A year of momentous change

September 2022

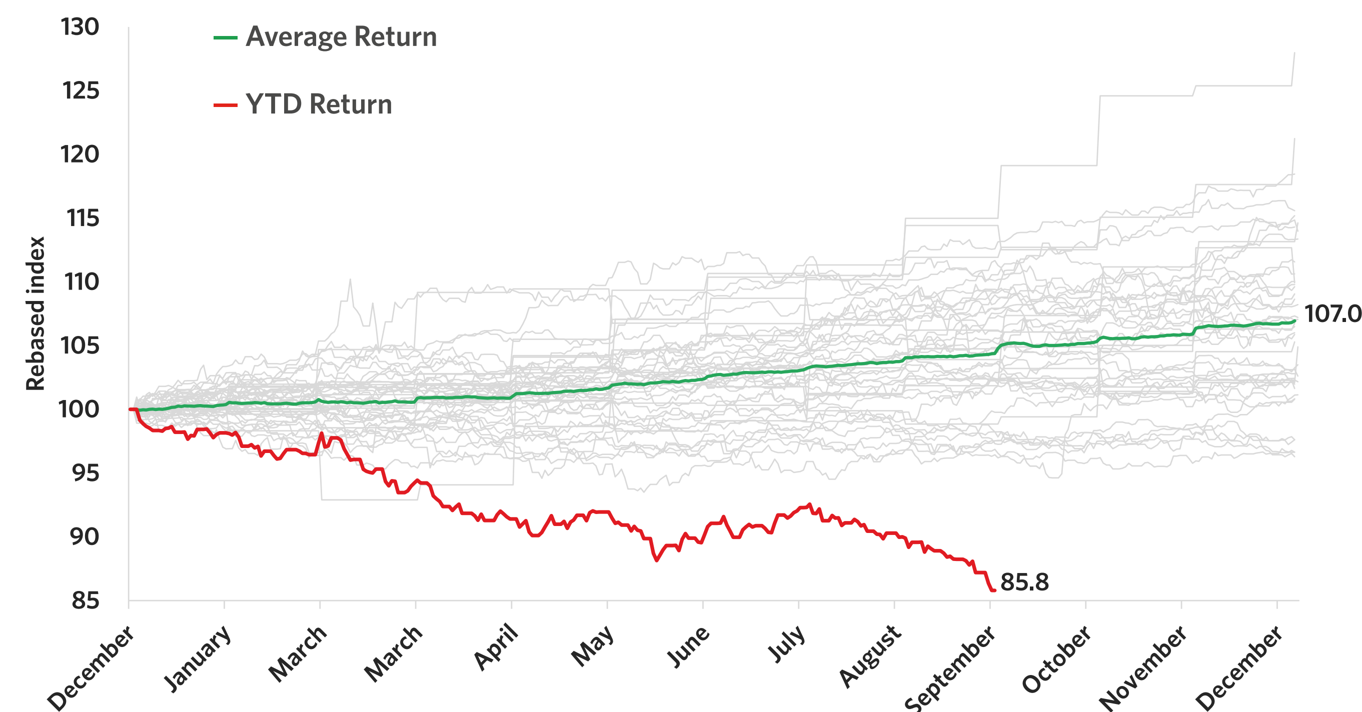
In a year of momentous events the past few days will surely go down as one of the most tumultuous periods. Russia's serious setbacks in Ukraine triggered its first mobilisation of reservists since WWII and heightened the already considerable uncertainty stemming from the war; outcomes now range from the beginning of the end of the Putin regime to a further escalation of hostilities that draws the West directly into the military conflict. But of more immediate impact to markets was the further shift to hawkishness among the developed world's central banks, led by the US Federal Reserve.

Had there been any doubts about the Fed's intent to bring inflation firmly under control, even if that means higher unemployment, a weak housing market and an extended period of below trend growth, they were dispelled by the Federal Open Market Committee meeting on 21 September. The third consecutive rise of 75bps in Fed Funds takes the current monetary cycle to the tightest since the Volcker era, and Powell made it abundantly clear that the Fed will stick to its tightening until the job is done and inflation is heading firmly back to the 2-2.5% target range. The Fed is now expecting the policy rate to reach around 4.5% by the end of 2022, 100bps higher than they were anticipating only 3 months ago, and for the rate to move higher in the first half of 2023, and then stay close to or above 4% until the end of 2024. What was also evident from the Fed's statement was the very considerable uncertainty around medium term expectations, with its forecasts for Fed Funds in 2024 in an exceptionally wide range. The policy tilt is now firmly towards a hard landing and the risk of policy error has increased significantly.

Bond markets reacted with another substantial lurch down, taking yields across most government bonds up by 100bps or more from end July levels, to the highest since before the Global Financial Crisis (GFC). A much higher discount rate combined with the growing risks of a hard landing pushed most equity markets to lows for the year and underpinned a further sharp rise in the dollar.

This caps one of the most extraordinary years ever for bond markets. Figure 1 shows the performance of US Treasuries for each of the past 45 calendar years, including 2022 year-to-date. This year's returns have been by far the worst and have been no better than equity markets, as shown in Figure 2. While bond markets can be expected to fall and yields to rise in the early stages of a monetary tightening cycle it is extremely unusual for safe haven assets to offer no protection whatsoever compared with riskier asset classes. This has undermined the performance of the traditional balanced portfolio, the typical 60/40 equity/bond split, and also raises questions about more broadly diversified global multi-asset portfolios, with diversification seemingly of little benefit when nearly all asset classes have been under pressure.

Figure 1:
YTD Returns vs prior 45 years return path



Source: Momentum Global Investment Management, Bloomberg Finance L.P. US Treasuries shown for 45 years (ICE BoAML Index G0Q0) return to 15 September 2022.

Figure 2:
Global government bonds underperform global equities

Source: Momentum Global Investment Management, Bloomberg Finance L.P., data to 28 September 2022.

Benefits of multi-asset portfolios undiminished

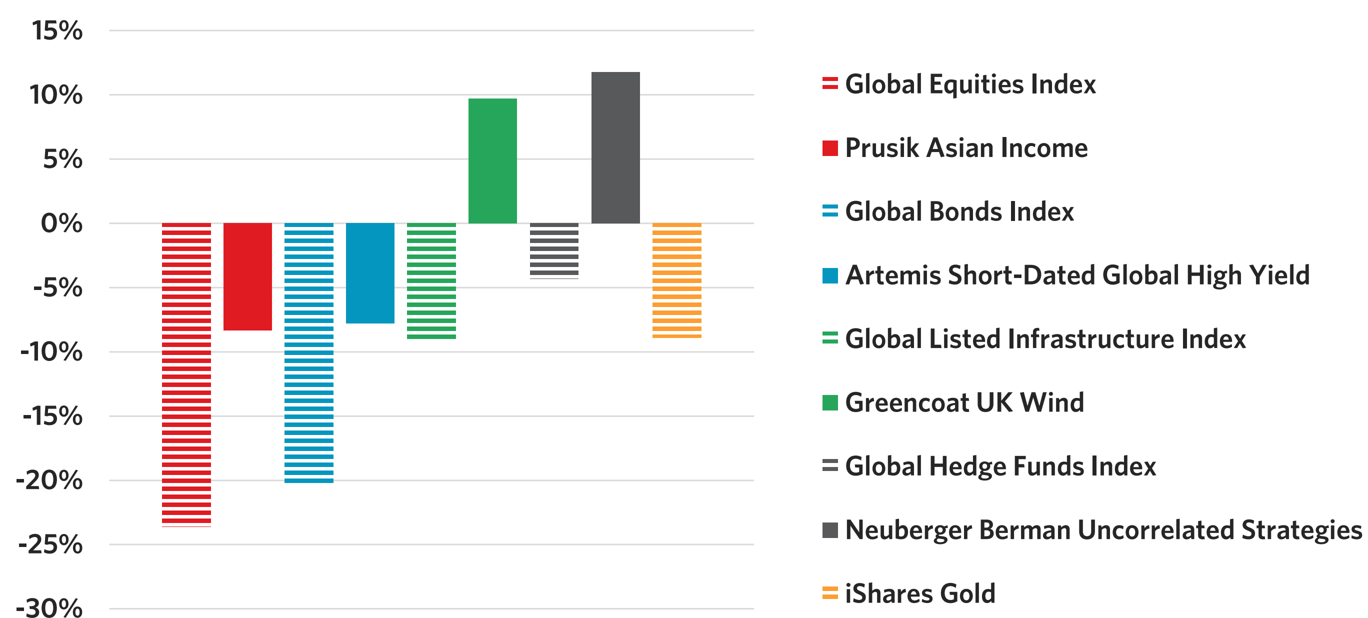
This concern overlooks several factors. First, some asset classes have been resilient; parts of infrastructure and green energy have performed well, as have pockets of real estate where income is linked to inflation. Second, multi-strategy hedge funds, which have offered minimal returns for several years, have been beneficiaries of the trends in markets and have produced meaningful positive returns. Third, not all bond markets have suffered sharp falls; China is the only major country that has been easing policy this year and bond yields have been relatively stable, providing good downside protection. Fourth, several equity markets have held up in local currency terms, notably Japan and the UK, along with some emerging markets, and some style factors have also performed significantly better than market averages, with value stocks adding good diversification benefits at various times through the past year. It remains the case that the broader the diversification is across non-correlated assets the better will be the performance.

Figure 3 shows the benefits this year of diversification across such a wide range of asset classes, strategies and styles. Our multi-asset portfolios benefitted from being invested in parts of the market that have proved more resilient, such as global infrastructure, hedge funds and gold, respectively +15%, +20% and +15% ahead of global equities, measure in base currency. Investing through active managers, that typically run concentrated portfolios with a substantially different performance from their reference markets, has brought additional defensiveness and improved returns. Below, in solid colours, is the performance of some active strategies that are widely held across our various multi-asset portfolios and have significantly outperformed their respective benchmarks, driven mostly by different investment style and successful security selection.

By virtue of not being tied to one single asset class or to a restricted investible universe, multi-asset funds can take advantage of various regional, sectorial, currency, asset, and manager opportunities. Careful asset allocation and portfolio construction are the cornerstones of multi-asset investing and ultimately are the most effective way to maximise the probability of delivering on a certain outcome, whilst providing a palatable journey. Although market volatility is unavoidable and can have brutal effects on short term performance, as has been the case this year, it remains vital to keep focusing on the long-term performance as measured against the risk and return outcomes expected. Figure 4 shows the net performance track records over the past 10 years of two of our US-focused multi-asset portfolios, namely the Harmony US Dollar Balanced and Growth portfolios, that target an average return respectively of 3% and 4% above US Dollar cash. Despite the negative performance this year, both funds remain well aligned with their long-term target outcomes and we believe the next decade should provide a comparable journey to our investors.

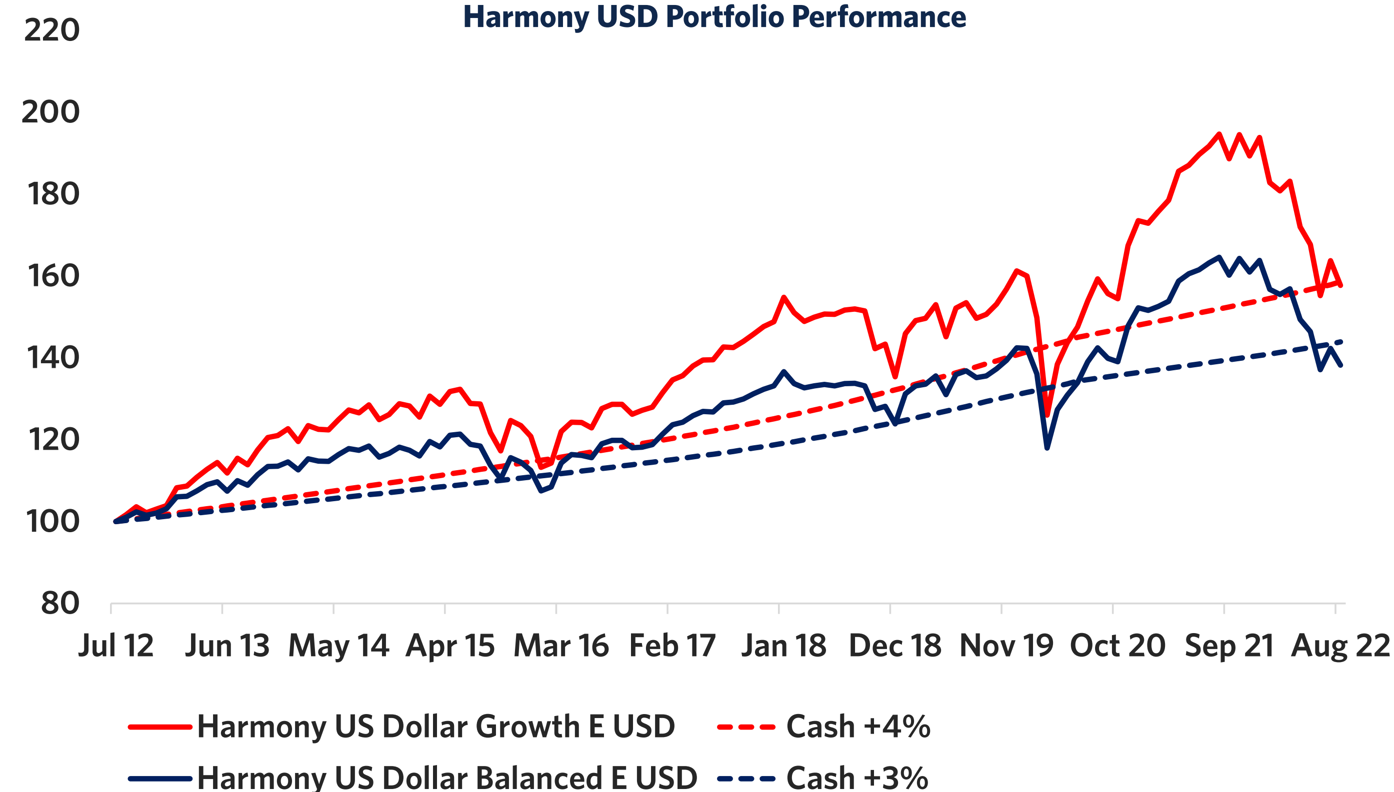
We do not believe that the case for multi-asset global diversification has been diminished by the experience of the past year. The dramatic rise in safe haven government bond yields comes from an historically low base and has undermined all bond markets. The ultra-loose monetary period has been brought to an end, with the exception of in Japan, and is returning bond yields to more normal levels. While yields could well rise further before the cycle turns, there are now some attractive nominal and real yields on offer in many parts of the bond universe, and these provide good diversification benefits which were much reduced or non-existent when yields were structurally low throughout the post-GFC period.

Figure 3:
Performance in 2022



Cumulative returns of various asset classes and strategies, in base currency, from 31/12/2021 to 29/09/2022.

Figure 4:
Harmony USD Portfolio Performance



Source: Momentum Global Investment Management, JP Morgan Bank (Luxembourg) S.A., Bloomberg Finance L.P., Morningstar, Lipper Hindsight. Performance to August 2022.

The $ is king - but not forever

Perhaps the biggest impediment to performance of multi-asset portfolios this year has been the US dollar has surged relentlessly higher against nearly all currencies, reaching its highest levels on a trade weighted basis for over 20 years. Aside from its damaging impact on financial conditions globally, the dollar's strength has offset the diversification benefits for USD based investors of non-US investments in almost any asset class.

However, we are confident that the dollar's inexorable rise of the past two years will in due course come to an end. Timing movements in currency markets over the shorter term is notoriously difficult and risky, and not a strategy we deploy, but on a longer-term purchasing power parity (PPP) basis the dollar is significantly overvalued and has been buoyed by the more aggressive policy tightening of the Fed compared with other central banks. At some stage next year, it is highly likely that the Fed will pause or even cut rates, while other central banks will still be tightening, and the worst of the energy crisis in Europe is likely to be over; this could be a catalyst for a turn in the dollar. We cannot be confident about the timing, but when it arrives the benefits of global diversification for dollar-based investors will return.

Outlook

We are at the stage of the cycle when indiscriminate selling of assets is now taking place, as rates climb sharply, and liquidity is withdrawn by the Fed. There have been few hiding places for investors in this environment. However, as the cycle evolves, inflation peaks and the end of the monetary policy tightening comes into sight, we expect to see a much wider dispersion of returns from asset classes, and a commensurate increase in diversification benefits. Now would be a particularly inappropriate time to be stepping away from these potential benefits.

We are already seeing the foundations for the recovery in markets which lies ahead. Timing, as ever, is highly uncertain and markets are likely to remain under pressure in the shorter term as central banks have further tightening to do, and the uncertainties surrounding the depth and duration of the economic slowdown are intense. But by the end of this year most of the policy rate rises in the US will be behind us, and inflation is likely to have peaked. We have already seen sharp falls in commodity prices in recent months, including the critical natural gas markets in Europe, and there is increasing evidence that supply chain pressures are easing. The end of the ultra-loose policy regime, which resulted in unsustainably low interest rates and government bond yields, is creating considerable pain in markets during the adjustment phase but returns these key markets to more normalised and sustainable levels and is ultimately a welcome development.

This is a cycle triggered by ultra-loose policy and post-pandemic imbalances unleashing strong inflationary forces, inflamed but not caused by Russia's invasion of Ukraine. Central banks have been way behind the curve in addressing the inflation surge but are now in full inflation-fighting mode and will bring it under control in due course. Unlike in the last great inflation surge in the 1970's, inflation expectations have remained well anchored, making the job of central banks to control inflation more manageable, with a commensurately lower risk of inflicting severe damage on economies. There will almost certainly be falls in housing markets across much of the developed world and a rise in unemployment as economies inevitably slowdown, but the household and corporate sectors enter the tougher period in a healthy financial state, and, most importantly, banks have very strong balance sheets and large capital buffers to weather the storm. There will be bumps on the way and some casualties among more highly leveraged parts of the economy, but these are likely to be containable and there are no significant systemic risks in sight.

The further sharp repricing of financial markets in recent weeks, particularly in bonds, is rapidly discounting the increasingly hawkish shift by central banks. Valuations have improved materially. Real yields on longer dated bonds in the US have moved from sharply negative to significantly positive and valuations in equity markets are at levels which discount much of the uncertainty and consequences of the looming slowdown. The extreme over-valuation of many stocks in the growth and quality sectors in particular has now been corrected and it has become possible to buy into these long-term growth opportunities at valuations which seemed unattainable in recent years. For investors prepared to accept shorter term timing risks, the longer-term upside potential is now significant.

Recovery potential ahead

To illustrate the potential, we show below the average performance of a range of our multi-asset portfolios in the "growth" risk profile, those with higher allocation to equities. Performance is shown (in local currency terms) for 12, 18 and 24 months from the market lows reached in the most significant corrections over the past fifteen years, including the Global Financial Crisis in 2008-09, the Eurozone crisis in 2011, the Chinese market turmoil in 2015, the 2018 fall and the 2020 Covid pandemic. On average, our multi-asset growth funds have recovered +26% from the market lows over the next year, +34% over two. The message is clear: the best strategy when times are dire and sentiment is low is to stay invested and rely on globally diversified portfolios to navigate through volatile markets and capture the recovery that inevitably starts when hopes are at their lowest.

Harmony USD Growth Portfolio return from market low

	12 months	18 months	24 months
2009	28%	28%	45%
2011	18%	25%	32%
2015	23%	30%	35%
2018	21%	12%	29%
2020	56%	69%	59%
Average	29%	33%	40%

Source: Momentum Global Investment Management, JP Morgan Bank (Luxembourg) S.A., Bloomberg Finance L.P., Morningstar, Lipper Hindsight. Performance to August 2022.

Harmony USD Balanced Portfolio return from market low

	12 months	18 months	24 months
2009	24%	25%	35%
2011	11%	16%	20%
2015	17%	24%	26%
2018	17%	10%	23%
2020	41%	49%	41%
Average	22%	25%	29%

Source: Momentum Global Investment Management, JP Morgan Bank (Luxembourg) S.A., Bloomberg Finance L.P., Morningstar, Lipper Hindsight. Performance to August 2022.

Harmony USD Growth and Balanced Portfolios 5 years discrete performance

	Harmony USD Growth	Harmony USD Balanced
Aug 21 - 22	-19.0%	-16.0%
Aug 20 - 21	22.2%	15.6%
Aug 19 - 20	6.4%	5.4%
Aug 18 - 19	-1.5%	1.0%
Aug 17 - 18	6.6%	3.5%

Source: Momentum Global Investment Management, JP Morgan Bank (Luxembourg) S.A., Bloomberg Finance L.P., Morningstar, Lipper Hindsight. Performance to August 2022.

The strongest advantage of multi-asset funds is their much larger investible universe and their ability to invest wherever there are hidden opportunities or lower risks, helping to manage the drawdown and capture the upside. Markets invariably offer the best opportunities when fear and uncertainty are at their greatest. The carnage across virtually all financial markets and asset classes so far this year might not yet represent the moment of maximum risk aversion, but it has brought that time much closer. With peak inflation approaching, policy tightening well underway and growth slumping, markets will in due course start to discount the recovery which will surely come. Patience, a longer-term perspective, and sensible diversification are invaluable at times like this, to avoid missing out on the early fruits of that recovery.

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