Snapshot

Market insights from Fisher Institutional
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Market Turmoil: why did it happen and what's next?

Expert & Indepth

October was a volatile month for global share markets. While falling prices were the dominant theme, there were also days where prices rose dramatically. Volatility like this is confusing and can be downright scary for some investors.

Read on for insight into what was behind this market turmoil, what might come next and some thoughts on how we tend to think about bouts of volatility like we have experienced.

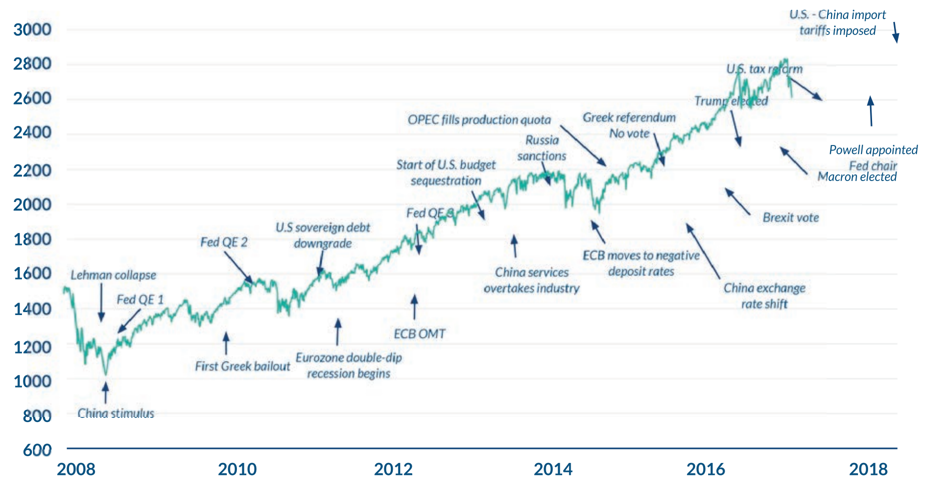
It's always about the economy.

The economic cycle is an important driver of company profits, and profits ultimately drive the share market. This doesn't mean the economy leads the market but that market participants obsess about what's happening in the economy and buy or sell shares accordingly.

They don't always get this right: there's an old market saying that the share market has predicted eight out of the last four recessions. Either way, the direction of the economic winds, fair or foul, foretell an important story about financial market sentiment.

In October, the US share market sold off by 11.2% at its lowest point. It's always hard to pinpoint the exact causes for a sharp correction like we have experienced. There were definitely some technical factors contributing. In particular market participants had become excessively optimistic leading to overbought conditions that, like a tinder-dry forest, are ripe for a fire. While important contributors they are not the main act. In this case the expected pace of economic growth lurks in the background as the primary fear driving market participants.

S&P 500 Price Index



The United States economy has enjoyed strong growth in 2018. This has been built on a continuation of the long slow economic recovery since the global financial crisis (GFC), with lower unemployment driving consumer sentiment and boosted by a recovery in business investment

What has marked 2018 out as special is the powerful fiscal stimulus provided by corporate and personal tax cuts. This saccharine hit boosted growth in the last quarter to a heady 3.5% (coming on top of last quarter's 4.2% growth). Strong growth and lower taxes have been a boon to corporate earnings, driving aggregate company earnings higher by 22.5% over the last quarter. This has, until recently, been supportive of higher share prices.

Stronger economic growth presents its own challenges. US unemployment has fallen to a cycle low of 3.7%, industrial capacity utilisation has tightened, and consequently, the US Federal Reserve has begun normalising interest rates, increasing them three times this year to 2.25%. Higher interest rates tend, like the pull of gravity, to exert downward pressure on economic growth. This is strike one in many investor's minds reducing the outlook for US growth in 2019.

Strike two comes from slowing growth in the rest of world and the negative effects of the ongoing trade wars that have been a feature of Donald Trump's presidency. Nowhere is this more evident than in China where growth expectations continue to be revised lower, leading to a bear market in Chinese shares. The rest of the world is not helping with leading indicators of growth weaker in Europe and ongoing budget negotiations in Italy hardly adding to positive sentiment.

Of course the benefits of tax cuts don't last forever and, at least on a year over year basis, the positive growth impact of lower taxes will roll out of the data leading to lower numbers. This for many investors is strike three.

We have some sympathy with this perspective. There is no doubt, in our mind, that economic growth will be lower in 2019 than it has been in 2018. Similarly, the earnings growth enjoyed by US companies will not continue at the current clip with slower revenue growth and increasing costs seeing to that.

Slower growth does not mean recession

This distinction between these two is important. We are of the view that growth in the United States is likely to return to a cadence in line with the post GFC recovery, low, but very importantly, positive.

While this has been a formula for good financial market performance over the past decade we are less sure that the environment will be as friendly for investors going forward. Things have changed. Interest rates are higher, wage and raw material costs have been rising, which will pressure company profit margins, and inflation is less well contained.

This leads us to be cautiously positioned. The expectation that interest rates will rise is our most strongly held view. This leads us to investing materially less in global fixed income markets than we would normally expect to.

We also have less shares than we would normally hold although this is a less significant position. While slower corporate earnings growth is not a great backdrop for share market performance, valuations are now below long term averages with real opportunities beginning to emerge, particularly outside of the United States. In the absence of an outright corporate profit recession we are not of the view that this is a time to be too pessimistic about share markets.

Caution not panic is warranted

So at this stage of the cycle, and despite market volatility, we believe that there is more to fear from inflation rising rather than a slump in growth. Trade wars, the fiscal spend up and a row that has been brewing between the US President and the Fed Chairman complicate this but still point in the direction of inflation concerns first and foremost.

As a result of this, caution not outright pessimism, is our catch cry.

Volatility is normal

Share markets don't always go up. Volatility is the cost that goes hand in hand with the higher long term returns we expect from shares. Just because we might know that, doesn't make it any less uncomfortable when the inevitable bouts of volatility hit. It is natural to be worried.

Our worries don't stop the share market from rising. Those of you who have attended our roadshows have seen the chart above. It shows the performance of the Standard and Poors 500, the best barometer of the performance of the US share market, over the past decade. This period, like most, has been full of things to worry about; a European sovereign debt crisis, banking problems in Greece, Spain and Portugal, a possible credit rating downgrade in the United States and a new US President that most commentators thought would be a financial markets disaster, yet the market more than doubled over these years.

Very often our worst fears are short lived and if we responded every time we would have missed a decade of wonderful investment performance.

We focus more on companies than on headlines

So far we have focussed on the big picture — the things driving the market in aggregate.

Of course at Fisher Funds we are a very selective investor, hand picking a portfolio of investments in New Zealand, Australia and the rest of the world that we believe will generate attractive returns over the long term.

During bouts of volatility we tend to focus more on the micro than the macro; are our companies well positioned for the future, are the business models they have robust, sustainable and getting stronger, will they keep growing profits? Viewed through this lens fluctuating prices become more an opportunity than something to be worried about.

Jeff Bezos, the founder and CEO of internet retail behemoth Amazon.com, talks about building business strategy on things that won't change. In his case it's unlikely that customers will want slower deliveries, less choice and higher prices. Focus on delivering those things and Amazon will be successful is his view. This is a good approach when thinking about financial markets.

What do we know to know to be true about financial markets? In ten years' time we are pretty sure:

1. Western populations will be older and sicker — portfolio companies Ryman Healthcare, Summerset and Nanosonics will all have larger potential customer bases and should be materially larger companies.
2. We will all be buying more online then we are today — our investments in PayPal, Mastercard, eBay and Freightways will be huge beneficiaries of this.
3. Trade and the need for cross border logistics will continue to grow — Mainfreight, Wisetech and Descartes have decade long growth runways.
4. Individuals and businesses will keep wanting to find more efficient ways to get things done — companies like Xero, Seek, Carsales and Vista Group make things more efficient. Customers are already voting with their feet and will continue to adopt these solutions.

Volatility isn't fun and right now a sensibly cautious position is warranted. With investments in some of the best companies in the world — companies with powerful long term growth drivers — sleeping well at night is not a challenge for us. Your money is in good hands.

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Market Movements

As at 31 October 2018

Stock Markets*	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P Developed LargeMidCap - (Local Curr)	737	-6.9	-4.9	-0.5	2.0
S&P Developed LargeMidCap ($NZ)	N/A	-6.9	-2.3	5.7	5.4
S&P Global LargeMidCap ($NZ)	N/A	-6.1	-2.3	3.8	4.8
USA - S & P 500	5369	-6.8	-3.3	3.4	7.3
USA - Nasdaq	8468	-9.2	-4.5	3.9	9.7
Japan - Topix	2444	-9.4	-5.3	-6.4	-4.8
UK - FTSE100	6266	-4.9	-6.9	-3.1	-0.9
Germany - DAX	11448	-6.5	-10.6	-9.2	-13.5
France - CAC40	13362	-7.2	-7.4	-5.5	-4.4
HK - Hang Seng	69723	-10.0	-11.8	-16.6	-8.4
Australia - S & P 300	59319	-6.2	-6.0	-0.5	2.9
NZ-S&P/NZX 50 Gross Index (inc imp credits)	10535	-6.3	-1.5	4.2	8.6
NZ-S&P/NZX 50 Gross Index (excl imp credits)	8752	-6.4	-1.9	3.7	7.4
Market Volatility - VIX	21.2	75.2	65.5	33.3	108.5

New Zealand Property		%	%	%	%
S&P/NZX All Real Estate (inc imp credits)	1350.6	-3.4	0.6	7.3	12.0
S&P/NZX All Real Estate (exc imp credits)	1308.1	-3.4	0.5	6.8	11.0

Ten Year Bonds	%	Yield Changes			
USA	3.15	0.10	0.19	0.20	0.79
Japan	0.12	0.00	0.06	0.07	0.06
United Kingdom	1.46	-0.10	0.12	0.04	0.13
Australia	2.61	-0.05	-0.05	-0.17	-0.05
New Zealand	2.54	-0.08	-0.22	-0.48	-0.38

90 Day Interest Rates	%	Yield Changes			
USA	2.34	0.15	0.31	0.47	1.25
Japan	0.05	0.00	-0.04	-0.05	-0.02
United Kingdom	0.82	0.02	0.02	0.11	0.38
Australia	1.91	-0.03	-0.06	-0.12	0.22
New Zealand	1.91	0.00	0.00	-0.11	-0.03

Bond Indices	Closing Values	Changes over: 1 Mth %	3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	714.98	0.16	0.48	0.99	1.96
S&P/NZX NZ Government Bond Index	1731	0.43	1.56	3.29	4.79
Barclays Capital Global Aggregate Index (Hedged NZD)	N/A	-0.22	-0.29	0.31	0.43

Hedge Funds & Commodities		%	%	%	%
HFRX Global Hedge Fund Index (USD)	1221	-3.1	-3.3	-3.4	-3.5
DJ-UBS Commodity Index Total Return	173	-2.2	-2.0	-6.2	-1.7
Gold (US$/ounce)	1212.30	1.7	-0.9	-7.9	-4.3
Oil (US$/barrel)	74.84	-9.5	0.9	-1.4	22.0

Currencies		%	%	%	%
NZD / USD	0.6530	-1.5	-4.1	-7.3	-4.7
NZD / EUR	0.5763	1.0	-1.0	-1.2	-2.0
NZD / GBP	0.5111	0.5	-1.5	-0.1	-0.9
NZD / AUD	0.9213	0.6	0.6	-1.3	3.1
NZD / YEN	73.69	-2.1	-3.3	-4.4	-5.3
Trade Weighted Index	71.67	-0.2	-1.8	-4.3	-4.1

**Total Return Indices. Indices are net of offshore tax.*
Source: Thomson Reuters Datastream

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