Higher volatility – the risks and potential returns

Strategies in Focus: Multi Asset

As the US Federal Reserve engages in a series of gradual interest rate rises, the tightening of monetary policy by the world's most influential central bank comes at a time when there are a growing number of perceived threats to markets. So while we believe there are still strong supports to risk assets, the path to higher prices in 2016 has the potential to be bumpy.

Pretty much every month brings a fresh set of challenges to test investors. It is the sheer diversity of these challenges and the opportunity set available to multi-asset investors with which to answer them that attracted me to multi-asset investing in the first place. So as we enter 2016, our base case forecast is that a muted but stable demand growth backdrop and accommodative monetary policy from the major central banks are likely to be broadly supportive to risk assets. But this is not a view about which we are in any way complacent.

The counter-thesis step in our process forces us to explore where we might be wrong

A key part of our multi-asset investment process is the counter-thesis. This is an explicit process step that forces us to explore in depth where we might be wrong – at the individual trade level and in the thematic biases reflected in wider portfolios.
One of the risks to portfolios that we have recently debated at length is the likelihood of higher market volatility. Potential catalysts to that higher volatility include a faster than expected slowdown in China. It is clear from the Chinese renminbi devaluation in August that investors globally are increasingly sensitive to the China story. Ultimately, we believe that the Chinese authorities have the tools to boost growth, but we are well aware that the path to structural change is unlikely to be smooth.

Other potential catalysts to higher volatility include heightened geopolitical risks, terrorism, oil price volatility, high duration / low yields in bond indices, and central bank policy divergence.

None of these risks are in any way new for 2016. But the perception of those risks has, until recently, been subdued by the liquidity provided by central bank quantitative easing (QE). Now that the US Federal Reserve has stepped back from QE and is raising rates, it seems rational to conclude that while compelling opportunities still exist, there is at least the potential for higher volatility going forward. That view is supported by the additional negative impact on overall market liquidity from regulatory changes. Capital adequacy directives have forced banks to reduce proprietary trading at the same time as overall daily market volumes have increased. These developments raise the prospect of more frequent spikes in volatility in the future.

Compelling merits of genuinely diversified sources of return and accurate risk budgeting

It is important to remember, however, that volatility creates opportunities as well as presenting risks. As experienced global multi-asset investors, we believe that we have the tools, expertise and investment universe to exploit efficiently any opportunities that may occur. And whether higher volatility arrives or not in 2016, the merits of genuinely diversified sources of return and accurate risk budgeting remain as compelling as ever.

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