Stay calm, it is just a correction

Special Commentary of the Investment Advisory Bureau

- Equity markets have come under very significant pressure in the past few weeks. It appears that we are dealing with a “risk-off” episode, i.e. a flight from risk assets that is typical of stock market cycles.

- The declines in stock prices have been the deepest for three years, which has driven most equity indices into the red in year-to-date terms. It should be noted, however, that such corrections are characteristic of the stock market. What was unusual in recent years was precisely the extremely limited volatility, which was largely conditioned by non-orthodox central bank policies.

- There are several reasons for the current sell-off, but the most important include the deteriorating outlook for global growth, a return to normal monetary policy in the United States, the lack of a deeper correction for three years and the current difficult geopolitical environment.

- In our opinion, the current declines are a correction, i.e. at the moment we do not expect them to turn into a trend reversal in the global stock market. This does not mean, however, that we have reached the trough.

- It should be remembered, nevertheless, that in the long term the fundamentals will prevail and the asymmetry of risk will not last forever. Despite the recent slump in economic activity, the foundations of global growth do not look alarming.

- We maintain our positive view on the equity market and expect that in the longer term, indices will return to trend growth. We would, however, like to point out that the time when stock prices increased with just small corrections is already behind us.

- In order for our outlook on the market to change, we would require much stronger fundamental signals that would call into doubt the ongoing recovery in the global economy. An escalation of geopolitical risks could also result in the revision of our attitudes. At the moment, none of these scenarios appear very likely.
Causes of market declines

After the global equity markets were again close to reaching historical peaks in the past month, the last few weeks have brought a very strong decline. The sell-off affected all indices regardless of local fundamentals. It appears that we are dealing with a “risk-off” episode, i.e. a flight from risk assets that is typical of stock market cycles. Many investors are probably wondering what triggered such a sharp sell-off, and what might happen in the coming weeks and months. This commentary is meant to answer such questions.

Let us start by looking at the global market situation as reflected by the MSCI World. The Chart below shows that during the past few years, corrections in the stock market rarely exceeded a few percent. Larger corrections were usually associated with serious economic perturbations (such as e.g. in 2011 when the very survival of the eurozone was called into doubt). Given the prevalent low volatility, however, each subsequent correction was less pronounced. This pattern has only been broken by the present decline, which is already in the double digits. The declines in stock prices have been the deepest for nearly three years, which has driven most equity indices into the red in year-to-date terms. It should be noted, however, that such corrections are characteristic of the stock market, and it was in fact the period of several years without significant drops that was an aberration.

So what was the reason for the recent movement? It appears that there were several reasons but the most important included:

- Deteriorating outlook for global growth
- Return to normal monetary policy in the U.S.
- No significant corrections for nearly three years
- Unstable geopolitical environment
Starting with the first factor, recent months have seen a slump in economic activity on a global scale. This can be clearly seen in the Chart below, which suggests that the slowdown affected global trade, industrial production and manufacturing PMIs.

Chart – Fundamental economic activity indicators on a global scale (3-month average, annualized percentage change)

All this has led the International Monetary Fund to revise global growth forecasts for 2014 and 2015 downwards to 3.3% and 3.8% respectively (i.e. by -0.1 and -0.2 p.p.). Additionally, disappointing data have been reported from the German economy where some macro readings for August revealed declines comparable to those from crisis years, which affected sentiment throughout Europe. For example, industrial production plunged by as much as 4% m/m. Worse outlook was also reflected by leading indicators such as the PMI, Ifo and ZEW.

Chart – Industrial production growth in Germany

Source: International Monetary Fund

Source: Bloomberg, Citi Handlowy
Another factor that affects sentiment in equity markets is the expected normalization of monetary policy in the United States. By normalization we mean a return to typical monetary policy, i.e. a departure from quantitative easing schemes and so-called forward guidance (assurance that interest rates would be maintained at an unchanged low level for a long time). During the past three years, we could have stated at any time that within a year, interest rates would not change. This relationship is clearly visible in the Chart below, which shows the implied interest rate.

Additionally, the QE3 scheme will be probably phased out this month, which means that the U.S. central bank will no longer inject liquidity into the financial system as it used to in recent years. All this fuels uncertainty and thus volatility in the financial markets. In such conditions, corrections – even when they are brief – may be much more severe than in recent months. This increase in volatility can be seen very clearly in the Chart below, which presents the VIX (dubbed the fear index) for the S&P500, which has reached levels last seen in 2012.
The third reason, which exerted the greatest sway over the market, was that we have not seen a major correction in equity markets for nearly three years. With stock valuations, which exceeded historical averages in some markets (especially in the United States), and given very strong gains in recent years, the temptation to take profits has been huge. As a result, after a strong first move more investors started to sell stocks, exacerbating declines. Psychological factors also mattered given the fact that technical resistance was broken for multiple indices and a downtrend formation emerged.

The uncertainty has also been amplified by the unstable geopolitical situation. On the one hand, there is the unresolved tension between Russia and Ukraine and on the other, there is the conflict between the Islamic State and the international coalition in the Middle East. Additionally, there is a growing threat of an Ebola pandemic, which at the moment seems unstoppable, at least in Africa.
Possible scenarios

In which direction may the markets go in the coming weeks and months? In our opinion, the current declines are a correction, i.e. at the moment we do not expect them to turn into a trend reversal in the global stock market. In order for our outlook on the market to change, we would require much stronger fundamental signals that would call into doubt the ongoing recovery in the global economy. An escalation of geopolitical risks could also result in the revision of our attitudes. At the moment, none of these scenarios appear very likely. This does not mean, however, that we have reached the trough. Looking at similar historical market events, we are probably halfway or three-fourths through the correction in equity markets, which is generally a highly dynamic phenomenon. Under such conditions it is, however, very difficult to determine the exact level of the trough at which the downward movement will be halted. It should be remembered, nevertheless, that in the long term the fundamentals will prevail and the asymmetry of risk will not last forever. Despite the recent decline in economic activity, the foundations of global growth do not look alarming. While the outlook for global GDP growth has been consistently revised downwards since the beginning of the year, market participants and observers (including the IMF) expect that in the next 12 months, the global macroeconomic situation will improve. We are now very far from recessionary scenarios or potential threats to the stability of the financial system (as was the case in 2008), which could lead to a reversal in the trend. The return to normal monetary policy in the United States is certainly an issue in terms of heightened risk in the markets, and in particular of the increase in volatility. It should be noted, however, that in global terms, monetary policy is and will continue to be expansionary. The interest rates increases in the U.S. should not be significant, in Europe the ECB is in quantitative easing mode and the Bank of Japan is pumping lots of cash into the financial system month after month. There is ample liquidity in the global market and it is difficult to consider the liquidity environment as a factor that could prompt a stock sell-off. When it comes to the final factor, i.e. the lack of a correction in the stock market for a long time, this correction has just arrived. It appears that after such a strong sell-off and drop in valuations, demand will ultimately materialize. Geopolitical risk factors – although still present – do not seem to be as important for global growth prospects at the moment.

Given the above, we maintain our positive view on the equity market and expect that in the longer term, indices will return to trend growth. This does not mean, however, that we will not experience severe corrections like the present one. These, however, tend not to have much significance for the long-term investor. As can be seen in the Chart below, despite the average decline of 15.7% (median: 12%), annual rates of return for the MSCI Europe were positive in 26 of the last 34 years. Investors should, however, remember that in the current environment this will be a commonplace situation and the time when stock prices increased with just little corrections is already behind us. As the U.S. monetary policy returns to normal, greater volatility will be inevitable.

Chart – Maximum declines during the year vs. the annual rate of return for the MSCI Europe (%)

Source: Bloomberg, Citi Handlowy
**Glossary of Terms**

<table>
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<tr>
<th>Term</th>
<th>Description</th>
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<tr>
<td>Polish Shares</td>
<td>denote shares traded on the Warsaw Stock Exchange (WSE) and included in the WIG index.</td>
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<tr>
<td>U.S. Treasuries</td>
<td>bonds issued by the government of the United States of America; figures used for the Bloomberg/EFFAS US Government Bond Index &gt; 1Yr TR, measuring performance of U.S. Treasuries whose maturity exceeds 1 (one) year.</td>
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<tr>
<td>Citi Research</td>
<td>a Citi entity responsible for conducting economic and market analyses and research, including that concerning individual asset classes (shares, bonds, commodities) as well as individual financial instruments or their groups.</td>
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<tr>
<td>Div. Yield</td>
<td>the amount of dividend per share over the share’s market price. The higher the dividend yield, the higher the yield earned by the shareholder on the invested capital.</td>
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<td>Long Term Duration</td>
<td>a term of more than 6 (six) months.</td>
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<td>Short Term Copper</td>
<td>a term of up to 3 (three) months figures based on the spot price per 1 (one) ton of copper, as quoted on the London Metal Exchange.</td>
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<tr>
<td>German Treasuries (Bunds)</td>
<td>bonds issued by the government of the Federal Republic of Germany; figures used for the Bloomberg/EFFAS Germany Government Bond Index &gt; 1Yr TR, measuring performance of German treasury bonds whose maturity exceeds 1 (one) year.</td>
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<tr>
<td>P/E (2014)</td>
<td>a projected price/earnings ratio providing information on the price to be paid per one unit of 2014 projected earnings per share, measured as the ratio of the current share price and the earnings projected by analysts (consensus) for a specified year (2014).</td>
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<tr>
<td>P/E (price/earnings)</td>
<td>the historic price/earnings ratio providing information on the number of monetary units to be paid per one monetary unit of earnings per share for the preceding 12 (twelve) months, measured as the ratio of the current share price and earnings per share for the preceding 12 (twelve) months.</td>
</tr>
<tr>
<td>Polish Treasuries</td>
<td>bonds issued by the State Treasury; figures based on the Bloomberg/EFFAS Polish Government Bond Index for the corresponding term (&gt;1 year, 1–3 years, 3–5 years, over 10 years).</td>
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<tr>
<td>Brent Crude Oil</td>
<td>figures based on an active futures contract for a barrel of Brent Crude, as quoted on the Intercontinental Exchange with its registered office in London.</td>
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<tr>
<td>Silver</td>
<td>figures based on the spot price per 1 (one) ounce of silver.</td>
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<tr>
<td>Medium Term</td>
<td>a term of 3 (three) to 6 (six) months.</td>
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<tr>
<td>U.S. Corporate (High Yield)</td>
<td>bonds issued by US corporations which have been assigned a speculative grade by one of the recognized rating agencies; figures based on the iBoxx $ Liquid High Yield Index measuring performance of highly liquid US corporate bonds with the speculative grade.</td>
</tr>
<tr>
<td>U.S. Corporate (Inv. Grade)</td>
<td>bonds issued by U.S. corporations which have been assigned an investment grade by one of the recognized rating agencies; figures based on the iBoxx $ Liquid Investment Grade Index measuring performance of highly liquid U.S. investment grade corporate bonds.</td>
</tr>
<tr>
<td>YTD (Year To Date)</td>
<td>a financial instrument’s price trends for the period starting 1 January of the current year and ending today.</td>
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<tr>
<td>YTM (Yield to Maturity)</td>
<td>the yield that would be realized on an investment in bonds on the assumption that the bond is held to maturity and that the coupon payments received are reinvested following YTM.</td>
</tr>
<tr>
<td>Gold</td>
<td>figures based on the spot price per 1 (one) ounce of gold.</td>
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