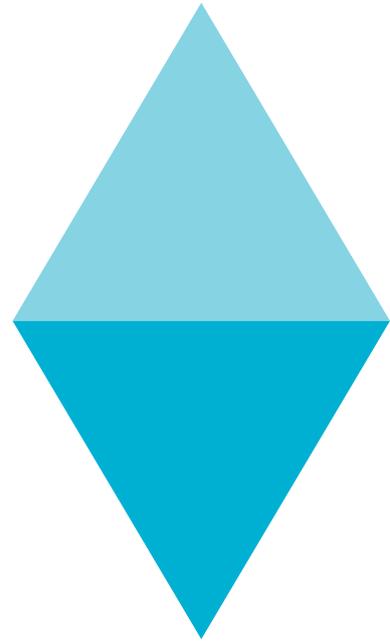


HEALTH WEALTH CAREER

MARKET TURMOIL

FEBRUARY 2016



WHAT JUST HAPPENED?

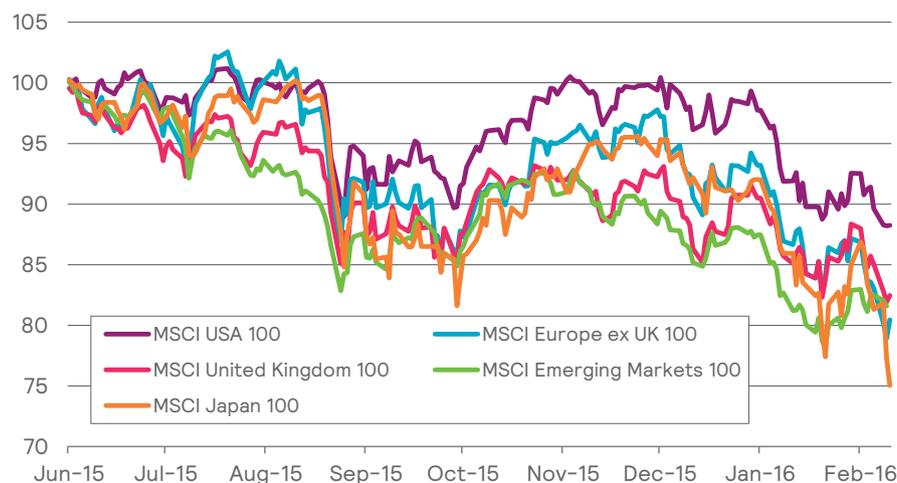
2016 has begun with a turbulent start, with falling equity markets and commodity prices, widening credit spreads but collapsing government bond yields, and extreme volatility in currency markets. It is reminiscent of the “risk-off” scare of August 2015, but the effects are more widespread and the consequences are potentially more far-reaching. The causes of such violent market moves are always complex, but there are four distinct catalysts which have contributed to this equity market rout:

- The price of oil began the year sliding below \$30 bbl, as investors worried about oversupply with the lifting of Iran sanctions, coupled with slowing Chinese demand and a mild US winter.
- China – a weak GDP data report (the lowest in 25 years), coupled with clumsy policy interventions in the equity and currency markets, led to a 25% drop in the Shanghai Composite, as investors feared the authorities were losing control.
- The US economy showed some signs of slowing with business confidence and GDP weaker than expected.
- The Bank of Japan introduced negative interest rates to weaken the currency and stimulate activity. The Yen subsequently soared.

Subsequently, there have been concerns that rising credit spreads and tightening financial conditions would derail the global recovery, and that some European banks may suffer significant losses over loans to the energy and commodities sectors as well as being harmed by a lower growth and interest rate environment.

STOCK MARKET PERFORMANCE

(local currency price indices rebased to 100)



Source: Thomson Reuters Datastream

HOW SHOULD INVESTORS RESPOND?

There has been a deterioration in the outlook for the global economy over the last two months, particularly within the advanced economies (in contrast, last year's "panic" mainly centered on emerging markets). The risk of a slump back into recession has risen, although it should be stressed that we don't believe that this is the likely outcome.

To be sure, with economic growth prospects diminished, and corresponding negative revisions to profit expectations, some lowering of equity index targets is justified. The increased risk of a more adverse scenario will also diminish appetite for risky assets such as equities and high yield bonds.

However, the actual market reaction to the deterioration in fundamentals seems extreme. Measures of sentiment, such as Credit Suisse's Risk Appetite Index, have entered "panic" territory, which normally suggests a buying opportunity. Is it different this time?

There are certainly some issues that warrant a degree of caution. Normally, in financial market panics, the monetary authorities loosen policy to provide liquidity and bolster confidence. On this occasion, the major central banks have little room for manoeuvre – only the US Federal Reserve has scope to cut rates, and this may well be regarded by investors as evidence of their impotence, in much the same way they greeted the Bank of Japan's move to negative rates.

In addition, as we have noted before, there is a problem with market liquidity, partly resulting from the onerous regulations imposed on banks to prevent a repeat of the 2008 financial crisis. This raises the possibility that markets "overshoot", and also increases the possibility that markets will precipitate a credit "accident" in a major institution. However, given that valuations of many risky assets are moving towards attractive territory, we would suggest that investors undertake a gradual buying programme to restore strategic weightings of equities and other growth assets back to benchmark. Given the daily volatility in markets, a gradualist approach may be better than trying to "pick the bottom."

We would counsel postponing a move to heavily overweighting risky assets until the outlook becomes somewhat clearer – at times of great uncertainty, overconfidence is a dangerous attribute. It is unusual for markets to climb as swiftly as they fall, and we believe investors will have time to accumulate assets if the current growth scares do indeed turn out to be exaggerated.

CONCLUSION

Equity markets have had a very poor start to the year, and there is no doubt that investors are fearful rather than greedy at present. However, there has been a deterioration in the global economic outlook and a rise in the risk of a recession that justifies some correction in risk asset valuations, albeit not of the severity implied by market moves.

Given concerns over liquidity and financial contagion, we recommend a gradual rebuilding of equity positions back to strategic benchmarks, but a postponement of a more significant move to overweighting such assets until the outlook becomes clearer and our confidence in authorities' ability to navigate the current environment becomes more robust.



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