



Opportunities and threats in distortions

Major distortions in financial markets are under pressure to correct. AXA's Chief Investment Officer, Mark Dutton, looks at some of the opportunities and risks that recent market distortions have created.

In brief

- Current market distortions present historic opportunities.
- A shift back to equilibrium is likely to produce above average returns in areas currently perceived as too risky, such as equities and corporate bonds.
- The flight to 'safety' has made some assets, such as government bonds, expensive and a move towards equilibrium is likely to produce negative returns.

“Stability is unstable”

Hyman Minsky, US Economist

This insight captures the warning that when unusually calm conditions continue for a long time, distortions are likely to arise, which must ultimately correct.

Between 2003 and 2007, stable and positive conditions set up the distortions which triggered many of the challenges we now face. These included over-optimism, increased speculation and excessive borrowing.

An unspoken corollary to this insight is that instability is also unstable. Right now, powerful forces are at play to bring distorted markets back to a more stable equilibrium. In simple terms, things can't stay out of whack for too long.

The highest risks are often present when investors become complacent, while the best opportunities frequently occur when investors are most risk averse. We now appear to face such opportunities.

Who moved my model?

Sitting behind our long run view of the world is a set of expectations about risk and return. We often model these expectations using a standard Normal Distribution of probabilities. This model assigns very low probabilities to returns which are a long way from the average.

According to some commentators referencing this model, we have just experienced 4 or even 6 standard deviation events – an occurrence that statistically speaking should only take place once every two and a half million years!

In practice, it is unlikely that we have experienced such a rare event. A more plausible explanation is that the model has changed, and our long-term expectations for risk and return have become distorted. The good news is this means the expected returns from forward looking 'models' are likely to be skewed, with a higher probability of positive outcomes.

This tendency to return to more sustainable equilibrium levels is the basis for a 'mean reversion' theory. Like a giant stretched rubber band, recent distortions have created powerful forces that should ultimately cause markets to pull back to more stable states.

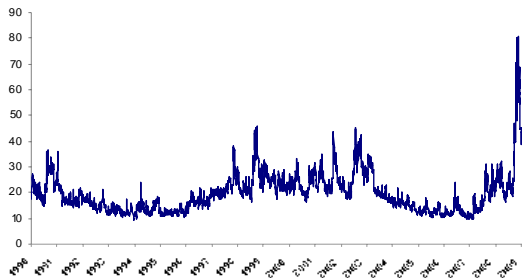
Sharemarket volatility above sustainable levels

The extreme events of 2008 caused markets to distort in all sorts of ways. When some markets, particularly credit markets, almost completely ceased to function during the later part of 2008, sharemarkets around the world experienced historic levels of volatility.



The VIX volatility index – a key indicator of market expectations of near term volatility conveyed by the S&P 500 stock index option prices – is high when it reaches around 30. Values below 20 generally correspond to more ‘normal’ times in the market. As shown in figure 1, in November last year the VIX volatility index rose to 81, its highest level on record.

Figure 1
Volatility Index (VIX)

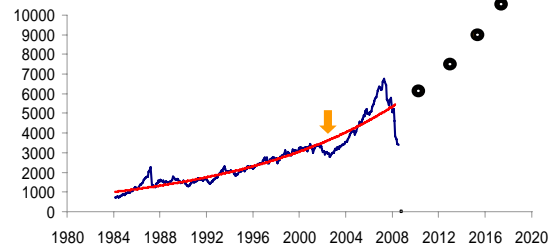


Source: Bloomberg. CBOE SPX Volatility Index.
Data from 2 January 1990 to 19 March 2009.

Investors can derive some comfort from the observation that volatility is also subject to mean reversion. As volatility reverts back to more normal levels, there is scope for prices to rise on risk based assets, such as shares. The good news is that volatility has already fallen from recent highs.

The Australian sharemarket is currently priced lower than its equilibrium growth trend, as shown in figure 2. Reversion to its long-term growth trend provides considerable upside potential. In fact, a full correction would imply a rise of more than 60 per cent on the All Ordinaries Price Index, with dividends adding to further upside returns.

Figure 2
The Australian sharemarket



Source: IBIS, All Ordinaries Index, year ended June.

Distortions in bond markets should revert

While risk aversion is also high in debt markets, the real culprit is the lack of liquidity in non-government bond markets. Large numbers of both willing and forced sellers cannot find buyers with the capacity to take more bonds, even at the highly attractive spreads now available.¹

For those who can invest now, there are potentially dual benefits. Not only are the wide spreads delivering attractive income, but a reversion to more ‘normal’ spread levels could generate capital gains of 25 per cent or more on some investment grade corporate bonds.

Conversely, the flood of money into Government bonds has pushed prices so high, that the resulting yield is unsustainably low. A reversion to the mean for these assets would be bad news for investors holding government bonds, since it would see bond yields rise and the value of existing bonds fall. For example, if it takes a year for the current yield of around 2.6 per cent on the 10 year US government bond to return to a more normal level of 6 per cent, investors would have booked a loss of more than 20 per cent.

¹ Spreads are the common way market participants compare the value of one bond to another. This example refers to investment grade corporate spreads – the difference between yields on corporate bonds and government bonds – which are at unusually high levels.



Opportunities and risks

The current disruption to markets means that powerful forces are at work to drive a return to normality. Recent headwinds will become tailwinds. The opportunities created exist now. But timing this shift back to equilibrium is very difficult. The markets have been dealt a severe blow, and it is not yet clear how policy actions will play out.

Having said this, assets perceived as risky, such as equities and corporate bonds offer the potential for considerable upside when markets shift from distortion to equilibrium. In contrast, assets that are currently seen as safe, such as government bonds, have become expensive and therefore carry risk of low returns going forward.

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