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The US stock market is trembling, but Europe needn’t worry

According to Angelo Meda, of Banor Sim, the correction was expected and was amplified by automated trading. The value to watch now is the yield on 10-year US bonds: if it suddenly tops 3% the markets will continue to fall. But right now, no one can tell what will happen

by Fabrizio Patti

Wall Street on the day of high volatility in February
SPENCER PLATT / GETTY IMAGES NORTH AMERICA / AFP

It has been called the most long-awaited correction ever. The fall in stocks on Wall Street occurred suddenly on Friday 2 February, worsening dramatically in the afternoon (evening in Italy) of Monday 5th, when selling sky-rocketed and the market closed 4.6 per cent down. Tuesday 6th was a roller-coaster day that ended with Dow Jones closing at +2 per cent. These movements were initially caused by good news, the data on US wage growth, but then prospects of higher inflation and a rate hike by the Fed brought a collapse in stock prices, which was in turn amplified by

automated trading linked to the increased volatility. What will happen over the coming weeks? We asked Angelo Meda, Head of Equities and Portfolio Manager at Banor SIM.

What's your take on the sudden change of direction in the Dow Jones last Friday, and even more so on Monday, when losses were apparently amplified by automated volatility trading?

We're not worried, we were expecting the correction. We'd had 403 days without a drop of 5% in the market and 320 days without a 3% drop. In terms of time without a correction, this was the longest period ever. Last Friday, a 3% correction finally occurred. Then, when automated trading in, say, volatility ETFs began on Monday and there was a larger correction in the evening, Flash Crash (ed.: the large, unexpected drop of 6th May) numbers came in indicating a loss of fully 6 points, clearly for technical reasons.

Just technical?

For the time being there's no change in the macroeconomic scenario, companies are still performing well and the economy is growing. This is why we think there might be a further decrease, but we're not expecting a 10% correction. We believe it was the first step in a necessary correction, triggered by wage growth data for the US, followed by the episode involving volatility ETFs that gave us Monday's results. On Tuesday 6 February the reaction was positive, with the Dow Jones up 2%.

Do you agree that the positive wage data, followed by fears of inflation leading to a higher than expected rate hike in the US, were what caused the change in direction? Many commentators have blamed the increase in 10-year US Treasuries to 2.85%, from 2.4% at the end of 2017.

Yes, in theory a half point rate rise becomes 7-8% in terms of drop in the stock market, although these figures are not written in stone. For this year's 10-year Treasury an increase of half a percentage point could have been expected, causing markets to lose 7-8% during the year, but progressively. Instead, yields rose suddenly and the effects were immediate.

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> *Angelo Meda, Banor SIM*

According to your current assessment, what scenarios do you expect for the market over the coming weeks? Was it a quick, sharp shock or is it reasonable to expect a much deeper correction?

We're monitoring rates on 10-year US Treasuries, which are what caused the recent correction. If yields stay below 3% and inflation stays under

control, we expect things to settle and the market to recoup half of what it lost in the past few days. Instead, if interest rates again rise sharply, the scenario will change.

If the yields on US bonds do increase more than expected, what do you predict will happen to shares and bonds in the US?

Very simply, until recently there was no alternative to equities because bonds yielded so little that they were not worth investing in. With rates rising above 3%, the picture changes. Already, high-yield bonds are offering around 5% for 7-year maturities and are beginning to look interesting even to European investors, despite the exchange rate risk. There could be a sort of spill-over between bonds and equities. In the short term there might be a sizeable move away from bond funds. But not all of this would go into equities as some would stay in cash.

Shouldn't it be the other way round?

If rates rise, we will begin to see negative yields on the bond component because it means a fall in bond prices. If investors see that their fund has dropped, they can redeem their units, causing rates to rise even faster. This is partly because there's no longer any guaranteed purchaser as the Fed is coming to the end of its quantitative easing (QE). There are several very different scenarios for interest rates, all of them equally likely. No one anywhere can tell yet whether they will go to 2.7% or 3%: that's the number to watch over the coming weeks. 3% is also a psychological threshold. Above that, bonds would yield more than the S&P 500 dividend; we'd begin to see less of a drive towards the stock market. How fast is important, as well as inflation data. The scenarios change all the time.

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If there's a generalised drop in the stock markets in the US, would the effects spread to the European markets?

In Europe, there are countries in the centre and north, from Germany up, where the same would probably happen as in the US, potentially with a rate rise due to very low unemployment and a good economic situation. At the other end of the scale we have southern Europe, where inflation is low and unemployment high. For the time being, however, we don't think that what is happening in America will be replicated in Europe, i.e. a sudden rise in interest rates. Of course, at 0.7% the yield on Bunds is bound to rise, at least over the next two years. However, the fact that the European Central Bank (ECB) is still active on the market could slow any sudden rate jumps. So we're not too concerned about Europe. Obviously, the Italian elections might bring some surprises.

Coming to Italy, should the change of outlook on the US markets be a source of concern for Italy, especially if there's a post-electoral deadlock?

Paradoxically, the market would welcome a failure to form a government in Italy because the potential coalitions differ enormously and their programmes are not particularly market-friendly – some more, some less so. As we see it, the risk is that Europe will ask for a public finance adjustment, possibly in the spring. At that point, a weak government that is only there to conduct ordinary business wouldn't have the political power to impose certain adjustments. The only case in which we think the spread might increase is if Europe insists on a rapid adjustment of the public finances. Politically, I can't see any political party wanting to approve a recessionary measure with the prospect of soon have to go back to the polls. So the risk comes more from Europe, from a demand at the wrong moment. European politicians are not known for getting the timing of their demands right.