PRIVATE BANKING INSIGHTS
Market Update

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Yves Cochez
Senior Vice President
Chief Investment Strategist

PORTFOLIO REBALANCING VERSUS MARKET TIMING

The past three months have acted as a powerful reminder that market timing can be a tricky endeavor and one that has to be performed in a very thoughtful and disciplined manner. As readers (I put an 's', as I hope my Dad is not the only one) of this newsletter should know, I am a big believer in tactical asset allocation (TAA) but two important caveats should be made. First TAA should not be confused with market timing and the investment horizon for such decisions should be measured in months, not in days or weeks. Too frequent asset allocation changes lead to increased transaction costs, tax consequences and a non-trivial risk of being wrong. Indeed, successful market timing can only be achieved by being right both on the way out of the markets, but also on the way back in. Human psychology renders this task very difficult as we have a tendency to feel so good about ourselves when we sell just ahead of a correction and struggle to get back into markets once they start to recover as we remain too focused on how amazingly smart we were at the onset of the market pullback. The second caveat is that TAA decisions should not be made in isolation but in connection with a long-term plan and a strategic asset allocation framework tailored to the specific return needs and risk tolerance of each investor. I am not revealing a big secret here but it is worth repeating that defining an efficient and forward-looking strategic asset allocation target is much more important than anything else when it comes to portfolio management. At Webster Bank, we go through this process on a yearly basis in order to make sure that our portfolios are well positioned for the next few years, instead of relying on static and backward-looking benchmarks such as a typical 60/40 mix.

With this in mind, I would like to come back to the recommendation we made in July and also provide an update as to how we are positioned today and our views for financial markets in coming months. I first have to come clean and admit that I am also a human being and subject to emotions too. During our investment committee meeting at the end of July, we decided to reduce our exposure to equity markets, just a few days before the start of the August/September correction. As you can imagine, I am trying to talk about this as often as possible, even with complete strangers who couldn't care less. Did we expect the markets to rally back towards the end of the year? Yes! Did we expect them to rebound in a straight line as early as the beginning of October? Not really... I even took a week off at that time, as I was relatively convinced that nothing major would happen in the first half of October. Does it mean that markets perform better when I am on vacation and I should therefore do so more often? Maybe...

In any case, what we did in July was to rebalance our equity exposure back to levels in line with the strategic asset allocation. Portfolio rebalancing is one the best and easiest ways to implement some level of dynamic asset allocation. It forces one to sell the relative winners and to buy the relative losers. We stopped short of moving to an underweight position as we were looking for a correction within an ongoing bull market. To put things in perspective, US stocks - as measured by the S&P 500 declined 11.2% between August 10 and August 25, rebounded for a while, dived back down and then staged a powerful rally of 12% between 9/28 and 11/3. US stocks are pretty much back to the levels seen before the correction started.

SO WHAT HAS CHANGED IN RECENT WEEKS?

Looking back at the main factors which have acted as triggers for this correction, a few things have changed.

First, the message from Janet Yellen and the Fed has evolved from being borderline depressing to slightly more encouraging. Following the Fed meeting in September and downbeat comments about global growth and dangerously low inflation, investors had become increasingly nervous with equities and other cyclical asset classes. In recent days and weeks however, the Fed has sounded more constructive and seems to be leaning towards a rate hike at their December meeting, a confirmation that they feel more comfortable with the economy's ability to handle slightly tighter monetary conditions.

At the same time, this reversal is unlikely to lead to tighter liquidity conditions globally since other important central banks are contemplating additional monetary policy easing. The most specific sound bite came from the ECB which seems to suggest that more QE is on its way as well as potentially a further cut in the already negative deposit rate for the Euro area. While the Bank of Japan refrained from implementing any new policy measures in October, there is a growing consensus that more QQE is coming - the second "Q" is for Qualitative. Indeed, the BOJ is already purchasing more government securities on a monthly basis than the current pace of net issuance by the Japanese Government. As a result, the BOJ is likely to announce an expansion of their purchases of other assets, such as equity ETFs and J-REITS.

The second factor which sort of precipitated the start of the equity correction was the sudden "devaluation" of the Chinese Yuan. This was overwhelmingly seen as a sign that the economic momentum was rapidly decelerating and a desperate measure to restore Chinese exports' competitiveness. Our view was that this had more to do with the Chinese authorities' goal to have the Yuan included in the IMF special drawing rights currency basket rather than a typical "beggar thy neighbor" measure to boost Chinese exports through a weaker currency. Over the past few weeks, the Yuan has actually appreciated against the USD (~1%) and the PBoC has implemented another rate cut and further reduced the amount of reserves commercial banks need to set aside, thereby freeing up some capacity for loan growth to pick up in coming months.

The bottom line is that we still live in a world of extremely accommodative central banks on a global basis and this is probably why the upcoming Fed liftoff is seen as a positive sign for the US economy rather than the beginning of significantly tighter monetary conditions.

PORTFOLIO POSITIONING

Our equity allocation is still at levels in line with what we consider neutral (i.e. our strategic asset allocation). Our portfolios are however positioned for further gains in cyclical asset classes as we have further increased our exposure to alternative strategies, which should benefit from a continuation of the current equity market rally. Within equities, we are still overweight developed international markets and underweight US and emerging markets. Our view remains that Europe and Japan should continue to benefit from weak currencies, expansionary monetary policies, more attractive valuations and stronger earnings growth. We are contemplating adding some exposure to these markets in coming days/weeks, probably on a currency hedged basis. While US stocks have nearly fully recovered from the most recent correction and trade close to record high levels, international markets have some room to go before they get back to the previous highs (for the EAFE index, another 10% rally would be needed to get there).

We remain underweight fixed income despite our ongoing belief that bond yields are unlikely to move up dramatically going forward. Given the Fed's apparent willingness to hike in December, we believe we will have an opportunity to add to our bond holdings at more attractive yield levels in the next few weeks. Within fixed income, high yield remains an area of relative value. High yield spreads have widened quite a bit during the correction but this was mostly driven by a few sectors such as energy and materials. Broadly speaking, high yield spreads are relatively high compared to where we are in the business cycle and the relative strength of corporate balance sheets. The recent pickup in corporate leverage is a source of concern but should be seen in the current context of extremely low funding costs.

Seasonality will also be a powerful tailwind for equity markets as the 3-month stretch between November and the end of January tends to be the best historically. If you are worried that we are due for a pullback after such a strong performance in October, let me ease your concerns with the following statistic. Looking at the 20 best months of October over the past 60 years (with an average performance of +6.1%), November ended up on average 1.8% and only 6 times was the performance negative for the month. Fundamentals and historical precedents seem to point to further gains before we finally say goodbye to what turned out to be a very interesting year.

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