THE THREE QUESTIONS INVESTORS SHOULD ASK IN THE MIDDLE OF A GEOPOLITICAL SHOCK

Originally published on FE TRUSTNET on October 06, 2015 and authored by Gary Jackson, Editor.

Columbia Threadneedle’s global CIO reveals the three questions he asks when deciding how to react to a geopolitical crisis and which risk is concerning him the most right now.

Russia’s growing involvement in the Syrian conflict has raised a new risk for investors to include in their decision-making process, but Columbia Threadneedle’s Colin Moore says there are three questions investors need to ask when weighing up how to respond to a geopolitical event.

Recent years have been marked by a number of geopolitical worries that spilled over and affected markets, with examples including Russia’s annexation of Crimea and intervention in Ukraine, the rise of ISIS in Syria and Iraq, China’s dispute with Japan over the Senkaku Islands and the Greek debt crisis.

Exhibit 1 shows that returns from different parts of the globe have been mixed since the start of 2014 but illustrates that investors have generally been in for a rocky ride, owing to geopolitics, high valuations and worries about the timing of interest rate hikes.

IN THIS ISSUE

- The three questions investors should ask in the middle of a geopolitical shock
- Third-quarter earnings report: Industrial worries
- What are the credit markets telling asset allocators?
A more recent issue to emerge is Russia’s decision to launch airstrikes on Syrian anti-government insurgents, which has led to allegations that the country is supporting Syrian president Bashar al-Assad. Furthermore, Turkey has claimed that Russian jets have entered its airspace while the U.S. has alleged the country is building up its ground forces in the area.

Moore, the global chief investment officer for Columbia Threadneedle Investments, is cognizant that geopolitical events can have a significant effect on markets but points out that they can sometimes be catalysts to buy rather than sell.

He likens geopolitical events to a pebble being dropped in water — the effect is most pronounced at the point of impact but gradually fades as the ripple pushes outwards.

"At the center of an event you tend to get an enormous impact on your market, but unless certain other factors come into play the dissipation rate is very fast — the ripple just fades away with time and distance," he said.

An example of this would be the recent Greek debt crisis, he adds. The Greek stock market fell the most because of the crisis, with indices in southern Europe, the wider eurozone, the UK and the U.S.
dropping by smaller magnitudes.

The decision on whether to pull money out of the market, hopefully before other investors, or invest during a geopolitical crisis depends on if the event’s ripple is likely to build on itself to create a "tsunami" or fade away quickly, he adds.

Moore says there are three questions investors need to ask themselves in the midst of geopolitical event. An answer of "yes" to any one means that there is a strong potential for things to get worse rather than better in the short term.

Is a superpower involved?

"The first is the involvement of a superpower or a country that could be a superpower and has the ability to project that power. They can take a local issue and make it a global one," the CIO said.

"Russia is one of the countries we think is looking to return to being a superpower — it’s a "superpower wannabe" — and it is the creation or dilution of superpower that tends to lead to periods of instability."

Moore was speaking before launched airstrikes in Syria, but he highlighted Russia’s seeming aspirations to regain superpower status as the geopolitical risk that concerns him the most.
In order to be regarded as a superpower, a nation has to be able to project its power across the globe and the most conventional means of doing this is through building a strong navy. Moore argues that this was part of the reason behind Russia’s move to annex Crimea.

“One of the reasons they were interested in Crimea is because it’s one of the few warm water ports they have open to them; if you want to project your power, you need to able to operate your navy at all times,” he said.

“The assertion of being macho and strong leads to the potential for very risky behaviour that could take the market by surprise. And because it is coming from a superpower wannabe, it has the power to escalate. Anything that involves Russia is my biggest fear.”

**Is the global oil supply involved?**

Moore continued, "The second is a threat to the world oil supply; not so much gas, as gas is a regional commodity. Russia supplies western Europe with gas, so it makes it a super-regional thing, but it’s not really a global thing."

He pointed out that while the humanitarian cost of the instability in Libya has been "terrible," the market has shown little concern as the country is responsible for less than 2% of global oil supply.
GLOBAL PERSPECTIVES

However, when instability is seen in the Middle East — which produces far more of the world’s oil — the market impact is much more apparent. Of course, this is a risk that is heightened by the presence of a potential superpower in the Syrian conflict.

"You take that potential for instability to an area that is responsible for closer to 20% of the world’s oil supply and everybody can get really worried about it," he warned.

Exhibit 3

Is there a threat to the global banking system?

"The third one is a threat to the global banking system," Moore said. "That's relatively new so there's less research to prove that a threat to the banking system makes geopolitical events more impactful, but it's at least intuitive that this would be a way to make a crisis global."

In the run-up to the global financial crisis of 2008/09, the end result of mass defaults in the U.S. subprime mortgage market was the collapse or near-collapse of several major banks, a spike in public debt in many countries and a global recession which is still being dealt with today.

(continued next page)
"A bad mortgage situation in the U.S. causes a crisis in Iceland and then a European bank has to take a massive charge. Banking is a transmission mechanism; so is a navy, and if you think about oil, it's what we all use to move around and it's shipped across the world," the CIO said.

Moore concluded, "When I look at a crisis and ask if I'm going to sell or buy, I want to know if it's going to build on itself or if it's going to dissipate."

"The initial reaction of people is always panic so the second thing they should be thinking is, Shall I take advantage of that or should I try to get ahead of it? The three tests are: Is there a superpower involved?, Is oil involved?, and Is there a threat to the banking system? If not, then I know it's an opportunity."

Gary Jackson was recently a guest of Columbia Threadneedle on a media trip to the United States.
Global Perspectives

Third-Quarter Earnings Report: Industrial Worries

- Lower energy prices are not a noticeable tailwind for industrial companies close to contraction in the North American energy sector.
- It is hard to picture enough good news this quarter to cause a significant change in sentiment for stocks in the industrial sector.
- The rest of this year may be tough in industrials, and 2016 may not be that great either, but I think we can avoid more dire scenarios.

Corporate reporting season started in earnest this week, and with it all the analysis of results, parsing of management commentary, and triangulation across industries in order to refine our expectations for future results of companies and industries. Some of the most acute questions are in the industrial sector: Are we having a recession within industrials, or is the downturn in energy just casting a longer and darker shadow than we first thought?

This is not to say there is nothing going on in the other sectors. Many tech companies need to show progress in growth initiatives, migrating their products to “the cloud” and other key milestones. But that is more normal course for reporting season. The biotech indices sold off 20% in the last couple months, but that’s more about reimbursement jitters than quarterly results or even hitting milestones. Market volatility in August and September combined with expected credit losses in energy provided a minor stress test for the financial sector, but early reports aren’t showing too much damage concentrated in any one firm. Also, keep in mind that many are interested in getting more color from global consumer companies on sales in China and other EM regions. And of course, the energy sector is still working through its woes, but that has been and will remain an ongoing story.

So industrials are by no means the only interesting sector. But a recent comment by the CEO of Fastenal, an industrial distributor, certainly gets one’s attention: "The industrial environment is in a recession. I don't care what anybody says because nobody knows that market better than we do... [since] we touch 250,000 active customers a month… Right now, in the third quarter, 44 of our top 100 customers are down." -Dan Florness, CEO of Fastenal (Fastenal Investor Conference Call, October 13, 2015)

The three putative causes for this weakness are the decline in the energy and commodity sectors, a strengthening dollar and economic deceleration in China. Basic materials excluding energy encompass a broad variety of things from copper to corn, each with their own cycles and fundamentals. Broadly speaking though, basic materials started showing weakness in 2011. Orders for mining equipment followed soon after. But the energy decline is more recent, starting with the steep drop in prices last November, which was followed directly by decreases in spending by companies in that sector.
Many U.S.-domiciled industrial companies produce and sell all over the world, but a strong dollar does tend to hurt competitive position. China is a manufacturing powerhouse, but still imports various machinery and equipment. Also, many U.S. companies have joint ventures there that produce for domestic and other markets. So deceleration in China is transmitted readily to the results of many industrial companies. But none of these issues are new or new this quarter, so why the attention and worry? It’s a variety of things, but energy is probably foremost.

The shale oil boom drove spending and activity well beyond the confines of the energy sector. Industrial distributors saw increased sale of general tools and supplies, and pump and valve makers saw a rising tide, just to give a couple examples. Any time a major sector like energy (or housing) experiences a pronounced contraction, there is collateral damage in related sectors and even the broader economy. Unfortunately, that process may not be over in terms of the spillover effects of lower energy prices and the ensuing cuts to production. And while lower energy prices are a positive for businesses and consumers, that benefit is muted, diverse and not a noticeable tailwind for those industrial companies so close to contraction in the North American energy sector.

With business conditions tough in major swaths of the industrial sector, does that mean 2014 was a peak for industrials? 2014 certainly didn’t feel that frothy. Perhaps a de-leveraging economic recovery is bound to yield “don’t-blink-you’ll-miss-it” peaks. Despite references to “the” cycle, industrials run on a variety of cycles that are inherently different, even if they do exhibit some degree of correlation. Energy and other commodity industries, aerospace and consumer-driven industries like autos rarely move in lock-step. The good news is that the recession-like feel in industrials is probably the result of
a few significant negatives- energy, China slowing, and a strong dollar- all lining up at once, but with a relative scarcity of really strong positives.

So what are analysts and investors watching for this reporting period? Management teams will tell us how sales and orders trended through the quarter. Also, some companies are on a September fiscal year end so they will give guidance for the year to come. While there may be some bright spots, it is hard to picture enough good news to cause a significant change in sentiment for the stocks in the industrial sector. It will also be interesting to see how stocks react to bad news. The stock market is, after all, a forward-looking mechanism so the stocks should bottom before the results do. But to feel good about investing before the results reach a bottom, I think one of two things needs to happen. Either you need to have some sense that the bottom isn’t too far away or you need enough confidence in “normal” results that you don’t really care about the path to get there.

A silver lining to the tepid recovery following the great recession was that the slow pace of growth and cautious investment in people, machines and structures seemed to leave the economy free of any excesses. When economic jitters would creep in, it was hard to find any “overhang.” And while the pace and extent of investment in the NA energy sector leading up to 2014 looks more like overhang in today's environment, it is harder to say there has been general over-investment in capital goods. So the rest of this year may be tough in industrials, and 2016 may not be that great either. But I think we can avoid more dire scenarios.
WHAT ARE THE CREDIT MARKETS TELLING ASSET ALLOCATORS?

- Credit spreads can contain important information about investors’ expectations regarding risks to corporate solvency, and the economic cycle more generally.
- Rising credit spreads can also reveal strains in the financial system that are only later reflected in equity market valuations.
- We explain what the signals in the recent selloff tell investors and what we are doing with this information in portfolio construction decisions.

Credit spreads – the additional yield promised to investors over and above the yield offered by similar maturity government bonds – can contain important information about investors’ expectations regarding risks to corporate solvency, and the economic cycle more generally. Rising credit spreads can also reveal strains in the financial system that are only later reflected in equity market valuations. As such, it is worth asking what the substantial rise in investment grade and high-yield credit spreads over the past 18 months (Exhibits 1 & 2) means for investors.

Credit spreads compensate investors for a combination of underlying corporate credit risk and illiquidity risk. We have written before about a technique that is used by our investment team and the Bank of England to split credit spreads into these two components. Our analysis suggests that there has been neither an increase in theoretical liquidity risk premia embedded in credit spreads, nor an increase in empirical measures of illiquidity over the past 18 months. As such it would seem by process of elimination that the increase in credit spreads really is about an increase in perceived credit risk.

The increase in credit spreads has come at a time when many energy companies have experienced a very marked deterioration in their prospects. Energy is an important part of the U.S. high-yield market, accounting for around 16% of the face value of the market. Exhibit 3 compares the distribution of spreads for U.S. high-yield non-energy company bonds at the end of July 2014 when the oil price stood at $98 a barrel and September 2015 by which time the oil price had fallen to c$45. We can see that substantial distress has been priced into energy company debt when we repeat the exercise for energy companies, the results of which are shown in Exhibit 4. This shows that we have moved from a situation where virtually no U.S. energy company bonds traded with an option-adjusted spread above 1,500 basis points (bps) to one in which more than 15% of energy company bonds (by face value) traded with this risk premium.
Exhibits 1 & 2: Investment grade & high-yield option-adjusted spreads over last three years

![Diagrams of investment grade and high-yield spreads](source)

Source: BoAML and Bloomberg, as of September 30, 2015.

Importantly, the center of gravity for both energy and non-energy high-yield bonds has also shifted higher over the period, reflecting the fact that almost every sector of the market has been repriced (downwards). And interestingly, we find that the European high-yield market has also been largely repriced despite its much lower exposure to energy (Exhibit 2). It appears to be a victim of contagion in credit markets, and while we expect the default rate to spike higher in the U.S. market, we are looking for no such default spike in Europe.

Exhibits 3 & 4: Distribution of corporate spreads as a proportion of U.S. energy and non-energy high-yield bond index, July 2014 and September 2015

![Diagrams of corporate spread distribution](source)

Source: BoAML, Bloomberg and Columbia Threadneedle Investments, as of September 30, 2015.

This increase in corporate credit spreads has also accompanied a rise in corporate gross debt to EBITDA (a widespread measure of leverage), and a dip in EBITDA-to-interest cover, albeit from extremely high levels. Putting all these pieces together, it certainly looks as though there has been a change in the corporate landscape that has spooked credit investors.
But, as we dig a little deeper into what credit markets are telling us, this clear picture begins to blur. When corporate credit markets become concerned about near-term solvency risk, this becomes evident in two distinct ways. On the one hand, corporate yield spreads rise (as we have seen this cycle). But at the same time corporate spread curves tend to flatten and invert – that is to say that investors demand more spread for short-dated bonds compared to longer-dated bonds. Away from CCC-rated credit, there is little sign of credit spread curve flattening – in fact the opposite appears to be happening. Exhibit 5 shows the spread curve steepness in a variety of U.S. investment grade sectors which have each reached their steepest levels in 20 years. The picture at the upper end of the high-yield market is more nuanced, but the warning signs associated with elevated spreads are so far absent (Exhibit 6). Some commentators have pointed to elevated long-dated corporate bond issuance as a driver of steeper spread curves. But while higher levels of issuance have recently coincided with steepening, we find no stable correlation between curve shape and issuance trends over the last 20 years and so find such arguments inconclusive.

Exhibits 5 & 6: Spread curve steepness (10yr+ minus 1-10yr indices) for investment grade U.S. sectors, and BB and B-rated U.S. high-yield bonds

Source: BoAML, Bloomberg and ColumbiaThreadneedle Investments, as of September 30, 2015.

So, what does this mean for investors?

First, it makes us cautious in inferring a marked deterioration in prospective corporate solvency risks. If heightened solvency risks are foreseen by credit investors, we would see higher short-term credit spreads when in fact it is longer-term credit spreads that have increased the most. So rather than flashing two red lights, credit markets are flashing one red light (the level of spreads) and one green light (the steepness of spread curves). Investors seem relatively certain about the good near-term prospects of the market in general but have heightened uncertainty about credit conditions further into the future. This is true for both European and U.S. credit markets.
Second, the heightened uncertainty associated with wider credit yields has been sufficiently powerful to have challenged equities’ status as the asset class with the most elevated risk premium. Exhibit 7 shows U.S. high-yield credit yields (dark blue line) against global equity earnings yields (based on 12 and 24-month forward consensus earnings expectations). This shows how rising credit yields have historically coincided with rising equity earnings yields (falling PE ratios, typically associated with stock market falls). The recent stock market fall coincided with the latest spike higher in high-yield corporate bond yields – taking these higher than one-year and two-year global equity earnings yields for the first time since the global financial crisis and undermining the equity market’s status as the highest-yielding risk market. Investors are left with asset markets containing elevated risk premia across the piste, which makes for a more constructive investment environment, but also diminishes the attraction of equities as an asset class.

Informing this rise in uncertainty are three big themes: the cyclical strength of the U.S. economy in the context of weak labor market productivity; the oil supply shock; and questions regarding China’s economic rebalancing away from investment and heavy industry and towards services, combined with recent changes in Chinese authorities attitude towards currency policy. As such, we have not increased portfolio risk in any dramatic way, but have taken the opportunity to rotate our risk budget to take in more European high-yield exposure.
Thank you for your continued interest in research and insights from Columbia Threadneedle Investments. Our Global Asset Allocation team continually monitors global economic and market conditions in order to develop our Investment Strategy Outlook. If you would like to subscribe to this publication, please click here.

During the third quarter U.S. equities registered their first correction of more than 10% since 2011. This has left investors wondering whether the pullback represented a simple pause in the current economic cycle, as in 2011, or something more serious. To be certain, safe-haven assets like U.S. Treasuries and mortgage-backed securities have posted good relative returns across major asset classes thus far in 2015. However, simply noting this fact does not mean an imminent path toward recession over the near term is predetermined.

We are concerned about the recent trend in global earnings and other cyclical factors that put pressure on corporate earnings. As a result, we are moving from a neutral allocation to a modestly underweight position in global equity exposure within many of our risk sensitive multi-asset portfolios. Signals coming from a number of our quantitatively driven models mostly align with our fundamental research suggesting a downgrade to equities is prudent. Further, with Fed uncertainty now a part of the backdrop for at least another quarter, it does not appear that further recovery in equity markets is imminent. That said, global equity markets have already suffered a fair amount of damage, so while we are cautiously positioning our exposure to risk assets, we are also mindful that conditions can change quite quickly. Should valuations and investor sentiment worsen, a clear buying opportunity may arise where adding back incremental risk to portfolios may be warranted.

Within equities, we continue to favor large- over small-cap companies. Regionally, we are lowering our overweight in the emerging Asia region to a moderate overweight. This is a result of questions we have around whether China will continue towards further devaluation of their currency. Ultimately, further devaluation of the Chinese renminbi would benefit Chinese exports at the expense of other export-oriented competitors in the region. We remain modestly overweight Japan and underweight UK equities across most portfolios. We have also maintained a neutral position in eurozone equities, with a preference for core Europe over the periphery.

We maintain our moderate underweight in fixed income and are making no changes to overall fixed-income allocations within our core multi-asset portfolios. Our valuation model for bonds currently signals a neutral reading, indicating that further downgrading bonds is not warranted at this time. Deflation fears are increasing and are once again at the extremes seen toward the end of last year. Additionally, real yields in the U.S. have cheapened significantly, so we recommend adding to U.S. Treasury inflation-protected bonds (TIPS). We are not recommending any other changes at this time to fixed-income sectors and continue favoring investment-grade corporate bonds and high-yield bonds over securitized and developed market bonds.

We are recommending an upgrade (to a maximum overweight level) for alternative investments inside multi-asset portfolios. The need for sources of return not tied to the direction of traditional markets is even more pressing in an environment where correlations between equities and fixed income have risen. Within alternatives, we continue to recommend a maximum overweight to absolute return strategies. We remain neutral in respect to our view on commodities and convertible bonds while recommending a slight increase in exposure to real estate investment trusts (REITs).

Reducing downside risk has been challenging lately, as diversification alone has not been sufficient in a period where losses have encompassed a broad array of traditional assets. Beyond traditional diversification, investors can still embrace several strategies that are particularly well suited for minimizing volatility during these episodes. For example, we have increased our allocation to cash over the past several months from max underweight to neutral. In the current environment cash is not expected to produce a high return, but neither will it be expected to lose value in a down market. After
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Source: Columbia Management Investment Advisers, LLC

Past performance does not guarantee future results. It is not possible to invest directly in an index.

DESCRIPTION OF INDICES

The Barclays U.S. Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity.

The Barclays U.S. Corporate Investment Grade Index is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding. To qualify, bonds must be SEC-registered.

The BofA Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000 Growth Index measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.


The MSCI EAFE Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia and the Far East.

The MSCI EM Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

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GLOBAL PERSPECTIVES

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