Current Market Volatility : A Commentary from BMO Global Asset Management

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With the caveat that “only fools can predictably be relied upon to pick bottoms and tops” we will, nonetheless, give some opinions on current market prices, rather than forecasts!

Last week saw marked declines in equity prices and commodities, rises in market volatility, widening credit spreads and falling government bond yields. Much of the current stress can be traced back to events in China – with the ‘devaluation’ raising concerns over the state of the Chinese economy and many fretting over the prospects (and implications) of a bigger currency move. Emerging Market currencies have weakened further and risk assets have been sold aggressively, accelerating and exacerbating an existing trend.

China has genuine problems, both and structural and cyclical and several well-intentioned recent reforms have exacerbated the underlying problems. Chinese equities are a deflating bubble: down 37% since the June peak but still up 56% since the average in 2014H1. Given this backdrop it is hardly surprising that commodity prices and regional stock markets and currencies like the Aussie dollar have fallen in response. In the case of oil, weakness reflects actual and prospective supply (demand is growing strongly). More generally we are in the midst of a risk-off, position liquidation event.

While last week’s moves were large (in terms of equity declines – with some of the largest falls since 2011) it all felt relatively orderly, even with a big down leg on Friday. Today, however, is more disorderly, with European indices down 5%+ at present, China down 8.5%, etc. In the US, the VIX (Fear) Index has hit 38, the highest level since panic in 2011. Markets are now looking very oversold on many metrics but it is not clear what will stem the flow – and we know that policy makers have less room than at any point historically to act.

In our view, however, the reaction in developed markets now seems overdone. Inflation is no threat (neither is deflation when it is due to falling commodity prices), valuations are not excessive and monetary policy remains super-expansionary. The US and Europe, the two biggest economic blocs in the world are growing – not rapidly but fast enough to keep unemployment on a declining trend. The Fed have repeatedly told us that they expect to raise rates later this year but this is data dependent. With few signs of inflation in the US, they will raise rates only if data on the real economy improve. In Europe and Japan, the only issue is whether they ease monetary policy further.

From a fundamental perspective, equities are determined by earnings, the discount rate and risk appetite. Even if the US does begin to raise rates later this year, bond yields will edge up only slowly. Ultra easy money elsewhere in the developed world means that the discount rate will remain low. Earnings prospects look good in Europe and Japan. In the former, the cyclical upswing is continuing; and earnings have outperformed expectations in the last two quarterly reporting seasons. Growth of 20+% from current levels is entirely possible over the next few years. In Japan, genuine reforms are taking place with an increased focus on shareholder value. By contrast, prospects for earnings look dull in the US - there is limited scope for margins to expand further and despite subdued wage growth, unit labour costs are edging higher; the dollar remains strong especially versus EM currencies.

So, where to from here? There are numerous concerns – which we have discussed – on the macro side. Equity markets are no longer cheap, US rate rises are still on the agenda (though remain data dependant and less likely now to take place in September than was the case several weeks ago), Greece continues to cause concern and China has – so far – lost control of the market. That said, prevailing underlying trends are positive in developed markets and the recent price action runs contrary to fundamental improvement in Europe, for example. For this reason, we are tending to consider that the recent sell-off will not mark the end of a relatively constructive (albeit more volatile) environment for equities.

On this basis, if there is further weakness, then I may well look to add some more equity risk to the portfolio – albeit likely to average in.

There is clearly an alternate view that Emerging Market contagion may fundamentally derail developed economies and/or that the price action we are seeing is reflective of the beginning of a sustained de-rating of equity markets from expensive levels. While I cannot yet see a trend change in EM fundamentals we do not – at present - see a central case where deflation fears come to the fore and developed economies tip over into recession.

The current market sell-off does not give us the kind of compelling entry point to equity markets which would precede very strong price gains – simply because valuations are better than they were but not downright cheap. Despite the likelihood of the correction continuing further in the near term I am more inclined to become more constructive as markets become more deeply oversold and offer better value, rather than change our fundamental view and turn bearish. The health of developed market economies are critical in maintaining this call – ie avoiding recession in the US is critical in maintaining a constructive stance.

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