New Year, More Volatility—What Can Investors Do?

Why The calendar has changed to 2016, but the volatility story remains. The key concern: weaker global growth and its possible ripple effects, including low oil prices for an extended period. How should investors approach this challenge?

First, the backstory. Risk assets, led by energy stocks, took the brunt of the recent market sell-off; safe-haven assets, such as US and German government debt, gold and the yen, rose. Investors fear that the market slump also signals weakening global demand: China's 2015 growth was the slowest in 25 years, and global gross domestic product forecasts for 2016 were reduced.

There's also concern about the potential damaging effects of deflationary forces on corporate profits and balance sheets, including those of banks with exposure to commodity markets. Here's our assessment, and some things for investors to consider.

Little Change in Macro Outlook

Fundamentally, we don't see a significant deterioration or change in our macro outlook. China's growth will likely slow as it continues the difficult transition from an investment-led economy to a more consumer-oriented model. This will take time and create more volatility.

But lower oil prices appear driven more by higher supply than by lower demand. The odds of a global slowdown have increased, but we don't expect a recession in the US or other developed economies. Energy and materials companies have struggled with lower commodity prices, and further price weakness doesn't help, but earnings expectations and sentiment for these companies are already quite low.

As the earnings reporting season starts, it's critical to monitor developments both at the company level and macro level. Investors should be ready to adjust portfolio positioning as opportunities and near-term trouble spots emerge.

Managing Portfolio Exposures in Volatile Times

At the broader portfolio level, investors need to balance long-term objectives with managing recent bouts of volatility. We expect "risk-on/risk-off" conditions to persist, but from a fundamental point of view, we haven't seen any material deterioration in developed economies. This suggests that spillover effects are likely to be limited.

In a risk-on/risk-off environment, volatility itself is volatile, and a single concern or factor drives market moves. There are bouts of volatility and sharp price swings—both up and down. The key dilemma for dynamic allocation strategies is to determine whether each new episode is simply another short-lived bout of anxiety or the start of a sustained directional move.

So investors should think carefully when considering adjusting long-term portfolio exposures in an effort to reduce risk—a starting point might be staying close to strategic allocations. And they should avoid using a narrow set of volatility-based triggers to help set allocations; portfolios could be whipsawed by each new market move. We think the right approach to gauging volatility is broader—open to multiple signals and to the integration of both fundamental and quantitative assessments.

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