COMMENTARY

September 11, 2015

Dear clients and colleagues,

Global growth concerns led by China and uncertainty on whether the Fed will raise interest rates have created extreme volatility in the financial markets. Despite the market turbulence, we feel the overall economy is still healthy.

- US fundamentals are improving. Unemployment rate dropped to 5.1%, lowest since April 2008.
- Europe recovery continues. Exports are strong thanks to weak euro. Impact from Greece is limited.
- Major Japanese firms posted robust Q2 earnings. The re-election of Abe as the leader of ruling party this week should ensure policy consistency.
- Emerging markets' fundamentals are shaky. China is in a rebalancing mode, but the short-term pain is necessary.

Regarding China, we don't see a hard landing in the near future. Moderate and slower growth in China would be better.

There is low correlation between stock market performance and the Chinese economy. The economy is not decelerating by such a degree that would justify the volatility.

On the economic data front, results are mixed. Manufacturing PMI was low at 49.7 in August, slightly down from 50.0 in July. Non-manufacturing PMI remains resilient, 53.4 in August vs. 53.9 in July. Retail Sales inched down to 10.5% in July. Real income growth in the first half was 7.6%.

One data point we monitor closely is housing, because residential real estate including construction activities account for more than 10% of GDP. Property market in China is a good indicator of consumer confidence. July housing prices increased in 31 out of 70 major cities, ranging from +6.3% to -0.7% month over month.

Looking at the stock market, big swings and government intervention may puzzle foreigners but are actually "normal" by Chinese standards. According to Reuters, 85% of the trades are retail. Many invest with borrowed money based on FAITH in the government. So the government did intervene, as expected, which we believe is more related to concerns of social instability which might be caused by huge financial losses of individuals.

What comforts us is that China still has many tools to stimulate the economy, from rate cuts, fiscal stimulus, to currency devaluation. The current 1-year benchmark bank lending rate is 4.6%.

Looking ahead, we remain optimistic about the Global Small Cap market. Growth should support earnings, and high M&A activities should benefit small caps. In terms of region, we favor Europe and Asia over the US. Valuation is more attractive. The strong US$ has been a drag on earnings, based on Q2 results.

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Accommodative central bank policies are positive for stocks. The Bank of England has cut interest rates for the third time in four months. The Bank of Canada kept the same rate at its most recent meeting. The Reserve Bank of New Zealand has cut rates three times this year. What will the Fed do? A Bank of America study showed that the Fed rarely makes a move during times of extreme turbulence in the stock market. We shall have the answer next week.

Have a nice weekend.

The Global Alpha Team

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