Neil Dwane on... Global Markets

The perspective from the Global Strategist

21 January 2016

Enter the bear in January 2016?

Many equity markets are now in bear market territory as they have fallen over 20% from their highs, and 2016 has started much more poorly than all had expected. Has the New Year really changed investors perspectives of investment opportunities for 2016?

Key observations:

China

Economic data from China has remained dull at best with the same trends evident through 2015 still at work, namely that investment and manufacturing are slow and consumption steady at c.11% pa. Capital outflows remain an issue for Beijing and whilst the People's Bank of China (PBOC) is doing its best, the net effect of selling its reserves to cope with the outflows simply means that monetary conditions in China remain very tight, given the deflationary dynamic in the production data. This is exacerbated by concerns over policy implementation in Chinese markets (be it circuit breakers, currency interventions, interest rate shifts), which has clearly unnerved some investors. Nevertheless, fears over a collapse, or substantial devaluation of the Renminbi are overplayed in our view as it would not serve to aid the rebalancing of the Chinese economy and would cause an escalation in the "trade and currency wars" rhetoric. However, with the New Year beckoning and the next 5 Year Plan still being drafted, we should not expect China to become a force for good until the second half of 2016.

Oil

Oil continues to fall, driven more by oversupply headlines and Iran's return to production than any other actual factor. Oil production ex Saudi Arabia, Russia and Iran is now under great strain with Nigeria, Venezuela, Brazil and Mexico all now showing much distress. US shale remains more resilient than expected but with well starts collapsing and bank loans to the sector becoming particularly sensitive, we expect global supply to soon top out, whilst demand in a low growth world remains unchanged. With speculators holding record shorts and clear signs of capitulation from traders turning stocks to cash, it is hard to see how investment, capex and current production levels are viable at these prices.

Moreover, the geopolitical situation in the Middle East remains fraught with both Iran and Saudi facing off, with Egypt and Turkey exhibiting increasing political strains - the scope for a supply shock event remains very high, but ignored by markets.

US Monetary Policy and the US Dollar

Having eventually started the process of raising rates, at a time when economic growth was slowing and credit was weak, the Federal Reserve has added uncertainty to the interest rate debate for 2016 as there is considerable difference between their "dots" and the futures markets. Regardless, with more rates rises to come, the US Dollar remains strong (as does Gold!), boosted by "flight to safety" flows from risk-averse investors, which will only act as an increasing drag on Emerging Market (EM) economies, commodities and non-US debt borrowed in US Dollars. Whilst speculators are already very long the US Dollar, paired with short Euro, short Yen and other EM currencies, the strong US Dollar hurts all and, in US Dollar terms, the world economy is now 6% smaller than the currency-weighted growth last year of 3%!

An additional concern is that of a possible US Dollar shortage which is also washing through Asian and European Banking sectors, which have provided much of the Eurodollar funding to EMs, trade and commodity players and to China. Despite Quantitative Easing (QE) in Europe and Qualitative and Quantitative Easing (QQE) in Japan, the world needs US Dollars at a time when Fed monetary tightening has led to an increase in the Fed funds rate. While the Fed may take a lot of persuading to change course on interest rates so soon after its recent increase, we are hopeful that dollar shortages will be short-lived through the use of off-market swap arrangements with a number of Central Banks.

Corporate prospects

The earnings season has just started around the world and early signs are resonant of expectations - US earnings are hurt by the strength of the currency but boosted by the enormous share buybacks; Europe looks okay with the exception of the large exposures to Oil and Mining. Asia looks weak as its manufacturing sector suffers from both strong pricing pressures and excess inventories and slowing consumer tech demand. Mergers and acquisitions have remained strong so far with more deals in the Technology and Healthcare sectors. Earnings expectations, as ever, have a strong optimistic bias which will see downgrades as economies are weak and confidence falls with the markets and as downgrades come through, so some of the falls will be rationalised post-event. Industry specific stories remain generally negative for markets like the emissions scandal for Autos, the review of bad debts in Italian Banks and collapse in Mining.

Politics

Politicians around the world are dealing with the whole gamut of society-challenging issues from the austerity enforced from collapsing currencies, bribery and corruption, currency devaluations affecting living standards through to war, migration, a UK referendum on membership of the EU and rising nationalism. All of these factors are in themselves important and all are capable of adding to investor and market uncertainty, at a time when the ongoing effectiveness of monetary and fiscal policies is being questioned.

Liquidity and price discovery

Within Equities, the health of the market has long now been discussed as we find that market volumes are masking the painful effects of fragmentation - nearly half of volumes are algorithmic, buying and selling in a nanosecond and offering no value of price discovery at depth, over 30% is ETF and futures basket trades related, suggesting that the tail (the futures markets) is wagging the proverbial dog (the cash market), leaving most sincere investors befuddled as to what the market is saying. With post-Financial Crisis regulation hastening the retreat of market making from both Equities and Fixed Income, volumes are increasingly one way as the “algos” decide if the momentum is up or down, faster than a blink of an eye!

Additionally, the recent stalling of the US equity market[1], since May last year, and it’s frightening and worrying concentration into the fabulous FANG (Facebook, Amazon, Netflix and Google) and NOSH (Nike, O’Reilly, Starbucks and Home Depot) stocks has now resulted in serious technical damage and, unfortunately, with the August lows taken out (c.1867 on the S&P), could see markets fall another 20%, handing back three years of gains.

[1] This is no recommendation or solicitation to buy or sell any particular security.

Whilst many clients should be pleased to see a substantial pull back in Equities as an opportunity to add to assets at better valuations, offering both attractive dividend yields and prospects for capital appreciation, most will be unnerved and not seek to add to risk whilst volatility remains high and policy divergence marked. With so many Sovereign Wealth funds under pressure, and insurers under Solvency II, the buyer of last resort may well be able to wait for much lower levels.

Yet more risk-off may spill over into higher risk credit and EM bond markets, where illiquidity is already profound and lead, perversely, to yet more hedging in liquid equity market futures, precipitating further weakness. With such volatility it is likely that many Financials will come under greater scrutiny as their balance sheets remain gigantic. Japan and Europe are buttressed by QE to some extent but EMs are reliant on funding in US Dollars, which is getting more expensive by the day.

Equity valuations may still need to adjust to lower earnings, currency volatility and the removal of the old Chinese growth model but the global economy still offers growth opportunities, new market and disruptive prospects and attractive sustainable dividend income streams.

Act

Bear markets spend more time going up than down, but when they fall they fall quickly. Thus, it is important that investors maintain the asset allocation that serves their individual circumstances best, relying on active managers to navigate these volatile times.

Active managers with few, if any constraints, are able to find opportunities all over the world, across traditional and alternative asset classes, and through the use of a range of strategies.

ACTive investing allows investors to navigate these volatile times:

- Being Agile will enable asset allocators opportunities to buy on weakness into attractive investments;

- Confidence in the portfolio manager's investment process to add Alpha over the long term, again compensating for the volatility;

- Thorough in the work and analysis which has been done to find the right securities for the portfolios in order to deliver the right risk-adjusted returns.

With Central Bankers part of the markets now, rather than referees, we should expect to see more verbal intervention to calm sentiment - the PBOC is already active on a daily basis, the European Central Bank (ECB) continues to threaten more if required, as confirmed again in today’s press conference, and the Fed can offer more credit lines to other central banks easing the US Dollar shortage. The Bear may be here but Policy will be used to fight him and longer term clients seeking strong risk adjusted returns are being presented with opportunities to do so provided they are ACTive.

- Neil Dwane

Neil Dwane | Global Strategist

Neil is the Global Strategist for Allianz Global Investors and part of the Equity Investment Management Group. Neil coordinates and chairs AllianzGI's Global Policy Committee, which formulates the Allianz Global Investors house view, as well as leads and directs the agenda setting for the bi-annual Investment Forums. Neil still manages some European equity portfolios, and thought leadership articles written by Neil are published regularly.

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

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