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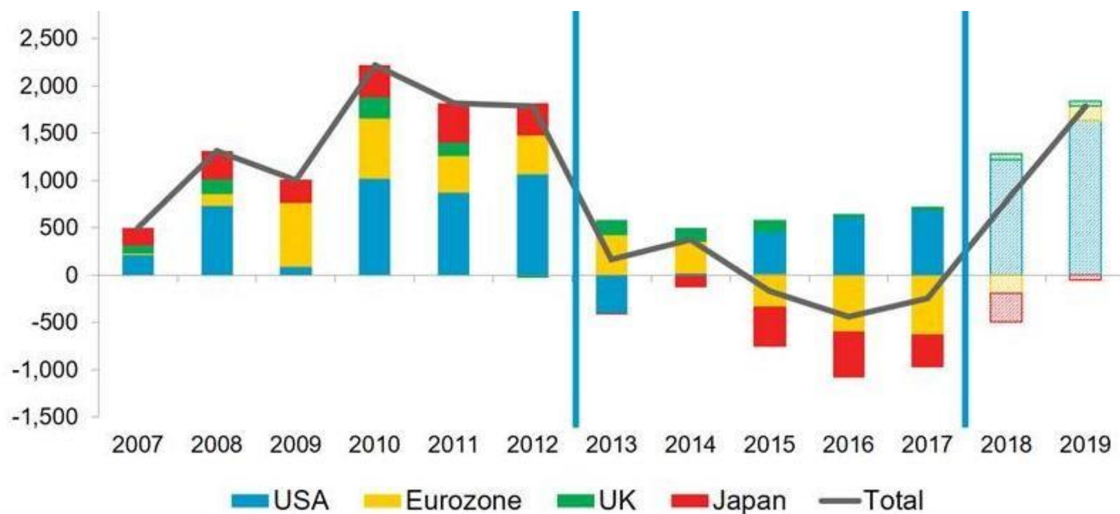
Spotlight on Volatility

A conflict between the head and the heart; the dislocation between sentiment and fundamentals

The shift in gear

Since the start of October, we have seen three moves in markets of more than 3% (up or down) after only four such instances in the preceding six years, between 2012 and 2017. Events such as these are rare and occur only 1% of the time. The 'free ride' risk assets that have hitched since 2009 is coming to an end, and it is now a case of looking at returning to analysis of the fundamental data to assess where the opportunities lie. We are starting to see the impact of the withdrawal of support of the fixed income market by the biggest asset purchaser, the Federal Reserve (FED). Below is a chart demonstrating this withdrawal which, we believe, will lead to the heightened levels of volatility that we have seen over the past couple of months to become the norm.



Source: LGIM, Bloomberg. Government bond supply, net of asset purchases, $bn

We have definitely seen a shift in gear. Markets have clearly become more sensitive to political news and tremors than we have become accustomed to over the past few years. October left many investors in the dust, as pretty much every asset class was in negative territory. A generic 60/40 portfolio had its worst month in October since the financial crisis:

60/40 portfolio of US equities and Treasury bonds

Source: Bank of America Merrill Lynch Global Investment Strategy, Bloomberg, ICE Data Indices LLC; data as of 31 October 2018.

As all investors and Financial Advisers know, the LGT Vestra model portfolios are risk-managed and run within defined volatility parameters. **So what does that mean when we have periods such as Q4 2018?**

First of all, we stress test the portfolios to ensure that in periods of heightened volatility, the portfolios do not breach the volatility bands. Even when looking at a 12 month period, much shorter than the targeted 60 month period, all of the portfolios comfortably remain within the set volatility targets.

	Target (over five years)		Target (over 12 months)	Realised data
	Annualised Volatility %	Annualised Return %	Maximum Loss %	12m annualised volatility
Defensive	2 to 4.75	3 to 4.5	-5.0	**2.85**
Cautious	4 to 7	4.5 to 6	-9.1	**3.69**
Balanced	5 to 9	5.2 to 7.5	-13.5	**6.30**
Growth	8 to 13	6 to 8	-19.0	**7.55**
Adventurous	10 to 16	7 to 10	-25.0	**9.54**

Data to end November 2018

The triggers of the selloff: a clear dislocation between sentiment and fundamentals

It is important to understand what has caused this sharp detoriation in asset prices over the past couple of months, and we believe that there were four triggers at the root of the rout.

The first trigger was the **FEAR of a trade war**

Trade war rhetoric between China and the US has been bubbling for many months, and has gradually been priced into equity markets in China and EM. In October, US equity investors started taking notice of the potential impact on American stock prices whilst concerns over the potential ongoing trade dispute caused global markets to take a significant leg down.

The second trigger was the **FEAR over valuations**

Up until the end of September, 120% of the return of MSCI World had been driven by the US and 43% of that return had been generated by the top ten largest companies. If investors weren't in these companies for the first three quarters of 2018, they got left behind by their peers so holdings in these large cap tech companies became momentum-driven and obligatory positions. When sentiment in markets started to change in October, these companies with (in some cases lofty) valuations, were the first ones to be cut.

The third trigger was **FEAR over politics**

The global political landscape has been undeniably unstable over the past two years, but in the last two months concerns over the outcomes of Brexit for the UK economy and the fragility of the European political environment has weighed on investors, adding to general negative sentiment in markets. As a house we are unwilling to make conclusive calls on the Brexit debate, we simply don't know what or when the eventual outcome of the situation will be. Investors should take comfort that only approximately 2% of the portfolio is exposed to Brexit Britain, which is very much by design as we reduced exposure to small and mid cap names in the portfolios last year.

The fourth was the **FEAR of the Fed**

Markets are also concerned that the world's largest economy is raising rates faster than warranted, creating a risk of policy error. This, amidst the turmoil caused by the above three triggers, was not taken well by markets. More recently we have seen signs that the Federal Reserve is likely to take a softer stance, which has caused bonds and markets to respond favourably.

What is clear from these four triggers, is that sentiment has been the overriding driver of markets over the past couple of months, and this has been exacerbated by the effect of quantitative trading strategies and ETF ownership, which makes up over 70% of market activity globally, on a daily basis.

Head versus heart

We believe one of the clearest illustrations of this dislocation between sentiment and valuation can be seen in analysis from Deutsche Bank. The analysis shows the valuation gap between where markets would usually price given market data (in this case Purchasing Managers Index (PMI)), versus where they are pricing today. The conclusion is that the S&P 500 is now 19% ‘cheap’ on this measure. A similar story holds true in Europe where the STOXX is 13% ‘cheap’ while the country level detail shows that the biggest differentials are in Germany and Spain (both 18% ‘cheap’). Italy is closer to fair value at 5% ‘cheap,’ which isn’t a great surprise given the data slump, while the UK is 9% ‘cheap.’ Outside of Europe, China catches the eye with the Shanghai Comp actually 27% ‘cheap’ compared to the implied PMI. We try not to over-analyse these results, preferring to use them to look at more general levels of global under/over valuations. However, they do support our view that markets look to have become too weighed down by negative sentiment.

Given this, where are the opportunities and why are we still overweight risk assets?

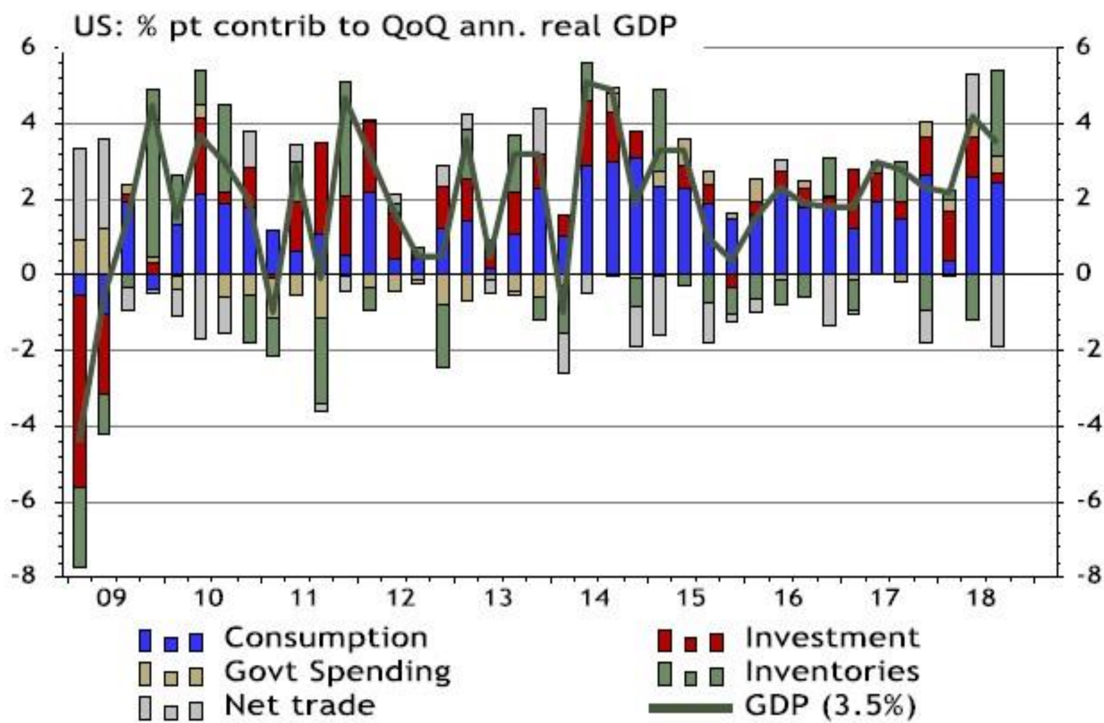
The fundamentals (data) remain strong

PMIs, Growth Domestic Product (GDP) growth and unemployment data are in a generally healthy place, particularly in the US, which for now remains the global engine of growth. However a more unusual data point we reference is truck delivery volumes, which as below is demonstrating a robust and healthy economy:

Seasonally-adjusted truck tonnage (Truck Tonnage Index)

Source: Seasonally-adjusted truck tonnage – US Department of Transportation, Bureau of Transportation Statistics (BTS) calculation from American Trucking Association Monthly Truck Tonnage Report

We also look to the US consumer to provide evidence for a stable economy. The chart below shows how robust the US consumer has remained in the face of a rate rising environment. Over the past few years, US consumers have consistently had money in their pocket and are spending it, shown by the blue columns which is the contribution by consumption to GDP growth. We believe that the US consumer will continue to remain resilient against the three predicted rate rises over the next 12 months.



Source: ASR. Contributions to GDP growth (US).

We invest in quality companies

Regardless of whether there are short term fluctuations impacting markets (either building or eroding sentiment) we believe that if we invest in solid good quality companies, these companies will grow in value and provide compounding returns over the long term. The proven and well known funds we used to express this view are Fundsmith and Lindsell Train, funds that are held across all of the portfolios.

We invest in income yielding stocks

A portion of all of the portfolios is also invested in companies that have attractive yields and reassuring dividend cover. Funds such as Fidelity Global Dividend target companies that pay attractive and sustainable yields.

We see opportunities in the London-listed overseas earners

At this point, with so much ongoing Brexit uncertainity it is difficult not to see the UK listed overseas earning stocks as attractive investment opportunities. Regardless of the outcome of the Brexit scenario, the FTSE is currently on a p/e of 14.3 and is boosted each time we get a leg down in the value of sterling. Conversely, if we get a 'good' Brexit, and sterling strengthens, it is likely that there will be a concurrent rally in the FTSE as the overseas asset allocators see a conclusion to ongoing uncertainities and want to take advantage of an attractive investment opportunity. Cheap quality is not an oxymoron at these levels.

We want exposure to attractive demographics and government policy across the world

The MPS portfolios are globally constructed. As mentioned above only 2% of the overall portfolio is exposed to domestic UK small and mid cap stocks. This allows us to invest in some fantastic countries, industries and companies where there is more certainty and in many cases much more compelling, long term stories. Self-inflicted reform programmes in many Asian nations excite the fund managers we use to invest in these areas of the world. Whilst in the UK we often feel surrounded by negative news and depressing political developments (or lack of!). Overseas many countries and companies are in a much better place and see huge opportunities for investment and growth.

The heart of the matter; how the portfolios are positioned to benefit

In light of the increase in market volatility and the transition we are seeing happen from one part of the current economic cycle to the next, the MPS Investment Committee have decided to make some changes to the portfolios. This is a transition from a benign policy environment (2016, 2017) to a more uncertain policy climate as Central Bank support is gradually being withdrawn.

The Asian exposure in the portfolios has been modified and we have included an additional fund to get exposure to increased numbers of funds, sectors and geographies. We have also reduced exposure to the US in the lower risk portfolios, by keeping the equity exposure the same whilst increasing geographic diversification. Finally, we have reshuffled the absolute return holdings in the lower risk portfolios as we continue to move towards an equal-weighted alternatives bucket.

In summary, it is very easy to become 'short-termist' in light of the recent events. The world is different today (when compared to the past five years) as a result of more inflation, more volatility, an increased volume of passive investing, de-synchronised growth and trade wars. We try to look beyond these events and focus on investing in areas that we believe offer good value particularly as this appears to be a 'valuations recession' rather than an 'economic recession'. As always, we emphasise the importance of analysing the economic evidence we have available to us. We understand what is driving markets and where applicable, disregard the short-term background noise. We do however expect the market to remain volatile and react to politics more so than seen in previous years.

Model Portfolio Service and Volare Investment Management Team

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