Equity Market Volatility

Global equity markets fell sharply over the last two weeks with all sectors moving lower. European equities maintained their historical correlation with the US stockmarket by falling even more in percentage terms despite the relatively lower valuation multiples at which European shares trade. This period of volatility began with the release of US payroll data on Friday 2nd February which suggested increasing wage inflation in the US in turn raising the threat of higher US interest rates. US 10-year bond yields rose to a four year high on the back of the employment numbers.

Rise in US Treasury yields the main catalyst for the recent stockmarket volatility

Source: Bloomberg

The US dollar initially saw some support reflecting its safe haven status, while Gold has also rallied. Corporate bonds have fallen slightly with the general rise in yields and some widening in credit spreads. Commodities have had a mixed performance with metals and agricultural commodities unaffected while oil has weakened. REITs have also fallen in price, reflecting their short term positive correlation with equities, and despite an improving environment for rent inflation.

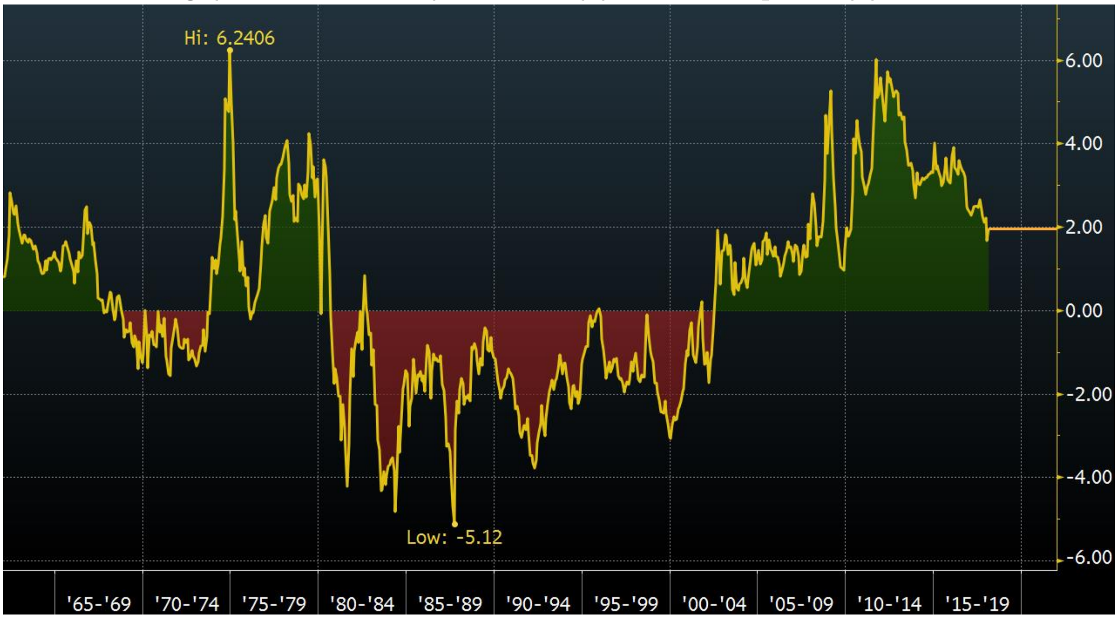
Higher interest rates and bond yields reflect the most obvious threat to stockmarkets over the next two years. Investors seeking returns over the past decade have had little choice but to buy stocks given the low yields available from cash and bond markets. Increasing bond yields offer equity investors an alternative asset class and so are expected to put pressure on stockmarket valuations. But interest rates will only move higher if accelerating economic activity drives inflation expectations up. Corporate profits would also be expected to benefit from the same economic growth and equity market valuations do not appear that stretched if this growth is taken into consideration. Even the most pessimistic bond commentators see relatively modest interest rate increases in the US by historic standards and even lower rate increases in the Eurozone.

Recent fall in equity prices (white) does not reflect strengthening earnings outlook (blue)

Source: Bloomberg

Bearing in mind the extraordinary period of low volatility and high returns in the US stockmarket over the past few years and, in particular, over the last few months, a correction should not be a surprise. The reliance of many investors on technical trading analysis (e.g. moving average strategies) as well as the increasing volumes transacted under various high frequency and automated algorithmic strategies has tended to make short term corrections more extreme events in recent years. The fact that the selling of the last few days has extended across all sectors regardless of the defensiveness of the sector's earnings or balance sheet strength suggests that the recent volatility is a technical correction reflecting profit taking following the strong gains of the last few months rather than a harbinger of something more sinister.

S&P 500 earnings yield versus US 10-year Treasury yield over the past fifty years



Source: Bloomberg

Q4 corporate earnings results continue to reflect strong trading and profitability, while the strong economic data which has worried bond markets, is a net positive for corporates. Overall, the conditions required for a sustained fall in stockmarkets remain, in our view, absent for the time being. These include cash and bond yields at a level that make equity valuations unattractive. The earnings yield on the US equity market (4.6%) remains well above the US ten-year treasury yield (2.8%) even after its recent increase. Underlying trading conditions and the macro-economic outlook remain positive for the global economy and Central Banks are unlikely to threaten what has been a slow and faltering recovery with an aggressive tightening of monetary policy.

Overall, we believe that the current stockmarket volatility reflects a combination of profit-taking following the recent sharp rise in global equities as well as concerns about the impact of rising interest rates and bond yields on economic growth and on investment in equities. We believe that concerns regarding the impact of rising inflation and higher interest rates are probably overdone as inflation and interest rates will only increase if economic activity supports them. The same economic activity should help increase corporate earnings and in turn company valuations. Technical market sell-offs fuelled by profit taking and exacerbated by opening and closing of hedging positions are difficult to predict and could continue in the short term until the valuation argument for buying becomes irresistible. Typically, technical corrections of 5-12% are not unusual, but are usually followed by a relatively swift recovery. Given the strong Q4 earnings currently being released, investors are being reminded continuously of the strong momentum behind corporate profits. This will help stabilise markets in the short term.

Wellesley Investments & Pensions Ltd.

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