Why the ‘risk-on’ rally will not last

By Richard Bernstein

The recent rally in global markets has been led by what most investors are now calling “risk-on” assets. Their counterparts, risk-off assets, have lagged. We question the longevity of this risk-on trade. Indeed, we believe that the secular investment theme remains risk-off.

Investors use the hackneyed term risk-on to refer to assets that have tended to outperform when investors are bullish. Commodities, real estate and emerging markets would be prime examples. Risk-off assets are perceived haven assets such as US Treasuries, German Bunds, the US dollar and even US stocks.

Yet few investors seem to understand the implied economic forecasts of the risk-on/risk-off trades. Our research shows that risk-on assets’ outperformance during the 2000s was directly related to the inflation of the global credit bubble. The most popular investments during the decade were all credit-related investments. When one buys risk-on assets, therefore, one assumes that the deflation of the global credit bubble will subside and that credit will again expand. The implied forecast of a risk-off trade is the exact opposite, ie, that the credit bubble will continue to deflate.

During 2009-10, it was widely thought that the deflating credit bubble was solely a US problem, and that economies in the remainder of the world were still healthy. Consensus at the time was that the US was de-basing the dollar, and the euro would soon be an alternative reserve currency. In 2011, investors fully realised that there were credit problems in Europe too, and talk of the euro becoming a reserve currency ended.

Despite 2011’s dismal emerging markets equity performance, investors continue to believe that the emerging markets are largely immune to the developed world’s credit hangover. But cycles often begin in the US, travel to Europe and then end up in the emerging markets. This cycle will likely follow that historical precedent. The emerging markets’ difficult tugs-of-war between inflation and growth indicate that the emerging markets, rather than decoupling from the developed world, were perhaps the biggest beneficiaries of the global credit bubble.

If risk-on assets are credit-related assets, then it follows they should outperform when credit is expected to expand, and underperform when credit is expected to contract. Accordingly, we expect risk-on assets’ outperformance to be periodic when policymakers attempt to reinflate the global credit bubble. Risk-on assets outperformed subsequent to the Federal Reserve’s attempts to stymie US financial sector consolidation, and they have been outperforming more recently as the European Central Bank made moves to thwart European bank consolidation.

The question is whether policymakers can fully alleviate the effects of a deflating global credit bubble. Longer-term investors should be sceptical.

Bubbles create overcapacity within an economy. For example, towns were formed during the California gold rush in the 1800s as the population of California swelled with hopeful prospectors. These became ghost towns once the gold bubble subsided and people moved elsewhere to find more productive work.

During credit bubbles, overcapacity builds on bank balance sheets. When credit bubbles deflate, bloated bank balance sheets are no longer a productive use of assets, and they inevitably contract. The only uncertainties are the means and the speed of balance sheet contraction. Economic history shows that the faster bubble-produced overcapacity is reduced, the quicker economies rebound. Economists, therefore, generally prefer speed in capacity rationalisation because they want assets to be used more efficiently. Politicians abhor such speed because it often means job losses and weak voter confidence.

The performance see-saw between risk-on and risk-off assets reflects this fight between economic and political realities. When policymakers take actions to attempt to counteract the economic reality that bank balance sheets must contract (as the ECB has recently done), then risk-on assets outperform.

But economic history is also full of stark reminders that bubbles cannot be reinflated despite best attempts of politicians to soften the blows of consolidation and deflation. When these economic realities prove more powerful than policy, the risk-off trade outperforms.

Could the secular investment theme for the 2010s indeed be risk-on? We doubt it. Risk-on assets' performance during the 2000s was propelled by credit. The global economy is now on the downside of a credit bubble, the full effect of which has yet to be felt in places such as emerging markets. The history of financial bubbles and their subsequent deflation seem to favour the secular underperformance of risk-on assets.

Risk-off assets will likely be the secular investment theme of the 2010s. US-based assets (both stocks and bonds) continue as our favourites. In fact, this significant secular shift is already under way. Despite the recent attention-grabbing rally in risk-on assets, the S&P 500 has outperformed Bric equities for more than four years.

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