Market Update

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Analysis of the Recent Market Sell-Off

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On Monday, 24 August, investor concern about weakness in global equity markets reached a more fevered pitch. Entering Monday's trading, global markets were unnerved by the 8.5% decline in the Shanghai Composite Index, its worst day since February 2007. The selling was severe across Europe and into the US trading day, with the S&P 500 Index falling more than 100 points intraday from Friday's close. In Tuesday's session, the Shanghai Composite fell an additional 7.6% to close at its lowest level since December 2014. After the market close on Tuesday, the People's Bank of China (PBoC) announced a 25 basis point (bps) reduction in the one-year lending and deposit rates and also reduced the reserve requirement ratio (RRR) for banks by 50 bps. These moves had been expected over the weekend and when they failed to materialize, investors interpreted the Chinese authorities' lack of action as a signal of unwillingness to support equity prices.

What Caused the Market Sell-Off?

We ascribe the recent weakness as being driven by five interrelated factors:

- **Concern over developed markets valuations, which are moderately above historical levels.** Many investors have been worried that markets have largely ignored macroeconomic and geopolitical concerns and focused more on monetary policy in recent quarters.
- **Fear of the upcoming moves by the US Federal Reserve to normalize monetary policy.** Given the importance of US monetary policy to the market's resilience, the end of US quantitative easing (QE) in the fourth quarter of 2014 and the looming beginning of a rate hike cycle has undermined investor confidence. The impending change in direction for the Fed has added to stress in emerging markets, where many investors fear a "Taper Tantrum 2.0" reminiscent of that in mid-2013.
- **Increasing evidence of a more severe economic slowdown in China than many had expected.** We have held the view for well over a year that China's growth will decelerate more rapidly than implied by consensus expectations. The market now appears to be arriving at a similar conclusion with fears being exacerbated by the lack of confidence in official Chinese economic statistics. The recent decision to devalue the Chinese renminbi and the inability of the central government to manage equity market volatility have further elevated fears that the economic trajectory in China is increasingly negative.
- **New lows in commodity prices** in part driven by fears over slower Chinese growth have increased the stress on many emerging economies that rely on commodity exports to fuel their growth.
- **The renminbi devaluation added to the commodity-related pressure in emerging markets economies** by making it more likely that these countries might feel compelled to devalue their own currencies to remain competitive.

What Lies Ahead?

While we do believe meaningfully slower growth in China is the base case scenario, we also believe the Chinese government and the PBoC have a number of tools at their disposal to mitigate the pace of the deceleration.

- **Monetary policy**: We expect further reductions in the RRR as one way of increasing liquidity in the Chinese economy (to offset capital outflows). We also foresee more interest rate reductions, potentially including asymmetric ones in which deposit rates decline by less than lending rates. These reductions would lower debt servicing costs while mitigating the pain for depositors. The delta would be absorbed by lower bank profit margins.
- **Currency**: The other major lever still available is further depreciation of the renminbi. We do not expect additional moves such as those on 11 and 12 August. Rather, we foresee a gradual depreciation of the renminbi against the US dollar over the next year or more. This should increase the competitiveness of Chinese exports, but is likely to be insufficient to stem the decline in growth rates as exports are now a smaller part of the Chinese economy than in the past.

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- **Fiscal policy**: There is already speculation about a sizable infrastructure initiative to improve water and sewerage systems in major cities at an estimated cost of ¥10 trillion (about US$1.5 trillion). This might be one of several initiatives. We would also not be surprised to see efforts to invigorate residential real estate sales and prices, especially in Tier 2 and Tier 3 cities where the glut of supply is most pronounced.

As it relates to the developed economies, we believe the increased anxiety in markets is likely to lead to:

- **Delayed Fed normalization**: For much of the last year, our base assumption has been that December would be the lift-off date for the Fed Funds rate. The market had been assuming an earlier lift-off but now appears to be in line with our view. There is a meaningful chance, however, that the Fed might delay raising rates until 2016. We would advocate such a move as the market instability of late highlights the fragility of economies outside of the United States.
- **European Central Bank (ECB) and Bank of Japan (BoJ) policies** that are likely to remain loose for longer. Much like the Fed, the ECB and BoJ are likely to recognize their vulnerability to slower growth in China. While US exports of goods and services to China account for 1.0% of US GDP, the equivalent figure for the euro zone is 1.6% and for Japan it is much higher at 2.9%.[1] The slowdown in exports that could arise as Chinese growth slows might reduce the tailwinds for growth that have supported Europe through 2015. Moreover, if the Fed delays raising rates and/or takes a more dovish approach to monetary policy, we could continue to see the euro and yen strengthen against the US dollar, pressuring the ECB and BoJ to act again to further loosen monetary policy.

If we step back and assess the global economy, it is important to recognize the following points about the three economies that in total compose more than US$35 trillion of the global US$77 trillion of GDP[2]:

- **The GDP of the US economy** (US$17.4 trillion) has grown substantially since 2009 but has yet to reach its potential. Deleveraging, widening inequality, and re-regulation have limited growth to date, but we believe that situation might be changing. Specifically, we believe the middle class might finally be participating more fully in the recovery as a result of stronger job growth, lower fuel prices, and credit score healing. We believe the United States could experience 3–5 years of economic growth before the next downturn, making this one of the longest recoveries on record. Growth is likely to be reasonably muted—in the vicinity of 2% per year—but is still sufficient to improve living standards and support higher equity prices.
- **The GDP of the euro zone** (US$13.4 trillion) has turned the corner. While growth is not as strong as it is in the United States, we see numerous signs of improvement in the euro zone as credit is becoming more available and cheaper, lower oil prices lift disposable income, and the weaker euro supports exports. Moreover, low interest rates on the back of the ECB's latent embrace of QE should reduce debt service burdens, especially for governments that remain overly leveraged. While the euro zone has pulled away from the brink, it still needs more structural reforms to realize the full potential of the economy. In the interim, earnings and profit margins remain depressed and valuations are no longer at the premium to history we observed as little as a month ago.
- **The GDP of Japan** (US$4.6 trillion) is perhaps the most vulnerable to a China slowdown but the leadership of the BoJ has been particularly forceful since 2013 in using monetary policy to lift inflation expectations and ultimately weaken the yen (which increases export competitiveness and profit margins). We believe the Japanese government and the BoJ would react in the event of a sustained swoon in global growth from current levels. With the recent decline in Japanese equity prices, valuations are below historical levels in a market where major moves are being made to increase returns on capital and deliver more value for shareholders.

How Should Investors Respond?

From an investment perspective, we view the turmoil in two different ways:

1. **Opportunity**: The market reaction to events in recent weeks has led to excellent opportunities to initiate new positions and add to existing ones. In Monday's market, for example, we saw some very domestically focused companies sell off as much as 20% at the open simply due to the fact that they were large and liquid, and hence easy to sell.

   We have taken advantage of the recent volatility to allocate capital to companies that we view as being punished in disproportion to their actual cash flow at risk. Having deep bottom-up fundamental research and clearly defined scenarios for company earnings and valuation can turn situations like these into excellent buying opportunities.
2. **Risk**: Volatility could be sustained for days or even weeks. This ongoing tug of war between fear and greed could lead to unsettling market declines but also could lay the groundwork for the next sustained move up. The key for investors is to focus on the goals they want to achieve and their respective time horizons, which are generally measured in years. If that is the case, gradually increasing exposure when markets are under the most pressure is usually a wise choice.

In summary, we believe investors should examine the current events through a longer-term lens. The world economy continues to grow and the healing since the global financial crisis is giving us more resilience and flexibility to respond to surprises. The China slowdown is to some degree inevitable as the law of large numbers and competitive pressures arising from wage increases and environmental degradation affect growth. Many companies have adapted to a range of economic changes in the last decade and will do so in this situation. Valuations are not stretched, especially after the recent sell-off, although they are above historical levels. When compared to fixed income alternatives, equities look inexpensive on many counts. Our view is that the near-panic seen in recent days in various markets could represent a capitulation that creates opportunities for investors with time horizons measured in years rather than months. The critical element of success for these investors in our view is strong fundamental analysis and bottom-up security selection that takes into account the many variables that are impossible to predict with precision. Only through this approach can investors develop a comprehensive view of risk and reward and commit capital appropriately.

Notes

1 As of 2014. Haver Analytics, national statistics bureaus

2 As of 2014. Haver Analytics, International Monetary Fund

Important Information

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