MORE OF THE SAME Caroline Rose, 2018

So far, 2019 has been a very good year for most asset classes. Over the last 100 years, there has only been one instance, in 1986, when equities (+18%), long-term bonds (+25%) and gold (+22%) were all up 15% or more in the same year. In late 1985 and early 1986, the US economy shifted from a rapid recovery from the early 1980s recession to a slower expansion. The Federal Reserve's accommodative monetary policy actions during 1986 (it cut the target rate from 8% to 5.875%) were influenced by indications of weak economic growth and moderate inflation. Despite many macroeconomic differences between the 80's and today, our Nowcasters are indicating a similar economic environment – one in which global growth continues to slow and inflation surprises on the downside, allowing central banks to lean on the dovish side. The last ten years of monetary stimulus created a highly correlated "everything rally" and with this still in mind, investors are trying to front-run central banks which are expected to do "more of the same".

WHAT'S NEXT?

The strong belief in the "central bank put" has pushed investors up the risk ladder in a desperate search for yield. The Q4 2018 sell-off, and the subsequent reaction, reinforced once more the perception that central banks will always be there to save the day. With cash trading at zero or negative yields in many parts of the world, complacency and a lot of creativity is needed in order to reach target yields (which are set far too high for the current environment). With the expectation of even lower rates, a new round of aggressive central bank front-running has started.

Valuation: falling interest rates raise asset prices…

In anticipation of more monetary stimulus, the most effective and most straightforward trade is to increase duration in portfolios. The unbelievable price appreciations of long-dated bonds (e.g. Austria 100-year bond is up 75% year-to-date) show how aggressive investors have been in allocating to longer maturities as they try to escape negative yields. With 50-year Swiss bonds at -44bps and 30-year Bunds at -16bps, the risk/reward dynamics of this trade have changed dramatically.

Consequently, this wall of money has been forced into the corporate bond market. Negatively yielding corporate debt rose from USD 20bn in January 2019 to the USD 1tn mark recently. At the same time, covenant protections, which buffer investors in the case of default, are at record lows. Besides the direct impact, there are also indirect effects of lower yields and lower credit spreads.

Debt instruments are key to calculating the opportunity cost of owning equities. As bond yields go down, the opportunity cost of holding equities goes down. Consequently, equity investors are ready to pay a higher price/earnings multiple. Due to the combination of low financing costs, corporate tax cuts, subdued economic growth and a lack of investment opportunities in the real economy, enormous amounts of cash has been pushed into the financial system, kickstarting a new wave of stock buybacks and mergers and acquisitions.

All these factors have driven up public equity valuations to expensive levels. With many investors concerned about the sustainability of these valuations, market participants are looking for cheaper alternatives. A lot of money has therefore gone into private equity and private debt to harvest the liquidity premium. With all this money waiting to be invested, buyout values have been pushed higher to levels not seen since the financial crisis. In addition, leverage has been used so aggressively that Janet Yellen, former Fed chair, said that she was worried by a huge deterioration in corporate lending standards, particularly for leveraged loans. The "everything rally" that has been going on for a long time is pushing all asset classes to very expensive valuations, but "more of the same" means that valuations will only get more expensive before they get cheaper.

…but simultaneously lower the future returns of assets

Monetary stimulus runs up against the law of diminishing returns in the financial market and diminishing effects on the economy. As long as economic growth doesn't pick up and real investment opportunities remain limited, the additional money will end up in the hands of investors. This will drive up financial asset prices even more, reducing the future expected nominal and real returns and risk premiums will progressively move toward cash returns. It will be even more difficult to reach target yields and the only solution will be to take even more risk in the form of increasing illiquidity and/or leverage.

Macro: short-term gain vs. long-term pain

Negative rates have distorted the most important factor in economic decision making – the pricing of risk. If central banks push rates below zero, this essential function does not work anymore. The consequences are overproduction and overcapacity driven by over investment and poor decision making. This keeps inflation in check and opens the way for more stimulus, and the debt spiral keeps on enforcing itself. It is also well understood that negative rates crush the player that is supposed to be responsible for the monetary policy transmission effect – i.e. the banks. Their margins are compressed due to low long-term rates and flat term structures. The decline in profits erode bank capital bases and further limit credit growth. "More of the same" will not do the trick for the economy, but the avoidance of any necessary short-term pain at the expense of prudent long-term thinking should be supportive for the economy and especially for financial markets in the short term.

Sentiment: the pain trade is to the upside

If there is going to be a recession, it will be the most telegraphed recession in history, with every investor preparing for it. Google searches for the term “recession” have surged to levels not seen since the financial crisis mainly due to one of the most reliable indicators, the yield curve inversion, pointing to an economic recession. We clearly pay close attention to the signals the yield curves are providing, but an inversion by itself is not a reason to reduce growth assets. First, when long-term bond yields fall below short-term yields, on average it takes 12 months before the recession arrives. This period is usually extremely good for growth assets. Second, during this first phase we interpret the inversion as a telling gauge of the negative market sentiment. Another indicator flagging the over bearish sentiment in financial markets is the recent high correlation between hedging assets, which indicates heavy crowding in defensive positions.

Asset allocation: exposed with hedges

Our Nowcasters are pointing to slower growth, but not a recession, and due to heavy disinflationary pressures, we expect increasing support from key central banks. On the back of that, we are overweight carry-related risk premia such as high yield, emerging credit and volatility. Further, relatively light positioning in pro-growth assets supports our constructive view on risk-on assets relative to hedging assets. The biggest risk to our upbeat market view is the considerable optimism about central bank easing. This could trigger a highly correlated market unwind/reversal of the “everything rally”. We are therefore maintaining hedges via optional structures to protect against a short-term correlation shock.

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IMPORTANT INFORMATION