Weekly Market Summary

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One Messy Global Financial System!
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Financial assets' movements in past days have suffered from summer doldrums, especially that news flows have remained light and markets stayed quiet.

After all, money managers, brokers and traders are human beings (though very greedy species!), and on warm, sunny summer days, many would rather plan their holidays to catch up with family and friends. That in turn means less investment professionals likely to buy and sell stocks, bonds, currencies and commodities, which could dampen volatility in the market place (though not a guaranteed outcome as reduced volumes could sometimes result in greater volatility with transactions completed having a bigger impact on the price of financial instruments). For Wall Street dealers, the summer doldrums extend throughout August and officially end after Labor Day (first Monday of September), when hedge fund managers and mutual fund gurus head back to work.

With that said, I reproduce below 2 interesting Bloomberg readings that warn against overstretched fixed-income and equity valuations (record low bond yields & very high equity valuations) and their extremely damaging impact on insurers and pension managers:

1- **Are Those Safe Heaven Assets Safe Anymore?** *(Suzanne Woolley – July 29th, 2016)*

Michael Sonnenfeldt does not mince words: "*There is no safety in safety*," the founder of Tiger 21, a network of "ultra-high-net-worth" investors, said. "*All of the historical places you could get safe income from—dividend-paying stocks, bonds—they have all been bid up because of quantitative easing to the point where it is just trash*."

Assets that include Treasury notes, high-quality dividend stocks, and low-volatility mutual funds have all seen spooked investors rush into their supposedly safe embrace. Sonnenfeldt and others argue that has transformed them. "*When you overpay for what used to be safe assets*," he said, "*they now have a lot of risk in them.*"

Whether they are "*trash*" is debatable. But the concern that the prices of these assets may now be propped up more by fear than by economic fundamentals is legitimate. The 10-year Treasury note for example is seen as a haven in a world where negative interest rates on sovereign debt are becoming more common. Last August, the 10-year Treasury yielded 2.2%. Since then, its popularity has driven its price up and sent its yield down to 1.5%. The current dividend yield on the S&P 500 is 2.1%. "*Historically people looked for debt to produce income and for the equity market to produce gains*," said Tiger 21's Sonnenfeldt. "*Now people look to the stock market for dividends and to the debt market for gains, because you won't get any income there.*"

Still, that price may have farther to go. "*If people get scared enough, they will rotate into Treasuries this time, too*," said Sam Stovall, U.S. equity strategist for S&P Global Market Intelligence. But that would not be wise, he added. "*We may see a good year eight, and maybe a year nine, in this bull market*," Stovall figures. "*Bull markets don't end when a lot of people are cautious. They end when everyone is fully invested and there is no money to propel it further*."

2- **The Titanic Risks of the Retirement System?** *(Mohamed A. El-Erian – August 12th, 2016)*

Imagine an entire enterprise set on course for disaster, driven by the owner’s arrogant pursuit of profit. The members of the management team, from the CEO on down, know better but fail to resist or are ignored. The clients remain totally unaware of the risks until far too late, with catastrophic results -- particularly for the poorest among them. This is the story line of the excellent "Titanic," a musical now playing at the Charing Cross Theatre in London. As I took in this powerful portrayal of the human failures that brought down a ship thought to be unsinkable, it occurred to me that if we're not careful, the tragic story could also end up describing the fate of the global retirement system.

With interest rates extremely low and the prices of stocks and bonds at historic highs, finding safe investments that can help guarantee a comfortable retirement has become increasingly difficult. This has put the managers of pension funds and other institutions that invest on behalf of future retirees in a difficult position, driving them to take ever greater risks in hopes of meeting their performance objectives -- targets that are unlikely to be met absent a major revamp of economic policies and corporate prospects. As a result, individuals are increasingly being exposed to the threat of losses that cannot be recouped quickly. The degree of long-term financial security that can be assured depends on three elements: future returns, correlations among different asset classes and volatility. The outlook for all three is becoming more uncertain.

What returns can investors realistically expect? With the combination of central bank activism and less robust economic prospects pushing bond yields into negative territory (most recently in the U.K.), fixed income markets no longer generate any meaningful returns -- unless one takes on a lot more default risk by accumulating junk debt issued by corporations and emerging-market governments. In the stock market, high-quality dividend-yielding shares have reached unnerving valuations, leaving more volatile and risky options.

More sophisticated investors may be able to access investment vehicles that traffic in less crowded areas -- but selecting the right manager is not easy, especially in a “zero sum” world in which one manager’s positive “alpha” is another’s losses.

In principle, the right mix of investments can provide greater return for the same risk. But this works only if the investments don’t move in sync -- and correlations among asset classes have lately become unstable and less predictable. Sophisticated long-term investors realize that portfolio diversification, while still necessary, is no longer sufficient for proper risk mitigation. Yet the next operational step is not easy, and it typically involves giving up some potential return.

Then there is volatility, which increases the chances that an investment will fall in value precisely when a future retiree needs the money. In recent years, central banks have largely been willing and able to repress financial volatility. Now, though, this is changing. Some, such as the Bank of Japan, appear less able while others, such as the Federal Reserve, somewhat less willing.

The repercussions for investment managers depend on where they stand. Those who oversee severely underfunded corporate or public defined-benefit pension plans are in a particularly tough bind: They must achieve high returns to meet their targets, so they face the greatest pressure to take on risks that could be catastrophic if companies and the economy don't perform well enough to justify existing asset prices. Even better-funded pension plans that have matched their assets to their liabilities will be challenged to maintain historical returns if they take on new entrants.

To avoid disaster, policy makers and investment managers should consider three fixes. First, be a lot more realistic about the returns that can be achieved within traditional risk tolerance parameters. Second, put in place policies to boost savings and income, so people -- particularly the most vulnerable -- will have more money available to put aside for retirement. Third, be transparent with retirees about the risks that are being taken on their behalf, also offering less risky options with explicitly lower expected returns.

Absent urgent change, the retirement system could end up following the example of the Titanic. Like the ship's passengers, many individuals would face the risk of devastating consequences. And like the second- and third-class passengers who had a hard time getting on lifeboats, the middle- and low-income segments of the population would be most at risk.

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