Protect and survive

Charles Gave | GaveKal | 11 June 2015 |

Bond yields keep rising, emerging markets are softening and key cyclical stocks have taken a bath. The more I look at the global situation, the more I am convinced that both economies and markets are reaching a point of transition. And as that old sage Yogi Berra said: "When you come to a fork in the road, take it!"

Simply put, the world economy is at a point where one of two discrete outcomes is likely:

- Positive scenario – The US economy recovers and the global economy moves into a "normal cycle", such that the US current account starts to deteriorate providing a demand boost to the rest of the world. In this event, it seems likely that the US dollar has already recorded its high for the cycle, while long-term interest rates have hit their lows (both in the first quarter). Such a scenario justifies a reduced US equities position, in favor of non-US equity markets which should outperform.
- Negative scenario – US growth stalls and the economy slides back into a deflationary bust. As a result, the "omnipotent" Federal Reserve's credibility is shattered, leading to a huge increase in financial market volatility. In this eventuality, the dollar would again soar and long bond rates would collapse.

Determining which scenario is unfolding is not made any easier by the ongoing turmoil in global bond markets. Clearly, it is possible to see the rise in yields as resulting from either the positive or the negative scenario. I recently expressed the view that these ructions contain minimal economic information as they resulted from (leveraged) investors dialing back unrealistic optimism about the European Central Bank's quantitative easing program. Hence, there is nothing particularly sinister in the rout save confirmation that the world's most liquid assets – the US and German bond markets – are, in fact, prone to severe price gapping. Given the suppression of volatility that central banks have presided over, perhaps this episode offers a foretaste of what will happen when equity markets eventually break on the downside (see A Post-Volatility World).

However, the more important question for investors is whether these market movements make the first or the second scenario more likely.

For the first scenario to occur, short rates need to rise and long rates should remain broadly flat. While the picture is not clear cut, it seems that markets are not heading in this direction. Hence, the current bond market rout could just as easily be a manifestation of the volatility threatened by the negative scenario. At this point, regular readers might rightly fire back

that Yours Truly professes to be a rules-based investor, so this is surely a moment to consult those tools for guidance on which fork in the road to take.

The problem is that all of my key indicators in recent months have moved from offering positive signals to flagging an absolutely "average" reading. Moreover, this is the first time I can recall seeing such an alignment. My concern is that the likely dynamic after such a shift will be for the reading to shift from neutral to negative. Hence, my advice is simple: global markets are in a transition phase from an environment driven almost entirely by central banks to something else, which is as yet not clear.

In such a fluid situation, my advice is to own a portfolio which offers the potential for reasonable performance in either eventuality. Such a portfolio may look something like this:

- 20% Cash
- 20% US equities
- 10% Asian equities
- 10% European equities
- 20% US treasury bonds (7-10 year duration)
- 10% Dim Sum bonds
- 10 % UK and Swedish medium term bonds

Such a portfolio positioning is not especially pretty, but it does offer the potential to assess the direction that markets and economies take in the coming months. It seldom pays to be a hero. Should the bad scenario come to pass, I will do fine with this portfolio. Should the good one occur, then I will underperform, but, crucially, I will survive. So go ahead - this is the time to think carefully and take that fork in the road.

Charles Gave is Founding Partner and Chairman of GaveKal Research. GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Ironbark Asset Management.

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