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MLC

Investment Insight

Recent market declines

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Even though there have been less than 12 trading days in 2016, major equity markets have declined in the vicinity of 8% this year and prices of higher risk bonds such as high yield have weakened further. Sentiment towards risk has turned sharply negative much like it did in August 2015, driven by further declines in the oil price and concerns over the robustness of Chinese growth. Tightening liquidity and US$ financial conditions have not helped.

In our opinion, the set of issues that have driven risk assets (shares) lower recently are catalysts - not necessarily core issues. For some time now we have felt valuations across risk assets have traded significantly higher than warranted by the elevated degree of uncertainty faced by the global economy. Central bank policy was (and remains) at the epicentre of mispricing across the risk spectrum as quantitative easing effectively distorts the cost of cash and funding across the yield curve, and drives demand for assets. The global savings glut sitting alongside unorthodox monetary policy compounds the problem of yield compression, further stoking demand for assets and making the situation worse.

Meanwhile, the critical flow through of quantitative easing to the real economy – although difficult to measure - has certainly not been as rapid or profound as the impact on asset prices. For instance, Japan's recent economic performance has been disappointing considering the massive stimulus programs that have been in place for some time and Europe's recovery remains fragile in nature. And just as importantly, the key imbalances that drove the global economy to the point of requiring ultra-low interest rates have not relieved to a great degree. Debt levels remain high in many economies, Europe is still polarised, reform in Japan is progressing slowly and China is only just beginning to take the hard steps toward rebalancing.

While recognising why things are the way they are is always important for investors, it is critical to draw a clear distinction between understanding the current economic climate and interpreting it as a new paradigm. Based on market behaviour, we believe too many investors confuse an explanation of the reasons for asset mispricing as justification for these prices.

This in turn can lead to construction of portfolios that are reliant on obvious, but narrow paths. Our process deliberately avoids that mistake by focussing on the entire set of credible scenarios rather than trying to figure out the path. And while we place significant effort in understanding the current environment, our focus is directed not towards the factors that are driving markets higher, but the broad range of imbalances that ultimately impact the relationship between risk and return and even more importantly, how these might evolve over time.

How has MLC positioned the portfolios?

Due to the way we approach portfolio construction and our concerns that risk is elevated, our multi-asset class portfolios have been defensively positioned for some time. More recently (in the December quarter 2015) we reduced risk further by raising the level of liquidity within the Inflation Plus series of funds. Deliberate use of a defensive benchmark agnostic global equity strategy has been a key feature of Inflation Plus for some time. Defensive option strategies have also helped.

Likewise the Horizon series has been defensively oriented for some time. Currency positioning (unhedged global shares) has played an important role in the defensive profile of both Horizon and Inflation Plus as has higher cash balances and reduced exposures to emerging markets. Although markets have pulled back, we do not believe that now is the right time to increase risk exposure within either Horizon or Inflation Plus.

Valuations need to reset further towards normalisation of the risk/return trade-off to trigger asset allocation changes. For now, we think that opportunities generated by the recent selloff are better captured via security selection positioning within building blocks rather than asset allocation changes. Markets may well bounce back quickly (as they did after the August 2015 declines), but both the possibility and consequence of further declines are enough for us to remain cautiously positioned at this time.

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