Global sharemarket slump an overreaction to China slowdown

- THE AUSTRALIAN
- FEBRUARY 2, 2016 12:00AM
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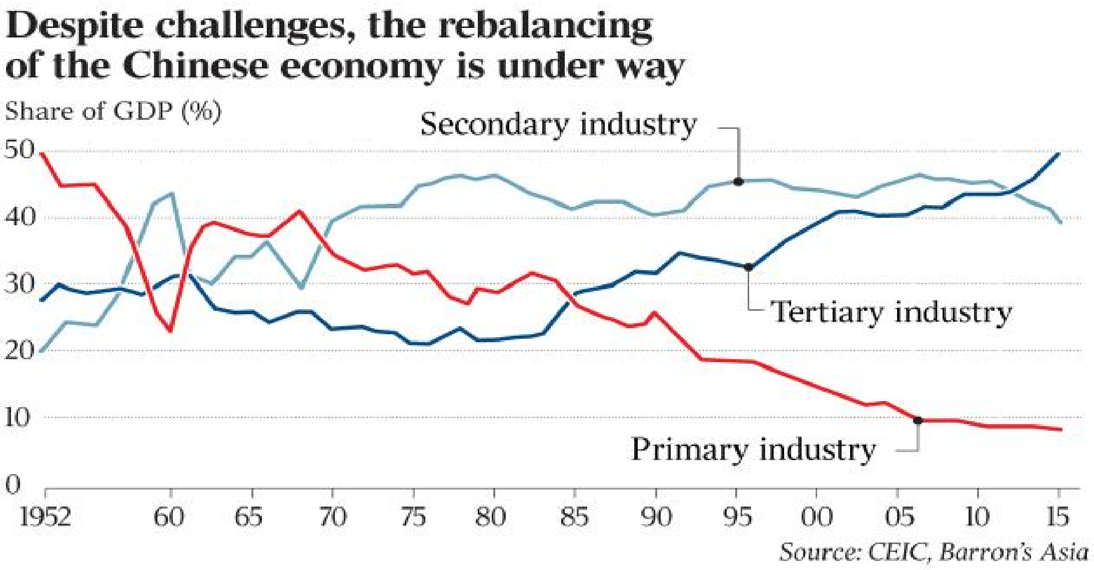

China trends

In January, sharemarkets were volatile and mostly gloomy. Expectations of a hard landing for the Chinese economy were a major concern.

Commodity prices, led by the price of oil, collapsed. What's more, worries developed that the US cash rate could be raised too quickly in 2016 — hurting equity valuations and causing the US dollar to move uncomfortably higher.

The dangers of disinflation, and even deflation, rattled many investors, even though global monetary policy remained highly accommodative.

Today's column looks at two aspects of recent sharemarket stresses that are particularly important for Australian investors — the heightened volatility in average share prices and the intensely negative perceptions of the Chinese economy. The high level of sharemarket volatility experienced recently reflects these diverse global influences:

• The huge purchases of bonds by the US Fed under its "quantitative easing" program had helped to repress volatility in investment markets in the US and around the world. US quantitative easing ended in late 2014; its stabilising effects are wearing off.

• In December, the US Fed took its first move in normalising its cash rate, which had been set at close to zero for seven years. Senior Federal Reserve officials have indicated they expect four further increases in the US cash rate during 2016 — a projection which many equity investors find disturbing.

• Late last year sharemarket valuations were somewhat stretched — at a time when global growth seemed to be losing momentum and concerns of a hard landing in China intensified.

• The scope for banks and brokers to stabilise panicking markets is now more limited. As Mohamed El-Erian, the former Pimco executive now with the Allianz group, puts it: “Facing tighter regulation and sharply reduced market appetite for short-term earnings deviations, broker-dealers are a lot less willing to take on inventory when the market overshoots.

“The good news is that such dynamics ultimately exhaust themselves … but a much better resolution would be if improving fundamentals could support and validate financial asset prices …”

Recurring bouts of volatility seem likely to be a feature of investment markets in 2016 — and seem on course to affect bonds as well as shares.

Investors need an investment strategy that recognises their individual tolerance of risk — and to stick with their considered investment strategy when markets turn skittish or exuberant.

As gloom descended in January, many investors feared the world economy would tip over into recession.

Mark Tinker, a fund manger with Axa, summarised the prevailing sentiment: “Market corrections are more common than recessions. The effects of the last big correction spilled over into the real economy so markets are automatically assuming this one will as well.”

Tinker’s view, which I share, is that investors’ interpretation of Chinese economic data has become somewhat too negative; the impact of China’s slowing economy on bulk commodity prices is being overdone; and the impact of the global oversupply of oil, gas, iron ore and coal has been underplayed.

Investors need to allow for the shades of grey in China’s economic performance and prospects. The year 2016 is unlikely to be a repeat of 2008 but it may have similarities to 1998 and 2011.

Investors need to allow that trend growth in China is slowing as that country’s GDP “base” expands and as productivity growth becomes harder to achieve.

The restructuring of the Chinese economy towards consumer spending and services and away from manufacturing and lumpy capital spending is delivering some gains, as the chart shows, but faces a lot of resistance.

But none of these complexities were given recognition by investment markets or by most commentators when China’s GDP statistics were released in mid-January, showing growth rates of 6.9 per cent in 2015 and 6.8 per cent (annualised) for the December quarter.

Surprisingly, most reactions and reports seemed to accept the official figures for China's economic growth.

Instead, their focus was on growth "slumping to its worst level in 25 years" or, as one commentator put it, the "world's second biggest economy"was having "its worst quarterly performance in a century".

Given the shrill reactions to the Chinese data, it's no surprise that few investors bought shares when prices weakened in January's gloom.

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