April 2, 2011

Line Dancing With the Markets

By JEFF SOMMER

NO one knows which way the world's financial markets will move on any given day. No one can know.

But recently, one thing has been easy to predict. Whether the markets move up, down or sideways, they are likely to be moving together.

Last Wednesday offered a particularly telling example. It was a positive day for stocks. In New York, the Dow Jones industrial average rose half a percentage point. Markets in Brazil and Mexico climbed, too, along with those in France, Germany, Hong Kong and Tokyo. In fact, of the 18 leading equity markets tracked around the world by Bloomberg, 17 rose that day. The only exception was Spain, where the IBEX 35 declined — but by less than a tenth of a percentage point.

It's as if the world's markets have been responding to the baton of a mercurial but authoritarian maestro, who changes direction often, but insists that all orchestra members play together as one. And it's not just stock markets that have been swinging in unison. To an extent rarely seen before, the bond, commodities and foreign exchange markets have been behaving like synchronized swimmers.

Why are markets so highly correlated? The answer may be found in "risk on, risk off," a bit of jargon favored by financial traders and strategists. The phrase describes a simple, binary decision — whether to buy high-risk, high-return assets like stocks, or to move to a position of greater safety — that has come to the fore since the brutal financial shocks of 2008.

"We're in a situation when there's one dominant force — risk — driving all markets," said Stacy Williams, an HSBC strategist in London. "Until people are convinced the global economic recovery is truly here to stay, this pattern is unlikely to really go away."

Researchers at HSBC, working with scholars at Oxford University, have used statistical techniques to document that correlations rose across asset classes in the years before the crisis and surged in response to shocks like the collapse of Lehman Brothers.

"Various events during the financial crisis triggered the birth of the risk-on, risk-off paradigm," an HSBC paper declared last August. Risk and the market's response to it are the main factors explaining the rising correlations, the researchers found.

The implications are considerable, the report said: "In current market conditions, there is little point trying to understand the nuances between different asset classes, or the relative value within asset classes. Commodities behave like bonds, which behave like equities. They are no longer easily identifiable, uncorrelated trades."

Furthermore, Mr. Williams said, close correlation of seemingly disparate assets implies that many portfolios may not be as diversified as we may think.

Other strategists have found similar patterns. UBS, the giant Swiss bank, for example, has developed its own Equity Risk Appetite Indicator, combining data from "credit, foreign exchange and equity markets," according to a recent report.

The risk appetite of global investors has swung dramatically of late, said Christopher Ferrarone, a UBS global equity strategist based in Stamford, Conn. In response to "geopolitical events and disasters" — the turmoil in the Middle East, a flare-up of the debt crisis in Europe, as well as the earthquake, tsunami and nuclear crisis in Japan — risk aversion leapt during much of March, he said. But the appetite for risk revived in the week of March 21, and surged again last week.

The risk-on, risk-off mantra may help explain some other anomalies, said Eswar Prasad, an economics professor at Cornell University and co-author of the book "Emerging Markets: Resilience and Growth Amid Global Turmoil." While the economies of emerging-market nations have grown more independent, their financial markets have been tightly synchronized with those of more developed nations, he said in a telephone interview from Nanjing, China, where he participated in a seminar on the international monetary system.

“Financial markets are supposed to be very helpful in diversifying risk, but the whole point is you want uncorrelated returns across markets,” he said. “If markets are more correlated now, it may be because people are trying to diversify by investing globally, but when there is a trigger event — when something nasty happens in the world — they sell assets across markets, and the usefulness of this entire diversification strategy must come into question.”

In a heavily annotated March market letter, James W. Paulsen, chief investment strategist at Wells Capital Management, scribbled “WOW” on a chart showing that correlations between commodity and stock prices had become “remarkably elevated.” Another chart showed similar links between those two asset classes and bonds.

In an interview, Mr. Paulsen said that while the current synchronization of disparate markets “is of greater magnitude and has been going on longer than in any period I’ve seen,” there were precedents.

“ ‘Risk on, risk off,’ it’s a new phrase,” he said, “but when you look back at, say, the period right after the ’87 stock market crash — that was risk on, risk off, baby. Risk was all anyone was thinking about.”

At the moment, he said, markets are still grappling with the “total obliteration of economic confidence in this country and in the world during the financial crisis.” He said we’ve gone from confidence levels “we’ve never registered before to levels you’d normally see in a recession.” How long it will take for fear to subside fully, he added, is anyone’s guess.

BUT Mr. Paulsen says he believes that an economic recovery is already well under way, and that the perception that this is a high-risk environment is mistaken. He advises a contrarian view: “People are already pricing things for a potential depression, so there’s a tremendous amount of protection in prices, and a tremendous upside,” he said. In fact, he added, it will be clear in hindsight that this was a time to embrace risk.

Investors can find many bargains in risk assets like stocks, he said, because their prices are still modest relative to the strong corporate earnings in the United States and abroad. “The dysfunction in the market — the high correlations — all of that is offering investors an opportunity rather than something to avoid,” he said. “Eventually this will all go away and that will be kind of sad, because it will mean these opportunities will be over.”