2018:

The Most Volatile Year Since 2008

2018 was a volatile year for the financial markets as the ongoing trade war between the US and China, concerns over slowing global growth, rising US interest rates, and US dollar strength rattled investor confidence. After two years of record-low readings on the Cboe Volatility Index (VIX), the S&P 500 dropped 10 percent into correction territory, and the 10-year US treasury yield increased from 2.5 percent to 2.85 percent in the first half of February 2018. The violent sell-off was largely triggered by January jobs report that showed the fastest year-over-year growth in average hourly earnings since 2008. January's 2.9 percent year-over-year wage growth led to a great deal of speculation that the FED would have to more aggressively raise rates to keep inflation under control while also putting downward pressure on asset prices and simultaneously strengthening the US dollar. What also increased the selling pressure were the high-risk, leveraged products and derivatives that traders utilized to bet against volatility and the complications that arose as a result of unwinding these crowded trades.

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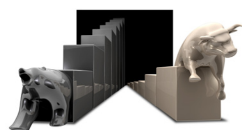
Additionally, January jobs report also encouraged the FED to be more hawkish, relying on robust economic data that indicated the US economy was firing on all cylinders. The Governing Council of the ECB, on the other hand, announced on January 25th that they expected the key ECB interest rates to remain at their present levels for an extended period of time, while the monthly net purchases of EUR 30bn - under the asset purchase programme (APP)- to continue through the end of September 2018. ECB's accommodative stance continued in the first half of 2018, amidst disappointing economic data coming from the Eurozone. And, by March and April, inflation had dipped lower, during which other economic indicators also pointed to slower growth ahead. A hawkish FED and a dovish ECB, which had caused the Euro to depreciate against the US dollar in the first half of 2018, brought down the pair from highs near 1.24 in April to 1.16 in June and closed the year at levels of 1.15.

Similarly, Dollar strength also pressured emerging-market currencies throughout the course of 2018. The MSCI International Emerging Market Currency index declined from 1,720 levels at the end of March to near 1,580 by September, although the index recovered some of its losses in the fourth quarter. Among the worst hit were the Argentinian Peso and Turkish Lira. In fact, the Central banks of Argentina and Turkey were in the spotlight during the summer of 2018, since their ability to effectively use monetary policy would ultimately determine how well these countries would navigate the currency crisis. Both Argentina and Turkey have high dollar-denominated debt, and as the inflation rates in these countries spiked and their currencies depreciated, investors pulled their capital out leaving Argentina and Turkey in a vulnerable position to finance their foreign currency denominated debt.

In September, the Central bank of Turkey tightened monetary policy by raising its benchmark interest rate to 24 percent, a hike of 625 basis points from the previous rate of 17.75 percent. This move was initiated in order to support price stability and to create an interest rate differential that would offset both the inflation rate and the depreciation of the currency. In addition, Turkey released the jailed US pastor in October, a development that helped ease tensions with the US. As a result, the Turkish Lira stabilized in the fourth quarter amidst the challenging economic and political environment. In August, on the other side of the Atlantic, the Central bank of Argentina raised its benchmark interest rate in August to 60 percent from 45 percent, all in an effort to halt the 45 percent decline in peso against the greenback and to control inflation increase that was running at more than 31 percent. By September, Argentina had managed to get a USD 57bn loan from the IMF (the biggest loan in the history of IMF), in a bid to shore up the country's ailing finances.

The sell-off in emerging markets, led by Argentina and Turkey, spilled into commodities in the second half of 2018. Ongoing worries about China's slowdown dragged industrial metals prices lower, and by December, the Bloomberg Industrial Metals Index fell 20 percent from a peak in April. As the US tariffs continued to bite into China's economy, the Central Bank of China injected USD 110bn into the banking system and cut reserve requirement ratios to encourage lending and spur growth in the world's second biggest economy.



At the same time, China's cooling property market weighed on construction and the contraction in the manufacturing sector suggested the economy was decelerating, further exacerbating global growth worries. In the fourth quarter, China reported some of its slowest growth in years, both in retail sales and industrial output. In response, oil prices fell sharply, stoking concerns about global growth and fuel demand since China is the world's largest oil importer.

Coupled with oil demand worries, global oil production continued to exceed consumption spurring Brent and WTI price volatility in November. The burgeoning global oil supply amid a bleak global economic outlook dragged oil prices down 30 percent in the fourth quarter, after increasing nearly 20 percent in the first three quarters. OPEC took steps to stabilize the oil market by agreeing on production cuts in December, but surging US supply partly offset the impact of OPEC's actions. The fourth quarter rout in oil markets exerted pressure on the companies operating in energy and industrial sectors that comprise approximately 16 percent of the S&P 500. In the second half of 2018, the financial world searched for a bigger meaning behind the shocking plunge in oil prices, and fears of recession plagued US and global stocks.

Despite a nearly 9 percent surge in S&P 500 in the first half of 2018, the lack of breadth in the US equity markets showed signs of trouble ahead. According to Larry Fink - the CEO of Blackrock - Amazon, Netflix, Microsoft and Apple were responsible for 83 percent of the S&P 500's gain from January till June. Outperformance of this handful of stocks gave away their gains in the fourth quarter after they reported their third quarter earnings- results that had fallen below market expectations. Equity markets started to roll over as earnings continued to disappoint, trade frictions escalated to new levels, and the fixation on rising US interest rates dampened risk appetite across the world.

Some economists and investors, however, continued to argue that the rise in rates would be more positive than negative and recession fears were misplaced given the strength of the US economy: the S&P 500 forward earnings multiple average was 15 times in the last 50 years, 10-year US government bond was around 6.5 percent, and the 90-day bill was 5 percent. As of September 2018, the multiple was about 16.5 times (10 percent above the historical norm), 10-year US government bonds were around 2.9 percent, and the bills were a little over 2 percent. Real interest rates (10-year US government bond yield adjusted for CPI), on the other hand, continued to hover around 0 percent levels in the fourth quarter, low enough to absorb further increases in rates. Regardless of such data indicating that the market was in the zone of fair valuation and conditions for a significant market decline were not present, fears that the FED is going too far in raising rates and a cooling global economy prompted investors to pull their money out from risky assets and triggered the December rout in equity markets.

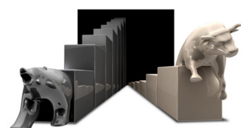
One of the beneficiaries of dampening risk appetite in the fourth quarter was gold. Although gold performed poorly in the first three quarters of 2018, it jumped about 8 percent from September to December. Several catalysts led to an increase in gold prices: safe-haven demand, equity market wobble, flattening yield curve, political dysfunction in Washington, Brexit uncertainty, and stabilization of the US Dollar Index Futures that had been supporting gold as 2018 came to a close.

Looking ahead, volatility is likely here to stay and investors should be careful in searching for yield in tumultuous waters. Indeed, there is already growing chatter about an impending recession, reflected by slowing global growth, decelerating earnings growth, and rising inflation and interest rates. It is fair to say that the US economy is witnessing a slowdown in housing and retail sales while the country is running large fiscal deficits. Meanwhile, the FED is continuing on its path to normalizing interest rates and continuing to favor its gradual approach to raising rates.

This strategy can be perceived as appropriate as the US economy has since recovered from the 2008 financial crisis; nonetheless, the FED is on path to reduce its balance sheet, which currently stands over USD 4 trillion. Unfortunately, the results will reduce global liquidity and negatively impact asset prices. Adding on to the volatility, US corporate indebtedness has continued to balloon in recent years, with companies now carrying a debt load of USD 9.1 trillion, compared to just USD 4.9 trillion in 2007. This debt, coupled with rising rates, will result in an increase in the cost of borrowing for corporations, having the potential to prolong the downturn. And, when the downturn comes, since monetary policy arsenal have largely been exhausted, the recovery path could be longer and more painful.

Meanwhile, Europe is also experiencing slower growth, and political fragmentation is rising. To add on to slower growth, uncertainty builds as Europe prepares for a no-deal Brexit. Simultaneously, China is also slowing down in the face of US sanctions and trying to deal with its overcapacity and excessive leverage. Likewise, emerging markets are continuing to feel the impact of trade war escalation and tightening monetary policy conditions in the US.

Going into 2019, as investors battle through the uncertainty and the late-cycle phase of the global economy, prudent strategies are necessary to hedge against future market corrections and to protect capital: conserve a decent amount of cash, own gold, and invest in large-cap recession-resistant companies operating in the utilities, consumer staples and telecommunications sectors.



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