# Global Equity Outlook

American Century Investments®

## Our Global Team's Perspective

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## Executive Summary

### LOOKING BACK

- The Chinese equity market downturn in August, which fueled fears that the economic cooling there may be greater than originally anticipated, was the dominant headline for the third quarter of 2015. Followed by a sudden currency devaluation, the stock market correction had ripple effects on the rest of the world's stocks.
- A close second was the decision by the U.S. Federal Reserve (Fed) at its meeting September 17 to keep short-term interest rates unchanged. The situation in China was a contributing factor to the decision.
- In this environment, stocks were down across the board globally, with emerging markets suffering the largest declines and the U.S. holding up the best.
- Despite some positive economic news and small gains in July, U.S. stocks declined for the quarter amid investor concerns about the prospects for global growth. The drop pushed the S&P 500® Index[1] into negative territory for the year-to-date period.
- After several consecutive quarters of economic improvement fueled by the European Central Bank's (ECB) quantitative easing (QE) program, economic activity and stock prices in Europe reversed, succumbing to pressure from the China turmoil.
- Japanese stocks were also hurt by the slowdown in China. As one of Japan's larger trading partners, the reduced economic activity is expected to have a negative impact on Japan's exporters. This is the very sector of the Japanese economy that had been supporting growth there, benefiting from a weaker yen and government stimulus programs.
- Emerging markets were the worst victims of the turmoil in China. Contagion fears, ongoing currency pressures, and concerns about the effects of China's slowdown on already weak commodity prices weighed on markets throughout the region and pushed stock prices down significantly.
- Geopolitical worries remained a concern. The ongoing debt crisis in Greece continued to worry global markets into August, despite a tentative agreement between the government and major creditors.

### LOOKING FORWARD

- The Fed's decision to hold rates steady underscored just how interconnected all aspects of the global recovery are now. In its statement, the Fed referenced "recent global and financial developments" that had led to concerns about global growth and potential pressure on inflation. It also alluded to recent market volatility, a nod to the significant swings investors endured after China's devaluation of the yuan. Heading into the quarter, consensus held that the Fed would increase rates before year-end and that the first hike in nine years would come out of the September meeting. While most Fed Watchers still expect the first increase to happen this year, some are now predicting rates will remain unchanged into 2016. Added to this debate is the question

[1] ©2015 Standard & Poor's Financial Services LLC. The S&P 500® Index is composed of 500 selected common stocks, most of which are listed on the New York Stock Exchange. It is not an investment product available for purchase.

of how far and how fast those increases will be once they do begin. Clearly, the Fed governors have become mindful of how a robust round of tightening could rattle the world's markets.

- The recent upheaval in the world's stock markets tells us that, despite conditions supporting modest growth in many economies, a smooth and sustainable global recovery is less likely than it was in quarters past.
- While largely a reaction to the downturn in China, Europe's contraction in the third quarter, after nine consecutive quarters of expansion, points out how tentative recovery can be in some regions. We expect that QE can continue to support growth, bolster earnings, and buoy investor confidence. An increased money supply improves access to credit and weakens the currency, supporting manufacturers and exporters.
- U.S. investor confidence has been clipped by the one-two punch of China's currency devaluation and stock market correction. Reacting to the China turmoil, the S&P 500's drop represented a correction (a decline of 10% or more) since its May high, the first since 2011. Investor sentiment will likely recover only after a series of positive economic data releases and with a clearer picture regarding the Fed's plans on interest rates. Conditions appear to support continued slow growth despite the short-term shocks from outside sources.
- "Abenomics," the Japanese prime minister's stimulative economic reforms, may not be enough to keep Japan's growth on track. QE has weakened the yen, and manufacturers and exporters, have benefited. At the same time, deflationary pressures and lackluster consumer activity continue to affect the more domestically focused sectors of the economy. Core inflation decreased near quarter-end to negative levels, prompting speculation that additional stimulus measures might be called for. We continue to monitor the situation.
- Exacerbated by the slowdown in China, the struggles in emerging markets are likely to continue. A stronger dollar, sluggish growth, and lack of clarity about the Fed's plans should continue to buffet emerging markets as a whole, despite pockets of solid performance in specific markets.

## MARKET ANALYSIS

The sharp correction that jolted global markets in the third quarter was triggered by the realization that the situation in China might be worse than originally thought. The dips in the Hong Kong[2] and Shanghai[3] exchanges were largely a result of government policy moves to tighten margin restrictions in an effort to ease what it viewed as an equity bubble. On the heels of the equity correction, the central bank allowed the currency to devalue about 2% overnight by lowering interest rates and bank reserve requirements to stimulate the slowing economy.

These policy moves set off a chain reaction around the globe. Companies with exposure to China tumbled. Commodity prices weakened further on fears of slower demand and a weaker yuan. Speculation that the Fed might stand pat in September gained momentum. World stock markets contracted.

As we see it, the central issue surrounding China is whether it can implement a slower yet steadier growth scenario through its various reforms and stimulus moves. And, if so, can the benefits of lower-cost goods from China offset the damage of lower consumer and industrial activity in the meantime. The former would benefit retailers and manufacturers who source goods, parts, and components from China (e.g., Walmart and Apple) while the latter will continue to pressure commodity-related names, luxury goods makers, and retailers and manufacturers selling into the Chinese market. For example, China is the world's largest auto market and the largest consumer of cognac and Swiss watches.

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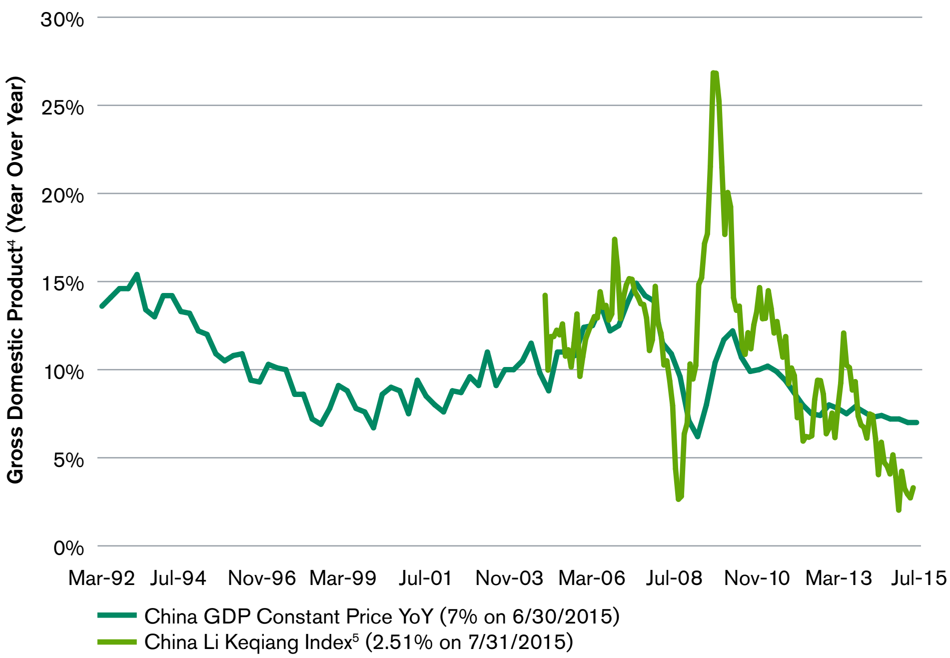
[2] Represented by the Hang Seng Index, a freefloat-adjusted market capitalization-weighted stock market index and the main indicator of overall market performance in Hong Kong.

[3] The Shanghai Stock Exchange Composite Index is a capitalization-weighted index that tracks the performance of A-shares and B-shares listed on the Shanghai Stock Exchange.

It is worth noting that China's growth did not come in one smooth, upward slope. As expected, there was considerable volatility on the rise, and investors should expect corresponding volatility during a downturn. We would not be surprised by additional rate cuts or further currency devaluation to stimulate economic activity. Such moves, if made judiciously, should help stimulate the Chinese economy in the near term and drive growth, as long as they do not set off a currency war in the Asia Pacific region. Such a war would likely export the same deflationary trends that the developed markets only recently began to reverse.

**China's Growth Is Slowing**




Source: Bloomberg.
Data from 3/31/1992 to 7/31/2015.

## Eurozone

Europe experienced a setback in the third quarter after nine consecutive quarters of expansion. Reaction to the slowdown in China, slowing economic growth, renewed deflationary fears, and lingering concerns about Greece and the sustainability of the economic union brought stocks down across the board.

The financial engines of Germany and France have seen slower growth, as have peripheral markets such as Spain and Ireland, which had been steadily improving over the previous few quarters.

Virtually all sectors of the stock market have suffered, including materials, energy and financials, where revenue and growth trends turned negative. Materials and energy declined in response to expectations that China's slowdown and the strong U.S. dollar would further lower demand and pricing for commodities and oil. Financials also declined on concerns about exposure to China and the emerging markets. We do not see any quick-fix for companies in these sectors, who are likely to continue to struggle until growth in the world's second-largest economy is seen to be stabilizing.

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[4] Gross domestic product (or GDP) is a measure of the total economic output in goods and services for an economy.

[5] The Li Keqiang Index was created by The Economist that measure's China's economy using three indicators: railway cargo volume, electricity consumption and bank loans. The index is seen as an alternative to official gross domestic product numbers released by the Chinese government.

Deflationary pressure persists, as headline inflation remains well below the ECB's 2% target rate. Sluggish growth and renewed deflationary concerns suggest that the central bank may soon up its €60 billion monthly bond-buying program in an effort to spark the economy once again. The ECB's accommodative policies have kept interest rates low and weakened the euro against other major currencies. A boost in the stimulus program should support these trends, and while growth is likely to continue, it could be at a very modest pace.

Despite the short-term negative reaction to the China situation, there are signs of improvement in Europe. Unemployment levels reached three-year lows, and expansion in money supply and credit growth suggest ECB policies are gaining traction. European growth should respond to additional QE, which we would expect to support recovery at the macroeconomic and company levels. A weaker euro would continue to act as a tailwind, helping European manufacturers and exporters by making their goods more competitive in foreign markets.

**United States**

Putting China aside momentarily, it is possible to see that U.S. economic data continues to point toward modest recovery. The second quarter's 2.3% annual growth rate was revised sharply upward to 3.7% in August, driven by strong consumer spending and domestic demand. Housing starts, home sales, and durable goods orders are all on the upswing. Corporate earnings, however, remain lukewarm amid the challenges of a strong dollar.

Jobs data was encouraging. Nonfarm payroll employment grew by 173,000 in August, slightly below expectations, but representative of 66 months (5½ years) of consecutive additions. Notably, headline unemployment decreased to 5.1%. This represents one of the magic numbers of the Fed's stated employment target before considering a rate increase. Therefore, excepting the global reaction to China's struggles, the economic data in the U.S. strongly suggested the Fed would be ready to make its first move in September.

Amid such confusion, the strong dollar, low interest rates, and falling energy and commodity prices continue to support the American consumer. Consumer discretionary areas such as restaurants, travel, retail, and home improvement remain among the top-performing industries.

So, we now wait to see if the Fed will launch its first rate increase in nine years before we sing "Auld Lang Syne" again. It is likely they will, and such a move may be priced into the markets. Of course, there remains a chance that it could prove a shock to the system after years of easy liquidity. Indeed, the Fed's statement after the September meeting noted their non-move was partly attributable to a concern about increased volatility. This is despite the fact that only 8% of U.S. exports are bound for China.

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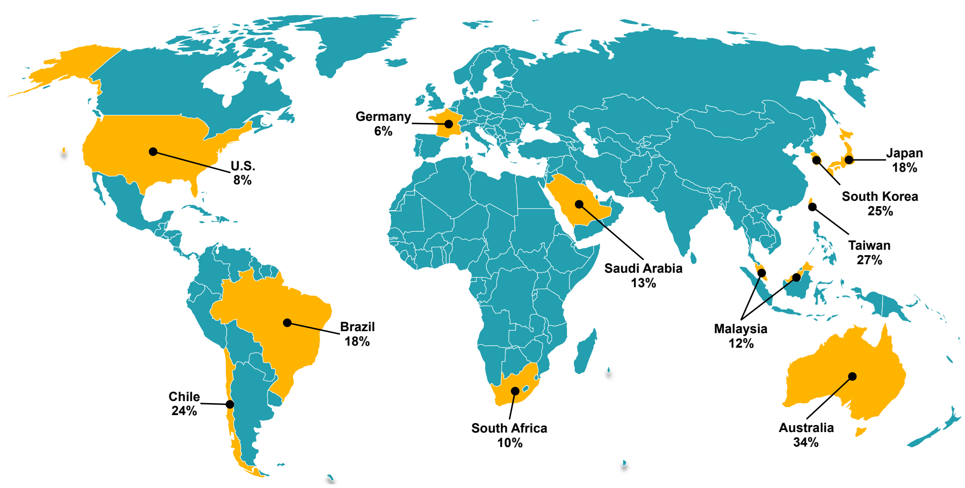
## China's Trade Partners

Percent of Each Country's Total Export to China




Data as of 12/31/2014; Taiwan data as of 12/31/2012.
Source: CIA World Factbook.

### Japan

Japan is another country that has struggled in the wake of the China slowdown. It may be that investors skeptical about the long-term prospects for stimulus programs there only needed a nudge to turn negative on Japan. A moderate percentage of the country's exports do travel to China, and export levels were down throughout the quarter as the yen rebounded temporarily. Japanese automakers were particularly hard hit by the downturn in China.

Also, Japanese domestic consumption has been weak, as real wages have struggled to keep pace with higher prices following the sales tax increase in 2014. The Japanese economy contracted in the second quarter, after appearing to turn the corner toward growth.

These conditions underscore our concerns as to the sustainability of the Japanese reforms, and we remain cautious about the economy going forward. Data support the trends: The yen continues to weaken overall, which would be expected to benefit export- and industrial-based companies, but core inflation remains well below Bank of Japan targets and both consumer activity and capital investment need to rebound.

### Emerging Markets

Emerging markets (EM) trailed all other regions by a wide margin in the third quarter. Given their strong ties to China's economy, it is not surprising they were the most significantly affected by the situation. Even before the corrections and currency devaluation in August, emerging markets had struggled in response to the strong U.S. dollar, sluggish global growth, and the expectation of a Fed tightening. Weakness in the global economy will naturally weigh on EM due to their inherent sensitivity to global activity and export demand. The extent to which each country is levered to global activity will have an important impact on relative returns throughout the year, but this dispersion between individual markets should offer opportunities for active managers.

Therefore, given this weakness in global activity, it should not be surprising that we continue to watch those themes that focus on the positive trends in domestic demand, either driven by reform or clear changes in consumer behavior.

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The recent weakness and general underperformance relative to developed markets has left EM trading below historical averages, creating a potential opportunity. Examples of opportunities in today's challenging environment come as a result of the effects of increased disposable income, notably uptrending global auto penetration and online search and e-commerce, all of which have benefited from increasing standard of living across the region in the longer term as well as the recent decline in energy prices in the shorter term.

EM investors are wise to keep an eye on the situation in China. The regional giant determines much of the EM's growth prospects. China's economy is a significant importer of commodities from its EM neighbors as well as a source of goods which will now be more competitive as the yuan weakens. Thus, the longer its malaise persists, the longer commodity and materials economies (e.g., Mexico, Russia, Indonesia, Brazil, and Chile) and competing manufacturing economies (e.g., South Korea, Vietnam, and Thailand) could stagnate.

Divergence in central bank policies is likely to continue until sustainable, long-term improvement is achieved across the developed markets. The dollar's effect on commodity prices and current account balances for EM economies could continue to hinder EM markets as a whole.

Of course, there are also reasons to be optimistic; improved fiscal responsibility, focus on reform, and increased infrastructure spending are creating individual pockets of opportunity within the region.

## CONCLUSION

As dedicated bottom-up stock pickers, we are committed to keeping short-term market trends in perspective as we maintain our disciplined investment approach. Though optimistic about the nascent global improvement, many investors have become more cautious about currencies, deflation, and the impact of China's slowdown on global growth. We believe that by analyzing opportunities on a company-by-company basis, regardless of short-term market conditions, we will be able to uncover attractive stocks that can offer the earnings acceleration potential that is the cornerstone of our investment process.

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