Flash Update

Cold sweat or cool heads?


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After fifteen consecutive months of positive gains and a strong start to the year – the MSCI AC World returned 5.6% in January in US dollar terms, taking net performance since end October 2016 to 31.8% (source: Bloomberg) – global equities were overbought and investor sentiment overly optimistic, traditionally fertile ground for some profit taking.

The environment remains supportive for global equities

A piece of seemingly good news can have the opposite effect. This happened last Friday, when the release of a healthy US employment report triggered a sell-off in equity markets. US employers added more jobs than expected in January and average hourly earnings increased by 2.9% YoY, the fastest pace since 2009 (source: Bloomberg). All in all, recent US data suggest that the US economy was already accelerating before the tax cuts were announced in late 2017.

Building inflation expectations have thus led to a reassessment of the pace of Fed tightening – the probability of three rate hikes this year has reached 82% according to Bloomberg, which is now in line with the Fed's own projections. This in turn has pushed long rates higher – the 10-year US Treasury yield rose to a four-year high at 2.84% on Friday (source: Bloomberg).

This robust economic backdrop is reflected across the globe. Business and household confidence measures have strengthened, encouraging the World Bank recently to upgrade its forecasts for global growth in 2018. As a result, government bond yields have been rising across the board, which tends to put downward pressure on equity valuations. Against this background, equity markets have sold off sharply in recent days. The MSCI AC World is down 6.3% from its high on 26 January (source: Bloomberg).

However, the macroeconomic environment and corporate fundamentals remain supportive for global equities. Economic growth and broadly accommodative monetary conditions have helped generate strong increases in sales and profits for businesses. 80% of earnings and sales reported by US companies for Q4 2017 have exceeded forecasts, the highest proportion since 2000. And a record 75% of businesses have revised upwards their guidance for 2018 results.

So what has driven the sell-off?

As suggested above, the long, steady rise in equity markets in recent quarters has set the scene for a sell-off. In our view, this has been exacerbated by a number of technical factors. In recent years, a number of systematic strategies have been launched in areas such as "risk parity" or "short volatility". One common denominator in these strategies is the reduction of exposure when risk appetite falls and volatility rises, just as has happened in recent days. Such trading techniques tend to accentuate moves, just as we observed during the brief "flash crash" in US equities on Monday 5 February.

However, the rapid shift in markets in the past few days has corrected some of the excesses we mentioned above. The US market closed yesterday at oversold levels. The VIX implied volatility index, a measure of risk aversion, shot up to reach 3-year highs, suggesting that investors had quickly shed their complacency (source: Bloomberg).

Conclusion

The Global Investment Committee held an exceptional meeting on Tuesday 6 February and we decided to keep our recommendations unchanged. This was based on our assessment of the key pillars in our investment process – the macro backdrop, market valuations and fundamentals, momentum and sentiment.

Our current recommendations for a defensive stance in fixed income investments in light of rising yields and a modestly overweight stance for equities remain in place. The committee will meet again tomorrow for a full review of our investment framework and will publish our updated House Views on Friday 9 February.

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