Commentary
Markets

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Low Rates, Persistent Volatility and a Measured Return to Risk

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Any investor hoping for a change from the now-familiar refrain of lower for longer will be dissappointed. And those low rates are clearly affecting factor performance.

Volatility continues to play a key part in everyone's outlook and it looks likely to remain so for some time to come.

We look at what this all means for investors and how they are reacting.

Still Lower, Still for Longer

It bears repeating that we think markets will respond to this crisis as less a reversal of existing trends and more a continuation of the same, and lower for longer interest rates are no exception.

Since the Global Financial Crisis, accommodative monetary policy, both conventional (in the form of lower policy rates) and unconventional (such as asset purchases in Quantitative Easing programs), has driven government rates lower and yield curves flatter.

Major central banks across developed markets are aligned in pursuit of strong policy responses (including rate cuts, QE and liquidity programs) to the COVID19 pandemic.

This collective action, in conjunction with supply and demand shocks stemming from the pandemic, suggests to us that rates are likely to be at or below zero and yield curves flat for the foreseeable future (at the very least going into 2021).

This is not a temporary phase, this is going to be the state of the world for some time now. What does that mean for asset prices?

Low Interest Rates Clearly Affecting Factor Performance

One phenomenon is the really clear effect that low interest rates have had on factor performances. In particular, we have seen the Defensive factors outperform the Cyclical, and Quality outperform Value and Small size.

And, given our view on rates, we expect these trends to continue.

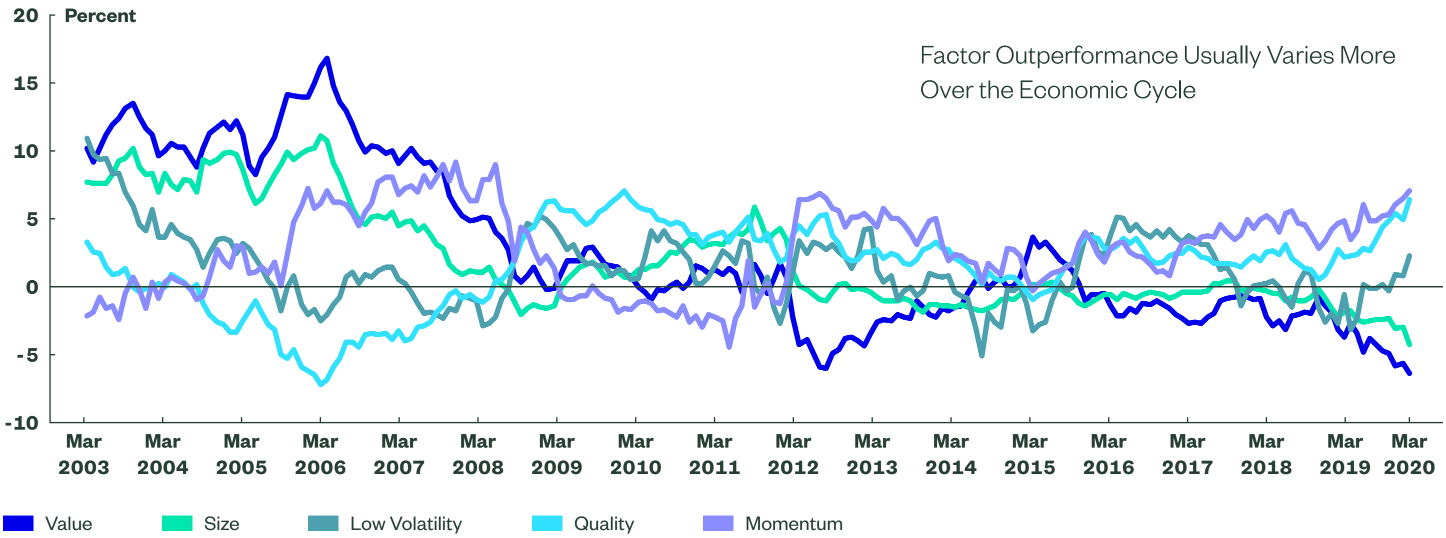
Another way of saying this is that we expect Momentum to persist. We expect the spread of factor relative performances to open wider. The turquoise Quality line should move even further away from the blue Value line. It's worth noting that Value has already shown the longest and worst period of relative performance in our data history.

One factor which we do think will show something of a rebound is Small Size. It's suffering about as much as Value at the moment, but may well benefit from local fiscal measures supporting smaller companies and domestic consumption, as well as deglobalisation and the shift towards more local supply chains.

Low Volatility has had an impressive recent performance and, as we discuss in more detail overleaf, we should see that strong relative performance continue.

Figure 1
Factor Relative Performances to Persist

Rolling 3-Year Factor Returns in Excess of the MSCI World



Source: State Street Global Advisors Long Only Factor Returns 31 December 1996–31 March 2020. Backtested performance is not indicative of the past or future performance of any SSGA offering. The portion of results through 31/12/2018 represents a back-test of the SSGA Single Factor Optimized models shown, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The performance does not reflect management fees, transaction costs, and other fees and expenses a client would have to pay, which reduce returns. Please reference the Backtested Methodology Disclosure for a description of the methodology used as well as an important discussion of the inherent limitations of backtested results. Past index performance is not a guarantee of future results. Index returns do reflect capital gains and losses, income, and the reinvestment of dividends.

Volatility On the Cards

Why will Low Volatility as a factor prosper? Put simply, we believe that we will see an increase in the background level of volatility. Market dynamics over the last 8 years or so, since Draghi's famous "Whatever it takes" utterance have seen participants repeatedly being rewarded for 'buying the dip'. And even though central bank policy could perhaps be characterised as "Whatever it takes++", with rates dropping to zero, or even negative, and debt issuance skyrocketing, we think there's a limit to the further calming capabilities of central bankers. We may even be in for an extended period of higher volatility than we've been used to in the world of Quantitative Easing.

For those old enough to remember, this could look more like 1998–2003, as we rolled from the LTCM/Ruble crisis, through the Dot-Com bust and 9/11 and the corporate crises which followed.

Volatility then, as measured by realised volatility or the VIX index of implied volatility, hovered around the low 20s rather than the low teens we've been used to recently, and Downside Protection in its many forms was a vital component of Portfolio Construction.

As this year still contains a US election — which we feel is much closer to call than the market is pricing in — as well as the slow moving car crash of Brexit, there could well be more, different, volatility to come.

Winner Takes All

If Rates stay low and Momentum continues to prosper, then the "winner takes all" composition of global stock markets will stay in place. In other words, equity indices will remain as concentrated as they are now, if not more so, which clearly poses challenges for active managers.

The level of concentration we are seeing right now for both Developed and Emerging Markets is illustrated below, and is calculated by dividing the effective number of stocks by the actual.

What we see in Developed Markets is that this level of concentration is around that reached at the height of the Dot-Com boom, where we saw global leadership from a small phalanx of large-cap US tech names. In Emerging Markets a similar phenomenon has seen concentration increase to unseen levels, even as the index has ostensibly broadened.

With a lot of these leading names strengthening their positions through the crisis and beyond, we don't see diversification coming any time soon.

Figure 2
"Winner Takes All" = Concentration

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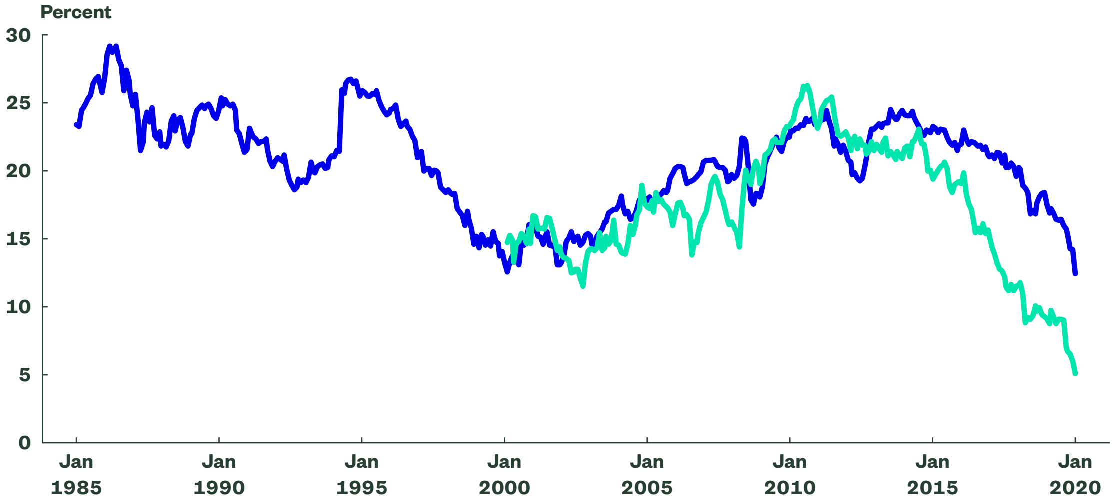
EM



Source: MSCI, FactSet. Data as of 31 March 2020.

How Are Our Clients Reacting?

Our colleagues in State Street Global Markets have a unique proprietary dataset covering a large portion of the world's asset owners.

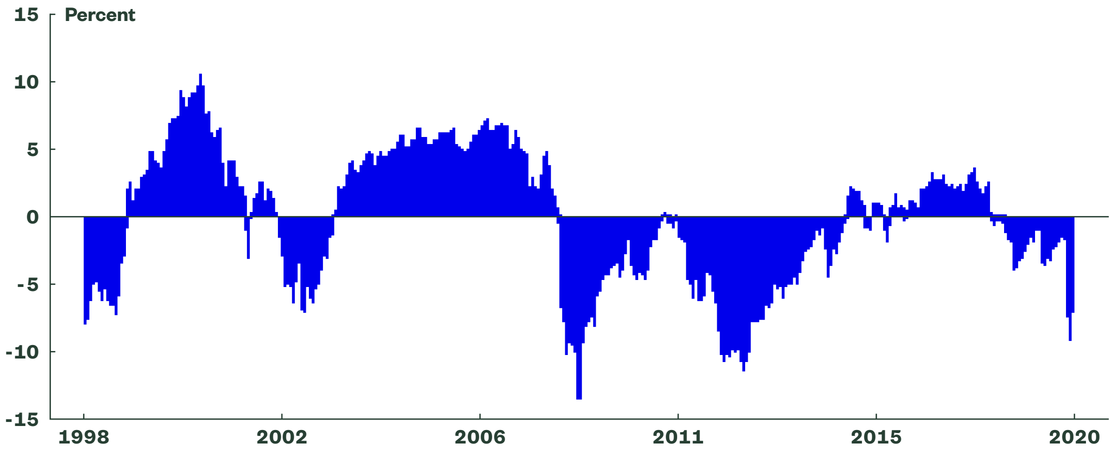
In the graph below we show that customers are underweight equities to a large, but not unprecedented, degree. No doubt this situation was helped by the recent bounce in risk assets and some rebalancing at the end of the quarter. There's still some way to get back to neutral weights however.

Some of that bounce in equities may have come from short covering, but there's still some way to go for levels to come back to where they were before the crisis hit.

In terms of cash holdings, we are seeing that these are holding steady. So, no signs of capitulation, and not the steady increase we saw around the Lehman collapse.

When we look at the aggregate split between risky and low-risk assets that clients hold, a measure we call the Behavioural Risk Scorecard, we're treading a familiar path seen in previous crises — a measured return to risk — clients aren't exactly jumping in with both feet, but some are certainly dipping a toe in the water.

Figure 3
The Equity Gap is Low but Not Unprecedented



Source: State Street Global Markets.

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For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $2.69 trillion* under our care.

* AUM reflects approximately $50.01 billion USD (as of March 31, 2020), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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