KayneCast

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Episode 12

CIO Commentary on Recent Market Volatility

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Equity markets here in the U.S. have become weak over the last four weeks with a lot of volatility last week, causing many investors to assess is this the correction that we've been expecting all along or is this something more meaningful like a major bear market starting to occur.

Large stocks have been on the verge of a correction last week. They were down 9.9% inter-day when the S&P briefly touched 1820. Small stocks have already been in correction territory, which really occurred in the second quarter, but peak to trough they were down about 13% in the middle of last week.

So what's changing, why has this volatility picked up dramatically, and what are investors concerned about? In a nutshell I think the key thing is that this is a global growth slowdown scare, centered primarily on Europe. We've seen weakening data out of Europe over the course of the summer. Even Germany, which had been a very strong pillar of growth in Europe over the last several years, has seen a material slowdown in their business activity in the third quarter. So there's more evidence of a triple-dip recession threat occurring in Europe these days, and I think that's where most of the global growth scares are really coming from.

The ECB has been jawboning a lot about supporting the economy, but really hasn't done anything material yet, and I think investors are starting to doubt whether or not the ECB will really carry out the re-stimulus activity that they mentioned. Additionally, there's been some drama between France and Italy, whose economies are suffering under the austerity programs, versus Germany, who insists on more austerity going forward. So there's some discontinuity and disagreement among the EU members about how best to proceed with fiscal policies which is creating some tension for investors.

And Greek bond yields have started to rise again after a long period of stability. Political elections look likely in Greece early next year, and some of the parties that appear to be winning out are parties which don't want to adhere to the austerity programs that the lenders in Europe have imposed upon them. So that's created some concerns about a future investment in Greece again. So this has led to some potential weakness in China, and particularly because Europe is a key export market for China, therefore causing some concern about stability of global growth.

Additionally, U.S. energy prices have been very weak over the last three months, falling from about 110 dollars per barrel down to the low 80s. This, I believe, has been principally caused by a modest slowdown, and I mean very modest slowdown, in global demand, but it has been mainly accompanied by a big increase in production output here in the U.S., particularly in the shale market, and I do believe that Saudi Arabia is trying to test out—given their low cost position in the crude oil market—what levels of WTI will actually cause U.S. shale producers to shut in some capacity here in the U.S. So I think there is no major concern in terms of energy prices overall, in terms of the demand side. There is some modest reduction there, but it is very modest.

The bond market of course has picked up on these growth slowdown concerns, and briefly last week we had the 10-year yield fall below 2% again, which it hasn't done for quite some time. Credit spreads, as evidenced by the junk bond market and emerging market debt, have widened somewhat as well, but they are nowhere near 2008/2007 levels when credit spreads blew out. They are widening somewhat from very, very historically tight levels that we saw at the end of the second quarter.

Additionally, we've had some health-care scares here in the U.S. Ebola has become more headline news, as a gentleman in Dallas unfortunately passed away. And the CDC has held numerous conference calls over the last week about the outbreak and efforts to contain it. I've sat in on a couple of calls, and they're not terribly inspiring. So that's created some additional fear I think in the marketplace. And that may get worse before it actually gets better here in the U.S., but I'm hopeful that that's not the case. Time will tell.

So are there any bright spots out there? Or is it all doom and gloom and is the global slowdown that people are concerned about, about to materialize eminently? There are some bright spots. First, third-quarter earnings. We haven't seen a lot of the reports yet, but many of the early reports that are trickling in for the most part have been good. Not quite as strong as second quarter started off, but we've had a few disappointments/pre-announcements as we always do every quarter, but nothing out of the ordinary, and I still believe that third-quarter earnings are going to come in fairly strong despite all the noise in the macro environment and the health-care issues that I cited earlier. And of course corporate earnings is what's been driving this bull market and will continue to drive this bull market as long as companies continue to perform well, and I don't have any reason to believe that isn't going to be the case going forward.

Small stocks, which have been underperforming for most of the year and are actually in a correction territory as I mentioned already last quarter, have actually started to regain their footing after declining about slightly more than 10% peak to trough as I mentioned earlier. This is good news, and maybe all that's happening here is that large stocks are finally starting to catch up to where small stocks have pretty much been all year long. So they're finally joining the correction party, if you will, that's been occurring in the Russell 2000.

And then the other piece of good news is the VIX indicator which briefly penetrated the 30 level last week. Historically —with the exception of the Great Recession of 2008—when you get above 30 on the VIX, that's typically indicating a lot of fear in the marketplace. Historically, that's typically always been a buying opportunity, both in the short and longer runs. So the fact that that did penetrate 30 last week tells you that there were a lot of fears out there, and the indicator this week seems to be coming back down, which is good news. It rarely goes above 30 unless there's some sort of real calamity in markets out there.

The other good news is that despite the Ebola headlines, the fact is there haven't been a lot of cases that have materialized yet in the U.S. Given the incubation period, we have to stay tuned for that going forward, but so far it's had little to no impact on travel plans or hotel visits here in the U.S. worth talking about, or even, for example, visits to Disneyland.

So what are the risks going forward? Well, the key risk I think is that Europe—which is where these global growth slowdown concerns really reside—gets so bad that it starts to drag down other economies around the world, China, other parts of Asia, and even here in the U.S. ultimately. I don't think that's likely to happen, but it is possible, and I would point out also that Europe has always been a slow-growth economy. So we haven't been banking, and are not banking, for high growth out of Europe at any particular point in time. That hasn't happened for over 30 years that I've been in this business, but we do need it to be stable and not falling apart. So hopefully that will happen as we go forward here.

The second risk is that business executives read the newspaper, they watch their stock prices, and they certainly watch their companies' stock prices, and sometimes if financial markets get bad enough, it actually can start to alter their behavior. It can alter their capital spending plans. It can alter their budgeting. It can alter the way they hire and build inventory, et cetera, and that can have a real impact on the global economy and the macro environment.

The third thing that can happen is credit spreads here could widen much more than they have already. If there's a real deterioration in credit and the spreads start expanding rapidly, that obviously has a major impact on credit costs and the availability of credit to many businesses, which of course is important to a growing economy.

The last risk is Ebola. If it ends up not being effectively contained here in the U.S. and it actually does get bad enough that it starts to impact consumers' travel plans and business activity, this could cause a temporary dislocation in business, which would not be good obviously. I don't think this is highly likely, but it is possible and a potential risk.

Despite all these potential risks, I strongly believe that today the evidence suggests this is nothing more than a garden-variety correction. Corrections are sharp and they're painful and that sort of feels like what this has been so far, and I don't have any reason to believe that this is going to escalate into something more dramatic than that at this particular point in time. We'll be mindful of these risks and keep an eye on everything as we go forward, but at this point it does look like it's a very garden-variety correction in the markets. Thank you for your time and attention.