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Finding your anchor

by Stephen Nguyen, CFA

What a difference a few months make. After a relatively calm year in 2021, we have witnessed several asset classes posting significant losses in the first half of 2022, including equities, credit, and sovereign bonds. We have seen an increase in volatility and traditional diversifiers like government bonds have failed to provide protection, as their correlation with risky assets has risen. The increase in correlation between bonds and equities has caused major headaches for the traditional multi asset investors. It is worth remembering that asset prices habitually swing from week to week and at times even intraday. Stock markets are volatile creatures and while historically they have reliably delivered strong returns when held for the long run, it is anybody's guess what will happen in the short term. You cannot control the market, but you can control how you react to it, by finding your anchor.

Markets have been very choppy amid mounting concerns about the economic and corporate earnings outlook. Investor sentiment has deteriorated over the course of the year due to many factors, not least the ongoing conflict in Eastern Europe, supply chain disruptions and soaring food and energy prices (pushing inflation to levels not seen for decades). Consequently, corporate margins are under pressures from surging producer input prices and rising labour costs. Central banks' 'transitory' view on inflation has, in hindsight, proven to be incorrect and they are now being forced to act much more aggressively than initially anticipated by both themselves and investors. The probability of a 'soft landing' is diminishing as the cumulative effects of these front-loaded rate hikes could potentially push the economy into a recession.

We believe market volatility is likely to persist in the coming months, but we are hoping to see some of the biggest drags on markets ease in the second half of the year: more visibility on the corporate earnings outlook; inflation peaking; and the Fed's tightening coming closer to its end.

Losses in sovereign bonds are somewhat to be expected as the rate re-pricing began from an unsustainably low level. However, the pace of the rise in bonds yields has caught investors by surprise. The market is struggling with the (low) growth vs (high) inflation dilemma, and this has led to continued elevated volatility in bonds.

Corporate spreads have also widened meaningfully, albeit from extremely low levels at the end of last year. At the same time, the decline in equities so far this year, particularly in the US, has been predominantly driven by a contraction in multiples.

We are conscious of the risks but can also identify longer-term opportunities. Equity valuations are now more attractive having seen multiple de-ratings across all regions. Meanwhile government bonds in the US are now offering higher yields across the curve, making them more appealing. Spread products (i.e. high yield) are already pricing in economic weakness and a pick-up in defaults which present opportunities for active investors. We continue to see promising opportunities presenting themselves in Japanese and non-US equities, and we are paying closer attention to US equities as valuations there become more attractive.

During times of turmoil, it pays to find your anchor and stay true to what works best and reliably over the long run. We let our bottom-up valuation discipline steer us towards the most attractive opportunities, whilst being mindful of the risks. Portfolio construction resiliency is important at the best of times, but it becomes vital when the seas are turbulent.

Investors should stay broadly diversified and remain patient when allocating to risky assets. One of our tenets is "diversify your diversifiers", and this has become increasingly important in recent months. While traditional diversifiers in the form of US Treasuries and gold have come under pressure this year, our allocation to Chinese government bonds and liquid alternatives have held up much better. Stocks are not outright cheap by historical standards; however, they are no longer expensive.

The biggest risk for investors is not price volatility, but rather the probability of not achieving their longer-term investment objectives. However, we are cognisant that short-term price swings could lead investors to act irrationally. Stay invested, be prepared for a bumpy ride, but avoid the temptation to try and time the next recession.

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