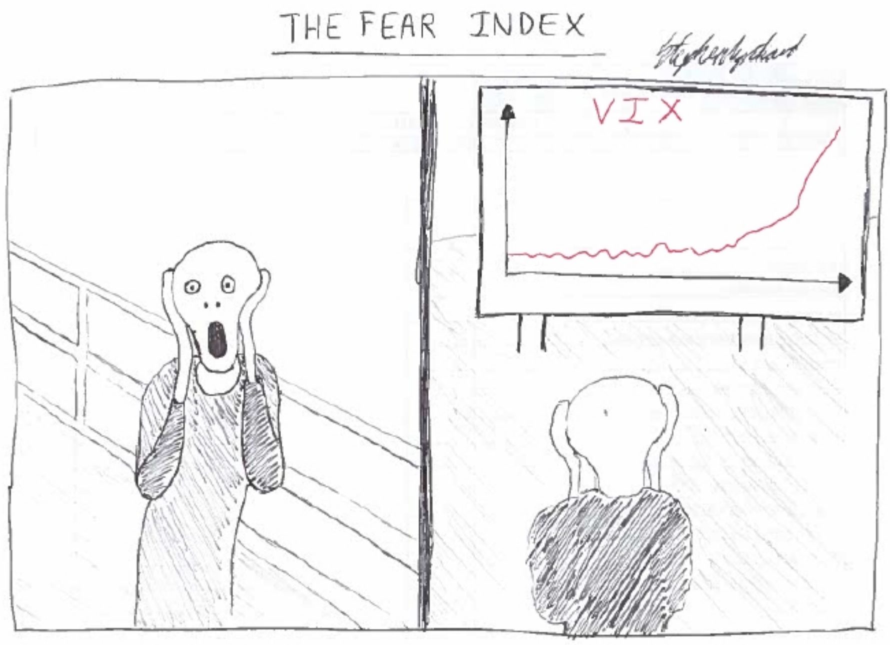
MVAM Newsletter

‘Something for a Fox to Munch on?’ February 2018



Suddenly everyone is talking about Vix and it's not our pet fox, enjoying life in and around Dorking. This Vix is the Volatility Index based on the US stock market. It is colloquially known as the fear index. In recent years, as investor confidence has risen, there has been less volatility in the market and Vix fell to very low levels. The trouble was some investors believed this was the new norm, prompting clever bankers to launch esoteric products to "bet" on this new norm of low volatility. These exchange-traded funds (ETFs) proved very rewarding in the era of low volatility, generating high returns for all participants. But as always, all good parties come to an end, usually with a hangover. In this case volatility returned with a vengeance, as stock markets fell sharply from the end of January. Trading strategies depending on calm collapsed, with investors losing more than their shirt in a few short days, as banks were forced to close the Vix product culprits at short notice. As always regulators and central bankers were asleep, if not at Davos sipping the finest champagne, telling each other how wonderful and safe the financial world is in 2018. As so often the risks of esoteric products are misunderstood until it is too late. Maybe the secret is to stick with vanilla products, such as simple equities and avoid derivatives and their like, which few understand, especially when it comes to risk.

So should private client long term equity investors worry too much about the recent share price falls? Clearly it is disappointing, and in the jargon of professionals the declines are a "correction", indicating a fall of 10%, but well short so far of a "bear" market, requiring a 20% setback. The trigger was the latest wage data in the US, which showed stronger growth, increasing inflationary fears. This hurt the bond market as expectations increased on the pace of interest rate rises. In London, the Bank of England is expected to increase rates again in May, as inflation stays above 3%. The negative sentiment across the bond market rolled across into equities, encouraging investors to lock in some profits from the rally of recent years.

Taking a step back from the recent market turmoil, the world economy is in a good place, with synchronised growth across the US, Europe and Asia. But rising interest rates, which accompany that stronger growth, will mean we will have to get used to increased stock market volatility. Carillion’s demise last month was a symptom of the changing times. At turning points in the interest rate cycle, the market reassesses what it “loves” and what it “hates”. This can cause angst in the short-term and may not be good news on the surface. But with most sectors of the market appearing reasonably valued, the increased volatility creates good buying opportunities for active long-term investors. As for Vix, the fox in Dorking, he or she may find a few sorry volatility traders in the dustbins. Easy come, easy go.

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