Fundamentals remain strong despite market volatility

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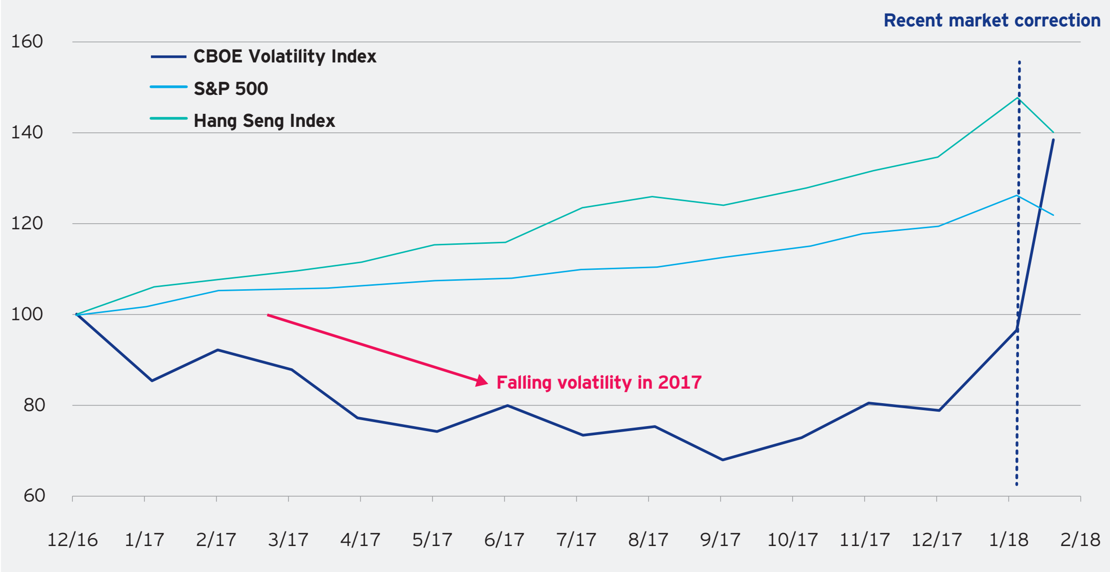
Global equities experienced a roller coaster ride in the beginning of 2018, leaving many in doubt of the market ahead. Paul Chan, Head of Multi-Asset & Hong Kong Pensions at Invesco, discusses his views on the latest market happenings and how pension investors should position themselves.

What do you think of the recent market sell-off? How has it changed your outlook for 2018?

The recent sell-off in global equities mainly stemmed from concerns over the US Fed's rate hike progress. The US Labor Department reported moderate wage growth in January 2018, fueling worries over accelerating inflation and thus tighter interest rate policies. Given low rates have been providing ample support to the equity market in the last decade or so, together with a massive budget deal passed by the US Congress earlier that had the market anticipate rising deficits, the fear of higher interest rates turned into widespread concerns.

However, with or without these incidents, this market retreat in equities still should not have come as a surprise after the rallies in 2017 and January 2018. In 2017, the S&P 500 index, representing the US stock market, rose 21.80%[1] while the Hang Seng Index rallied 41.20%[2]. In January 2018 alone, S&P 500 rose 5.72%[3] while Hang Seng Index climbed nearly 10%[4]. The recovering and growing risk appetite since the Global Financial Crisis has given rise to various structured investment products in the last 10 years, among which is "inverse volatility" investment instruments, which are, in essence, tools that allow investors to gain by betting on a continued lack of volatility in the market. These investments attempt to artificially depress volatility (which has remained sedate throughout 2017) to boost the equity market's performance, finally culminating in market overheat (see Figure 1).

Figure 1: Market volatility vs. equity performance since 2017



Source: Bloomberg, data rebased to 100 on December 31, 2016, in USD as at February 19, 2018.

The problem is that this is essentially a bet on market direction rather than an investment. Volatility is an effect, not a factor. When people invest in equities and the market is stable, volatility naturally goes down. When volatility spikes up, like in this market sell-off, "inverse volatility" investments can cause heavy losses.

The key takeaway for investors amid this market turbulence is that the fundamentals of the economy remain strong and stable. Investors do not have to be overly concerned about rising interest rates – it is a positive indicator that the economy is in good health. The financial market should have already priced in three rate hikes in 2018 as well. Despite the market correction, year-to-date US equities still gained 2.45%[5], and we continue to maintain a positive stance on equity markets for 2018. As "inverse volatility" investments have experienced a massive erosion, I do not expect volatility to return to its previous low. Risk premium is expected to rise to some extent, deterring investors from being too aggressive. The caution induced, in my opinion, will be advantageous to the overall market health.

Note 1: Source: Bloomberg, total return in USD terms as of December 31, 2017.
Note 2: Source: Bloomberg, total return in HKD terms as of December 31, 2017.
Note 3: Source: Bloomberg, total return in USD terms as of January 31, 2018.
Note 4: Source: Bloomberg, total return in HKD terms as of January 31, 2018.
Note 5: Source: Bloomberg, data as at February 16, 2018.

From the perspective of Hong Kong pension investing.

How will this market correction affect the Fed's rate hike decisions?

There should be no change to the three rate hikes the Fed forecast for 2018. The probability of a rate hike has gone up from less than 70% by the end of 2017 to 100% at the time of writing, albeit quickly dipping 4% on February 6, 2018, when the sell-off took place[6].

The US rate hike process started in late December of 2015, but the progress was twice put on hold by the then Fed chair Janet Yellen, who attributed the temporary halts to the devaluation of renminbi in 2015 and the Brexit referendum in 2016. While the Fed has good reason to be concerned with the recent market volatility, in theory macroeconomic factors and inflation should be the primary, if not only, considerations for central banks when deciding monetary policies. I believe Yellen's delays unnecessarily drove the financial market to over-rely on rate hike decisions as a trend indicator. Going forward, the Fed should continue to hike rate as scheduled despite this market correction.

What can pension investors do in face of such market volatility? How should they allocate their assets?

As mentioned above, fundamentals of the macroeconomy remain sound and stable, and investors do not need to panic. There is not a general rule that applies to all investors; it all depends on their personal circumstances and financial responsibilities. I have noticed how some pension programs in the market use age as a gauge to determine asset allocation, and I do not completely agree with that.

Age does not play as much role in making investment decisions than an investor's actual needs. Two investors of the same age can have completely different pension investments if, for example, one has a 30-year mortgage and dependent children while the other doesn't. Even at the age of 65, some investors may continue to invest, while others may choose to withdraw their benefits.

The rule that pension investors need to remember is to always keep a close eye on their pension investments and stay actively invested. The Mandatory Provident Fund (MPF) system in Hong Kong offers investors abundant investment choices. It is not recommended to choose default programs and forgo active investment choices out of convenience and merely a few percentage points of guaranteed returns.

Another phenomenon I have noticed is that many pension investors have a strong home bias – they tend to allocate the majority of their investment to the China and Hong Kong markets because they have the most knowledge about these regions. However, as the saying goes, don't put all your eggs in one basket. When investors are already earning, saving and buying houses in Hong Kong dollars, they need diversification to avoid the risk of over-concentration.

Note 6: Source: Bloomberg, data as of February 15, 2018.

From the perspective of Hong Kong pension investing.

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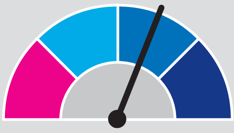
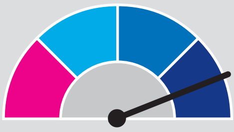
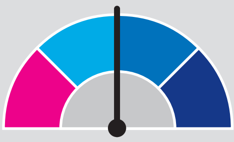
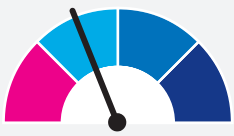
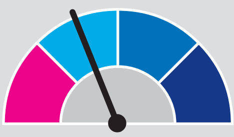
Strategic asset allocation

Asset Class	Positive	Negative
Equity Moderately favorable 	■ Dovish developed market central banks ■ Steady economic expansion in the US ■ Rebound in energy and materials prices	■ Low growth, low return with moderate volatility ■ Valuations at long-term historical averages ■ Downward earnings growth
Bond Less favorable 	■ Accommodative central banks policies ■ Low inflation risk	■ Valuation at multi-decade high ■ Record lows in rates and yields ■ Cyclical recovery expectation will raise bond yields
US Equity Favorable 	■ Private sector balance sheets continue to strengthen ■ Corporate profits benefit from globalization ■ Economic growth momentum strengthened	■ Valuation above long-term average ■ Below trend growth and inflation
Europe Equity Less favorable 	■ Current accounts continue to improve ■ ECB started QE purchases of government bonds ■ Cyclical recovery in earnings	■ Brexit uncertainty ■ Rising non-performing loans for the Italian banking sector ■ Jobless rates stayed elevated
Japan Neutral 	■ Bank of Japan mulls more easing ■ Healthy corporate balance sheets ■ Valuation below long-term average	■ Downgrade in earnings amid strong yen ■ Stubborn deflation ■ Tight labor market dampens productivity growth
Asia Pacific ex J, H, C* Less favorable 	■ Fundamentals appear to stabilize after two years of deterioration	■ Gradual slowdown in growth ■ Exports growth remain anemic ■ Central banks have limited reasons to ease monetary policy ■ Valuation above long-term average
China & Hong Kong Less favorable 	■ Valuations below long-term average ■ Economic growth in mainland China has stabilized	■ Banks are expected to see rising non-performing loans ■ High levels of corporate debts ■ Weak domestic demand in Hong Kong

Source: Invesco, as at February 13, 2018. The strategic allocation is on a relative basis. Opinions and forecasts are based on current market conditions and subject to change without notice. * J = Japan, H = Hong Kong, C = China (Mainland China)

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