INVESTOR INSIGHTS

LBC FINANCIAL SERVICES

MACKENZIE Investments

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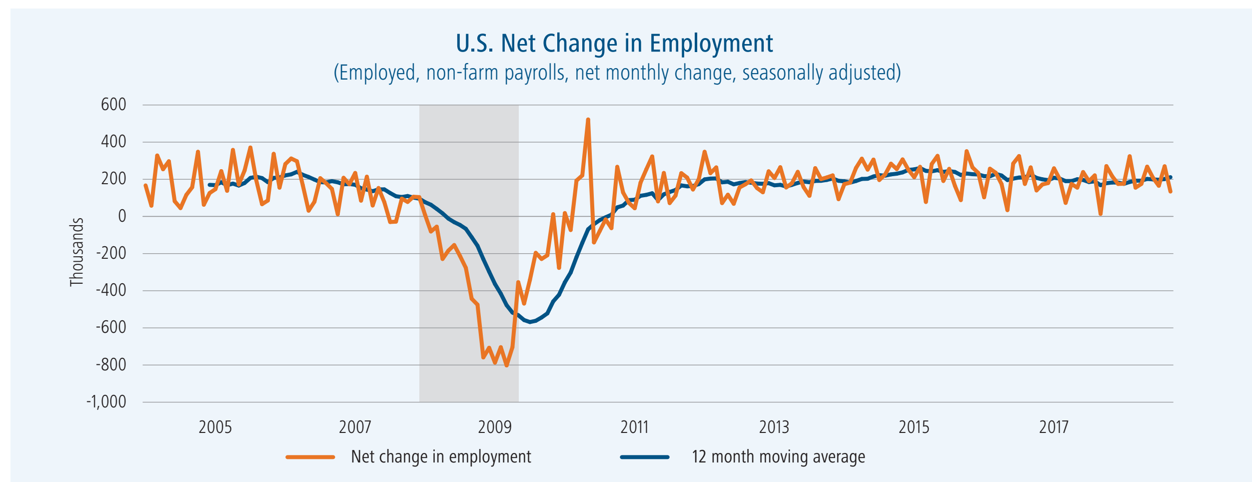
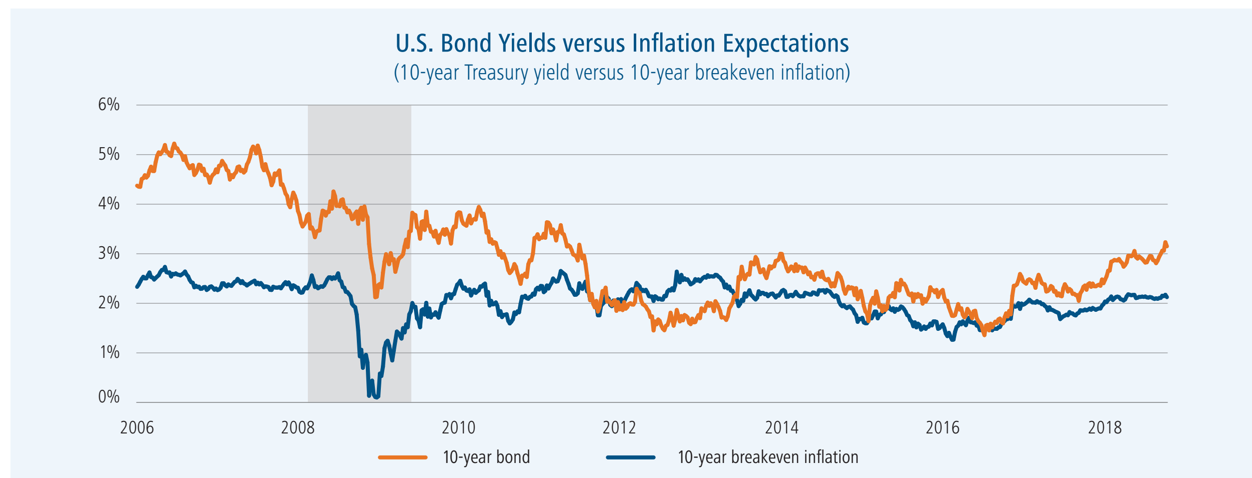
The current volatility we are witnessing in markets reminds us of what was experienced in the first quarter of this year. In February, it was a higher-than-expected wage growth number in the U.S. Employment Situation Report which led to a sharp increase in Treasury bond yields, unleashing higher cross-asset volatility. In a sense, the current situation is relatively similar: Strong upward revisions to the September non-farm payrolls gave us another move toward higher Treasury bond yields.



Source: Mackenzie Investments (BLS data via Datastream). Shaded areas = U.S. Recession.

At first glance, this provides an encouraging picture of the health of the U.S. economy. However, the issue for financial markets lies in the fact that the recent increase in bond yields comes not from higher inflation expectations, but rather from higher *real yields* – i.e., yields *net of* inflation expectations. This reflects both the stronger performance of the U.S. economy, as suggested above, but also the gradually increasing expectations of Federal Reserve interest rate hikes for next year. This is something for which the Multi-Asset Strategies Team has been positioned, with a tactical underweight position in fixed income assets since October 2017.



Source: Mackenzie Investments (data via Bloomberg). Shaded areas = U.S. recession.

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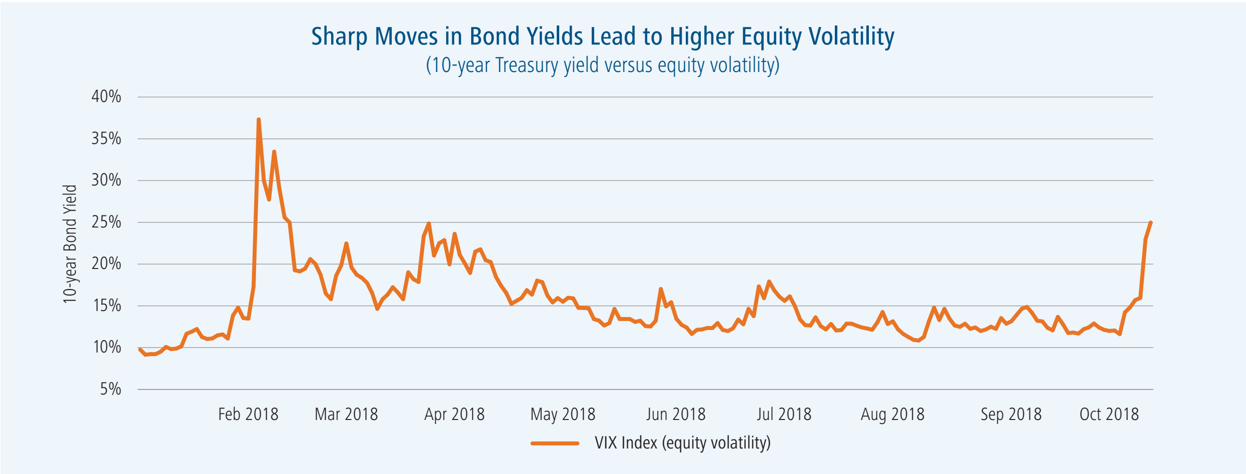
However, this is feeding into the equity markets via higher implied and realized volatility. The current shift in bond yields is akin to a regime change, since several asset classes were priced under the assumption of lower-for-longer interest rates. As markets felt confident that the Fed would move only slowly and gradually and that policy would remain accommodative, valuations on several assets – such as, for example, U.S. technology stocks – reached high levels. This assumption is currently being put to test, as the Fed appears keen to increase interest rates faster than was initially expected. It is therefore not a coincidence that both of this year's equity volatility events took place in February and in October, two periods in which bond yields rose rapidly. Since elevated equity valuations were somewhat dependent on low bond yields, this is having an initial negative impact on the equity markets. Finally, on top of rising bond yields, the resurgence of trade tensions between the U.S. and China did not help sentiment in the equity markets.



Source: Mackenzie Investments (data via Bloomberg).

In the first quarter of 2018, the Multi-Asset Strategies team moved to a neutral tactical position on equities, after having been overweight since the second half of 2016. Our overweight position served us well, but our readings of macro, valuation and sentiment factors affecting equities deteriorated in the first quarter of 2018. For this reason, we moved to a neutral position, which we maintain today. We also maintain our underweight tactical position in bonds, which has been in place since October of last year, as we continue to see poor value and macro drivers for the asset class in the months ahead.

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