ECB Bold Policy Moves

During its June meeting, the ECB Governing Council announced several bold policy measures in order to fight low inflation and boost the Eurozone economy. While these measures were broadly anticipated, the ECB action is aggressive and provides an important shift that delivers on the promise of recent comments by ECB officials.

The package of policy measures should help underpin a recovery in credit growth and support a rise in inflation expectations:

- A 10bp cut in the main refinancing rate to 0.15%
- A similar cut in the deposit rate to minus 0.1%. This negative deposit rate aims at discouraging banks to ‘park’ too much money with the ECB and instead use these excess reserves to provide credit to the private sector.
- A new round of Long-Term Refinancing Operations (LTRO) also aimed at boosting banks’ lending. Contrary to expectations, the conditions attached to this source of cheap funding are very limited, since banks only need to improve on last year’s net lending. Banks can borrow up to 7% of their current outstanding loans to the nonfinancial private sector. This is equivalent to EUR 400 billion and can be drawn at two LTRO tenders in September and December. If banks improve on last year’s net lending performance, they will also

Key Takeaways

- Contrary to widespread expectations at the start of the year, bond yields have actually moved lower. We see this as a counter-trend rally and expect the trend towards higher bond yields to resume as a more robust rebound in global activity takes hold.
- Investors continue to reach for yield without paying enough attention to valuation levels. Some of the year-to-date developments are unsustainable, in particular the strong gains in interest rate sensitive sectors such as utilities, REITs and preferred stocks.
- While the Fed remains on track to end the tapering process in 2014 and eventually hike rates next year, the ECB and the BoJ are likely to provide additional policy reflation. Such a decoupling of monetary policies supports our relative preference for international markets going forward.
- Further equity gains will be driven predominantly by earnings growth as opposed to rising valuation levels.
- From an asset allocation perspective, we continue to recommend exposure to asset classes and markets which are best positioned to benefit from the global growth recovery: this includes the Euro area, Japan and Emerging Markets.
- We reaffirm our view that the US dollar will gradually move higher in coming months. As a result, we recommend hedging the currency exposure when investing in Europe and Japan.
be able to borrow three times this improvement in future LTRO tenders (6 between March 2015 and March 2016) – this would result in an additional EUR 450 billion in LTRO if banks can collectively stabilize their loan books which decreased by EUR 150 billion last year.

- The forward guidance provides another level of assurance that policy rates will remain at current levels for an extended period of time. The maturity of the LTRO extending till 2018 should be seen in that context.

- The ECB also reaffirmed its commitment to accelerate the introduction of asset backed securities purchases for later this year.

- Finally, the sterilization of the sovereign bonds purchased under the Securities Markets Programme (SMP) will be suspended, thereby releasing an extra EUR 175 billion of liquidity into the financial markets.

With these aggressive policy steps, the ECB has finally recognized the need to provide more support for the Eurozone economy. While the region’s growth outlook has been steadily improving in recent quarters, several large issues required a more vigorous policy response:

- Inflation is well below the ECB target and still on a downtrend (only 0.5% in May). Low inflation (and even mild deflation in some peripheral economies) limits the potential decline in real rates.

- While the rate of decline is abating and banks’ lending standards have started to ease a little, credit to the private sector is still contracting and banks remain focused on strengthening their balance sheets ahead of the scheduled ECB stress-test and asset quality review.

- The ECB balance sheet has been steadily declining for nearly 2 years and overall monetary conditions have been too tight. As a result, the Euro is too strong, hurting export competitiveness and further depressing inflation trends.

- Despite a significant improvement over the past 2 years, fiscal policy remains a drag on growth.

Obviously, as Japan has demonstrated, aggressive monetary policies and ultra-low rates alone will not be sufficient, but it is nevertheless a bold step in the right direction. Moreover, Mario Draghi indicated that the ECB is not finished yet and that further policy steps will be taken if necessary. For now however, we believe that these measures will help support the unfolding economic recovery in the region through, at least, a stabilization and eventually a rebound in credit growth. These measures should also lead to reduced deflation fears, a further recovery in business and consumer confidence and, ultimately, a lower Euro. This will be particularly true once the Fed starts raising rates (most likely in 2H2015).
The apparent disconnect between equities and bonds

Going into 2014, most market participants (us included) had been anticipating a gradual move higher in US Treasury yields, driven by improving growth dynamics and the resulting slow adjustment towards a less accommodative monetary policy. Yet, at the end of May, the 10-year treasury yield stood at 2.48%, a sharp drop from 3.03% at the start of the year.

In recent years, declining bond yields have usually been a sign of weaker economic growth prospects and, as a result, equity prices have tended to come down in tandem. The fact that stock prices have been moving higher year-to-date despite lower bond yields is seen by many investors as inconsistent as higher stock prices would suggest that growth is improving, not softening.

At first glance, this analysis seems to make sense. Indeed, since the late 1990’s, equity prices and bond yields have usually been positively correlated. Over the preceding three decades, inflation developments acted as the main driver for changes in bond yields, resulting in a negative correlation (lower inflation -> declining bond yields -> higher equity prices). Over the past decade however, this correlation has changed as the disinflationary trends turned into a period of low and stable inflation. As a result, expectations around monetary policy became the main driver for yields. Given the obvious link between economic growth and the Fed policy decisions, this has also resulted in a positive correlation between growth, bond yields and equity prices. Improving growth prospects would usually lead to expectations of a more hawkish Fed, thereby driving yields higher. At the same time, equity prices would usually move higher too on brighter prospects for corporate profits.

In this context, the current large drop in bond yields could be a harbinger of bad news to come for the US economy and, at some point, equity prices will have to adjust accordingly. But, if economic weakness is the main factor behind lower bond yields, this should also lead to expectations that the Fed will be slower in raising interest rates going forward – so far this year, Fed funds futures have actually been moving higher though.

Despite the very weak growth recorded during the first quarter (GDP contraction, partially explained by adverse weather conditions and corporate de-stocking), recent economic data are consistent with a growth pickup for the remainder of the year. As a result, we do not believe that the recent trends in treasury yields are a warning signal for the economy. This is confirmed by developments elsewhere in financial markets such as the lack of support for gold prices (which would usually move higher when real bond yields decline as a sign of softer growth prospects) or the ongoing decline in credit spreads (inconsistent with growth fears).

Several factors, unrelated to the economy, help explain the most recent sharp drop in bond yields:

- Increased demand: Despite tapering, the Fed continues to purchase large amounts of Treasury notes and bonds on a monthly basis. Moreover, banks have significantly increased their holdings of government paper during the first quarter. Pension plans and insurance companies have also shifted money away from equities into bonds, as their reserves have been boosted by last year strong gains.

- Another source of demand comes from international investors. Bond yields in Japan and Europe have plummeted even
more than in the US, as investors expect additional monetary policy measures in these economies. At 2.50%, the US 10-year treasury yield is a lot more attractive than similar paper in Japan (0.6%) or Germany (1.4%).

- Reduced supply: There is a growing shortage of long-term treasury bonds, primarily as a result of the sharp reduction in the US fiscal deficit.

We see recent developments in the treasury market as a counter-trend rally following the sharp selloff last summer and extreme bearishness at the start of the year. Despite what some have referred to as the new “bond conundrum”, we would caution against de-risking portfolios based on the apparent message from the bond market and we maintain our constructive outlook for equity markets.

**Year-to-Date Market Trends**

The global economic backdrop continues to be supportive for financial markets – slow but gradually improving growth, subdued inflation and highly accommodative monetary policies. The global recovery started five years ago, but the pace has been slow by historical standards at only 3%. The US economy has only expanded at a 2% rate, the weakest pace for a recovery since World War II. This slow recovery helps explain why there has not been a large reduction in excess capacity (i.e. the OCED output gap is still relatively large) and this is keeping inflation depressed.

Monetary policies have been and will continue to be extremely accommodative in order to offset the deleveraging forces resulting from the financial crisis and avoid a debt deflation. The great recession left the global economy with a significant amount of slack which has yet to be fully absorbed, resulting in low levels of inflation on a global basis. This, in turn, will allow central banks to move slowly in normalizing monetary conditions and wait for clear signs that the economic recovery is on a firm footing.

Another characteristic of the current business cycle is the very low level of macro volatility, as evidenced by the recent declines in the standard deviations of both real GDP and inflation. Low levels of economic volatility, coupled with easy monetary policy and forward guidance to keep interest rates lower for longer, have resulted in very low levels of financial markets volatility as evidenced by recent trends in the VIX and MOVE indices (implied volatility for equity and treasury markets). Economic and financial stability in an environment of negative rates in real terms are the perfect ingredients for
a continuation of the “search for yield” strategy. As discussed earlier, the sharp decline in bond yields so far this year has resulted in several market trends consistent with this strategy – looking (stretching) for yield opportunities across asset classes:

- REITs and Utilities are the best performing sectors so far this year
- Preferred shares which offer an attractive yield pick-up (and a significant sensitivity to interest rate changes, courtesy of a 13.5 years average duration) rallied 10.4% in the first 5 months of the year, largely outperforming the broader market, in a reversal of last year dismal performance (-1%)
- Peripheral bond markets in Europe – The 10-year yield on Italian and Spanish paper dropped below 3% for the first time ever
- Emerging market currencies and bond markets have rebounded strongly from last year precipitous drop, which was caused by Fed tapering fears and rapidly rising treasury bond yields
- Across the board, credit spreads have continued to tighten as bond ETFs and mutual funds have seen consistent inflows year-to-date, a reversal from the “Great Rotation” trends in place during the second half of 2013

We believe that some of these trends are unsustainable though as the main support behind these recent developments can be traced back to the strong rally in global government bonds and the relative attractiveness they seem to offer in a world of depressed bond yields.

As mentioned, the decline in bond yields has been driven mostly by temporary factors and is not consistent with underlying economic trends and the likely path of Fed policy in coming months and years. While we do agree with the growing consensus view that a “neutral” Fed policy probably equates to a 3% Fed funds rate (rather than 4 to 5% as in previous cycles) given the structural downtrend in the potential growth rate and capital spending, as well as households’ increased propensity to save, the fact remains that last summer marked an inflection point in the Fed policy, starting with the ongoing tapering and moving towards the first rate hike in 2015. Extraordinary low volatility in equities, bonds and currencies is a byproduct of the tepid economic recovery and ultra-low policy rates. But market volatility will soon start to rebound as global growth picks up more decisively in coming months and investors start to discount the first Fed’s rate hike. If the first hint of tapering in May 2013 was capable of causing such a spike in bond yields, then one should expect a similar move when the fed starts preparing the market for an actual tightening of monetary policy.
Investment Strategy

As we stated in the January edition of this Market Commentary, the 10-year Treasury bond yield is unlikely to move significantly above 3% any time soon: “In a nutshell, the bulk of the large valuation distortion has been removed from the government bond market and the uncertainty around the start of tapering is also behind us. This means that, going forward, the trend in bond yields will be primarily influenced by the strength of the economy and expectations with regards to the likely path of the Fed funds rate. Unless investors start to price in a quicker path for the Fed to start raising rates, it is difficult to see the 10-year yield move significantly higher in 2014.”

While we did not expect a sustained bear market in government bonds, we also did not expect to witness the rally we have seen in the first five months of the year. Since there has not been a major change in our assessment of the outlook for both the US economy and the Fed, the risk/reward trade-off for Treasuries has sharply deteriorated with the 10-year yield at 2.50%. A mere move back up to 3% would translate into a negative total return of -2% in the coming 12 months.

From an asset allocation perspective, we continue to recommend exposure to asset classes and markets which are best positioned to benefit from the gradual global economic recovery. Putting in perspective recent economic developments as well as market trends so far in 2014, we highlight the following opportunities:

1) Europe and Japan:

We maintain our constructive outlook for international equity markets and recommend a further shift away from US stocks. As indicated previously, stock prices tend to benefit from an environment where growth is recovering but at the same time monetary policy is allowed to remain accommodative. On both fronts, international markets seem to be better positioned as the economic recovery is not as advanced as in the US.

Earnings growth tends to be particularly robust in those early stages of an economic rebound due to strong operational leverage.

Another major support factor for international markets is related to the likely decoupling of monetary policy settings. In the US, the Federal Reserve balance sheet is still expanding but the rate of change is coming down as the tapering process follows its course. We expect the Fed to start raising rates during the second half of 2015. While monetary conditions will still be easy at that time, at the margin, monetary policy will become tighter and it will be a departure from the zero interest rate policy which has been in effect since December 2008 (and the first rate hike since June 2006).

At the other end of the spectrum, the ECB has just announced a broad set of measures providing further and much needed monetary policy support to the Euro-area economy. Mario Draghi also made it clear that more stimulus could be coming if necessary and the forward-guidance seems to indicate that policy rates could remain stable until as far out as 2018 (the maturity of the new targeted LTROs). After a long and painful recession, the Eurozone economy is recovering
at a slow pace but leading indicators (consumer confidence and purchasing manager indices) point to a more robust rebound in coming months. More importantly, the economic rebound is broad based with activity also picking up in the periphery. The economic downturn has been particularly severe for some of these countries and deflationary pressures should not be underestimated. As a result, the ECB will have to make sure monetary conditions are accommodative enough to support a recovery in these weaker countries where unemployment rates remain elevated and credit to the private sector is still contracting. We believe that the recent package of monetary policy measures will have a positive impact on solidifying the nascent economic recovery and supporting a gradual rebound in bank lending. Bank lending is the primary mechanism through which easier monetary policy gets transmitted to the real economy, and this is particularly true for the Eurozone economy. As a result of these measures, we also expect the ECB balance sheet to expand (after nearly 2 years of contraction). This should act as a headwind for the Euro, which we expect to gradual depreciate against the US dollar in coming months.

The Bank of Japan has been the most aggressive central bank since April of 2013 with the implementation of Abenomics’ fist arrow. Reflationary efforts by the BoJ have helped improve growth conditions, weaken the Yen and lead to a steep rise in inflation expectations. The VAT tax hike has acted as a drag on growth more recently and the Yen is stabilizing on a year-on-year basis. The pressure for the BoJ to provide additional easing measures will likely intensify in coming months as the positive inflation developments are likely to roll over otherwise. Since limited progress has been achieved so far on the tax and structural reforms, the onus remains on the BoJ to further expand its balance sheet in order to achieve the 2% inflation target by 2016.

These divergent trends in central bank policies have several implications for investors. First, global liquidity conditions will remain abundant even when the Fed starts to pull back. This will provide an ongoing support for most markets. Second, it means that while bond yields are likely to gradually move higher in the US, the upside pressure will be much less pronounced in Europe and Japan. The third consequence is that relatively tighter monetary conditions and higher interest rates should support a further appreciation of the US dollar against other major currencies. Finally, relative monetary conditions should lead to outperformance from international equity markets, particularly if, as we expect, the relative earnings momentum also starts to improve.

Japanese equities in particular look very attractive at this stage. The poor performance year-to-date (both in absolute and relative terms) means that the key ingredients supporting a structural bull market are back in the picture:

- Valuations: The TOPIX trades at 12.5x next year’s earnings – this is not only significantly below Japan’s historical averages but it is also a large discount to the US. This is also the level at which the Japanese market was trading back in September of 2012 when the powerful Abenomics induced rally started.
- Earnings: After the sharp rebound in corporate profits last year, earnings momentum has been gradually decelerating in recent months. The recent pickup in domestic activity and the unfolding improvement in the global business cycle should soon lead to positive earnings revisions. (CHART 12)

- Nominal Growth: The Japanese economy remains on track to escape from two decades of nominal contraction towards positive nominal growth as deflationary forces abate. In the past, corporate profits growth was almost entirely driven by productivity gains and margin expansion, but sales growth will now be a more prominent factor in boosting the bottom line.

- Sentiment: The hype surrounding Abenomics seems to have vanished and investors’ expectations for renewed policy action are now very low. The bar for positive macro surprises has therefore been significantly lowered.

2) Emerging Markets

As indicated in previous editions of this newsletter, after 3 years of relative underperformance, emerging markets offer very attractive long-term opportunities but the challenge was to identify a set of catalysts which would unlock this relative value.

Emerging markets came under renewed selling pressure in January, dropping 6.5% but have since staged an impressive rebound and are now up 6.5% year-to-date, significantly outperforming US equities since March.

We see this rally mostly as a reduction in the large risk premium previously built into EM valuations as fears of a current account crisis have receded. This helps explain why the countries which were perceived as most at risk, the so called “fragile fives” have rebounded the most since the beginning of the year: Indonesia (+24.8%), India (+23.5%), Turkey (+22.9%), Brazil (+13.2%) and South Africa (+8.0%).

Contrary to investors’ fears last year, Fed tapering did not lead to persistently higher US bond yields, which was seen as a key negative for the asset class in draining liquidity away from these markets. The weakness in EM currencies last year was very painful for investors but this acted as a shock absorber (something which was not possible during previous EM crisis when currencies were pegged to the dollar). Weaker currencies and rate hikes implemented by several central banks have
resulted in a significant reduction in most current account deficits. Despite large net outflows from EM mutual funds and ETFs, the banking sector proved resilient and a feared credit crunch did not materialize.

We are constructive on EM debt markets, both in US dollar and in local currencies, following the painful re-pricing of last year. EM currencies trade at decent valuation levels (which should limit the risk for foreign investors), inflation seems to have peaked and EM debt offers a higher spread compared to developed markets for similar credit risk. Stable or even growing FX reserves in some cases provide an additional layer of protection if/when investors’ anxiety flares up again in coming months.

Another catalyst for a change in perception towards these markets came with the results from the Indian general elections. Investors had been worried that the heavy election cycle this year could lead to more political instability in the region. However, the scale of Modi’s BJP victory in the Indian election was well ahead of market expectations. The BJP now has the largest electoral mandate than at any time in the past 30 years. Over the past few years, investors have been disappointed with incumbents in many countries due to the lack of structural reforms. The outcome of the 2012 elections in Mexico was seen as a key positive given Pena Nieto’s renewed focus on implementing major reforms in sectors such as energy and telecommunications. The recent elections in India and Indonesia should be seen as a powerful catalyst for emerging markets as the prospect of better policies should translate into faster growth in the medium term.

As discussed, our view is that the recent strong performance in emerging markets was primarily driven by poor sentiment/positioning and easing concerns about the impact from some specific risk factors (Fed tapering, election cycle, Ukraine, among others). The next leg of outperformance will be driven by improving growth prospects. We see the following factors supporting our bullish outlook for the region in coming months:

- EM growth has been constrained, in our view, by a combination of cyclical and structural factors. On the structural side, the transition in China towards slower but more stable growth (focus on the consumer spending and less reliance on the manufacturing sector) has had some negative implications for intra-region trade and demand for commodities. However, we are encouraged by the fact that the government continues to push forward with its reform agenda despite the implications for growth in the near term. From a cyclical perspective, inflation trends have forced most EM central banks to tighten monetary policies over the past 2/3 years, and this resulted in slower growth. Moreover, the US recovery has been very soft by historical standards and the Eurozone economy only recently emerged from a long and painful recession. Most EM economies remain a leveraged play on global growth and global exports. Our view that both US and European growth are about to accelerate in coming months will lead to renewed strength in EM exports and earnings. We have already seen signs of better export performance for the region and this trend should continue and gather momentum in coming months.

- Higher interest rates in the US should not be seen as a negative for the region as it will be a sign of stronger economic activity, which will act as tailwind for large export sensitive economies such as Mexico, Korea or Taiwan. Historically, EM equities outperform during the initial stage of rising US bond yields and Fed rate hikes and last year’s tapering concerns are unlikely to resurface. Our strategy is nevertheless to focus on those economies with stronger external positions and most leveraged to the pickup in global trade such as Korea, Malaysia, Taiwan and Mexico.

- Overall liquidity conditions are expected to remain highly accommodative irrespective of the Fed’s exit strategy, particularly now that the ECB seems to have become more proactive and willing to implement bold policy measures.
- Investor sentiment towards the region is still poor with many institutional investors still carrying a large underweight position. Improving fundamentals and poor positioning should provide a boost to these markets once investors grow more confident that the rally is sustainable.

- Chinese equities have largely priced in the myriad of concerns/fears among investors over the past few months as valuation levels appear extremely depressed. Concerns about the shadow banking and a disorderly financial deleverage are gradually receding as investors understand that a credit crisis is highly unlikely given the country’s low total debt levels, the strong central government balance sheet and significant FX reserves. While growth is still trending lower, recent economic data indicate that the economy is stabilizing and the willingness to provide some level of support to the economy seems to be building, as evidenced by the mini-stimulus implemented in April or the Renminbi depreciation over the past few months.

- While EM equities can get cheaper, they are already cheap both in absolute terms and relative to their own history or to developed markets. The region trades at a Price to Book value of around 1.5x, a level which in the past (1996 and 2002) has marked the start of a powerful bull market. From a price-to-earnings perspective, EM trades at a 35% discount to the US market compared to the 20% median level over the past 25 years.

3) Liquid alternatives – Absolute Return Strategies

We believe that most investors would benefit from an allocation to absolute return strategies, particularly at this stage of the business and market cycles. Despite our constructive outlook for financial markets in coming months, we think that portfolio diversification and hedging against downside risks have become more challenging to achieve over the past few years. Following the global financial crisis, central banks have embarked on a great monetary experiment in order to offset the structural headwinds of deleveraging and slower potential growth rates. As already indicated, one of the main consequences of these policies was to drive interest rates to record low levels, forcing investors to reach for yield and return opportunities across various asset classes. Notwithstanding our base case scenario of a gradual global economic recovery and broadly supportive liquidity conditions, investors are faced with a set of challenges from a portfolio construction perspective:

- Risk diversification for traditional portfolios of equities and bonds: the benefits of adding bonds to equity investments is one of low or even negative correlation with bond prices going up when equity prices go down. This remains a valid point in today’s environment, but more so from the perspective of limiting gains when equity markets are going up. With growth rebounding and the Fed’s ongoing plan to exit its strategy of ultra-low interest rates, higher bond yields (and lower bond prices) are very likely to come together with rising stock prices. But the real question is whether bonds will be able to provide the downside buffer they used to provide when equity markets go down. Bond yields have been trending lower for the past 30 years and unless the US economy falls into a debt deflation spiral similar to Japan in the early 90’s, we see very limited room for bond yields to decline further from current levels, thereby limiting they role as shock absorber in traditional balance portfolios. Despite the counterintuitive decline in bond yields so far this
In our view, the “Great Rotation” away from bonds (after years of record inflows into bond mutual funds and ETFs) will reassert itself in coming months.

- **Diversification within fixed income:** It is well known and accepted that various sectors of the bond markets will exhibit different return patterns based on where we are in the business cycle. However, because of the constant search and reach for yield over the past few years in an environment of depressed interest rates, most fixed income sectors have become more highly correlated. Given the current low level of spreads across the entire spectrum (investment grade corporate, high yield, MBS, EM debt) and very similar levels of yields on a global basis, every bond sector has become much more sensitive to a change in Treasury yields. The unabated decline in average coupons has resulted in an ongoing increase in bonds’ modified duration or sensitivity to a change in interest rates. Granted, some areas such as bank loans or short duration credit are less exposed to this factor, but investors have poured so much money into these sectors that some dose of caution is required.

- **Diversification within equities:** Investing globally will always be a better strategy from a risk-adjusted reward perspective than investing only in domestic equities. That being said, correlation levels are as cyclical as the markets themselves and investors have been able to painfully verify that correlations tend to quickly move higher in time of stress. Hence, international diversification really only works as a return enhancer and risk mitigation factor in rising and/or stable markets.

- **Most investors have accepted the concept that commodities and REITs should be part of their portfolios as their alternative investment exposure.** Here again, we would be cautious in extrapolating the recent past too far out into the future. Commodities may very well provide the type of diversification investors should not be happy with, i.e. going down when everything else is going up. The supply/demand balance and the trend in the US dollar have reached an inflection point and should be seen as structural headwinds for the performance of commodities going forward. If commodity prices become primarily impacted by the ebbs and flows of the global cycle, instead of being underpinned by structural support factors, then they will not be able to provide the portfolio diversification benefits investors are looking for. As far as REITs go, their performance in 2013 (very weak) and so far this year (very strong) underscores their high and growing sensitivity to the trend in bond yields.

Based on these factors, we believe investors should look at other ways to balance the risk in their portfolios and at the same time be able to achieve these diversification benefits without sacrificing too much from a return perspective. As mentioned before, bonds will most likely continue to have a relatively low correlation with equities but this will come at a very hefty price from a return perspective.

Absolute return strategies are therefore likely to play a much bigger role in client portfolios in such an environment, in particular given the ever expanding offering of these strategies in liquid mutual funds with daily NAV pricing and lower investment minimums. Institutional investors and wealthy families have historically invested a large portion of their portfolios in hedge funds, in an effort to enhance risk-adjusted returns. With the introduction of liquid alternatives, these
strategies are now available to non-accredited investors and, as importantly, without having to give up anything from a liquidity perspective.

The absolute return space comprises a number of strategies with very different risk and return attributes, but the overarching factor across these various strategies is the managers’ ability to rely on a set of tools and investment approaches designed to achieve nontraditional (and therefore less correlated) sources of return.

In today’s environment, we recommend an allocation to the following strategies:

- **Absolute return fixed income**: the main benefit from these strategies is the much more active duration risk management and, in some cases, the ability to implement a negative duration through the use of derivatives and hedges.

- **Equity Long/Short**: with markets (in particular the US) reaching new highs and valuations not as attractive anymore, equity long/short managers are better positioned to exploit specific relative value opportunities through their ability to short certain areas of the market and/or leverage others where they see better opportunities.

- **Market neutral**: within this strategy, we are mostly constructive on convertible arbitrage (portfolio of convertible bonds with equity risk and interest risk hedged through stock and credit hedges), equity market neutral (statistical arbitrage and option strategies aimed at neutralizing market risk) and merger arbitrage (buying the target company and selling short the acquiring company). As the name indicates, these strategies tend to capitalize on price difference between similar securities while neutralizing the impact from the market underlying directional trend. These managers are very often long volatility, a strategy which will greatly help portfolios during market pullbacks.

If you have any questions or would like more information, please contact your Webster Private Bank portfolio manager.