6 February 2018

Implications of recent market volatility

After an extended period of low volatility, markets corrected from their highs in early February, as Treasury yields notably spiked higher (see figure 1 and 2). Bullish economic data releases in the US auguring inflation expectation, coupled with market expectations of higher interest rates, were key factors reassessed by investors. Markets have responded accordingly: the Dow Jones Industrial Average Index (DJIA) suffered its worst decline in more than six years as 10-year Treasury yields reached 2.84%[1].

In this Investment Note, Geoff Lewis, Senior Asia Strategist, Endre Pedersen, Chief Investment Officer, Fixed Income, Asia (ex-Japan), and Ronald CC Chan, Chief Investment Officer, Equities, Asia (ex-Japan) offer our views regarding the implications for investors from recent market movements.

Comments from Geoff Lewis, Senior Asia Strategist

Investors should not act as if the stock market correction in early February means that we are facing the end of the market cycle, as some in the financial media have been so quick to suggest. It seems reasonable to argue, as some US equity strategists do, that in 2018 the real economy will be competing more strongly with financial markets for the available marginal quantum of liquidity. That could still mean mid to high single digit returns from the S&P500 in 2018, accompanied by a modest price-to-earnings ratio (PER) contraction if earnings grow by 11 to 12 per cent as consensus expects.

To argue that the US market is currently facing a deep and lasting correction in what looks likely to be one of the best years for the US economy and corporate earnings since the upturn began is both unjustified and too bearish. It has not happened before. Not until wage inflation exceeds 4.0% year-on-year can we expect to see any significant pressure on corporate profit margins.

Comments from Endre Pedersen, Chief Investment Officer, Fixed Income (Asia ex-Japan)

US Treasury yields have moved sharply higher since the beginning of the year: from an initial starting point of 2.41% to recent moves up to 2.84%, a level previously seen in 2014. Yields came back down to 2.68% on 6 February highlighting jittery markets, uncertainty and heightened volatility.

We believe two factors explain this recent volatility. First, the market's reaction to the release of better-than-expected economic data. The January payroll report showed continued solid jobs growth along with tentative signs of increasing wages. Second, investor expectations' that interest rate hikes may come faster than current market expectations. The January Federal Open Market Committee (FOMC) statement was perceived to be modestly hawkish, which further contributed to the sell-off in US Treasuries.

In the current market environment, we believe Asian bonds remain well supported due to the impact of robust global growth on regional economies and strong regional demand for the asset class. To date, Asian local currency bonds have posted modestly positive gains while Asian dollar bonds are down around 1%, driven mainly by the rise in US Treasury yields. Our view is that the Fed will increase interest rates three times in 2018. As we actively manage the duration of our funds to protect against rising rates, we believe our funds are well-placed should we see more rate hikes ahead.

[1] Bloomberg, as of 6 February 2018. Treasury yields are represented by closing price.

Comments from Ronald CC Chan, Chief Investment Officer, Equities (Asia ex-Japan)

We believe that a correction in the markets is healthy given the strong performance in 2017 and year-to-date. Fundamentals in Asia have not changed as earnings continue to be strong, as seen through earnings revisions (see chart below) and valuations are undemanding relative to developed market equities[2]. We expect that economic growth in the region will be supported by a relatively benign interest rate environment as inflation stays at reasonable levels.

Chart 1: Asia ex-Japan earnings revision ratio[3]

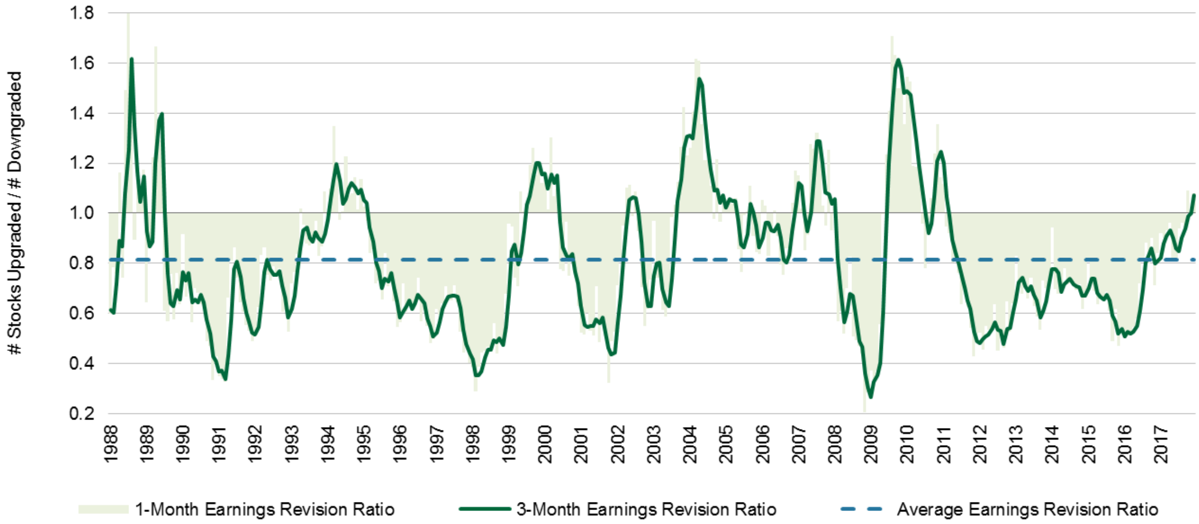

Figure 1: Market movement since 1 February 2018[4]

	Last closing price	2-days change	Year-to-date change
MSCI World Index	2103.64	-4.92%	+0.01%
MSCI Europe Index	128.88	-2.89%	-1.92%
MSCI Asia ex Japan Index	741.43	-2.61%	+3.92%
MSCI China Index	96.83	-2.11%	+8.37%
Dow Jones Industrial Average	24345.75	-7.03%	-1.51%
S&P 500 Index	2648.94	-6.13%	-0.92%
NASDAQ Composite Index	6967.53	-5.66%	+0.93%
Chicago Board Options Exchange Volatility (VIX) Index	37.32	+177.06%	+238.04%

2 FactSet, as of 31 January 2018.
3 BofA Merrill Lynch Asia Pacific Quantitative Strategy, MSCI, IBES, as of 31 December 2017.
4 Bloomberg, data as of 5 February 2018, price returns in US dollar. Past performance is not indicative of future results.

Figure 2: US 10-year Treasury movement since January 2018[1]