



Equity Markets hit by storm

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By most measures, the first two weeks of 2016 have been the worst-ever start of the year for risk assets. With the MSCI All-Countries index down nearly -20% in USD from last May's high, we have gone through the largest correction since 2011.

While the latest rout has come as a surprise to most, the reasons seem obvious today.

- 1) There is huge uncertainty about the economic outlook in China and especially the currency outlook is murky. The market is digesting the risk that China will join the currency war and devalue significantly, thereby exporting deflation to the rest of the world.
- 2) There is a significant margin call moving through all facets of commodity markets. The owners of oil and other commodities, from shale-companies in the US to sovereign nations in the Middle East, have highly levered balance sheets. Throughout the boom years of 2001-2013 they used their assets to borrow, build, and promise well beyond what can currently be delivered. So as the asset prices crash, and their expected cash flows collapse, they must devalue as is seen in South Africa, Russia and Brazil and otherwise quickly raise alternative sources of funds to pay their debts and keep their promises - or else! Therefor the selling pressure is huge in the commodity space. But unfortunately also outside commodities, since sovereign wealth funds have started to liquidate the reserves

accumulated in the previous upturn. This includes listed equities in Western markets.

- 3) China's instability and collapse of the oil industry could push the US into a recession. We are already seeing that the US industrial production is in recession, declining 6% yoy. Furthermore, S&P500 profits are falling, primarily because of a strong USD and weak commodity earnings.

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In the following, we will expand on these risks

It is widely accepted that the best leading indicator of future financial instability is rapid debt to GDP growth over a period of several years as it's a strong sign of significant malinvestment. It is estimated ("This time is different", Reinhart & Rogoff) that once a country grows its private debt to GDP ratio by over 40% within a period of four years, there is a 90% chance that it may run into financial system trouble. The disturbance can be in the form of a banking sector re-cap, sharp currency devaluation, high inflation, sovereign debt default or a combination of these. China's private debt to GDP ratio rose by 75% between 2009 and 2014, by far the highest in the world. At the peak, over four years from 2009 to 2012, the ratio in China rose by 49%.

There is a growing risk that China's debt situation has passed the point of no return and it will be difficult to grow out of the problem, particularly if the growth continues to be driven by debt-fueled investment in a weak-demand environment.

The most likely forms of financial instability that China may experience will be a combination of RMB devaluation, debt write-off and banking sector re-cap and possibly high inflation. Most investors have probably forgotten or never known, but China has experienced all of these forms of instability previously in the 1980's and 1990's.

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However, we do not share the view that collapse is imminent. It is likely China eventually will go through a big economic crisis because of too much unproductive debt. However, we believe the Chinese leadership is still in control and believe recent policy change is only sensible.

It is clear that from now on the Chinese central bank will:

- 1) Manage the renminbi more against a trade-weighted basket of currencies (much like Singapore) than against the US dollar, and
- 2) Tolerate a greater degree of exchange rate volatility than in the past

It will do this simply because 1) it makes sense, and 2) if you want to have your currency develop into a global reserve currency you need to move away from simply being a USD-proxy and become independent of US monetary policy. It should not come as a surprise to markets.

The domestic Chinese A-market will continue to create noise simply because it is grossly overvalued. However, for an international investor this should be irrelevant; A-shares are not owned by international investors but by domestic investors. The real risk coming from China is whether the central bank will continue to have control of the currency. We believe they will, but in order for us to assess whether things develop smoothly or not it will be important to see that capital outflow from China does not accelerate further

in the coming months, and that the offshore Chinese Renminbi does not deviate significantly from the domestic spot rate.

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On the oil price we don't have much to add except to observe that the “correlation of doom”, that has been between the oil price, EM currencies, high yield credit and equities, remains intact. Should EM currencies continue to depreciate against the USD, the oil price will most likely continue to drift and take credit and equity markets with it. It is interesting to observe that the equity markets started falling and the oil price collapse accelerated again after the most recent OPEC meeting December 4. Here it became clear that OPEC was broken. We understand that Saudi Arabia now wants to deliver whatever the market can take, similarly to how Rio Tinto and BHP have acted in the iron ore market. The consequence is most likely low prices for the long term. However, we are approaching an oil price that should be conducive for the start of a healing process that will include consolidation, leading to an improvement in returns on capital. This is doubtless on its way, but unfortunately, the initial news flow about defaults and bankruptcies will probably be negative, not positive, for market sentiment. However, outside the energy market, this should be positive. Every

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household in America and Europe is net short the energy asset. This crash in energy is a huge transfer of wealth away from the levered global energy asset holders to the unlevered average consumer. But because we see the fire sale and default effects much faster than the wealth effects for consumers, it feels pretty messy. There is short-term pain here but a lot of long term gain.

In fact, if we dig deeper, this is almost the opposite of the 2008 housing crisis in the US. Going into 2008 the home ownership rate was just under 70%. Over 2/3 of American households were levered long to the asset that had a 10 standard deviation move to the downside. We would argue that today over 99% of US households are currently net short (not levered short, but still short) to an asset that just has had a 10 standard deviation move. This is a HUGE positive for the global consumer!!

We are transferring enormous wealth away from foreign sovereign wealth fund savers, and giving it to high marginal propensity to consume domestic consumers. Main Street loves this, but for Wall Street it is trickier. The "excess selling glut" will likely keep some pressure on risky assets as the energy margin call moves forward. But against that a stronger consumer will "eventually" buoy growth and corporate earnings. And the disinflationary pressures from lower energy prices will keep the Fed on the side-lines.

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While we acknowledge there are a few – but rising number of – indicators pointing in the direction of a US general recession, there is an even longer list of indicators stating the opposite. Salaries are not overheating, inflation is non-existent, cyclical sectors are not extended, the FED is still extremely expansionary, and – most importantly - the housing market continues to expand and has plenty of runway before it hit levels of activity that previously have been associated with a coming downturn. Therefore, while the odds of a US recession have increased recently we think the likelihood is still low that we will actually enter one over the next year or two. What could change our view would be if for some reason housing markets deteriorated or that the banks reduced their willingness to extend credit, something we are following closely.

In the short term, lousy market conditions are likely to persist for a while longer. Is there a bright side? If you can stay solvent, there is. Arguably, this year's sudden decline is a reaction to the end of two major distorting influences. One was the Fed's zero interest-rate policy, which artificially boosted global asset prices for seven years following the 2008 crisis. The other was China's long-running stimulus program, which artificially boosted commodities and related sectors until the end of 2014.

Painful as things might be right now, global markets and economies are better off in the long run with the removal of these economic drugs. Now they are being forced into withdrawal from both drugs simultaneously, and they are shrieking. Nevertheless, after a period of rehab, markets should do a better job of gauging what assets are really worth.

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As Baron Rothschild said – There's blood in the streets. The return to more normal market conditions has increased investors' sensitivity to macro risk because prospective returns seem low relative to investment risk. However, as we have previously communicated the world is a very diverse place, and the difference in returns between winners and losers will continue to be very high in the years ahead. This is fertile ground for stock picking, and we are very optimistic about our ability to find the good equity story in a volatile world.