Economic Outlook

Third Quarter 2015

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China's New Export: Market Volatility

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SEI recently released its third-quarter 2015 Economic Outlook. A summary of its conclusions is provided below:

- The bursting of the stock-market bubble in China in late June, followed by an unexpected depreciation of the renminbi against the U.S. dollar in mid-August, has led to substantial financial-market reverberations in both developed and developing investable markets.
- We do not believe that the bull market in global equities has ended; however, the character of the bull market certainly has changed. As we have pointed out frequently, economic and market cycles in recent years have been quite disjointed and out of sync from region to region and country to country.
- Our expectation is that the bull market in the U.S. still has a few of years of life left in it, as share prices rise with underlying profitability. Thus, we believe the current price correction represents a buying opportunity.
- Since the beginning of 2015, other equity markets (notably Japan and the countries of the eurozone) have found increased favor among investors. Volatility notwithstanding, it is our expectation that monetary policies will remain far more expansionary and for longer in Japan, Europe and the rest of the world than in the U.S.
- It's our strong conviction that developed economies will not only avoid recession but will actually step up the pace of growth in the year ahead. If demand flags in those regions, deflationary pressures will probably intensify.
- Between 2007 and 2014, China's total debt as a percentage of gross domestic product (GDP) has surged by a remarkable 100 percentage points to 250%. Historically, no developing country has been able to increase debt this quickly, and to such a high level relative to GDP, without suffering a serious hangover afterwards.
- The stock-market bust in China, although devastating from a psychological perspective, is something of a sideshow. The development that really unsettled markets was the Chinese government's decision on August 11 to allow its currency to float against the U.S. dollar.
- Concern is growing that China will let its currency float more freely, causing a sharp depreciation against its major trading partners in the months ahead.
- The Federal Reserve's decision to stand pat in September suggests that the Fed is more than data-dependent. It is also market-dependent (and China-dependent). This emphasis on waiting to raise rates until markets calm down is hard to reconcile with the majority view that an interest-rate increase is appropriate by the end of the year.
- Sterling, meanwhile, remains exceptionally well-bid. As in the U.S., this appreciation of the currency is being viewed as the equivalent of a monetary tightening. Valuations are decidedly unattractive, with U.K. equities having been as expensive as they were versus other developed equity markets at the end of the third quarter only 7% of the time since 1997.
- In terms of fiscal policy, Europe still remains focused on austerity measures and its need to reduce debt loads in the periphery countries. China, too, could experience a sharper slowing than we expect if the government loses control of the debt unwinding process. In the U.S., gridlock is once again running hard up against the calendar, with threats to the timely passage of the federal government's budget and a debt ceiling increase.
- Despite the turbulence of recent months, our tactical view remains basically the same. We continue to favor equities over bonds, developed international exposure over the U.S., long-dollar positions against a variety of currencies and a generally pro-cyclical orientation within sectors.

A full-length paper is available if you wish to learn more about this timely topic.