INCISIVE VIEWS FROM PROFESSIONALS
HEDGE FUND INSIGHT

Into the Mind of a Macro Manager – with Archbridge Capital

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By **Hakan Kocayusufpasaoglu**, CIO of Archbridge Capital, with an introduction by **Simon Kerr**

Introduction

Some hedge fund strategies are more difficult to engage with than others. Most investors could understand what equity hedge funds do, but other strategies can be difficult (like volatility arbitrage) or just opaque (like most high end CTAs). Global macro investing, one of the original hedge fund strategies, has a whiff of mystery about it – how do those "Masters of the Universe" read global flows and politics and market dynamics inside one brain? Hedge Fund Insight asked Hakan Kocayusufpasaoglu, CIO of Archbridge Capital, to go through an example of a position from idea generation to implementation. Here is how he develops his trade ideas.

Reading the Global Economy

8.30 am, October 2012, A rainy day in the office. Like everyday it is time to make sense of the vast array of data that is released daily and informs us of the wellbeing of our global economy. Each country's health matters and has a substantial effect on the financial markets. Like detectives traders evaluate each market in order to understand what discrepancies exist between their view of the world and what the financial markets are pricing; the markets' view of the world. Questions like: Will the eurozone exit its recession? Is China going to slowdown? Will US economic growth continue? and how will that affect the financial markets? require thorough and ongoing analysis of macroeconomic data. And the analysis starts with every morning.

Our proprietary forward indicators for the US are strong, showing a decent recovery for the US markets. Again budget talks in the news. About time that they agree finally, since we already know they will not let the USA go bankrupt simply because Congress does not agree an increase to the budget numbers.

Hakan H. Kocayusufpasaoglu
Founder & CIO

Best to fade that part of the newsreel. Bloomberg has plenty of other news stories of interest. Getting back to our daily analysis of the world. Our proprietary and faithful overnight system breaks down the economies of the world into indicators that we like following and also updates our proprietary indicators nightly so that we have our own forward looking guidance and a decent opinion about where we are for each defined economic region in the business cycle. Let us see what 'Inspector Gadget' (yes, our proprietary system has a nickname, which in this case was given because it can do so many things, from relative value analysis to macroeconomic story building) has to say about Euroland. Overall nothing positive to report except that there seems to be a small break-up risk compared to last year. But the overall economy - verdict: recession.

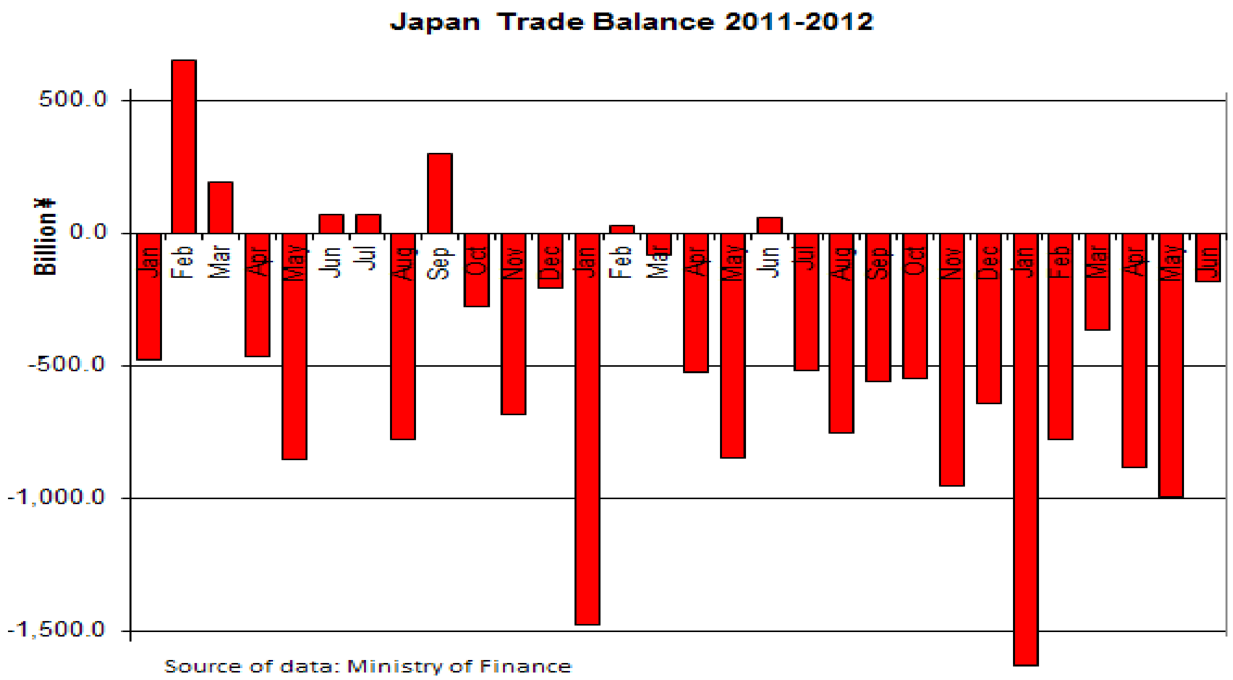
Turning to Japan, hmmm, a more interesting, but pessimistic outlook: disaster! Savings rates are diminished substantially, some months even worse than the USA (and the US consumer is not known for its propensity to save). Trade deficits are occurring frequently in Japan. (Isn't the Japanese economy supposed to survive on exports?) Suzuki is going bankrupt in the USA (ie the US division of Suzuki) citing high Yen levels. With Japan's debt levels at 200+ % - this country will hit a wall. And what happens then? The only viable thing is for the exchange rate to depreciate as it happens with all countries that hit a wall. This is getting interesting especially since the Yen has been made much stronger since the '08 crisis and has remained strong till today. This needs further investigation!

The Japanese Situation Commands Attention

Japanese GDP in 2011 was negative, while in 2012 only the first two quarters were strong (and clearly coming from a low base) and the third quarter was near zero growth. And all these real GDP numbers are bolstered up due the rampant deflation that has been plaguing Japan for more than a decade. Deflation nationwide was still around 1%, excluding food and energy.

What a country - with anaemic growth rates, an ageing population which has been propped up for years on government stimulus which has driven countries debt to GDP to above 230% (today more like 250%) - it is impressive if one thinks about it.

In contrast Greece is rolling over and having to be bailed out when their debt to GDP is exceeding 130% of GDP and here we have a country which for years has had deflation, anaemic growth but a strong credit and bond market with a AA- rating all the while having debt levels which would have caused any European country to default! How can this be?



Having analysed countries, including Japan, for over a decade and a half I know that this is due to a uniquely Japanese situation. 90% of all issued bonds are in the hands of domestic investors: it is their conservative nature and their ageing population of savers that is enabling such a large debt level to exist without causing the country to default on its debt. Deflation, however harmful to an economy's growth rates, has meant that savers are rewarded and interest rates are kept low. In other words, debt servicing costs are tremendously low for years with the 10 year JGB rate at 0.25% for the last few years and savers getting rewarded in real terms for their savings. Imagine, then, that you are a saver. Why would you care that interest rates are very low if there is no inflation? In fact prices are falling every year, making the real purchasing power of your savings increase however low interest rates are (and nominal rates cannot go below zero).

So overall a very high savings rate has over the last decade or so financed the government's debt levels, while exports have assured that economic growth, though anaemic has continued to grow and herewith has financed the governments injection programmes and debt levels. However, all of this should imply a relatively weak currency rate. Hmmm, but the yen has been bid up over the years since the 2008/9 crisis as it was considered a safe haven, while also conservative Japanese have repatriated their fortunes to the homeland and away from what they perceived as risky, foreign investments.

For a long while I was playing with the thought of shorting the yen against pretty much all other currencies in the world, since at some stage the country had to simply give up. I never did, because for years there was no catalyst, exports were financing economic growth and savings were financing government expenditure and bond issuance. However now, for the first time since the 70's when the Japanese 'wunder' started emerging we are seeing that trade deficits are cropping up consistently, not just one month of data. Exports are suddenly not financing GDP growth anymore. The engine is stalling. At the same time savings rates are diminishing - the other engine is stalling. Japan must be hitting a wall soon. Especially now that the crisis and fear levels are abiding we have to think that the yen will finally weaken...Inspector Gadget you again did your trick, pointing us to the right direction of analysis.

Policy Implications of Macro Analysis

Now it is time to do a little further digging which should take an hour or two of ploughing through the data in a little more detail, now excitedly focusing on Japan. The day has been set: It is Japan research day! Hours feel like seconds, a blink of an eye but we are now confident from a macro-economic standpoint that the Yen will have to weaken, since there are no other choices. The macro economic theme is however only a starting point. Much more needs to be done before we can initiate a trade. But our radar is firmly on Japan.

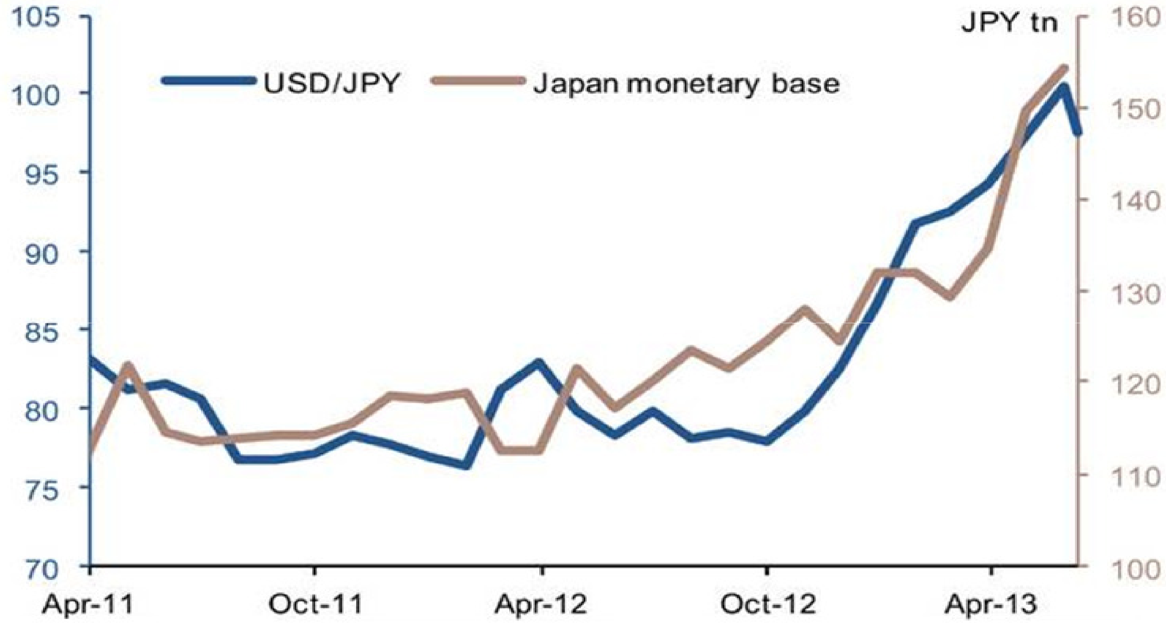
Next let us explore more and more about the upcoming elections in Japan, they are still a few months away and the markets are not moving yet. In the back of my mind is continuously that these elections could be a catalyst? Perhaps.

After ploughing through the information of the opposing parties and understanding their platforms only one is standing out, one aggressive party proposal which in effect is running on the economy and realises that Japan will not be able to survive unless a 'full throttle' approach is implemented. If this party were to be elected, then Japan would be in essence doing what the US has done to wave off a depression in 2008/09 (and quite successfully we might add.).

Calculate the Impact of Policy Change on the Economy

The numbers are being crunched and the numbers are mind-boggling. If Japan were to do this, if this party was to be elected then money would in essence be pumped into the economy in such unprecedented quantities that this would be the single largest monetary experiment of all time, even overshadowing the US experiment (which in essence was not an experiment, since it was a repeat of what was done after the Great Depression, without waiting for the depression to arrive. Bernanke learned well.) But in Japan this strategy would have to be employed to finally get out of a decade long deflation which is slowly but surely killing the economy. If his party came to power then Japan would have a fighting chance, in essence it would be like giving a dying patient electro shocks to bring him back to life. How amazing would that be. Then the Yen would weaken beyond our wildest dreams…could this happen? How likely was it that Abe could get elected? How likely that he would push these reforms and succeed? Glancing out the window into a dark rainy night, was it evening already? All I could think about was Japan.

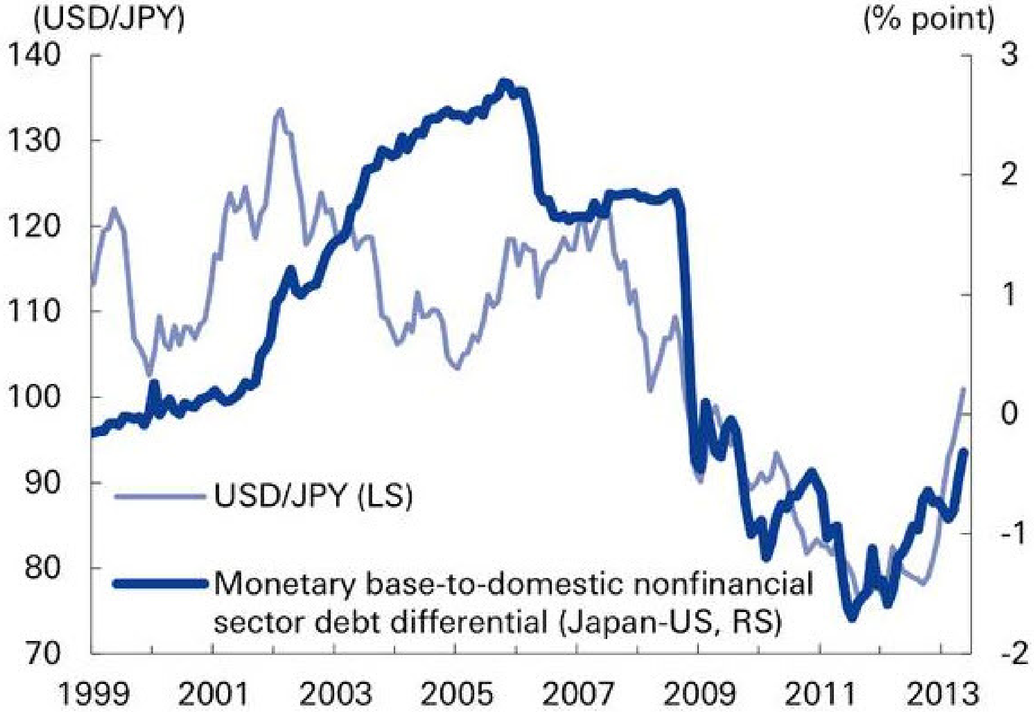
Yen Debasement



Now that we had structural reasons for the yen to weaken over time, we now had a potential catalyst that could make this happen very quickly and cause the trade to go into the stratosphere. Game on: further analysis now on the likelihood of Abe coming to power.

I remember Abe, he was an unpopular president of Japan for a short while in years past. Well, I guess that means he understands politics and could make things happen. But wasn't he a traditionalist, a conservative? Ah well, perhaps not the best catalyst. But let us wait for the further research on the parties, the inside political track which I will receive this evening via email. Now it is time to let the team in on this exciting new development and see if anyone can find a chip in the armour.

Monetary base/debt ratio differential (US vs Japan) & USD/JPY



The rest of the day passes - I can think of few other things but this research, scenarios swirling through my mind. What if he is the real thing, and if he is, then he can change the Bank of Japan governor, he can in effect implement change immediately. Is his plan to be believed? Finally I get the report - I devour the 50 pages or so in minutes. Or what felt like minutes. It looks as if not only has Abe used his time out of office well in developing his views, but it does look as if he is serious, as if he really does want to implement the largest monetary injection in history and push japan out of deflation. He could be Japan's economic saviour of sorts. And yes I was right about the appointment time of the BOJ governor which is in the first half of 2013. Well it is only October 2012, so plenty of time for him to get settled, initiate his programme and get the BOJ on board. If the BOJ is unwilling he can change the members of the BOJ to more likeminded people. This could really work.

Now to the last pages with early poll results and demographic responses. It does look as if Abe has hit a chord with the younger population of Japan. Great. But with an ageing population let us see how he tracks there. Hmmm, better than expected but could be stronger. Well he has another few months and being a seasoned politician he could pull this off and win overwhelmingly.

Co-Opting External Expertise

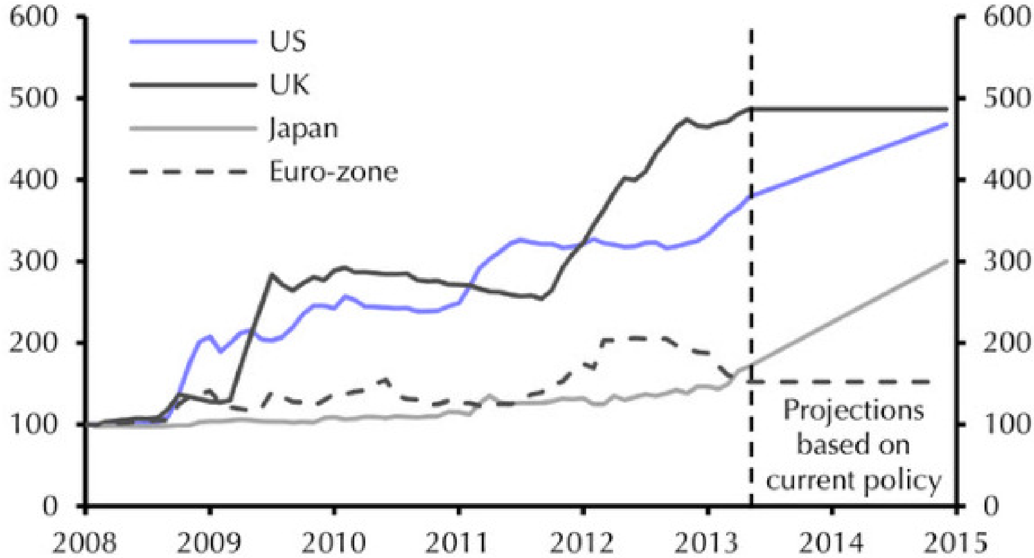
Now with our economic view in place and a decent understanding of the elections it is time to talk to our political consultant, who works for Her Majesty’s civil service. One phone call to schedule an appropriate time and one call to gain all the political insight. Perhaps I am missing something. If only sleep was not required and I could call right now. But it is the middle of the night and I am getting a little tired – looking at the watch I realised I had been working for 16 hours straight! No wonder I feel tired and hungry. Best to hit the hay and get up refreshed and run all systems again. Make sure I have not missed anything, before talking with our political expert.

Scoring the Drivers of the Market

Finally, 8.30 again, I jump onto my seat and open “Inspector Gadget”. This time I am more concerned with the main drivers of FX especially pertinent for JPY vs the US$ – I investigate all correlations and the usual drivers I have selected over the last decade plus years of investigating foreign exchange movements (including interest rate differentials, current account, balance sheet differentials etc etc etc the list is long, I look at all of them and rate them. Then, finally, I focus on our proprietary top 5 driver score list. I do not want to miss anything.) I also look at traditional indicators like Purchasing Power Parity and overvalued/undervalued indicators (even though a currency can stubbornly go against such indicators for very long periods of time) as well as even the big mac index. All point to a similar story: the yen is overvalued by far, that is it is far away from fair value.

I have over the years analysed different country’s economic situations so often that I have developed my own way of looking at a country’s most important factors via my own indicators and in a certain order. That way I can obtain an understanding of a country’s current situation and its forward bias relatively quickly. Inspector Gadget gives this to me by downloading the raw macroeconomic data and presenting it to me in ‘story’ like fashion. I go over the Japan ‘story’ again and come up with the same conclusions I had not missed a thing. So overall the macroeconomic story is pointing to a Japan that without intervention will hit a wall and structurally the yen should start to weaken; but if a newly elected party wanted to kick-start economic growth in Japan they would have to weaken the yen quickly and aggressively, while holding debt service costs low; and perhaps engineering some inflationary expectations and get out of this deflationary rut. Although I have my doubts about being able to engineer sustainable inflation via these policies (since that would require continuous devaluations of 10-15% per annum, since a one-off yen level change would only achieve temporary inflation) it simply does not matter, perhaps ultimate success for Japan may not be possible, but the only way to try was to weaken the yen substantially and continuously.

Monetary Base (Jan 2008=100)



A Potential Catalyst

The FX drivers and value analysis are all pointing to a weaker yen. There is a potential catalyst which would mean a much weaker yen, faster, and driven by immediate monetary action. And the yen is not moving. Still hanging around the 78-80 range. I cannot wait for the 15.00 telephone conversation to confirm the political side of the trade.

The conversation last for an hour and confirms all our assumptions: Abe will win and he will implement his plans. The firmest answers I have heard from our consultant to date. It is the real thing. My excitement is rising. But patience. Now it is time to get the market feel by talking to some large FX traders in the market.

Yep all traders are non-commital and nobody is hugely positioned. Great!

Back to inspector gadget who will give us the statistics on the yen futures positions IMM, CFTC – overall no bias confirming what the traders had told me. (This being FX the largest market in the world and mainly done over the counter it is worthwhile getting an idea of positioning from the actual traders, since published stats about positions are not conclusive enough). It is as if the market is still in shock that the yen is this strong at the moment and cannot get weaker. A phenomena called 'anchoring' – a price level is somehow perceived as a 'normal' level and people have difficulty in imagining it ever changing again. But we know better don't we.

Timing the Markets

Now it is time to consult our systems for market timing. These systems consist of 5 different proprietary technical systems, some trend following, some pattern recognition and some swing systems, which make money in their own right over time. These tools for us are used for market timing. Once a conclusive analysis has been conducted, that looks into the macro, flow and drivers of the underlying, market tone, positioning, possible catalyst, volatility levels and option prices we would consult our timing systems, affectionately called 'Tom and Jerry' for just that: timing.

Tom & Jerry is not involved in the trade yet. There is still time. The market seems currently uninterested and we seem to be early in our conclusions. Other news and events, position management and trades overshadow the rest of the day.

At night, however, I read only reports about Japan and see differing view points. Smiling at various analysis – how much easier life is since we developed Inspector Gadget, who gives us all the information that we find in any of these reports but in a way that I can easily digest them. All at your fingertips. The upshot of all I read: confirming all our assumptions. We are definitely onto something!

Risk Management Begins with Instrument Selection

Now it is time to analyse which instruments to utilise for this trade once the time comes (and the time comes with Tom & Jerry as our guide, since we would only enter in a trade like this when it has already started moving in our favour, with a predetermined stop).

Choice of instrument: Volatility (vol) is low across markets on all FX instruments. If what we are thinking should occur then vol will be getting bid very quickly to higher levels from the current 5% or so. Options seem a good way to go. We look at options and the underlying for our trade and decide on a mix.

We analyse the mix as it would fit into our portfolio: correlations with our other positions, sensitivity analysis and positions sizing. We enter our confidence levels into our matrix and conduct our 'when to reduce position size' analysis.

This is a two step process, where we a) stack our arguments and discuss how we have to reduce our positions if each block falls away and b) how much we need to reduce if our risk blocks materialise. This is irrespective of price move, a high level risk analysis (though it must be said that if any of our fears materialise we would expect some price response).

Then we conduct a risk analysis based on price and volatility. We set our stops, we set our trailing stops if the trade should move in our favour and we set our 'soft' risk analysis matrix on top. We are set. Ready to put on the trade. But we wait.

Trade Execution and Maintenance

We wait. We wait, each day looking at Tom and Jerry for our entry point. Doing our daily analysis of the macroeconomic world, then the demand-supply analysis of commodities we analyse and relative value trades we follow. We evaluate new data and set our scenarios for what we think will happen next and search for discrepancies across the globe. All the while glancing at the yen.

Finally, early November the time has arrived, we get signals from Tom and Jerry. The overall Macro story fully intact and even more likely for Abe's party to win and implement change. It is now mid November 2012.

All else is already set, analysed, predetermined and mechanical, we know our risk before we enter and our overall portfolio performance with this additional trade; from now on it is really more mechanical. Our execution trader gets the go-ahead with all relevant parameters: we are now involved.

The seeds have been sown, now it is in fact a mechanical exercise: whenever a risk materialises we mark it in our matrix. If enough items are marked a certain predetermined action will be taken (like increase the position or reduce the position). We move our stops higher in line with the price move and volatility indicators. We continue to ride this position all the way to 103. Then one of our pre-determined risk factors occurs and we mechanically reduce the position by half and finally cut the position. Our entry point at 82. Our exit 102.25. It turns out to be a successful trade!

Being the Casino, Not the Gambler

But many do not turn out the same way. A lot of time and effort is wasted on analysis and more analysis only to wait for the 'perfect' timing to only watch your exit stop getting hit within the first weeks of the trade. But since we analyse trades where we risk 1% but make a minimum of 2% if we win the odds are clearly stacked in our favour, especially since we try to pick trades with a better than 50:50 hit rate, which is much harder than people think! Overall our research intensive process assists us in keeping a high 'hit ratio' and finding good risk:reward trades of 2:1 or 3:1. Combined with strong risk management and diversification across both asset classes and strategies of relative value and fat tail trades, we manage to achieve our strong statistics to date: a sharpe ratio above 2 and two digit returns with 17% year to date.

Questions are the start of any analysis and many end in further research which proves them wrong, but then there are some, which upon further research stand out as solid trading opportunities, worth investing in. The short Yen trade was one of them.

Archbridge Capital AG is based in Zug Switzerland.

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