RAYMOND JAMES

Financial markets make progress in July against a difficult backdrop

Jeremy Batstone-Carr, *European Strategist, Raymond James Investment Services*

"Not dead, only resting": The Case for Portfolio Diversification

The investing environment could hardly be more challenging. Global economic activity is slowing, Western developed economies are flirting with recession, inflationary pressures are extremely elevated, and Western central banks remain committed to raising interest rates in a concerted effort to bring them under control. The geopolitical backdrop is still as dark as ever; the war in Ukraine continues, China's bellicose threats against the United States ahead of House speaker, Mrs Nancy Pelosi's visit to Asia have become more pointed. Europe faces a natural gas shortage over the coming winter, Dr Mario Draghi's Italian government has collapsed, while in the UK, the same fate has befallen Mr Boris Johnson's administration. And yet, despite all of this, Western developed financial markets have delivered positive returns. The FTSE 100 has recorded its best month of the year to date, while the more domestically focused FTSE Mid250 Index has delivered its best return since November 2020.

> *"The FTSE100 has recorded its best month of the year to date..."*

Over in the sovereign bond market, prices have risen sharply, and yields have fallen. The benchmark 10-year gilt-edged yield stood at 2.60% at the end of June but has subsequently dropped to just 1.95%, in line with government bonds elsewhere. Financial markets, it should be remembered, inhabit the future, not the present.

Clearly, recent price action confirms that investors are trying to "look through" further near-term economic weakness, persistent inflationary pressures and yet higher interest rates to a more constructive environment beyond.

Strange indeed that we entered 2020 perturbed by, amongst other things, too low bond yields, too tight spreads between risky and core credit and bond markets, sky-high equity valuations and a relentless "value investing never works" refrain. Yet over a tumultuous first half of the year, we saw higher bond yields, wider spreads, cheaper valuations, value outperformance (most notably from the energy and basic materials sectors) and systemic central banks attempting to steamroller everything in their path. Be careful what you wish for!

All the above is etched deep in investor consciousness as we think about the longer-term outlook for diversified portfolio performance. The higher financial asset prices have climbed, the greater the concern regarding future returns from traditional 60/40 portfolios (60% equities, 40% bonds).

Until this year, these perturbations seemed not to matter. Global stocks and bonds rose in harmony, humming away nicely and delivering both positive returns and favourable diversification strategies. Then 2022 came along and diversified 60/40 portfolios lost an aggregate 16.5% (for both European and US investors alike), wiping out all gains accumulated since September 2020.

All this raises an important question: Do such large losses achieved with both stock and bond prices moving in the same direction simultaneously mean that diversified portfolios are fundamentally broken in an era of tighter policy?

One way in which traditional 60/40 portfolios might be broken is that they simply cannot deliver a reasonable return going forward. Contrarily, though, lower stock and bond prices over

the first half of the year have raised, not lowered, anticipated future returns. Is it this realisation that has served to drive July's revival in investor sentiment and deliver such positive returns? Whilst an audible sigh of relief might be in order, all but the most hardened risk-takers are likely to remain wary, especially in the short term. The IMF has lowered its outlook for global economic activity again, the battle against inflation has not yet been won, the European Central Bank has only just started raising regional interest rates as the US Federal Reserve has delivered back-to-back 0.75%-point rate hikes and the Bank of England is pondering an acceleration in the UK base rate to address domestic inflationary pressures which show few signs of diminishing.

Does the above suggest that portfolio diversification is dead? Positive bond–equity correlation has indeed proved a feature of the investing landscape in recent years, assisted in no small measure by the geographically widespread monetary and fiscal policy interventions of 2020 aimed at limiting the economic impact of the Covid pandemic and associated lockdowns. Yet, for all this, one should not confuse direction and magnitude. Bonds continue to represent a useful portfolio diversification tool.

"Mathematically, even if stocks and bonds are now positively correlated, that correlation is still less than 1."

Mathematically, even if stocks and bonds are now positively correlated, that correlation is still less than 1. This means that whilst these two asset classes appear to move together, there are still plenty of days in which they don't. Why this matters is that even a positive correlation can still dampen financial asset and portfolio volatility. What we see now is important slippage in both trailing and present asset volatility. For portfolio construction, that really matters as it should serve to dampen outsized fluctuations. Thus, despite recent travails, the case for diversified portfolios remains intact. The sharp first-half fall in asset prices has served to boost estimated longer-term returns to their highest levels in almost a decade.

"The sharp first-half fall in asset prices has served to boost estimated longer-term returns to their highest levels in almost a decade."

Important notice: This "Marketing Communication" is not an official research report or a product of the Raymond James Research Department. Unless indicated, all views expressed in this document are the views of the author(s). Authors' views may differ from and/or conflict with those of the Raymond James Research Department. The author is not a registered research analyst. There is no assurance the trends mentioned will continue or that the forecasts discussed will be realised. Past performance may not be indicative of future results. Neither Raymond James nor any connected company accepts responsibility for any direct or indirect or on sequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon any information contained in this document. The information in this document does not constitute advice or a recommendation and you should not make any investment decisions on the basis of it. **With investing your capital is at risk.**

Raymond James Investment Services Limited, a wholly owned subsidiary of Raymond James Financial, Inc. (RJF), is a member of the London Stock Exchange and is authorised and regulated by the Financial Conduct Authority. Registered in England and Wales number 3779657. Registered Office Ropemaker Place 25 Ropemaker Street London EC2Y 9LY.
APPROVED FOR CLIENT USE