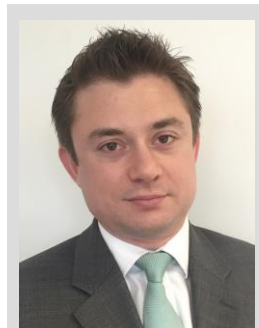


Filtering noise in search of the signal

Physicists and engineers have developed several tools over time which allow them to filter “noise” out from their various works. Fourier Transforms are a method by which repetitive or rhythmic noise, such as that from an aircraft’s engine are easier to eliminate from an environment, such as the aircraft’s passenger cabin, through introduction of “anti-noise waves”. These anti-noise waves cancel out the noise, leaving only the desired “signals”, such as the air stewardess asking what drink you would like to ease into your flight.



By **Kasim Zafar, CFA**
Portfolio Manager

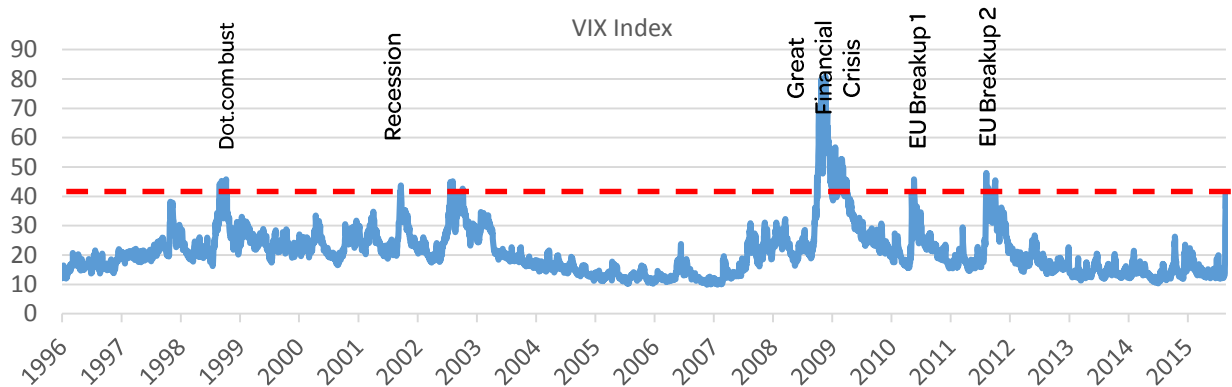
The capital markets usually have some element of noise but unlike the rhythmic noise of an aircraft engine that can be cancelled out by sophisticated engineering, the markets are currently reeling from several loud ‘bangs’. At times like these, professional investors will rightly take a step back and attempt to filter through the noise in search for the signal. The last few days have been awful, particularly in the equity markets. Having taken a step back and filtered through the market activity, we have reached a few conclusions:

1. We think that the current panic is essentially “Made in China”.
2. We don’t see evidence of a major global slowdown.
3. While a speculative bubble may have burst in the Chinese equity market, we don’t see the main underlying trend in the Chinese economy materially adversely affected.
4. China’s economy is on a longer term transformation that will be difficult for commodity markets and may have a knock-on effect on emerging markets which rely heavily on commodity exports.
5. However, we see tremendous value in select Asia equity markets.
6. And, we think central banks may keep interest rates lower for a little bit longer.

The reasoning behind them is then explained below. To learn what we’re doing about it, see the final section.

Background

It began on 11 August when the first of three days’ worth of devaluation of the Chinese Yuan currency took the market by surprise, leading to speculation of the Chinese economy heading for a ‘hard landing’ as it comes down to earth after years of stellar growth – and that there would be further currency devaluation to come. Market chatter then continued onward to speculate this would lead to similar currency adjustments by other emerging markets and the return to an Asian Currency crisis of 1997/8. Commodities then went into precipitous decline causing commodity sensitive emerging markets to sell off aggressively which itself propagated into a full blown global growth scare that saw developed market equities suffer their biggest one-day losses since the 2008 financial crisis. The chart below shows that the VIX Index, a popular measure of market “fear”, has soared to levels synonymous with recessions, the dot-com bust or the breakup of the European Union.



Signals

We simply do not see things anywhere near as bad as that. Fundamentally, Asian economies are in a much stronger position today than they were in the late 1990's so we do not believe there is a currency crisis on the horizon. In developed markets, recent data from major economies including the US, the EU and Japan have, on the whole, been good. There have been the odd spot of weakness, such as in US manufacturing driven by the strength of the US Dollar, but generally, aside from the bad news from China there is little to support fears of a major global downturn.

This market cycle has suffered several periods of panic such as fears of a US 'double dip' recession, concerns over the break-up of the Euro and a hard landing in China. Although this recovery has been weaker and less synchronised than those in the past, economic conditions continue to be supportive in the developed world, if anything they are getting better. We are seeing a strong labour market in the US including the first signs of rising wages, while in Europe the economic recovery appears to have taken hold with some periphery countries very much on an upward trajectory. Furthermore, we recently wrote about US GDP and its apparent weakness in Q1, noting that in recent years Q1 weakness has been followed by strength in Q2 and that releases of such data are frequently the subject of revisions. On 27 August we saw the second revision to Q2 2015 data that have shown the US economy growing at an annualised rate of 3.7%, 0.5% higher than the market was expecting. So once again, we do not see evidence of a major global slowdown.

China

China spooked the market with the timing of its currency devaluation given its coincidence with release of export data that showed a significant fall relative to market expectations and with the flash estimate of August manufacturing PMI which came in below market expectations. Chinese equities, which had already been struggling for several weeks, fell off a cliff by dropping almost 9% in one day. Sounds bad, right? Well, not if you consider things on a longer time scale:

- From the peak of China's Shanghai Shenzhen CSI300 Index, it has fallen 43%. Ok, so that's still pretty bad, but...
- From the start of last year, it is actually still up 29.8%

By comparison, over the same time period the S&P500 Index in the US is up 1.4%, the FTSE100 Index here in the UK is down 9.6% and the DAX Index in Germany is up 1%. So despite the dramatic fall, the Chinese equity market is still doing relatively well.

The fundamental reality is that the Chinese equity market had blown its top off with an unjustified 130% rise (to its peak) since January 2014 driven almost exclusively by unsophisticated Chinese retail investors who were encouraged by the Chinese government to invest in the domestic equity market. With millions of leveraged trading accounts being opened each week, even street traders selling bananas (see picture opposite) were suddenly equity market participants and sent trading volumes in China through the roof, exceeding those of the New York Stock Exchange! At the same time, the valuation of several parts of the Chinese equity market became extraordinarily expensive; so much so that the local authorities began implementing measures to curb excessively speculative behaviour – if you have ever been to Macau, you know how much the Chinese like to gamble!



Unlike developed markets where a significant portion of household wealth is invested in the capital markets, the proportion in China is much smaller given their preference for savings in cash and property. Therefore, the recent falls have effected a large number of people to a small degree, but worries about an economic fallout from the China sell-off are overdone, even with respect to China itself!

The other concern has been with regard to the fall in China's growth rate. In 2007 the Chinese economy was growing at a rate of 14% whereas today that figure is roughly halved. However, the much larger size of the Chinese economy today, being the second largest on the planet, means the contribution to global demand has actually been pretty stable. What interests us most about China is the *transformation* in composition of growth currently underway. Driven relentlessly by President Xi Jinping, the reform agenda of China is real, where they are moving away from an economy driven predominantly by manufacturing to one where most recently, the greatest contribution to growth is coming from the tertiary or services sector. This structural change has massive consequences for many years to come and is the subject of a detailed research paper that we will be publishing soon.

Commodities and "Emerging Markets"

This adjustment phase in China's economy will be difficult for commodity markets and those emerging markets reliant most heavily on commodity exports. However, where lower commodity prices are a function of high supply at least as much weak demand, these lower input costs are surely a net positive for the global economy and particularly those emerging markets that are net commodity importers, such as India. Hence the blanket reference to "Emerging Markets" today has far less meaning than it used to, given the lack of homogeneity amongst them and so the indiscriminate sell off in emerging markets and emerging market currencies was, once again, in panic.

One cannot escape a discussion about commodities without discussing the price of oil. Again, taking a *slightly* longer term view than the last one week shows us the price has been falling

steeply since around June 2014. The fall has been largely due to some weakness in global demand, but far more so due to actions by OPEC in November 2014 where they maintained high production levels in an effort to defend market share against US shale oil producers. The depth of the decline has, we believe, even taken Saudi Arabia by surprise. They have been burning through their FX reserves which has taken them decades to build up, they have recently been issuing debt into the capital markets to help fund their massive budget deficit and have also been in the news for cutting fiscal expenditure by USD100 billion due to the fall in oil revenues. So it's hard to believe they will be tolerant of falls much below the current levels.

Interest Rates

With that in mind, it is important to remember that the bulk of the drop in oil price occurred in the second half of 2014. Therefore, as long as prices don't fall further from here, oil will have an ever reducing deflationary effect and hence the rate of inflation in developed markets is about to lose one of its main headwinds over the last year. While other commodities have fallen dramatically in price as well, their contribution to the measure of inflation is indirect. A more immediate driver of inflation that we are watching is employment and wages, both of which are rising in the developed markets.

However, in a parallel universe if we were presented with a world with very low levels of inflation, meagre rates of growth in the developed world, a debt sustainability profile that looks questionable at best for most countries, you would be forgiven for expecting the next move in interest rates to be down, not up! All considered, we believe the likelihood of rate rises has been pushed out a bit further into the future, given the recent financial instability.

What are we doing?

The sharp declines have had the feeling very much more of a "growth scare" and reversal of some broad consensus positioning (long European equities, short Euro, long US Dollar, long Japan) rather than anything more fundamental. Indeed, from the start of the decline to today, the FTSE100 has recovered more than half its loss, there is a similar story with the S&P500 in the US, emerging markets are still down heavily from their April peak, but have also recovered more than half the loss since 20 August.

Looking at valuations, emerging market equities (Asian equities in particular) are trading at some of the cheapest levels we have seen in a decade. Given there is still a chance that some continued repricing will take place across the region over the coming months as the full extent of the changes in China become better understood, we do not feel the need to increase our tactical positioning here. Furthermore, there are some heightened political risks in the region on the Korean peninsula. We are, however, undertaking some "deep dive" research into India which has sold off, but we feel has some very interesting fundamental dynamics.

Given the significant falls in developed market equities, however, we believe the best risk adjusted return opportunity is to be found in European equities, including UK mid and small caps. We are concerned about the larger cap end of the UK spectrum given its exposure to oil and commodities which could suffer further bouts of volatility led by concerns about China again.

Important information

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