

Volatility Is Back From Extended Vacation. Market Crash. Buy Opportunity?

If you sold in May and went away you'd have been back in July, re-established positions and got your throat slit in August. The S&P and broad equity market benchmarks have lost some 10% in a week, most of it in a couple of days, Europe has done slightly worse, down some 12%, and China, apparent epicenter of the troubles is down a fifth, yes, 20% in the last week. Emerging markets have lost some 28% since April in a steady decline. In this time, US, European and Japanese equity markets ground steadily higher, until last week. And then they played catch up. Is this then an emerging market phenomenon unfolding before us? The Lat Am equity markets have been falling steadily since last August (2014). They have lost 50% since then, and 30% since April 2015. Emerging markets as a group are not the catalyst. Was it just China? China equities peaked in mid-June then fell precipitously while western markets chugged along unfazed. It could have been China's signal that it would no longer support its equity markets but would allow western style market forces for price discovery that broke the camel's back.

What about credit markets which investors have been fretting over for the past year or two, worrying about market liquidity and the risk of higher interest rates? The US high yield market is down 5.4% since its April high, its European counterparts are down 2.3%. The leveraged loan market is down 1.3% from its April high. Emerging market bonds are generally off their April highs by some 4.3%. Treasuries have rallied, even the US variety where a potential interest rate hike looms.

On August 11, the PBOC introduced market forces into the determination of its CNY reference rate, which resulted in a 2% devaluation. Emerging market currencies which were already weak from weak commodity markets fell further while the relative strength of the USD to EM currencies reduced the probability of a September rate hike thus bolstering JPY and EUR. But the lags in currency movements to the PBOC's announcement was measured in days, not minutes or seconds as is usual for FX markets.

Commodity prices have been weak since early 2011 with an acceleration to the downside in oil

beginning in mid-2014. Commodity prices seem to have correlated well with emerging market equities and currencies.

No smoking gun. Sometimes markets move because of a confluence of events and technical price patterns. Could economic fundamentals be driving markets? The US economy is stable and growing at a very steady if slightly tepid rate. Europe is in a cyclical recovery even if it is a structurally flawed region; Europe is simply not an optimal currency region. Greece is out of the limelight, despite having found no lasting solution; it may once again serve as a focus sometime down the road. China's economic weakness is a known fact, perhaps the degree of the slowdown has been underestimated. The PBOC's relaxing of the currency reference rate mechanism could be seen as a competitive devaluation strategy signaling greater problems in China. But China has the economic and financial resources to manage any kind of liquidity crisis. In any case, given the semi closed structure of China's markets, there should not be and has not been contagion at the financial market level. There will likely be economic consequences of slowing Chinese growth. The Chinese stock market phenomenon is remarkable in the lack of contagion to its credit markets, both USD and RMB. The Chinese high yield market has seen a 3% retracement in the last couple of weeks which is well within the volatility tolerances of this market. At the fundamental level, corporate China has been borrowing against equity to invest in equity markets, a clearly unhealthy practice.

So we cannot explain what happened apart from blaming technicals and jumpy investors. So far so normal. It will not deter us from making predictions about the how the various economies and markets will evolve.

Let us look for excuses to sell the markets.

Central bank policy has created a number of problems. The US Fed is apparently at the point of raising interest rates, and some time down the line, reducing the size of its balance sheet. The Bank of England is similarly advanced in the cycle. The ECB is only in month 6 of an 18 month QE program. The Bank of Japan is in the middle of an interminable QQE program. The PBOC has been in expansionary mode since mid-2014 although it hasn't yet started to directly buy assets, it is a pretty sizeable repo counterparty.

The Fed is in a difficult position having very early on telegraphed its intentions to raise

interest rates. It counted on a long runway to manage expectations and soften the blow of raising interest rates from 0.25%. A long runway has its advantages but is also vulnerable to changing conditions. The US economy is stable but there is no sign of above target inflation and one could argue quite easily is far from being in need of higher interest rates. If the Fed raised interest rates now it would certainly slow an economy only showing tepid growth. In the meantime, expectations of higher interest rates and a resurgent manufacturing sector have boosted the USD and tightened financial conditions. The recent equity market volatility is also tightening financial conditions for the Fed, making a rate hike less justifiable. Having so early on signaled its intentions to raise rates, however, the Fed now risks investors interpreting prevarication as a sign of a weakness, which could lead to wider credit spreads, weaker equity markets and thus tighter financial conditions. Over and above the question of interest rates there is the Fed's expanded balance sheet which needs to be shrunk at some point, hopefully in an orderly manner. The question of how to shrink a balance sheet gently is a question which will be asked of all the world's central banks at some stage or other.

The rally since 2011 has been driven re-rating, not so much by earnings growth. Re-rating has been driven by falling interest rates, falling cost of debt to fund buybacks. US equities are unlikely to face falling earnings but they may face a gradual de-rating. Even if earnings grow at 2X GDP growth, the range is 5-7%. A de-rating from 16.5 to 14.5 would still lead to a lower market level. European equities are cheaper than US equities but they show the same trading pattern, that is, much of the returns have come from a re-rating. That said, earnings growth in Europe is expected to be quite robust at c.18%. Also, the ECB is not quite as late in the cycle as the US Fed. The risk of de-rating is not as great.

So much is dependent on central bank policy. The widespread use of QE has led to a disconnect between fundamentals and asset prices to the extent that it is difficult to estimate asset prices in the absence of QE. The recent volatility in the US equity market is an interesting case in point. While other economies have their problems, the US economy is sufficiently robust, at least according to the Fed in the past months, for lift higher interest rates. And yet, the stock market was in free fall for three whole days, losing some 10% of value. As discussed, there are no credible single catalysts for this volatility. Perhaps it is the difficulty in valuing US assets under QE and the fact that interest rates may be raised at a time when the Fed is no longer expanding its balance sheet, and may in fact shrink its balance sheet a year from the first rate hike, that is responsible for this volatility.