Hermes' Murray: Five key risk factors to watch in 2017

A 'bumpy ride' ahead

Eoin Murray 30 JANUARY 2017

Eoin Murray, head of investment at Hermes Investment Management, expects greater returns amid market volatility as he looks at the five key risks investors could face over the next 12 months.

The ability of investors to digest uncertainty has never been stronger than in 2016, as equity markets moved serenely past Brexit and the ascent of Donald Trump. But does the current calm mask underlying fragility?

Volatility - expect a bumpy ride ahead

Across the board in 2016, long-term implied volatility measures fell for all asset classes, excluding bond volatility. In the last quarter, we saw a modest spike around the US election but that dissipated very quickly.

That is consistent looking at 2016 in its entirety, with each asset class choosing different times to have a short-lived volatility hiatus, but, in general, the volatility of all asset classes moved from low to lower.

Not only do we expect volatility to increase in 2017, we would **urge investors to remain cautious** of leveraging positions too far as the year progresses. Investors can expect a bumpier ride, but greater dispersion of returns will also lead to greater opportunity for active managers prepared to grasp it.

Correlation - are we set for a surprise?

Analysing correlation surprise allows us to capture the degree of statistical unusualness in current correlation levels relative to history. As with any statistical measure, its interpretation requires some caution. In general though, we can see spikes in correlation surprise followed, more often than not, by disappointing returns.

Our correlation surprise indicator began the last quarter at the highest level in the last 17 years. However, as the quarter progressed it fell back to more typical levels. We feel it is important to continue to watch the development of this signal.

From time to time we would expect false positive signals, but we think it is wise to remain cautious about any portfolio assumptions with respect to cross-asset relationships.

Stretch risk - valuations on shaky ground

Stretch risk allows us to identify assets that trend in one direction for a considerable period of time, suppressing headline volatility to a reduced level, and giving an impression an asse is less risky than is the case.

By and large, the fourth quarter of 2016 seemed to act as a turning point for certain assets which looked stretched either from a momentum or extreme valuation perspective.

One outlier is **US equity markets which have risen strongly** on the back of the US election result. It may seem very late in the cycle to many observers, but that alone will not stop equity momentum.

While it dampened volatility, the extreme levels of intervention in certain key markets may well have hindered the mechanism of price discovery - creating a situation where investors' confidence in valuations has actually been weak and reliant on that intervention. This has led to an unstable floor for downside risk.

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