Gathering storm clouds – time to make hay!

The first quarter of 2018 saw developed market equity indexes enter correction mode, amid rising concern over inflation, the path of interest rates and stretched valuations. The VIX volatility index celebrated its 25th anniversary by awakening from its long-term slumber and trading at around double its average level over the past year, suggesting investors are becoming more divided over the outlook for stocks.

Certainly, weakening investor sentiment makes sense. Asset markets have had a great run, fuelled by an era of cheap money and high liquidity that is set to come to an end. The global macro story has also been constructive, with developed and emerging markets converging around positive narratives that include strong consumer and corporate confidence and robust domestic demand. It couldn't last forever, and as storm clouds gather, assets managers can be forgiven for thinking it's time to baton down the hatches.

TAC ECONOMICS analysis, however, suggests investors should not be too hasty. Certainly, higher volatility is a red flag that points to significant markets moves ahead. However, the direction of those moves is another matter, and TAC ECONOMICS models suggest the outlook for equity markets is positive on both a three- and six-month horizon. The reasons are the same that have driven recent performance, namely strong corporate profits, relatively low borrowing costs and a positive global picture.

The key question investors must ask themselves, therefore, relates to timing. If they accept markets are in a mature phase, in which high volatility reflects increasing nervousness over valuations, they must decide how long to stay or, put another way, the right moment to jump.

Based on TAC analytics, now is the time to keep your nerve, ignore the fact that markets are trading at a premium to fair value, and focus on resilient asset classes (for example in EM local currency as opposed to hard currency bonds), at least for the remainder of 2018. Constructive positioning should be supported by the positive impact of US fiscal policy on growth (which will outweigh the impact of slowly rising borrowing costs), limited inflation (restraining the Fed) and TAC's bet that recent talk of trade wars is probably overstated.

Into 2019 and the outlook starts to look more threatening, with tighter monetary conditions feeding through into US corporate balance sheets around mid-2019, pushing the US 10-yr yield to as high as 4.0%, compared with 2.8% at present. After that, all bets are off.

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[1] David Wigan, a capital market participant, offers his quarterly thoughts on the key trends revealed by TAC ECONOMICS quantitative models and insight.