CIO BLOG

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IT WAS THE BEST OF TIMES, IT WAS THE WORST OF TIMES

August tends to be a sleepy month in markets, with many finance professionals away with friends and family, reading the classics as opposed to finance news – the title of this blog is borrowed from Charles Dickens' *A Tale of Two Cities*. We should use it to reflect on what has been a great year for investors, the latest in a rip-roaring decade. Indeed, equities continue to rally, with the US market at an all-time high, up over 20% year-to-date. UK and European equities, while not as buoyant, have also recorded double-digit gains year-to-date; Chinese equities have soared by nearly 30%. Indeed, risk assets continue to rise as the equity bull run barrels on for an eleventh year. *It was the best of times.*

Yet, in stark contrast from other similarly aged bull runs, fear abounds. Safe-haven German and Japanese bonds maturing a decade from now offer outright negative yields, part of over $13 trillion in government debt yielding below-zero at present. Investors are clearly willing to pay out of their pockets for the privilege of lending to these governments – which speaks to their pessimism of the future. Thirty-year Gilts yield just 1.32%, well below the rate of inflation, partly as fears of a hard "Brexit" have soared again. Gold, a crisis hedge for thousands of years, has rallied by 11% thus far this year, trading at a six-year high. *It was the worst of times*.

How can it be both?

Hard Times

Over a decade on from the lacerations of the financial crisis, global economic growth is still insipid despite the colossal efforts of central banks around the world. These efforts – low / negative rates, quantitative easing – while somewhat fruitless in their primary cause (i.e. sustained, above-trend growth), continue to directly underpin bond markets. The Bank of Japan is still actively intervening, buying government bonds, corporate bonds, and equities. The European Central Bank is running a negative base rate and has signalled it will reverse its seven-month hiatus on its quantitative easing program in September. The US Federal Reserve reversed a string of nine rate increases, cutting its base late in July. Market expectations are for the Bank of England are to do much the same – its rate is only slightly above historic lows in any event. All of this is keeping bond prices up and yields down.

And the lower yields are on government bonds, the more attractive equities appear in comparison for two main reasons. One is simply mathematical: future cash flows from corporate earnings are "discounted" less (i.e. the opportunity cost from holding "risk-free" bonds is less of a drag). Two, bonds are yielding outright negative returns in much of the world – and once inflation is taken into account, negative real returns exist is nearly all developed markets. Very few investors are holding them as a traditional, lucrative investment, but rather as a crisis hedge. In this context, unless one is expecting a recession or a negative shock, equities simply are far more attractive: *at least one expects a positive real return, albeit muted at this stage in the cycle.*

This inevitably pushes individual investors further along the risk continuum and increases overall systemic risk in markets. While equities are the only asset class where a real return is likely, they can be dangerous given their propensity for sharp falls. Moreover, central banks (or any other entity) cannot continue bond-buying or super low-rates indefinitely without seriously inflating the value of bonds, and thereby skewing traditional risk / reward parameters in financial markets. Such skews tend to result in sudden and savage reckonings. Perhaps most importantly, there is no substitute for economic growth. While it is not correlated with asset class returns in the short-run, it is in the long-run. *Markets would prefer risk assets underpinned by healthy long-term economic fundamentals rather than short-term monetary ones.*

Bleak House

A number of other economic and geopolitical risks muddy the waters further at present. The current equity bull run has been seriously challenged when fears of a slowdown in the Chinese economy have risen. That risk is clearly exacerbated by the ongoing trade war, with market ructions in May a recent testament. The developed world is also under the cloud of weak growth and anaemic inflation – shocking considering the monetary paradigm and low levels of unemployment. Of course, closer to home, the UK public's decision to sever its membership in the European Union remains as unresolved as ever. A new occupant in Number 10 Downing Street will certainly act as a catalyst, but to what end? Sterling volatility has shot up higher than that of some emerging market currencies, a clear sign of uncommon stress. This is just one of the Eurozone's myriad problems: weak growth, populism, poor demographics, painful decision-making amidst laborious consensus building. In addition, emerging markets, while full of promise and potential, have been disappointing investments in hard-currency terms over the last decade. It is right to question expected returns from these regions, especially in risk-adjusted terms.

These are some of the triggers to equity markets sputtering, faltering or plummeting, but the list is far from exhaustive.

Great Expectations

We recognise a discomforting backdrop to global markets. Nonetheless, we remain sanguine: **equities** are still our most significant allocation. Why? First, the discomfiting backdrop is itself a reason to be invested. While equity valuations now stand between fair to slightly expensive, depending on the market, the asset class is in a strong uptrend, *but without the over-bullish sentiment which would be a red flag.* The relative case is crystal clear: other core alternatives – cash and government bonds – are hideously expensive.

Having said that, we recognise that markets can move with staggering speed and we continue to have significant allocations to **government bonds** despite record low yields and high valuations. They are held primarily to diversify away from equity risk. But that is not the only reason. Government bonds are also in positive momentum and surrounded by negative sentiment, both aspects we like. It is prudent to remember they have delivered positive real returns over the last one, three and five-year periods through conditions similar to today – a surprise to many. It is more than possible that they will continue to surprise, particularly given yet another turn to loosening in monetary policy from key global central banks. Indeed, over the second quarter, we recently increased duration in our government bond holdings going from short to neutral, and yields have fortuitously fallen further since.

Much like a Dicken's novel, there is a tremendous amount of nuance. No doubt the months ahead will test our views and convictions. As we have always done, we will stand by our investment process to navigate the uncertainty; it has stood the test of time, best, worst, or somewhere in the middle.

Source: Factset, Bloomberg – Data as at 30 July 2019

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