LOM OFFSHORE FINANCIAL SERVICES

**Monthly Global Market Commentary**
**February 12, 2018**

**Corrections and the Fed Put**
**By Peter Goodall**

Choppy trading characterized a volatile week. The S&P 500 (SPX Index) fell 5.10% in choppy trading. The MSCI World Index (MSDUWI Index) was down 5.56%.

## Correction Territory

The stock market entered correction territory last week. A correction is typically defined as a drop of at least 10% from the high. It is important to remember that this is the fifth correction since the end of the Great Recession, so we see corrections are a normal occurrence over time. As I mentioned last week, this correction has been largely driven by rising interest rates and fears of how fast and high rates may go from here. There was some speculation in the news that the dip was driven by algorithmic traders but there is insufficient evidence to support this, and the narrative appears to be going away. The recent fall in the equity markets is generally being viewed as healthy as the underlying economic fundamentals remain strong and this down leg likely represents prices reverting back from somewhat overvalued levels.

## VIX

The VIX is commonly known as the fear index. Over the past several years, we've seen the VIX trade at historic lows. This, in part, was driven by the "Fed Put" - an industry term that basically means the Fed will step in to protect markets from falling too far. The recent transition of the Fed Chair has brought the feasibility of a continued "Fed Put" into question. Some of the selloff on Monday was due to traders using VIX ETFs which has very likely exacerbated market moves.

## Discouraging Risk Taking

On February 5th, Janet Yellen officially handed over the reins of the Federal Reserve to Jerome Powell. Much of the market uncertainty is centered on whether he will continue dovish Janet Yellen's legacy. Mr. Powell has historically voted in line with the Federal Reserve on rate cuts. Transcripts from the 10/24/12 Federal Reserve Open Market Committee shed some light on his potential demeanor. In those notes, Mr. Powell is on the record stating the Fed was "at the point of encouraging risk taking, [which] should give us pause." He also expressed concerns that the Fed was "blowing a fixed-income duration bubble right across the credit spectrum that will result in big losses when the rates come up down the road."

There is now good cause to believe the Federal Reserve can raise interest rates. The Trump administration has put in place fiscal stimulus during a healthy market while fourth quarter earnings have been strong and the tax cuts under the Trump administration are expected to boost profitability going forward. It is worth noting that the increasing deficit from the tax cuts are expected to dampen long term growth. However, those effects are far enough down the road that they are not reflected heavily in the market.

We are also seeing strength in the jobs market as the seasonally adjusted unemployment rate in the labor force has fallen to just 4.1%. These positive tailwinds provide some breathing room for the Fed to deleverage with less impact on the overall economy. A trend towards normalization of rates means the Federal Reserve is more prepared for the next recession. There is some concern that, as the 10-year Treasury moves closer to three percent, we will see greater incentives for some market participants, currently in the equity market, to move towards bonds.

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For example, large institutional investors such as endowments and pensions have mandates to pay out a certain portion of their investment portfolio. In order to maintain their asset base, they are constantly striving to structure their investments in such a way that it pays out enough in dividends and interest to cover their expenses and meet distribution requirements. Traditionally, they would operate in bond markets, but with fixed income rates too low to cover their expenses, they have moved to alternatives, hedge funds and equities to boost their income. However, rising rates now give them a more lucrative option than before in the traditional bond markets. Assets moving from stocks to bonds may continue to pressure equity prices, but with the 10-year Treasury still trading comfortably under three percent, we do not see it as a significant threat right now.

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## Stock Market Performance

| | 2/12/18 | W-o-W | M-o-M | Y-o-Y |
|---|---|---|---|---|
| DJIA | 24,191 | -0.6% | -6.2% | 19.3% |
| S&P 500 | 2,620 | -1.1% | -6.0% | 13.1% |
| MSCI World | 2,051 | -2.5% | -6.2% | 13.0% |
| S&P/TSX | 15,035 | -2.0% | -7.8% | -4.4% |
| BSX | 2,269 | -1.9% | -1.7% | 15.7% |
| FTSE100 | 7,180 | -2.1% | -7.7% | -1.1% |
| DAX | 12,278 | -3.2% | -7.3% | 5.2% |
| CAC | 5,142 | -2.7% | -6.8% | 6.5% |
| Nikkei | 21,383 | -5.7% | -9.6% | 10.3% |
| Hang Seng | 29,460 | -8.6% | -6.2% | 25.0% |
| Shanghai | 3,154 | -9.6% | -8.0% | -1.3% |

## Key Rates and Prices

| Currencies | 2/12/18 | Month ago | Year ago |
|---|---|---|---|
| EUR | $1.23 | $1.22 | $1.06 |
| GBP | $1.38 | $1.37 | $1.25 |
| JPY | ¥108.67 | ¥111.06 | ¥113.22 |
| CAD | $0.79 | $0.80 | $0.76 |
| CHF | $1.07 | $1.03 | $1.00 |
| AUD | $0.78 | $0.79 | $0.77 |
| **Fixed Income** | | | |
| 3M LIBOR | 1.82 | 1.72 | 1.04 |
| 3M Treasury Bill | 1.57 | 1.44 | 0.54 |
| 2Yr Treasury Note | 2.09 | 2.00 | 1.19 |
| 10Yr Treasury Note | 2.88 | 2.55 | 2.41 |
| Fed Funds Rate | 1.50 | 1.50 | 0.75 |
| **Commodities** | | | |
| Gold/oz. | 1,318.30 | 1,337.95 | 1,233.65 |
| Silver/oz. | 16.40 | 17.25 | 17.96 |
| Copper/lb. | 3.06 | 3.23 | 2.76 |
| Oil | 60.31 | 64.30 | 53.86 |

## Global Economic Calendar (February 12th — February 16th)

**Mon:** Treasury Budget (US)
**Tue:**
**Wed:** Consumer Price Index (US), Retail Sales (US), EIA Petroleum Status Report (US)
**Thurs:** Jobless Claims (US), PPI-FD (US), Industrial Production (US),
**Fri:** Baker-Hughes Rig Count(US), Housing Starts (US)

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