

Moving To The Beat Of A Different Drum

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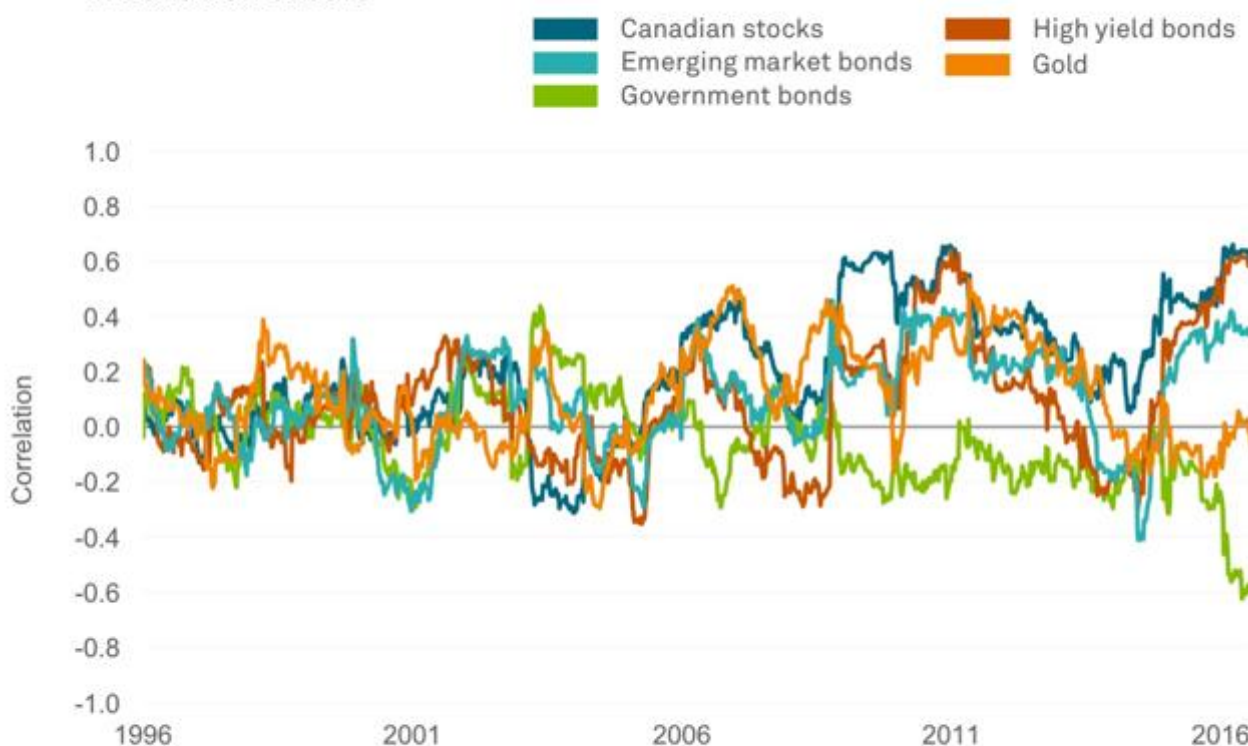
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Correlations between crude oil and other higher risk assets, such as stocks, emerging market assets and high yield bonds, remain elevated. Fortunately, high correlations with oil since earlier this year have meant strong performance for most of these riskier assets. But what happens if another bout of risk aversion grips financial markets and crude prices drop back into the 30s?

Stretched valuations, high levels of uncertainty about the macroeconomic backdrop and tight correlations would seem to warrant a closer look at assets that can help offer true diversification benefits and downside protection in the event of another synchronized decline across a whole spectrum of riskier assets.

Riskier assets still tied to swings in oil prices

52-week correlation between changes in oil prices and selected indexes, in Canadian dollars



Source: BlackRock Investment Institute, Bloomberg and BofA Merrill Lynch, August 2016.

Note: We use the S&P/TSX Composite Index as a proxy for Canadian stocks, the Bloomberg/EFFAS 10+ Canadian Bond Index for government bonds, the BofA Merrill Lynch Emerging Markets Sovereign Bond Index for emerging markets and the BofA Merrill Lynch U.S. High Yield Index for high yield bonds.

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If it looks like a duck and quacks like a duck

Since the 2008-09 global financial crisis, a broad array of risky assets, including commodities, have tended to move in lockstep during times of panic and heightened uncertainty. The fall in oil prices that culminated in big declines for stocks, emerging market assets and high yield bonds at the beginning of this year is the most recent manifestation of this linkage.

When so many assets move down together, like they did in January and early February, many investors are left wondering what happened to the diversification benefits they expected, especially at precisely the time they needed them most.

Many forces have collided to create this somewhat unusual relationship between commodities, emerging market debt, speculative grade bonds and stocks. Expectations of sustained demand growth in emerging markets justified higher oil prices, which in turn supported the debt-financed buildout of additional energy resources. When the dollar suddenly strengthened beginning in 2014 and emerging markets decelerated more quickly than expected, assets tied to industrial commodities output or geared to the global economy turned down together.

10,000 spoons when all you need is a knife

Although recently rising prices for stocks, high-yield bonds, commodities and other riskier assets would suggest otherwise, investors remain skittish over the still unresolved and quite concerning risks facing financial markets, such as the U.S. presidential election, the potentially prolonged post-Brexit renegotiations, Italian bank solvency and a slowing China.

Not only are these uncertainties still with us, they have likely prompted central banks to roll out even more monetary stimulus, which in turn has likely lifted asset prices and given the false impression of a backstop against further sharp declines.

We expect more volatility ahead and wouldn't rule out another risk-off event in the months to come. So, the natural question is: what will help diversify my portfolio if trouble hits the oil patch again? In our view, diversification can take many forms:

- Government bonds continue to exhibit a low correlation to oil prices and commodity cyclicality in general. Although sovereign bonds are expensive at these low yields, they could have a role to play in portfolio construction.

- Gold is another option to consider given its low correlation to other assets. With rates low, some early signs of deflation and central banks in a stimulative mood, gold prices could be a good hedge against financial market stresses.
- Investors may also want to consider limiting or diversifying their exposure to certain macro factors, such as changes in economic activity and oil prices, by pursuing minimum volatility and multifactor strategies.

So while low and negative interest rates across the globe has inspired flows into stocks, emerging market bonds and corporate credit in search of higher yields, keep in mind the high correlations of these assets to oil prices and the advantages of holding actual diversifiers in your portfolio to smooth the ride.

Source: BlackRock Investment Institute, BofA Merrill Lynch and Bloomberg.

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