Market Perspective

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A healthy market is not a comfortable market

"The first time I see a jogger smiling, I'll consider it."

Joan Rivers

The equity market is not meant to be a comfortable place to invest. It is meant to be stressful. Equities are risky assets and risk is uncomfortable, that is why we demand higher returns for investing in equities.

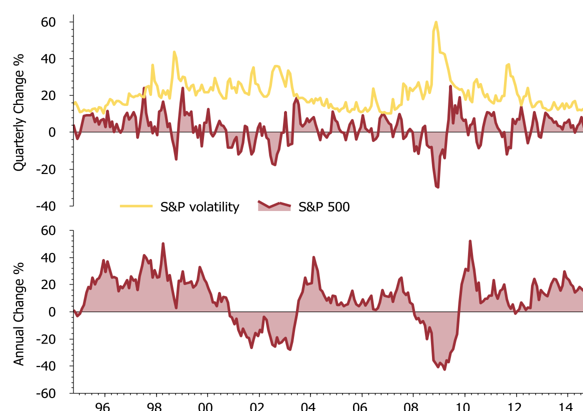
Risk, therefore, is a healthy part of investing. It is when risk becomes too low that investors become complacent and serious financial damage gets done. It may not feel comfortable but then being healthy often doesn't!

Certainly as the top two lines in chart 1 show, risk had temporarily disappeared from the financial system. The yellow line shows the VIX gauge of uncertainty, the so-called fear index, which had diminished to a very low level and has only just corrected back to its previous level. The red line in the upper pane shows the rolling quarterly moves in the S&P500. The chart shows it has historically been quite common to have negative quarters, the last of which was in December 2012. The lower graph shows that annual losses on equities are far less common, being associated with the recessions of 2001/2 and 2008/9. Since the start of 2013 there has been a dearth of risk in equities, which should be one of the riskiest of asset classes.

Ironically the lack of risk was causing some anxiety in the upper echelons of the Federal Reserve. William Dudley of the Federal Reserve Bank of New York said "I am a little bit nervous that people are taking too much comfort in this low-volatility period. As a consequence, they'll take more risk than really what's appropriate." The Bank of England Governor, Mark Carney, echoed the warning "We are alert to the possibility that financial markets may be mispricing risks".

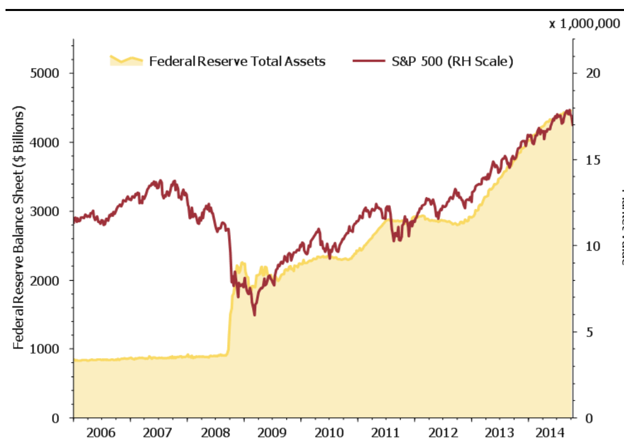
More ironic than policymakers being concerned about investors being tempted to take too much risk, was the fact that this was a deliberate tool of policy. As Mark Carney said "there are increased signs of complacency in financial markets, in part reflecting the search for yield amidst exceptionally accommodative monetary policies." Such policies came in response to fears that companies did not feel inclined to invest and drive further gains in standards of living. The policy response was to make such investments cheaper for them. This was achieved by driving investors into higher risk assets, in turn by driving them out of low risk assets - through so-called quantitative easing.

Chart 1: Risk is back, and this time it's...quite similar to the way it used to be.



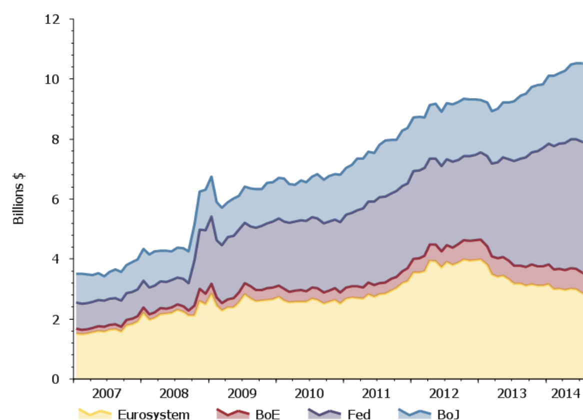
Source: Datastream/Brewin Dolphin

Chart 2: Does the end of QE herald the end of the bull market?



Source: Datastream/Brewin Dolphin

Chart 3: Central bank liquidity is being withdrawn (because the economy is recovering)



Source: Datastream/Brewin Dolphin

With the economy improving, and concerns over the low level of the VIX index and observed volatility building, US policymakers have been reducing the amount of stimulus being applied to the economy. They have tapered asset purchases and may be happy with the results so far.

Investors are cautious again and yet borrowing costs remain exceptionally low, in fact the return of volatility has seen them fall further. It is unlikely that this can continue. Either animal spirits return to the equity market and the broader economy, in which case risk assets will resume their upward march, or the economy is faltering and any planned withdrawal of stimulus will have to be reconsidered. Should we fear a cataclysmic sell-off without money printing support? Some have pointed to the eerily similar growth of the Federal Reserve's balance sheet and the S&P 500 index market value (Chart 4) as evidence that without the programme the index would be substantially lower. We'll never know of course because despite the purchases winding down, outright asset sales are still unplanned and we feel are unlikely to happen. The Federal Reserve balance sheet is not about to contract so even fans of Chart 4 ought to feel equities are underpinned.

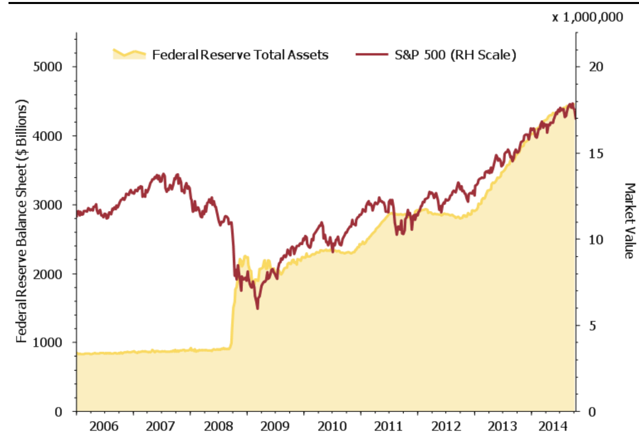
A rise in volatility driven by the change in US policy looks reasonable, but risks still remain.

One such risk is a hard landing in China. We are entering our second year of pessimism about Chinese growth and things are panning out much as we had expected. Policymakers are employing the minimum amount of stimulus possible to meet the lower end of growth targets in order to wean the economy off its credit addiction. China looks to be heading for a protracted soft landing.

The opposite is the Eurozone where economic conditions are rapidly deteriorating. Again, we expected very low but positive growth for the Eurozone this year, but now it looks like the risk of recession is rising as we move towards 2015. The Eurozone needs both stimulus and reform and but is running out of time in the current political cycle in which to enact the reform. The saving grace is that China's weak growth now appears to be weighing heavily on Germany's trade surplus, which had been a major source of imbalance within the Eurozone.

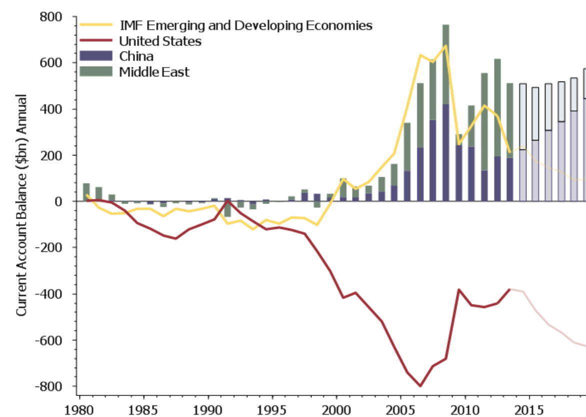
Slower Chinese growth, therefore, could trigger an economic realignment which finally begins to unwind some of the imbalances that have defined the global economy for the last decade or so. From the Eurozone's perspective it will need to be accompanied by reform, and preferably stimulus. Both are in question in our mind as we are a little more cautious on the ability and willingness of the ECB to push through a new quantitative easing programme (and indeed on the efficacy of such a programme). Overall, however, it remains the case that employment in the Eurozone is expanding while other sources of optimism include the imminent results of the asset quality review (which may embolden banks to lend), a new round of

Chart 4: Does the end of QE herald the end of the bull market?



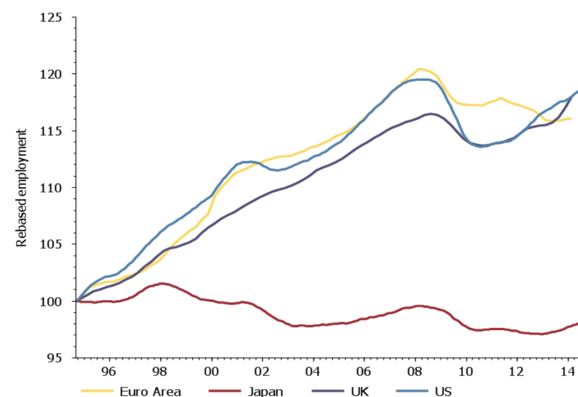
Source: Datastream/Brewin Dolphin

Chart 5: Global imbalances would be reduced by less investment in China and slower exports from Germany



Source: Datastream/Brewin Dolphin/IMF

Chart 6: Inflation is low and the rich world is enjoying a synchronous recovery in employment



Source: Datastream/Brewin Dolphin

Targeted Long Term Refinancing Operations (TLTROs) and the ECB's expressed desire to bring down private sector lending rates.

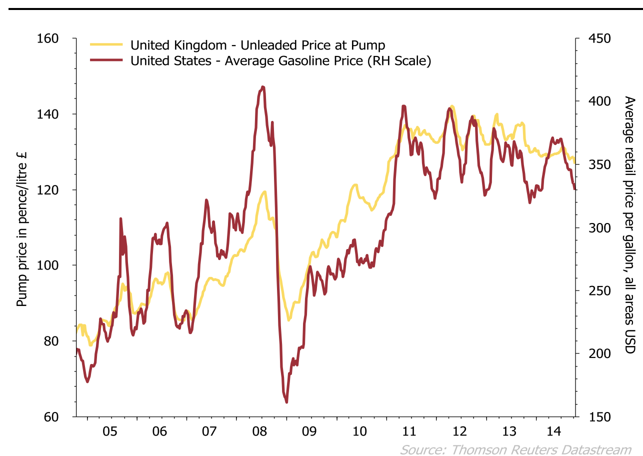
A further stimulus comes from the market itself. Gasoline prices in the US have fallen more than 13% since the end of June. Even after the punitive duties imposed in the UK, petrol prices have fallen more than 7% over the last year. The picture is repeated throughout the major economies, coinciding with a synchronous expansion in employment.

It is a final irony, therefore, that the current weakness in commodity markets – is likely to be substantially more stimulative than the outgoing raft of official measures in the Anglo Saxon economies. Quantitative easing worked through buying government bonds, to lower government bond borrowing costs, which in turn lower corporate bond prices and thereby encourage investment. The extent to which that feeds through to households and small businesses is difficult to quantify but it is clearly far from direct. By contrast, a fall in the oil price represents cost savings for almost every economic strata, from large airlines and shipping companies to sole traders and commuters.

Furthermore it does not represent a rise of inflationary pressure. It is inflation that represents the greatest threat to a bull market as that requires monetary policy to be tightened, making cash and eventually bonds more attractive than equities. The current move in the market, even in the UK, has not yet triggered the 10% decline which would make it a technical "correction". It does, however, give monetary policymakers the scope to react to any weakening of core inflation even as weakness in food and energy prices have the potential to boost disposable incomes and profits globally.

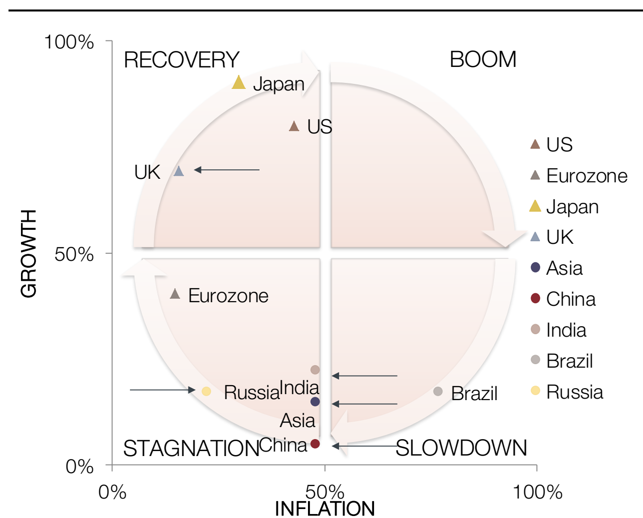
This is encapsulated by our investment cycle indicator which shows stable growth but falling inflationary pressure everywhere except Russia. There the evidence suggests that western sanctions have been surprisingly effective in pressuring President Putin to pull troops back from the Ukranian border and dispatch Sergei Lavrov for talks with US Secretary of State John Kerry – one risk, at least, that seems to be diminishing.

Chart 7: Lower energy prices represent a tax cut to the global consumers and a cost reduction to producers



Source: Datastream/Brewin Dolphin

Chart 8: The investment clock remains in the early phases meaning equities remain the favoured asset class



Source: Brewin Dolphin

Important Notes:

Main source of information: Company Report and Accounts, Bloomberg

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