Neil Dwane on... Equities

The perspective from the Europe CIO Equity

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Volatility, Volumes and VW Strike Equity Markets

Over the past 6 weeks, equity investors have been impacted by significant change in both volatility and confidence in equities. Why?

China

During the summer, China was obviously trying to rein in its falling equity market after having sponsored the more aggressive upward moves earlier in the year. The persistence of policy changes had only temporary effects on the levels of Chinese equity markets, which increasingly unnerved both domestic and international investors. This contest of state-sponsored market management versus underlying capitalist markets eventually resulted in a loss of faith in the Chinese Party and Central control, culminating in the apparent devaluation of the Renmimbi, which I spoke briefly about here. After the Tianjin port explosion, confidence fell further – exacerbated by the obvious slowing of the economy.

Nevertheless, the consumption side of the Chinese economy is growing and remains quite robust such that China is not "collapsing" but is now exporting deflationary processed industrial products like steel to the rest of the world, and is readjusting its consumption of other commodities to lower levels... a source of growth for the world has stalled.

US Monetary Policy

"Will she, wont she..." After months of uncertainty and much press and investor speculation, Janet Yellen and the US Federal Reserve did not raise rates, which was taken negatively. So good news is now bad news? The Fed did not raise rates despite a solid level of employment and a dull but stable US economy because it feared both a stronger US dollar, which makes exports less competitive, and because it was concerned about the slowdown and recessions emerging in China, Brazil and elsewhere. Gone are the days that the "US dollar is our currency and your problem!"

So economic growth and policy dithering have raised volatilities and placed a large level of uncertainty before investors. This very much fits with our premise of Financial Repression where growth is fragile and central banks remain inert!

However equities have suffered far more than just a small squall of seasonal summer skepticism.

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Corporate News *

The fraud now evident at VW has rocked not only the German establishment but also the whole Automotive industry and its credibility with consumers and regulators. The fall in VW alone has amounted to nearly 30 billion euros of lost market value, as investors weigh up the repair costs of potentially 11m vehicles with regulatory fines that could exceed $20 billion.

M&A has also stalled as first Monsanto, then Zurich and possibly others found the synergies lacking, the price too high and the funding increasingly scarce.

Earnings in the oil and mining sectors have seen savage downgrades and the collateral damage is appearing in many industrial and service sectors, as well as in many emerging markets. Nevertheless, earnings in aggregate are rising for the first time in six years.

Investor Flows

Investors have been withdrawing money from both emerging market equities and bonds, creating a redemption cycle in an uncertain market. The USA has seen only share buy backs supporting its market, whilst Europe has phlegmatically neither added nor sold for some time.

Positioning and Liquidity

Many investors had similar positions in stronger dollar and weaker euro trades, and have seen the rising volatility obligate them to lower position sizes and become forced sellers. Markets have also become less liquid with nearly 30% of market volumes in the hands of high frequency and algorithm traders, who do not help to discover the right clearing level for stocks. Technical positions in the markets are also being closely watched by traders and value at risk compliance staff so that many positions could soon be "risked out" of portfolios. Key levels to watch are around the mid-August lows, where traders will change positions and cut positions, if support is broken.

Prospects

The volatility of equities has returned, and will be unnerving and unsettling clients. However the bigger picture has not changed:

- The economies of Europe are doing better
- Valuations in Europe are not unattractive on a longer term basis
- Industrial restructuring in Europe is still ongoing
- The sell-off has so far again been indiscriminate so that stock correlations have been high; stock picking skills will return to add alpha to portfolios as markets calm down
- Dividend yields are the only significant income available to European investors, with cash yielding negative levels and bonds providing little real yield.

Until 2015, markets have been able to rely on the volatility-lowering QE policies of Central Banks, affording us all the luxury of lower and less volatility, and smooth beta returns. Well that period is over, but the investment challenge remains the same: investors must accept some risk to earn a return, given that the ECB has already said it will do more and for longer if monetary policy seems ineffective.

With bonds offering no return, European investors can use this market down-draught as an opportunity to add some risk and return to portfolios. Equity dividend strategies offer high yields and lower volatility.

- Neil Dwane

We welcome your comments, thoughts and opinions. Follow us for the latest market updates!
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