Multi asset

Balancing cyclical and structural influences in multi-asset investing

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Key takeaways

- We take a two- to three-year view of the world when building our central economic thesis.
- We believe it is vital to consider both cyclical and structural forces in building this thesis.
- These factors also influence some of the ideas in our portfolio

Despite what has been an incredibly tumultuous, unpredictable and at times unimaginable period for global politics and an initially spluttering return to global growth, central banks appear to have successfully steered markets through the worst, ironing out the kinks and at times acting together to present a semblance of global harmony. Sometimes, markets have appeared to simply ignore events that in less interesting times would have caused a rout. Somehow though, it still doesn't feel that the aftermath of the financial crisis is fully behind us, nearly 10 years on, and we believe it is vital to consider both cyclical and structural forces in building our economic and market outlook.

Cyclical factors can often dominate investor thinking, but typically exert a short-term influence on the markets. We take a two- to three-year view of the world when building our central economic thesis, which guides and anchors – but does not strictly dictate – our investment decisions. For this reason, we also need to incorporate, or at least acknowledge, some of the structural influences that can very quickly become a core focus for investors.

What is our central economic thesis?
Heading into 2018, our current outlook for the next two to three years is as follows:

Global growth prospects remain subdued

- Economic growth is being boosted by cyclical factors (e.g., consumption, trade).
- Structural issues, such as high debt, continue to hamper future growth potential.
- Global liquidity is grinding lower, capping the upside for credit growth in this cycle.

Low inflation is likely to persist

- Lack of pricing power and debt overhang will keep inflationary pressures contained.
- There is some upside potential from wages as politics influence wage negotiations.
- But, the global price of labour will likely remain low.

Core bond yields are capped; there is long-term structural support for the US dollar

- Core bond yields are ultimately driven by structurally lower nominal economic growth.
- Despite near term uncertainty, the US dollar has support from its global funding role.
- Broader policy conflicts are influencing central bank decision making.

Cyclical earnings improvement provides some support for risk assets

- US earnings per share is supported by financial engineering, fuelled by loose monetary conditions.
- Expensive credit is vulnerable to policy change; equity returns are dominated by dividend income.
- Diversified alpha is an additional source of value.

Volatility is stubbornly low but likely to rise from here

- Lingering macro uncertainties suggest equity market volatility is unsustainably low.
- Fixed income and currency volatility are sensitive to central bank action.
- Market volatility is impacted by investor behaviour (e.g., the search for yield)

How has our thesis evolved over time?
When we launched our strategy in 2013, our central view was characterised as "cautious optimism," which served us well at the time. However, with the benefit of hindsight, we can see that we have been too cautious more recently, underestimating the ability of risk markets to continue performing in the prevailing low rate, liquidity-induced environment. We were caught off guard by ever-declining market volatility – however, we still believe that volatility will return.

For three years, our cautiously optimistic view of the world led to some of our investment ideas being implemented through simply buying equities or buying bonds because financial markets were still underpinned by extraordinarily loose monetary policy. We became more cautious as we saw a more complicated policy backdrop in the face of persistent structural challenges, which drove us to look for alternative sources of returns.

Speculation around the future direction of interest rates or the likely unwinding of asset buying programmes remains a potential trigger for financial markets and, while volatility remains at historic lows, we believe it continues to present opportunities as an asset class in our two- to three-year investment horizon as macro uncertainties linger. Another side effect of this low volatility world is that some of the more traditional investment ideas now look less obvious and more fully valued.

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Balancing cyclical and structural factors
When you look at some of our investment ideas, it is possible to see this push and pull of cyclical and structural factors playing out. For example, we expect real interest rates in Europe (government bond yields minus inflation expectations) to rise but, at the same time, we expect eurozone inflation expectations to fall.

The cyclical influence on this idea comes in the form of the limitations of European Central Bank (ECB) monetary policy. During and post the financial crisis, policymakers sought to respond to the collapse in economic growth by pushing down real interest rates. Negative real interest rates were needed to stave off the crisis and, as time has moved on, the result of central banks keeping interest rates low and keeping extraordinarily loose monetary policy in place has been a gradual increase in inflation expectations.

However, it appears that global central banks are now starting to retreat from this policy for a number of possible reasons. Firstly, policymakers need to determine how useful such extraordinary policy is in driving economic growth from here. Looking at Europe, there has been an economic recovery despite nominal growth remaining weak versus history, which means that there is less support for maintaining such emergency levels of policy support.

The other important driver for the potential change of behaviour by policymakers is how effective this approach to policy is in stimulating the next phase of the economic cycle. In particular, negative real interest rates undermine bank profitability, which could impact economic growth over the longer term. This is one of the reasons why we believe the current level of negative real interest rates in Europe is unsustainable longer term.

The structural influences on the idea are reflected in our view that if real interest rates rise, inflation expectations will start to fall. This captures the ongoing structural difficulties that the eurozone continues to face. Core inflation is relatively dormant, demographics continue to play their part and wage inflation has been the missing link in the improvement in labour market data for the region. All of this suggests that, if real interest rates do head higher (which appears to be the only path for the ECB), then inflation expectations could decline in response as ultra-loose monetary policy appears to have been one of the major factors underpinning the rise in longer-term inflation expectations that we have seen to date.

Maintaining our two- to three-year view
Volatility has continued to fall in recent years, which is perhaps surprising given all of the macro uncertainty which has prevailed. We continue to monitor risk and the level of volatility very carefully because our portfolios explicitly target less than half of global equity volatility over time. We police our portfolio volatility (and so the diversification of the investment ideas within our portfolios) through extensive scenario testing. We seek to ensure that we can participate in the upside of financial markets while avoiding any major drawdowns.

We are sometimes asked why we don't increase risk in order to improve returns. However, there is a constraint to how much independent risk we can take from our individual ideas, so a lower-than-target risk level represents the effects of diversification rather than too-conservative ideas.

We will always look forward over the next two to three years – it would be imprudent to overrule this view in order to try and boost short-term returns, especially given current market uncertainty. We firmly believe that it is important to not succumb to this type of pressure. While it is very difficult to accurately predict a change in regime, it is important to consider that one could come at any time.

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