Weekly Strategy

Multi Asset Navigator

UNIGESTION

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Smoke on the Water Deep Purple 1971

On the surface, things look relatively calm and healthy. While global growth has slowed down slightly in 2018, global equity indices have broadly delivered positive returns, fixed income assets have also returned positive performance despite monetary policy normalisation, and energy commodity prices have recovered, gaining 15% since the start of the year. However, under the surface, the situation is very different, with dispersion within assets at historical highs. What does this mean for asset allocation? Should we prepare for a market correction and start singing, "Smoke on the water, fire in the sky"?

WHAT'S NEXT?

Performance divergence is growing

In August, dispersion across and within assets has been unusually large in terms of both sectors and geography. As an illustration, the S&P 500 index was up 2.8% but the EuroStoxx50 index fell by 3.5% and the MSCI EM index declined by 4.5%. Within European equities, the IT sector was up 1% over the month while the banking sector fell by 8%. Bonds also experienced large divergences: the US 10 year bond yield declined from 2.96% to 2.83%, while at the same time UK 10 year bond yield rose from 1.33% to 1.43%. In the foreign exchange (FX) market, aside from the US dollar's bullish trend versus both developed market (DM) and emerging market (EM) currencies, moves have been divergent and significant. As an example, SEK declined by 3.7%, similar to AUD and NZD, but EUR and CAD were only down slightly, while CHF was markedly stronger (+2.2%). In our view, there are three key factors which explain this situation:

1. Macro: less synchronised global growth and the US economy leadership. Our analysis shows while the MSCI AC index posted a 4% gain since the beginning of the year, it is down 2.6% if we exclude US equities from the index.
2. Sectors: as S. Poloz discussed during the last Jackson Hole forum, digital disruption is "the fourth industrial revolution." The contribution of the technology sector in the positive performance of global equity indices has been large and larger than their economic weight vis-à-vis value add to GDP. As an illustration of this concentration, the MSCI AC equi-weighted index underperformed the market cap-weighted index by 7.3% since the beginning of the year, which is the largest underperformance since 2000.
3. Momentum: the best performers move higher and worst ones lower. The MSCI World Momentum Index is one of the best-performing strategies across assets this year with a year-to-date performance of 17% vs. 9% for Quality, 4.3% for Min Vol, 3.1% for Size and -0.1% for Value.

Balance of risks shifting toward the downside

Historically, these periods of high dispersion and concentrated contributors are red flags and point to deteriorating fundamentals and divergent policy. In our weekly jukebox, we have recently mentioned several risks to monitor and account for in dynamic asset allocation: 1) Trade war risk and its impact on China and the US dollar 2) The Italian situation and its implication for financial stability and European governance 3) Emerging market fragility with poor current accounts and political instability 4) Policy mistakes with Fed and European Central Bank (ECB) divergence.

So far, global growth and corporate earnings have been supportive enough to maintain the balance of risks to the positive. In our view however, the threat for assets is to see these idiosyncratic risks, as they become more frequent and impactful, becoming systemic. The turn is likely to arrive quickly and harshly as global consumer and business confidence remain near historical highs according to OECD data. As a result, we believe that today is the right time for focusing on hedges and adapting the rhythm of our portfolio to the new market song.

Diversification should help

When large asset moves are making a comeback, when performance divergence is increasing, when the liquidity from central bank is declining, it's crucial to ensure our asset allocation is well-balanced across macro risk factors. Multi asset strategies tend to be typically overly reliant on growth-oriented assets and are thus not equipped to face adverse scenarios. In our investment process, we believe that being diversified across macroeconomic regimes through a large spectrum of assets is key for delivering positive and smooth returns over time. As a result, we include structural hedges against unfavorable macroeconomic scenarios such as recession, inflation shock and market stress episodes, which together represent 40% of macro regimes over the last four decades. In recent weeks, assets such as sovereign bonds, risk managed equities and defensive FX strategies have helped to protect the portfolio against unusual dispersion in asset returns.

Dynamic risk management matters

As we mentioned last week about trading volatility, timing and implementation play a crucial role in successful asset allocation. In our current balance of risks, we think that the situation in Europe – with the upcoming Italian budget, slowdown in activity, weak financial sector and the ECB's lack of ammunition in case of new financial crisis – is the biggest source of concern for the short-term. Therefore, we seized an opportunity with low implied volatility to buy optional protection on the EuroStoxx index. We have also implemented a strategy playing Euro downside in order to benefit from a potential dovish ECB stance in response to Italian uncertainty and deceleration in growth. Overall, the strategy has also increased its duration and lowered its exposure to emerging assets and credit spreads. Thanks to the optionality implemented recently, we have also raised the convexity of the portfolio which should help the strategy navigate well in case of market stress over the coming weeks.

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