Glimpses of Hope

- Discretionary managers are performing well year to date
- An important factor to watch will be China FX policy
- Brazil real weakness is relentless, on external imbalances

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Discretionary managers drive volatility

Different opinions are what make a market. A dealing price always has a bid and an offer. This is, in itself, the backdrop for current low realized and implied price volatility.

The process of price discovery has gradually been replaced by indexation and pre-set strategies in exchange-traded funds. Recent academic papers explore the mechanics behind market price stability and liquidity enhancement against underlying disaggregation.

Glimpses of hope have arrived year to date, however. Two good examples of discretionary versus auto-pilot strategies are discretionary macro in relation to risk-parity indices. Discretionary macro has had a good start to the year, up 3.4% to date.

Meanwhile, a risk-parity index controlling volatility to 15% annualized, with leveraged US Treasury and S&P 500 exposure is up only 1.1% YTD. These results contrast to one of the best years ever for risk-parity funds in 2019, when they returned 28%, against 4.8% for discretionary macro.

Behind all of this is a successful mix within discretionary macro. According to our calculations, so far this year discretionary managers increased beta to equities from 0 to 0.12 while reducing beta to bonds from 0.48 to 0.24 (see chart). Both asset classes’ beta remains remarkably timid in historical terms, explaining a still compressed implied volatility environment.
Meanwhile, we estimate risk-parity funds reduced exposure to equities while raising bond positions. This has been the core backdrop for their year to date underperformance. The same beta calculation between a 15% volatility-controlled risk parity index to US Treasury returns increased from 0.1 to 0.2. The beta to the S&P 500 declined from 0.30 to 0.26. In fact, we find that risk-parity funds have adjusted equity exposure from 0.44 in June last year to 0.27 today.

*Hedge Fund Research HFRX Macro/CTA Index: Beta to Global Bonds and S&P*

![Graph showing beta of HF/Macro to Global Bonds and S&P]({})

Source: BNY Mellon Markets calculations. Note: rolling betas to each corresponding asset class are estimated using weekly changes over three-month rolling windows.

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**China FX policy is unclear**

One important yardstick to watch will be China fixings. Our own estimates of China renminbi valuation stand at a 7.7% overvaluation. The current environment would explain potential depreciation going forward quite well. Despite the signing of the Phase I agreement, Beijing policymakers should look to a 1.5-2pp adjustment in activity this year. Such a slowdown would by any means justify easier policies.

In the chart below we take a snapshot of an estimate of the CFTES basket fixings against FX implied volatility. Since September last year and until the eve of the Phase I signing, Beijing engineered 3.2% higher fixings, signaling a desire to reduce the pace of depreciation observed since the first introduction of tariffs in Q1 2018.

Since January 21 this year, officials engineered a modest depreciation in fixings. Each
subsequent wave of lower fixings was followed by higher FX implied volatility. From the
summer of 2018, the basket weakened 4% followed by a 2.2 increase in FX implied
volatility. In Q2, China basket fixings declined 5%, followed by a 3 vol increase in FX
implied volatility.

*Implied Currency Volatility and CFTES China Basket Fixings*

![Graph showing implied currency volatility and CFTES China basket fixings.](image)

*Source: BNY Mellon Markets and Bloomberg L.P.*

**Despite the Phase I signing, Beijing policymakers should look to a 1.5-2pp adjustment in activity this year**

**Brazil ends balance sheet management**

Yesterday, the Brazilian Central Bank (BCB) announced a change in policy bias adopted
since last August. Back then, the BCB announced it would seek to reduce its stock of
USD swaps and FX reserves, with an expected neutral impact on FX. We were skeptical
about the outcome because the fundamental impact of each instrument is different.

FX reserve accumulation was intended as an insurance policy against a negative fiscal
outlook environment. Meanwhile, FX swaps were about reducing short term, temporary,
exogenous shocks. A policy geared to reducing both would introduce a higher level of
uncertainty down the road.

All of this took place, while the BCB was easing quite aggressively. Since June the BCB
has cut its key reference rate from 6.5% to 4.25%, and this took place while local
institutional investors were increasing long USD positions by roughly two-thirds,
according to BM&F futures reporting.

One of the main concerns with regards to BRL valuation is the balance of payments,
which remains precarious despite an otherwise weak exchange rate. The BRL is about
14% undervalued, largely because the currency depreciated 15% over the past year but
inflation remained relatively tame, at 4.3% y/y.

In the table below we show that the current account is deteriorating. This is about a
wider deficit in the balance of services and meaningful income imbalances: Brazil still net
pays meaningful amounts of debt servicing and dividends to foreign investors.

**Brazil Balance of Payments Model**

<table>
<thead>
<tr>
<th>USD Million</th>
<th>Dec-13</th>
<th>Dec-14</th>
<th>Dec-15</th>
<th>Dec-16</th>
<th>Dec-17</th>
<th>Dec-18</th>
<th>LTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>% GDP</td>
<td>-3.2%</td>
<td>-4.1%</td>
<td>-3.0%</td>
<td>-1.3%</td>
<td>-0.7%</td>
<td>-2.2%</td>
<td>-2.7%</td>
</tr>
<tr>
<td>Trade Balance</td>
<td>389</td>
<td>(6,629)</td>
<td>17,655</td>
<td>44,635</td>
<td>63,960</td>
<td>53,048</td>
<td>39,404</td>
</tr>
<tr>
<td>% GDP</td>
<td>0.0%</td>
<td>-0.3%</td>
<td>1.0%</td>
<td>2.5%</td>
<td>3.1%</td>
<td>2.8%</td>
<td>2.1%</td>
</tr>
<tr>
<td>% GDP</td>
<td>-1.9%</td>
<td>-2.0%</td>
<td>-2.0%</td>
<td>-1.7%</td>
<td>-1.8%</td>
<td>-1.9%</td>
<td>-1.9%</td>
</tr>
<tr>
<td>Income Balance</td>
<td>(37,492)</td>
<td>(49,420)</td>
<td>(37,963)</td>
<td>(41,544)</td>
<td>(43,170)</td>
<td>(58,825)</td>
<td>(55,989)</td>
</tr>
<tr>
<td>% GDP</td>
<td>-1.5%</td>
<td>-2.0%</td>
<td>-2.1%</td>
<td>-2.3%</td>
<td>-2.1%</td>
<td>-3.1%</td>
<td>-3.0%</td>
</tr>
<tr>
<td>Transfers Balance</td>
<td>3,683</td>
<td>2,725</td>
<td>2,751</td>
<td>3,125</td>
<td>2,123</td>
<td>28</td>
<td>964</td>
</tr>
<tr>
<td>% GDP</td>
<td>0.1%</td>
<td>0.1%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.0%</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

| LTM Capital Account Balance | 78,626 | 96,586 | 56,152 | 15,714 | 9,926 | 42,422 | 53,055 |
| % GDP       | 3.2%   | 3.9%   | 3.1%   | 0.9%   | 0.5%  | 2.2%   | 2.9%   |
| Assets      | (62,930) | (74,073) | (26,164) | (31,683) | (32,057) | (12,344) | (37,736) |
| % GDP       | -2.5%  | -3.0%  | -1.4%  | -1.8%  | -1.6%  | -0.7%  | -2.0%  |
| Liabilities | 135,520 | 183,061 | 87,335 | 55,664 | 47,782 | 60,447 | 66,410 |
| % GDP       | 5.5%   | 7.4%   | 4.8%   | 3.1%   | 2.3%   | 3.2%   | 3.6%   |
| FDI         | 75,211  | 87,714  | 64,738  | 74,295  | 68,885  | 78,162  | 78,559  |
| % GDP       | 3.0%   | 3.6%   | 3.5%   | 4.1%   | 3.3%   | 4.1%   | 4.2%   |
| Portfolio - Fixed Income | 30,136 | 32,745 | 4,843 | (31,672) | (11,027) | (3,341) | (8,245) |
| % GDP       | 1.2%   | 1.3%   | 0.2%   | -1.8%  | -0.5%  | -0.2%  | -0.4%  |
| Portfolio - Equity | 11,120 | 10,620 | 0,547 | 0,793 | 2,903 | (2,213) | (4,742) |
| % GDP       | 0.4%   | 0.4%   | 0.0%   | 0.4%   | 0.1%   | -0.1%  | -0.3%  |
| Other Liabilities | 19,046 | 51,109 | 8,326 | 2,002 | (15,750) | (11,313) | (1,116) |
| % GDP       | 0.8%   | 2.1%   | 0.5%   | 0.1%   | -0.8%  | -0.0%  | -0.1%  |

Source: BNY Mellon calculations and Haver Analytics

Please direct questions or comments to:

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