Standard Life Investments

# Rapid Response Note

25 August 2015

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## Our view on current market turmoil

**As 2015 has progressed, divergences in the global economy are becoming more apparent. Indeed, the current rout in the Chinese stock market and volatility induced from the devaluation of the Chinese reminbi are only the latest developments to buffet markets. Knee-jerk policy reactions by China will trigger short-term buying but questions remain over the second-round effects from such moves.**

Since the start of the year, we have observed that asset markets would likely exhibit volatility because of widening gaps in policy and growth, which would naturally pressure selected markets with stretched valuations. However, we still consider that the global growth cycle exhibits few of the imbalances that typically bring an asset market cycle to a close, and we do not see this period of market volatility as the start of a bear market. Rather, we see current developments in China within the context of the typical adjustment process for asset markets to appropriately price in the probability of the US Federal Reserve raising interest rates later in 2015. As a result, this significant correction could well have further to run, even though some assets are over-sold in the short term. Mindful of recent fluctuations and the impact they may have on our clients' investments, we will continue to monitor events carefully and make modest adjustments to raise or lower risk levels where appropriate.

With an eye on recent developments, we remain cautiously optimistic on the outlook for equity and real estate markets, supported by an improvement in the corporate profits cycle. Within equities, we favour Europe and Japan, where there are signs of economic recovery, central banks are easing monetary policy and the banking systems are now healthier. In the US, we feel corporate earnings are proving less supportive at this phase of the cycle. Meanwhile, we are Light in developed Asian and emerging markets, as we believe the full brunt of a stronger US dollar, adjustment in commodity prices and slowdown in China have yet to be fully priced in.

### Our analysis

The causes of this downturn are complex and include:

- fears that stock markets are moving to rich territory,
- worries about the global economy in the light of questions about the ability of Chinese policymakers to support their economy and financial markets,
- concerns about the strength of other major emerging market economies as commodity prices decline, and
- anxieties about the impact of the first tightening of US monetary policy since 2006.

**Equity market valuations** – when stock market valuations are relatively rich on a historical basis, concerns about even a moderate growth slowdown will have an impact. The US stock market has just experienced its third longest period without a 10% correction. Until recently, European equities traded on a nearly 20x price-to-earnings multiple (on a 12-month forward basis), making it one of the more expensive markets. However, the earnings season was broadly positive for Japan and to a lesser extent Europe. Indeed, in both markets, the positive trends in top-line sales growth should serve as a useful driver to further profit gains.

**Global growth** – we are reassured about the medium-term outlook for risk assets, as we do not believe that recent market turmoil reflects an aggressive slowdown or recession in the global economy. Certainly, global growth has disappointed this year, with the trade and industrial production cycles particularly

weak. Furthermore, weakness in commodity prices over recent months is likely to reflect a combination of softer demand (particularly from some emerging market economies) and favourable supply developments. However, the services sector, which accounts for a larger portion of global economic activity, has fared better and global GDP in 2015 is expected to be broadly unchanged from last year.

**Economic activity is certainly becoming more uneven** – the US and UK continue to grow solidly and this should be sufficient to allow policymakers to consider tightening policy in the not too distant future. Trade linkages should be put into context. Looking at US exports, for example, about one-third go to emerging economies, with China accounting for roughly 5% of the total (or less than 1% of US GDP). Meanwhile, the domestic recovery in Europe is becoming more entrenched and while activity has disappointed in Japan we expect better going forward. The Chinese economy is clearly slowing, but concerns about the export and manufacturing sectors should be set alongside the steadier services sector and resilient consumer spending. Brazil and Russia are mired in painful recessions, which will not be helped by the further fall in commodity prices. More generally, emerging markets have struggled against a backdrop of a slowing China, weak commodity prices, sluggish global trade and expectations of tightening dollar liquidity.

Overall, there are clearly risks around global activity, particularly emanating from emerging markets (EM). However, while growth has been bumpy and uneven, we do not believe this signals the start of a more pronounced global downturn. In our view, the weakness of global manufacturing, where there is evidence of an inventory overhang, is less important than the continued strength of global services, supported by real income and employment growth plus lower energy costs. All this provides some reassurance about the medium-term outlook for selected corporate earnings and risk assets.

**Chinese equity and currency markets** – we see current price developments in the stock market reflecting the natural unwind of a classic retail-driven bubble; this process has been ongoing for several months and could take a while longer. Even after recent falls, the CSI300 Index is still up 30%-40% from a year ago. It is extremely difficult for any government to control such a situation. After spending some $200 billion, the government has finally decided not to throw more money at the issue but try to moderate the derating process; hence the announcement over the weekend that Chinese pension schemes could eventually invest up to 30% of their assets in equities.

The collapse of the equity bubble tells us very little about the state of China's economy, where the broader picture is a country in transition. Although the equity market sell-off will not have a major impact on growth, as it would in most developed markets, its impact on household confidence, business sentiment and government credibility should not be underestimated. For example, while there may not be a discernible 'wealth effect' in China, policy uncertainty from a failed government attempt to support the markets could have a negative impact on business investment and durables consumption.

As far as the currency is concerned, we consider that the decision by the Chinese authorities to introduce a market-driven exchange rate was less about boosting exports and more around the need for currency flexibility especially vis-a-vis the US dollar. 'Currency war' headlines are wide of the mark, as China would need a much larger devaluation than the current 3%-4% in order to increase its exports substantially. Therefore, we see a willingness to create greater currency volatility in order to help China's application for the renminbi to enter the IMF's special drawing rights basket, and a preference for greater monetary policy autonomy with the Fed on the verge of hiking, as more important reasons behind the recent decision. Nevertheless, the decision did startle investors during thin August markets, encouraging some to short those Asian currencies that they perceive as vulnerable.

**Emerging markets** – forecasts of an impending financial collapse similar to 1997-98 look wide of the mark. Last year, we reviewed the various pressures on EM countries in a Global Horizons research paper, which we updated this spring. Although we found individual problem countries, affected by debt issues such as Brazil or commodity issues such as Russia, a key conclusion was that systemic risks were low. There is little risk of EM inflation lifting off, while debt/current account positions are generally more sanguine. However, we are cognisant of the very real issues facing certain countries, including the ability of companies in some EM economies to cope with their debt schedules. Until EM equities indices fully derate to reflect the structural fall in growth, lower commodity prices and the effects on return on equity, these markets will serve as a useful hedge to volatility in developed markets.

## The House View

Since the start of the year, we have slowly been removing risk positions from the House View portfolio, for example in credit and equity. The only Heavy equity positions currently are in Japan and Europe, where corporate earnings growth is expected to be more favourable into 2016. The most recent decision by our Global Investment Group (GIG) was to move back into a Heavy position in European bonds once the latest Greek crisis was seen to be brought under control. We are selective in credit bearing in mind the impact of the sharp decline in commodity prices on the energy and raw materials sectors.

Our pro-risk view remains supported by the outlook for corporate earnings and the ability of firms to meet their dividend and coupon commitments. A small move to tighten monetary policy in the world's largest economy will likely pressure firms, but only modestly, resulting in lower returns in the next stage of this bull market. Valuations are also likely to come under pressure from the slow unwind of QE policies that had previously supported risk taking.

## Focus on Change triggers

Barring a major global growth shock, we expect the Federal Reserve's decision whether to begin the process of tightening US monetary policy, and at what pace, to dominate asset markets over the next six months. Our House View still expects that the Federal Reserve would prefer to raise interest rates before the end of 2015 (with the Bank of England following suit in early 2016). A sharp slowdown in the US economy – not our House View – would spark a step up in this crisis. Against that backdrop, signals at this week's Jackson Hole conference about the outlook for US monetary policy, say reflecting stock market moves or trade linkages, become more important.

China has today announced an unexpected policy response: the People's Bank of China cut benchmark lending and deposit rates by 25 basis points (to 4.6% and 1.75% respectively), and the reserve requirement ratio (RRR) by 50 basis points. Simultaneous rates and RRR moves are unusual, a sign that policymakers want to deliver a strong message, say ahead of the major 3 September military parade. In addition to action on interest rates and RRR, adding liquidity would help as very short-term interest rates have risen recently. More supportive fiscal policy is also expected. Recently recapitalised policy banks will begin to play a greater role in financing infrastructure investment and government expenditure is expected to increase in line with year-end targets. Questions will now be asked about the efficacy of all such moves.

On the negative side, triggers to consider will be signs of a wealth effect on consumer spending, particularly in countries such as the US and UK where direct share ownership is high. Additionally, a drawn out financial panic might affect household and business confidence, and therefore investment plans, especially in China.

## Conclusion

We see this correction in equities as significant but not the start of a major bear market, hence we are looking for opportunities to add risk as and when appropriate. Some of the growth concerns underlying this episode are genuine. For example, much of global manufacturing is in poor shape while there could be some spill-over effects on business and consumer sentiment. It also puts the Federal Reserve in a more difficult position because global problems are beginning to have an effect domestically even if the labour market still looks healthy. However, we do not foresee a global recession and therefore still expect a further positive phase for the current bull market.

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