Market commentary

7 February 2018

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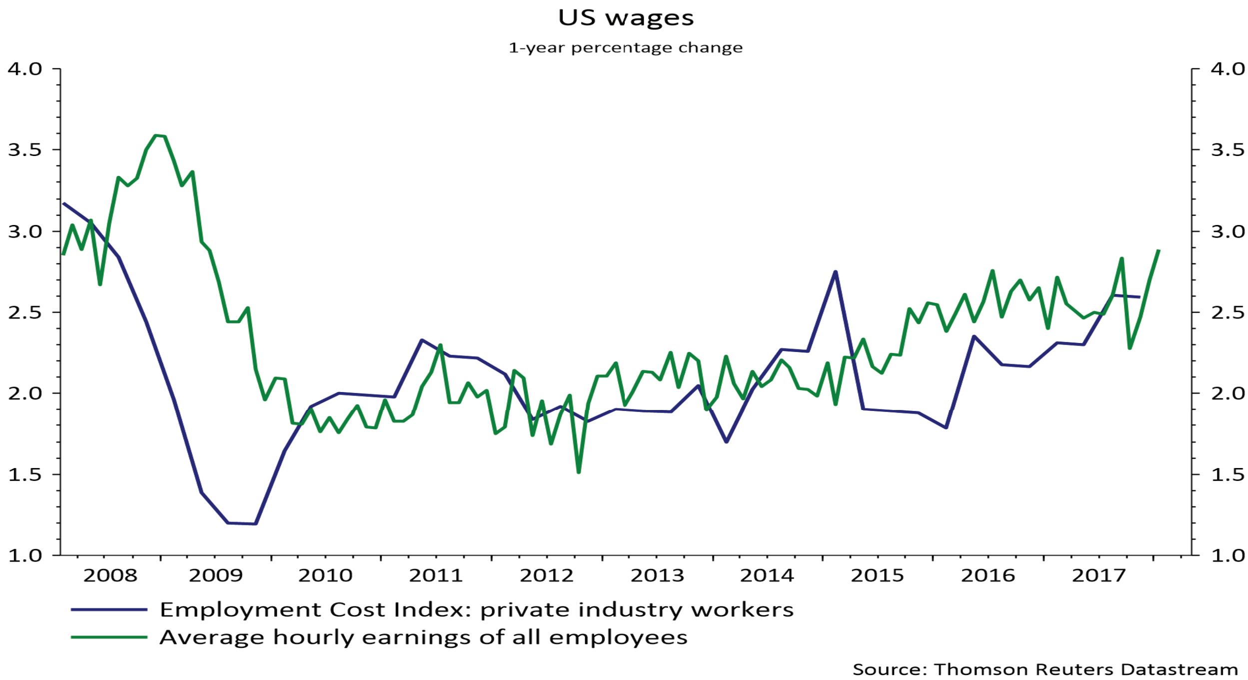
Chief investment officer

Volatility is back - but don't panic

Global equity markets have fallen sharply in recent days and market volatility, a gauge of investor fear, has risen significantly. The recently-released US employment data appear to have been the immediate trigger for the sell-off. US wages increased 0.3% month-on-month in January while December's growth rate was revised upwards to 0.4%. It takes more than two data points to make a trend but the January employment report shook complacency regarding the pace of future interest rate rises.



Wages are rising strongly because of the strength of the US economy. Gross domestic product growth was healthy in 2017 and may accelerate in 2018 as President Trump's newly-signed tax cuts and jobs act stimulates an already strong economy. The cut in corporate tax rate from 35% to 21% will encourage businesses to invest while simplified personal tax rates will encourage consumers to spend more.

This all sounds like good news. Equity markets have, however, been falling because investors fear that rising interest rates will reverse the trend of recent years and encourage investors to sell shares and seek the relative safety of cash and other fixed interest investments.

Despite strong global economic prospects, I have, in recent months, reduced clients' allocations to equities across most strategies and funds although I continue to prefer the asset class overall. Inflation and interest rates are rising but they have further to go before monetary conditions become restrictive. Clients' investments in equity funds ended January biased towards Europe excluding the UK and some emerging markets, where valuations remained attractive in preference to the US and the UK, where near-full employment may lead to inflation and interest rates rising more rapidly than anticipated. The US equity market has appeared expensive for some time and Brompton's residual investments in US equities have been focused on financial stocks, which should benefit from rising interest rates.

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The eurozone is benefiting from a manufacturing revival and growth in global trade. In contrast to the US and the UK, there is still significant excess capacity in the eurozone's economies. Eurozone inflation and interest rates are likely to remain low for some time, with unemployment at 8.7% compared with 4.1% in the US and 4.3% in the UK. At times of investor panic, however, equity markets typically fall in unison. This may provide a buying opportunity for longer-term investors.

Bond markets are vulnerable to rising inflation and interest rates, particularly longer-duration securities, which tend to be highly-sensitive to interest rate rises. Clients' investments in bond funds ended January biased towards short-duration, inflation-linked and local-currency emerging market sovereign bonds, which may make gains and provide some protection from rising interest rates.

Brompton has also initiated or increased investment on behalf of most clients in daily-priced absolute return funds such as long/short equity funds. The direction of underlying markets has little or no influence on such funds, which rely for positive returns on the stock-picking ability of their managers. The increase in market volatility and moral hazard as a result of the gradual withdrawal of monetary stimulus may increase the opportunities for these managers.

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