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OUTLOOK

Risk management to take centre stage

Whether we like it or not, markets have now entered a new regime.

Since 2012 markets had enjoyed one of the strongest bullish trends in history – until they started to roll over in the spring of 2015. The catalyst for this regime change was simple: markets had been fuelled by confidence in central banks' ability to return world economies to their pre-crisis shape.

Hot on the heels of the US Federal Reserve quitting its own quantitative easing programme, last year brought the unwelcome news that despite central banks' best efforts, global economic growth was tepid and fragile. Worse, with monetary policy still extraordinarily accommodative, there is next to no ammunition left for central banks to smooth out the next economic downturn when it comes.

The new regime means less supportive trends for asset prices as their main performance engines – growth and central bank support – are sputtering, with more instability since central banks don't have the firepower to dampen volatility.

> "With monetary policy still extraordinarily accommodative, there is next to no ammunition left for central banks to smooth out the next economic downturn"

Passive funds have had their time of glory, while risk management was looked after by central banks. After five years of misery watching assets move to cheaper index trackers, active fund managers can now demonstrate that managing risks brings value.

But that's easier said than done. Risk management can be a powerful marketing concept, but the proof of the pudding is in the eating. The inertia of markets and the vested interest of asset managers to promote an ever-bullish narrative can keep investors' optimism – and therefore comfort with passive indices – unchanged.

When a serious market dislocation happens it is too late to do much. Long-term performance depends enormously on how you weather market storms. In the past 20 years, removing the five worst months of the S&P 500 index doubles the performance from 300 to 600 per cent. The goal for active managers is, over and above stockpicking, sector allocation, portfolio construction and tactical short-term trades to succeed in managing unexpected 'tail' risks.

This is where the concept of risk asymmetry, or convexity – which was partly buried after 2009 and completely since 2012 – needs to be exhumed.

When interest rates are at zero per cent, or in negative territory, the risk they present has lots of convexity. Interestingly, this has nothing to do with probabilities. It is perfectly possible to argue that the most likely scenario is that interest rates remain low for a prolonged period of time.

But the risk is asymmetric in that interest rates going down further would not be a big event, whereas a rise in interest rates could be a major shock, with brutal ramifications. This is because extra-low interest rates represent a stretched rubber-band that transforms any small rise in the absolute level of rates into a giant move in percentage terms.

In spring 2015, slightly better economic numbers from the eurozone propelled the yield on 10-year German bond rates from 0.07 to 1 per cent in less than three weeks, which represented a 9 per cent loss for the holders of supposedly safe German 10-year bunds.

More importantly, many governments and corporates worldwide have accumulated such high levels of debt that they are hostages to low rates. Here there is convexity, since a small rise in rates would just be painful, while any further increase would rapidly make the situation unsustainable.

For instance, China's private debt-to-GDP ratio of 250 per cent means a rise in the cost of debt would rapidly cause a surge in credit defaults. This would in turn hit an already weak financial sector, which would then lead the credit-to-deposit ratio to soar, triggering a credit crisis. Lehman Brothers' bankruptcy in 2008 was a perfect example of a highly convex event.

Many asset prices today have accumulated large convexities. In addition to the bond market risk, the oil price risk is convex because global spare oil production capacity is close to all-time lows. Therefore a small disruption in supply could have a disproportionate impact on the price of the commodity.

Equity market risks also present convexity because their increase of the past six years has fuelled consumption growth through the wealth effect, hence a strong market reversal would be self-reinforcing.

Genuine risk management is coming back to the fore and will be about being lucid on risk asymmetries in advance, so as to be able to act rapidly when the 'wrong' accidents strike.

Didier Saint-Georges is a member of the investment committee at Carmignac

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MONETARY POLICY
US/CHINESE CENTRAL BANKS

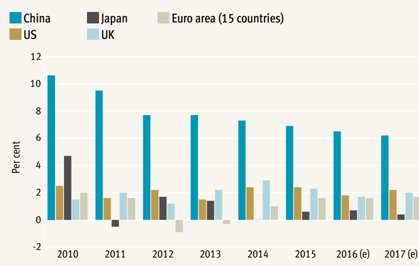
Alex Wolf, emerging market economist at Standard Life Investments, assesses how the diverging monetary policy paths of the Chinese and US central banks have affected capital flows in China:

"Although many factors, including softer domestic growth and capital account liberalisation, have played a role in renminbi volatility, the largest factor in the currency's weakness continues to be policy divergence between the People's Bank of China (PBOC) and the US Federal Reserve.

"The ongoing feedback loop between the Fed's push for policy normalisation and the PBOC's attempt to ease policy and maintain a stable exchange rate have been affecting financial markets and forcing both central banks to be more cognisant of each other's policy intentions. As domestic interest rates have continued to fall in China, and expectations of Fed hikes continue to build, pressure has mounted on the renminbi.

"The policy loop could be described as such: the renminbi moves weaker against the dollar, both because of weakening economic fundamentals but also capital flight. This deepens depreciation expectations, which sparks further capital flight. Capital outflows and reduced PBOC foreign exchange reserves spur global risk-off sentiment and increases US financial stress, which in turn impacts Fed policy. This delicate balance has been playing out since the PBOC started cutting rates in 2014 and has forced an increase in co-operation between officials of both central banks, with reports suggesting that PBOC officials are directly asking Fed officials for the timing of the next interest rate hike."

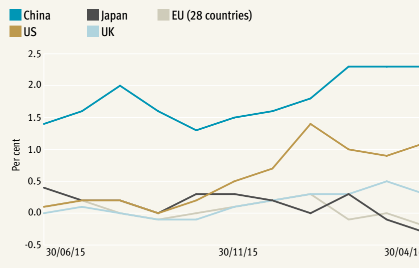
ANNUAL GDP GROWTH



Source: OECD. Data as at June 15 2016

CONSUMER PRICES INFLATION

Increase over the same period in previous year



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