Opinion **Markets Insight**

Markets need a happy outcome on five key issues

Achieving the right balance needs progress

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Having experienced a sudden air pocket, US stocks have entered a period of higher and, for some, unsettling volatility.

The particular sequence of the last month — abrupt correction followed by a rapid bounce back and then last week's pull back — raises interesting questions as to whether markets are in the initial phase of a prolonged sell-off or, instead, being placed on a stronger medium-term footing. The answer to that question will be determined by five factors.

After returning 22 per cent in 2017, the ninth year of an impressive rally, and an additional 7 per cent in just the first four trading weeks of 2018, the S&P 500 suffered a correction of 10 per cent. It then retraced some 70 per cent before experiencing another leg down.

Too quick a round trip after a price correction raises concern about investor complacency. Yet continued disruption opens the door for a disorderly closing of the gap between still-elevated asset prices and less buoyant but improving economic fundamentals. Achieving the right balance needs progress on the following.

Stronger economic growth

Supported by pro-growth policies in the US and a natural economic healing process in Europe, the global economy is in the midst of a synchronised pick-up in growth. Consumption and business investment, rather than financial engineering, have become the major drivers of this improvement. With the potential for wider adoption of structural reforms and more balanced demand management in the advanced countries, growth can gain additional momentum if the world avoids a costly stagflationary trade war.

The brighter the prospects, the stronger the transition by markets away from excessive reliance on liquidity from both central banks (via large-scale asset purchase plans) and companies (via buybacks, dividends and acquisitions). After all, the best that liquidity can do is to provide for an enjoyable journey for investors. It does not secure a sound destination. For that, strong economic fundamentals are essential.

Orderly normalisation of unconventional monetary policy

Once viewed as tricky path to navigate, the Federal Reserve is progressing on a "beautiful normalisation" that has seen it stop large-scale asset purchases, raise interest rates five times, guide investors to expect three to four further hikes in 2018 and start a measured reduction in its balance sheet. In Europe, the European Central Bank is getting closer to terminating its asset purchase plan, something the Bank of Japan would also likely consider.

Importantly, all this is happening without derailing economic growth. As such, there is greater confidence in the ability of an individual central bank to normalise policies in an orderly fashion. What remains to be seen, however, is what happens if the policy transition becomes more simultaneous — that is, several systemically-important central banks moving away from unconventional monetary measures at the same time.

More realistic yield curve

Given recent developments, it is not surprising that markets have repriced government yields higher, with implications for other asset classes. This has happened in a relatively orderly way for fixed income markets, which is encouraging. The incentive for excessive risk taking is being reduced, especially when it comes to leverage and credit. Meanwhile, the notably flat curve is still more reflective of liability-driven investment flows and bond issuance patterns, as opposed to prospects of a significant economic slowdown.

Greater respect for financial volatility and for liquidity

The impressive rebound in stocks has not, at least for now, been accompanied by a return of unusually low implied volatility. After registering six of its seven lowest levels in 2017, including unusually prolonged periods of sub-10, before spiking dramatically, the Cboe's Vix index has largely fluctuated in a more realistic and sustainable range Meanwhile, the implosion of some exotic products and the redesign of others, together with regulatory interest on the part of the Securities and Exchange Commission and CFTC provide a reminder to investors of the importance of liquidity.

Overcoming investor complacency

Investors seem less confident in selling volatility in its many forms. This comes after a period of intense "buy-the-dip" market conditioning associated with almost unquestioned faith that central banks would always rush to repress any instability. But, unlike previous periods, this time central bankers did not immediately provide markets with comforting signals. If anything, they brushed aside the possibility of negative spillovers for the economy and their policy objectives.

Further progress on all five of these issues would put markets on a firmer footing and lower the risk of a much more dramatic and durable market sell-off. Importantly, it would be part of a liquidity-to-fundamentals transition that has been long in the making and long needed.

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