FPM Comment **Reducing the Noise**

Raik Hoffmann – 1/2018 dated March 6, 2018

Latecomers beware ...

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- Our assessment of the correction at the start of this year: much of the downturn is over
- Rising interest rates have reintroduced volatility
- Inflation will rise
- Probably no new highs in the coming months
- Prices and timing favour re-entering the equity market

Our view on the first correction of 2018

"All in all, the equity markets should have further potential in 2018, although this is likely to be accompanied by increased volatility as a result of higher interest rates – including a bigger correction than in 2017." That was what we wrote last December and rarely has a prediction come true so fast."

Moreover, rising interest rates do seem to have been the cause, although not the only one. That said, we were also somewhat surprised by the momentum of the correction, especially the extreme hike in volatility. We do not wish to join the speculation as to whether or not the VIX future was deliberately manipulated and, ultimately, it is presumably irrelevant. The correction can be explained to a large extent by the concepts of risk measurement and risk management. If a market rises with extremely low volatility, as was the case last year, the value-at-risk (VAR) falls analogously. Since many portfolios are managed using this parameter, this means that the risk - including leverage - can be increased across the board. The bitcoin spectacle shows that in the end there was a good deal of speculative money in the market. At the same time, there was increasing investment in products that benefit from declining volatility. While this was a very lucrative strategy for a long time, it took only a few days to bring about a total loss. It was a bit like picking up cents in front of a steam roller: it might turn out OK, but it's more dangerous than people think and in any case it's hardly worthwhile.

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Regardless whether volatility rose first or equities fell first or both happened at once: they were mutual driving forces. Increased volatility means increased risk, risk managers therefore demand that the equity risk (leverage!) is reduced, which in turn results in price declines and a further increase in volatility, products with short exposure to volatility (a very popular trade as we have already mentioned) have to be covered, credit-financed private investors have to sell, and so on. That continues until the speculative positions have been weeded out, over-exposure has been reduced and new buyers have entered the market because valuations have dropped.

The price dimension ...

Evidently, the big question now is whether the correction is already over. Alongside price, every correction also has a timing component. Looking at the price component – based on the definition of a correction – most of the correction is already over, unless there is something big happening in the background, which will only become clear with hindsight (e.g. if the debt problem in China is getting out of control, see liquidation of assets by HNA, but that is not our working hypothesis!). If a normal correction is defined as a price decline of 10 - 15 %, the DAX is already in this range. Evidently there is still a residual risk of a few percent – including an overshooting, but catching the low with perfect timing is probably very rare.

... and the timing dimension

That brings us to the timing dimension. Normally, corrections run for several months and they do not start by crashing over a few days. On the contrary, during a correction phase the market slowly rolls over, repeatedly endeavours to run towards the old highs (but typically only achieves lower highs), and then, at the end, the downward trend accelerates. Since the opposite happened this time, it is possible that the correction will not last as long as usual. The market will probably stage recovery rallies but frequently drop back, and further lows cannot be ruled out given the pronounced weakness of European and German shares relative to the USA.

Interest rates and economic development

On the other hand, we started by postulating that rising interest rates would be the main factor in the return of market volatility. And that is precisely what has happened. The future interest rate trend will doubtless be one key factor. Another one will be the development of the economy, which has been rather sidelined in the debate in recent weeks. We have recently pointed out that the economic outlook remains good and that a recession is at most a secondary scenario (e.g. as a result of more serious debt problems in China). We also pointed out that the high economic momentum seen at the end of last year was not sustainable. This has proven true (decline in PMIs and the ifo index) and is highly likely to continue for a while, with the associated lack of impetus for the equity markets. This slight weakening should also halt or at least slow the rise in interest rates.

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Impetus from the USA

On the inflation front, it is too early to give the all clear for the USA. It is fairly clear that inflation will rise in the coming months as a result of the reference base. On an annualised basis, this will reflect the sharp drop in mobile communication charges in the USA on the one hand, and the impact of the weaker dollar on import prices on the other. Energy prices will probably also push up inflation during the year. Until the summer, inflation could thus move towards the Fed's target and normalisation of monetary policy could continue with several interest rate rises in 2018. Our prediction of four interest rate rises has now become something of a consensus. It remains to be seen whether wage inflation rises as a result of the low unemployment rate.

The tax reform and a possible infrastructure programme in the USA are really coming at the wrong time because taking such procyclical action relatively late in the cycle when the economy is at full capacity is more likely to create further shortages and generate inflationary pressure. However, structural reforms are only possible when there is a political majority, we should show some mercy. In any case, here in Germany we can only dream of tax reductions - and then at most in the run-up to every election. However, the programme is likely to drive inflation and will be accompanied by higher government debt, which also suggests that interest rates are likely to rise. The trade tariffs envisaged by Trump will only reinforce this trend. That said, record positions in the futures market show that the market has already anticipated this to some extent.

The situation in Europe may look different and for us the weak dollar means falling import prices (especially important for oil), but it seems relatively unlikely that interest rates in Europe will fail to react at all to US rates. Interest rates in the euro zone have been distorted downwards by the ECB's bond purchase programme, and even though inflation is not yet a problem here, our repeated comments that there is a mismatch between a yield of 0.7% on 10-year bunds and 1.6% inflation with full employment are no less incorrect. Consequently, Europe is unlikely to escape rising interest rates.

Market development up to early summer

There are therefore many factors suggesting that the market is unlikely to head for new highs before the early summer. But by then most of the current downside factors should be behind us. Most of the increase in the US inflation rate should be over. There could possibly be two interest rate rises in the USA before the summer, and by then it will be clearer whether one or even two further rises are likely before year-end (at any rate, this will be priced into the market). Moreover, by then the ECB will have to say what it intends to do about its bond purchase programme from the autumn onward (i.e. whether it will be reduced or discontinued). The temporary economic slowdown should then largely be over and the headwind for German companies coming from the US dollar should gradually be declining.

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On the timing question

Summing up, on the price side there are already many factors in favour of re-entering the equity market, whereas from a timing viewpoint there does not seem to be any great hurry at present. However, given that in recent years many investors failed to benefit from the rally because they were constantly waiting for corrections, there is a big danger of missing out altogether. With no sign of recession, shares remain attractive at their present level and many have corrected far more than the market as a whole. Besides, given the rapid downturn it is possible that the duration of the correction could be shortened.

Sincerely yours,

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