insightpaper

AMP CAPITAL

THE CORRECTION WE HAVE BEEN EXPECTING

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For over a year we have been expecting a correction in equity markets. This is now occurring. After moving equities back to benchmark from overweight in April last year, our view has been the steady march upwards in share markets couldn't go on without a 'reset' at some stage but the fundamental backdrop remained supportive of the trend.

Corrections in markets are not typically caused by share market overvaluation, but by some other event. The catalyst for the current correction was China's currency devaluation this month. This raised concern in some minds that the China slowdown is serious and the economy could be heading for a hard landing.

China's slowdown has been casting a shadow over emerging markets for some time, particularly commodity exporters, but the recent devaluation has seen the sell-off extend to the large developed markets, including Japan, Europe and more recently, the US.

US share markets have been treading water all year, in anticipation of the first rate hike from the US Federal Reserve (the Fed). Higher US rates was always a prime candidate for a correction but given current volatility, the odds are now declining of a rate hike this year.

Our view is that China is not heading for a hard landing. The economy continues to grow and the authorities have ample firepower to prevent a downward spiral. Ironically, China is slowing partly because it is trying to reduce the chance of a hard landing in years to come, by reigning in credit growth. In a 'health check' this month, the IMF reported that China is moving to a slower yet safer and more sustainable growth path.

THE LESSON OF THE LAST FEW YEARS IS NOT TO PANIC DURING MARKET CORRECTIONS.

Share markets recovered from the taper tantrum, US debt ceiling debacle and periodic Euro crises because the global economy continued to grow, monetary policy remained very loose and the global banking system was better capitalised compared to previous crises. Nothing has changed on these fronts.

SHARE MARKET CORRECTIONS CAN PRESENT BUYING OPPORTUNITIES FOR THE MORE PATIENT LONG TERM INVESTOR.

Essentially, such investors provide liquidity during market dislocations. When there are too many sellers, shares must be sold at cheaper prices to bring buyers into the market.

Of course, no one knows for sure how far shares have to fall to bring enough buyers into the market to stabilise prices. Shares could get cheaper still, but we think further China easing or a delay by the Fed will be enough to put a floor under share prices. Those outcomes are looking more likely each day.

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