INVESTMENT TALKS

Get Used to Volatility

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Giordano Lombardo
Group CIO

Edited by **Claudia Bertino**
Head of Financial Communication

Giordano Lombardo, Pioneer Investments Group CIO, comments on recent market turmoil and gives his view on the economic backdrop and financial markets:

- *The recent equity market correction has been driven by a combination of macroeconomic and technical factors, mostly related to China*
- *These contingent elements are just a reflection of a deeper malaise of policy-dependent financial markets, with the risk of policy mistakes increasing on multiple fronts*
- *On one hand, market volatility is here to stay testing investors' nerves for most of 2016. On the other hand, volatility can offer interesting opportunities for active managers, to play market dislocations and asynchronies in policy actions*
- *A long term and cautious approach is needed, as well as the adoption of investment techniques that can help mitigate volatility and protect from "tail risk" in the next few months.*

Market volatility is here to stay testing investors nerves for most of 2016.

What are the reasons that are driving the equity market correction in early 2016?
The ongoing market correction is, in my view, a combination of different factors; macroeconomic and technical. As already happened last summer, financial markets have become more skeptical of the capability of China to manage the economic transition and avoid a sharp slowdown at the same time. The fact that the country has to dramatically reduce its overcapacity in some sectors (typically, the industrial sectors) is good news for the long term outlook for the country in terms of sustainability of growth, but it is bad news for the Emerging Markets, highly dependent on Chinese demand for commodities.
Specifically, the markets have been disappointed by recent economic data, with the Markit Purchasing Manager Index dropping to 48.2 in December from 48.6 in November, remaining firmly below 50, the threshold that indicates a contraction of economic activity. The larger-than-expected depreciation of Renminbi reference rate added to the fears of greater currency devaluation to come. Moreover, other technical factors have triggered a big sell-off in the Chinese equity market that has generated volatility on risky assets across the board. The scarce market liquidity has amplified the movement.

The contingent elements of the recent market sell-off are just a reflection of a deeper malaise of policy-dependent financial markets, with the risk of policy mistakes increasing on multiple fronts.

Do you think that this volatility will continue in the coming weeks?
I think so. Financial markets have progressively become more vulnerable, and we already saw signs of this fragility in 2015. Last year, the performance of most equity indices was modest (S&P500 +1,4%, MSCI World unchanged)[1] or negative (MSCI EM -15%), with a few exceptions on European and Japanese markets which posted decent returns. At the same time, the volatility has remained sustained since the summer. Yields on core government bonds are still very low, and manipulated by the actions of Central Banks, while the weak commodity cycle is weighing on some EM and credit segment (i.e. energy). If we look at the long term expected returns, they seem extremely low across all asset classes, and investors should be prepared to run a higher risk with the perspective of a lower return than in the past.

[1] Source: Bloomberg, December 31, 2014 –December 31, 2015, index with reinvested dividends.

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On the positive side, in our view, the economic outlook for the most of the developed countries is more resilient than in the past.

What is, in your view, the main reason for caution going forward?
Almost everywhere, the economic outlook is largely dependent on policy actions and exposed to the risk of policy mistakes. Central Banks have played a key role in fueling the risk asset bull market. They will continue to be key players in 2016, but the room for additional intervention is smaller almost everywhere than it was in 2015, and they are running out of 'weapons'.
China, and many other Emerging Markets, are undergoing a deep transformation. The implementation of reforms will require a long time and could be painful in the short term. And even where the political will is strong, such as in China, current events are showing us how difficult it is to influence financial market sentiment through rules and regulation. On the contrary, the reputational risks of changing rules during a period of market stress can be high and detrimental to confidence. Furthermore, the present situation where commodity prices are low while the US dollar is strengthening remains a very dangerous situation for a lot of EM economies.
Geopolitical risks are high everywhere. Due to these multiple sources of uncertainty, we see an increased probability of a "tail event" mainly driven by policy mistakes.

Do you see any reasons for optimism in the next few months?
If we look at the overall economic outlook, we see some positive developments in most of the developed countries. In the US, the recovery is well on track and in the Eurozone, the structural reforms implemented in the last years should make the economy less vulnerable to external shocks. The fiscal policy is less restrictive almost everywhere and should provide some oxygen to the economy.
The monetary policy, as I said before, is still accommodative, even though there is a smaller margin for action than in the past.
These elements should support some resilience of the economy even if there is volatility generated by Emerging Markets and China.

What are the investment implications of the above scenario?
As already mentioned in our **2016 Investment Outlook**, this year, it will be crucial to manage market turmoil carefully, with the adoption of investment techniques that help mitigate volatility and protect from "tail risk". This volatile market environment can be a fertile ground for active managers that can play dislocation between market/sectors/securities or asynchronies between Central Banks policies. In our view, a selection of high conviction ideas at macro and micro levels, flexible and unconstrained approaches, and investment techniques that aim to preserve capital will be key for generating value for clients in 2016.

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