Year of the black swan?
Risks in 2018

UOB Asset Management

In sixteenth-century England, it was commonly understood that all swans were white, and thus that a "black swan" was non-existent — an expression of impossibility. In modern times, the term popularised by Nassim Nicholas Taleb in his 2001 book *Fooled by Randomness* is now used as a metaphor for events which are by their very nature unpredictable, or at least very difficult to predict with any great accuracy.

Recent decades have seen black-swan events such as the Asian financial crisis, the September 11 attacks on New York, the Icelandic banking crisis, and the Fukushima nuclear disaster. Whilst some of these are explainable with some level of authority with perfect hindsight, not many people — if any — predicted these events before they occurred. This is what makes them so hard to hedge.

When we look across global markets today we see many potential risks. Each has a narrative that warrants our attention, but each is challenging to predict with any accuracy. Three key risks we will be watching in 2018 are North Korean tensions, European stability, and a possible pull-back in equity markets.

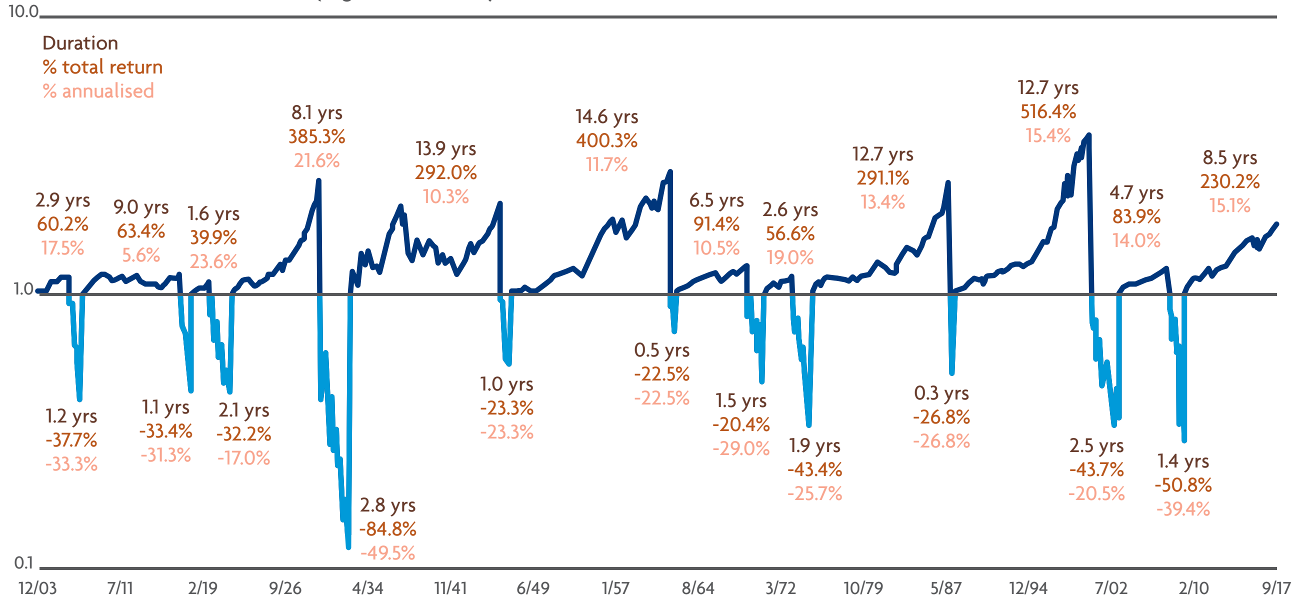
North Korea: Although making up only about 0.3%[1] of the world's population, North Korea garnered well above its share of news headlines in 2017. The country's nuclear-weapons programme remains one of the world's biggest geopolitical challenges; in a worst-case scenario, it has the potential to trigger major conflict on the Korean peninsula and elsewhere across the region. The ramifications of such an event would be devastating.

European stability: Following the UK's vote to leave the European Union in 2016, the market-friendly outcomes of the 2017 German and French elections were welcome. However, far from being able to put European politics in the rearview mirror, the first half of 2018 is going to play host to the much-awaited Italian election. Investors will be hoping for another market-friendly result, but the increasing popularity of anti-establishment parties in that country makes such an outcome far from certain. Indeed, we may soon find ourselves questioning the strength of the Union once again.

Equity pull-back: The equity bull market is now one of the most durable on record. The rally is fast approaching nine years, making it the sixth-longest in history (see Figure 1). Meanwhile, at time of this writing, volatility has been low, with the S&P 500 experiencing its longest streak ever without a 3% intraday drawdown. This has been a great time to be invested in markets, and many hope that this will continue for much longer. However, as investors, we must be cognisant of the chance of a "correction" — a sell-off of 10% or more across equity markets.

[1] Source: The World Bank as at end December 2016.

US Equity bull & bear markets: 1903 to 2017
S&P 500 index total returns (logarithmic scale)



Sources: S&P Dow Jones Indexes, Wellington Management. Data to 30 September 2017

Figure 1

As we move through 2018, we will keep a close eye on these three risks as well as any others we may see developing. In managing a portfolio we will continue to add opportunistic hedges when and where we believe these would benefit the portfolio. In the instance of a black-swan event, we would rely on our disciplined risk management techniques to help minimise losses to the portfolio.

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