Principal Global PERSPECTIVES

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Principal® Global Investors

THE CEO AND AN ECONOMIST DISCUSS: MARKET TURMOIL

TURBULENCE DEMANDS VIGILANCE

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It is fairly likely that most market participants would be willing to forget the first trading week of 2016. With sell-offs in most equity markets around the world, volatility seems to be an early, if somewhat expected, arrival in the new year. Since the first strains of pessimism emerged with a weak manufacturing report from China, clearly there have been negative developments. Most notably is the further slowing in growth prospects in emerging economies.

For different reasons, Brazil and China both appear, because of very high debt levels, to be reaching the end of their ability to stimulate growth by further credit expansion. Cheap and plentiful commodities, driven by excessive investment and improved technology, have cushioned the problems for China, but made them worse for most other emerging countries.

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THE MANY SIDES OF THE MARKET GYRATION STORY

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According to the Chinese zodiac, 2016 will be the Year of the Monkey when the Lunar New Year arrives on Monday, February 8th. So far though, it has felt more like the Year of the Pelican, a bird known for diving headfirst out of the sky and into the ocean in search of food.

That said, I don't believe that all is doom and gloom. One can paint a somewhat non-negative picture of both the recent stock market collapse and the drop in the yuan/dollar exchange:

- Stock market: The Chinese regulator was planning to end the prohibition against large stockholders selling this week; all investors knew that and tried to sell in anticipation; the new circuit breakers caused them to rush to sell ahead of market closure. Now, with selling prohibitions still in place and circuit breakers ended, calm has returned.

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TURBULENCE DEMANDS VIGILANCE
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This all delays any prospect of a swift recovery for emerging market equities and debt, and indicates that 2016 will likely be another very tough year for emerging economies.

Widening in credit spreads, for both high yield and investment grade, have been a further factor to consider. While defaults and downgrades are likely to increase during 2016, so far it looks like this will be tightly focused around commodities and emerging market corporates. For now, there appears to be only a very modest fundamental impact on developed markets. However, investors need to be vigilant for signs of contagion, particularly looking at exposure to these troubled areas from global banks.

Interest rates, as well as commodity prices, seem likely to stay lower for longer than most observers think. The Federal Reserve will probably do only one, or at most two, increases to the federal funds rate in 2016.

Longer term, the low-rate environment will become supportive of asset valuations, including the equity market. But equity markets and credit spreads will stay very volatile because of structural changes in markets (as we have noted before) and much-reduced liquidity from the banks in the trading system. These liquidity effects have been especially intense in the first week of the year, where collateral demands from the lower oil price and the fall in Chinese equities sucked liquidity from the system and thereby amplified the global market set back.

In U.S. equities, this still looks like an overreaction, and in our view, the longer- term investor should stay up to weight, investing on setbacks. From my point of view, it is still too early to consider emerging equities. And slow growth reduces the general attractiveness of European and Japanese equities. Any involvement with commodities or commodity-related markets, e.g., Australia and Canada, would require scrutiny and caution.

For the United States, the positive opinion is all based on the idea that innovation, technology, and housing will continue to benefit the domestic economy. Eventually the U.S. consumer will spend a little more of their residual benefit from lower energy costs, especially gasoline. And the strength in the dollar will hurt U.S. trade only a little. All in all, the situation continues to require vigilance from investors.

THE MANY SIDES OF THE MARKET GYRATION STORY (CONTINUED)

- Currency: China's central bank announced in December that it would follow a basket of currencies rather than a strict peg to the U.S. dollar (USD). The dollar was only a quarter or so of that basket. Calculated versus the basket, the yuan has been stable since mid-December; since the USD has appreciated versus others in the basket, the yuan/dollar dropped in order to stay the same versus the basket, but the central bank is still in control. Thus, the drop in yuan/USD has no meaning beyond a change in the peg.

However, the uglier version of the story that has been the focus for much of the first week of trading has two sides:

- There is the belief that China is intentionally weakening its currency to perk up its depressed manufacturing sector and that a massive devaluation is coming.
- There is a view that China has indeed lost control of its currency and a huge devaluation is coming as funds fly out of the country.

I think we need *much* more evidence to believe either of those stories. Evidence that either of these tales were true would be a significant and persistent weakening against the yuan's announced basket of currencies. That hasn't happened yet.

> "So, I don't necessarily think a big devaluation is coming (whether voluntary or not)."

The ugly story is only about the currency; the stock market gyrations are not relevant outside of China except insofar as a collapse would foster more capital outflows. I don't think either version of the ugly story has much weight… at least yet. China's central bank made it clear in December that it was not willing to follow the U.S. dollar higher anymore, especially in a Fed tightening cycle. So, some weakening against the dollar as it rose against others in China's basket was natural. Further, China has spent hundreds of billions of reserves to stabilize its currency, over US$500 billion in 2015 with over US$100 billion of that spent in December alone. China needs a stable currency to prevent large outflows and to avoid difficulty in repaying dollar-denominated debt.

So, I don't necessarily think a big devaluation is coming (whether voluntary or not). That is what markets were worried about during the first week of trading in 2016: a big devaluation would export deflation widely to the rest of the world, pulling jobs and growth into China from other countries, and starting deflation in asset markets.

These market gyrations do expose the risk that lies in emerging markets, especially China, as they deal with the aftermath of the 15-year boom driven by China's investment surge. But, unless it continues and the above evidence starts to mount, I would classify this as another market correction.

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