WealthHealth
Personal Wealth Management

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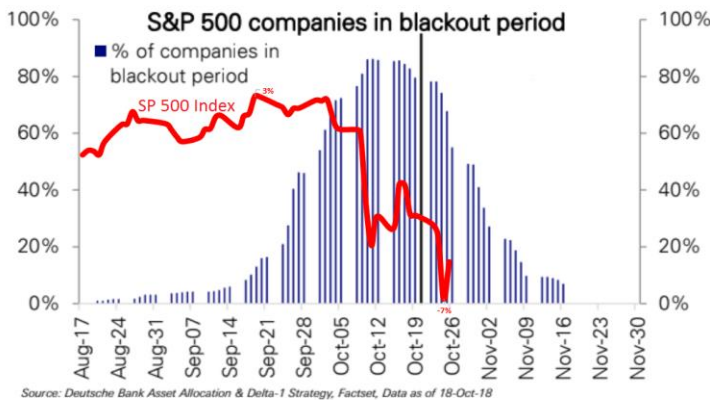
Market Review

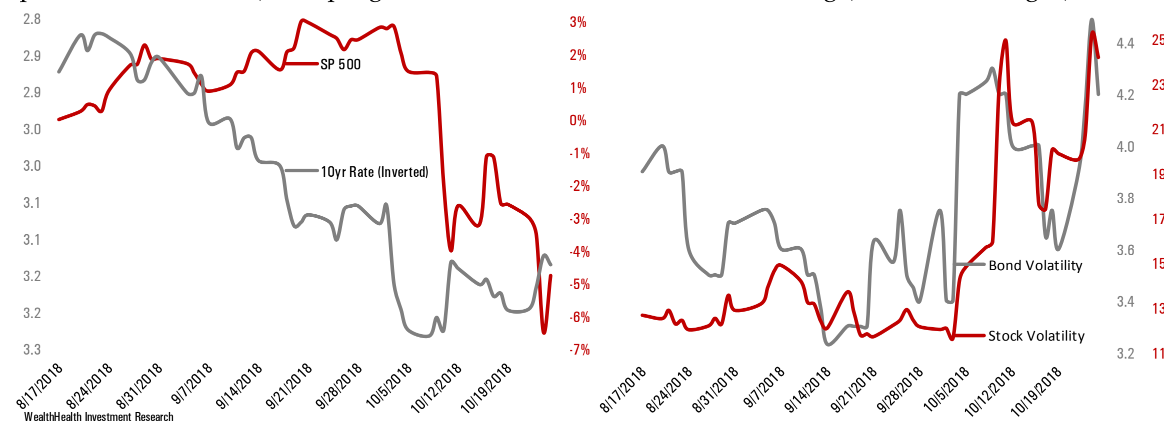
US Equity markets ended the 3rd quarter of 2018 on a stellar note with tech firms leading the way. However, at the time of this writing most of those gains have been reversed with international and emerging market equities continuing to underperform.

As mentioned in the previous letter, corporate share buybacks provide an important underpinning to the continued bull market in US stocks. To put things into perspective, if buybacks continue at the current pace, there will be approximately $800 billion of share repurchases this year alone. But this isn't a new trend. Looking back over the last 10 years, approximately $5 trillion dollars was spent on buybacks and over that same period, the SP 500 market cap increased from 6$ trillion to $24 trillion, an increase of $18 trillion dollars, 28% of which, was corporate buybacks. While the exact effect of stock buybacks is difficult to quantify precisely, in general, this huge flow of money works to reduce the number of outstanding shares and lift stock indices. More importantly, with less shares outstanding, it becomes easier to move markets as remaining incremental buyers become increasingly influential. Conversely, when buybacks cease, the effects can be negative. Around the time of earnings being released, corporations usually have what's called a "blackout" period, where no shares are repurchased as to avoid any potential inside-information conflicts. During this time, equity market sensitivity is heightened, and volatility is easier to spark, especially since most of today's trading is done by programmatic traders. Programmatic or algorithmic strategies make up the bulk of equity trading volume and can be triggered to initiate indiscriminate selling should certain thresholds become breached.



Technical note: the red line in the chart to left represents the SP 500 while the blue bars represent the proportion of SP 500 firms *not* buying back their own shares. As corporations step away from providing market support, equities become prone to draw-downs as seen over the last few weeks.

Since algorithmic traders need a catalyst to start selling, we look back to see what, if any, culprits exist. We find that the reason could have been the sharp jump in interest rates during the first week of October. Notice in the bottom-left chart, as rates rose *gradually* (and bond prices fell *gradually*) the SP 500 kept climbing. It wasn't until *after* the sharp spike in bond volatility (or sharp spike in interest rates) that programs became active and started selling (seen bottom-right).



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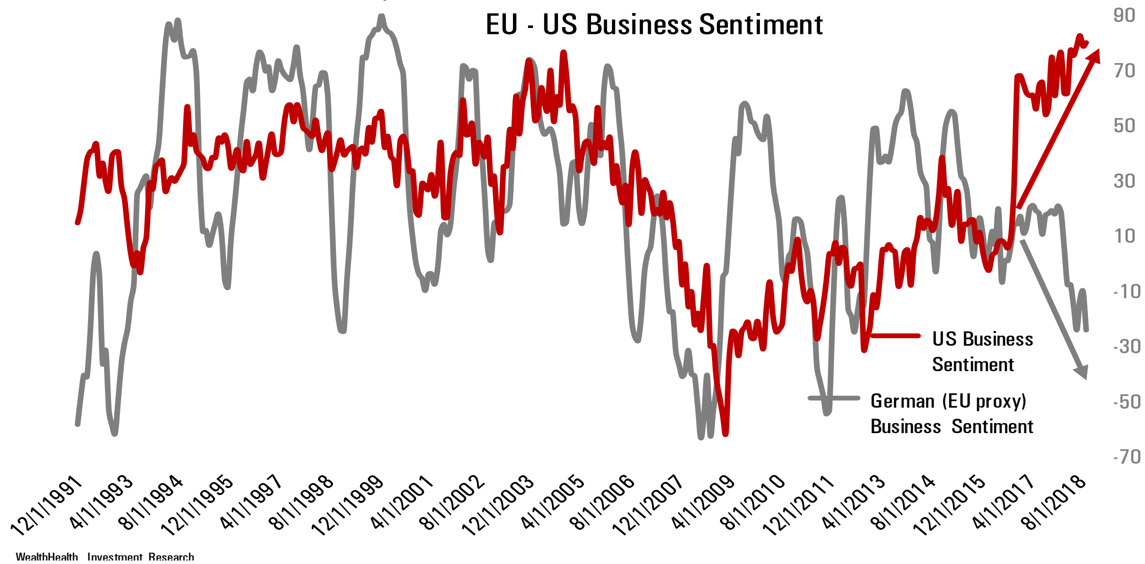
Broad Look

The US economy continues to be one of the strongest economies in the world with signs of acceleration of growth as tax-cuts make their way through the system. The most recent quarter-over-quarter GDP growth numbers place the US ahead of virtually every other nation, including China, Germany and the broader European Union as a whole. As a result, business confidence continues to show record high numbers. Seen below is a comparison of US and EU overall business sentiment. After the passage of the Tax Cuts and Jobs Act, business sentiment in the US rose to record levels, concurrently, EU business sentiment faltered to near all-time lows.



However, it seems that the recent slowdown in the EU may have been overdone as economic 'hard' data seems to be rebounding, pointing to a resurgence from the UK and the EU. Whereas over the last 12 months it was the US leading the way, it may be possible that looking ahead, Europe may re-establish its footing and rebound from what was otherwise a disappointing start to the year. Notice the dramatic decline in economic data, from the EU in gray, pulling down the US and UK with it. However, there seems to more positive economic news from the Euro area over the last few months and this is a trend that we will continue to monitor.

As at 21 September 2018
Source: Bloomberg, Citigroup

While economic data from the Euro area is generally positive, political risks remain. Brexit is an ongoing issue as England is expected to begin its exit from the EU in March 2019. Italy is experiencing budget woes while growing increasingly defiant of the EU. And immigration related tensions with Western Europe (Hungary) continue.

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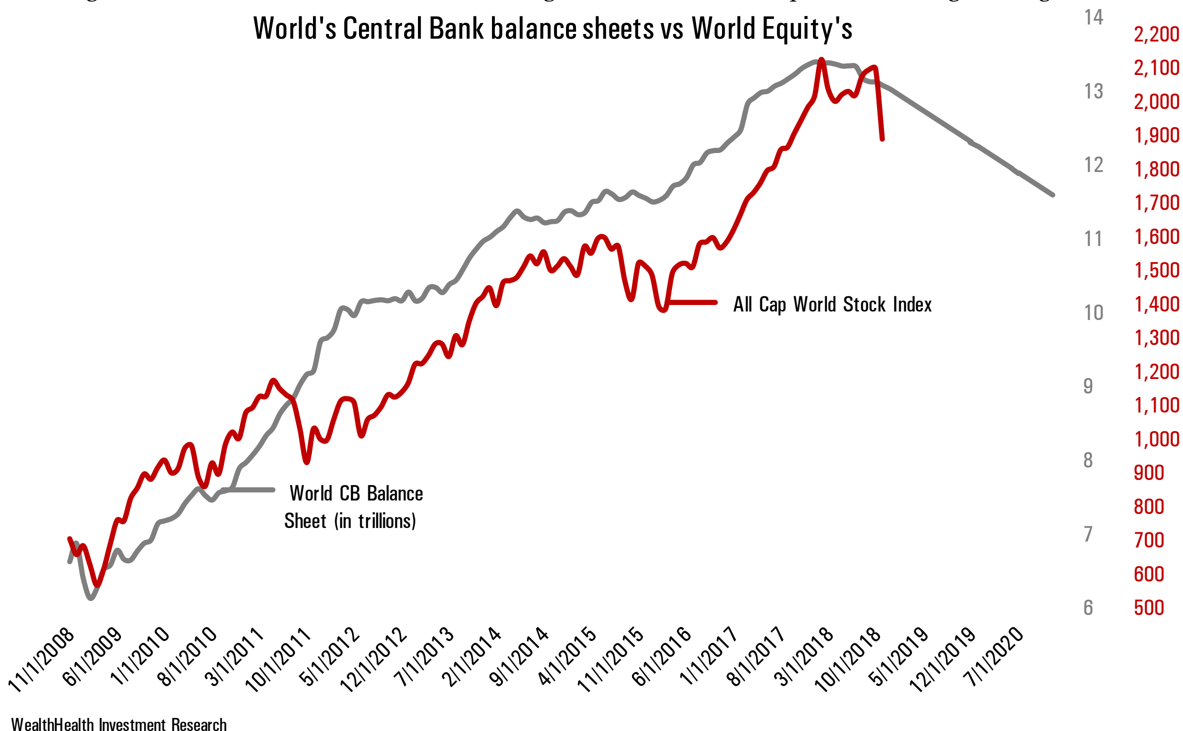
About one and a half years ago in May 2017 we wrote about the expected change in global financial market conditions. To wit, we wrote the following:

"The most important on our list of potential volatility aggravators, is the removal of central bank liquidity—a factor that is known to markets, but with uncertain consequences. Recently, various members of the Federal Reserve have begun to publicly discuss the gradual unwind of the Fed's balance sheet. In addition, the European Central Bank may also begin to reduce its asset purchase program at the turn of the year. Finally, and most surprising of all, there is growing public speculation that the Bank of Japan may reduce its bond buying program."

Coincidentally, 2018 has proven to be a volatile year thus far as accommodative central bank policies have begun to wind down. 'Quantitative easing' has now become 'quantitative tightening'.



Contrary to former Fed Chair Janet Yellen's suggestion that this period of central bank tightening would "run quietly in the background" and be as exciting as "watching paint dry", volatility has instead remained elevated. Year-to-date global capital market losses are approaching $9 trillion with most of the brunt being absorbed by emerging markets, followed by developed international. As it stands right now, emerging market equities are trading below their 2007 highs with international equities trading near their 2007 highs. The US however, is well ahead at more than twice its 2007 high.

To be fair, some of the volatility can be attributed to uncertainty in trade policy, mid-term elections and political dislocations in Europe. But these variable's do little to explain the rapidity and velocity of the most recent re-pricing of US markets. International and emerging markets have been selling off consistently since February, meanwhile US stock markets continued to stubbornly push higher. Instead, the likely explanation for the most recent equity sell-off is the combination of a rapid interest rate jump into an equity market weakened by a reduction of two powerful forces, corporate stock-buybacks and central-bank bond 'buybacks'.

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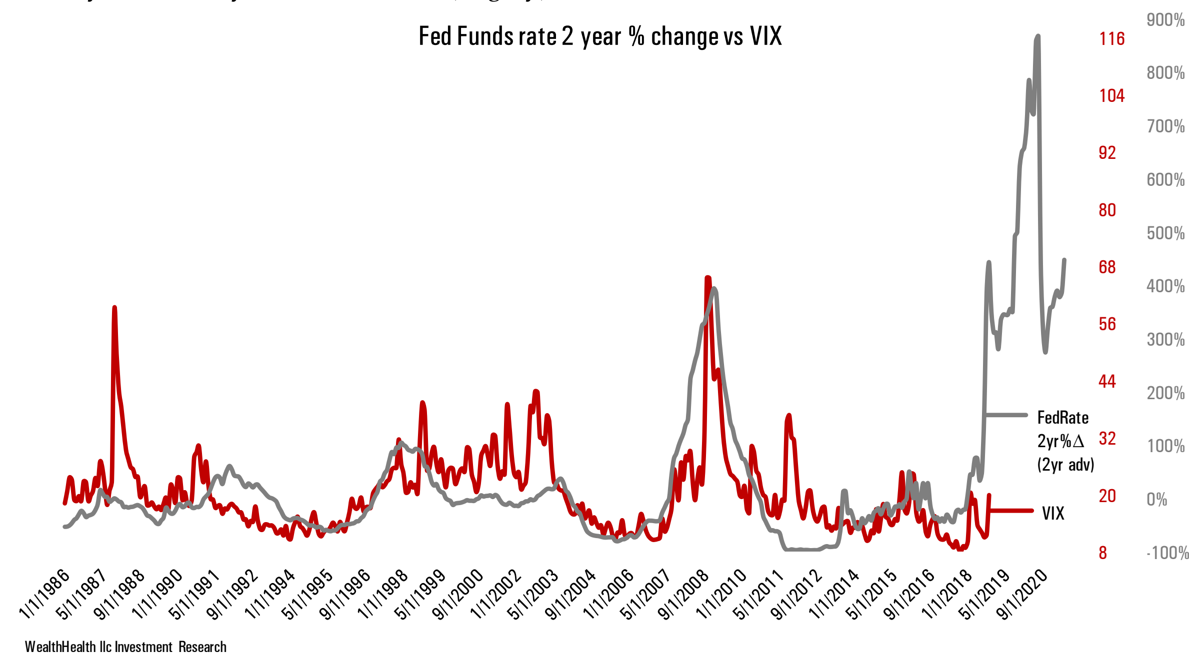
Looking Ahead

As mentioned earlier, our economy continues to do well in both relative and absolute terms. Much of this strength can be attributed to the stable and equitable marketplace the US offers to investors, entrepreneurs and employees. It is very difficult to compete with the spirit of achievement and ingenuity our country fosters. In addition, we enjoy something no other country does, a world reserve currency. Most of world trade is done in US dollars but more importantly, in the event of a market dislocation, investors find safety in US Treasury bonds. Our debt is bar-none considered the safest in the world. For this reason, in the event of a correction, investor don't flock to Europe, Africa or South America for safety, they instead allocate their capital here and next time won't be any different.

However, there are clear and discernable risks that have been permeating for some time. We've mentioned some of them throughout each of our last 6 quarterly newsletters. Our largest concern is the level of corporate, government and personal debt moving into an environment that is becoming increasingly restrictive and less liquid. While higher interest rates reduce liquidity by making capital more expensive (and capital markets less stable), tariff rates reduce liquidity by shrinking the size of commercial exchanges as there are less market participants (buyers and sellers). Though not widely discussed, higher tariffs invariably lead to less liquid markets. It total, three powerful forces are now contracting liquidity, higher rates, higher tariffs and lower central bank balance sheets.

Seen below is a 2-year percentage rate increase of the Fed Funds Rate (the rate banks charge each other to borrow). Using this time-series and advancing it by 2 years we are able to see the effects of rising rates and consequently, less liquid and stable markets. Volatility (in red) follows the path set forth by the velocity of rate increases (in grey).



In Summary

While US economic fundamentals continue to look good for the immediate future and equity markets should stabilize as buybacks return, we are growing increasingly cautious about the longer-term outlook. As liquidity continues to evaporate, we expect volatility to increase and stability to decrease. However, with risk comes reward and with volatility, opportunity.