

News or Noise: After Months of Calm, Markets Get Volatile

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After months of near-stagnant market action, volatility in risk assets was triggered on Friday by North Korea's nuclear test and fears of rising interest rates. The VIX spiked by 33%, and most major markets dropped about 2%. The most complex part of this movement was that in a risk-off trade, interest rates were actually moving higher—meaning typical flight-to-quality holdings like long treasuries actually sold off with stocks.

Last week's losses were attributed to the shifts occurring in interest rate markets and, specifically, fears that central banks are collectively backing away from providing new stimulus or, in the case of the U.S. Federal Reserve, looking to raise rates again in the near term. But this view doesn't square with the fact that short-term rates in the U.S. really haven't moved much, indicating that investors still don't think a September rate increase will occur and that even December is not a certainty. We touch more on the central bank talks below as well as last week's stories from North Korea and Saudi Arabia.

No. 1: North Korea Advances in Nuclear Race



News



Noise

In the media, most of the blame for Friday's sell-off centered on central bank talk and the potential for rising interest rates. However, we suspect that North Korea's nuclear test played a part. Of course, the nuclear testing is not a new story. North Korea has been firing missiles and expanding nuclear capabilities for years. Meanwhile, world leaders have done virtually nothing to try to inhibit these advances. President Obama announced the tests as "provocative and destabilizing" and a "grave threat" to the region. However, most believe that little will be done as a result. In recent weeks North Korea has fired missiles



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into Japanese territory and announced after Friday's nuclear test that it has perfected the capability of miniaturizing the warheads that would be delivered via missile.

At some point, North Korea will actually move the technology to such a level that it has to be taken seriously. We aren't experts enough to know if that is occurring now, but it is safe to say when it does happen, it will be newsworthy and will likely take the world by surprise.

No. 2: Is There a Shift from Monetary to Fiscal Stimulus?

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The market volatility that surprised investors on Friday was likely triggered by a breakout in interest rates. The 10-year U.S. Treasury had been range bound between 1.5% and 1.6% for nearly six weeks, never rising to more than 1.63%. With large moves higher on both Thursday and Friday, the rate moved from 1.53% to 1.67%. Maybe even more important, this is not just a U.S. issue. German bunds, which had been negative since the Brexit vote (hitting a low of -0.20%), moved back above zero. Japanese government bonds (JGBs), in similar fashion, have moved from -0.30% in July to 0% now. The basis seemed to be central bankers indicating the end of ever more extreme stimulus measures. Last week several Fed members seemed to indicate a true desire to see a return to the normalization process started last year. Moreover, European Central Bank President Mario Draghi refrained from announcing any changes to stimulus measures in Europe, though the measures in place arguably remain very significant.

Last week we wrote about the G-20 meeting and the apparent coordinated shift toward fiscal stimulus. The markets are acting as if the baton will be handed from monetary to fiscal stimulus. In a fiscal-stimulus world, interest rates are likely to rise as a demand boost occurs and inflation shifts slightly higher. But we doubt that central banks will ease up on the gas pedal anytime soon—which means both fiscal and monetary are likely to act together. This will work to increase gross domestic product (GDP) but without the rising interest rates (true, the lows may be in, but the pace of increases will be more subdued) of fiscal acting alone. This would also be the best possible outcome for risk markets.

Bottom line: Short-term interest rates haven't really moved much in recent weeks, indicating the move in longer-term rates is not really about a near-term move by central banks. The current move could just be like previous "taper tantrum" events that eventually runs its course and the "lower for longer" view re-emerges.

No. 3: Saudi Arabia Stress Builds with Low Oil Prices

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Saudi Arabia was in the headlines last week when it announced plans to cut more than \$20 billion of projects that were on tap. And the nation is likely to make more headlines, as an additional \$70 billion in projects are under review. The projects cover everything from housing to transportation to health care. Saudi Arabia has drawn down its foreign reserves by nearly \$200 billion since 2014 (from \$730 billion to \$550 billion). On top of this, the

country has been actively selling debt in global markets for the first time in more than a decade. The International Monetary Fund forecasts the country's GDP will expand by just 1.5% this year, the slowest pace since 2009 and much too slow to add jobs in a country with a rapidly growing workforce. Finally, the country is also planning to float an IPO of a minority stake in state oil company Aramco, which will likely become the largest publicly traded company in the world.

As oil markets have continued to try to find a new level of equilibrium, talks last week focused on Russia and Saudi Arabia scheduling a review of a potential oil production freeze at the upcoming OPEC meeting. Though the freeze talks have marginally helped oil prices recently, we find little evidence that either country can afford to slow production. The geopolitical team at BCA Research talks about desires and constraints when forecasting policy moves, with constraints being the most important factor. In this case, the tremendous need for cash by both Russia and Saudi Arabia (both get more than 70% of state revenue from energy production) is a constraint that shows neither country can afford to not produce at the highest possible rate. The market doesn't really believe a production freeze is likely; thus the faint hints of talks is not likely to be newsworthy, but it will continue to add to near-term volatility.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to reprocess stale information or reformat the day's useless headlines. Thus, in our investment blog, "News or Noise," we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important, and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.

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