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MARKETS & INVESTING

Cooler heads will prevail even as markets panic

Selling pressures in China will keep spilling into other regions



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INSIGHT

Markets in the first weeks of 2016 were unexpectedly violent. After one of the worst starts for equities on record, I remain pessimistic that things will meaningfully improve soon.

One of the most disturbing aspects of the global sell-off in equities and commodities is the virtual lack of panic or fear. Despite a period of relentless selling in US equities, market volume has failed to increase and measures of fear, such as the CBOE Volatility Index (VIX), have been at levels associated with calm.

Panic is a key indicator of a market bottom. Panic is associated with sharp increases in trading volumes as investors fearing further decline seek to liquidate positions. That kind of selling causes volatility to spike, as price movements accelerate to the downside. None of this has been associated with the decline to the start of 2016, which tells me we have more downside before we see bottom.

A number of analysts are currently painting a bleak picture for the global economy. Candidly, I don't see it. Despite the Federal Reserve's recent actions, monetary conditions remain highly supportive for global economic growth. In the US, the index of leading economic indicators shows no warning signs of recession.

Many analysts point to widening credit spreads and falling equities as foreshadowing a recession. I remind folks that we had a similar scenario after the market crash of October 1987, and the US recession was still two years away. For those of us who remember, that time became a great buying opportunity. I could say the same for 1994 and 1998.

Meanwhile, the persistent weakness in oil continues to exert its negative influence on all markets, especially corporate credit. Oil prices likely have further to fall: not until approximately it reaches \$25 per barrel will we begin to see oil production shuttered, which should then set the stage to stabilise the energy sector.

Additionally, if market turmoil continues as I expect it will, and lower oil prices damp headline inflation, the Fed is likely to delay further rate increases. Given

strong employment growth and continued wage growth, along with a stimulative fiscal policy now in place, the US economy is likely to thrive in 2016.

What about China? The Chinese have locked themselves in a vice. The currency needs to depreciate to help keep their economy competitive with other nations – like Japan and Korea – that have allowed their currencies to depreciate.

As it becomes apparent that the renminbi will depreciate, pressure mounts on capital flows out of China. This causes asset liquidation, which drives their stock market lower as investors attempt to avoid the losses associated with currency devaluation.

Somehow, the world had become convinced that the Chinese would be able to maintain the value of their currency despite competitive pressures from its neighbouring nations.

Once again, investors are learning that market forces will win in the end. While the renminbi could be propped up for a time, imbalances ultimately build to extremes that overwhelm artificial prices.

When the dam finally breaks, market moves are violent. This is

what we are seeing in China. Chinese stocks are down 20 per cent from recent highs, but there is more pain to come. Markets do not move in straight lines; any pause in the sell-off should not be viewed as a trend reversal.

The good news is that I do not believe the volatility in Chinese equity markets will have any meaningful impact on the US economy. In the short run, however, selling pressures in China will continue to spill over into other equity markets including the US. This is the product of global capital flows. Eventually, the capital leaving China must find a new home. The US and Europe will eventually benefit.

As I look at the markets so far this year, I am reminded that "cooler heads will prevail". While the market will remain volatile and likely lead to a period of outright panic, that is when having a "cool head" will pay off. Those who are prepared will find exceptional opportunities for investment.

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