False Dusks

A few extreme movements have occurred in the last couple of weeks, and, unsurprisingly, there is no shortage of commentators suggesting that these are harbingers of an imminent market crisis. Many have been making the same prediction for a number of years, and so it is tempting to take the current round with a pinch of salt. However, no smoke without fire and all that, and we are far from complacent. Here's our take on four key developments.
Last week I wrote about the rapid and large shift in favour of Value stocks relative to Growth. I have unearthed more data on this rotation, and it turns out to have been the 17th worst month for the Momentum style since 1952 in the US, posting a 5% loss relative to the wider market. For those who like to collect such information, the worst ever month was March 2000, when Momentum suffered a staggering 15% relative loss, which rang the bell for the peak of the Tech boom. On the basis that at least some of the current movement is predicated on a slightly more favourable growth outlook (or, at least, a backing away from the precipice), then it should not be the precursor to wider market dislocation.

Another perceived bearish straw in the wind is the postponement of the Initial Public Offering (IPO) of shares in office-space provider WeWork, which, alongside the disappointing post-IPO performances of high-profile ride-sharing companies Uber (-25% since IPO) and Lyft (-35%), echoes the Tech bust. Not only that, but the company's projected IPO value collapsed from $47 billion in its last funding round (however puffed up that might have been to suit lead investor Softbank) to around $16bn – and a mooted original IPO valuation of $65bn! So far it is private investors who have taken most of the hit, and there seems to be limited contagion to more seasoned quoted technology stocks – and then there is the whole debate about what constitutes a technology stock as opposed to a real estate manager or a taxi booking firm! The US IPO market itself is nowhere near as frothy as it became in the late 1990s, when an average of 400 new companies came to the market every year as opposed to just 75 so far this year. The IPO market certainly doesn't feel as manic as it did then, and that is borne out by another statistic: the Developed Market value of IPOs is running at 0.2% of total market capitalization versus 0.7% in 2000.

Even as I was putting the final touches to last week's Digest, the oil price was having its sharpest upward move since Saddam Hussein was throwing his weight around in the early '90s. This was down to the potential loss of around half of Saudi Arabia's production following a drone attack on its main refinery. That in itself represented 5% of global production, so the squeeze was understandable, although was exaggerated by being traded in the less liquid Asian markets overnight. In terms of a barrel of Brent crude, the price went from $60 to $72 initially, but has since settled back to around $64 as Saudi supplies will not be affected as badly or for as long as was first feared. But this episode has highlighted the escalating risk in the Middle East, and the price of oil is notoriously sensitive to small changes in the balance of supply and demand. The pessimists hark back to the 1973 oil embargo which saw prices quadruple amidst supply shortages, but our usual game theory approach to such events suggests that it will be in no side's interest to push matters that far. Furthermore, the Middle Eastern supply pool is not as dominant as it was back then, and the global economy is also less oil intensive (although we do use a lot more). So this looks like another potential incoming missile to track on our radar, but not one that is about to blow us up.

The final big move to report was the big spike in the overnight dollar repo (repurchase) rate early last week. This is the rate at which banks borrow from each other overnight, and usually sits within the Federal Funds range, which at the time was 2% - 2.25%. On Tuesday it shot up to around 10%, meaning that the Fed had to step in to provide liquidity at the proper price for the first time since – you've guessed it – the financial crisis. Cue the expected calls that the financial system's plumbing had clogged up and a meltdown was on the way. Well, here we are a week later and the world is still turning and banks are going about their business. I have argued consistently over the last few years that the world's central banks are much more attuned to this sort of liquidity risk than they were in 2008, and the Fed fulfilled its role as "lender of last resort" – admittedly having perhaps been a bit slow to react initially.

It's worth making further comparison with 2008. The shortage of dollars in the system last week appears to be have been mainly the result of excess demand to make tax payments and settle purchases of Treasury bonds, possibly exacerbated by banks being more conservative as we approach the end of the quarter when their balance sheets are assessed by regulators. But there is no sign of balance sheet stress such as we witnessed in 2008 when banks' assets were devaluing at a rate of knots and nobody was sure who was going to bust next. It may well be that certain technical factors mean that we will see future spikes, but they are not necessarily indicative of deeper problems.

Issues such as these are keeping everyone on their toes, and ensuring that the euphoria that is associated with market peaks remains notable by its absence, with fund manager sentiment surveys generally saying "buy" not "sell".

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

International Consolidated Airlines	4.5%
John Wood	4.5%
SSE	4.4%
AstraZeneca	4.4%
BT Group	4.3%
Micro Focus	3.9%
Rentokil Initial	3.8%

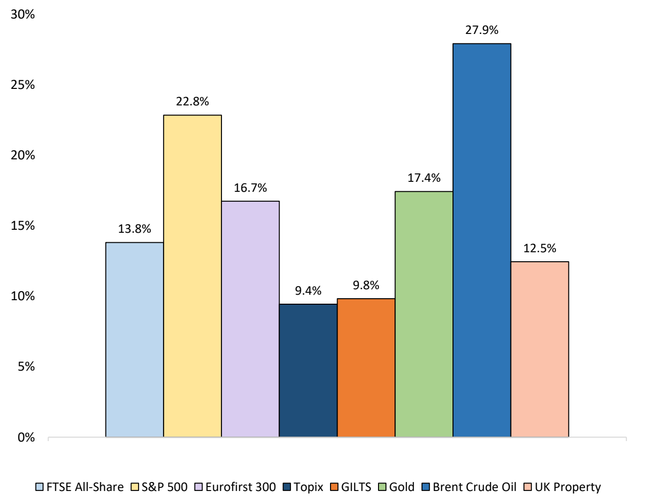
Source:FactSet

FTSE 100 Weekly Losers

Evraz	-8.3%
Smurfit Kappa	-7.5%
DS Smith	-6.6%
Mondi	-6.5%
St James's Place	-5.8%
TUI	-5.0%
Rolls-Royce	-4.7%

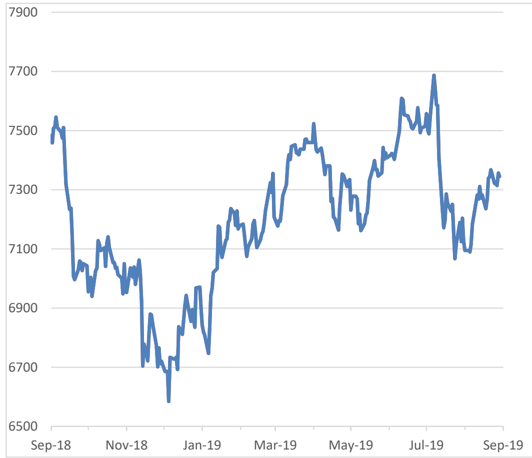
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet