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Why summer storms loom for investors

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Pressure on emerging markets, uncertainty on China and Fed rate rise concerns make explosive package

A summer break for investors looks highly unlikely this year. While many of us are already enjoying or planning some welcome down time away from the shackles of the office, asset prices appear vulnerable in the coming weeks against a backdrop of uncertainty driven by China and the US Federal Reserve.

No matter the recent easing in tension between Greece and its creditors, the big story framing the rest of summer is a timeworn classic, previously seen during the US bond market taper tantrum of 2013 and more spectacularly in 1998.

Emerging markets are under severe pressure, with a JPMorgan index of major EM currencies loitering at its lowest level since 1999, hampered by a one-two punch of a stronger dollar and collapsing commodity prices.

The tumult reflects a convergence between the outlook for China's economy and markets with US central bank policy intentions.

Given the scale of intervention by China's authorities in trying to stem their equity market rout, investors are increasingly sceptical that the country's economy is expanding at an official rate of 7 per cent. Talk of China growing below 5 per cent has stirred markets of late, hence renewed downward pressure on commodity prices such as oil, copper and iron ore. That nasty price action is weighing on exports across the EM sector and spurring broad deflationary worries.

Against that backdrop, we have a clearly ascendant US dollar, reflecting expectations that the Fed will finally shift borrowing rates north in the coming months, perhaps as early as September.

Simon Derrick at BNY Mellon highlighted this week how the summers of 1998 and 2013 saw a hawkish stance from the Fed foster turmoil in emerging equity and currency markets.

“In both cases the Fed subsequently took a more dovish position that ultimately helped international markets stabilise.”

Any recurrence stands to take some time, given the natural focus of US officials on an expanding domestic economy, buoyed in part by cheaper oil for American drivers seen as eventually bolstering consumer spending.

With many central banks around the world having eased policy this year — thereby driving up the US dollar — to combat their weakening economies, the Fed can downplay the risk of contagion unsettling domestic markets.

After the central bank’s latest policy statement on Wednesday, investors were left guessing as to whether the Fed, shifts into a higher policy gear in September or waits until December.

An open sense of timing over rate hikes that spurs further dollar strength and exacerbates EM/commodity weakness is not good news for areas under pressure within US equity and bond markets. And all before the poor liquidity typical of August that can exacerbate swings in asset prices.

Strip out the buoyant performance of US healthcare and consumer stocks and you can see why the S&P 500 only stands some 2 per cent higher for 2015, weighed down by the energy, materials and industrials sectors. Another concern is how a small number of stocks are leading, a pattern together with lofty valuations and the prospect of the first quarter of negative earnings per share since 2009, all suggesting that a market top beckons.

Dan Greenhaus, strategist at BTIG says: “Simply put, a stock market increasingly driven by fewer and fewer stocks, at valuation levels we deem ‘elevated’ as Fed policy is expected to tighten later in the year, does not make for a compelling market backdrop.”

The US corporate debt market also looks pallid. A surge in mergers and acquisitions this year in conjunction with huge share buybacks, has spurred a flood of bond issuance. Moody’s BAA average yield is back above 5 per cent, up from 4.40 per cent earlier this year, while lower quality debt sold by oil and mining companies has been hammered.

Market volatility is closely associated with any major shift in Fed policy, and we are certainly seeing signs of that at present. Solid US employment reports over the next six weeks could well pave the way for a September Fed move, but significant escalation in global market stress in the coming weeks may well cast the decisive vote.

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