More black swans in store for financial markets?

Last year was characterised by highly unexpected events, from the heavily publicised Brexit vote and Donald Trump's stunning victory in the US presidential election to South Korean President Park Geun-hye's dramatic removal from office.

Certainly, black swans were swimming wildly for almost all of 2016, so much so that investors accepted, and indeed expected, the unexpected. Those of us in the financial markets, especially, learnt some hard lessons and should be better prepared this year. Nothing can faze us now, or so we think.

But history has shown that financial market players never really become accustomed to surprises. In other words, surprises always tend to surprise even the most hardened individual who thinks he will not be surprised anymore.

This is a hard fact to swallow but financial market players have weak memories of the past, which is why financial market bubbles and crashes happen over and over again. Greed and fear — two of man's most primal instincts — are permanent fixtures in history and will remain so for as long as the human race exists.

Let's take the case of the so-called "Taper Tantrum" in May 2013. Prior to former US Federal Reserve chairman Ben Bernanke's rhetoric that sparked widespread panic in the global bond market, investors were already guided, and to some extent prepared, to accept the news of an end of the monetary easing programme. At the time, many accepted the fact that risk-adjusted returns were not on the bond market's side. Rates would eventually go up and everyone would be fleeing the bond market.

However, the bullish mood in the bond market did not fade. In fact, yields continued to be pressured downwards. In the US, the 10-year treasury notes continued to draw investors and until April 2013, yields barely touched 2%. Also in that momentous month, the 10-year Malaysian government securities (MGS) yield slipped below 3.4%. In other countries, yields fell to cyclical lows even though many felt that it was just a matter of time before the bond market imploded.

So, although many had known that it was a matter of time before the Fed signalled an end to monetary easing, Bernanke's mild statement of "The committee currently anticipates that it would be appropriate to moderate the monthly pace of (bond) purchases later this year" at the federal open market committee meeting that month still sparked panic and sell-offs in the global bond market.

Things unsurprisingly became rocky after that, with long-term US treasury yields leaping more than 110 basis points to 2.74% by early July 2013, from merely 1.63% at the beginning of May. Bernanke's words also spooked those in the emerging markets. The three-year MGS yield closed about 80bps higher in July from mid-May while the longer term 10-year MGS yield skyrocketed — by more than 105bps — in the same period to close above 4.1% for the first time since January 2011.

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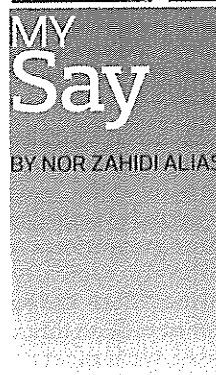

Naturally, the ringgit reacted to the amount of capital that flowed out of Malaysia. About RM28 billion worth of bonds were sold by nervous foreign investors between May and August, leading to a 3% reduction in their holdings of total Malaysian bonds to 21% of the total outstanding. Similarly, the ringgit weakened, although not excessively, by 6% to nearly 3.30 against the US dollar from 3.09.

That is not the only knee-jerk reaction we have observed in the financial markets in recent times. Events in 2005 and 2008 also suggested that the financial markets were not ready for them, although signs of market corrections were already there.

In both periods, bond yields spiked and foreigners slashed their holdings of total outstanding Malaysian bonds by half to two-thirds, causing the ringgit to weaken by up to 13%. The capital outflows of 2005 were partly attributed to the increasing gap between Malaysian and US interest rates as the Fed (then under chairman Alan Greenspan) continued its "measured pace" hikes that began in the summer of 2004.

Again, the rate-hike eventuality was somewhat expected by the financial markets as the Fed had flashed clear signs of its intention to do so. However, about RM22 billion in foreign holdings of Malaysian bonds were sold off within five months, leading to a decline in foreign holdings to 5% of the total outstanding from 10% at the peak of the cycle. In 2008, during the global financial crisis, foreign investors slashed their holdings of Malaysian paper by RM84 billion to 7% of the total outstanding (from 21% at the peak of the cycle). The ringgit, accordingly, depreciated 13% in 11 months.

And finally, during the recent rout sparked by Trump's rhetoric on raising US government spending and the attendant effects of this proclamation on inflation, global bond markets slumped, pushing yields up significantly at end-November 2016. The benchmark 10-year US treasury yield jumped almost 90bps at one time before moderating while the 10-year MGS yield climbed more than 80bps in November from September.

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About RM26 billion worth of capital exited Malaysia in that period. The ringgit slipped more than 6% against the greenback in November alone. Although Trump's victory was highly unexpected, the scenario of higher yields had been circulating in the financial markets in the preceding months following the Fed's favourable assessment of the US economy. Therefore, the increase in yields was not totally unexpected. Yet, it surprised the financial markets!

If surprises keep surprising the financial markets as they have done in the past, the chances are that we will see them continuing to cause multiple knee-jerk reactions this year. Global uncertainties have not dissipated; on the contrary, they have grown.

Although the growth momentum of the world's largest economy looks more positive now, the roller-coaster ride in the global bond and currency markets will not stop anytime soon, especially when the new US president regularly tweets his controversial opinions to the public.

What is certain is that some markets and economies will get hit more than others. The consolation for us in the Malaysian markets, however, is that with an increasing number of long-term investors holding Malaysian government paper (for example central banks and pension funds), the volatility in capital flows would be less severe than before.

Still, tempering that little bit of optimism with some caution will not go amiss.

Nor Zahidi Alias is chief economist at Malaysian Rating Corp Bhd. The views expressed here are his own.