MV CAPITAL MANAGEMENT

Weekly Market Flash

A Market of Wandering Cats

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Something odd has been going on underneath the main headlines in investment markets over the past twelve months. The big story, of course, is how everything has gone up from US stocks to emerging market bonds to industrial metals, fossil fuels and more. All that is true -- and yet, there has been an unusual lack of correlation between the price movements of asset classes that normally track very closely.

Take equities, for example. In most years, the correlations between different equity asset classes, from US style classes to non-US developed and emerging markets, have been very close. Think of a horse race, with all the horses coming out of the gate together and basically running in the same direction at very similar speeds. This past year, though, the correlations between these asset classes have been very weak -- less like horses out of the gate, and more like letting a bunch of cats out of a box to wander around as each one sees fit.

2017's Odd Math

Exhibit A is emerging markets. In 2017 emerging market equities rose, and so did the S&P 500. But statistically speaking, there was virtually no correlation between the two asset classes. The statistical measure of correlation is a spectrum from 1.0 (perfect positive correlation) to minus 1.0 (perfect negative correlation). A correlation of 0.0 suggests no tangible connection between whatever moved each individual asset over the time period measured -- each marched to its own set of influences.

In 2017 the correlation between the S&P 500 and the MSCI Emerging Markets index was 0.04 -- zero, for all intents and purposes. The average correlation over the past 5 years for these two asset classes was 0.59 -- statistically relevant positive correlation. 2017 was an anomaly. What the correlation tells us is that the fact of the S&P 500 and MSCI EM both going up that year was more coincidental than it was explained by similar driving factors.

An even odder pairing of wandering assets is seen in the US style classes of growth and value. The average correlation between the Russell 3000 Growth index and the Russell 3000 Value index over the past 5 years was 0.87 -- a very strong positive correlation. For 2017 the correlation was 0.23 -- still positive, but very weak. Correlation that weak between these two assets would make any covariance measures -- like alpha and beta -- statistically useless.

PMs Love Wandering Cats

An astute investor might say: So what? All those equity classes rose in 2017. Do I care how closely two assets are correlated? The answer is yes. It is important because portfolio managers make allocation decisions based in part on the correlation properties of the assets they include in a diversified portfolio. And for these managers, a bunch of wandering cats is actually much more attractive for portfolio inclusion than eight horses running in lockstep. The property of low correlation with other asset classes is value-additive; all else being equal, the manager would prefer combining emerging markets with the S&P 500 when the correlation is zero as opposed to when it is 0.6 or more.

So the key question is this: Did something change so structurally in 2017 as to suggest that correlations between historical birds of a feather (e.g. style and geographic equity asset classes) are moving to a lower plateau? Or are the wandering cats a one-off phenomenon, with the customary high correlations set to return in due course?

We'll have to see what the numbers tell us as 2018 moves along. In the meantime, we will be testing out some hypotheses. One hypothesis is that the growth in passive investing -- primarily through ETFs -- is a catalyst for lower correlations. ETFs make it easier to trade asset classes wholesale, as opposed to the emphasis on individual stocks employed by traditional active managers. It's entirely possible that this could lead to more pronounced variations between asset classes as the passive strategies, driven by more frequent short-term trading volumes, propel them in different directions on different days.

Now, why that would have only shown up in 2017 is another question, without a convincing answer. We'll have a better sense of that a few months down the road. Expect to hear more about this from us as the year progresses.

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