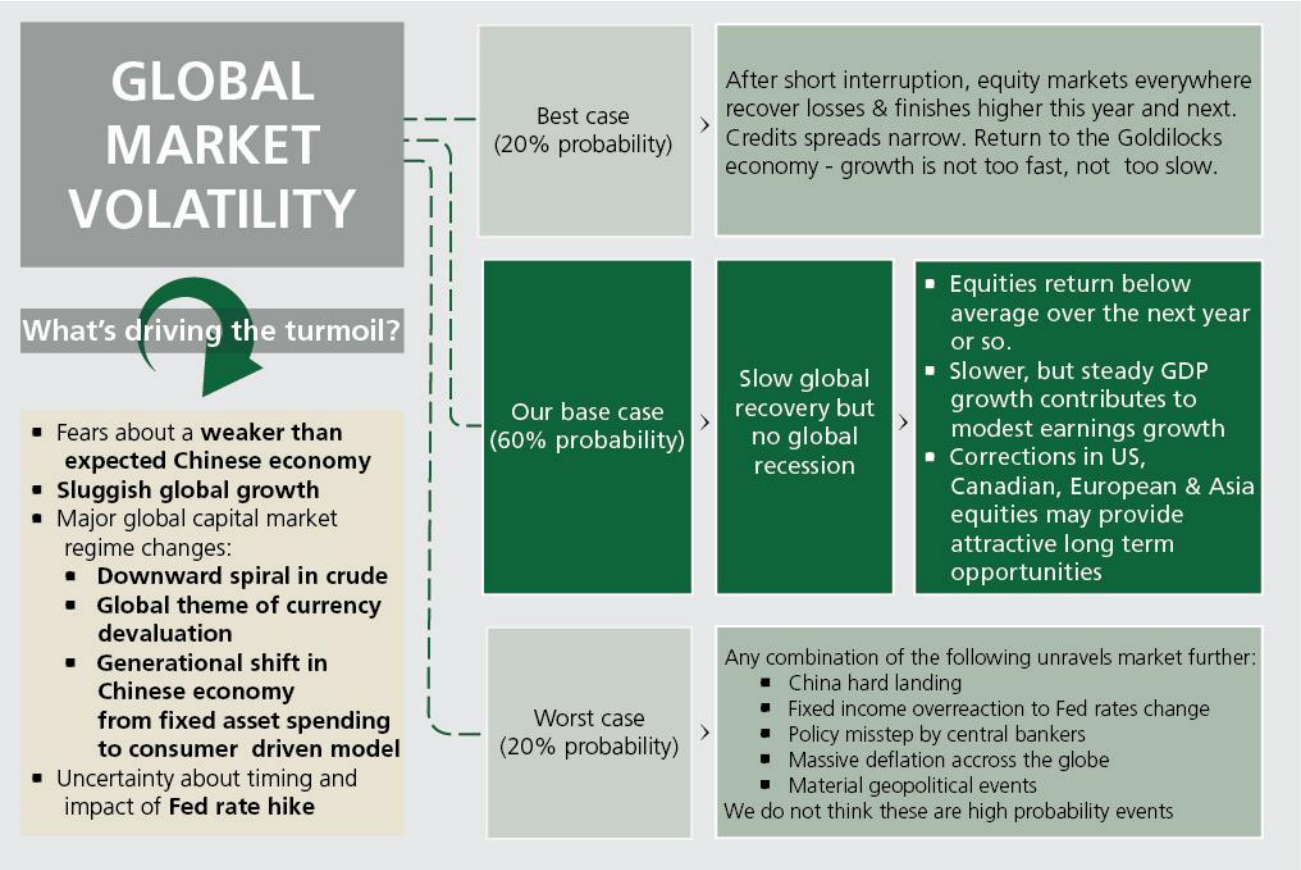
Global market turmoil - where do we go from here?

As global equity markets continue to be volatile following a significant sell-off on Monday, Bob Boyda, Co-head of Asset Allocation and Philip Petursson, Managing Director, Capital Markets and Strategy assess the longer term implications of the market volatility and explain why there may be investment opportunities for investors with a steady nerve.

Implications of the global market turmoil



Source: Manulife Asset Management

- Equity markets 'letting off steam'
- While volatility may persist over coming weeks, we do not believe economic or market fundamentals suggest a more ominous long term rout.
- Volatility may be an opportunity to take advantage of equity market weakness for an improved return profile

Background –Necessary correction as markets 'vent'

In our view, the current market volatility is symptomatic of the equity markets letting off steam. That's not to say markets were overheated, but rather that there has been a lot in the way of macro events - think China, Greece, the Fed, etc - that leaves one needing to vent. Equity markets have been in a consolidation pattern for months now, looking for direction and signs of a pick-up in growth.

Following the recent announcement by the People's Bank of China that it is relaxing the trading bands for the Chinese Renminbi, the realization of a weaker Chinese economy has started to set in. This follows data points that have illustrated the growth challenge in China - electricity usage, rail freight and auto sales with negative year on year growth rates and fixed asset investment that has fallen from last year. Where China has been an offsetting counter-balance to slower growth elsewhere in the world, that support mechanism is now under question.

Three major global capital market regime changes contributing to volatility

In the context of the major secular changes occurring in the global economy, some tapering of risks particularly in the global equity markets were easy to see coming, but as always are a challenge psychologically.

Three major secular regime changes have finally caught up with money flows:

- China is on a major generational shift from industrial to a consumer-led market putting pressure on the commodity exporting winners of the last decade;
- Organization of Petroleum Exporting Countries' (OPEC) oil cartel may have ended, shifting capital spending and permanently lowering the global cost of energy. This has significant winners and losers associated with it;
- Zero interest rates in the world's largest economy may be coming to an end after 7 years: the end of experiments on this scale is always stressful.

In addition, this is all happening in the midst of a global theme of currency devaluation.

So where do we go from here? Three possible scenarios:

1) Worst case scenario – Unlikely: 20% chance of occurring

Our worst case scenario is that global equity markets correct more than 20% from here. Any combination of the Chinese economy tumbling to a hard landing, the fixed income markets over-reacting to the Fed's rate announcements, the Fed or other central bankers making policy missteps, a pervasive malaise triggered by massive deflation across the globe and any sort of material geopolitical events could unravel markets further. We don't think that these are high probability events individually or taken together.

2) Best case scenario – Unlikely: 20% chance of occurring

In our best case scenario, after this short interruption, equity markets everywhere recover all the losses and finish higher this year and next, credit spreads narrow and we return to the goldilocks economy where growth is not too fast, not too slow. As desirable an environment as this may seem, it is also relatively unlikely. Valuations have been stretched and corporate earnings have not caught up to prices. The glimmer of hope would be that consumers everywhere begin to reap the benefits of lower energy and material costs and start spending what amounts to an enormous tax cut/ stimulus and that the global economy kicks into high gear as a result.

3) Our base case scenario – Most likely: 60% chance of occurring

Our most likely scenario is a slow global recovery. Typically following a financial crisis, recoveries are considerably longer and slower. Historically, one of the after effects of a debt-induced financial crisis is that GDP grows 1% slower on average during the 10 years after the crisis. As a result, excesses do not build up in the system. On the other hand, economic growth seems persistently weak and will rarely get above the average of the growth trend preceding the crisis. We see the global recovery taking place as a textbook example of this typical pattern.

Comparisons are being made in the media between the current market turmoil and the global financial crisis in 2008-9. In our view, there is little to compare the two. Bear markets are typically characterized by recessions following excess in the system, and/or overvalued markets (as in the case of 1987). The global economy is undoubtedly sluggish but to say recessionary conditions exist would be a stretch at best. A typical recession would see an inverted yield curve, the manufacturing PMI index fall below 50 or capital spending as a percentage of GDP peak out near 30%. We do not have any of those conditions present today.

As a result, we are not seeing any signs of a recession in the near term. Indeed, in the world's largest economy, the United States, the economic recovery is looking positive. The US consumer remains healthy, the labour market continues to improve, wages are growing, and housing starts are rising.

Investor implications: No change to our equity return expectations

While the volatility may persist over the coming days or weeks, we do not believe the conditions exist from an economic perspective or within the market fundamentals for this to develop into something more ominous. This is more likely the correction the market has been predicting for the last couple of years and it should be welcome after four years of fairly consistent market gains.

We expect equity returns to be below average over the next year or so. Slower, but steady GDP growth will likely contribute to modest earnings growth. Stock market valuations that are above their 5-year average have also kept our return expectations somewhat more subdued. This however, does not lead to bear market expectations.

It is possible that there is a corporate profits recession in the making in the US that pushes equity prices below a 10% correction. However, there are enough green shoots coming out of Europe and Japan where profitability has been subpar for years to suggest that investors have a place to reposition assets. We remain in the camp that this is a bull market (globally) and that corrections are sharp, hard, psychologically tough to deal with and therapeutic, a part of the value restoration project.

As such, while we are in correction territory for Canadian, European and Asian equity markets, and at or near for the US (whether your yardstick is the Dow Jones Industrial Average or the S&P 500 Index) the current volatility may be an opportunity to take advantage of market weakness for an improved return profile, longer term.

Manulife Asset Management

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