US equities: Volatility rising

Philip Petursson, Managing Director, Portfolio Advisory Group from Manulife Asset Management examines the recent spike in volatility in global equity markets and suggests we are seeing a correction as global growth slows. He remains constructive on US equities for the next year, but expects more modest returns than in previous years.

Over the past few weeks global equity markets have seen greater volatility than we have witnessed in quite some time. Measured by the Volatility Index (VIX), volatility for the S&P 500 reached levels that haven't been seen since late 2011. The VIX closed at 24.64 on 13 October 2014 as investor capitulation helped to push the S&P 500 Index below its 200-day moving average for the first time since November 2012. Precipitating the drop over the past weeks is the increasing evidence that global growth is slowing. A few of the key data points are highlighted below.

- The September Manufacturing Purchasing Manufacturers Index (PMI) fell below 50 in Germany in September (49.9). France remained below 50 and the Eurozone fell to its lowest level (50.3) since July 2013. South Korea, another key global exporter, also fell below 50 in September[1].

- German Industrial Production dropped 4% in August on a month-over-month basis, the biggest drop since 2009.

- The International Monetary Fund (IMF) has cut their outlook for global growth to 3.8% for 2015. In addition, the IMF warned that the probability of the Eurozone re-entering a recession in the next six months has roughly doubled to 38% since its April outlook.

The relevance to these numbers is that global growth may be slowing. If Germany, the largest economy in the Eurozone, experiences a slowdown, that may start to weigh on the other European economies. Keep in mind that France's economy, the second largest in the Eurozone, has remained below 50 for its manufacturing PMI in 22 out of the last 24 months.

We wrote at the start of 2014 that equity markets have previously been driven by multiple expansion and less from earnings growth (recall the components of market returns - earnings growth, dividends and price-to-earnings (P/E) ratio expansion/contraction as described in "US Equities: Looking forward in 2014" (10 January 2014). Our contention was that earnings growth was likely to be a much more dominant contributor to market performance in 2014 and likely 2015 as it has been for much of this year. Should the global economy slow, that puts headwinds against accelerating earnings growth – growth that was already priced into the market.

Herein lies the problem. If early evidence of slowing global growth materialises into something more relevant, earnings expectations are likely to be met with disappointment. In markets across the Eurozone with already lofty P/E multiples (on a trailing basis), earnings disappointments may be likely to face a P/E contraction. Thus far we have seen markets in Europe dip into correction territory (Germany, France, Italy) or very near (UK, Spain).

US resilience

Meanwhile, the US economy continues to remain resilient. The labour market remains healthy, economic growth is stable and the US Federal Reserve (the Fed) appears in no hurry to tighten interest rates. That strength is not without its own challenges however, as the US dollar has moved up against its global peers. The DXY (US dollar index) has gained 9.9% since its low in May. As approximately 40% of S&P 500 companies' earnings are international based, US companies too face earnings headwinds on a rising greenback. Meanwhile, large cap US stocks have not seen a sell-off of quite the same magnitude as their European peers. The S&P 500 Index has fallen 7.2% from its high. Small cap stocks have fared less well, falling 13.8% as measured by the Russell 2000 Index. Our view remains that we are likely to see continued accelerating earnings growth through this and next quarter. Into 2015 the rate of growth, while likely to continue positively, becomes more questionable.

[1] Source: Markit

The current market reaction is most likely an adjustment of expectations. We do not view the risks pushing the market into more than a typical correction. Past bear markets have coincided with a recession. We cannot find evidence of an emerging recession in the United States. And as such, remain constructive on US equities over the next year with accommodations for a more modest return than what we have enjoyed in the past few.

Oil prices to fall further?

Oil has fallen into bear market territory with a drop of 20% from its high in June due to a weaker outlook for global growth, a stronger US dollar and a dramatic drop in speculative interest in crude futures. This has weighed on the energy sector as similar drops have befallen other commodity producers.

There is a limit to how low oil prices can fall before we start to see supply disruption and prices reverse. Saudi Arabia for example has a target price for oil that is needed in order to meet their economic budget. This is US$95/bbl for 2014 (Brent). Below that price and Saudi Arabia runs into budget problems as 90% of their fiscal outlays are paid for through oil revenues. So, while global growth has contributed to lower prices, there is less of a chance that the price of oil will remain below US$85 without seeing supply disruption from the Middle East and the market self corrects back to the marginal or fiscal breakeven prices. We may be near those levels. Further, valuations for the producers may also be near their lows. Should we hit an inflection point for either for the commodity price or producer valuation the S&P 500 may regain those losses.

In the meantime, lower prices for crude and subsequently gasoline are a relief for consumers. Our calculations show that a US$0.01 change per gallon in gas prices is the equivalent of approximately US$900 million in US household spending on an annualised basis. Gasoline prices have dropped approximately US$0.50/gallon since April[2].

Timing, they say, is everything. A growth scare adds to the confluence of events that are skewing investor sentiment to the downside, including the end to Quantitative Easing, the potential for a shift in the Fed's policy to a tightening bias and the length of the current rally without a correction (now over three years). Investors have been calling for a correction for some time now. Good news for them, this time it may actually materialise.

We keep in mind the fact that while growth may be slowing it is not contracting. We believe we still have a few years yet to the current economic expansion, predominantly in North America, but likely in the major economies as well. Our key recommendations on how to manage the volatility are to focus on high quality companies with growing dividends. Maintain modest return expectations in the mid to high single digits for the next year. Take advantage and buy the dips as the odds are in our favour that this too shall pass.

[2] Source: Energy Information Administration