MONTRUSCO BOLTON / Solutions

A Panoramic View

April 2019

Markets – the Big Bang and the way forward

Advocates of the Big Bang theory believe that the expanding universe could end up in either a Big Freeze - where the universe stops expanding - or the opposite, a Big Crunch - where the universe contracts. We believe that, over the medium term, financial markets can have similar outcomes. Here's a brief explanation.

The unprecedented 2007-08 financial crisis caused significant collateral damage. Massive interventions by central banks to save the global financial system caused unintended consequences. By leaving interest rates at excessively low levels for a long period of time, central banks created an environment where the perception is that rates will remain low forever. This phenomenon has long existed in Japan, is more recent in Europe, and has spread to Canada and the United States of late. This perception causes investors to potentially react very strongly to a small rise in rates (considering the effect of debt and leverage in the economy) and not at all to a decline in interest rates. Additionally, it renders interest rates a lesser reliable indicator of the economic reality of any country. Increasingly debt is issued that does not reflect real credit risk.

Under normal circumstances, the combination of good growth, rising inflation and rising global debt should cause interest rates to rise. But we are not in a normal environment. As long as central banks can act as buyers of last resort, the risk premium should be nil, as in the Big Freeze scenario. No risk of loss, but no extra return for the extra risk that is being taken.

The steep market correction of the last quarter of 2018 and the rebound of 2019 provide a good example. As soon as risk premiums increased and risky markets underperformed, central banks stepped in. In the space of a few weeks, the Fed moved from a hiking and robust growth stance to a no-hikes and moderate growth stance. Markets readjusted and interest rates declined. This is a zero-sum game, and it seems that we are under the influence of a big freeze that could become even more significant if global growth slows markedly. Although this is a real structural phenomenon, such a deceleration is not in the cards in the short term (2019).

And where is the big crunch in all this? It implicates a revaluation of assets to reflect the real risk premium, as in the not-so-distant past. Such a revaluation would be great for investors because risk

premia would rise. But the price to pay would be high: rising interest rates and widening credit spreads (to reflect reality), equity market revaluations and a major recession. Under such circumstances, cash would be king! As a stress test, it would combine the dot com crisis of 2001, the credit crisis of 2007-2008 and the sovereign debt crisis of 2011!

With a big freeze, investors do not obtain sufficient returns on traditional assets (bonds and listed shares).

Investor options and the way forward

Provided this new reality, what should investors do? Invest in assets where the return potential is low and the risk is high under the Big Freeze, Big Crunch risk scenario? Not very attractive, given the risk-return. Traditional, value-added investment strategies are no longer as effective because correlations between assets have evolved significantly (positive relation between bonds and stocks). A typical 60-40 asset allocation can no longer produce the mythical return of 7% plus; the underlying risk of a sell-off is high. Although many financial products are trying to adapt (smart Beta and smart Alpha), the result for investors is below expected returns.

What is the investment solution to a problematic structural reality? Investors should focus on absolute return strategies rather than relying on benchmark tracking ones. The emphasis should be on capital preservation and implementation of a structure to achieve these risk-return objectives systematically and repeatedly. Alternative investments, which are better suited to the current context, partially address this problem. Highly specialized alternative managers can develop specific risk-return profiles which are weakly intercorrelated and weakly correlated to traditional public markets.

However, it should be noted that the alternatives market has inherent risks such as investment liquidity and greater management complexity. Choosing an effective manager for this market is also more complex than for traditional markets, since management styles are highly varied.

Considering the other potential impediments to growth (demographic trends, geopolitical tensions, protectionism and trade wars, etc.), the return outlook may seem less promising than in the past decade, but any environment eventually creates opportunities. The more creative and flexible managers will capture them.

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2019 Outlook – As long as interest rates stay where they are (!)

The next few quarters will be interesting; as the impact of tax cuts in the United States wanes, central banks are expected to remain on hold considering slowing global growth expectations. But the most important factor will be growth outside OECD countries – a key catalyst over the past decade. However, the economies of these countries are starting to run out of steam. China and its neighbours will bear watching.

Interest rates should and will remain at current levels. A rate hike when growth is fragile would be ill-advised, but rates should not be cut either because this would leave central banks little room to manoeuvre. If rates are cut and quantitative easing (QE) policies are used, rates will fall even further, and this time they will remain at rock-bottom levels without creating growth (as in Japan and Europe).

Credit markets as well as emerging markets remain at risk, mainly because of low liquidity and portfolio positioning and that could give rise to a fire sale.

The bond market will be stable, the stock market will lack direction, and most of the performance will come from currencies. Potential rate cuts in coming quarters instead of the expected rate hikes should result in currency volatility. This should once again favour the US dollar.

Energy and materials prices cannot rise much in a slowing economy; consequently, the Canadian market will lag.

As for illiquid markets, we expect real estate, infrastructure and private equity to perform well. However, the private debt market, like the credit market in general, will be challenged.

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