Quant Insight

More science, less opinion

Risk On vs Risk Off
The Macro Perspective

Qi empirically demonstrates how rich or cheap an asset is relative to the prevailing macroeconomic environment. By focusing exclusively on a group of cyclical indicators across asset classes, we can highlight broad asset allocation trends and specific instances where growth optimists / pessimists have run ahead of the fundamentals.

➢ **Russell 2000 is starting to look extended versus the S&P500.** The chart below shows Qi Fair Value Gap on the RTY/SPX model near 12month highs.
➢ That is a US phenomenon though. **The iShares MSCI EAFE Small Cap ETF (global developed market small caps, ex US and Canada) is at fair value.**
➢ It is still modest but two widely watched cyclical indicators in Fixed Income - the shape of the US yield curve and AUDJPY fx - both point to ‘risk on’ potentially getting overextended.

![HISTORICAL VALUATION GAP](chart)

In the table overleaf we look across asset classes for securities that are typically perceived as indicators of the global economic cycle. They range from cyclical versus defensive equity sectors, at the equity index level small versus large caps; or, in Fixed Income, the shape of the yield curve or a currency pair like AUD (pro-cyclical) versus the Yen (a safe haven).

The table shows model confidence - whether macro matters for that security or not - and Fair Value Gap - how far spot price is from macro fair value. We include both Short and Long Term models.

What picture emerges from this multi-asset perspective?

Qi
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Macro does indeed matter. Only 3 models show model confidence under our threshold for a macro regime. Generally, **macro is important in explaining price action across all asset classes.**

Almost half the securities are close (within +/- 0.5 sigma) to macro-warranted model value. **There isn’t yet a broad, consistent pattern pointing to excessive valuations.**

There is, however, **a clear bias to cyclical assets pricing in a more optimistic scenario.** In some cases, there are early signs this is moving too far relative to the fundamental macro backdrop.

There are caveats. The richness of Consumer Discretionary versus Consumer Staples reflects the Amazon effect.

However, **the RTY-SPX signal is consistent across both Short and Long Term models.** Moreover, the LT FVG is +0.9 sigma. Back testing +1 sigma FVG as a sell signal (sell RTY / buy SPX) since 2009 produces a 67% hit rate for an average return of 0.8%.

**AUDJPY displays strong model confidence across both ST and LT models; spot is rich versus macro on both.**

The shape of the US yield curve has two health warnings - mediocre model confidence and the potential to reflect increased US Treasury issuance as well than economic growth - but again there is a consistent signal across both models.
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