Weekly Market Summary

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A Disturbing Disconnect .... Bond Indifference Versus Equity Exuberance?!

Fadi Nasser - Deputy Chief Investment & Treasury Officer

Asset Correlation is a measure of how investments move in relation to one another and when. Whenever assets move in the same direction at the same time, they are considered to be highly correlated (positive correlation). When one asset tends to move up whilst the other goes down, the two assets are considered to be negatively correlated. According to The Pros Guide to Diversification from Fidelity Investments: "*Correlation is a number from -100% to 100% that is computed using historical returns. A correlation of 50% between two stocks, for example, means that in the past when the return on one stock was going up, then about 50% of the time the return on the other stock was going up, too. A correlation of -70% tells you that historically 70% of the time they were moving in opposite directions -- one stock was going up and the other was going down.*" A correlation of 0 means that the returns of assets are completely uncorrelated (or non-correlated); In which case, the price movement of one asset has no effect on the price movement of the other asset.

Under what is known as modern portfolio theory, one can reduce the overall risk in an investment portfolio and even boost his/her overall returns by investing in asset combinations that are either negatively correlated or not correlated at all. As a result, your highs may not be as high as your friend's, but neither will your lows be as low. But then again, that is just good on paper! The correlation and non-correlation theory makes good sense, but it was always easier to prove it back when markets behaved more rationally - mostly driven up/down by economic fundamentals (bullish/bearish data releases). Today, markets are not as predictable - not as stable and are changing the way they move - driving many legendary long-time investors insane! In fact, most financial experts agree that correlation seems to have really changed post-financial crisis of 2008 (and really-really-really changed post Trump election!).

Take for example investors' focus on the stock-bond relationship: Intuitively, a negative correlation between equities and bonds – which has been largely true of U.S. equities and Treasuries since the early 1990s – would suggest that bonds perform well when equities sell off, whereas a positive correlation would be evidence that bonds are not an effective hedge against equity risk. What is key from an investment perspective is that bonds provided needed diversification to equity risk in six of the past seven recessions; The sole exception was 1973, when Treasuries returned -3.5% during the recession's first half (but ultimately produced positive nominal returns by the end of the recession). That, in turn, implied holding a combination of stocks, bonds and, perhaps some cash and real estate over the long term would do the trick for any conventional investor; After all, these assets tended all to perform in a less-than-correlated-way, and in a combination that was supposed to help dampen the overall volatility of a portfolio. But whilst that proved to be the right approach to portfolio diversification during the height of the financial crisis in 2008/09 when the historically negative stock-bond correlation held and the rally in bond markets helped to a great extent hedge against a significant equity market sell-off, recent price action would suggest there is more merit in going long all asset prices, courtesy Mr. Trump's relentless efforts to lift equity markets and a hopeless, "*better dovish than sorry*", squeezed, shamed Federal Reserve!

Going back to the period extending from early 2016 to late October 2018, correlation between the two asset classes (bonds and equities) dived into negative territory as Treasuries sold off whilst U.S. stocks climbed (S&P rallying 58% whilst 10-year US Treasury yields doubled in value, rising from 1.63% to 3.26%!). Then in late 2018, caught between a Federal Reserve still keen on normalizing interest rates / its balance sheet and a mad US President turning global trade upside down, markets witnessed the steepest monthly sell-off in equities in years (a drop-in excess of 20% between early November and late December).

US Treasuries, on the other hand, saw a sizable jump in prices, with yields on 10-year US Treasuries retracing from a high of 3.26% to a low of 2.68% during the same period (a full 58 bps or 18% yield dive!). That prompted Richard Turnill, BlackRock's global chief investment strategist, to write in a note to clients that "*the correlation between equity and bond returns will remain significantly negative in 2019 as the economic cycle enters its late stages…Bonds may offer a more formidable ballast to equity exposures.*" Instead, markets have only witnessed a perfectly positive correlation between those two asset classes and a relentless rally in both equity and bond prices since early 2019.

So how can this phenomenon be best explained to our valuable readers?

Last year's – as well as the past couple of weeks' - huge rally in government bonds reflects deep anxiety (most likely overdone!) about the health of the global economy. Benchmark 10-year government bond yields in the US sank from about 2.68% at the end of 2018 to as low as 1.44% back in early September 2019, before closing 2019 at 1.92% (last at 1.81%). The simplest explanation is that investors responded to a combination of weaker-than-expected economic data – mostly in China and Europe – intensifying political / geopolitical tensions globally and increasingly cautious signals from the Federal Reserve & other major central banks. However, there are reasons to believe that bond markets might have overreacted to cues from the global economy. China is slowing but in a gradual way (this morning's data showed China's economy growing 6.0% in the fourth quarter of 2019 and 6.1% YoY, whilst fixed-asset investment accelerated for the first time in six months – signalling that a firmer recovery could be underway), Europe is weak but still seems unlikely to face a recession and the Federal Reserve currently expects the US economy to expand at an annual rate of 1.75% -- 2.00% in 2020, similar to 2019 figures and in line with the economy's longer-run trend. The Fed Funds futures markets indicate that traders think the US central bank will cut rates once more in the second half of 2020, though many fund managers argue that looks excessive in the face of slower but still resilient growth. "*The bond market is sniffing out a global recession, but a little too aggressively*," said Abhay Deshpande, chief investment officer at Centerstone Investors. "*We'll probably see a muddle-through, slower growth and some growth scares, but I think the Fed may have averted the worst-case scenario.*"

As to equity markets, they surely remain on fire! Driven mostly by Wall Street, global stocks presided last year over their largest annual advance since 2010. The 14% climb in US benchmarks over the past three months alone has been supported by a positive outlook for equity earnings and hopes that progress in US-China trade talks would culminate in the signing of a phase one Sino – US trade deal (The "*Beautiful Monster*" of a deal with China was signed, sealed and dusted last Wednesday afternoon, though the American bankers Association's Economic Advisory, a group of chief economists from large banks, has played down any prospect the signing would lift American growth in 2020, contradicting the optimism of the Trump administration). Additionally, investors continue assuming - for the right reasons – that the US president needs, wants and will do "*whatever it takes*" to ensure a sustained stock market rally throughout 2020! Surely Mr. Trump is anchoring his re-election prospects firmly to a booming stock market and a record economic expansion given that that there has been an "*extraordinarily strong*" correlation between an incumbent president's margin of victory and household economic confidence, based on surveys going back to 1992.

How much further this dual rally last is the million-dollar question!!

With markets now mostly focused on positives and investors ignoring or placing very low probabilities on potential market reversals – not to forget widespread recurring geopolitical and political concerns that could eventually lead to heightened market volatility – there is a huge risk that all the good news has by now been fully priced in at current elevated equity valuations (I am that boy who keeps crying wolf ☹ However, in doing so, I truly have our clients' best interests in mind). Similarly, "*flashing red*" signs of a bond bubble are all over the place as fixed-income traders and cash-rich investors hunt for any opportunity to lock-in yield; The latest evidence: Italy's offering of 30-year bonds earlier this week received over 44 billion euros ($49 billion) of orders (the previous record for a sale of this duration was 41 billion euros, set last year), with investors putting on the side concerns about political instability in the country.

Italy joins a growing list of borrowers riding the seemingly ceaseless demand for new government notes. A Spanish bond sale on Tuesday enjoyed record orders too; ditto an Irish offering last week. In a world of easy monetary policy, stubbornly low inflation (surely not the case if you're sending your son to study in a UK university! ☹) and almost $11 trillion of bonds still trading with negative yields, traders are being forced to make peace with those kinds of risks.

John Authers – a Bloomberg columnist – suggests recent market distortions are a direct result of a "*Tidal Wave of Liquidity.. And Waves Crash*." Indeed, John confirms that global liquidity has surged upwards over the last few months, and in normal times that would be followed by an uptick in business activity. Why does liquidity look quite so bullish? As ever, John thanks central banks and particularly the US Federal Reserve. Twelve months ago, the U.S. central bank intended to restrict liquidity steadily by shrinking the assets on its balance sheet on "*auto-pilot*." That changed, though. It reversed course and then cut rates three times in the second half of 2019. And most importantly, it lately started building its balance sheet again in an attempt to shore up the repo market - which banks use to access short-term finance - when it suddenly froze up last September (another Bloomberg article refers to a "*Federal Reserve Stuck in Quantitative-Easing Hell*"). Other central banks matter as well; Last year, the People's Bank of China tightened liquidity as it attempted to clean balance sheets in over-extended local governments. Now, signs are emerging that it will be able to loosen again: After dramatic withdrawals of liquidity, the PBoC has now returned to injections, while also reducing the reserve ratio that banks must maintain, effectively allowing them to lend more.

The bad news is that we have the conditions for speculation to run riot! In the shorter term (which significantly does include the U.S. presidential election), the liquidity administered by the Fed should keep everything floating upwards. However, it will also be hard to see how bond yields go much lower unless they are driven down by poor economic performance. And if that happens, it surely would be tough for the stock market to extend or maintain its current gains!

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