Are we in a bull or bear market?

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The multi-manager view: Robin McDonald assesses the global market environment following a start to 2016 that has been characterised by extraordinary falls by the leaders of recent years and extraordinary outperformance by the laggards.

We on the Schroders Multi-Manager team have written repeatedly in recent quarters of how we felt investor positioning had become dangerously lopsided and vulnerable to rotation. Coming into this year, the atmosphere appeared as serene as the summer of 2007 for many of the market leaders. At the same time, it felt like early 2009 for the laggards – principally commodities and financials – who were enduring fierce bear markets.

So far in 2016, however, we have seen some extraordinary falls by the leaders of recent years and extraordinary outperformance by the laggards. By way of example, the Philadelphia Gold and Silver shares index (down 80% over the last five years) is up close to 50% year-to-date. The Nasdaq Biotechnology index in comparison (up 330% over five years) is down close to 25% year-to-date – a colossal dispersion in a two-month period. So in response to the question – 'are we in a bull or bear market?' – the answer appears to be both!

Indeed, if this rotation proves to be meaningful and not just the biggest short-squeeze in over 20 years, 2016 will likely feel like a bear market for the majority of active managers, as a bull market gets underway for the former laggards and the hitherto leaders suffer, at the very least, a sustained period of relative underperformance.

Is gold signalling a turn in the US dollar?

In our Q3 note we highlighted a number of consensus themes embedded within the market, and warned of their maturity. The list is repeated below:

1. The US dollar is early in its structural bull market
2. Commodities are in a structural bear market
3. We are in an era of permanently subdued inflation (so bond yields will remain low)
4. Developed markets trump emerging markets
5. High quality trumps low quality
6. Defensives trump cyclicals
7. Low beta trumps high beta
8. Growth trumps value

Unambiguously, all of these themes are now being challenged. By flipping the consensus on its head, let's speculate as to what might be going on…

- Is the US economy on a weaker trajectory than generally perceived? If so, the dollar would fall as investors begin to contemplate the Federal Reserve (Fed) turning dovish again. A weaker dollar would relieve pressure on the commodity complex and by extension emerging markets and financials. Stable to rising commodity prices would foster a less deflationary backdrop meaning the demand for high quality, defensive, low-beta strategies would recede, allowing value to mean revert against growth.
- Is Chinese growth stabilising? One could certainly argue the case given the historically high correlation between industrial commodities and Chinese economic prospects. If it is, this would undoubtedly lead investors to abandon the hard landing narrative that has helped keep commodities and bond yields down and the dollar up. Sure enough the laggards would crush the leaders in such an environment.
- Lastly, let's consider the case for a re-emergence of inflation. Core measures in the US are trending notably higher in spite of the strong dollar and year-on-year weakness in oil and other commodities. As mentioned in our 2016 outlook, we believe this speaks in part to the tightness of the domestic labour market. If inflation materialises as a risk which investors feel compelled to hedge, they will most likely do so through the purchase of 'hard' assets like commodities. Against this backdrop, low-yielding bonds and bond proxies within the equity market would be in real bother. Again, the dollar may weaken in this environment (particularly if the Fed argues that inflation should be allowed to play catch-up and temporarily overshoot).

We believe it's too early to fully adopt any of these scenarios as a base case. However we also believe that each one is a plausible outcome over the next 12-18 months. Therefore the degree to which investors are crowded into assets that benefit from slow growth and deflation, consciously or not, represents the stand-out opportunity on a relative basis in our view. How confident one can be of making absolute returns in this environment will depend on which scenario plays out.

Market rotations are often initially dismissed as temporary "short-squeezes". Invariably, however, every market rotation begins with a short squeeze, as leveraged investors particularly have to unwind their stale positions. Only time will tell whether this one is transitory or marks a fundamental turn. We have plenty of scope to reinforce the latter if necessary by reducing what cash we hold in lieu of equities.

The move in gold is something we find particularly intriguing. Arguably it could be heralding any one of the three scenarios outlined above. Importantly, when precious metals peaked in 2011 it marked the climax of the US dollar bear market. At its recent low, gold had retraced almost perfectly 50% of its bull market beginning in 1999. It is currently emitting all the hallmarks of a trend change. The same is increasingly true of the dollar.

The risk-adjusted return of equities

Central banks have nurtured an environment this cycle whereby the returns generated by equities on a risk adjusted basis have been the strongest in over 50 years. Until recently, we've basically enjoyed a very low volatility bull market by historical standards. Unfortunately, the 3-year rolling information ratio for equities peaked last year and appears to be in the process of mean reverting from another historic extreme. This doesn't guarantee negative returns, but argues for a sustained period of lower returns and higher volatility.

NIRP and central bank fatigue

There was a time when central banks obtained both instant and sustained gratification for their generosity to financial markets. Nothing lasts forever, mind you, and increasingly those days appear to be over.

From the point at which global interest rates were essentially cut to zero, central banks have been utilising unorthodox policy tools to help stimulate higher nominal growth with limited success. Quantitative easing (QE) was the first iteration. We now have negative interest rates policy (NIRP). Our sense is that NIRP will be even less effective than QE, but nonetheless, here are a handful of intended "benefits":

1. To encourage banks to lend more and at lower interest rates.
2. To suppress the yield curve.
3. To encourage consumers to bring forward yet more consumption from the future.
4. To depreciate the currency in order to support exports and increase imported inflation.

On the opposite side of the ledger, here are some likely negative consequences:

1. NIRP punishes savers, and makes life difficult for pension funds and insurance companies who are already struggling to earn enough income to meet their obligations.
2. It exacerbates income inequality and damages social cohesion.
3. It causes misallocations of capital by inducing banks to make loans they otherwise wouldn't.
4. It reduces bank profitability, which when loan losses next rise will amplify the threat to their solvency.

I think it's important to register that while the global economy continues to expand, albeit modestly, the benefits of unorthodox policies appear to outweigh the costs. We will keep our fingers crossed for what happens when the business cycle turns down, as it inevitably will. At that point the limitations of such policies will become more obvious and probably manifest themselves in another damaging crisis. The difference next time round will be that we will start with populations already angry and divided.

Positioning

The best opportunity we observe within the markets today is one of mean reversion from what are historically extreme prices, both high (bonds, the dollar) and low (value-style equities and higher-beta assets). Assets that have benefited from a deflationary backdrop appear low-risk, but we consider them anything but. To us on the Schroders Multi-Manager team, they are overpriced, crowded and vulnerable under various scenarios, some of which we've outlined above.

Our current strategy is to balance what are otherwise relatively depressed and out of favour assets with sufficient cash such that we participate more when prices rally than we do when they fall. This is the very essence of what we try and deliver over time, and will hopefully prove a fruitful strategy in what we expect to be a volatile year.

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