Northern Trust | Being Risk On While Taking Risk Off

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Investors find themselves in a difficult spot this week, as recent favorable macroeconomic data prescribes a risk on posture, while in contrast the market's behavior has been distinctly risk off. Although we feel last week's slump was a temporary reset, it may characterize the new normal in terms of equity volatility. This requires very careful portfolio positioning and begs the question, can we build a portfolio that is simultaneously risk on and risk off? Let's take a look.

The S&P 500 reached an all time high on July 26, fueled by anticipation of more accommodative monetary policies and an optimistic view on trade. That all changed in early August, as messaging from Chairman Powell was perceived as garbled and trade disputes escalated. The S&P dropped more than 6%, the 10-year Treasury bond yield plummeted, and the VIX index of implied equity volatility more than doubled. The market clearly got the jitters.

In the midst of this turbulence, we must remember economic releases were relatively benign. Job claims, consumer sentiment, and the PMI all came in near expectations. There was no new information suggestive of an economic slowdown or a sustained market downturn. Still, we have strong reason to believe higher equity volatility is likely.

There are two key indicators of equity volatility to come. First, over the last 30 years, the slope of the yield curve has been highly predictive of future equity risk. Today the 10 year and three month yields are inverted-- at levels which would historically have portended implied equity volatility in the range of 35% to 40%, significantly higher than current levels. Although the inverted yield curve isn't necessarily indicative of a recession, it's a leading indicator of risk, even in the absence of a contraction.

Second, we feel an additional September rate cut has already been priced into the market. This is partially softened the blow of modestly declining EPS assumptions, but it's also unsustainable. Any future weakening of earnings will not be offset by the Fed.

How do we position for this higher risk, recognizing we are still late cycle? Allocating out of equities to bonds is ill-advised, as equities offer a better value than bonds given current yields, and doing so would limit market up capture. In seeking to maximize upside, we should maintain our equity allocations, but cut the downside risk of our equity portfolios through prudently designed, low volatility strategies. In this way, we can be both risk on and risk off.

In the face of low bond yields and high equity risk, investors need to rethink their risk positioning. Being a risk asset with a lower risk profile, low volatility strategies are the perfect equity solution.

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