Stock market falls no big surprise

Many commentators had been warning recently that stock markets looked to be heading for much more turbulent times given stretched valuations, a prolonged period of uninterrupted gains, very low volatility and signs of a return of 'irrational exuberance' in certain instances. This was all occurring in the context of central banks starting to wind back extremely accommodative monetary policies, putting upward pressure on bond yields.

It is worth noting that the adverse scenario for the 2018 EU-wide banking sector stress tests is not based around economic factors or the fall-out from Brexit, but rather "an abrupt and sizeable re-pricing of risk premia in global financial markets" that results in a large fall in asset prices. Meanwhile, although both the IMF and OECD recently upgraded their growth forecasts for the world economy, they also warned that elevated valuations in the major global equity and bond markets left them vulnerable to a sizeable correction.

In the end, it was a pick-up in wage growth in the US that triggered sharp falls in stock prices this month and the return of volatility in markets. The ironic thing is that this pick-up in earnings growth may prove a statistical quirk that could unwind in next couple of months. But even if it was not wage data, we believe that something else would have unnerved stock markets as they were ripe for a sharp correction.

What we are seeing is a return to more normal trading conditions in markets, involving volatility and risk taking across all asset classes, as central banks struggle with how to normalise monetary policy in the context of continuing low inflation and without undermining the strengthening recovery of the global economy.

Bond yields look to be on an upward trajectory, which is a challenge for equity markets with stretched valuations, most notably in the US. But higher yields are being driven by favourable economic developments, not concerns about asset quality and credit risk, which is a long-term positive for financial markets.

Hence, we do not see major spill-over effects into the real economy from the setback in financial markets. Interest rates may be rising, but only modestly and off a very low base. Monetary policy is set to remain accommodative, supporting growth. Fiscal policy is also turning to be more supportive of growth. Improving labour markets, a pick-up in global trade and expanding credit also point to favourable conditions for the world economy.

Neither, do we see this as the start of a major market crash. As long as global inflation stays subdued, central banks can be patient about withdrawing monetary accommodation and thus raise rates at a very slow pace. This should help avoid a major upheaval in markets.

Granted, US and Japanese stock markets are in correction territory, having fallen by more than 10%. However, this has only returned them to their levels of last November. Both the Dow Jones and Nikkei indices are still up 32% since President Trump's election win in November 2016, while the S&P 500 is 23% higher.

Overall though, it would appear that the easy ride for investors is now over, with much trickier trading conditions in store. Bond yields are likely to rise somewhat further and tight credit spreads should widen. Stocks markets, especially in the US could see further losses and will likely need continued good corporate earnings reports to start moving higher again.

Thus, we can expect continuing fluctuations in markets as they are buffeted by both positive and negative forces. Volatility is back in a return to more normal market trading conditions.

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