2/6/2018

CIO Flash

Back to normality

The strong start into the year left markets vulnerable. However, we remain constructive due to solid economic fundamentals.

It's been quite a market correction, these past two days. On this, at least everybody can agree. But as soon as you try to put things into perspective, opinions diverge. As an extreme example, consider Bitcoin. By many, the cryptocurrency's swift ascent was seen as evidence of market exuberance and carelessness. Since its peak in the middle of December, the price of Bitcoins has fallen by about 70%. That sounds dramatic. But it leaves Bitcoin pretty much where it was trading at the beginning of November – only three months ago. That sounds a lot less scary.

The patterns in most equity markets are similar. The MSCI AC World Index, for example, is still showing gains for the year. To be sure, a few indices suffered the "worst daily decline in their history." However, that's only true if you look at the decline in index points, and mainly due to the rapid share price gains we have seen in recent years. In percentage points, corrections of 4%, as recorded in the S&P 500 on Monday, are not at all unusual by historic standards. What was unusual was that the main U.S. equity index had not seen any five percent correction for more than 400 days. Already, this long period of steady gains had surpassed the previous record of 395 days from 1996.

This observation is important, and not just in terms of the frequently mentioned suggestion that some sort of correction has long been overdue. It also helps to explain the virulence of recent price movements. The long upward trend, together with solid economic figures, caused market volatility to be unusually low, for unusually long. The recent doubling of the Vix, which measures the volatility implied by S&P 500 index options, has finally driven investors out of their comfort zone. The Vix is now at levels last seen in 2011. This increase in volatility expectations has important implications for many investment strategies.

We think that much of the market movements of recent days has been due to self-reinforcing portfolio repositioning and forced selling by certain trading strategies. This includes short selling of volatility options, as well as funds with binding risk targets. Many momentum driven strategies are also having to reposition themselves. This could take a couple of days and could cause markets to overshoot. We would probably use such movements to increase our holdings in equities and selected bonds.

A justified warning shot

Perhaps, the latest strong U.S. employment report, newly rekindled inflation fears and ensuing concerns that interest rates might rise more swiftly than expected, are some of the causes of the

In a nutshell

- A market correction was arguably overdue
- In addition to technical factors, the steady rise in inflation expectations probably played a role
- Given the strong economic backdrop and solid earnings growth, we remain optimistic on equities and do not expect a bond sell-off

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correction. These concerns do have some justifications, but one should not overdo it either. The U.S. unemployment rate is near lows only seen a few times in the post-war period. Wage growth has been accelerating for the last few quarters, even if it remains quite moderate. A few sectors have experienced difficulties at filling vacancies. All this is why we would not fully dismiss the risk of a sudden jump in wage growth. However, our base case remains a continuation of the pattern we have seen in recent years. We expect U.S. core inflation to accelerate to a moderate 1.8%, from 1.5% in 2017. Based on this, we only see scope for 3 Fed rate hikes by the end of this year.

Because of rising inflation concerns, we could also see a negative reassessment of recent U.S. tax cuts in bond markets. The dangers of deficit financed tax reductions at this stage of the economic cycle have certainly become more apparent.

Outlook – global growth should support markets

We maintain our positive outlook for most equity markets and do not expect bond yields to continue to rise at their recent pace.

We view it as unlikely that bond yields on 10-year U.S. Treasuries will trade above 3% by the end of the year, or that equivalent Bund yields will be above 1%. Yields on government bonds have even declined in recent days. This confirms their status as a safe harbor in turbulent times. We continue to see them as a suitable instrument to consider when managing overall portfolio risk. We also take comfort from the relative calm in corporate bond markets, where we have observed no signs of market stress. Default rates remain near zero.

For equities, we also maintain our year-end targets (Dax: 14,100 and S&P: 2,750). However, recent events confirm our view that 2018 is likely to be more turbulent than the calm seen in recent years. Investors have to reacquaint themselves with inflation. In one important respect, this correction has certainly been different from others we have seen in recent years. The presumed trigger was not bad news on the economic outlook, but more optimistic readings. For the first time in quite a while, the danger of the U.S. economy overheating has moved into sharp focus. At the same time, equity investors have to get used to another recent development. Given the rise in yields on U.S. Treasuries, equities no longer look like "there is no alternative." In less than two years, yields on two-year Treasuries have risen from 0.5% to 2% and now once again exceed the dividend yield of the S&P 500. We have already taken this into account for our index targets, which incorporate a slight contraction in earnings multiples.

Overall, we remain constructive for equities, due to the synchronized global recovery, which we expect to underpin strong earnings growth. Given that until recently, investor sentiment was near record highs, we think that some sort of correction was indeed overdue. For stock pickers, such phases can certainly bring opportunities.

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Glossary

Bitcoin

Bitcoin is the pioneer amongst the cryptocurrencies.

Bunds

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Core inflation

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

Cryptourrency

Cryptocurrencies are a new generation of digital currencies and payment systems that rely on cryptotechnology and distributed data management. They are privately organised and not bound to oversight by central banks or other official institutions. The pioneer and still most traded cryptocurrency is the bitcoin.

Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Default rate

The default rate refers to the proportion of borrowers who cannot service their loans.

Federal funds rate

The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

MSCI AC World Index

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

Option

An option is a contract which gives the buyer the option – but not the obligation – to buy or sell an asset in the future at a specified price.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Short

Short, in a financial-markets context, refers to approaches that seek to gain from a fall in the price of the underlying asset.

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Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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