Five things to learn from the Sharemarket's rollercoaster ride

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Many investors describe recent moves in sharemarkets as turbulent.

Globally, shares shed 11 per cent of their value in January and early February. Predictions of a global recession were frequent and shrill. Oil and iron prices tanked. Adding further to the gloom, a cleverly marketed research report did the rounds, predicting an early collapse in Australian house prices and bank shares.

Then, the widespread gloom dissipated. By March 10, key share indexes in the US and Australia — and, surprisingly, those in emerging economies — had recovered earlier losses. Bulk commodity prices shot upwards — iron ore by an impressive 66 per cent. Bank shares were keenly sought.

Now we can stand back and consider five things we learnt from this recent rollercoaster period:

1. When sentiment on the global economy is fragile, the accumulation of even mildly negative news can drive sharemarkets a lot lower.

2. In such times, investor positioning — and the subsequent unwinding of those positions — can trigger big moves in share prices.

3. Sometimes (such as 2008), a sharp fall in share prices portends a lengthy period of difficult times for investors. At other times (for example, 2011 and, it seems, early 2016), the crash in share prices soon corrects — and is quickly forgotten. Paul Samuelson famously quipped in 1966 that the US sharemarket had predicted nine of the previous five recessions.

4. The challenge for investors is to pick whether or not the sharemarket sell-off will be followed by a lengthy slump in share prices. It's useful for investors to consider what the traditional indicators of recession — a sharp rise in unemployment, credit tightening or an increase in short-term interest rates relative to long-term rates — are showing. But much depends on how investor confidence and sentiment will track, and that's hard to foretell. Sensible diversification, including a good allocation to cash, makes sense at times of heightened uncertainty.

5. Investors, generally, were too pessimistic early in the year on global growth prospects; now, there's a balanced outlook and shades of grey are being recognised. But key concerns — such as the sustainability of negative nominal interest rates in Europe and Japan —

haven't been addressed. Further swings in investor sentiment are to be expected in the months ahead.

But what actually caused this recent swing in sharemarkets?

Markets often swing widely when big investors take or unwind similar positions. In January and early February, many large investors — hedge funds particularly — adopted similar investment decisions. This included selling, and in some cases shorting, assets that would probably plunge in price when China fell into the hard landing the investors expected.

Fiduciary's Michael Mullaney described the January sell-off in shares as reflecting "an oversold condition with everyone on one side of the boat".

I agree, though I'd express the observation this way: the January sell-off in shares reflected an oversold condition — with most of the passengers, and just about all the crew, on one side of the boat!

Later, the rush to close out these short positions added intensity to the sharemarket rebound — often at significant cost to investors with the short positions.

Investors put too much emphasis on soft numbers from China and the US. The relationship between GDP growth and average share prices is weak and unreliable. But sharemarkets generally move when big investors change their collective view on the world economic outlook.

In January and early February, many investors interpreted data on China's external trade and manufacturing as confirming the "contraction" of the Chinese economy. Bulk commodities dropped in price; fears of global deflation intensified; bonds rallied; and shares plummeted.

Subsequent information suggests gains in retail sales and the services sectors in China have - partially offset the slowing growth in manufacturing and heavy industry. China faces many problems; but the hard landing predicted since 2011 has, so far at least, been avoided.

In the US, market sentiment in the early weeks of the year focused too much on the risks of consumer spending remaining soft and of losses on energy loans crippling US banks. As it turned out, US job creation and consumer spending are tracking at reasonable rates.

Be wary of predictions of an imminent housing crash in Australia. Repeatedly, claims have been made that Australian housing is in a bubble; that house prices are about to crash; and the prices of our bank shares will crumble because of bad debts.

A report marketed in January and early February by portfolio manager Bronte Capital and hedge fund Variant Perception argued that our house prices and bank shares could soon lose half or more of their value. Their shrill conclusion gave little recognition to the low default rates that are a feature of housing finance here — in large part because most loans are full-recourse to the borrower. Excesses in the Australian housing market are usually worked off by average house prices moving sideways for a few years; falling prices are rare.

Economist and fund manager Christopher Joye rightly suggested investors who had shorted bank shares would be scrambling to buy them back to close out their positions. Subsequently he could comment: “Bank stocks have bashed the ‘johnny-come-lately’ hedge fund barbarians that stormed the gates last week.”

In the end it seems the catalyst across the markets has been fact triumphing over fiction.

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