Every silver cloud has a dark lining

There has been much to confound the financial market punditry so far this year. Of course, there always is. Personal experience has taught this humble pundit that much.

In any case having issued the pundits' caveat emptor, the element of the financial landscape that continues to confound me is the quite different perceptions of the outlook being taken by developed sovereign bond markets on the one hand, and the equity market on the other. The former is sounding the alarm on potential recessionary conditions ahead while the latter are a lot more relaxed about what is to come.

Of course, the simple (and at this stage seemingly accurate) answer is that the decline in yields has ameliorated any nascent equity market concern.

For investors, the environment has been a good one as it continues to be the case (as it has in the 10 years or so since the emergence from the GFC) that one can put together, at a modest cost, an appropriately risk-weighted portfolio comprised of index exposure to bonds and equities and receive quite handsome returns.

That circumstance has in part been responsible for the disproportionate flows into ETFs tied to the performance of large, well-known bond and equity indices and the relative paucity of flows into their actively managed counterparts (with some honourable exceptions).

The question is whether those factors that underlie the simultaneous strong performance of bond and equity markets can continue to be compatible?

I have my doubts.

While markets have this year enjoyed a 'Goldilocks' run, the investing landscape is confronted with a number of uncertainties.

The global growth outlook is at best uncertain, with risks asymmetrically weighted to the downside.

Trade tensions are still simmering despite the relief (simplistic in my view) that greeted the G20 'truce' between the main protagonists in the US and China. There have been a number of such 'truces' in the past that have evaporated in as little time as it takes to construct a few tweet missives.

President Trump casts himself as "Tariff Man" and has already opened up new fronts in the trade war with the EU, Japan and India, and it is not difficult to see a re-escalation of trade tensions with the Chinese.

Moreover, the President has raised the stakes by accusing Europe and China of currency manipulation. The simultaneous launching of a 'currency war' while a 'trade war' is already waging injects a huge amount of uncertainty into global financial markets.

Sustained 'tweet risk' in the currency market may have far-reaching consequences for global bond and equity markets and likely herald a return to higher levels of volatility. Quite why the President might wish to choose a path that ultimately results in a reduction of national purchasing power (and standards of living) by depreciating the currency, when the economy is pretty close to capacity, is something I find difficult to fathom, even for one possessed of such mercurial 'talents' as President Trump. Surely the 'problem' of a high USD simply reflects current US economic outperformance.

Europe is mired in political and economic dysfunction and not just Brexit. The tension between nationalists and 'pan-Europeans' remains elevated. The 'gilet jaunes' make France almost ungovernable; Merkel is in government but not in power; and Venezuelan style economic policy populism reigns in Italy.

Structural challenges abound. These range from climate policy challenges, perceptions of inequality, cyber-attacks, 'oligopolisation', a fissuring of the post-war liberal / social democratic consensus and a rapidly changing geo-political environment (including where the US President fetes traditional foes and spurns traditional friends).

All this occurs when the policy armoury remains dangerously depleted. There is almost no room for manoeuvre on monetary policy or fiscal policy in Europe or Japan, little room on fiscal policy in the US and only a little more on monetary policy. China can engage in some stimulus but faces an increasingly fraught balancing act between cyclical requirements and structural requirements related to a more efficient allocation of capital.

(Incidentally, this policy conundrum has seen the proffering of some unorthodox solutions such as 'modern monetary theory' (MMT). That not even the exponents of MMT can agree on just what it is or that history does not offer up any successful portents is not promising on this front.)

In such an environment, and with bond yields already at or close to historic lows, can bond yield movements continue to ameliorate any nascent equity market concern? And if there is a 'tipping point' where bond yields are incapable of performing that task, and the aforementioned downside risks manifest themselves, I wonder if investors will maintain their current ebullience to the end of 2019.

The forgoing simply underscores the importance of a focus on diversification within portfolios. With equities seemingly 'richly' valued and bond valuation massively distorted by QE, perhaps the time is ripe for investors to seek uncorrelated sources of return within portfolios. This may entail a (perhaps modest) de-weighting of index exposure to both bonds and equities and an increase in absolute return / 'unconstrained' exposures in both the bond and equity space. The former may also be increased at the expense of low yielding cash or TD exposures.

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