It’s vital for investors to recognise shades of grey

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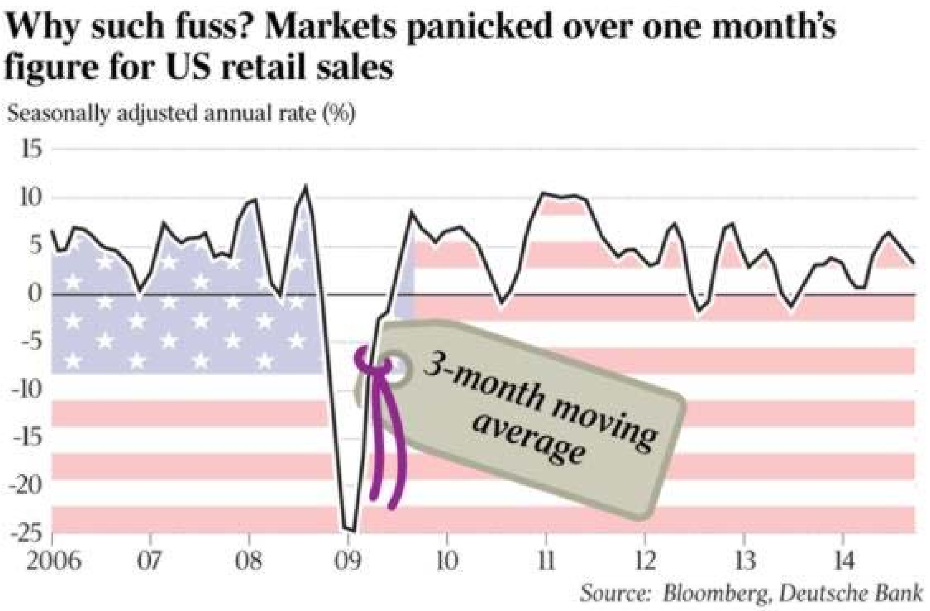

Why such fuss? *Source:* TheAustralian

THE prevailing sentiment in sharemarkets did a sudden reversal last week — and jumped a gear as well.

The apparent triggers for the mood swing — among them, a reported fall of 0.3 per cent in monthly retail sales in the US — may otherwise have been innocuous. What mattered was the build-up in investors’ concerns about downgrades to global growth, the heightened risk of Europe slipping into deflation and recession, the accumulation of geopolitical problems and — though inconsistent with the other worries — prospects of higher interest rates in the US.

Not only were shares dumped, but bond yields fell (briefly) to extreme lows, oil prices plunged, and the US dollar (mostly) moved higher. And volatility reached exceptional levels, both for bonds (the experience of US 10-year yields moving in one trading session from 2.2 per cent to l. 87 per cent and back to 2.15 per cent will be talked about for decades) and for shares (the much-watched VIX index of volatility in US sharemarkets has more than doubled recently).

What can investors do to avoid being numbed and confused — or worse, sucked in — by these sharp swings in market mood? Can investors benefit from the extreme volatility?

First, investors need to recognise that investment markets — and particularly shares — often move emotionally and irrationally. Indeed, it's these swings in returns, and their uncertainty over the short term and medium term, that largely explain the generous long-term returns (a bit over 10 per cent a year) Australian shares have generated for patient investors.

Second, as Warren Buffett, the great builder of investor wealth, often reminds his shareholders, success in investing involves being prepared to buy in gloom and to sell when the market moods are optimistic. It's sentiment-driven markets that create both extremes.

Third, while market sentiment often swings between the view everything is fine to a conviction we're off to hell in a handbasket, the investment outlook is usually not all good or bad; doing well requires that we recognise shades of grey. Take, for example, the sudden build-up of fears of a marked slowdown in the global economy.

Certainly, Europe is a worry: near-zero inflation could morph into deflation; the European Central Bank keeps talking about — but is slow in implementing — an aggressive policy of quantitative easing; and some banks need to be recapitalised.

However, as Gavyn Davies of Fulcrum Asset Management in Britain writes in a recent blog, a euro-area recession "could certainly have very damaging effects on confidence elsewhere. But even in the extreme euro crisis of 2012, it was not enough to send the world economy into recession."

At the same time — and despite the preoccupation in investment markets with the allegedly weak figure for retail sales in September — the US economy has moved up a gear. And, currently at least, the Chinese economy seems more likely to achieve growth of 6 per cent next year than to trip into a hard landing.

Here's another example of the importance of shareholders recognising shades of grey. Even at the time when forecasts for global growth are being trimmed, many investors worry US bond yields will soon push higher — and this increase in the so-called risk-free rate of return could cause a sustained weakening in share prices.

Ashley Owen at Philo Capital has looked at each of the 27 spikes in US bond yields since 1945. He finds there was no consistent impact from the higher yields on bonds to share prices. When bond yields and inflation are low to start with, as they are at present, share prices more often than not have risen as bond yields increased; and the effect on shares depends on what has caused the bond yields to move higher.

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