Weekly Digest
5 February 2018

Investec
Wealth & Investment

The weekly insight into world stock markets

The Big One?

Residents of Los Angeles and San Francisco live in fear of "The Big One", the long-awaited, possibly overdue, earthquake that will be caused by a readjustment of the tectonic plates that meet along the San Andreas fault which runs through much of California. You don't necessarily see the nervousness reflected in daily life, but any meaningful tremors always elicit the question of whether it is indeed just a tremor or the prelude to something catastrophic. Investors in both bonds and equities are in a similar position currently. The thirty-five year old bond bull market is claimed by many to be over; the economic cycle is long in the tooth; stock markets have made a series of highs with unprecedentedly low levels of volatility. So when the US stock market has its worst week since 2016, and the US 10-year Treasury yield hits a four-year high, investors are predisposed to ask: "Is this The Big One?" - the start of a much bigger fall in asset prices.

I have already used all of this year's Weekly Digests to discuss the topics of market valuation, the threat of rising interest rates and bond yields and the strong momentum in the global economy and corporate earnings. Like seismologists with an ear to the ground, we have been listening for the early warning signs of a more volatile period for asset prices. It finally came upon us last week, but so far is still in the "tremor" category rather than anything more serious. So is it time to hide? Our first instinct is: not necessarily. Even falls of a few more percent would not be catastrophic and only take equity markets back to where they were a few weeks ago. Indeed, blowing a bit of froth off the top of the market would be seen as quite healthy. One reason, perhaps, why equities sold off a bit more dramatically on Friday was because of a call from a prominent strategist at Bank of America, citing the fact that his proprietary contrarian sentiment indicator was now flashing "sell". Finally, the market had just become too euphoric and gains were too readily made.

The publication of his call coincided with another strong employment report in the US, one that showed an acceleration in wage growth. As I have discussed previously, faster wage growth is seen as a key lead indicator of higher inflation in the prices of goods and services. Thus, encouraged by comments from the latest Federal Reserve meeting that appeared to endorse another interest rate rise in March, bond investors hit the "sell" button, sending the yield of the 10-year Treasury bond over 2.8%. Almost a year ago, the last time that the bond markets were selling off more aggressively, I discussed the debate about the impact of rising bond yields on other assets, notably equities. The broad consensus was that there are two key risks. The first was the level of yields, and most strategists were of the opinion that equities would not come under great pressure until the US 10-year yield rose to at least 3%, and more probably to 3.25%. Taking into account the subsequent rise in equity markets combined with the growth in corporate earnings, the general view is that those levels still prevail. The other factor that would be of concern was the pace of the rise in yields, and I think it is the speed of the current rise that is unnerving investors more. Bond investors in aggregate do not appear to be positioned for a surprise tick-up in inflation. So we certainly understand the current bout of nerves, but this does not necessarily point to the development of a bear market for equities (defined by a fall of 20% or more from the peak).

As part of our Vision 2018 series of investor presentations we have looked at all the bear markets in the United States since the 1920s, and it is notable that they are almost always accompanied by an economic recession. It's very hard to find anyone who is predicting a recession at the moment, and little reason to expect one given the momentum, which will have been given a boost by Trump's tax deal. The question remains whether or not the Federal Reserve becomes aggressive enough to cause a recession because it sees too much inflation risk and raises interest rates even faster than markets currently expect. We believe that to be improbable. Neither does it look as though any other large region is suddenly about to hit the buffers. So that would suggest holding tight for now.

However - and aren't there always exceptions that prove the rule in financial markets? – we did find two bear markets that occurred with no recession in sight. The first was in 1963, around the time of the Bay of Pigs invasion when there was a real threat of nuclear war in the air. Does that sound familiar? Escalation of tensions in the Korean Peninsula cannot be discounted, but is a separate issue to what we have discussed so far. The second non-recessionary bear market was in 1987, when the market crashed in October. As discussed at the time of last year's thirty-year anniversary, that fall was exacerbated by the use of "portfolio insurance" programmes. There are echoes of that risk today in the form of all manner of computer-driven trading, a huge outstanding "short volatility" position, and the uncertain influence of Exchange Traded Funds in a falling market. These all raise the possibility of an overshoot to the downside, but, on fundamentals alone, there is insufficient reason to say that "The Big One" has started. To be continued…

Finally, the Battle of Mengo Hill took place in Uganda. This week, the nickname of which Ugandan national sports team is the Silverbacks?

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

BAE Systems	2.1%
3i Group	2.1%
Smurfit Kappa Group	1.7%
Sky	1.3%
Johnson Matthey	1.3%
Unilever	1.1%
Rolls-Royce Holdings	1.1%

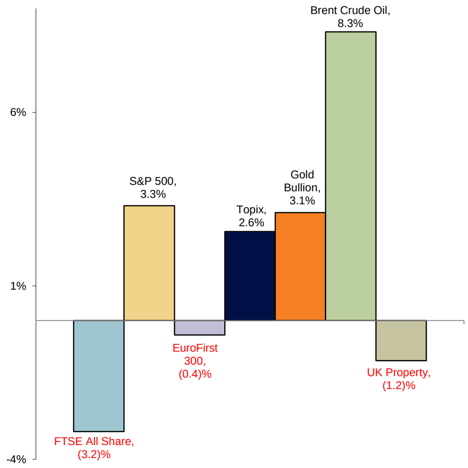
Source: FactSet

FTSE 100 Weekly Losers

Barratt Developments	-7.1%
Barclays	-6.9%
CRH	-6.7%
Berkeley Group Holdings	-5.3%
BP	-5.2%
Royal Dutch Shell Class B	-5.1%
Taylor Wimpey	-5.1%

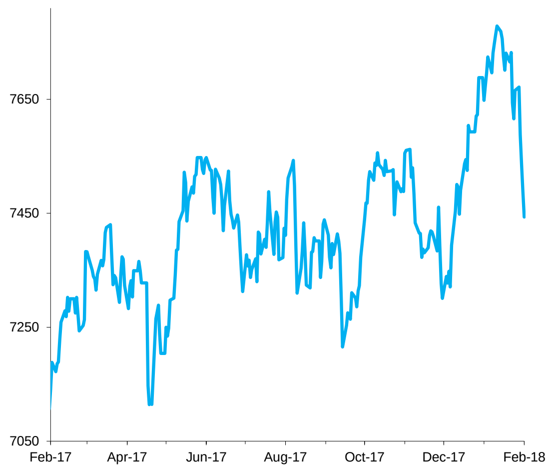
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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