Elevation Sickness:

Protecting Your Portfolio in an Era of High Asset Valuations

Last November, the Federal Reserve released the first of what are meant to be twice-yearly reports that examine the nation's overall financial stability. In the report, the central bank highlighted issues like uncertainty around Brexit, and trouble in China and other emerging markets that could destabilize U.S. financial systems. While the report concluded that these vulnerabilities are at a "moderate" level, they remain heightened by elevated asset prices. Though the report acknowledges that stock prices are high "by some measures," it may be severely understating how overvalued global assets have become.

Deutsche Bank recently released an extensive report that tries to identify what may cause the next financial crisis, and if anything can be done to prevent it. In the report, financial strategist Jim Reid addresses asset prices, but his analysis is much direr than the Fed's. In Deutsche Bank's estimation, "we're in a period of very elevated global asset prices – possibly the most elevated in aggregate through history."

The analysis looked at 15 government bond markets and 15 equity markets, and tried to put them in a historical context, going back to the year 1800. The report finds that "an equally weighted bond/equity portfolio has never been more expensive." If looking solely at equities, while there have been times when prices were more elevated, they preceded massive declines. In looking at the cyclically-adjusted price/earnings ratio (CAPE), the equities markets have "only been higher before the 2000 equity bubble bursting," and were "only slightly higher ahead of the 1929 crash."

Whereas the Fed views the sky high elevation of asset prices as making our current situation only moderately more precarious, Deutsche Bank sees this as the setup for a potential catastrophe. Their report concludes with the warning that while asset prices remain as high as they are, there remains the "risk of a sudden correction that could be destabilizing to a financial system and global economy."

It is important that the Fed recognize the reality of danger posed by elevated asset prices, as current monetary policy is at least partly to blame for current valuations. Central banks have kept interest rates very low for the last decade. With rates so low, investors have been incentivized away from safer, more traditional methods of saving and driven to the higher returns that come from stocks and other assets, skyrocketing prices around the globe.

One of the best ways to offset potential losses is to include U.S. Treasury bonds in your portfolio. These bonds generally have a negative correlation to the stock market, meaning that when the stock market falters, they can be expected to perform better. During the market crash of 2008, total U.S. stock returns for the year were down about 37 percent. On the other hand, the return on a 10-year treasury bond was up more than 20 percent.

Another way to protect your portfolio would be to buy puts. Puts are essentially insurance policies you can take out on a given equity, and allow you to create a floor underneath it, mitigating your potential losses should the market drop. We would also recommend that your portfolio is diversified. While high asset valuations are widespread, it may be beneficial to include precious metals or non-U.S. equities to guard against losses. In times such as this, the nature of the stocks you hold is especially important. Risk can be mitigated by ensuring that your equities are from companies that are high quality, and offer good, stable, long-term earnings.

As the adage goes, the higher the climb, the farther the fall. As asset prices continue to rise, it is important to reassess the level of risk you are willing to tolerate, and ensure that your portfolio is protected in case these sky high valuations come crashing back to Earth.