Market Alert

Recent market volatility both domestically and around the globe, has caused many investors to revisit their investment strategy at the open of 2016. Over the first few weeks of the year, several themes have emerged as likely determinants of future market returns. At USI Advisors, we believe many of the concerns being addressed by market participants currently, are not new revelations, but instead represent a reassessment of prior conditions. By revisiting some of the broad market themes of 2015 and data driving the current volatility, we believe we can provide a useful assessment of the current situation and help clients define a path forward.

A Brief Recap of 2015

While broad U.S. indices produced positive returns in 2015, specific industry sectors, notably energy, struggled. Internationally, investors faced a more challenging environment. Broadly, developed countries finished in slightly negative territory for the year, while emerging markets struggled in the presence of declining commodity values. Despite a mixed bag of returns in 2015, which brought turbulence to equity and fixed income investors alike, the year provided reasons to be encouraged about the prospects of 2016. At the forefront of these market conditions was a year which brought an intense focus and borderline obsession with monetary policy and economic indicators. The world's two largest economies, China and the United States, appeared to be diverging. Despite domestic challenges, the U.S. seemed poised to continue its' seven year long path of slow economic growth. China, conversely, seemed destined for a slowdown, unlikely to keep pace with economic growth expectations. Financial news headlines throughout the year were dominated by the action or inaction of the Federal Reserve Open Market Committee (FOMC) and its members, all while postulating about future policy decisions. December seemed to bring resolution, as the FOMC increased the target range for the federal funds rate by 0.25%, the first increase since 2006. In a public statement, the FOMC, cited expectations that economic activity will continue to expand at a moderate pace as the primary driver of the increase. These expectations were supported by increasing improvements in consumer spending, an improved labor market, increasing business investment, among other economic factors. Market participants appeared to have subscribed to the Fed's rationale, as volatility expectations, as indicated by the CBOE Volatility Index, decreased by nearly 25% by the end of 2015. The belief entering 2016 was that while the global economy would likely decline, due to ripple effects of a Chinese slowdown, the U.S. economy had recovered sufficiently and would avoid the impediment. Despite remaining concerns about how this scenario would develop and the severity of the downturn in China, during the closing weeks of 2015, domestic investors seemed to have finally tasted a bit of the optimism many had yearned for all year. Given this sentiment, many market participants now find themselves asking "What changed so far in 2016?"

Recent Market Events in China

Trading in the Shanghai Stock Exchange began the year on shaky ground. Within the first two weeks of the year the Shanghai Composite Index had fallen by approximately 10.5%. Perhaps more shockingly was the path taken to reach this low. Trading on the exchange was halted after less than one hour on two occasions, as sell-offs triggered trading circuit breakers which were put in place to prevent panic driven market crashes. While these events are certain to attract headline attention, the more pertinent issue is the underlying forces driving volatility.

USI Advisors, Inc.
www.usiadvisorsinc.com

The market downturn was largely attributed to the People's Bank of China (PBOC) manipulation of the Chinese currency, the yuan. Manipulation of the value of the yuan is not a new tactic by the PBOC, but represents a tool that has historically been utilized to help boost the Chinese economy. Given the slowing Chinese economy, devaluation of the yuan was expected by market participants, however it was the pace of the change which caught investors off guard. By January 14th, the value of the yuan had slid almost 1% in relation to the U.S. dollar. In the simplest form, devaluation was achieved by the PBOC through the use of currency reserves, which manages valuation based on the daily target exchange rates set by the bank. The target rate has been consistently lowered in 2016, driving down the value of the yuan.

The rapid devaluation suggests two issues. The first is the on-going management of the currency by the PBOC. In December of 2015, the PBOC shifted away from pegging the value of the currency strictly against the U.S. dollar, instead opting to manage against a basket of currencies. At the time, this action suggested that the valuation of the currency would be allowed to float more freely and be partially influenced by market forces, rather than being dominated by outside intervention. While this was viewed as a positive development, the recent and notable intervention suggests that a currency valuation influenced by market forces may be unrealistic. Secondly, the devaluation of the currency suggests there may be a deeper structural economic issue in China. As mentioned, currency management as an economic policy tool has been used by the PBOC to spur the Chinese economy previously. Devaluing the currency serves as a way to make the country's exports more affordable to foreign trade partners, this in theory would spur economic growth. While there is general agreement that the economy is slowing down, the question remains as to what extent and how quickly will it occur. To many, the recent intervention by the PBOC is a signal that conditions may be worse than previously thought. Economic data from China has been frequently scrutinized, with many calling to into question the data's accuracy and reliability. Official figures released through State agencies indicate quarterly GDP growth has dropped by about 1.1% since 2013, to 6.9% as of 3rd quarter end. Other less formal measures, such as the "Keqiang" index, a measure popularized by The Economist, illustrate a more severe situation. The index focuses on industrial output, electricity consumption, and freight traffic, factors which are reported to be preferred by Premier Li Keqiang, when assessing the economy. These factors have all been steadily declining over the last two years, with their growth rate sitting below that of the published GDP figure of 6.9%. In the absence of firm economic data, the actions of the PBOC provided reinforcement that conditions could be worse than previously assumed. Under this scenario, investors potential face a rapidly declining economy and a currency expected to continue to decrease in value. Combined, these two conditions make for a difficult investment environment, which triggered an exit for many investors.

Why China Matters to Domestic Investors

During times of market volatility it is important to understand how portfolio risk and return may be impacted. The events in China are unique as many investors will not have direct exposure to securities listed on the Shanghai Stock Exchange, which is largely a byproduct of Chinese capital controls. Investors can potentially have exposure in several other ways. World Bank data from 2014 indicates that China received the world's largest amount of foreign direct investment. This inflow of capital represents companies based outside of China investing directly into resources within the country. In general, the implicit assumption when making these investments is that China offers a source of future growth. If the Chinese economy fails to deliver on these growth prospects, companies outside of China who undertook the investment could be adversely affected. Secondly, the effect of a Chinese slowdown will likely have an impact on other economies in the region. China partners with many emerging market countries when conducting trade and it is particularly important to countries who export commodities. A lack of demand from China due to an economic slowdown would be detrimental to these trade partners and potentially prolong difficulties in emerging market economies. Lastly, a lack of demand from China presents a similar problem for the U.S. economy. Given the already low growth prospects for the United States, challenges faced by a key trade partner such as China, have the potential to derail future growth. Additionally, while the devaluation of the yuan relative to the dollar means cheaper goods for U.S. based consumers, it also presents problems for domestic monetary policy. In a sense, through the devaluation China is exporting deflation to the United States. Prices, broadly speaking, are unlikely to rise in the presence of more affordable Chinese goods. Deflationary pressures could make it difficult for U.S. policy makers to continue to steer the economy towards the stated 2% inflation target, while creating uncertainty around future policy decisions.

The Path Forward

USI Advisors is continually monitoring market conditions and will provide updates as appropriate. As additional data is released, and we are able to further observe the actions of policy makers and market participants, we believe a more accurate picture of the path forward will emerge. In our view, market events such as these can be quite common and it is often beneficial to fully assess the situation before acting. Our team of investment consultants is readily available to address any questions or concerns specific to your investment lineup or portfolio.