From liquidity surfing to bull running

Tai Hui | JP Morgan Asset Management | 31 January 2014

Five years after the global financial crisis and a number of false starts in recovery, there are growing signs that the developed economies are finally on the mend. This also triggered the US Federal Reserve's first step in normalising its monetary policy, by reducing its asset purchases gradually. Although we envisage this phase of global recovery to still be gradual and far from a v-shape, the start of the end of the Fed's money printing is expected to reshape the global investment landscape. The US, Europe and Japan returning to a stronger footing is expected to help boost corporate profits in their home markets, as well as in emerging markets with high export exposure. Benign inflation, at least for now, will also contribute to company profitability. For fixed income, a rise in US Treasury yields is likely to have a profound impact on bond benchmarks. We nevertheless believe bonds should remain a critical component of an investor's portfolio in 2014, given lower volatility relative to equities and a now higher income contribution. Nonetheless, a more active approach in managing this part of the portfolio is necessary as liquidity tailwinds could gradually turn into headwinds at some point in the future.

1. SYNCHRONISED GLOBAL GROWTH

Calendar 2014 is expected to be the first year since 2010 in which all four the the world's largest economies - the US, Euro area, China and Japan - are all expanding.

In the US, 2013 was weighed down by politically induced economic uncertainties, such as the fiscal cliff, federal government shutdown and debate over the increase of the federal debt ceiling. Not only did higher taxes and reduced spending have a direct impact on the economy, uncertainties from political bickering undermined consumer and business sentiment. A piece of good news is that with the Congress mid-term elections approaching in November 2014, Republicans and Democrats seem more willing to compromise on matters that have an impact on the real economy, such as the Congress passing the US$1.1trn budget to fund government operations. Reduced political uncertainty is expected to help support sentiment. In particular, with US household balance sheet deleveraging making considerable progress, as shown by the record high net household assets at US$71trn and a falling jobless rate, US consumers have more reasons to maintain steady spending, which is 70% of US GDP.

For the Euro area, there are still plenty of structural issues to be handled, such as high youth unemployment, banking sector reforms and governments' fiscal debts. Nonetheless, an easing in fiscal austerity and a more constructive global environment are helping the region to return to growth. In China, the era of 8% to 10% growth is behind us, as the economy matures. The Xi-Li leadership has also shifted the government's priority of economic development to the quality and sustainability of growth, instead of the speed of growth. Urbanisation, environmental sustainability, state-owned enterprise reforms and financial market liberalisation are all key events that could define China's progress in the next five to eight years. While the rate of growth will inevitably slow as a result, investment opportunities could rise with market forces playing a more prominent role in the economy.

2. INVESTMENT LANDSCAPE IN THE POST QE WORLD

With the economy in the US slowly on the mend and the jobless rate falling, the Federal Reserve is doing the right thing embarking on the reduction of its asset purchases, in our view. After all, we believe the most recent round of quantitative easing has been less effective in supporting the real economy than previous rounds. The normalisation of US monetary policy is one of the most important events in shaping the investment landscape in years ahead.

Although the Fed may not look to raise its key policy rate (the Fed Funds Target Rate) in the near term, US Treasury yields are likely to react ahead of any policy action and price in further recovery in economic activity and potential inflation pressures earlier, possibly much earlier. Ten year Treasury yields have already risen from a low of 1.7% in May 2013 to 3% before falling back to their late January 2014 level of around 2.80%.

We believe it is fair to assume in this situation that bond yields should continue to rise in the years to come. Our analysis has shown that equities outperformed bonds in a rising yield environment. This should not be hard to appreciate because a higher yield equals lower bond prices, which has been a critical contributor to bond returns in recent years. Meanwhile, a stronger economic environment does help to support corporate earnings and underpin equity performance. Of course, not all bonds generate negative total returns when Treasury yields are rising. Nonetheless, it is important to note that traditional bond indices are likely to face more headwinds in the years ahead and investors will need to take a more active approach and not be rigidly bound by traditional fixed income benchmarks. Active investors should aim to find opportunities within duration, currencies and credit spreads to generate return. For example, corporate high yield bonds were negatively impacted along with other fixed income products in 2013, but their relatively high coupon return and credit spread compression relative to risk-free assets provided a positive total return to investors. Emerging market debt, despite the recent volatilities on the back of fear of reduced liquidity, also has the same potential but this will require even greater scrutiny during the selection process.

A bond yield rising from a low level is positive for equity performance. There is a positive correlation to equity market performance between the US S&P500 and US 10-year Treasury (UST) yield movements when the UST yield was below 6%, using data since 1963. However, this positive correlation turns negative once the level of UST yield rises above 6%. The results are similar for global and Asian equities. We believe that UST yields rising from a low level reflects a recovering economy with limited inflationary pressure, including low funding costs for corporates. This is beneficial to earnings. We believe the recovery environment is likely to persist, while inflation risks are still limited in the foreseeable future. This underpins our continued optimism on equities. Our optimism could, however, change under two circumstances: first, if US and global economic growth falters again; and, second, if inflationary pressure gathers momentum, which would be reflected by a sharp surge in UST yields beyond the level that historically has been consistent with the recovery/benign inflation combination that forms our base case scenario.

3. THE DAY OF RECKONING AND CAPITAL ROTATION

Using data from the US fund industry, we have noted that US investors have been heavily investing in bond funds between 2009 and mid-2013. This is not surprising given the volatile nature of the global macro-economic environment since the global financial crisis, the risk-on/risk-off sentiment that increased uncertainties, and also the implicit guarantee by major central banks around the world to keep bond yields low. However, this trend abruptly changed in mid 2013 when Ben Bernanke indicated in May 2013 that the Fed would start to look at conditions that would signal the need to reduce asset purchases. Since June 2013, investment flows into equity funds have exceed bond funds and we believe this trend is likely to continue.

Another point to consider is the risk-return proposition to investors. In recent years, bonds, especially emerging market debt and high yield corporate bonds, have delivered strong returns to investors at a relatively more modest volatility than equities. This high return/low volatility combination has unsurprisingly lured investors into bond funds and related investments. However, as US monetary policy normalisation begins, this ideal scenario is likely to end as the expected return from bonds deteriorates to become more in line with their volatility profile. This day of reckoning gives investor two options. They can either maintain their risk profile but accept a lower return. Alternatively, another possibility we see most investors could adopt is to maintain their return objective, but to take on more risk to achieve this objective. We believe this trend could impact on asset allocation and portfolio construction in the years ahead. In our view, the capital rotation noted earlier is only at an early stage as investors are just starting to rebuild their equity allocation, while gradually retreating from bonds.

4. EQUITIES – INVEST LONG AND PROSPER

As investors return to equities, it is worth reiterating that it is a volatile asset class and the odds favor those who stay invested, instead of trying to time the market. Our analysis has shown that retail equity investors are often led by emotion. They often buy during periods of euphoria (greed) and capitulate when there is widespread panic (fear). For example, investors who had invested US$100,000 in S&P 500 at the start of 1980 would have seen their investment grew to over US$1.7mn by the end of 2013, without taking into account dividends. Amongst these 8,800 trading days, the top 10 days of gains were responsible for half of the total return, taking into account the compounding effect of these up days.

In addition to better returns, investors should also be able to reap the benefits of reduced volatility by having a longer investment horizon. The range of returns for equity investment for any one-year period between 1950 to 2013 was from +51% to -37%. This range falls to +28% to -2% if the investment period is raised to five years. Moreover, investors' return variance can be reduced further by adopting a more diversified portfolio by including both bonds and equities.

5. THE GREAT ESCAPE: FROM LIQUIDITY SURFING TO BULL RUNNING

The start of US monetary policy normalisation implies investors should actively review their asset allocation and look to step up exposure to risk assets, including equities and high yield bonds. It is also unusual in the current phase that non-US major central banks are likely to maintain ample liquidity that would support risk assets. Like bull running, equity investment requires discipline to manage risk and we believe that staying invested, instead of trying to time the market, can help to improve return and control volatility.

Tai Hui is Chief Market Strategist Asia at JP Morgan Asset Management, Hong Kong. He is part of the faculty of speakers at the 2014 PortfolioConstruction Forum Markets Summit.