Voya Global Perspectives

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Executive Summary

- There may be a lot of ugliness out there — China, oil prices, currencies — as free markets re-assert control, but such normalization reduces broader risks to the economy and markets.
- The U.S. economy's march toward normalization, led by the consumer, has been the bright spot around the world.
- Without strong earnings growth and the artifice of fed stimulus, markets currently are behaving as normal markets do.
- Investors should stick to the plan made in calmer times, as it is the best defense from irrational — and often self-defeating — actions.

Risk Assets Suffer in August

Index	Aug 2015	YTD
Equity		
S&P 500	-6.0	-2.9
S&P MidCap 400	-5.6	-1.5
S&P SmallCap 600	-5.2	-2.1
Global REITs	-5.9	-5.3
EAFE	-7.3	0.1
Emerging Markets	-9.0	-12.6
Fixed Income		
Corporate	-0.6	-0.8
U.S. Treasury 20+	0.0	-1.7
Global Aggregate	0.1	-2.7
High Yield	-1.7	0.2
Senior Loans	-0.3	3.2

Data as of 08/31/2015

Source: FactSet, FTSE NAREIT, Voya Investment Management

China Bumbles, Markets Tumble, While Free Market Reigns

Much like China's infamous empty cities, the country's perfectly constructed economic statistics obscure the truth of what lies behind them. While U.S. and international companies certainly were selling real product to the richest of China's 1.4 billion consumers — as well as to other parts of the emerging world — signs of a slowdown were lurking behind the well-manicured walls.

These indicators were years in the making. It didn't help matters that China appeared to believe its own press regarding its omnipotence. Like a moth to a flame, the People's Bank of China couldn't resist toying with Adam Smith's free market, easing into a more market-determined exchange rate for its yuan. Surely 250 years of American free-market history was no match for the Chinese central-planning machine, as encapsulated by the now-pejorative term "state capitalism"? But having left ajar the door to free-market capitalism, China was defenseless against its onslaught. The unrest was punctuated by the most significant downward yuan adjustment in 20 years before spreading into already-struggling equity markets to finish off — like Smith's "invisible hand" — what remained of 60% year-to-date gains. Chinese policymakers have tried everything under the sun to mitigate the selloff — rate reductions, stock purchases by state-backed funds, new liquidity measures — to no avail. It is ugly for now, but what we are witnessing is "normalization"; i.e., letting the free market reign.

Normalization of Markets Is Painful but Necessary

Normalization has been an important yet poorly appreciated dynamic of late. In ending its quantitative easing program and preparing to raise the federal funds rate, the Federal Reserve is in the process of normalizing policy and thus return markets to a state in which supply and demand determines prices free of the central bank's protective net. While it's hard for investors experiencing negative returns to see how this is a good thing, normalization ultimately lowers tail risk — black swans, like the extreme events of 2008 that almost destroyed the global financial system. So the Fed, in its desire to prevent another such meltdown down the road, may be willing to abide a market correction in the near term.

Although in practice no economy is truly as "free" as Smith envisioned, we'll take U.S.-style capitalism over the state capitalism practiced by the likes of China any day of the week. And while normalization in China has made for ugly headlines, it can also be seen in other corners of the economic world, for bad and for good.

Take crude oil, the price dynamics of which have been untethered from supply and demand since OPEC began to make its influence felt during the early 1970s. With the shale-oil revolution in the U.S. stripping the oil-producing cartel of its control over global supply, crude oil has sunk to $40/barrel, its 30-year average, and is unlikely to see triple digits anytime soon. While this example of normalization is terrible for oil producers and exporters — especially OPEC, which is quickly turning into a quaint historical artifact — its benefit to consumers worldwide is still being priced by the market.

Currencies, including the U.S. dollar, were artificially suppressed by unconventional Fed monetary stimulus for years before the slow unwinding of said stimulus sent the greenback jumping. That strengthening may seems like a positive until you look at the currency carnage it created worldwide, underscored by the yuan's plummet when it adjusted its dollar peg.

The U.S. economy's march toward normalization has been the bright spot around the world. The U.S. consumer has been the game-changer here. Retail sales in July hit an all-time high of $446 billion led by record-level auto sales, especially in the light trucks and SUVs that are benefitting from low oil prices. Housing continues to plow forward; the latest year-over-year price increases of 4.6% easily outpaced inflation, while existing-home sales surged 17% and housing starts posted the biggest increase in eight years. Meanwhile, it's estimated that every home built in the U.S. creates four jobs, which can be seen in the booming market for construction employment. In fact, the jobs market as a whole is at its healthiest in 15 years, consistently adding more than 200,000 jobs a month to the economy with all sectors except energy expanding.

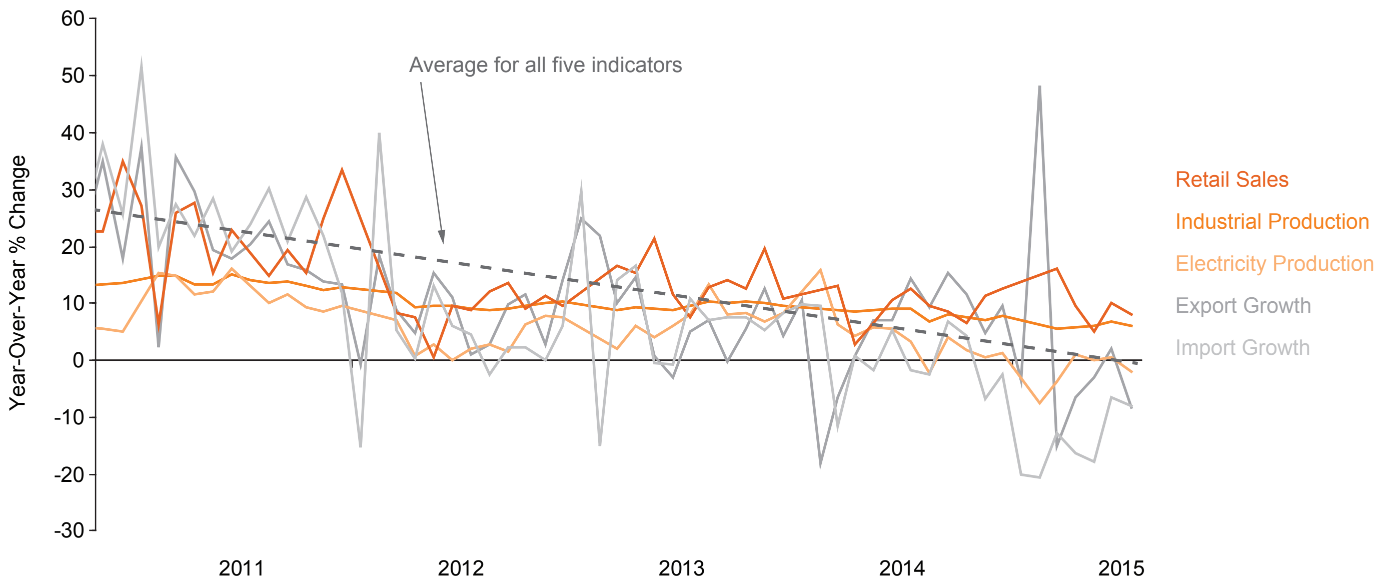
While the revision of second quarter GDP growth to 3.7%, from the previous 2.3%, verifies the strengthening domestic economy, markets are ultimately driven by corporate earnings. With nearly all the S&P 500 having reported second quarter results, year-over-year earnings growth is -.6%. (Notably, the consumer discretionary sector bucked the broader trend, posting earnings growth of more than 9% for the quarter.) While the 55% drop in energy sector earnings was the primary culprit for the quarter's results, companies across the board were facing headwinds, with currency, Europe, China, Energy and oil being the top five terms cited during earnings calls in order of frequency. In addition, revenue growth for the quarter struggled year over year.

Investors' search for growth in the relatively barren environment can be seen in the wide divergence in performance between growth and value stocks; for example, the Russell 1000 Growth Index has returned more than 700 basis points than the Russell 1000 Value Index year-to-date through August. It's also worth noting that large-cap growth stocks tend to outperform value-oriented ones in a rising-rate environment, as rising interest rates are typically indicative of a stronger economy that favors growth names.

Conclusion

Without strong earnings growth and the artifice of fed stimulus, markets currently are behaving as normal markets do — free markets are decisive, quick and relentless in their desire to correct mispriced assets. Such movements are normal and expected, and in reducing

Official GDP Statistics in China May Not Tell Full Story of Slowdown



Source: FactSet
Data as of 07/31/2015.

tail risk are ultimately good for the market. Market corrections (declines of 10–20%) usually occur once a year, while bear markets (declines in excess of 20%) normally come calling once every 3.5 years. The good news, however, is that while bear markets last for only around 10 months, bull markets can run for five years on average.

Fed rhetoric suggests that it intends to take a measured approach to the coming tightening cycle, but the central bank will act as it sees fit. And if you think the Fed can manage the reaction of markets, you may want to consult with Beijing. Given the uncertain road ahead, investors' best defense is to ensure their portfolios are effectively and prudently diversified, with a realistic three- to five-year window. Our advice: Stick to the plan made in calmer times, as it is your best defense from irrational — and often self-defeating — actions.

Investors Have Been Willing to Pay a Premium for Scarce Growth

Index	Aug-15	YTD	2014	2013	2012	2011	2010	2009	1 year	3 years	5 years	10 years
Broad Market												
Dow Industrial	-6.4	-5.7	10.0	29.6	10.2	8.3	14.0	22.6	-1.0	10.7	13.3	7.4
S&P 500	-6.0	-2.9	13.7	32.4	16.0	2.1	15.1	26.5	0.5	14.3	15.9	7.2
S&P 100 (OEX)	-6.5	-2.9	12.7	30.4	16.1	3.2	12.5	22.3	-0.1	12.9	15.4	6.9
Nasdaq Composite	-6.7	1.7	14.8	40.2	17.7	-0.8	18.0	45.3	5.6	17.5	19.2	9.5
Large-Cap												
Russell 1000	-6.0	-2.6	13.2	33.1	16.4	1.5	16.1	28.4	0.4	14.7	16.1	7.4
Russell 1000 Value	-6.0	-6.1	13.5	32.5	17.5	0.4	15.5	19.7	-3.5	13.9	14.7	6.2
Russell 1000 Growth	-6.1	1.0	13.0	33.5	15.3	2.6	16.7	37.2	4.3	15.3	17.4	8.4
Mid-Cap												
Russell Mid-Cap	-5.3	-2.3	13.2	34.8	17.3	-1.5	25.5	40.5	0.0	16.1	16.6	8.4
Russell Mid-Cap Value	-4.7	-4.5	14.7	33.5	18.5	-1.4	24.8	34.2	-2.5	15.8	16.0	7.9
Russell Mid-Cap Growth	-5.8	-0.3	11.9	35.7	15.8	-1.7	26.4	46.3	2.5	16.2	17.1	8.7
Small-Cap												
Russell 2000	-6.3	-3.0	4.9	38.8	16.3	-4.2	26.9	27.2	0.0	14.1	15.5	7.1
Russell 2000 Value	-4.9	-6.8	4.2	34.5	18.1	-5.5	24.5	20.6	-5.0	11.8	13.2	5.7
Russell 2000 Growth	-7.6	0.9	5.6	43.3	14.6	-2.9	29.1	34.5	5.1	16.5	17.8	8.5

Source: Dow Jones, Standard & Poor's, NASDAQ, Russell Investments, FactSet

Note: All returns are total returns including dividends expressed as percentages. Returns for 3-, 5-, and 10-year periods are annualized. **Past performance is no guarantee of future results.**

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