Downturn on financial markets: where do we stand?

Following the fallout of the Chinese equity market downturn and the subsequent market rout that sent global equities and commodities sharply lower on Monday, August 24, Petercam IAM market specialists believe a short update is warranted. Hans Bevers (Senior Economist), Guy Lerminiaux (CIO Equity) and our fixed income experts give their view.

Q: What does the current market environment look like from a macro perspective?

A (Hans Bevers): The sharp decline in equity and commodity prices witnessed in recent days suggests the world economy is entering a major slowdown phase or even renewed recession. Moreover, EM currencies are suffering badly prompting some to argue that a full-blown financial crisis in emerging markets is just around the corner. **In short, this is not our view**.

Financial markets are increasingly worried about the Chinese growth slowdown, especially since policymakers devalued the RMB. But all in all, the incoming data are still consistent with China's economic rebalancing efforts rather than a hard landing scenario. Although the long-term trend is clearly down, both earlier monetary stimulus measures and additional budgetary spending efforts should soon start to have positive effects.

EM weakness is likely to persist and several EM are likely to stay vulnerable. But a full-blown emerging market crisis seems unlikely for several reasons: (1) more flexible exchange rates (overcoming the "fear of floating"), (2) less pro-cyclical fiscal policies allowing larger budget deficits in times of crisis, (3) less debt in foreign currency (the original sin) avoiding a currency and maturity mismatch between domestic revenues and foreign liabilities, and (4) significantly more international reserves that can be run down to mitigate currency depreciation. The latter is important because for heavily indebted countries with liabilities in foreign currency, FX depreciation can be contractionary instead of expansionary.

With regard to the situation in the US and the Eurozone, economic confidence indicators are still confirming our moderate global recovery scenario. We have argued before that the Eurozone is still facing major hurdles and we would certainly not label the US economic recovery as spectacular. That said, we see little reason to become too pessimistic either. The global recovery is showing signs of hesitation but leading indicators do not point to a sharp slowdown.

Q: What is the situation on equity markets?

A (Guy Lerminiaux): **We believe that the sell-off on equity markets is somewhat overdone**. Everyone had been waiting for a correction and this is exactly what happened.

We believe investors are getting carried away by the negative news coming out of China. In fact, the conditions for further growth in Europa are still intact. The fall of commodity prices may not be a good thing for those producing commodities, or for emerging markets. However, it is a boon to the western consumer, although he is feeling lower prices with some delay.

Overall we think that European equities remain attractive. Overall we can see that when the VIX index spikes above 40, over the past 30 years it has been a good indicator to start dipping your toes in the water. That is what we did on Monday August 24th. It may not have been 'the' low, but **some opportunities presented themselves and we benefited from those**.

Q: Finally, the expectations and outlook for fixed income markets?

A: Fixed income experts:

- As a rule we state that assets that are valued at low risk premia will provide for low future returns and vice versa.
- Term premia on core DM government bonds are extremely low and even negative across the front and medium part of the yield curve. Term premia represent deviations from the expectation hypothesis i.e. that the long bond yield is the average of expected short-term rates. The forward rate is the expected future short term rate. These low or negative term premia cannot be fully explained by low growth and inflation expectations. **Central bank direct intervention (QE purchase programs), communication or overall regulation exerts downward pressure onto term premia.**

- **We claim that as long as QE programs are in place (ECB, BoJ, Fed…) value resurfaces in DM government bond markets the moment spot rates spike and go well beyond the level that forward rates showed before the rout**. Such instance occurred during the US Fed induced taper tantrum in the spring of 2013. It happened again during this spring as we had an upside reset to of European long rates and 10y German Bund rates went from 0.07% towards 1.00% early June. **Since then we have been consolidating within that wider 0.50% and 1.00% range.**

- **The events in China and EM markets in general that occurred over past weeks have had a minor impact on rate markets. On Monday the 24th of August we did not witness any meaningful flight into German quality bunds.** China pushed Greece off center stage. While both have the potential to support Eurozone government bonds the strength of the current "Flight to Quality" bid is clearly different. Possible headwinds for EGB's are mainly flow-based. Issuance is expected to pick up after the summer lull. Though typically September and October issuance is not as heavy as Q1 or Q2 issuance it is clearly more than the quiet summer months. Another source of supply to watch out for is the net flow into balanced portfolio's. Outflows (or de-risking) in the biggest success products of the last couple of years could result in considerable selling of bonds and put further pressure on the negative correlation we have grown familiar with between high quality bonds and risky assets. **Value and interest will reappear as soon as 10y bunds rise beyond 0.80% towards 1.00%.**

- In terms of **inflation**, the overall devaluation of emerging currencies re-ignites the deflationary trends, especially for developed markets. Oil, and other commodities, have weakened based on increasing supply expectations (Iran) and weaker demand expectations (weaker global growth). As such, commodities are also adding to the disinflationary pressure. The leads us to expect that developed markets **real rates will remain low and range bound at around current levels**. **Inflation expectations have decreased significantly and have been aggressively priced down to the extent that the current price levels are cheap – even give the above disinflationary factors**. We therefore prefer to switch to inflation linked bonds around these levels. It does remain bottom calling: it's difficult to catch a falling knife, especially if you don't know the height of the person dropping it.

- **IG credit risk premia** are fair given our assessment for an extended low default rate environment. However, given low government bond reference rates the corporate yield one buys as a percentage of spread is high. That results in an environment where IG credit spreads lose part of their buffer function as rates rise. Nonetheless an investor with a 4 to 5 year investment horizon finds value when he buys an Iboxx € IG corporate bonds index yield of 1.70% or a yield of 2.10% through the Petercam Quality fund.

- **Along with the correction in the equity markets, the high yield market has been also in a risk-off mode**. For the US markets, we have argued in the past that a strong relationship exists between a major correction in the equity market i.e. a drop > 8% and an important correction in the HY market i.e. a drop > 4%. This relationship has played out once again. Clearly the correction has been exacerbated by poor liquidity in the credit market along with US HY outflow and declining oil prices (a major sector in US HY). European high market are not immune from the situation in the US. Nevertheless, the correction has been more muted: the index is losing 1.85% against 3% in the US.

  The situation is quite different for the European High Yield market: Energy sector weights less than 2% in the index, and most European high yield companies have a European focus and are less dependent of China. Equity volatility is a key factor along with default rates. Default rates are expected to remain low. S&P forecast a 2.7% default rate by March 2016.

  Currently, the spread premium is discounting a cumulative default rate of 27% for the next 5 years.

  We clearly need to see a stabilization of the equity volatility before expecting any long standing rally in the European high yield market. Nevertheless, from the perspective of a "buy and hold" investor with the same investment horizon than the

fund, the correction has been creating a decent cushion to absorb default losses. The Petercam corporate high yield fund boasts a yield of 4.57%.

- Last but not least, **Emerging Markets** showed acute stress reaction to the new leg of commodity weakness that began early July. The move was exacerbated two weeks ago when China unprecedentedly allowed the renminbi to depreciate by approximately 3% against the U.S. dollar, which the market took as a declaration of (currency war) against its competitors. Energy exporters obviously took the brunt of the sell-off, but the EM debt complex as a whole was quickly contaminated by the risk-off environment.

  Russian local bonds (no exposure) got most of the brunt, and were on the close of August 24th down 25% quarter-to-date. Local Latin America was down 15% QtD, excluding distressed Argentina and Venezuela. China's competitors in Asia as well as Africa were down around 10% over the same period. The only region immune to the sell-off was Central Europe.

  Our conviction is that the worst is behind us after yesterday's capitulation, for the following reasons:

- **China's move was not a competitive devaluation but a move towards the liberalisation of its foreign exchange market and capital account – which is a long-term positive for EM.**
- **The sell-off in commodities, driven by excessive supply rather than fading demand, was differentiated and, as a matter of fact, have improved the terms of trade of many emerging countries.**
- **Valuations in local debt have become very attractive by historical standards, including the period 2008/2009. Real interest rates are now particularly high while EM currencies are much more competitive in real effective terms.**
- **Outflows out of EM assets have been more benign than what high frequency data recently suggested. This tends to show that long term investors are likely to rebalance their allocation in favour of EM debt and equities.**

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