

Don't Panic: Putting Market Turbulence in Context

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KEY TAKEAWAYS

- Falling equity markets and bond yields signal insufficient aggregate demand; the world needs a new growth engine to borrow and spend.
- Developed markets have outperformed emerging markets for some time; recent market panic continues this theme.
- Low US inflation and increasing deflation risks from abroad give the Fed few reasons to rush rate hikes.
- China has engineered a weaker currency, but devaluations are not a new game.
- The trend of wider credit spreads continues, creating value; profitability is critical at this stage.
- As valuations adjust, low global interest rates and central bank easing should reinvigorate risk-taking.

Sharp declines in China's equity markets have heightened fears about the country's economic prognosis and what it might mean for global growth. While concerns center on the emerging markets, the tumult has spilled across global financial markets.

Our advice: don't panic. August regularly brings periods of particularly low liquidity in financial markets, and this can cause significant price moves. The challenge for us is to try to understand what the capital markets are signaling and assess how those signals fit with our core macro views.

Here, we lay out some of the major investment themes we are focused on and discuss recent financial market price action in the context of our macro views.

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| 1 | Global Savings and Weak Demand: Who Is Going to Borrow and Spend? |
| 2 | Rotation of the Global Credit Cycle Favors Developed Markets Over Emerging Markets |
| 3 | Fed Rate Hike: Balancing Domestic vs. International Developments |
| 4 | Competitive Devaluations Are in Vogue |
| 5 | The Disjointed Credit Cycle |
| 6 | Rates Can Stay Low, but Can Risk Appetite Stay High? |



Global Savings and Weak Demand: Who Is Going to Borrow and Spend?

At a basic level, aggregate demand and credit creation are a function of saving, borrowing and spending on consumption or investment. For every saver, there must be a borrower to spend those savings, otherwise aggregate demand falls short. When equity markets fall and bond yields decline, as they have recently, financial markets are signaling that demand is undershooting expectations.

The world needs a new growth engine to drive borrowing and spending. Developed market consumers, banks and even countries have deleveraged and saved since the 2008 financial crisis. Credit as a share of GDP has declined by 10% to 30% in many developed countries over the last five years.⁷ This is a key reason why developed market GDP growth has continuously disappointed in recent years.

Emerging markets stepped in to fill the borrowing and spending void after the financial crisis. China was at the vanguard with its massive fiscal and credit stimulus, which saw credit as a share of GDP rise by more than 40% since 2010.⁸ But emerging markets are now fading as global growth engines. China's saving rate has been increasing. Many emerging economies face deleveraging pressures, credit growth is slowing, profits are challenged, emerging market assets are deflating, and the ability to borrow and spend is becoming impaired.

A key question now is whether developed markets can fill the spending deficit left by emerging markets and increase their borrowing, consumption and investment to absorb excess savings and maintain a level of aggregate demand that supports stable prices.

Rotation of the Global Credit Cycle Favors Developed Markets Over Emerging Markets

Financial markets have been pointing to the outperformance of developed market equities and currencies relative to emerging markets for some time. We view the recent panic in financial assets as a continuation of this theme. As noted previously, the post-crisis borrowing and spending spree took place in many

emerging markets, led by China, while developed markets saved and delevered. We believe this trend is reversing and expect attendant demand shortfalls in emerging markets along with improved borrowing and spending from developed market consumers and companies.

Developed market consumer plays have been outperforming compared to globally exposed sectors. But we don't know how significant the deleveraging cycle in emerging markets will be. Will it be gradual or forced through financial market panic, as was the case with developed markets in 2008? There are some encouraging signs: Though emerging equity markets and currencies have underperformed since 2011, we have not seen significant evidence that the markets and economies have been unable to adjust. And there have not been widespread signs of foreign-exchange-related mismatches on company balance sheets, unlike during the Asia crisis of 1997-1998. Additionally, floating emerging market exchange rates and high foreign exchange reserves are a buffer compared to the emerging market crisis in the late 1990s. For these reasons, and because emerging asset markets are becoming cheap following roughly four years of underperformance, we currently believe the conditions favor a gradual adjustment. However, a gradual adjustment suggests a prolonged process that may be difficult to manage politically.

Fed Rate Hike: Balancing Domestic vs. International Developments

Financial markets are signaling that the Federal Reserve (the Fed) could be making a policy error if it hikes in September, so we expect the first rate increase will be delayed until later in 2015.

The current relationship between the Fed, domestic GDP growth and international developments is more like 1998 than 2008. In 1997, the Fed hiked rates once by 25 basis points, but the Asian financial crisis interrupted that tightening cycle. As Asian deflationary pressures spread around the world, the Fed cut rates by 75 basis points in 1998, despite annual US GDP growth of 4.5%.

Currently, with low US inflation and increasing deflation risks from abroad, we don't see why the Fed should rush to hike interest rates.



Competitive Devaluations Are in Vogue

When faced with persistent demand shortfalls, policy makers will use every tool available to try to stimulate demand, including devaluing the currency. China is the latest to manage its currency lower. The modest devaluation of around 4% is a recent source of anxiety in the markets, but devaluations are not a new game. The US managed to devalue the dollar after the financial crisis from 2009-2011. As the US economy recovered, the rest of the world began to devalue against the dollar. The Japanese started in 2012, the Europeans in 2014, and most emerging markets started in 2011. China has been one of the last to engineer a weaker currency, and it is not surprising given the shortfalls in aggregate demand we see in China. The US just happens to be facing less acute deflationary pressures than many countries and is better able to withstand a stronger currency.

The Disjointed Credit Cycle

Credit spreads have been widening during the recent financial market panic, but we see this as a continuation of the trend, not something new. We call it a disjointed credit cycle because US non-financial credit sectors are exhibiting late-cycle behavior, with increasing leverage and shareholder-friendly activity, while the Fed policy rate is still near zero. Typically, the Fed would be well into a tightening cycle with the levels of mergers and acquisitions, debt issuance, and share buybacks we have seen. However, other parts of the US economy, namely the consumer and housing, are lagging the non-financial corporate sector in the credit cycle, creating a mismatch. As such, credit spreads have leaked wider over the past year, and US credit sectors have underperformed Europe and the UK. Global credit sectors are all at different stages of this disjointed credit cycle. As credit spreads widen, better value can emerge. However, profitability is critical at this stage and needs to rebound to maintain leverage ratios. A profit recession would be a greater risk to credit spreads than current emerging market adjustments, in our view.

Rates Can Stay Low, but Can Risk Appetite Stay High?

Low interest rates are a solid backstop for supporting risk appetite. However, rates are already low, and risk appetite has been waning due to a combination of late-cycle corporate behavior in the US, softer profit expectations, deflation of commodity prices and the fading Chinese global growth engine. We believe a more effective policy response needs to come from China, which is at the center of the emerging market adjustment. Chinese rate cuts and fiscal policy adjustments to soften the downturn will be par for the course, but it would be more encouraging to see excess capacity eliminated through market forces instead of draping a forbearance blanket on top of problems. So far, Chinese easing efforts have not impressed investors. However, we believe that as valuations adjust, low global interest rates and continued easing efforts by the European Central Bank, Bank of Japan and the People's Bank of China will once again encourage investors to take more risk in their portfolios.

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Endnotes

- ⁱ BIS, National Sources; data as of 12/31/2014.
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