Financial Markets / Central Banks

From risk appetite to caution

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It is still too early to take stock of the year but, with a little more than a month to go until it ends, everything indicates that 2018 will have been the year in which the financial markets ran head on into reality. In 2017 a very positive tone dominated the markets, due to a combination of factors that shaped a very favourable global environment: global growth remained robust and financing conditions were still very accommodative. This context provided a sense of security − underpinned by an environment of liquidity as abundant as it was unusual − that encouraged investors to explore investment alternatives in order to achieve that extra return that was no longer being offered by the safer assets. As a result, risk appetite intensified, materialising in a massive flow of capital to funds that invested mostly in equities and emerging markets.

There is an underlying swell that shows the environment in 2018 is rather less benevolent. Firstly, the central banks of Europe and the United States have remained steadfast in their normalisation process. In Europe, the ECB is going to stop injecting liquidity into the system and will be ending its asset purchase programme after four years. In the US, the Federal Reserve is going to raise interest rates by another 25 basis points in December, bringing the figure to 100 basis points for the year as a whole. This, together with a stronger dollar, has led to a significant tightening of global financial conditions. Secondly, the global economic cycle is already giving us the first signs of deceleration, clearer in China and in Europe, while in the US they could become more evident next year. And, finally, there are the latent risk factors that are looming over the global scenario. These include the trade tensions between the US and China and the uncertainty in Europe associated with Italy and Brexit, elements that do not seem likely to dissipate any time soon and that will surely take their toll on growth.

The recomposition of portfolio flows and recent movements in the prices of financial assets tend to support this view. Cash flows are registering moderate outflows after a year in 2017 that was marked by massive inflows of capital. In recent months some markets have already been experiencing turbulence. First in the emerging markets, which have been stymied by the rise in global interest rates and the appreciation of the US dollar. Although, on this occasion, they have shown themselves to be more resistant since investors have clearly been differentiating between them, penalising the most vulnerable. More recently, developed markets have also suffered sharp falls in their stock indices, although in perspective, it seems an adjustment to valuations which are more consistent with higher interest rates and a heightened perception of global risk.

In short, markets are moving from optimism − in some cases even complacency − towards caution, thus aligning themselves with a more uncertain economic environment.

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