WIDELY ACCEPTED MACRO DYNAMICS OVER THE LAST TEN YEARS AND THEIR IMPACT IN FINANCIAL MARKETS

1. Technology Innovation and Social Media

The increasing pace of technology innovation has penetrated many corners of society and in particular, has tectonically shifted large swaths of the economy in developed as well as emerging markets. Digital advances in cloud computing and artificial intelligence for example, have dramatically changed the way market participants, from consumers to employees, companies and governments behave (and interact with each other) in almost every sector of the economy. Financial markets have become a mayor turf where these advancements (especially in big data and computing) is taking place, as well as a catalyst of how these improvements will influence other services industries.
Electronic markets around the globe, around the clock, and in more sophisticated financial instruments have enabled market participants to trade and mobilize capital almost instantaneously and, barring still rigid compliance and other regulatory hurdles in some places, arbitraged dislocations and prevented in a way the creation of large asset bubbles, bringing efficiency and transparency to the process.
Social media has also become another significantly growing input into the investor behavior, bringing a broader view and a closer read of the market sentiment.
Likewise High Frequency Trading firms (HFT) have contributed to real time efficient markets, by exploiting real-time gaps in financial asset prices between electronic exchanges utilizing ultrafast connection infrastructures.
These new forces have led market participants to adapt to a faster, efficient and more transparent environment in which traditional institutions such as banks, pension funds and money managers had to reshuffle their business processes, reducing inefficiencies to the largest extent by automating processes where possible.

2. Exchange Traded Products

Thanks to Financial engineering in the last couple of decades, new products have spawn out arguably to address the needs, risks and requirements of a wide spectrum of investors. These new instruments of investments have on the other hand provided an important source of capital to the economy, especially in developed ones, giving light to a whole new breed of sophisticated investors. However, the 2008 financial crisis exposed several flaws in the design, origination and trading of some of these products, especially on CDOs/CLOs/CMOs to more exotic structured products linked to various traditional asset classes.
On the hand, the growth of Exchange Traded Funds (ETF) has nonetheless been exponentially growing to close than 8,000 new ETF/ETPs with 15.600 listings on 70 exchanges in 58 countries in just 15 years[1]. These funds let investor get exposure to a particular asset class (e.g. equity, credit, rates, FX, commodities etc.) by tracking a popular index (or strategy) are sold through a registered fund wrapper (much like an open end fund), and are traded like any stock in any registered exchange venue, providing sufficient liquidity, specific market/strategy exposure and tax efficiency to investors across the risk scale.

3. Globalization and trade agreements

More digital interconnected global financial markets wouldn't have been possible if it were not for a globalization trend has been instrumental to economic growth for the last 30 years. Trade agreements between rich and developing economies in goods and services has allowed for financial markets to become essential in securing financing by moving and allocating capital in the form of debt, equity or other hybrid instruments to vital capital intensive projects (e.g. manufacturing, renewable energy etc.). In particular, financial markets are

[1] According to ETFGI LLP, an independent ETF research firm in London UK.

paramount to these globalization efforts, laying out the rules of engagement for capital to flow in and out through various channels and investment asset classes.

4. Regulation and Government oversight

Government and central bank policy responses (mainly in the US and Europe) to stabilize financial markets in 2008 called for significant action in legislation and henceforth regulatory frameworks in order to safeguard the system stability and prevent moral hazard and other asset bubbles by, among other things reigning in banks off-balance sheet financial contracts and risky proprietary trading activities and avoid jeopardizing the trust of the traditional deposit taking institutions.
Other regulatory agencies were overhauled and expanded to increase oversight of the shadow banking (i.e. banking outside the bank system) and in particular spot, prevent or desensitize reckless investments that could destabilize key credit markets.
Other reforms also aimed to tighten control of illicit activities, like anti money laundering or terrorism related flows and increase surveillance under more transparent markets. Pension market reforms were also undertaken to address more structural threats under a new normal environment of chronically suppressed yields, higher public and private budget deficits, lower productivity and older populations.

EMERGING DYNAMICS OVER THE LAST FEW YEARS AND THEIR EVOLUTION IN FINANCIAL MARKETS

1. AI and algorithmic trading

Algorithms, big data analytics and cloud computing have leveraged each other to become a powerful alternative investor force in the last couple of years, bringing rigorous pattern-based trading strategies, arbitraging in single and multi-asset class markets within traditional hedge fund trades such as global macro, commodity trade arbitrage, long short and structured products.
These quantitative participants employ big data analytics within a wide array of traditional and non-traditional data to find behavior patterns on different markets for trading and investing, scour deeper insights in borrower repayment/default prediction for lending, and automate the portfolio allocation and security selection roles by inferring investors' risk/return profiles and restrictions as well as market conditions.

2. Environmental, Social and Governance Investing

Socioeconomic market challenges, widespread corruption and climate change have been around for decades. But on the last few years we've witness the growth of socially responsible forward looking conscious investors come to the forefront, driven in part by an changes in legislation and a more vocal awareness society through social media platforms, that lay increased accountability towards meeting sustainability standards and more ethical milestones. ESG investors restrict financial returns to social and social/environmental guidelines. More generally, impact investing have grown at a rate of 16% annually compounded since 2014[2], and ESG-investment mandated assets could comprise half of all professionally managed investment accounts in the US by 2025, aided in part by the use of artificial intelligence to uncover unstructured data points into insights not necessarily disclosed by the companies/investees, as well as more stringent government regulations demanding more transparency and uniformity from investor due diligence in their quest to generate alpha.

3. Cryptocurrencies and Blockchain

[2] According to Deloitte Insights 2019

Alternative currencies (i.e. Alt-currencies) have been traditionally touted as a frontier or shady investment left to amateurs and enthusiast. Ever since Bitcoin gained popularity as possible replacement of traditional fiat money, investors have increasingly focused on cryptocurrencies as a more mature asset within a portfolio, and many institutional investors now deem it as distinct asset class in and of itself, and consequently get assigned a particular allocation within a strategic model portfolio. By 2018, Cryptos and Bitcoin in particular had gained sufficient institutional interest that led to the launch of the first futures contract, and thereby offering investors a more direct and tactical approach to this new asset class, and opening the prospects to a wider array of tailored products offerings.

FORECAST FOR THESE DYNAMICS IN THE SHORT AND LONG TERM

Technological innovations will continue in financial markets as companies and investors need to better allocate capital and exploit inefficiencies arbitraging transparent and ultrafast markets. A major force in driving this trend is investors need to find alpha in more remote less arbitraged markets as well as bring it to smaller less sophisticated investors.
Therefore the technology sector will continue with its momentum and expect an outperformance in the sector in the mid to long term, especially in well diversified companies. We see a range bounded market in the sector with higher volatility for the short term.
Overall equity markets will remain highly volatile with a slight trend upwards in the short term as it remains a headline, retail investor driven, with technology, financials, healthcare/pharmaceutical and staples outperforming the rest of the market. For the mid and longer term forecast, we see equity returns in the high singles digits with larger institutional investors coming slowly back in, but with volatility bouts every more often, therefore dampening risk adjusted yields.

While a less globalized environment is warranted in the short and medium term, due to popular governments and political and social unrest, we could see the advent of more temporary bilateral trade agreements that could give flexibility and nimbleness to medium term regional economy needs. Under this backdrop, major emerging economies (BRICS) and their currencies should outperform in the mid to long term, as we also forecast a longer recovery in commodity prices across the board with some markets (e.g. industrial metals) to outperform others. In the short term the broad commodity and EM currency space will remain under pressure as fears of a continued lockdown in major economies and resulting drag on economic activity dominates any rebound. Bonds and other credit markets will continue to bifurcate into a wider dispersed asset class, with a smaller investment grade pool whose spreads will keep compressing and trade rich for the mid to long term, while an ever growing number of underperforming sector names, relying heavily in debt issuance given the current free money environment central banks created and amplified lately, whose spreads will widen dangerously past high yield levels into distressed in the short to medium term, as businesses and households pull back demand in non-essential goods and services, with some household staple names filing for bankruptcy or slashing large chunks of assets or divesting at fire-sale prices.

Government intervention in economies, whether voluntarily or as a last resource, by regulation or decree, temporary or more permanent, will increase around developed and emerging markets to increase social security and unemployment safety nets and patch free market faults and distortions, poverty and deep inequality. As such, deficits will keep growing, widening rate risk premiums and spreads, weakening currencies usually linked to commodities and keeping a lid on hard currency rates as sluggish demand drags inflation expectations down, fueling further recessionary pressures. In the mid to long term view, higher productivity, population longevity and savings rate in developed economies will keep dragging down long term yields and inflation expectations, creating a "Japanification"[3] effect in these mature markets.

SHIFTS WITHIN FINANCIAL MARKETS AS A RESULT OF THE RESPONSE TO COVID-19

1. Higher Volatility

A sudden exogenous shock to demand and supply chains, elevated valuations in risk asset prices prior to the pandemic, combined with the popularization of quant-computer driven strategies in market indexed products, created a perfect storm that led to an abrupt spike in volatility across markets and geographies. This new high vol regime is more permanent than prior crisis, as the a stagnant global economy add to an already bleak health prognosis.

2. Fed and Treasury Puts

As first responders and lenders of last resource, central banks around the world put on accommodative emergency measures that dampened the financial shock of households and companies as a result of government preventive health measures. The in the US, the Fed strengthened its aggressive lose monetary policy, granting financial markets with another dosage of an effective Fed Put[4] and avoided a stress scenario in money market and other critical money markets essential for a day to day smooth functioning of the economy. The same measures and results have taken place in other developed economies.
But aside from central banks, at least in the case of the US, a government "Put" has also been critical and instrumental in keeping the economy alive. Unlike the Fed, which essentially keep lending flowing but are nonetheless keeping households and companies indebted and encumbered, emergency fiscal policies have in effect put hard fiat currency into their pockets, thereby buying valuable time and aiding (in general terms) to keep employees hired or households paying rent. These emergency packages were replicated around the world with different scales and scopes, efficiency and speed.

3. Tech vs non-tech, service vs manufacturing and staple vs discretionary sectors larger gaps

The stock market in general has been the largest beneficiary of a financial recovery currently taking place. But the current equity markets are experiencing a large dispersion in returns within the asset class itself. As such, each sector have fared differently depending on their direct and short term exposure to the health crisis and immediate economic consequences of the population response either by government mandate or voluntary determination.

4. Stronger US dollar

Global trade tensions, as well as anemic growth and consequently still very accommodative central bank money rates in other developed regions other than the US, provided support for the US dollar before the global

[3] In reference to Japan's extreme low interest rate environment for the last two decades, deflation, aging population and spending-anemic economy highly dependent on its external sector.
[4] Bond market presumption that the US central bank will always come to the rescue of investors; a concept that was arguably responsible for avoiding a deeper recession a decade before, but has dangerously created asset bubbles in other parts of the economy and increased inequality.

pandemic hit at the start of the year. The ensuing crisis gave it a fresh new push, even with the arguably distant prospect of a negative rate path from the Fed and market repositioning of other strong currencies. With a severe recession for the next two quarters on most forecasts, the greenback is not only likely to be well supported, but could make a be the only FX game in town, especially given a slow recovery ,or even W-shaped one, dragging all commodities lower, with the exception of precious metals. Notwithstanding the above, the lower spreads in money market yields and across the curve between the USD and the Euro or Yen, helped softened the hedging costs for companies financing in these currencies as the strong demand for the Greenback is over weighted by the extreme zero rate policy of the Fed, closely matching those of the ECB and the BOJ.

5. Commercial and Residential Real Estate under pressure

One of the biggest game changing investment themes could arise within the real estate sector. Service companies keeping their workforce at homes need to see a decent recovery, or at the very least a well-supported funding market to be able to maintain the long term leases on their physical premises for an extended period of time. On the contrary, should they see an extended protraction in their bottom lines, unsecured long term commitments like their leases should outweigh the implied productivity benefit of having employees physically present. This will obviously have enormous consequences that could trickle down to capital market investors, putting many asset backed securities and commercial real estate funds on distress levels with potential non negligible systemic risks.
One potential solution for corporate landlords in the sector could entail converting office/retail space into residential use, thereby increasing much needed affordable housing supply and relieving a chronic urban population growth problem.
Likewise, similar effects although less probable and less drastic, could be felt in the US residential real estate sector, if school systems across the country start upending their curriculums to remote learning, thereby lowering the appeal of housing in many urban and suburban areas.

AREAS THAT STILL NEED TO BE ADDRESSED IN TERMS OF THE CURRENT CRISIS AND FUTURE RESPONSES TO POTENTIAL EVENTS OF SIMILAR MAGNITUDE

1. Repo market and it's de facto replacement as quantitative easing by the Federal Reserve

The extremely lose policies implemented during the 2008 crisis were meant to correct temporary dislocations in the credit markets and long part of the yield curve, provide support and stimulate long term investors. The current pandemic initial stress on short funding markets and US dollar shortages across the world were quickly suppressed by the Fed's repo operations increasing banks' reserves as well as extending swap lines to provide much needed US dollars. All these moves came at the expense of inflating an already swelled balance sheet to around $7T. As any expected recovery delays to materialize, this transitory increase will became more permanent and harder to unwind as the bond markets become more complacent with the low-for-longer view on rates. Ultimately the time of reckoning and dealing with this issue means an explosive and swift higher forward guidance rate, treasury yields and/or inflationary pressures. Since we don't foresee an inflation regime creeping for the next couple of years due to more structural productivity, population and savings propensity changes described above, this could mean that central banks will become the larger debt holder and a de facto financier of chronic large government deficits, potentially destabilizing and/or eroding monetary policy effectiveness in future crisis interventions.

2. Stifle corporate moral hazards and other distortive, reckless behavior

Large corporation have been used to play the markets in their favor by utilizing an array of tactics at their disposal with little if no real benefit to their existing long term shareholders, clients and employees, including large dividend distributions and share buyback programs, designed to increase short term gains with no real strategic plan for future growth and profitability. Furthermore, as in the case of the banking industry, they have shown reckless behavior, and put the economy under a great deal of systemic risk. On the other hand, faced with a big blow to their main revenue source or a deep economic crisis like the current pandemic, these large corporations rely (and sometimes demand) some sort of government bailout program to keep operating, with the excuse of being a big employer in the economy, systemically important or are of a national security interest. This corporate behavior of privatizing the gains and socializing the losses, exhibited to the full extent in the last few global economic crises, needs to be well understood, regulated and contained by governments to prevent not only destabilizing financial markets and the economy in general, but also potentially causing widespread social discontent and civil unrest.

3. Income inequality through a more progressive redistribution policy

The Fed's dual mandate of low inflation and unemployment has increasingly being challenged on both fronts. The last decade has proved it ineffective of reaching a comfortable inflation level to spew out more investment and growth. On the unemployment front, its accommodative policies have arguably translated in record low unemployment, but with extreme low productivity and wage gains at the bottom end of labor force, and a structural and deeper long term unemployment of a the higher skilled end. This has widened the gap in terms of wealth creation and spiraled viciously into deteriorating income opportunities.
Therefore, a more progressive income redistribution through tax legislation, labor or financial market regulation is necessary to correct the path of this undesired collateral consequence of monetary policy. Likewise a more robust, steadfast and coordinated government intervention is needed to protect employees' paychecks, including some sort of job guarantee program with basic living standard wages to provide a wider and more effective safety net that can support basic incomes, re boost spending and therefore private business investments hence smoothing out exogenous economic shocks.

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