27. Jun 2019 Multi Asset

Reduce risk, increase flexibility

- After a strong start to the year for most asset classes, returns have faded and diverged. For multi-asset managers, however, both periods were similarly challenging.
- The escalation in the trade conflict, lower interest rates and rich stock-market valuations lead us to enter the summer with a more defensive allocation.

8 min Lesezeit

by Christian Hille, Head of Multi Asset

We are less gloomy on the outlook than bond markets. In our view, equity markets have to correct before offering opportunities for entry.

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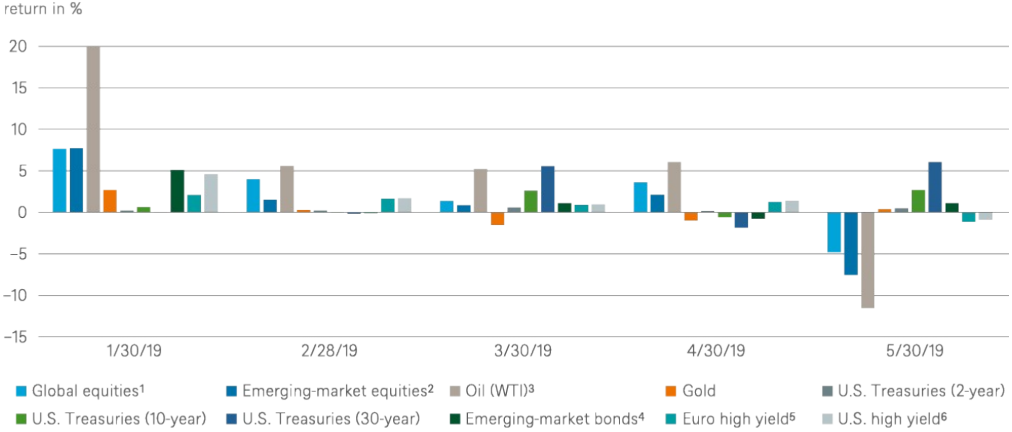
When can multi-asset<javascript:void(0)> managers actually show their worth? Let's take a look at the first five months of this year. As the chart shows, the timeframe can roughly be divided into two phases. In the first three months it went well for almost all asset classes. But results were mixed in April and in May as almost everything that was not labelled "long-term government bond<javascript:void(0)>" crashed. Some people might think that having the right asset mix was unimportant in the first three months of the year, as almost every asset class yielded<javascript:void(0)> good returns anyway. And that, by contrast, in April and May, multi-asset managers might have proven their worth as it took the right hand to reap a good harvest.

A diverse year

As the returns on various asset classes declined sharply over the period, the divergence in returns between the individual asset classes increased sharply.



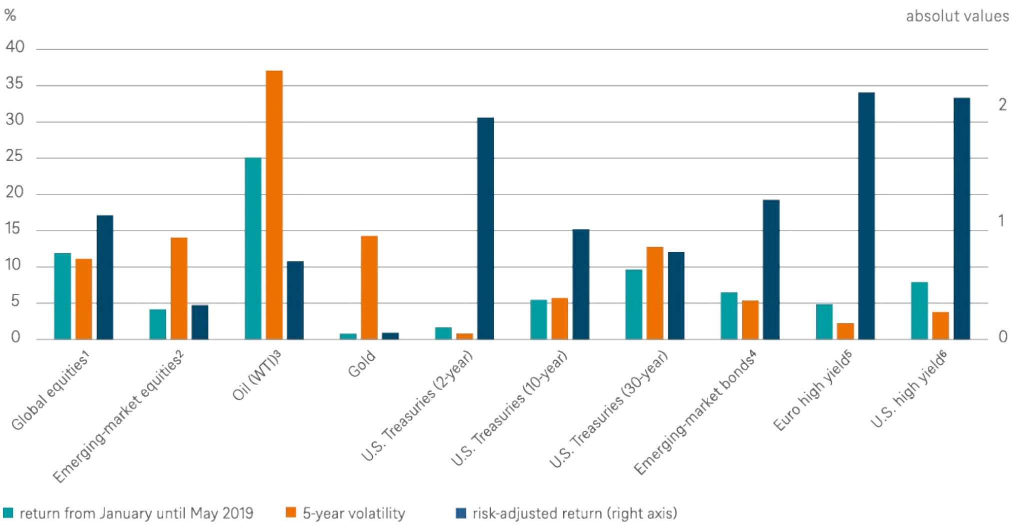
Sources: Refinitv, DWS Investment GmbH as of 6/18/19

[1] MSCI World Index<javascript:void(0)>
[2] MSCI Emerging Markets Index<javascript:void(0)>
[3] West Texas Intermediate<javascript:void(0)>
[4] J.P. Morgan Emerging Market Bond Index<javascript:void(0)>
[5] Markit iBoxx EUR Liquid High Yield Index<javascript:void(0)>
[6] ICE Bofa Merrill Lynch US High Yield Index<javascript:void(0)>

The argument above, however, is not quite right, in our view. We believe that multi-asset funds have the potential to be the better option in good as well as bad market environments. Returns on different asset classes, even if they are the same, can be of different quality. In this case, quality means risk, which is commonly expressed in capital markets by volatility<javascript:void(0)>. The more the returns on an investment fluctuate, i.e. the higher its volatility, the more investors want to be remunerated for holding it. This explains the attraction of government bonds from industrialized countries or even the preference of some households for cash. As well known as the low-volatility appeal of bonds and cash is, it is often forgotten when the performance of different asset classes is compared. The second chart shows how over time, the ranking of the top-return-delivering asset classes changes if the question of risk or volatility is taken into account. It shows the risk-return profile of various investments by relating the return achieved from the beginning of the year to the end of May to historical volatility. What was perceived to be best in class, namely oil, plunges into a middle ranking when adjusted for risk, while the previously thought to be rather poorly ranking U.S. and euro high-yield bonds take the lead – ahead of the long-term risk-return king, 2-year U.S. government bonds. So even if the markets march uniformly in one direction, it is still a matter of choosing the right investments, i.e. those with a better risk-return profile. And the job of the multi-asset manager is to select the right investments in each market phase and put them together with the right weighting.

There is almost no return without risk

The performance ranking changes quite a bit when adjusting returns for risk.



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Good multi-asset management depends on finding the assets with the best risk-return profile within different asset classes. And then, finding the most suitable collective mix of these types of assets. Depending on how strongly individual asset classes are correlated<javascript:void(0)>, the weightings of multi-asset funds can be determined in such a way to provide exposure to the lowest level of risk for a given target return. Or, to put it another way, seek the maximum return for a certain targeted level of risk. We discussed this briefly in our last Quarterly CIO View (Strength through length as of 3/15/19 </en-lu/insights/cio-view/emea-en/strength-through-length/?setLanguage=en>) and at greater length in our January study (Multi-Asset Long View as of 1/31/19 </en-lu/insights/global-research-institute/long-view/?setLanguage=en>).

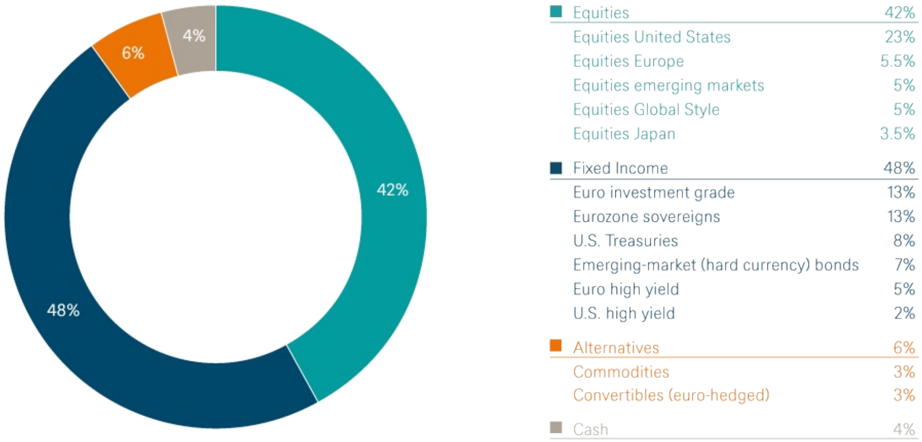
Even if quantitative models play a major role in portfolio optimization, we believe the basis for investment decisions remains the qualitative analysis of the economy and politics, which brings us to our past and present portfolio construction. Given our view of the global economy we believed that the market setback in December was exaggerated and was partly triggered by non-fundamental issues. This meant that staying invested in risk assets was recommendable and it proved to be the right choice as the recovery started at the beginning of the year. The price declines were more severe than we believed justified, given our view of the economy. For our current portfolio construction, we are guided by two basic macroeconomic assumptions: 1. The market is too optimistic in the short term, which is reflected in high valuations<javascript:void(0)>; 2. We believe that a recession<javascript:void(0)> will not occur this year and will be only a risk in 2020, but even then it will not be our base case. For this central scenario to hold, we believe the U.S. administration will have to refrain from exacerbating its conflict with China or opening up any further fronts in its trade disputes with the rest of the world. As this scenario is far from being certain, we have recently recommended to take some profits. And to keep some powder dry (cash) in order to be able to expand risk positions again (see our model portfolio in the chart) in the event that asset prices fall heavily to attractive re-entry levels. We think prices could easily suffer a serious summer meltdown. It will not, in our view, be troubles in Europe such as Brexit<javascript:void(0)> and the Italian budget, nor fresh tanker fires in the Persian Gulf, that will cause it. Three other issues have, we believe, far more explosive potential: 1. A worsening of the conflict between China and the United States, dragging on well beyond the G20<javascript:void(0)>[1]<javascript:;> summit; 2. A U.S. Federal Reserve (Fed)<javascript:void(0)> which fails to satisfy markets having delivered such a dovish<javascript:void(0)> statement on June 19 – perhaps because of a surprisingly strong economy; 3. Or, on the contrary, there are signs that the economies in the United States, Europe or Asia are developing weaker than the market expects.

If there were to be major price setbacks without us having to revise our medium-term macroeconomic outlook, we would be buyers in the market. Therefore, our current allocation is defensive and diversified. We have significantly reduced our equity exposure in our allocation. Some stock markets are not far from their historic highs, boosted recently by the Powell Put[2]<javascript:;>,at least, as perceived by the market. We prefer emerging markets<javascript:void(0)> and the United States strategically, even though we might still face setbacks in individual companies and sectors in the short term as a result of the trade war. We currently see no reason why Japan and Europe should outperform over the summer months.

We have topped up bonds in our multi-asset mixture. We assume that government-bond yields will remain low for longer and that we will have seen the peak in the cycle of interest-rate hikes in the United States. Though markets seemed a bit ahead of themselves in recent weeks when they pushed down yields so far, the moves were justified by centralbank actions. In Europe, we are increasingly focusing on corporate bonds because they offer a good mix of security, diversification and yield. Of course, the cash position, which we have also expanded, always offers the greatest security and agility to re-enter the market.

Buy-and-hold is not likely to be an appropriate investment strategy over the summer. We will react in an agile way to steps forward or back in the markets in response to the trade disputes and to signals from the Fed. At the same time, we will look for points where the market has anticipated too much in one direction or another in order to adjust our allocation in our model portfolio (see chart). The recent confirmation of the structural low-yield environment by central banks is one more reason why we believe that risk assets such as equities should be added in periods of market weakness.

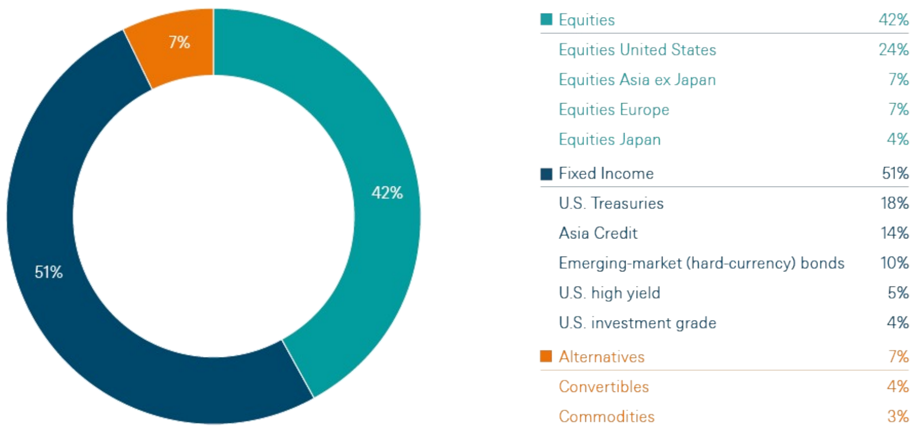
Multi-asset allocation for European Investors
Broadly positioned with less risk and more cash to be prepared for opportunities in summer.



Source: Multi Asset Group, DWS Investment Management as of 5/31/19

The chart shows how we would currently design a balanced, euro-denominated portfolio for a European investor taking global exposure. This allocation may not be suitable for all investors and can be changed at any time without notice. Alternative investments involve various risks and are not necessarily suitable for all clients or for every portfolio.

Multi-asset allocation for Asian Investors
We have reduced the equity and alternatives exposure and increased the bond allocation.



Source: Multi Asset Group, DWS Investment Management as of 5/31/19

The chart shows how we would currently design a balanced, dollar-denominated portfolio for an Asian investor taking global exposure. This allocation may not be suitable for all investors and can be changed at any time without notice. Alternative investments involve various risks and are not necessarily suitable for all clients or for every portfolio.

Indicators

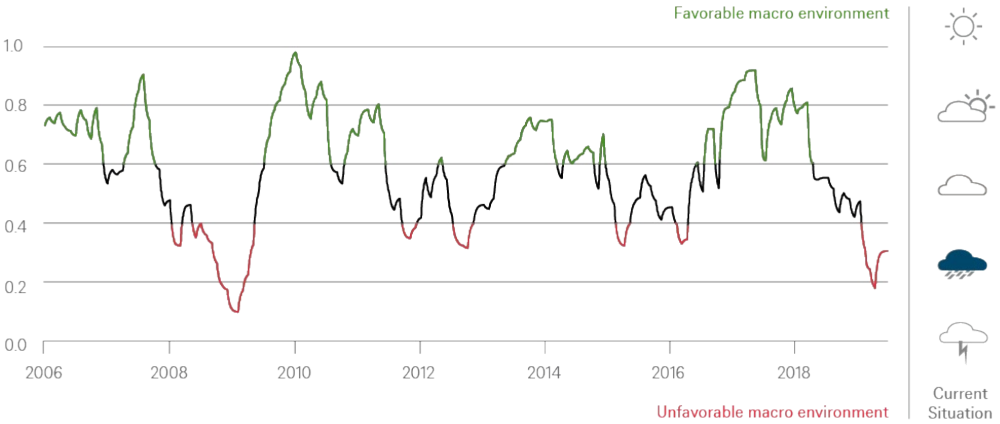
Rough weather condition

All three indicators currently paint the same picture ...

...and it is none too rosy. Therefore caution is advisable, in our opinion. All three DWS indicators have been unanimously indicating a negative environment for a good three weeks now. The macro indicator is at its lowest level since 2009 and shows little sign of improving. The risk indicator shows investors' risk appetite is low and the surprise indicator reflects the fact that most analysts' expectations are being disappointed. The current escalation of geopolitical risks, especially the trade dispute between the United States and China, seems to explain this gloomy picture. And yet, despite this dark backdrop, the capital markets are almost bewilderingly sunny. All major stock indices are within reach of their annual highs. In the case of U.S. stock markets, they are even within striking distance of their historic highs. The very dovish<javascript:void(0)> attitude of the central banks seems to have fuelled this divergence. The market now expects the U.S. Federal Reserve (Fed)<javascript:void(0)> to cut interest rates almost three times this year. Our indicators point to the unique fragility of the market environment. Should the Fed fail to deliver the priced-in rate cuts, a correction<javascript:void(0)> in the equity market can probably be expected. If one considers that economic growth in the United States in the first quarter was at an annualized rate of over 3% and that nearly full employment prevails, disappointment in the hopes for an interest-rate cut soon can certainly not be ruled out. Or are the central banks<javascript:void(0)> seeing something approaching of which the stock market may not yet be aware?

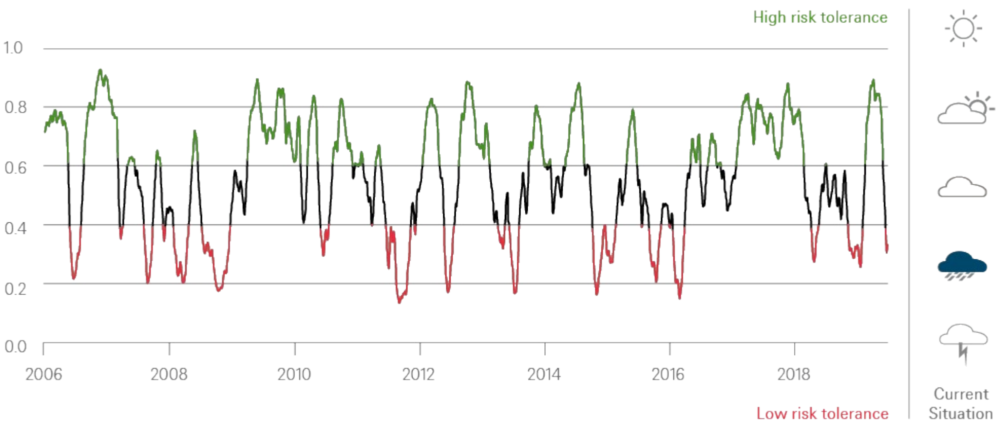
MACRO-INDICATOR / Condenses a wide range of economic data

In April, the macro indicator recorded its lowest level since 2009. Thenceforth, it has recovered somewhat but remains deep in the red zone. The global purchasing managers' indices<javascript:void(0)> and sentiment in the manufacturing sector are particularly depressed.



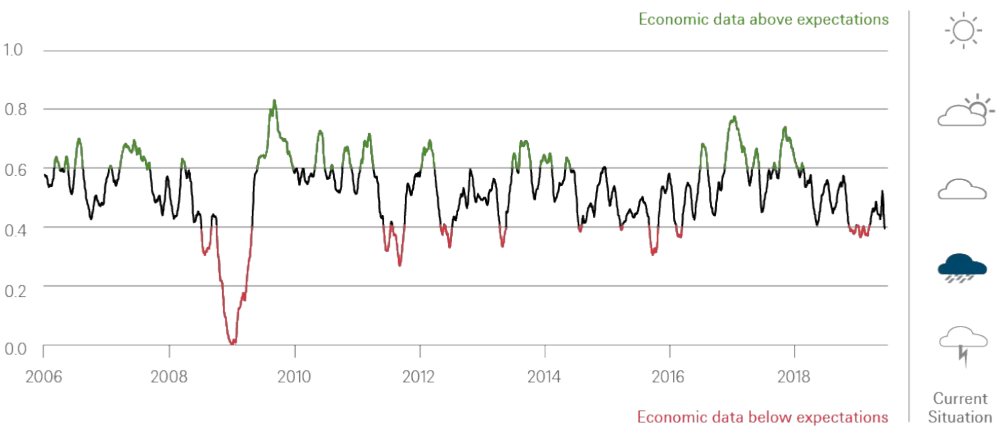
RISK-INDICATOR / Reflects investors' current level of risk tolerance in the financial markets

After the recovery in the risk indicator in the first quarter, the spontaneous intensification of trade-war rhetoric on the part of the United States very quickly clouded risk sentiment. In mid-May, the risk indicator fell back into negative territory and is currently roughly at the very low level of late 2018.



SURPRISE-INDICATOR / Tracks economic data relative to consensus expectations

The surprise indicator has been in the red for most of the year. But regional sub-indicators have been quite divergent. Recently, however, all the main regions (United States, Europe and Asia) have been in the negative zone at the same time. Expectations within these regions are therefore regularly disappointed.



Source: DWS Investment GmbH as of 6/10/19

Performance in the past 12-month periods (in %)

	05/14 - 05/15	05/15 - 05/16	05/16 - 05/17	05/17 - 05/18	05/18 - 05/19
ICE BofA Merrill Lynch US High Yield Index	1.8%	-0.9%	13.9%	2.3%	5.4%
J.P. Morgan Emerging Market Bond Index	0.5%	6.3%	8.9%	-3.7%	6.2%
Markit iBoxx EUR Liquid High Yield Index	3.6%	0.1%	7.4%	0.8%	2.2%
MSCI Emerging Market Index	-2.3%	-19.6%	24.5%	11.5%	-10.9%
MSCI World Index	3.7%	-5.9%	14.2%	9.5%	-2.2%
U.S. Treasuries (10-year)	5.0%	4.4%	-0.4%	-2.4%	8.6%
U.S. Treasuries (2-year)	0.8%	0.7%	0.6%	-0.1%	3.5%
U.S. Treasuries (30-year)	9.7%	8.4%	-1.6%	0.1%	11.0%

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 5/31/2019
Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect. DWS Investment GmbH as of 5/31/19.

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1. ^ <javascript:;> This year the G20 meeting is taking place in Osaka on June 28 and 29.
2. ^ <javascript:;> In reference to the Greenspan Put, the market is now also talking about the Powell Put after the clear rhetorical turn of Fed Chairman, Jerome Powell, at the end of 2018. This refers to the central bank's willingness to intervene with an expansive monetary policy in the event of a sharp fall in stock markets.