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Icarus flight and lessons for todays markets

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History, but also legend, teaches us to be cautious of the risks around us. The low level of inflation and volatility benefited markets in the past, but as market conditions change, investors should be diversifying portfolios by including fixed income into their asset allocation.

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> *"Complacency in the markets is a key risk. As we have seen over the past few days, market conditions can change dramatically, indicating that investors should adopt a balanced, diversified investment approach."*

Icarus, the Greek mythological character who attempted to fly off the coast of Crete with a set of wings constructed by feathers kept together by wax, was warned by his father to be aware of two major risks: the sea, as getting too close would soak the feathers, and the sun, as flying too high will melt the wax.

Beware of Risks

As in the Icarus myth, investors today should be mindful of the impact of two risks; inflation and volatility.

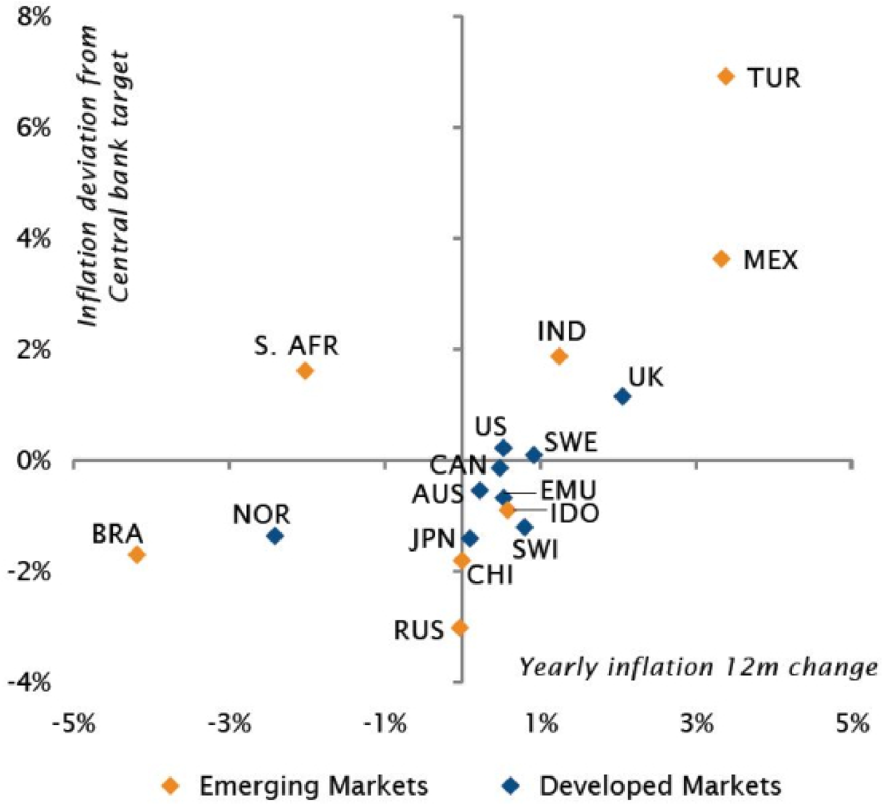
The persistent low level of inflation and an expectation of a benign future path provided a positive background for bonds and equities, but as the recent market moves proved; nothing is certain.

As we know, the traditional relationship between bond prices and interest rates is one of inverse correlation. The level of interest rates is determined by a number of factors, such as economic growth and the status of the labor market, but in the recent past the key driver has become Inflation, or more precisely its low level, and the low expectations for the future which implies that rates will drift upwards slowly.

Low inflation can be seen both in the disappointing December data in Europe and in the FED's Beige Book, where the inflation expansion is described as modest-to-moderate, but also in the low compensation that investors demand for holding bonds. This environment has so far been positive for bonds as it reduces fears of losses from sharp moves in interest rates.

Low inflation is also positive for equities. One way to price equities is to divide future profits by the prevailing interest rate over the period, which implies that a rise in interest rates would make equities worth less today, likely resulting in a price decline. High valuations though, as currently indicated by the Cyclically Adjusted Price-Earnings (CAPE) ratio, make equities more vulnerable to a correction, despite the fact that in the current environment of low inflation expectations, the potential for rates to increase dramatically is limited.

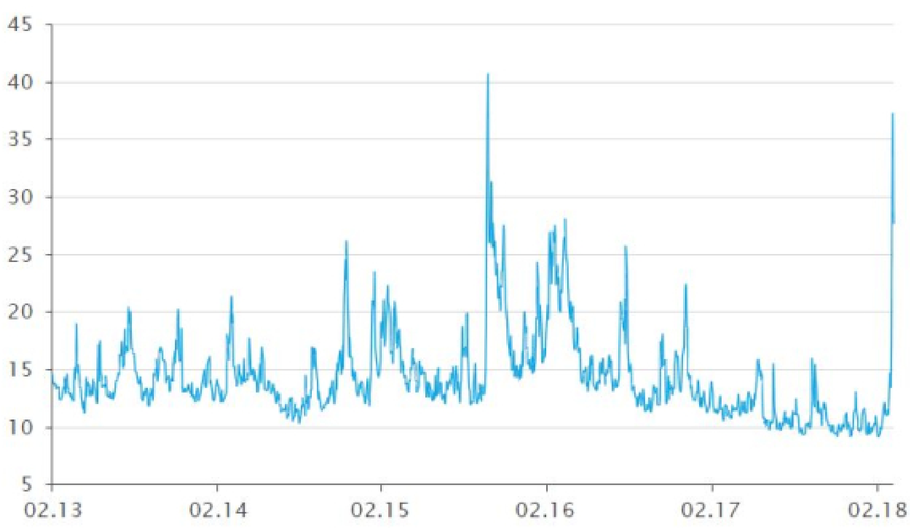
Inflation 12M trend and deviation from central bank target



Source
Factset, SYZ Asset Management. Data as at : 1 January 2018

The level of volatility, which has been a discussion topic for years, was ripe for a spike. The Chicago board options exchange SPX volatility index (VIX), which reflects a market estimate of future volatility, has been extremely low for the past few years. As mentioned at the June 2017 Federal Open Market Committee (FMOC) minutes "a few participants expressed concern that subdued market volatility, coupled with a low equity premium, could lead to a buildup of risks to financial stability". Decreased volatility during business cycle expansions may lead to lower risk constrains for investments (e.g. value-at-risk) and increase in leverage. The consequence, as we have seen, might be that a shock can increase volatility and the market could experience a dramatic correction.

Volatility increased dramatically over the first week of February



Source
Bloomberg. Data as at : 26 January 2018

As equity valuations soar, a fixed income allocation is needed in order to balance risks effectively. This can take many forms: Inflation protection bonds protect from inflation increases, government and investment grade bonds offer very low correlation to equities (the twenty five-year correlation between the S&P 500 and 10-yr treasuries and investment grade bonds is -0.19 and 0.22 respectively), subordinated bonds (look at note here) are characterized by attractive yield, high quality and ability to absorb interest rate increases, and finally high yield (on top of the ability to absorb interest rate increases) offers similar returns to equities over time, with less than half the volatility and the benefit of seniority in the capital structure.

The desire to achieve beyond boundaries is essentially human, but in order to avoid the unfortunate fate of Icarus, investors need to remember the importance of a diversified investment approach that includes an allocation to fixed income. Looking forward, markets might not move in a straight-line and investors must remember to protect their feathers.

	Average annual returns						Average annual volatility					
	1 yr	3 yr	5 yr	10 yr	15 yr	25 yr	1 yr	3 yr	5 yr	10 yr	15 yr	25 yr
10-year Treasury	1.5%	1.0%	0.8%	4.3%	4.4%	5.4%	2.2%	6.2%	6.0%	7.6%	7.5%	7.2%
Investment-grade bonds	6.1%	3.9%	3.7%	6.5%	6.2%	6.8%	1.6%	3.6%	3.7%	5.6%	5.3%	5.0%
Aggregate Bond Index	3.2%	2.1%	2.0%	4.3%	4.5%	5.7%	1.5%	2.8%	2.9%	3.5%	3.5%	3.6%
High Yield	9.5%	6.0%	6.3%	8.2%	9.1%	8.1%	2.5%	5.9%	5.4%	10.0%	8.6%	7.8%
S&P 500	22.9%	10.9%	15.7%	8.3%	9.4%	9.7%	3.9%	10.1%	9.5%	15.1%	13.4%	14.2%
Russell 2000	18.3%	11.1%	15.0%	8.8%	10.8%	9.7%	7.7%	14.1%	13.9%	19.9%	18.3%	18.6%

Source
JP Morgan, Bloomberg. Data as at : 31 December 2017

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