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January 2018 Portfolio Review

As we write, for the first time in over a year, markets have fallen sharply. Keeping a cool head about markets is important when others are panicking. Through 2017, we experienced the lowest levels of equity market volatility in a generation so yesterday's 4.5% negative move in the S&P 500 is something investors haven't experienced since 2011.

Stronger-than-expected US wage data on Friday reminded investors that inflation risks are building and that the Federal Reserve will continue to increase interest rates. With other central banks winding down their Quantitative Easing policies, investors are worrying about the end of the cheap money era which has underpinned market confidence and valuations over the past few years. Bond markets wobbled, with US Treasury yields reaching close to 3%. However, to give perspective, US markets still only fell back to where they were already at the beginning of the year.

Last night's fall in the US coincided with macro-economic data releases showing both the US, as well as the European economies in even better shape than previously anticipated. The global economy is in good shape, with data continuing to point towards synchronised growth across the major blocs of the US, Europe and Asia in the year ahead, even a possibility of acceleration if corporate capital spending improves. It would be extremely unusual to see a sustained or deep equity bear market against such a positive economic background. Set against this, we have been concerned by demanding equity valuations and by apparently complacent investor sentiment, evident in such low stock-market volatility. With levels of volatility so low, there is a risk that a small rise could lead to a larger market reaction, as investors receive a reality check. Recent low volatility is the exception and not the norm, so there may be a few people (and programs) scrambling to recalibrate their risk models and a need for some to reappraise whether they have taken on too much risk.

Indeed, there had been increasing concerns voiced by institutional investors that equity market valuations particularly in the US had become overextended - unless the exceptionally low interest rate and low yield environment of the past years was to continue indefinitely. Against the backdrop of slowly normalising inflation expectations this is an increasingly unrealistic position.

As a result of the widespread valuation concern, investors have in recent times made significant moves towards systematic and easily tradeable investment strategies such as passive funds and "risk-parity" funds. These funds have pre-set rules for trading and are designed to avoid human intervention. However, they rely on market liquidity provided by other investors.

As bond yields gradually moved higher it appears that active (human) managers became extremely wary since last week, reducing market liquidity through their increasing unwillingness to continue to be buyers of equities. On the other side, the acceleration in markets price moves actually increased the systematic funds' need to find buyers, i.e. market liquidity. Without any human intervention, these funds have sold at whatever prices have been available. While systematic trading has existed for almost as long as markets, its current extent is the largest ever.

The result of the market correction thus far is that equities are trading at much less extended valuation levels than before and in some instances, have even fallen back to long term historical averages as observed during periods with interest rate and bond yield levels more in line with what may be ahead now. This return of value upside potential to markets has historically attracted back the aforementioned active (human) investment managers into buying the equities that the systematic strategies are forced to sell. This leads to a gradual return of buyers/liquidity to markets and generally presents a buying opportunity for rational investors.

The low volatility, high return environment of the past 14 months was a pleasing, if unusual experience for long term investors. This sudden return of market volatility is a timely reminder that higher returns do come at the risk of higher capital fluctuation over the shorter term. At this point it is key for investors to remember that the route to superior long-term returns is determined by 'time in the markets' rather than attempting to 'time the markets' as so many investors in the above mentioned systematic risk parity strategies are just finding out again.

Given the economic and corporate news-flow was very positive over the week, we interpret this sell off as a temporary profit taking and also hope that it will quell recent US equity investor exuberance for a while longer. 5-6% global stock market growth in a single month (without being a recovery from a previous fall) has just all hallmarks of an overheating capital market environment which usually leads to nasty corrections in due course.

At this point it is important to note that compared to the last equity market correction of January / February 2016, there are currently no widespread concerns about a slowing economy or rising corporate default risks.

This episode of market volatility has not yet played out and could well involve more wrenching trading sessions for investors. Central banks are moving towards a more normal interest rate policy, and this will see some of the distortions of the last few years unwinding – not always smoothly. But the economic cycle has not yet turned, the growth outlook remains healthy, and this suggests that we face a market correction, not a sustained downturn or a recession.