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The worst start ever to the year for the S&P 500 (but in perspective)

By Ron Bewley*

Anyone trying to keep across current market gyrations would struggle unless one could devote oneself full-time to the task. But even then, the media seems to have a leaning towards bad news – because it sells – and so care must be taken in judging who is making the most sense if one consumes opinions expressed in the media rather than creating one's own research. Let me try and give you 'my' balanced view of the first 8 business days of 2016 using my own research intertwined with media commentary.

The Big Picture

There was a brilliant advert on the business TV channels already this year – put out by BNY Mellon. I don't have ready access to the data so let me try and paint the picture for you. The ad shows a chart of per capita GDP from the nineteenth century to 1938 – the eve of World War 2. Almost a decade after the 1929 stock market crash and the years of the Great Depression that followed, the straight line trend growth was broken in 1929 but a recovery to a new, but lower level was being established.

This behaviour led Alvin Hansen – some say the US equivalent of Lord Maynard Keynes (the academic who was rescuing the British economy) – to call for an ensuing period of 'secular stagnation'. In today's language, he might now have said welcome to the 'new normal' that people talk about these days.

The benefit of analysing Hansen's 1938 call is that we have had nearly 80 years of data to assess the appropriateness of his analysis. It turns out that, not long afterward, this measure of economic prosperity grew faster than ever before – massively overshooting the old pre-crash trend. GDP then glided back to the same old straight-line trend that existed pre-1929 – and for decades.

It would be harsh to criticise Hansen. Forecasting in real time is always extremely difficult – particularly when conditions were far worse than one had been used to. So what about the recent GFC and the recovery? Some argue that government policies have been wrong because the world economy isn't now booming. This has to be the wrong comparison. The only comparison of interest is whether we are better off than we would have been with no – or some other – policy in place.

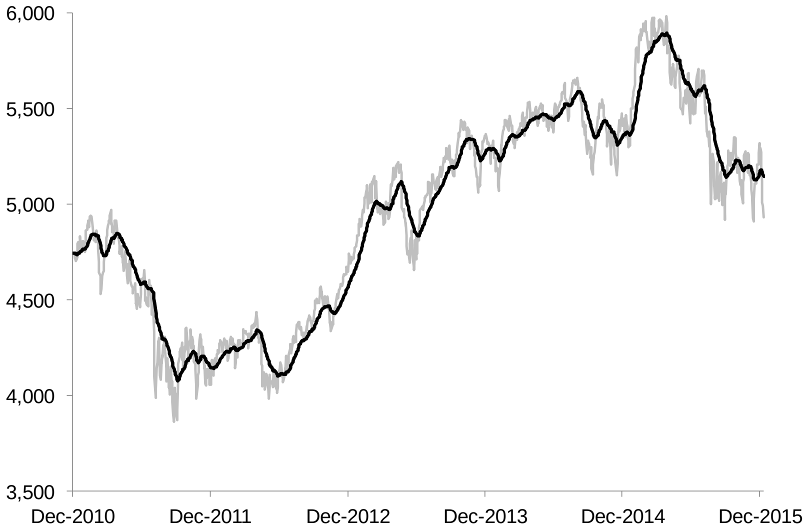
The previous Chairman of the US Federal Reserve, Dr Ben Bernanke (a former Harvard Professor), studied the economics of the Great Depression as a scholar. He concluded that the length and extent of the Depression was worsened by the government backing off too soon. What we can say with certainty is that economic conditions after the GFC are far better than they were after the Great Depression. Indeed, Americans refer to what we call the GFC as the Great Recession (and not the Great Depression!).

Volatility

Whenever a market moves sharply, it is tempting for analysts to say what is causing that move. The truth is there are usually many factors at work and it is impossible to say precisely why a market moved on a particular day. But what we can say is that the more good and bad news that abound the more likely it is that markets will become more volatile.

Volatility is the phenomenon of a market going up and down – not just a measure that the market is just going down. But it is human nature to remember the bad times more than the good. So unless we analyse what is actually going on, we can be tricked by our short-term memories.

In Chart 1, I show the ASX 200 price index together with a smoothed version of that data. [Technically, the smoothed data is an exponentially weighted moving average with a smoothing coefficient of 0.06] The point is that short-term movements up and down will cancel out in the smoothed series if there is volatility without a 'direction'.



Source: Thomson Reuters Datastream and Woodhall Investment Research

What should be clear from this chart is that, since the beginning of October 2015, the smoothed series has been fairly flat. But the light grey index bounces quite sharply around that trend. What has been happening is that there have been many 'false starts' of the market trying to return to some higher level.

China stock market

So what are the factors that have been buffeting our market? People have been fixating on a China slowdown since at least June 2011 and so far that economy is still charging along at near 7% per annum. The 'perma bears' have been wrong for at least four and a half years!

To put the China economy into context we must understand that any country has to go through various stages to get to a mature economy. The US and others have already done it. China is now trying to enter its final stage of 'consumerism'. At each juncture, new things are being tried and tested to aid the transition and no country gets them all correct first time – just remember the US Great Depression!

China is trying to get away from unsustainable double digit growth based almost entirely on government expenditure to, say, a sustainable 5% based almost entirely on the private sector. Therefore, we should rejoice the fact that they are getting close to 5% and a few tiny wobbles along the way are nothing.

Part of the current transition for China involves having a proper functioning stock exchange like ours. Their market is currently full of less informed mum and dad investors (about 90% of trades each day are, apparently, from these investors) – and very few fund managers! Of course there are state-owned investors but these don't trade much.

So there is almost no connection between what is going on in the China economy and what people are trading on the Shanghai Composite Index! That is far less true on the ASX 200, Wall Street, etc.

There was a big, big correction in August last year on the Composite which prompted the regulator to bring in measures to calm the market. Those measures included things like stopping short selling, IPOs and government agencies selling at all – for a period of six months. Well that six month halt is just about this up. I had forgotten that fact but obviously investors would get twitchy just before the lifting of these measures.

On top of that, China brought in the 'circuit breaker' or trading halts for when the index falls 5% (15 minutes halt) or 7% (close for the rest of the day).

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This breaker was first introduced on Monday 4th January 2016. That same day the market was halted for 15 minutes after a 5% fall. Soon after re-opening the 7% trigger closed the market for the rest of Monday. And the same happened the next day.

If you imagine being invested in such a market and you see a sharp fall, the incentive is to sell while you can before the market closes and you are stuck on hold. In other words, the circuit breaker arguably caused the market closure!

Nicholas Brady introduced Wall Street's circuit breakers when he was US Treasury Secretary after the 1987 crash. He set two limits for short halts in trading when price fell by 5% and 7% – and a market closure at 20% (not 7%, as in China). He claims that China set the limits too narrowly.

China's market is nearly always more volatile than the US so a 5% fall on Wall Street is a very different signal to a 5% fall on the Shanghai Composite. If the US market – arguably the most efficient in the world – doesn't close the market until the price falls 20%, what is the highly volatile Shanghai Composite doing if it closes after a 7% fall? But, before we are too quick to criticise China, we should remember the US had no limits for at least the 100 years before the 1987 crash. China is coming of age possibly better than many other countries did. But there will be teething problems along the way. This is not a systemic issue such as that which caused the GFC. So China repealed the circuit breaker rules a few days later and the market then calmed down.

On Wednesday 13th January, China trade data came in much better than expected and the market liked that. Possibly the lower Yuan has started to help? In my opinion, all of the talk about a China slowdown, etc. was spurious. China just got a few regulatory rules a bit out of line. What rules did the US get wrong about the causes of the GFC?

China currency

China's Yuan (or Renminbi) was pegged to the US dollar until recently. The Yuan has an offshore and an onshore exchange rate. The gap was widening. Hence, some action from China was necessary to redress the imbalance.

The US economy is the first major economy to have started to return to normal. As a result, the US dollar was appreciating strongly taking the pegged Yuan with it. Of course our dollar depreciated over the last year because we are not pegged to the US dollar and we are not doing as well.

A few months ago, China stated that it wanted to focus less on the US dollar and more on a 'representative' basket of the currencies of its trading partners. So, last August, China instigated its first break from the US dollar – a depreciation of about 2% – and you may recall the headache that caused markets. In the first week of 2016, China did it again. Some speculated that it showed China's economy was struggling but the real problem was in communication. They said they wouldn't but they did! There is no fundamental problem but surprise causes volatility. Analysts now watch the 12:15pm (AEDT) 'fix' of the Yuan – until everything settles down again.

Oil and iron ore

The prices of oil and iron ore have been under pressure for over a year but new (recent) lows have been reached. Commodity prices are affected by (fundamental) demand and supply and speculation. Demand might be a fraction weaker but supply of oil and ore are being forced higher (and, therefore price lower) for other reasons.

The big three (BHP, RIO and Vale) forced the ore price down to get smaller, higher cost producers out of the market. Once a mine is shut it costs to get it back on line so the big three win in the long run.

OPEC was happy to force the price of oil down to force the growing US shale oil producers out of business. The difference between oil and ore is that shale oil can be cheaply turned off and then back on. The Saudis are reportedly now hurting and Venezuela (the highest cost, highest government debt OPEC country) is in real trouble.

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The next OPEC meeting is scheduled for June but there is not yet an end in sight. But the IMF has apparently written a report saying Saudi Arabia will be bankrupt by 2020 unless something gives! But low oil prices help consumers and net oil importing countries.

Other shocks

In the first week of the year, North Korea claimed to have set off an H-bomb; the Saudi's executed an Iranian cleric; and that resulted in Iranians attacking the Saudi embassy in Tehran. If nothing else had happened in that week, markets may have shifted owing to the heightened geopolitical risk.

But there is more. The Royal Bank of Scotland (RBS) came out with a note saying 'Sell everything (except high grade government bonds)'. Since the RBS collapsed in the GFC (but was rescued by the British government) their track record on forecasting isn't that hot. They claim markets will fall by up to 20%. They could of course turn out to be correct but if they are not right they pay no penalty for being wrong! It is a cheeky, attention-grabbing note in a slow-media period.

JP Morgan came out at the same time telling people to sell on the rallies but UBS came out with a forecast of 2,275 for the end of 2016 (when the index was 1,940). So it matters to whom you listen! Attention seekers should always be avoided!

Some of the confusion comes from the parallels some try to draw between now and the GFC. The GFC was as big as it was because no one knew who owed what to whom and so credit markets froze. Nobody wanted to lend to anyone in case they couldn't pay it back. That is not the case now. The only issue now is how smoothly China can adjust to a consumer-led economy. Speed bumps along the way are annoying but they do not alter the long term view – and, hence investment strategies.

Conclusion

People over-react because they sell before they are able to process the information. As soon as China fixed its rules over the stock market and the currency market, things settled very quickly and the market stabilised up. But volatility will not just go away. It will come back. Investors need a long period of stability to begin to react in a more measured way.

Investors who try to trade through periods like these run the risk of selling during a dip and not buying back until the market is much higher. That means such investors are locking in trading losses. It is far better to position one's investment strategy before these events and then just ride through the volatility – whether in cash or growth assets.

It is impossible to predict with any certainty what will happen in the short-run but 75% of US companies who reported this week beat earnings forecasts. Little that happened in the last couple of weeks should affect the long-run but it is hard watching markets fall in the short-run.

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