



HAVE THE BEARS EATEN GOLDILOCKS?

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David Eiswert

Portfolio Manager, Global Focused Growth Equity Strategy



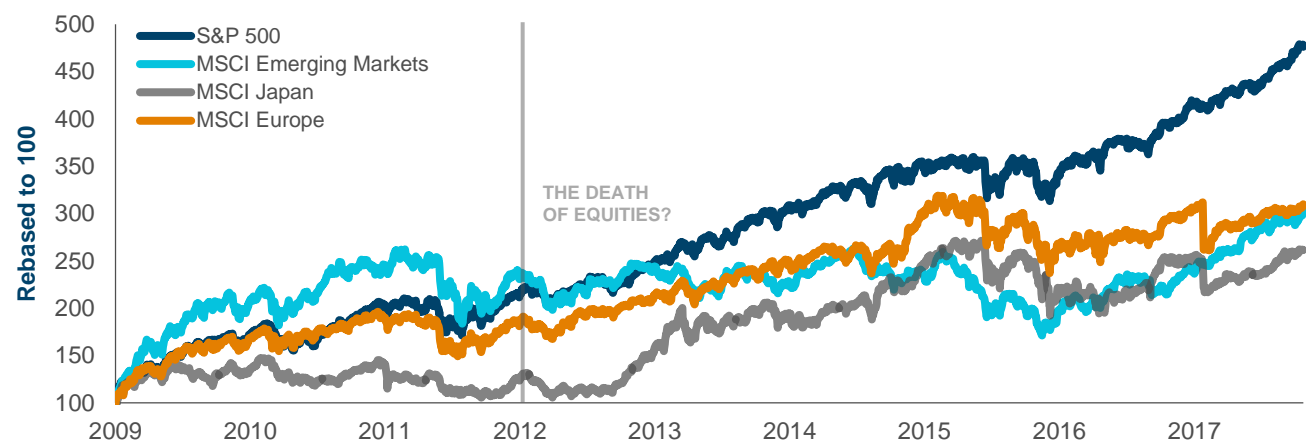
While regime change is an absolute certainty when considering the evolution of economic and equity cycles, the rise in volatility and fall in global equity markets in February has shown once again how much equity markets tend to react in the short term to points of change. In this case, with a decent sized tantrum.

The somewhat unusual trigger for the biggest single day point loss for the Dow Jones Industrial Index in history was centered on a positive upside surprise for U.S. wage data. While you might think that indicators of the real economy getting better might be viewed as positive, clearly the prospect of inflation rising, temporarily, or more sustainably, got the market thinking more about life after QE and maybe life in a higher interest rate world. One way or another, change has once again shown itself to be a lot less loved than presumed certainty.

Given equity investors have enjoyed an unusually stable and profitable period in 2017, change and evolution was always likely, with selling pressure the most obvious outcome. This is especially true with bears having sharpened their claws on the back of a +25% return for global equity markets in 2017.¹ This has of course come on top of the monumental returns over the past nine years (Figure 1).

Figure 1: The Unloved Global Equity Rally

Regional returns, as of December 31, 2017.



Sources: MSCI and FactSet.

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¹MSCI All Country World Index +24.62% for 1-Year to end December, 2017.

What are our observations on the market correction? The catalyst, while fundamental in origin, felt quite technical in execution. To re-iterate our view, we believe that the economic backdrop remains largely stable-to-improving and that equity valuations remain reasonable, given a solid corporate earnings outlook. Pretty undramatic stuff.

However, we have felt investor sentiment rising a long way over the past year. Given this, the market adjusting to new data around inflation “risk,” via a rise in the Chicago Board Options Exchange’s Volatility Index (the VIX), and a pull-back in markets is intuitively quite “normal.” Perhaps less normal was the speed and magnitude with which capital withdrew from markets, as a rising VIX index seemed to shock volatility-linked products into selling and rebalancing.

While no one knows the true extent to which market ownership has changed over the past few years, February’s pull back gives some indication that portfolio insurance and target volatility products are meaningful market movers in way that was not the case in decades past. This perhaps indicates that while volatility has been low, inflection points will be harsh. With the last meaningful risk off environment nearly two years ago (China and oil), so it proved to be the case as the rush for the exit door unfolded in February.

The saving grace for investors is that despite the sharp falls, the pull-back has only eliminated one month’s gains (January’s 5% return in effect)², while sentiment and markets have steadied in March. In addition, the volatility shock has somewhat pushed away the risk that markets have been flirting with excessive optimism or even mild euphoria, and reminded us all that equity investing and volatility naturally go hand in hand.

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WHY DO WE REMAIN SANGUINE?

While we can see that an inflation impulse is playing out year-on-year from a low base level in Q1 2017 (when many companies and consumers were grappling with what U.S. political regime change meant for them), we remain relatively skeptical that inflation will meaningfully and persistently rise ushering in a new market regime of considerably higher interest rates. Our expectations for how much inflation may change from today’s muted levels have their roots in structural deflationary forces that exist today. The secular impact of technology, globalization and demographics upon inflation remain headwinds for a sustained rise in inflation. While these factors do not sit comfortably in economists models and are hard to measure, these influences are real and have been showing themselves in inflation data that should, all being equal, already be much higher.

So why is the market so concerned? We talked about this back in August last year in the article, “Inflation Surprise? Don’t Fear the Reaper!” In this article, we identified that tightening U.S. employment may be the indicator to look out for as the potential trigger for higher interest rates and investor concern, and so it has proved to be. While the U.S. Federal Reserve has started to talk much tougher around the upside risks to inflation, we still believe that all else equal, the deflationary factors will mute the rise in prices over the next phase of this cycle, versus previous economic cycles.

While we remain open to change, we currently sense very little appetite from corporates to embark on a sustained rise in wages. Given this and despite a portion of tax cut benefits being passed onto employees in the near term, the inflation cycle still looks modest to us. February’s volatility spike, however, is a reminder that a slow shift in regime is key to market stability, as it will give markets, corporates, and consumer’s time to adjust as interest rates begin to gradually rise.

²As measured by the MSCI All Country World Index.

DO THE BEARS HAVE A FEAST AHEAD?

If we are wrong, a rise in inflation and tighter monetary policy could certainly be a risk to the not too hot, not too cold “goldilocks” market environment, but one month’s data does not a trend make. We are likely to have a bumpier ride ahead, as a greater breadth of sentiment emerges on less universally positive data points. While challenging for investors that want to allocate capital to themes associated with obvious improvement, some injection of uncertainty feels normal as well as healthy. This is especially true for us as fundamental stock pickers who now get a chance to improve portfolios on weakness.

We will continue to use any form of volatility and market decline to refresh our portfolio, and that is exactly what we have been doing in recent weeks. It has allowed us to top-up on our favored positions, but also add exposure to stocks that we had judged to have been on the more expensive side. We now sit with a portfolio of stocks that we believe can perform well, even in a potentially more volatile environment.

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