

THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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Staying with an accommodative Fed but switching away from China

- **The Fed flip flops of when it will taper but retains an air of monetary accommodation.**
 - **Jackson Hole meeting could be a source of fixed income market volatility.**
 - **Exaggerated sell-off of the equity materials sector and commodity markets.**
 - **US 'economy re-opening stocks' have suffered marked losses over the month.**
 - **Investors seeking to buy Emerging markets ex-China see the value in Russia and Brazil but need more confidence in near term catalysts.**
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Two dominating themes continue to move the markets around. The market's **perception of future Fed policy shifts** moves with every statement or comment from the central bank. As the late rally in equity markets at the end of last week showed, investors still consider the outlook to be pro-equity. Given the recent slowdown in global growth, the most likely outcome is a turn-of-the-year-start to the tapering of bond purchases. Meanwhile, **China's seeming policy reset** continues with investors debating just how far the measures could damage near-term growth, and the merits of investing in certain sectors. Investors are also seeking to switch their focus away from China and to other emerging economies where the perceived value lies.

The Fed minutes from their last meeting caused a midweek stir but nothing more. The Fed, like the markets, are reactive to the economic data flow. When the Fed last met, the US economy looked rosy, inflation was higher than expected, and unemployment was falling sharply. Since the meeting and the drawing up of the Fed minutes, China has had a significant wobble, and COVID cases in the US have risen, hurting both industrial and consumer confidence.

The broad perspective of the Fed governors set out in the minutes was that there were reasons to **consider** tapering bond purchases by that an official rate rise was still a long way off. In the past few days some of the Fed governors have tried to roll back the tone of the minutes to imply that tapering could still be months away. This week's Jackson Hole meeting gives the Fed yet another opportunity to add to the dialogue with the market. Suffice to say that the US equity market is still of the view that we will have easy monetary conditions for the foreseeable future.

Over the past month, the US equity market has primarily traded sideways. However, there has been a significant sell-off in cyclical and economic 'reopening' stocks. Las Vegas plays are down as much as 20%, FedEx is down 11%, and the share prices of many of the payments companies have fallen by as much 10%. The materials sector fell 5-10% last week on concerns that the crackdown in China would lead to a slowdown in global growth.

The fall in commodity prices and cyclical stock prices appears exaggerated. While the crackdown in China has investors worried about near-term growth, we do believe that the Chinese authorities are consciously allowing the economy to slow significantly. While economists have pared back their third-quarter GDP forecasts, they remain universally convinced that any growth slowdown will see the authorities loosen policy through injections of liquidity into the banking system and/or an easing of fiscal policy.

The sharp setback in the Chinese equity market has put a great deal of focus on the emerging markets in general. Indeed, there is quite a debate among the investment houses at present about the outlook for emerging markets. Firms such as Goldman Sachs and Lazard have recently reiterated their upbeat view of emerging markets, given the substantial underperformance witnessed in these markets in recent years.

Chart 1: Emerging Markets' marked underperformance against Developed Markets

MSCI Emerging markets relative to Developed markets \$ (rebased to August 2016=100)



Source: Bloomberg

However, it's not as simple as making a broad call on emerging markets. We believe three factors will support emerging markets to varying degrees in the coming years: First, we expect a structural increase in commodity prices. Russia and Brazil are obvious winners; second, we expect China's inward focus to offer opportunities for other countries that provide diversification of suppliers away from China; India and Vietnam come immediately to mind. Both have done particularly well year-to-date. Finally we expect US monetary policy to remain accommodative restraining any advance in the dollar.

The recent substantial outflows from emerging market equity funds on the China issues have hit most emerging markets. In July, outflows for EM equity funds were to the tune of \$10 billion, a 10-month low in terms of net flows. Such heavy outflows push many emerging equity markets lower even in the face of value in other parts of these markets. Nonetheless, JP Morgan was on the wires recently extolling the virtues of Brazilian equities on their lowest valuation in 15 years. Russian equities have fallen with the recent setback in the oil price, which seems overdone. A forward PE multiple of 6x and a yield of 4.3% is low even by Russian standards.

Oil prices have fallen 7% since early July, which may be an exaggeration of the fundamentals. Oil demand is weaker than expected, particularly in China. The recent spike in COVID is slowing, it has affected the mobility of people, causing a significant drop in air travel. We are also moving into a seasonally weaker period when US refinery outages for maintenance will crimp demand growth. Meanwhile, supply growth is widely debated, too. Iran has managed to push production to a recent high, and ongoing negotiations between Iran and the US open the risk of an increase in supply from Iran at some stage. That said, the IEA cut their projections for aggregate OPEC supply by 600,000 barrels last week; hence the recent slip in prices appears to have discounted the adjustments to forecasts for both supply and demand. At \$65 per barrel, the Brent oil price is virtually unchanged since just before COVID hit.

In conclusion, in the emerging equity markets, an opportunity based on pure valuation does seem at hand in places such as Brazil and Russia. However, you could persuade yourself to be

patient in building up positions. In Brazil, politics is still challenging with the government delaying the much-needed structural reforms. In the case of Russia, near-term oil price weakness is a challenge, as is the increase in local interest rates. However, for the medium term, the valuations of both equity markets shout BUY, but patience is probably warranted at this stage.

The Japanese equity market continues to fail to reflect the improved economic data at home. Last week's release of second-quarter GDP showed growth well ahead of expectations at 1.3% quarterly annualised, with good growth in both consumer and investment sectors. Inventories detracted from growth, suggesting that production still has scope to catch up with underlying demand in the coming months. Despite the marked improvement in analysts' corporate profits growth, the equity market has failed to catch up. Since the end of March, the consensus forecast for the level of corporate profits this financial year has risen by 17%, but the market has traded sideways.

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