Research Bulletin

Market update – global markets welcomes chaos for the start of 2016

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Global Markets start 2016 in chaos – is the caution on China overdone and what are the implications for Australia?

Wow…what a start to the New Year.

What's happened?

Global equity markets have fallen circa 10-15% in the first few weeks of 2016 losing billions of dollars along the way in what some have described as the beginning of another crisis.

The S&P/ASX200 has lost approximately 19%, the Dow Jones Industrial has shed 14% whilst the FTSE100 has just crept into 'bear' territory losing 20% since their highs back in April/May 2015…The S&P/ASX200 has lost 7% already in the in the opening three weeks…Why the commotion?

Why has this happened?

China growth concerns have been the focal point of all this volatility. This, coupled with sentiment taking a beating due to market negativity and fear of another global financial crisis (GFC), is playing havoc with share markets globally. A perfect example of this occurred last week when British bank, RBS, urged investors to "sell everything".

While we can't foresee what's going to happen in the near future, the dynamics of today's markets are very different to those which ravaged global markets back in 2008. To begin, low oil prices and low interest rates are providing a boost to consumers in terms of disposable income, while a number of sectors, most notably export orientated companies, are also benefitting from a lower $A. These two scenarios were not evident during the GFC.

Nikko AM as well as a number of other major investment houses including Franklin Templeton and AMP, believe the market selloff to start 2016 has been overshot and that although volatility will continue throughout the year, recent market losses should not be a signal to start selling portfolios, nor should it be construed as the start of another GFC. This view supports the position of Centrepoint Alliance.

While China growth has certainly slowed over the years, and the recent sell-off plus the sharp fall in its currency has renewed concerns regarding the Chinese government's ability to manage a slowing economy; recent swings in the share market are less to do with fundamentals than they are regulators.

We believe China powerbrokers still have the tools and levers in place to counter the recent slowdown and the move from an investment driven economy to a consumer driven economy won't be achieved without teething problems and some level of volatility.

It's also important to take into account the size of China's economy. Unlike five to ten years ago, the China economy has grown to the point of being the second largest in the world. Growth rates are expected to decrease as this occurs, as growth normalisation commences. Lower levels of GDP at a much greater base still produces massive levels of global aggregate demand.

Finally, the quality of growth in China has improved in recent years. Increasing labour costs and interest rates have put downward pressure on profits; however, higher wages boost consumption, which has increasingly become the anchor of Chinese growth. Franklin Templeton estimate that consumption is close to 60% of GDP and rising. This is nearing levels of the US.

What does this all mean? Simply, stick to the plan. Short-term volatility should not be a green light for knee-jerk reactions.

Recent data out of China has not been all that bad. At the time of writing, China's economy grew 6.8% in Q4 from a year earlier, slightly below market expectations of 6.9% and the slowest since the GFC. This apparently has placed pressure on Beijing to roll out more support measures as fears of a sharper slowdown panic investors.

The number further emphasises that China's economy is cooling down. Although based on the size of its economy relative to what is was 20 years ago, single mid-digit rates as opposed to the heady days of double-digit growth rates of the past five to ten years will be far more sustainable and, more importantly, there no signs yet of a hard landing, which investors fear.

There is good news however in that most market participants have seen 2015 as a turning point in the overall dynamic of the Chinese economy in that GDP growth will hopefully be driven by consumption as opposed to fixed-asset investment going forward.

China's economy is growing at two speeds, with the old model of rust-belt industries from steel to coal and cement in decline, while consumption, services and technology do better. This was evident in the Q4 numbers as retail sales climbed 11.1% in December from a year earlier, however less than an 11.3% rise expected by the market. Fixed-asset investment growth grew 10.0% in 2015 from the previous year, also missing market expectations. Despite obvious dramas, China generated circa 40% of total world growth, and is predicted to do about the same this year.[1]

[1] Source: Kenneth Courtis, former Asia vice chairman at Goldman Sachs Group Inc. and now chairman of Starfort Holdings.

What affect will it have on Australia?

The Australian market could be problematic. With demand in our key resources falling, along with the continued weakness in commodity prices (added pressure on terms of trade), plus the transition to non-resource sector led GDP slow and tedious, growth looks set to muddle along for another year. Expectations are of 2.5% but there is quite a number of headwinds.

China's economic shift will continue to have both positive and negative implications on our economy depending on which sector we are referencing.

What can we expect?

Volatility to continue throughout 2016, at least over the medium-term. Interest rate direction and general policy divergence between the US Fed and other central banks and its effect on share and bond markets, emerging market implications, currency "wars", and geopolitical risk, are just some potential headwinds to be faced throughout the year.

As commodity prices keep falling and the AUD falls with it, our resource and materials sectors will be hurt. However, the services sectors such as financial services, healthcare, education and IT will hopefully prosper due to a depreciating dollar. Whether this will be enough to pick up the slack remains to be seen.

2016 looks like it could be a year of consolidation and focussing on preserving capital.

Centrepoint Alliance thoughts and portfolio implications

The Australian economy is one that will be affected more than others as a direct result of China fortunes. Although the domestic market has long been the favoured asset class among advisers and their clients due to the level of franking that accompanies distributions, company pay-out ratios could well be under pressure this year, which will see share prices hammered and yields fall dramatically. This is something to be cognisant of and ensure portfolios are well diversified.

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

For more information or assistance please do not hesitate to contact the Fundzcorp Financial Services team at **admin@fundzcorp.com.au**