IE

Global Investment Event

19 May 2017

Global market volatility rises amid US political concerns

- US political concerns have dented risk appetite, with global equity markets declining sharply and market volatility spiking higher. Developed market government bonds, gold and the Japanese yen have rallied on increased safe-haven demand
- Financial market participants appear concerned that the Trump administration's plans for tax cuts, infrastructure spending and deregulation could be delayed, or even fail to materialise at all. This has come amid a mild softening in recent US and Chinese economic indicators
- The latest US political developments are likely to reduce a key upside risk for US, and global, growth. However, it also dims the prospect of a more aggressive tightening of Fed monetary policy. The global economy also remains on a stable footing, with economic activity running at a healthy pace
- Despite the recent market wobble concerning US politics, Asian equities still offer attractive prospective returns, in our view. The benign global macro and policy environment is supportive for taking Asian equity risk. Currency appreciation over the longer-term may provide an additional tailwind

What's happened this week?

Global risk aversion has spiked higher this week, with global equities selling off sharply and perceived safe-haven assets such as developed market government bonds, gold and the yen rallying. The US dollar index (DXY) has declined to levels last seen in early November. Meanwhile, US stock market volatility, as implied by the much watched VIX "fear gauge", has risen sharply, after having hovered around multi-decade lows.

The predominant trigger has been mounting political concerns centred on the US Trump administration. More specifically, there have been claims that the US president interfered in an FBI investigation into the former national security adviser and that he had revealed sensitive information to Russian officials. This has raised speculation over the future of Trump's position as US President, and importantly for investors, further dimmed the prospect of his administration implementing pro-growth economic, regulatory and fiscal policies. These have been key components driving the so called global "reflation trade" since his election victory on 8 November 2016 (higher equity prices and government bond yields).

These concerns have arisen amid evidence of slightly weaker economic momentum in the US and China. Data released last Friday showed US Core CPI inflation (ex food and energy) dropping to 1.9% yoy in April, an 18-month low. Meanwhile, China's April activity data showed weaker external demand and domestic investment as well as softer growth momentum in the manufacturing sector after a strong March.

What it means for the US and Asia?

The latest allegations facing Trump's administration may result in delays in implementing the President's mooted pro-growth policies, including planned tax cuts, infrastructure spending and deregulation. This reduces a key upside risk to US and global growth prospects. However, it also reduces the risk of a faster pace of monetary tightening from the US Federal Reserve. This would potentially support Asian assets given the risk of investor outflows as US interest rates rise.

What's the state of Asian economy?

The state of the Asian economy remains healthy, supported by the upswing in the global economic cycle. This is reflected in an uptick in global manufacturing and trade, and the spillover to the domestic economy. A rebound in commodity prices from January 2016 lows has also provided support, in addition to still accommodative global monetary conditions. Fiscal policy, especially infrastructure push, also helps domestic growth. More recently, however, the pace of Asian economic activity has softened somewhat, primarily due to a modest slowdown in Chinese growth momentum. This is likely the result of Chinese policymakers adopting a tighter monetary and regulatory stance in order to rein in leverage in the financial system and mitigate financial stability risks. We believe the Chinese authorities are likely to proceed with policy/regulatory tightening carefully to avoid a sharp economic slowdown or financial system instability, but it is still worth monitoring this development closely.

Asian equities offer good value

Over the past year, risk premia have compressed substantially across asset classes. As a consequence, we are being less rewarded for taking risk today. However, in our view, Asian equities are one of the few markets that are still offering attractive prospective returns.

Based on our structured and robust valuation framework, we currently measure a market-implied equity risk premium of around 4% for Asian stocks in US dollar hedged terms. This is particularly attractive relative to competing asset markets. The benign macro and policy environment is also supportive for taking Asian equity risk, despite the latest wobble in the US. We also believe Asian currencies are poised for appreciation over the longer-term versus the US dollar. If we are right, then the prospective return would be even higher for an unhedged US dollar investor.

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