Global Matters Weekly

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Embracing Uncertainty

by Lorenzo La Posta

The only certain thing in financial markets is uncertainty. And if you can't avoid it, you'd better embrace it.

Today, uncertainty takes many forms. It revolves around inflation, supply chains, energy prices, interest rates, wages, growth and more. Is the current bout of inflation more than transitory, or will inflation indicators turn down towards the widely used 2% target any time soon? When will disruptions to global trade end? Will labour shortages and raw material supplies come back to normal? Is there such a thing as 'normal' anymore, or are we heading towards a 'new normal'? Is the recent surge in oil and natural gas prices going to hurt economies more or have we seen the worst? Are we going to survive winter without emptying out our wallets? How is all that affecting global growth? How much longer than expected (or hoped) will it take for economies to get back to full speed, given all these problems? How will central banks react to all these conditions? Are interest rates about to be increased rapidly and inexorably?

To this long (and not comprehensive) list of uncertainties, there are many possible answers and even more news headlines, thought pieces and opinions available out there. A lot of that is probably confusing noise. We do worry about all these questions but are conscious that it's important to distil the most significant and impactful information out of all that confusion.

In our scenario modelling and stress-testing, we highlight a few possible scenarios that we may encounter in the coming months and put down some assumptions on what interest rates, earnings growth, equity valuations etc would look like in each of these. Different combinations of inflation and growth dynamics determine very different market conditions and while we have a view on what scenario is more likely than others, we do not put all our eggs in one basket. It's important to account for the tail risks, for those events that are less likely but far more dangerous than others. Currently we see stagflation as the main tail risk: rising inflation and slowing economic growth would be the most damaging scenario for most asset classes. With rising interest rates on top of that, in this low probability scenario we would expect to see equities and government bonds lose ground. However, even in such a grim scenario, opportunities would appear; commodities (and their producers) could do well, regions like the UK and Japan would arguably fare better than the US, floating rate bonds would be well suited and inflation-linked bonds would probably outperform nominal treasuries.

We are outcome-based investors, in that our focus when building portfolios is providing our clients with the most efficient way to achieve their objective. We worry about two things: maximising the probability of achieving the desired outcome and providing a palatable journey towards it. Key to both things is having a diversified portfolio. No matter what economic environment you are in, diversification remains the best way to decrease overall risk (it is the only free lunch after all). We own commodities, floating rate and inflation-linked bonds for the stagflation scenario; emerging market equites, or real estate for a high growth, high inflation world; government bonds for a stagnation scenario, with little growth and decreasing inflation; and developed market equities and convertible bonds for another round of the 'goldilocks' scenario. Alternative assets, such as hedge funds, are useful across most scenarios as their uncorrelated nature means they can generate good returns across all environments, no matter what growth, rates and inflation levels prevail, so we do have a strategic allocation to those across all risk profiles.

Ultimately, we believe that investing is not too different from sailing a boat. To get to your destination, you need a good, solid vessel and a reliable crew sailing it. You need to point in the right direction, but also be able to change course as obstacles come and winds change. The vessel here is the strategic asset allocation, that must be risk-efficient, diversified and tailored to the desired outcome. The crew needs to take care of the tactical asset allocation, which is often a three-step process. Step one: understand what the possibilities and probabilities are. Step two: understand what the consequences of those events would be on the various asset classes. Step three: tilt the portfolio accordingly.

If today the world seems more uncertain than usual, with all that's happened over the past 18 months, we think sticking to a diligent and proven investment process is the best way to manage the risks that lie ahead.

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