

Heads or tails?

Monday markets down, Tuesday up, Wednesday down, Thursday....?



Coin toss

Markets circular dance as normalisation reality sinks in

At times in every business cycle, there is a significant negative relationship between stock prices and bond prices. Not surprisingly. One asset class, equities, is a risk-asset, that does well when sentiment is strong, and the other, bonds, is a safe haven play. But also, the valuation of equities depends in part on what the risk-free alternative rate (bond yield) is. So when yields rise, stock valuations dip (it is a net present value thing).

Right now, we have a tangled dance going on between a bond market that is rising because economic fundamentals are strong, inflation is, if not exactly rising, showing a tendency to rise slightly in the future, and central banks are either tightening, thinking about tightening, or thinking about not easing further.

This has met market pricing and positioning that was not priced for the beginning of the end of easy money, and as a result, we have experienced some interesting market fallout. On one day, when strong economic fundamentals would once have simply pushed equities higher, the underlying earnings story is now tempered by rising expectations of higher inflation, policy rates, and bond yields. With market valuations already looking stretched by some metrics, this has led to a sharp downward correction in stocks.

As stocks have fallen and hit market confidence, bonds have rallied and their yields have fallen.

The equity market has gained hope as valuations improve. And so the cycle continues...

This might go on for a while yet. Are we close to the bottom? Honestly, this is anyone's guess, though my sense is that no one is really panicking yet, so perhaps. But if it isn't the bottom, it has been a pretty insignificant market correction. Increased volatility will enable those who missed much of the run-up in stocks to buy on dips, and at least get invested, though I suspect they would have been happier coming in after a 10-15% correction. Still, there is plenty of mileage left in this normalization story yet, so don't rule out further sharp falls.

Asian FX - mixed bag

Unhelpfully, the Asian FX story is not really following a strict risk-on / risk-off story. Two of the currencies that tend to get hit hard in any period of market uncertainty, the PHP and IDR are looking very different, with the IDR losing all the ground (and more) that it made in January. But the PHP is making gains against the USD as thoughts of BSP tightening grow (if not today then we expect a hike by quarter end and two more to follow over the course of 2018). Elsewhere, there are some signs of stability in some currencies, though the KRW still seems to be finding it hard to find a solid base in contrast to one of our other preferred currencies for 2018, the MYR, which has been far steadier. On the other side of the coin, the THB, which we view as one of the regions more overvalued currencies, continues to look solid. Whilst this volatility continues, we have no strong convictions as to the likely direction of these currencies and will wait for some further clarity.

What's on today?

In Asia, today's top story is undoubtedly the Philippine Central Bank (BSP) rate decision. The market consensus is for no hike today - a view with which we concur. Though the central bank governor has been sounding a little hawkish recently, and a hike cannot be ruled out. If no hike today, then a March hike seems probable, as the recent inflation rise has not yet run its course, and the arguments for a hike will seem even more compelling by then.

Elsewhere, China trade data is due. This has a bit less market prominence than it once had, given the greater emphasis on consumer-driven growth, but still has the power to surprise, especially in proximity to the data-distorting Chinese New Year.

In the G-7, Japan releases a raft of highly volatile and therefore not very informative data on trade, portfolio flows bank lending and bankruptcies. We would be surprised if any of these gave rise to significant market reactions.

The Bank of England also meets today and is widely expected to leave rates alone, though there remains a lingering threat of more to come from Governor Mark Carney, and the tone of the outcome could err on the hawkish side. There is little significant data to note in the US, though an overnight Senate budget agreement may help avert a government shutdown likely otherwise on Friday. The plan suspends the debt ceiling until March 2019, and provides more funding for the military (\$80bn) this fiscal year and (\$85bn) next. An interim spending bill will need to be passed in the meantime to keep the government afloat until the longer term budget measures are passed. The fight now passes to the House of Representatives, where it will meet opposition, but may still pass.

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