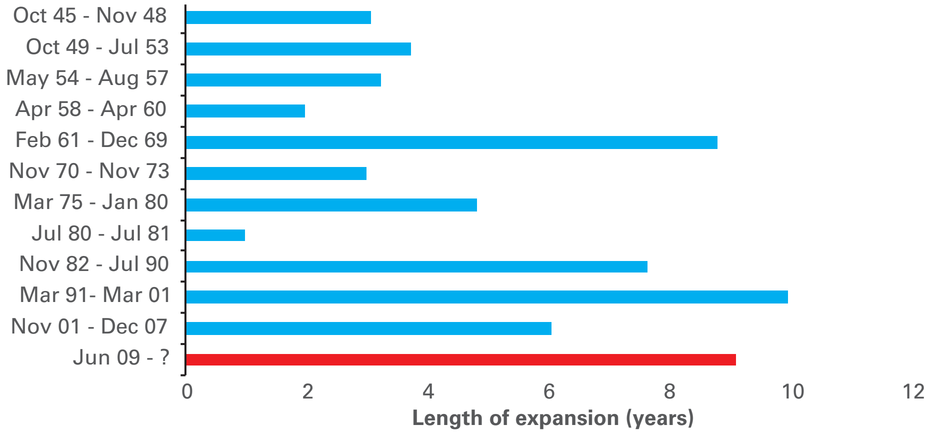
Late-cycle dynamics and low-risk portfolios

With interest rate hikes and 'quantitative tightening', the end of the economic cycle draws nearer every day. How do you manage low-risk portfolios and mitigate the 'nightmare scenario'?

The end of the economic cycle draws nearer every day. Tightening central bank policies and increased volatility have fuelled fears of the next economic contraction. Investors can look to multi-asset solutions and portfolios to establish a lower risk holding during these times. However, we believe that many world economies are still in the mid-expansion phase and that assets still have some potential for further growth. Nonetheless we remain alert to the risks, in our own low-risk funds, of the 'nightmare scenario' – where equities and bonds fall simultaneously.

Figure 1: The end of the cycle is drawing nearer every day



Source: LGIM, Bloomberg LP.

THE ECONOMY WAS FROZEN

Though it might not always feel like it, the global economy is heating up. To put this into historical context (see figure 1), since 1945 expansionary periods have typically lasted between two and five years. The stimulus policies of the major central banks can take credit for maintaining the expansion. As one of our LGIM economists likes to analogise, it takes longer to cook a pizza from the freezer than one from the fridge, and following the financial crisis, the economy was well and truly frozen.

CENTRAL BANKS...BOOM, BOOM

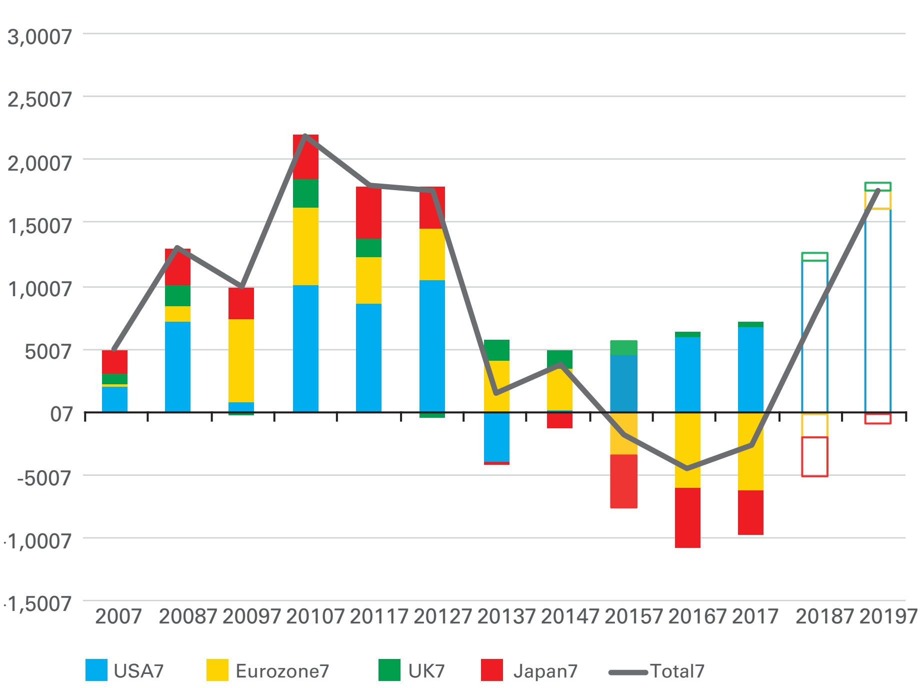
Asset prices have come a tremendous way over the last 10 years, driven by central bank policy. Through their quantitative easing (QE) programmes, central banks have bought immense amounts of government securities; pushing down yields and inflating asset returns since the financial crisis. Central bank balance sheets and currency reserves have tripled over the last 10 years as the equivalent $3 out of every $10 of annual global GDP now sits on major central bank balance sheets. With the notable exception of cash, every major asset class has delivered returns consistent with what we might expect from a booming economy over the past decade.

Central bank stimulus, in part, took the form of the re-acceleration of the QE programmes. For example; 2013 saw the Federal Reserve (Fed) buy more US Treasuries, than the government issued that year, meaning investors were forced to buy higher-risk assets to meet their income and return requirements.

When the European Central Bank and the Bank of Japan joined the Fed to purchase government bonds,

QUANTITATIVE TIGHTENING IS HERE

Figure 2: The government bond supply, net of asset purchases, $ bn



Source: LGIM, Bloomberg LP. As at 30 April 2018.

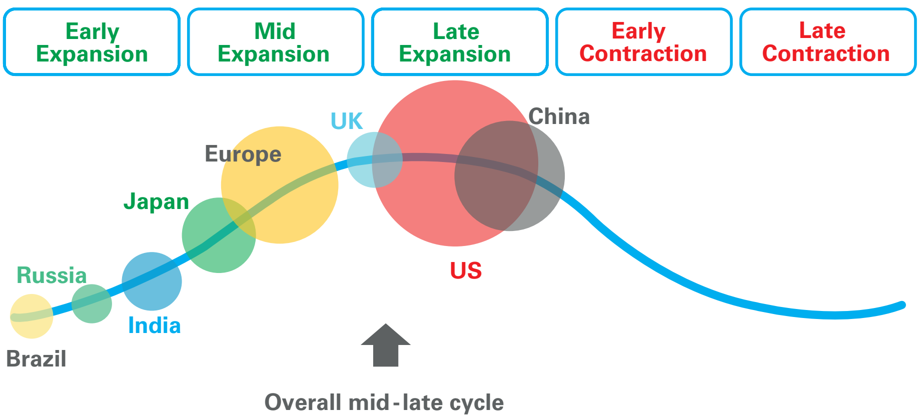
it actually caused the global net new supply of developed market government bonds to turn negative between 2015 to 2017 (see figure 2).

'Quantitative tightening,' the removal of this massive stimulus, due to rising inflation has resulted in the positive net supply of government bonds in the world as of this year.

IN THE CYCLE LANE

Given the realities of quantitative tightening, one of the overriding concerns of investors today is the question of where we are in the economic cycle as this will be a key determinant of the market's direction. Investors are understandably less willing to take on as much risk if they fear that a downturn is imminent.

Figure 3: Getting lost in the cycle?



Source: LGIM as at June 2018, size of circle is representative of economy's approximate relative size

But a closer examination of where the major economies are in the cycle reveals that many economies have actually not yet reached mid-late expansion phase (see figure 3).

However, there are other economies we see as being much earlier in the economic cycle. Brazil and Russia have recently gone through recessions and we would see them as being in the early expansionary phase.

While the Bank of Japan and the European Central Bank are slowing the rate of asset purchasing, they are continuing to expand their balance sheets to generate more inflation and so we would see these economies in the early-mid expansion phase of the economic cycle.

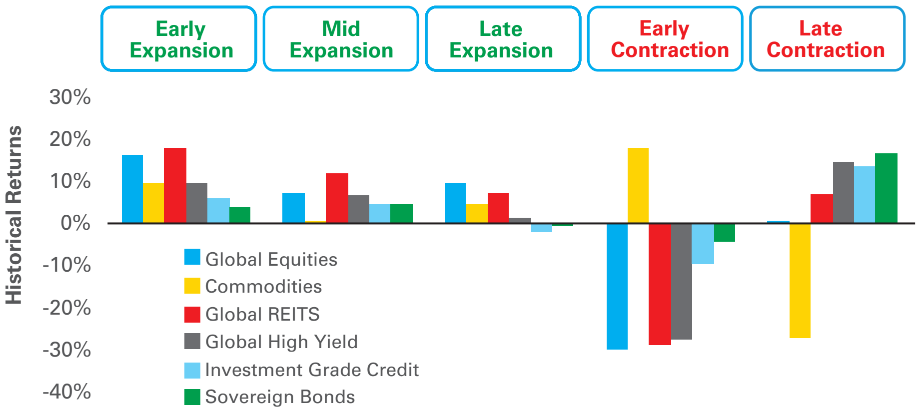
Of course there are more upward pressures on inflation and increased volatility but both of these are not necessarily negative for asset prices. For instance, while the best time to invest in global equities is in the early economic expansionary phase, the second strongest returns are seen during the late expansionary phase (see figure 4).

IT'S NOT ALL ABOUT DURATION

Low-risk portfolios can often appear to have a high sensitivity to interest rate changes. Duration measures the amount a bond's price is expected to change after a 1% change in interest rates. For example, the typical UK gilt index has on average a duration of around 12 (figure 5), meaning that if interest rates go up by 1%, investors might expect a dramatic 12% loss.

However, the actual risk implications of such interest rate rises may be quite different. When it comes to the risk for

Figure 4: Phased returns



Source: LGIM, Bloomberg LP. As at 30 April 2018.

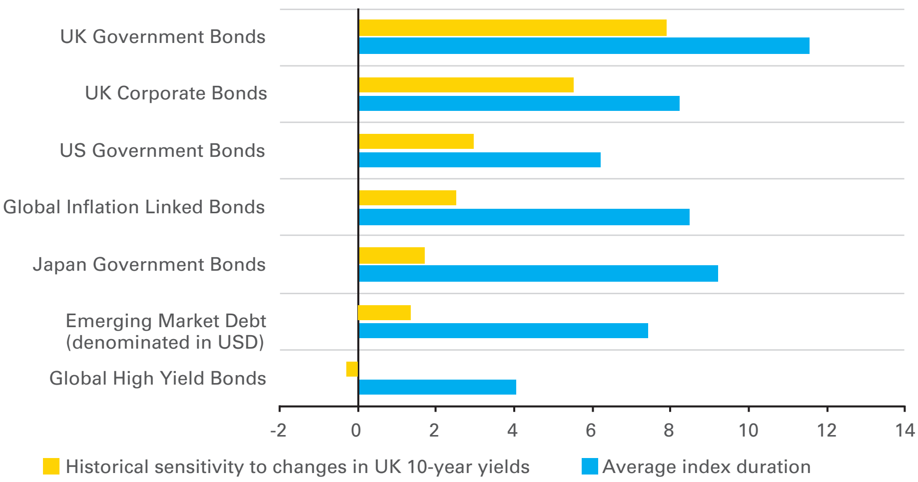
fixed interest assets, what arguably should matter to UK clients most are UK interest rate changes and the effect this will have on their investments. Changes in rates, particularly rate rises, will have other wide-reaching consequences such as mortgage repayment increases.

However, clients can mitigate these associated risks by diversifying their portfolio bond allocation to asset classes such as global inflation-linked bonds, Japan government bonds, as well as non-fixed income asset classes including equities and alternatives.

The headline duration of our lowest risk multi-index portfolio (Multi-Index 3 Fund) is around five (see figure 6). If interest rates were to rise by 1%, one might expect a 5% drop in the portfolio's return. However, what matters is the sensitivity to specific interest rate changes.

The portfolio's historical sensitivity to UK 10-year rates in particular (figure 6), has long been a fifth of what the headline duration implies and, considering the current environment for UK rate rises, a very unlikely course of events in the near term, in our view.

Figure 5: A look into fixed income
Looking beyond the headline duration in estimating sensitivity to rates



Source: LGIM, Bloomberg, JP Morgan, Barclays, Bank of America Merrill Lynch

Duration of the underlying indices is as of 30 April 2017; the sensitivity to changes in yields is calculated as a beta coefficient in a uni-variate regression of historical weekly total return index returns on historical weekly changes in 10-year yields (weekly data from the start of 2011 to the end of April 2017).

THE NIGHTMARE SCENARIO

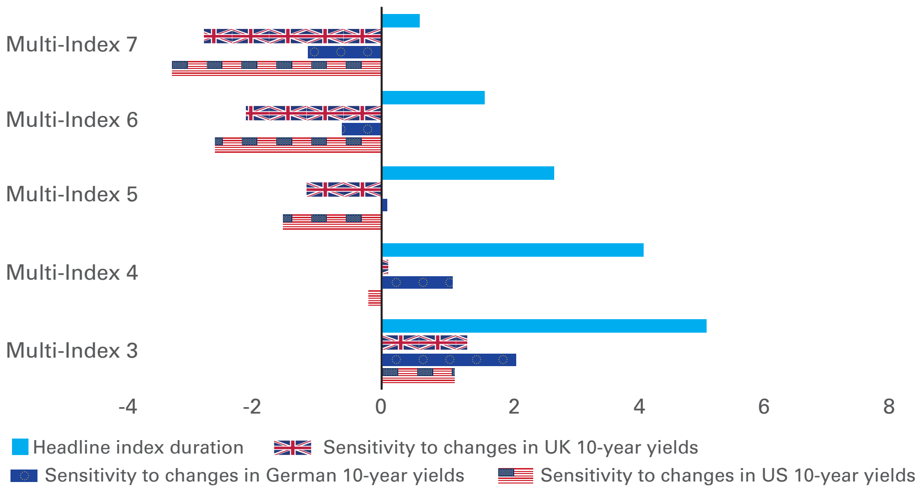
The fear many investors have is that of a 'nightmare scenario': one where both equities and bonds fall in value simultaneously. This has happened in short bursts in the recent past, at the beginning of 2018, and perhaps most notably during the 'taper tantrum' of 2013.

The prospect of faster-than-expected Fed rate rises or a faster-than-expected quantitative tightening in the US could have a dual effect of causing yields to rise as the central bank slows its massive bond purchasing programme, and equities to fall as liquidity is removed from the market.

While it's unlikely that investors could prevent all losses in this scenario, there are methods of constructing a portfolio that can help dampen these effects.

First is to consider the underlying reason which may cause the Fed to quickly hike interest rates – higher-than-expected inflation. Therefore holding assets whose value is tied to inflation would be beneficial. In our government bond exposure for example, we currently have half of it allocated to index-linked securities, predominantly in the US that would benefit from that upside inflation, helping to at least lessen some of those falls relative to conventional bonds. Another action investors can take is via the currency exposure. In the funds, we have looked to increase our exposure to the US dollar. If the Fed is raising interest rates faster than the market expects, the difference with the rest of the world will grow.

Figure 6: Multi-Index allocation



Source: LGIM, Bloomberg, JP Morgan, Barclays, Bank of America Merrill Lynch

Duration of the Multi-Index funds is based on the duration of the underlying indices as of 30 April 2017 and the current target asset allocation for the funds; the sensitivity to changes in yields is calculated as a beta coefficient in a univariate regression of the fund's actual weekly returns since inception on weekly changes in 10-year yields in a given region (weekly data from the funds' inception on 23 August 2013 to the end of April 2017).

This attracts US dollar investment back to the US and causes the dollar to appreciate in value in doing so. While bond and equities may fall in the nightmare scenario, the one asset class we might expect to do well is the US dollar, hence our overweight position in the lower risk funds in particular.

STAYING PREPARED

In building a global multi-asset portfolio the key determinant of risk, and therefore returns, is going to be asset allocation. The ability to be active in asset allocation and seeking out future winners is more important now than it has ever been. With central banks starting to think about shrinking their balance sheets, the uncertainty from the aftermath of the global financial crisis still has far-reaching effects. Being able to react to a changing environment and dynamically adjust asset allocation will be crucial for multi-asset funds to manage overall risk but also to deliver attractive returns.

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