Views on Current Market Turbulence

Market volatility has risen as investors face a number of growing uncertainties — whether the downturn in commodity prices and weak economic activity in China are indicating a global growth slump, as well as when the Federal Reserve (Fed) will raise rates.

Equities rallied Wednesday, with the S&P 500 up 3.9%. However, investor uncertainty will likely keep volatility elevated, in our view. We are including here a brief summary of recent developments, as well as our outlook on global markets, the economy and portfolio positioning.

Recent market turbulence:

- As of Tuesday, August 25, the S&P 500 had declined nearly 12.5% from its May high. Wednesday's rally brought the decline to roughly 9%.
- A series of concerns have weighed on investor sentiment: China's plunging stock market, fears about looming Federal Reserve (Fed) rate hikes, another leg down in commodity prices and the strength of the U.S. dollar have all been major sources of uncertainty.
- Most recently, the shift in China's exchange rate policy has compounded fears over the growth outlook for the world's second-largest economy and its major trading partners.
- Volatility spiked, and the VIX Index[1] rose as high as 53 intraday on Monday, closing at 30 on Wednesday.
- European and Japanese equities were down roughly 15% (in local currency terms) from their recent highs, as of Tuesday.
- Bonds have rallied in a flight to safety, and as investors lowered their expectations of a Fed rate hike in September. The 10yr Treasury yield briefly dipped below 2% on Monday and closed at 2.07% Tuesday, from 2.30% a month ago.

China focus:

- China's economy comprises roughly 15% of world gross domestic product (GDP), and a third of global growth, according to BofA Merrill Lynch (BofAML) Global Research.
- Chinese equities have plummeted in recent months on concerns over slowing growth, leverage, and capital outflows. As of Tuesday, the Shanghai Composite had fallen by more than 40% from its high in June. However, it is still up 35% over the past 12 months.
- Earlier this month, a drop in the Chinese yuan startled investors and stoked concerns of competitive currency devaluations weighing on global growth.
- On Tuesday, China's central bank cut the bank reserve requirement ratio and interest rates, in an effort to stabilize markets.
- BofAML Global Research China economists expect further policy easing as the government tries to stimulate the economy to maintain 7% GDP growth. They see room for 1-2 more interest rate and reserve requirement ratio cuts this year, and expect further weakness in the yuan through this year and next.

Global economic outlook:

- The U.S. economy continues to recover at a moderate pace. BofAML Global Research economists forecast a 2.3% growth rate in 2015, thanks to job creation, a pickup in housing, and rising consumer confidence.
- Our base case is for advanced economies to weather this downturn from China. Both European and Japanese central banks have stated their commitment to supporting growth through next year with very accommodative monetary policies.

[1] VIX Index is the Chicago Board Options Exchange Volatility Index reflecting a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of S&P 500 Index options.

- While global growth looks set to remain in the 3% range, we expect Emerging Markets to face challenges as headwinds from rising rates, lower commodity prices, and cheaper currencies from their competitors make it harder to sustain growth.

The Fed's next steps:

- The July Federal Open Market Committee (FOMC) minutes surprised by suggesting the Committee has become somewhat more concerned about low inflation. Investors largely interpreted this news as dovish. The market-implied probability of a September rate hike has dropped to roughly 25% from 50% last week, as of Wednesday.
- The BofAML Global Research Economics Team's view is this is a bit of an overreaction. September remains their base case for the first Fed rate hike, but the next few weeks of data will be important for updating their view. While the current market volatility is not sufficient to delay the first rate hike on its own, in their view, it will likely affect the subsequent pace of further rate hikes.
- Our base case remains for interest rates to remain lower for longer and for the Fed to raise rates at a gradual pace.

Global equity outlook:

- We maintain our positive outlook on equities over bonds. In our opinion, the current market decline is a correction and not a long-term bear market. We do expect returns from equities to be more moderate going forward and come with higher volatility.
- We are constructive on developed market equities - U.S. equities and currency-hedged positions in Europe and Japan.
- BofAML U.S. Chief Equity Strategist Savita Subramanian's year-end price target for the S&P 500 remains 2,200. We would add to exposures in high-quality large capitalization stocks with stable earnings and dividend growth characteristics.
- We have recently downgraded our view on Emerging Market equities to a negative outlook, as a slowdown in Chinese economic activity and falling commodity prices should continue to weigh on the asset class. We advise investors to remain selective and favor active management. We prefer reform-minded countries such as India and high-quality dividend-paying stocks.

Technicals on U.S. equities:

- BofAML Global Research Technical Analyst Steve Suttmeier believes that this pullback was long overdue. This marked the first S&P 500 drop of 10% or more since the 2011 decline of 19%. Since 1928, the S&P 500 has had 93 drops of 10% or more, which means that they occur about once per year.
- According to Suttmeier, Monday's climactic volume with 90% of the NYSE stocks down points to interim stability. However, the damage to market technicals suggests that base-building is needed before a sustainable rally. He sees the potential for retests and undercuts of Tuesday's 1867 low to the October 2014 low of 1820.
- Suttmeier notes that during secular bull markets the average drop of 10% or more in the S&P 500 is 15.56% with drops in excess of 15% occurring 34.8% of the time, and declines of 20% or more occurring only 13.0% of the time.

Bonds and rates:

- BofAML Global Research rates strategists maintain their view for the 10yr Treasury yield to rise to 2.35% by year-end, and 2.85% in 2016.
- They prefer intermediate maturities in Treasuries (10-15 years) and slightly longer duration in municipals.
- Lower commodity prices and continued weakness in Emerging Markets could keep rates low, particularly for the longer end of the curve.
- High Yield may remain under pressure from a high concentration in the Energy sector, and a pickup in issuer defaults from historical low levels.

Commodities:

- As of Wednesday, commodities were down more than 30% in the past year, led by oil prices. WTI Crude is down nearly 60% in the past year, falling below $40 per barrel for the first time since 2009.
- BofAML Global Research commodity strategists expect WTI to stabilize by year end and to rise to an average of $57 per barrel in 2016. The supply / demand imbalances are likely to persist keeping oil prices lower for longer.
- They expect gold prices to remain pressured by a stronger dollar and low inflation expectations. They forecast gold prices to fall in 2016, averaging $1,088 per ounce for the year.

Today compared to the Asian Financial Crisis of 1997-98?

- The macro picture today versus 1997-1998 is very different. Asian currencies are no longer pegged to the dollar and current account balances are much improved.
- Liquidity in these markets is significantly higher as well, with Emerging Market foreign exchange reserves totaling over $9 trillion today versus just $821 billion back then.

What may mark the end of this correction?

- Investors want to see more clarity on the health of Emerging Markets, particularly China, which could take some time.
- A more proactive response from global policymakers would likely signal an important turning point, and we have already begun to see some movement from central banks. China's central bank has moved to cut its lending and deposit rates as well as the bank reserve requirement ratio. They could do more.
- There has been some suggestion by Fed officials that recent exchange rate and commodity price movements will be taken into consideration as they look to start raising rates.

Risks to our view:

- We reiterate our positive view on the global economy, and a preference for equities over bonds. However, we recognize several risks to our outlook.
- Policy uncertainty may escalate into September, when the Fed next meets, the congressional budget expires (leading to concerns of a government shutdown) and the Iran nuclear agreement will be presented to Congress.
- Additionally, continued negative economic data abroad could reinforce fears of a global growth slowdown, which could cause further declines in equities. Although this is not our base case, these developments bear watching.

Broad portfolio guidance:

- Investors should look for opportunities to rebalance to their goals-based strategic asset allocation. Having a disciplined rebalancing approach can help to manage risk exposures, lock in capital gains periodically, and avoid poor market-timing decisions by averaging in over time.
- Volatility provides an opportunity to reposition into oversold and attractively valued asset classes. It should be distinguished from a permanent loss of capital, which is more detrimental to long-term investors. Through diversification, monitoring and a disciplined approach that is tied to one's asset allocation and rebalancing plan, investors can minimize the chances of permanent loss of capital.
- Alternative Investments, where suitable, can help diversify a traditional stock / bond / cash portfolio.

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