Don't Ignore the Threat of Another Market Tantrum

October 25, 2016

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Jeff Knight looks at why market tantrums are the greatest risk management challenge facing investors today — and three ways to help protect your portfolio.

On September 9, following more than 40 trading days where it failed to make a full percentage point move in either direction, the S&P 500 Index dropped by nearly 2.5%. On the same day, the yield on the benchmark 10-year Treasury bond rose from 1.60% to 1.68%, a loss of roughly 0.7% in price terms. Commodities fell by several percentage points. REITs lost almost 4%, and the list goes on. September 9 was a painful day for concentrated and diversified portfolios alike. While the damage was softened, if not reversed, for most asset classes by the end of the month, the pattern of performance that day should be noted because it represents the most insidious risk management challenge facing investors today. Specifically, how can we protect our portfolio values if all asset classes decline at the same time, particularly if these declines become more significant or more durable?

Consider the likely source of the financial market’s vulnerability to simultaneous declines. Nearly every major asset class has been increasing in value since the financial crisis.

Prices of most asset classes have steadily increased since the financial crisis

Asset class performance (annualized): 03/09/09 to 09/30/16

Source: Bloomberg and Columbia Management Investment Advisers, LLC

The link between monetary policy and previous tantrums

This price appreciation is a consequence of a global monetary policy designed to produce this very outcome. If low rates and quantitative easing can produce a rally in financial assets, the theory goes, then a wealth effect cannot be far behind once investors contemplate their portfolio gains. But we should note that this policy-driven windfall has a darker side. If the outside agent (monetary policy) that has washed over all of the asset classes in a positive way should change, then we should not be surprised if its removal has an opposite and negative effect.

We have seen this pattern before. The chart below plots the average performance of a variety of asset classes across four distinct episodes of market volatility. Each of these episodes was sparked by an inflection in monetary policy, beginning with the taper tantrum of 2013. We see a meaningful cause-and-effect pattern of these tantrum environments. The cause has been a hawkish inflection of monetary policy, while the effect has been simultaneous declines across asset classes.

Asset class performance during tantrums

Source: Bloomberg and Columbia Management Investment Advisers, LLC

Investors should plan for this risk management challenge now

Central banks appropriately regard their current monetary stance as reflective of special, almost emergency circumstances. This mindset sets the stage for eventual “normalization” of monetary policy, which should concern any investor who has seen the previous chart. The current “emergency” stance of monetary policy has been in place for quite a long time, making it increasingly difficult to view the measures as appropriate given that the financial crisis itself ceased to be an emergency long ago. Also, the real world — as opposed to the financial market — benefit of these policies is difficult to detect. Given that there are winners and losers from these aggressive monetary policies, we would expect that a lack of real world response to these policies might eventually cause a shift in the overall policy recipe. Even without any significant improvement in economic data, the Federal Reserve seems to be deepening its resolve to continue with gradual rate normalization. Finally, the price inflation that has already occurred has, in most cases, outpaced any improvement in underlying intrinsic value for the world’s asset classes. So some of the gains have come directly at the expense of future gains.
returns, meaning that future returns are likely to be lower than returns of the recent past.

The September 2016 tantrum is also noteworthy because the triggers were not actions, but merely words. For example, on September 9, the president of the Federal Reserve Bank of Boston, Eric Rosengren, observed that “a reasonable case can be made” for policy normalization. A well-known money manager added to anxieties that day by warning that the Federal Reserve might raise rates solely to counter the reputation that such moves don’t take place if the markets aren’t expecting them. The market reaction reveals an edginess on the part of investors that suggests even a small trigger can incite a relapse into these volatile conditions. Checking the fourth quarter calendar, we see some potentially large triggers, including a U.S. presidential election, the December Federal Open Market Committee meeting and several key votes across Europe.

**Defending your portfolio from tantrum risk**

Dealing with this risk management challenge will be difficult in the presence of a more significant or durable tantrum. We suggest three portfolio adjustments:

1) Develop a plan to reduce risk if the prospect of a material tantrum arises. Two conditions would suffice to trigger the need for risk reduction. The first would be a decline in bond yields to a level where their diversifying potential is severely compromised. As long as bonds are reasonably priced, they should help to stabilize a portfolio through a protracted tantrum episode. Should yields fall below a fair value range, however, we would acknowledge the need to reduce risky asset positions. The other condition would be a clear-cut catalyst for monetary tightening, like a sequence of stronger than expected economic data.

2) Search for an expanded palette of diversifiers. Despite their recent struggles, we continue to advocate for the incorporation of liquid alternatives or other investments with low correlation to traditional markets into overall portfolio strategy.

3) Identify hedging positions that may help offset simultaneous declines across asset classes. Some positions that would have been helpful in past tantrum episodes include long positions in volatility and the U.S. dollar exchange rate and put option protection for volatile equity positions. Each of these hedging positions should be evaluated in the context of its carrying cost.

Additional disclosures: The asset class descriptors reference the following indices: S&P500 Index (U.S. equity), MSCI ACWI (global equity), MSCI EAFE Index (developed international equity), MSCI Emerging Markets Index (emerging market equity), JP Morgan EM Bond Index (emerging market bonds), Bloomberg Barclays U.S. Aggregate Bond Index (U.S. aggregate fixed income), Merrill Lynch U.S. High Yield Index (high yield bonds), FTSE NAREIT Index (REITs), Bloomberg Barclays U.S. Treasury Inflation Notes (TIPS), HFRI composite (HFRI composite), Bloomberg Barclays U.S. Treasury Total Return (Treasuries) and Bloomberg Commodity Index (commodities).

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