Weekly Market Comment

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Central Banks - None the Wiser

While politics and another desperately sad case of corporate man-slaughter dominated UK news, economics at home and abroad were dominated by central bank policy action, in-action and signs of rate setting committee dissent.

Global stock markets appeared content and except for a 3-5% correction in the exceeding highly valued US tech sector traded sideways at their recent highs.

On Wednesday, the Federal Reserve Board had raised their target short-term rate to 1.25% (from 1%) as had been widely expected for the past month. However, more importantly they also indicated a plan on how to start a "tapering" of their QE bond holdings in 2017, again in line with expectations, but without a definitive start date. The Fed's rhetoric accompanying the announcement imparted confidence in the economy and gave markets a sense of only marginal tightening of policy. US government bond yields rose marginally across the curve, but not enough (by itself) to undermine the equity market.

On Thursday, apparent dissent amongst the Bank of England's (BoE) Monetary Policy Committee provided more of a shock. Although there was no change in the 0.25% "base" rate, three members of the eight saw the need for a hike.

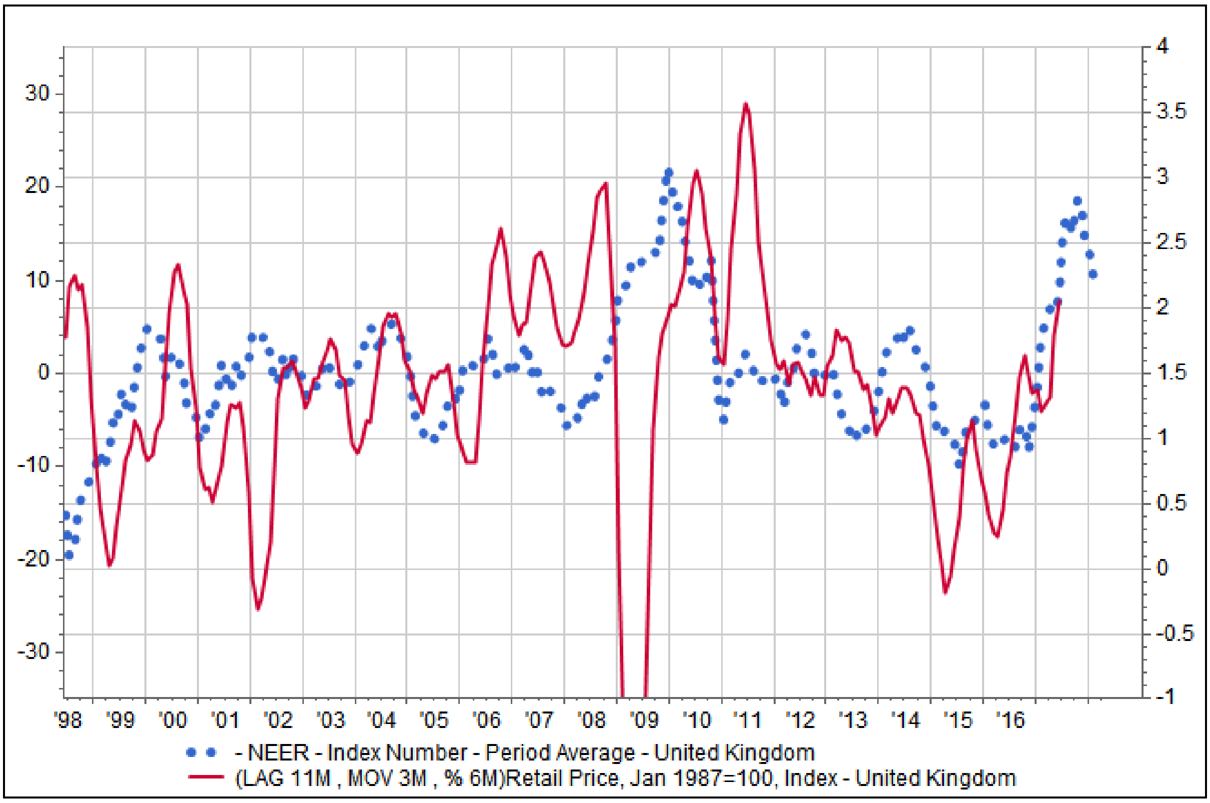
Before the meeting, the UK economy's data readings had given rise to generally at least mild concern as they had been the equivalent of steady drizzle (soggy and grey). Despite employment rising to record levels (and unemployment remaining at only 4.6%), employees' pay rose only 1.7% over 12 months, which against a 2.9% rate of inflation amounted to a pay cut. Unsurprisingly, retail sales volumes for May showed a decline of 1.2% from April, leaving the change over the year at a measly +0.6%.

So why would the three MPC members think that people needed a rise in mortgage costs?

Well, it would have been concerns of inflationary pressures as prices of "core" goods (the things we generally have to buy) rose 2.6% in the 12 months to May. The old measure of inflation, the Retail Price Index, rose 3.7% in the year.

While that's good news for those on index-linked pensions, employees on low wages are badly affected because "core" goods form a greater proportion of their spending than those on higher wages.

Underlying this inflation rise has been the weakness in the pound. In the graph below, Jim has tried to show the influence that the fall in our currency has had on UK inflation (the old RPI, because the data has a much longer history). The red line shows changes in the RPI versus 6-months ago, while the dotted blue line shows a measure of how sterling's fall has added to inflationary pressure. (This has been pushed forward to show how it exerts influence in the near future). As one can see, the pressure to push inflation higher can be expected to remain strong into the year's end if the relation in the past continues to have relevance for the future.



(Source: IMF, UK ONS, Factset)

To us this clearly suggests that the current spike in inflation is transitory and therefore not policy relevant, whereas the same cannot be said with the same conviction about the economic slowdown since the beginning of the year. In a separate article below - *Unwinding of QE – first appearance on the horizon* – we comment more broadly about what we take away from a week filled with central bank announcements.

As a contrast to the UK, the May inflation data from the US, Europe and China came out on the low side. China is of particular interest. For three out of the past four years, it has been the source of deflationary pressure. The past year saw a sharp reversal, as the government eased fiscal and monetary policy. However, 2017 has seen a reversal of that easing, culminating in May's producer prices declining again.

While China has backed away from outright monetary tightening in recent weeks, their actions have been felt quickly across the world in goods price terms, and so inflation pressure has dissipated as quickly as it arose.

So, for the UK, our best guess is that soft final domestic demand and lack of external price pressure will leave the only pressure coming from the after-effects of sterling falls. This should mean that the incentive to raise rates will lessen over the next few months.

Coordinated economic strength across the world through the second half of 2016 caused optimism over company earnings prospects. Now, much of that synchronised strength and improved business and consumer sentiment has receded and is now only found in the previous concentration in Continental Europe and parts of Asia. There is a slight concern that the new leaning towards monetary tightening of central bank's from China, to the US and now even the UK may prove premature and might even have already tipped activity into coordinated softness. This may mean that after encouragingly strongly corporate profit growth in the first quarter of 2017, analysts' extrapolation of those growth rates may prove similarly premature and lead to renewed earnings pessimism in the second half of 2017.

As mentioned at the start, equity markets continued to trade at their highest levels this past week. At the same time, stock market volatility has picked up, both in actual stock price movements and in the price of options on those stocks. We expect things to get even rockier over the next few weeks, with increased stock market volatility no longer just focused on the highly valued US tech sector.

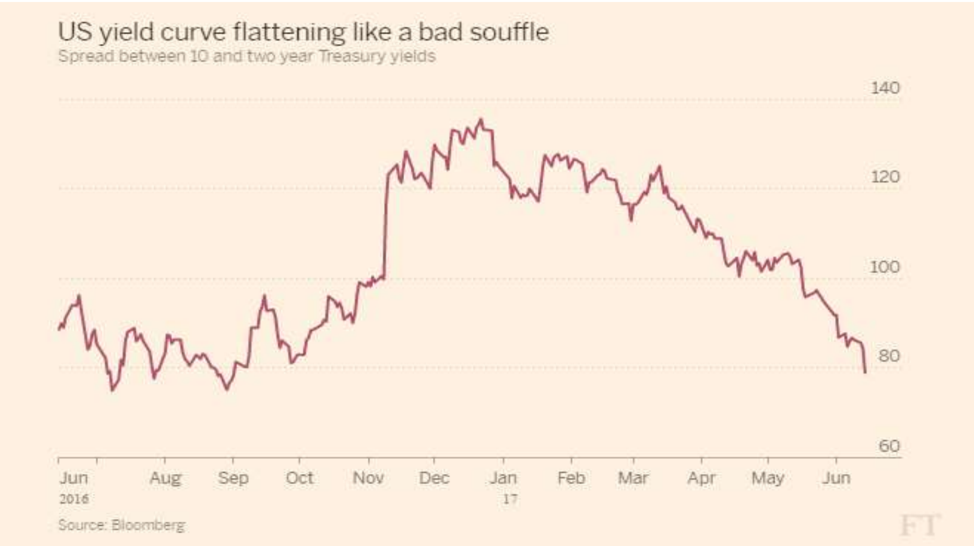
Unwinding of QE – first appearance on the horizon

While there were no real surprises in this week's policy announcements from the European Central Bank (ECB), the US Federal Reserve (US Fed) or the Bank of England (BoE), there is still uncertainty about the relative strengths and weaknesses of the economic data in each case, and, as result, uncertainty about the future direction of monetary policy in all three.

On the face of it, and in light of each of the central bank's decisions, the US economy is in good health and even further monetary tightening may be required later in the year. The EZ is responding well to the ECB's accommodative policies, but the risks are more evenly balanced than in the US.

In the UK, risks are finely balanced and Brexit is viewed as a potential deflationary cloud looming on the horizon. However, not all commentators would agree with this simple description of economic conditions in the US, EZ and UK. Some economists believe the US Fed may have erred in its policy, and that a narrowing between short and long-dated yields indicates a market expectation that the economic outlook is actually dimming (see graph below).

Narrowing in the spread between 2 and 10 year US Treasury yields



Source: FT, June 2017

The ECB was first out of the blocks for the month on 8th June, announcing its decision to hold interest rates. As for the "non-standard" monetary practice of quantitative easing (QE), the ECB maintained the level of net asset purchases at a monthly rate of €60bn, intended to run until the end of December 2017 (or beyond if required). The ECB is maintaining a balanced policy - keen to ensure the EZ economy is on a firm and sustainable growth path before acting on interest rates and before attempting to slow or unwind QE (releasing asset purchases from its own balance sheet).

Economic conditions in the US appear more favourable, and led to a further interest rate increase this week. The Fed raised the target range for the federal funds rate by 25bps to give effect to a rate of 1 to 1.25%. Even though the Fed's move had been clearly signalled (by the Fed in March) and was widely expected by markets, there was still some surprise at the Fed's decision to raise rates. Why?

The Fed's rate increase follows a series of weak inflation readings. Over the last 3 months, personal consumption expenditure inflation (PCE) has actually fallen. Therefore, the Fed's decision delivered a hint of a 'hawkish' surprise to markets, who may have expected that soft inflation data would make the Fed reconsider its planned series of rate hikes.

However, the Fed remains confident in its own forecasts for inflation, and expects inflation below 2% in the near term, stabilising around the 2% objective over the medium term. As for QE, the Fed's intentions are consistent with its stance on interest rates – it intends to begin (very slowly!) unwinding its $4.5tn balance sheet as early as this year.

What about the UK? The BoE were split on the decision of whether to raise interest rates. At its meeting on 14th June, the BoE's monetary policy committee (MPC) surprised with a smaller majority of 5-3 to maintain interest rates at 0.25%. It seems that differing views between the BoE and external MPC members over whether the current spike in inflation is transitory or will prove more sustained was the primary cause for the split.

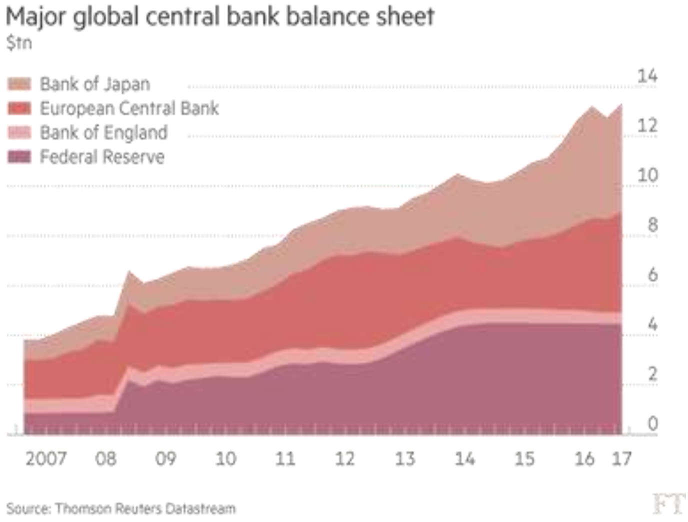
According to the BoE, CPI inflation has been pushed above the 2% target by last year's £-Sterling depreciation; reaching 2.9% in May, above the MPC's expectation. It also stated that inflation could rise above 3% by the autumn, and is likely to remain above the 2% target for an extended period, as £-Sterling's depreciation continues to feed through into consumer prices.

Even though there is a current spike in inflation, economic conditions in the UK appear relatively subdued. The BoE note that the rate of GDP growth declined markedly in Q1, in part reflecting weaker household spending. It remains to be seen how large and persistent this slowdown in consumption will prove. This suggests the BoE's view may be correct; the current spike in inflation is import-led and transitory.

On the question of QE, the MPC vote was unanimous – electing to maintain the stock of £-Sterling investment-grade corporate bond purchases at £10 billion. The MPC also voted unanimously to maintain the stock of UK government bond purchases at £435bn. The BoE gave no indication of any let-off in QE, or unwinding of its balance sheet.

Recall that, post-GFC, QE provided an injection of liquidity into the markets and financial system ("oil the wheels", as it were), while the asset purchases associated with QE also helped to underpin asset values and thereby arguably prevented a 1930's style deterioration from recession towards depression. However, the economic downturn still lasted longer than perhaps expected and the central banks of the US, UK, Bank of Japan and the ECB now hold ~$13tn of assets on their balance sheets. A sizeable amount by any standard.

Bloated balance sheets: assets purchased and held by the major central banks



Source: Thompson Reuters Datastream

As economies recover and policy tightens, interest rate rises will be one of the signals for an unwinding of QE (as in the US). Some or all of these assets will be "repatriated" (back to the market). We believe that, in order to avoid any market shocks which would effectively undo all of the work to date, the unwinding of QE will require careful management over a long period. This will mean any sell-back will need to be gradual, and consistent with managing money flows and interest rates toward target inflation.

This is exactly how Fed chair Janet Yellen is planning to proceed, gradually. Setting aside the question of whether the US Fed is right to start the run-off at this time (before sustained and tangible growth has taken a firm hold), the Fed's proposal to slowly increase the amount released quarterly – over 12 month periods up to the end of 2020 – appears measured and pragmatic.

Moreover, the Fed has indicated that any sell-back will only proceed "as long as the economy evolves as expected". Again, we believe this is a measured approach and is unlikely to cause any severe market adjustments, assuming the US economy does evolve in accordance with the Fed's own projections.

As far as the UK MPC's split vote is concerned, we noted with interest the currency market reaction of an upward move in the value of £-Sterling. A slight but sustained recovery of £-Sterling would not hurt UK export competitiveness, but would alleviate inflationary pressures of dearer imports, which would help the UK consumer. We therefore do not think it entirely impossible that the MPC's intention was more one of 'talking-up' or putting a floor under the value of £-Sterling than seriously considering hiking rates at a time when the UK's economy is slowing considerably.

Eurobonds on the horizon?

This week, Spanish finance minister Luis de Guindos has called for major reforms within the Eurozone, including the creation of a European treasury or monetary fund with the power to decide over a percentage of national budgets. According to Mr Guindos, "There is a pervasive perception that there are flaws in the Eurozone that we have to correct."

Part of this proposal would include the long-discussed issue of debt mutualisation at the Eurozone level – the issuance of 'Eurobonds'. These would be bonds that investors could buy for the purpose of investing in government debt at the European level – a common European government bond market – rather than the current system of every national government issuing its own bonds.

The government in Spain has been advocating a common bond market for some time now. Back in March, Prime Minister Mariano Rajoy said to his parliament that a joint European budget was necessary to "send a message of unity, hope and integration."

The benefits of such a move are not immediately obvious to understand, but revolve around greater bond market stability at the national level. In a monetary union government bond market stability is reduced, because domestic central banks are robbed of the ability to devalue their currency unilaterally in response to an economic shock that is specific to just their nation. In the absence of this policy instrument, bond investors may become concerned that an adversely affected country may be drawn into a downward spiral of economic decline and consequentially try to dispose of their bond holdings as quickly as possible. This further increases the downward pressure on the economy and the downward spiral of decline becomes perpetual.

This is roughly what (almost) happened to Spain and Portugal during the Eurozone crisis and the run on Spain's and Portugal's bond markets only stopped when the ECB threatened to buy up unlimited amounts of the affected government bonds (Ref. Draghi's famous "will do whatever it takes" speech in London).

Beyond the resulting improvements market resilience at times of economic turbulences, bond issuance at a community level would lower borrowing costs for those still suffering from the aftermath of the Eurozone Crisis as bond yields across the Eurozone would converge towards an average. At the moment yields still vary considerably – the 10-year rate for Spain is at 1.4% compared to Germany's 0.3%, while the embattled bonds of Greece come in at 5.9%.

For Spain's Guindos, however, Eurobonds would only be the beginning of the story. "We have focused too much on Eurobonds. Eurobonds are a very minor point. The more important point is about economic policy integration, not just for fiscal policy but also in areas such as structural reforms." The key reforms necessary, he argues, involve centralised control over European government budgets in pursuit of a "consolidated fiscal stance", and giving European bodies the ability to force countries into reform. Such a move would involve a monumental power transfer from individual states to the EU, exceeding even those enshrined in the Lisbon Treaty.

A fiscal union has long been considered the next step in the grand project of European integration. Debt distribution (or lack thereof) is a stumbling block which constantly frustrates moves towards the 'ever closer union'. Take Greece, for example. Were it a standalone country outside of the monetary union, its numerous crises could have been dampened by currency devaluation. Were it just a state within a truly federal union, reallocation of funds at the federal level could have alleviated its issues. Given that it's neither, however, and instead has a sort of half nation half federal state status, its options are limited.

The arguments against a Eurobond market are largely political and rooted in national populous' distrust of other nations' commitment and/or ability to responsible fiscal budget management. This regularly overpowers the argument of the mutual monetary and economic benefit of pan-European debtor solidarity in the form of debt mutualisation, as described in numerous academic articles.

In particular, Germany has long been an opponent of such measures; each iteration of the 'Eurobond' dream over the years has been promptly shot down by the bloc's largest economy. For Germany, European debt mutualisation would mean less well-off states piggybacking off their fiscal discipline. Why should any of its neighbours be able to take advantage of Germany's hard-earned AAA debt rating, goes the line. A common bond market without the above reforms would leave peripheral nations with little incentive to enact reforms towards fiscal tightness. However, as mentioned, those reforms could involve a massive power transfer to the EU and, in an environment where anti-EU and populist sentiment has been spreading throughout the continent, any reforms in that direction would themselves be likely very unpopular.

However, is it possible that the tides of politics may be changing? "We have a window of opportunity of no more than six months after the German elections" said Mr Guindos, who added that the Brexit vote and the apparent reluctance of President Trump to pursue internationalism meant that change was more urgent than ever. "We cannot allow a second Brexit. We have to keep together." Indeed, the defeat of populist parties across Europe this year seems to support the idea that Brexit was seen as somewhat of a wakeup call on the continent.

What's more, the calls for fiscal integration have grown louder since the arrival of their new champion, the avowedly pro-European French President Emmanuel Macron. Macron's party, La République En Marche, look set to win a solid absolute majority in Parliament this weekend after emerging as the largest party in last week's first round of voting. This would give the young President the power to enact the reforms he wishes. It also potentially strengthens his hand in trying to convince Angela Merkel of his desire for a "fiscal union".

Anti-EU populists have been receding across the continent, and the wider Eurozone economy is now firmly going strong after a lengthy stagnation. It is possible that EU leaders (specifically Germany) will see this as an unmissable opportunity to move forward with the integration project before it's too late. And, given the inevitable winding down of the ECB's QE program, fiscal integration will also be more necessary.

Until now, the ECB's bond purchases, along with the European Stability Mechanism (which borrows on behalf of EU nations to fund rescue programs), has been the closest thing the union has to debt mutualisation. Though not the official stated aim, QE has helped to equalise the cost of government debt burden in most of the Eurozone states. However, with the ECB likely to begin a gradual monetary tightening (Eurozone growth and employment are both on the up), now more than ever some form of debt-sharing will be needed.

Given Germany's likely continued opposition and mistrust toward the plan, more gradual steps than a full fiscal union may have a better chance to yield progress. We have discussed one such softer approach here before – that of a mixed pan-Eurozone and domestic government bond market. Under this approach nation states of the Eurozone would only be able to borrow up to an agreed percentage of national GDP through the common facility. Anything above the agreed level would have to be underwritten nationally and thus most likely be penalised and discouraged through a higher interest burdens. Given Germany's government debt level of around 70% of GDP, an arrangement that took Germany's level as the upper limit would still go a long way to mutualise the bulk of government debt across the monetary union, where the average currently stands at 89%.

If the Brexit pressures lead to improved cohesion across the remaining Eurozone members and an improved sense of solidarity amongst the peoples of Europe and prosperity returns than there may be a small possibility that the Eurozone may indeed try and address the fatal flaw of its monetary union – after Germany's general election in September.

China's capital markets door opens - a little - further

This week, the IMF surprised by raising its 2017 growth forecast for China from 6.6% in April to 6.7%. It wasn't just positive regarding economic data but noted positively that China is reigning in risky lending and rising debt levels from the shadow banking sector. In the regulated banking sector bank loans surpassed expectations in May. Nevertheless, according to the central bank (People's Bank of China – PBoC) the shadow banking market deleveraging took its toll, leading to the slowest rate of money supply growth in 20 years. Although this followed an exceedingly positive first quarter for 2017, the slowing of money supply has many – including us - worried what the 2nd calendar quarter may bring.

The IMF upgrade plays favourably into the hands of President Xi Jinping ahead of planned the political reshuffle in the autumn. The party's 19th party congress since 1921, with 350-odd members up for reselection, will give Xi Jingping the opportunity to form a Central Committee of allies. The formerly unpopular economic reforms, mainly due to passive resistance within the current committee, are more likely to be implemented under a Central Committee more friendly towards Xi's reforms, going forward.

The PBoC, with reform interests aligned to those of the President, said this week it wishes to continue to balance the shadow banking market deleveraging with the need to keep liquidity stable, but also commented that lower money supply should be accepted as a new normal. With this in mind, it is unlikely that further reforms will be pushed forward before the Autumn, in order to maintain economic and financial market stability, which should help to maintain Mr Xi's popularity.

In a further effort to support regulated capital markets and overcome the economy's dependency on the shadow banking market, China is aiming at positioning itself as a significant global financial centre. A first important step was made in 2016, when the IMF included the renminbi alongside the dollar, euro, yen and pound in its "special drawing rights" basket (SDR) of the most important global currencies. As a consequence – albeit with considerable delay – the European Central Bank (ECB) announced it had started to hold foreign exchange reserves in Renminbi, reflecting China's importance as a lead trading partner.

In a further step of opening its domestic financial markets, in an announcement this week, China released more details on how it is broadening foreign access to its debt market through a tading facility called "bond connect". With this move China is aiming to draw greater overseas investment, counter balancing any capital outflows coming from domestically unpopular reforms. At present, less than 2% of Chinese debt is owned by overseas investors, a small investment considering this is the world's third-biggest bond market. Yet, for bond connect to attract inflows, several underlying concerns need to be addressed. The main criticisms from overseas investors of the Chinese bond market focus on three areas; the lack of faith in mainland credit ratings, concerns over liquidity and capital controls.

Foreign investors remain sceptical about Chinese ratings companies, traditionally known to provide inflated assessments of companies amid fierce competition from other providers. Regarding liquidity, Chinese bond market trading volumes are only around 7% of those in the US, despite comparable overall size. Recent efforts to reduce financial leverage are unhelpfully further limiting liquidity. The also recently tightened capital controls aim to reduce outflows (capital flight) but, in the process, are potentially impacting bond connect. Foreign investors are naturally concerned that under the controls they may not be able to transfer proceeds abroad if they use bond connect. On top of the above scepticism, China's trade settlement system is not connected to international settlement systems, a move which would be highly effective in obtaining inflows.

It is therefore likely to be quite a while before foreign bond investors gain confidence in the Chinese markets. Lack of confidence in regulation, the PBoC's conflicting and generally tightening monetary policy and as yet unknown economic impact of Xi's reforms are all uncertainties that will let bond investors shy away from the market or lead them to demand a higher risk premium than domestic investors are currently receiving. With gradual steps to open markets and operations to overseas investors, confidence may slowly grow, but over the coming months economic uncertainty will continue to loom over China's changing economic dynamics from old to new industries which will keep international investors cautious in the near term. That said, the bond investment door to China is starting to open…

Change in stock selection dynamics lurks beneath the 'technology tantrum'

Global technology stocks have experienced a sharp sell-off, or 'tech tantrum', over the past week, and tech shares took another hit following the US Federal Reserve's decision to raise interest rates for the second time this year.

Last Friday, tech shares were down 4%, losing about $140 billion in market capitalisation. In particular, Apple came under pressure from a number of ratings downgrades from analysts on lower iPhone sales, and Amazon 'flash-crashed' $50 of its above $1,000 share price.

While there are concerns over high valuations – a result of a good run year-to-date – we believe there is a bigger story behind the rapid sell-off, one that revolves around the drastic changes to market structure that has taken place over the past decade.

There has been a clear shift towards factor based and passive or tracker investments – to the tune of $2 trillion flowing out of active funds into passives. These funds merely aim to replicate the performance of a market index or even just a specific investment parameter style and buy the entire list of stocks that represent that index or style, rather than buying a stock for its expected performance as an active manager/ stock picker would do.

Essentially, we think that the change in market structure has altered the types of investors active in the market today, along with what these 'new' investors buy and for what reason.

To explain why we and some others have come to this conclusion, we need to look deeper into how last week's US Tech sell-off flies in the face of perceived wisdom, unless we also consider the new influence introduced through passive style investment dynamics.

Is the reflation trade over?

After the surprise election of Donal Trump as US president in November last year, the Trump or reflation trade favoured value (or bond proxy) stocks like financials and utilities (though one might argue whether banks are truly value stocks) as the newly elected president's fiscal stimulus promises led to a perception that economic growth would quicken. As a result, bank stocks shot up, given their high operating leverage to economic growth (more loans get made to consumers and businesses, so in theory profits should rise).

That reflation dynamic appeared to stall over the course of March as reflation signals were reversing. We note that commodity and oil prices in particular have been weaker, while reading of US inflation (CPI) and break-evens (future inflation expectations) are all lower. Also important is the powerful inflation dynamic from China. Its slowing domestic growth weakened commodity prices, thereby reversing one of the main upward pressures on general price levels. Producer Price Indices (PPI) in China, one of the key bullish arguments behind global reflation, have declined already and are feared to roll over even more sharply.

For the reflation trade, bond yields matter in determining sector leadership. Crucially, today, bond yields remain largely range-bound and the yield curve has flattened significantly, especially in light of the Fed's interest rate increase. We think that, if bond yields do not breakout and move higher, then any potential upside for value stocks will be restricted.

Rotation into growth stocks

As a result of weaker growth expectations, investors strongly rotated back into growth/cyclicals – i.e. technology – and is evident from the solid share price gains for those styles. Essentially, in a low growth environment, you buy growth. This is particularly true when key growth drivers like fiscal stimulus and central bank actions have dropped out of the narrative.

Investors piled into tech and collectively added a whopping $600 billion of market capitalisation to the biggest technology companies in 2017, which is equivalent to the combined GDP of both Hong Kong and South Africa.

As a result, the US so called 'FAAMNG' stocks of Facebook, Amazon, Apple, Microsoft, Netflix and Google have all enjoyed solid gains in 2017. So far in 2017, the US S&P500 Tech sector is up 22% as of last Thursday, versus the broader index gain of just 9%.

What impact(s) has this rotation had? – Big tech less volatile than staples/utilities stocks?

The impact of those nearly constant inflows into tech has meant that the 6-month realised volatility (vol) of the five biggest technology stocks has fallen to just 14%, which would be the lowest in the market if they were their own sector. This is lower even than the realised volatility levels of more defensive shares like utilities (14.2%) and staples (14.6%).

Another driver of lower volatility has been the steady sales growth and rising cash levels on very secure balance sheets, all of which have further dampened vol. This suggests that, at least on the face of it, large tech like Apple, Amazon, Facebook and Microsoft and Google look more similar to consumer staples (i.e. food producers) than the wider technology sector.

Why is low vol an issue?

Investors have become more sophisticated when selecting stocks, particularly on a risk or volatility adjusted basis. However, if vol is low, then investors might unknowingly underestimate inherent business or economic risks in tech stocks.

JP Morgan noted that levels of vol are at extreme lows. Over the last 20 years, the VIX Index, a measure of equity volatility, has closed lower than 10 for a total of just 11 days. 7 of those days occurred over the last month.

Interestingly, as a stock's realised vol drops, there is an increased likelihood that it will attract the attention of passive 'low vol' strategies who might buy the stock, which would push up returns and cushion downside moves. The problem then comes if the qualities that attracted a low vol buyer were to reverse, due to a fundamental reason like a change market position or sales. Then, vol could rise, causing those same strategies to sell, which would then increase downside risks as they all mechanically sell the specific stock.

The reasons for this low vol environment could be due to both low correlations (the degree to which prices move together or separately) and levels of dispersion (the difference between a stock and index return). Some analysts estimate that the flows from quant, thematic trading and passives are keeping levels of vol lower by around 2-4 points. It is also worth pointing out that passive investors generally have a long time frame and rarely sell, while quants do not usually take large directional positions and do not overreact to events in the same way (emotional) humans do.

Another force is that of central banks, where liquidity flows of around $2 trillion creates a powerful effect that impacts different sectors and styles based on their sensitivity to interest rate and policy effects. Typically, low interest rates might encourage the selling of volatility.

Tech – a crowded trade?

Added into the mix for investors worried about valuations are reports from investment banks like Goldman's suggesting that, while tech firms have historically generated good levels of cash flow, higher share prices have dented FCF (Free Cash Flow) yields. And, big tech has spent heavily on cloud investments, which could reduce profits if those capital expenditures fail to achieve desired results.

As a result of those flows, Tech had become one of the most crowded trades around, which led to concerns that the sector was unduly pulling in capital from investors who were merely chasing returns for FOMO (fear of missing out), pushing valuations artificially high and making a correction more likely.

What caused last week's Tech correction?

While we do not think there was one single trigger point, as investors rotate between stocks, sectors and investment styles (factor investing) on an ongoing basis (particularly as there was no fundamental news), it is likely that a combination of factors were at work.

There are some signs, as noted above, that the move lower was a classic investor-driven rotation, but the idea that so many different investors all suddenly decided to rotate at the same time seems unlikely. We believe that the change in market structure, along with new types of investors with different motivations from traditional active fund managers, could help explain what is going on.

Who are these new investors?

Over the past decade, passive or tracker funds have gained in prominence, at the expense of active funds, while new quantitative-based investors appear to have stocks caught between these powerful trends. To understand the scale of the transformation in markets, both passive and quantitative investors now account for about 60% of stock assets, versus just 30% from 10 years ago, according to JP Morgan.

They also estimate that just 10% of daily trading volumes come from traditional fundamental investors and, while those fundamental stories about price action get the most attention, a large proportion of equity buyers are not acting on company specific information.

These new investors utilise correlations and volatility in a different way. In the past, low correlations were good for stock pickers, as markets were driven by corporate newsflow. However, correlations

Exhibit 2: Momentum is becoming increasingly crowded
Valuation of Momentum (6 month Leaders vs. Laggards): # of Std. Dev. Above/Below 3-year avg.

Source: Goldman Sachs Global Investment Research.

are low today for a different reason, as both large sector and style rotations are increasingly driven by quant flows, monetary policy and political events, i.e. growth versus value, high versus low volatility style trades.

How are they buying?

These new investors are also buying in a different way and generally operate on styles (growth, value) and factors (momentum, size, balance sheet, Price to earnings). We note that the strong recent gains in the tech sector have made the price momentum factor increasingly crowded as those quantitative buyers were attracted by the positive signal of rising momentum. Indeed, if factors are evaluated, then momentum is 1.8 standard deviations above its 3-year average, according to Goldman Sachs.

Tech stocks are considered growth companies, and momentum is increasingly trading like growth, suggesting that the correlation between tech, growth and momentum is high. This might be down to the fact that investors preferred investment opportunities that are not reliant on political or policy factors.

As Goldman's note, the "outperformance, driven by secular growth and the death of the reflation narrative, has created positioning extremes, factor crowding and difficult-to-decipher risk narratives".

Where does that leave investors?

The rise of quant and passive strategies is likely to have an increasingly larger impact on market movements. We believe that we could see an alternating pattern of monthly rebalances that quant investors take between going long low vol, growth and momentum and short high beta (risk), and then reversing those trades as trading signals dictate.

For tech stocks, JP Morgan notes that "upward pressure on Low Vol and Growth, and downward pressure on Value and High Vol peaked in the first days of June (monthly rebalances), and then quickly snapped back, pulling down FANG stocks. The contribution coming from quant rebalances to this snapback is now likely over".

The concern is that, with US stock valuation multiples at elevated levels, that the price action we saw in the tech sector could be replicated in others. While the global rally in equities has been driven by expectations of improving earnings, recent analyst revisions have been less positive.

While corrections or sell-offs are not unusual, the speed and uniformity of direction of last week's technology movements suggest that investors had been chasing price momentum but decided to head for the exit at the same time. For such factor driven investors, Friday could be a warning, that when things move against you, you need to move quickly. However, for the more fundamentally driven investors such insights into trading patterns of the passive and factor driven investment sector could open new doors to exploit their predictability. Over the longer term this could lead to a renaissance of active investor outperformance results.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7463.5	-0.8	-63.8	→
FTSE 250	19816.4	0.2	46.4	→
FTSE AS	4085.0	-0.6	-26.6	→
FTSE Small	5614.6	-0.2	-10.2	→
CAC	5263.3	-0.7	-36.4	→
DAX	12752.7	-0.5	-63.0	→
Dow	21368.5	0.5	96.5	→
S&P 500	2428.3	-0.1	-3.4	→
Nasdaq	5682.5	-1.0	-59.4	→
Nikkei	19943.3	-0.3	-70.0	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
CAPITA	21.0	ANGLO AMERICAN	-10.5
LSE GROUP	7.4	FRESNILLO	-10.3
DIRECT LINE INSURAN	4.5	RIO TINTO	-6.8
ST JAMES'S PLACE	4.3	RANDGOLD RESOUR	-6.3
WORLDPAY GROUP	3.3	POLYMETAL INTERNA	-6.0

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	21.6	Brazil	235.8
US	26.9	Russia	164.8
France	24.9	China	65.7
Germany	15.7	South Korea	50.6
Japan	30.4	South Africa	186.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	0.24	OIL	47.2	-1.9
USD/EUR	1.12	-0.03	GOLD	1254.3	-1.0
JPY/USD	110.87	-0.50	SILVER	16.7	-3.1
GBP/EUR	0.88	0.25	COPPER	256.3	-3.3
JPY/GBP	6.81	-0.18	ALUMIN	1872.0	-1.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.0	1.3	0.01
US 10-Yr	2.1	-2.5	-0.05
French 10-Yr	0.6	-2.3	-0.02
German 10-Yr	0.3	4.5	0.01
Japanese 10-Yr	0.1	0.0	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.5
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.5
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

For any questions, as always, please ask!

If anybody wants to be added or removed from the distribution list, just send me an email.

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel