Quarterly Investment Outlook

4th Quarter 2020 September 2020

ameliora
WEALTH-MANAGEMENT

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Advisor‘s Commentary

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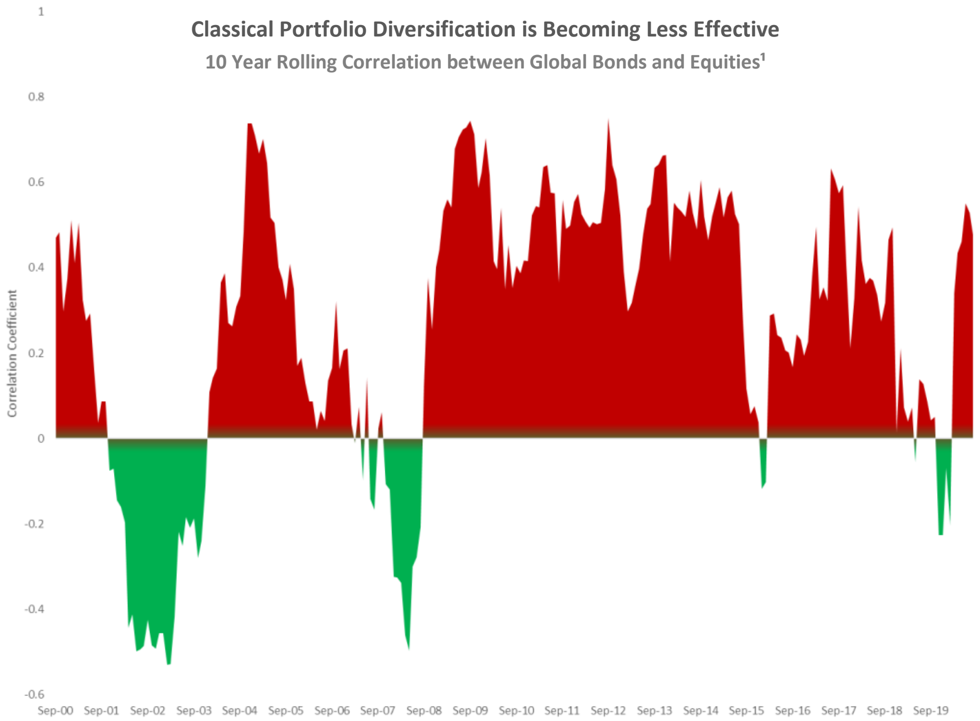
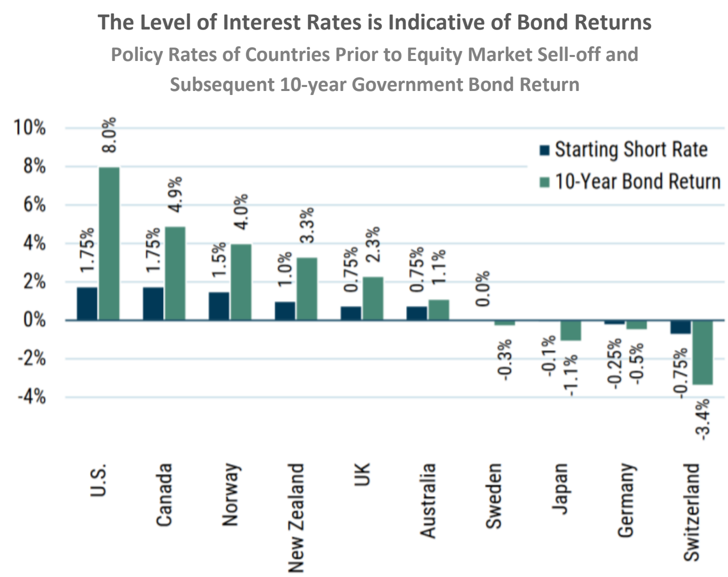
An important condition in well-diversified portfolios is that the correlation properties among portfolio assets is somewhat low. That implies that the price movements between the asset classes are either diverging or not moving meaningfully in the same direction. Conceptually, it would work like this: for an asset experiencing a price decline, another asset displays an offsetting price increase so that the overall portfolio result is neutral. In practice this works slightly different, as the magnitude of offsetting moves are seldom equal and sometimes do not occur simualteanously. However, diversified portfolios containing assets with low correlations have typically reduced both portfolio volatility and drawdowns. *(Please read our June and March 2020, and September and March 2019 investment outlooks, available on our homepage for more on this topic)*. Global bonds, especially, have been a staple asset class in most diversified portfolios due to their beneficial correlation properties to global equities. Historically, bonds effectively mitigated portfolio risk when global equities sold off. As such, the correlation between the two assets classes have at times been highly negative, i.e. a positive property. Bonds’ appealing features have been a mix of high quality credit status, inherent in most government bonds, and dependable fixed income payments. Nevertheless, since the Great Financial Crisis, the correlation between global bonds and equities has stayed remarkably positive (read negative), implying that prices have moved mostly in the same direction and hence provided less diversification than would be expected.



¹ The correlation coefficient measures the degree of direction and magnitude between the two asset classes, bonds and equities. A reading close to +1 indicates similar movements and is deemed as negative from a diversification perspective (red area). A reading close to -1 indicates opposite movement and is deemed as positive (green area).

Source: Bloomberg, LP. Ameliora Wealth Management AG. Indexes: Global Bonds = Bloomberg Barclays Global Aggregate Index, Global Equities = MSCI World Net Total Return USD Index. Period covers 31.08.2000 to 31.08.2020

The challenge investors are facing today is how effective global bonds will be in mitigating future equity market sell-offs. With coupons on bonds at post-war lows and far below equity dividend yields, capital gain is the only property that would offset any price decline in equities. However, for bonds to appreciate sufficiently, the level of interest rates is key and indicative of how much prices could move. Interest rates across the world are currently near or at zero as central banks have cut rates to combat economic weakness. At these levels, any further reduction becomes less effective in pushing up bond prices. Looking at countries that have run either low or negative policy rates, the corresponding return on risk free government bonds was dismal during the equity market sell-off this year and hence, provided little diversification benefit. This is indicative of what one could expect from future bond returns as both policy rates and longer dated interest rates move closer to the zero bound. As such, the potential offsetting return from bonds, should the global economy weaken again, is significantly diluted.



Source: GMO. Short Rate are levels as of 31.01.2020 and bond returns are returns from 19.02.2020 to 23.02.2020

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