Investment Strategy Update

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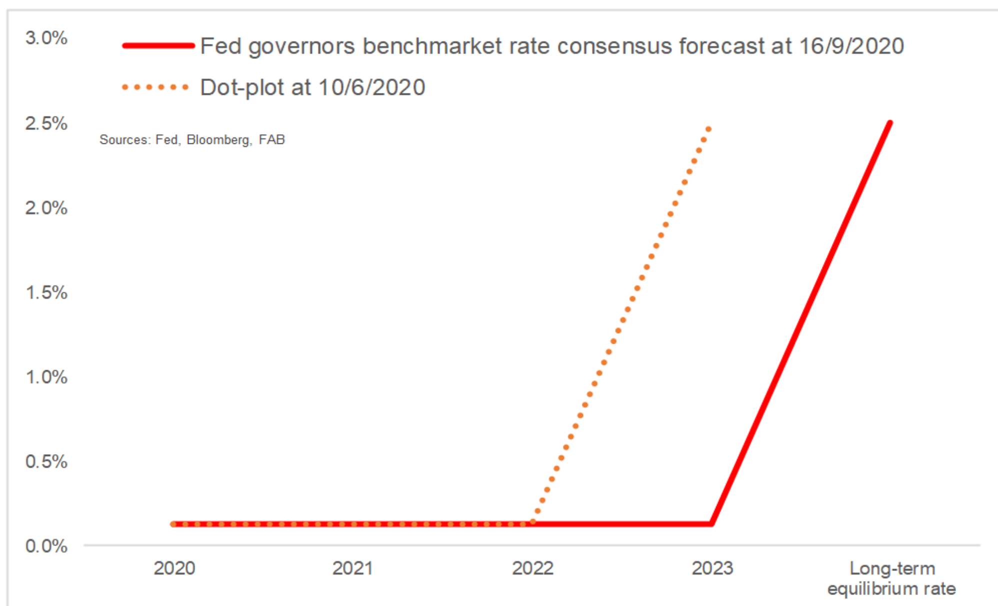
With the Fed meeting in the past, time to rebalance portfolios

- **Federal Reserve has extended for a year its forecast of zero-rates, though the market is indicating it may go even further in the future.**
- **Low rates for a very long time will make higher yielding and high growth assets even more attractive.**
- **For now, however, institutional investors rebalancing portfolios could be a temporary headwind for markets.**
- **Move could prompt some momentum selling too, but the amount of liquidity in the system suggests markets should bounce back in due course.**
- **The FAB AAC favours hard currency emerging market debt and investment-grade corporate bonds.**



One of the tricky parts of running a clear asset allocation strategy is that whenever one asset is doing very well, the portfolio manager has to reduce the exposure to it.

That process probably was partly responsible for the very significant run in stocks in the second quarter and relatively muted performance for bonds, as large institutional investors reduced their exposure to debt (which had rallied strongly in the first quarter) and moved more money into stocks after their huge drop in March. With most equity indices having logged historic rallies over the past six month, funds may be reversing that.

Goldman Sachs analysts predicted in a recent report that some US$200 billion of equity investments could move into other assets as pension funds rebalance in coming weeks, as the MSCI World index has rallied 50% since 23 March.

Most portfolio managers, however, would not even start that rebalancing process until they knew what the Federal Reserve is doing next. Hence, while some of the rebalancing flows may have started in the past two weeks, they are likely to accelerate now that the central bank's meeting is in the rearview mirror.

After two consecutive weeks of negative returns for stocks, a third and more pronounced weekly loss could trigger some stop-loss orders from both hedge funds and some retail investors. It could also start to trigger margin calls for some of the leveraged investments in equities. These dynamics, therefore, could exacerbate the sell-off for a few days.

There is, also, some reason to be slightly cautious about equities, a position the FAB Asset Allocation Committee has held. Some valuation metrics are relatively high, the amount of stock buybacks has dropped significantly, and there has been a record amount of stock issuance.

The consensus forecast among Fed governors is for zero rates until at least 2023

This supply and demand picture alone would normally mean lower equity prices. However, these are not normal times and there is record liquidity in the system, so positive net issuance of stocks should not be enough to undermine the rally.

Such liquidity (and the prospect that it will be around for a long time, suggests that any sell-off in risk assets is likely to be short-lived.

With cheap money stock buybacks are likely to come back soon, as will be margin investing. Once the rebalancing is done and the margin calls are over, investors are likely to continue to chase assets that offer higher yields and higher growth to compensate for zero, or even negative returns in government bonds.

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