Manulife Asset Management

28 January 2015

Volatility rising: The good, the bad and the ugly

With volatility rising due to a number of global events, Macan Nia, from Manulife Asset Management's Portfolio Advisory Group examines the drivers for this increase in volatility and shares his views on what we are likely to expect in the year ahead.

As investors, we have been spoiled over the past couple of years with above average historical returns coupled with below average historical volatility. Unfortunately, if January is any indication, lower volatility is likely to give way to increased pressure from geo-political risk (Greece) and commodity risk (oil), among other factors. Volatility is often painted with a negative brush. However, an investor whom is patient and able to filter through the headline risk can often find that our friend volatility provides incredible investment opportunities. In the midst of the volatility created by the various central banks in the world (the Swiss National Bank and European Central Bank), we take a step back and view the world through the eyes of a long-term investor. From this view, we notice the good, the bad and the potential for outright ugly.

Since early 2011, we have been positive towards US equity markets relative to others. The justifications have changed over the years, but as we enter 2015, we continue to believe that US equities provide the best opportunity for our clients on *a risk adjusted basis*. For the most part, investors are their own worst enemy. Who could blame them when they are inundated with nothing but negative news; it allows a rational individual to react irrationally in volatile times. Over the past twenty years, the average annual return for the S&P 500 Index is 9.9% (as of 31 December, 2014 on a US dollar total return basis), however the average annual retail investor has earned a third of that return[1]. Why? The average investor has allowed volatility to be their enemy; manipulating them to buy and sell at the worst times. In a global context, US equities, with the backdrop of a strengthening economy, fair valuation and strong corporate balance sheets may traverse the upcoming year with less volatility. However, relative to last year we expect this year is likely to be much choppier. Let us examine the good, the bad and the potential ugly as to why.

The Good

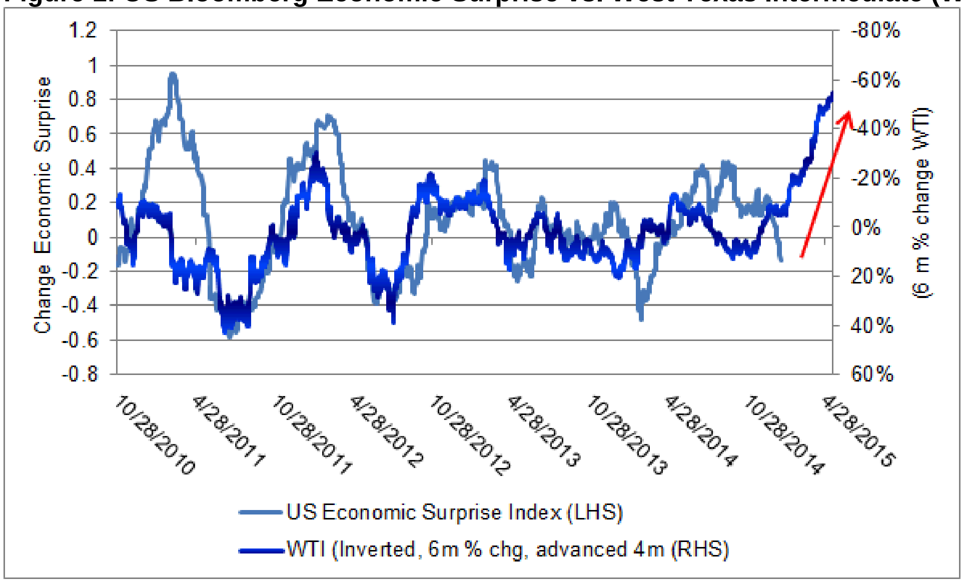
There are many positive animal spirts (A Keynesian term used to describe human emotion that drives consumer confidence) emerging in the US. A tailwind supporting the US is the increase in good inflation and decrease in bad inflation. Good inflation is characterised by an increase in real wages due to a tightening labor market. US payroll gains made 2014 the best year for job growth since 1999 with real hourly earnings rising 1.7%. According to the Duke Fuqua School of Business CFO Business survey, CFO's expect real wage growth of 3.5% this year (this survey result has historically correlated strongly with real wage growth). In addition to the survey, there are multiple sources including the Atlanta Federal Reserve Dashboard that points to wage growth in that range. In an economy that derives approximately two thirds of its GDP from consumption, an increase in wages will be a positive tailwind for 2015.

The US Federal Reserve (the Fed) believes that energy price changes are often transitory. Therefore, lower energy prices will only temporarily offset the inflation pressure of wage growth. As a result, the broad belief is that the first rate hike by the Fed will likely occur in the back half of 2015. If history is any guide, volatility will ensue, leading up to and following this decision. We should remind ourselves that volatility has come as a result of an improving economy which over the long term, will be beneficial to US company earnings and to shareholders.

[1] According to a study by Dalbar, a US-based financial research firm.

For the time being however, bad inflation (which is characterised by an increase in energy and financing costs) is decreasing. Since June, the price of West Texas Intermediate (WTI), the benchmark for North American crude prices, is down 60% and gasoline prices are down 40% per gallon. With cheaper gasoline prices, the US consumer is entering 2015 with a savings of approximately US$2,000 for the full year (after tax dollars) which is equivalent to a pay raise of 4.5%. The chart below compares US economic surprises relative to the 6 month change in oil, advanced by four months. The data series for the change in oil is also inverted, meaning when it is pointing upwards, oil prices are declining. It highlights a relationship between lower energy prices and stronger economic activity. Based on this relationship, we should expect stronger economic surprises for the US economy as we move further into the first half of the year.

Figure 1: US Bloomberg Economic Surprise vs. West Texas Intermediate (WTI) Inverted



Source: Manulife Asset Management. Capital Markets & Strategy Group. 31 December 2014.

From a housing perspective, which is one of the largest drivers of the US economy, the Federal Housing Administration (FHA) announced that it would lower its annual insurance premiums. In addition to record low mortgage rates, a reduction in insurance premiums will make home ownership more affordable for two million Americans over the next three years according to the Department of Housing and Urban Development. For the typical FHA applicant, is equates to a monthly savings of US$80. With reasonable valuations, an economy that is beginning to see real wage growth and lower bad inflation, for the patient investor, the US economy looks to be on sound footing.

The Bad

Now for the bad news. Recent accommodative monetary policies announced by the European Central Bank (ECB) and Bank of Japan in an attempt to stimulate their respective economies have failed to provide any meaningful economic impact. It remains to be seen if last week's announcement by the ECB for its version of quantitative easing (QE) will amount to any form of meaningful economic growth. In China, the stellar growth profile that country experienced over the past decade is slowing; highlighted by the drop in growth rates for Chinese rail freight traffic, electricity consumption and retail sales.

However, these economies are large consumers of oil. Consumers in the emerging markets spend a larger percentage of their salaries on food and energy. Similar to the United States, the drop in gasoline prices will increase disposable income, and likely help these slowing economies.

In our opinion, the more meaningful stimulative impact of lower oil prices will be felt by emerging governments as fuel subsidies, seen as crucial policy to maintain social order become less a drag on fiscal budgets. Fuel subsidies are a significant budgetary expense in the countries of India, Nigeria, Indonesia and Russia to name a few. According to the International Energy Agency, fuel subsidies increased by 60% from 2007-2013 which totalled as astonishing US$550 billion. As a result, the fiscal health of these governments faced stress and limited their ability to implement fiscal stimulus in a time of slowing economic growth. The decline in oil is reducing the cost of fuel subsidies.

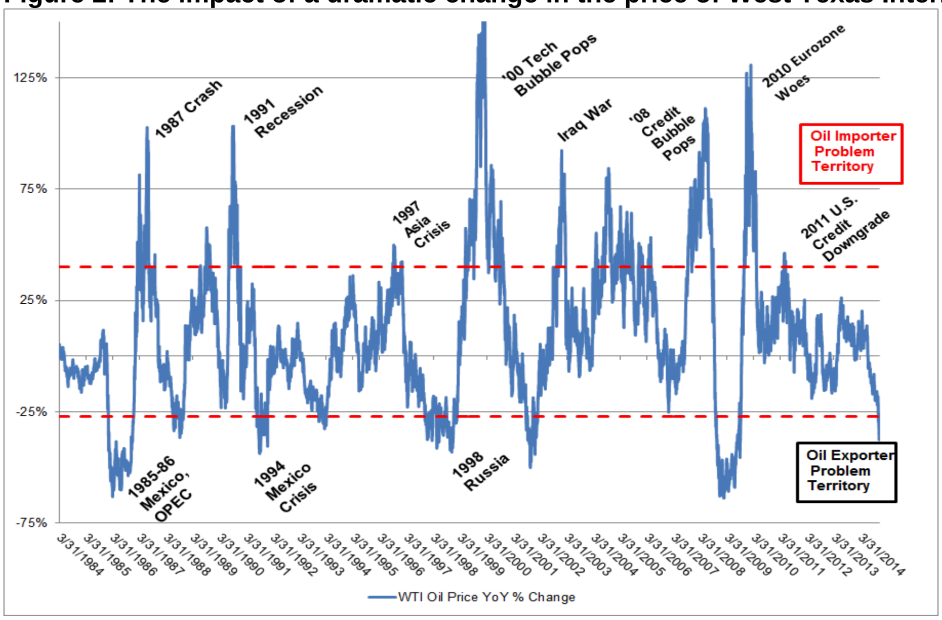
The drop in oil has proven stimulative for fiscal coffers but has also provided reprieve for many of these emerging market central banks. High inflation which is an annoyance for many emerging markets has been decreasing, in part aided by lower oil prices. As a result, lower inflation has allowed many central banks to decrease rates in attempt to stimulate their economies; as India recently did. When the Swiss National Bank acted, it was lost in the news that the Reserve Bank of India reduced their benchmark rate by 0.25% to 8.75% citing lower than expected inflation and weak crude. In the months ahead, it is likely that the news will be dominated by headlines of slowdown in emerging market growth, however, it's important to look further and realise that net-net, a decline in oil prices will benefit the very same economies that are currently slowing (with the exception of Russia, Norway, and Canada) and as a result global growth is likely to increase towards the second half of the year.

The Ugly

Unlike the good and bad, the ugly is near impossible to forecast. The ugly were the Russian Default Swap, the Crash of 1987 or the Global Financial Crisis in 2008, all fairly unpredictable events. What caused these types of ugly events? Many things, but mainly they were surrounded by geopolitical and monetary factors that led to asset bubbles. The main premise is a dramatic increase/decrease in an asset class. What concerns us is the dramatic move in a major asset class (perhaps oil?) over a very short period of time and its impact on government revenues or hedge fund performance (perhaps leading to a forced liquidation?).

Historically, a change of 60% of the price of oil (upwards/downwards) has been followed by an ugly event. As highlighted below, when the price increases dramatically, it becomes an oil importer issue and when it drops dramatically, it becomes an oil exporter issue as oil revenues constitute a large percentage of these government's revenues and exports (Russia, Iran and Nigeria to name a few). In Russia for example, hydrocarbon sales account for 50% of the government's revenue and 75% of its exports. With this volatility, it increases the chances of irrational geopolitical strategy or social unrest.

Figure 2: The impact of a dramatic change in the price of West Texas Intermediate (WTI)



Source: Manulife Asset Management. Capital Markets & Strategy

In addition to the movement in oil, the strength of the US dollar will likely add to global volatility as the world readjusts to the strength in the world's reserve currency (the greenback gained nearly 13% against a basket of major currencies last year, the strongest since 1997). Historically, volatility in major currencies has precluded an ominous event. Over the past several weeks we have seen two main examples whether it was the Swiss National Bank's decision to end its euro peg or the ECB's decision to implement its own form of QE. We believe these decisions and their secondary effects will set the landscape for a volatile 2015.

As we enter 2015, we have many factors helping, hurting and raising question to the health of the global economy. On balance, the drop in oil prices should prove to be beneficial. However, given its dramatic drop in such a short period of time, it has the potential to lead to increased volatility as the world adjusts to a new norm. Over the past seventy years, we have experienced wars, periods of deflation/inflation, defaults and collapses of currency; the constant remains that an investor who is patient, and invests in good companies at an attractive price with strong balance sheets which produce desired products have experienced a return of close to 8% in an equity portfolio versus the average investor whom allows headlines to affect their decision making which results in their return being half of that. Assuming your portfolio is in the right companies, volatility can influence us in two ways – positively, which allows us to take advantage of price dislocations, or negatively, selling at the bottom and buying at higher prices. Perhaps it is best to remind ourselves the next time that volatility shows up that this time is no different.