ONERIVER DIGITAL
ASSET MANAGEMENT

It was too easy for too long. Buy and hold the narrative. Passive investments are challenged by a low-return world of financial repression. Active strategies and the avoidance of undue leverage are investor-friendly tools for the way forward.

market notes: Stay Active, in Spirit and in Portfolios

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1. The Golden Era for passive investment has passed. It was a remarkable run. Returns from a 60-40%, stock-bond portfolio returned on average of 9.5% between 1990 and 2021 (Figure 1). In periods of strain, like 2008, bonds provided a considerable cushion to the massive equity downturn. And in periods of strong gains, like the 1995 surge in share prices, bonds still enjoyed healthy returns.

2. The value of passive, balanced portfolios showed strongly after the equity downturn in the early 2000s (Figure 2). Whereas equity drawdowns were substantial and took nearly a decade to recover, adding a boring bond allocation lessened the severity of the drawdown and supported a faster recovery. Using leverage in fixed income portfolios did even better, and strategies were formed based on that performance.

3. Clues emerged during the pandemic that the times were changing. Figure 3 illustrates drawdown dynamics centered on March 2020. The stock-bond differentiation evident in the early 2000s vanished in the 2020 drawdown. Stocks and bonds performed with similar risk attributes and recovery rates from the drawdown. Passive strategies were strong in the end – a 60-40% portfolio averaged returns of 15.3% in 2020 and 2021. But it was increasingly clear that a common excess was the cause – low real interest rates.

4. The secular decline in real interest rates that started as a diversifier to portfolios turned into a risk factor. It was all about inflation. Rising productivity and increased globalization kept inflation subdued even during periods of strong growth. Monetary policy — convinced inflation could not be an issue — became more determined to cut rates on downside surprise than to hike in good times. No doubt, the Fed QE in 2021, at $1.425 trillion, was larger than the 2008 crisis response despite rapidly declining unemployment. Inflation couldn't return.

5. And then inflation returned. The recent downturn in equity markets that followed higher inflation is not the issue. Stocks are down in the low double-digits this year – investors have lived through worse with better people in charge. But nothing provided a hedge other than USD cash. Leveraged bond exposure added to risk, rather than serving as an extra cushion, as UK pensions learned earlier this year when on the brink of bankruptcy. Everything has changed.

6. Passive allocations to digital assets met a similar fate, though with important differences. In the 2015-2021 period, a moderate allocation to digital assets in an unleveraged portfolio mirrored the performance of a passive portfolio leveraged to bonds (Figure 4). True, digital assets suffered from the sharp rise in real interest rates, designed to keep inflation expectations low. But digital did a lot less damage relative to leverage in traditional assets on the way down.

7. 2022 marks the great normalization. Policy was faster to tighten than to ease for the first time since the mid-1990s. Unlike the mid-1990s, policy signals suggest that this is likely to be a lasting asymmetry. The latest FOMC projections are consistent with a gentle US recession, yet the Fed maintains a path to tightening. Quietly in the background, quantitative tightening is also set to continue.

8. It is all about the macro. And there are three forces that are likely to dominate in the period ahead. First, government debts bloated by subsidized interest rates will take decades to resolve, not years. Second, the least-resisted path to resolving excessive government debt is financial repression – a long period of higher inflation. Third, 2% inflation is more likely to be a floor in coming cycles than a cap, as in cycles of the recent past.

9. Long-term returns will be challenged in that world. Figure 5 illustrates our estimates of 10-year returns with 5.5% nominal GDP growth, 3.26% annual bond returns reflecting financial

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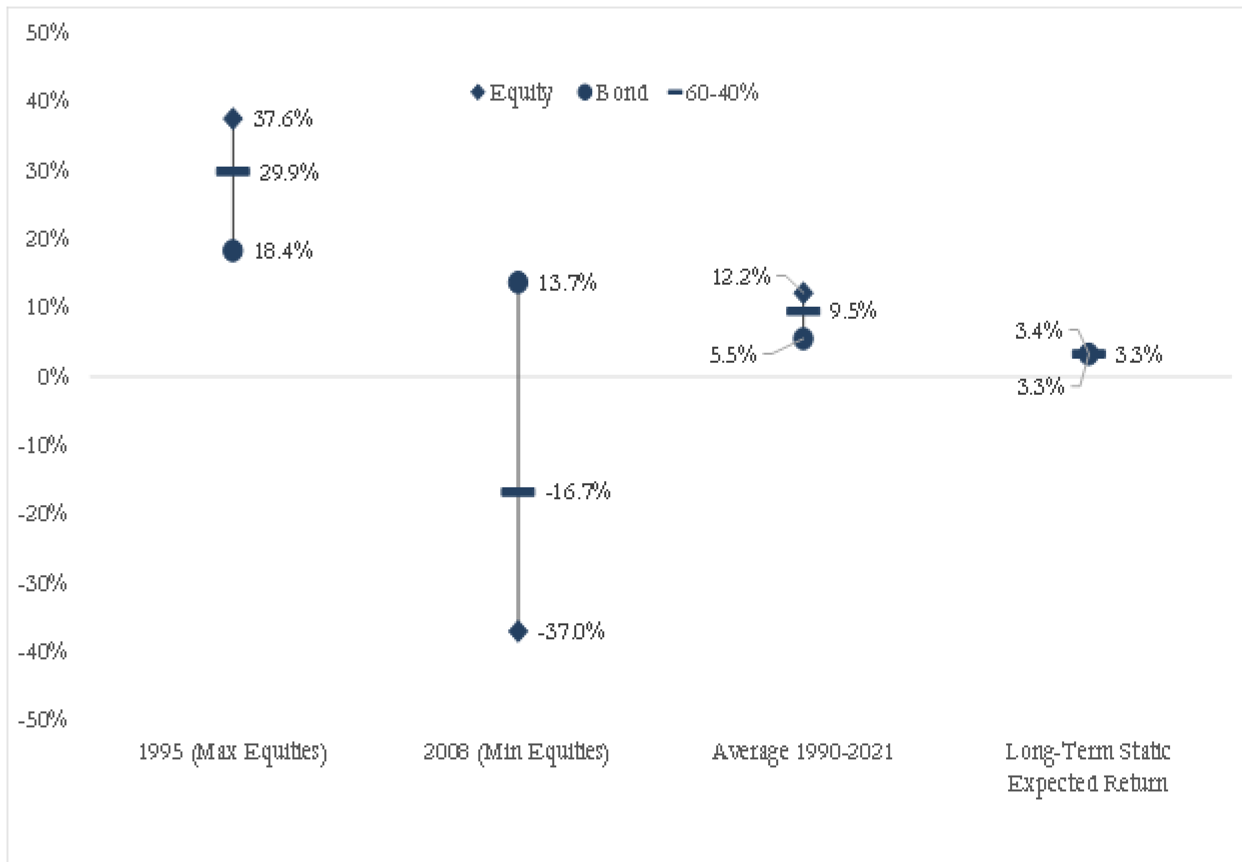
repression, and a gradual return of equity valuations to longer-term norms. It is an innocuous set of assumptions. Allocations to digital assets can have a material impact in a low-return world by disrupting existing market segments.

10. History is a useful tool to identify the pathway forward. A long period of low returns is not about a flatlining of asset prices. It is about high volatility around a very weak trend. It is an environment of profound change where markets are hunting for new equilibrium anchors. Active strategies that are attentive to volatility are the right tool as they are more adaptive, and less prone to extrapolating an existing trend.

11. Be technologically agnostic to the role digital assets play. We cannot be sure where the un-lock will emerge – art, governance, social media, and mobile phones are all possible. But the pressure for efficiency enhancement in the payments system, spurred by digital technologies, is not going away. It will be met with change. Elon Musk, an unlikely champion of that change through Twitter, argues that "whichever [currency] has the least error & latency will win." Actively manage the trend.

Figure 1: Tougher Times Ahead for Passive Portfolios



Source: Bloomberg LP. S&P 500 total return index. Bloomberg US government bond total return index. One River Digital Calculations. The 3.3% balanced portfolio return assumed 5.5% nominal GDP growth, 1% dividend yields, and a return of equity valuations to longer-term norms. Bond returns are assumed to be at current yields.

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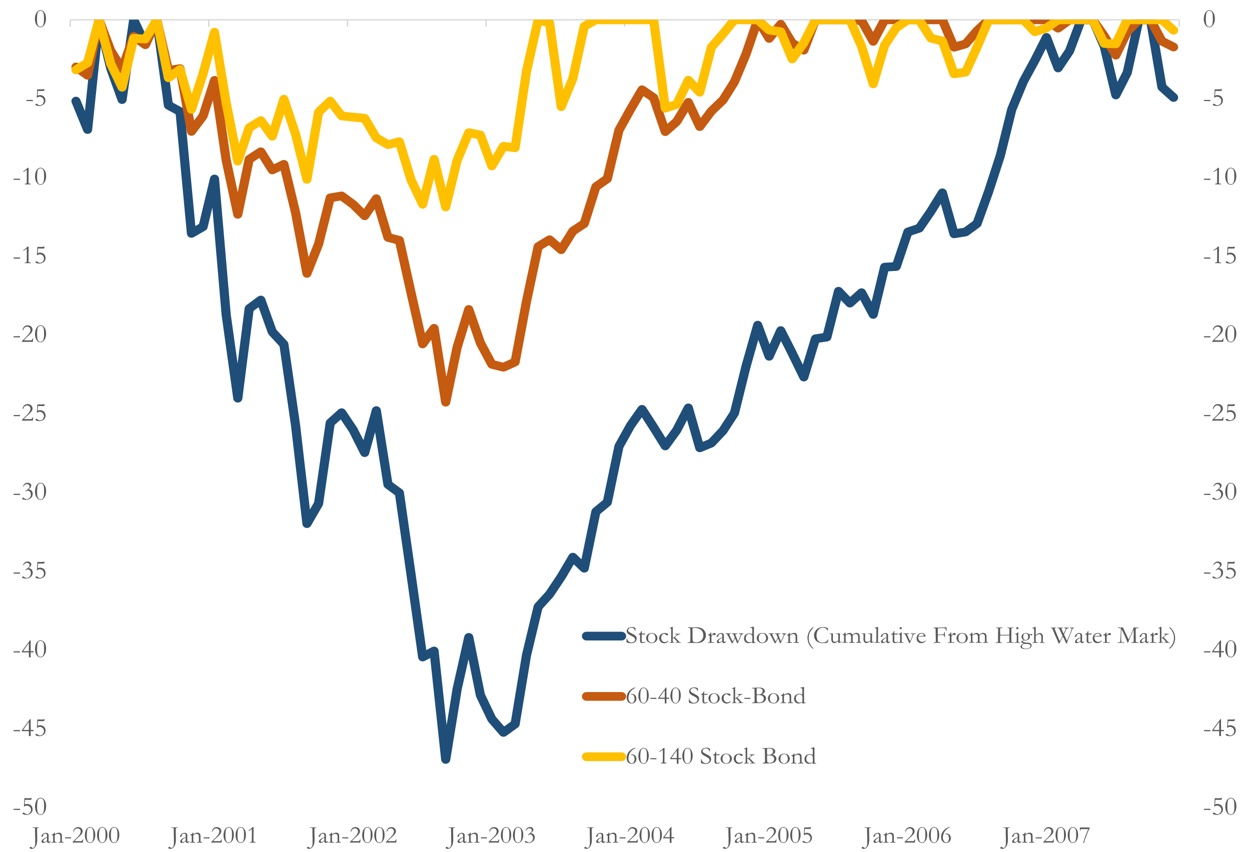
Figure 2: Bonds Smoothed Early 2000s Drawdown



Source: Bloomberg LP. S&P 500 total return index. Bloomberg US government bond total return index. One River Digital Calculations.

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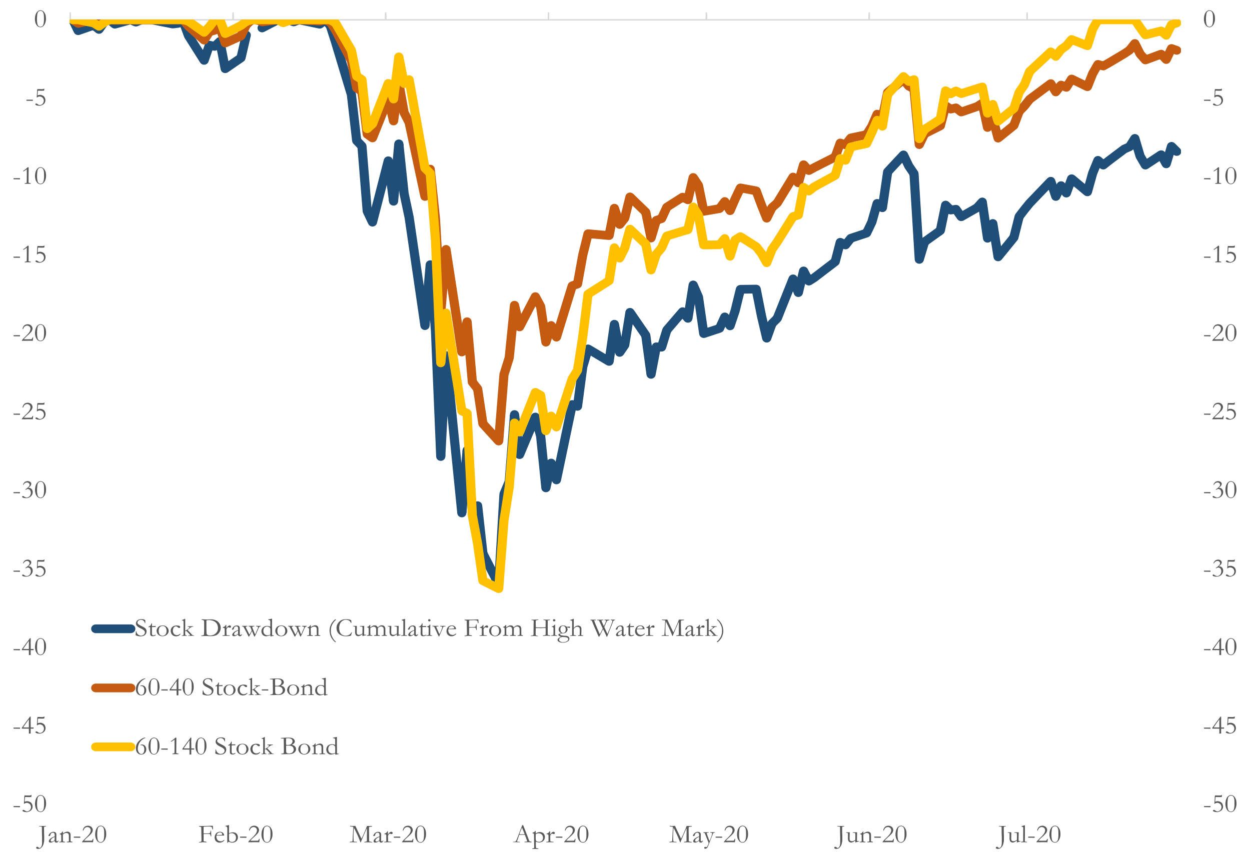
Figure 3: Drawdown in March 2020 More Correlated



Source: Bloomberg LP. S&P 500 total return index. Bloomberg US government bond total return index. One River Digital Calculations.

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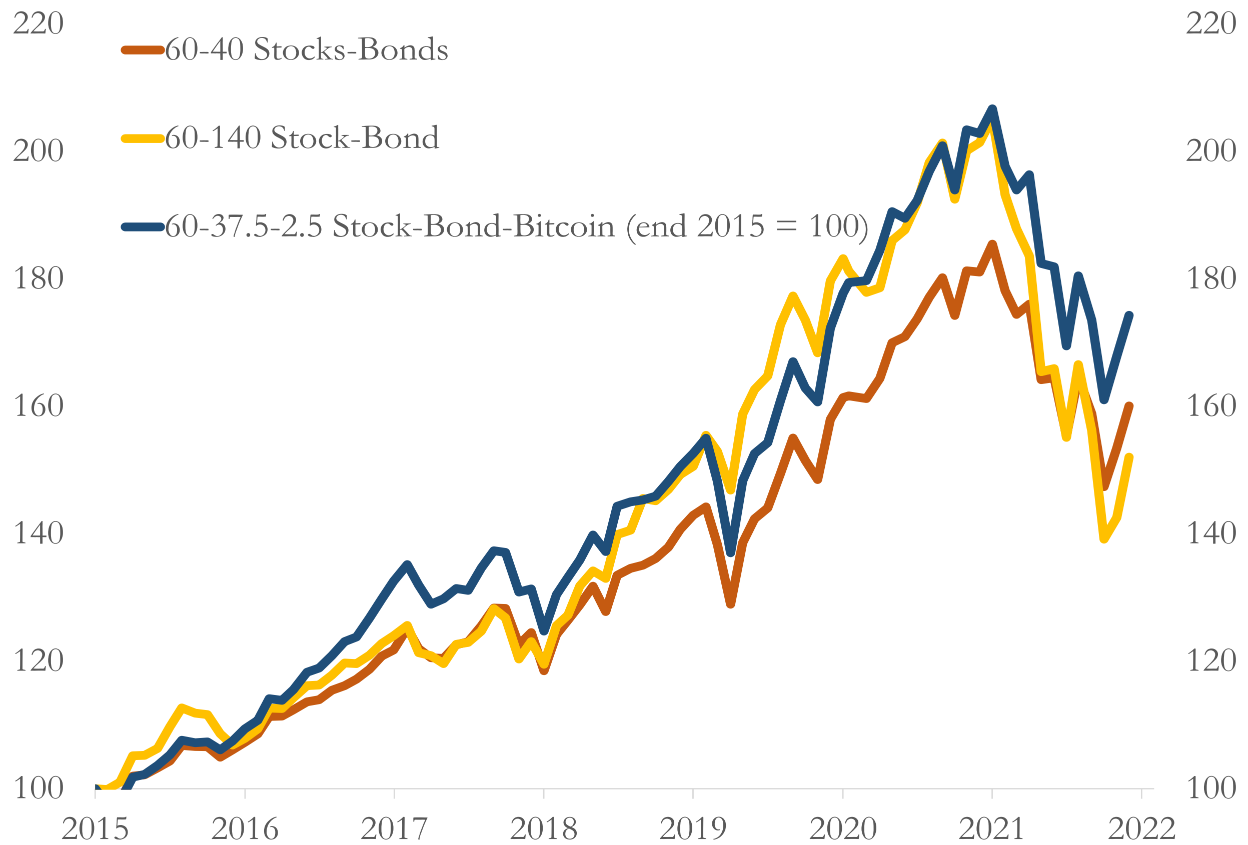
Figure 4: Digital Assets Mirrored Leveraged Bonds Up, Less Damage Down



Source: Bloomberg LP. S&P 500 total return index. Bloomberg US government bond total return index. One River Digital Calculations.

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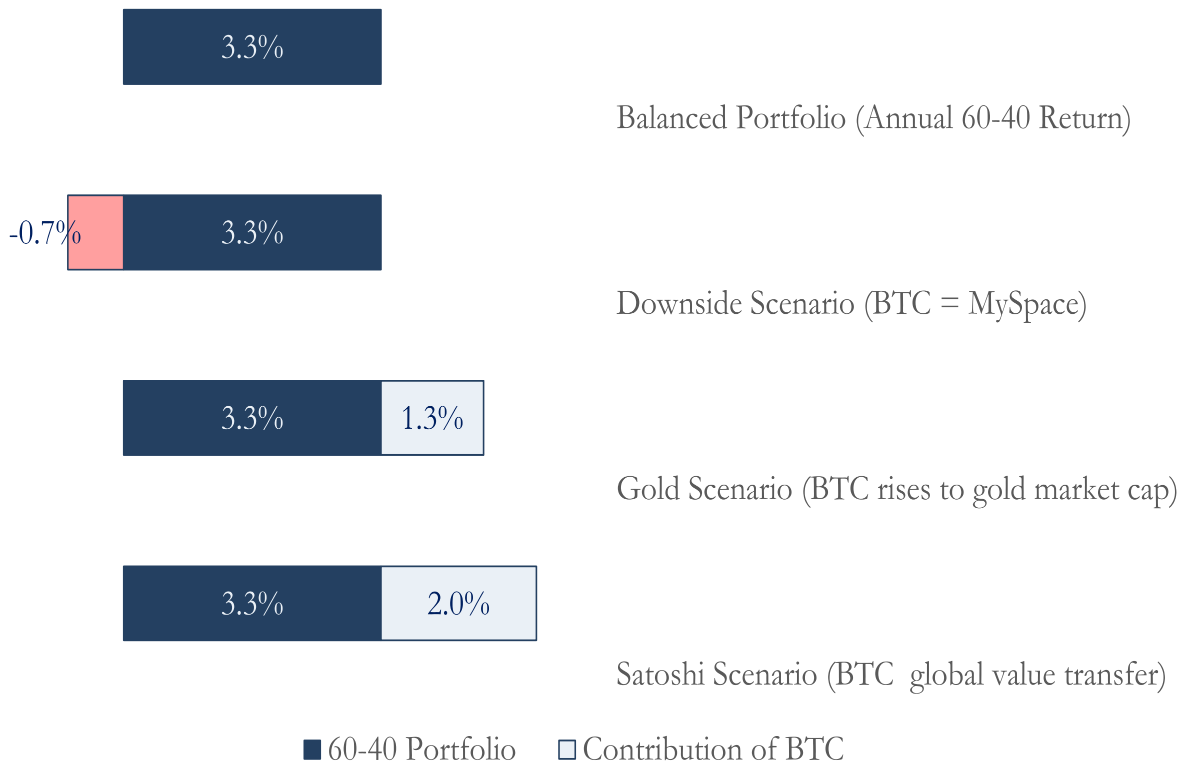
Figure 5: Soggy Forward Return Expectations Makes Digital Disruption More Impactful



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