

## **Goldman Sachs Exchanges**

### **Investing during times of market stress**

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**Allison Nathan:** Elevated inflation, market volatility, and evolving Fed policy are changing the dynamics of portfolio construction. So how should investors invest during times of market stress?

**Christian Mueller-Glissmann:** There's a benefit of getting more active in asset allocation compared to the last 10 to 20 years, where buy and hold 60-40 portfolio did really well and you didn't really have to become active because, when the bear markets happened, it was very concentrated in a short period of time and you had very long cycles. Whereas now, bear markets might actually be smaller but more frequent, and that creates much more market timing opportunity.

**Allison Nathan:** I'm Allison Nathan, and this is Goldman Sachs Exchanges.

Portfolio diversification between stocks and bonds that worked for decades broke down last year as surging inflation and rapid rate hikes hit bonds and equities alike. But a new set of market stresses in recent months has seen diversification benefits return. So are they here to stay? To help explain the factors that investors should keep in mind when building portfolios during times of market stress, I'm sitting down with my colleague in Goldman Sachs Research, Christian Mueller-Glissmann, who heads asset allocation research within portfolio strategy. Christian, welcome back to the program.

**Christian Mueller-Glissmann:** Thanks for having me again, Allison.

**Allison Nathan:** So Christian, there is a lot going on in the economy right now. Maybe let's just start by getting your read on where we are in the economic cycle and how that may broadly affect asset allocation strategies.

**Christian Mueller-Glissmann:** I think when we think

about asset allocation, there's always multiple overlapping cycles we need to look at. And I think, in the broad sense, we have the structural cycle, which are longer term themes and regime shifts that are going on; the business cycle, which is essentially how much you're growing versus trend, the time spent between recessions; and the sentiment cycle. And I think last year, it was all about the structural cycle shifting, after a decade of low and anchored inflation with US 10-year yields being relatively low, ranging from 2 to 2.5% on average, you have this huge inflationary spike. And markets had to reprice inflation risk.

And I think that's starting to shift a bit to the background, this structural cycle change. And now it's much more about a shift from inflation risk to growth risk. And there's much more focus on the business cycle. And the business cycle is late. I think unemployment rates are low. You have inflation, which is relatively elevated. You have profit margins that are high. And one feature which is definitely not particularly nice for investing is that risk premia are low. That's a typical late cycle feature because usually macro conditions are quite good, and that's what have been. I think the corporate sector has actually surprised to the upside with regards to earnings. The consumer

remains incredibly strong.

And what we are seeing now is a lot of interaction between the sentiment cycle and the business cycle where occasionally markets get a bit more bearish than the base case that you are stuck in late cycle. And we saw that around the regional US banks crisis. And sometimes it's getting a bit more bullish. For example, at the end of February, where it seemed like the US was continuing to do really well despite all the central bank tightening.

So I think there's, like, mini sentiment cycles, but the business cycle is late. And I would say that broadly means that the asymmetry to invest is not that great. So the upside is capped because you're late in the cycle. You can't really grow debt strongly. And at the same time, you have that downside tail looming, which might not be immediate but we always worry about it and certainly markets worry about it. So that's where we are right now.

**Allison Nathan:** And let's put us into the context of the traditional 60-40 portfolio, which is 60% stocks, 40% bonds. When I spoke to you around the turn of the year on this podcast, we had discussed the fact that 60-40

portfolios had substantially underperformed in 2022, but that has reversed in 2023. Are balanced portfolios back?

**Christian Mueller-Glissmann:** I think 60-40 was never gone. That's your starting point for investing. That's the largest asset classes. That's where the depth is. And I think sometimes these portfolios do better; sometimes they do worse. And what we were saying in our balanced bear research is that 60-40 portfolios have to go through that structural cycle change I mentioned earlier where, I think in the last 10 to 20 years, they've benefited from very anchored inflation, which meant that the equity bond correlation was very reliable. Bonds were a very good buffer for equities. But also, you had a trend lower in bond yields, which meant that you had two tailwinds in the portfolio.

And we were just saying that, with the structural cycle changing, the market needs to prepare for a period where those portfolios are unlikely to do as well in risk-adjusted terms. So 2022 was this example of such a shock. I don't think that in the coming years we can sound completely clear with regards to the structural problems. I think inflation volatility is likely to remain elevated. And there's

still a lot of uncertainty on the inflation normalization process considering the stickiness in the services sector in particular.

But I would say that the recovery we've seen so far -- and just to be clear, you haven't recovered all of the losses from last year -- but the recovery you've seen so far is very much linked to inflation normalization progressing in line with and possibly better than expectations. And that has given it a bit of a tailwind. And from that perspective, if you want to say it like that, I think 60-40 portfolios have come back a bit, but I would still caution to say that we will have the next decade being similar to the previous 20 years, which were phenomenal for these type of portfolios.

**Allison Nathan:** And part of the problem was that we just saw very positive correlation across equities and bonds last year. So they moved up and down together. What does asset class correlation look like right now?

**Christian Mueller-Glissmann:** That has been a shift here. I think equity-bond correlations have shifted negative since the regional bank stress in the US has emerged. And this comes back a bit to what I mentioned at the beginning.

The shift from the market away from structural cycle concerns and inflation concerns to more business cycle and growth concerns. And that just means that the bond market has started to resume its role as a buffer in the portfolio to some extent. But I would still be a bit less excited about that maybe than what the headline might suggest because, if you look at the 10-year yield, for example, since December, which is when we taped our last podcast from what I remember, they're flat. So it's not like you made money necessarily from bonds you meant to carry, which is higher, and that's fair. But you also may carry with cash. So they had, like, a round trip. You had bond yields going high in February when the market got excessively optimistic. And then they reversed these kind of increases in line with what I mentioned on the sentiment cycle.

So I think it remains to be seen still how much the bond market can buffer if you do have a genuine growth shock. And I think the important thing to keep in mind is that the market has pulled forward quite a bit of the central bank put already. So central bank put essentially means that central banks are cutting rates because they're worried about growth, they're worried about financial stability.

So if you look at the Fed pricing, how much cuts are priced for the next 12 months, you actually see that the market is pricing already cuts this year. So to some extent, it means that the actual buffer you might get when there's a shock happening might be a bit lower, especially if you do get the back end steepening, like the curve steepening, which most people would expect if you get sharp cuts from the Fed, especially if you still have elevated and sticky inflation. So that's the challenge we have a bit right now.

It feels like markets have put a lot of emphasis on financial stability risk. Even a small probability of the US regional banks crisis escalating would potentially mean very large cuts from the Fed. And now that also means that, if the financial stability risks are fading, rates might actually move back. And allocating to long-duration bonds right now could become a bond. So it's much more symmetric, you could say, than maybe the last 10 to 20 years, where bonds tended to rally in risk off, but they very seldom sold off a lot in risk on. So net, you had a much better asymmetry when inflation was lower.

**Allison Nathan:** So asymmetric and uncertain. And if



we think about the extent of uncertainty in the economy and in the markets today, one of the interesting aspects is that it doesn't really appear to be reflected in equities, especially when you look at equity volatility, which has remained very low. So what do you think is driving that low equity market volatility?

**Christian Mueller-Glissmann:** We get that question a lot. And it seems to be like a bit of a dissonance between investor concerns and macro risks out there, especially events that are coming up like the US debt ceiling, and where the realized volatility is in terms of how much the S&P has been moving year to date and in the last month or so but also where the pricing of volatility is. So I think there's a few things at play here.

The first thing to keep in mind is what I mentioned at the beginning with the business cycle. So we are late cycle. On the one hand, that makes you worried about where you will be in a year or two. But right now, macro conditions are good because late cycle means the unemployment rate is low, companies are having good profits, and defaults are low. So from that perspective, that is actually an anchor for equity volatility. And what we actually found is the

labor market is an incredibly important driver of equity volatility. And the labor market in the US and a lot of developed markets is actually incredibly resilient and strong currently. So we find that is an important anchor.

It's unlikely you will have that low volatility purely based on macro stay where it is because you also have a lot of uncertainty, especially political uncertainty. You have macro uncertainty on inflation. Policy uncertainty. And we found in our modeling that this normally means that it's unlikely that the S&P will continue to realize as low as it did. But for now, the market has probably been less volatile, even based on the macro. And I think there's two reasons for that.

The first reason is the rotation you've had underneath the index level, which is absolutely remarkable. Around the kind of US banks crisis, on the one hand, the market de-rated cyclical domestic US exposures because of concerns of the credit conditions tightening that might come from the US banks crisis. But because of the decline in yields, it also re-rated longer duration stocks that potentially were de-rated last year.

You remember last year, it was very painful to be long, these long-duration tech stocks because they suffer from rising rates. And when the rates came down so sharply around the US bank stress, it created a huge amount of relief. And these type of long-duration stocks rallied at the spread between NASDAQ and Russell as a proxy for that type of rotation has been as large as it's normally in the bear market. And that has meant that, from an index level perspective, because these stocks, the mega cap tech stocks are such a large weight in the index, you didn't move that much. And it masks a bit the actual underlying pain which the market is pricing because of these mega cap stocks dominating the index level.

And the other thing which I think is a bit more something you could fade is earnings season. So while we had the SVB bank stress occur, you just were about to enter the earnings season, which always means that stocks are less correlated because it's much more idiosyncratic. And that has also anchored volatility. So you have a few factors there that are telling me that some of the factors are probably justified. Some of them are something I wouldn't extrapolate. Net, I'm learning towards volatility being a bit skewed to the upside just because where we are in the late

cycle position and the risks we have ahead.

**Allison Nathan:** So what is the market actually pricing?

**Christian Mueller-Glissmann:** The market pricing, just to be clear, is not that complacent on that. First of all, the implied volatility, like the VIX index, the FIA index, trades actually a pretty big premium to the realized volatility. So that tells you the market also isn't completely trusting that low realized volatility.

Then you have the volatility term structure like the curve is actually upward sloping and quite steep. So the market is expecting an increase in the volatility already.

And the last thing that shows me that not all the investors are trusting the current low volatility is the skew. So the cost of puts versus calls has also shifted materially more to the bearish side.

So all in all, it tells me the volatility is low, but I don't think that there's complacency as such. And I would certainly not say that it's a signal that would make me more bullish from here.

**Allison Nathan:** On the flip side, if we look at bond market volatility, it's remind I would say stubbornly high. A lot of people coming into the year were optimistic because the view was the Fed's going to come into the end of its hiking cycle. Other major central banks as well. And the tremendous rate volatility that we saw last year would subside. That really hasn't played out. So how is that affecting portfolio allocation strategies?

**Christian Mueller-Glissmann:** I think normally, you would expect, with that handover from inflation to growth concerns, you would expect a handover from rates to equity volatility, and we haven't really seen that. And there's a few reasons for that.

One of them is probably scar tissue, which, because of the very large swings last year but also in Q1, it's more difficult for investors to maybe sell volatility. So I think that can certainly contribute.

But there's another reason. The market has shifted very quickly from right-tail risk on rates, which dominated last year, to left-tail risk, because of these financial stability

concerns. And there's this perception that, if the Fed is forced to cut right now, it would primarily be because of financial stability, which could mean they would have to cut quite aggressively.

And again, so it's somewhat linked to what I mentioned earlier that, if financial stability risks are fading, it might help volatility on rates settle, as you would expect. But I think one thing that we found quite interesting in our research as well is that, while we would expect a handover from rates to equity volatility in this type of late cycle backdrop, rates volatility can be quite elevated late cycle just because the market is always worried about a recession. So there can be, like, a sticky left tail. So even if the market prices some of those cuts out, prices some of that left-tail risk on rates out, it might not do that completely because the unemployment rate is very low. We are dealing with financial conditions tightening, central bank tightening, credit tightening, which means that the skew on rates is to the downside. And from that perspective, we wouldn't necessarily expect a low vol regime in rates to appear as well.

But certainly, you're right, I think the rates volatility has

been very sticky, which, at the margin, comes back to the role of bonds in the portfolio. I think they have better yield. They have helped you a bit in risk off. But they've also been volatile, which means, in a Markowitz Portfolio Theory thinking, that means that maybe it still warrants slightly smaller rates.

**Allison Nathan:** So we talked about uncertainty around Fed policy. We have the debt limit issue playing out. Stress in the banking sector. How should investors be thinking about diversification strategies outside of stocks and bonds in this very uncertain environment?

**Christian Mueller-Glissmann:** I think you might remember in the last podcast we were discussing that there's potential for much broader diversification and divergence, and we've seen that year to date. So for example, gold has been a quite instant diversifier because it's negatively correlated with the dollar. It does benefit from peak in real yields and as an incremental driver from central bank buying. So suddenly gold has become a quite useful safe haven and has helped portfolios not just diversify risk off but also diversify dollar exposure. So if you're, like, a European portfolio manager and you own US

stocks, it was quite a useful thing to allocate to gold to mitigate some of the dollar weakness which you had year to date.

So I think definitely we see more potential in gold diversification. Also broadly in FX. There's been more value in international diversification. That's the other thing which we said last time. Like, clearly in the last cycle, the US equity market was the strongest performer. Was also the best risk-adjusted return. So it wasn't just high beta, it was actually, compared to risk, the best performer.

Whereas if you look, since the COVID crisis, you have seen much more international diversification potential where I think you've seen cycle divergence, policy divergence, inflation divergence, lockdown divergence, and that has meant that international equity diversification has helped. And the recent outperformer has clearly been Europe. I think Europe had a phenomenal start to the year coming from very depressed levels because of concerns on the energy crisis.

Whereas more recently, it's been Japan that has decoupled a bit. And my sense is that's a bit, like, how to think about



it. I wouldn't necessarily say it's easy to always pinpoint which market has the best potential, but just broadly thinking about more international diversification is definitely helpful. And I think one statistic I found interesting is, if you look at the international equity correlation of the 25 to 30 largest equity markets in the world, since the '90s, that has been trending up. And a lot of academic research has said it's the end of international equity diversification because markets have become too integrated, economies have become too integrated.

But actually, since the COVID crisis, these correlations have collapsed, and they've stayed low. So it's not just that they were really low during the actual COVID crisis or last year, when you had these huge duration differences between equity markets. They've stayed low year to date as well. So I think we might be having a few more years or at least month of cycle diversion. So international diversification is interesting, both in FX and equity.

**Allison Nathan:** And what about the private markets? Do they offer opportunities for diversification in portfolios?

**Christian Mueller-Glissmann:** I think that's quite

interesting. So far, private markets have fared really well. And that has been a reason for concern from a lot of investors in the sense that, clearly, it's an asset class that is illiquid and there's a concern that the gap between valuations in private and public markets is a risk to the downside.

But a few things worth mentioning here. First of all, valuations are starting to come up again, which is quite interesting year to date. I just mentioned earlier the kind of mega cap tech. You've seen a pretty significant expansion of tech valuations in the last few months. And mega cap tech is trading, again, at -- not at the COVID premium but certainly one of the highest premia we've seen in a long time in terms of PE ratios.

So to some extent, this starts to come down as a concern a bit. But I think my sense is there's still a lot of concern with regards to illiquidity because we have to be clear that illiquidity risk premia are not as attractive if you actually get paid 5% in cash. I think, if you live in a zero-rate environment, you are pushed up the illiquidity curve much more. And I think right now, it's not necessarily the main motivation that you have low rates.

So you have to think about other reasons why private markets are interesting. And what we've been saying in our balanced bear research as well is private markets can give you access to really interesting assets and companies that might not be on the public markets. And I think that is still the opportunity to me.

If you think about it, infrastructure is an asset class which you cannot easily access in public markets, certainly not in every country. And there's a lot of regulation, a lot of changes. And as a result of that, having private exposure to that can be attractive. And we think strategic allocations to infrastructure are getting more interesting with high-end inflation volatility. So that's one example.

Another example is, to some extent, growth equity is having a renaissance related to AI. We have a lot of investors asking what's the opportunity related to AI? And clearly, that's a long discussion, but there's a good chance that private markets will capture some of those opportunities earlier and maybe some higher growth opportunities than what you get in public markets.

And the last thing I find quite interesting is private credit because we are dealing with credit tightening. We are dealing with, for example, US regional banks going through a consolidation. And that could create a lot of opportunity for private credit to take market share. And so my sense is I want to think about private markets not necessarily a replacement that does exactly the same as public markets, but a diversification tool via giving access to assets and investment strategies that might not be available in public markets.

If you think about it like that, especially if you then also have manager alpha and manager benefits, for example, in times of distress in terms of stabilizing the capital structure, I think my sense is there's a good role for private markets in the portfolio.

**Allison Nathan:** And so some diversification benefits from international, from private. Are there other ways to just reduce overall risk in portfolios, given all the uncertainty today?

**Christian Mueller-Glissmann:** Yeah, I mentioned already the market has gone through this major rotation

towards quality. And currently, the flavor has been mega cap tech, which has some interesting optionalities maybe on AI, which has the strong consumer supporting it but also very strong balance sheets.

And in Europe, we had a lot of focus on the so-called granolas, these large cap defensive growth companies, that actually managed to have pricing power. So I think the market is already looking for quality, but there are other opportunities to go up in quality.

In equities, for example, we think low volatility stocks, which is a famous strategy to reduce risk in portfolios in a late cycle backdrop, they are actually trading at a discount to the S&P 500. That could be an interesting strategy. Quality and stable dividend payers is another strategy that historically has done quite well late cycle.

So my sense is shifting up in quality in equity and credit, maybe even in FX, I think that is a strategy that can help reduce risk late cycle. Otherwise, we see a lot of focus on alternatives. Last year, clearly allocations to trend following did really well. And that has a lot to do with inflation because inflation itself is trending more. It creates

more price momentum that can be captured by these strategies. So we have clients certainly quite focused on thinking about the diversification potential from alternatives getting better, like also macro strategies and macro investing has been very successful in the last few years. So we see much more focus on alternatives.

The last thing I would mention is options. Option overlays certainly have become more valuable in a kind of more long-term sense. If you don't have diversification between equities and bonds, you could argue that you need to deal with the risk at source. And if you find attractive hedges that make sense, I think it's not been easy last year because the market didn't sell off very sharply because it was related to inflation and rates volatility, as we discussed earlier, rather than growth volatility and equity volatility. So it was not easy to make money by buying equity puts, for example.

But if you do see a shift towards equity volatility, that might start to change. You might actually see long option protection strategies be more successful. Right now, as I mentioned earlier, some of those are actually quite expensive, as I mentioned with regards to volatility risk

premia, long-term structure, and skew. But certainly we're looking always for interesting option overlays across assets.

But the last thing I would say -- the really last thing -- is I think it's just an environment which kind of just calls for much more dynamic and tactical allocation. And that's certainly something which we're discussing a lot with clients where there's a kind of benefit of getting more active in asset allocation compared to the last 10 to 20 years where buy and hold 60-40 portfolio did really well and you didn't really have to become active because, when the bear markets happened, it was very concentrated in a short period of time and you had very long cycles. Whereas now, you might get shorter cycles. Bear markets might actually be smaller but more frequent. And that creates much more market timing opportunity. So we actually discuss a lot with clients frameworks and processes to kind of position going forward for these more shorter cycles.

**Allison Nathan:** So there are a lot of ways to reduce portfolio risk in this environment. What catalysts are you watching that could affect investors' portfolio strategies ahead?

**Christian Mueller-Glissmann:** Yeah, I mentioned earlier we're late cycle in a lot of these type of metrics, but what we haven't had is negative macro momentum. And you really start to worry with regards to a late cycle position when you get negative macro momentum. So we need to just follow the dataset with regards to growth and see if there's a new kind of negative momentum emerging. And the big focus is, of course, the labor market and the consumer, which has been remarkably strong. So we need to follow very closely the resilience of the US labor market.

Also, the thing in terms of catalysts is of course debt ceiling. I think our US economics team has been very focused on that, and that's certainly a catalyst that starts to get nearer. So we start to talk to clients much more about it. I feel like three or four weeks ago, people said, "I will deal with that when we get there," and now we're there. And I think we start to see investors really think about hedges, think about their portfolio exposures, so the debt ceiling is definitely another thing we watch out for.

But the other thing we're watching very carefully, not to talk too bearish as well as the manufacturing sector, because manufacturing PMIs are one of the biggest gaps to



the services PMIs. So you could also see the manufacturing sector recover. And that could be a near-term positive catalyst which could drive a bit of pro cyclical rotation in line with what I mentioned earlier. It could drive a bit of repricing higher in rates.

I'm not sure it will be that positive for equities in aggregate, but it could drive a bit of reversal of the rotation to what quality we just had. So we're also watching the manufacturing sector very carefully because it's remained quite weak, and certainly there's a potential for recovery there.

**Allison Nathan:** Christian, thanks for joining us.

**Christian Mueller-Glissmann:** Thanks for having me.

**Allison Nathan:** And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called The Markets. Each week, in just 10 minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Search for “Exchanges the Markets” on all podcasting

platforms.

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