Market View

A necessary correction…

Guy Monson
Chief Investment Officer
and Managing Partner

The abrupt market correction last quarter now feels like a logical response to gathering deflationary risks, and growing worries over the credibility of central bank policy. A fear of geopolitical fragmentation (especially the Syrian and migrant tragedies) has added to concerns. After recent falls, though, lower equity valuations and higher running yields are starting to offer value. Yes, profitability has been damaged for commodity and energy producers, and for the more indebted emerging world companies. On the other hand, though, sharply lower energy costs, renewed corporate restructuring and (over time) windfall export gains from the collapse of emerging world currencies offer huge opportunities. Meanwhile, with lower bond yields and interest rates, global equity income strategies are starting to look compelling.

For more than six years, the US Federal Reserve's (Fed) stimulus policy has both supported a remarkable bull market in equities and underpinned an (albeit sub-par) global economic recovery. Whenever events have flared up that might threaten this recovery (the euro zone crisis, Ukraine, or – repeatedly – Greece) rate expectations have faded, more quantitative easing (QE) has been promised by one central bank or another, and bond markets have rallied. This conveniently offers just enough economic growth to sustain profits, but just enough worry to prevent actual rate rises. It has proved a near perfect tonic for global markets.

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What changed over the summer?

Two things appear to have altered the equilibrium in August. First, the spectre of deflation is more worrying for markets than in previous crises, because the sell-off in global commodity prices, Chinese equities and emerging world currencies have all happened simultaneously. This is already impacting global trade volumes (see chart 1) and increases the risk of wider economic damage to China, emerging markets and – potentially – the global economy. Corporate profits have already felt the backlash in the commodity and energy sectors, and there is concern that this could now extend to the industrial and auto sectors (which are already facing the widening VW scandal).

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Forward (mis)guidance?

The second concern is that Fed policy this time around has served to confuse rather than comfort investors. Chair Janet Yellen has allowed herself to become hostage to global economic and market events, rather than acknowledge good domestic reasons for finally ‘getting off zero’ and lifting rates. Her perceived dithering is reflected in rising equity market volatility and the extraordinary press speculation on what is, after all, a numerically insignificant increase.

It is not only the Fed that has seemed rather flat-footed of late. The Chinese response to its stock market correction has appeared heavy handed, and at times counterproductive. Meanwhile in Europe, even the worst of the Greek and wider euro zone crisis pales in significance compared to the challenges and tragedy of today’s migrant crisis. The lack of unified policy (where is the ‘United States of Europe’?) suggests a more fragmented, divided Europe, and one where fundamental concepts like ‘Schengen’ may ultimately come under question. This year’s Spanish elections and next year’s Brexit debate may well become wider polls on the wisdom of a centralised Europe.

Unsurprisingly, equity markets are demanding a premium for these uncertainties and for the associated risk to profits, as China’s slowdown ripples out beyond the mainland (China’s manufacturing PMI fell again last month). With US and – increasingly – global valuations already expensive, the correction has been sharp and widespread. World equities have fallen more than 12% from their peak, while emerging world currencies are close to decade lows, and commodities prices near to levels seen last in the depths of the 2008/9 credit crisis.

Pricing in today’s worries

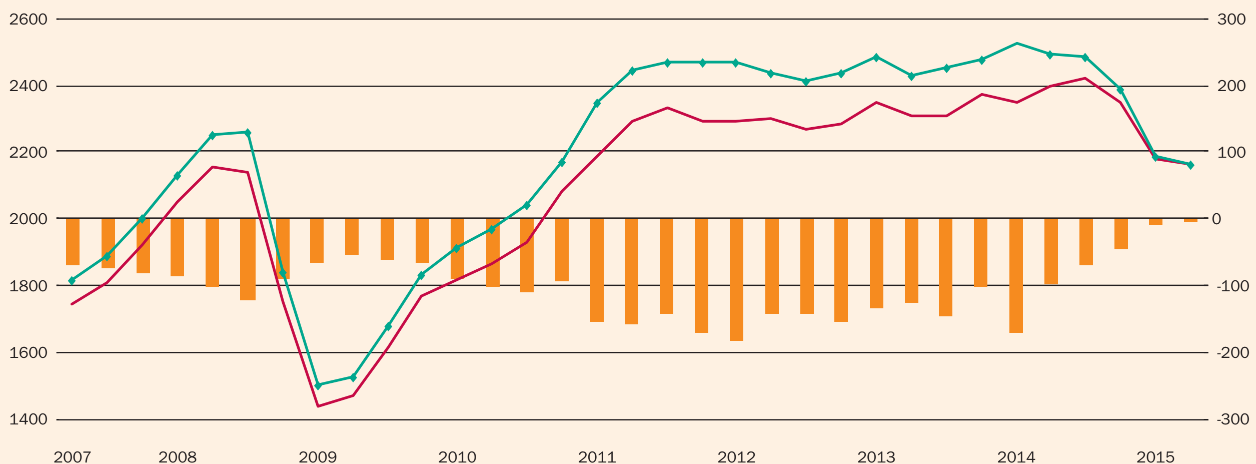
Are the current political, deflationary and policy challenges priced into global markets yet? We would argue that they broadly are. To begin with, US and UK bond yields have fallen back by almost 30bp over the last three months, while rate rises have been delayed and the probability of QE either being extended or increased in Europe and Japan has risen. All have made equity yields look attractive.

For example, both the EURO STOXX 50 and the FTSE100 have gross dividend yields of more than 4% today, which is more than twice the yield on a ten-year gilt and seven times the yield on the German Bund. Despite the market volatility, our income flows from repeatable and well governed business models have been robust, with higher bank dividends (finally) and a raft of ‘specials’ offsetting the likely cuts in the commodity and oil sectors.

Second, we believe that continued QE programmes in Europe and Japan (in the Bank of Japan’s case including direct equity ETF purchases) will support equity assets, especially when combined with active corporate restructuring agendas. We are also considering adding to corporate bonds, where spreads have widened and income again is compelling.

Signs of a global slowdown? The value of global export and imports fade as the dollar strengthens and volume growth slows…

Chart 1: G7 and BRIICS – Merchandise trade in US$ billion



Seasonally adjusted data at current prices and exchange rates

Balance (right axis) — Exports — Imports

Source: OECD Sept 2015

Robotics, big data and solutions for a smarter planet are amongst the disrupting influences that could open up profitable opportunities

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Third, we believe that a strong dollar, while challenging for US exporters (although many invoice in the US currency), will offer windfall gains, particularly to emerging world exporters. Emerging world consumers will benefit as sharply lower food and energy costs feed into household budgets (note that Chinese retail sales have accelerated this year to 10.8% annualised).

Finally, our thematic drivers should, we believe, generate top-line growth for selected companies even if overall growth slows. Opportunities to 'trade down', demographic trends, big data, robotics, and solutions for a smarter planet are all potentially disruptive influences that can generate windfall profits for key innovators and franchises.

In short, investors see the glass today as very much half-empty, with deflation risks, a Chinese growth crisis and policy confusion at the top of their global worry lists. We may soon, though, remember that not so long ago we thought that cheap oil, cheap food and low interest rates were good things, and that equity yields that were more than double bond yields were a cause for celebration, not despair!

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