Diversification works - most of the time

Early last week we recommended investors to reduce equity holdings. Many investors tend to focus only on one set of data when making allocation decisions. We look at four different groups of data, and we see sufficient movement in several of them that we believe it is time to move from a moderate overweight in equities to a moderate underweight.

And no, we do not think that the social media-driven fuzz about Gamestop is a factor that needs attention right now. We follow the story, and see no reason to make a mountain out of a molehill.

Currently, we look at correlations, macro and investor sentiment

It is early days, but changes in the correlations between equities and the longest bonds are visible. Instead of moving in opposite directions (negative correlations), we now observe a positive correlation. When that happens, it has consequences for one of the most important elements in portfolio construction, risk diversification.

One the basic tenets of investing is that one should have a diversified portfolio, so losses on some assets are compensated by gains on others. This is good, sound advice.

Except when it is not, that is.

There are situations where it simply does not work. When all assets fall in parallel there is nowhere to go. In such cases, cash is king. Short positions, reverse ETFs or put options may also be useful.

It is not that often we see the main asset classes correlate positively. Such situations often end in tears.

Exactly a year ago, all markets increased in parallel. We used that opportunity to make the most dramatic call of 2020, to sell all shares.

We do not yeat see all investors heading for the hills at the same time. But we see clear signs that it could happen.

It also means that now is the time to focus on what happens in the markets. This has not really been the case since last year in September, but the changes we see are serious enough to warrant attention.

We look to macro to find clues. Long bonds usually fall if the market fears that a major issuance could depress prices (not a particularly bright way of looking at things, but anyway). Or it could be fears that inflation will return. Even if the central banks have tried to tell us that nearly all new government debt will be hoovered up, the fears of inflation are beginning to become manifest. The story goes that once the pandemic is over, the governments will be slow in reining in the enormous support packages agreed to keep the economies afloat. The governments are expected to overshoot their intervention.

What are the central banks up to, really?

If we focus only on the current economic situation, we establish that the COVID-19 provoked downturn so far has been longer and deeper than expected back in March 2020. But markets constantly try to guess what happens after the pandemic is brought under control. And it appears that the bond markets now see trouble ahead, pointing to increasing inflation expectations. We referred to this back on 24 September 2020, "A correction or just volatility" (Read the section 'Global monetary policy has changed').

In typical fashion, stock markets have also been trying to "look through" the pandemic for a while. Continued low interest rates have supported soaring stock markets. So far, the absence of inflation fears has also been a positive factor.

Now, it seems, stock markets also appear to catch the bug, undermining the gung-ho "there is no alternative to stocks" attitude. We do not know how far this mood change will run. As long as 10 to 30 year bond yields creep upwards on both sides of the Atlantic, it will keep stock markets nervous.

One thing to remember: Last year Federal Reserve clearly indicated that the institution would aim to increase inflation. The traditional inflation target was essentially declared moot. The statement briefly received some attention but was soon forgotten. Maybe it is time to go back and read that statement. When central banks change long standing policies, they very often end up having their way.

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