MARKET FLASH

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What has been happening recently on the markets?

After a spectacular start to the year in risky assets, equities in particular (with the MSCI World All Countries up 5.6% for the month of January), investors have been troubled by the rapid rise in yields throughout the US curve.

The 60bp increase in the US 10-year yield within three months was not offset by an equivalent rise in the equity market risk premium. We are tempted to say that is now the case, with US equities now almost 9% off their 26 January 2018 peak. With 12-month forward P/Es falling from 19 to almost 16 (when factoring in upward earnings revisions) the risk premium has fallen by… 60bp.

The problem is in how sudden and brutal the correction was. After such a shock, the market will take a little time before coming to its senses.

A closer look at how the various asset classes have reacted

In equities, the rush for the exits has been driven mostly by the unwinding of short-volatility quantitative strategies, with investors forced to hedge their sales of options with sales of shares in order to maintain the same level of risk. However, we have thus far not seen a significant sector rotation that might point to a change in trend.

On the credit markets (particularly in high yield), investors have remained calm and focused on corporate earnings releases.

Nor in currencies have we seen a flight to quality that would point to a change in paradigm, i.e., safe haven being taken in the yen, the Swiss franc or the US dollar.

One more thing: bond yields, which is where the correction began, have not accelerated upward. On the contrary, they have fallen by about 10 basis points, thus invalidating fears of a rapid run-up in inflation or an accelerated exit from accommodative monetary policies.

No change to our strategy of overweighting equities and keeping duration as low as possible as the year begins

With all this mind, a fact-based analysis of the current situation is no different from the analysis we made as the year began, i.e., leading indicators remain especially solid on both the macroeconomic level (with upward revisions in the growth outlook in both the US and the euro zone) and in projected earnings growth. In light of this, we are making no change at this stage to our asset allocations in the diversified portfolios.

Still remaining cautious

We will be paying especially close attention to how fast long bond yields rise, to signs of inflation, to risk indicators (volatility), and, above all, to investment inflows and outflows, which will guide market momentum. But in the midst of this return of volatility, we mustn't overlook the most important thing: that corporate and economic fundamentals are pointing to earnings growth, so companies should be well able to accommodate rising prices and wages.

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