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News & Views

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MARKET TURMOIL TRIGGERS GLOBAL CONTAGION CONCERNS

By Esther Armstrong, BNY Mellon Investment Management

- Equities the "end of a whip" that is moving drastically – *The Boston Company Asset Management*[1]
- Lack of transparency on Chinese data increasing risk aversion – *Mellon Capital Management*[2]
- Policy response from central banks will be crucial – *Standish Mellon Asset Management*[3]
- Parts of US economy look pretty late-cycle; significant push back of rate hike expectations in US slated

Bond market liquidity, the Fed interest rate decision and US growth are all under intense scrutiny, say cross-boutique experts at BNY Mellon.

Market volatility over the past few weeks has stemmed from authorities getting to grips with the reality of lower growth rates in both developed and emerging economies going forward, according to experts from boutiques at BNY Mellon.

Bart Grenier, chairman, chief executive officer and chief investment officer of The Boston Company Asset Management, says: "If you believe stocks follow earnings you need economic growth to be a tailwind to drive market performance.

"Currently many people are focused on China but I've never really had issues with factors that are widely known in the marketplace. I worry much more about factors that are not the current focus or are unknown. One area to be mindful of is countries either explicitly or implicitly pegged to the US dollar, as we would expect the dollar's strength to continue in this environment and these countries may also face competitive pressures to devalue."

Will the contagion continue?

Sinead Colton, head of investment strategy at Mellon Capital Management, says the commodity markets over the past year have signposted some slowing in China, as well as oversupply in some individual commodities and her team has seen better opportunities in developed markets for this reason. "Core eurozone countries and Japan have held up well and earnings expectations are still pretty robust. That is different to many other markets so it is more important than ever to be selective."

Concerns over contagion are front and center at the moment as market participants observe the correction which started in China and knocked onto other markets heading into the final days of summer.

Colton continues: "There is a worry that if growth in China is reduced it will impact other economies that may have been weakening already, or are experiencing less robust recoveries. Exports to China vary significantly within developed markets so you cannot use a broad brush. An additional complication with China is that many market participants have some concerns about the reliability of economic data. This means when markets price

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[1] BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) is the distributor of the capabilities of its investment managers in Europe, Middle East, Africa and Latin America. Investment managers are appointed by BNYMIM EMEA or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNYMIM EMEA or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNYMIM EMEA and its clients or by the Prospectus and associated documents related to the funds.

[2] Ibid

[3] Ibid

risk they will take that uncertainty into account and perhaps react more strongly than if another economy was slowing."

Potential policy response

David Leduc, chief executive officer and chief investment officer at Standish Mellon Asset Management, says over the short term he will be looking out for policy responses from central banks, with the People's Bank of China the most obvious candidate.

Additionally the Federal Reserve could delay any move towards monetary policy normalisation. "In the last minutes from the Federal Open Market Committee members were split and there was reference to the external environment and commodity markets. Since those minutes came out, the external environment has only got more challenging, so it's probable the first rate hike could be delayed."

Meanwhile, Steve Kolano, head of multi-asset solutions with the Investment Strategy & Solutions Group, says recent market movements can be rationalised by putting them in the wider economic context. His main concern is whether the correction could turn into a rout: "We'd be asking 'What are we missing?' There's no doubt at the moment that people are pricing in a lower level of growth but if contagion continues we would be looking for what else is at play. Brazil is one significant factor that we feel has been kept to the margins so far. There's been political turmoil, a lot of US dollar-denominated and local debt issuance and commodity-related weakness in the economy. Yet this has been talked about relatively little and could come to the surface."

The liquidity premium

Liquidity is another factor in the mix and managers from across BNY Mellon Investment management note August is typically a "terrible month" for liquidity because the volume of trade is reduced significantly during vacation season.

Leduc says: "This year August's low volume constraint on bond market liquidity has been exacerbated by structural changes happening in the market. However, the behaviour of stock markets in recent days has shown this is not just a bond market liquidity issue.

"The question you have to ask is whether what's going on in China is going to lead to a significant slowdown in Asia and impact the outlook for the rest of the global economy; and secondly whether it will have a material impact on your view of the US. At the moment we'd say 'maybe and not likely' in response to those to factors. If the Federal Reserve does hold back on a rate hike, this will be largely positive for risk assets, we believe."

Grenier views the equities markets as the "end of a whip" that is "moving around pretty drastically" at the moment.

He concludes: "Three elements have come together to create the current situation: 1) commodity markets led by oil and the weakness that has created in many economies, 2) China's slowdown; and 3) a persistent strengthening of the U.S. dollar after decades of weakness, which has implications on all the countries and corporations issuing debt in US dollars."