Fear Grips Markets

Risk-off sentiment dominant

Risk-off sentiment has dominated financial markets year-to-date, largely driven by concerns over the health of the global economy and effectiveness of central banks’ policies, especially negative interest rates.

Equities have taken a hammering, with the Nikkei falling for the last six days to leave it down by 21.5% so far in 2016. The Euro Stoxx 50 index is down 18%, while US markets are down over 10%. The FTSE All-World stock index is now entering bear territory, having fallen by more than 20% from last year’s peak.

Bank shares have been particularly hard hit, with European banks shares down 30% year-to-date.

Benchmark bond yields have collapsed, with ten year Japanese Government Bond yields turning negative, German bund yields at 0.2%, while UK ten year gilt yields touched record lows of 1.3% with ten year US Treasuries nearing 1.5% at one stage. Benchmark bonds yields are generally down 50-70bps year-to-date.

Yields at these levels are seen by some as a signal for the onslaught of a global recession as is the recent marked flattening of yield curves. Meanwhile, oil prices are down 20-30% this year and are now trading at $25-30 a barrel, although this is due more to over-supply than weak demand.

There has been a major shift in market expectations on interest rates. The BoJ stunned markets by unexpectedly moving to negative interest rates in January, while the ECB also caused a surprise last month in hinting that it was likely to loosen policy further in March.

The big changes in the outlook for rates, though, have been in the US and UK. The Fed projections in December showed four 25bps rate hikes were likely in both 2016 and 2017, while the market view was there would be two rate hikes per year.

Now markets don’t expect any US rate hike until end 2017. In the UK, where a rate hike had been expected at end 2016, the view now is that it could be 2019 before we see a BoE rate increase. Indeed, there has been some talk that US and UK rates could be cut.

The unwinding of rate hike expectations in the US and UK and heightened risk aversion in markets have seen the dollar and sterling weaken, while the traditional safe-haven currencies—the yen, Swiss franc and euro have strengthened. Brexit concerns have added to sterling’s woes. The euro has risen from 70p to 78p since the start of December and from $1.06 to $1.13. The dollar has fallen from ¥121 to ¥112 in the past fortnight.
Fear Rather than Data Driving Markets

The turmoil in markets seems to be driven by market fear rather than economic data or any one particular event – there is no Northern Rock, Lehman or AIG moment. The major economic release year-to-date, the US employment report for January was very solid. PMI data have generally held up in recent months. There has been some softening in data in the US in recent months but the Fed only this week reaffirmed it positive outlook for the US economy, as has the BoE for the UK economy.

There are concerns, though, about the weakening of growth in emerging economies and their high debt levels, with particular worries over China. While commodity prices have fallen further this year, there has not been a marked worsening trend in economic data in emerging economies. There has been no great change in data on the Chinese economy or anything to suggest a deepening downturn in the economy.

Instead, there appears to be a loss of faith in monetary policy as more and more central banks opt for negative interest rates and hint policy can become even more expansionary. Markets worry whether central banks have the power to sustain the recover in activity, even with ultra-low rates and massive liquidity. They also fear that negative interest rates will hit banks profitability and that banks may not be adequately capitalised.

Perversely, a new concern is that the volatility and weakness in financial markets will feed through into the real economy via negative wealth effects and impact confidence and business investment. George Soros calls it “reflexivity” per the FT, as the markets create a downturn whereby sharp falls in asset prices driven by fear lead to a decline in economic activity.

What could help restore calm in financial markets and confidence in the economic outlook? Measures by oil and other commodity producers to scale back production to eliminate the over-supply in their markets as this would boost prices and help emerging economies. Second, government announce they are going to take advantage of very low long-term funding rates to ramp up badly needed capital spending in the next couple of years. Third, a pick-up in wage inflation which has been very subdued in this cycle.

Market’s gaze will be very much focused on macro news

There is a serious situation in financial markets, which are in a virtual state of panic. The falls in riskier assets like equities are substantial. No one seems to be able to put their finger on a particular reason why this is occurring. Sentiment was brittle in financial markets for much of H2 2015 and this has now developed into the most serious downturn for markets since the financial crisis of 2008-09.

Given the current, very poor market sentiment, the best that can be hoped for is that markets stabilise around current levels - i.e. bounce along the bottom for a while, although they are likely to remain volatile. Much focus will be on economic data for H1 2016 to see if market fears of a recession in advanced economies are justified. This could set the long-term direction for markets. As Janet Yellen pointed out this week in her testimony to Congress, while the financial turbulence is a negative for economic growth, the sharp fall in long-term interest rates and commodity prices is an offsetting factor that should help boost activity. We are not convinced that a recession is at hand, but for nervous markets the proof of the pudding may well have to be in the eating.