New Albany Investment Management

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Market Insight
by Barbara Huff

Falling Asset Correlations Signal New and Friendly Market

The global markets have been disjointed and inconsistent in 2013 compared to the pattern of the previous four years. Since the crash in 2008 thru the end of 2012, most markets and sectors moved in tandem, where stock and bond prices moved up during 'risk-on' periods, and dropped during 'risk-off' periods. Investors were cautious, using primarily defensive sectors like US Large Value stocks (consumer staples), and bonds to find return. But 2013 is looking quite different and perhaps signaling a truly new investing landscape.

This year, relative price movements across asset sectors have been inconsistent. Equities have rallied strongly, but this time small cap stocks, which are considered far riskier, have led the charge. And, High Yield bonds, which have always rallied with equities, have refused to follow, and in fact in some areas, have declined in price. Corporate Bond returns have been flat to negative this year. despite a very muted growth /inflation forecast and expectation the Fed will continue QE well into 2014.

Asset Correlation: The relationship of how one asset class price moves relative to another asset class is called 'correlation'. A high correlation means all asset class prices (equities, bonds, commodities) move in tandem, both up and down. In general, a highly correlated market tends to be more volatile and signals a less confident, more defensive investor. Today, we see just the opposite where both volatility and price correlation have fallen dramatically both across and within the major risk classes. The price movement of US Stocks, Emerging Stocks, Commodities, High Yield Bonds, and Currencies are not only decoupling from each other, but also the leadership within each sector is changing.

Lower correlations suggest the fading concerns of global risks, and a rise of local/national forces. Some of this reduction stems from greater divergences in fiscal policies. For example, the US is tightening fiscal policy this year, while Europe is expected to go softer on austerity and Japan is moving to outright fiscal stimulus. But another part maybe coming from diverging positions, valuations, and issuance across markets, with bonds being arguably over-owned, overvalued, and well-supplied and equities under-owned, undervalued, and undersupplied. These underlying differences are fundamental and are not going away soon. Hence, correlations at the asset class, sector, regional, and security level will likely remain lower than they have been over the past 5 years and bode well for a less volatile broad market.

Investment Implications for Low Correlation:

Low Correlation implies potentially lower volatility and thus allows for a higher risk budget. In other words, if each asset sector is influenced by factors unique to its sector then the portfolio can afford higher exposure in each sector. As investors believe/accept the low correlation concept, more money will flow to riskier assets like stocks, and out of low risk investments like bonds.

Investment Strategy:

Over the last month, portfolios have been repositioned such that total risk is now near the upper band of the risk range established for each portfolio. Risk was added in US Small and Mid cap stocks and Foreign Large Blend stocks. Risk was reduced in US Corporate bonds.

As always, please contact me with any questions or concerns.

Kind Regards,
Barbara