The implications of post-peak liquidity and the case for the Polar Capital Global Absolute Return Fund

Introduction

In May last year, we highlighted the emerging inflationary risks in our report *What is Driving Inflation?*. In it we predicted "multiple CPI prints over 5% [are] possible and, perhaps, likely…we do not believe that markets are priced for this possibility and consequently tail risk has grown for duration-sensitive assets." Since then, as is widely known, that is precisely what has happened.

Here, we examine the implications, arguing the inflation that we have already seen has fundamentally changed the investment landscape by forcing policymakers to accelerate liquidity reduction – which we argue has been responsible for much of the past 13 years' advance in asset prices. Consequently, we suggest the current focus over the durability of inflation is misguided and investors should instead be focusing on the implications of this shift in macroeconomic policy and asking themselves: 'If surplus liquidity provision provided a tailwind to asset prices, will a reduction in surplus liquidity provide a headwind?'.

The answer to this question has profound implications for all investors. In the analysis below, we explain why we believe that the answer to the above is 'Yes' and explain why, if correct, this would imply that the coming years will look very different to the past decade.

We go on to discuss the characteristics of the Polar Capital Global Absolute Return Fund and how, against this backdrop, we believe the Fund is well positioned to generate strong absolute and risk-adjusted returns.

Liquidity, Beta and asset price inflation

In the wake of the global financial crisis, the US Federal Reserve, followed quickly by other developed market central banks, embarked on one of the largest macroeconomic experiments of all time. Interest rates were cut to historically low levels where, besides a brief period of normalisation prior to the outbreak of COVID-19, they have stayed for over a decade. At the same time, public balance sheets exploded as central banks, in an attempt to monetize away all problems, flooded economies with liquidity, with the Federal Reserve ultimately owning nearly one-third of all US Treasury debt. Taken together, these two steps formed the basis of Quantitative Easing (QE), the driving force behind financial markets for the past 13 years.

This exceptionally accommodative monetary policy unleashed the greatest bull market the world has seen in modern times. As shown below, the S&P 500's 16.74% annualised return in the years since the March 2009 low is larger than any post-war decade-long advance, exceeding even the 16.5% annualised gain from the 1987 lows to the dot-com highs. Moreover, the uninterrupted 3.5 standard deviation move relative to the nearly 100-year trend is also a first, with only the three standard deviation move from 1987 to the dot-com highs coming close.

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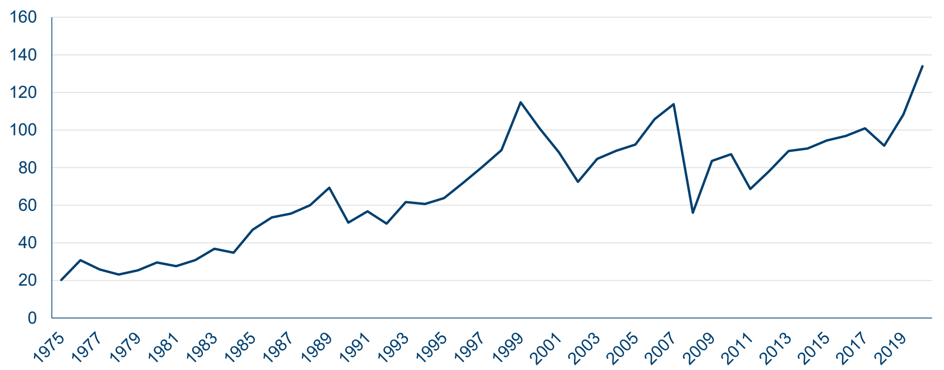
"QE gave investors both the means and the incentive to buy risk assets in an almost price-insensitive fashion"

S&P trend and regression since 1929

Source: Bloomberg; data at February 2022.

The manner in which this was accomplished is simple and now well-understood. By both back-stopping risk and crowding-in investment by driving risk-free returns to zero, QE gave investors both the means and the incentive to buy risk assets in an almost price-insensitive fashion. As a result, it was not just prices but also risk asset valuations which expanded significantly as the market cap of equities as a percentage of GDP rose to all-time highs, as shown in the graph below. Moreover, this valuation increase was not limited solely to risk-assets as, according to Goldman Sachs, both Equities and Bonds are in the 100th valuation percentile of their history – the first time this has happened simultaneously since the late 1920s.

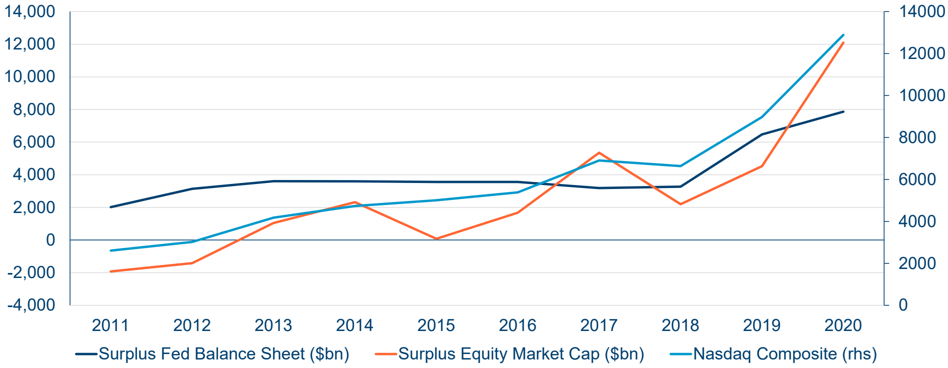
Global equity market cap to global GDP



Source: World Bank; 16 December 2021

The graph below makes the direct causality very clear. It shows that the growth in the relative market cap of US equities is explained almost perfectly by the growth in the Fed's balance sheet, clearly demonstrating the direct, causal effect that central bank liquidity provision has had on asset values.

Fed balance sheet growth versus equity capitalisation growth



Source: World Bank; US Federal Reserve. 31 December 2021.

"Liquidity provision is beginning to have a net negative effect on overall wealth and income"

These elevated prices and valuations imply the potential for forward-looking returns have diminished and are heavily dependent upon continued excess liquidity provision, making an understanding of the macroeconomic policy framework critical for all investors.

Inflation and macroeconomic policy

Unfortunately, we believe the emergence of inflation has changed the calculus for central banks. The loudest concern raised against QE is debasement of the currency – that by issuing so much money (liquidity), central banks would engender significant inflation. For all practical purposes, this is the primary constraint on liquidity provision because, if monetary easing does not engender inflation, then it results in 'pure' wealth creation: a rising tide of wealth that benefits all. It is only if inflation occurs that there is a direct cost associated with QE as those who are not recipients of the liquidity provision find that inflation has made them worse off in both an absolute sense and relative to those fortunate to receive central bank largesse. Taken to an extreme, this inflation can end up overwhelming the positive benefits of QE. For example, if monetary easing creates an additional 1% growth but causes 2% inflation then the economy as a whole ends up 1% worse off in real terms.

However, this constraint has been absent for the vast majority of the experience with QE. Through 2020, inflation remained low despite negative real interest rates and a 7x increase in the Federal Reserve's balance sheet.

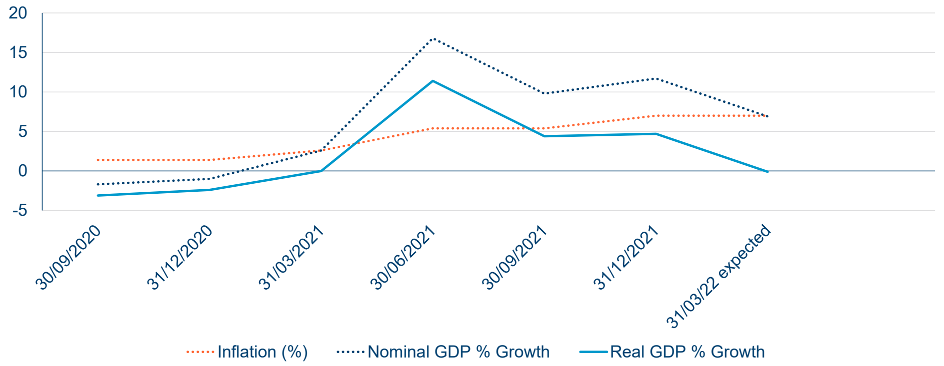
However, the policy response following the emergence of COVID-19 has broken this trend of benign inflation by vastly accelerating the liquidity provision. In a single quarter, the US Federal Reserve quadrupled the size of the US Money Supply (M1) and ultimately increased it by nearly 80% of GDP. Although this supported economic growth, it has also helped create the inflation we warned of last year, as shown below.

Over the past year, inflation has continued to rise and now threatens to durably exceed GDP growth, thereby overwhelming the positive effects of the Fed's liquidity provision. Since first becoming unstuck, inflation has rapidly caught up to GDP growth and, on consensus figures, will exceed nominal GDP growth in the first quarter of 2022. As growth slows further in later quarters that do not benefit from the easy comparison relative to periods disrupted by Covid and lockdowns, this reduction in real economic output threatens to become more significant.

This implies that liquidity provision is beginning to have a net negative effect on overall wealth and income. By extension, this implies that the limits of liquidity have likely been reached.

> **“Beta will be less ample and more variable in the coming years. Investors who have become accustomed to buying the dip should therefore expect to require more Alpha-centric strategies to deliver returns”**

GDP growth: real versus nominal



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, 31 December 2021; Bloomberg, 10 February 2022.

Within this context, it is easy to understand why, during his latest Senate testimony, Chairman Jerome Powell indicated that the Federal Reserve will reduce the balance sheet “sooner and faster” and will not be dissuaded by movements in asset prices. In particular, when asked whether market movements would affect Fed policy, he clearly answered in the negative saying “our ultimate focus… is on the real economy… and price stability.” In very simple terms, Powell made clear that he accepts inflation has now begun to preclude liquidity provision and that liquidity reduction is required, regardless of the path of future inflation.

Thus, the question is not whether liquidity will decline, but by how much.

The Importance of Alpha

As noted above, we believe that this reality has huge implications for asset price returns in the coming years and, by extension, investors’ asset allocation decisions.

In short, the reduction in liquidity suggests Beta will be less ample and more variable in the coming years. Investors who have become accustomed to buying the dip should therefore expect to require more Alpha-centric strategies to deliver returns. This argues strongly that investors should be increasing their weight to absolute return, market neutral and uncorrelated strategies in general.

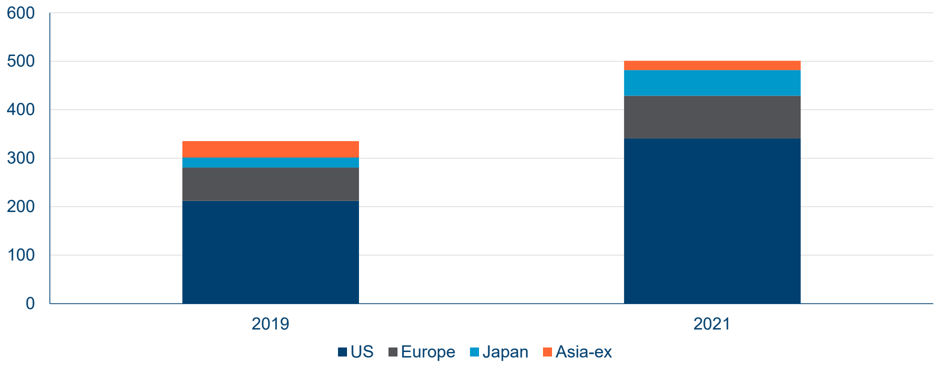
Moreover, the reduction in liquidity and associated increases in interest rates imply an environment characterised by higher volatility for risk-asset pricing as well as ongoing levels of high dispersion, especially relative to the past decade of historically high correlations.

We believe these provide highly opportune conditions for absolute return convertible strategies in general and the Polar Capital Global Absolute Return Fund (ARG) in particular. This is because convertible bonds are the sole major asset class with a positive correlation to volatility as higher levels of volatility increase the value of the call option embedded within convertibles.

Moreover, thanks to robust issuance, the size of the convertible market has grown significantly, increasing by over 50% in the past two years, as shown in the chart below. This has resulted in one of the broadest opportunity sets for the asset class in memory.

Convertible bond markets are thus likely to benefit from both valuation tailwinds and an unusually large opportunity set. This set-up makes convertible bonds extremely well positioned to generate solid absolute returns going forwards; moreover, when compared to the potential for headwinds in Beta-sensitive assets, this makes their risk-adjusted potential extremely compelling.

Convertible market capitalisation ($bn)



Source: BoAML, 31 December 2021

The case for the Polar Capital Global Absolute Return Fund

Even among other absolute return convertible bond funds, we believe ARG is especially well placed to benefit from these developments. This Fund is differentiated compared to its peers in its design and construction in ways that are particularly suited to the current investment landscape. It is designed to generate Alpha through five primary strategies which should enable it to do so in all market conditions, as described below:

- **Equity hedged**

These "classic" convertible arbitrage trades access the volatility in the option embedded within convertibles. By focusing on attractive profiles and companies with strong credits and known equity catalysts, these can create strong lower-risk opportunities to profit from movements in share prices.

"This Fund is differentiated compared to its peers in its design and construction in ways that are particularly suited to the current investment landscape"

- **Asymmetric**

These are "long" convertible trades in which the Fund identifies attractive risk-adjusted opportunities to benefit from increases in a company's share price. These trades are informed by the research process underpinning the highly-successful $1bn long-biased Global Convertible Fund that is run by the same team.

- **Put profiles**

These are "short" convertible trades in which the Fund identifies attractive risk-adjusted opportunities to benefit from declines in a company's share price. The Fund looks for both attractive convertible profiles that generate very strong risk/reward opportunities as well as companies whose share prices the Fund's research determines to be over-valued.

- **Income/defensive**

These are "bond-like"opportunities. These are typically trades where the Fund's fundamental research indicates that the credit is attractively mis-priced and/or the Fund's fundamental research indicates that the equity has a "fat right tail" and the option has more value than the market assumes, essentially "paying the Fund to wait".

- **Call writing**

The Fund has the ability to overlay call writing as hedges for a long convertible position, enabling it to profit from volatility discrepancies across markets or capture premium in situations where its fundamental research indicates a lack of near-term equity catalysts.

We believe this structure provides ARG with a uniquely broad set of Alpha-generating opportunities which not only enable it to make consistent returns throughout any market cycle but are also particularly well suited to the current environment. Specifically, we note that:

- **ARG is structurally long volatility:** Due to long convertible bond positions being the basis for all trades, ARG will have tailwinds if and as market-realised and/or implied volatilities increase.
- **ARG is inherently risk-controlled:** The Fund's trades are all designed to enable it to control for risk by identifying the maximum loss on any trade a priori, sizing it accordingly, and thus mitigating drawdown potential.
- **ARG is long both volatility and dispersion:** By being able to take long and short positions in addition to hedged strategies, ARG is able to be not only long volatility but also dispersion. Dispersion, we believe, is the most interesting current characteristic of the equity market. For example, more than 50% of NASDAQ-listed stocks have fallen over 50% from their peaks, yet the index remains near all-time highs. Being able to buy those equities that have fallen and short those who have not, and do so in the risk-controlled manner convertibles enable, is a highly attractive opportunity.
- **ARG is market neutral:** ARG equity exposures are limited to up to 20%, long or short, except in exceptional circumstances. Since inception, the Fund's average net equity exposure is only 8.4%.
- **Peer-leading risk control:** Risk control is at the heart of the ARG investment process. In particular:
    - The Fund is fundamentally driven with credit analysis core to investment decisions, ensuring we retain maximum capital protection capabilities.
    - The Fund's trades are inherently designed to mitigate capital loss potential. Drawdown risk is identified at the outset of trades and managed dynamically; trades with loss potential that exceeds tolerances will not be considered.
    - Low leverage: the Fund's strategy does not require much leverage to generate returns and typically operates with materially less leverage than typical convertible arbitrage funds.
    - The Fund utilises macro hedge overlays to further reduce risk, when appropriate.

"We believe [The] Fund has a uniquely broad set of Alpha-generating opportunities which not only enable it to make consistent returns throughout any market cycle but are also particularly well suited to the current environment"

Taken together, these imply ARG is in a highly opportune position. Its strategy is designed to profit from the forces we feel will dominate investment returns in the coming years: Alpha, volatility and dispersion. Moreover, the Fund's focus on risk control is perfectly suited to what are likely to be more challenging trading conditions going forward.

In conjunction with the historic size of the convertible opportunity set, we are hugely excited about the potential for ARG to generate strong absolute and risk-adjusted returns and believe it can play a crucial role in helping investors navigate the challenging market environment.

Polar Capital Global Convertible Team

10 February 2022

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