

Staying sure-footed

Our panellists give their take on how investors can harness or tame volatility to benefit their portfolios



2016 has been challenging so far, dogged by economic worries and Asian market risks on the downside. What strategies are likely to fare well in this environment? Our experts share their views.

Genevieve Cua: How do you read the recent down-draft in markets: Is it a buying opportunity, mere noise or a sign of worse to come in the real economy?

Alexis Calla: One of our key themes at the start of the year was the likelihood of volatility trending higher. This has indeed been the case. Looking beyond this short-term outlook, uncertainty and downside risks have risen since December 2015. This is grounds for a more balanced positioning than before. However, we do not believe conditions have deteriorated sufficiently to justify an outright defensive approach.

On balance, we still expect positive equity-market returns. However, we would use market upturns to trim our equity exposure and reallocate to corporate bonds and alternative strategies.

The market downturn since the start of the year can be attributed to several factors. These include concerns about the outlook for US economic growth, inflation and corporate earnings due to a strong US dollar (USD) and low oil prices; China's continued slowdown and risk of

a currency devaluation amid sustained capital outflows; the sustained decline in oil prices and its fallout on non-energy sectors (especially on US and European banks); and the implications of negative interest rates in Europe and Japan, especially on bank earnings.

Where we are in the US economic cycle is key. Equities generally fall six to nine months prior to a US recession. Our central scenario is that we are some way from the end of the cycle, but the risks have increased. While economic indicators – including the job market and consumption – paint a reasonably positive picture, the downward revisions to corporate earnings are flashing amber, signalling recessionary risks.

A coordinated and credible G-7 policy response, combining fiscal and monetary stimulus, would be a huge positive for global growth and for fighting deflationary pressures. Such a move would also be positive for equities, but there are few signs of this so far.

The other question is whether China is having a hard landing, as that would be a major deflationary force. Although China's manufacturing sector has clearly slowed significantly over the past year, its services sector has continued to expand – last year, it expanded more than 8 per cent to account for half of the economy.

We see this shift towards a consumer-driven, services-oriented economy (and away from a manufacturing and investment-led economy) continuing over the coming years. This should help China avoid a hard landing.

Also, assurances from Chinese policymakers to keep the yuan broadly stable against the currencies of China's main trade partners have helped calm markets lately. Their ability to stem the ongoing capital outflows is likely to be decisive in stabilising the yuan.

The USD strength is also seen as negative for risk assets. We expect the USD's rally to be less pronounced, less prolonged and less broad-based in 2016 as Fed rate-hike expectations are pushed back. The market is now pricing at most one rate hike this year.

The reversal in the USD strength would be beneficial for the US economy, while taking the pressure off emerging markets, many of which have suffered from significant currency depreciations over the past year.

Kelvin Tay: Over the last six months, market volatility has been driven by three main factors: sharp declines in oil prices; renewed concerns about a potential hard landing in China and the accompanying shenanigans of yuan devaluation, shrinking FX (forex) reserves amid capital outflows; and a weakening US economic recovery.

These factors have been overshadowing capital markets this year – potential global deflation, which in turn means asset prices must debase to reflect a deflationary global economy. Hence, the downdraft in markets.

Firstly, let's look at oil prices and the US economy as they're both related. Over the last 12 months, the daily correlation between changes in oil prices and

changes in asset prices such as global equities, global high yield bonds, government bonds, corporate bonds and even the USD, has increased significantly. Even the FTSE Straits Times Index has not been spared this rather unusual occurrence.

We believe the correlation between oil prices and asset prices is likely to remain in place until oil prices stabilise.

A recovery in oil prices will spur a recovery in asset prices with risk aversion taking a back seat. Our expectations are that the strong correlation we are seeing at the moment will break down eventually, but it may still take some time before this universal fear of lower oil prices begins to subside.

Oil prices have already fallen from US\$100 to US\$40 (at mid-March). With the number of oil rig counts in the US declining sharply, the worst in oil-price declines is probably behind us although the volatility may remain high until oil fundamentals continue to improve.

Although lower oil prices are in general positive for the economy, there are some negative effects as well due to the massive reduction in capital spending by the energy companies that usually follows a prolonged decline in oil prices. Any large-scale pull back in capital expenditure will likely affect the economy, although this impact is likely to be limited.

This is because energy companies' share of capital expenditure in the US has fallen sharply from 10 to 5 per cent over the past year. Is it possible for it to fall to zero per cent? Certainly, but that would be unprecedented. In other words, unless it's Armageddon in the oil industry, we have probably

seen the worst in terms of the negative impact of falling oil prices on the economy.

We therefore strongly believe that the markets are overly pessimistic about the negative aspects of lower oil prices on the US economy. If businesses share the same sentiments, they would not be hiring close to 300,000 workers in February and also for each month in the last quarter of 2015.

While the risk of a US recession in 2016 is not negligible, we expect ongoing positive economic growth. Low unemployment, rising wages and low energy prices support consumption. Despite slower employment growth and negative wealth effects, we expect consumption growth to remain positive.

Furthermore, given the tightening in monetary conditions that has been brought about by the selloff in risky assets in recent months, the US Federal Reserve is unlikely to hike its policy rate further in the months to come.

But markets would be wrong to assume that this deceleration represents the start of a recession. Unemployment is under 5 per cent. Average hourly earnings are growing at their fastest pace since 2009. Mortgage rates are just 3.7 per cent, and petrol prices are the cheapest they've been in years. Household debt relative to GDP (gross domestic product) has dropped a full 20 percentage points over the past six years.

These factors should enable real disposable incomes to increase at a sufficient pace to sustain consumption growth, and keep the US out of recession. Furthermore, with unemployment below 5 per cent, improved wage-bargaining power should translate into continued income growth, even if jobs growth slows from last year's 221,000 per month pace.

What about China? The depreciation of the Chinese yuan (CNY, -1.5 per cent) against the US dollar has led to questions about the government's intentions for the currency, and is raising concerns over greater regional currency volatility and global deflationary pressure. The higher USD/CNY fixings signal to the markets that the People's Bank of China (PBOC) is more actively managing the CNY on a trade-weighted basis, considering that the USD has strengthened broadly in recent days versus major currencies.

Although the trade-weighted moves in the currency so far have been relatively small, uncertainty over the government's policy means the tail risk of a larger move has risen. As China experiences relatively weak nominal growth, a risk scenario of sustained depreciation in the yuan could push sales growth of global companies in China into low single-digits, a major change from the double-digit growth of recent years.

The divergence between the continuous growth recovery in the US and the ongoing slowdown in China should also diminish the relative interest rate gap between the two countries. The PBOC is likely to cut interest rates further to support growth while we anticipate the Fed to follow the rate hiking path it started in December. This situation sets the stage for persistent capital outflows and comes with a steady drop in foreign exchange rate reserves.

Chinese unit labour costs have grown 7 per cent annually for the past 15 years. For the US manufacturing sector, the growth rate has been negative. In other words, wages have grown much faster in China than they have in the US, and as a result, there has been substantial erosion in Chinese competitiveness relative to the US.

Against this backdrop, it makes sense for China to depreciate their currency modestly to regain some of their lost competitiveness. And for China, the consensus expects Chinese GDP growth to be 6.5 per cent in 2016 and 6.3 per cent in 2017. That is not a hard landing.

However, we do not believe a massive devaluation is on the cards for China. Rather, a massive devaluation will not only exacerbate the capital outflows, it will also result in imported inflation and higher interest rates as China is the world's biggest importer of commodities, accounting for 20 per cent of the global commodities trade. It is also the world's biggest importer of energy.

We believe that a combination of fiscal and monetary stimulus coupled with improving economic data would help to further reassure investors that the Chinese economy will not experience a hard economic landing.

THE BUSINESS TIMES' WEALTH ROUNDTABLE

Genevieve Cua, BT Wealth Editor poses questions to wealth experts for investment strategies to employ in a volatile environment.



Alexis Calla is Standard Chartered Bank Global Head of Investment Strategy, Advisory & Discretionary. Alexis is responsible for defining and delivering the bank's wealth management advisory proposition. He also oversees the Private Bank investment advisers. He enjoys painting and collecting art, and is an avid supporter of emerging young local artists.



Kelvin Tay is UBS Wealth Management Regional Chief Investment Officer Southern Asia Pacific. Kelvin is responsible for the Asia ex Japan strategy and is a key member of the Global Emerging Markets Investment Committee. He enjoys gardening in his spare time.



Norman Villamin is Union Bancaire Privée (UBP) Head of Investment Services. Norman has over 20 years of experience managing wealth both on an advisory and discretionary basis. Since relocating to Switzerland, he enjoys travelling in Europe with his wife and four children.



Kelvin: Investors should continue to diversify their portfolios in light of the heightened volatility. We have been highlighting this increased volatility in the markets since 2014. At UBS, we have increased our allocations to hedge funds. Hedge funds are an essential component of any long-term investment strategy: They are proven to improve diversification, are expected to earn attractive risk-adjusted returns over the next five years and offer additional advantages. Specifically, we currently recommend an allocation of 14-18 per cent to hedge funds, depending on the investor's risk profile.

In January this year, we reduced the tactical overweight we had in global equities by reducing European equities to neutral. We had felt at that time that sustained periods of market volatility could leave markets vulnerable to bad news, especially as we had felt that there was downside risk to oil prices. In hindsight, that turned out to be a good decision.

Since then, the selloff in most asset classes presents an opportunity, in particular for investors who have been awaiting for the right time to put cash to work in financial assets. Valuations aside, global economic fundamentals do not seem any worse off in recent months. If we focus on the big picture, the US, Europe, and Japan are all making economic progress.

For instance, even excluding the troubled energy sector, US high yield debt has a credit spread of more than 700 basis points, effectively pricing in a recession, which is not our base case. We believe investors with limited exposure to the asset class could see this as a good opportunity to build up long-term holdings. We therefore shift our allocation for US high yield to overweight, funded by a corresponding reduction in our exposure to high grade bonds.

Norman: When major central bank policies were aligned in 2012-2015, investors were rewarded implicitly – for example via high yield or convertible bonds – or explicitly – via direct equity exposure, taking equity risk. We believe the current environment will not be so kind to undiscerning, “beta” (equity) focused investors. Instead, we are encouraging investors to look within asset classes to drive portfolio performance for the balance of 2016.

Within fixed income, carry and total return strategies focus on fixed-income segments that underprice the current environment or reward investors with wide spreads in the current period of elevated volatility. We believe high quality, emerging market external debt provides attractive carry opportunities for investors, complementing high yield bonds which at their lows of Q1 2016 were pricing expectations of cyclically high rates of default.

Within equities, we have taken a value-oriented, stock-picking approach as we expect stock selection to be the key driver to total returns rather than geographic or necessarily sector approaches in 2016.

In addition, in 2016, we expect hedge-fund strategies will be an important source of return and stability in portfolios as they present investors with the capability to capitalise upon tactical opportunities that emerge as volatility rises. Moreover, periods of elevated volatility have historically been strong relative performance drivers for hedge funds over a more volatile direct equity exposure. As a result, macro strategies, relative value strategies, and equity long short strategies should begin to see a revival after largely tepid performance in the post-2008 period. **W**

Norman Villamin: The market volatility of Q1 2016 can best be thought of in the context of the longer-term cycle of central bank policy convergence and divergence.

When three of the world's leading central banks effectively aligned policies, beginning in mid-2012 with Mario Draghi and the European Central Bank (ECB) leading with their “whatever it takes” assurance, the US following with QE3, and the Bank of Japan (BOJ) later countering with QQE, global equities rose over 50 per cent through mid-2015.

The volatility of early-2016 simply continues the volatility of H2 2015 as the Fed began to guide towards rising rates; the PBOC re-framed its previously strong currency bias; and more recently, the ECB and the BOJ pivoted to a negative interest rate policy.

Put more generally, while the “normalisation” of Fed policy was largely anticipated by markets, as Europe, Japan and China all turned to a new set of tools as they sought to continue the repair and transformation of their respective economies, markets chose to price increased uncertainty about both the effectiveness of these new policies as well as the probabilities of their success. Unlike the transition to quantitative easing for the Fed or even the Abenomics announcements out of Japan, these pivots by policymakers across the four-largest economic blocs in the world have been ineffective at using communication as a tool to lay the groundwork for markets to more easily absorb these transitions in policy, resulting in the volatility seen to date.

Thus, while some concerns have been allayed as reflected in the strength in markets since the February lows, the transition of policy regimes presents new risks for investors. This means the “beta” strategies of 2012-2015 will likely no longer drive outperformance in markets. Instead, “alpha” strategies and manager selection will be more valuable in what we expect to be, at best, a moderate return environment for the balance of 2016.

Genevieve: What (traditional or alternative) strategies might you recommend that can tame or even harness this volatility profitably for portfolios?

Alexis: From an investment perspective, keeping a balance is key. Equity exposure remains important, in our view. However, we acknowledge the US and China outlook is more clouded than before. Hence, we believe corporate bonds offer a more attractive way of gaining exposure – in an optimistic scenario, current markets offer an opportunity to lock in very attractive yields, while in a pessimistic scenario, volatility is likely to be more limited than in equities.

Balancing this with alternative strategies and high-quality corporate bonds remains key to managing uncertainty. We believe US Investment Grade (IG) corporate bonds are in a sweet spot. They usually outperform risky asset classes significantly in pessimistic outcomes (for example, a US recession), but today's attractive valuation levels mean they offer room for gains in a “risk-on” scenario as well.

Similarly, alternative strategies are appealing amid heightened uncertainty. Macro strategies have demonstrated considerable “insurance value” during periods of volatility (including the last two months). Equity long/short strategies, meanwhile, provide exposure to equities with lower volatility than simple long-only exposure.

Looking forward, we expect an increase in volatility, as markets contemplate the implications of a move to the later stages of the economic cycle. While our income objective remains achievable, there's a risk of larger pullbacks as we move through the year. The first two months of the year have been a preview of what might be in store for the remainder of 2016.

Playing the diversification card through a series of market-linked (directional) strategies in equity and fixed income is becoming more challenging. With this in mind, we advocate income-focused investors look to substitute some of their directional or market-linked exposure with a multi-asset absolute-return strategy. Diversification through strategies which have a low correlation with traditional assets, such as relative value and hedging strategies, should help protect investors during pullbacks which we are likely to experience over the course of the year.