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A 'Transition' Market Environment and its Implications for Portfolios

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What is a transition environment?

We are calling where we are today a 'transition' market environment because we believe that this set of economic and market conditions will see risky assets perform less well, as a so-called 'bull market' becomes less confident in its longevity. Eventually, the transition phase gives way to a sustained market downturn, a so-called 'bear market', in which the tables are turned dramatically on risky assets by a large outperformance from bonds.

We do not believe we are in that final phase or even about to enter it, but rather see conditions taking us towards that eventual outcome.

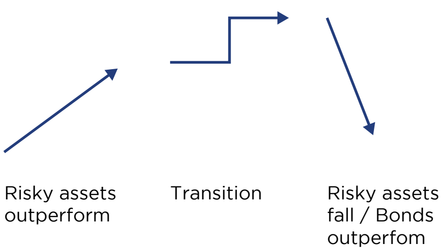
A question we are often asked given the length of the current bull market is when the ultimate market downturn arrives. We have no special insights on the exact timing for this. However, its arrival sometime in the next one to two years would seem a reasonable estimate. On our reckoning, if we time the entry into the transition environment to have been at the start of 2018 and then further assume that the market downturn phase arrives in the summer/autumn of 2020, we will have been in a transition phase for some two and half years. While this is plausible, our view is that this is probably at the upper end of the likely length of the current transition phase in markets.

Of course, nobody has the foresight to call the timing of the market downturn with any precision, and as the comments below should make clear, the downturn is more of a 'process' which sees a number of conditions falling into place, many of which occur in the transition phase.

Market phasing

Market cycle measurement typically focuses only on rising and falling risky asset performance centred on equities. This does not recognise the intermediate or transition phase we are referring to here when risky assets start to perform less well. It is correctly understood that risky asset outperformance phases are four or five times the length of the risky asset underperformance phase.

As the stylised diagram below tries to indicate, however, some part of the large difference in duration between the two market phases can, in fact, be attributed to the difficulty of allowing for such a transition phase.



In reality therefore, some part of what is measured as a risky asset outperformance phase is in fact part of the transition phase. Equally, some part of the risky asset sell-off phase may also belong to the transition phase. Typically, transition markets see a tussle between factors pushing markets higher, and those which are pulling markets lower. Down markets should be seen as the end of a process which is set in motion in transition environments. It is what happens in the transition phase that ushers in the final market phase of sharp falls in risky asset prices and outperformance of defensive assets.

Triggers for the beginning and end of the transition

Why are we calling current conditions a transition market, and what would end the transition phase? Current market conditions have the following two attributes which we have discussed in more detail elsewhere:

- We are in an environment where the longevity of the global business expansion that began 2009 is now looking suspect. US policy interest rates have been rising, broad financial conditions are tightening and expansionary fiscal policy is likely to create added strain at a time when US labour markets are tight and expansion capacity is limited. At the same time, global threats to the economic expansion are rising, given more trade protectionism and growing economic divergence between the US and other regions. The economic risks from this are seen in a flattening US yield curve.

- Equity markets and risky assets are on rougher ground given rising interest rates and narrow risk premiums. Low long duration bond yields still provide some support to equities, but high valuations look less sustainable given the broader economic message from low bond yields. This applies across the board to equity, credit and real estate valuations. There has been some adjustment to credit valuations in recent months, which is in keeping with the view that it tends to be a leader in risky asset market cycles. It is also an early indicator of the difficulty in sustaining rising risky asset prices.

What would finally end the transition phase? The transition phase ends as a logical culmination of the changes that are occurring through time. However, a 'shock' of some kind is probably needed, which can come from some economic development – a significant rise in inflation which brings concerns that the US Federal Reserve will need to raise rates by more/faster than currently discounted, or a major economic growth slowdown that comes from either the lagged effect of higher interest rates or the creeping effects of trade protectionism. Alternatively, a shock can come from seemingly nowhere, i.e. a development outside investors' current radar such as a more pronounced challenge to the Eurozone from Italy or a large devaluation in the Chinese currency. Any of these could be a trigger for the end of the transition process. Probabilistic analysis of these developments, let alone timing them, is extraordinarily difficult for obvious reasons.

From our perspective, we monitor the risks to markets from a set of indicators that we broadly regard as measuring the tightness or looseness of financial conditions, as well as investor risk appetites . This may help us identify a move to much more difficult market conditions than we are in at present. However, these lay no claim to prescience on the exact timing of the onset of the final bear market.

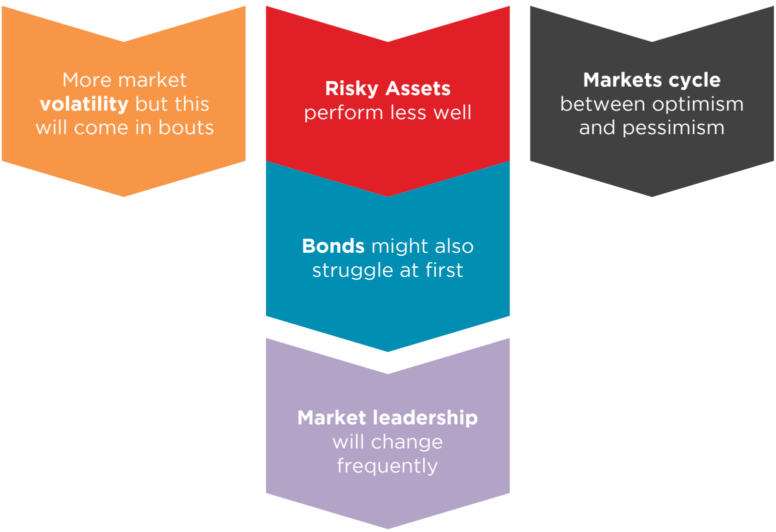
Key attributes of a transition environment

The key attribute of transition environments is that risky asset performance starts to fade. The underlying trend in risky assets

flattens, diminishing the reward for bearing risk. While simple measurement of market phasing is likely to attribute this to the 'outperformance' phase, in reality, it is part of the next phase. However, as we show in the diagram below, in such an environment, it is perfectly possible that bonds will also not do well. This is because such a transition market environment typically occurs late in an economic cycle. These late cycle conditions typically see capacity

Key features of the market transition phase

The key attribute of transition environments is that risky asset performance starts to fade. The underlying trend in risky assets flattens, diminishing the reward for bearing risk. While simple measurement of market phasing is likely to attribute this to the 'outperformance' phase, in reality, it is part of the next phase. However, as we show in the diagram below, in such an environment, it is perfectly possible that bonds will also not do well. This is because such a transition market environment typically occurs late in an economic cycle. These late cycle conditions typically see capacity utilisation limits approaching, inflation or inflation expectations creeping up and rising policy interest rates. These are not bond-friendly conditions and the broad universe of bonds is likely to be under pressure even though long duration bonds can perform better, as they are doing currently, for a variety of reasons.



It is important to note that though market drawdowns should be expected during transition environments, there is no obvious case for these falls to be sustained. Rather, markets will go through a number of mini-cycles. Volatility will go higher in a jumpy, discrete, process that essentially reflects the higher level of economic and market uncertainty.

It is not necessarily the case that market moves in the three largest risk asset categories of equities, credit and real estate (to take the three main areas of risk asset exposure in typical portfolios) are synchronised in the transition phase. Differential moves can easily appear. It is typically only in the final market large drawdown phase that there are sympathetic moves in risky assets across the board.

As we note in the diagram, market leadership at sector and stock level can change drastically, though this is not a given. Two factors will determine the likelihood and scale of such shifts. Firstly, if rising markets have created valuation anomalies, the more uncertain environment is more likely to see such anomalies either being broken open or becoming very much more accentuated. Second, the way economic cycle phase will affect market sectors differently given their varying sensitivities to economic factors. Changes in growth, inflation, interest rate and currency can impact sector fundamentals.

Portfolio challenges in a transition environment

This is a very challenging period for the investor. The age-old problem is what to do. Staying the course with risk asset markets appears a gamble given the likelihood of the ultimate large reversal. However, anticipating the downturn by selling risky assets is also a problem. Even though the investor will be aware that the ultimate drawdown is likely to destroy capital on a very large scale (of the 30% plus variety) quite quickly, early de-risking on a significant scale is difficult. There will be regret risk given the opportunity costs of foregone market gains, since the transition phase can still see the market gain significantly over its duration. The record of investors being able to anticipate large market falls very close to the event and to leave avoidance action till just before the onset of large market falls is not confidence-inspiring.

Neither is diversification into assets with intermediate risk-return characteristics that easy a compromise. The diversification promise may not materialise one way or other as made clear by the experience of the financial crisis with some asset classes, and with the very low return profiles in some cases thereafter (as with most hedge fund strategies). The longer the period of risky asset strength, the more likely it will seem that diversifiers carry high opportunity cost, quite apart from the usual mix of issues arising from their higher complexity and relative illiquidity.

Investing in bonds can be even more challenging. While it is true that in the ultimate bear market phase, we would expect bonds, particularly longer duration bonds, to do well, as we noted above, transition environments can quite easily see bonds do poorly. Historically, this has been more likely the case than not. The fact that risky assets run into difficulties in the transition phase provides some level of support for bonds it is true, but other late cycle economic conditions are bond-unfriendly and can outweigh this support.

Notwithstanding these difficulties, our view is that this is a good time to re-examine risk in portfolios. Focus should be on the extent of risky asset exposure in portfolios and likely courses of preparation and action in the eventuality that large market declines appear to be nearing. It is a good time to be considering the extent of diversification in portfolios currently through less directional or correlated asset classes and whether more can be done to buffer portfolios better from much more difficult market conditions which are likely to appear in time.

Portfolios may already have a mix of defences built into investment strategy, in which case, there is less to consider and do. These portfolios will have underperformed higher risk portfolios during the periods of maximum market strength. In a transition environment, there is all the more reason to persist with such an approach even at the cost of some near-term underperformance versus higher risk portfolio peers.

Summary

- Market conditions suggest that we have moved into a transition phase this year, taking us from a long period of risky asset strength towards an eventual market downturn phase when bonds will be the only performing asset.

- The move to the final phase of a large market downturn still does not appear imminent but sometime within the next year or two looks a very reasonable expectation for such an event.

- The entry into a transition environment reflects the effect of changing economic conditions and tighter financial conditions. This transition will end once certain processes work through and a tipping point is triggered by a shock which could come from a number of sources.

- The key attribute of a transition environment is a flattening underlying price trend in risky assets but with alternate cycles of optimism and pessimism. It is also consistent with bonds struggling, given typical late cycle conditions.

- Higher volatility and less conviction on returns in this transition phase reduce the reward for investors' risk bearing.

- Transition phases could also see big changes in market leadership at sector and stock level. Higher uncertainty can either accentuate valuation anomalies or break them open. As sensitivity to changing economic conditions increases, winners can quickly become losers and vice versa.

- Navigating a transition environment is difficult. Though there is a strong likelihood of substantial capital losses down the road, early de-risking can bring its own problems.

- Despite these challenges, our view is that this is a good time to be thinking ahead. Portfolio exposures to risky assets, the extent of diversification that exists and whether more buffers can be made available to prepare for much more difficult market conditions are all good areas for consideration.

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