Wall Street Unnerved by Herd Strategy's Best Month Since 2014

By **Dani Burger**
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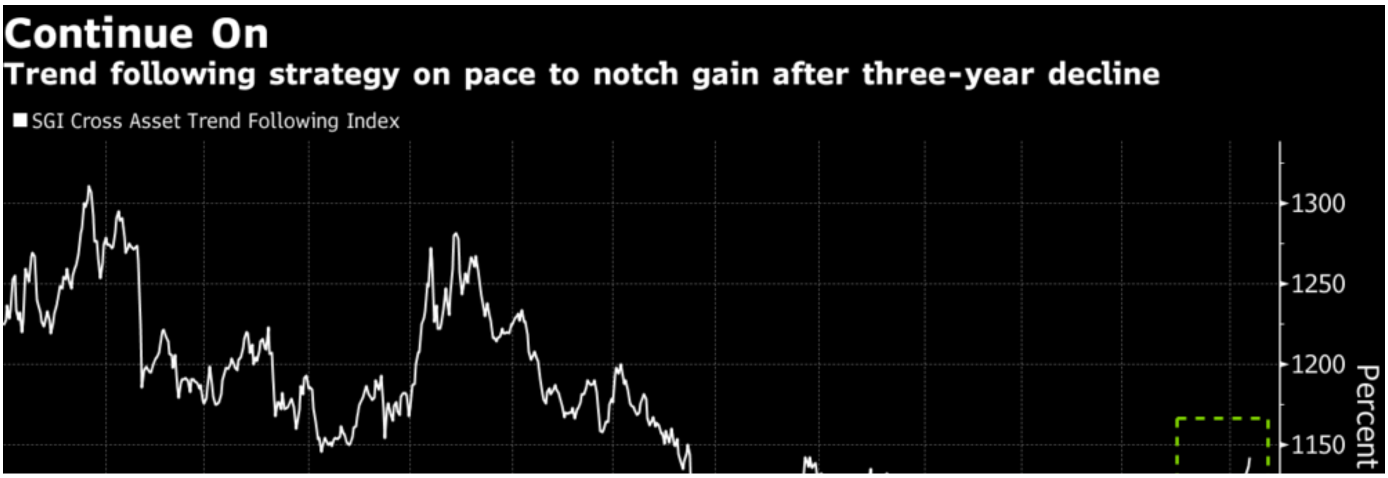
- Trend-following captivates stocks, bonds, fx, commodities
- Warning signs point to coming reversal, pain for popular trade

Asset allocators hoping to turn a profit this month only needed one simple rule: Don't fight the trend.

Everywhere you look -- stocks, bonds, commodities, currencies -- past winners keep thriving. Despite concern over shifting central bank policies or a sudden flare-up of inflation, January has been more of the same. In fact, cross-asset market momentum has only been this bullish three other times in the past decade.

If you held four separate portfolios of each main asset class, bought the best performing securities over the past few months and shorted the worst, each category is on pace to advance in January. Together, the simultaneous upswing is the strongest since 2014, according to a Bloomberg analysis of Societe Generale SA data.



“There’s a consistent cyclically bullish undertone and a consistent message which is that everything is good on the economic side which is why all the trend following stuff is working perfectly well,” said Andrew Lapthorne, head of quantitative strategy at Societe Generale.

It’s a stark contrast from the past few years, where political upheavals and hawkish central bank talk sparked sudden selloffs or quick reversals in the most-loved securities. In the past, the lack of volatility resulted in meandering markets without clear direction. Like in 2017, the calm is sending market leaders on an unimpeded path higher.

Betting on past winners is the most strong in equities, piggybacking off of the best year for stock trend following since 1995 thanks to technology company leadership. This month, every asset joined in charting a cyclically bullish path as global growth remains strong, Lapthorne said.

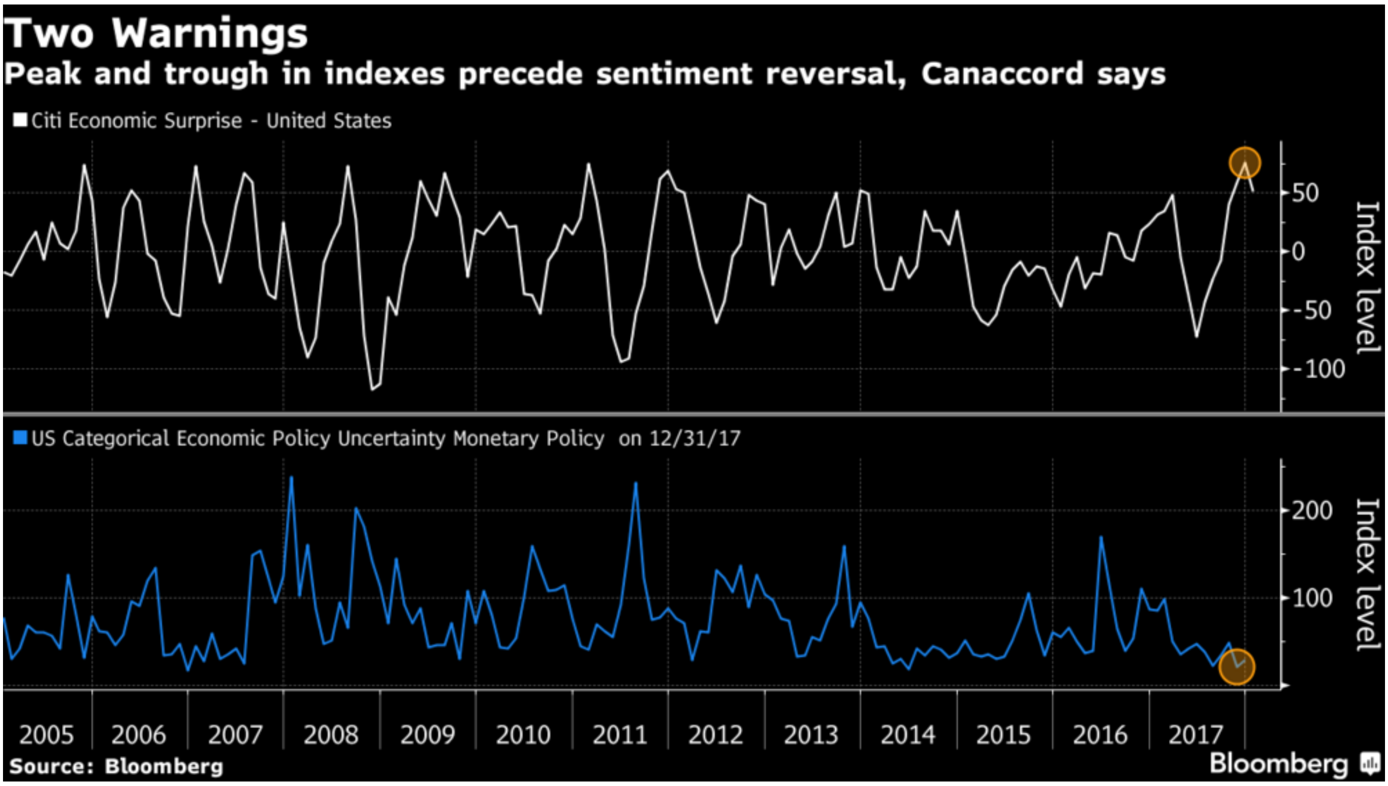
Yet, like the flattening yield curve, not everything fits the message, he said. Besides equities, trend-following has worked best in currencies with a short dollar position, in spite of steady U.S. economic growth and tax cuts.

Story on why market optimism is unnerving Pimco <https://www.bloomberg.com/news/articles/2018-01-18/pimco-says-lack-of-fear-in-markets-means-you-should-be-worried>

Cracks in the bullish trend are forming and will be painful for those riding the wave, according to Societe Generale. That’s especially so at a time when dormant volatility has encouraged investors to put on trend trades with little protection. The risk is that as soon as the direction changes, a stampede will rush out.

“You could argue that people’s position size might need to radically change if there’s a big up in volatility,” Lapthorne said. “Defensive assets have been complete dogs over the last 12 months and people aren’t thinking defensively. People don’t want to pay up for insurance right before things start catching fire.”

Canaccord Genuity Inc.'s Tony Dwyer noted a peak in the Citigroup Economic Surprise Index of forecast-beating data and a low in the Federal Reserve's Monetary Policy Uncertainty Index -- two points that historically precede incoming volatility and a reversal in investors' optimistic views. For now, the Cboe Volatility Index sits far below its 10-year average.



Sooner or later, trend-trading expectations may overshoot "reality," according to Melissa Brown, managing director of applied research at Axioma Inc., a provider of tools for risk management and portfolio construction.

"Having worked with momentum models, that's something you see once in a while," Brown said. "It's a strategy that's really good until it's bad."

Large groups of automated traders are trend followers, having loaded up on the best-performing assets as clear patterns emerged without volatility. And the same triggers could send them out of the trades at once, exacerbating a selloff, according to strategists <https://www.bloomberg.com/news/articles/2017-01-11/wall-street-s-most-famous-quants-fed-up-with-jpmorgan-soothsayer> at JPMorgan Chase & Co.

So far in 2018, those with a herd mentality have been on the winning side.

"Everything has gone in a straight line," James Barty, Bank of America Corp.'s head of global cross-asset and European equity strategy, said by phone. "You've come into the year with a perfect layup of strong data and tax reform. There's barely been a pull back, but at some point, things will have a shake out."

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