Winston Floquet | **END Q3 2018**

Current Environment

As September marked the 10th anniversary of Lehman's collapse, there was widespread commentary on the likely source of the next crisis. While opinions varied significantly, the consensus view was that it was impossible to predict: like the 'sucker punch' in boxing, it's the one you don't see that gets you.

While recognising that it is notoriously difficult to pinpoint the particular event (the 'Wile E. Coyote' moment) that will trigger the next downturn it is nevertheless worth examining some of the risks which are building.

Risks building in equity and bond markets

Valuations of equities are not cheap, but neither are they much higher than the long term averages, so a sell-off on the grounds of elevated valuations seems unlikely. [CHART 1] We postulate the more likely reason could be rising interest rates and debt related issues.

Total world debt has surged since the financial crisis. [CHART 2] The massive injections of funds by central banks facilitated a recovery from the depths of the 2007/8 collapse and brought interest rates down to all-time lows. But these actions have clearly left a legacy of debt which has to be both serviced and eventually repaid.

The unprecedented expansion of central bank balance sheets is now beginning to reverse. [CHART 3] Not only has the Fed commenced the unwinding of its balance sheet but the European and Japanese QE programs are slated to end soon. Central banks across the globe have started raising policy rates – after a decade of cutting them – resulting in escalating short term interest rates. [CHART 4]

This contraction of global liquidity removes the strong tailwind which has fanned equity markets over the past several years. This tightening of global liquidity, and steadily rising interest rates, will inevitably impact negatively on both equity and bond markets. The dilemma for equity investors is determining at what point higher yields will cause a significant reversal in share markets and materially impact on economic growth. (The two will not occur at the same time.)

The tipping point is unpredictable but, once it occurs, herd mentality often takes over and sizable downside momentum results.

US bond market issues

There is a further dimension which requires consideration. Particularly in the US, corporate debt has soared as companies took advantage of all-time low rates to issue bonds rather than equity. And, with investors searching for yield in this low rate environment, the huge increase in supply from corporates was easily absorbed. The size of the corporate bond market has more than doubled.

Much of this was of relatively poor quality: some 47% of investment grade debt is rated at just one notch above junk (compared to 27% before the crisis). The risk of downgrades to junk in the next recession has increased significantly. Given that the banks have, due to regulation, cut their exposures dramatically, liquidity (already greatly reduced) is likely to become a serious issue if there is a major sell-off.

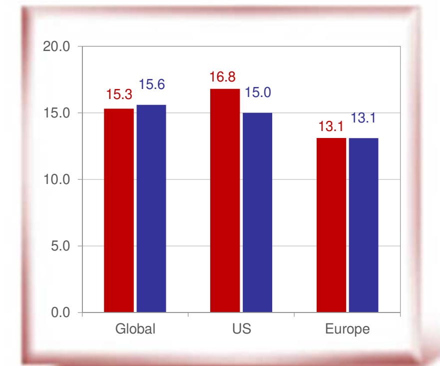
Possible outcomes

This is clearly not a major concern for now. While world economies are growing at above-trend rates, there is little near-term risk of distress among bond issuers.

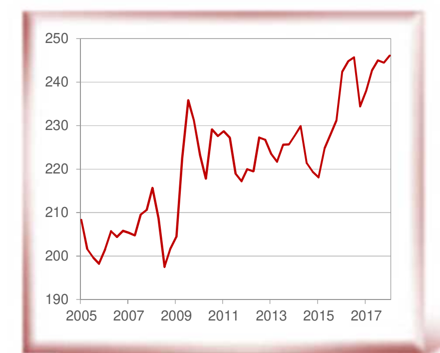
However, there are other worries: rising inflation, falling earnings revision ratios, soaring government deficits, escalating trade disputes, emerging market debt and slowing (but still strong) world growth. But, to us, the impact of rising rates and central bank balance sheet reductions on global liquidity, are the greatest concern.

While the elusive trigger point is clearly an unknown, the uncertainties are now significant enough to require a restructure of portfolios to limit potential losses. Clearly reducing equity exposure sacrifices some potential upside but reduces the losses in the next downturn. Our portfolios have been amended accordingly.

Forward PE vs Long Term Average PE

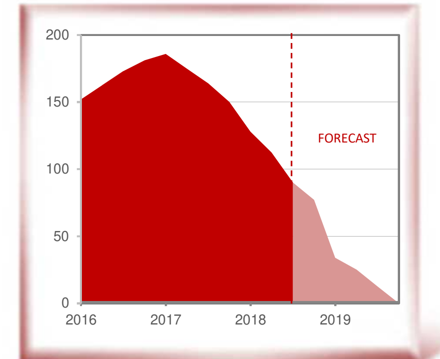


Total World Debt-to-GDP (%)

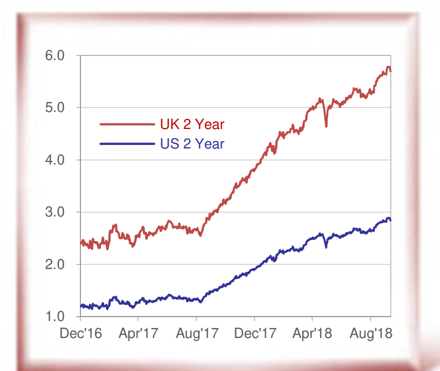


Central Bank Asset Purchases ($bn)

BoE, US Fed, BoJ, ECB combined



US and UK 2 Year Interest Rates



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