



Crystals and investor worries as we go from seasonal weakness to strength

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Key points

- > Risks regarding China and the Fed may be receding a bit for now but there remains plenty to keep an eye on including the risk of an “accident” flowing from slower emerging market growth and the plunge in commodities.
- > However, our broad assessment remains that the cyclical bull market in shares is likely to reassert itself in the seasonally strong months into year end.

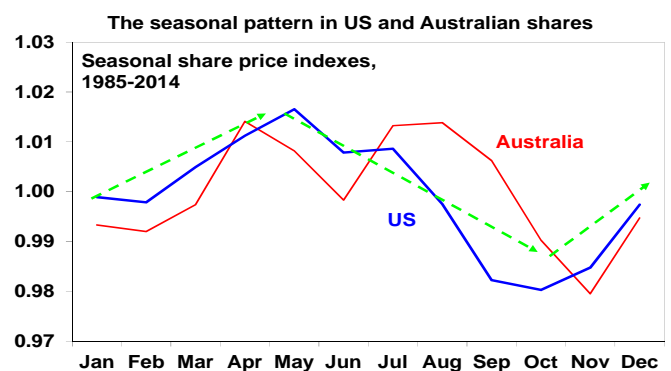
Introduction

Back in April this year when shares were riding high, it seemed the worry list investors had was relatively short and mild. Since those highs the worry list expanded dramatically. Reflecting this major share markets saw falls to their recent lows, viz US shares -12%, Australian shares -18%, Eurozone and Japanese shares -19%, emerging market shares -22%, Asian shares (ex Japan and China) -23% and Chinese shares -43%.

Two things regularly get me worried about investment markets. The first is May – recall the old saying “sell in May and go away” – and this got me concerned about a correction being on the way in May this year. See “Correction Time?” [Oliver's Insights](#), May 2015. And the second is whenever I go on holidays because it invariably coincides with falls in markets. Last week I took a few days off in Byron Bay and of course right on cue markets had a further tumble early in the week with the US share market testing its August low and several markets elsewhere falling to new lows. But as I went to the beach at Byron in the midst of this I saw a guy meditating with a crystal on his chest...maybe in an effort to quiet his mind in view of the “billions being wiped off share markets” that day. Later that day thinking there must be something in it my family and I paid a visit to the Crystal Castle in the hills above Byron Bay and we did our own meditation with a crystal! Maybe it all works, because now that I have returned to work shares have had a good bounce back. But is it sustainable?

From seasonal weakness to seasonal strength

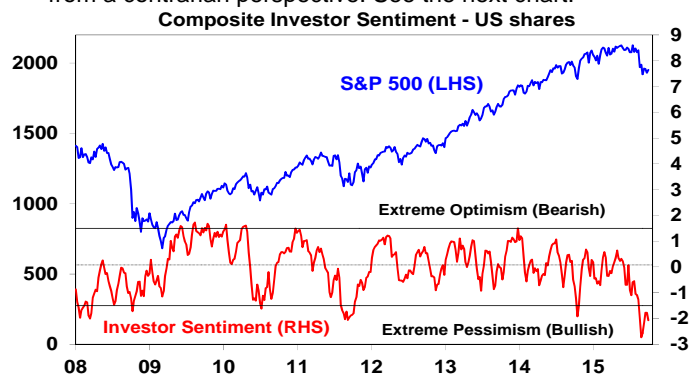
A good place to start deciphering the share markets at present is the seasonal pattern in shares. Typically the period from May that we have just come through is the weakest period of the year. The September quarter has lived up to its reputation as being poor for shares with both global and Australian share prices down around 8%, the worst since the September quarter 2011. Worries about China, the emerging world, commodity prices, Greece and the Fed have clearly played a big role. However, October is known as a “bear killer” month, as it often sees market declines bottom ahead of seasonal strength into year end and the new year. See the next chart.



Source: Bloomberg, AMP Capital

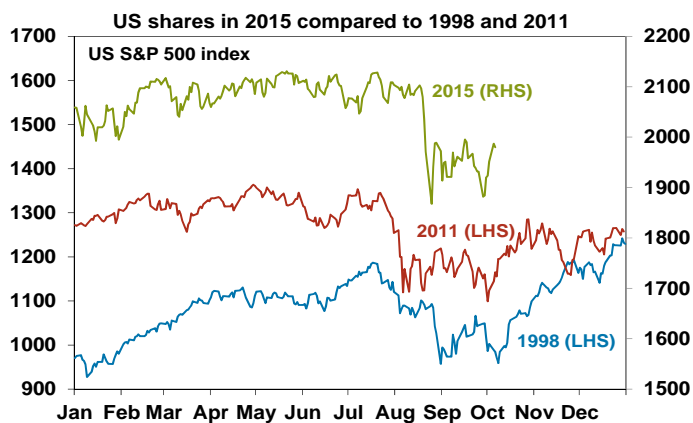
A further leg down in shares remains a risk in the weeks ahead. However, along with the more positive seasonal pattern in the months ahead there are fundamental reasons to see a resumption of the cyclical bull market.

- shares have become cheaper as a result of their falls;
- global monetary conditions remain very easy and in some cases are getting easier (with easing in China, Taiwan, Norway and India recently, the ECB threatening more easing and the Fed delaying tightening);
- this in turn should help ensure that the global recovery continues albeit at a sub-par and uneven pace; and
- investor sentiment is very negative, in fact falling to levels associated with share market bottoms, which is positive from a contrarian perspective. See the next chart.



Source: Bloomberg, AMP Capital

It is worth noting that the US share market – which has been driving global markets – has so far been following a very similar pattern to both 1998 and 2011 that saw sharp falls into August, a bounce and then a retest or new lows around late September/October, followed by gains into year end. Time will tell. From a technical perspective the failure of commodity prices and emerging market shares to hit new lows with last week's global share market falls is a positive sign suggesting risks on these fronts may be receding (at least for now).



Source: Bloomberg, AMP Capital

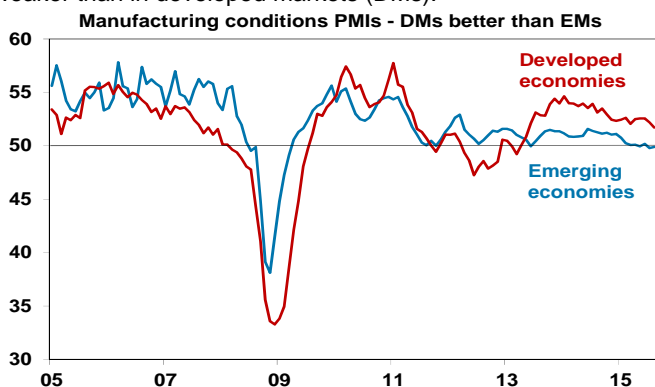
But what to watch? We would nominate the following.

The Chinese economy

Chinese economic data has disappointed this year. However, there are reasons for optimism that risks regarding China may be receding. First, policy stimulus has stepped up with most recently a sales tax cut for small cars and another reduction in the required deposit ratio for first home buyers. Second, average home prices are now rising suggesting the risk of a property crash is rapidly fading. Third, recent business conditions PMIs have shown signs of stabilisation and consumer confidence has risen to its highest since May last year. Growth in the September quarter looks likely to have slipped below the 7% level, but the next few months are likely to see confidence improve that Chinese growth is under control. Fourth, Chinese mainland shares are trading on a forward price to earnings multiple of 11.2 times and Chinese companies listed in HK are trading on less than 7 times making them very cheap. Finally, September data on China's foreign exchange reserves indicate capital outflows have slowed and hence worries about a crash in the Renminbi are receding.

Emerging countries

Growth in the emerging world has already slowed significantly. Business conditions PMIs in emerging markets (EMs) are weaker than in developed markets (DMs).



Source: Bloomberg, AMP Capital

In 2011 emerging countries grew 6.2%, whereas this year it's likely to be around 4%. Brazil and Russia are in recession. A lot of bad news has already been factored in for emerging markets with forward price to earnings multiples around 10 times (compared to around 14 in Australia) and a 40% fall in their currencies. But while valuations are good and extremely negative sentiment towards them is a positive, their economic cycle and liquidity backdrop reflecting high interest rates in some countries are bad. The main thing to watch for though is whether they start to drag down growth in advanced countries.

Commodity prices

Commodity prices are down 50-70% from their highs several years ago. With the supply of commodities still rising the

secular decline in commodity prices may have further to run. However, the bulk of the price damage is likely behind us and they are due for a cyclical bounce.

An EM/commodity related accident

Perhaps the biggest risk associated with the collapse in emerging market currencies and commodity prices is the risk of an accident they might throw up. This was seen with the Russian default/LTCM crisis in the 1998 emerging market crisis and Lehman's collapse in the GFC. The fear of such I think largely explains investors' twitchiness and worries about Glencore for example. Fortunately Glencore is not a Lehman Brothers – it's much smaller and less connected to credit flows.

The US and Fed rate hikes

The start of a tightening cycle in US official interest rates is often associated with market volatility. Fortunately, the Fed has not blindly increased rates and has signalled it is aware of global risks and the impact of this on US inflation. In fact, with US growth looking like it's continuing to trend around 2-2.25% and inflationary pressures still very weak, the first Fed rate hike looks like it will be delayed into 2016. While some fret about a US recession, the historical experience tells us this is very unlikely in the absence of significant monetary tightening and we are a long way from that.

A US Government shutdown/debt ceiling crisis

The decision by US Congress to extend Government financing to December 11, averting an October 1 shutdown, means the issue will now come up again later this year when it will get rolled into the need to raise the debt ceiling, which will be reached around November 5. This could see more brinkmanship as ultra conservative house Republicans still seek to defund Planned Parenthood. However, the vast majority of Congressional Republicans are more focussed on winning next year's elections so a shutdown/debt ceiling crisis is likely to be avoided. Expect nervousness around this next month though.

Spain's general election

With Greece "settled" for now and the Catalan election not really advancing their independence from Spain, the next big risk on the horizon in Europe is Spain's general election later this year. The populist Eurosceptic party Podemos has lost support but polling points to an inconclusive result between the Governing Popular Party and the centre left Socialist Workers Party. However, most of the heavy lifting on reforms has already been done. So a Euro threatening outcome is unlikely.

Australia

Australian growth is sub-par at 2% and this could continue for a while yet requiring more help from RBA rate cuts and a lower \$A. But we are already half way through the mining investment slump and the economy has not crashed as some feared. There are several reasons: the boom was managed better this time around with no inflation or trade blow out, which should mean a milder bust. While mining exposed parts of the country are struggling, non-mining sectors like housing, consumer spending, tourism, agriculture and higher education are benefitting from lower interest rates and the fall in the \$A. We continue to see better opportunities in global shares, but the ASX 200 should make it back to 5500 by year end.

Concluding comments

There is plenty to keep an eye (what's new!) with the main risk being some sort of accident flowing from the emerging market/commodity slump. However, our broad assessment remains that the cyclical bull market in shares is likely to reassert itself in the seasonally strong months into year end.

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