Tumultuous start to Year of the Monkey

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- We do not expect a hard landing in China, at this stage.
- Commodity and oil market turmoil has caused a degree of contagion in Australian markets.
- Stocks look attractive after the recent pull-back.

The Chinese Year of the Monkey has started in a tumultuous way for investors in a range of asset classes. Australian equities have been dragged along in the wake of a number of major macro headwinds starting with tightening US dollar financial conditions, a sharp drop in the oil price and concerns about the outlook for Chinese economic growth. In addition, we have seen the Sovereign Wealth Funds of oil producing nations offloading equities to raise funds to cover budget shortfalls. The Australian equity market is now back at a far more attractive valuation since the start of the pull-back in May last year.

We would also make the following comments about the macro headwinds mentioned above:

a. The US Federal Reserve is now on the path of tightening financial conditions as it has been since the end of its QE program. Additionally, it recently made its first rate increase in many years. This will be a different investment environment to what we have experienced since the end of the GFC. In particular, we expect volatility to be higher as the US Federal Reserve continues to tighten.

b. China faces very substantial headwinds as it seeks to deal with excess capacity in many of its heavy industries and residential housing sector. Also, China must still address the bad debts in its banking system and an overvalued currency. From time to time, these issues will cause concerns for investors as they did in January. At this stage we do not expect a hard landing in China, but we are continuously monitoring the situation as a policy mis-step by the government could trigger a sharper downturn.

c. The oil price has now fallen by around 80% since May 2014, which was driven by a combination of supply and demand driven factors. On the demand side, we have seen China, Brazil and Russia experience slower growth or contractions in demand in the last 18 months. On the supply side we have seen an expansion in supply from the US and Russia, and the Saudis showing a reluctance to reduce supply for fear of losing market share. Also, there is a geopolitical element to the Saudis' actions given the current hostilities in the Middle East between forces aligned with the Saudis on one side and Russia and Iran on the other. According to the energy consultancy, Wood Mackenzie, energy groups have cut about $400bn of spending on new oil and gas projects since the oil price collapse. This decline in investment should stabilise oil prices in the 2H16. Given the average annual decline rate of approximately 5% for oil production, the oil price will eventually move higher to stimulate replacement capacity.

The turmoil in commodity and oil markets in January (which has continued into February), has caused a degree of contagion in our markets. A number of mining, energy and related companies are being priced as if their financial viability were in question. We have seen this fear feed through to the banks which finance them as well.

There are some commentators comparing the current market to 2007/08 period. We disagree for a number of reasons:

a. The global economy still appears to be in reasonable shape, in particular, the US economy, which continues to solidly add jobs. We believe we are likely to see more of the anaemic growth we have had since the GFC.

b. The Australian economy faces a number of challenges with ongoing commodity price declines, the end of the associated capital expenditure cycle, a peaking housing cycle and a dysfunctional political system. However, we continue to stumble along with sub-trend growth supported by a weak currency and loose monetary policy.

c. The market has performed poorly over the last 12 months and is not expensive as highlighted above. As such, it is hard to get overly bearish.

d. Corporate Australia is in far better financial shape on average than it was at the start of the GFC.

e. The domestic banking system is much stronger than it was back in 2007, albeit it could be strengthened further.

So, what do we expect from here for markets?

Credit markets have clearly tightened (and become less liquid) so investors seeking to raise funds through the sale of holdings will likely continue to look to the equity markets. At a point, the lower valuations will attract funds back from the sidelines. We are seeing specific stocks look attractive after the recent pull-back. As such, we will look to deploy some of our cash and re-balance the portfolios to take advantage of these opportunities.

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