

## Kyklos Capital

### Outlook: How All Markets Act the Same-- Until They Don't. USD Revisited.

***"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."*** *Extraordinary Popular Delusions and the Madness of Crowds*, Charles Mackay

Similar markets, like herd animals, have a tendency to move together, which in statistics-speak is known as correlation. In the current Covid crisis, investors may be the ultimate non-social-distancers, as they buy and sell all together much more than usual. The reason we talk about correlation is that investors benefit from avoiding it. The best way to cut investment risk is to own some assets that zig while others zag. The global Frontier equity markets, which we focus on at Kyklos, cut risk significantly in this way. They are resistant, but not immune, however, to joining the herd in these scary times.

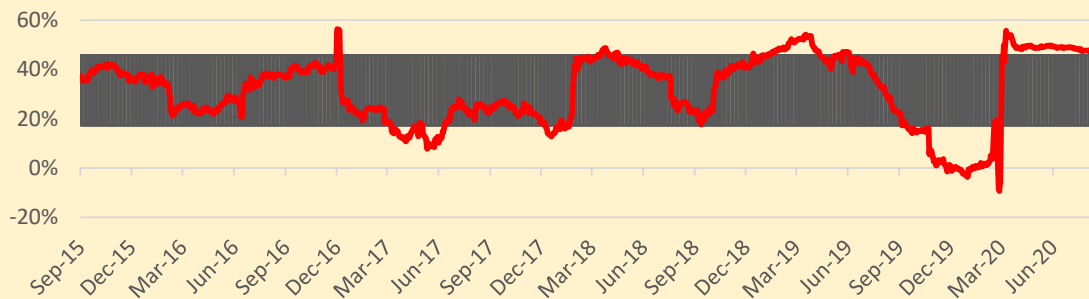
Exhibit one: Frontier markets, which together offer the lowest correlation of returns of any major equity class to the US market, at just above 30% on average (see graph below), have recently seen spiking correlations to above 50%-- still offering good bang-for-buck in terms of risk reduction for a US-focused investor, but a lot less than usual.

Exhibit two: Kyklos, as an active manager, is designed to offer added risk reduction benefits versus the simple passive market indexes such as the MSCI Frontier 100 Index. And indeed, its average correlation to the MSCI Frontier 100 ETF is about 50%. For an owner of the S&P 500 Index, a fund that only correlates at 50% to its asset class, which itself only correlates at 30%, offers huge diversification benefits. In today's feverish Covid markets, however, Kyklos's 120-day returns correlate with the Frontier ETF at 100%. All stocks are marching to the same drummer.

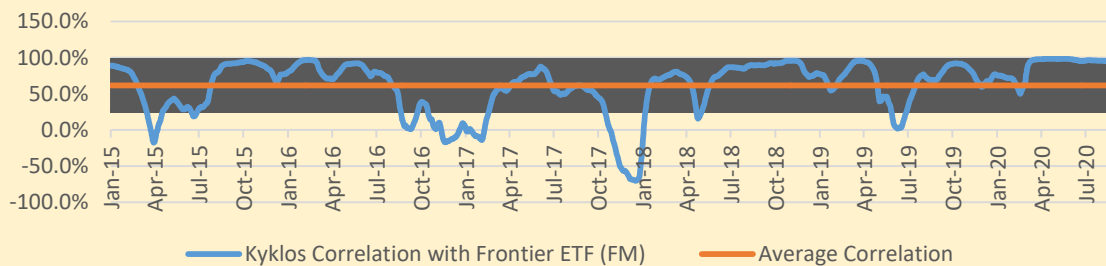
As all investors know, however, when you buy a stock, you get the future, not the past. Since this is about making predictions, here is a bold one: The spike in correlations shall reverse, both for Frontier markets with the US, and for Kyklos with the broad Frontier markets. Frontier's past correlation with the S&P 500 maxed out near current levels in 2019, 2018, and 2017. Kyklos's correlation with Frontier peaked in each of those years as well as in 2015 and 2016. As for possible catalysts that could get markets moving in different directions again, several would do the trick: a Covid vaccine, better pandemic control discipline, economic visibility following US elections, or maybe a Chinese GDP recovery. Covid remains wildly unpredictable, but fear-- **which is what drives markets--** has probably peaked.

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### Is This Peak Correlation? Frontier's Correlation with the S&P Maxes Out...

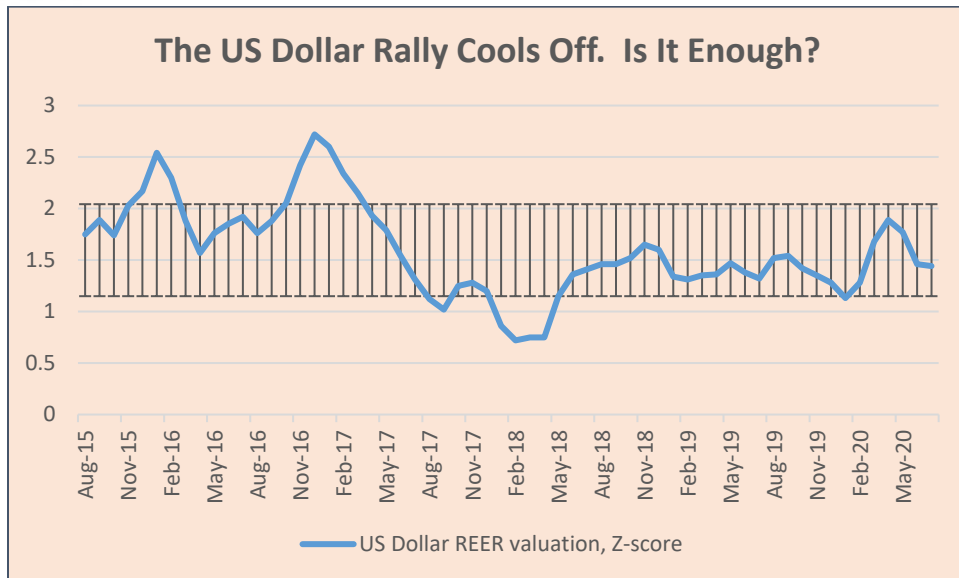


### ... And So Does Kyklos's Correlation With Frontier



### What's Up With the US Dollar?

Back in June we noted, along with a lot of other commentators, that the US dollar looked ripe for some weakening, which would typically be good news for Frontier markets (see Kyklos' June investors letter section entitled, "So Frontier is cheap. What can turn it around?"). An investor who shorted the US Dollar Index (DXY) and bought the MSCI Frontier Markets Index (MXFM) on June 30 would have bagged over 5% on each leg of his trade. The chart below highlights that, fundamentally at least, the dollar is looking less stretched, but not especially discounted. As a driver for Kyklos's returns, some of our expected dollar weakness is in prices, and country and stock selection will again be critical.



Charlie Gushee  
August 31, 2020

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