Market Reset, Not Recession

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The global market selloff of these past days has tested the mettle of many investors—particularly as the turmoil has followed an unusual period earlier this year, where equities delivered healthy advances with very little volatility. While we've gone on record saying that we expected volatility to persist (including in our most recent Outlook), we have been surprised by how severe the downturn has been. However, experience teaches that there can be many opportunities in volatile markets.

The Calamos Investment Committee has been closely following the recent market turmoil and the factors driving it. Below, I've summarized some of our key thoughts.

In our view:

» Neither the U.S. or global economy is headed for recession; instead, we are seeing a market reset that is not entirely unexpected.

» Markets are likely to be extremely choppy over these next months, and we may see additional corrections.

» Over the near term, energy and commodity prices will remain volatile, with global interest rates and currency turmoil adding to the headwinds.

» Market dislocations are providing us with select opportunities to establish and build positions in fundamentally strong companies, worldwide—including in emerging markets.

» In an environment of uncertainty, stocks of companies with higher quality fundamentals are likely to perform better than lower-quality companies.

» Within fixed income markets, widening spreads create increased opportunities within high yield.

China and the Emerging Markets. Many have pointed to recent PMI data as an especially ominous harbinger. China's economic growth is decelerating, but the consensus of our Investment Committee is that China is not headed for recession. In our view, much of the negative sentiment surrounding China is the result of failed expectations and slowing demand for Chinese exports, not negative growth. The risks in Chinese equities will increase if the markets stop believing that quantitative easing will work, but we do not believe we are at that point. Manufacturing data may continue to be weak in these next months, with more than 10,000 manufacturing companies temporarily shuttered to provide blue skies for the country's military parade to mark the 70th anniversary of the end of World War II in Asia.

As Senior Co-Portfolio Manager Nick Niziolek has noted in his recent blogs, the Chinese government has many levers at its disposal to stabilize its economy and markets. We have seen monetary easing, an acceleration of government stimulus, and an ongoing shift from state- owned-enterprises to private-sector development. These long-term stimulative efforts will take time to work their way through the economy. Importantly, many of China's efforts to increase liquidity in 2015 have been focused on supporting equity markets.

In regard to positioning, our strategies that can invest in China are currently underweight versus their benchmarks. However, we maintain conviction in a select group of Chinese companies, where valuations remain attractive relative to growth potential. Where appropriate, we continue to seek out opportunities to participate in China's growth potential through convertible securities, which may offer enhanced downside protection through fixed-income attributes (for more on this, see "Investing in China's Expanding Universe of Opportunity While Maintaining a Risk-Managed Approach.")

Anxiety about China has led to an emerging market selloff that we would characterize as indiscriminate. We believe that the recovery will be more discriminant, favoring countries with better balance sheet fundamentals, commodity consumers over commodity producers, and those tied to secular trends, such as those tied to the emerging market consumer.

Developed Markets. Our Investment Committee believes the U.S. economy remains in the mid-cycle phase. In this slow-growth phase, market volatility is not unexpected. We expect volatility to be especially pronounced in the energy sector, which is in the midst of an earnings recession. However, the negative headwind of the energy sector does not overshadow the positives we see. We are encouraged by dynamics in the housing market, as well as employment gains. These should contribute to a wealth effect that we believe will be amplified as lower energy prices contribute to increased consumer spending.

The Federal Reserve has not acted rashly so far, and we expect it to maintain its data-driven and thoughtful course. For two years, the Fed has prepared the markets for a rise in interest rates, and a market correction on its own shouldn’t change its course. And as we have noted in the past, a more normal interest rate environment provides incentives for banks to issue more loans (especially to small businesses), which would stimulate economic growth and increase job and wealth creation. While we expect monetary policy to remain supportive overall, fiscal policy (or lack thereof) is likely to create headwinds to more robust economic expansion in the run up to the 2016 presidential election.

In this environment, we continue to identify a range of opportunities in the U.S. equity market. Overall, we’d describe our positioning in the U.S. market as cautious, but not defensive. Valuations remain attractive, particularly among growth-oriented companies. In a low growth environment, companies with strong balance sheets that generate above-average organic growth have typically been rewarded by investors.

Our Investment Committee is becoming increasingly constructive on high yield debt as credit spreads have widened significantly. When the Fed does eventually raise rates, we expect a slow and shallow path, which we expect would further the appeal of the asset class. Moreover, our credit analysis suggests default rates (away from energy) will remain well below long-term averages, even as spreads reflect higher expected defaults.

Elsewhere in the developed markets, we continue to find opportunities in Japan and Europe. Within Japan, we are favoring companies demonstrating improved capital allocation and corporate governance, along with beneficiaries of quantitative easing (QE) and exporters. Within Europe, we are also focused on QE beneficiaries and exporters, as well as domestic consumption exposure. Additionally, in both Europe and Japan, we are maintaining an emphasis on companies positioned to capitalize on secular growth themes, an approach which we believe can provide resilience during volatile periods.

Conclusion

Volatility increases the temptation to time the market, but those who let short-term uncertainties drive their decision making usually end up whipsawed—capturing the downside but missing the upside.

The Calamos Investment Committee continues to believe that the upside in the global financial markets remains abundant for those who understand the risks and take a long-term approach. We are confident that our portfolio management teams have positioned their portfolios appropriately in this fast-moving environment. It has long been our view that volatility creates opportunity, and we believe that this period is no different.

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Quantitative easing refers to central bank bond buying activities. PMI is a measure of manufacturing activity.

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