2015 – Issue 3

STUART + CARLYON

Financial advisers for your lifetime goals

Look past the noise and watch the horizon

The last few weeks have been an uncomfortable reminder of the share market uncertainty and volatility experienced seven years ago. We can't control the markets but we can look through the noise, staying focussed on fundamentals to keep clients and portfolios on track. The following excerpts provide some useful perspective from diverse sources.

The New Yorker - James Surowiecki

The sell-off in the US was driven mainly by the turmoil in China, which is dealing with the precipitous deflation of a stock-market bubble and is struggling to maintain its economic growth.

Given how much we hear about China's economic importance, you might think that these problems would have a big impact on the U.S. They won't. In fact, total U.S. exports to China are less than one per cent of G.D.P. There are certainly firms—including commodity producers, microchip makers, and fast-food companies—for which China is a huge market today.

> "Total U.S. exports to China are less than one per cent of G.D.P."

But for most firms the prospect of selling billions of products to Chinese consumers remains more of a promise than a reality. Goldman Sachs, for instance, estimates that just two per cent of the S. & P. 500's revenues come from sales to China.

Globally, China's slowing pace of growth has certainly had spillover effects. In the past decade, its boom has created a voracious appetite for commodities of all kinds, from iron ore and copper to oil. As growth there has slowed, the price of these commodities has fallen, and the price of oil has been pushed down further by a production glut.

This has been bad for energy and mining stocks, and it's been very hard on developing economies, like those in Latin America, which relied on commodity exports to China. But for the U.S. economy cheaper commodities are a good thing, putting more money in consumers' pockets and lowering production costs for American firms.

Some pundits worry that all this market turmoil could presage something like the meltdown of 2007-09 or the Asian financial crisis of 1997-98. Yet those were ultimately severe insolvency crises, involving enormous piles of debt that were not going to be repaid, companies and countries going bust, and economies that were deep in recession.

The situation today isn't analogous. Unlike the Asian countries that got in trouble in the late nineteen-nineties, China is a creditor to the rest of the world, not a debtor. It has plenty of debt troubles—thanks to enormous over borrowing by corporations and local governments—but those are largely internal issues, unlikely to go global.

As for the struggling emerging-market economies, they, too, are in much better shape than they were in the late nineties. Nowadays, these countries typically have sizable dollar reserves and, instead of running big current-account deficits, are mostly running surpluses with the rest of the world. So the ingredients for a full-blown financial crisis don't seem to be in place.

Platinum Asset Management

For all these woes, there is evidence that the recovery in the West is becoming more entrenched. The question is then whether markets have now reached a level where the prospect of slow growth, and associated weak prices in commodities (oil, metals and agricultural produce), is fairly discounted in share prices. We believe that this is the case in many instances. However, it does not rule out the possibility of a market overshoot.

Comforting is the fact that when one can buy powerfully entrenched businesses on valuations that are generally in line with their 20 year averages, one normally makes good returns in subsequent years.

Harbour Asset Management

We see the US economy as robust. As a result we may be moving into a phase where markets become less reliant on policy stimulus, and more focused on economic fundamentals and company earnings.

Stepping back from the noise, we are neither bullish nor bearish equity markets. More generally, after 6 years of strong returns, investors should not expect equity markets generally to charge ahead. The slow-down in New Zealand economic growth seems likely to peel back earnings expectations from more cyclical companies, while the fall in the NZ dollar in recent months is likely to lift earnings from companies with a global focus.

> “The fall in the NZ dollar in recent months is likely to lift earnings from companies with a global focus.”

Morningstar Research

Tanking equity markets, commodity price plunges, spiking volatility across the world, the last act of the US Federal Reserve's grand experiment to control asset prices. China's attempts to control everything and earnings season – the most exciting and worrying two weeks of the year, even in benign times. What should we make of it all? There's no shortage of noise and reflex trading.

We take a long-term view. Short-term noise has limited impact on our long-term theses. Rather than focusing on last year's earnings, next year's outlook, investor sentiment, or chart wizardry, we seek to understand the fundamental drivers of the actual businesses shares represent, perform bottom-up analysis on those, and then let the market come to us.

Russell Investments

While markets are presently undergoing a bout of eye-catching weakness, the world economy remains in reasonable shape. The US, European and Japanese economies are all in recovery mode and China, while slowing, is still likely growing at over 5% in real terms, underpinned by a range of stimulatory policies. Areas of true recession – Russia and Brazil are the standouts in this regard due to both lower GDP and currencies – are too small in our view to drag down the entire global economy.

Meanwhile, growth in Australia and New Zealand is being held back by a relentless downdraught in commodity prices. Even in this region, however, falls in the Australian and NZ dollars, together with encouraging monetary policies from the Reserve Banks, are providing a cushion to maintain acceptable growth rates.

What's on the horizon?

Every cloud has a silver lining. The outlook could be good news or bad news – depending on your perspective. Set out below is a succinct picture of some of the issues facing major economies.

	Positives	Negatives
China	• $3 trillion in reserves • Policy willingness to boost economy • Signs that housing / retail sales stable	• Pockets of turbulence across Asia • Downside risks / short term volatility • Lower demand for commodities
US	• Reaccelerating economy • Robust employment growth • Expect healthy GDP growth	• International risks • Disinflationary conditions • Fed rate hike uncertainty
Eurozone	• Cheaper exchange rate • Lower oil prices, monetary easing • Strong fundamentals, economy improving	• Less demand from China • Low inflation • Political instability
Aust/NZ	• Currency weakness / Imports expensive • Boost to tourism, exporters, manufacturers • GDP growth still good	• Plunging bulk commodities prices • Low inflation, bumpy road ahead • Further interest rate cuts

Is low inflation really a negative? Central banks know how to combat high inflation but very low inflation is problematic to manage. It seems the US Fed wants inflation firmly imbedded in business and financial expectations well before it starts raising interest rates. The lesson is, for any set of events, some parts of economies and some countries benefit while others do not. That old chestnut, diversification, has never been more important.

155 Parnell Road, PO Box 137-154, Parnell, Auckland 1151, New Zealand Phone: 64 9 307 2331 Fax: 64 9 307 2330 www.stuartcarlyon.co.nz