Global Asset Management

Insights on the Downturn

After an extended period of calm, the last couple of weeks have seen volatility increase and equity markets decline close to 10%. Many investors are now concerned that these ups-and-downs could be the start of a prolonged period of weakness or perhaps indicative of the next economic recession. This summary recaps what has been driving recent volatility and whether it marks a change in the outlook for the economy and markets.

What caused the market reaction?

On February 2nd, strong wage growth data out of the U.S. led to concerns that higher inflation may lead to faster rate hikes, particularly as investors questioned whether the new Fed Chair – Jerome Powell – would be as soft on inflation as former Chair Janet Yellen.

In the days that followed, higher volatility triggered additional selling in specialized investment products and hedge funds that were required to maintain target levels of risk. The faster volatility rises, the quicker these investments need to sell equities, basically creating a circle of selling activity that persists until these vehicles have sufficiently exited the market. To a large extent, the depth of the drawdowns in recent days have been a result of these indiscriminate selling programs.

At this point, the recent correction appears isolated to equities and does not seem linked to a broader problem in the economy. Though the indicators we monitor have been improving at a slower rate, economic growth around the world remains very healthy and new data releases continue to surprise to the upside, albeit at a moderating pace.

Looking ahead we continue to have a favourable outlook for growth as momentum remains strong, financial conditions are still friendly, increases to interest rates appear manageable and the impact of rising oil prices has diminished. While inflation indicators have picked up recently, our expectation is for inflation to move towards 2.0-2.5% and not much beyond that given changing demographics, globalization and technological advancements, all of which help keep inflation in check.

Broadly speaking the market correction has been isolated to the stock market. At this time there are no visible signs that this is spilling over into the broader economy. We remain watchful for any indications that this has changed.

The interplay of fixed income and equity markets

Significant equity market moves are often preceded by signals in the bond market. Key among these are a flattening yield curve, where the difference between short term and long term interest rates starts to narrow, and widening credit spreads, which indicate a growing concern about the ability of corporations to pay interest on their debt.

Up to now, neither of these indicators has accompanied the recent sell-off in equities. We've actually witnessed the yield curve steepen this year, and while credit spreads have widened modestly, they remain tight and we haven't seen a decline in credit quality or interest coverage ratios. We are continuing to monitor these signals carefully but for now their stability is further evidence that the market sell-off has been contained to the equity market and driven more by technical factors rather than major fundamental flaws in the economy or capital markets.

The bottom line

Unfortunately for investors, the headlines throughout this recent correction have been anything but reassuring. While it's impossible to predict the future with any certainty, our team of portfolio managers and analysts are continually monitoring the economy and markets for any deterioration in fundamentals. Thankfully, these signals are currently benign. While we remain vigilant and expect that volatility could continue to present itself, the opportunity that this sell-off has presented us with at this time is much improved relative to recent history, though not as attractive as it has been during other points of the cycle.

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