Let's Dance, David Bowie 1983

With the revival of trade war tensions, global equities experienced their largest drawdown of the year last week. After an impressive rally year-to-date, exceptional in terms of both amplitude (one of the strongest starts to the year since 1970) and path (one of highest hit ratios in history), global equities fell by 2.5%. Does this signal the end of the beta party that was triggered by the US Federal Reserve's accommodative turn last December or will the market continue to dance? And against this backdrop, has diversification and hedging proved effective?

WHAT'S NEXT?

Classic diversifiers have not delivered expected protection

As is usual during market stress events, contagion to other risky assets has been large with rising implied volatility, widening credit spreads and falling cyclical commodities. Within this market environment, classic defensive assets have failed to protect diversified portfolios. Global sovereign bonds were slightly positive, while precious metals declined slightly and systematic hedge fund defensive strategies, such as CTA, posted negative returns over the period. Although the period under review was too short and the trigger too noisy to create a large 'flight to quality', it does challenge the benefits of using these kinds of defensive assets in a multi asset portfolio.

Firstly, the drawdown follows a very poor year for diversification. Indeed, a distinctive feature of 2018 was the lack of benefits from diversification, which is one of the key pillars of multi asset strategies to deliver smoother returns over time. Most of the 'usual' defensive assets posted poor returns over the year and were significantly lower compared to previous equity market corrections. We have analysed the performance of these classic hedges (global sovereign bonds, defensive hedge fund strategies, commodities) in the years when the MSCI World AC index posted a negative annual return. Our findings show that diversification did not play its role in 2018, with an average hedge performance of -3.9% versus an annual average of +4.4% for the period 2000 to 2017. Some usual defensive strategies helped to smooth the return last year such as low volatility equities but, overall, with a higher frequency of large moves, 2018 delivered one of the largest correlation shocks in many years.

Secondly, if correlation across assets and correlation between defensive assets and macro regimes are changing, we need to adapt our dynamic risk management. It is crucial at this stage of the economic cycle to dissociate 1) diversifiers, such as sovereign bonds or gold, which provide positive carry but uncertain protection due to changing correlations, and 2) hedges, such as long volatility or optional strategies, which are more certain but have a negative carry. We believe in both diversifiers and hedges, which would allow us to dance until the very last song.

The new central bank put: from rates channel to volatility channel

Quantitative easing (QE) has modified the impact of central bank action on both asset returns and asset behaviour. Before the great financial crisis, central bank easing had an impact on long-term rates through the forward curve and on risky assets via discount rates. The correlation between sovereign bonds and equities turned from positive to negative in the 1990s for Japanese assets and from 2000 for US ones. In the US, this was referred to as the 'Fed put' – the Fed's willingness and ability to adjust monetary policy in a way that was supportive for stock markets.

Since the financial crisis, the role of central banks is no longer to ease financial conditions but to suppress volatility shocks. Liquidity injections and low rates for longer periods pushed investors to take on more risk via longer duration, higher leverage or lower credit ratings. The rising ratio of central bank balance sheets to GDP has lowered realised and implied volatility for financial assets and macro data. Whatever the news, that is good for risk because central banks are and will be there.

In the past, central banks would surprise markets to prove their independency and increase their credibility, but in 2013 we had the famous 'taper tantrum' episode. Since then, we have guidance and dot projections and this has helped reduce any element of surprise. But what does this mean for diversifiers and for hedges?

Firstly, it is counterintuitive. It increases the cost of hedging because selling volatility becomes more and more profitable, while carry costs of being hedged become more and more expensive. Secondly, if the probability of or if the amplitude of shocks become lower, the need for hedges declines. We then enter a vicious cycle where lower implied volatility creates higher risk taking, leading to bigger drawdowns when there are unexpected shocks, which in turn leads to closer central bank monitoring to avoid financial instability, triggering lower realised volatility.

That last implication of QE is the low level of interest rates. If we consider that there is a floor for negative rates, the cushion provided by bonds with negative rates becomes lower.

Diversifying the protection

Against this new backdrop, we believe that strategically encompassing new sources of return in order to diversify protection is key to delivering smooth returns. Using FX strategies is one way because they react to macro risks and central bank actions, they are liquid enough to be flexible and they are not as constrained as bonds with negative yield.

We have developed two defensive strategies to expand the universe of diversifiers beyond traditional ones, such as sovereign bonds and low volatility equities. Our FX value strategy, which is long undervalued FX versus overvalued FX, has delivered positive absolute returns over the last five years but, importantly, it has posted positive returns during periods of market stress. We have also developed a defensive FX strategy to increase our equity protection. Mixing different criteria such as correlation to equities, high hit ratios when equities decline or constraints on the cost of carry, the strategy aims to deliver positive returns with higher asymmetry than sovereign bonds when risk assets suffer. These FX strategies worked very well in 2018 and also posted positive returns last week. We like going to the dancefloor and listening to the 'new' music of central banks. However, we prefer to dance with a large spectrum of diversifiers and intensify our dynamic hedging through optional strategies because when the music stops, correlations and asset returns shift to the negative, leading to lower realised protection compared to expectations.

Listen to Let's Dance by David Bowie.