Investec

OUT OF THE ORDINARY

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Flip Flops

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The first time I visited Florida I was amused to see a sign outside a hotel that read “No Thongs”. Quite right, I thought. Who wants to share public space with people wearing unfeasibly skimpy nether garments? It turned out that the sign actually referred to the footwear that I knew as “flip-flops”. Two nations separated by a common language. And Americans were also missing out on the wonderful onomatopoeic qualities of the word.

All of which introduces the theme of this week's piece on the flipping of correlations between different asset classes. We have written regularly in the last few years about what might happen should there be a correlation shift between equities and government bonds. For the last two decades, equities and bonds have been negatively correlated, meaning, broadly, that when equities were falling, bonds were rising and vice versa. During an era when bond yields were trending lower, this delivered excellent risk-adjusted returns to investors in a classic 60/40 portfolio (60% equities/40% bonds) because the negative correlation suppressed overall portfolio volatility.

The correlation between equities and bonds

However, historical analysis suggested that the biggest risk to this rosy scenario would be a sharp rise in inflation, especially if US Consumer Price Indices settled above 3% for a sustained period (the main drivers of global portfolio performance are US equities and the US 10-year Treasury yield). And this, of course, is what happened in the first half of 2022. The consequences were disastrous. As we wrote in the latest Monthly Commentary: "[...] holders of US 10-year Treasury bonds were subject to the worst performance in the first half of a year since 1788. Global equities suffered their first consecutive quarterly reversals since the Great Financial Crisis (GFC), with the S&P 500 Index in the United States having its worst start to the year in six decades."

However, just as obituaries were being written for the 60/40 portfolio, in recent weeks the correlation flipped back to negative as investors' concerns shifted from inflation to recession. While equity markets hit new lows for the year during June, government bonds rallied, with, for example, the US 10-year Treasury yield falling from a peak of 3.49% to as low as 2.80%. The 10-year UK Gilt yield fell from 2.65% to 2.04%. Falls in yield of such magnitude and speed have only been witnessed in this century during the Great Financial and Covid crises. Even if we remain cautious on risk assets, we don't think we are on the brink of a crisis. Such big moves might well reflect poor liquidity in bond markets, as well as the increased influence of computer-driven trading strategies.

The correlation between equities and commodities

To add to the difficulties facing balanced portfolio investors, there has been another big correlation shift recently, that between equities and commodities. Last year the big question was how best to diversify equity risk in portfolios if government bonds weren't up to the task. And if the main factor behind that was higher inflation, historical correlation models suggested Commodities as the asset class of choice. It's fair to say that a great part of that conclusion was based upon the relative performances of equities, bonds and commodities in the 1970s, but there were enough other less extreme instances to lend credence to the theory.

Thus, we saw commodities perform well during 2021. Some of this was no doubt thanks to the gradual reopening of the global economy and there was also a boost to certain metals from the longer-term demand that would result from the Energy Transition to a lower carbon-consuming world. But for most of 2021 equities were performing well too, and so there wasn't any great urgency to increase commodity weightings from a portfolio diversification perspective. That leg of demand only really kicked in when equities (and bonds) started their big decline in January, and it was boosted by Russia's invasion of Ukraine which exacerbated existing supply shortages, notably in the energy sector. Bloomberg's Spot Commodity Index climbed by a third between January and March having risen by a quarter during the whole of 2021.

It continued to be very well supported until it hit its peak on 7 June, since when it is down 17% (with a peak-to-trough decline of 21%). What on earth happened? In a nutshell, recession fears combined with a sharp reduction in long-term inflation expectations (as derived from bond market prices). This is the ultimate two-pronged attack on commodities as an asset class: lower short-term demand owing to reduced economic activity, combined with decreased need as a diversifying asset class if long-term inflation risks are receding.

The impact of hedge fund strategies

The market moves have also almost certainly been exacerbated by trend-following hedge fund strategies. They have been consistent buyers of commodities the further they rose and then switched to selling as the falls accelerated. The trusty market historians at Deutsche Bank pointed out that the recent 20-day fall in commodity prices was the third largest experienced in the past 90 years, beaten only by a period at the start of World War II and then during the GFC. And just to underline the point about volatility, in March we saw the fourth highest 20-day rise in commodity prices during those same 90 years, beaten only by the beginning of World War II and two separate episodes during those inflationary 1970s.

What has been our diversification strategy?

And so, what has been our diversification strategy this year? We correctly identified the risk to both equities and bonds, although, in retrospect, were not sufficiently bearish. However, we did anticipate that volatility would increase across all asset classes and recommended increasing exposure in our Alternatives class to hedge fund strategies that can capitalise on increased market volatility without necessarily exposing us to a single or extreme directional market view.

I hope I have demonstrated that having all of one's eggs in a single basket that is predicated upon a specific outcome can be incredibly risky when circumstances change, especially during the current period when economic signals remain distorted by the effects of Covid and subsequent policy decisions. Although we have most recently suggested switching some of the Alternatives back into sovereign bonds as a more specific recession hedge, we remain broadly diversified and await clearer signals on the economic, monetary policy and corporate earnings outlooks or a more compelling valuation opportunity, before increasing risk budgets again.

What might we see long-term?

There is much debate about how the longer term plays out, but there are reasonable grounds to believe that inflation will settle higher in the post-Covid world, driven by a combination of reduced global trade, greater demand for social/wage equality, demographics, ESG factors and the energy transition. Given that the current crop of central bankers has not experienced such conditions (at least not while in office), it would be unsurprising if a few policy mistakes were made. This could well lead to greater volatility in inflation itself, which could, in turn, see the correlations between asset classes flip-flopping on a more regular basis. This possibility cries out for more creative portfolio construction solutions than just relying on two asset classes (equities and bonds) to do all the heavy lifting.

Economic Commentary

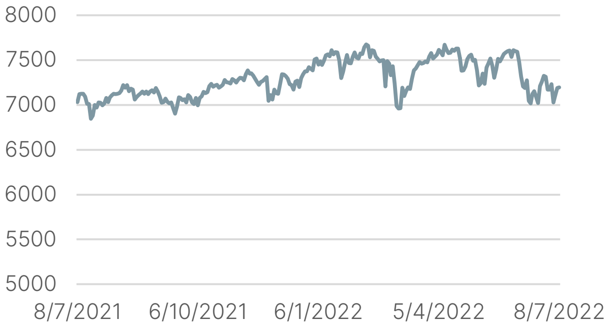
FTSE 100 weekly winners

Auto Trader Group PLC	9.2%
Scottish Mortgage Investment Trust Plc	8.7%
Ashtead Group plc	8.2%
Experian PLC	7.1%
Rightmove plc	6.8%
Halma plc	6.7%
Spirax-Sarco Engineering PLC	6.7%

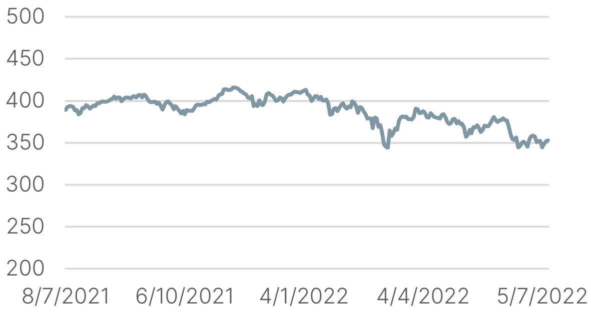
FTSE 100 weekly losers

Entain PLC	-12.4%
Fresnillo PLC	-9.8%
Standard Chartered PLC	-5.5%
Persimmon Plc	-5.2%
British American Tobacco p.l.c.	-4.3%
Taylor Wimpey plc	-4.3%
Shell PLC	-3.7%

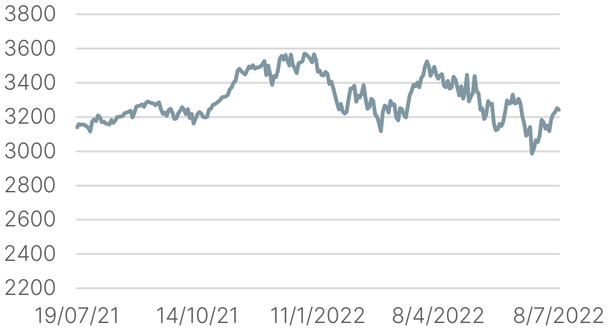
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



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