Don’t fasten your seatbelts too tightly

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UOB Asset Management

- Economic fundamentals remain solid globally although trade restrictions and growing geopolitical tensions could impair financial conditions.
- Contradictory signals suggest equity markets may be more volatile this year compared to 2017.
- We are positive overall on global equities although we maintain a keen focus on risk management.

After the clear skies of 2017, recent market turbulence is important to watch. Now is a time to reflect on what markets may be telling us and how one should consider reacting.

As with other sell-offs, the volatility in February and March likely had a number of causes: escalating trade tensions, the threat of tech-company regulation, weaker macroeconomic indicators, the unwinding of low-volatility positioning, and the Fed's most recent rate hike. Although these were reasonably well understood issues, the tipping point appears to have been these risks materialising against a backdrop of higher asset valuations.

We believe that the most important things to watch now are how trade restrictions and the West's broader relationship with Russia unfold alongside financial conditions. "Financial conditions" is a vague term used to describe whether financial markets feel good or not. The term has different definitions although these generally include market indicators such as the level of interest rates, credit spread indicators, volatility and sentiment. Tighter financial conditions — where rates, spreads and volatility are all higher — are bad for the real economy.

The direct cost of trade restrictions announced so far is fairly low, and we also need to bear in mind that the current announcements from both the US and China represent the beginning of negotiations. It is important to focus on what is actually enacted and whether restrictions escalate into a trade war. Significant trade retaliation and the knock-on effects of disruptions to global supply chains and inflation could cause financial conditions to tighten meaningfully. This would feed into the real economy through lower spending by households and businesses, and could put risk assets on a downward course.

That said, investors shouldn't forget that global economic fundamentals are solid, US tax cuts and lower regulation are supporting investment and hiring, China has the resources to avoid a hard landing and central bank policy is still quite accommodative. If trade threats turn out to be more bluster than reality, markets should normalise. A good sign is that the Trump administration exempted Canada, Brazil, South Korea, Mexico and Germany from tariffs for now. These countries together account for more than 50 per cent of steel imports to the US, according to the International Trade Administration under the U.S. Department of Commerce.

With markets today having to digest contradictory signals, it is easy to surmise that this year will be more volatile than last. But, with fiscal stimulus in the US and less mature cycles in many other parts of the world, we are cautiously constructive on global equities this year. However, with this optimism comes a keen focus on risk management. It is these tools that we will rely on to help protect our clients' investments should negative news begin to outpace the positive.

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