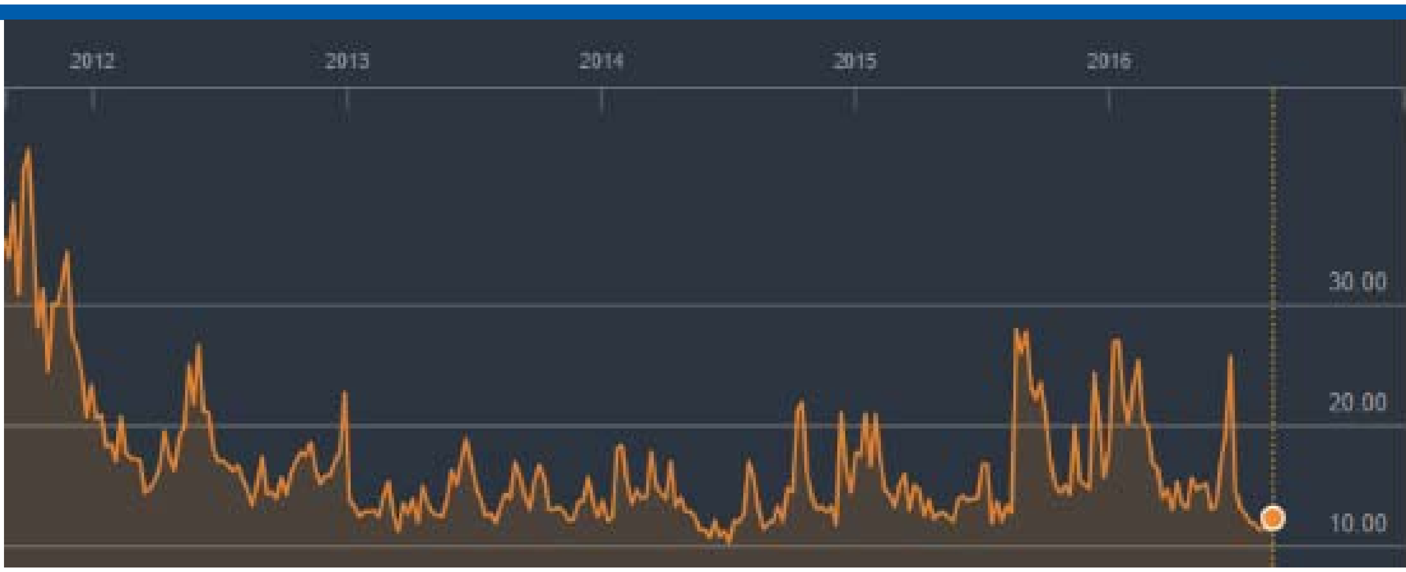
TAM INTERNATIONAL INVESTMENT NOTE

Riding high under a clear blue sky

This time last year, the UK's stock market was at a similar level to today and pretty much where it had been sitting calmly for over a year. International bond and currency markets were relatively sanguine; all playing along nicely to the script written by the US Federal Reserve. Improving economic data, supportive central banks and some temporary relief from eurozone woes, courtesy of the sacrosanct European Commission holidays, added to the general feeling of a classic stock market summer daze.

All that ended with the unexpected Chinese currency devaluation which shook markets out of their slumber, sending stock markets into a tailspin from which they would not recover until late November.

In hindsight, markets were pretty quiet, maybe too quiet as they say, and we can see that from the VIX Index, a measure of US stock market volatility quoted on the Chicago Board Options Exchange. For an index that rarely drops to 11, even in the blissfully happy days of 2006/7, a reading of 11.95 in August 2015, just prior to the Chinese devaluation, smacked of complacency.



Source: Bloomberg, 19th August 2016

Of course, volatility can describe a market rising as well as falling but it is usually associated with periods of uncertainty, which markets hate. However, the VIX does tend to be much more inclined to be higher when markets are falling rather than rising and this is generally attributed to the tendency of markets to fall faster than they rise. Indeed, the VIX index is often referred to in the Financial Times as the "fear gauge". Thus, a chart of the VIX looks like a series of peaceful rambling Lakeland foothills punctuated by the occasional Swiss Alp of fear.

Actually, the aftermath of the Chinese devaluation was not a vintage year for volatility. Reaching 28, it ranked as only the 8th most volatile August in 20 years. The years following both first Greek crisis in 2011 (around 42) and the Great Financial Crisis in 2008 were far worse (think of 80 plus...).

Today's VIX reading of 11.8 is a 2-year low, and low by any measure, so it's not surprising to see numerous articles asking if the market is again being a little too complacent. After all, the US S&P 500 Index is near an all-time high despite disappointing GDP economic growth data in the first two quarters of the year.

This is where we see the familiar paradox of "bad news is good news" for it is taken by markets that any stagnation in the main economic indicators will be sufficient reason for the Federal Reserve to delay hiking interest rates, which they have done repeatedly this year. Add to that scenario the Bank of England joining the European and Japanese central banks in boosting their monetary loosening measures and it's not hard to see how this form of financial methadone is helping stock and bond markets to serenely carry on.

Indeed, the weakening of the Chinese currency, which sparked last year's spike in volatility, is even weaker this year and seemingly troubling no one. This may well be because the Chinese authorities are resisting the temptation to tinker with currency markets and letting them float freely. But who is to say that they won't wake up tomorrow and decide enough is enough?

With one-off policy changes hard to predict, markets closely followed events at last weeks annual economic policy symposium in Jackson Hole, Wyoming. Attended by central bankers from around the world, we can expect to see some debate as to where monetary policy can possibly go from zero or negative interest rates. Following the recent decision to cut interest rates by 0.25%, The Governor of the Bank of England, Mark Carney, said "the future potential of this economy and its implications for jobs, real wages and wealth are not the gifts of monetary policymakers", suggesting that the monetary instruments of interest rates cuts and more QE have done their bit and any further heavy lifting may have to done by the government using the fiscal power of tax cuts to stimulate the economy.

A general agreement amongst central bankers on this point wouldn't mean an immediate reversal of QE. But just the suggestion, at a time when bond markets are trading at extreme highs (with bond yields at record lows), could provoke a negative reaction similar to the taper tantrum in 2013 when bonds sold off on the back of an easing of policy QE from the Federal Reserve.

It may all come to nothing. Jackson Hole summits are not exactly rock gigs at the best of times. But, mindful of stock market highs, bond yield lows and currencies like Sterling and Yen pushing technical limits, one doesn't need too many warning signs to believe that the current self-assured market malaise cannot last.

Some of these extreme moves are hard to justify in the light of the first of a series of positive economic data that fully capture the post Brexit vote. As we outlined in our previous note, we have not chased the short term speculation, having made the decision to preserve portfolio values prior to the referendum. Barely two months on, a reversal of some moves could present us with an opportunity to take profits on those investments that shot up in the immediate aftermath, some simply down to currency. Indeed we may yet find that a spike in volatility is actually no bad thing.