Standard Life

March market review 2018

An outlook on worldwide markets

For financial advisers only

In his latest monthly market commentary Andrew Milligan Head of Global Strategy at Standard Life Investments considers how interest rate increases in the US and UK might affect markets and what's next for market volatility. He also looks at Trump's trade threats - not yet trade wars - how markets are performing 10 years on from the financial crisis and what challenges the rest of 2018 could have in store for investors.

Interest rate hikes are on the horizon - what does this mean for markets?

Financial markets react to new news, so to answer such a question we first need to ask ourselves: what are the drivers, what's changing and especially what's already priced into the market place?

In the UK, the money markets are close to pricing in an interest rate increase in May, with the potential for a further increase in November if the economy continues to grow steadily. Across the Atlantic, the Federal Reserve raised interest rates at its March meeting and investors already expect a steady series of increases, probably every quarter this year. However, these further rate moves assume that inflation remains contained. While wages may be rising, it's worth noting that a lot of technological aspects of the modern world – say online shopping restraining high street prices - are still restraining inflation. All in all, it would need an inflation shock to cause central banks to be more aggressive than the market has already priced in.

The financial crisis – a decade on

A decade on from the collapse of Bear Stearns and the ensuing financial crisis, the backdrop to the financial sector appears quite upbeat – that's assuming politicians don't interfere too much.

From an economic standpoint, the improvement in business activity and the fact that companies want to spend more capital should be a favourable setting for more bank lending. On top of that, an environment of rising interest rates and bond yields usually supports financial sector profits, as banks lend more money.

But there are a couple of issues which could cause problems. The first is concerns around a trade war, which if it appears could slow the economic recovery, and the second is regulation. While US policymakers look to be rolling back banking regulation, encouraged by President Trump, the pendulum is swinging much more towards tighter regulation in the EU: MIFID is a prime example.

On balance, at Aberdeen Standard Investments, our funds selectively like financial sector firms. However, we're well aware of some of the financial risks still out there. These include high levels of debt in some parts of the world economy, such as some US companies, some emerging market economies such as China, and housing sectors in countries like Canada and Australia. We remain focused!

Market volatility – a return to normality

Markets have continued to experience volatility over the last month despite some positive economic data.

At times like this I'm often asked if I expect this volatility to continue and what it means for investors.

I find it's helpful to compare the levels of market and the period before. We really must emphasise that 2017 was the unusual year – a simple example shows that the US stock market index experienced 15 successive positive months, with no decline. We've not seen an outcome like that since the early 1950s.

Looking at how markets have behaved since February 2018, we think we're seeing a return to more normal levels of volatility. Importantly though we don't expect volatility to return to abnormal levels, for example those seen during the financial or Eurozone crises. That would require major changes to some of the deep, underlying drivers of markets – we still benefit from steady rates of growth and inflation, while changes in central bank policy-making and market regulation are generally cautious.

Trade war and Trump's tariffs

As I touched upon earlier, Trump's proposed tariffs, both on many Chinese goods, and steel and aluminium imports more globally, have sparked headlines. But it's important to remember that there's a world of difference between the economic impact of the tariffs proposed by the US and China, and the impact on financial markets as a whole.

The sums of money involved are actually quite small and the sectors quite specific; for example only about 2% of US steel imports are from China and US exports equate to less than 2% of China's steel exports.

However, rightly or wrongly the markets are looking further ahead. They fear that these skirmishes are the early stages of a major tussle between China and the US, as well as between the US and a range of other countries. More worryingly, these skirmishes could grow to include more sectors, such as cars, aircraft and food stuffs.

When equity markets are relatively expensive and priced for a period of above-trend growth, so a sharp about-turn caused by political upsets would spark a difficult time for investors.

What challenges lie ahead?

Investing is rarely easy for long. Stability ultimately sows the seeds of instability – although the timing is always hard to predict.

The first of the main challenges that lie ahead is political – where do tariff discussions go, how much regulation will the tech sector experience? The second is economic, namely inflation. Moderate changes in headline inflation have been priced in, so central banks are still cautious when tightening policy.

As far as portfolio construction is concerned, it's key to consider how to manage risk in the context of higher day-to-day, week-to-week volatility, and how to find effective diversifiers in an environment where even the highest quality government bond markets may not provide much protection.

For an in-depth look at what's happening in global markets, read the Aberdeen Standard Investments Global Outlook April 2018

The information in this blog should not be regarded as financial advice. Please remember that the value of your investment can go down as well as up and may be worth less than you paid in.

Information is based on our understanding in April 2018.

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