FLASH

# Differentiated solutions required to overcome ‘age of anxiety’

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With a global economic slowdown on the horizon, investors are fearful of the impact on markets. However, market sentiment is far worse than the current performance of financial assets, and the world economy is so far holding up. In this ‘age of anxiety’, central banks have again taken the driving seat – both in reassuring investors and trying to stem the inevitable.

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The ECB’s recent decision to resume quantitative easing was the first time a central bank announced stimulus measures without an end date. This ‘infinite QE’ should help stabilise economic activity. Moreover, the clever introduction of a tiering system, which takes into account bank capital structures, should minimise the negative impact of lower rates on the financial sector.

However, it also confirms we are in a low-yield environment for the foreseeable future. By acting so boldly, the ECB put pressure on the Federal Reserve to cut rates soon after. The US central bank has also hinted at a potential round four of QE to expand its balance sheet. This will prolong the hunt for yield as the key question for investors over the next few years becomes how to generate returns in such a low-rate environment.

**Multiple sources of uncertainty**

The extension of accommodative measures has boosted asset prices in the short-term, with European equities climbing and US stocks again close to all-time highs. Nevertheless, this might start to fade rather soon. QE has little real impact in the medium term, as banks remain reluctant to provide credit to the real economy.

Moreover, political issues – such as Brexit, US tensions with Iran and the ongoing Trump-Xi trade war – are far from solved. There is also a vast dichotomy between lagging manufacturing sectors and thriving consumer industries.

Additionally, we are starting to witness the reversal of longstanding market trends, as evidenced by the abrupt crash of momentum stocks, such as some in the technology and consumer sectors, over the past month. While the return of traditionally more defensive value stocks – in financials, utilities and the energy sector – is typically synonymous with a pickup in global growth, the trigger this time remains uncertain.

All in all, investors are wrestling with an increasingly complex environment. As geopolitical tensions persist, QE takes on an air of permanence and prior market leaders experience heightened volatility, investors must look beyond traditional allocation strategies.

**Rethinking age-old allocation**

The present challenging situation requires a sophisticated solution. Investors must take a flexible, unconstrained approach to protect against a potential downturn, while still generating returns.

To unearth yield, investors have to think outside the box. The way the ECB designed the latest round of QE has narrowed the yield spread available in Europe. Ten-year yields have already converged – the highest is Greece at 1.28% and the lowest, Germany, at -0.6%. There is not a lot of room to generate alpha.

Therefore, we are diversifying bond portfolios by investing in a ‘barbell’ way – combining long duration government bonds with short-duration high yield and emerging market debt. It might seem counterintuitive to hold longer duration positions. However, as we witness the Japanification of the global economy – low growth and low inflation for longer – shortening the duration of an entire bond allocation could leave investors exposed to persistently low rates.

In this context, we will need to see concrete signs of economic activity picking up before increasing exposure to risk assets. The upside is still uncertain and encouraging macro indicators do not carry the same weight as positive company results, which have yet to materialise. As a result, we are cautiously neutral on equities and selective on regions – with a marginal preference for Europe for its attractive valuation. Nevertheless, we are staying invested in order to capture potential upside if the balance tips to the positive.

Where protection is concerned, the effectiveness of traditional portfolio hedges – such as gold, long treasuries and quality stocks – is still valid, but might be challenged in the current environment. Therefore, we have added equity derivative hedges, in order to protect the portfolio against a dramatic fall in asset prices.

This combination of long equities and hedges – including gold, long treasuries and quality stocks, as well as derivatives – has already proven its efficiency, with most of our balanced portfolios ending the summer slightly up.

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