

# Investment Insights

## What did we learn from the 'market turmoil' in the third quarter?

Quarter Four - 2015

The third quarter of 2015 seems to have brought a stream of shrill headlines from writers about falls in risky assets, an increase in volatility across most asset classes and increasing signs of a significant slowdown in China.

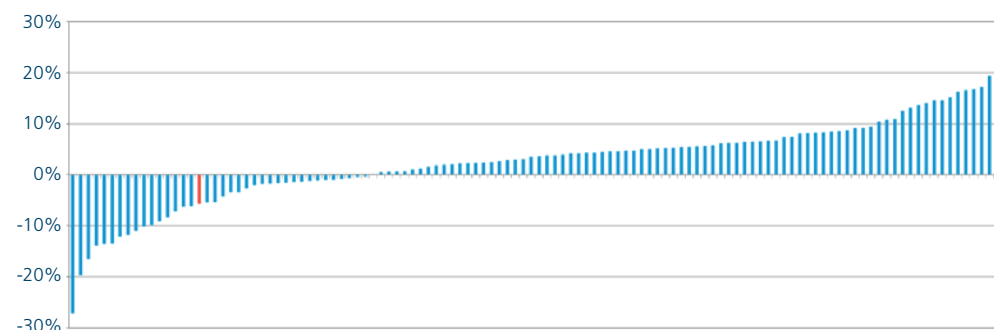
Against this backdrop, interest rates remain at historic lows. In this note we look at how much of this is out of the ordinary and warrants concern, how much is just writers looking to sell newspapers and where this leaves us looking forward.

### Market falls in the third quarter and 'Black Monday'

The third quarter of 2015 felt like a bad quarter for markets, with newspapers dubbing 24 August 'Black Monday' on the back of an 8.5% fall in the Shanghai Composite, leading to a knock-on fall of 4.5% on the FTSE All-Share that day. Things must have been bad to have had a 'black' day, but now that the quarter has ended, was it really all that bad?

Taking the FTSE All-Share as an example, the third quarter was far from extreme. The chart to the right ranks the FTSE All-Share quarterly returns over the past 30 years, with the red block showing the performance over this quarter. It shows that the quarter was nothing compared to that of the fourth quarter of 1987 – when US equities fell over 22% in one day – but still, there have only been sixteen worse quarters for UK equities in the past 30 years.

FTSE All-Share - Quarterly Returns since 1985



Source: FTSE

Equities weren't alone in falling: high yield bonds fell by over 4%, commodities fell by nearly 15% and spreads on investment grade credit widened significantly so, whilst long-dated gilts returned over 5%, sterling credit barely rose over the quarter.

As a result, whilst it wasn't quite the quarter where everything fell at once, as we saw during the crash in 2008/09, there were limited areas where investors could make positive returns. There were opportunities for preserving value, but it was hard to offset the falls in risk assets.

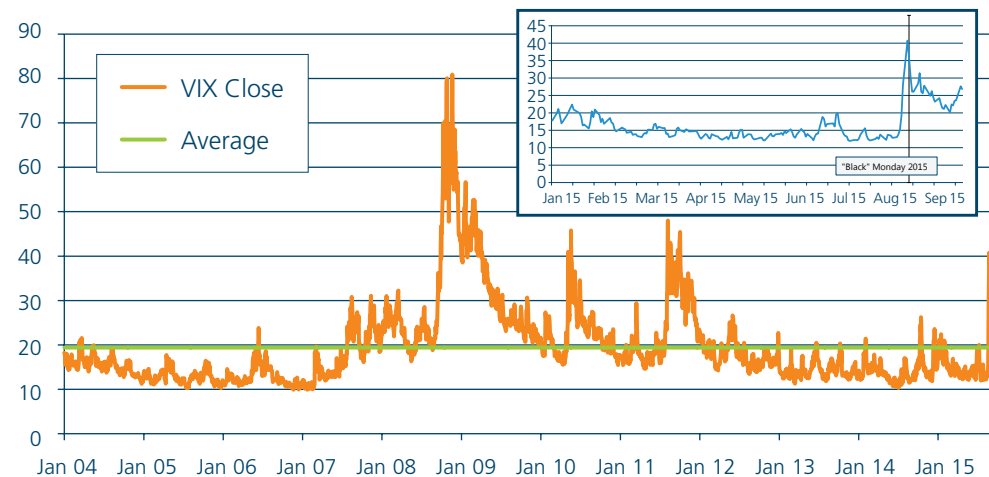
*As an aside, commodities are on course to be the worst performing asset class for a fifth year in a row. This goes some way to explaining why UK equities have underperformed global equities so significantly over the past 5 years.*

## Volatility has returned to markets

We have written before about the low levels of volatility across all markets and asked 12 months ago whether that was about to change? It has so far during 2015.

Volatility in currency and bond markets started to pick up in the first quarter, whilst remaining low in equity markets until the middle of the third quarter. The initial volatility spike in bond market volatility was most likely sparked by a combination of the European Central Bank announcing its huge quantitative easing programme, coupled with the realisation that the US Federal Reserve will raise rates at some point – an event not seen by many in the market in their career. The catalyst for the spread to equities appears to have been the sustained fall in Chinese stock markets and the unexpected devaluation of the renminbi in the third quarter.

The charts below show how recent spikes in equity volatility (as measured by the VIX on the S&P 500) compare to historic levels. We can see that it is certainly higher than we have become accustomed to over the past three years and is even higher than long-term average; however, current levels of volatility are far from a rare event.

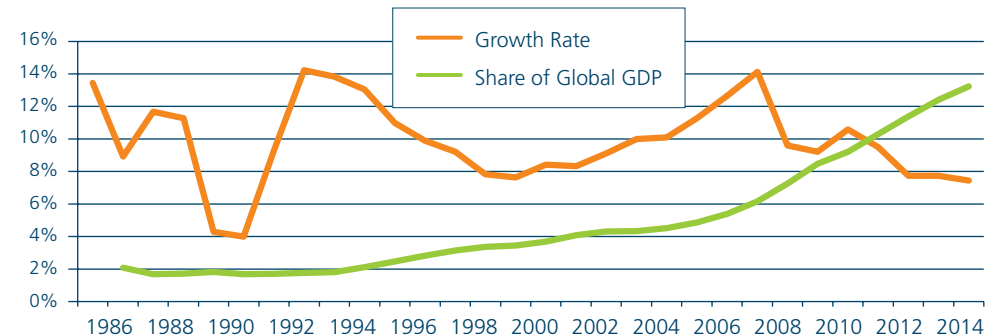


Source: CBOE

*So investors shouldn't be fooled that we are in any sort of unusual market dynamic; we are just perhaps entering a period we have not seen for some time. With the prospect of increased volatility we think it's key that trustees have assessed their governance structure; being able to be nimble may well prove incredibly valuable. Triggers to capture improvements in markets are one such approach.*

## The knock-on effect of China's challenges

As referred to above, many commentators point to China as the source of the market shock during the third quarter of 2015 and therefore point to the continued slowdown in their growth rate as a cause to be concerned going forward. In this section we examine briefly the validity of this claim and the importance of China in influencing investors' portfolios.



Source: World Bank

Current growth rates in China are lower than at any point in the last 25 years but China has experienced slowdowns before – is there any reason for markets to be more concerned this time? Well, for starters, over the past six years, China alone has accounted for over a third of the growth in World Gross Domestic Product (GDP), even before you consider the second order effects of its growth. It now stands as the second largest economy in the world. In short, the impact on global growth of any such slowdown now is likely to be far greater given China is 25 times the size it was 25 years ago.

However, investors need to separate the potential impact of a slowdown in China from the 40% falls in Chinese stock markets that dominated headlines over the third quarter. Unlike the US, in China only 7% of household assets are exposed to the stock market. As such, stock market falls are less likely to have a significant knock-on effect on China's economic growth. In the same way the 110% rise in Chinese markets in the six months preceding the fall had minimal impact. So focus on China's growth figures, not the performance of the stock market.

We have therefore seen so far in 2015 a rise in volatility, although not to any exceptional extent, and a fall in equity markets, although not to any exceptional extent. It feels as though the commentary around such events is louder than normal. This is perhaps down to such events being unusual in recent times with many market participants having never seen a rate rise from the US Federal Reserve (the last was 2006). Mark Carney is the only current G7 central banker to have ever actually raised rates – in Canada rather than the UK. Therefore, is the over-reaction of the market to the events of the third quarter simply a reflection of the market's lack of experience of such scenarios?

## China slowdown - how could it impact UK pension schemes?

Should pension schemes be concerned about it? At the headline level China seems relatively unimportant to UK pension schemes; the typical UK pension scheme will have less than 1% invested in China. However, as the second largest economy in the world there are likely to be some knock-on effects which will affect UK pension schemes.

**Impact on UK equities allocation** - China accounts for around half of the world's consumption of nickel, zinc, aluminium, copper and iron ore. If the Chinese economy continues to slow and policy makers try to divert the economy away from investment then this will have a substantial impact on the commodity sector and commodity based economies. UK pension schemes typically invest around 20% of their assets in UK equities; given the bias of the FTSE All-Share towards energy and mining companies the impact of China on commodities could continue to feed directly into this part of their portfolios.

**Rise in yields** - China has built up a huge holding of US Treasuries – estimated to be between \$1.25 and \$1.5 trillion – which they have recently started selling off. If China continues to sell down its reserves could this cause a spike in US yields with a likely corresponding impact on UK gilt yields?

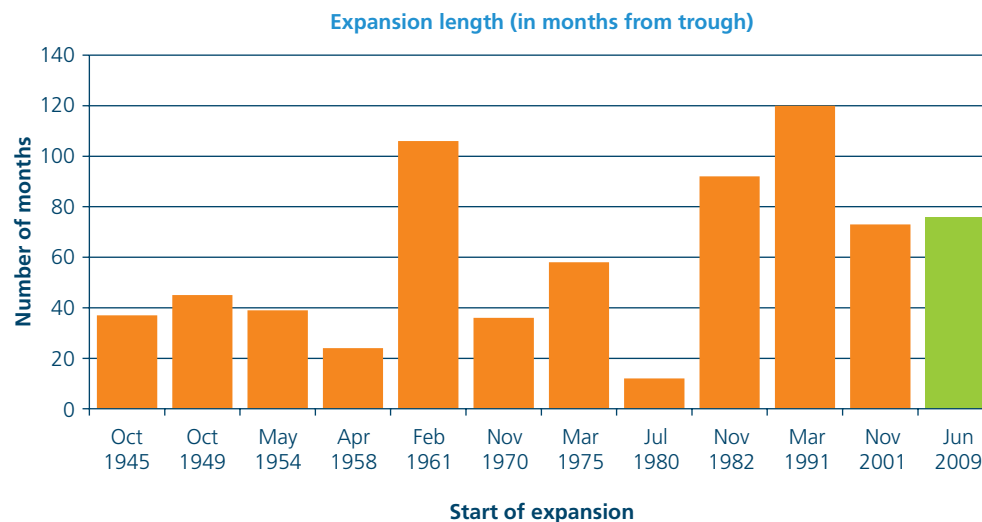
If this happened it would likely bring good news for many UK schemes, who may use such a spike to increase their level of liability hedging.

**Deflation** - As a result of the rapid growth in China and other emerging market countries over the past decade there has been a huge increase in supply capacity. If global growth continues to slow, this level of supply is no longer needed and a surplus emerges. Such a surplus may be one of the driving forces behind the very low levels of inflation currently being seen in the UK, Europe and the US.

Whilst low levels of inflation may appear to be positive for pension schemes, a knock-on effect of low levels of inflation is a lack of pressure on the Central Banks to raise rates. It may therefore be some time before inflation levels support the rises in interest rates that pension schemes seek.

**Risk of contagion via emerging markets** - China is a major trading partner to a large number of emerging market countries - if China is slowing it is likely to lead to emerging market economies slowing. In that scenario can the developing economies take up the slack? We think this is a significant challenge and could be the main route by which a China slowdown transmits itself across the globe.

## Rate rises could still be some way away



Source: National Bureau of Economic Research/Haver Analytics

Against this backdrop of increased volatility and falls in risk assets, the base rate in the UK remains at 0.5%. Furthermore, the Bank of England has been pretty clear that when it does raise rates it is only going to be able to do so to a limited extent. Reading between the lines of the various speeches and announcements from the Bank of England, they expect interest rates in the UK to peak between 2.25% and 3% in the forthcoming rate cycle.

To put that into context we have to remind ourselves that from the inception of the Bank of England in 1694 up to 2009, they had never lowered interest rates below 2%. The Bank is now saying that the peak of the forthcoming interest rate cycle is only just going to get to a level that had previously not been seen for over 300 years.

Comparing this to previous cycles, the current expansion is pretty long in the tooth, as shown in the chart above (looking at the US recovery), and – although we know the economy doesn't move in smooth cycles – at this stage of the cycle it is very unusual for interest rates to be still so low; maybe it really is 'different this time'.

*At the equivalent stage of the last two expansions (2001 and 1991) US interest rates were at 4.5% and 5.5% respectively.*

## So what does all this mean?

Looking forward, we are fundamentally concerned that the debt crisis has not been resolved and this is the fundamental reason why interest rates globally remain at 'zero' – and the first rate rise from the US Federal Reserve or Bank of England seems forever six months away. Too much debt has often been cited as the cause of the credit crisis that started in autumn of 2007 and yet in the period since that date global debt levels have continued to rise ahead of the growth rate of global GDP.

Against this backdrop, what happens when the next recession or slowdown arises? When a shock to the economy comes - perhaps via China - growth will slow, fiscal policy seems politically 'unable' to act and, if there is no room for manoeuvre on monetary policy, how will governments and markets react to such a shock? Will policymakers be left trying ever more 'inventive' responses? Negative interest rates are currently already being tried in a number of countries – could we yet see these in the UK?

We know history never repeats, but it does perhaps 'rhyme' as Mark Twain so famously put it. Debt has been moved globally – to governments' balance sheets in the developed world and, more generally, to the emerging economies that were previously touted as 'low debt' economies. So the catalyst for debt concerns will come from a different area than in 2007/08, but we encourage investors to keep an eye on such issues.

We equally know that equities have generally been getting more "expensive" over the past few years and have been supported by share buybacks running at record levels. Earnings have not been coming through and if the global economy is indeed slowing then this suggests earnings, and therefore equity returns, may be challenged going forward.

We worry that the challenges and excesses of pre 2007 have not actually been recognised and dealt with in the subsequent eight years and therefore we are ill placed to deal with the next economic shock. If the slowdown in China continues, the next economic shock may be closer than we think.

A potentially challenging time as we head into 2016...

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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