COLUMBIA THREADNEEDLE INVESTMENTS

It's quiet...too quiet?

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Financial markets in 2017 have been unrattled by events that would normally cause at least short-term volatility. It has been quiet — possibly too quiet?

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There's an illusion of calm in the financial markets, and it's something I've been thinking about a lot recently. I believe that there are big opposing influences at play right now, which may be dampening volatility. On one side is the unusual occurrence of synchronized economic growth. Japan, Europe, emerging economies and the U.S. are all growing at the same time, and even though it's at low levels, there's a real benefit from this synchronization. But on the other side, the U.S. Federal Reserve is increasing short-term interest rates, and there's been an escalation of geopolitical tension and rhetoric. North Korea's regular appearances in news headlines fall into the latter category.

I think these counteracting forces are mitigating each other, resulting in the appearance of low volatility. This can be thought of in terms of sound waves. When a sound wave from one source is met by a sound wave from an opposing source with the same frequency and perfect timing, the resulting pattern appears as a sound wave that is standing still and has no vibration.[1]

While this creates the *perception* of quiet, it's not the same as having *no* vibration. If we relate this to the financial markets, it doesn't mean that things are calm. There's actually a lot going on, and the opposing forces are simply canceling each other out.

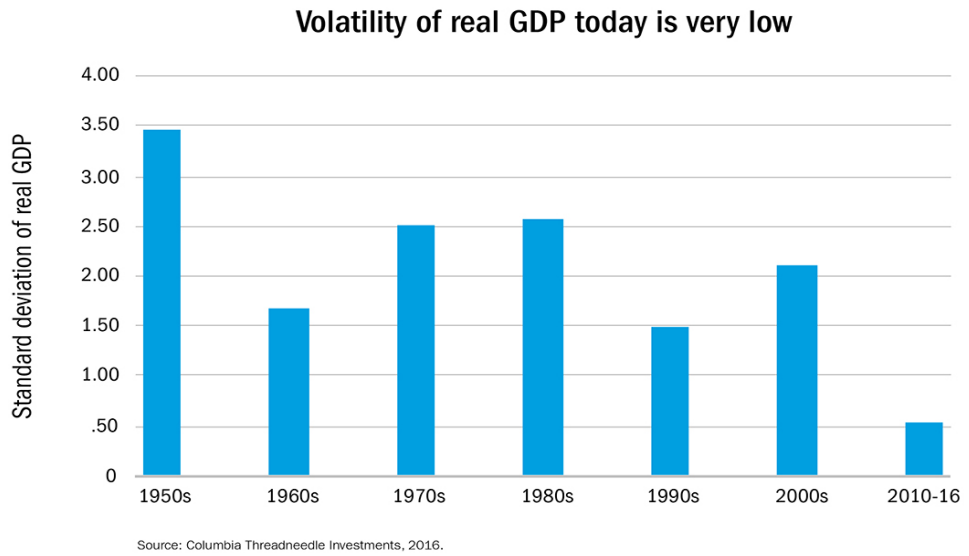
The low volatility and valuation debate: asking the experts

With over 450 investment professionals around the globe, I don't need to debate the low volatility environment alone. I recently asked some of our most experienced investment professionals for their interpretation.

One response brought a smile to my face. Anwiti Bahuguna, senior portfolio manager on the Global Asset Allocation team, reminded me of the problem-solving principle called Occam's razor. This principle is attributed to English Franciscan friar and philosopher William of Ockham and is believed to state, "Among competing hypotheses, the one with the fewest assumptions should be selected." In other words, "Keep it simple, stupid!" And to put it simply: Economic fundamentals and

corporate earnings are good, and there's a lot of money moving through the markets (referred to as liquidity). Hence, performance in most risk assets has been strong in 2017.

Jeff Knight, Global Head of Investment Solutions, reinforced this idea by affirming that low volatility in financial markets makes sense given the low volatility and synchronization of economic data. This chart shows how the volatility of real GDP, a key economic measure, is lower now than any decade since World War II. Investors shouldn't expect a sudden burst of volatility simply because volatility is low today. Unlike extremely high volatility, which has a tendency to expire quickly, low volatility can persist for a very long time.



William Davies, Global Head of Equity, created the following table of opposing influences on investors. He analyzed the complexity in financial markets and simplified it to focus on some of the key factors. This includes the influences of synchronized growth, monetary policy on interest rates and the geopolitical tensions that I mentioned earlier. It also highlights one of the primary concerns investors have, which is that valuations are high.

Bullish forces (+)	Bearish forces (-)
▪ Synchronized economic growth ▪ Good earnings growth ▪ Accommodative monetary policy providing low discount rates ▪ Bull markets are born in fear, grow on skepticisim and die from euphoria	▪ U.S. equity valuations are high (using the Schiller PE ratio) ▪ Demographic trends suggest economic growth could become lower (and therefore corporate earnings may be lower) ▪ Disruption is happening, which can be a threat or an opportunity ▪ Geopolitical tensions ▪ Potential changes in monetary policy ▪ Policy uncertainty

William doesn't think high valuations *alone* will derail equities. However, equities will face headwinds at some point as the supportive monetary environment recedes. In recent years, we've seen numerous risks avoid becoming worst-case scenarios. This

has led investors to be increasingly prone to downplay the adverse outcome of risk, which is typical when the market is doing well. Awareness of and sensitivity to risk becomes even more important as valuations rise.

As William pointed out, valuations are high. But what does that mean for investors? In the table, he mentioned the Schiller PE ratio, also known as the Cyclically Adjusted Price Earnings (CAPE) ratio. In short, the CAPE is higher than average, but this tends to lead to *lower* returns over the next 10 years rather than *prolonged negative* returns. This doesn't mean financial markets can't suffer short-term setbacks.

Melda Mergen, Deputy Global Head of Equities, pointed out that while the S&P 500 Index appears to be making a slow and steady climb, there's still a lot going on within the market. Melda's analysis showed that the list of sectors leading the index is regularly changing, and relatively small clusters of stocks are driving the market average, particularly when the market is doing well. We can observe this behavior but can't be certain of the cause. We suspect the sector rotation is in part driven by flows into and out of passive ETF products as investors react to changing views on what's driving economic growth. The cluster effect may be caused by a similar trend. My theory is that the greater the confidence in broader and stronger economic recovery, the broader the participation of market participants (the rising tide lifts all the boats). But as this broad economic enthusiasm abates, investors' views on which sectors are attractive do change, and they seek out companies with individual growth stories.

The valuation question also relates to fixed income. The following is an excerpt from Colin Lundgren, Global Head of Fixed Income, in response to my inquiry of how he thought the current market would affect fixed-income investors who are stretching into riskier sectors for more yield: "The total return opportunity of high yield has diminished over the last twelve months, and the market is more fully valued. Lack of fear and volatility have lulled investors to demand less yield for the risk they're taking, which has resulted in coupons around 5.5% for the riskiest fixed-income asset class. Put more harshly, the coupon, or income payment, on fixed-income is at or near all-time lows, and I think the asset class will struggle to produce coupon-like returns in the next 12 months. That doesn't sound like a good risk-adjusted opportunity to me…investors shouldn't get lulled to sleep by the apparent peace and quiet."

Bottom line

There is a significant difference between calm caused by no activity and the *appearance* of calm caused by competing influences. The appearance of calm relies on opposing influences being of similar effect, so even a change in the magnitude of one influence relative to the others could significantly increase volatility.

While current valuations are high in a number of asset classes, many of the fundamental influences are quite good. Our research suggests that higher than average valuations lead to lower returns rather than prolonged negative returns.

[1] http://www.physicsclassroom.com/class/waves/Lesson-4/Formation-of-Standing-Waves

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