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CIO Viewpoint

Portfolio risk and real interest rates, from Goldilocks to bear market

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Throughout 2017 markets enjoyed a 'Goldilocks' economy in the US with neither-too-hot-nor-too-cold conditions for strong returns thanks to synchronised growth and low inflation[1]. This year, we entered the late phase of the economic cycle as the metaphorical market porridge started to overheat. If investors are to avoid burning themselves, wealth managers need to provide the tools to defend portfolios from the inevitable illiquidity of a bear market.

In September we wrote about our approach to managing late-cycle portfolios. In this article, we explore one of the indicators that we are using to monitor the evolution of markets and anticipate declining liquidity.

Markets this October have shown the second sign this year (after January/February) of the volatility that we think is part of this late-cycle process. October's bout of market volatility does not alter our convictions. Rather, it confirms our view that after a decade of low interest rates, valuations are only now pricing in interest rates in the US, which are now in line with the economy's fundamentals.

Let us be clear: while we do not expect to see a major economic downturn within the next 12 to 18 months, we are anticipating slowing growth in the US and China in 2019. For now, the US economy is growing at a strong pace of 3% annually, thanks in part to a round of fiscal stimulus.

Since June, and in anticipation of increasing illiquidity, we have worked to reduce the risk in portfolios by first cutting positions that we think could be the most difficult to shift in the event of a sustained market fall. That means we have been reducing the expected shortfall[2] of our portfolios, and have raised cash holdings by transferring the most vulnerable asset classes, emerging debt, convertible and high-yield bonds. These asset classes are exposed to rising financing costs and so the most likely to turn illiquid quickly in a renewed downturn.

Keeping it real

In particular, we are watching the evolution of real interest rates (in other words interest rates adjusted to exclude inflation) against potential growth in the US. This, we think, is the main driver to watch. As we wrote in June[3], historically, real interest rates that rise above US potential growth have been followed by recessions. On the other hand, when real rates remain below potential growth, the level of interest rates is not a trigger for a bear market in equities.

The immediate trigger for October's falls across equity markets was a rise of between 35 and 40 basis points (bps) in real rates as the Federal Reserve (Fed) increased interest rates and bond

1 The invention of the term 'Goldilocks economy' is claimed by David Shulman in an article for Salomon Brothers in March 1992, https://www.barrons.com/articles/SB116562493362745118
2 Expected shortfall here refers to the average losses that an investor may face in the worst 5% of markets
3 https://www.lombardodier.com/contents/corporate-news/investment-insights/2018/june/real-rates-growth-and-a-flatteni.html

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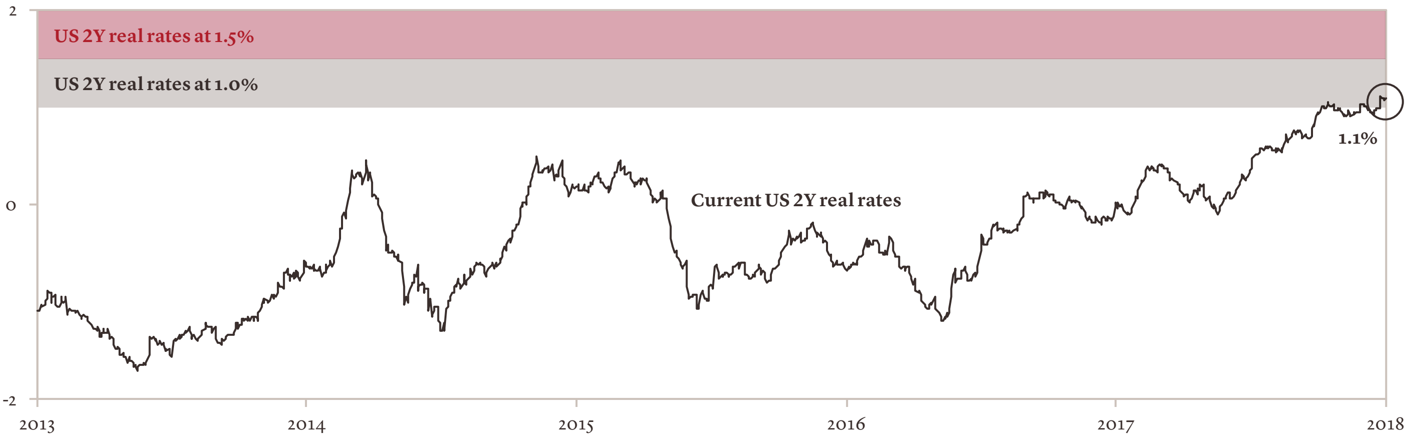
prices caught up with the economic fundamentals. This month equity markets have declined between 6% and 7%, compared with a fall of around 10% early this year when real rates increased by 40 bps.

Equity fundamentals now remain fairly strong, with undemanding valuations, especially after this month's market declines. We anticipate that third-quarter earnings will help to stabilise equity markets as the consensus is for earnings per share to rise by around 20% in the US and by 13% in Europe.

Real two-year interest rates in the US are now around 1.1%, and estimates for US potential growth between 1.4% and 1.8%, suggesting there is margin for further rate rises before they trigger a bear market (see chart 1).

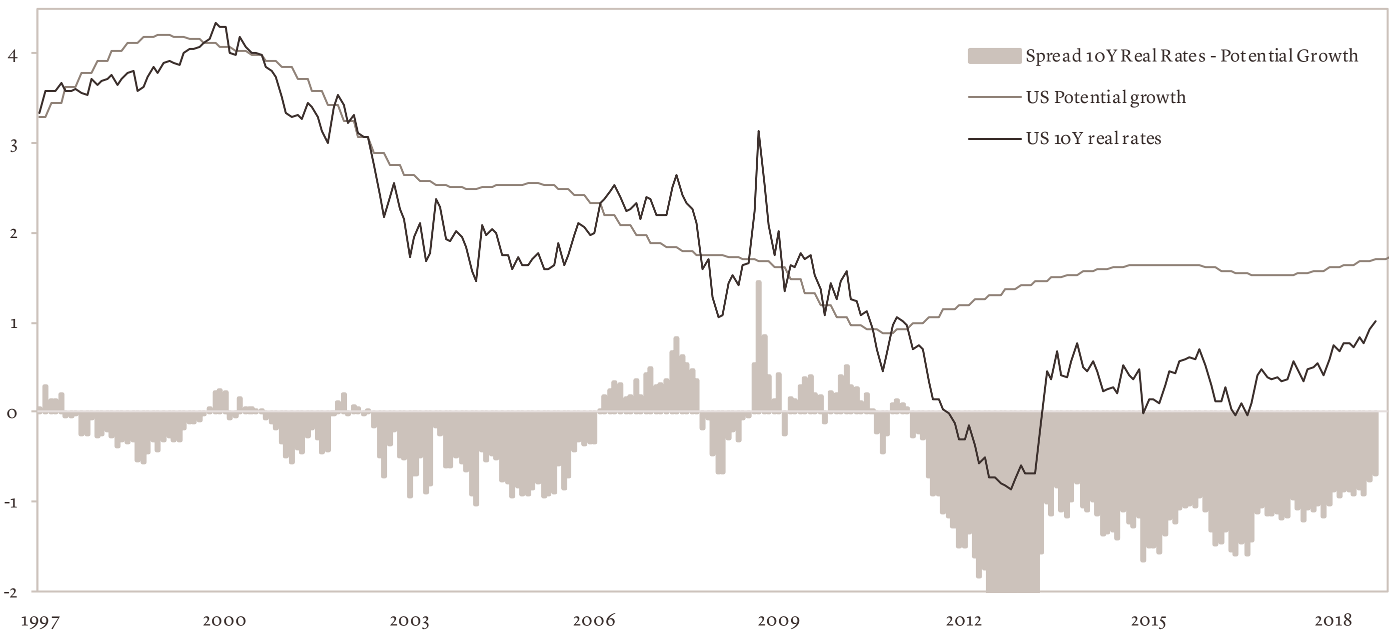
Chart 1 – Real rates are rising



Sources: Bloomberg, Lombard Odier.

The spread between real rates and potential growth is tightening, and we estimate start to present a risk of a bear market at around 1.5% (see chart 2) as the cost of capital starts to affect the economy. Nevertheless – and this is worth stressing – until then, we think that we should remain invested in equities.

Chart 2 – Real rates are anchored by low potential growth



Sources: Bloomberg, Lombard Odier.

Our expectation is for the Fed to hike rates once more before the year-end, and three more times in 2019. The main risk that we see is if the Fed accelerates the pace of its interest rate hikes to more than once per quarter over the coming twelve months. While it would not be the first time that the Fed has hiked rates above expectations (think of 1989 or 2006 when rates moved 100 bps above consensus), the probability of that happening next year is low, in our view. In fact, for that to happen, we estimate that the Fed would have to raise interest rates up to 4%, which is unlikely while core inflation remains relatively stable.

The other threats to markets, we believe, include any further escalation in the US's trade war with China, the uncertainty of the US mid-term elections next month and, in Europe, the political risks surrounding Italy's budget and the UK's negotiations to leave the European Union. We have considered each of these separately in recent publications.

Conclusion

The main reason we have now adopted a more neutral stance in terms of risk exposure, rather than an outright defensive positioning, is that the current levels of real rates in the US, well below the level of potential growth, are not likely to trigger a bear market. And at this stage of the cycle, investment discipline is crucial. Actions taken over the past few months to strengthen our portfolios have resulted in a selective risk asset allocation, driven by asset liquidity and quality. This has reinforced our ability to act nimbly under any market conditions: asset liquidity helps us to adjust risk exposure amidst rising uncertainty while our cash holdings allow us to selectively seize tactical opportunities that arise in maturing cycles.

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