Bulletin – Protecting against downside risk

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Current market volatility has reminded investors that what goes up can in fact, go right back down. Markets have recovered their losses, but this stark reminder has people contemplating downside risk, and how to protect against it.

Currency Hedging

I've been crowing about this one for a long time now. In Canada, we have little control over currency markets, as our currency's value is largely dictated by the oil and commodity prices, as well as the US Federal Reserve's impact on the US Dollar Index through rate hikes or decreases. The Fed is on a tightening cycle. It is wise to employ currency hedging strategies at this time, as this will reduce currency risk.

Bond funds and fixed income

It has been a long in the tooth bull market for fixed income, but this is ending. The US Fed is on a tightening cycle, and this does not bode well for bonds, as other major economies will likely follow suit in order to protect their currencies from falling too far against the world's reserve currency. There is tremendous downside risk in bonds, and especially bond funds right now.

Gold and precious metals

Not a great place to be right now, because if the US dollar rises due to Fed rate increases, the price of precious metals not used for industrial purposes tends to fall, as they are inversely correlated.

Dividend paying equities and financials

The premium on dividend paying equities will suffer, as will financials, when rates start rising. Financials will start to suffer from defaults at the higher end of the risk scale, while investors may slowly move into credit products due to a breakaway from ultra-low interest rates.

What will benefit?

Companies like Visa, Mastercard, McDonalds', Walmart will benefit in a rising dollar environment. People saddled with high mortgage payments will use their credit more, eat more cheap food, and buy more now cheaper Chinese goods as their personal budgets get squeezed by rising rates. The takeaway: focus on unsecured debt and places that sell cheap (not premium) goods. The focus will move away from premium towards value for the consumer.

This move will not be an instant flip, but will be a gradual shift. Less BMWs, more Toyotas and Fords. As rates rise, on a macroeconomic scale, the shift towards consumers becoming more cost sensitive on a gradual scale. Noting that most mortgages are on variable and 5-year fixed terms, these are leading indicators that will not take effect immediately.