Bulls versus bears

Equity Journal Q1 2018

Trade wars and tech 'trump' data

Developments within the US have driven market sentiment over the first quarter of 2018. A snapshot of key issues and our current views on equity markets are set out in this summary.

January was largely business as usual for broad equities as markets continued to trend up on the back of encouraging macro-economic data, corporate tax cuts in the US and overall low volatility. The key exception was the UK market (returning – 1.9%) which declined on the back of Sterling appreciating relative to the US Dollar (a large proportion of FTSE All-Share firms' revenues are earned in Dollars and translated back to Sterling).

The following key developments occurred over February and March, as volatility returned to the system after a relatively benign 2017.

- There was a sharp sell-off on the 8th of February (Global equities fell by 3.5% in GBP terms, with US equities detracting by 4.5% in GBP terms). This was largely driven by data in the US pointing to a rise in wage growth, which created fears around inflation. The implication being that higher than expected inflation could increase the number of Fed hikes over 2018. The market sell-off was compounded by various investors trading 'short volatility' via ETF products on markets (these products bet on markets remaining benign and decline if volatility – measured by the VIX – increases).
- Markets did recover from this particular event and exhibited a strong rally at the end of the second week of March, following the release of the US payroll data which showed an increase in jobs created to 313,000 (with the speed of annual wage growth dropping from the previous month). These numbers were further supported by the release of US inflation data, which was in line with expectations (increasing 0.2% from February).
- However, the respite was short-lived, with investor sentiment proving to be extremely erratic for the remaining portion of the quarter. Global equity returns were largely affected by US politics, as the Trump administration set out plans to implement 25% tariffs on approximately $60 billion of Chinese imports – creating potential for a global trade war. Each piece of 'news' relating to the proposed action and Chinese response (a small initial reciprocal plan to impose approximately $3 billion tariffs on US imports) influenced short term trading patterns across regions, as investors shifted between 'risk off' and 'risk on'.
- Performance was also curbed by concerns around Facebook's use of member data, with the stock sliding in value over March and causing a wider sell-off in technology stocks. This sector has been at the forefront of global equity returns over the past few years (and constitutes 6 of the 10 largest holdings in the MSCI World Index).
- The combination of these various levers translated into equity markets free falling again on the 22nd of March (with the S&P 500 falling by 2.7% in GBP terms) before recovering slightly in the final week of March.

Overall, global equity markets returned – 4.7% (in GBP terms) over the quarter.

Despite intra quarter volatility stemming from the US, UK equities were the worst performing region over the three month period, falling by 6.9%. UK stocks were also negatively impacted by Sterling continuing to rally and relatively weak economic indicators.

'Bulls of the quarter' – US job and global economic data → Minimal overall impact

'Bears of the quarter' – Politics, inflation fears and technology sell-off → Meaningful impact

The Bears win!

The Ones to watch – KPMG view

We believe that investors should be mindful of the current geo-political environment and this, alongside volatility in the tech sector will continue to foster bouts of market stress. Currently political developments are moving equity markets rather than fundamentals. Nevertheless, this may change over Q2 as the impact US corporate earnings data is felt by markets (expected to be a positive indicator).

In our view, one key risk over the year will be the potential for unexpected inflation to creep into the system. Though fundamentals in the US (the largest component of market cap) look healthy at present, US fiscal policy is a potential concern, with a combination of low unemployment and higher wage growth creating a possible source of inflationary pressures.

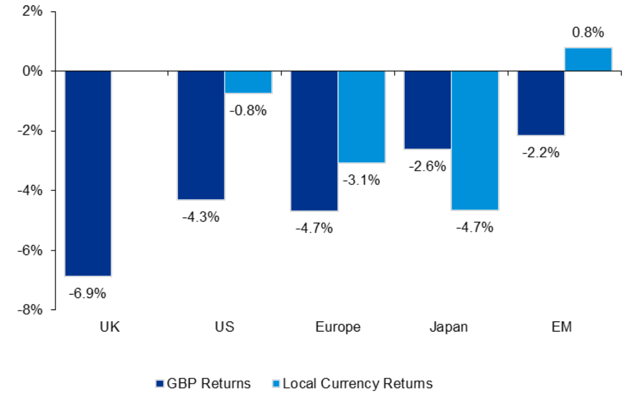
Additionally, an escalation of the current trade dispute between the US and China in to a far-reaching global trade war could trigger a global slowdown which would have negative ramifications for markets.

Overall, we believe the current environment is an appropriate time for investors holding a meaningful allocation to equities to consider reducing the risk within their equity portfolios.

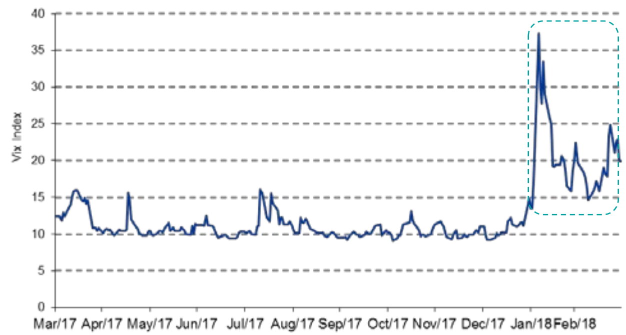
Topical charts

US market over Q1 2018

Regional attribution over Q1 2018 – Currency impact



VIX – Volatility spiked over Q1 2018



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