Weekly Market Flash

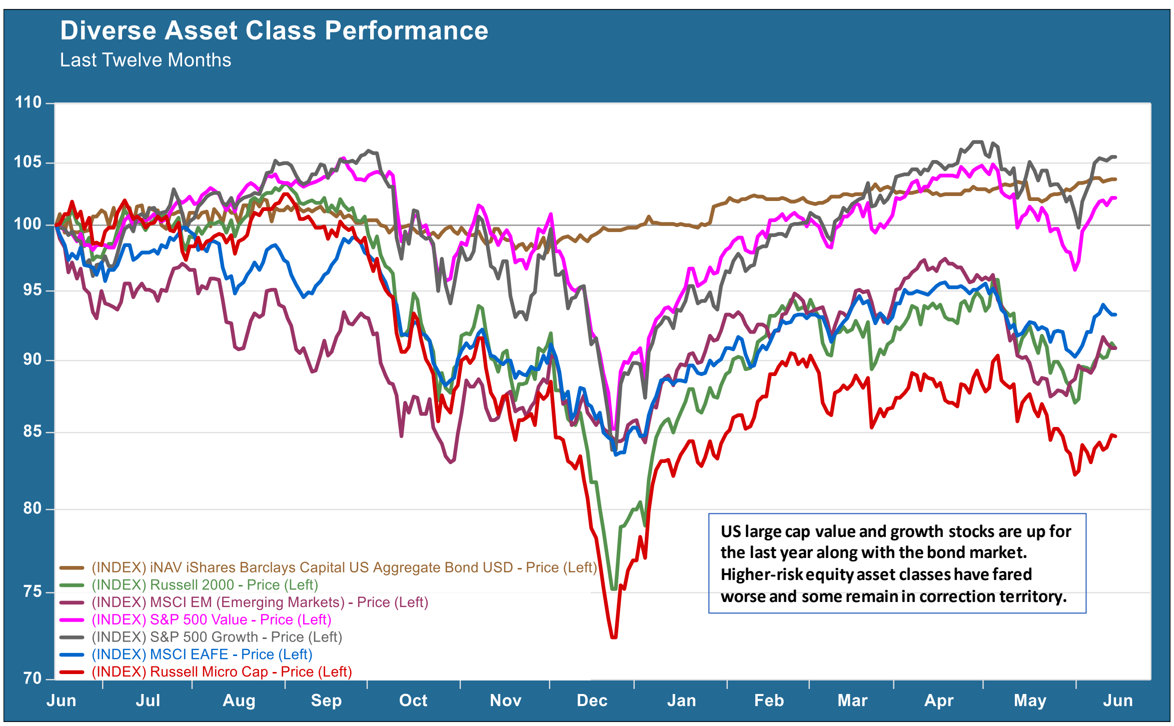
Risk-Off, With a Side Helping of Large Cap Equities

June 14, 2019

Let's go back in time exactly one year – to June 14, 2018. Someone from the future visits you and tells you that in the first four months of 2019 – from the beginning of January to the end of April – the S&P 500 will rise by 17.5 percent. The future-visitor then beams out, leaving you with just that one piece of information and a portfolio strategy to plan. What would you assume about the world at large? That gain in US large cap equities is one of the strongest on record, so you would probably be inclined to imagine "risk-on" as the dominant sentiment in global markets. A healthy allocation to core equities and higher-risk satellite classes like small cap and non-US emerging markets would be a plausible strategy, while perhaps reducing core fixed income weights to the lower end of your approved range.

No Reward for Risk

Of course, being in possession of just that one snippet of information about the future means that you wouldn't have known that stocks came within a whisper of ending their decade-long bull market in December 2018, or that the Fed would make a sudden and radical U-turn in January towards a more dovish policy stance. Even so, one of the noteworthy things about the 2019 incarnation of the equity bull is how confined it is to US large caps, while riskier asset classes have sputtered. The chart below illustrates this divergence between bonds and large cap stocks on the one hand and everything else on the other.



Source: MVF Research, FactSet

From that point in time one year ago both US small caps and non-US emerging markets are down around 10 percent – still in or close to a technical correction. Non-US developed markets haven't fared much better, in part due to the translation effect of a strong dollar on foreign currency assets. So a broad-based risk-on mindset has never really set in. The star asset class for this period, particularly when looked at on a risk-adjusted basis, is fixed income. The US Aggregate Bond index is up low-mid single digits for this period, performing a little better than large cap value equities and just a bit behind large cap growth stocks but with much less volatility, as clearly seen in the chart.

Divergence Ahead?

Bonds are in favor largely because the market has talked itself into believing that a forthcoming economic downturn will necessitate aggressive action by the Fed and other central banks (the presumed downturn being global in nature and in fact catalyzed more by flagging economies outside the US than here at home, at least for now). But there is a twist here within the friendly confines of the fixed income space. If economic conditions really are set to turn down, then a logical assumption would be that credit risk spreads start to widen. But that has not happened. Investment grade corporates and high yield issues alike are holding up just fine. The iShares iBoxx High Yield Corporate Bond ETF is up around 6.4 percent in total return for the year to date.

So here's the picture: while the market is definitely not in a "risk-on" mindset, as evidenced by the poor performance of many higher-risk asset classes, neither is it completely "risk-off" as shown by those healthy returns for large cap stocks and the absence of credit risk spread widening. It's as if there is some arbitrary line, on the one side of which are assets thought to be protected by a dovish Fed, with the other side being for assets vulnerable to the full-on effects of a worsening economy.

In recent commentaries we have argued that this odd arrangement is not sustainable. At some point either we realize that the economy actually is stronger than expected – in which case asset classes should revert to a more traditional risk frontier (higher return for higher risk) – or that a global recession is indeed imminent, in which case the market goes full risk-off, credit spreads widen and large cap equities get their comeuppance.

But there is an alternative view, which appears to be the one embodied by today's conventional wisdom. This view holds that the magic of central banks will continue to work well enough to keep the worst of a downturn at bay. In this world, holding a handful of traditionally higher-risk assets like large cap US equities and low investment grade / high yield bonds makes sense, but taking on additional risk from other asset classes doesn't pay (since the source of market return is permissive monetary policy, not organic economic growth). To be perfectly honest we think this is a risky view with the potential for serious mispricing of certain asset types. But it's 2019, folks, and strange is the new normal.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

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