



The risk of complacency calls for more circumspection

This summer has been a rather uneventful one for financial markets. The S&P 500 traded within a tight range in August and remains at an all-time high. UK equity markets have also shrugged off worries about Brexit, with the FTSE 100 rising through July and consolidating those gains in August. Meanwhile, the FTSE 250, which includes smaller and medium-sized companies, has also seen a meaningful recovery. Since the Brexit-related spike in June, volatility has subsided across global indices. The most well-known of these 'fear indices', the CBOE Volatility Index (VIX Index), which measures expected volatility levels of the S&P 500, has fallen significantly and is now below its historic average.

Markets are being driven less by fundamentals and more by liquidity, hopes of continued central bank policy measures and, recently, perceptions of a potential boost from significant government spending. Many investors are comfortable in the belief that, as long as global central bank support remains forthcoming, this 'goldilocks' state can continue. Hedge funds, in particular, have been fervent sellers of S&P 500 volatility via option contracts. They consider that monetary stimulus and improved forward guidance from policymakers, which provides financial markets with predictability, are likely to suppress volatility for some time. The income generated from selling option volatility is an attractive source of income for many investors, particularly when government bond yields are so low.

Upcoming events highlight ongoing uncertainties

There is a danger, though, that investors are relying too heavily on global central bank support and perceptions of potential government stimulus. Global central bank credibility will continue to be tested and questions persist around the efficacy of current policies; note how Westminster parliamentarians have recently questioned the Bank of England on whether it has acted too early. The Federal Reserve remains caught between an economy reaching full employment and a corporate sector that is still reluctant to invest for future growth. This creates challenges for Fed policymakers as they attempt to raise interest rates from near zero levels. Furthermore, attempts by the Bank of Japan to weaken the yen have so far proven counter-productive, leading to greater calls for fiscal intervention.

Central bank policy manoeuvring remains a key driver of market behaviour and, no doubt, there will be a lot of focus on the upcoming policy meetings this month. Over the next few weeks, we also have the first of the US presidential debates and, in November, an Italian referendum on constitutional reform, which may potentially provide another forum for anti-establishment dissatisfaction. While these events could pass unremarkably, investors need to be alert to underlying risks, which may have faded over the summer but have not been eradicated.

In particular, US equity valuations across a range of multiples remain at historic highs, though corporate earnings have yet to catch up. US companies are adjusting to the strength of the US dollar but tighter employment conditions could lead to higher wage demands, adding further pressure to profit margins. Moreover, while we have had some reprieve from the Brexit headlines over summer, the clock will start ticking on how the UK government will deliver. Needless to say, there remains opaqueness around the UK's relationship with the Single Market and how it will forge a compromise on freedom of movement principles.



Contact

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Bolstering portfolio defences in becalmed markets

Being risk-aware should not be mistaken for being overly pessimistic about the future. However, as equity markets remain in a becalmed state, investors should consider opportunities to bolster portfolio defences. As volatility falls, the cost of insuring a portfolio against a market downturn gets cheaper. We believe it is prudent to protect some of those gains made in equity markets over the summer, strengthening our portfolios in the event of any potential shock.

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