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Market Outlook & Strategy

Third Quarter of 2015

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Executive Summary

- **Global equity market returns were awful in Q3.** The U.S. market declined by -7.3%; international developed market returns returned -10.2%, and emerging market equities returned -17.9%.

- **The downturn in equities was largely due to increasing concerns that the global economy is slowing and that China is decelerating faster than anticipated.** Investors were further unsettled by Federal Reserve Chief Janet Yellen's decision in September to postpose increasing the Federal Funds rate.

- **The 'flight to quality' helped U.S. Treasuries and other high-quality fixed income, but other areas of the fixed income market struggled.** In particular, high-yield debt sold off sharply due to its high exposure to the energy sector and its greater correlation to equities.

- **In this issue, we examine some of the drivers of the recent market selloff and their implications for portfolio strategy. In particular, we look at what is ailing the emerging markets (besides low commodity prices), China's economic situation, and why the Federal Reserve is struggling to 'normalize' interest rates.** We conclude that emerging market assets are highly unlikely to provide attractive returns until governments undertake additional structural reforms. We also conclude that it is going to be very difficult for the Federal Reserve to do much in the way of normalizing interest rates until growth starts to accelerate, and that China has more ability to act than do western economies. **As such, how China responds is key to understanding how global economic data might unfold.**

- **Strategy.** In terms of strategy, we made few substantive changes to our investment stance during the quarter, apart from further reducing our exposure to emerging market bonds and equity, and undertaking some early tax-loss harvesting during the market decline.

- **We plan to adjust our fixed income strategy by modestly increasing duration and reducing the current credit tilt once high-yield recovers further.**

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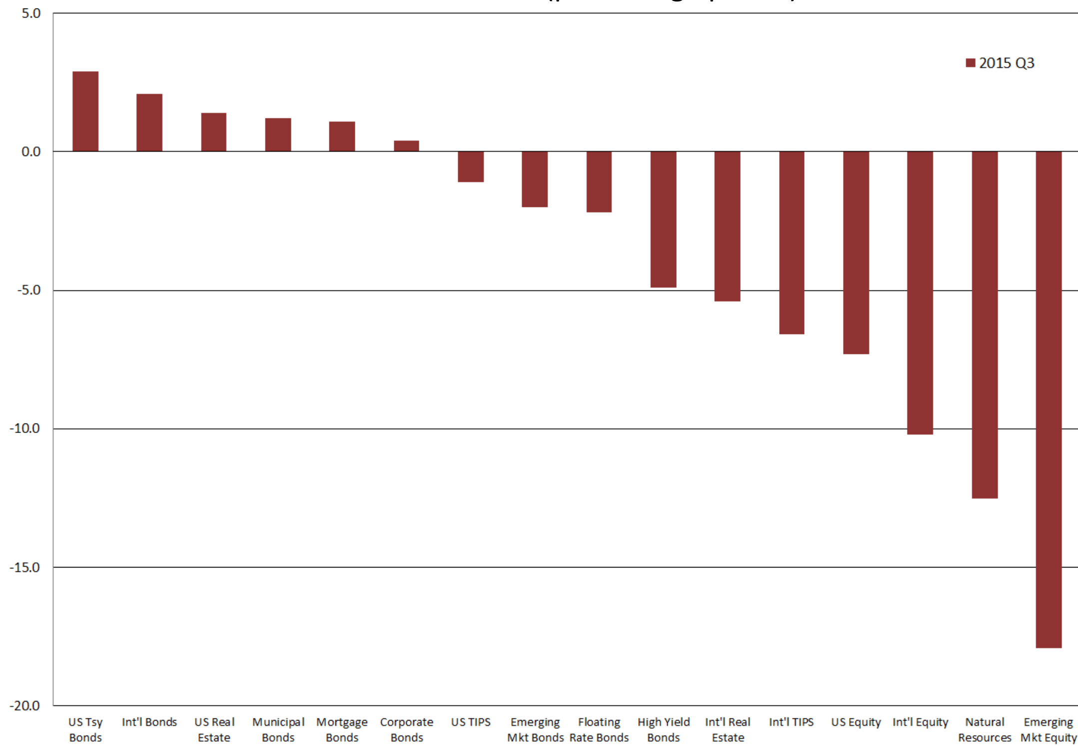
Markets in Review

It was a very disappointing quarter in global markets. A long stretch of calm ended abruptly in August when China devalued its currency, sparking increased concern over ebbing global economic growth. Investors were further unsettled by Federal Reserve Chief Janet Yellen's decision in September to postpose increasing the Federal Funds rate due to concerns over the global economic outlook and very low inflation readings. <u>The net result was the worst quarter in four years</u>. In the U.S., the overall market declined by -7.3%, with smaller companies hit especially hard, declining by –10.8%. (See figure 1)

Figure 1: Asset Class Performance in Q3 2015 (percentage points)



Other markets fared similarly. Europe, with its somewhat dysfunctional Eurozone institutions and tepid underlying growth, declined by about -10%, despite some encouraging economic readings during the quarter. However, Eurozone inflation remained well below target — at just 0.1% in August and failed to increase at all in September — increasing the prospects of further quantitative easing by the European Central Bank (ECB).

Emerging markets fared the worst, declining by -17.9%. China is a huge market for other emerging country exports, and the China currency devaluation puts them in a very difficult situation of potentially needing to continue to allow their currencies to depreciate to stay competitive but in so doing, increasing the burden of their very large dollar-denominated debts. As a result, investors got the jitters, and almost all emerging market equities sold off sharply.

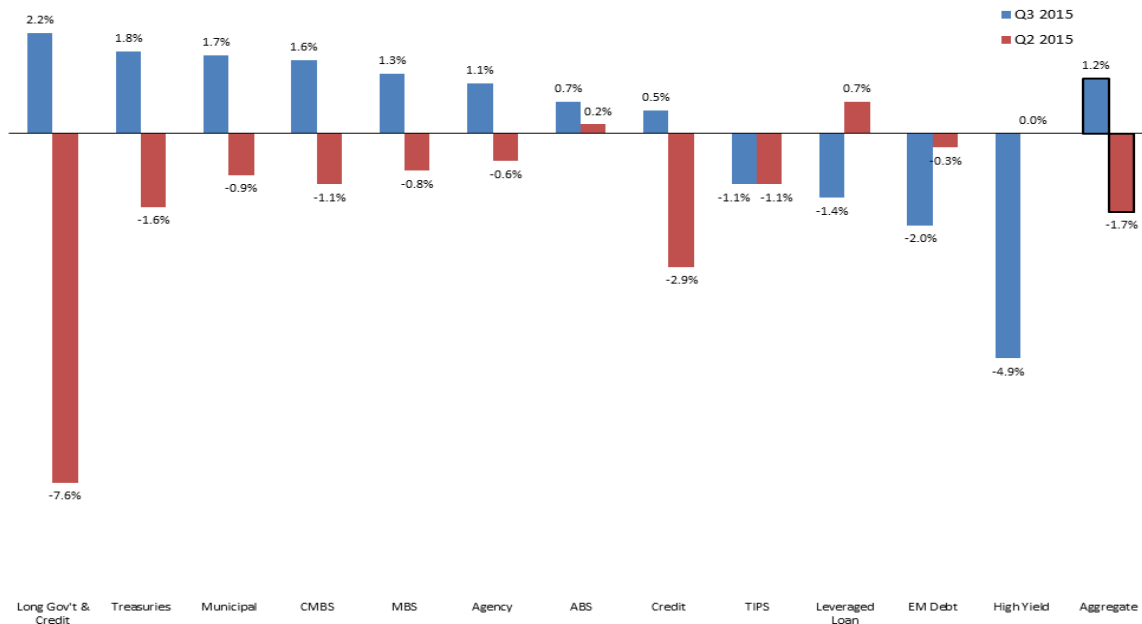
For fixed income, the only place to hide was in U.S. Treasuries, whose prices rose as yields fell during the quarter due to investors rushing in to seek safe haven. (See Figure 2 next page.) The flight to quality also helped provide modestly positive returns to high-quality fixed income such as municipal debt. In contrast, credit versus interest-rate fixed income sold off sharply in August and September. High-yield debt was especially hard hit due to its high exposure to the energy sector and its higher correlation to equity returns. Those who were tilting toward credit-sensitive and low-duration debt as a hedge against higher interest rates were sorely disappointed. As shown in Figure 2, however, the bond market has been gyrating back and forth over the last two quarters, in part due to Federal Reserve policy uncertainty. This makes it difficult to forge any strategy, let alone a winning one.

Finally, commodities continued their multi-year decline. Even gold, a typical safe haven in times of market tumult, lost over -5.0% during the quarter.

Key Investment Themes: Emerging Markets, the Federal Reserve and China

This quarter’s results no doubt have investors wondering why global markets are so unsteady this year. We can pinpoint at least three key drivers of recent volatility — emerging markets, the Federal Reserve and China — and their implications for portfolio strategy.

Figure 2. 2015 Q3 versus Q2 Fixed Income Returns



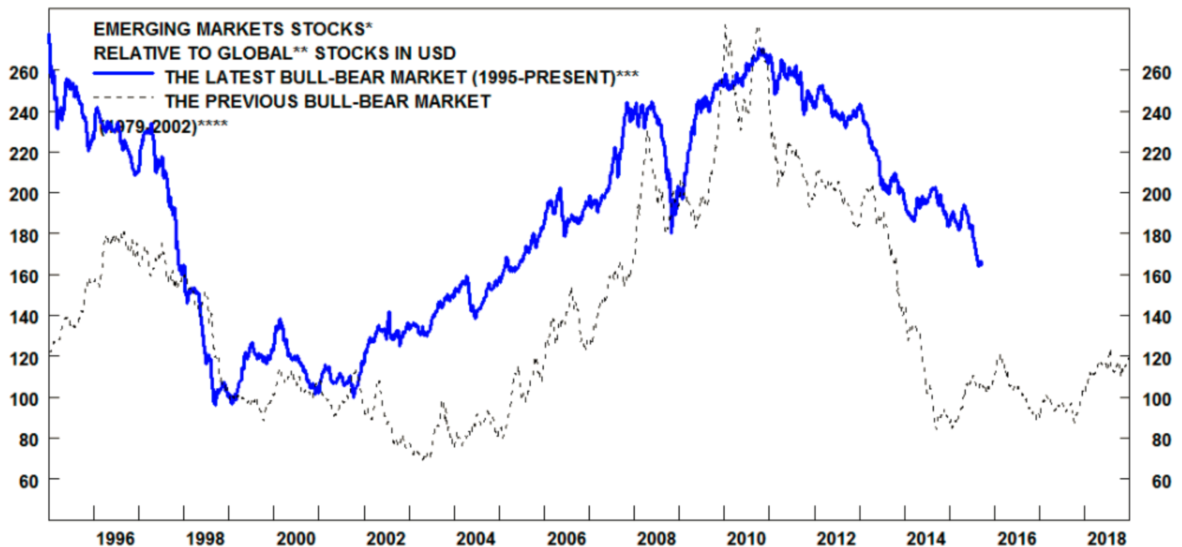
Source: Fidelity

Why are emerging markets struggling?

To understand what is happening in emerging markets today, we need review events of the last decade. The last decade was, by most measures, an excellent one for emerging markets (figure 3). China's impressive growth rates fueled a bull market in industrial commodities and other emerging market exports. As prospects brightened for many emerging markets, the money started flowing in from all parts of the world and equity markets, and credit growth exploded.

Unfortunately, it seems, emerging market politicians didn't take advantage of these good times to undertake needed structural reforms (e.g., reforms that make it easier to open a business, hire and fire, and compel companies to be better governed) to increase economic efficiency and productivity growth. As a result, productivity growth and investment efficiency began to decline rather rapidly. (Brazil is an excellent case example of this failure to reform.) This, coupled with the steep decline in commodity markets, has led to some stark EM equity underperformance since 2010. (See Figure 3 again.)

Figure 3. Emerging Market Equity Returns Relative to Global Market Returns



Source: BCA Research

The solution to these problems requires bold actions by policymakers to increase labor market flexibility, reform corporate governance and improve incentive structures. Pessimists argue that we shouldn't and can't expect a quick turnaround, as it typically takes a deep and painful crisis to spur policymakers toward reform.[1] In addition, China itself is going through some deep structural change (see later section for a discussion about China), and few expect a resumption of strong commodity demand.

Why is the Federal Reserve struggling to increase interest rates?

At the heart of the problem is slow global growth. For the past six years, governments around the world have been relying on monetary policy to stimulate growth. This year alone, the central banks of over 40 countries reduced interest rates, lowered bank reserve requirements, or embarked on a bond-buying program in a bid to stimulate their economies. Notwithstanding all of these efforts, the International Monetary Fund just

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[1] See "The Coming Bloodbath in Emerging Markets", Special Report by BCA Research, August 19, 2015.

recently published that the world is expected to grow at 3.3%, its lowest rate since the financial crisis.

The reasons for slow growth appear to be both cyclical and structural. The cyclical problem is lack of adequate aggregate demand due to both consumers and companies cutting back on consumption and investment to improve their balance sheets (a.k.a. deleveraging). This lack of demand has not been fully offset by government spending, hence a large global output gap is believed to remain. (An output gap is defined as the difference between what an economy is capable of producing without creating inflation, and what an economy is currently producing.)

Economists are increasingly of the view that the output gap may well persist as labor force and productivity growth slow, with no catalyst such as broad technological change in sight to change the trajectory. The problem with the labor force in many developed countries is simply the result of lower working-age population growth, due to falling fertility rates during the post-World War II era, exacerbated in the U.S. more recently by the somewhat puzzling withdrawal of many workers from the labor force.

In addition to slower labor force growth, falling productivity growth in both advanced economies and emerging markets has also contributed to the decline in actual, and even potential, growth. Productivity has recently slowed because companies have been slow to invest in the capital stock, but slowing productivity began well before the financial crisis for reasons that are still hotly debated.

Standard economic theory tells us that over the long haul, slower trend growth should lead to a lower level of real interest rates. The reason is that if firms expect demand to grow at a slower pace than in the past, they are going to be less likely to build new factories, office buildings and apartments. This lack of spending will tend to push down borrowing rates. At the same time, consumers are likely to spend less today if they feel their income will grow less quickly, if their productivity gains are on a downward slope.

Thus, the real problem the Fed faces is that very low interest rates might be the new normal. If that’s the situation, then increasing interest rates might cause growth to slow even more and deflation to get worse. A related problem is that no one knows how large the output gap really is. If it is not as big as many believe, keeping interest rates low to stimulate activity may cause inflation. This tug-of-war goes to the heart of the debate going on at the Fed currently.

An additional concern is the impact that a rising interest rate environment might have on emerging markets. As discussed earlier, many emerging market economies are in a fragile state due to declining commodity demand and prices, and declining currencies – which makes it more expensive to service their burgeoning dollar-denominated debt. The fear is that rising interest rates and a stronger dollar will lead to increased capital outflows from emerging market countries (after all, why take the risk of lending to emerging markets when interest rates become attractive at home) and rising defaults. At its worst, increasing global interest rates could turn into another emerging market crisis similar to what we witnessed in the late 1990s.

What is happening in China?

I believe that China holds the key to understanding how global economic data might unfold. First, there is an increasing view that monetary policy is just about out of bullets, and that the only remaining lever to foster demand is expansionary fiscal policy.[2] Yet at the same time there is a widespread view that the political environment on both sides of the Atlantic is not conducive to taking any meaningful fiscal action. This leaves China, the world's second largest economy, to provide the catalyst.

There is little doubt that the Chinese economy has weakened, in part due to declining export demand, but also in part because the China is in the midst of a major transition from a capital-intensive export-oriented economy to one that is more focused on consumption and services. Yet unlike many other countries, Chinese policymakers still have plenty of scope to reduce interest rates, ease reserve requirements, allow further currency depreciation, and have the latitude to act fiscally by virtue of having no net debt. This is because Chinese debt consists mainly of quasi inter-governmental liabilities, typically in the form of state-owned bank loans to local governments and state-owned enterprises. These loans can be netted out since they simply represent one part of the public sector lending money to another part of the public sector.

Thus, we will be watching closely how Chinese policymakers respond in the next weeks and months, especially with regard to expansionary fiscal policy. Expert China-watchers say that while the policymakers are comfortable restructuring to achieve slower but higher quality growth, they don't want to decelerate too quickly. (Indeed, as I write, the headline news is

[2] See, for example, Larry Summers' piece entitled "Global Economy: The Case for Expansion" in the Financial Times, October 7, 2015.

that China is lowering a key benchmark interest rate and reducing bank reserve requirements, which is no doubt helping boost equity markets at the moment.)

Artemis Strategy

We made very few substantive changes to our investment stance during the quarter.

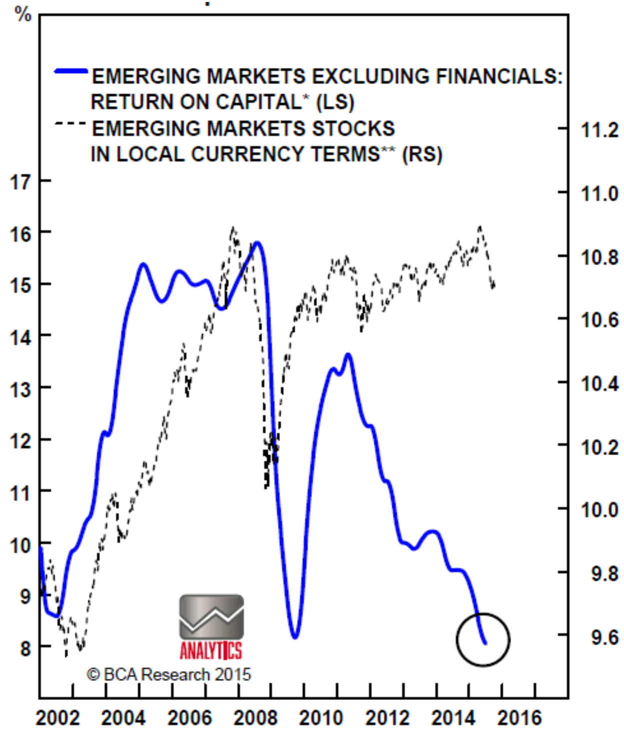
For quite some time, our overall equity strategy has been to be overweight developed market (especially the US) equities, and underweight emerging market assets. The latter includes commodities, since they are so tightly linked to emerging markets, which we stopped investing in all together in 2012. Our underweight stance in emerging market equities and bonds has grown over time: Our first reduction in equity exposure was in the summer of 2013, we then further trimmed in the spring of 2015, and then did a bit more this last quarter. Although the timing of this last reduction was not optimal given October's rally, we made this reduction on the high conviction view that emerging market assets are not going to fully heal anytime soon. As shown in Figure 4 on the next page, even though emerging market equity prices have dropped, valuations do not yet even come close to fully discount the deteriorating underlying fundamentals.

As for bonds, increasing corporate defaults of dollar-denominated emerging market bonds are a certainty, particularly in light of the strong dollar. Thus, my view is that I can find a higher-returning use for these funds over the next couple of years. Our view is unlikely to change until we see true reform in emerging markets and/or substantive stimulus emanating from China.

The other key tenant of our strategy has been to be modestly underweight fixed income overall and to position our fixed income portfolios for increasing interest rates. Of late this has meant being overweight more credit-sensitive segments of the fixed income universe such as floating rate and high-yield debt, and underweight duration (i.e., underweight bonds that are more sensitive to price declines when interest rates rise, such as U.S. Treasuries). As we wrote in our individual client letters this quarter, this strategy did not pan out this quarter, as interest rates actually declined over the last quarter, the exact opposite of what happened earlier in the year. (See Figure 2 again.)

We are in the midst of making some modest adjustments to our fixed income strategy, particularly in light of the emerging consensus that global economic conditions no longer seem to support much in the way of rising interest rates. In investment parlance, this means our stance is becoming more neutral from an interest rate perspective.

Figure 4. Emerging Market (EM) Equity Returns Versus EM Return on Capital



Finally, we took the opportunity during the recent market rout to do some early tax-loss harvesting for the year, which generates trades without any change in strategy. You will be happy not to have a tax bill in a year of such mediocre market returns.