



## Monthly comment by Chief Strategist, David Bakkegaard Karsbøl

August 2015

### Volatility across the board

After a period with little momentum in the stock market and increasingly poor macro data from China, the Chinese authorities' decision to devalue the Chinese Renminbi, by approximately 3% over two rounds, apparently triggered one of the biggest collapses in the market since 2008/9:

- Chinese shares fell by almost 30% in seven trading days.
- Global equity markets fell by 10-15% - especially EM equities – over four to five days
- The VIX rose to an intraday level of 54 (and then fell back quickly)
- Several of the EM currencies plummeted

Towards the end of August, however, most of these trends have seen a correction and the western markets in particular have regained some composure. In my opinion, the market collapse was not due to macro factors; these still seem supportive for growth and the stock markets (above all, the expansive monetary policy). The collapse was therefore more likely caused by one or more of the following factors:

1. The average investor has been overly optimistic AAI's (American Association of Individual Investors) weekly survey showed that the average proportion of investors who were 'bearish' was very low and this proportion increased until August, which could indicate that the market as a whole was over-optimistic.
2. As a result of new and tighter financial regulation, stockbrokers have reduced their holdings of financial instruments significantly, compared to previous levels (pre-2008). This means that market liquidity has deteriorated drastically, and that they are no longer able to "grab the falling knives" in any market correction to the

same extent as before. This was probably also one of the causes of the so-called 'flash crash' in 2010.

3. Market volume in the upturn since 2009 has been historically low. For example, the volume of S&P500 futures contracts (one of the world's leading and most traded instruments) has been at around a quarter of the volume that it saw during the recovery from 2003-2007. At the same time, a larger proportion of market volume is now formed by so-called 'algo-traders' - i.e., robots / computers acting on mathematical rules. This may have rendered the market more fragile and susceptible to unfavourable feedback mechanisms than would have been the case if all trade was conducted by people of flesh and blood.
4. The market is increasingly questioning whether China's growth is sustainable in the long run. Or rather, most have probably accepted that growth rates would be down over the next ten years from the current (official) 6-7% to a more moderate 3-4%. The Chinese authorities' decision to devalue the Renminbi has apparently been perceived as a sign of desperation or panic, which has probably changed mainstream perception to the point where the expectation is now that China will slip into a lower growth pattern considerably faster than over a ten year timeframe.

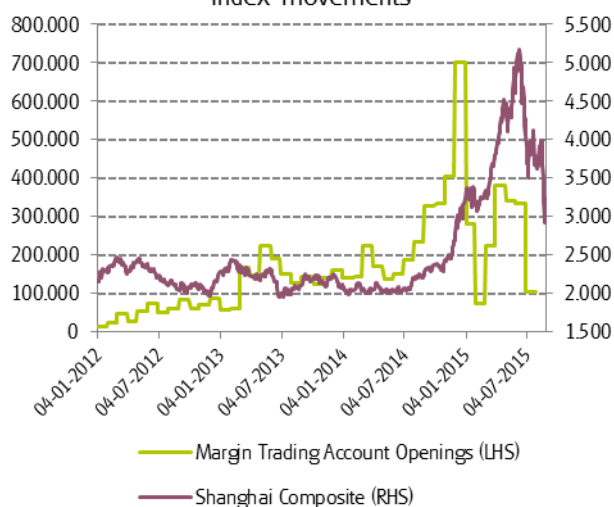
Figure 1 - Share of bearish investors (½ year average)



## China's struggle for growth

The reason for the large drop in Chinese equities can be found primarily in the fact that the Shanghai Composite had risen by over 150% in the 12 months to the summer of 2015. By the end of 2014, a long term investor looking at the explosive growth in the number of so-called 'account openings for margin trading' (a good measure of speculative interest in the stock market in China) could conclude that there was a bubble forming that should be avoided. The fact that from New Year to mid-June, this number increased by 65% did not make things better. The average P/E of the Shanghai Composite is now down from 26 at the top to around 16, which is more comparable with other major markets (but still higher than other emerging-market equities, which typically trade at a P/E that is 25% lower).

Figure 2 - Shanghai Composite Index movements



Authorities should generally avoid knee-jerk reactions to what the stock market is doing. Nevertheless, there is no doubt that the Chinese authorities are panicked at the large declines. First, they introduced an absolute ban on freedom of expression regarding disparaging comments about the stock market (censorship); then they lowered the provisionally set RRR (Reserve Ratio Requirement) of the largest banks (which in itself would free up about 100 billion in bank reserves), and finally the PBoC lowered interest rates to stimulate growth further.

If markets are increasingly sceptical about Chinese growth figures and growth prospects, it is strongly linked with the fact that the official figures are notoriously unreliable. The significantly more credible PMI figures for the dominant manufacturing industries have been around 50 (ie zero growth) since the autumn and, over the last two months, have shown values significantly below 50.

In addition, China as a whole is experiencing an accelerating outflow of capital, which in itself is contractionary for the economy and thereby forces the PBoC to increase liquidity through interest rate cuts and lower RRR requirements. We have not yet seen how great an effect devaluations have had on this outflow (we only have figures for July), but part of the reason for it could be that Chinese investors believed that the currency was overvalued and thus sought to protect themselves by gaining exposure to other currencies. Chinese foreign reserves have also dropped by a total of 8% in the last 12 months, which, in itself, is a sign that the currency was overvalued.

A devaluation of about 3% is probably not enough to have brought it close to its real market value - and certainly not when the PBoC has, in the interim, lowered interest rates further. Therefore, you should probably not be surprised to see further, smaller devaluations in the future - and keep in mind also that even though inflation was historically low in China, it has still been higher than in Western countries, leading to pressure on current, nominal devaluations - all else being equal - to maintain China's competitiveness.

## US growth was a positive surprise

US data has surprised the market positively in late August, but it is clear that the stock market and China have greater market attention. However, it should be mentioned that both orders for durable goods and capital goods showed much stronger growth than expected, and that the second estimate of second quarter GDP in the US was revised upward to

3.7% (annualized). In addition, PMI data for the United States remains high, and even ISM manufacturing remains well above 50 (which is neutral or zero growth), despite the strong dollar.

### **The bond market is unconcerned**

It is noteworthy that the bond market has been largely unaffected by a period of unusually high volatility in the stock market. During the five trading days when the stock market was in steepest decline (18<sup>th</sup> to 24<sup>th</sup> August), interest rates were largely unchanged. Even PIIGS spreads relative to German yields were virtually unaffected, suggesting that the bond market at least is not envisaging a possible return of the Euro crisis in the near future.

I believe that the explanation for the volatility of lies in one or more of the four factors mentioned above (and not in the macro-factors), and it appears that the bond market agrees.

High Yield bonds have been affected - but here it is the issuers that are especially exposed to the production of raw materials and energy, that have been hit hard, while the rest of the market has been relatively unaffected. In the market for investment grade bonds, only a marginal expansion of the OAS can be seen.

### **What typically happens after a market collapse?**

Market collapses, such as we have seen in the second half of August, are, fortunately, relatively rare, but over the course of history, there have been enough of for us to be able to draw some tentative conclusions about what typically happens in the aftermath.

Here we refer to data samples showing market collapses of more than 10% in 10 trading days. This happened in 1929, 1930, 1946, 1962, 1966, 1970, 1974, 1987, 1998, 2001, 2002, 2008, 2009, 2011 and 2015. The typical pattern is that the increased volatility remains high in 2-3 months after such events. A relatively quick backlash can typically be seen in the form of rising stock prices, but it is also common for the lowest levels after the collapse to be retested by the market in the next 2-3 months. In most cases, the "test" can be deemed successful, as the market subsequently increases.

### **High volatility and a lack of momentum**

At Sparinvest we remain sceptical about opportunities to 'time the market'. This is an extremely difficult exercise in which investors can - all too easily - lose their savings. Nevertheless, we have developed a tool that can, with some success, differentiate between an 'inspiring' market and an 'uninspiring' market. The model is built to screen volatility and momentum in over 50 equity indices on a monthly basis.

The model suggests that it is a signal to reduce risky exposure when stock markets across the board experience more volatility than upward momentum. The signal from the model can assume values between 0 and 1, where 0 is a market collapse and one is a market with extremely strong momentum. A value below 0.6 reflect that volatility going forward will often be greater than the upward momentum, and therefore a good reason to risky positions. It has been possible to back-test the model, in its present form, using data since 1970 and in slightly modified (estimated) form since 1955, therefore meaningfully long periods. Results show that the model could have kept investors out of unattractive markets throughout the period (see the historical values in figure 3 at the end and note that the value at the end of a month is the signal for the coming month).

Our 'MomVol' model at the end of July, gave a value of 0.63 and thus - for only the second time since 2012 - was extremely close to giving a 'sell signal'. With the market events that have materialised in late August, it is virtually certain that the model will give a 'sell signal' at the end of August. One should therefore reconsider any higher risk exposures over the coming month.

### **My assessment - a buying opportunity?**

There is no doubt that the market caused shock waves in August. As discussed above, such shocks are often accompanied by increased volatility. At the same time our 'MomVol' indicator shows that momentum has disappeared in the stock market. Moreover, history shows that in the aftermath of a market collapse, the lowest levels are often tested by the market again within 1:02 to 3:00 months.

The fundamental story here could be driven by any decision by the FOMC to raise interest rates in the United States despite great nervousness in the market, or by the emergence of any more weak data from China, which could hit the market. So far, this is not something that I expect to see, and one should not automatically assume that the Chinese authorities will throw in the towel. Loan growth is actually high-

er than normal in China, and that means – all things being equal – that Q3 growth will surprise positively. In addition, the macroeconomic factors still support global growth and, in particular, the monetary policy of the central banks should support stock markets.

My best advice is that you should be extra vigilant and careful with investments over the next two to three months.

The information contained in this article is not, and should not be construed as, a solicitation or offer, or recommendation, to acquire or dispose of any investment or to engage in any other transaction, or to provide any investment advice or other financial or banking service. The material has been prepared solely as a guide to you and your financial institution. There are always risks involved when investing and it is stressed that past performance or past return cannot be considered a guarantee for future performance or return. Sparinvest does not undertake any responsibility for the advice given and actions taken or not taken in respect of this material. Sparinvest makes reservations for possible typing errors, calculation errors and any other errors in the material.

Figure 3 – MomVol model

31-07-2015	0,63	31-05-2011	0,75	30-03-2007	0,92	31-01-2003	0,12	30-11-1998	0,53	30-09-1994	0,27
30-06-2015	0,75	29-04-2011	0,98	28-02-2007	0,96	31-12-2002	0,59	30-10-1998	0,41	31-08-1994	0,67
29-05-2015	0,87	31-03-2011	0,87	31-01-2007	0,98	29-11-2002	0,51	30-09-1998	0,29	29-07-1994	0,40
30-04-2015	0,73	28-02-2011	0,98	29-12-2006	0,98	31-10-2002	0,00	31-08-1998	0,41	30-06-1994	0,00
31-03-2015	0,75	31-01-2011	1,00	30-11-2006	0,98	30-09-2002	0,04	31-07-1998	0,65	31-05-1994	0,54
27-02-2015	0,90	31-12-2010	0,98	31-10-2006	0,96	30-08-2002	0,12	30-06-1998	0,88	29-04-1994	0,85
30-01-2015	0,63	30-11-2010	0,98	29-09-2006	0,69	31-07-2002	0,14	29-05-1998	0,88	31-03-1994	0,31
31-12-2014	0,75	29-10-2010	0,94	31-08-2006	0,71	28-06-2002	0,35	30-04-1998	0,88	28-02-1994	0,85
28-11-2014	0,81	30-09-2010	0,23	31-07-2006	0,71	31-05-2002	0,45	31-03-1998	0,94	31-01-1994	0,85
31-10-2014	0,79	31-08-2010	0,17	30-06-2006	0,77	30-04-2002	0,69	27-02-1998	0,82	31-12-1993	0,92
30-09-2014	0,85	30-07-2010	0,60	31-05-2006	0,85	29-03-2002	0,92	30-01-1998	0,88	30-11-1993	0,77
29-08-2014	0,94	30-06-2010	0,54	28-04-2006	0,96	28-02-2002	0,82	31-12-1997	0,76	29-10-1993	1,00
31-07-2014	0,81	31-05-2010	0,46	31-03-2006	0,96	31-01-2002	0,78	28-11-1997	0,76	30-09-1993	0,92
30-06-2014	0,96	30-04-2010	0,87	28-02-2006	0,96	31-12-2001	0,80	31-10-1997	0,88	31-08-1993	1,00
30-05-2014	0,77	31-03-2010	0,94	31-01-2006	0,96	30-11-2001	0,22	30-09-1997	1,00	30-07-1993	1,00
30-04-2014	0,75	26-02-2010	0,81	30-12-2005	0,92	31-10-2001	0,02	29-08-1997	0,94	30-06-1993	0,92
31-03-2014	0,90	29-01-2010	0,88	30-11-2005	0,94	28-09-2001	0,10	31-07-1997	1,00	31-05-1993	0,85
28-02-2014	0,90	31-12-2009	0,96	31-10-2005	0,87	31-08-2001	0,34	30-06-1997	1,00	30-04-1993	0,92
31-01-2014	0,94	30-11-2009	0,96	30-09-2005	0,98	31-07-2001	0,28	30-05-1997	1,00	31-03-1993	0,92
31-12-2013	1,00	30-10-2009	1,00	31-08-2005	0,94	29-06-2001	0,26	30-04-1997	0,94	26-02-1993	0,92
29-11-2013	0,98	30-09-2009	0,98	29-07-2005	0,94	31-05-2001	0,64	31-03-1997	0,94	29-01-1993	0,69
31-10-2013	0,98	31-08-2009	1,00	30-06-2005	0,90	30-04-2001	0,54	28-02-1997	0,94	31-12-1992	0,46
30-09-2013	0,75	31-07-2009	1,00	31-05-2005	0,56	30-03-2001	0,18	31-01-1997	0,94	30-11-1992	0,38
30-08-2013	0,69	30-06-2009	0,98	29-04-2005	0,54	28-02-2001	0,34	31-12-1996	0,94	30-10-1992	0,15
31-07-2013	0,79	29-05-2009	0,90	31-03-2005	0,90	31-01-2001	0,36	29-11-1996	0,88	30-09-1992	0,15
28-06-2013	0,69	30-04-2009	0,69	28-02-2005	0,96	29-12-2000	0,40	31-10-1996	0,82	31-08-1992	0,15
31-05-2013	0,83	31-03-2009	0,17	31-01-2005	0,94	30-11-2000	0,28	30-09-1996	0,76	31-07-1992	0,23
30-04-2013	0,92	27-02-2009	0,02	31-12-2004	0,94	31-10-2000	0,36	30-08-1996	0,76	30-06-1992	0,54
29-03-2013	0,96	30-01-2009	0,00	30-11-2004	0,79	29-09-2000	0,24	31-07-1996	0,88	29-05-1992	0,77
28-02-2013	0,88	31-12-2008	0,08	29-10-2004	0,73	31-08-2000	0,24	28-06-1996	0,88	30-04-1992	0,62
31-01-2013	0,94	28-11-2008	0,00	30-09-2004	0,60	31-07-2000	0,33	31-05-1996	0,94	31-03-1992	0,46
31-12-2012	0,96	31-10-2008	0,00	31-08-2004	0,46	30-06-2000	0,44	30-04-1996	1,00	28-02-1992	0,69
30-11-2012	0,94	30-09-2008	0,17	30-07-2004	0,37	31-05-2000	0,33	29-03-1996	0,94	31-01-1992	0,38
31-10-2012	0,92	29-08-2008	0,69	30-06-2004	0,79	28-04-2000	0,67	29-02-1996	0,94	31-12-1991	0,46
28-09-2012	0,87	31-07-2008	0,25	31-05-2004	0,81	31-03-2000	0,96	31-01-1996	0,94	29-11-1991	0,54
31-08-2012	0,67	30-06-2008	0,31	30-04-2004	0,88	29-02-2000	0,96	29-12-1995	0,88	31-10-1991	0,62
31-07-2012	0,58	30-05-2008	0,31	31-03-2004	0,90	31-01-2000	0,96	30-11-1995	0,88	30-09-1991	0,85
29-06-2012	0,73	30-04-2008	0,21	27-02-2004	0,94	31-12-1999	0,93	31-10-1995	0,76	30-08-1991	0,85
31-05-2012	0,65	31-03-2008	0,06	30-01-2004	0,92	30-11-1999	0,67	29-09-1995	0,88	31-07-1991	0,77
30-04-2012	0,88	29-02-2008	0,19	31-12-2003	0,92	29-10-1999	0,63	31-08-1995	0,88	28-06-1991	0,92
30-03-2012	0,92	31-01-2008	0,27	28-11-2003	0,96	30-09-1999	0,37	31-07-1995	0,82	31-05-1991	0,92
29-02-2012	1,00	31-12-2007	0,54	31-10-2003	0,98	31-08-1999	0,70	30-06-1995	0,75	30-04-1991	0,85
31-01-2012	0,69	30-11-2007	0,50	30-09-2003	0,96	30-07-1999	0,93	31-05-1995	0,69	29-03-1991	0,85
30-12-2011	0,19	31-10-2007	0,60	29-08-2003	0,98	30-06-1999	0,89	28-04-1995	0,69	28-02-1991	0,92
30-11-2011	0,10	28-09-2007	0,71	31-07-2003	0,96	31-05-1999	0,89	31-03-1995	0,38	31-01-1991	0,54
31-10-2011	0,08	31-08-2007	0,63	30-06-2003	0,87	30-04-1999	0,96	28-02-1995	0,44	31-12-1990	0,00
30-09-2011	0,02	31-07-2007	0,90	30-05-2003	0,53	31-03-1999	0,67	31-01-1995	0,19	30-11-1990	0,08
31-08-2011	0,06	29-06-2007	0,87	30-04-2003	0,16	26-02-1999	0,48	30-12-1994	0,63	31-10-1990	0,15
29-07-2011	0,13	31-05-2007	0,94	31-03-2003	0,14	29-01-1999	0,48	30-11-1994	0,60	28-09-1990	0,23
30-06-2011	0,46	30-04-2007	0,90	28-02-2003	0,27	31-12-1998	0,71	31-10-1994	0,53	31-08-1990	0,23

31-07-1990	0,62	30-05-1986	0,83	31-03-1982	0,50	31-01-1978	0,58	30-11-1973	0,25
29-06-1990	0,62	30-04-1986	0,92	26-02-1982	0,67	30-12-1977	0,67	31-10-1973	0,42
31-05-1990	0,46	31-03-1986	0,92	29-01-1982	0,42	30-11-1977	0,33	28-09-1973	0,50
30-04-1990	0,46	28-02-1986	0,92	31-12-1981	0,50	31-10-1977	0,42	31-08-1973	0,50
30-03-1990	0,62	31-01-1986	0,92	30-11-1981	0,67	30-09-1977	0,42	31-07-1973	0,58
28-02-1990	0,38	31-12-1985	0,92	30-10-1981	0,50	31-08-1977	0,33	29-06-1973	0,50
31-01-1990	0,38	29-11-1985	0,83	30-09-1981	0,42	29-07-1977	0,33	31-05-1973	0,67
29-12-1989	0,75	31-10-1985	0,83	31-08-1981	0,58	30-06-1977	0,33	30-04-1973	0,67
30-11-1989	0,75	30-09-1985	0,75	31-07-1981	0,58	31-05-1977	0,42	30-03-1973	0,83
31-10-1989	0,75	30-08-1985	0,83	30-06-1981	0,58	29-04-1977	0,67	28-02-1973	0,67
29-09-1989	0,92	31-07-1985	0,92	29-05-1981	0,58	31-03-1977	0,58	31-01-1973	0,58
31-08-1989	0,92	28-06-1985	0,83	30-04-1981	0,50	28-02-1977	0,42	29-12-1972	0,75
31-07-1989	0,92	31-05-1985	0,92	31-03-1981	0,58	31-01-1977	0,25	30-11-1972	0,92
30-06-1989	1,00	30-04-1985	0,92	27-02-1981	0,58	31-12-1976	0,25	31-10-1972	0,92
31-05-1989	1,00	29-03-1985	0,83	30-01-1981	0,50	30-11-1976	0,08	29-09-1972	0,83
28-04-1989	1,00	28-02-1985	0,92	31-12-1980	0,83	29-10-1976	0,17	31-08-1972	0,83
31-03-1989	0,92	31-01-1985	0,92	28-11-1980	0,92	30-09-1976	0,42	31-07-1972	0,92
28-02-1989	1,00	31-12-1984	0,83	31-10-1980	0,92	31-08-1976	0,42	30-06-1972	0,92
31-01-1989	1,00	30-11-1984	0,75	30-09-1980	0,92	30-07-1976	0,42	31-05-1972	0,92
30-12-1988	0,92	31-10-1984	0,67	29-08-1980	0,92	30-06-1976	0,58	28-04-1972	0,92
30-11-1988	0,67	28-09-1984	0,42	31-07-1980	0,75	31-05-1976	0,67	31-03-1972	0,92
31-10-1988	0,92	31-08-1984	0,50	30-06-1980	0,83	30-04-1976	0,67	29-02-1972	0,92
30-09-1988	0,83	31-07-1984	0,58	30-05-1980	0,83	31-03-1976	0,92	31-01-1972	0,67
31-08-1988	0,83	29-06-1984	0,33	30-04-1980	0,83	27-02-1976	0,92	31-12-1971	0,25
29-07-1988	1,00	31-05-1984	0,33	31-03-1980	0,58	30-01-1976	0,83	30-11-1971	0,17
30-06-1988	1,00	30-04-1984	0,75	29-02-1980	0,75	31-12-1975	0,75	29-10-1971	0,25
31-05-1988	0,83	30-03-1984	0,83	31-01-1980	0,83	28-11-1975	0,67	30-09-1971	0,33
29-04-1988	0,75	29-02-1984	0,67	31-12-1979	0,75	31-10-1975	0,42	31-08-1971	0,67
31-03-1988	0,67	31-01-1984	0,75	30-11-1979	0,83	30-09-1975	0,17		
29-02-1988	0,33	30-12-1983	0,92	31-10-1979	0,67	29-08-1975	0,58		
29-01-1988	0,25	30-11-1983	1,00	28-09-1979	0,75	31-07-1975	0,67		
31-12-1987	0,17	31-10-1983	0,92	31-08-1979	0,75	30-06-1975	0,67		
30-11-1987	0,25	30-09-1983	0,92	31-07-1979	0,75	30-05-1975	0,92		
30-10-1987	0,58	31-08-1983	1,00	29-06-1979	0,83	30-04-1975	0,92		
30-09-1987	0,67	29-07-1983	1,00	31-05-1979	0,75	31-03-1975	0,75		
31-08-1987	0,75	30-06-1983	1,00	30-04-1979	0,92	28-02-1975	1,00		
31-07-1987	1,00	31-05-1983	1,00	30-03-1979	0,83	31-01-1975	0,50		
30-06-1987	0,75	29-04-1983	1,00	28-02-1979	0,67	31-12-1974	0,25		
29-05-1987	0,75	31-03-1983	1,00	31-01-1979	0,67	29-11-1974	0,17		
30-04-1987	0,83	28-02-1983	1,00	29-12-1978	0,67	31-10-1974	0,08		
31-03-1987	0,67	31-01-1983	1,00	30-11-1978	0,83	30-09-1974	0,00		
27-02-1987	0,75	31-12-1982	1,00	31-10-1978	0,75	30-08-1974	0,00		
30-01-1987	0,75	30-11-1982	1,00	29-09-1978	1,00	31-07-1974	0,17		
31-12-1986	0,92	29-10-1982	0,75	31-08-1978	1,00	28-06-1974	0,08		
28-11-1986	0,92	30-09-1982	0,42	31-07-1978	0,92	31-05-1974	0,33		
31-10-1986	0,58	31-08-1982	0,42	30-06-1978	0,92	30-04-1974	0,25		
30-09-1986	0,58	30-07-1982	0,42	31-05-1978	0,92	29-03-1974	0,17		
29-08-1986	0,67	30-06-1982	0,25	28-04-1978	0,75	28-02-1974	0,50		
31-07-1986	0,58	31-05-1982	0,42	31-03-1978	0,58	31-01-1974	0,58		
30-06-1986	0,75	30-04-1982	0,50	28-02-1978	0,25	31-12-1973	0,33		