Market doomsayers can ask these three questions

- THE AUSTRALIAN
- FEBRUARY 16, 2016 12:00AM
- **DON STAMMER**

In sharemarkets around the world, investor sentiment has turned extremely negative. Gloom has been feeding on itself.

Many investors worry about the similarities with 2007 — the banking problems, build-up of debts and slowing economies — and fear an imminent global recession will cause share prices to slump a lot further. I think there's more resemblance to the experiences of 2009 and 2011, when investors worried — unnecessarily as it finally turned out — that the US economy would double-dip and China would have a hard landing.

Big swings in market sentiment are a recurring feature of sharemarkets. Investors who persist in travelling along that wobbly path are rewarded, over time, by attractive long-term returns. But there are times when investors should ask are the views — gloomy or positive — that dominate market sentiment well based or have they run too far?

Here are three key themes in the current sentiment in investment markets — two from the gloom of sharemarkets and one from the optimism of bond investors — which investors might give some thought to.

1 Why are share markets and the oil price suddenly — and unusually — highly correlated?

Recently, sharemarkets have followed the price of oil up or down. When oil prices have risen, so have shares; when the oil price has fallen sharply, sharemarkets have plunged.

The huge drop in the price of oil recently is painful for companies that produce, distribute or market oil, gas or coal. However, for many other businesses, a lower oil price reduces costs and boosts the spending power of their customers. Currently, market sentiment is not allowing for such complexities.

The main reason for the oil price and sharemarkets to be moving in lock-step is the widely held contemporary view that the oil price is a measure of the pulse rate of the world economy. But the recent collapse in the oil price doesn't reflect a fall in demand. It's the result of excessive supply as global production is boosted by US shale oil, increased production as Russia and Saudi Arabia try to revive their moribund economies, and as the embargo is lifted on Iran selling oil to western countries. The global inventory of oil rose to a billion barrels in 2015.

Of course, the slump in the oil price has some indirect effects that will dampen business conditions — the writedowns by banks on loans to energy companies; losses by holders of bonds issued by oil companies; and fear of a round of corporate failures. But currently these concerns seem exaggerated — and sharemarket sentiment is ignoring the beneficial (though lagged) effects a low oil price will have for the world economy.

2Is China tipping into its much-predicted hard landing?

The dominant theme among investors is that China, the world's second largest economy, is tipping into recession, led by downturns in manufacturing and construction. Moreover, it's broadly thought there's little the policy authorities there can do to stabilise the Chinese economy, even by the big currency devaluation they're allegedly contemplating.

Certainly, the Chinese economy is slowing — cyclically as well as in trend terms. Levels of debt have increased; overcapacity is a problem in property and manufacturing; and the rebalancing towards consumption and services and away from manufacturing is creating strains and facing resistance. But there is a silver lining in the grey clouds. Output of manufacturers has slowed not contracted; retail sales have grown by 10 per cent; average house prices are on the rise in some major cities; and shifting the daily exchange rate setting to a trade-weighted basis instead of the US dollar gives the Chinese authorities a better opportunity to avoid a currency crisis.

3. Why are bond markets expecting inflation will be extremely low for a long time.

The dominant view of bond investors is the exceptionally low inflation we're currently experiencing will be with us for a decade or more. This is implied, for example, by the yields on longer-dated government bonds — recently, 1.75 per cent in the US and 2.6 per cent in Australia.

Bond analysts often compare the nominal yield on a conventional bond with the yield on an inflation-linked bond issued by the same government. In the words of the Australian Treasury, "the difference between yields on nominal and (inflation) indexed bonds — the 'break-even' inflation rate — can be regarded as representing the compensation investors' demand for being exposed to inflation and to uncertainty about future inflation".

On this figuring, bond investors (on average) currently expect inflation to run at annual rates, over the next decade, of 1.25 per cent in the US and of two per cent in Australia. To me, that's an unlikely outcome; inflation is likely to be noticeably higher in the medium and longer term than is incorporated in market expectations.

Inflation — particularly unexpected inflation — hurts savers, in part by eroding the purchasing power of many of the assets and income streams they've built up from their thrift. Despite what market expectations suggest about inflation not being a problem for a decade or more, investors would do well to give thought to how their investment portfolios might be restructured to cope when the cycle in inflation returns to haunt us

Don Stammer chairs QV Equities, is a director of IPE, and is an adviser to the Third Link Growth Fund and Altius Asset Management. The views expressed are his alone.