Flash

The panic on stock markets is overdone

A number of factors are behind stock markets' poor start to the year. They include recession fears, though we are still of the opinion that current trends do not yet indicate a recession. We also think that the general market reaction to the obvious problems in China's financial system has been excessive. So far as geo-politics are concerned, there has been no major incident to ratchet up already existing tensions. While a continuing fall in the price of oil could spell further trouble for the markets, central banks continue to prop up those markets with their massive injections of liquidity. The power of this central bank support for risk assets should not be underestimated. Given this assessment, we are thinking about buying equities and a further 5% fall in markets would trigger purchases to offset the portfolio impact of recent declines.

Several factors lie behind the poor start for equities this year

Stock markets have begun the year in panic mode. Recession-fears, falling oil prices, China concerns, geo-political developments and the view in some quarters that the Fed's December rate rise was a mistake have all been cited as factors behind equities' poor start to 2016.

The economic conditions for a recession are not in place.

The recent fall in the American ISM Manufacturing index from 48.6 to 48.2 has produced a flood of negative comment on US economic trends. Left out of much of this comment is the fact that manufacturing now accounts for just 11.7% of the US economy. Indeed, it represents just 8.6% of total US employment. The other 88% of the US economy things are going fairly well in much of the US. A similar one-sided interpretation can be observed with respect to Chinese data. Thus the decline in the Caixin Manufacturing PMI from 48.6 to 48.2 is widely viewed as troubling while data showing continued growth in China's now-important services sector have gone unreported. Good data points on Europe's economy seem also to have gone unnoticed. Taken together, the macro data published in the first days of 2016 give a fairly balanced picture. For several reasons we don't believe that the world economy is yet heading towards a recession, although such an assessment must be qualified by the possibility of external shocks or policy mistakes by the central banks.

The general stock market response to the decline in Chinese stocks and in the yuan is overdone.

On two days steep price declines have led to a trading halt on China's stock market. While this has made some investors very nervous, one should remember that even when the Chinese stock market was doing well only 4% of the Chinese population was actively investing in it. Also, only a fraction of the Chinese stock market is held by foreign investors. Thus movements in the value of Chinese stocks should not have any significant impact on the real economy. The yuan's loss against the US dollar has also contributed to current nervousness. But given the history of China's exchange rate policy, and the fact that the country has $3300bn. worth of foreign currency reserves, we think the chances are that the future development of the Chinese currency will be orderly. Suggestions that the declining yuan signals an impending credit crisis seem exaggerated to us. All in all, we believe international bourses have overreacted to the weakness of the Chinese stock market.

The latest geo-political incidents will not have a lasting economic impact.

So far as global tensions are concerned, two events have made the headlines. Recent Saudi decisions that upset Iran were motivated by Saudi internal political considerations. Saudi leaders feel impelled from time to time to appease the hardline Sunni constituency in that country. Even so, the behavior of the Saudi authorities suggests a social instability which we view as a medium-term general risk for the markets. For the nearer-term, we see Saudi concerns over the emergence of Iran from near-total isolation being soothed to some extent. The second event concerns North Korea, though we doubt that country has been able to successfully explode a hydrogen bomb. Still, Kim Jong Un seems to have lost none of his touch when it comes to provoking the rest of the world.

In the near-term, the oil price could cause further market turbulence.

Since the start of the year the price of oil has lost 15%, triggering debate about the negative consequences for investment in the energy sector as well as the credit worthiness of those engaged in energy supply. Countries such as Saudi Arabia are still seeking an increase in market share. Saudi hopes in this way to limit a Budget deficit which is currently approaching $100bn. pa. With this perspective, one can well imagine that even a further decline in prices could encourage an increase in oil supply, at least in the near-term. Thus, it is quite likely that the oil price will overshoot on the downside in the next few months.

But the central banks will continue to support the financial markets in 2016.

Central banks will keep monetary policy at the service of the financial markets in 2016. Sluggish economic trends could encourage the ECB and the Bank of Japan to further open their monetary floodgates in coming months, while the Chinese central bank is still in the process of changing policy in the direction of stimulus. Given current uncertainties, we think the Fed will be very cautious when it comes to further increases in US rates. Thus chances seem low that the Fed will err by tightening its monetary policy too sharply.

A further 5% fall in equities would turn us into buyers

Given these considerations, and the fact that the UK referendum on the EU is still some way off, we are minded to buy equities should the markets fall another 5% in order to offset the portfolio impact of recent price declines. We are aware that a further fall in the oil price could so hit markets as to undermine this strategy. However, were that to happen, a straight-forward overweight stance in equities might well become appropriate.

Aquila & Co. AG, 14. January 2016

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