Too Much, Too Fast

Even the most resilient markets can crumble under pressure, as we have seen from the volatile start of 2016. Markets have been buffeted by instability and further government intervention in China, plummeting oil prices, geopolitical jitters and concerns that the global economy will grow even more slowly than forecast, with very little bounce in global inflation.

Unforced policy errors?

As 2016 got underway, China introduced, and then suspended, circuit breakers that were designed to limit intraday stock market volatility. Each major slide in Chinese share prices during the year’s opening week was led by a drop in the Chinese yuan. Many investors appear concerned that China is joining the so-called currency wars — devaluing its currency in order to spur export competitiveness. Others, however, counter that the Chinese currency remains quite strong on a trade-weighted basis. China recently announced a shift in policy that will target a basket of currencies, rather than the bilateral exchange rate against the US dollar. One thing is clear, however: Weakness in the yuan prompts greater capital outflows from China, which in turn prompt greater currency weakness, resulting in a classic negative feedback loop. What is also clear is that market participants have lost a great deal of faith in the ability of Chinese authorities to manage an increasingly complex economic and market landscape.

Fears of policy mistakes extend beyond China. Many question the decision by the US Federal Reserve to tighten monetary policy — despite the fact that financial conditions had already tightened considerably in advance of the December rate hike. Conditions began to tighten in the wake of the Fed ending its asset purchases in late 2014, and have tightened further on the heels of a strong US dollar. US growth appeared to slow significantly in the fourth quarter of 2015 and inflation remained extremely low, so the need for a rate hike was not obvious. Notably, the VIX index, which measures implied volatility on the S&P 500 Index, began spiking within days of the rate hike. And since the Fed cited global economic and financial developments as a rationale for delaying a hike that many expected last September, there is speculation that it could do so again in 2016.

Since the Fed hiked policy rates in mid-December, long-term rates have actually fallen, illustrating that there are still serious concerns about the economic backdrop. The recent market turmoil has prompted financial markets to trim expectations for the number of Fed rate hikes this year. Given the jump in market volatility and the erosion in the geopolitical backdrop, a further hike at the March Federal Open Market Committee (FOMC) meeting is now seen as far less likely than it was just three weeks ago.

Geopolitical concerns have also begun to weigh on global markets. In early January, North Korea appeared to have tested a nuclear device — an indication that it remains unfazed by China’s efforts to restrain its nuclear ambitions. Geopolitical tensions are mounting too in the Middle East, as Saudi Arabia and Iran intensify their cold war.
Crude crumbles
Decelerating growth in China has likewise been a major catalyst for the price slide in oil and other raw materials. Within the developed markets, exporters of commodities, like Canada and Australia, have been hard-hit by the downturn in Chinese growth. China’s slump has also cast a shadow over the emerging markets’ (EM) growth story. Reduced Chinese demand has compounded EM countries’ structural issues by adding cyclical challenges like low commodity prices and slowing global trade. EM exporters of commodities have been hard-hit, and to make matters worse, political risks are rising in a number of large emerging markets, particularly Brazil, Russia and Turkey. Moreover, those commodity-sensitive developed economies have seen a significant hit to the terms of trade, which has resulted in weakening currencies and falling interest rates.

The oil market has also had to contend with a surge in supply from the United States, a price war initiated by Saudi Arabia as it jockeys for market share, and the expected reentrance of Iran into the global market as sanctions are lifted under the recent nuclear deal. At the same time, forecasters continue to take down their expectations on the demand side, highlighting the growing supply/demand imbalance.

A decade-long capital expenditures boom in the commodities and infrastructure sectors has been derailed by the Chinese slowdown. The effects are obvious in sectors like metals and mining but extend far beyond. Persistently low energy prices may even have a negative impact — though most likely temporary — on growth in the US, which, despite the shale oil boom, is still a significant oil importer and has traditionally gotten a boost from low energy prices.

Where do we go from here?
Ripple effects from China have heavily impacted emerging markets. Demand from China has waned at a time when debt levels in EM have been building, and in some places building rapidly. Higher rates from the Fed and wider risk premia make servicing that debt more difficult. Political risks continue to percolate in Europe, where coalition building has proven elusive after recent national elections in Spain and Portugal, the cash-constrained Greek government hangs on with only a tiny majority, the risk of Brexit increases and the refugee crisis divides policymakers.

So what are the takeaways for investors? While our investment process is not based on a specific macro outlook, we do focus on individual companies and consider to what extent growth expectation has been reflected in the share price. As always, we continue to assess the long-term strategy and positioning of businesses, working closely with our equity, credit and quantitative analysts to discern changes in underlying trends. We try to identify winners, with a base assumption that economic conditions will likely remain difficult.

US multinational companies continue to face some earnings headwinds due to a strong US dollar and a below-trend economic recovery — although many of them continue to deliver positive underlying organic growth. We have also seen margins begin to peak across sectors, and top-line growth has been very company-specific. Examining recent earnings results, we see significant discrepancies in performance between companies that are able to deliver growth and those that cannot. In other words active stockpicking matters.

Europe may see a continued recovery, although the strength of the recovery will be extremely moderate, and some European stocks have already priced in these expectations. Looking further out, we believe global multinationals based in Europe, currently hurt by their exposure to emerging markets, will continue to provide good long-term value.
In Japan, while overall valuations appear low on a relative basis, we are very selective in identifying compelling opportunities. While there are some world-class niche businesses in Japan, and the focus on shareholders is marginally improving, fundamentals remain challenged because of weaker demand from overseas, particularly from China, and pro-growth reforms to bolster the Japanese economy are proceeding slowly.

Within resource-heavy Canada, valuations don’t appear washed out as earnings and profit expectations have declined, but we are finding attractive investment ideas amid the broad market pullback. This is especially true in certain materials and financial services companies, the latter where we have for some time favored the more US-exposed banks. We are also now finding certain regulated energy company valuations with good balance sheets moderately more interesting relative to their growth prospects.

In emerging markets, we tend to favor consumption areas rather than infrastructure or commodity-based industries or state-owned enterprises. Broadly speaking, we also continue to be underweight sectors such as energy, commodities and basic materials.

Although concerns in the bond markets remain, high-quality sovereign bonds have performed well recently despite a drawdown in China’s foreign exchange reserves as the authorities attempt to slow the slide in the yuan. High-grade bonds, which are still viewed as safe haven assets, will likely continue to benefit from any flight from risk assets.

We do expect to see more market volatility, which actually started to make a comeback last summer. Accordingly, this is a good time for investors to reexamine the risk profile of their holdings — particularly in those asset classes where the valuations are rich and the upside is limited. Whether or not we’ve reached the end of this cycle still remains to be seen. With so many forces stirring the pot at present, we expect market conditions to remain somewhat challenging in the near term. It is important, therefore, to have a longer-term view and an anchored process to guide investment decision making.

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