Research Bulletin
Market update - correction or crisis?

25 August 2015

Markets have had quite a tough time in August, and as always trying to forecast how they will act and which direction they will take is difficult. One thing we do know is that financial markets are volatile which is often brought on by irrational behaviour.

Market efficiency tends to get thrown aside as irrational investor behaviour usually overwhelms rational market behaviour.

The recent sell-off we believe is just that. The markets correcting due to a period of strong growth. It was expected. What followed was the irrational behaviour of investors that began to indiscriminately sell as a result.

We all need to take a deep breath and realise that short-term market noise is not a reason to panic. Volatility is expected and should not be the cause of mass selling or hasty decisions.

What's happened?

Global markets have been routed over the past two trading days experiencing falls not seen since the depth of the global financial crisis in 2008.

Amid one of the worst sell-offs since 2008, global markets experienced falls of up to 8-9% as panic selling gripped the world taking no prisoners.

The rout pushed the S&P 500's two-day bludgeoning to 7%, while the world's second largest economy, China, saw its sharemarket sink 8.5%, the most since 2007.

The Australian market itself suffered its worst day yesterday as the S&P/ASX 200 Index fell 4.1%, its largest fall since the GFC.

Why has this happened?

Some have labelled what has happened over the past two days "the perfect storm", the correction we had to have, while others have interpreted this as perhaps the start of another financial crisis.

The epicentre of recent events however has been agreed upon. China and the faster than anticipated slow-down in economic growth.

The propping up of the Chinese sharemarket by the government did not come this time and coupled with the devaluing of its currency, which many perceived to be a policy measure in response to slack economic growth, set the ball rolling.

However, there's been a number of other factors which have contributed. The fear of rising US interest rates and continuing doubts over the recovery of the Eurozone have also underscored the recent sell-off.

Let's get back to China. Don't forget the Chinese sharemarket, the Shanghai Shenzhen CSI 300 Index, has grown by approximately 108% over the past 12 months fuelled by a retail stock buying frenzy. Chinese investors continued to borrow money to access the markets pushing up valuations to levels not supported by fundamentals. As news filtered through that the economy was slowing, panic set it and the sell-off begun. Most global markets were also at pre-GFC levels as investors pushed the price up on growth assets as bond yields hit all-time lows.

A pull-back was inevitable.

What can we expect?

We believe sharemarket volatility will continue in the short-term. Confidence levels have taken a hit in recent days and investors will remain fearful and cautious as it waits on further news out of China.

It must also be remembered that China is a maturing market. Growth tends to slow as markets mature so expectations must be tempered. This would no doubt alleviate the potential of disappointment due to overly optimistic growth projections.

What affect will it have on Australia?

Our sharemarket, although suffering, remains fundamentally sound. We are a commodity-driven economy and our fortunes as a result are closely correlated with those of China. We will feel the pain as we slowly move to a non-mining driven economy however we do have the luxury of being one of the few countries that can still pull the monetary policy lever.
The RBA will keep a close eye on events and will perhaps consider cutting rates again to re-install confidence if required.

Centrepoint Alliance Research thoughts and portfolio implications

From an investment/portfolio construction perspective, we again stress the importance of staying the course. Coupled with irrational selling, we believe recent events were expected as markets rallied beyond their means.

"Don't lose sight of your strategy or your investment horizon"

The best approach is not to react too hastily. No knee-jerk reactions to short-term volatility and market noise. Markets will become volatile. It's important to ensure that your investments are well diversified.