Different this time?

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In case you only saw the final result, it was quite an eventful quarter. Global equities ended unchanged but only after first experiencing a precipitous downdraft. The market recovery from the lows did not occur by itself, however—it took central bank assistance and considerably lower bond yields. It was a telling reminder that we are in a world of sluggish economic growth and elevated risk. The period also saw a flight of capital and a significant re-pricing of assets in a range of market sectors. The silver lining is that opportunities to take advantage of dislocations appear to be markedly better.

It's always dangerous to say that it is different this time but we absolutely live in an era that has little precedent. Most obvious is today's low levels of interest rates and bond yields. Nominal interest rates have never been this low, except in the United States during the Great Depression and its aftermath. The world today is nowhere near as bleak as it was then (we're absolutely not in the "sell everything" camp), but the combination of low rates, high valuations, high debt levels and high savings in the global economy is unparalleled.

Yields are low because productivity is low and investment opportunities that provide good returns are in limited supply. Investors own bonds voluntarily, and they would not do so at today's yields and on such a scale if they could obtain better risk-adjusted returns elsewhere. Additionally, investors and consumers who could borrow at low rates are choosing not to avail themselves of those rates to put money to work. Low yields and lack of investment opportunities also reflect greater risk aversion on the part of consumers. The savings rate in the United States is back up at 5%, still below its long-term average but well above the level that preceded the Global Financial Crisis. Consumers are far from being tapped out, and their capacity to spend could produce a strong tail wind for the economy.

Low yields also mean that asset prices are much more sensitive today to changes in yields. As already mentioned, it is probably not an accident that the rebound in equity values was accompanied by a dovish stance on the part of central banks and market relief that interest rates would be unlikely to go up any time soon. Developed-market bond yields in the quarter declined by 30 to 50 basis points, a very significant change, especially in Germany where the 10-year yield fell to near zero, and in Japan where the 10-year yield moved into negative territory. The textbook intuition behind discounted present value—that $100 in the future should be valued less than $100 today—is a lot less true today.

Low yields similarly mean that currencies are very sensitive to small differences across countries in interest rates. Recent dollar weakness has much to do with the outlook for a narrowing of the interest rate differential between the U.S. versus Europe and Japan.

Other things that may fit under the heading of different this time are the ripple effects of lower energy prices and the uncertainty in China. The collapse in oil prices represents an extraordinary economic event, and we have all felt the direct effects such as lower energy bills and the declines in value of energy-related firms. But there have also been more subtle effects. In particular, the vast wealth accumulated by the sovereign wealth funds of energy producing nations now has to contend with funding deficits rather than investing surpluses. Anecdotally, these institutions have been de-risking and liquidating investments, including capital held in hedge funds. We believe that such shocks to large asset pools have contributed to the greater correlation recently observed in hedge fund behavior and performance. We last witnessed such strongly correlated hedge fund performance in October of 2008 when Lehman filed for bankruptcy and a temporary ban on short selling was instituted. We are optimistic that this one too will pass.

Our China concern is primarily about the risk of contagion. By various measures, China has experienced the most significant credit expansion in world history and estimates are that there will ultimately be some $3+ trillion in loan write offs. At the same time China is experiencing major capital flight. The combination of these and other factors raises the likelihood of a significant currency devaluation, which could occur at a measured pace or suddenly. Our main concern here is with contagion risk at the broad portfolio level: should a devaluation of the yuan occur, it might help China but at the expense of the rest of the world. We think that hedging the Chinese yuan at the very least provides some asymmetric tail protection for a globally invested portfolio.

What is definitely not different is our approach to investing which is rooted in the bottom-up search for attractive opportunities coupled with the top-down management of macro risk. The world is vast and, even if the outlook is not broadly positive, there remain many places to allocate capital. Our search for opportunities is anchored in manager selection where we maintain a very high bar on talent. Great investors remain great investors provided they are focused, appropriately sized and incentivized—including having their own capital invested alongside us. We also strive to achieve a good balance of opportunity sets and to partner with our managers to execute on those opportunities in an efficient manner. Our managers collectively provide a powerful means of sifting through the wreckages of market dislocations, and we focus on making the most of this resource, especially in turbulent environments.

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