What Does August Augur?

As it did in 2000 and 2008, this August has brought an abrupt surge in market volatility. Sharp swings in major equity markets are reminding some investors of the volatile times that preceded September market plunges in 2000 and 2008. The sources of the current market turmoil are familiar and widely agreed upon: worries about slowing Chinese growth and economic policy after a surprise currency devaluation, falling commodity prices led by oil, and the disruptive effects of a stronger U.S. dollar. The question is whether current volatility foreshadows a repeat of past events—or if equities will instead rebound as they did in 2011 after the eurozone debt crisis first rattled markets.

To consider what may lie ahead, we asked leaders from BNY Mellon's investment affiliates what factors they're watching now, both for potential opportunities and for signs that markets are headed for further turbulence.

Sinead Colton, Head of Investment Strategy at Mellon Capital Management, is focused on China and whether its central bank will provide additional support for markets. "We're looking at knock-on effects from what happens in China, especially the potential impact on developed markets. We're also being cautious about emerging markets due to Federal Reserve tightening. Add in slower growth in China and the outlook for EMs could turn bleak," she says.

Simon Cox, Asia-Pacific Investment Strategist with BNY Mellon Investment Management, is also focused on China and says investors should keep a careful eye on the government's various fiscal efforts. "Public spending has been unusually inhibited in recent quarters, thanks in part to President Xi Jinping's crackdown on corruption and Beijing's clean-up of local-government finances. China is undershooting its fiscal deficit target for the year, allowing government deposits to pile up in the banking system," he says. "That gives it room now for further stimulus efforts such as tax cuts, higher social spending or public investment in affordable housing and pollution abatement. That should allow China to restore its growth rate in future quarters, without slavishly replicating the growth patterns of past years."

David Leduc, Chief Executive Officer and Chief Investment Officer at Standish Mellon Asset Management, is watching for liquidity shortages that could drive further sell-offs. "August is traditionally a poor month for liquidity because many people are on vacation, but now it's exacerbated by structural reductions in market liquidity driven by regulatory changes. On top of that, the Chinese devaluation took a lot of people by surprise. We believe China's government still has enough policy flexibility to stop the rout in the markets. Still, we're watching closely to see whether there are signs of a further slowdown in China that could spread across Asia and affect the overall global outlook. Our view is that we don't expect a change in outlook for China that would affect our expectations for U.S. and global growth, though it could impact the timing of a Fed rate hike. We're also closely watching flows, because any sign of significant outflows could create additional volatility."

Bart Grenier, Chairman, Chief Executive Officer and Chief Investment Officer of The Boston Company Asset Management, is more concerned about the potential unknowns facing markets than about familiar concerns such as the slowdown in China. "Currently many people are focused on China, but I've never really had issues with factors that are widely known in the marketplace such as China. I worry much more about factors that are not the current focus or are unknown. One area to be mindful of are countries either explicitly or implicitly pegged to the U.S. dollar as we would expect the dollar's strength to continue in this environment, and these countries may also face competitive pressures to devalue," he says.

Nick Clay, Global Equities Manager at Newton, says the slowdown in China as it attempts to rebalance its economy has always been a process that the team felt would generate many challenges, not just for China but for all that have relied upon it for the last decade. The moves in China with regards to devaluing its currency have in his opinion further increased the disinflationary backdrop, which will only be increased by further currency responses from other nations. Against this backdrop, Clay says:, "We continue to believe the U.S. interest rate cycle is not normalizing, and that therefore bond yields will remain low for longer and the entire curve flat."

Mr. Clay notes that while the moves in the past week have been, in their view, long overdue, they see scope for further downside in equities, as their overvaluation becomes apparent to market participants and earnings expectations get ratcheted down. "Additionally, lack of liquidity, inbuilt leverage and forced sellers could become self-reinforcing. As we know, authorities have time and again pulled 'rabbits out of hats,' though the trick has become long in the tooth."

Steve Kolano, Head of Multi-Asset Solutions with the BNY Investment Strategy & Solutions Group, is looking for signs of contagion in whether or not credit spreads begin to widen as liquidity is withdrawn from markets. "September will tell us a lot as that's when the new credit issuances take place. If the issuers find they're having trouble placing new debt, we'd see that as a sign that the current credit cycle is coming to an end. So far, though, we've not seen any signs of liquidity being withdrawn." Kolano is also looking at the nature of U.S. central bank policy response for indications about where markets may move. "If the Fed looks to curb liquidity, then I'm concerned," he says.

Jack Malvey, Chief Global Markets Strategist with BNY Mellon Investment Management's Center for Global Investment and Market Intelligence, says "intermittent general asset price corrections commonly occur. Over the short run in 2015, financial markets likely will stabilize upon further digestion of a world with slower Chinese economic growth, abundant energy resources, and eventual normalization of monetary policy. Typically in immediate response to a correction, most investors are best served by a steady-state approach to asset allocation and security selection. Corrections and accompanying market volatility escalations convey medium- and longer-term signals about the longevity of business cycles. Indeed, the frequency and intensity of corrections usually climb as business cycles enter middle and old age. So if this current correction of August 2015 was followed by several additional market stumbles over 2016 and 2017, then the heightened prospect of an economic downturn would warrant the consideration of more defensive portfolio strategies."

Nobody can predict market moves with certainty, and history generally doesn't repeat itself in any sort of reliable short-term pattern.

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When there is little or no active trading market for specific types of securities, it can become more difficult to sell the securities in a timely manner at or near their perceived value. In such a market, the value of such securities may fall dramatically.

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Emerging markets tend to be more volatile than the markets of more mature economies, and generally have less diverse and less mature economic structures and less stable political systems than those of developed countries.

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