A Time to Defend not Attack?

As "Short" Traders Make Hay Whilst the Sun Shines?

It is difficult to point to a single event that triggered this move towards safe haven assets causing equity markets and bond yields to fall to their lowest levels of the year. Indeed much of the bad economic and geopolitical news has been in the public domains for weeks if not months! Debt issues in the US and the Euro zone are well documented and so is the inability of our central bankers and politicians to effect any meaningful (and long lasting) solutions! So is the extreme volatility we are now witnessing being caused by short-term traders benefitting from thin volumes whilst long-term investors have one eye on their summer holidays (a common phenomenon in August) or the signs of something more foreboding – a double-dip recession?

Despite agreement in the US to raise their debt ceiling, effectively staving off an imminent credit rating downgrade, markets have failed to reactive positively. As we suggested two weeks ago this was a binary decision – either they passed the plan (as expected assigning it to a non-event in the annuals of history) or they delayed which would have sent severe ripples through credit markets. Of more relevance today, perhaps, is the intervention of the Swiss and Japanese central banks to reign in their soaring currencies in the wake of the European and US credit woes. Both complain that amid signs of a global slowdown the higher values of their currencies are hurting domestic exports. Indeed the relative strengths of the US Dollar, Euro and Sterling against each other remains fairly static, through each has declined dramatically against the world's perceived safer currencies of the Swiss Franc, Australian Dollar and Norwegian Kroner as examples.

All Eyes Are On The US Economy - The summer has not been kind to fundamental investors as across the globe economic data is failing to support the thesis of a sustainable recovery making a double dip recession a possibility. Credit crisis aside, the fractured euro zone has reported that the manufacturing sector has hit a two-year low and more worryingly that its dominant service sector is suffering also. Closer to home the pictures is equally poor with second quarter growth in the UK almost non-existent.

However, it is still the US economy that is setting the tone . We are witnessing signs of stress as consumer sentiment has fallen to lowest level since 2009, retail sales growth subsides, and the unemployment rate is at a year high. It is clear that the economic recovery will be slower and more difficult than predicted. Over indebted nations require growth to pay off debts, but are struggling to maintain even modest levels of growth due to the debt itself–a "Catch 22" situation. Successful implementation of the recent US debt reduction plan is dependent on an average growth rate of 3.25% over the next five years. Estimates of annual GDP growth now lower than 1% for the first half of the year this look alarmingly optimistic. Many believe that further quantitative easing is the only solution to restoring investor confidence in the economy, policy makers and the equity market. If and in what form this takes is yet not clear.

A More Defensive Stance

With high volatility and uncertainty in the market this does not form a fertile ground for high conviction investing given the short term skewed risk/reward ratio we are facing. During such times of exceptional market stress we have historically retreated into a more neutral stance and in the current environment a move towards lower beta (lower market risk) or more defensive investments forms part of the strategy.

Nonetheless the non equity component of portfolios is holding well in this highly volatile environment but the following defensive action has or is being taken.

Higher conviction funds are downsized to reflect the enhanced risk reward scenario and the core defensive funds utilised

The Strategic Flexibility to reduce Equities is utilised

Liquidity based equity investments are paramount as we use the more nimble capability of ETF's (where possible) against the forward pricing of collectives for the timing of any recommitment

Increased Defensive positions through Fixed Interest product or higher cash levels

Longer Term Equity Case Still Valid

Whilst we remain of a conviction that the longer term outlook for the equity case is still valid the dust will need to settle on the economic stresses presently dominating the landscape. Short term traders who we believe influenced the initial downturn have been followed by some more serious technical and fundamental sellers.

With a possibility for QE3 and likely Political and Central bank intervention there is likely to be a few twists and turns in the next 7-10 days. The length and breadth of any relief rally will depend on statements relating to these issues. We remain ready to recommit as it's not over just yet!