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The summer of our discontent

Peter Szopo

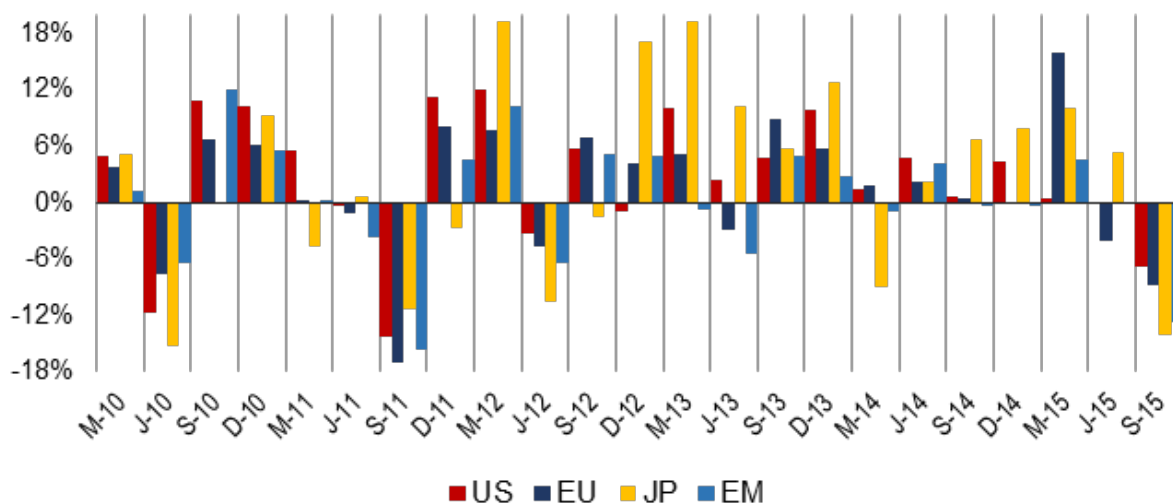


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Only in a few months we will likely know, whether the bull market that started in mid-2009 really ended in the summer of 2015. What we know, however, is that the headwinds that have emerged in recent months will not recede anytime soon. Another challenging quarter, it seems, lies ahead of equity investors.

The summer quarter of 2015 was the worst quarter for global equities in recent years. The S&P 500 lost 6.9%, the Euro Stock 600 8.8%, the Nikkei 225 14.1% and the MSCI Emerging Markets Index 12.8% (all in local currency). In the quarterly performance ranking since 1995, 3Q 2015 ranks in the 9th decile in the US and in Europe and in the 10th decile in Japan and Emerging Markets (EM). For most markets, this was the worst performance since 3Q 2011, when fiscal issues on both sides of the Atlantic – the US debt ceiling standoff and the sovereign debt crisis in Europe – weighed on markets.

Regional equity performance (q/q)



Source: Bloomberg; Erste Asset Management

Under the spell of monetary policy

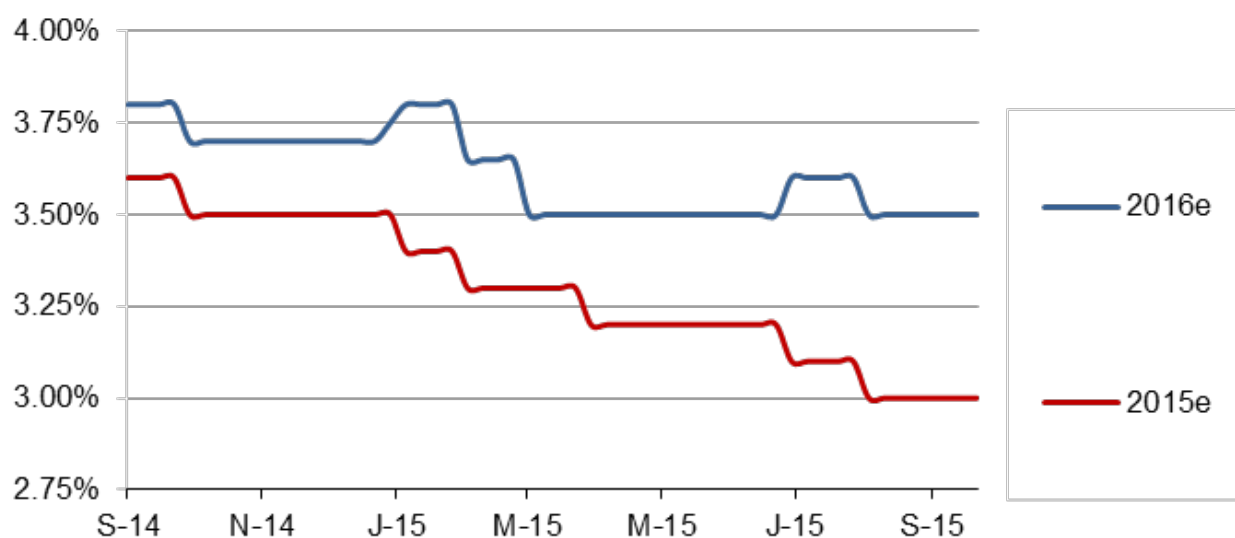
This time around, monetary policies were at the core of the havoc. First, in mid-August, the Chinese Central Bank surprised the market with a depreciation of the Renminbi, thus adding to deflationary pressures in the rest of the world and raising further concerns about the strength – or rather weakness – of the Chinese economy. Second, in September, the Fed hesitated to start the rate lift-off. While the Fed’s reluctance, in itself, was understandable given the lack of inflationary pressure in the US, the bank’s communication sent out mixed, if not confusing signals to investors. On the one hand, Chairwoman Yellen pointed to threats to the US economy coming from global economic turbulences, particularly in emerging markets, as a reason not to hike, while on the other hand she confirmed the bank’s intention to start the lift-off before year-end.

Finally, some sector and single-stock events added to the overall deteriorating market backdrop: The political debate about drug-pricing in the US, triggered by Presidential candidate Hillary Clinton’s call for tighter regulation; the affair around Volkswagen; and concerns about the financial stability of Glencore, one of the largest players in the mining world.

The new quarter started on a more positive note, but whether we will see a lasting rebound will depend on a number of (partly) related factors:

First, the outlook for the global economy needs to improve. Global growth has been undershooting expectations for years and the current year is no exception. Consensus forecasts have come down by more than 50 bps over the past 12 months and [recent 'nowcast'-exercises](#) point to renewed weakness in the third quarter. Without any signs that the global economy is regaining momentum, equities are unlikely to perform. Therefore, it came as a surprise that risky assets, including equities reacted positively on the latest payroll release in the US. Yes, it has reduced the odds of a rate increase in the Fed’s October meeting, but it is hard to understand, how a softer US economy ultimately is something to cheer about.

Global growth (GDP, y/y, consensus)

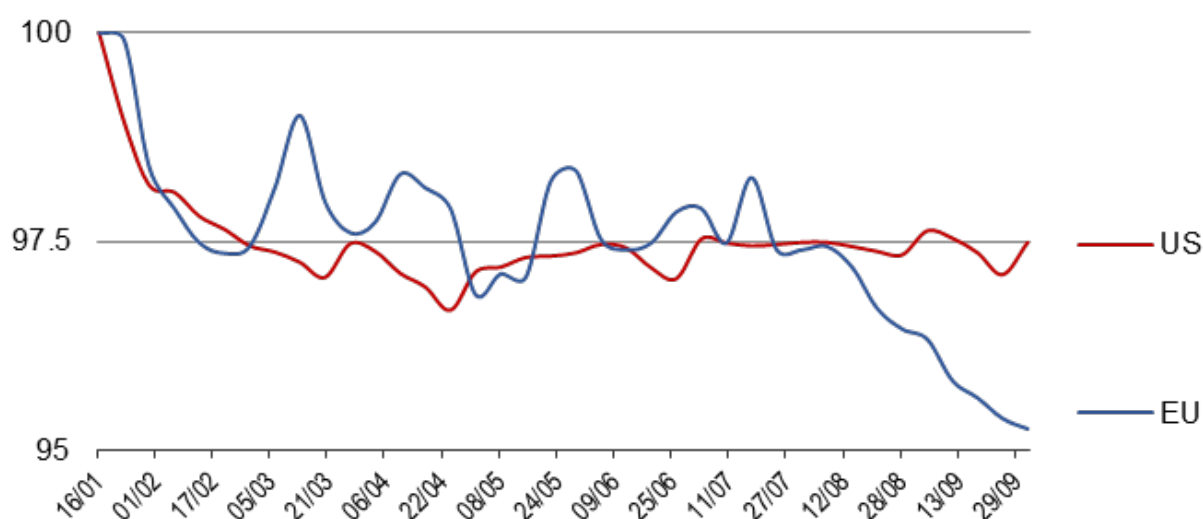


Source: Bloomberg; Erste Asset Management

Second, fears of an Emerging Markets (EM) meltdown need to recede before one could expect investors' risk appetite to come back. [The IIF forecasts](#) that EM, for the first time since 1998, will suffer a net capital outflow in 2015. In the third quarter alone, [portfolio flows led to a US\\$40bn outflow](#) (evenly divided between equity and bonds), which is both a sign of investor capitulation and an additional factor adding to the troubles in emerging economies. That said, a fully-fledged EM crisis is not the most likely outcome. As a group emerging economies run a current account surplus, reserves were above US\$ 3,000bn (excl. China) at the end of 2014, public debt has been falling and inflation has been in the low single digit range (see e.g. [Cecchetti and Schoenholtz](#)). However, the dispersion within the EM universe has increased in recent years, with some economies like Venezuela and Ukraine dropping from investors' radar screens and others - including Brazil, Turkey and South Africa - looking more fragile against a backdrop of a strengthening dollar and, possibly, rising interest rates.

Third, earning momentum must pick-up, particularly in Europe. While consensus estimates still point to a 40%+ rise in Euro Stoxx 600 earnings, the earnings revisions ratio (upgrades to downgrades) has stayed below one since July and EPS forecasts came down 5% in 3Q. In the US, earnings forecasts have been more resilient with the earnings revision rate hovering around one in the past few months and index earnings (S&P500) staying unchanged. The upcoming reporting season in both markets will be key to determine the near-term path of equity indices.

EPS 2015 consensus (mid-Jan 2015 = 100)



Source: Bloomberg; Erste Asset Management

Bottom-line: Only in a few months we will likely know, whether the bull market that started in mid-2009 really ended in the summer of 2015. What we know, however, is that the headwinds that have emerged in recent months will not recede anytime soon. Another challenging quarter, it seems, lies ahead of equity investors.

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Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research department at Alfa Bank in Moscow.

After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

Along with his analysis activities, he worked from 1997 to 2000 at Eastfund Management as the fund manager for Central and Eastern European equity.