October 2015 Investment Newsletter

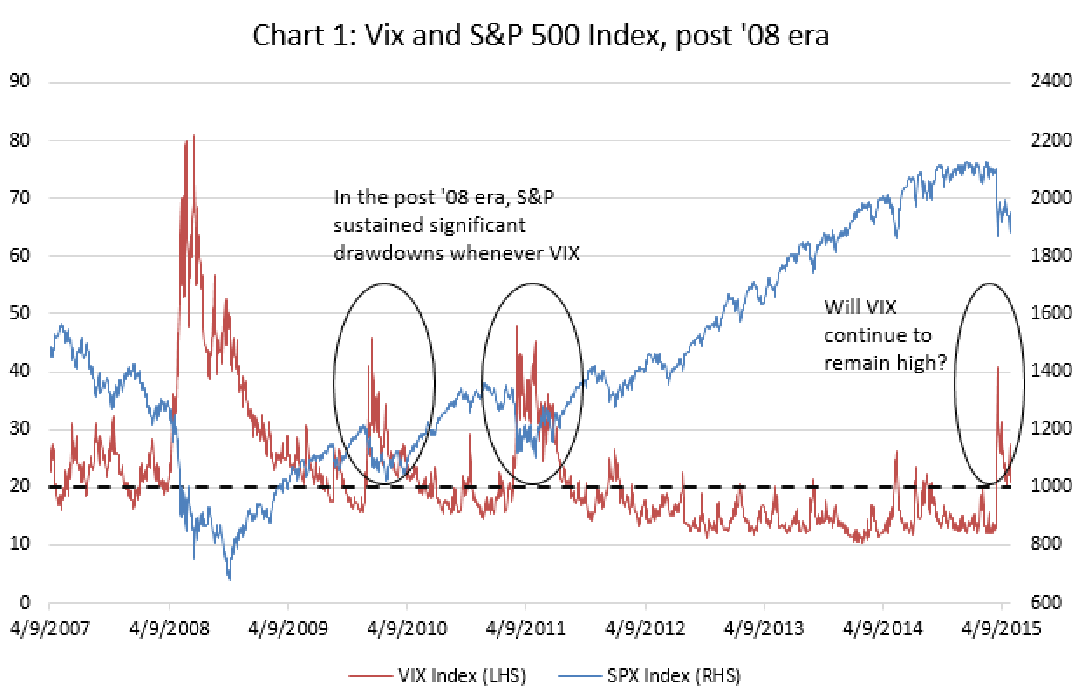
A month to be cautious

1. Risk remains elevated

September and 3rd quarter in general have been brutal for risk assets, with a number of markets posting the worst returns in years. Add to this backdrop a resilient rally in the first two days of October, some analysts are starting to call for a rebound in the 4th quarter. While this may yet happen, we note that risk remains elevated and now may not be the ideal environment to add to risky assets.

Volatility has gone up in recent weeks and remain elevated. Chart 1 below shows the relationship between the VIX and the S&P 500 Index in the post-Lehman era, which is characterized by massive central bank intervention. During this period, VIX hardly stayed above 20 as the S&P 500 made a steady recovery from its Mar 09 lows. The only two significant periods whereby VIX remained elevated above 20 was in the summer of 2010 due to the Greek debt crisis and in 3rd quarter of 2011 when US credit rating was downgraded. During those two periods equities suffered significant drawdowns of 16% and 18% respectively. Right now VIX has remained above 20 since end Aug 15 while S&P 500 is presently around 8-9% off its peak.

Should we desire to add to equities, a more favorable time would be to see further evidence of volatility dying down, with VIX dropping (and staying) below 20.



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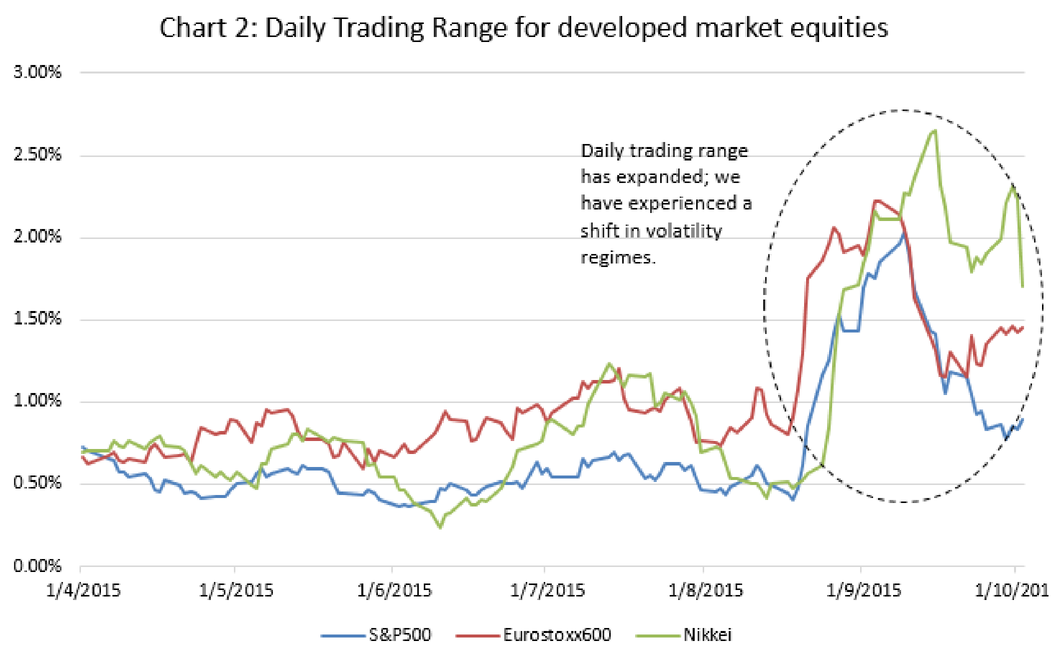
Besides the VIX let's also take a look at how the daily trading range has been evolving. Chart 2 below shows the daily trading range as a percentage for developed equities for the past 6 months. (The daily trading range derived here is from taking the 14 day average true range expressed a percentage of the index value. The indices presented here are the S&P 500, Eurostoxx 600 and the Nikkei 225.)

As we can see, the daily trading range has expanded. For example, prior to Aug – Sep 15 S&P 500 had an average range of 0.5%; now the range has almost doubled. The same is true for the Eurostoxx 600 and the Nikkei 225. We have experienced a shift in the volatility regime.

Short term traders would have to be nimble in this kind of environment and adjust their position sizes (lower) in response to the higher volatility if they wish to maintain the same level of risk. Longer term investors should understand that their positions would be subject to larger intraday fluctuations in this kind of environment.



2. There may yet still be negative surprises from the commodity fallout

The sharp fall in energy prices in the second half of 2014 have come and gone. 2015 have seen energy prices remaining in a bearish stance. Upstream players have to plan for a prolonged period of lower energy prices which would affect business and employment prospects and thus impinge on earnings growth. The China economy slowing down is also a major argument against a sustained rally in energy prices.

What we *do not know* is which other high profile names would now be shaken out and be thrown into the spotlight. Recently we have seen Noble being questioned on its accounting practices and Glencore having to reassure investors on its debt situation. Both these stocks have taken a severe beating.

We do not think we have seen the end of the commodity saga yet, and it is not far fetched to imagine one or two major bankruptcies or restructuring. With the markets more jittery in recent times, such news filtering out have the capability to exacerbate market stress, especially if fears of contagion to the financial system become more pronounced.

3. What could cause markets to rally?

Before we do that perhaps it is timely to mention the most watched event for Oct. The FOMC is meeting on 27-28 Oct and this is a 'live' meeting. However, the market has interpreted last Friday's employment numbers as weak and have largely written off a rate hike this month.

In any case, any rate hike is likely to be gentle and not designed to shock the markets. Yellen is supportive of markets and financial stability, and the Fed has repeatedly stated that rate hikes are meant to 'normalise' interest rates, and not to explicitly tighten monetary conditions. Yellen has also previously mentioned that they could also do additional QE .

In short, we still have a very accommodative Fed. This is the same for Europe and Japan. US, Japan and Europe inflation data have been stubbornly low as well, thus affording them ammunition (excuses?) to potentially further expand their QE programs.

In a scenario whereby QE is aggressively expanded we could not exclude the possibility of equities surging upwards, however the risk to reward ratio is not as favorable as in the past. The unthinkable has now become a possibility: Like a sick man given repeated doses of antibiotics, the market is increasingly showing signs of resistance to additional QE measures. We have to watch closely how markets react to additional QE. If equity rises with a corresponding fall in volatility, that would be a more bullish signal. If markets fail to rally and prove to be inured to the additional effects of QE, it could fall precipitously until it overshoots to the downside (i.e. until it looks very attractive from a fundamental perspective).

Date sources: Bloomberg

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