Exchange-traded funds

Strategies for mitigating the new risks of the new year

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Key takeaways

- We see new risks on the horizon for both equity and fixed income investors, but there are various exchange-traded fund strategies that we believe can help.
- We expect that a loss of profit momentum in 2019 could lead to increased volatility and correlations, and we believe that the Low Volatility and Quality factors may perform relatively well in such an environment.
- With the overall climate still tilting in the direction of higher rates in 2019, one way to potentially manage that risk is to build bond ladders using defined-maturity bond funds.

In the new year, we see new risks on the horizon for both equity and fixed income investors. Equity markets are anticipating a loss of momentum for corporate profit growth. And, for the first time in 12 years, fixed income investors are forced to wrestle with the challenge of navigating a multi-year upward trend in interest rates at both the short and long end of the bond universe. There are various exchange-traded fund strategies that we believe can help with both challenges.

Equities: Loss of profit momentum could support Low Volatility and Quality

Factors are measurable characteristics of a security that help explain its performance. Academic research has shown that different equity factors have the potential to outperform the broad market, but they have historically done so during different types of market conditions. So what trends do we believe could impact factor performance in 2019?

In 2019, corporate profit growth will face the headwind of difficult year-over-year comparisons to 2018, as we expect the impact of the Trump tax cut to dissipate, monetary tightening to continue, the inventory cycle to turn less constructive for output, and the lagged effect of dollar strength to eat into profitability. Additionally, the deterioration of housing affordability during 2018 is a harbinger of cyclical weakness, in our view, and rising labor costs and buoyant diesel prices due to fuel regulations have worked to squeeze profit margins. A wildcard for profitability will be Chinese-US trade tensions and tariffs.

We expect that a loss of profit momentum in 2019 could lead to increased volatility and correlations. In addition, we expect that the Federal Reserve's rate increases over the past few years could also exacerbate volatility (historically, changes to the federal funds rate have preceded equity volatility by about two years). Given this view, we believe that the Low Volatility and Quality factors may perform relatively well in such an environment. Additionally, as we move later into the cycle, we would expect the spread between growth and value to narrow, and we believe a factor combination of Value/Momentum may shine under those conditions.

In terms of emerging markets (EM), we believe that fundamentally weighted strategies have the potential to fare better than the overall market. 2018 saw a vicious EM sell-off, which priced in a bleak outlook for the asset class as a whole, but there are potential positives on the horizon: New political leadership in Brazil brightens the forecast for favorable economic reforms and privatization, China is working to stimulate its economy through fiscal measures such as tax cuts, any investors who fear the impact of sanctions have likely left the Russian equity market already, and Russia's fiscal house looks healthy (although geopolitical tensions remain).

Fixed income: Interest rate risk could spark interest in bond ladders

In some ways, the fixed income outlook for 2019 is more clouded than it was at the start of2018, when well-established global growth trends were driving visibility in both equity and fixed income markets.

The rise of trade tensions between the US and China – and the ensuing tariffs – have softened global growth expectations, and thereby potentially eased, to a degree, the expected upward pressure on interest rates in both the US and Asia. On the other hand, solid US economic growth combined with improved wage growth and low unemployment in the US support the expectation that the Federal Reserve will maintain the gradual pace of short-term interest rate increases through 2019.

At the long end of the yield curve, we expect acontinuation of 2018 – that long-term US interest rates may continue to move higher onthe back of heavy issuance from the US Treasury, and that rates in Europe may gradually rise as the European Central Bank begins to slowly bring interest rate levels back above zero.

The main risk to this scenario, we believe, would be a meaningful further strengthening of the US dollar in 2019. While the dollar had begun to resume its longer-term downtrend in 2016 and 2017, the rise of trade tensions and the shift in US trade policy in the second quarter of 2018 triggered a sell-off in global equity markets that drove the dollar up significantly in the ensuing months. And since the global financial crisis, the fast-growing emerging market economies have become highly dependent on US dollar lending.

A stronger dollar, therefore, would restrict growth in the emerging market economies by stressing the balance sheets of foreign borrowers as their debt burden and interest expense rise in local currency terms. Recent data has also clearly demonstrated that the availability of dollar-denominated credit growth weakens when the dollar is rising, presenting adouble-whammy headwind to many emerging market economies that are dependent on US dollar-based credit growth.

Finally, a stronger dollar presents a headwind toboth US corporate profits generated overseas and domestic inflation. With political risk in Europe as well as US-China trade tensions building into 2019, the risk of a countertrend rise in the dollar next year presents, in our view, the most visible risk to our forecast of higher short- and long-term interest rates in 2019.

With the overall climate still tilting in the direction of higher rates in 2019, one way topotentially manage that risk is to build bond ladders using defined-maturity bond funds, whether domestic or international. A bond ladder is a portfolio of bonds that mature at staggered intervals across a range of maturities. If rates continue to rise, proceeds from each maturing rung of bonds can be reinvested in longer-dated bonds at higher rates. Defined maturity ETFs can help investors build bond ladders quickly and easily, with a range of bonds that can help provide diversification to aportfolio.

Another way to help mitigate the impact of currency volatility on fixed income portfolios is to stick with US-dollar-denominated international bond portfolios.

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Past performance cannot guarantee future results. Diversification does not guarantee a profit or eliminate the risk of loss.

Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude.

Factor investing is an investment strategy in which securities are chosen based on certain characteristics and attributes.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The low volatility factor uses volatility rankings to attempt to minimize the effects of market fluctuations. Of course, low volatility cannot be guaranteed.

The momentum factor ranks securities relative to peers, using relative strength methodology to identify the strongest and weakest investment trends.

The quality factor ranks the long-term growth and stability of a company's earnings and dividends.

The value factor aggregates stocks that are trading at less than their intrinsic values – usually identified by lower-than-average price-to-book or price-to-earnings ratios.

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