2018 Market Volatility. Where Do We Go From Here.

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Recent market action:

I would never advise anyone to look at market movements on a daily basis. At these time frames what we observe is noise and not signal. With this caveat, let's have a look at what has happened.

US markets ended last week with a sharp fall on Friday (Feb 2), ostensibly triggered by strong employment and wage data fuelling fears of inflation and more aggressive policy reaction. After the weekend we saw a week of very high volatility. From peak to trough in over the last 2 weeks, the S&P500 was down over 10%. VIX rose from below 10 to over 50. One inverse VIX ETF has been liquidated. Commodity prices have been falling in sympathy with bond and equity prices. Even the gold price has fallen. As risk assets have sold off, the USD which had been very weak as the risk assets rallied all last year, rallied, behaving like a haven asset.

The 10Y UST has traded from a yield of 2.6 to over 2.8 and the 30Y from 2.93 to 3.1. The USD yield curve steepened, the 2 – 10 steepening 17 bps. The HY bond market has seen spreads widen from 3.00 to 3.31. The IG spread has been volatile but has generally tightened as the duration element has dominated pricing leading perversely to spread tightening. Loan spreads have begun to widen but have so far lagged and been stable.

The blame for the initial sell off has been inflation expectations and a more hawkish Fed. 5 year 5 year breakevens, the market pricing of inflation have jumped from 2.15 to 2.26. But PCE Core inflation hasn't seen 2% since 2012 and at 1.5% still has room to rise before it even reaches the Fed's target. Eurozone inflation is even further from target. If inflation is really a threat, the market is being very forward looking, and jumpy.

Is there a fundamental weakness?

The reasons there is not:

- Global growth is strong, accelerating and broadening to include more regions and countries.
- International trade has rebounded and is growing.
- Inflation is rising but is well below central bank targets. (More on this later.)
- Emerging markets have their balance sheets in order with less USD liabilities.
- Interest rates remain low. Among the majors, only the US Fed is tightening and even then is doing so very gently. All other majors remain accommodative.

The reasons there is:

- The global economy has lived off 10 years of QE. While the ECB and BoJ continue to operate QE, there are fears that they may taper their programs. Already the US Fed is raising rates and shrinking its balance sheet. We are about to discover if global economic growth can be sustained without QE.
- Global debt levels are high. Debt levels have increased significantly in the last 10 years. Debt has not been paid down but has been transferred from private balance

sheets to public ones. And why not since everyone including central banks are such willing lenders. Non financial corporates have been the most aggressive borrowers followed by governments then the financial sector with households trailing the lot.

- Inflation may be rising. The US labour market is showing signs of tightness with higher wage growth, lower unemployment and higher quits rates.
- Political risk remains. While the US seems to be surviving a Trump White House, the French have eschewed National Front politics, the UK continues to limp ahead with the ruling Conservatives split down the middle. Germany will have a grand coalition but also the AfD in the Bundestag. Italy goes to the elections in early March.

When markets rise the public focus on the good fundamentals. When markets fall sufficiently they will once again focus on the bad fundamentals. In a sense, the market influences how we look at the world.

Inflation

At this time inflation seems to be to blame for the market sell-off. The strong labour market data in the US on Feb 2 triggered fears that inflation would rise and that the rates market and possibly the Fed might be behind the curve and have to compensate. Since equity market valuations were high, and being justified by low interest rates, the threat of higher and rising rates naturally caused a re-assessment of equity valuations.

Inflation in the US is 1.5% (core PCE, the Fed’s benchmark measure.) The Fed’s target is 2%. Inflation in the Eurozone is 1.4% (HICP). The ECB’s soft target is 2%. China’s headline inflation’s recent peak was 6.5% in 2011 from which it has steadily fallen to the current 1.8%. Japan’s inflation is only just in positive territory and barely merits mention. It seems premature to fear an overshoot of inflation when current measures are significantly below targets.

Is the inflation threat real? If trade protectionism gains momentum, it would add to inflation pressures. So would a fiscal deficit, a weak USD, rising energy and commodity prices, and a tighter labour market. We think that rising interest rates itself will spark inflation for technical reasons. So I do expect inflation to rise and for the rise to accelerate, but I also see that inflation levels will only be a concern over a year from now. Has the market become so forward looking? We do not think so.

QE dependency

The global economy has survived on QE for 10 years. Like any painkiller, it is difficult to give up. QE has done a lot of good, it has given regulators time to restructure and recapitalize the banking system. It has cushioned the blow of recession and shortened the duration of the slump. It has cheapened cost of debt and helped the economy to find its feet and recover. On the other hand it has strengthened moral hazard, it has distorted prices, not least the price of money (interest rates), not only at short maturities but at all points along a 30 year yield curve. It has inflated asset prices and exacerbated inequality resulting in over saving. By intervening in the market mechanism for pricing assets, we now do not know the right price of assets without QE. And we may be quickly discovering what those prices may be.

The US Fed has begun to shrink its balance sheet and no longer buys the quantity of bonds it used to. The ECB will stop expanding its balance sheet Sep 2018. The BoJ looks like it will continue QE for the foreseeable future. The PBOC manages towards domestic objectives but is trying to risk manage a financial system which has leveraged itself up acutely. It is not the level of liquidity that matters but the rate of change, and the Fed's actions will have significant impact.

Market expectations over next 12 months

We've had 9 years of uncertainty over global growth punctuated by mini crises and growth slumps, patchy recoveries and tepid growth and how did the market react? With a 9 year bull market. Earlier this year asked how markets would react to a growing consensus of confidence and optimism and appear to have found my answer.

In order of confidence

<u>Interest rates will rise</u>.

The Fed is not just reacting to inflation expectations but has to reset its primary policy tool in case it has to be deployed again. The strength of the economy gives the Fed a window of opportunity to do so. I am quite confident that that the Fed will stick to 3 hikes this year with a small risk that they may do four. What could confound my expectations? So far the market volatility has been most felt in equities. If the yield curve steepens too quickly or if credit spreads widen too much, this could do the job of the Fed for them in which case they might slow down.

<u>Credit spreads will widen.</u>

Corporate credit spreads are very tight relative to history and it is very difficult to see spreads tightening further. Also, as we are in a late stage growth phase I would expect to see increased leverage and with rising base rates, rising debt service. Default rates are likely to rise and recovery rates to fall. The credit market is a fairly rational one and will likely price these dynamics in.

In mortgage bonds, however, I see continued improvement in collateral and in debt service with a stronger labour market.

The yield curve will steepen.

In addition to rising rates we also see inflation picking up. I think that this is a slow but steady process and that the curve will steepen to price in the inflation. Not only that, the US budget and tax reform will increase the borrowing requirements of the US government resulting in greater issuance. Add this to the Fed normalization and the uncertainty on whether China will remain a big buyer of treasuries and the recipe for curve steepening is set up. What could confound the view? Inflation hasn’t even reached central bank targets in any of the major economies and if the current trend in rising prices might not gain momentum.

USD will recover.

The weakness in the USD all of 2017 was somewhat of a mystery to us. The Fed was the only major rolling back accommodation, the economy was strong and continues to be strong. Experts cite the stronger growth in Europe and the risk that the ECB might taper QE thus favouring EUR but the USD was also weak against JPY and the BoJ is in no danger of tightening anything soon. Our view is that the USD is a haven asset and that a heightened risk aversion will support the currency. Or at least re-focus investors to the fundamentals of the US, a net importer trying to be more protectionist, a strong economy, with a central bank pulling back the liquidity reins.

Equity markets will continue to rise.

With a strong economy and wide spread upward earnings revisions it is unwise to bet against a rising market. However, if a market rises to X% above fair value and it corrects you can be sure it will not stop at fair value but can easily fall to X% below fair value. On average and over the long run, I should expect markets to track growth and earnings.

Volatile markets with a trend represent an opportunity. It allows the active investor to rotate between being long the market via the underlying stocks to being short put options to being long call options, and to take advantage of volatility.