SEPTEMBER 3, 2015

The Market Dynamics of A(ugh)ust

August was the worst month for U.S. equity markets since 2012, with the S&P 500 falling 6.3% in price terms (including an 11.2% peak-to-trough decline between August 10 and August 25) and broad-based weakness across sectors, styles and size categories. Global markets were also hit hard, with European and Japanese equities losing 8%-10% and Emerging Markets also falling sharply. Though the speed and extent of the decline surprised many market participants, it came after an unusually long period of subdued price action for risk assets.

THE CALM BEFORE THE STORM

The lead-up to the recent market selloff was relatively calm:

- **Fewer corrections:** Prior to the August downdraft, it had been nearly four years since the last 10%-plus correction for the S&P 500, quadruple the length of the historical average and the fourth-longest gap in history between market downturns.
- **Fewer mini-corrections:** Prior to August 10, the S&P 500 had just over 200 trading days without a 5% correction. The last daily drop of over 2.5% was on June 20, 2013, and the last one-day fall of over 3% was on November 9, 2011.
- **Limited volatility:** Prior to the August 21, 2015, volatility spike, the Volatility Index (VIX Index)[1] had not been above 20 since January 2015.
- **Tighter trading ranges:** The S&P 500 traded within a 3%-4% range since the start of the year and prior to August, an abnormally tight trading range by historical standards.

WHAT CHANGED IN AUGUST?

A number of variables converged in late summer to upend the markets: China's plunging stock market, fears about looming Federal Reserve (Fed) rate hikes, concerns over a slowdown in global growth, weakness in commodity prices and, following China's August 11 devaluation of the yuan, the prospects of currency wars. But the primary concern for global investors at present is uncertainty over China's economic growth prospects.

Growth has clearly slowed in China, but fears of a "hard landing" are overdone, in our view, and we instead expect a long transition in China toward more consumption- and service-led growth.

A few points often overlooked by investors:

- Services, having overtaken industrial activity in 2012, now account for nearly 50% of China's Gross Domestic Product (GDP).
- Service activities meanwhile expanded by 8.4% in the first half of this year, compared with 6.1% growth in manufacturing and construction.
- Consumption as a percentage of GDP is still low in China (38%) but is moving higher.

China's internet-based economy remains quite strong—retail ecommerce in China is expected to surge by over 40% this year, and is projected to maintain double-digit growth over the near-term (based on estimates from Emarketer)[2].

The bottom line is that the composition of China's growth is changing, and given its large economic size (along with the U.S., China is the only $10 trillion-plus economy in the world), it isn't a surprise to see its growth decrease from the rapid pace of recent years. Indeed, even with much slower growth, China's contribution to global output will remain significant. Real growth of just 4% in China this year would still be equivalent to 8% growth (in terms of incremental annual output) at the peak of the last cycle in 2007 given how much larger China's economy is today.

1 The VIX Index is the Chicago Board Options Exchange Volatility Index, reflecting a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of S&P 500 index options.

2 Source: eMarketer - Market Research Company. Data as of July 2015.

The problem (or source of global weakness) lies with the multitude of emerging markets that have become dependent on China for export growth. In 2000, five nations counted China as their top export market; today the number is greater than 40. The burden of adjustment is on this cohort. Emerging-economy weakness should therefore persist over the near term, although expected growth in the U.S./EU/China (accounting for around half of world GDP on a purchasing power parity [PPP] basis) will greatly reduce the odds of a global recession.

Besides China, another source of concern lies with the prospect of the Fed raising rates for the first time in almost a decade between now and year end. And at the recent Central Bank Conference held in Jackson Hole, the Fed's main message was that despite the recent market volatility, it might still proceed with its first hike this month. Markets seemed to hear the message, with federal fund futures pricing in a 40% probability of a September rate hike, up from 25% previously. However, we do not believe that a modest Fed rate hike will either derail the U.S. economic recovery or halt the U.S. stock market uptrend. Bear markets begin at the end of a Fed tightening cycle, not at the beginning.

Looking ahead, we expect more accommodating policies and signals from the world's central banks—notably the European Central Bank (ECB), the Bank of Japan and China's central bank. We also expect to see more monetary easing from Taiwan, South Korea, Singapore, and other nations where circumstances warrant lower rates. More aggressive fiscal policies are needed as well, with Japan, China and the European Union all moving (if slowly) in this direction.

For the market to find a base and provide more attractive prospective returns for investors, we believe five developments need to occur: 1) China needs to provide comprehensive policy plans, which would include both further monetary and new fiscal policy responses; 2) the Fed needs to be moderate, patient and consistent with policy; 3) credit markets need to settle down, with spreads narrowing; 4) U.S. and European earnings and GDP growth need to trend higher; and 5) oil prices need to stabilize.

MARKETS VERSUS MACRO

Falling equity prices and general financial market volatility are often a signal of fundamental macroeconomic problems. For now, real global growth appears to be holding up around the long-term average of 3.5%, led by domestic demand in the U.S. and Europe, but weighed down by commodity exporters with strong trade links to China and high levels of dollar-denominated debt. On the other hand, falling inflation means global nominal growth measured in dollars is likely to be negative in 2015 for the first time since 2009. A key macro point for investors is that low inflation/nominal growth has caused the conventional wisdom to translate a contraction in dollar-denominated nominal global GDP into a real growth decline that has not happened.

In summary, although growth has been slowing in the Emerging Markets, the developed economies are improving, led by the U.S., and we do not expect a severe decline in world economic growth.

GOOD DEFLATION VERSUS BAD DEFLATION

Global real growth is holding up because of "good deflation." The major transmission mechanism for the structural shift in global growth away from China and natural resource markets to the U.S. is a stronger dollar and lower oil prices. GaveKal Global Research puts it this way: "On all recent occasions when the oil price has halved—1982–1983, 1985–1986, 1992–1993, 1997–1998, and 2001–2002—faster global growth followed." Every $30 fall in oil prices shifts a trillion dollars from producers to consumers. More than $2 trillion of stimulus has been created for oil consumers again. This is a bigger boost than the Chinese and U.S. fiscal stimulus in response to the 2008–2009 financial crisis. This is good deflation. It raises real growth by as much as it reduces inflation.

This is evident in the U.S., where real consumer spending growth has accelerated this year and the housing cycle is gaining momentum. We still think the U.S. is firmly in midcycle. Firmer wage growth and Fed rate hikes will be signs that the U.S. is transitioning to the later stages of the business cycle, but there is still room to run as investment sectors—like housing and nonresidential construction—still have pent-up demand from the Great Recession. Good deflation is also aiding the recovery in Europe, where, despite fears of Emerging Markets contagion, there has been a re-acceleration and/or stability in many measures of activity such as retail sales and business surveys. Credit is also expanding and helps to reinforce the cycle. The ECB has been vocal about expanding quantitative easing if the recovery loses momentum. Lower oil prices will also help Japan, but a significant share of Japanese exports go to China, so the economy will be more impacted by the slowdown there. We also wouldn't be surprised to see an expansion of quantitative easing from the Bank of Japan if reflation looks as if it is getting off track.

Foreign exchange adjustments are also helping the global rebalancing process. Commodity-linked currencies, for example, have gone from being overvalued to fair-to-undervalued, on balance. This will help these economies adjust to the lower-commodity price environment.

WHAT'S THE RISK? BAD DEFLATION

Although this is not our base case, two specific risks that could trigger bad deflation are a hard landing in China (reinforcing fears of a global slowdown) or a policy misstep by one of the major central banks. Bad deflation is deflation that triggers a debt-deflation cycle of self-perpetuating cuts in incomes and spending. It is characterized by the need to liquidate debt quickly in a financial panic. This is what central banks are fighting against with "reflation" policies and why a policy misstep is a risk. There is a risk of this debt-deflation in the emerging markets because incomes and cash flows in local currencies have shrunk relative to dollar debts. Those debts are concentrated in the corporate-bond market rather than the government or banking sectors, which makes a slower liquidation possible without as much systemic risk—as in 1997–1998, when banking systems were at risk.

Despite fears of bad deflation, we think good deflation makes the risk of a significant slowdown in Europe and the U.S. small and concentrated, and this should keep the global growth engine firing despite headwinds from emerging markets. Global financial stress indicators are suggesting this, given the fact that they have only nudged higher recently due to equity volatility and not banking or funding stress.

HOW DO WE IMPLEMENT OUR VIEWS?

Given our belief that the U.S., and the world for that matter, are not on the cusp of a recession, we see the recent downturn in equity markets as a normal, albeit large correction in a long-term bull market. Although emerging market growth continues to slow, the global backdrop is supported by improving growth in the U.S., further stability in Europe, pro-growth policies in Japan and low oil and commodity prices, which should support rising real incomes and higher consumer spending as we head into 2016. Despite concerns about the Fed nudging short-term rates higher this year, we expect the Fed to remain patient and moderate any rate hikes in the coming quarters, as there are disinflationary forces (excessive debt burdens and economies running below potential) that should keep global interest rates lower for longer.

EQUITY VIEW

With a supportive macro and policy backdrop and relatively attractive valuations, we maintain our positive outlook on equities over bonds. Within equities, we favor developed markets—the U.S., Europe and Japan—over emerging markets. We advise hedging non-U.S. equity positions given our outlook for a stronger dollar. We prefer high-quality large capitalization companies with solid balance sheets and stable cash flows, with a bias toward those exhibiting consistent earnings and dividend growth. This fits our equity theme of "getting paid to wait" through a more volatile period.

FIXED INCOME VIEW

Bonds remain an essential part of a diversified portfolio, as they can offset equity market volatility. Within fixed income, we are looking for marginally higher rates and expect the yield curve to flatten somewhat as short-term rates rise. We advise building a diversified portfolio of high-quality municipals and short-term high-grade corporates as the core and, given rising concerns in high yield, we would remain underweight this area. Corporate bonds have sold off significantly, but investors should be selective and favor higher-quality issues.

THEMES

When constructing portfolios, we continue to favor investment themes based on long-term structural trends, which we've dubbed "A Transforming World." An aging global population is creating increased demand for health care goods and services, investment in new medical technologies, and demand for financial solutions for longevity income. We see longer-term opportunities as emerging market economies rebalance toward consumer-driven growth supported by a growing middle class. Globally, defense and aerospace investment is on the rise again given the continued rise of geopolitical volatility, and an aging infrastructure needs to be replaced to support economic growth. Finally, we see the deployment of technology, cybersecurity, the Internet of Things, driving technology spending for a generation.

PORTFOLIO STRATEGY AND ACTIONS

In the current markets and in the period of volatility we expect, we believe investors should be rebalancing portfolios by increasing exposure to assets that have since fallen to more attractive levels. This rebalance should be across all asset classes, including alternative investments, where appropriate, which may help lower overall portfolio volatility. For taxable investors who have accumulated gains over the past few years, trimming positions in areas that have underperformed recently to offset realized gains can be incorporated into their rebalancing strategy.

We think market volatility can create opportunities, and should be distinguished from a permanent loss of capital, which is more detrimental to investors. Through diversification, portfolio monitoring and a disciplined rebalancing approach that is tied to one's goals and asset allocation, investors can minimize the chances of permanent loss of capital.

Christopher Hyzy
Chief Investment Officer
Bank of America Global Wealth & Investment Management and
U.S. Trust, Bank of America Private Wealth Management

Karin Kimbrough
Head of Macro and Economic Policy
Merrill Lynch

Christopher J. Wolfe
CIO, Portfolio Solutions, PBIG & Institutional
Merrill Lynch

Adon Vanwoerden
Assistant Vice President
Merrill Lynch

Robert T. McGee
Director of Macro Strategy and Research
U.S. Trust

Joseph P. Quinlan
Managing Director and Chief Market Strategist
U.S. Trust

John W. Donovan
Head of Fixed Income and Trading
U.S. Trust

Ehiwario Efeyini
Senior Research Analyst
U.S. Trust

Jonathan Kozy
Senior Research Analyst
U.S. Trust

Merrill Lynch
Bank of America Corporation