Market Volatility—*Perspectives* Update

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When market volatility returns with a vengeance as it did recently, it is important to go back to first principles to avoid over-reactions. The big picture hasn't really changed—the global economy is expanding at a brisk pace, while inflation remains well-behaved in most parts of the world. Given the improving but still non-inflationary cyclical backdrop, many central banks are slowly taking "the foot off the accelerator", but are in no rush to put on the brakes. In other words, on balance, the global monetary policy stance remains accommodative.

We titled our last *Perspectives* edition *"As Good As It Gets?"* and went on to ponder that, after a stellar year for the world economy in 2017, the main question was not whether the growth outlook is good or lacklustre. The real question was: how long can this last? How long can the equity bull market continue before it hits a bump in the road? The past few days have answered our question, admittedly sooner than we may have thought. What can we expect next?

Why have investors suddenly turned so jittery? It relates to the recent turn of events in the U.S. economy. Over the past week there has been a re-pricing of U.S. inflation expectations, with more and more market participants worrying about an overheating U.S. economy. This has led to a move higher in both short-term and long-term interest rates. In terms of magnitude, this bond market pullback is comparable to the "taper tantrum" episode in the summer of 2013. This time around, however, it is the threat of higher cost-push inflation potentially leading to higher interest rates that is the main source of concern. Very tight labour conditions have been translating into faster wage inflation. If significant enough, the build-up in cost-push pressures could force the U.S. Federal Reserve (Fed) to deliver more aggressive rate hikes, putting the U.S. economic expansion at risk. Higher inflation can also lead to lower profit margins and ultimately the revenue growth of S&P500 companies.

We raised this risk of faster-than-expected inflation triggering higher financial market volatility in the last edition of *Perspectives*. To keep market participants cool-headed, they have to remain convinced that inflation is no threat and that central banks have plenty of time on their side to renormalize monetary policies. However, the more the global economy surprises on the upside, the greater the risk for central banks of falling behind the curve. Recent financial market developments are validating the concerns we raised late last year—inflation showing its ugly head faster than generally expected could be enough to spoil the party for global investors.

Luckily, Europe and most emerging economies are well behind the U.S. in terms of the inflation dynamics, which leaves their respective central banks some leeway to remain gentle in their policy renormalization. Inflationary pressures also have less negative impact on corporate profitability in these regions, which leaves us more constructive on their financial market prospects. This is at the root of our current asset allocation strategy. Our strategy strikes a balance between being underweight the U.S. equity market and overweight international and emerging markets, while maintaining a balance between total equity versus fixed income exposure.

All in all, major central banks' policy renormalization continues and is expected to generate higher volatility than the recent past. That is the negative aspect. The positive is that this renormalization is occurring *because* there is a fundamental improvement in underlying economic activity. Finally, central banks are not

expected to short circuit this economic expansion—that is, at least until inflation proves to be self-sustained. In our opinion, that is still a long way off, given the global headwinds remaining.

VIDEO

Perspectives Video Commentary

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