HIGHVISTA STRATEGIES

The Risk Environment

August 1, 2017

The second quarter of 2017 saw a continuation of calm and rising markets against a backdrop of heightened political gridlock and uncertainty. Market volatility, which started the quarter at near historic lows, remained there with two brief exceptions: the first surrounding the French elections when markets feared a Brexit-like sentiment might lead to a surprise outcome, and the second corresponding to the firing of FBI Director Comey and his subsequent congressional testimony. The events had little ultimate impact on the markets but reminded us that geopolitical risk is real and the next event may not be so benign.

Now eight years into this bull market (and nearing the record length of ten years), it is top of mind whether a significant market correction is looming. Historical price charts would suggest “yes”, but on a forward-looking basis it is much less clear. The fact is that near-term earnings and other fundamentals are solid in most parts of the world, and there is little to suggest that increases in discount rates are imminent. World GDP is forecast to grow at a healthy rate of roughly 3.5% per annum (slightly better than the average of the last several decades) and inflation, if anything, is surprising on the downside. With the exception of China, banks are mostly very healthy and corporate leverage, while on the rise in certain sectors, is not yet excessive. In fact, the firms with the largest market capitalizations have zero net debt and unprecedented amounts of cash. Where the most significant leverage does reside today is at the sovereign level, including the central banks who have little incentive to unwind rapidly. Solid growth, tame inflation and excess cash with nowhere to go make significant rate rises in the near future unlikely.

As we wrote in our last commentary, we view today’s high equity market valuations and low bond yields as being indicative of a sustained period of lower future broad asset class returns rather than a harbinger of an imminent market decline. We estimate that a passively managed 60/40 global equities/bonds portfolio is priced to deliver a real return of 1-2% below its historical average of 5% per annum. This creates a conundrum for the many not-for-profits and other investors who have spending needs in the range of 5% per annum. They will need to either take significantly greater risk or rely on alpha generation (outperformance) to meaningfully close that gap.

As we have already mentioned, market volatility is extremely low today. Return correlations have declined not only across assets classes, but also across geographies, sectors, and at the individual stock level. **Exhibit 1** shows how the correlations between U.S. and foreign equities (developed as well as emerging market equities) have declined significantly over the last year. **Exhibit 2** shows how REITs too have lower correlations with equities and have become increasingly aligned with bonds.

Exhibit 1: Correlations are Lower between U.S. Equities and Foreign Equities[1]

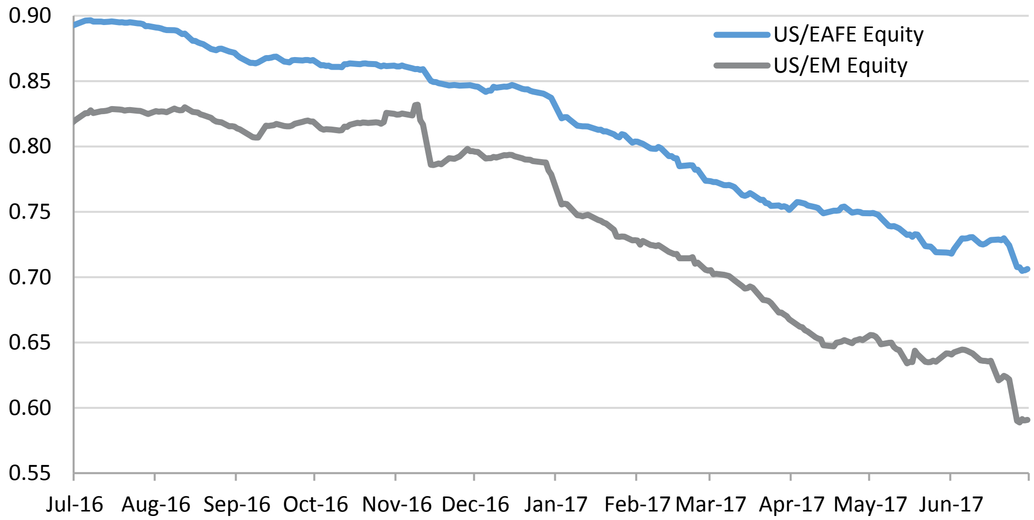
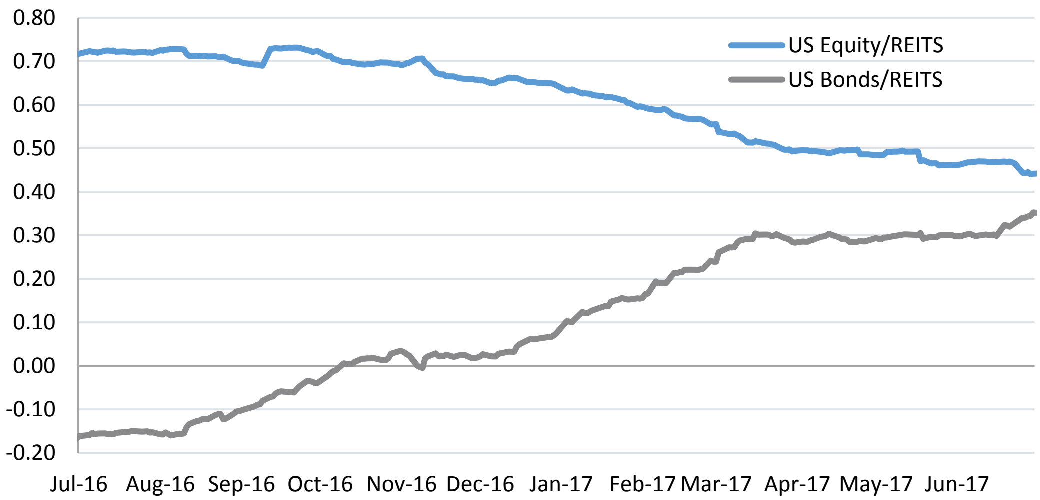


Exhibit 2: Correlations are Lower between U.S. Equities and REITs; Higher between REITs and Bonds[2]



Declining correlations among market segments make diversification more beneficial and is a key reason that overall market volatility is so low. These statistics reflect that many parts of the capital markets have increasingly been marching to different drummers. Said another way, the drivers of markets have tilted towards local rather than systemic risks—at least in the near-term.

[1,2] Source: HighVista Strategies risk analysis.

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