Janus Henderson Multi Strategy – Overview

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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 are my own, but I will attempt to provide a distillation of the expert and diverse views across the team.

Operating environment:

"You were only supposed to blow the bloody doors off."
Michael Caine as Charlie Croker in 1969's The Italian Job

It appears it can go on – for a little while yet at least! Government expenditures grew an upwardly revised 4.9% year-on-year in the third quarter of 2023, more than offsetting wobbling consumer sentiment. Getting up after getting knocked down is not just an important part of being a successful investor, but in every aspect of life. Like investing, life rarely proceeds smoothly from one period to the next. I believe our teamwork and our tenacity in pursuit of better client outcomes, is one of our most undervalued virtues.

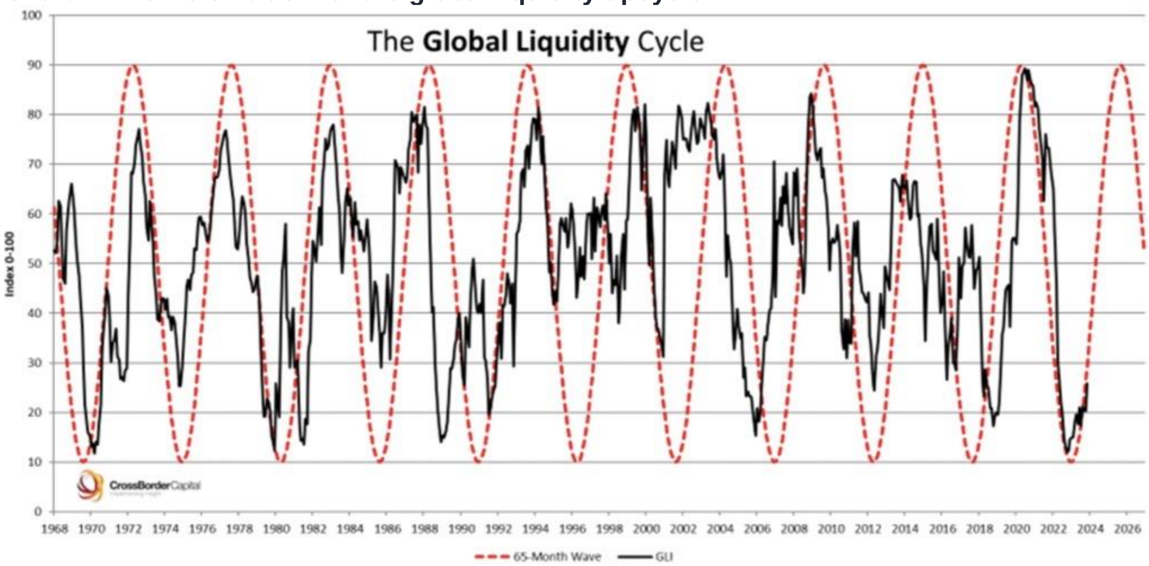
It is not just getting back up, however. Equally important is taking a long hard look in the mirror and assessing what went wrong, what could be done differently, and whether there are ways to reduce the probability of adverse outcomes recurring in the future.

As I struggle to gauge the lingering effects of monetary and fiscal largess over the post-COVID period I cannot help but wonder if Jerome Powell, Chair of the US Federal Reserve, had a similar opinion to Charlie Croker when talking fiscal policy with Treasury Secretary Janet Yellen. The long lags inherent in monetary policy, the constant on/off contraction of the balance sheet (running scared of plumbing and financial system accidents) and the nonstop fiscal giveaway all combined to make cyclical projections very hard for the last 24 months. This of course has been reflected in the apparently schizophrenic reactions of the front of the US yield curve – from more hikes to complete policy reversal in less than three months.

As I look forward to 2024, several factors give me pause on both sides of the 'recession or no landing' ledger. Here are a few:

- Circa US$11 trillion sits in cash in the US, between money market funds, T-bills, and CDs. How will that ocean of liquidity behave if rates (particularly real rates) fall back toward zero? In late 2023, we saw retail investors rush to increase their equity exposure, and once again the high-end real estate market perked up (mostly cash transactions). Is this a foretelling of what will happen if Powell blinks?
- At the Board of Governors of the Federal Reserve System, there are 97 Democrat economists and only two Republican economists – a ratio of 48.5 to 1 (Independence Institute data as at fall 2022). Coming into the 2024 election cycle, and with partisanship apparently never more extreme, it would seem logical to expect monetary policy to have a profoundly dovish bias all else equal.
- Focusing Treasury issuance into the short end of the curve has driven a rapid unwind of the Reverse Repo facility (very tax inefficient for money market end investors), exacerbating a structural underweight in investor duration exposure over the last few years, and with inflation falling faster than expected. The consequence: a face-ripping rally in bonds. New funding announcements in 2024 should have material effects, especially if met with an end to quantitative tightening. Is there a risk that Yellen continues to focus on the short end, and duration supply is much less than currently priced in?
- Debt forgiveness is the new normal. Whether it is student loans, 'Buy Now Pay Later' facilities, or mortgage foreclosure forbearance, there seems to be a widening of the bail out mentality toward the bottom of the economic hierarchy (sometimes expressed as the cycle of wealth redistribution away from wealth accumulation). Spending what you don't have without consequence may give us pause as to the behaviour of seemingly debt-burdened consumers, at least in the short term.
- The current US administration has its foot firmly planted on the fiscal accelerator, with the deficit running at c.6.5% of GDP (combined with a c.5% GDP trade balance). There are apparently only external constraints and political inhibitions to this largess – the former apparently not yet binding and the latter in full focus in the first few months of 2024.
- The global liquidity cycle appears to have bottomed – driven in no small part by a growing recognition in China that the economy needs sustaining. This has been accompanied by increasing support of the manufacturing sector to balance the rapid and enormous contraction in the property sector. Chart 1 above all others gives me a bullish pause for thought.

Chart 1: Are we on track for the global liquidity upcycle?



Source: CrossBorder Capital, Global Liquidity Index modelled against a 65-month liquidity cycle. 31 December 1967 to 30 September 2023. ***Past performance dues not predict future returns. There is no guarantee that past trends will continue, or forecasts will be realised.***

Unsurprisingly, with all the above in mind, corporate earnings and real wages have remained far more robust than many (me included) would have imagined at the beginning of 2023.

On the opposite (less positive) side of the balance ledger:

- Data suggests there is indeed a weakening of the US labor market, and this is finally creeping into the service sector side of the economy.
- The prospects of a shutdown in the US government in Q1 are (in my view) far greater than the market currently prices. If politics is so broken that nothing is done to mitigate the massive scale of illegal migration into the US, despite an almost universal public consensus that something must be done, then finding a way through the budgeting process seems a very remote prospect in my opinion. The impact of a shutdown would be quite dramatic and is underappreciated.
- Geopolitics continues to be “the dog that barks but does not bite”. The impact of trade flows, costs, and the cleavage of technology solutions into at least two non-connected worlds remains my number one concern in the medium term.
- The US housing market – like most markets in the US – appears to be divided into the wealthy and the rest. While Architectural Digest-worthy homes continue to increasingly transact off market (it is not just debt markets that have gone private) the multi-family and more normal sections of the market appear far less robust. I am convinced that there is no inventory shortage – it is simply sitting in the short-term rental sector. The Airbnb bubble is real in my opinion and will unwind if there is any hint of a meaningful recession. Watch the decline in long-term rental costs start to reflect the increased supply from multi-family completions and Airbnb tourists react to a dearth of short-term renters. While US housing has a very large moat around it, created by the optionality inherent in the structure of the US residential mortgage market, natural life cycles of death, job movements and family builds should, over time, generate a normalization of house prices, if financing costs do not rapidly reduce the cost of purchase.

Balancing all these factors is of course the essence of investing. Currently, I find the bullish components hard to ignore, while remaining cognizant that many of the negative factors have the ability to significantly impact asset prices if they come to the fore – producing materially skewed potential left-tail risks.

One factor that currently allows balance in a multi-strategy portfolio is the decline in equity volatility and a lack of downside skew, which perhaps reflects a lack of fear about negative outcomes, which makes me wonder if the ‘Fed put’ is being priced back in. Systematic exposure to this type of protection at current pricing can potentially enable investors to take more exposure to some of the positive factors outlined above, while running what appears to be underpriced insurance to the negative factors. 2024 looks to be interesting times indeed.

Strategy implications:

Ex post, we have erred on being overcautious over the last 18 months. What has materially improved, in my view, is that the price of volatility in equity markets has become much more attractive, allowing us to return to our 2019 approach to left-tail hedging. As volatility declines, we must remember there is an almost mechanistic tendency for markets to build leverage and risk. Volatility cycles are varied in time, but more certain in path. This allows us to take more risk in our core portfolio while maintaining our highly convex portfolio protection positioning. It is this balance between recognizing and participating in what may be an ephemeral positive investment environment, with a constant focus on what can go wrong, that I believe characterizes our approach to managing client funds. The environment has improved materially as fear is priced out of equity markets.

Over the holidays I found time to do a little off-piste reading, which included a collection of letters from the late, great English writer Evelyn Waugh. It perhaps acts as a reminder that excessive use of force can have greater impact than is immediately apparent. It also made me smile:

“Writing to his wife in May 1942, Evelyn Waugh recounted a true story of military derring-do. A British commando unit offered to blow up an old tree-stump on Lord Glasgow’s estate, promising him that they could dynamite the tree so that it “falls on a sixpence”. Col. Durnford-Slater DSO said to his subaltern, “have you put in enough explosive in the tree”? “Yes sir; 75lbs”. “Is that enough?” the Col. asked. “I worked it out by mathematics, so it is exactly right” the subaltern replied. “Well put a bit more so we don’t disappoint”. And then after his port he told the Subaltern to put in a little more just to be sure.

After completing their boozy lunch, they all went down to witness the explosion. But instead of falling on a sixpence the tree-stump rose 50 feet in the air, taking with it half an acre of soil and a beloved plantation of young trees. A tearful Lord Glasgow fled to his castle only to discover that every pane of glass had been shattered. He then ran to his lavatory to hide his emotions, but when he pulled the plug out of his washbasin “the entire ceiling, loosened by the explosion, fell on his head.”

Perhaps Yellen and Powell should learn the lesson – more is not always better!

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