Weekly Digest

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The weekly insight into world stock markets

Investec
Wealth & Investment

The Blame Game

Two years ago equity markets were in freefall, but the circumstances were quite different to the present. The perceived problem then was not enough growth, with widespread fears that China was heading for a severe slowdown. Now investors worry about the prospect of too much growth, and specifically about the potential upward pressure on wage growth, consumer price inflation, interest rates and bond yields. We have commented in the past that the latter stages of a market cycle can lead to counterintuitive outcomes, particularly when good news for the economy and corporate earnings can be bad news for financial assets. We seem to have reached that point now.

As has been universally acknowledged, the match that lit the flame of the current correction was the release of US employment data on February 2nd revealing a sharp increase in annual hourly earnings growth from 2.5% to 2.9%, suggesting a very tight labour market. There was a mitigating factor in the news that average weekly hours worked fell from 34.5 to 34.3. The change in the denominator alone boosted hourly wages by around 0.5%, but nobody seemed to care, suggesting that investors were primed to interpret any news as bad, much more attuned to the risks than the rewards. And not without reason, perhaps, given the duration of the bull market and the unprecedentedly long period of subdued volatility. Also, although very difficult to prove, there is a feeling that the market was not positioned for higher inflation, so suddenly a lot of people had to rejig portfolios. This has echoes of the 2013 “Taper Tantrum”, when investors suddenly woke up to the risk of tighter monetary policy following comments from Federal Reserve chairman Ben Bernanke.

Still, that doesn’t fully explain the extreme speed of the sell-off. Fire investigators first look for the origin of a fire, then turn their skills to seeking the accelerant. This can be something, such as a flammable liquid, that just happened to be there, or it could have been deliberately applied to make the fire worse. In this particular market conflagration, the finger of blame is being firmly pointed at funds that were exposed to “short volatility” positions. It would be hard to make criminal allegations in these cases, but there are certainly accusations of negligence and recklessness.

The key players are deemed to have been “Short Volatility” funds, Risk Parity funds and Variable Annuity funds. Not surprisingly, they are all blaming anyone but themselves, with the boss of the Chicago Board Options Exchange, holder of the licence to the VIX volatility index and all its derivatives, being particularly vocal on the subject. It’s important to note that they don’t all operate in the same way. “Short Vol” funds effectively sell market insurance to investors who are more cautious. They rake in the premiums until something goes wrong, which gives the illusion of a steady stream of returns, but can be wiped out in a meaningful setback. The best know fund, the VelocityShares Daily Inverse VIX Short-Term Exchange Traded Note (ticker XIV), almost tripled in value during 2017 (from $47 to $138), but fell to $5 last week (and was subsequently withdrawn from the market), wiping out all the returns (and more) of anybody still holding it – and a lot of people were still holding it, because its market value peaked just shy of $1.9 billion as recently as 1st February this year. Anyone who was short of volatility was scrambling to buy it back as markets began to fall, pushing volatility up even further. The move of the VIX volatility index from below 10 to over 50 was the biggest on record in such a short time. The prospectuses of “Short Vol” funds made it clear that such a move could wipe the funds out, but investors had either failed to read the small print or just ignored the risks (I suspect the former).

Risk Parity and Variable Annuity funds are different beasts. They, very simplistically, raise their weightings in riskier assets such as equities as volatility falls (because falling volatility is taken as an indicator of a lower risk of loss). As volatility rose, they were forced by their own rules to sell equities. Naturally, both industries deny that they are to blame, but they are surely at least part of the problem, if not all of it. A white paper written by Christopher Cole of Artemis Capital Management (NOT the UK fund manager) in October 2017, calculated that there was as much as $1.5 trillion of funds exposed to “short volatility” strategies in some form or other, and that it was an accident waiting to happen. But even he could not predict the catalyst or timing.

The good news is that markets have rediscovered their poise, for now at least, but another test awaits us on Wednesday in the form of the US Consumer Price Index release for January. Economists in aggregate are forecasting a fall back to 1.9% from 2.1% in December, which should come as some relief if the forecast is met. US bond investors are not taking any chances, though, with the 10-Year yield still at a four-year high of 2.85%. We definitely appear to have left the deflation risk era behind us for now.

Finally, a slightly more optimistic thought. The performance of US High Yield corporate bonds has been resilient. Although spreads (391 basis points from a low of 334 bps) and yields (6.6% from 5.9%) have backed up a bit, there are no real signs of stress, underlining the fact that markets remain relatively relaxed about the growth outlook. This is important in light of last week’s observations that bear markets tend to be associated with recessions. Finally, the nickname of the Ugandan basketball national sports team is the Silverbacks. This week, the Olympic Basketball gold medal has been won by either the USA or the Soviet Union at 17 out of 19 summer games. Who were the other two winners?

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Head of Investment Strategy

FTSE 100 Weekly Winners

Compass Group	2.8%
Direct Line Insurance Group	1.0%
Paddy Power Betfair	0.2%
Kingfisher	0.1%
Admiral Group	-0.1%
TUI	-0.2%
Just Eat	-0.4%

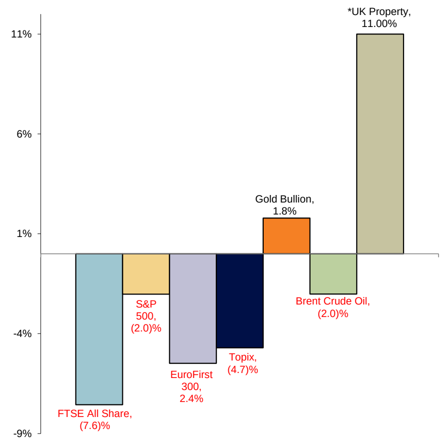
Source: FactSet

FTSE 100 Weekly Losers

Randgold Resources	-14.6%
G4S	-9.6%
Schroders	-9.5%
Hargreaves Lansdown	-9.3%
Standard Life Aberdeen	-9.1%
Sage Group	-8.9%
Evraz	-8.6%

Source: FactSet

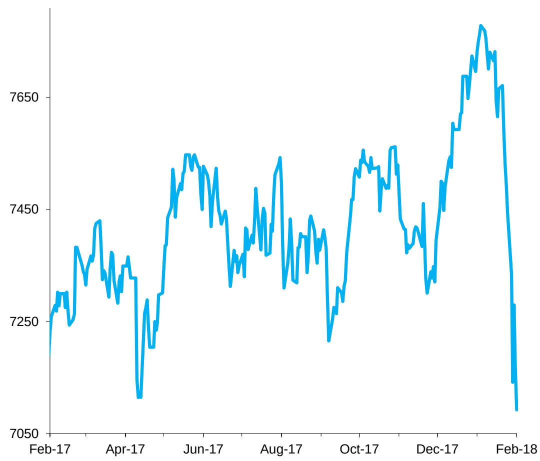
Year to Date Market Performance



*Lagged to latest UK IPD Total Return All Property Index (Nov 2017)

Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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