HEALTH WEALTH CAREER

FROM QE TO QT

BUILDING ROBUST PORTFOLIOS

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WHERE HAVE WE COME FROM?

The reaction of the monetary authorities to the global financial crisis of 2008 and 2009 was to put in place extraordinary monetary policies with the explicit aim of avoiding both a downward spiral in economic activity and price deflation. These policies included record low short-term interest rates and central bank asset purchases (known as “quantitative easing” or QE) as well as other measures to provide liquidity to the banking sector.

These policies worked. The potential downward spiral in world economies was averted and deflation was avoided. The policies also fueled an exceptional boom in asset prices generally. The current bull market was kick-started by low interest rates feeding through to higher asset prices through the discount rate effect. Thereafter, the increased confidence of markets that central banks would “do whatever it takes” together with a long, drawn-out and gradual upswing in economic growth saw asset prices driven to new highs in a bull market that is approaching its 10th anniversary.

As these extraordinary monetary policies were put in place, there was a widespread expectation that they would ultimately be inflationary (a reasonable assumption in that they were explicitly seeking to counteract deflationary forces). However, meaningful price inflation has not, as yet, resulted from these policies — although we have witnessed substantial asset price inflation in a number of asset markets. Only now, after nearly 10 years, are there modest signs of an inflationary upturn in consumer prices — in the US, for example — and these can be attributed to the strength of the real economy feeding through to the labor and commodity markets, rather than there being a direct causal link with QE itself.

WHERE ARE WE NOW?

The era of extraordinary monetary policies is coming to an end. Globally, monetary policy has started to turn less stimulative as major central banks are planning to gradually remove their support. The Fed is likely to raise the overnight lending rate to near 2.5% by the end of 2018 and to over 3% by the end of 2019. We expect other central banks to cease or scale back their asset purchases and, eventually, consider increasing policy rates.

EXHIBIT 1: QUANTITATIVE EASING BECOMES QUANTITATIVE TIGHTENING

Source: Fed, ECB, BoJ, BoE, JPMorgan.

WHAT HAPPENS NEXT?

How might this shift in policy feed through to asset markets, and how might portfolios be shaped to both reduce downside risk exposures and capture profitable investment opportunities?

At one level, we don't know because just as those extraordinary monetary policies have not been put in place before, neither have they been "unwound" before. However, we do have past experience of previous monetary policy cycles, when policymakers attempted to slow the pace of economic expansion and reduce the risk of inflation accelerating.

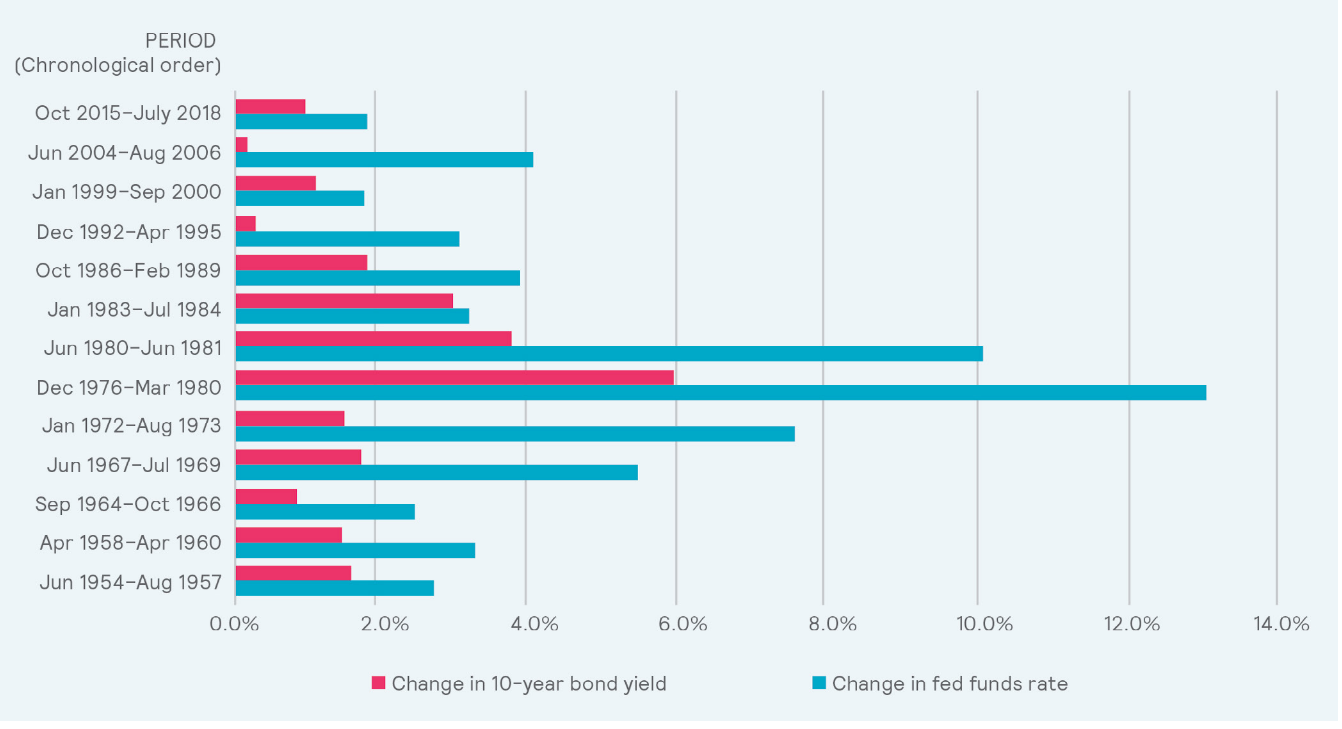
In the next section ("How Does Monetary Tightening Impact Asset Returns?"), we have set out our thoughts on how this changing policy environment might affect the returns from individual asset classes, based on the "rising rate" phase of previous economic cycles. In the following sections, we look at portfolio construction in more holistic terms and suggest some actions that might be taken.

HOW DOES MONETARY TIGHTENING IMPACT ASSET RETURNS?

Much depends upon the speed at which monetary policy is tightened. The normal pattern of a policy tightening is for short rates to be increased in steps in order to counteract rising inflationary pressures in an economy that is considered to be growing too fast. This tightening aims to slow growth sufficiently to "choke off" inflationary pressures. Hence, the policy action of higher rates is generally followed, sometime later, by a reaction of slowing growth in the economy.

The extent to which higher short-term rates are coincident with increasing longer-term bond yields depends on market expectations for longer-term inflation and how these are changed by the policy action being taken. Using the US as a case study, the chart below shows that in the past, when the Federal Reserve has increased short-term rates, longer-term bond yields have also generally increased, albeit to a lesser extent.

EXHIBIT 2: FED FUND RATES AND BOND YIELDS DURING RISING RATE PERIODS



Source: Federal Reserve Bank of St Louis, Robert Shiller; Yale School of Management.

RISKS AND IMPLEMENTATION

Since the global financial crisis, longer-term bond yields have arguably not reflected the ongoing environment of economic growth and inflation, being depressed by both the persistently low levels of short rates and asset purchases under QE programs. However, with short-term interest rates on the rise and the ending of asset purchases under the QE program, it may be reasonable to expect longer-term interest rates to also rise as demand for longer-term bonds falls.

How longer dated bond yields react will therefore be a function of the upward pressure from increased supply of these bonds to the market (QT), and the upward or downward pressure that will be exerted by how the market transforms these policies into expectations of future inflation and growth. The ending of QE could also be expected to encourage a widening of credit spreads as non-government bonds have formed a material part of the asset purchase program (especially in Europe).

A period of rising short rates, rising bond yields and widening credit spreads seems to be a plausible, if daunting, scenario — therefore we should begin to consider how asset markets will behave in this environment.[1]

A period of rising short rates, rising bond yields and widening credit spreads seems to be a plausible, if daunting, scenario.

[1] We discuss current credit cycle dynamics and their portfolio implications in more detail in a paper entitled "Preparing for Late Cycle Dynamics."

THOUGHTS ON ASSET CLASSES

BONDS AND BOND-LIKE ASSETS

Non-government or credit bonds might be expected to perform worse than government bonds of similar duration if the expectation that the QE to QT transition results in credit spreads widening is borne out in practice.

One reason for this expectation is that QE has included the buying of credit assets (in Europe, for example), and therefore QT might reverse this. Equally, in scenarios of strong economic growth in the latter stages of the credit cycle, credit spreads will tighten as the market demands more and more credit as companies' finances improve. Given these conflicting arguments, the outlook for credit markets is highly uncertain, but with credit spreads remaining reasonably tight in a historical context, our global dynamic asset allocation view remains underweight at the time of writing.

It is likely that, if there is a general increase in bond yields and provided inflation is not seriously out of control, inflation-linked bond real yields could also be expected to rise despite not featuring in QE purchases (in the way that they have fallen as nominal yields have fallen, in the last few years, while inflation has remained modest).

So sovereign bonds and credit bonds, fixed interest and inflation-linked, might all be expected to struggle in this environment of rising rates and yields (absent a downward shock in growth or an upward shock in inflation). But there are also bond-like assets which pay a floating (rather than fixed) rate of interest (usually based on LIBOR or equivalent) which should be less vulnerable to, and even benefit from, a rise in underlying rates.

Floating rate notes (such as bank loans) are the obvious choice, but most private debt instruments are also structured as floating rates (albeit with a floor that may be above current LIBOR rates) and the returns from these should also increase to reflect higher headline rates. The challenge is whether higher interest costs will "press the brake too hard," leading the economy into recession, putting leveraged companies under increased financial stress, feeding through to more debt defaults and, ultimately, capital losses from the higher rates.

Absolute return bond funds have grown to become sizable players in the fixed income market in the last few years. In theory, these funds, which are targeting modest positive absolute returns in all market environments, should be a safe haven in a rising interest rate environment. They aim to have a neutral position of zero interest rate duration so, in theory, rising yields need not be a headwind. Currencies always offer the possibilities of positive returns (they can't all go down together), as well as short interest rate positions, floating rate instruments, volatility trading, short dated bonds and those bonds where other fundamentals outweigh the impact of the general upward move in yields and spreads (for example, some emerging market debt).

The absolute return bond fund manager does have access to a wide range of sources of return, but effective reading of the market, as well as skill and conviction in positioning the portfolio, will be necessary to deliver target levels of return. And if inflation does pick up meaningfully, this would be a headwind for these funds as "absolute" returns may be very low (or even negative) in real terms.

LEVERAGED ASSETS

If funds with embedded interest rate duration and exposure to credit spreads are in the "firing line" when it comes to an environment of QT, then assets with leverage (assuming the leverage is a variable rate) will also be exposed. Both assets and funds that rely on leverage to generate returns are likely to be adversely affected by rising rates. Some real estate funds incorporate leverage to increase returns; unless this leverage is fixed and long term in nature, future returns will be impaired by rising rates.

Some assets are much more sensitive to the rising rates of leverage than others, such as heavily geared companies (which might have above-average representation in smaller cap or "value" equity portfolios). Portfolio structures that incorporate leverage (such as risk parity strategies) should also be reviewed to assess whether they are robust in an environment of rising rates (and yields). Leveraged liability-matching portfolios should be stress-tested to understand the potential effect of higher rates and yields on collateral requirements.

Sectors and companies where financial and operational leverage are both high are expected to be exposed to high rates and the likely slowdown in growth.

EQUITY PORTFOLIOS

Equity portfolios, where valuations are generally already relatively high, would be expected to react unfavorably if there is a move in rates and/or bond yields that is sufficient to be considered restrictive to growth, with both the "discount rate" effect and the anticipation of a slowdown in future growth having an impact. The effect would likely be different across the range of sectors, stocks and styles of management, as well as across different regions.

Sectors and companies where financial and operational leverage are both high are expected to be exposed to high rates and the likely slowdown in growth. For some stocks and sectors, the customer base is also likely to be highly interest rate sensitive. Brick-and-mortar stores, for example, that are already having a hard time competing with online retailers, could be impacted as shoppers find it more expensive to borrow and fund spending.

Systematic low volatility equity portfolios are often flagged as being likely to suffer from rising rates, although it is not clear to us that this relationship would always hold. Other defensive equity strategies (such as strategies with a bias to defensive quality), if they are constructed of businesses that have low financial and operational leverage, could be expected to be relative gainers in a weak equity market if that weakness is driven by higher interest rates and lower growth.

HOW SHOULD PORTFOLIOS BE POSITIONED?

As we have emphasized earlier, we don't have all the answers. The degree of uncertainty is high because there is little precedent for the policy environment that we may be entering.

Uncertainty is high, volatility has picked up (since the start of 2018) and downside risks have probably increased. This environment does not appear to be one in which there is the opportunity for particularly strong asset class returns, offering compensation for higher uncertainty. So the risk/reward trade-off appears to have deteriorated.

The most important question to be asked in terms of portfolio construction and dynamic asset allocation becomes, "Is the right amount of risk being taken, being mindful of the asset returns likely to be available?"

So the first and most important step in reviewing portfolio construction is to ensure that the risk/return balance is appropriate. Holding assets with significant exposure to market risks, or "beta," has generally been well-rewarded in recent years — it could well be that the riskiness of these assets (the likelihood of downside outcomes) has gone up, but this has not been offset by an increase in the likelihood of stronger returns.

In light of a more cautious view on the risk/return trade-off over the medium term, there could be an improved case for a reduction in growth asset allocations in favor of low-risk assets. Such low-risk assets would be unlikely to be "ordinary" bonds, unless used for liability or cashflow matching. Less volatile assets generally, even cash or funds with an embedded lack of exposure to market direction, such as hedge funds and other liquid alternatives, may be particularly worth considering at this unusual time.

It is likely to make sense to avoid leverage wherever possible, and to understand (and limit) exposures to interest rate duration that are not specifically hedging an equivalent liability. Portfolio structures that incorporate leverage (such as risk parity strategies) should also be reviewed to assess whether they are robust in an environment of rising rates (and yields). Leveraged liability-matching portfolios should be stress-tested to understand the potential effect of higher rates and yields on collateral requirements.

Private market assets were excluded from QE buying programs, and may look attractive in the current environment as a result, since they are therefore unlikely to be directly impacted by QT — particularly where leverage remains at conservative levels.

As always, we would advocate maintaining an equity portfolio with a diverse mix of style exposures. It may be worth trying to understand the interest rate sensitivity of the total equity portfolio, and whether sufficient exposure to defensive equities has been incorporated in the structure.

The real winners are likely to be strategies with inherent negative correlation to interest rates and equities, the "purest" of which are specific protection strategies.

In an environment of rising rates, yields and widening credit spreads, which is likely to be tough for many asset classes and portfolios, it is much easier to spot those assets with the potential to be adversely affected than to find a wide range of assets that will be relative beneficiaries of QT. The real winners are likely to be those strategies with inherent negative correlation to interest rates and equities, the "purest" of which are specific protection strategies.

There may be relatively few places where it will be possible to "hide" and certainly few where strong positive returns are likely to be available. We should perhaps be grateful for the long bull market that most asset classes have experienced since 2009 and be moderate in our expectations for medium-term gains from here.

CONCLUSION

We believe we are at a stage where, as QE becomes QT, an environment of rising rates, rising yields and widening credit spreads is a distinct possibility. This is likely to be an environment of heightened investment risks but without higher expected asset returns to compensate for these risks. This makes a review of portfolio structure important, first assessing the overall portfolio's likely risk/return characteristics against appetite for risk in this environment, and second, considering the appropriateness of reducing the exposure to return-seeking assets in favor of lower-risk assets, being mindful of the different range of assets that fall into this lower-risk category, at this stage of the economic cycle.

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