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Diversification in a rising interest rate environment

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Steadily rising short-term US interest rates are affecting the properties of traditional asset classes and altering the correlation patterns between them. **Tony Finding**, multi asset fund manager, identifies diversification strategies that can respond effectively to the changing environment.

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For much of the period since the financial crisis, developed market government bonds played a diversifying role in periods of short-term weakness in equity markets. Today, this dynamic could be changing. In February 2018, rising US interest rates meant that Treasuries were a *contributor* to volatility rather than a mitigant.

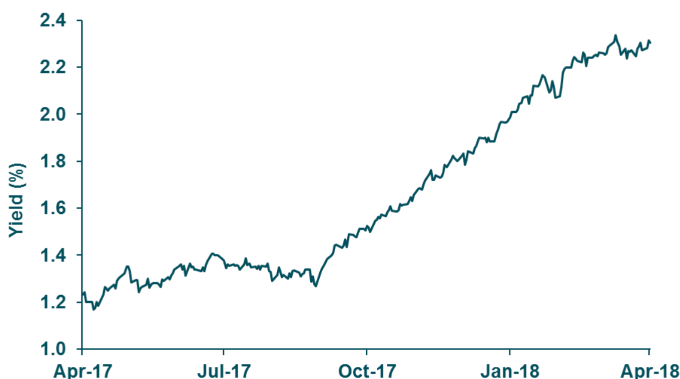
With the era of ultra-low interest rates appearing to be at an end, there is a need for institutional investors to consider how changing correlations within, as well as across, asset classes, may affect investment performance and how to approach this.

Rising US rates: a correlating force?

Short-term interest rates are a building block for the valuation of all assets. They represent a measure of the market's preference for cash today versus cash in the future and serve as a competing asset. Once high returns can be earned on apparently less risky assets, other assets should adjust to continue to provide compensation for adopting additional risk.

In the US, two-year T-Bill yields have been rising sharply since September 2017.

Rising rates in the US: US two-year Treasury yield (%)

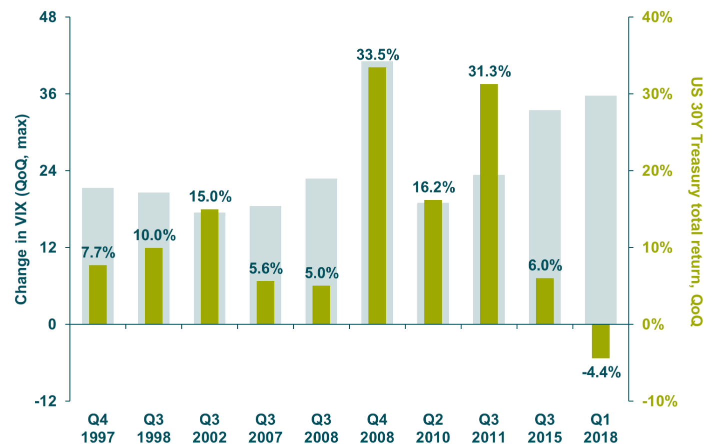


Source: Bloomberg, as at 11 April 2018

Rising rates may not always have a negative impact on other assets. For example, if rates increase because of strong growth, equity markets may respond positively. Alternatively, it may be the case that assets are already attractively valued in their own right and offer a sufficient buffer against modest rate shifts.

However, after such a long period of low rates in the US, it is not surprising that a change in that environment can prompt material volatility and changing correlation patterns. In recent months, US equities and bonds have seen correlated weakness.

Changing insurance properties: VIX Index and 30Y Treasury total returns



Source: Datastream, VIX Index (change in inter-quarterly maximum), as at 31 March 2018

The first quarter of 2018 represented the first time in the past twenty years that a meaningful increase in the VIX volatility index (which measures the extent of short term movements in US equities) was accompanied by declining US government bond prices.

As equity markets fell, Treasuries did not provide the insurance policy to which many have become used since the financial crisis. This shift in interest rate dynamics suggests that such traditional sources of 'safety', such as US or UK government debt and high

grade corporate bonds, may not play the same role as they have in the past.

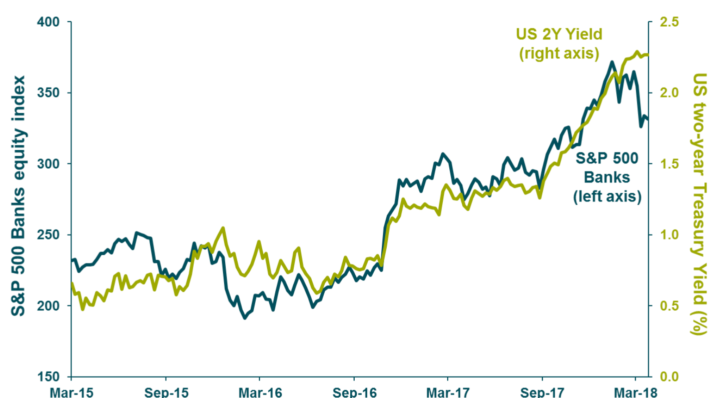
Achieving diversification through new sources: within asset classes

A changing regime for asset correlations may mean that diversification will have to be achieved through less-traditional sources – such as relative value strategies within asset classes, active currency and duration management, and more targeted exposures to non-rate sensitive factors, including within asset classes.

One example would be banking stocks in some developed markets. Banks can traditionally benefit from a steep yield curve due their function of lending over the longer term. However, in the US and Europe, banks also hold significant reserves with their central bank. Higher interest rates increase the returns on these reserves and so selected banking stocks can respond well to rising rates when other areas of the equity market are pressured.

Recent correlation between banking sector equities and two-year Treasury yields can be seen in the chart below.

Bank stocks 'decouple' from US two-year Treasuries



Source: Datastream, S&P 500 Banks (GICS Level 2 Index), as of 6 April 2018

In Europe, banks remain attractively valued as a legacy of the Eurozone crisis and have significant scope to display similar properties to their US counterparts should European policy follow in the footsteps of the US.

While inflationary pressures seem unlikely to pressure interest rates in the short term, the European Central Bank (ECB) is showing increased confidence. In March, it dropped its pledge to extend its €30 billion monthly asset purchase programme beyond September 2018, though ECB president Mario Draghi's balancing act continued a week later by reiterating that interest rates should not rise until mid-2019 at the earliest.

One should not take Draghi's comments entirely at face value, as the ECB has previously shown its willingness to change its response as it feels necessary. If the European economy continues to improve, European banks appear to be a far more attractive hedge against rising rates than euro-denominated bonds.

Achieving diversification through new sources: dynamism across and within asset classes

Another key source of diversification for multi asset investors is tactical adjustment of exposures in response to short-term volatility. We believe that assets can periodically display periods of idiosyncratic volatility (or 'episodes') driven by behavioural, rather than fundamental sources.

These episodes can often set up assets for uncorrelated behaviour as behavioural forces abate and fundamentals once again assert themselves. For investors who are prepared to add capital to such episodic opportunities, there is scope to both enhance returns and add diversification to a portfolio.

An example of this can be found in the behaviour of Mexican Government bonds in 2017. Both the bonds and the Mexican peso appeared attractive following an idiosyncratic episode in and around the US election at the end of 2016. As this episode corrected, not only were attractive returns delivered, but the asset behaved differently to other global bond markets and emerging market currencies.

As investors grapple with the impact of rising rates on other assets, such periods of volatility can be expected across geographies and asset classes, as was the case in the first quarter of 2018. Investment strategies that are in a position to respond to these opportunities could well find new sources of diversification at a time when they are less available from traditional sources.

How long will rising rates continue?

It is impossible to predict whether US interest rates will follow their expected path, or when other developed economies will catch up with the US in their recoveries. Instead, it will be important to pay attention to relative valuations as investor sentiment shifts relative to rate expectations.

Many assets across the world continue to offer a significant buffer against the pressure of rising rates in developed markets. Large parts of the emerging world, for example, have not been beneficiaries of the low rate environment and therefore should be less vulnerable to any reversal. Therefore, while we might expect further volatility to arise across asset classes in response to changing US or European bond yields, this should be a source of opportunity. This is particularly true should rate increases be associated with strong growth. In this instance, medium-term pressure on risk assets – particularly equities – should be more limited.

For now, investor sentiment has shifted away from concerns since the financial crisis around secular stagnation. A new era of rate divergence should create new opportunities, but investors should still tread carefully in search of higher yields, while at the same time avoiding assets that have been the beneficiaries of the low rate environment.

Contact

Grant Hadland
+44 (0)20 3790 2623
grant.hadland@mandg.co.uk

Nick Robert-Nicoud
+44 (0)20 3790 1331
nick.robert-nicoud@mandg.co.uk

Sam Collings
+44 (0)20 7548 3279
sam.collings@mandg.co.uk

www.mandg.co.uk/multiasset
www.mandg.co.uk/equities
inst.eqma@mandg.co.uk

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