Close Brothers
Asset Management

Investment **Insight**

Market Update

06 February2018

Our Asset Allocation quarterly will be published shortly, but here are some key messages we want to share in light of the recent market volatility.

2018 YTD peak to trough local currency share price declines					
US	EUR	UK	Japan	Asia	EM
-8.1%	-5.3%	-5.9%	-5.5%	-8.7%	-9.5%

Source: CBAM, Bloomberg Finance L.P. Data to 5th February 2018.

What we are experiencing is a correction:

- This was overdue; we have had 13 straight months of positive gains, at extremely low levels of volatility. This is very unusual.
- Remember, this was the first time since 1927 that the US market has not experienced a correction of 10% or more in a 12 month period.
- Sharp declines are often followed by equally strong and powerful rallies
- Technical selling at the close of the market (computer driven trading) exacerbated the decline.

The correction was largely in response to the prospect of rising rates:

- The catalyst for the decline was largely the pricing in of higher interest rates. The US 10 year yield has moved higher c.30bp since early January 2018.
- The case for higher interest rates was further validated by the increase of 2.9% in wage gains in the US last week.
- The market is now pricing in higher inflation expectations.
- We believe that interest rates and inflation will move modestly higher in 2018 and markets are adjusting to this new reality.
- This is a change from the ultra-loose liquidity conditions of the last few years.

However:

- The increase in interest rate expectations is not because of systemic risk or a policy mistake, but because economic growth is stronger. This is good news.
- US Interest rates are still low by historical standards and inflation has not yet moved higher – it is still close to 2%.
- We know that the US Central Bank (The Fed) takes an evidence-based, data-driven approach to setting monetary policy, monitoring wage data over time.

The fundamentals are still solid:

- Global economic growth is strong – as the International Monetary Fund noted recently, this is the strongest synchronised global growth upswing in over a decade.
- Global earnings generated by companies remain strong and continue to deliver double digit gains.
- Economic growth could still benefit further from fiscal stimulus, likely infrastructure spend and decreased regulation in the US.
- A move away from the era of secular stagnation and the spectre of deflation is positive.
- But a shift to higher global growth also means that interest rates need to adjust to the new economic reality – this is interest rate and Central Bank normalisation.

We believe this is a sharp correction within a bull market:

- Global liquidity conditions, growth and earnings give us no reason to reduce risk.
- Research shows that missing the last 12-36 months of a bull market can cost investors dearly, 20-25% on average.
- Of course, the markets are not without risks and we remain vigilant:
  - Global earnings must grow faster or, at least, in line with the rise in rates.
  - The US fiscal position is deteriorating and this may result in higher than expected US bond issuance in 2018 (circa $950bn versus $519bn in 2017).
  - Political and geopolitical risks can always provide negative surprises.
- However, we do not see the conditions in place that would suggest a deterioration in fundamentals such as:
  - Declining economic and profit growth
  - Surging inflation
  - Aggressive tightening by Central Banks

Our strategy – add selectively on weakness:

- Corrections are healthy and remove “froth” and a degree of investor complacency from markets.
- They serve to remind us that outsized returns and one-way markets are not the norm.
- They bring opportunities to re-position portfolios and add selectively on weakness.
- **Given our constructive view on markets, we will be slightly increasing our exposure to equities, adding to favoured names and our emerging market allocation.**