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SHARES HITTING BEAR MARKET TERRITORY

The fear of fear itself or something more fundamental?

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KEY POINTS

- The malaise in financial markets is continuing with Europe, Japan and emerging markets in a bear market. New Zealand shares are down 6% from the peak at the end of 2015.
- Global growth worries could drive more short term weakness. But in the absence of a US/global recession it's hard to see a deep and long bear market.
- The key for investors is to recognise that periodic declines in share markets are normal, that selling after big declines just locks in a loss, that dividend income from a well-diversified portfolio is little affected by share market volatility.

INTRODUCTION

The malaise affecting equity markets and risk assets generally has shown no let up with New Zealand shares slipping into bear market territory (defined as a 20% or greater decline from the most recent high). In some ways it is reminiscent of 2008 with tightening credit markets, bank shares under pressure and worries central banks are powerless.

From their highs last year to their latest lows, US shares have now had a fall of 13%, New Zealand shares -6%, Japanese shares -25%, European shares -26%, emerging market shares -27% and Chinese shares -49%. So New Zealand is not alone – in fact the drivers of the fall from last year's high are global and many markets have had deeper falls.

With global growth worries likely to linger we could still see more downside in the short term. However, a critical differentiator between whether that further downside is say 5-10% and short versus say another 25% and drawn out is likely to be whether the US/global economy has a recession and whether central banks can provide more helpful policy support.

FAULT LINES IN THE GLOBAL ECONOMY

What started in January as mainly China based worries has clearly broadened back out to concerns about global growth. At its core there are five fault lines running through the global economy.

The first is the malaise in emerging markets that began earlier this decade, with Brazil and Russia in recession. The second is the ongoing concern about China and its intentions regarding the value of the Renminbi. The third is the collapse in commodity/oil prices which is weighing on energy producers and hence business investment, credit markets and driving selling by sovereign wealth funds. The fourth is the strong US dollar which has made the fall in the oil price worse, raised debt servicing concerns in the emerging world and weighed on the US economy. Finally, there is fear itself as financial market turmoil drives fears that this will cause a global recession via reduced confidence, lower wealth and tighter credit conditions. This in turn is reinforcing selling pressure and pushing share markets even lower. Worries about banks – and their exposure to energy loans and higher bad debts if there is a recession – seem to be at the centre of this.

These are all feeding on each other to a degree. However, there are some positives: Chinese economic data has been more mixed rather than negative lately; the Renminbi has settled and the US dollar looks to have peaked; and central banks are becoming more dovish.

There are three key issues. How serious is the problem regarding banks? Will the US have a recession? And are central banks out of ammo?

WHAT IS THE RISK OF ANOTHER BANK CRISIS/ CREDIT CRUNCH?

While the risks have risen, there are several reasons for believing that a GFC style credit crisis is unlikely. Banks are better capitalised now, and US and European bank exposure to energy loans at around 2-4% of total assets is a fraction of their exposure to housing loans (at the centre of the Global Financial Crisis). In addition, new restrictions on proprietary trading have limited banks' exposure to riskier corporate debt and the issues of low transparency and complexity that bedevilled the sub-prime mortgage market are not really an issue in corporate debt markets now. So far we are not seeing any blow out in interbank lending rates.

IS THE US ECONOMY HEADED FOR RECESSION?

This is a critical question as the US share market sets the direction for global shares, including the New Zealand share market. Historical experience tells us that slumps in shares tend to be shallower and/or shorter when there is no US recession and deeper and longer when there is (eg the 'tech wreck' and GFC). See the next table.

FALLS IN US SHARES GREATER THAN 10% SINCE 1989

SHARE MARKET FALL	MTHS	% FALL TOP TO BOTTOM	RECESSION YES/NO	1 YR GAIN FROM LOW, %	CAL YR RETURN, %
Sep 89-Jan 90	4	-10	No	+5	32 (89)
Jul 90-Oct 90	3	-20	Yes	+29	-3
Oct 97-Oct 97	1	-11	No	+21	33
Jul 98-Aug 98	2	-19	No	+38	29
Jul 99-Oct 99	3	-12	No	+10	24
Mar 00-Oct 02	31	-49	Yes	+34	-21 (02)
Oct 07-Mar 09	17	-57	Yes	+69	-37 (08)
Apr 10-Jul 10	3	-16	No	+31	15
Apr 11-Oct 11	6	-19	No	+32	2
Apr 12-Jun 12	2	-10	No	+26	16
Average	7	-22	NA	+30	NA
May 15-?	9?	-13?	NA	NA	NA

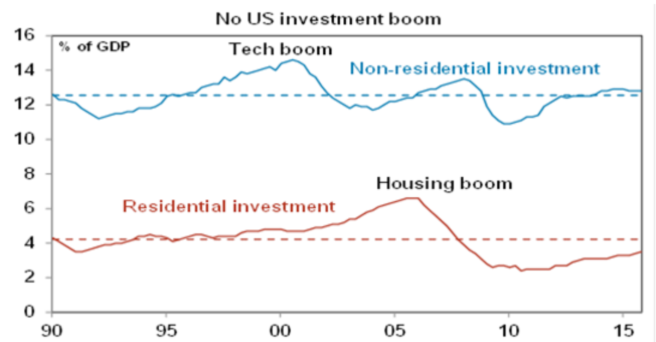
Bear markets are highlighted in blue.

Source: Bloomberg, AMP Capital.

A range of considerations have raised the risk of a US recession: December quarter GDP growth slowed sharply; credit spreads (ie the interest rates on corporate bonds relative to government bonds) have blown out to levels associated with recessions; and falling energy related investment is weighing on manufacturing. But against this:

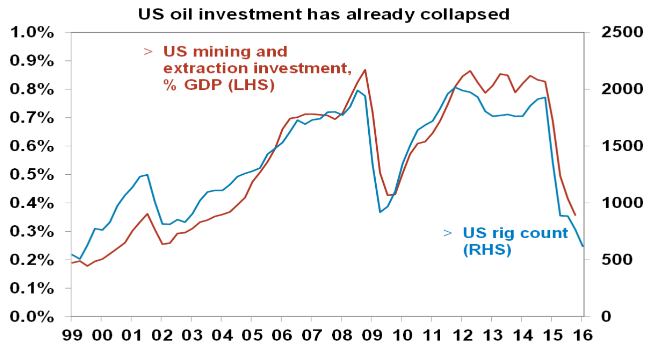
> US growth has regularly run hot and cold since the GFC.

> We have seen none of the excesses that precede recessions – like excessive growth in private debt, over-investment in housing or capital goods, high inflation, or a speculative bubble in shares or housing.



Source: Thomson Reuters, AMP Capital

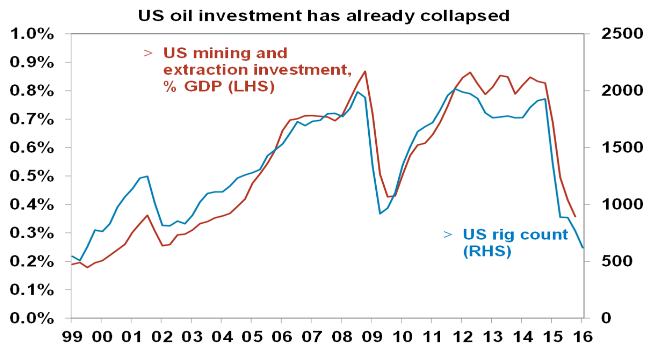
> Some of the softness in recent US economic data has been due to falling energy related investment. But with resource investment having fallen from 0.9% of US GDP to just 0.4%, the bulk of the damage from this may already be behind us.



Source: Thomson Reuters, AMP Capital

> While the collapse in oil prices is a big drag on energy producers, it is a huge boost to household spending power. This is very different to the loss of household wealth that flowed from the housing collapse at the centre of the GFC.

> Nor have we moved to an inverted yield curve (where short term interest rates exceed long term interest rates) driven by aggressive monetary tightening like the 17 Fed interest rate hikes seen prior to the GFC. Inverted yield curves have regularly warned of recession.



Source: Bloomberg, AMP Capital

ARE CENTRAL BANKS OUT OF AMMO?

This is a common concern with interest rates already at or around zero for major central banks. However, they are a long way from being unable to do anything:

> the Fed can reverse last year's interest rate hike and launch another round of quantitative easing (QE);

> the ECB could provide more cheap short term funding for banks;

> both the ECB and Bank of Japan could expand their QE programmes; and

> QE programmes could be focused on buying corporate debt to bring down corporate borrowing rates.

More negative interest rates are also an option but central banks may be wary of this after the negative impact of Japan's move on banks. Perhaps the ultimate option is for central banks to provide direct financing of government spending or tax cuts.

If credit markets and bank share prices don't settle down soon many or all of these measures are likely to be adopted with the ECB potentially launching a QE programme focused on buying corporate debt as early as next month.

Meanwhile, the People's Bank of China (with an official benchmark rate of 4.35%) and the RBA (with an official cash rate of 2%) still have a long way to go before they even have to consider unconventional monetary policies.

WHAT SHOULD INVESTORS DO?

Times like the present are very stressful as no one likes to see the value of their investments decline. Investors need to allow for several things:

> First, sharp falls are regular occurrences in share markets – we have seen it all before. Shares literally climb a wall of worry over many years with numerous events dragging them down periodically, but with the trend ultimately rising and providing higher returns than other more stable assets.

> Second, selling after a major fall just locks in a loss.

> Third, when shares and growth assets fall they are cheaper and offer higher long term return prospects. So the key is to look for opportunities that the pullback provides – shares are getting cheaper, investment yields on shares and corporate debt are rising. It's impossible to time the bottom but one way to do it is to average in over time.

> Fourth, while shares may have fallen in value the dividends from the market haven't. So the income flow you are receiving from a well-diversified portfolio of shares continues to remain attractive, particularly against bank deposits.

> Fifth, shares and other related assets will bottom at the point of maximum bearishness, ie just when you and everyone else feel most negative towards them. So the trick is to buck the crowd. As Warren Buffett once said: "I will tell you how to become rich... Be fearful when others are greedy. Be greedy when others are fearful".

> Finally, turn down the noise. At times like the present the flow of negative news – via traditional and social media – reaches fever pitch, making it harder to stick to an appropriate long-term strategy let alone see the opportunities that are thrown up.

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