

# MARKET

## PERSPECTIVES

STC Investment Committee

Bruce L. Swanson

September 20, 2015

Global equities fell sharply in August after China's surprise 3% currency devaluation on August 11. As this devaluation closely followed the Chinese authorities' heavy-handed support of the frothy mainland equity market, investors suspected that the Chinese growth slowdown might be greater than previously assumed.

Global equities fell sharply in August after China's surprise 3% currency devaluation on August 11. As this devaluation closely followed the Chinese authorities' heavy-handed support of the frothy mainland equity market, investors suspected that the Chinese growth slowdown might be greater than previously assumed. Volatility spiked on a record 1,000 point intra-day plunge in the Dow Jones average on August 24, further spooking investors. Accordingly, they liquidated any asset linked to China, including Chinese stocks, other Asian stocks, commodities producers or anything else sensitive to global growth. The world equity index declined double digits intra-month, but finished down 6.9%, leaving equities solidly in the red at -3.5% for 2015 thus far.

The dollar lost about 2% against major currencies such as the yen and euro as hedged Japanese and European equity and carry-trade positions were unwound. Traders gradually reduced odds of a September federal funds rate increase. The dollar continued to gain against most emerging market currencies. Commodities

were little changed overall as oil and gold gained 3-4% over the month from depressed levels. Iron ore and coal prices continued their downward spiral. Commodity indices remain down 30-40% over the past year.

Despite economic reports that featured a 3.7% second quarter gross domestic product increase and other strong reports in durable goods, housing and labor markets, U.S. equities fell 6%, the worst monthly return since 2012. Losses were widespread across capitalizations and styles, but healthcare was the worst sector, down 8%. Foreign developed-market equities fell 7.4% in August, but have outperformed U.S. stocks by 2.7% thus far in 2015. European equities also were down 7% in August, as the announcement of a Greek bailout was overshadowed by concerns over exports to China. Despite the trade linkages to China, Japan declined only 5.8% in August and remains the best performing large-equity market at +7.5% for 2015. Australian equities, down 11.4%, were hard hit by their ties to China. Smaller-capitalization equities

were judged to be somewhat insulated from the China slowdown and outperformed, falling only 4.4%.

Emerging market equities were hard hit by the market volatility and economic outlook for China as fund outflows reached their highest levels in 2015. Emerging markets fell 9.0% for the month and have plunged 12% in 2015 and 22% for over the past year. Interestingly, China-H (Hong Kong-listed) shares have actually outperformed other emerging markets. While they were down 11.7% for month, they were only down 9-10% for 2015 and the past year. In contrast, the bubble was pricked in the mainland market, with A-shares falling 37% since mid-June (but, they were still up 47% on the trailing year). Brazilian equities experienced yet another double-digit decline as budget deficit and governance issues piled on top of China and commodities problems. The Brazilian stock index has fallen 53% over the past 12 months.

Given the plunge in global markets, with the proximal cause being global recession concerns, one might have expected Treasury bonds to rally, particularly as near-term federal funds rate increases became less likely. In fact, Treasury yields actually experienced the opposite result. They increased slightly as selling pressures outweighed the expected safe-haven bid. It remains to be seen whether the sellers were China and other emerging market central banks disposing of Treasury reserves to support their currencies or risk-parity and other levered bond managers de-risking portfolios. Despite the modest recovery in

*Continued on back.*

*September market perspectives continued.*

crude oil prices, credit markets were weak, with domestic high-yield bonds down 1.7% for the month as energy (-7%) and metals and mining (-5%) bonds led the downturn.

In terms of portfolio positioning, there is little change in what I articulated last month: U.S. equities remain unattractive. After recent declines, however, I am boosting tactical targets from 82% to 84% of strategic levels. I prefer international equities, where normal (100% of strategic targets) levels are maintained. Within international equities, I am further raising my emerging market target, taking into account the fundamental valuation attractiveness of emerging-market currencies (down over 12% year-to-date) in addition to their dis-counted equity values. We are considering funding an emerging markets manager whose strategy of selling call options is seemingly well positioned for the current volatile environment, where call premiums are elevated. The large hedge fund over-weight is maintained.

What has changed is my macro-view in the aftermath of the counter-intuitive Federal Reserve Board ("Fed") announcement earlier this month. As the *Wall Street Journal* encapsulated precisely, either the Fed would pair a rate increase with dovish language or pair a rate hold with hawkish language. Instead, by neither raising rates nor giving any indication that a rate rise is imminent, the Fed succeeded in scaring investors, who were concerned either that the Fed knew something they didn't (China or other recession concerns) or that this Fed is even more dovish/clueless than previously assumed. In any case, the two-day post-Fed meeting reaction was for investors to sell equities and other risk assets.

The Fed's action did not change my tactical targets appreciably; but it has slowed the speed at which I want to approach them. The reason is that the Fed has added to investor uncertainty regarding how the gap between the Fed's internal interest-rate forecasts and those of the market will be closed. For example, the market forecasts a 0.8% federal funds rate at year-end 2016; while the Fed's forecast is 1.4%. One Federal Reserve member estimates the rate will be close to 3%. For year-end 2017, the market estimates the rate will be 1.3%, while the Fed estimates 2.9% and one member predicts 4%. The combination of a rate-hold and dovish language has further damaged the Fed's credibility and has increased the odds of a dramatic market event should inflation surprise to the upside.

*Next month's third quarter Market Perspectives will focus on the investment implications of our assessment (either affirmed or revised) of the global macro-economic outlook.*



---

2001 Kirby Drive, Suite 1200

---

Houston, Texas 77019-6081

---

713.529.3729

---

[sentineltrust.com](http://sentineltrust.com)