Market Update

Update – Global market volatility

24 August 2015

The past few weeks have seen increased volatility and sell-offs across global risk markets. This is a complex and evolving situation that increasingly impacted the global economy, where growing concerns over the economic slowdown in China have put downward pressure on multiple markets, particularly equity and commodity markets. What are Russell Investments' strategists expecting?

Background – What's happened in global markets in recent weeks?

The past few weeks have seen increased volatility and sell offs across global risk markets, such as share markets. This development has particularly impacted emerging markets and currencies, where growing concerns over the economic slowdown in China have put downward pressure on commodity markets, emerging market equities, and caused a global 'flight to quality'[1] .

In the developed markets, the Russell 1000 index (US shares) is down 6.3% month-to-date, and European equities have now fallen a meaningful 15% from their highs of April 2015[2]. In the Asia-Pacific region, we are seeing China A shares trading 35%[3] below their 2015 highs (up 150% in the 12 months ending mid-June 2015); Australian shares are down 15% on the same basis; and New Zealand shares are down just on 5%.[4]

However, while markets are presently undergoing a bout of eye-catching weakness, the world economy remains in reasonable shape. The US, European and Japanese economies are all in recovery mode and China, while slowing, is still likely growing at over 5% in real terms, underpinned by a range of stimulatory policies. Areas of true recession – Russia and Brazil are the standouts in this regard due to both lower GDP and currencies[5] – are too small in our view to drag down the entire global economy. Meanwhile, growth in Australia and New Zealand is being held back by a relentless downdraught in commodity prices. Even in this region, however, falls in the Australian and NZ dollars, together with encouraging monetary policies from the Reserve Banks, are providing a cushion to maintain acceptable growth rates.

Key driver of global market volatility: The Chinese market's adjustment period

It has been apparent that the Chinese economy is going through a difficult adjustment period. Transitioning from a global manufacturing powerhouse to a consumer-led growth model does not happen overnight. Recent turbulence in the China A-share market (typically the market domestic Chinese investors use for investments), a modest

1 A 'flight to quality' occurs when investors move their money to lower risk investments—like cash or government bonds—even though such investments typically offer lower returns.

[2] Sources: Equity market returns are sourced from Thomson Reuters Datastream as at 21 August 2015. European equities are proxied by the Euro Stoxx 50 price index.

[3] As at 24 August.

[4] Sources: Australian shares (S&P ASX 200) and NZ shares (S&P NZX All Index). Data through 24 August 2015.

[5] Russian GDP is down 2% from 1 year ago and the rouble is down 20% since May 2015. Brazilian GDP is down 1.6% from 1 year ago, with the Real declining by one third.

devaluation of the Chinese Renminbi's exchange rate, and disappointing Chinese data on exports and industrial activity have all raised concerns that a 'hard landing' is underway.

Russell Investments' perspective: It could be a bumpy ride, as global markets wait on the US Federal Reserve

In Russell Investments' third quarter Global Market Outlook, our investment strategy team highlighted that market volatility was likely to pick up as we moved closer to the first rate hike from the US Federal Reserve. We maintain a neutral strategic preference for shares versus bonds, and we will be watching the situation closely for appropriate risk management strategies and potential opportunities in portfolios.

Looking ahead

China: We expect continued short-term volatility, but longer-term growth

We are likely to see continued pockets of turbulence in China, its Asian trading partners, and commodity prices, and we remain cautious on these markets in the near-term, given the broader economic headwinds. While downside risks have clearly escalated, we do not expect an uncontrolled deceleration of the Chinese economy. With over $3 trillion in reserves, the Chinese government has both the ability and willingness to cushion its economy. In addition, recent high frequency indicators on housing prices and retail sales have shown tentative signs of stabilisation.

United States: Healthy growth expected, but the timing of the Fed's interest rate hike is more uncertain

In the United States, international risks and the disinflationary impacts from declining commodity prices complicate the Federal Reserve's looming decision to raise interest rates. We still expect Fed liftoff in September, but it's now a very close call (roughly 55% odds) whether or not a raise will happen at that time. Importantly, that liftoff decision would be predicated on improving US economic conditions. US employment growth remains robust and the broader economy has reaccelerated after a slow start to 2015. We continue to expect healthy US real GDP growth of 2.5-3% over the next 12 months, which should help push the global economy forward.

Europe: We expect continued recovery, given strong fundamentals

European financial markets have faced significant downward pressure in recent weeks. But the domestic euro zone economy continues to improve, and boosts from a cheaper exchange rate, lower oil prices, aggressive monetary policy, and attractive relative valuations, provide the building blocks for our continued expectation of strong performance in this market over the next 12 months. We are closely monitoring the situation for potential opportunities in this market given the strong fundamentals.

Australia and New Zealand: A bumpy road to recovery with an end to the resources boom

The overarching challenge for the Australian and New Zealand economies, and for their associated share markets, is an end to the resources boom. This can be seen in the plunging prices of bulk commodities, such as iron ore and coal (Australia) and of agricultural commodities such as milk and timber (New Zealand). However, economic growth rates in the order of 2.5% in these countries still compare favourably with growth in recovery-mode regions such as the eurozone, Japan, and even the US. Weaker commodity prices are not all bad news – they are driving currency weakness, which is proving to help tourism and import-competing industries; and they are keeping inflation low, thereby giving the Reserve Banks of both countries scope to cut interest rates further, if required. The net yield on Australian shares now stands at 5.1%, which is twice that of interest-bearing alternatives such as term deposits.

What should you do with your investments—and what is Russell Investments doing?

Markets rise and fall, particularly over the short term. If you're a long-term investor, it's best to avoid knee-jerk reactions at the risk of 'locking in your losses'—because you don't truly feel the pain of market declines until you sell investments at a low. Sometimes, short-term volatility provides good buying opportunities.

As always, Russell Investments is continually monitoring its funds and seeks to help clients manage risks through diversification. Our multi-asset team has deliberately reduced exposure to shares through the month of August, as we move closer to the expected US interest rate hike. Volatility in emerging markets has further validated our stance, and we have been satisfied with our defensive position as broader global markets have recently begun to sell off in earnest.

If you want to evaluate your specific situation, contact your financial adviser or Russell Investments' relationship manager.

FOR FURTHER INFORMATION:

Please contact your Client Relationship Manager or contact at Russell Investments. For up-to-date market information, visit www.russell.com/au/insights/marketinsights.

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