

Soft, Hard or No Landing?

Landings can be cushioned by trend following

September 2022

Private and Confidential

Picture this: the year is 962 in Belgium and large crowds are gathered around a tower in Ypres to witness Count Baldwin III throw a cat from the top, only to be surprised when it survives. Fast forward to Ypres today where, each year, this legend is commemorated with the throwing of toy cats. Welcome to Kattenstoet ("Festival of the Cats") where celebrations are wholly devoted to the cat, the creature that always lands on its feet.

Similar festivities could be in order, should an equivalent result occur for the economy which would see inflation tamed and recession avoided - otherwise known as a "soft landing". The opposite to this would be a "hard landing", where inflation moderates but pain is felt through a recession induced by central bank actions. A third prospect could be that of no "landing" at all, where inflation stays persistently high and the economy stagnates - also known as stagflation. In this piece, we will explore the characteristics and assess the likelihood of these three potential scenarios ('soft', 'hard' or 'no' landing) and ponder their potential implications for institutional asset owners.

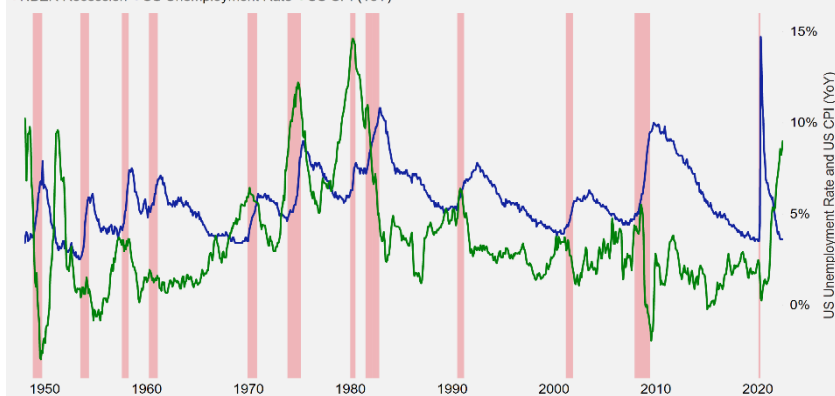
For the next stage of this ongoing inflation saga, if you buy into either the 'hard' or 'no' landing story, big shifts in strategic asset allocation may be warranted. In these environments, the economic growth engine that powers stocks, bonds and commodities may not be as reliable. Therefore, a diversifying alternative investment may be needed to compensate for the lower returns expected from traditional assets. But the challenge is how to choose such an alternative investment and have confidence in its ability to deliver during economic environments which may not have been seen for several decades? One answer to this is to consider systematic strategies, whose behaviour is repeatable and can be tested through different historic market environments, and which also have very long track records of live trading in a similar fashion during those historic periods. Systematic trend following is an example of just such a strategy, which also benefits from being very liquid, having high capacity and being available in cost-efficient and well risk-managed investment vehicles. When considering the possible 'soft', 'hard' and 'no' landing scenarios, we will therefore also assess how trend following might navigate such periods.

The combination of the post-pandemic stimulus-fuelled demand-side boom and supply chain pressures coupled with commodity price shocks have contributed to stubbornly high and historically broad-based inflation. Central banks need to curb excess demand and hamper growth through monetary tightening whilst desperately hoping for quick relief in supply problems that are out of their control. Given this bleak outlook, it is our belief that recent sentiment about the possibility of a soft landing seems too optimistic. Sure, bond yields have retreated somewhat, and stock markets have rebounded on the back of recent US inflation deceleration. Even so, the prospect of a dead cat bounce is conceivable (during Kattenstoet or otherwise), especially considering that initial selloffs were underpinned by very valid recessionary concerns. Current data suggests to us that the tightening cycle is far from over and structural reasons for inflation remain. So, what about the tight US jobs market? Yes, this can be a sign of economic resiliency but according to lauded economist Larry Summers, recessions have always followed two years after periods of inflation measures above 5% and unemployment measures below 4%. Low unemployment coupled with high inflation usually foreshadows recessions as the chart below shows.

Figure 1: 74 years of Inflation, Unemployment and Recession Data

NBER Recessions, US Unemployment Rate and US CPI (YoY): 1948 to 2022

■ NBER Recession ■ US Unemployment Rate ■ US CPI (YoY)



Source: Aspect Capital.

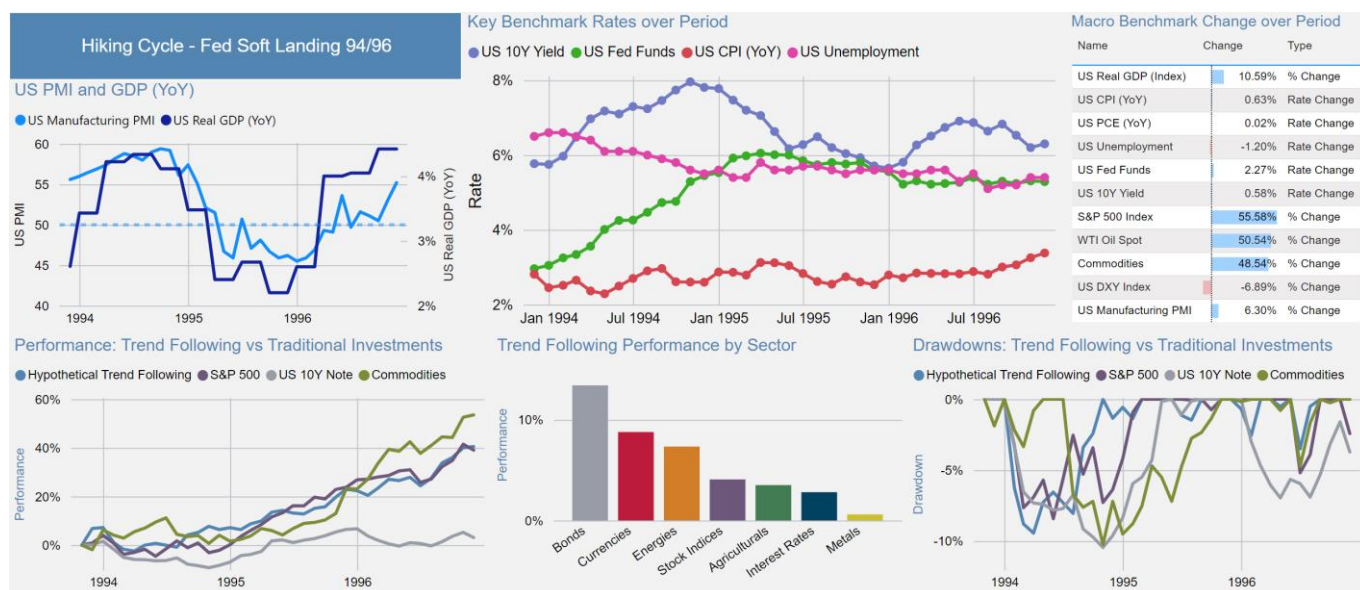
We acknowledge that this discussion is US-centric on account of the US being the most widely watched economy with the longest history of consistent data. Recessions tend to be denoted by the National Bureau of Economic Research (NBER) classification which, at the time of writing, states that the US is not yet in a recession despite two consecutive negative quarterly GDP figures.

Let us time travel for a moment and see what we can learn from three famous historical periods that can be described as a soft, hard and no landing. We will enlist the help of a long-term multi-asset pure trend following strategy simulation utilising Aspect's current trend following models. Futures prices are back-extended with synthetic futures constructed from the daily spot price where available. Market coverage prior to 1980 is largely commodity markets with some stock indices, currencies, and US Treasuries. Positions are scaled up to compensate for missing markets in earlier time periods to ensure a consistent risk level throughout and it targets an annualised volatility of 10%.

The Soft Landing of 1994/1996

The most cited example of a soft landing came between 1994 and 1996. The Federal Reserve, led by Alan Greenspan, raised the Fed Funds rate by 3% between December 1993 and April 1995. This aggressive tightening program followed the view that inflation needed to be pre-emptively addressed in the face of a strong recovery following the 1991 recession. Inflation was indeed kept quiet whilst the growth continued at a slower pace.

Figure 2: Soft Landing



Source: Aspect Capital, Bloomberg. THESE RESULTS ARE BASED ON SIMULATED OR HYPOTHETICAL PERFORMANCE RESULTS THAT HAVE CERTAIN LIMITATIONS. UNLIKE THE RESULTS SHOWN IN AN ACTUAL PERFORMANCE RECORD, THESE RESULTS DO NOT REPRESENT ACTUAL TRADING. **PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.** PLEASE SEE IMPORTANT RISK DISCLAIMERS ON PAGES 7 AND 8.

Quite noteworthy during the period of tightening is the US dollar's depreciation despite the increasing US yields shown in the top middle panel of Figure 2. This was related to an economic recovery in Europe and widening US trade imbalances, especially with Japan where trade talks were halted. The trend following strategy picked up on this trend and made strong gains from short USD positions as well as short US fixed income positions. Long commodity positioning from the start of this period amid the strong growth that drove the Fed into action also added to profits. Traditional long-only portfolios are proxied with S&P 500 and US 10Y Note futures. Commodities have been included using the S&P GSCI Commodities Index as another potential investable diversifier to allow

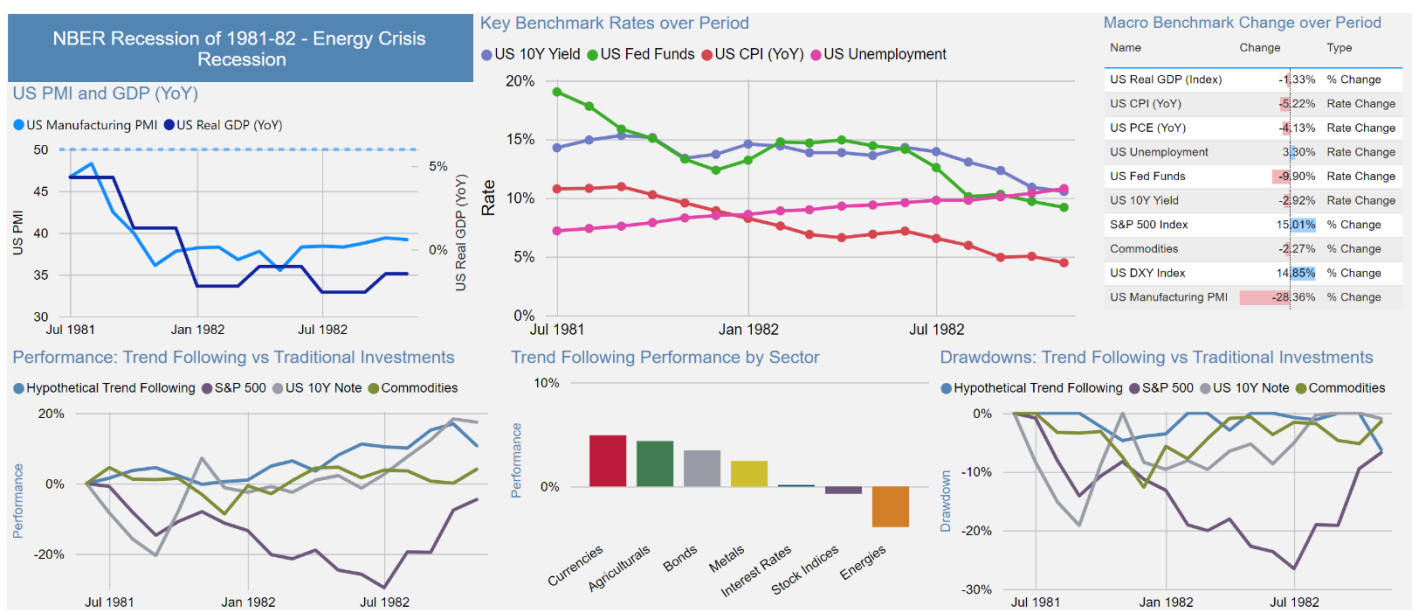
for a broader comparison. Soft landings are great for traditional portfolios and commodities, which would have fared well with gains from stocks and commodities offsetting bond losses, but it's striking that trend following would have kept up pace in an uncorrelated manner.

Unfortunately, soft landings are very rare and we believe the likelihood of this period being similar to today seems very low. Unlike today, the early 90s saw the US labour force grow through immigration and rising birth rates in addition to rising productivity fuelled by technology. Unlike the protectionism of today, the NAFTA agreement in 1994 ushered in mighty globalisation and Eastern European countries added to global supply in the years after the fall of the Berlin wall. 1965 and 1984 could also be considered as soft-ish landings. In contrast to our precarious situation today, all three previous softer landings saw very early action from the Federal Reserve and average inflation rates remaining under 5% without many of the supply shocks currently present.

The Hard Landing of the early 1980s

A hard landing would see inflation tamed, but only at the expense of the economy, which would find itself in a recession. The recessions in the early 1980s are probably good examples of a hard landing. Paul Volcker was appointed Fed Chairman in 1979 because he had very strong anti-inflation views. Following the 1980 recession that was partly caused by President Carter's credit controls, Volcker allowed rates to approach 20%, inducing the long and controversial recession of 1981/1982. Faced with repeated calls from Congress to loosen policy as the recession and unemployment worsened, Volcker remained steadfast until inflation was far enough from double-digit figures.

Figure 3: Hard Landing



Source: Aspect Capital, Bloomberg. Please see important disclaimers at the end of this document.

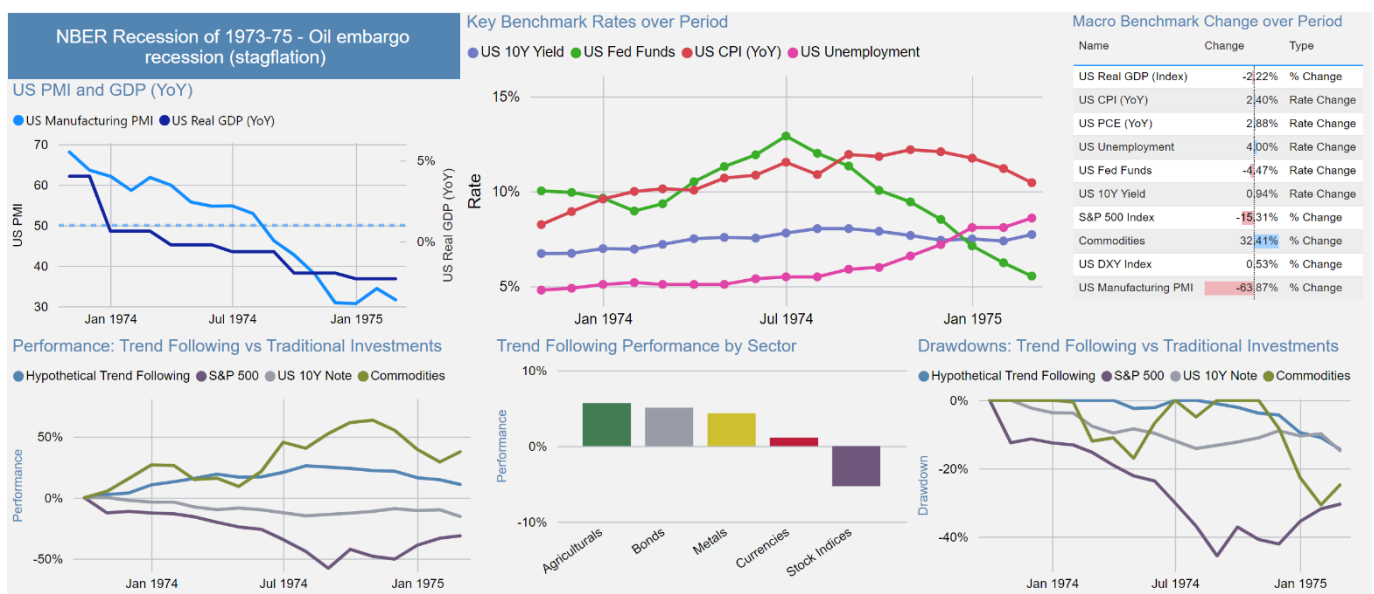
Looking at previous cycles in history, most attempts to meaningfully bring down inflation result in a contraction of the economy and it's hard to imagine that not happening now. The early 1980s example of this saw the trend following simulation make gains from long USD bets, short commodity and long fixed income positions. Holding a traditional portfolio and commodities during this hard landing would have required some mettle given the deep drawdowns in equities and it is likely that trend following would have relieved the pressure.

No Landing of the mid 1970s: Stagflation

A 'no' landing scenario would most likely feature a prolonged period of stagflation, where efforts to reduce persistent inflation fail whilst economic growth is minimal or negative. We have been beating the drum of potential stagflation since 2019, fuelled by ultra-loose monetary and fiscal policy. Our earlier paper - ['The Return of Stagflation?'](#) – discusses the anatomy of historical stagflation periods since 1800 alongside possible investment solutions to mitigate its effects.

The period between 1973 and 1975 might be a good example of a 'no' landing scenario. Prior to the stagflation period, interest rates were on the rise in 1972 to combat the threat of inflation posed by the abandonment of the Bretton Woods system in favour of a fiat US dollar. President Nixon sought 1972 re-election through substantial fiscal stimulus and, fuelled by the end of his notorious price controls and massive supply shocks from the OPEC-led oil crisis, inflation began to run away. Despite subsequent insistent monetary tightening, 1974 began with a recession and a surge in both inflation and interest rates, the worst possible combination.

Figure 4: No Landing



Source: Aspect Capital, Bloomberg. Please see important disclaimers at the end of this document.

Central bank policy can only go so far in the face of heavy supply shocks, which bear an eerie similarity to where we currently are. Policy missteps and a perception that authorities didn't have the situation under control also kept costs high in the 70s. It's possible that the Fed's credibility could come under question again and lead to rising inflation expectations.

Compared with the 140+ markets currently in the trend following strategy, there were only 35 tradable markets in this period. This didn't stop the strategy (which usually thrives from larger breadth) from making gains from long commodity and short fixed income positions. This relatively consistent return stream contrasts with the heavy losses from traditional assets and steep drawdowns in ultimately profitable commodities. Similarities between this historical period and now include the fact that bonds added to the difficulties suffered by traditional portfolios, even though they have historically provided protection.

Back to the Future

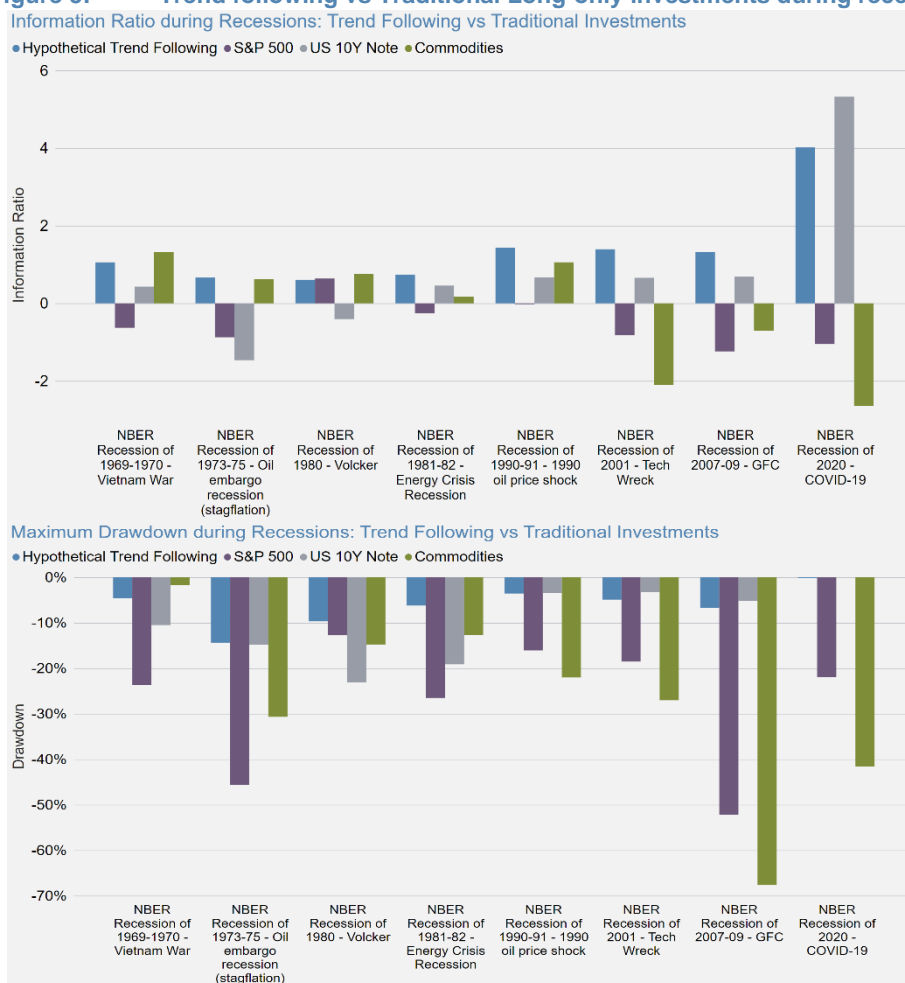
We should take comparisons to historical scenarios with pinches of salt, but it is significant that trend following was the most consistently performant investment in all three scenarios. Looking ahead, a case can be made for each scenario though a hard or no landing seem more likely. Here are some arguments:

Soft Landing	<ul style="list-style-type: none"> Recent decline in energy and food prices helped recent headline CPI and PPI rise less than expected, relieving some pressure There is recent early evidence of a fall in US demand (e.g. retail sales) and an easing of some supply chain pressures Post-pandemic shift away from services to goods could mean that less tightening is required to curb excess demand in these typically rate-sensitive sectors High job vacancy rates mean that tightening could curb excess labour demand without causing unemployment and ease wage pressures Long-term inflation expectations have been more subdued than anticipated. However, low inflation expectations could also support the hard landing outcome
Hard Landing	<ul style="list-style-type: none"> Q1 and Q2 2022 US GDP numbers have already emerged negative – this leaves the US with what could be described as a technical recession A growing number of inversions in US yield curves keep popping up, which usually signal inbound recession Policy rates are still below inflation expectations – tightening may still have a long way to go before more tangible ramifications Economic downturn seems likely, spurred by reduction in money supply from commercial banks through increased borrowing costs to companies and provisions to reduce their risk-weighted assets Elevated asset/house prices and private sector debt levels could mean amplified reactions to monetary policy tightening from increased debt service costs Unless the Fed's 2% inflation target is moved higher, excessive tightening might be required Recent economic growth has been driven by a drawdown in savings rather than real income and this is less sustainable US productivity had its biggest ever annual drop in Q2 2022
No Landing	<ul style="list-style-type: none"> Inflation persistence remains through continued supply bottlenecks, reinforced by the war in Ukraine and reimposition of lockdowns in China Ongoing de-globalisation Millions of retiring baby boomers who will spend much more than they produce The more broad-based the inflation (as is the case), the longer it takes to come down which gives more time for second round effects linked to higher wages to have an impact The largest components of CPI - rent and owner-equivalent rent - often react to high house prices with a lag, and this is yet to be fully felt Real wages continue to take a hit, setting the stage for further collective bargaining amongst workers who want to recoup losses; if salary increases lie ahead, we could have drawn out wage pressures keeping inflation higher for longer. Inclement weather as a result of climate change could continue to hamper food production

Conclusion

Whilst a soft landing can be shown to be the best scenario for traditional assets, it also seems the least likely. In our view, recession risks are growing and, when compared to more traditional long-only stocks, bonds and commodities investments, trend following tends to outperform with a consistently positive information ratio during recessions as shown in Figure 5. Trend following can also be more protective against drawdowns than traditional assets during recessions and, although it is not a panacea which never experiences losses during recessionary periods, the paths of returns in Figures 2, 3 and 4 show that its drawdowns have historically rarely aligned exactly with those of traditional assets during the 'soft', 'hard' and 'no' landing scenarios. In fact, across all the recessions shown in Figure 5, the average correlation of trend following to the S&P 500 is -0.55 and to the US 10Y Note is -0.06, emphasising the strategy's ability to provide diversification to traditional portfolios just when it is most needed. While some previous examples show that a long-only investment in commodities would have been performant during historic inflationary episodes, Figure 5 demonstrates that it is less reliable, and its risk-adjusted return tends to have been inferior to that of trend following in recessions.

Figure 5: Trend following vs Traditional Long-only investments during recessions



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Equities and bonds are both jeopardised by higher rates and recession risks that may emerge from higher rates as central banks tighten in the face of persistent inflation. This is possibly the worst environment for a traditional 60/40 portfolio and an unlikely soft landing presents the only chance of better outcomes unless diversification into alternatives is considered. History has shown trend following to be performant not only during soft landings but also to be reliable in the face of hard landings and stagflation which we believe to be increasingly likely scenarios.

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