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Smart[im]: Weekly Market Review

02 February 2018
Smart Investment Management

The week to date as at 12 p.m. Friday (GMT).

Markets and key events

Rising bond yields spook markets

Having started the year almost universally bullish, a bout of investor nerves returned to markets this week as the United States (US) government bond market sold off, taking equity markets with it. The 10-year US Treasury yield rose to 2.79% (which moves inversely to price), its highest level in four years, dragging equities down with it over concerns of elevated valuation levels. The MSCI All Countries World index dropped 1.7% over the week. However, unlike the taper tantrum in 2013, not all markets were universally impacted, with, for example, the Australian S&P/ASX 200 rising 1.2% over the week benefitting from strength in the energy and banking sectors.

The US S&P 500 fell 1.8%, EuroStoxx 50 fell 3.0%, having been heavily impacted by the continued strength of the Euro which has hurt exporting companies, the United Kingdom's (UK) FTSE All Share fell 2.6%, Japanese Topix index lost 0.8% and the emerging markets fell 1.9% to 12pm London time.

Government bond yields also rose in Europe, with the 10-year German bund yield now trading at 0.74%, its highest level since September 2015. Perhaps more notably, the 5-year German bund is no longer trading at a negative yield, the first time since mid-2015, now trading at a yield of 0.06%. UK gilt yields also rose, with the 10-year trading at 1.56%. Bond markets have been hit by a combination of rising expectations of inflation, and rising expectations of increasing US debt issuance, in part to compensate for the recently announced tax cuts. This is all happening at a time when the US Federal Reserve (Fed) is pulling back from its bond purchasing programme, requiring the private sector to pick up the slack.

Inflation concerns and… Amazon worries

As if rising bond yields were not sufficient to worry about, healthcare stocks took a hit this week as news that Amazon, Berkshire Hathaway and JPMorgan Chase were setting up a company aimed at cutting healthcare costs for their US employees. Nowadays, just the mention of Amazon taking aim at an industry sector is enough to get investors running for the hills. Janet Yellen presided over her last Fed meeting, with interest rates remaining on hold at 1.5%, although reaffirming the outlook for gradual rate increases over the year as inflation is expected to pick up. At 1.30pm London time, the US non-farm payrolls employment data is released for January, with forecasts of 180,000 jobs having been created outside of agriculture. The greater focus, however, will be on wage inflation pressures coming through.

Australia - a bright spot

The Australian stock market benefitted from the energy and banking sector this week, both posting strong returns of 2% and 1.8% respectively. On the economic front, Australia's manufacturing sector continues to improve. The Australian Industry Group showed that the sector PMI (Purchasing Manufacturing Index) expanded to a score of 58.7 for January, with readings above 50 indicating an expansion in sector activity. This was up from 56.2 in December. Also in news this week, the Australian Q4 2017 inflation reading came in slightly below expectations as headline CPI (core price inflation) rose 0.6% for the quarter, below forecasts of 0.7%.

Changes to the portfolios

There have been no changes to portfolios this week.

Issues under discussion

Long overdue volatility

The volatility seen in markets this week has been long overdue, with equity markets having scaled a vertical wall in 2017 with barely a blink. Rising bond yields are likely to be a headwind for equity markets as at some level, bond yields will increasingly swing the pendulum in favour of safer government bonds. However, we do not think we are there yet and unlike the taper tantrum in 2013 when markets last worried about rising interest rates, the global economy is in much better shape. However, that is not to say that this period of volatility is over, especially as the next few months of year-on-year inflation comparison data are likely to give the impression of rising pressures due to a very subdued period last year. If there is any material fall in equity markets over the coming months, we are likely to see this as a buying opportunity, rather than a reason to exit.