Bridgewater Reassesses Flight to Quality

If you stop to think about it there are several analogies for the Fed's "tapering", under which they gradually relax the support which has been underpinning the bond market. Maybe it's the parent who creeps out of the young child's bedroom at night believing they're finally asleep, only to be halted by renewed cries from the little one. Maybe it's Jenga, a game played with wooden blocks where players alternate turns of removing one without causing the structure to collapse. Or perhaps the magician who dramatically whips the tablecloth smartly off the table while leaving the place settings unmoved.

Whatever imagery does it for you, somewhere within the investment horizon of most people the Fed will make their move. Which is why a Bloomberg article on Bridgewater's $80BN All Weather fund caught my attention earlier today. It seems that in recent weeks Ray Dalio substantially reduced their exposure to Fixed Income. Apparently not in reaction to the weak bond market of the second quarter, but instead as a result of many months of analysis which concluded bonds were no longer as attractive in a portfolio that's expected to generate positive, uncorrelated returns most of the time.

The classic justification for holding bonds is the diversification they provide to a heavy weighting in equities. It's worked more often than not, but we may just be heading into a period of time that will test conventional wisdom. To start with, yields on high grade and government bonds are unattractive on a buy and hold basis. It'll be hard to finish ahead of taxes and inflation with yields of 2-3%. The idea that bonds will rally during times of equity market stress, thus mitigating the inevitable mark to market swings of a conventionally allocated portfolio only seems to justify bonds if you'd actually sell them when they're bid up through a flight to quality. Few investors do, and the ownership of bonds for the temporary sugar high that turmoil may bring seems less interesting when the long term prospects are poor. Watch for creative explanations from financial advisors to defend clients' bond holdings in the future.

But the other side of things is that stocks and bonds may at times be highly correlated on the downside. If the Fed's attempts to at least slow the growth of its $3.5 trillion balance sheet awake the sleeping child, or perhaps even result in a smashed dinner set all over the floor, weaker stocks may be accompanied if not even caused by weaker bonds. The flight to quality may not work.

We believe the most likely outcome is one of very measured, non-threatening reductions in Quantitative Easing and a further very long interval until short term rates rise. This is what the Fed has told us to expect. But that's just a forecast, and we could be wrong. However, if we do find ourselves in a substantially weaker equity market caused by the Fed's lack of manual dexterity, we at least won't have compounded the error by owning bonds as well.