investor shorting fixed income futures in a rising rate environment will face a headwind of -6% per year compared with an investor being long the same futures markets in a declining rate period, all else being equal."

Fig. 14: The Negative Carry



That last part is the million dollar input, of course. Will "all else be equal" stand true?

It's not too hard to imagine that the shape of the price curve will change along with the direction of the trend, moving to a point where eventually traders may be thinking future rates will be lower than the rising rates we're going into, thereby switching that roll cost on short trades to a roll yield. Only time will tell – but this is an interesting dynamic which managed futures/global macro haven't had to deal with in around 30 years, although they've dealt with shorting markets in backwardation plenty. It's not the kind of thing that will cause large asset class losses, but could be just the thing which leaves people wondering/asking why managed futures didn't do even better than they did with the big down trend in bond prices.

Conclusion

That's all we've got for now. Actually, we have more - like managed futures likely to suffer in the early parts of a stock sell off, like discretionary Ag traders due for a big year, and the rhetorical question of what happens when everyone is selling weekly options - but are trying to keep this from becoming a small novel.

In the end, managed futures and global macro will do what they do in 2017. They'll analyze these contracted ranges in all sorts of markets and crave breakouts and outlier moves from those compressed, ready to spring, levels. They'll hope that Mr. Trump adds the good kind of volatility, and we avoid more of these binary market events where millions of algorithmic fingers are poised waiting to hit the button as soon as the [fill in the blank] happens.

Of course, a big year would come from true Black Swan events, events that don't already have 20 articles written on it by different financial journalists, and ones not covered here. The biggest outliers come from way off the radar. A good year will come from a normal expansion of volatility and resulting trends. And a bad year will come from continued low volatility readings across markets and time frames.

It sure feels like one of the most unpredictable years in recent memory, with no financial crisis to unwind, debt to be tackled (there's plenty of it, just not talk of it), wars to be fought, etc. Not to mention stock markets at all-time highs and looking toppy and interest rates set to have their first meaningful rise in nearly a decade. But here we are at the start of the year with volatility at historic lows per the VIX. What gives? And who's right? The volatility sellers or buyers? The answer to that will likely drive managed futures/macro performance this year. Either way, it's bound to be a fun ride, and we're thankful for all those who are coming along.

Jeff Malec, CAIA
Managing Director & Partner

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*Pg. 2 Source: All ETF performance data from Morningstar.com
Sources: Managed Futures = SG CTA Index, Cash = 13 week T-Bill rate,
Bonds = Vanguard Total Bond Market ETF (BND),
Hedge Funds= IQ Hedge Multi-Strategy (QAI)
Commodities = iShares GSCI ETF (GSG);
Real Estate = iShares DJ Real Estate ETF (IYR);
World Stocks = iShares MSCI ACWI ex US Index Fund ETF (ACWX);
US Stocks = SPDR S&P 500 ETF (SPY)

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We believe education means more than just a glossy brochure showing how managed futures is non-correlated to the stock market. We believe it means ongoing analysis of what's happening now, not just what happened over the past decade; and we provide daily research and commentary via our popular 'Attain Alternatives' blog covering all things alternative investments, as well as periodic whitepapers digging deeper into topics, guest posts by fund managers, and more.

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