FINANCIAL PARTNERS

Weekly Digest

Week ending **14 May 2017**

Volatility: Deep Calm in the Markets

“Not since Watergate have our legal systems been so threatened, and our faith in the independence and integrity of those systems so shaken,” These were the words of Senator Richard Blumenthal of the US Judiciary on the incendiary news that President Trump has fired the Director of the FBI, James Comey. The timing of the termination, occurring whilst the presidential campaign is under investigation for possible ties to Russian collusion has raised eyebrows: Already, Democrats are fuelling calls for a special prosecutor to be installed to oversee the affair. Even some on the Republican side, notably John McCain, have gone so far as to say that at a minimum, the possibility of Russian electoral interference warrants a select committee investigation.

Yet those searching for some immediate negative market reaction to events reminiscent of the Nixon debacle would be hard pushed to find much of any real significance: A small slide on equity futures and a brief flight to currency safe havens (a fleeting rally on USD/JPY to a 114.32 high which swiftly retraced to a 113.63 low) were about all- Indeed the S&P500 index even ticked upwards, closing at a record high of 2399.63 on the day. What is more, the US equity markets have remained largely flat since February, whilst volatility on treasuries also remains low. What effect this latest twist will have on Trump’s longer term economic plan of tax reforms, protectionism, healthcare and infrastructure investment remains to be seen. Some indicators that it is stalling were already in place after a tumultuous first one hundred days, and it is hard to see these latest developments helping matters.

This lack of negative market reaction is indicative of a wider trend we have observed of late: historically low market volatility in the face of a global climate generally pointing to the contrary. Emmanuel Macron’s newly founded En Marche party roundly defeated the rightist nationalist platform of Marine le Pen, and may have afforded the EU some breathing space. It is sobering however that a country such as France, within living memory of the Vichy regime, can deliver 33.9% of the vote to the de facto candidate of the Front National. In light of this and events elsewhere on the continent, it would seem short sighted to read into this result any long term overturning of the forces of populism in Europe, with all of the uncompetitive corollaries that may bring. More broadly, uncertainty around Brexit, brinkmanship between North Korea and the US, territorial disputes in the South China Sea, a bellicose Russia and a host of flashpoints across the Middle East paint a picture hard to square with how unperturbed investors appear to be. There may be some sound reasons that volatility continues to remain so low: none of these events have so far crystallised in ways that majorly impact key world economies. But whilst it might be tempting to welcome calm markets and high valuations as a sign that investors are not overreacting, similarly they can point to another underlying phenomenon: complacency.

Since its inception in 1990, The Chicago Board of Exchange VIX index has estimated the implied volatility of index options on the S&P 500 index over the subsequent 30 day period. In more straightforward terms, this has proved a useful metric in measuring the ‘fear’ of investors - the lower the level of the index the safer investors feel. Recently the VIX index closed at 9.77 (08/05/17) representing a 23-year low. Only on two other brief occasions has the index closed below the 10 mark, clustered around early 1994 and 2006. Last Tuesday (09/05/17) represented the eleventh consecutive day the index closed below 11, an all-time record.

Counterintuitively perhaps, sustained lows on the index are often interpreted by analysts as a warning sign in the markets (indicative of the complacency mentioned above). There is some disagreement as to how much should be read into data such as this, and it would be misleading to necessarily interpret these lows as a portent of a sharp downward correction to come. In an index of this nature, separating the artificial from the actual is open to a range of views. Our view is that this period of low volatility may well continue, but with downside insurance representing good value, we conclude it may be prudent to add some protection to our portfolios. To this end, we have been looking at a couple of strategies involving index options. Firstly, replacing some of the equity component in our funds and buying upside calls, or alternatively buying downside puts, maintaining our equity exposure. On balance, we favour the latter. Coupled with our philosophy of remaining well diversified, we believe our funds are well positioned for whichever direction these historically calm markets resolve themselves.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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The **Marketplace**

- Global equities flat as volatility nears record-lows
- US inflation slows in April
- Gilts higher after BoE downgrade growth forecast
- US & China outline 100-day trade plan
- Merkel's CDU Party win key state election in Germany

Market **Focus**

US

- US equities retreated 0.3% over a placid week. The high to low range of the S&P 500 index in intraday trading was a mere 0.9%, while the VIX volatility index broke records on Tuesday by closing under 11 for the eleventh consecutive day for the first time since records began in 1990.
- April's inflation report showed the headline consumer price index rising by 0.2% month-on-month, as expected. However the core inflation reading, which excludes volatile food and energy prices, came in slightly below expectations by rising 0.1% month-on-month. This resulted in the rolling 12 month inflation rate falling for the third consecutive month, to +1.9%.
- Elsewhere the US and China reached the first set of trade agreements as part of one- hundred days of trade talks that commenced following President Trump's meeting with Chinese President Xi Jinping last month. The talks have helped to stifle fears of a future trade war between the world's two largest economies.

UK

- The Bank of England's Monetary Policy Committee (MPC) voted 7-to-1 to keep the Bank rate unchanged at 0.25% in their May meeting last Thursday, while also voting unanimously to keep the stock of corporate and UK government bond purchases at GBP 10 billion and GBP 435 billion respectively.
- While the above outcomes were expected, the MPC also downgraded their growth forecast for 2017 by one tenth to 1.9%, while increasing their forecast for inflation to 2.8% later this year. The result was a notable sell-off in sterling, and an increase in Gilt prices.
- Over the week, sterling depreciated 0.7% against the US dollar, to USD 1.289, while 10-year Gilt yields (which move inversely to prices) fell 3 basis points to 1.09%. UK equities outperformed, rising 2.1%.

Germany

- Exit polls following local elections in Germany's most populous state show Angel Merkel's Christian Democrats (CDU) unseating the Social Democrats (SPD), in what was seen as a key test for Mrs Merkel ahead of September's general election. 34.5% of votes in North Rhine-Westphalia are projected to go to the CDU, with 30.5% for the SPD, and only 7.5% for the far-right Alternative for Germany (AFD) party.
- The Euro is 0.4% higher versus the dollar on Monday morning following the result, while European equities are up 0.4% after falling 0.1% last week.

Oil

- Brent crude oil recovered 3.5% to USD 50.84 per barrel, following its cumulative 11.3% loss over the prior three weeks.
- Prices were helped by data showing US crude stockpiles declining by the most in a single week this year, as well as reports that Russia and Saudi Arabia are in favour of extending OPEC's supply limit agreement by nine months, until the end of March 2018.

James Jones & Oliver Bickley

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Asset Class/Region	Currency	Currency returns			
		Week ending 12 May 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	-0.3%	0.4%	7.3%	17.6%
United Kingdom	GBP	2.1%	3.4%	5.9%	26.7%
Continental Europe	EUR	-0.1%	2.7%	12.3%	24.5%
Japan	JPY	2.0%	3.2%	5.1%	20.7%
Asia Pacific (ex Japan)	USD	1.7%	1.3%	16.1%	25.5%
Australia	AUD	0.2%	-1.3%	4.5%	13.5%
Global	USD	-0.1%	0.9%	9.0%	17.0%
Emerging Market Equities					
Emerging Europe	USD	1.0%	-0.2%	5.7%	17.7%
Emerging Asia	USD	2.3%	2.5%	18.7%	29.5%
Emerging Latin America	USD	3.8%	4.6%	17.3%	25.9%
BRICs	USD	3.3%	2.4%	16.4%	30.4%
MENA countries	USD	0.1%	0.2%	1.1%	8.2%
South Africa	USD	3.0%	1.8%	12.1%	23.1%
India	USD	1.5%	1.2%	22.0%	25.4%
Global Emerging Markets	USD	2.5%	2.6%	16.8%	27.2%
Bonds					
US Treasuries	USD	0.1%	-0.2%	1.2%	-1.3%
US Treasuries (inflation protected)	USD	0.1%	-1.0%	1.0%	0.9%
US Corporate (investment grade)	USD	0.4%	0.1%	2.5%	3.1%
US High Yield	USD	0.3%	0.2%	4.1%	14.0%
UK Gilts	GBP	0.6%	-0.2%	1.6%	6.6%
UK Corporate (investment grade)	GBP	0.6%	0.4%	2.8%	9.0%
Euro Government Bonds	EUR	-0.1%	-0.2%	-1.2%	-0.8%
Euro Corporate (investment grade)	EUR	0.2%	0.1%	0.9%	2.7%
Euro High Yield	EUR	0.3%	0.6%	3.6%	9.4%
Japanese Government	JPY	-0.4%	-0.5%	-0.4%	-2.7%
Australian Government	AUD	0.2%	-0.2%	2.0%	0.5%
Global Government Bonds	USD	-0.4%	-0.5%	2.2%	-3.8%
Global Bonds	USD	-0.2%	-0.2%	2.4%	-2.2%
Global Convertible Bonds	USD	0.0%	0.4%	5.8%	6.1%
Emerging Market Bonds	USD	0.4%	0.0%	6.0%	7.3%

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 12 May 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	-1.3%	-1.8%	-1.0%	-1.4%
Australian Property Securities	AUD	-0.7%	-1.1%	0.4%	-1.8%
Asia Property Securities	USD	0.7%	0.6%	12.4%	14.6%
Global Property Securities	USD	-0.1%	-0.2%	4.9%	4.0%
Currencies					
Euro	USD	-0.6%	0.2%	3.8%	-4.0%
UK Pound Sterling	USD	-0.7%	-0.6%	4.2%	-10.9%
Japanese Yen	USD	-0.6%	-1.8%	3.2%	-3.9%
Australian Dollar	USD	-0.3%	-1.2%	2.7%	0.9%
South African Rand	USD	0.6%	-0.3%	2.1%	12.1%
Swiss Franc	USD	-1.5%	-0.8%	1.7%	-3.1%
Chinese Yuan	USD	0.0%	0.0%	0.8%	-5.4%
Commodities & Alternatives					
Commodities	USD	1.4%	-0.9%	-4.8%	0.4%
Agricultural Commodities	USD	0.2%	1.3%	-0.1%	-2.7%
Oil	USD	3.5%	-1.7%	-10.5%	5.7%
Gold	USD	-0.1%	-3.1%	6.5%	-2.9%
Hedge funds	USD	0.0%	0.2%	2.3%	6.8%

Source: Bloomberg

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