Investment Insights

Happy New Year?

BESSEMER TRUST

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Highlights

- Global equities have started 2016 on a decidedly dour note, dragged by a myriad of fears
- Our global economic views have not changed — we remain constructive on developed economies and believe China will successfully manage its growth slowdown this year
- However, our view on oil has changed somewhat and we now see more near-term downside risk
- Overall, we increasingly expect that pockets of volatility will be a reoccurring theme — with that in mind, we are exploring how we may fine-tune asset allocation appropriately

Happy New Year? Three trading days into 2016, and the S&P 500 is already down nearly 3% with global equities experiencing similar or larger declines.

Why so negative? Just this week, data showed U.S. business sentiment for December holding at strong levels (54) and a key measure of the labor market — the Challenger Gray & Christmas survey — suggesting an improving trend in layoffs (even with rapidly rising layoffs in energy-related firms, the overall economy is seeing fewer job cuts). Meanwhile this week in Europe, data showed rising economic sentiment into the end of 2015, reaching a near five-year high, and falling unemployment. Even China, the main source of the latest global market volatility, saw leading indicators in December holding steady or improving slightly. Put these trends together — we have a bifurcated but overall improving U.S. economy, a European economy with modest cyclical momentum and a China that is structurally slowing but (so far) is managing to transition more to a service/consumer-led growth model.

And yet here we are, with global investor sentiment in the dumps in the first week of January. We see two main, related reasons for the angst: China and oil.

China

The year has started with China continuing to suffer growing pains (which we outlined in detail in our October 1 *Quarterly Investment Perspective*). On the first trading day of 2016, China unveiled new equity circuit breakers, designed to manage market volatility in periods of distress. Local equities were already under pressure thanks in part to speculation that a ban on sales (implemented last summer) for certain investors and stocks could soon be lifted — other investors wanted to get ahead of any such selling. The circuit breakers, rather than keeping the market calm and orderly, appeared to only add to the local anxiety. By Thursday's close, the Shanghai Composite Index had lost 12% for the year so far, and Thursday's trading session lasted less than 30 minutes before trading was halted for the day. Indeed, shortly after the end of China's regular trading day, the government announced that they would suspend its new circuit breaker program.

At the same time, it appears that Chinese authorities wanted to allow some currency weakness against the dollar to hold the trade-weighted renminbi (RMB) stable. (Recall that last year, the Chinese central bank announced it would increasingly use the trade-weighted currency index as a tool to manage the country's export competitiveness, rather than overly focusing just on the USD/RMB exchange rate). The declines in the RMB on January 4th and 6th were the largest one-day falls since mid-August last year. To keep this in perspective, the RMB has lost 1.79% year-to date versus the dollar, while the Australian dollar and South African rand are each down some 4% over the same period.

Oil

Through early Thursday in the U.S., both Brent and WTI crude oil prices had fallen more than 10% year-to-date, with WTI testing below $33 per barrel (a 12-year low). Some of this latest selling pressure ties to China. The volatility in Chinese markets, and underwhelming Chinese manufacturing business sentiment data released for December, fueled worries about Chinese demand for commodities broadly. Further, speculation that China could devalue its currency further, with sensitive countries' currencies following suit, threatens to push the U.S. dollar higher. Historically, commodities including oil and the dollar have tended to have an inverse relationship, with a stronger dollar acting as a drag on commodity prices.

More importantly, in our view, this week has seen a continued escalation in tensions between Iran and Saudi Arabia. Assuming sanctions are lifted, Iran is set to produce substantially more oil this year. Saudi Arabia, now more than before, does not want to help Iran by supporting oil prices and in turn allowing Iran to secure more revenue. A production shift from Saudi Arabia, especially anytime soon, seems less and less likely. Meanwhile, data from the U.S. are showing unexpectedly large increases in gasoline inventories and still robust crude and gas production (despite falling drilling rig counts). Finally, news that Pioneer Natural Resources Co., a shale producer, was able to raise $1.4 billion in equity to help finance operations this year added to speculation that forced production cuts that help balance oil supply and demand may not emerge as quickly as previously thought.

In the case of China, we think the current bout of anxiety is likely to prove very short-lived. Modest RMB weakening after years of steady appreciation is reasonable. However, it is not in China's interest to let equity or currency volatility undermine business and consumer confidence at home, or China's image globally. While the central bank is running down its currency reserves, it still has trillions (with a "t") left as ammunition, as well as other policy tools it can quickly deploy (along with other parts of the government) to support growth and confidence.

Frankly, oil concerns us much more, especially looking at the next weeks and months. We firmly stick to our view that lower energy prices, over the medium term, are a significant net positive for many of the world's consumers, including in the U.S. and Europe. The fact that consumers dominate global growth trends suggests that low oil is highly unlikely to lead to recession.

However, in the short term, weaker oil prices are creating various paths of distress. This is not limited to companies tied directly and indirectly to energy. Credit markets feel it through energy-focused high yield bond selling that broadens out to a wider reduction of credit exposure. Banks feel it as investors worry that loans to energy companies may not be fully paid back. Energy-centric markets (from Canada to Norway to Russia and Mexico) feel it as investors question oil-related revenues. Even the S&P feels it — not just energy-related stocks but more generally as investors use the liquid, relatively low-cost equity market (often via options, futures and exchange-traded funds) as a hedge of sorts against other asset-class exposures.

It's difficult for even the most energy-savvy analyst to know exactly where oil prices go and how quickly. We can't rule out that WTI falls further — a key technical support level increasingly cited is $25/barrel, another 25% below current levels. We are not sure if it goes that far, but valuation alone is unlikely to stabilize oil. A catalyst is needed as well. We are closely watching a few, including signs of stronger Chinese demand, data suggesting more dramatically falling U.S. production, and/or comments from major oil producers that supply needs to be cut soon.

Glass Half Full or Half Empty?

In recent years, it has paid to stand firm during these pockets of distress — equity markets have regularly bounced back as the underlying positive economic fundamentals have reasserted themselves. Last August and September, for instance, it paid off not to reduce equities — global markets bounced some 7% from those lows through year-end.

However, our view on managing these pockets of volatility is evolving, for a few reasons. First, we are now in a U.S. monetary tightening cycle — the Fed will not ignore financial-market volatility as it sets policy, but without a major shift in the economic landscape, it's not likely to go back to easing anytime soon. Rising U.S. interest rates, even if very slowly and from extremely low levels, is a change in the financial-market landscape and at a time when bond and credit market liquidity has notably deteriorated.

In addition, we know we are getting later in the economic cycle. We do not believe the U.S. is teetering on recession by any means — again, the U.S. is a consumer-driven economy and the consumer is benefitting from low energy prices, wealth from rising home values and more jobs. But as the economic cycle gets more mature and equity valuations rise from cheap to fair to slightly expensive, further gains tend to be more muted and attained with more bumps along the way.

Third, we would argue that there are more market inter-linkages than ever before. Important among them is the influence of China's economy and financial markets on asset classes around the world, especially at a time when China appears serious about moving to a more flexible, trade-weighted basket-centric currency policy and foreign investors remain uncertain as to China's next steps.

So how should we marry what is still a constructive global economic view, which in turn should provide a measure of support to cyclical assets, with what could be regular "air pockets" for markets like we are seeing this first week of January?

Shifting to a large cash position, in our view, seems overly defensive at this time. Indeed, we would be reluctant at this point even to consider a meaningful reduction of equity exposure — unless one of the risks highlighted above turns into a worse-than-expected reality (a major China devaluation or sustained plunge in oil prices from here, for instance). What we think could make good sense as an incremental step is to focus on ways to reduce the volatility of the equities we currently hold. That is not to say just buying high-dividend, steady utility stocks as an example. Many of these "go to" defensive equities are expensive by our metrics. What we prefer are baskets of reasonably valued equities, which via diversification among them can lower the total volatility of our equity exposure.

Our Investment Department is exploring different ways to manage through a world that even with positive and improving global growth, feels like it has more questions than answers. Any decision to effectuate an asset allocation shift will be communicated broadly and in a timely way (we will also have Q&A at our Emerging Themes in 2016 webcast on Tuesday, January 12). For now we wanted to share our thoughts on these rocky markets and our latest considerations around protecting our clients' capital in a thoughtful way.

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