Looking ahead as clouds clear across market

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Investment markets were gloomy and choppy during June and in the first half of July, with investors especially concerned about flow-on effects from the Greek financial crisis and the plunge in Chinese share prices.

To the surprise of many investors, sentiment in investment markets quickly turned positive again. That came after the framework for a deal for Greece was tentatively and reluctantly agreed, although key details of the bailout have still to be formally approved.

Also, wide-ranging interventions by the Chinese government to stabilise the country's sharemarket — including temporary bans on trading in about half of all listed stocks — seem to be working, at least initially.

The recent bout of extreme nervousness in financial markets is certainly not done and dusted. But the lessons investors can learn — and perhaps have to relearn — to cope with wide swings in market sentiment are clear enough.

• Investors, especially those holding shares, must expect — and allow for — ups and downs in investment markets. Such swings are a major reason why, over the medium and longer term, share investors are rewarded with higher average returns.

• The market values of growth assets, especially shares, fall sharply whenever the prevailing mood in investment markets turns suddenly negative. Investors need the protection that a thoughtful diversification across asset classes can provide — including good allocation to bonds, cash and term deposits even when interest rates are disappointingly low.

• Diversification not only reduces the financial pain an investor feels when market moods sour; it also reduces the likelihood of the investor throwing in the towel and dumping quality growth assets at depressed prices.

• Certainly, a feeling can develop at times of stress that "things will never be the same again". Sometimes, such as in 1987, 2001 and 2008, that attitude can persist for several years. But most times the extreme gloom abates relatively quickly. What may initially have seemed like a time to exit the sharemarket is subsequently recognised as an outstanding opportunity to have bought shares.

• At the least, investors should always be ready to spot shades of grey in the investment outlook. For example, in the near-total gloom of early 2009 — soon after the worst days of the global financial crisis — it was clear central banks would do whatever it takes to support their financial systems and boost their economies. On average, US shares have since trebled in value.

Here are two examples from recent months of the benefits to investors who can sight silver lining in the storm clouds.

In the drawn-out discussions on Greece's debt, investors needed to allow that Europe is better placed to cope with the economic effects of Greece's exit from the common currency than it was two or three years earlier, when Spain, Portugal, Ireland and Italy were also facing sovereign debt problems.

And investors needed to be aware that the links between China's economy and sharemarket are exceedingly loose. In the years after the financial crisis, China grew at 10 per cent, but share prices slumped. Shares boomed from mid-2014, as economic growth slowed. A sharemarket crunch doesn't necessarily depress the Chinese economy.

• During the recent stress in investment markets, many investors and commentators were so preoccupied with day-to-day news on the Greek and Chinese crises they gave little thought to the key themes likely to dominate investment markets as and when the problems for Greece and China become less pressing. These themes are: global monetary policy will remain accommodative; the Fed is likely to raise the US cash rate by year's end, but it will also reiterate its expectation that subsequent moves in the cash rate will be gradual and drawn-out; and there are no reasons for Europe, Japan and China to tighten their extremely easy settings of monetary policy in the foreseeable future.

ϖNonetheless, the rise in bond yields (fall in bond prices) that started in May seems likely to resume as the US and Europe generate better-than-expected growth numbers. Yields on 10-year government bonds — which last week in Australia, the US and Germany were 3, 2.4 and 0.85 per cent respectively — look unsustainably skinny.

ϖGrowth in China has slowed, and is likely to slow further. Nonetheless, China seems well placed to avoid the economic hard landing that's often been predicted.

ϖSince early 2009, sharemarkets have moved significantly higher. Some measures of sharemarket valuations — especially average price-earnings ratios and share prices as a multiple of book values — now look somewhat expensive, although average dividend yields are attractively high relative to bond yields and cash rates.

My guess is that average share prices will move modestly higher as and when a prospective pick-up in global growth improves the outlook for corporate earnings — and stock selection will be a crucial factor in share investors' returns.

Investors need to make careful and considered decisions to cope with sudden swings in market sentiment.

The Fidelity group advises investors: "If watching your balances fluctuate is too nerve-racking for you, think about re-evaluating your investment risk to find one that feels right. But be wary of being too conservative, especially if you have a long time horizon, because more conservative strategies may not provide the growth potential you need to achieve your goals."

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