20 Seconds

The macro outlook is benign and it seems that the fiscal and monetary policies of the world have brought about some kind of normalcy and equilibrium.

There is consensus that equities should rise, government bonds will struggle, commodities and precious metals will appreciate, the USD will resume its weakness against the emerging market currencies and the Euro will decay or decompose.

In non-extreme states the consensus is usually a reliable guide and we are not at an extreme, except perhaps in sovereign debt.

US economic growth will likely trundle along at a healthy pace, abetted by the Fed's funding of government largesse. Never underestimate the effectiveness of a blunt instrument as an all purpose tool. This is view is true for most economies.

Inflation is elevated almost everywhere except in the US where it is a paltry 1.1%. This is an area of potential risk.

Investors have tolerated money printing and low interest rates in the US because the labour market is loose, growth while positive is 2.6%, short of a 50 year trend rate of 3.3% and inflation is a paltry 1.1%. If inflation was to surprise on the upside, the reaction in the fixed income markets could be significant. Inflation is already under-measured due to the 25% weight of owner equivalent rent in the CPI and is closer to 3.5% than 1% assuming a double dip in housing is underway. Already the breakevens are saying 2.5%.

The implication for US equities is as significant. With economic growth as sluggish as it is, the spectre of inflation may suggest a higher structural NAIRU and a world where inflation is higher for each level of economic growth. This is the opposite of the 90’s Goldilocks economy where high growth coexisted with low inflation and low interest rates. The share of manufacturing in the economy is an explanatory factor. Almost everywhere manufacturing is driving the global recovery. Whatever the cause, high inflation and slow growth is not a desirable outcome.

Be that as it may, we now have a catalyst to look out for.

As long as governments are fabricating money, anything that cannot be extracted, manufactured or grown faster than the printing presses will appreciate.

Equities rarely track economic growth tightly or in phase. Equities are likely to be driven by macro factors for another year which means appreciation driven by fiat money debasement. Idiosyncratic risk is likely to continue to rise, albeit slowly. The recovery of idiosyncratic dispersion has been glacial since the crisis with performance dispersion being explained mainly by rotation through thematic macro and country factors. This is a difficult environment for the fundamental stock picking long short manager. A thematic trading manager will find easier pickings.

On other fronts, the number of M&A deals has steadily risen. Cash on balance sheet, successful refinancing of debt and low interest rates has brought a moribund market back to life. Even PE sponsored MBOs and LBOs have begun to resurface. The appreciation of acquirer prices is likely to embolden more CEOs fuelling more activity. Merger arbitrage funds are likely to see more opportunities going forward.

Governments’ pump priming has lead to wafer thin yields, increased debt issuance and desperate investors feeding a refinancing frenzy in 2010 so much so that default rates have dwindled as even the weak postponed their fate. The opportunities for distressed debt investors will definitely be less rich than last year. They are likely to get another chance. In the meantime, it pays to be extra discriminating when hiring a distressed debt manager.

Predicting the fortunes of macro funds is a tricky exercise, like riding a bicycle backwards. Macro will have ample opportunity to shine (or burn) given how macro driven markets have become. This is likely to persist at least until macro falls out of investors' focus. The caveat is that the opportunity to get it wrong is quite great as well. Central banks telegraphing their intentions provide tailwinds to macro but particularly in the fixed income area.

Trend followers have done an average job. There have been a couple of reversals in the market but by and large markets have been well behaved enough for algos to take hold. Again fixed income has been easier for trend followers.

Convertible arbitrage has settled into its old cycle of rotation through gamma, vega and delta strategies as the market has unfolded. Issuance has recovered a little but no to pre crisis levels. Asia is the exception where issuance has been robust and arbs have been quick to take advantage.

Pure vol strategies have struggled, especially structurally long vol strategies. May provided a spike in vol but otherwise vol has trended down in a normal pattern. The trend has been so consistent since June that vol arbs should have been able to adjust. Many didn't as they are chronically long vol or were unable to short vol and cover the tails.

For relative value and arbitrage, there is no new or old normal. As long as markets are liquid and the rules are known, these strategies will return to normal, and they have already. Moreover, the arbitrage opportunities have been sufficient for these funds to generate good returns at lower levels of leverage than prior to the crisis.

It's a good time to be investing in arb and rel val.