ALTERNATIVES

October's Market Ups and Downs Put Into Perspective

November 3, 2014

Global equity markets went on a rollercoaster ride in October, although given the cauldron of global issues that were brewing for some time and the month's history of big moves, it shouldn't be all that shocking many investors got spooked. While much of the media focused on the short-term panic, long-term investors used such pullbacks to search for bargains. In the long-term camp, our equity teams view corrections as par for the course, remaining focused on a long-term thesis and not short-term hysteria. Several of our investment professionals share their perspective on the recent market ups and downs.

Ed Perks, CFA®

It was not that long ago (early to mid-September) when the market debate was centered around the strengthening US economy and the pace that we would see the Federal Reserve (Fed) start to shift gears and tighten monetary policy in response to a very strong economy. For the most part, we think that scenario is very much still intact; the US economic data continues to point to a strengthening US economy. What has changed, though, is a bit of the global macro picture. Other major economies, particularly the eurozone, are decelerating a bit, and that's raising concerns that those economies may be falling back into a recession.

In the United States, I think a big part of this recent global equity market selloff, particularly the violent nature of it in October, is an indicator that perhaps the scars from the 2007–2009 financial crisis still are fairly deep. If we were to go back to July or August of this year and survey folks wanting to get into the equity market, I think many or most would probably have said they wanted a bit of a pullback. It's when we are in the midst of a pullback that it becomes a real challenge to have the intestinal fortitude to stick to your plan and look for opportunities. For us, this kind of market in many ways is a great opportunity. I've always viewed these types of markets as a way to reset or recharge our portfolios.

Energy is clearly one of the areas that has been hit the hardest across market sectors. There are, I think, some valid fundamental reasons why we have seen a pullback in energy prices, but the selling in that sector has been so indiscriminate and across the board, in our view, based largely on fear or forced selling. Energy is one sector that we are now looking at and think there is greater opportunity in select names, and that's where our bottom-up stock selection process comes in.

Don Taylor

The recent downturn in the global equity market has been attributed to a litany of different things, including slowing growth in the United States, China, Europe and Japan, geopolitical issues in Russia and Ukraine, ISIS in the Middle East and even Ebola cases in the United States. It may sound silly, but October's history as a month of heightened volatility may also have played a factor in terms of market sentiment; for example, the "Black Tuesday" crash of 1929 and "Black Monday" crash of 1987 both took place in October. I think the market has in recent years become more and more dominated, at least in the short run, by trading-oriented accounts that can also magnify volatility when sentiment shifts. We could find trends in any given week or month aggressively reverse.

In light of this recent market uncertainty, the US Federal Reserve (Fed) certainly has the tools to start easing again if it deems necessary. We've seen some comments to that effect come across the tape in October, essentially sending a message that Fed policymakers are not going to let bad things happen in the markets.

Overall, I suspect it will become more clear, especially as we get deeper in the earnings season, that US growth appears to be OK. Maybe there will be some slowdown in the United States reflecting the slowdown we've seen in some of the other parts of the world, but we still see a pretty favorable environment for the market. Most US companies do sizable business outside the United States, so it's clearly relevant, but I think in the United States, we're in an environment where there are not the major excesses that would likely cause a really sharp downturn. There may be a perception that the global economy is falling apart, but it wouldn’t surprise me to see some strengthening in the market in November and December.

Peter Langerman

I think the pace of the recent equity market drop, particularly in Europe, took some investors by surprise. When sentiment started to take a turn for the worse, the market did feel similar to a few years ago—the panic, the heightened volatility, the intraday ups and downs. We really hadn’t seen that sort of action for some time as volatility had remained relatively low for an extended period.

We certainly are not in a position to call a bottom, but when you look at the fundamentals for the US markets, we think the situation is not so dire. Europe is a little different; Europe has taken some real hits. I think the recovery in Europe has struggled to meet expectations throughout much of the year. Even Germany, one of the stronger markets in Europe, has shown some real signs of weakness, and that’s an issue. While this is partly attributable to ongoing issues related to Ukraine, there are probably additional factors contributing to the recent economic weakness. There are some serious concerns about the pace of the recovery in Europe, but we believe many European corporates paint a picture that belies the macroeconomic headlines. In our discussions with companies located there, we casino pa natet have found that while things aren’t great in Europe, they don’t appear as bad as the last several weeks and months of market action would seem to indicate. The silver lining from an investment standpoint is that we are finding more potential investment ideas in Europe at better prices than before.

It can be difficult for investors to keep calm amid days of extreme volatility like we’ve seen in October, but I think the good news is that the financial system is in much better shape today than it was six years ago. There are pockets of weakness (such as energy stocks, which have been pummeled), but we aren’t seeing major liquidity issues. We aren’t seeing big banks or other financial institutions teetering on the edge of bankruptcy like we did during the financial crisis of 2007-2009.

That said, I don't think investors should just jump in and buy everything. It's important to be selective. At Franklin Mutual Series, we will remain disciplined as we look to take advantage of potential opportunities created by the market's ups and downs. Nobody can call the market bottom. As we have seen time and again, things can turn around very quickly, often for no apparent reason, but historically, we have been able to take advantage of these periods due to our opportunistic approach.

Norm Boersma, CFA®

I would emphasize that the fundamentals in Europe today are very, very different from 2010 and 2011. Bond yields are in line if not below where the United States is, and the peripheral countries have been slowly moving in the right direction in terms of reform, some more quickly than others. One of the things that I think still needs to happen (and the European Central Bank (ECB) has definitely been pushing in this direction) is related to reform in the banking system. Corporate Europe depends less on bond markets for financing than does corporate America, so the banking system is the main financial intermediary in the region. Policymakers are trying to get the banks to increase lending to spur credit creation, but at the same time they are requiring them to raise capital and pay punitive fines. Both of these goals may be understandable, but they are also largely incompatible. Hopefully the regulators' "Comprehensive Assessment" should help reconcile the differences.

The results of the Asset Quality Review "AQR" and stress tests released October 26 were mostly benign, yet their specific conclusions matter less than their symbolic importance. As the ECB assumes supervisory control over the regional banking system, clarity and transparency should improve, in our view. Confidence should follow, and the newly recapitalized banks could begin to increase lending in a less uncertain regulatory regime. The ECB's recent decision to increase asset purchases and set negative deposit rates should help, and are all part of a bigger push to get the credit mechanism going again. I think that's part of the reason that the growth has been weak. There is a demand issue, but there's also a money supply issue that I think needs to be addressed. If banks don't lend, you don't get inflation either. So we've seen deflation, magnified as periphery countries are trying to cut costs at the same time banks aren't lending.

The emerging market slowdown has also had a bigger impact in Europe. So what we have seen then is a pretty sharp selloff in European equities, and we think within that pullback lies opportunities. In the short term, there isn't much on the horizon that would make us wildly optimistic, but we have been looking for new opportunities and nibbling away in Europe, energy stocks being one area we are examining closely. There are a lot of European cyclical stocks that also look pretty interesting to us.

We also have been looking at opportunities in the emerging markets, which actually have had a pretty good run this year in general, despite recent weakness. There are a number of infrastructure plays, for example, that have pulled back pretty sharply and present good long-term opportunities, in our view.

We think a market pullback like we have seen recently is pretty normal. We just haven"t seen volatility of a similar nature for a while. That's why people get scared about equities, but that is part of investing—and, we think, part of the opportunity.

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