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INVESTMENT OUTLOOK
SPECIAL REPORT – MARKET CORRECTION

8 February 2018

Equity markets started the year exceptionally well but were then subjected to a severe market correction. Selling off started on 26 January and the equity markets lost about 7%. Our balanced EUR portfolio has lost roughly 0.7% year-to-date (as per 5 February).

Our Investment Committee has been discussing the market developments on a daily basis. We consulted with a number of market participants and independent research firms to better understand the cause of the market turmoil and determine which conclusions can be drawn.

We consider the recent equity market sell-off as largely driven by technical factors, and thus likely to be short lived. Yesterday's rebound in the markets seems to confirm this view. We therefore decided to increase our equity market exposure somewhat, by adding to European and Japanese equities. In essence, we are bringing the exposures back to the warranted portfolio weights (overweight Europe and neutral Japan). However, markets will become more volatile, which will require more frequent tactical portfolio adjustments.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

EQUITY MARKET CORRECTION AND VOLATILITY SPIKE

After a strong rally of risky assets at the beginning of the year, we saw a worrying sell-off, starting on 26 January. Developed equity markets, were up 7% until 26 January and since then have lost about the same amount. Emerging markets equities gained roughly 10% and lost 7.5% thereafter.

The salient question is whether this is the beginning of a major market correction or a short-term sell-off which will not change the positive outlook for 2018.

In order to answer that question, we have investigated the cause of the sell-off. At the end of January, it became apparent that inflation, which remained surprisingly subdued in 2017, is set to increase. This became especially clear when the US labor market report of 2 February revealed that average hourly earnings had risen 2.9% in January, the largest increase since 2009. This sparked fears of rising inflation and faster monetary tightening by central banks. As a result, equity markets lost and bond yields climbed.

The magnitude of the sell-off was puzzling, however, but can be explained by the certain developments.

Implied volatility, the price of options to insure against market losses, rose significantly (Fig. 3). Many hedge funds have profited from falling volatility levels, which resulted in elevated positions in so-called inverse volatility strategies. Those hedge funds incurred heavy losses when implied volatility spiked recently. Losses from such trading can be illustrated by Fig. 4, which shows the loss incurred by a Credit Suisse product which gives exposure to the inverse of the volatility. In order to exit their positions in the volatility trade, hedge funds had to sell equities to hedge out their option positions. On top of that, there is evidence that funds, pursuing quantitative trend following strategies, acted as additional sellers when markets were already falling, amplifying the sell-off.

To summarize, while the macro environment is certainly changing as inflation finally returns, the recent market crash can partly be explained by technical factors. This suggests that the market correction will be rather short-lived and looks exaggerated. Therefore, we today cautiously added some equity exposure.

Nevertheless, we expect that central banks will normalize their monetary policy faster than expected, which will bring back more volatility to markets. In our view, this should not change the still positive outlook for equity markets in general.

MARKET CRASH

The following charts illustrate the major market developments during the recent market crash. Equity and bond markets sold off. Implied volatility spiked (Fig. 3), which has hit those hedge fund managers hard who were positioned to benefit from falling volatility levels (Fig. 4). Credit spreads widened somewhat, but the damage was less pronounced.

Fig. 1: Major equity indices

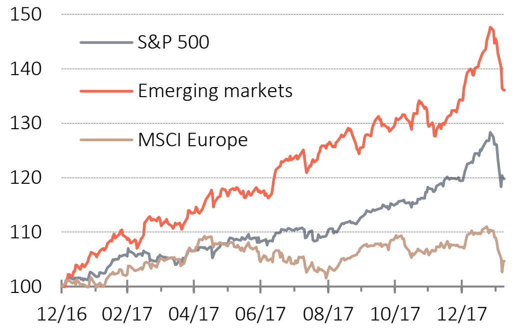


Fig. 2: 10-year bond yields

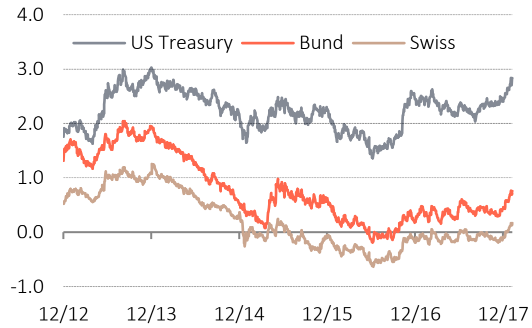


Fig 3: Implied volatility index, VIX

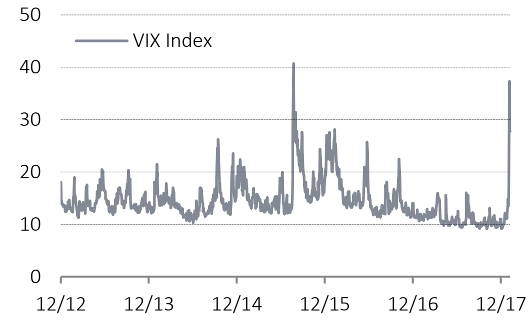


Fig. 4: Credit Suisse's inverse VIX product

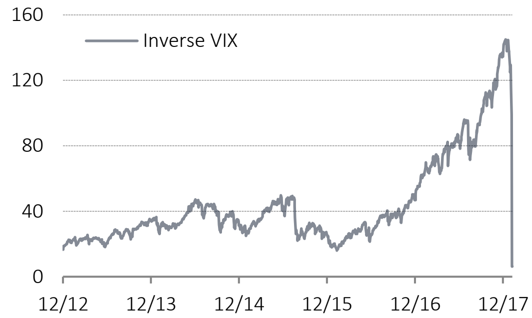


Fig 5: Fixed Income volatility

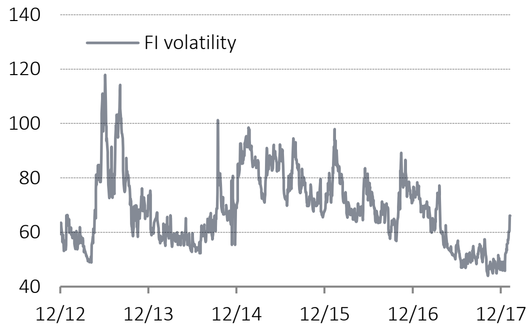
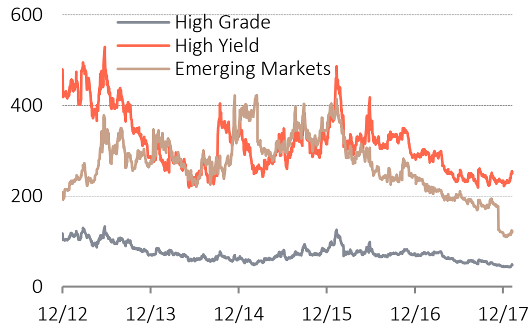


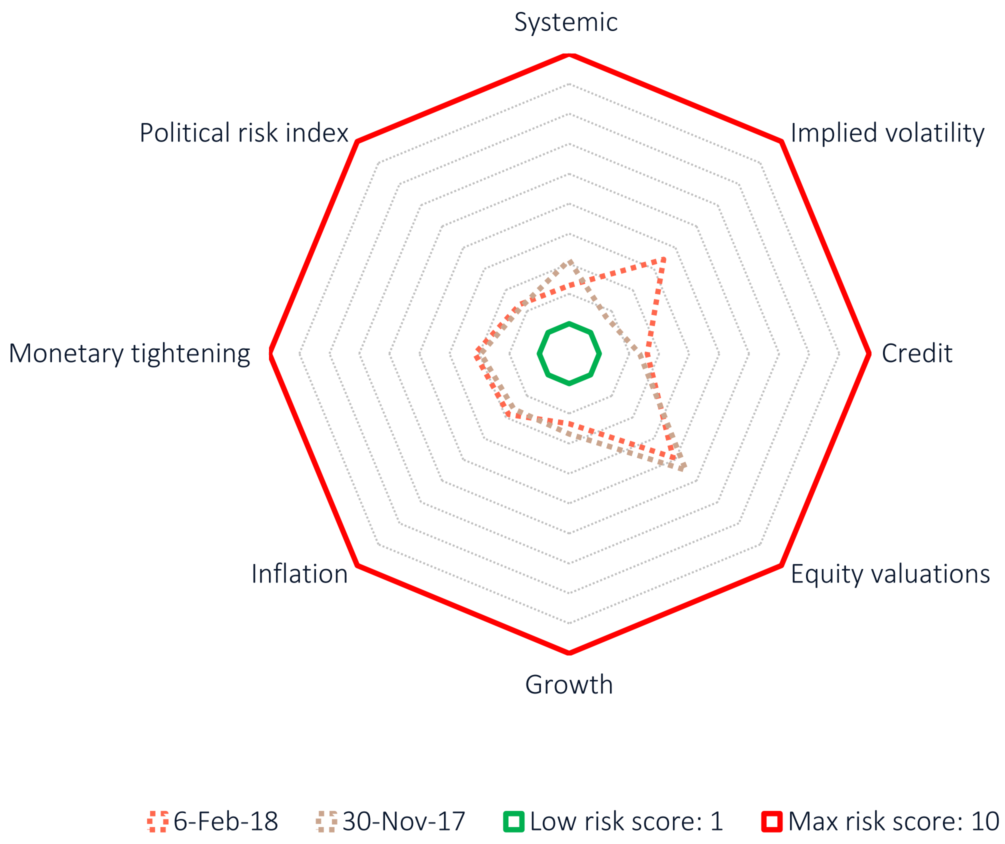
Fig 6: Credit spreads



RISK MONITOR

Our risk monitor illustrates what happened in the markets. If we compare the risk landscape on 6 February with the corresponding picture in November 2017, we see that in particular implied volatility spiked. In addition, inflation risk together with monetary tightening risk increased. It is reassuring that systemic risks, i.e., banking sector risks, which were the core problem during the last financial crisis in 2008, remain low. The market correction has helped to reduce equity valuation risk somewhat.

Fig. 7: IMT Risk Monitor



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Source for all graphs: Bloomberg, IMT Asset Management AG.