Weekly Market Summary

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A Disturbing Disconnect .... Bond Pessimism Versus Equity Exuberance?!

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Asset Correlation is a measure of how investments move in relation to one another and when. Whenever assets move in the same direction at the same time, they are considered to be highly correlated (positive correlation). When one asset tends to move up whilst the other goes down, the two assets are considered to be negatively correlated. According to The Pros Guide to Diversification from Fidelity Investments: "*Correlation is a number from -100% to 100% that is computed using historical returns. A correlation of 50% between two stocks, for example, means that in the past when the return on one stock was going up, then about 50% of the time the return on the other stock was going up, too. A correlation of -70% tells you that historically 70% of the time they were moving in opposite directions -- one stock was going up and the other was going down*." A correlation of 0 means that the returns of assets are completely uncorrelated (or non-correlated); In which case, the price movement of one asset has no effect on the price movement of the other asset.

Under what is known as modern portfolio theory, one can reduce the overall risk in an investment portfolio and even boost his/her overall returns by investing in asset combinations that are either negatively correlated or not correlated at all. As a result, your highs may not be as high as your friend's, but neither will your lows be as low. But then again, that is just good on paper! The correlation and non-correlation theory makes good sense, but it was always easier to prove it back when markets behaved more rationally - mostly driven up/down by economic fundamentals (bullish/bearish data releases). Today, markets are not as predictable - not as stable and are changing the way they move - driving many legendary long-time investors insane! In fact, most financial experts agree that correlation seems to have really changed post-financial crisis of 2008 (and really-really-really changed post goofy Trump election! ☺).

Take for example investors' focus on the stock-bond relationship: Intuitively, a negative correlation between equities and bonds – which has been largely true of U.S. equities and Treasuries since the late 1990s – would suggest that bonds perform well when equities sell off, whereas a positive correlation would be evidence that bonds are not an effective hedge against equity risk. What is key from an investment perspective is that bonds provided needed diversification to equity risk in six of the past seven recessions; The sole exception was 1973, when Treasuries returned -3.5% during the recession's first half (but ultimately produced positive nominal returns by the end of the recession). That, in turn, implied holding a combination of stocks, bonds and, perhaps some cash and real estate over the long term would do the trick for any conventional investor; After all, these assets tended all to perform in a less-than-correlated-way, and in a combination that was supposed to help dampen the overall volatility of a portfolio. But whilst that proved to be the right approach to portfolio diversification during the height of the financial crisis in 2008/09 when the historically negative stock-bond correlation held and the rally in bond markets helped to a great extent hedge against a significant equity market sell-off, recent price action would suggest there is more merit in going long all asset prices, courtesy Mr. Trump's relentless efforts to lift equity markets and a clueless, "better dovish than sorry", squeezed, shamed Federal Reserve (check our March 8th , 2019 market piece).

Going back to late last year, Nov/Dec. 2018 in particular, correlation between the two asset classes (bonds and equities) had dived into negative territory as Treasuries climbed whilst U.S. stocks tumbled. At that time, caught between a stubborn Federal Reserve and a mad President, markets witnessed the steepest monthly sell-off in equities in years (a drop in excess of 20% between early November and late December). US Treasuries, on the other hand, saw a sizable jump in prices, with yields on 10-year US Treasuries – the US bond market's bellwether – retracing from a high of 3.26% to a low of 2.68% during the same period (a full 58 bps or 18% dive!). That reversed a pattern seen earlier in the year when both bonds and shares retreated, a phenomenon Goldman Sachs Group Inc. dubbed a "*balanced bear*" and one that had upended the traditional strategy of using bonds to hedge stocks. It also prompted Richard Turnill, BlackRock's global chief investment strategist, to write in a note to clients that "*the correlation between equity and bond returns was back and will remain significantly negative in 2019 as the economic cycle enters its latter stages…Bonds may offer a more formidable ballast to equity exposures.*"

Instead, markets have only witnessed a perfectly positive correlation between asset classes and a relentless rally in both equity and bond prices since early 2019. So how can we best explain this phenomenon to our valuable clients?

This year's huge rally in government bonds reflects deep anxiety (most likely overdone!) about the health of the global economy. Benchmark 10-year government bond yields in the US sank from about 2.68% at the end of last year to as low as 2.34% last week - a reflection of rising prices – as investors responded to a combination of weaker-than-expected economic data – mostly in China and Europe - and increasingly cautious signals from the Federal Reserve & other major central banks. Hedge funds have capitalised on this shift and posted solid quarterly returns. "*It has been a really good quarter*," said Andrew Wilson, chief executive of Goldman Sachs Asset Management, whose macro hedge fund has been betting on falling yields in seven-to-10-year US Treasuries and is up about 8.8% before fees in the first quarter. Computer-driven funds (Momentum and Algorithm trading) have also been profiting; GAM Systematics' Quantitative fund was up 17.7% in the first three months of the year, while its Core Macro fund gained 11.8%, said a person familiar with the matter. The fund benefited from the rally in bonds, but also from gains in stocks and moves in other markets. However, there are reasons to believe that bond markets might have overreacted to cues from the global economy. China is slowing but in a gradual way (the latest March PMI Manufacturing & Non-Manufacturing numbers showed an improvement from previous months), Europe is weak but still seems unlikely to face a recession and the Atlanta Fed's "nowcasting" model indicates the US economy is expanding at an annual rate of 1.53% (surely no recession on the near horizon!). The Fed Funds futures markets indicate that traders think the US central bank will cut rates at least once this year, and possibly more, but some fund managers argue that looks excessive in the face of slower but still resilient growth. "*The bond market is sniffing out a global recession, but a little too aggressively*," said Abhay Deshpande, chief investment officer at Centerstone Investors. "*We'll probably see a muddle-through, slower growth and some growth scares, but I think the Fed may have averted the worst-case scenario*."

As to equity markets, they surely remain on fire! Driven mostly by Wall Street, global stocks ruled off on their largest quarterly advance since 2010. The climb over the past three months was sealed this morning on hopes for progress in US-China trade talks that resumed in Beijing (latest update on that front is that Beijing would be given until 2025 to meet commitments on commodity purchases and allow American companies to wholly own enterprises in the Asian nation). With US equity indices (Dow Jones Industrial Average and the S&P 500) currently trading just 1.7% below all-time highs registered in early October 2018!, investors are assuming - for the right reasons – that the US president needs and wants a policy win so badly! And surely Mr. Trump is anchoring his re-election prospects firmly to the stock market and the economic expansion given that that there has been an "*extraordinarily strong*" correlation between an incumbent president's margin of victory and household economic confidence, based on surveys going back to 1992. However, if the bond market is right, the economic prognosis could be on the verge of getting grimmer at a dangerous time for a president preparing to campaign for re-election. "*Bond markets are reflecting this increasing fear that the next stage of this cycle is a recession*," says Gregory Daco, chief US economist of Oxford Economics. Equities have proven sensitive to higher interest rates, with last year's turmoil initially kicked off by a sharp rise in US bond yields in early October, though falling bond yields in recent months – so far supporting the rally in stocks – are not necessarily good news either, given the message they send about the global outlook for economic growth.

How much further this dual rally last is the million-dollar question though?! With markets now mostly focused on positives and investors ignoring or placing very low probabilities on potential market reversals – not to forget widespread rising geopolitical and political concerns that could eventually lead to heightened market volatility – there is a huge risk that all the good news is by now fully priced-in at current elevated equity valuations.

Next up for investors is this afternoon March U.S. jobs report*, which is forecast to show an acceleration in employment gains after a weak February. With traders betting that the next Federal Reserve move will be to lower interest rates, not raise them, the fixed-income market could be affected by the headline numbers as well as any signs of wage strength in today's release: Bloomberg consensus is for March payrolls to have risen by a healthy 177,000 (following a depressed 20,000 jump in NFP for the month of February). It will also be worth keeping a close eye on the other important elements of the report, namely the unemployment rate (expected to remain unchanged at 3.8%), average hourly earnings (likely to rise by a strong +0.3% mom & +3.4% yoy), the participation rate (expected unchanged at 63.2%) and average weekly hours (expected unchanged at 34.5 hours).

**Following "weakish" payroll data in February due to poor weather conditions, March offered some relief. The US labour market created 196,000 last month, slightly surpassing market consensus, whilst February was revised up by 13K. The unemployment rate remained unchanged at 3.8%, but that was partly helped by a fall in the participation rate. The big surprise was the downside miss in wages. The 0.1% monthly advance (vs. 0.3% expected) led to a 0.% drop in the year-on-year reading to 3.2%. As the US economy continues to approach full employment, hiring gains are set to cool over the rest of the year.*

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