SIGNIA TALKING POINTS

February 2018

SIGNIA

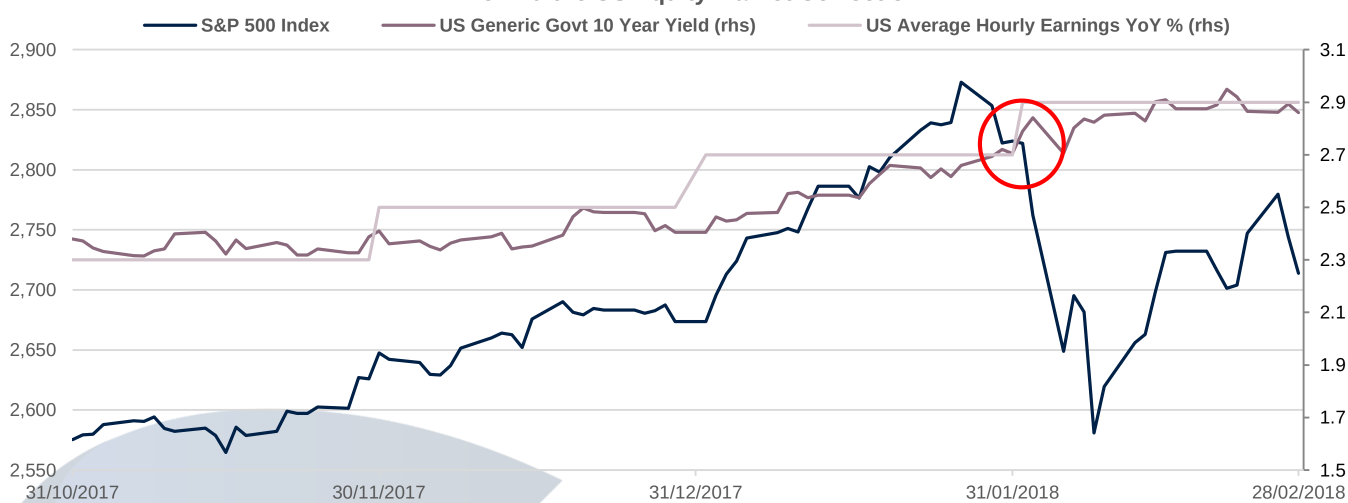
Dissecting the equity market correction: ominous warning sign or healthy dose of volatility?

Equity markets often react differently than bond markets to economic data and are subject to a much greater degree of price volatility and investor myopia. Monetary policy, however, is one market driver that binds both asset classes inextricably together, and February's equity market correction was a good example of this.

As shown in the graph below, US average hourly earnings had the highest reflationary print of 2.9% since June 2009. This meant expectations for the Federal Reserve's (Fed) interest rate path was marked up, causing equity and bond prices to decline as long-term discount rates applied to future cash flows increased. As a result, future corporate earnings and investment income would be worth less today than they did previously in a lower interest rate environment. This 'normalisation' of economic expectations unfortunately coincided with the end of a stable four-year term for the U.S. central bank Chairwoman Janet Yellen. Her Republican successor, Jerome Powell, represents a change of guard at a critical phase for US monetary policy, where a policy error could prove fatal to an equity bull market entering its tenth year.

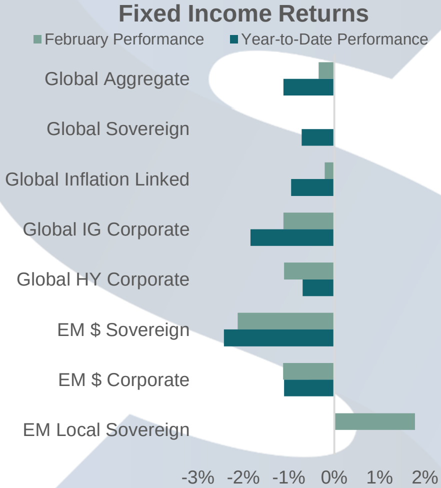
We believe that the Fed is unlikely to stray too far from its slow and steady rate hike path and expect inflation to remain within its 'healthy' range, between 1% and 3%. This should allow equity markets to continue their upward march, albeit accompanied by higher volatility, as a combination of tax cuts, fiscal easing and deregulation in the U.S. supports the global economic expansion, whilst technological innovation, globalisation and demographic trends keep rising inflation in check.

Behind the US Equity Market Correction

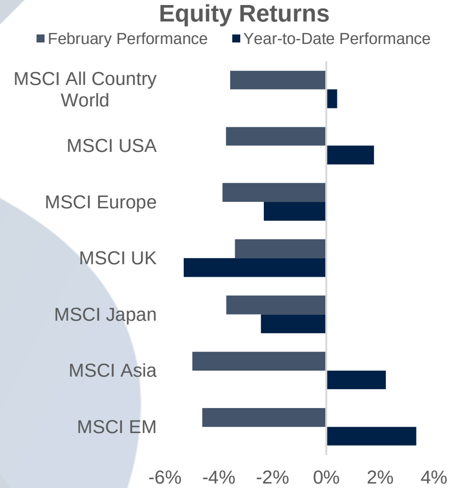


Source: Bloomberg

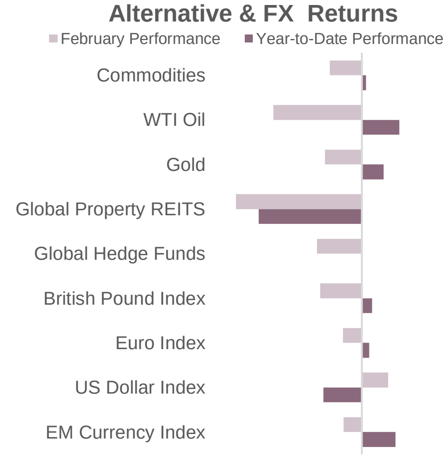
Fixed Income Returns



Equity Returns



Alternative & FX Returns



Global Agg: Bloomberg Global Aggregate TR Hedged GBP; Global Sovereign: Bloomberg Global Treasury TR Hedged GBP; Global IL: Bloomberg World Govt Inflation Linked Bonds 1-10Y TR Hedged GBP; Global IG: Bloomberg Global Corporate TR Hedged GBP; Global HY: Bloomberg Global High Yield TR Hedged GBP; EM$ Sov: Bloomberg Emerging Markets Sovereigns TR Hedged GBP; EM% Corp: Bloomberg EM USD Corporate 10% Cap Hedged GBP; EM Local Sov: Bloomberg EM Local Currency Govt TR Unhedged GBP; Equities: MSCI indices reflect net total returns in local currency, except Asia and EM in USD; Commodities: Bloomberg Commodity TR Index; Global Property REITS: FTSE EPRA/NAREIT Global Index; Global Hedge Fund: HFRX Global Hedge Fund Index; British Pound: Bloomberg British Pound Index; Euro: Bloomberg Euro Index; US Dollar: Bloomberg US Dollar Index; EM Currency: JP Morgan Emerging Market Currency Index. Source: Bloomberg. Data **as at 28/02/2018.**

Analyst Commentary

Fixed Income

- US 10-year treasury yields jumped to just below 3% after inflation data released surprised on the upside and spooked investors by raising inflation expectations and causing bond prices to decline
- Global investment grade and high yield credit spreads widened as investors are anticipating lower corporate profits in a tightening monetary policy environment, whilst low default rate expectations are preventing bond yields from rising significantly
- Emerging market US dollar denominated debt was not spared in the market turmoil and was the worst performing segment of the global fixed income universe in February

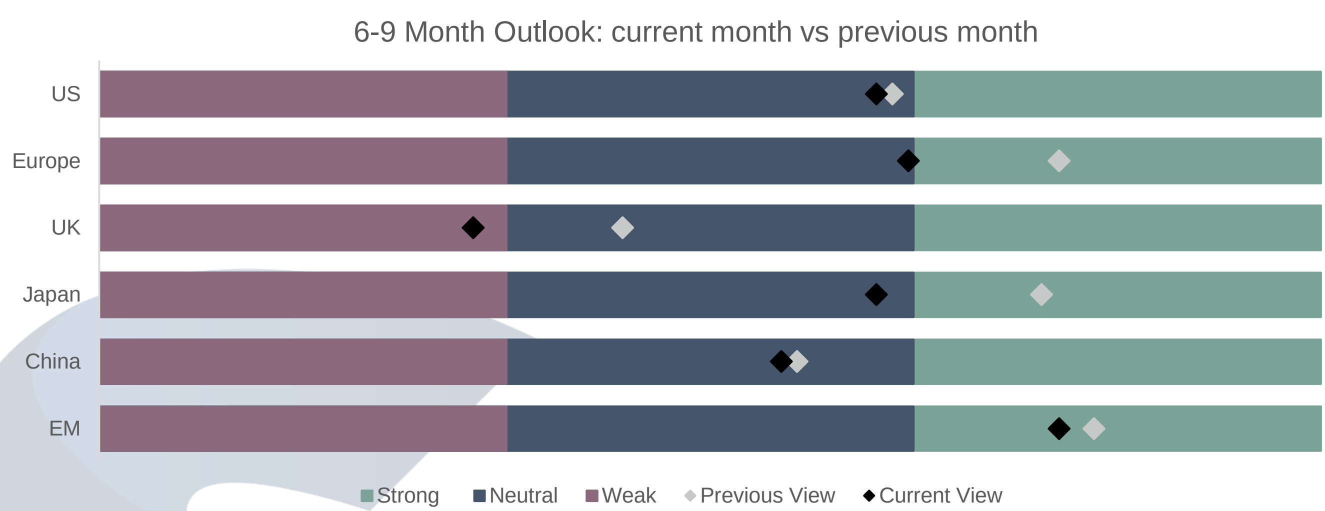
Equities

- February saw a pullback in global equity markets, with many commentators sighting technical selling and increased investor sensitivity to rising inflation as the likely causes of the correction
- In a highly volatile and broadly risk-off month, the worst performer was Emerging Markets, with cyclical sectors and notably Asian technology leading the fall
- Despite US equities selling off sharply at the beginning of the month, the remainder witnessed a partial recovery, as earnings came in stronger than expected and future earnings estimates were revised higher
- European equities sold off in line with other developed markets, with upcoming Italian elections having limited additional impact

Alternatives & FX

- Commodities pared most of their January gains in February with the broad market index returning -1.73%, led by energy prices
- Natural Gas prices were the big mover on the month declining -11.07% due to warm weather in the eastern United States, although weather forecasts show a return to colder weather during the first week of March, the bigger picture suggests that warmer temperatures will return right behind the cold weather, cutting into demand for the heating fuel
- The US Dollar DXY Index made up some of the losses it incurred in January by recovering to 90.6 (+1.7%). Bullish sentiment on the Euro indicated by various positioning indicators reached an extreme in February and there was need for a reversal. This was a reason for the dollar strength cited by some

Signia Macroeconomic Outlook



Source: Signia Wealth. **Data as at 28/02/2018**

- **Global**: We are most positive on the strength of the economic outlooks for Europe, Japan and the Emerging Markets, and remain most cautious for the outlook on the UK economy
- **US**: The passing of tax cuts and reforms by congress should further support a continuation of a solid economic expansion for an economy that was previously viewed as being in the latter stages of its cycle
- **Europe**: Economic and earnings recoveries are earlier in their cycles and gathering momentum, but face potential headwinds from a less accommodative European Central Bank and strengthening domestic currency
- **UK**: High consumer price inflation and negative real wage growth, combined with existential Brexit uncertainty with the European Union, has begun to weigh on consumer sentiment and the growth outlook for the UK economy
- **Japan**: The Bank of Japan remains firmly committed to its accommodative policies to stimulate consumer price inflation, whilst the Japanese economy stands to benefit most from a continued synchronised global economic expansion this year
- **China**: Curbing of pollution levels in China is an environmental positive but comes at an economic cost by slowing industrial output growth at a time when the corporate sector is deleveraging and economic growth is on a downward trend
- **Emerging Markets**: Buoyant commodity prices and a weak US Dollar environment are historically a perfect cocktail for strong emerging market growth, which also stands to benefit from a continued synchronised global economic expansion this year

Important Information