

Immediate Insight: current market volatility

05 August 2011



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Rising volatility in markets

Financial markets have become hugely volatile once more. The combination of the escalating sovereign debt crisis in Europe and indications of a more marked slowdown in global growth have led to some extreme market moves. Core government bond markets have seen yields fall sharply, with ten-year German bund yields now trading at 2.3%, down from 3% a month ago. US Treasury yields are also significantly lower and UK gilts have fallen to levels not seen since World War II. Safe-haven currencies, namely the Swiss franc and Japanese yen, have strengthened to levels that have prompted both central banks to intervene. Meanwhile, Spanish and Italian bond yields have moved above 6% and credit markets are under pressure. The crossover index is trading at over 500bps, some 100bps wider on the week. The physical corporate bond market is also seeing prices marked sharply lower, with moves being accentuated by thin holiday trading. Meanwhile, major equity markets are now down some 10% on the year, with falls of 3-5% yesterday, while bank shares have plummeted even more sharply.

The source of investor concerns

One of investors' concerns seems to be that any policy response is likely to be ineffective or inadequate. For example, it did not take long for markets to decide that the EU summit of 21 July had not done enough to protect Spain or Italy, hence the ongoing sell-off in those countries. Yesterday, the European Central Bank (ECB) came into the market to buy Irish and Portuguese bonds, but notably not Spanish or Italian debt, which only led to further spread widening there. It also made renewed commitments to provide unlimited funds to the banking system. One of the problems facing the Eurozone is that the new powers of the European Financial Stability Facility (EFSF) are unlikely to be ratified by all countries until later in September for purely logistical reasons. Thus the ECB is not yet in a position to issue 'euro-bonds' to strengthen its war chest and then to go into the market to buy peripheral market debt.

A second concern is that the markets doubt that a €440bn fund is going to be enough to support Spain and Italy. However, to get greater financial commitments from other eurozone members could put pressure on their own credit ratings. For the moment, therefore, the ECB remains the main support mechanism for the market. Unlike the Swiss National Bank, which has accompanied its intervention with the announcement of quantitative easing, the ECB has explicitly ruled this out. The other current concern is market liquidity, which is usually poor in August and even more so given current risk aversion. However, it is notable that liquidity is far better in UK and US credit markets than in Europe.

Insight's view

For the moment, we do not see any immediate resolution to the market's concerns. The US recently demonstrated its inability to act decisively in the way it handled the debt ceiling issue. The European authorities are struggling to come up with solutions that give lasting comfort and unilateral action by the Swiss and Japanese has had only limited effect.

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How Insight is positioned

We have been positioned defensively within our portfolios and funds for some time. We have not held any Portuguese, Irish or Greek government debt for a long time and we are underweight Spanish and Italian government debt where those countries are in benchmarks. Our corporate funds have also been very defensively positioned with regard to peripheral market corporate debt. Where guidelines allow, we have also actively positioned to be 'short' sovereign debt through credit default swaps (CDS) and have expressed defensive views on several corporate names. To improve liquidity, we have raised cash levels in our funds, as noted, are already defensively positioned. Indeed several of our more flexible funds have strategies in place that should be well placed to generate alpha within the current market environment.

The past few years have produced stressed market conditions on a number of occasions and Insight has consistently demonstrated the ability to deal with challenging conditions. We remain committed to managing client portfolios and funds prudently, while seeking to add value as opportunities arise.