Three regions, three strategies

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Fundamentally, there are three ways to make money in financial markets:

- Momentum trades – ideally, buying high and selling higher.
- Return to the mean trades – ideally, buying low and selling higher.
- Carry trades – borrowing short to lend long.

Most investors have their biases. Growth guys tend to be more momentum-driven. Value guys tend to favor a return to the mean. Younger investors like carry trades. These biases will pay off at different times. As a cycle matures and yield curves flatten, it pays to have a return to the mean mentality and to avoid carry trades. As the cycle bottoms, carry trade guys, including banks, make out like bandits. And, as the cycle turns up again, momentum trades typically deliver higher returns. Of course, a well structured and well-diversified portfolio should encompass all three strategies, across all geographies. Which brings us to the simple question – what should investors buy now, and where?

In North America – Over the last few years, the momentum of the US equity market, and of the US dollar, has been impressive. Lately however, the volatility of both has picked up without generating better returns. This may indicate that US momentum trades have become too one-sided and are getting long in the tooth (see "Does It Still Make Sense to Overweight US Equities?"). Meanwhile, over the past six months, US corporate spreads have been widening, as has the spread between treasuries and other OECD government bonds. So, perhaps transitioning from momentum trades towards return to the mean and carry trades is starting to make sense? At the very least, investors would increase yields and reduce volatility.

In Europe – Although exporters have enjoyed solid momentum, the European story over the last few quarters has been of disappointing growth and flattening yield curves. The question is whether this is set to change? Will European growth accelerate from here? And, if it does, will yield curves steepen again? (If so, we should probably load up on banks which at this point are both carry trades and return to the mean trades.) Or, is the buying power of the ECB too overwhelming for Europe's supply-constrained bond market?

In Asia – after several years of tightening, Asian central banks have clearly started a new easing cycle. This should favor momentum trades. Sure enough, in recent months, India, China and Japan have outperformed.

Putting this all together, it appears today's well-structured portfolio should include interest rate sensitive equities in Asia (to play the unfolding momentum), carry trades in North America (where yields in some sectors are becoming attractive) and value in Europe (where parts of the markets have been left behind by the recent rally).

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