PRIVATE BANKING INSIGHTS
Market Update

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MARKET CORRECTIONS & AMPLIFICATIONS

Selling pressure greatly intensified last week across global stock markets and we believe we may be in the midst of what could turn into a more meaningful correction for US and global equities. We are not surprised that stocks are having a difficult time, as we have been watching the markets with some concern over recent weeks, and in fact reduced our equity exposure in late July. However, we are cautious, not bearish, and view corrections within a bull market as potential buying opportunities. We caution against panic and believe investors are best served by remaining true to their long-term strategic allocations, as painful as that may be in the near term.

As we have indicated in the past, the last correction (10%+ decline) for US equities was in 2011, and it is highly unusual, even during a powerful bull market, to spend so much time without a correction. In the meantime, outside the U.S., international markets have already seen a few corrections, with some markets even experiencing bear market conditions (20%+ declines). At the end of July, we reduced our equity exposure in line with our long-term strategic allocation, while maintaining an underweight position in fixed income and commodities. As a result, our cash exposure is the highest it has been for quite a while.

Our decision to position our portfolios in a more defensive way was motivated by a variety of factors, one of which was the deterioration in economic momentum globally, and particularly in emerging markets. Safe haven government bonds have rallied significantly in recent days as investors' concerns about global growth, and disinflationary forces have pushed bond yields back to extremely low levels and expectations of Fed tightening in coming months have been lowered once again. To paraphrase former Fed Chairman Alan Greenspan, it seems that these depressed bond yields are either consistent with a bubble, showing signs of irrational exuberance, or at the least look like a conundrum. The only fundamental justifications for the current level of bond yields would be that we are either "turning Japanese" and achieving 2% inflation in the short- or long-term is just a wild dream, or that the global economy is gradually and inexorably moving towards another economic contraction (a euphemism for a nasty recession).

As we have repeatedly indicated in past newsletters, all leading indicators (whether based on economic data, monetary factors or financial markets) are inconsistent with the probability that we are heading back into recession *(see box below)*.

LEADING INDICATORS INCONSISTENT WITH RECESSION:

- **The yield curve** (particularly the difference between 30-year and 10-year treasury yields) is still positive at a round 60 basis points (the long end of the yield curve has always been inverted ahead of a recession)
- **Short-term interest rates adjusted for core inflation** are still negative (a pronounced rise in real short term rates is usually seen ahead of recessions as an indication that monetary conditions are too tight).
- **Global liquidity conditions** are still extremely loose as most central banks are in easing mode, irrespective of if and when the Fed starts raising rates. We have QE in Japan and Europe, and interest rate cuts implemented by other major central banks, including in China.
- **Leading economic indicators** are also far from flashing warning signals and the current recovery following the Great Recession of 08/09 has been relatively tepid globally, resulting in ongoing slack in various parts of the global economy. Recessions usually happen when economies are operating at full capacity and central banks are forced to tighten monetary policy to pro-actively fight inflationary pressures. And right now, inflation is pretty much missing in action.

SO, WHAT IS GOING ON AND WHAT SHOULD INVESTORS DO?

As mentioned above, we are not too surprised that stocks are having a hard time right now as we have grown more concerned in recent weeks due to a combination of factors:

FACTORS GIVING RISE TO CONCERN:

1. Weak global growth momentum, in particular in China and commodity exporters.
2. Approaching "lift-off": while it seems that the first rate hike by the Fed might be pushed back to December, this will be a major shift for financial markets with unknown consequences after 6 years of ZIRP (zero interest rate policy)
3. The plunge in commodity prices is very typical of what is usually seen during economic recessions. We continue to believe that, although demand for commodities is weak (mostly due to the slowdown in China), the real issue depressing commodity prices in one of excess supply not adjusting fast enough to lower demand and a reversal of financial flows out of the sector. These large price declines are wreaking havoc on commodity producers, exporting nations and add to global deflationary forces.
4. Growing concerns about the situation in China where the traditional drivers of growth are very weak (fixed asset investment, housing and exports) and recent events have made investors question the authorities' true willingness to move ahead with bold structural reforms. The intervention to prop up the bursting equity bubble in the A-share market was a case in point. The sudden move to "devalue" the Yuan was seen as confirmation that growth might be even weaker than previously thought and that China is joining the so-called currency war and trying to support its export sector, despite official willingness to rebalance the economy towards domestic demand. The fact that the Chinese corporate sector is estimated to hold $1.2 trillion in dollar denominated debt is another concern for investors. The reality is that the move seen in the CNY has been minimal so far and is unlikely to boost Chinese export competitiveness in any meaningful way, particularly since the Chinese currency has dramatically appreciated in real effective terms in recent years. We view this move as being motivated by two main factors – breaking the link with the USD ahead of Fed tightening (which could lead to renewed dollar strength) and allowing market forces to play a greater role in determining the value of the Yuan, ahead of the IMF decision to potentially include the CNY in the SDR basket (special drawing rights).
5. As already indicated, the messages from the bond markets are quite worrying - the yield curve is flattening, inflation expectations are tanking, forward contracts seem to point to the current environment of abnormally low yields for many years to come, and credit spreads for both investment grade and high yield issuers are widening. Once again, these are either signs that the bond markets are moving closer to bubble territory or that something really bad is about to happen to the global economy - a recession and/or a more significant decline in long-term potential growth rates and persistent low inflation with growing deflationary risks.
6. Despite (as always) positive surprises during the most recent earnings reporting season, the reality is that corporate profits in the US are weak and suffer from USD strength and weak oil prices while pressures on profit margins are building.
7. Technical factors and seasonality: Market breadth is weak and key moving averages have been broken to the downside, while trends in leadership are also worrying. Moreover, the period between August and October is also widely seen as a time when things usually get tougher for equity markets, another reason for short-term caution.

On top of these concerns which resulted in our decision to take some risk off the table and keep some powder dry for later in the year, the **Yuan "devaluation"** and the significant weakness seen among EM currencies is bringing back **memories of the 97/98 Asian financial crisis.** It is fair to say that there are many similarities but also several key differences.

While the Chinese currency was stable during the 97/98 crisis, it was devalued by 30%+ in January 1994, just months ahead of the "Tequila crisis" and probably played a role in Asian economies' troubles a few years later. The Asian crisis was a typical balance of payments crisis caused by excessive accumulation of external debt, capital outflows, limited and rapidly shrinking foreign exchange reserves in an effort to defend fixed exchange rate regimes and a resulting lack of monetary and fiscal policy flexibility. Today, several economies face a deterioration in their current account balances due to the sharp reversal in the commodity cycle, growing external debt servicing burden and weak foreign capital inflows (portfolio flows and foreign direct investment). The rapidly shrinking growth differential with developed economies and a declining return on investment are key factors behind this deterioration in current account balances, at least for some of these countries. A strong dollar and expectations of rising rates act as additional headwinds. In this context, the recent CNY devaluation is seen by some as the spark that could ignite a full-blown crisis.

While these parallels are worrying, **there are very important differences today** and we doubt that we will see a repeat of how events unfolded back in the late 90's. One could also argue that we have had our emerging market crisis already for the past few years with rapidly declining currencies and significant relative underperformance from EM equities, which are basically flat for the past 6 years in USD terms.

- First, **most EM currencies are freely floating.** As such, the sharp declines seen in recent months provide these economies with one additional tool to deal with current account weakness by supporting their export sectors and, with a lag, attracting foreign flows looking for cheap assets. It is also important to highlight that the countries facing a tough situation from a current account perspective are more limited than during the late 90's (investors have referred to these countries as the "fragile 5").
- Second, since the 97/98 crisis, and thanks to a significant increase in global trade and the commodity super-cycle, most EM countries have accumulated a **record amount of FX reserves** which are acting and will continue to act as very precious war chests in servicing external debt obligations and dealing with foreign capital outflows.
- Third, there has been a significant **shift away from USD denominated debt to local currency debt,** at least when it comes to public debt. As a result, countries are much less exposed to the negative impact from dollar strength. This is a very important change compared to the situation in the 90's. The weak spot today is probably the rapid accumulation of private sector debt and, in some cases, a decent chunk of this borrowing took place in USD. However, the difference between corporate and public debt is that companies generate a decent amount of their revenues in USD and there is therefore a natural hedge against their USD debt servicing obligations.
- The final difference has to do with **policy flexibility,** which is the direct consequence of the move away from pegged currencies. Defending a currency peg means that a country needs to deplete its FX reserves to defend the value of its currency when the dollar moves higher. As a reminder, the previous period of strong dollar was during the second half of the 90's. It also means that these countries are losing control of their own monetary policy and are not able to support a weakening economy through interest rate cuts or other measures. They basically need to adjust their monetary policy to the Fed. Today, most economies have that flexibility, in particular for those economies benefiting from the rapid drop in commodity prices and the resulting decline in inflationary pressures. As a result, we have seen interest rate cuts in numerous EM economies in recent months. There are obviously some exceptions such as Brazil where, despite very weak growth (more specifically recessionary conditions), the central bank has been forced into a series of rate hikes due to elevated inflationary pressures (a byproduct of the significant drop in the BRL over the past 4 years).

The weak spots in EM are therefore those economies running current account deficits and highly sensitive to commodity prices. But overall, the contagion channels and the likelihood of a crisis throughout the region is relatively low.

WE ARE CAUTIOUS, BUT NOT BEARISH

We expect additional weakness in the near term and would not recommend stepping back into equities at this juncture. The technical picture is very weak and markets are not yet oversold. We think this correction has further to run.

But, based on fundamentals, we think this is only a typical correction, not the beginning of a new bear market. It is impossible to know how far this correction will go, and equally impossible to know how fast markets will rally back up.

Once again, we don't see the early signs of a looming recession which could be devastating for corporate profits and equity prices. We also don't believe we are headed toward a full-blown EM crisis. We believe plunging commodity prices are more a reflection of years of new capacity investment and oversupply rather than a sign that demand is abnormally weak. We don't expect a hard landing in China and believe that China will continue to gradually implement some reforms, open their capital accounts, and provide some short-term monetary and fiscal stimulus. We also believe that corporate balance sheets (outside of the energy sector) are still in relatively good shape and credit spreads should soon stabilize. We are concerned with the structural decline in long-term potential growth globally but believe this view is already very much discounted in asset prices. We also believe that the Fed will soon start a process of normalizing interest rates, and beyond the short-term volatility and risk aversion, this will not change the fact that global monetary conditions will remain very accommodative. We therefore continue to believe that government bond markets offer a very poor risk/reward trade off. While equity valuations are stretched, they remain relatively attractive in light of limited opportunities in other asset classes and a rebound in corporate earnings should help stock prices move higher going forward.

We still think we are in a structural bull market that still has some legs, particularly outside the U.S. where valuations are more attractive and the potential for sales growth and margin improvements are much more significant. As a result, we feel comfortable with our current positioning and look at our relatively high cash positions as opportunistic in order to move back into risk assets later in the year. On our shopping list, emerging markets (where we are now underweight) and high yield bonds are at the top, as well as some sectors within the US equity market, such as financials.

In these market conditions, it is crucial not to panic as corrections within a bull market are buying opportunities, as painful as it might be in the near term. We will keep you posted when we feel the time is right to get back into the markets or, alternatively (and hopefully not) whether the economic outlook has deteriorated to a point where an even more defensive stance is required. The most likely scenario though is that the bull market will resume later in the year.

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