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Ch-ch-ch-ch-changes?

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"I watch the ripples change their size... But never leave the stream" - David Bowie, 'Changes'

So how was February for you? For many it would have been a bit of a shock with the global indices in aggregate posting their first monthly loss since the autumn of 2016, which is a long time ago. The real question however is whether this heralds a new downward trend, whether this is just a new volatility reality or whether we should view this as a buying opportunity?

Financial markets are only simple in hindsight and in times of flux and change even the most experienced participant can be blown around by lurid headlines and fluctuating prices on a screen. Cutting through it all, I believe there are three critical factors that will collectively answer the above question from a full year 2018 perspective.

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The first is our old friend the US Dollar. Exchange rates really matter for economies and financial markets because - as one wise economist once pointed out - a variation in the exchange rate is the one way to change all the effective prices in an economy immediately. The dollar - consistent with its overvalued status using purchasing power parity valuation techniques - has now racked up five successive quarterly falls; it has not gone unnoticed that this has helped balance the global economy a bit more and encouraged investors to look once again at both the European and emerging country financial markets. February however saw an increase in the Dollar and an underperformance of the European and emerging country markets.

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Some have linked the Dollar's recent rise to an increase in bond yields, with the influential 10 year US Treasury re-approaching the 3% level. Global fixed income also had a poor month in February, with one big index provider noting that - for the first time in three years - all of its regional sovereign bond indices displayed positive yield shifts during the month. Bond yields tend to go up because either economic growth or inflation hopes are pushing up, and both have been influential over the last few months. However the other reality, coming initially out of the United States, is that the formal reduction of the central bank balance sheets bloated by quantitative easing, is starting to either happen or at least be talked about. The waning influence of central banks as buyers of bonds is also a big influence in rising bond yields.

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Now this raises some interesting questions about relative equity-bond valuations around the world. Contrary to the longer term trend, investment markets in many countries, over recent years, have seen equity indices yielding more than even medium-term duration bond indices. This 'pick-up' yield has also been a support to global equity markets and clearly any changes in this relationship may cause volatility.

History suggests we are approaching an interesting juncture in this relationship and so an expectation of volatility, or - as we put it in our big quarterly briefings in December and January - 'less euphoria', seems reasonable. But some hope still lays with our third big influence: the scope for government policymaker led reform. Yes, making economies more dynamic is not always headline grabbing, but it is of increasing importance in a world where central banks will progressively do less of the heavy lifting. Within Europe this naturally focuses us on changes in the European Union and (more for the UK) the ongoing Brexit debate. There have been plenty of excitable headlines from both of these areas during February and they will continue throughout the year, but - as we saw the ascent of both the Euro and the Pound during 2017 - even some baby steps can have a positive influence in encouraging global investors.

So despite the cold early March weather across much of Europe, and the still volatile financial markets, we are not without hope. Keep watching the Dollar, bond yields and government policymaker reform efforts and know what you are investing in and why. Changes are afoot but that does not mean a big change is inevitable.

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