MAERKI BAUMANN & CO. AG

PRIVATBANK

Less liquidity = more volatility

Market Comment, January 2019

In the first half of December we warned of an imminent rise in market volatility. Volatility can increase for different reasons. On the one hand there are structural reasons: less liquidity in the markets, less monetary liquidity, geopolitical risks. On the other there are also cyclical factors like the economic slowdown. Investors who like less volatility should not dismiss equities altogether as valuations have now fallen. Instead they can adopt a more defensive approach through the greater use of equities that are less market-sensitive or by giving a greater weighting to so-called safe havens like US government bonds and gold.

The weeks around the year-end showed us something that we may have to get increasingly accustomed to over the next few months: fluctuations of several percentage points in equity markets, first in one direction, and then in the other. What lies behind this increase in market fluctuations? We see four causes. First, the market share of private investors declined after the two equity market slumps of 2001/02 and 2008/09. There has also been a sharp decline in the market volume share of global banks since the entry into force of the "Volcker rules", which have largely prohibited proprietary trading. Due to the rise of algorithmic computer programmes, which are used not just by hedge funds but also by many institutional investors, it is not humans but machines that now dominate market volumes. Particularly at times of low market liquidity, as the Christmas holiday period, a few orders can therefore bring about daily movements of 3–5% in equity markets. Algorithmic computer programmes react to specific signals – e.g. overly restrictive words on the part of the US central bank, by automatically executing large sell orders. These "trader robots" are becoming increasingly dangerous precisely because their modus operandi is conducive to higher volatility.

Second, the increase in volatility is also attributable to a decline in monetary liquidity. Central banks all over the world mastered the 2008 financial crisis only through massive purchases of bonds and equities, in addition to interest rate cuts. Financial markets have become so accustomed to this "monetary medicine" as a support that equity markets in particular are reacting to its withdrawal by central banks with declines in stock market valuations and a rise in volatility. The Fed is now reducing its balance sheet by some USD 50 billion a month and progressively raising interest rates. The European Central Bank also confirmed that it would undertake no further bond purchases from December onward. This has contributed to the decline in monetary liquidity in the financial markets, which ultimately means higher financing costs and therefore lower earnings growth for companies.

> "Investors seeking lower volatility focus on equities with lower market sensitivity or on US government bonds and gold."
>
> Gérard Piasko, Chief Investment Officer

Third, the rise in the volatility of not just equity markets, but also other cyclically sensitive investments such as commodities and cyclically sensitive bonds is being driven by increasing uncertainty over the strength of the global economy. There have been clear indications over the last few weeks that economic growth in 2019 will be weaker than in 2018. In the worlds major economies, namely the US, China and Europe, key leading indicators have not just disappointed the (already low) expectations of analysts and economists, but have also slumped in a short space of time, which is a phenomenon not witnessed for many years. Although the new automotive emissions test can be cited as a special cause of the decline in German industrial production, the accumulation of batches of increasingly negative data across various continents in a short space of time is very striking.

Fourth, the rise in volatility is also being fuelled by profit warnings by various leading companies, most notably the tech giants such as Apple and Samsung. The record profit margins we have seen in recent years, particularly in the world's most important stock market (the US), could now be a thing of the past, given the recent evidence of saturation in the smartphone market, falling global sales of semiconductors, and above all a decline in the growth of global trade. One development that could improve depressed business sentiment in many countries and reinvigorate the equity markets of Europe in particular is a permanent – rather than just temporary – end to the trade conflict between the US and China. This is because this trade conflict, which has now dragged on for many months without a resolution, is increasingly weighing not just on equity markets, but also on the level of investment activity in the global economy. Europe is facing an additional uncertainty factor in the form of the ongoing Brexit saga. Were the UK to exit the EU in an unregulated way, i.e. without a formal agreement, the impact for corporate earnings could be important, above all for export-oriented equity markets and companies.

The situation we currently find ourselves in is one we have described on a number of occasions in the past: The longer the various global political uncertainties persist, the greater the economic risks, and the higher the risk premium (i.e. the valuation discount) demanded by the equity and higher-risk corporate bond markets.

So what would help to put higher-risk asset classes and equities in particular back on an enduring upward trajectory? First and foremost, for the Fed to accept (and not just temporarily) that even higher interest rates would increase the risk of recession – and respond to this realization by providing the markets with greater monetary liquidity.

Second, US President Trump should understand that any further escalation of the trade conflict would have a negative impact on the US economy too – as various indicators are already suggesting.

Third, China's President Xi Jinping needs to not just reduce tariffs and allow the US and other Western nations fairer market access to China, but also respect the intellectual property rights of Western companies and cease insisting on the transfer of technology to China.

Fourth, China should deliver greater stimulus to its economy. Fifth, the EU should adopt a more compromising stance vis-à-vis the United Kingdom and thereby steer Europe away from the unwelcome outcome of an unregulated ("hard") Brexit. And last but not least, the governments of Eurozone member states must somehow get their economies back onto a stronger growth trajectory.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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