



The Sum of All Fears

MARKET COMMENTARY

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For investors, 2016 has thus far been anything but a happy new year. January is on pace to rank as the worst month for equity markets since February 2009. This month's sell-off is the result of a variety of factors, none of which alone may seem sufficient to justify a market correction. Added together, though, they raise concerns about the strength of the global economy and the likelihood of recession.

Our portfolio managers are closely watching these and other factors to determine whether the current correction represents merely a short burst of overly-negative sentiment or the start of a more significant downturn. Certainly, evidence exists to support either view. For his part, Newton portfolio manager **Nick Clay** notes that “In U.S. dollar terms, which most companies and countries trade in, global GDP growth has contracted for the past two quarters, so the world is technically in recession.”

The Boston Company portfolio manager **David Daglio**, on the other hand, sees the U.S. economy as being in a sustained recovery capable of generating 2% to 3% real growth in 2017. “We believe corporate profits will be helped by the decline in energy costs and will help drive the broad equity indexes to new highs in time,” he says. “My view for the broader market is constructive over the next 12 months. We are still at a point in the business cycle where there is not a lot of exuberance and valuations are OK.”

The current turmoil began in 2016's first week when China's government employed various technical interventions including “circuit breakers” to keep its equity market from falling more than 7%. That sell-off was prompted by an unexpectedly large depreciation of the yuan's central parity rate currency policy earlier that same day. The awkwardness of moves by Chinese policymakers in that first week of trading strained investors' already-weak confidence that Beijing had a firm grip on China's economy and markets, just as last summer's surprise currency devaluation had done earlier.

“While China may have started the January jitters, it's hard to blame it for the January 20 sell off,” says **Simon Cox**, Asia-Pacific investment strategist with BNY Mellon Investment Management. “China's economic growth figures were released on January 19 and weren't great. Deflationary pressure intensified and infrastructure investment weakened last month, but China's 6.9% growth rate was initially welcomed by the markets, perhaps because China doomsayers had imagined something worse.”

Cox notes that China's government has made it harder in recent days to bet against the offshore yuan in Hong Kong. “Ironically, that seems to have encouraged investors to bet against Hong Kong's own currency instead. The Hong

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Kong Dollar has moved towards the weak end of its HK\$7.75-HK\$7.85 trading band against the dollar. The Hong Kong Monetary Authority has the financial wherewithal and the political will to defend its longstanding peg.” “Its foreign-exchange reserves were 1.7x its monetary base at the end of November. Although the odds of a devaluation are small, speculators would profit handsomely if it happened. That kind of low-probability, high-payoff bet may look attractive in such a bleak investment environment.”

In 2009, China helped stimulate the economic recovery through a large-scale asset purchasing program, but that’s not a policy response that investors can count on this time. As Newton portfolio manager **Iain Stewart** notes, “Whatever level of growth they have started from, they set about the biggest expansion of debt and credit after the global financial crisis that the world has ever seen. I’m not sure what it would look like if they hadn’t done that but the concern in the marketplace now is about how the debt problem is going to evolve.”

Oil prices have dropped from more than \$100 per barrel in June of 2014 to less than \$30 per barrel today. While that seems like a boon for consumers and many industries, it has also contributed to market volatility this month. “Insofar as it’s possible to identify a trigger for the troubles,” says Cox, “it may have been the International Energy Agency’s warning that the oil market might ‘drown in oversupply’. The oil price seems to have supplanted the Vix as a ‘fear gauge’ for the global economy. When it drops, risk assets follow.”

The Boston Company portfolio manager **Robin Wehbé** doesn’t see oil prices heading up soon. “Oil is still in trouble,” he says. “Iran sanctions are coming to an end and the rest of the Middle East is pumping flat out. The recovery of demand appears to be stalling a bit with global uncertainty.”

Why Now?

China’s government has been acting to restructure the economy and the country has shown many signs of slowing growth for the past several years. Similarly, oil prices have been falling since 2014. So why has investor sentiment turned negative and markets volatile now? One reason, in our opinion, is that data continues to accumulate suggesting that growth in even the most apparently healthy regions of the world is on a weaker footing than had been widely believed. “Any economic number below expectations is being closely scrutinized given fears among U.S. investors of an intensifying global slowdown,” says Stephen Kolano, head of multi-asset solutions with the Investment Strategy and Solutions Group.

Stewart observes that some of those numbers, such as a U.S. unemployment rate that has remained at 5% since October¹, raise concerns. “The U.S. is quite markedly showing an increase in employment,” he says. “The times when job opportunities and employment levels have risen over the several years and are high have generally been close to the end of the cycle previously. So the idea that this is indicative of the start of a cycle is a bit odd.”

Stewart sees other worrisome signs from the U.S., “A manufacturing and industrial recession is already in place, profits and cash flows are already down. The manufacturing and services ISMs tend to be very closely aligned and there has never been a divergence like this one. It is not as robust a recovery as they would like us to think it is. The Federal Reserve has created and sent signals to the economy to invest and given low hurdle rates to access that money and the result is all sorts of capacity in areas it is not necessarily needed.”

A 2.5% drop in U.S. housing starts in December and weaker corporate earnings are other numbers that may be spooking markets. “Earnings season is now in full swing and this will be a main focus,” says Kolano. “Major action in the U.S. is reflective of the market’s confidence in earnings expectations for 2016, or lack thereof,” he adds.

Developments in another developed market, Japan, are also playing a role in prolonging the current volatility. The Nikkei 225 index has fallen roughly 18% from its 52-week high, set in June 2015². Kolano says that the sell-off in Japan that started the most recent bout of volatility reflected a combination of Japan’s exposure to a slowing China plus a strengthening yen. “Investors view Japan’s currency as a defensive one and anytime the yen strengthens, Japan trades lower,” he notes.

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What’s Next?

The last time the S&P 500 fared this badly was in February 2009³, not long before it reached its post-financial crisis bottom and began a protracted rally as the global economy began to recover. This time, we believe the likelihood of a global recession remains low, but markets may remain rocky.

Newton Capital Management global strategist **Peter Hensman** observes, “We have warned about the likelihood of such episodes of volatility and market weakness for some time, and to us very little has changed as we move into 2016.”

Wehbé says, “It looks dicey out there with Asia still in panic mode as liquidity has drained from China. This means less liquidity, which is bad for risk assets, especially commodities.” He suggests that investors remain defensive but layer in cyclical exposure extremely gradually. Overall he believes the odds of a recession have increased but he still isn’t expecting one.

With respect to fixed income **Sarah Percy-Dove**, head of credit strategy, Asian Fixed Income, Standish remains “quite constructive on China, even though we currently expect below consensus economic performance in 2016, based on valuations. “The stock market gyrations don’t really impact the Asian USD bond market directly,” she says. “It’s quite a small part of the Chinese economy and is (currently) heavily impacted by government decrees. The ripple effect into the broader economy is not direct and not of huge import. It does get a lot of air play offshore though and gives global markets a good reason to “act up” when it suits.

Stewart also expects more turbulence, but says investors may still find opportunities. “We firmly believe that in a future environment with greater volatility, lower returns and lower yields, a focus on companies with solid and repeatable cash flows, sensible capital allocation and robust balance sheets which pay sustainable dividends remains an attractive and conservative way to generate stable returns,” he says.

¹Source: U.S. Bureau of Labor Statistics, January 20, 2016.

²Source: Bloomberg Business, Stocks, January 18, 2016.

³Source: Bloomberg Business, January 20, 2016.



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