Janus Henderson Multi Strategy – overview

Q2 2023 For professional investors only

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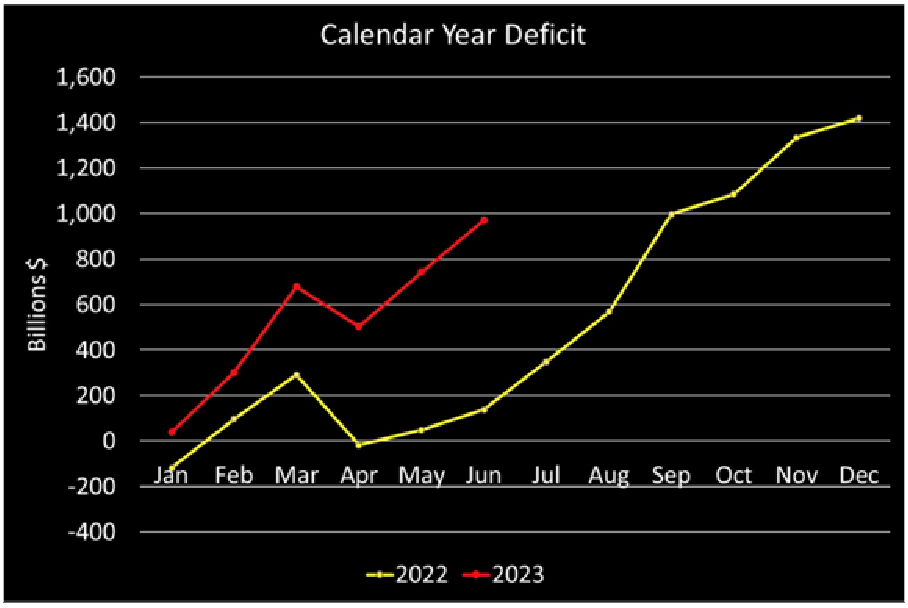
A world in flux merits increased communication. This series outlines the way we see the world, provides our ongoing view on the shifting opportunity-set for our seven overarching strategies, and addresses any issues where outcomes have disappointed. As with any multi strategy process, the positioning and return achieved by the team is a reflection of many inputs and approaches. Here, the views will be my own, but I will attempt to provide a distillation of the expert and diverse views across the team.

Operating environment:

The long-awaited recessionary reaction to an unprecedented rise in yields throughout Western economies has delayed its appearance. Inflation continues to fall as we expected at the end of the first quarter of 2023, but this has not been accompanied by a material deterioration in labour market conditions. The combination of higher yields and lower inflation has in many places lead to significantly higher real yields (the UK being perhaps the exception – more on that later).

Positive real yields and continued deterioration of monetary aggregates we expected – the blasé reaction was more of a surprise. Modest bounces in housing data, for example, leaves me scratching my head. What can account for the robustness in the US economy? In Q2 it became belatedly clear that populism on both sides of the political divide will be accompanied by unprecedented fiscal laxity – maybe with different target recipients but equally untethered from historical limitations. The US deficit soared to a total running at 9% of GDP in the first half of the year. We are not officially at war (yet), nor in a recession (yet) – in fact employment is incredibly robust.

Chart 1: The US economy remains robust, despite a burgeoning US deficit



Source: Bloomberg 1 January 2022 to 30 June 2023.

The main drivers:

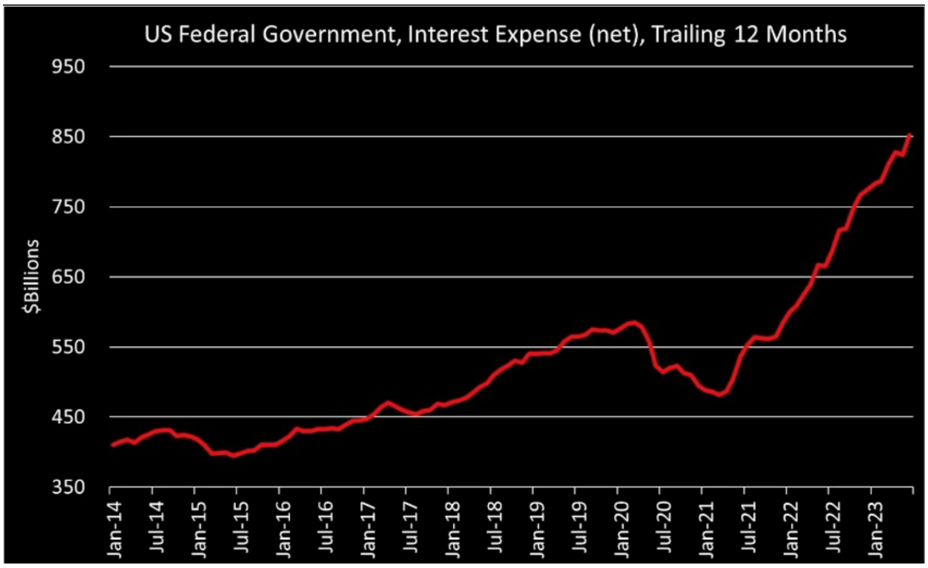
1) Employee Retention Credit (PPP) continues to run amuck two years after the average citizen put the pandemic behind them.

PPP receipts in 2023 (by month, US dollars)

January	February	March	April	May	June
$19.5bn	$14.6bn	$15.9bn	$17.7bn	$23bn	$28.8bn

2) The Inflation Reduction Act heads toward US$1 trillion of subsidies in semi-productive investments and shows itself in growing manufacturing construction employment numbers.
3) The reluctance to give up student loan forgiveness despite the US Supreme Court blocking his US$430 billion plan.
4) An unprecedented non-recessionary fall in tax revenues by almost 10% year-on-year.
5) A huge leap in the cost of deficit funding (Figure 2), reflecting both higher yields and the very short average duration of US government debt. The growing losses experienced by the US Federal Reserve (Fed) on its enormous pool of QE-purchased stock, recognised in negative carry, has generated a funding requirement in place of a revenue source for the US Treasury.

Chart 2: The collapse of SVB saw an inflection point in rates expectations



Source: Bloomberg – 1 January 2014 to 30 June 2023

On one side of the economy, we see the consumer, who wisely locked in financing rates at negative real yields, clinging on to the free rates optionality that US 30-year mortgages bestow, and robust corporate balance sheets fortified through the same rates opportunity (less the free option of course).

On the other side, we see a government sector balance sheet unusually exposed to rising rates, given its historically short average duration. The resultant fiscal injection into the economy I believe is what has kept the economy out of recession. Combine this with the stealth QE balance sheet expansion that accompanied the stealth banking crisis in the first quarter of 2023 and the economy rumbles on.

Looking forward, we must seek market restraints on the fiscal largesse or should assume that it will continue into the 2024 election – there is now no meaningful constraint over debt until January 2025 after the new US Fiscal Responsibility Act effectively ruled out the possibility of a default. While the market anticipates falling rates and continued disinflation to steepen the yield curve, it is possible that any such steepening could have bearish consequences, rather than bullish, and the market will reject the supply of debt forthcoming. Particularly if US Fed Chair Powell is good to his word and QT continues (I have re-entered the 2-10 steepener, being agnostic of its nature but convinced that it cannot sustain at these unprecedented inversion levels).

Markets are thereby caught between the positive of rising real yields (negative for risk assets) and unbridled spending by governments (an unmitigated positive for equities exposed to this level of spending). Unlike the UK, where a sniff of similar behaviour during Prime Minister Liz Truss's short tenure saw markets soundly rejected the prospects of unfinanceable deficits, the US shows no such bond vigilante behaviour – the Fed is sure to back stop if the recession appears after all. Only the recent weakening of the US dollar raises an eyebrow, perhaps.

Strategy implications:

The above macro juxtapositions have been challenging for our investment strategies during the first half of the year. In particular, Equity Market Neutral, where we have added risk, Macro protection and the systematic Trend and Commodity Alpha strategies.

However, the improving opportunity set underpinned by the transition from quantitative easing (QE) to quantitative tightening (QT) remains a strong, positive undercurrent for our strategies and is providing us with opportunities to increase risk exposures. Additionally, carry in our Systematic Long Volatility has improved and remains an important part of our risk control, should these gyrations manifest into dislocations, giving us the ability to deploy capital counter cyclically.

Glossary:

Steepener trade: Buying short-term Treasuries and shorting longer-term Treasuries to take advantage of a steepening yield curve.

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GCC: 200-99-122913 07-23