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opinion

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Playing defensive: Time to hedge against rising uncertainty

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March marked seven years of the US equity bull market. If the S&P500 index holds up until the end of May, investors will celebrate the second-longest bull market in US history. This begs the inevitable question: is this bull-run getting too long in the tooth? And, if so, how should we hedge against an eventual downturn?

The first question is always difficult to answer with any degree of certainty. This became apparent in the first quarter when US stocks plunged more than 10 percent from the start of the year until mid-February, only to bounce back and recoup the early-year losses by April. The factors behind the early year sell-off – concerns about slowing growth in the US and China, falling commodity prices and worries about a sharp devaluation in the Chinese currency – also led to the subsequent rebound as those concerns eased, helped in no small measure by increasingly accommodative central banks.

However, one should not be lulled into complacency by the recovery in riskier assets – which included a strong rebound in commodities, Emerging Market stocks and higher yielding bonds from oversold levels. In our view, the latest rally masks an increasingly uncertain outlook for global growth and earnings. Given this, we believe the rally offers an opportunity to partially rebalance out of equities into more defensive assets such as bonds and alternative strategies which are less likely to move in tandem with equity markets.

US expansion continues

The US economic expansion since the 2008-09 financial crisis is already the fourth longest in the past century. So, history is not on our side. Economic expansions are typically longer following a major downturn as providers of goods and services cater to pent-up demand. In the current context, the US economy has been recovering from the most prolonged and deepest recession since the Great Depression as demand for housing, automobiles and other consumer durables are met.

Moreover, with borrowing costs near record lows, inflation still subdued and central banks worldwide staying highly accommodative, the US economy continues to generate jobs at a steady pace, keeping the consumer-driven economy humming for a while longer. The recent weakness in the USD and recovery in oil prices also reduce drag on US export and energy sectors.

Meanwhile, China's economy appears to be stabilising – note the nascent recovery in manufacturing and services sector business confidence, strong pick up in the property market as well as exports and the pause in capital outflows. With policymakers in Beijing cranking up fiscal and monetary gears to defend growth – temporarily at the cost of reforms – the economy is likely to avoid a hard landing.

Warning signs
Nevertheless, the warning signs emanate from the US corporate sector. US corporate earnings are forecast to have fallen by 6 percent in Q1 from a year ago. That would make it the third straight quarter of earnings decline. Although energy and materials sectors are largely to blame, there are signs of broad-based weakness in demand – corporate revenues are estimated to have fallen for the fifth straight quarter. For sure, there are tentative signs of stabilisation in full-year earnings expectations after several months of downgrades, but this needs to be watched closely.

Moreover, US wages, which have remained subdued so far, may become a concern over the coming months as the job market tightens. Also, there has been a perceptible downtrend in US auto sales since late last year, taking the shine off a recent pick-up in manufacturing sector business confidence.

Meanwhile, Japan's economy has taken a turn for the worse. The quarterly Tankan survey showed manufacturers were downbeat on the outlook for business conditions and investment spending as the JPY rebounded, making exporters less competitive; annual spring-time wage negotiations for the manufacturing sector were disappointing; there are increasing questions about the Bank of Japan's ability to revive growth and inflation. This in turn raises doubts about the success of Abenomics – Prime Minister Abe's plans to revive the economy through fiscal and monetary stimulus and structural reforms.

Time to be cautious
All these headwinds warrant caution.
Although equities could still deliver positive returns, the uncertainty surrounding these returns has risen significantly, in our opinion. As a result, after years of adding exposure to equities, we believe it's time to adopt a more balanced approach. For a multi-asset investor, the recent rally offers an opportunity to shift the risk profile to a more conservative stance, moving towards bonds and alternative assets. For instance, in our model allocation for a moderately aggressive investor, this has involved reducing our overall equity allocation to 54% from 60% six months ago.

Within fixed income, we have a preference for corporate credit, especially US Investment Grade bonds.

In Asia, we would raise our allocation to regional USD-denominated Investment Grade corporate bonds. We are comfortable with this asset class, as the region's economy remains healthier than other Emerging economies such as Latin America and Eastern Europe, partly due to its lower exposure to commodities, sturdier external balances and stronger domestic demand. That said, there is a risk China's slowdown could lead to deterioration in credit quality. Hence, our preference for Investment Grade bonds in the region.

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