AMP CAPITAL

Correction time?

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EDITION 15

Key points

> We have now entered a tougher time of the year for shares & the recent volatility could have further to go. Greece & the Fed are the key risks to keep an eye on.

> However, we remain of the view that we are still a long way from the peak in the investment cycle and that recent volatility represents just another correction.

Introduction

The last few weeks have seen the investment scene hit another rough patch: US shares have had a fall of less than 2%, but for Japanese shares it was 4%, Australian shares 6%, Eurozone shares 7% and Chinese shares 9%. This note takes a look at the key drivers, whether it's a correction or something more serious and some of the key threats and risks investors should keep an eye on.

Wobble drivers

Several factors have contributed to the recent wobble.

- First, deflation fears have abated, which is good but it's pushed up bond yields, after sharp falls earlier this year. This partly reflects the fall back in the $US as expectations for the first Fed interest rate hike have been pushed out – which has allowed commodity prices and notably oil prices to rebound as they move in the opposite direction to the $US as they are priced in US dollars. And so the acute oil-price-collapse-driven-fear of deflation seen earlier this year has receded allowing bond yields to move higher. This has been given a push in Europe by stronger growth and higher German bond yields have also removed a lid on US and Australian bond yields. Over the last few weeks 10 year bond yields have gone from lows of 0.07% in Germany to 0.55%, in the US from 1.86% to 2.14% and in Australia from 2.28% to 2.84%. The rise in bond yields has made shares, notably high yield shares like banks, look less attractive.
- Second, some share markets were due for a correction – notably Europe, Japan and China – after very strong gains so far this year and were thus vulnerable.
- Third, we've entered a seasonally tougher part of the year.
- Finally, apart from the global lead, Australian shares have also been hit by perceptions the RBA may have finished easing, fears about a stronger $A and talk (reality in NAB's case) of bank capital raisings.

Is it a correction or something worse?

Our view is that while shares have rallied a long way from their global financial crisis lows we are still a long way from the peak in the investment cycle. Put simply shares are not seeing the sort of conditions that normally precede a new cyclical bear market: shares are not unambiguously overvalued; they are not over loved by investors; uneven & below trend economic growth is extending the economic expansion cycle; and monetary conditions are likely to remain easy for a while yet. (See "Where are we in the investment cycle?" Oliver's Insights, April 2015.)

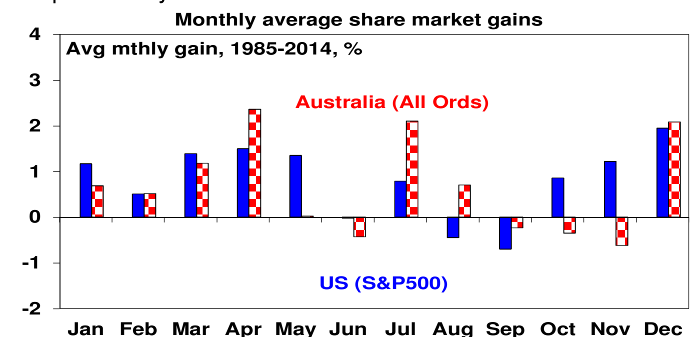
However, periodic corrections are healthy and normal. For example, Australian shares had a 9% pullback last September-October, an 11% pullback in mid 2013 (remember the taper tantrum?) and 10% decline in mid-2012 all against a rising trend – so what's new? In fact, viewed in this context recent volatility barely registers – see the next chart.

Source: Bloomberg, AMP Capital

While a benign April US jobs report – strong enough to support confidence in US growth, but not so strong as to invite fears of an earlier Fed tightening – has helped sooth nerves, it's too early to say whether the recent wobble has run its course.

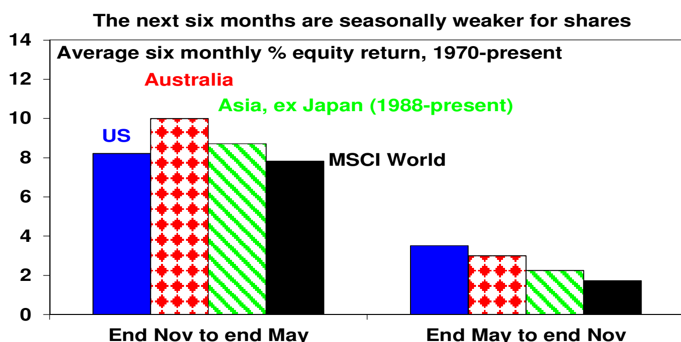
Seasonal patterns

As we come into May I get kind of nervous given the old saying "sell in May and go away, buy again on St Leger's Day." The seasonal pattern for shares typically sees rougher returns over the period May to November. See the next chart.



Source: Bloomberg, AMP Capital

As can be seen in the following chart, most of the returns from share markets occur in the November to May period. Note this chart shows total returns including dividends.



Source: Bloomberg, AMP Capital

Anecdotally, most major share market falls and corrections have occurred in the May to October period: the 1929 crash, the October 1987 crash, the post Lehman Brothers collapse in October 2008 and the worst of the Eurozone.

So what are the main known threats? Those worth keeping an eye on are: the Fed; bonds; Greece; China; geopolitical threats; and the risk of recession in Australia post the mining boom.

Fed rate hikes

The start of a rising cycle in US official interest rates is often associated with market volatility. How far will it go? Is the Fed going to crunch growth? The start of the last two major interest rate tightening cycles by the Fed in 1994 and 2004 were associated with falls in US shares of 9% and 8%. So it would be reasonable to expect a bit of volatility around the start of rate hikes this time as well, particularly as they have been at the current record lows for six years. However, this year has seen the US share market significantly underperform on fears the Fed will tighten prematurely and will ignore the dampening impact of the stronger $US. So maybe it's already anticipated.

More importantly, the Fed is not stupid. It's clear from recent Fed commentary that it is aware that the rise in the value of the $US (by slowing inflation and growth) is doing part of its job and that it will not mindlessly raise interest rates but rather that it will be dependent on growth continuing to improve and confidence that inflation will head back to around the 2% target. Our base case is that the first Fed hike won't come till September but the risks are skewing into 2016. And when the Fed does start to hike it will likely be gradual. But anticipation of hikes will likely cause more bond and share market wobbles.

A bond rout – like 1994 all over again?

Talk of another 1994 style bond crash has been with us ever since the end of the GFC and so every time there is a backup in bond yields it re-emerges. Like now. However, a sharp sustained bond sell-off is unlikely: global growth remains below trend with recent PMIs slowing a bit, so spare capacity will remain; core inflation in the US, Europe and Japan remains too low; the US looks like having another year of okay but disappointing growth; even when the Fed does start rate hikes it will be dampened by a stronger $US which will bear down on oil prices and hence act as a drag on inflation taking off. So while I can't see great returns from government bonds because yields are so low, it's hard to see a bond crash just yet either.

Greece – this is not 2011

Greece is annoying. That said, it's unlikely to drive a return to the Eurozone crisis. Agreement needs to be reached quickly between Eurozone finance ministers and Greece to allow the disbursement of funds soon or else a Graccident (Greece defaulting on either debt servicing payments) sometime in June will be likely. This need not mean that a Grexit (Greek exit from the Euro) will be inevitable and in fact it could help focus the mind of the inexperienced and unstable Greek Government on the tenuous situation they are in. The good news is that the rest of Europe remains far stronger than it was in 2010-2012 with significant budget repair and economic reforms and the ECB's quantitative easing program. So a Graccident or even a Grexit is unlikely to derail the Eurozone economic recovery. But it could cause volatility.

China slowdown

Growth in China is starting to fall below the Government's comfort zone. However, the authorities appear to have realised that monetary conditions are overly tight and so have now started to ease more aggressively, with another interest rate cut just announced. More policy easing is likely. This should help ensure growth comes in around the Government's target of 7%. An easing in property price declines also suggests that the threat from a property collapse may be abating.

There is of course another possibility. Chinese shares have more than doubled over the last year and while it's well known to be a highly speculative market its last three big swings were associated with turning points in growth: the 2007-2008 bear market was associated with a collapse in growth; the 2008-2009 bull market led a growth surge from around 6% to 12%; and the 2009-2013 bear market led a slump in growth from around 12% to 7%. So it begs the question whether the current share surge is presaging a growth upturn. It's worth a thought.

Source: Bloomberg, AMP Capital

Geopolitics

Geopolitical threats remain but have faded a bit. The battle over Ukraine looks like becoming a frozen conflict. The terror threat from IS remains but its military progress in the Middle East looks to have been checked. Tensions continue in the South China Sea (and are worth watching) but this could drift on for years. The threat from Ebola has receded (at least for now).

Australia

Australian growth this year is likely to remain sub-par. Worries about impending recession in Australia have been common ever since the mining boom ended around 3 or 4 years ago. The risk remains. But it is dangerous to overstate these risks. The boom was managed better this time around with no inflation or trade blow out, which should mean a milder bust. While mining exposed parts of the country are struggling, non-mining sectors like housing, consumer spending, tourism, agriculture and higher education will benefit from lower interest rates and the fall in the $A. In other words we will see a more balanced economy. We continue to see better opportunities in global shares, and the Australian share market has recently got ahead of itself but the ASX 200 should make 6000 by year end.

Concluding comments

First, Greece and more significantly the Fed are the key risks to keep an eye in the short term. Both could cause wobbles.

Second, most threats look to be manageable at this stage, and unlikely to threaten the broader cyclical bull market in shares.

Finally, given the risk of a correction in bonds and shares we have been running a higher cash allocation and see recent moves as healthy and as setting up investment opportunities.

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