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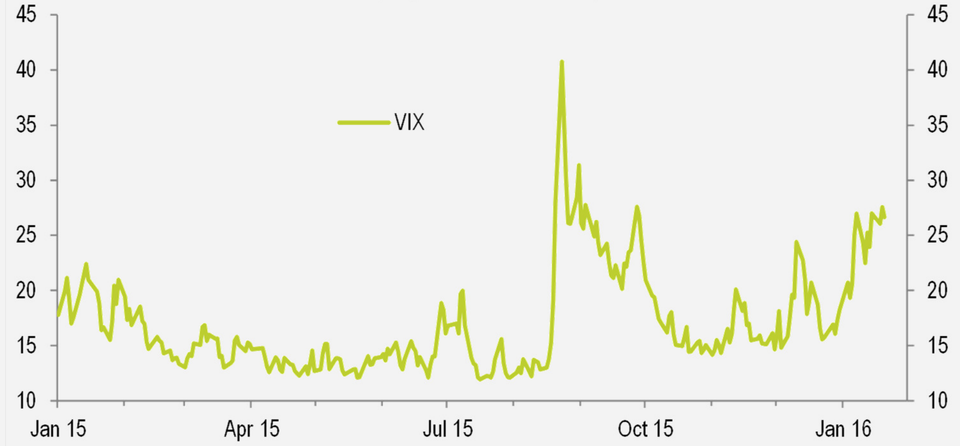
January 2016: Harbinger or hiccup?

Overview

- The volatile start to 2016 is only surprising in its degree. Highly valued equity and fixed income markets, combined with divergent monetary policy in three major economies (US, eurozone and Japan) and the rebalancing of the fourth (China), made it inevitable that there would be significant and sudden movements in asset prices.
- The medium-term outlook for developed market economies is still positive, however, so investors must take advantage of the opportunities presented by these sharp dislocations.
- While the emerging market crisis is not over, it does not present a threat to the global economy and parallels drawn to 2008 are exaggerated.
- Signs that things are getting worse include declines in US economic activity, while an increase in trade volumes could be a positive catalyst.



Data as at 21/01/16. Sources: Bloomberg, BNP Paribas Investment Partners.

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HARBINGER OR HICCUP?

The steep fall in global equities markets this month has come as a shock to many investors. However it is more the steepness and swiftness of the decline that is surprising rather than the fall itself. Like many, we have been expecting heightened volatility in 2016 — and now we have it. The only question was what would trigger the volatility: China or the Middle East? The US Federal Reserve or the European Central Bank? The key question facing investors now is whether the equity market's decline is a signal of broader macroeconomic instability, a harbinger of doom. Or just a temporary setback, a normal (if exaggerated) equity market hiccup.

We believe markets are overreacting and that they will recover. The key causes cited for the market's decline are yuan devaluation, Chinese economic growth, collapsing oil prices and weakening corporate earnings (either in the US because of the strong dollar or in Europe because of emerging market exposure). While there are certainly concerns, they are not significant enough in our view to warrant further dramatic losses in equity markets when developed world economic growth is broadly solid. Let us consider each risk in turn.

Chinese yuan

The yuan's depreciation has been unsettling as it followed five years of steady appreciation and certainty that the People's Bank of China (PBoC) would determine the rate of change. The Chinese yuan was recently included by the International Monetary Fund into the currency reserve basket that makes up the Special Drawing Right (SDR). The PBoC has consequently said the value of the yuan would be driven more by market forces and that they would target the value of the yuan against a basket of currencies instead of the US dollar. As the yuan has depreciated, worries rose of another battle in the "currency wars" of the last several years and that China was deliberately reducing the value of its currency in order to boost the growth of the economy. Predictions of a shock devaluation of up 50% can be seen in the press. Should anything like this occur, the effect on global economies and markets would be severe, both for those emerging market countries whose exports compete with China, for example Korea, but also for those countries which export to China such as Germany.

Predicting the "fair value" of a currency is hazardous at the best of times, but it is all the more difficult when the currency's value is managed by a central bank and a country's current account is closed, or at least restricted, as is the case in China. It is nonetheless unlikely that China wants, or that the economy needs, to see a significant depreciation in the yuan. From a macroeconomic point of view, one should expect the yuan to be appreciating versus the dollar, not depreciating, as China still runs a significant trade surplus with the US. The main way this surplus would decline is through Chinese exports becoming more expensive so that the US imports less. It is also unlikely that the Chinese government is attempting to weaken the currency. In fact, they have been trying to prevent its decline by using their substantial foreign currency reserves to support the yuan's value (reserves have fallen from a nearly USD 4 trillion to USD 3.3 trillion at the end of December).

On the other hand, markets are expecting interest rates to rise in the US but to fall in China, which would argue for a weaker yuan as the interest rate differential narrows. Another factor driving the yuan lower is the flow of capital out of the country as Chinese individuals and corporations try to convert their yuan into dollars in anticipation of further declines in the yuan's value. This demand for dollars weakens the yuan, generating the exact outcome they fear. It will be necessary that the PBoC is able to stabilise the exchange rate before these capital outflows slow, but it is not clear when this will happen.

Chinese growth

Despite the recent announcement of 6.8% GDP growth rate for the last quarter of 2015, doubts persist about both the level and trend rate of growth in the country. Many investors find it difficult to reconcile such a strong growth rate with other figures that suggest many parts of the economy are continuing to struggle (for example, manufacturing PMIs). The primary challenge the government faces is managing the rebalancing of the economy away from investment and towards consumption.

Based on the latest figures, this rebalancing is taking place. The contribution of consumption grew from 4.0% in the third quarter of 2015 to 4.6%, while investment declined from 3.0% to 2.5%. It is worth noting that exports have not been a significant contributor to growth for many years, supporting the argument that a weaker currency is not a goal of the government (see chart).

Data as at 21/01/16. Sources: National Bureau of Statistics of China, BNP Paribas Investment Partners.

While we acknowledge the challenges facing the economy, we believe there is enough strength in the "new" China economy (internet commerce, travel, health care, etc.) to offset the weakness in the old (manufacturing and state-owned enterprises). The services sector has surpassed the manufacturing sector in size and should continue to increase as industries like tourism and health care expand.

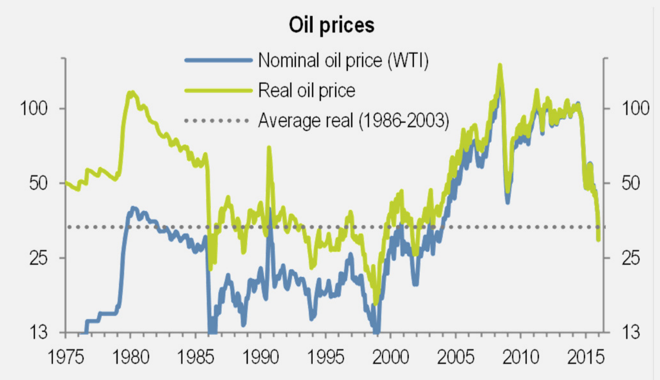
The main criticism of the economy made by those who are more pessimistic about the country's outlook is the debt burden, which has risen from 130% to nearly 210% of GDP, according to calculations by Bloomberg. There is certainly a risk that some of these loans will not be repaid, but in contrast to the situation in many other emerging markets, the debt is denominated in local currency and not in US dollars. There is consequently less risk of any defaults sparking a crisis outside of the country. Moreover, the assets of the banks that have loaned this money to the companies are ultimately backed by the Chinese government, which has the resources to stand behind them, in contrast to Ireland or Spain when they faced their own banking crisis.

China will remain a worry for investors and a source of volatility as it is the second largest economy in the world, undergoing a significant transition, and the workings of the economy are opaque. We believe, however, that there is enough opportunity in the new economy for investors, even as we remain wary of those countries and industries which depended on ever rising demand for commodities from China.

Oil prices

Oil prices are correlated with expectations for global growth, and in particular Chinese growth more recently. Can we interpret the collapse in prices as a sign that economies around the world are likely to slow significantly? We believe that the collapse in oil prices is primarily the result of an extended period of oversupply relative to demand, and importantly, oversupply relative to *rising*, not falling, demand.

Adjusted for inflation, oil prices have returned to the average levels from 1986-2003 of around USD 33 per barrel (see chart). Given the persistent overhang in supply and production from Iran coming sooner than expected, it is not surprising that prices have overshot. Prices are likely to remain weak until the imbalance in supply and demand is rectified. However, it is more likely that prices will remain near pre-boom historical averages rather than the more anomalous and more brief period when they were around USD 100 per barrel.



Data as at 21/01/2016. Source: Bloomberg, BNP Paribas Investment Partners.

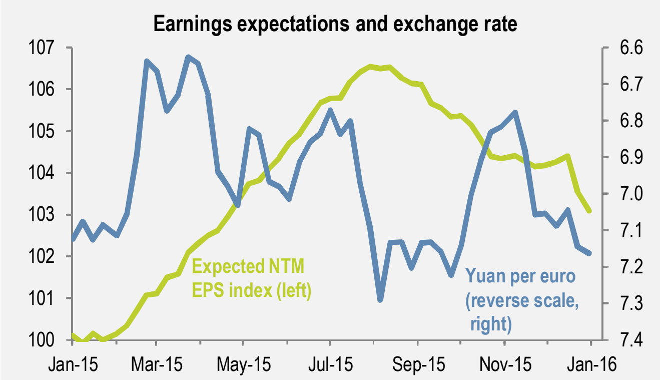
As with the adjustment in the Chinese currency, this change may be broadly benign (the developed world benefits greatly from lower energy prices), but the adjustment will be extremely difficult for oil-exporting countries and oil-producing companies. But even here there may be opportunities. Spreads for high yield debt issued by companies in the energy sector have topped 1,600 bps, which appear high given the default and recovery rates we anticipate. The yield on the Barclay's US High Yield index is higher than the peak level in December 2008, and notably the total return on the index from that point for the next year was 66%.

There is another perversely pernicious effect, however, from the fall in oil prices and that is the effect on inflation, both the level of inflation expected by the market and what is likely to appear in realised inflation in a year's time. Inflation expectations have dropped by 70 bps in the eurozone and over 100 bps in the US since 2014. This may seem plausible given that oil prices have declined by 75%, but it overstates the disinflationary effect oil is likely to have. Looking at the historical relationship between oil prices and core inflation, we are likely to see just a 40 bps drop in US inflation over the next year, assuming oil prices stabilised at these levels (while they are likely to rise by the end of the year). Normally lower inflation is considered beneficial for the economy, but it becomes uncomfortable when inflation is already at uncomfortably low levels as it is in the eurozone. Investors should not overreact, however, as the ECB is certainly aware of the challenge and is likely to provide further monetary stimulus to offset the effect of oil, and in any event the disinflationary pressures should receded on their own as the eurozone economy improves. The US is showing the way, with core CPI already having recovered to 2.1%, near its 20-year average.

Corporate earnings

Positive, but lacklustre, GDP growth in the eurozone has meant that sales to emerging markets are particularly important for European corporate earnings. Sales to emerging markets accounted for 20% of total revenues for companies in the MSCI EMU index last year, of which 5% went to China. The slowdown in China was compounded by rising US interest rates, which has slowed market economies, and weakened EM currencies

broadly, making eurozone exports more expensive. The depreciation of the yuan was just the latest shock. The deteriorating outlook can be seen in earnings expectations for eurozone companies, which have been declining for several months (see chart).



Data as at 21/01/16. Sources: IBES, Bloomberg, BNP Paribas Investment Partners.

While the near-term outlook remains challenging, eurozone equities should still outperform those in the US. Valuations for both markets remain slightly above average, but the prospects for earnings growth in the eurozone are brighter. US corporations face rising labour and financing costs (offset partly by falling energy prices), when margins are already at historic highs. Eurozone corporations by contrast face few cost pressures and have the potential to improve productivity. Margins for companies in the region are forecasted to be just 6.5% for 2016 compared to the historical high of 8.8%. While margins are unlikely to return to that level, there is still significant room for expansion.

The US market remains vulnerable to Fed interest rate hikes and earnings downgrades. However, over-optimistic forecasts for the year mean that there is still scope for expectations to fall. That said, the market should still generate modestly positive earnings growth in 2016.

Conclusion

As expected, markets have proven to be volatile. We believe that investors need to take advantage of the volatility as opposed to seeking safety in overvalued haven assets. A perpetually bearish stance is no more advisable than a perpetually bullish one. When corrections such as the one we have seen in January, we believe that assets should be reallocated to those with high betas such as information technology and energy in equities or high yield debt. Positions should become more defensive when volatility falls too low (the VIX near 15 in December was a warning).

While parallels to 2008 have been drawn, global or system imbalances do not exist on the same scale. Emerging markets will continue to suffer, but the emerging markets storms should not overwhelm the economic strength of developed markets.

We believe the negative catalysts to watch out for include deteriorating market sentiment and positioning; lower oil and commodity prices; equity valuations or earnings expectations discounting a US recession; renewed easing messages from the Bank of Japan and European Central Bank, or the US Federal Reserve signalling a pause in the rate of hikes; mergers, consolidations, bankruptcies and defaults taking out expected commodity supply.

By contrast, positive catalysts would include improving global trade volumes; signs of structural reform in emerging markets; steeper yield curves; aggressive, proactive policy easing in China and other emerging market countries with relatively strong current accounts and currencies. In addition weak emerging market currencies getting weaker as opposed to fighting the declines with higher interest rates, which would only serve to compound growth and recessionary fears.

So do we believe that recent moves are a harbinger of doom or just an exaggerated hiccup? On balance, our view is that markets are overreacting but that catalysts on both sides need to be carefully monitored.

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