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Reflections & Insight

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"Faced with the choice between changing one's mind and proving that there is no need to do so, almost everyone gets busy on the proof."

J.K. Galbraith

At the start of the year, the news headlines for those of us sad enough to read such stuff, were full of exuberance about something called a 'melt-up'. This is a phenomenon, last seen in the dotcom boom in 2000, where all equities go up in a coordinated and somewhat parabolic manner. The news was so good three months ago, with tax cuts in the US, rising earnings expectations, low volatility and subdued inflation, all against the background of coordinated global growth, that a melt-up was 'obviously' on the cards. January did indeed start with a bang, but it didn't last. Some worrying inflation data (since revised) was enough to trigger a violent sell-off around the world, exacerbated by a spike in volatility which caused a number of speculative products to unravel.

The initial wobble stabilized but was then sucker punched by talk of tariffs and trade wars, and topped off with concerns about the behaviour of the tech sector, which fell sharply and was particularly influential on market levels given its weight in the indices and its recent excellent performance.

Where does this leave us? There are many cross currents at work here, but it seems worthwhile to focus first on what has changed. Low volatility looks like the major casualty. As discussed often in these reviews, when a large majority of market participants believe much the same propaganda, it's a fair bet the belief is already embedded in prices. At the turn of the year, the bullish consensus was widespread and investors were positioned to benefit from rising equity prices and low volatility. When this unravelled, many were surprised by the extent to which speculative activity had leaked into capturing something as ephemeral as volatility, which was trading at historically low levels. The reward system had been Pavlovian for long enough that even those who should have known better were exposed to this absurd trade.

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The second major element which feels different is the extent to which market participants are paying attention to politics. Hitherto, even the wilder thought bubbles of our esteemed leaders had little impact on stock or bond prices, but suddenly they seem to matter. There isn't much on which the economics profession agrees, but the benefit to the global economy of free trade is one such thing. The heightened risk of a trade war, the unpredictability of its reach and the scale of its consequences add a new dimension to investor worries. It is also a measure of the way in which politics is becoming increasingly transactional – something which increases uncertainty. Many prognosticators believe that all of this is just rhetoric – a negotiating ploy, but it is easy to imagine how this could get out of hand given the participants and their backgrounds.

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Politics also has a bearing on the tech stocks. These have been market leaders for a long time now and the extent to which the business models of the big corporates have concentrated power in a small number of networks has begun to come to regulators' attention. Life for these businesses is likely to become more difficult, and without them, the stock market headline indices may find it harder to make significant progress.

The third thing that has changed is valuation. This has been a perennial worry for this review, and while the level of valuation remains high by historical standards, rising earnings and falling prices have brought the expected forward levels of value into much less worrying territory.

There are also many things that haven't changed. First, the global economy remains in reasonably good shape. There are some signs that the heady pace of the last six months may be coming off a little, but growth is still respectable. This is reinforced by the second thing that hasn't changed – inflation, which continues to be quite unthreatening. This doesn't mean it is not there, just that it is not a major headache and the trajectory of quantitative tightening expected for this year and next remains in place. Thirdly, earnings, especially in the US, are very strong, with forecasts this year of an increase of 11%. This is exceptionally strong so far into an economic cycle.

When you put all this together, the underlying foundations for being exposed to equities have not changed, but the risks have unquestionably risen. In circumstances like this, the recipe would suggest an increase in asset weightings to those categories not correlated to equities.

This used to mean bond markets, but these are very expensive by historical standards. Indeed a recent Bank of England study suggests that the bond bull market that began in 1981 is the second most intensive – and second longest – in a historical record (of nine such episodes) which stretches back to 1311 when Venetian bonds first began to trade. Furthermore, in July 2016, the risk free rate fell to its lowest level in the last 700 years. In other words, the last 37 years have been a humdinger of a bond bull market, and this has left valuations extended, much as they have been in equity markets. That condition is necessary for a reversal but is not sufficient in the absence of a shock of some sort. This would normally be a resurgence of inflation, yet the evidence of a pick-up remains modest despite what theoretical models are predicting. Indeed, bond markets have rallied into the latest equity decline, suggesting that they are less sanguine about economic prospects than most equity investors.

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Nevertheless, the central case is that we are in the latter stages of an economic cycle with an unusual fiscal stimulus in the largest economy, and a retreat from austerity more generally. Inflation has been subdued for a series of secular reasons, much reviewed in these parts and while not dead, shows only modest signs of life.

A trade war could alter these dynamics very quickly, as could a further injection of populist policy, but both of these are inherently unpredictable. Given the deterioration expected across the world in fiscal balances, the room for manoeuvre available to Central Banks is quite limited. Any sign of a slowdown is likely to be met with yet more unorthodox monetary policy. The global economy is not robust enough to deal with 'normal' interest rates – there is simply too much debt still in the system.

So, for the time being, a recession looks unlikely. Monetary policy will continue on its cautious path to a removal of excessive stimulus, but a conventional monetary tightening seems unimaginable.

If bonds are not attractive, how does an investor compensate for a higher risk environment? The key here is to find assets that are not correlated to equity markets. The most obvious of these is cash, also expensive in the sense of offering no return, but containing a value to an investor in the sense of 'optionality' – in other words, it gives you choices. Other asset classes to consider include the various forms of alternatives out there, but this has not been a happy hunting ground in recent years, largely because volatility has been so low.

In the longer term, the populist pendulum appears to have further to swing. Inequality of income, and probably even more importantly, wealth, has disenfranchised a large part of the population in the developed world. For example, the bottom 50% of US workers have had stagnant or falling real wages since 1979, a measure repeated to some extent in all developed countries. The disparity in wealth has benefitted the old at the expense of the young in a way which has not previously been recorded, and it would be naïve to assume that these factors will not have some bearing on political policies over the next generation. Add in the geopolitical conflicts, migration problems, climate change – the world could look very different in twenty years' time. This is not the moment to position for these phenomena but it is worth bearing in mind that the shelter provided by very benign monetary policy in a modestly growing economy is getting a little threadbare. Conventional risks are rising and longer-term worries are discernible. Portfolios need to reflect the shorter-term risks and the longer-term issues should be kept on the radar.