Diversification amid the disconnect

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Key Takeaways

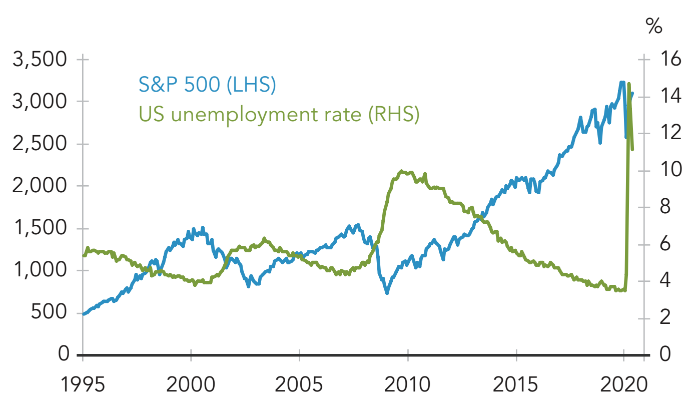
- We see an unprecedented disconnect between the stock market and the economy
- We are focused on diversification over directionality in this uncertain environment
- We have reduced our nominal bond holdings in favour of gold, TIPS and EM assets

Three months ago, we wrote that we would be scaling into equities in our Canadian multi asset class funds, with dislocations and attractive valuations having emerged amidst the panic. That proved smart. We also wrote that we would be buying only gradually as we expected the market to take some time searching for a bottom. That proved not so smart. The market's recovery was nearly as powerful as its sell-off; the 44% rise in the S&P 500 from the March lows to the June highs was the largest such rally in a century.

Now major market indices are not far off their record highs. The unemployment rate is also not far off a record high. This is the opposite of what we tend to see and what we would expect (see Exhibit 1). The stock market and the economy have become disconnected in an unprecedented way.

We can rationalize this disconnect. The stock market is forward looking, so has been able to look past the induced coma into which the global economy was placed beginning in mid-March to factor in the inevitable recovery. Furthermore, the monetary and fiscal policy response has been very aggressive; the resulting flood of money has clearly made its way into asset prices rather than spending, at least initially. One can also argue that the nature of this unusual economic shock may actually be helpful to the large companies that dominate the

EXHIBIT 1: Unusual to have both stocks and unemployment near the highs



Sources: Bureau of Labor Statistics, Standard & Poor's, Haver Analytics, FMR Co.

equity markets; the disproportionate hit to smaller businesses may lessen competition, and the technology companies leading the market may benefit in particular from what look to be durable changes in the way we work and live.

But we could also rationalize a market returning to the lows. Even on optimistic projections (for COVID19 and otherwise), the economy will take years to recover to its prior growth trend, and that trend itself is challenging – demographics remain a persistent headwind, and the inevitable-looking reconfiguration of supply chains as globalization retreats will hurt productivity. Moreover, the share of the economy claimed by company earnings may decline from its lofty level, particularly if the November elections in the US usher in more labour-friendly policies. And while fiscal and monetary policies are highly stimulative, you can only go all-in once. For us, statements like 'stocks look fair on projected 2022 earnings' that are used to justify the current level of the equity market are presumptuous regarding just what that 2022 environment will look like.

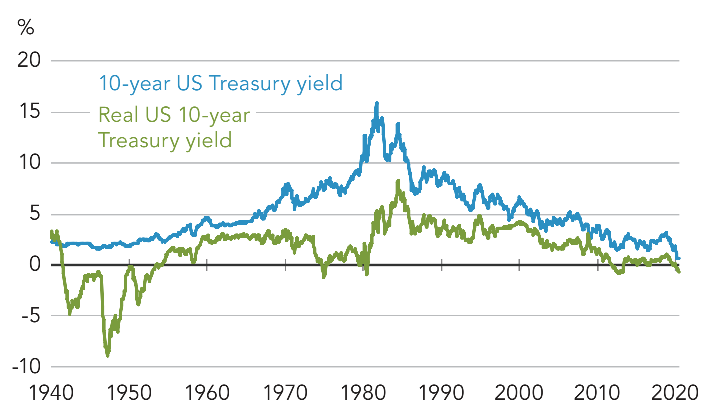
Under these circumstances, we think making an aggressive call on the direction of equities from here is inappropriate. As we have written many times, one of our core tenets is not to try to call the uncallable. Rather than focusing on one particular outcome, our approach is to build portfolios that are resilient to a wide range of outcomes. We believe that constructing portfolios that are well-diversified across asset classes, styles and regions is the right way to both grow and protect capital over the long run.

Diversification is itself a greater challenge in the current environment. Over the past few decades, a reliable way to achieve diversification has been to combine positions in stocks and bonds, with the latter providing a cushion to the former. But that strategy may not be as effective now – just simple arithmetic shows that the prices of bonds at near-zero yields have limited scope to increase to offset drawdowns in equities.

We have therefore become more creative in our approach to portfolio diversification. First, we have reduced our holdings of nominal bonds. We do not think government bond yields can increase much – central banks will almost certainly be persuaded or forced to maintain low interest rates across the curve – but they cannot fall much either, and so as noted above cannot provide much diversification in the portfolios (nor income for that matter).

While nominal yields cannot fall (much) below zero, however, real (inflation-adjusted) yields can. We saw this in the post-WWII era, which shares many similarities with the current environment of high debt and financial repression (see Exhibit 2). Falling real yields provide significant scope for appreciation in assets like gold and inflation-linked bonds (TIPS in the US, Real Return Bonds in Canada), thus providing a more useful diversifier against equity weakness; we have expanded our holdings of these assets in our funds.

EXHIBIT 2: Real yields can decline further

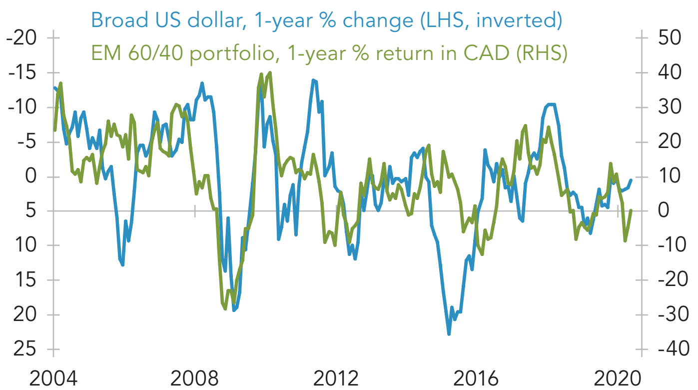


Note: Real yield prior to 2003 calculated as nominal yields adjusted for CPI inflation, TIPS from 2003 onward. Sources: Federal Reserve, Bureau of Labor Statistics, FMR Co.

We are also using currency positioning to enhance portfolio diversification. We are maintaining our longstanding underweight to the Canadian dollar, whose value is correlated with equity market movements. We have, however, adjusted the profile of the currencies we hold as offsetting overweights, shifting away from the US dollar towards euros and Japanese yen. In our view, the US dollar looks overvalued in an environment where the dollar's status as the world's reserve currency is coming into greater question.

The prospect of a weaker US dollar has also made us comfortable in diversifying further into both emerging-market equities and debt, which tend to do well in such an environment (see Exhibit 3). These are cyclical assets so they will vary with equity market movements, but the higher incomes on these instruments can offset the effects of broader drawdowns. Moreover, we expect the retreat of globalization to reduce the correlation among regional economies and markets, enhancing the diversification potential of emerging market assets vis-à-vis developed market assets.

EXHIBIT 3: Emerging markets like a weaker USD



Note: Broad dollar represented by DXY index, EM 60/40 portfolio composed of 60% MSCI EM equity index and 40% GBI-EM Diversified local currency bond index, returns converted to CAD. Sources: MSCI, JP Morgan, Bloomberg, FMR Co.

To conclude, we have an historic disconnect between the economy and the equity market, whose resolution is uncertain. In that context, our active positioning is focused less on market direction and more on portfolio diversification, all with the unwavering goal of managing risk while maximizing performance in our Canadian multi asset class funds.

David Wolf and David Tulk, July 16, 2020

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