



# Weekly Digest

Week ending **09 April 2017**

## It's a marathon, not a sprint

Barely a week goes by these days without North Korea featuring in the news and this week is no exception. Yesterday saw the running of the annual marathon in the North Korean capital Pyongyang, now in its 27th year. Hats off to the men's winner Pak Song-Chol, a North Korean national who ran home in 2 hours 14 minutes and 56 seconds.

Over in Palm Beach Florida Donald Trump met with Xi Jinping, President of the People's Republic of China, to table discussions around the risks posed by the hermit kingdom having previously said the United States would act unilaterally to deal with the threat, with or without China's help. Meanwhile, a US aircraft carrier group arrived in waters near the Korean peninsula.

The world is never short of risk it seems but sometimes markets suggest it is. There has been plenty of recent commentary highlighting how low the 'VIX' has fallen, an index sometimes known as Wall Street's 'fear gauge' which measures the market's expectation for the volatility of the S&P 500 index over the next 30 days. It is an implied risk measure derived from option prices on the index, itself a function of the underlying stocks' expected volatility and the correlations between them. Certainly it remains low in its historical context and even President Trump's missile launch into Syria last Thursday had limited impact. Today, the VIX trades above 13% after briefly dipping under 10% in February, but with a lifetime low of 9.3% we remain at the lower end of the range.

With the VIX being a forward looking measure, the absence of future binary risk events such as elections or important data releases means the index may periodically find its level being influenced by historic or realised index volatility which today is extraordinarily low; the 90 day historical volatility of the S&P500 index is currently only 6.5% with only 2 days this year when the index has moved by more than 1%. The question is, if the fundamentals remain

supportive of owning equities, at what point does the risk become under-priced?

This is a difficult question to which there is no definitive answer. Arguably today most markets are under-pricing risk, a situation that has come about largely as a result of central banks' aggressive balance sheet expansion. The purchase of sovereign, mortgage and corporate debt (and equity ETFs and J-REITS in Japan) has lowered longer term interest rates, as desired, and in turn driven up prices in riskier assets to the point where the cumulative effects of the concurrently running QE programs have effectively acted like a tranquiliser on risk markets, where market wobbles were met with an increased dose. Added to this already muted volatility, structured selling of volatility to enhance historically low yields can make the future appear rosier than it otherwise might be.

As multi asset investors it is important to look at risk through the multi layered lens of portfolio risk. Low levels of equity risk mean little in isolation so it is important to consider broader asset class risk measures and how they come together in order to make a more informed assessment of how risk is pricing. Low volatility has permeated most markets today including rates, credit and currencies while at the same time valuations have marched higher. It is true that lower rates can support higher valuations but not at the expense of diversification, complementing traditional 'beta' strategies with liquid, less directional alternative sources of income and return should serve to shield a portfolio against external shocks. Volatility is akin to a risk premia in itself and the lack of it has a distorting effect on all other risk premia and their interaction with each other. As such it is important to build robust portfolios which can work through different volatility regimes. Even so, while the portfolio managers' plan for the unexpected in the core portfolios, don't bet on an American winning the Pyongyang marathon anytime soon.

## The Marketplace

- Geopolitical tensions rise over North Korea & Syria
- March US non-farm payrolls reading disappoints
- FOMC minutes spark equity declines
- Eurozone PMI data reaches multi-year high
- South Africa's sovereign credit rating downgraded

## Market Focus

### US

- Global equities reacted in a relatively benign fashion, losing 0.4% over the week, following news of an airstrike carried out by the US on a Syrian airbase and reports that a US Navy fleet was diverted towards the Korean peninsula amid ongoing concerns over North Korea's ballistic missile programme.
- Theresa May deemed the US airstrike as "an appropriate response". North Korea called it an "intolerable act of aggression", while Russia, an ally of the Syrian government, called it "an aggression [...] in violation of the norms of international law."
- Meanwhile, a more conventional contributor to risk-off sentiment was the Federal Reserve's March monetary policy meeting minutes. Some members were said to have 'viewed equity prices as quite high relative to standard valuation measures', while the potential sale of bonds purchased by the Fed during its quantitative easing programme was also discussed.
- Finally, the employment report for March showed the economy adding 98,000 jobs over the month, versus the consensus estimate of 180,000. Although it is the weakest figure since last May, many are blaming the disruptive effects of Storm Stella for the smaller number, and are instead pointing to the fall in the unemployment rate from 4.7% to 4.5%: its lowest level since May 2007.

### Europe

- The final Markit Purchasing Managers' Index (PMI) numbers for the Eurozone showed the composite index rising from 56.0 in February to 56.4 in March. PMIs are viewed as an accurate proxy for economic activity, and the March numbers round off the strongest quarter since spring 2011 for the indexes; the print is consistent with GDP growth of around 0.6% for the whole of the first quarter, according to Markit.
- Amongst the components of the index, employment rose at its fastest pace for nearly a decade and overall business optimism increased to a new record high.
- The UK PMI numbers, although both above 50 and signalling expanding activity, were mixed compared to estimates. The manufacturing PMI fell from 54.5 to 54.2, while the services PMI rose from 53.3 to 55.0. Prior estimates for the respective indexes were 54.6 and 53.5.
- Continental European equities were flat over the week, while UK equities gained 0.5%.

### South Africa

- Credit ratings agencies S&P and Fitch both lowered their ratings for South African government debt last week following the sacking of several key cabinet members by President Jacob Zuma, including the finance minister Pravin Gordhan.
- Fitch now rates local currency government debt as BBB-, which falls under junk bond status, while S&P's rating on local currency debt is still classed as investment grade.
- South African equities fell another 1.5% last week, while the rand fell 2.9% against the dollar to ZAR 13.76.

*Alex Harvey (CFA) & Oliver Bickley*

Asset Class/Region	Currency	Currency returns			
		Week ending 7 Apr. 2017	Month to date	YTD 2017	12 months
<b>Developed Market Equities</b>					
United States	USD	-0.3%	-0.3%	5.6%	17.1%
United Kingdom	GBP	0.5%	0.5%	4.3%	24.9%
Continental Europe	EUR	0.0%	0.0%	6.9%	21.3%
Japan	JPY	-1.5%	-1.5%	-1.0%	19.6%
Asia Pacific (ex Japan)	USD	0.0%	0.0%	12.8%	21.6%
Australia	AUD	0.0%	0.0%	4.8%	23.3%
Global	USD	-0.4%	-0.4%	6.0%	16.1%
<b>Emerging Market Equities</b>					
Emerging Europe	USD	0.5%	0.5%	1.9%	16.2%
Emerging Asia	USD	0.3%	0.3%	13.7%	21.4%
Emerging Latin America	USD	1.4%	1.4%	13.7%	33.2%
BRICs	USD	1.1%	1.1%	12.8%	28.6%
MENA countries	USD	1.4%	1.4%	2.5%	13.9%
South Africa	USD	-1.5%	-1.5%	2.8%	13.1%
India	USD	1.2%	1.2%	19.1%	28.2%
Global emerging markets	USD	0.4%	0.4%	11.9%	21.6%
<b>Bonds</b>					
US Treasuries	USD	0.1%	0.1%	0.8%	-2.0%
US Treasuries (inflation protected)	USD	0.0%	0.0%	1.4%	1.3%
US Corporate (investment grade)	USD	0.2%	0.2%	1.5%	2.7%
US High Yield	USD	0.3%	0.3%	3.0%	16.6%
UK Gilts	GBP	0.4%	0.4%	2.0%	6.3%
UK Corporate (investment grade)	GBP	0.3%	0.3%	2.1%	8.8%
Euro Government Bonds	EUR	0.7%	0.7%	-0.9%	-1.0%
Euro Corporate (investment grade)	EUR	0.5%	0.5%	0.7%	2.5%
Euro High Yield	EUR	0.2%	0.2%	2.0%	8.9%
Japanese Government	JPY	0.2%	0.2%	-0.3%	-1.9%
Australian Government	AUD	0.9%	0.9%	2.2%	2.0%
Global Government Bonds	USD	0.2%	0.2%	1.6%	-4.4%
Global Bonds	USD	0.1%	0.1%	1.4%	-3.0%
Global Convertible Bonds	USD	0.2%	0.2%	4.1%	4.7%
Emerging Market Bonds	USD	0.6%	0.6%	4.4%	8.4%

Asset Class/Region	Currency	Currency returns			
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<b>Property</b>					
US Property Securities	USD	1.0%	1.0%	1.7%	4.3%
Australian Property Securities	AUD	2.3%	2.3%	1.1%	4.4%
Asia Property Securities	USD	1.9%	1.9%	11.1%	13.2%
Global Property Securities	USD	1.1%	1.1%	4.9%	5.8%
<b>Currencies</b>					
Euro	USD	-0.9%	-0.9%	0.8%	-6.8%
UK Pound Sterling	USD	-1.3%	-1.3%	0.2%	-11.9%
Japanese Yen	USD	0.1%	0.1%	5.3%	-2.7%
Australian Dollar	USD	-1.8%	-1.8%	4.3%	0.0%
South African Rand	USD	-2.9%	-2.9%	-0.9%	10.5%
Swiss Franc	USD	-0.8%	-0.8%	1.1%	-5.1%
Chinese Yuan	USD	-0.4%	-0.4%	0.7%	-6.3%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	0.9%	0.9%	-0.9%	15.5%
Agricultural Commodities	USD	-0.8%	-0.8%	-1.1%	2.0%
Oil	USD	4.6%	4.6%	-2.8%	40.1%
Gold	USD	0.9%	0.9%	9.4%	1.6%
Hedge funds	USD	0.0%	0.0%	1.7%	6.6%

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