FINANCIAL TIMES

Investors fear summer market storms loom

By David Oakley

Complacency is a danger as months of thin trading could incite volatility

Another turbulent week in the markets has investors fearful of larger storms arriving this summer.

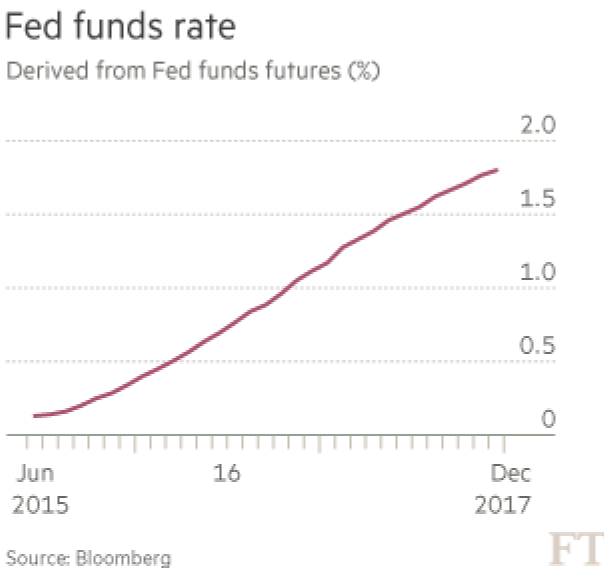
German government bonds sold off, equities whipsawed while foreign-exchange markets experienced large swings as investors scrambled to position themselves against a backdrop of uncertainty in Greece, worries over US rate policy and fears of Chinese credit bubble.

Increasingly, investors worry that this week's turbulence could well look like nothing more than a minor squall when compared with potential disruption over the summer, when low volumes often exaggerate volatility and can swiftly erode returns.

"Economic recoveries continue but there are three key risks facing investors,'' says Tim Haywood, GAM investment director, who highlights a Greek default, a too-rapid rise in bond yields and the start of the first US rate rise cycle in over a decade. ''All these could cause disruption," he warns.

Looking across the main markets for equities, bonds and foreign exchange, there appears no shortage of risks facing investors given lofty valuations for many asset classes, notably in the case of China's roaring stock markets.

Years of aggressive central bank support, led by the US Federal Reserve and presently coming from the Bank of Japan and the European Central Bank that have suppressed bond yields are pinpointed for having fuelled a great deal of complacency among investors.



"We are warning clients about the risks, particularly in bonds where there has been a lot of volatility, says John Roe, head of multi-asset funds at L&G Investment Management. "The summer months can be tricky as a lot of people are away on holiday and volumes are down."

Against that backdrop, many worry that surging equity valuations and worries of a bubble in China may well spark broader turmoil in the coming months.

Should the world's second-largest economy suffer a big correction, then the implications not just for the emerging markets but for the rest of the world are likely to be on a scale that could jeopardise recovery in a number of economies.

While Chinese stocks have doubled in value since the start of the year as the growth of credit has ballooned to close to 200 per cent of gross domestic product, signs of easy money distorting markets and investor behaviour are clearly seen elsewhere.

Global equity issuance has hit a record high of $424bn this year as a flood of initial public offerings and secondary issues buoy the markets, say Thomson Reuters.
A significant number of private equity groups are also cashing out, according to data from Prequin.

With US mergers and acquisition activity, funded by cheap borrowing, currently surging, the risks of a deep stock correction are rising, particularly as S&P 500 profit growth has been slowing.

For bonds, the risks are mainly focused on the outlook for US interest rate policy and at what pace the US central bank will raise overnight borrowing costs.

Although moving away from near zero per cent has been well telegraphed by the [US Federal Reserve](#) with an overwhelming consensus expecting policy to be tightened later this year, there is potential for volatility because of differing views between policy makers and investors over when the central bank will move.

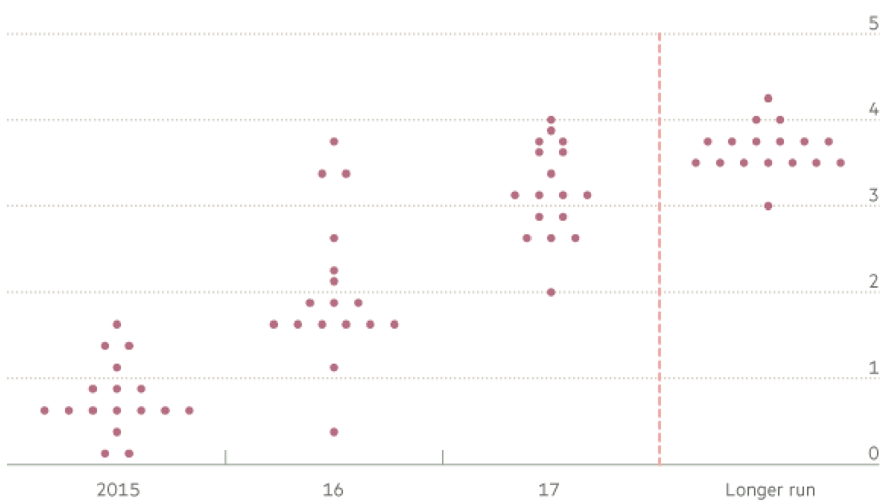
According to the Fed's dot plot charts, which set out expectations of policy makers on the rate-setting open market committee, rates will be at 0.5 per cent by the end of the year, having risen from the current zero to 0.25 per cent corridor.

In contrast, the market forecast through Fed fund futures expects rates will reach only 0.35 per cent by year end. This reflects the views of some investors that the central bank will widen the corridor from zero to 0.35 per cent rather than implement a full 0.25 per cent increase to 0.5 per cent.

John Stopford, co-head of multi-assets at Investec, says: "A decisive 0.25 percentage point increase in September could catch out some investors and cause a lot of volatility." A further concern for bond investors is Greece, with a default probably prompting a switch out of peripheral bond markets into havens such as gilts and US Treasuries.

Appropriate pace of policy firming

Midpoint of target range or target level for the federal funds rate (%)



Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run

Source: US Federal Reserve

FT

In the foreign-exchange markets, the emerging-market currencies look most vulnerable, particularly those in resource-rich countries.

But the euro could come under pressure too, say some investors, as policy divergence between the Fed and the ECB becomes more marked.

John Wraith, head of UK rates strategy at UBS, says: “If the US and UK start raising rates, then the dollar and sterling are likely to strengthen against the euro as rate rises in the single-currency zone remain a long way off.”

Although investors are not warning of another August like 1998, 2007, or the frantic moments ahead of the collapse of Lehman Brothers in September 2008, there are a number of clouds on the horizon that may spell trouble for markets over the summer.
“The adage that you should sell in May and not come back until St Ledger Day in September looks quite apt this year,’’ says Mr Stopford. ‘’However, once we have got through the summer, we are quite confident that markets can rally and economies can recover.”