MARKET INSIGHTS

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WhittierTrust

INVESTMENT & WEALTH MANAGEMENT

Commodities, Currencies and China

With virtually all risk assets in either a correction or a bear market already, investors are now wondering if markets are discounting a U.S. or global recession and just how much lower prices could fall.

Global stocks have sold off sharply as concerns of a global deceleration have transformed into fears of a global recession. We find 3 themes to be particularly relevant in the current environment.

The rout in commodity prices has now breached 2009 levels, devaluations in emerging currencies have raised the specter of currency wars and, perhaps most significantly, China's ability to grow even modestly is being severely challenged.

We analyze each of the three negative catalysts to assess the global outlook and conclude that neither a U.S. recession nor a cyclical end to the U.S. equity bull market is likely at this point.

I. What are commodities really telling us about global demand?

We begin with a closer look at commodities since they have often been used as a gauge of economic strength.

The recent plunge in the Bloomberg Commodity Index in Figure 1 to pre-crisis levels is dramatic and actually quite alarming if driven solely by a decline in aggregate demand. After all, if it took a Great Recession to depress commodities prices so much in 2009, how dire is the outlook today at even lower prices?

To temper the pessimism that it may be all demand-related, we highlight a couple of other factors that have contributed to commodities weakness.

FIGURE 1

First, as Figure 1 shows, the strength of the U.S. dollar in 2014-15 helps explain weaker commodity prices at least partially. Commodities tend to be denominated in dollars and so, as an example, the price per barrel of oil or a bushel of corn goes down as the dollar goes up.

Second, the slump in commodities has also been triggered by a supply shock in the form of excess capacity and production. The blue line in Figure 2 shows that world-wide consumption of Brent oil has actually increased in 2015. The higher demand for oil has, however, been overwhelmed by even higher production represented by the green line.

A number of factors have contributed to the supply glut – OPEC's decision to protect market share instead of prices, booming U.S. shale production and technological innovations that have supported profitable drilling even at lower prices. We believe that as the U.S. rig count declines, domestic supply could well reverse and support oil prices going forward.

FIGURE 2

Notwithstanding the effects of a stronger dollar and systemic oversupply, there remain concerns that the demand for commodities has been and will be curtailed by slower global growth than anticipated.

We turn our attention next to the emerging markets to understand how real that threat is.

II. Currencies and China … a repeat of the Asian crisis in 1997-98?

The devaluation of the Chinese yuan on August 11 drew more attention to, and perhaps crystallized, the unfolding slowdown in China. The initial announcement of a -1.9% percent devaluation was motivated by weak July exports and viewed as a stabilizing mechanism to spur exports and stimulate growth. The market reaction was anything but stable – with China growth concerns now firmly in the cross-hairs, the Chinese stock market sold off by more than 20% over 4 days and the rest of the globe followed suit.

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It also triggered a cascading round of currency weakness in the emerging economies which were already struggling with weak commodities and lower exports within Asia and globally. Unlike recent years when the Eurozone debt crisis has often held center stage, the current scenario bears an eerie resemblance to the Asian currency crisis in 1997-98.

We address the China growth question to better understand the likelihood of a global recession.

It is quite likely that China won't be able to deliver its projected 7% growth rate for 2015. In many ways, the secular shift from an economy driven by Investments and Exports to one reliant on Consumption was always going to be a slow and painful process.

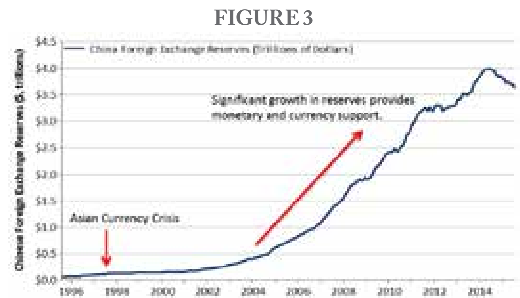
The key question now is not whether Chinese growth is 7% or not, but rather how low could it be – is it 5%, 2% or even negative? The answer is critical to understanding the global outlook since China's contribution to global growth is now almost 30%.

Unfortunately, the question is hard to answer definitively based on available data but we offer hope along an alternate line of thinking.

We believe that the downward spiral in global growth prospects will need a meaningful policy response to create additional stimulus. It seems natural that this policy stimulus needs to originate in the emerging economies, and especially China, since that is where the underlying problems lie.

Towards that end, we observe that foreign currency reserves in the emerging economies, and China in particular, are a lot higher than they were in 1997.

FIGURE 3



We believe that with over $3.5 trillion in reserves, China has enough policy tools available to manage a currency crisis and engineer a soft landing in its domestic economy. In addition, the Fed may well hold off on its rate hikes in the near term, the ECB is likely to express a willingness to extend QE beyond September 2016 and the BOJ may be more inclined to ease following negative first quarter GDP growth.

We note that most recessions tend to be triggered by significant acceleration in inflation and subsequent tightening as a result. In this instance, falling inflation and simultaneous easing should be pro-cyclical and conducive to growth.

China, however, remains the big wild card and the outlook for a global recession depends critically on its ability to transition gradually, but not precipitously, to a slower growth trajectory. If history is any indication, we believe that China will avoid a hard landing and, in turn, help avoid a global recession.

III. How healthy is the U.S. economy and stock market?

The U.S. economy continues to grow at a modest clip, the labor market continues to improve and the housing market continues to show strength. With limited direct exposure to China – less than 10% of total exports and revenues each – we believe the growth story in the U.S. remains intact. We are inclined to rule out a U.S. recession with greater certainty.

And finally, we examine how much lower U.S. stock prices may have to go before finding valuation support. We recognize that U.S. stocks are re-pricing the risks of uncertain future growth. Without the visibility of even modest sustainable growth and without the benefit of a domestic QE program, U.S. stock indices have corrected by more than -10% from their recent highs.

The decline in the S&P 500 index through August 24, 2015 has brought its forward P/E multiple down from above 17x to below 15x. We are encouraged to note that:

1. Valuations are now close to the long-term average forward P/E of around 14x and in line with those prevailing in periods of low inflation and low interest rates
2. The recent decline in bond yields creates further support for stock valuations
3. Earnings are still projected to be up slightly in 2015 and over 10% in 2016

We acknowledge that earnings estimates may be vulnerable if growth slows down more than we expect. In such a scenario, we expect that further weakness in the dollar would help corporate profits and bond yields would help stock valuations.

Summary

Consistent with our view that neither a U.S. recession nor an end to the U.S. equity bull market is imminent, we are cautiously optimistic on U.S. stocks. We look to add selectively to U.S. companies with strong fundamentals as this mid-cycle correction unfolds.

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