

Keep calm and carry on

Weekly Digest

12 February 2018

– Alex Harvey, CFA

What a difference a week makes. After a year of profoundly low volatility, only the most dedicated armchair investor would have failed to notice the sharp correction in equity markets that has played out over the last week. It would be remiss of me not to comment given this is something we have been positioned for in our portfolios, albeit not knowing quite how or when any repricing might occur.

The events that unfolded a week ago seemed on the face of it to be very technical in nature. Yes, the Dow Jones index did suffer its largest ever points fall last Monday (and second largest three days later) but in percentage terms we have seen much worse. Black Monday in October 1987 saw a 22.6% decline but ‘only’ a 508 point loss on the day; less than half last Monday’s move of 1,175 points. Implied volatility as measured by the VIX index, a measure of traders’ expected equity volatility over the next 30 days, went through the roof as the tail wagged the proverbial dog in a market that had swelled with complex products allowing participants to bet on continued low volatility. What had been a highly profitable trade for several years unwound in a day with several funds forced to liquidate, closing out positions that exacerbated the move.

Initially the price action seemed limited mostly to equities with implied measures of price risk on bonds and currencies seemingly contained. There has been some subsequent price action in credit, but the traditional safe havens of treasuries, gold and the Japanese Yen provided little respite. That is why it is so important today to use the full suite of tools available to us when constructing multi asset portfolios, using more alternatives to diversify the traditional asset class mix further, and selecting managers and styles that complement each other when blended into a portfolio.

In recent months we have been able to further mitigate downside risk through buying a portfolio of under-priced put options at differing strikes and expiries that benefit when the US market falls. Bourses in the US did briefly enter ‘bear’ territory last week - falling more than 10% - but in reality, US equity prices remain expensive at a time when treasury yields are moving higher with inflationary expectations. Should that continue then equity valuations are likely to face renewed pressure and longer dated put options still have some appeal.

This episode is somewhat reminiscent of 2013’s taper tantrum when ascending US treasury yields led to a risk sell-off, with little protection from traditional asset allocation blends. With the market perception of US inflation risk very much on the upside today, central bank monetary policy and communication thereof will be crucial to maintaining calm in markets globally. In 2013 it was Ben Bernanke’s Fed that spooked the market with arguably misunderstood comments around the withdrawal of monetary stimulus. Fast forward five years and cross the pond and Mario Draghi has similar challenges at the ECB, although inflationary risk is more muted today in his sphere of influence. Faced with this evolving and delicately balanced landscape, investors should remain invested and be aware that volatility presents opportunities as well as threats, and is a prerequisite for defining risk premia and creating wealth over the longer term.

The Marketplace

- Global equities fall heavily following US sell-off
- Angela Merkel reaches coalition agreement with SPD
- Brent crude falls 8.4% amidst record US oil production
- Bank of England upgrades UK 2018 GDP forecast

Market Focus

US

- US equities suffered their worst week in two years with investors concerned about the impact of rising inflation on interest rates and heightened valuations. US equities declined 5.1% in the week, while the VIX index, a measurement of implied US equity market volatility, rose to above 50 intraday, the highest level since August 2015.
- Senate leaders announced a two year budget deal including USD 300 billion of additional spending and a suspension of the federal debt ceiling until March 2019.
- The December trade deficit was slightly higher than expected at USD 53.1 billion versus a 52.1 billion consensus.

UK

- The Bank of England upgraded the UK's GDP growth forecast in 2018 to 1.8%, up from 1.6%, while 2019 forecasts were held at 1.7%. The upgrade follows a stronger than expected global economy and rising wages.
- The Bank of England's Monetary Policy Committee voted unanimously to hold rates at 0.5%. Comments by Governor Mark Carney were notably hawkish, stating that rate hikes were likely to be earlier and to a greater extent than anticipated in November.

- The December trade deficit widened to GBP 4.9 billion vs 2.4 billion expected.
- Flash Purchasing Managers' Indices were lower than expected, with the composite reading at 53.5 versus 54.6, while the services PMI reading of 53.0 was the lowest since September 2016.
- UK equities fell 4.6% in Sterling terms following a global equity market sell-off.

Europe

- In Germany, the CDU/CSU and SPD reached a coalition agreement, with the SPD likely to gain the finance and foreign affairs ministry positions.
- The final reading for the Eurozone January composite Purchasing Managers' Index was revised up 0.2 points to 58.8, a circa 11 year high.
- The German trade surplus in December was smaller than expected at EUR 18.2 billion versus 21 billion expected. For the first time since 2009, the annual trade surplus fell, albeit marginally.
- The European Commission upgraded its GDP growth forecasts for the Euro area to 2.3% in 2018 (up from 2.1%) and 2.0% for 2019. UK 2018 GDP growth was forecasted at 1.4%, 0.4 percentage points lower than the estimate by the Bank of England.
- Brent crude oil fell 8.4% in the week with rising US production putting pressure on prices.

Asia

- Asia-Pacific equities fell 7.3% in US Dollar terms while Japanese equities fell 7.1% in Yen terms following the US equity market sell-off.
- Japan's Prime Minister Shinzo Abe is expected to re-appoint incumbent Bank of Japan Governor Haruhiko Kuroda. This will be the first re-appointment in 60 years

Asset Class/Region	Currency	Currency returns			
		Week ending 9 Feb. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-5.1%	-7.2%	-1.9%	15.1%
United Kingdom	GBP	-4.6%	-5.8%	-7.6%	1.8%
Continental Europe	EUR	-5.0%	-6.8%	-4.5%	5.0%
Japan	JPY	-7.1%	-5.7%	-4.7%	16.9%
Asia Pacific (ex Japan)	USD	-7.3%	-8.7%	-2.6%	24.0%
Australia	AUD	-4.6%	-3.3%	-3.7%	7.6%
Global	USD	-5.5%	-7.3%	-2.4%	15.6%
Emerging markets equities					
Emerging Europe	USD	-6.7%	-7.7%	1.7%	19.6%
Emerging Asia	USD	-7.7%	-9.4%	-2.1%	29.2%
Emerging Latin America	USD	-5.9%	-7.7%	4.5%	18.3%
BRICs	USD	-8.0%	-10.1%	0.2%	30.7%
MENA countries	USD	-2.6%	-2.4%	2.8%	2.2%
South Africa	USD	-4.7%	-8.0%	-5.4%	25.6%
India	USD	-3.3%	-6.3%	-1.6%	24.9%
Global emerging markets	USD	-7.1%	-8.9%	-1.3%	26.2%
Bonds					
US Treasuries	USD	0.1%	-0.6%	-2.0%	-0.1%
US Treasuries (inflation protected)	USD	-0.5%	-1.3%	-2.2%	0.2%
US Corporate (investment grade)	USD	-0.5%	-1.3%	-2.3%	3.3%
US High Yield	USD	-1.5%	-1.9%	-1.3%	4.1%
UK Gilts	GBP	-0.1%	-0.5%	-2.6%	-0.4%
UK Corporate (investment grade)	GBP	-0.8%	-1.3%	-2.2%	2.5%
Euro Government Bonds	EUR	0.1%	-0.1%	-0.5%	1.3%
Euro Corporate (investment grade)	EUR	-0.1%	-0.3%	-0.6%	1.8%
Euro High Yield	EUR	-0.6%	-0.9%	-0.5%	5.3%
Japanese Government	JPY	0.1%	0.1%	-0.1%	0.9%
Australian Government	AUD	-0.2%	-0.2%	-0.7%	1.8%
Global Government Bonds	USD	-0.3%	-1.1%	0.2%	6.3%
Global Bonds	USD	-0.5%	-1.2%	-0.1%	6.5%
Global Convertible Bonds	USD	-2.8%	-3.6%	-0.1%	6.9%
Emerging Market Bonds	USD	-2.2%	-2.9%	-3.4%	1.7%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-3.7%	-6.6%	-10.5%	-8.0%
Australian Property Securities	AUD	-3.7%	-4.4%	-7.6%	-5.6%
Asia Property Securities	USD	-9.0%	-9.8%	-3.1%	15.4%
Global Property Securities	USD	-5.6%	-7.7%	-6.7%	5.6%
Currencies					
Euro	USD	-2.0%	-1.6%	1.6%	14.6%
UK Pound Sterling	USD	-2.6%	-2.8%	1.9%	10.2%
Japanese Yen	USD	1.6%	0.9%	3.9%	4.4%
Australian Dollar	USD	-2.1%	-3.3%	-0.4%	2.0%
South African Rand	USD	-0.7%	-1.9%	2.3%	11.0%
Swiss Franc	USD	-1.1%	-0.7%	3.6%	6.6%
Chinese Yuan	USD	0.1%	-0.1%	3.4%	9.2%
Commodities & Alternatives					
Commodities	USD	-4.5%	-4.8%	-1.7%	1.3%
Agricultural Commodities	USD	-0.5%	-0.4%	1.6%	-7.3%
Oil	USD	-8.4%	-9.1%	-6.1%	12.9%
Gold	USD	-1.7%	-2.0%	0.5%	6.4%
Hedge funds	USD	-1.6%	-2.2%	0.2%	5.2%

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