September 2015

Global Stock Markets See Wide Swings in August

Overview

In late August, several factors conspired to prompt investors to sell global stocks sharply over a short period of time. We believe that the main reasons were (1) concerns over the magnitude of the economic slowdown in China and the policy response, (2) the revaluation of the Chinese currency, (3) new near-term lows in commodity prices that reflect anxiety about global growth especially in emerging markets, (4) some skittishness about moderately above-average asset valuations in developed markets, and (5) speculation about the timing and effects of action by the U.S. Federal Reserve before year-end in light of the foregoing, including effects on the relative strength of the U.S. dollar and the earnings of multinational companies. We could distill these reasons further into China, oil, and Fed. In our view, the recent widespread stock turbulence, especially for developed markets, reflects the sell-offs or corrections that often attend event-based shocks rather than a deep and prolonged bear market that typically accompanies a recession. That distinction is important because it suggests something not only about the depth but also the length of the equity pullback, namely, that it is likely to be temporary. As we explain in this month's issue of *Sage Insights,* we view August's market action as an overdue pullback in an upwardly rising U.S. economic cycle.

Performance

Major stock and bond benchmarks generally declined in August.

Index Name	August 2015	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.20	1.04	3.96	4.49	US Muni Bonds
BarCap US Agg Bond TR USD	-0.14	0.45	2.98	4.46	US Taxable Bonds
BarCap US Corporate High Yield TR USD	-1.74	0.15	7.34	7.43	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.91	1.24	5.33	7.21	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-5.38	-12.30	-1.88	4.84	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-3.08	-1.07	0.92	0.08	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-6.20	-5.68	13.38	7.42	US Equity -- Large
S&P 500 TR	-6.03	-2.88	15.87	7.15	US Equity -- Large
NASDAQ Composite TR USD	-6.70	1.65	19.10	9.39	US Equity -- Large
Russell 1000 TR USD	-6.02	-2.57	16.07	7.35	US Equity -- Large
Russell Mid Cap TR USD	-5.28	-2.33	16.56	8.40	US Equity -- Mid-sized
Russell 2000 TR USD	-6.28	-2.97	15.55	7.12	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-7.64	-4.18	4.76	4.04	Int'l Equity -- Comprehensive
MSCI EM NR USD	-9.04	-12.85	-0.92	5.52	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-0.92	-12.82	-6.96	-4.91	Commodities
HFRX Global Hedge Fund USD	-2.21	-1.00	0.80	0.56	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 8/31/2015

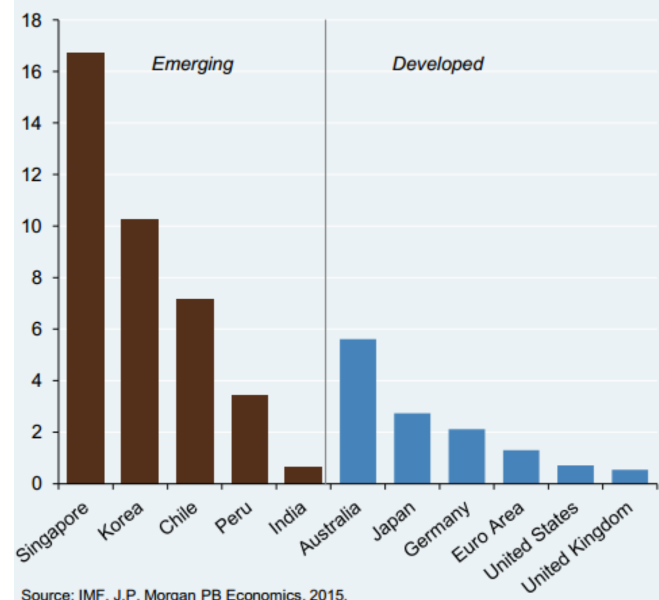
Last month, when most equities declined by about 5-6%, U.S. core bond prices remained largely steady (municipals were slightly higher, taxable bond were slightly lower). Given headline risks from China, emerging market stocks fell the most of the major indices, and foreign stocks declined more than domestic stocks.

For the year 2015 through August, core and high yield U.S. bond returns are positive. Domestic equities moved into negative territory, down between 2-3% YTD. Diversified foreign stocks have declined a little more through August; the MSCI All Country World Index ex-USA is down 4.18%. (As a housekeeping note, we have replaced in the market yardsticks table the MSCI EAFE index with the MSCI All Country World Index ex-USA [i.e., "ACWI ex-US"]. The reason for the change is that the EAFE only included developed markets [predominantly Europe and Japan], whereas the ACWI ex-US is a comprehensive index of foreign stocks. This broader index more accurately reflects the portfolio components of most core diversified large-cap investment strategies. The ACWI ex-US Index will appear in future reports for this reason.)

Outlook

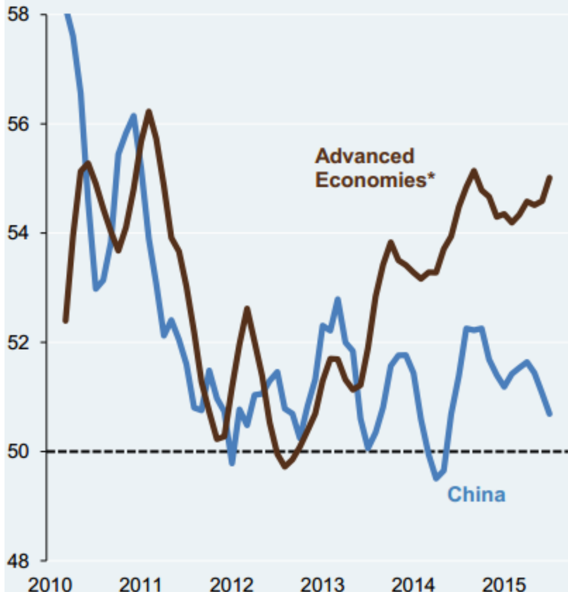
As we look to what lies ahead for the global economy and investments in the wake of August's equity volatility, we still believe, as we have previously remarked, that the key global macroeconomic factors that will influence market action are (1) developed market (i.e., U.S., European, and Japanese) economic growth, (2) China's and emerging market economic growth and transitions, and (3) commodity price dynamics, all within the context of (4) the Fed's first interest rate increase in nearly a decade. Economic growth is solid in the U.S., improving in the Euro zone, and largely stable in Japan (especially after accounting for weather-related effects on GDP in Q2). Conditions are most conducive in those regions -- the U.S., the Euro zone, and Japan -- to gradual asset price recovery from August's declines.

To be clear, we do not anticipate an imminent recession in the U.S. Declining unemployment, decreased household and private-sector debt since the financial crisis, and steadily positive manufacturing activity all point to continued overall economic growth. The fact that the Fed continues to debate *when,* not whether, to increase interest rates and begin to normalize its rate policy signals that underlying U.S. economic strength is sufficient to support tighter monetary conditions. Monetary policy in Europe and Japan remains stimulative and is likely to remain loose for the time being. Japan is perhaps more vulnerable than the U.S. or Europe to weakness in China simply because of its higher economic trading volume, but even that is small with exports to China counting at present for just over 2% of Japan's total GDP (see nearby chart).



Overall, advanced economies have a generally firm fundamental economic foundation, and the export trade exposure of most advanced economies to China's slowing growth is limited. According to Goldman Sachs, China accounts for about 2% of S&P 500 revenues and only 0.5% of U.S. corporate profits. Growth is slowing

in China, which itself is not a new development, but the effect of that slowing growth in China on the bulk of world economic activity should be put into perspective.

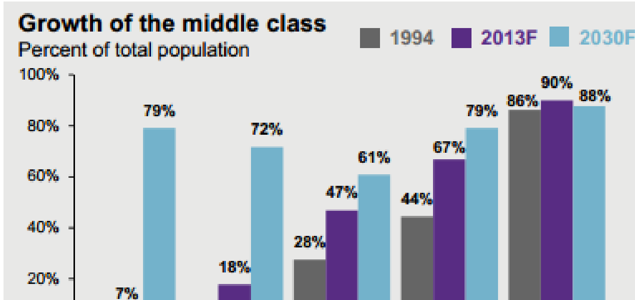


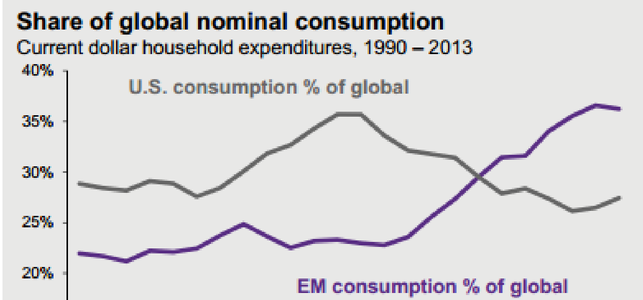
What about economic developments in China? In the nearby figure you can see a comparison of manufacturing activity in advanced economies (defined as the U.S., the Euro area, and Japan) and China. Both data lines show values that are above 50, and so indicate expanding activity, but the trending direction of China's economic growth has been flat to down over the last several years. This trend in Chinese manufacturing activity represents an economy in transition. Rail traffic and cement sales have reversed from the robust pace of the early 2000s. The economy is transforming, or being transformed, from one driven by capital investment and infrastructure build-out to one that will be increasingly driven by domestic consumption and the service sector. That transition is underway. It is a necessary transition. But it will take some time to unfold more fully and will likely not occur without disruptions.

At the same time, whatever discrepancies exist between official Chinese GDP and actual GDP, China is growing at a healthy level for a large economy. It is still generating massive amounts of economic output. One estimate from a portfolio manager at Oppenheimer, who recognizes all of these dynamics, is that the Chinese economy will still compound at 5-6% annually over the next five years. Estimates for U.S. economic output by contrast are largely in the 2-3% range. In this sense, China is projected to remain a key global growth engine.

None of this is meant to suggest that the structural shifts underway in China, as well as some other developing market countries, do not pose near-term challenges. They do. As such, volatility in emerging market stocks may continue in the near-term. Commodity prices may well be in the same boat given their often close connection with many emerging market economies. We have remained invested in emerging market stocks as investors whose time horizon is measured not in quarters but in years.

The long-term economic growth in emerging markets will likely stem from (1) a growing middle class, (2) a favorable demographic profile including young labor, and (3) the urbanization process. Economic growth should flow from all of these factors, but not every country will display each of these features all of the time. For



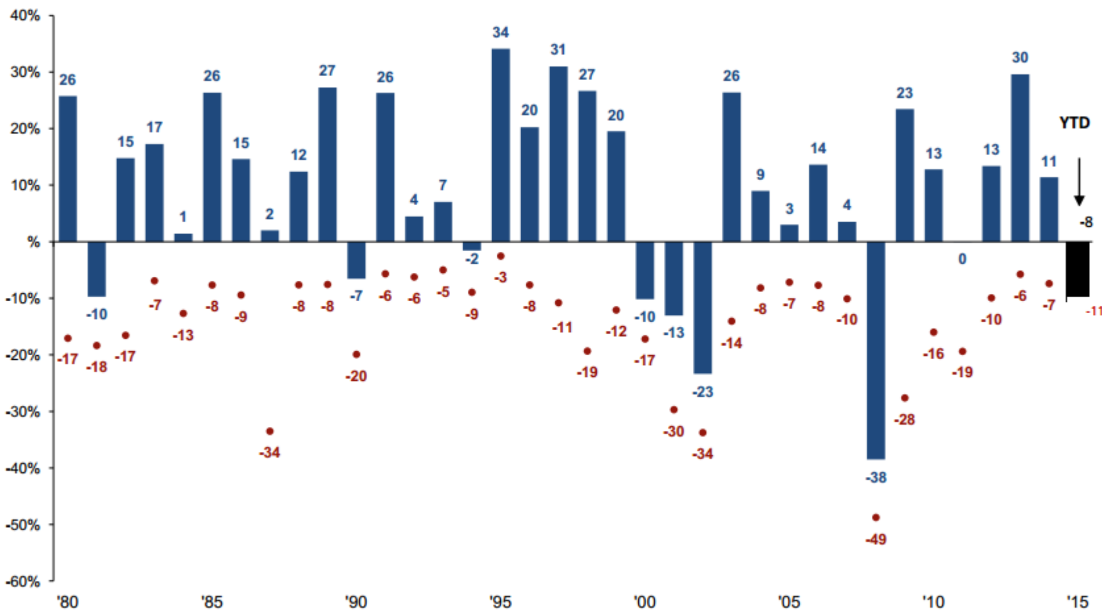


Source: JP Morgan's Guide to the Markets (June 30, 2015)

instance, as you can observe in the graphics above, the share of emerging markets' contribution to world GDP has almost doubled over the past 10 years. With the growth of the middle class comes the growth of consumption and new opportunities for companies to meet growing consumer demand. There is not a one-to-one correspondence between economic growth and investment returns; however, over time growth in dynamically and differently developing countries should allow companies in these markets to capitalize on similarly dynamic and different opportunities in ways that will benefit investors.

In the meantime, in China, officials within the People's Bank of China are likely to continue to ease monetary policy to stimulate the economy. On August 25, the central bank reduced the reserve requirement ratio for banks and lowered the one-year lending and deposit rates. Second, in addition to monetary policy stimulus, over the next year there may be some gradual depreciation of the renminbi against the U.S. dollar. Although this development would not alter the secular or structural shift of declining growth rates from exports compared to the past, it would increase the competitiveness of Chinese exports in the near-term as the economic transition matures. Third, it remains possible that the Chinese government will embark upon some new fiscal policy initiatives to upgrade essential infrastructure assets like water and sewage systems in major cities. Such measures, if they occur, may not only buoy economic activity and asset prices in China but also could help other developing markets closely linked to China, such as Brazil.

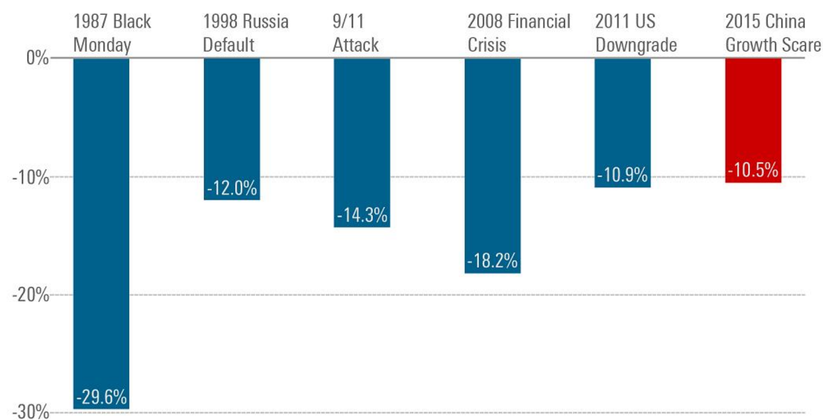
In last month's *Insights*, we reiterated that the U.S. had gone an exceptionally long time without a stock market correction of 10% or more. The last such correction was about this time of year in 2012. As you can see from the graph below, intra-year stock market declines are very common (the red dots and numbers for each year). These happen to some degree each year, even when the calendar year returns are positive, which has occurred in 27 of the last 35 full calendar years.



Source: Bloomberg. J.P. Morgan Asset Management.
Returns are based upon total returns not including dividends. Intra-year drops refer to the largest market drops from a peak to a trough during the year. *Returns shown are calendar year returns from 1980 to 2014 excluding 2015 which is year-to-date.
Year-to-date data through 8/24/2015.

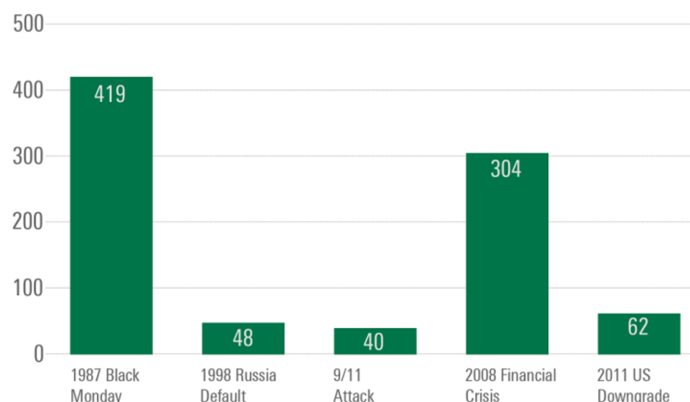
We also noted that U.S. stocks often experience declines shortly before or in conjunction with the beginning of a Federal Reserve interest rate hiking program, although an initial decline in U.S. stocks is usually followed by recovery and additional, but modest, gains 12 months later. In the absence of a recession, then, such a pullback as we have seen in the last month -- both after a long period without a 10% or more correction and in advance of a likely Fed rate hike perhaps before year-end -- is not unusual.

What is unusual is that this decline occurred so quickly, most of it within five trading days (from Aug 19-25). As we noted in the introduction, we view the recent decline in developed market stocks as an event-based shock. Of the five times that the Dow Jones Industrial Average previously fell 10% or more within five days, the three that were of roughly similar magnitude were event-induced pullbacks: the 1998 Russian debt default, the 9/11 attack, and the downgrade of U.S. debt in 2011.



Source: Morningstar.com as of 8/27/2015.

More instructive is the recovery time for the losses of event-induced declines: the time for stocks to recover their losses from event shocks was much shorter than the two recovery periods prompted by U.S. recessions.



Source: Morningstar.com as of 8/27/2015.

We do not at present see signs that signal a U.S. recession warning. Movements along the Treasury yield curve are a result of expectations of policy rate *normalization*. Durable goods orders in the U.S. rose 2% in July from June for the second straight month after rising 4.1% in June from May. Personal income was up 0.4% for July. Personal spending increased 0.3% in July, and personal consumption gained 3.1% in the second quarter. Inflation remains moderate. And second quarter U.S. GDP was revised up from 2.3% to a more robust 3.7%.

The precise time for U.S. stocks to recover from their recent declines is unpredictable, and for this reason we show the graphs above for illustration purposes only. It is quite possible that there will continue to be additional global stock market volatility as investors sort out the coinciding data from China, commodity markets, and the U.S. central bank. We further believe, as we have explained in previous issues of *Insights*, that the U.S. and European economies are on solid and generally improving footing, despite some headline risks.

We encourage our clients and friends to view the current events through a longer-term lens. In times when some market participants are panicking, investors who remain level-headed are better able than otherwise to see how one's longer-term investment plan may overshadow current events. Such a well-crafted plan itself takes into account the regular volatility of equity markets. In this way, such investors may more easily practice the discipline and patience that leads them successfully to what they are typically really after: the achievement of long-term goals for themselves, their children, and their benevolent interests.

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