The New Challenges of Price Discovery
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by Frank Holmes
of U.S. Global Investors

As investment managers, one of our most important fiduciary responsibilities is buying and selling stocks for the best possible price and execution. We do this by using the statistical strategies I’ve previously covered, from monitoring short- and long-term cycles; implementing probability models such as standard deviation, mean reversion and oscillators; and identifying the relative valuation of stock with the portfolio manager’s cube.

If only it were that simple.

In the past few years, price discovery—or the act of finding the “right” price for a security—has become much more challenging because of falling stock volume and widening bid-ask spreads. These challenges are directly attributable to the infiltration of high-frequency traders into the market, not to mention the expansion of dark pools and non-exchange trading.

Simply put, when stock volume is high and transactions increase, the bid-ask spread narrows. Brokers and dealers accordingly price shares to move, and investors have a pretty good estimation of what they’re going to spend on a security.

But when there are fewer transactions and volume is down, the bid-ask spread widens. Price discovery, then, becomes difficult because stock valuation has a broader range in which to move. I discussed this last week using the intraday performances of the TSX Venture Exchange and Market Vectors Junior Gold Miners ETF (GDXJ) as examples: in the afternoon, after volume and activity tend to decrease, spreads widen.

Think of this in terms of real estate. If volume is up and homes are selling rapidly in Neighborhood A, both buyers and sellers have a good idea of what a fair price is, based on the dollar amount of square footage of nearby homes sold within a certain timeframe. Price discovery, therefore, is reasonable.

But if homes in Neighborhood B languish on the market for lengthy periods of time, relative price comparisons begins to dissolve. Who knows what the homes should go for? Closing deals becomes tough because, in such a scenario, a buyer’s bid might come in way under what the seller is willing to accept. As a result, the price of homes, even those in adjacent lots, can fluctuate wildly.

Volume Drops, Volatility Rises—But Opportunity Remains
To see these concepts in action, look at the chart below. The S&P/TSX Venture Composite Index, which lists about 500 Canadian micro-cap venture companies, has seen a drop in volume of more than 60 percent since mid-2011. This has widened the bid-ask spreads of individual equities in the index—not the index itself—complicating price discovery.

Despite the challenge, we try to take advantage of the volatility that other investors might flee from. Decisions to buy or sell a company are first fundamentally driven, and then trading is based on statistical analysis of fund flows, volatility over different time periods and relative performance to the gold indices we strive to beat. For the Gold and Precious Metals Fund (USERX), it’s the FTSE Gold Mines Index; for the World Precious Minerals Fund (UNWPX), the NYSE Arca Gold Miners Index.

Our style resembles that of the Navy SEALS, in that we prefer to be nimble, surgical and tactical. During the bear market that ran from mid-2011 until February 2014, we nibbled rather than munched on inexpensive companies that were lagging in relative performance over one day, one month and one quarter. And when these companies showed a surge in price and volume, we often trimmed our holdings rather than sold outright. This incremental “nibbling” strategy is a little like investment reconnaissance, enabling us to test our conviction in a company before taking a weightier position.

Another disruptive factor to price discovery has been the proliferation of exchange-traded funds (ETFs). Accounting for more than 30 percent of trading volume in the markets, some ETFs are influencing the markets they track and impacting their underlying holdings. A study by Goldman Sachs confirmed that ETF trades influence stock prices. The study looked at which individual stocks move...
more with the dynamics of the ETF than on their own fundamentals and found that those stocks most affected by ETF activity are in the Russell 2000, probably because of their lower levels of liquidity, lower volume and cheap prices.

We’ve witnessed this same phenomenon with some junior gold stocks in the GDXJ. A gold stock can have a significant price move based not on changes to its fundamentals or a corporate event but rather shifts in sentiment toward gold that is compounded by fund flows. The inclusion or exclusion of a stock in the underlying index can result in a flurry of disruptive trading unrelated to changes in the company’s fundamentals.

Just as one man’s trash is another man’s treasure, one man’s fear of volatility is another man’s opportunity. Part of successful active management is not getting discouraged, learning to adapt to a changing climate and coming to terms with the market’s often erratic behavior.

But the erratic behavior has only ramped up in recent years.

**HFT: Trading at the Speed of Greed**

As I said earlier, price discovery has become much more difficult in recent years because of growing high-frequency trading (HFT), dark pools and non-exchange trading—all of which have changed, perhaps irreversibly so, the formation of capital in the investment industry.

HFT is a controversial practice whereby automated computers using sophisticated algorithms transact orders at lightning-fast speeds. In a process called latency arbitrage, high-speed traders are able to gain access to crucial order information and other market data milliseconds before “normal” or “slow” traders. They manage to do this through a number of means, including placing their computers as close as possible to stock exchanges and using best-of-the-best fiber optic cables.

After acquiring the information, such traders can get in front of other buyers’ purchases and, almost instantaneously, turn around and scalp the shares within less than a blink of an eye. Often gains are less than a penny per share, but because they trade so frequently and rapidly, it’s easy to make fast money.

This new form of legalized front-running became the talk of Wall Street after the March 2014 publication of financial writer Michael Lewis’s critical book on the matter, *Flash Boys: A Wall Street Revolt*. In one passage, Lewis deftly recounts the infamous Flash Crash that occurred at 2:34 on May 6, 2010:
For no obvious reason, the market fell six hundred points in a few minutes. A few minutes later, like a drunk trying to pretend he hadn’t just knocked over the fishbowl and killed the pet goldfish, it bounced right back up to where it was before. If you weren’t watching closely you could have missed the entire event… Shares of Procter & Gamble, for instance, traded as low as a penny and as high as $100,000. Twenty thousand different trades happened at stock prices more than 60 percent removed from the prices of those stocks just moments before.

A spread of $99,999.99. If that doesn’t give a trader pause, I’m not sure what will.

The chart below shows just how dramatically HFT has heightened intraday volatility in the SPDR S&P 500 ETF, arguably the most popular of its kind in the U.S. Up until 2007, daily price changes had a relatively steady heartbeat. But in 2007, when HFT as we know it today emerged, the average intraday volatility more than doubled. In August 2011, the peak volatility climbed to one that was 10 times higher than in 2006.

“All of a sudden the market is all about algos and routers. It’s hard to figure this stuff out.”
—Michael Lewis, from his book Flash Boys

Image source: Tabitha Soren
Lewis’s book has created a much-needed awareness of what HFT has brought to the market: disruption, unsettlement and a loss of trust and transparency. Like thieves in the night, high-speed traders can swoop in to a market that you created and take advantage of it.

Michael Matousek, head trader at U.S. Global Investors, has experienced this unpredictability firsthand. On numerous occasions he has put in a buy order, based on up-to-the-second liquidity information, but received only a fractional amount.

As for liquidity, Michael says that HFT might increase it, “but when an order is ‘sniffed,’ [high-frequency traders] cancel. So the perceived liquidity is gone within fractions of a second.”
Not only does the liquidity disappear, but because transactions often come with a flat fee, costs increase when orders are only partially filled.

Fellow U.S. Global trader Mike Ellingsen notes how HFT has also affected depth of market, or the measure of the liquidity of open and, I should add, transparent buy and sell orders.

True depth in the equities market has become hard to gauge," he says. “Trust is key in this entire conversation.”

This trust, however, has been tarnished in a system dominated by HFT, which currently accounts for more than 70 percent of all market activity in the U.S., according to research conducted by European Central Bank economist Peter Hoffmann.

Trading in the Dark

So what do you do if you’re a large institutional trader who has a million shares to move but doesn’t want to be preyed upon by high-speed front-runners? The solution for many is to use not a conventional exchange, where market information is publically shared, but a private exchange. In such exchanges, known as “dark pools,” transactions are conducted secretly and anonymously. There is no trading floor, no orders visible to the public and no transparency.

Dark pools aren’t anything new; they’ve been around since at least the 1980s, mostly to reduce market impact and lower transaction costs. But an increasing number of large investors are using these exclusive pipelines to (allegedly) hide and protect their transactions from high-speed traders. In recent years, non-exchange trading has surged, accounting for close to half of all stock trades today.

The problem, as you might guess, is that stock volume in the U.S. is being usurped from the trading floors and drying up faster than the Aral Sea. Again, when volume drops, bid-ask spreads widen, which complicates price discovery.

According to TabbFORUM, whose Equities LiquidityMatrix™ consolidates monthly exchange data, industry volume dropped 1 percent in July. That doesn’t sound like much, but when you’re dealing with more than 5 billion shares in the U.S. market alone, a decrease of 1 percent is huge. And every month seems to tell the same story.

In the last decade and a half, the greatest loss of volume occurred in 2012. The S&P lost 27 percent; the Dow Jones Industrial Average, 28 percent; the NASDAQ, 20 percent; and the Russell 2000, 22
percent. Since 2000, 70 percent of NASDAQ volume has disappeared.

The Case of the Disappearing Stock Volume
As more large investors turn to dark pools, stock volume in the U.S. drops

Two years ago, a headline for a Bloomberg BusinessWeek article asked: “Where Has All the Stock Trading Gone?”

The answer: dark pools.

Fair Games Call for Fair Rules and Referees

Back in April, no doubt as a result of the national debate Lewis’s book sparked, U.S. Attorney General Eric Holder announced that the Justice Department is looking into the legality of HFT. His department is joined by the Federal Bureau of Investigation (FBI), the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC).

We welcome the regulators exploring ways to better manage these issues for a more level playing field and more transparent trading arena.

But it’s not just the high-speed traders themselves that need refereeing. The “real black hats,” as New York Times financial columnist Andrew Ross Sorkin points out, are the big stock exchanges.

“These exchanges don’t just passively allow certain investors to connect to their systems,” he writes. “They have created systems and pricing tiers specifically for high-speed trading. They are charging higher rates for faster speeds and more data for select clients. The more you pay, the faster you trade.”
The U.S. has a lot of catching up to do to level the playing field and soften the deleterious effects of predatory trading. Some of the SEC’s proposals—registration of all high-frequency traders, an increase in market transparency, among others—are still months and perhaps even years away.

Canada, on the other hand, already has many such regulations in place. Germany’s High Frequency Trading Act, which became effective in May 2013, mandates that all high-frequency traders apply for a Federal Financial Supervisory Authority license and imposes fees on traders who make “excessive use” of HFT. In Italy, a 0.02 percent tax is levied against all HFT transactions.

However you feel about HFT, you cannot deny that it has greatly affected the investment industry and changed how easily price discovery is conducted and capital is formed. Despite the added challenge, our investment team at U.S. Global Investors continues to believe in and use the time-honored strategies that have served us well in the past.

**Be Nimble, Yet Nibble**

So what do we do as active managers? We use statistical models to try and sniff out both value at a reasonable price and accumulate at attractive relative prices, even when there are so many new factors to consider. We remain confident as we adapt to changes in the landscape, taking a nimble approach while nibbling on opportunities we find.

Curious investors who have read our previous writings on these themes recognize that we navigate all of the complexity and intensity of constantly changing landscapes by using patterns in trading, whether standard deviation moves, daily patterns, or broader, seasonal patterns.

In case you missed any of them, you can read them here:

- The Importance of Cycles in the Investment Management Process
- The Importance of Oscillators, Standard Deviation and Mean Reversion
- Picking Mining Stocks in a Bear Market
- Anticipate Before You Participate: Patterns in Trading

As active managers we are confident in our use of these analytical tools, enthusiastic in our approach, and optimistic about the future. Happy Investing!

**Index Summary**

- Major market indices finished higher this week. The Dow Jones Industrial Average rose 0.23
percent. The S&P 500 Stock Index gained 0.22 percent, while the Nasdaq Composite advanced 0.06 percent. The Russell 2000 small capitalization index fell 0.36 percent this week.

- The Hang Seng Composite rose 2.13 percent; Taiwan fell 0.30 percent and the KOSPI declined 0.92 percent.
- The 10-year Treasury bond yield rose 11 basis points to 2.46 percent.

**Domestic Equity Market**

The S&P 500 Index rose to new highs again this week after rallying on Friday and being down slightly the first few days of the week. Sectors that have been out of favor in recent months led the way, with consumer staples, utilities and consumer discretionary areas outperforming. Energy was the negative outlier this week with lower oil prices, stabilizing geopolitical situations and cooler weather pushing share prices lower.

![S&P 500 Economic Sectors](image)

**Strengths**

- The consumer staples sector outperformed this week. Drug stores Walgreens and CVS had strong performances this week even as Walgreens reported disappointing same-store sales results for August. The hypermarket names also had a good week with Costco reporting strong same-store sales data.
- The consumer discretionary sector wasn’t far behind as Staples and PVH Corp were the two best-performing names in the S&P 500 this week, both rising about 10 percent. Staples rose on
speculation that it could merge with Office Depot, while PVH Corp reported earnings that were well received by the market.

- Other areas showing strong performance include footwear, aluminum and computer & electronics.

**Weaknesses**

- The energy sector was hit hard this week in a broad-based selloff. Exploration & production along with energy service names were the hardest hit, with many stocks falling by more than 4 percent. The refiners were the only bright spot in the sector this week.
- The technology sector was also a laggard this week led by Apple, which fell by more than 3 percent.
- Nabors Industries was the worst performer in the S&P 500, falling by 6.98 percent. Nabors is primarily a land driller, and while there was little news directly attributable to the company, it was part of the broad-based energy sell off.

**Opportunities**

- The European Central Bank (ECB) cut interest rates in a surprise move this week and committed to an upcoming quantitative easing (QE) program this fall. This is good for risky assets in general, and more specifically global equities.
- The U.S. economy is currently a bright spot in the developed world, holding the opportunity to funnel money back into the U.S. equity market.
- The path of least resistance for the market appears higher as this “classic” bull market phase (of grinding higher with lower volatility) remains intact, for now at least.

**Threats**

- Volatility has been low and this bull market has been an unusually smooth ride. The calmness won’t last forever though, since late-summer early-fall has traditionally been more volatile.
- The market may begin to worry about a policy mistake from the Federal Reserve, either raising interest rates too soon or not fast enough. Either scenario could negatively impact the market.
- Geopolitical tensions remain high, and while the market has been able to shrug off these events so far, an escalation could be the catalyst for a long-awaited correction.

**The Economy and Bond Market**

Treasury yields rose this week on good U.S. economic data, even though the ECB surprised the market with an interest rate cut. The 10-year Treasury rose by 11 basis points this week as key economic indicators such the ISM Manufacturing Index rose to the highest level in more than three years. The absolute level is very high, indicating robust manufacturing activity and boosting confidence
in the strength of the overall economy. This was tempered somewhat by a weaker-than-expected jobs report on Friday, but the overall sentiment remains positive on U.S. economic growth prospects.

**Strengths**

- The ECB cut interest rates this week and committed to a QE plan of its own in the next few months. Deflation risks remain in Europe and we are now in the midst of another global easing cycle.
- The ISM Manufacturing Index rose to the highest level in more than three years, reinforcing the idea that the economy is finally starting to hit its stride and move into a truly self-sustaining dynamic.
- Factory orders rose 10.5 percent in July, related to Boeing aircraft orders as mentioned last week.

**Weaknesses**

- U.S. bond yields rose this week even as the ECB cut interest rates. The U.S. and the rest of the developed world are on diverging paths, with the U.S. exhibiting considerable economic momentum while many other areas of the world are stalling.
- Nonfarm payrolls grew to 142,000 jobs in August, which was the slowest growth since December. This number may be an aberration, but with most economic indicators looking strong, it is a surprising negative outlier.
- Luxury homebuilder Toll Brothers reported disappointing results. This is one more indication that the housing market remains weaker than expected and is unlikely to be a positive catalyst in the near-term.
Opportunities

- Bond yields in Europe remain exceptionally low, with German two-year bond yields at negative 7 basis points. Even Ireland’s two-year bond went into negative territory this week. U.S. fixed-income yields look attractive and could bring in money flows from overseas.
- The ECB’s rate cut and pledge to implement a QE program this week, highlights the deflationary pressure around the world. The decisions also highlight the fact that materially higher interest rates seem unlikely in the near future.
- With key global central banks back into easy policy mode and inflation trending lower in many parts of the world, the path of least resistance for bond yields likely remains down.

Threats

- The U.S. economy has some positive momentum and appears poised to continue to build on that as we move into the fall. Recent indications from some Fed officials point to the potential for higher interest rates sooner than many were expecting.
- U.S. retail sales will be reported next week and with consumer confidence at the highest level in years, a better-than-expected report could pressure bond prices.
- Several Fed speakers have become more vocal in recent weeks indicating a potential shift in Fed thinking toward normalizing interest rates.

Gold Market

For the week, spot gold closed at $1,268.92, down $18.89 per ounce, or -1.47 percent. Gold stocks, as measured by the NYSE Arca Gold Miners Index, fell 6.48 percent. The U.S. Trade-Weighted Dollar Index rose 1.22 percent for the week.
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**Strengths**

- According to the HSBC, central banks around the globe are expected to buy 425 tons of gold next year. The bank estimates buying this year to be at 400 tons, showing a steady increase in central bank purchases through 2015.

- Gold imports into India are estimated to rise to between 60 and 70 tons per month, up from 38 tons in July. The significant rise in gold imports comes on the back of the start of festival season in India. The uptick in demand should be very strong for gold for the rest of the year.

- The disappointing nonfarm payroll numbers that were released on Friday offer more support to the notion that the Federal Reserve will not be raising rates any time soon. The continuation of low interest rates will mean a continuing tailwind for gold.

**Weaknesses**

- Unfortunately, the new Modi government in India is not expected to relax the country's gold import restrictions. The import duties are set to remain for some time unless the government can induce other exports to alleviate a growing trade deficit. A consequence of the restrictions has been an increase in gold smuggling into India as festival season ramps up.

- Demand for gold in the U.S. continues to weaken as reports indicate that year-to-date sales of the U.S. Mint American Eagle Gold bullion coins declined almost 54 percent. One bright spot in the data, however, is that August 2014 sales more than doubled from a year ago.

- The dollar is breaking out after the European Central Bank (ECB) cut rates and announced plans to enact a form of quantitative easing (QE). Traditionally, gold holds an inverse relationship to the
dollar. As the dollar rises, more people are determined to hold their wealth in dollar-denominated assets, suppressing the demand for gold as a wealth preserving asset. The Dollar Index Spot rallied 1.15 percent on Thursday, adding to a monthly increase of roughly 1.6 percent.

Opportunities

- The recent atypical decline in gold has led gold traders to be the most bullish in four weeks. Lower prices are predicted to spur more purchases, while geopolitical unrest still creates significant demand for gold.
- On Tuesday, Australia’s upper house Senate voted to do away with its mining tax. The removal of the tax on mining profits is a win for mining companies operating in the country.
- Comstock Mining Inc. has received unanimous approval from the Storey County Board of Commissioners of its mining permit application. Comstock had applied to expand production through its Lucerne Resource Area, which contains the company’s largest gold and silver resources, and its American Flat processing area. Comstock has invested a significant amount of resources in developing and expanding these areas, making this a huge win for the company.

Threats

- Gold output in certain countries is on the rise, which raises supply concerns for the precious metal. Australian gold production was up 9 percent in 2013-2014 from the previous year. Between January and July, Russia’s gold output was up 23.7 percent, totaling 149.95 tons. The increasing supply could pose a threat to gold prices in the future. However, central banks continue to be new accumulators of bullion.
- Although more of a security concern, it is worth noting that intelligence agencies have recently issued a warning that the missing Libyan jets could be used in attacks. Last month, Islamist militants seized nearly a dozen commercial jetliners, leaving many to ponder and worry over the purpose of their use.
- Gold-based financing has been on the rise in China, particularly in the banking sector. In gold leasing deals, the bank loans money to the customer against their gold deposits and then the bank enters into a forward contract to hedge the price risk of gold. With this surge in lending, it is unclear if the forward hedging is having any damping

Energy and Natural Resources Market
Strengths

- The S&P Supercomposite Steel Index made a new 52-week high during the week, driven by a decline in iron ore prices, lower imports and growing industrial activity. U.S. Steel Corp. posted a gain of 4 percent.
- Forest & paper stocks outperformed our commodity benchmark due in part to a stronger U.S. dollar. The S&P/TSX Forest Products Index gained approximately 1 percent this week despite generally weak trading for natural resource stocks.
- Rail and transport stocks were strong this week, with the S&P Supercomposite Railroads Index rising 1.5 percent. Union Pacific Corp. saw strong gains, returning 2 percent.

Weaknesses

- Oil service and equipment equities underperformed on softer oil prices and exposure to eroding offshore fundamentals in the floating rig market. Accordingly, offshore driller Noble Corp declined over the prior five days.
- Despite a weaker-than-expected jobs report, the price of gold bullion declined on the heels of further ECB rate cuts and concurrent U.S dollar strength. Small-cap precious metal producers Klondex Mines Ltd. and Mandalay Resources Corp fell by 2 and 3 percent, respectively.
- Given heightened geopolitical tensions and growth concerns in Europe, crude oil prices fell by 2 percent this week. Large-cap international producers, Occidental Petroleum and Anadarko Petroleum also declined.

Opportunities
• Positive reports emerged for BHP NewCo this week. According to Macquarie analysts, BHP NewCo's ebitda is expected to grow at around 9 percent in the first five years, while free cash flow is expected to rise to $1.35 billion from roughly $870 million.

• Non-residential construction is breaking out. Dodge commercial and manufacturing contracts have sharply increased since May. The increase in non-residential construction is positive as it pertains to much larger and intensive infrastructure projects.

• Nickel is on the rise as supply concerns mount. A proposed bill in the Philippines would require minerals to be processed before exported in order to boost domestic refining. Modeling Indonesia’s policies toward metals and minerals, the bill could serve to constrain China’s largest nickel supplier.

**Threats**

• One-month implied volatility, a gauge of future price swings for the pound against the dollar, rose by 19 percent on Monday. Increasing volatility in the pound corresponded with the release of a survey revealing rising support in Scotland for independence. The increased currency volatility in one of the world’s largest economies serves as a headwind for commodities.

• Chevron is said to be assessing the impact of Ebola on its Liberia unit. As fears surrounding the virus mount in Liberia, Chevron has decided to relocate some its staff to remote work sites where they can continue to support operations. Needless to say, any increase in the severity of the outbreak poses a threat to Chevron’s Liberia operations.

• The Korean government, displeased with America’s recent import duties on cheap tubular goods, has decided to legally review the actions. If the import duties are removed or weakened, it could serve to harm the competiveness of domestic steel producers in the United States.

**Emerging Markets**

**Strengths**

• Hong Kong resumed its leadership in Asia this week, as the HSBC China Services purchasing managers’ index (PMI) posted the largest monthly jump since October 2011. China relaxed debt financing rules for listed property developers in the A-share market to assist new housing project funding, working capital replenishment and bank loan repayment.

• Qatar rallied this week as concerns that the country may lose its ability to host the 2022 World Cup eased. The Qatar Exchange Index (DSM Index) sold off the prior week after the government imposed labor reforms to address growing criticisms from the international community. Nevertheless, the reforms appear to be a net positive with the DSM Index rising over 4 percent this week. Furthermore, markets responded positively to news that Qatar National Bank QSC will be expanding in Africa after acquiring a 12.5-percent stake in Ecobank Transnational Inc., the second-largest lender in Africa.
Further eurozone stimulus has become a reality. Earlier this week, the eurozone cut its three major interest rates, pushing the euro down to its lowest level since mid-2013. Draghi’s comments to enact an asset-backed purchasing program, similar to those in the U.S. and Japan, comes as a positive sign assuming it boosts demand in the struggling economy, which has been a drag on global markets.

Weaknesses

- South Korea was among the worst-performing countries in Asia this week, as August exports growth remained anemic for the country and bellwether Samsung Electronics Co Ltd traded at the lowest level versus Apple Inc. since 1993. The brokerage community continued to revise down earnings estimates for the company.

- Consumer services was among the worst-performing industries in Hong Kong this week, led by further declines in Macau casino operators as the city’s August gaming revenue dropped 6.1 percent year-over-year, worse than expected, representing a third-consecutive month of contraction.

- Despite the rally in Eastern Europe on news of a ceasefire in Ukraine, the situation is still very troubling. Russian-backed separatists in Ukraine, and indeed Russian forces themselves according to NATO, have caused substantial damage to Ukrainian forces. The ceasefire backed by Russia comes on the back of a weaker Ukraine, allowing Russia to temporarily avoid harsher sanctions while also keeping certain territorial gains.

Opportunities

- The upcoming launch of the Shanghai-Hong Kong Stock Connect program in mid-October aims to integrate Chinese and Hong Kong stock exchanges into a “one China” market with daily trading value as much as $35.7 billion, the third largest in the world. Global investor pre-allocation to China and Hong Kong may sustain in the near term in anticipation of significant portfolio flows after the official start, given improving sentiment towards China amid a favorable policy environment.
As we suspected last week, the further monetary easing in the eurozone is underway. As such, it is now more likely that increasing expectations of a weaker euro will serve to strengthen cheaper borrowing in the eurozone. This could boost investment in Asia as investors seek carry trade profits from higher yielding Asian assets.

Employment data in the U.S., which trailed estimates, served to boost emerging market currencies on Friday. The worse-than-expected data out of the United States offers another piece of evidence to the argument that the Fed will not raise rates sooner than expected, giving emerging markets a bit more breathing room before the eventual rate hike.

**Threats**

- Since the Second-Child policy was approved in China earlier this year, eligible couples have been slow to embrace looser restrictions based on provincial statistics. Growth prospect of China’s mass consumer sector, such as infant foods and diapers, has significantly diminished due to structural migration to e-commerce and rising competition to name brands.

- As shown in the chart below, the decline in the Russian ruble since the annexation of Crimea has been less severe than other Eastern European currencies. Although this has been positive so far for Russia, the policies used to prevent a massive depreciation in the Ruble have been three interest-rate increases. The higher borrowing costs for Russia, currently hovering at around 9.5 percent, are ultimately unsustainable and are already causing a deceleration in the economy. Therefore, if geopolitical tensions persist in Europe, Russia will find itself shoved even harder in-between the threat of a severely weak Ruble or a stagnating economy due to higher interest...
On the other side of the eurozone stimulus story, the falling euro has caused a significant boost in the dollar. Traditionally this has been negatively associated with emerging markets, as a rising dollar correlates with weaker commodities and slowing global growth. This poses a threat to many commodity-sensitive regions such as Latin America. Furthermore, it is a sign of shifting capital flows out of emerging markets and into the United States. Over the next few months it will be important to keep a close eye on the dollar and its relationship to emerging market performance.

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