Market Update

What has happened?

Over the last couple weeks, equity markets have largely continued to trend down, led by falls in US technology stocks, which are the same stocks which drove markets higher over the last few years. The much talked about FAANG stocks are now down 28% on average from their 52 week highs.

We also saw a large drop in the oil price more recently on concerns regarding rising supply and fears of slowing economic growth.

Why has it happened?

Understanding investor behaviour is always difficult, especially over shorter periods of time. From the information we've seen and the ongoing analysis conducted, we can see four main reasons for the current turbulent market movements:

1. US central bank policy (not new, ongoing concern)
2. US-China trade wars (not new, ongoing concern)
3. US technology stock valuations (new, shouldn't be surprising)
4. Panic / algorithmic / ETF selling (potential opportunity)

As mentioned, the first two are ongoing issues, which continue to stoke investor concerns. The US central bank has turned a little dovish more recently softening some of their rhetoric, however, they remain somewhat clear that they expect to raise rates another 5-6 times over the next 12-18 months before stopping their tightening cycle. In contrast, market expectations are that they stop after 3-4 rate rises (middle of 2019) as the US economy rolls over and gets too soft for them to raise any further. At this point, it's a 50/50 bet either way.

On US-China trade wars, the market got a little optimistic earlier in the month that some sort of common ground might be reached when President Trump and President Xi meet, which may pave way for the end to the trade conflict. That optimism was short-lived. Whilst it's in both Presidents' best interests to find some common ground, we put the probability of that occurring at this meeting at around 30%, though up from 0% not that long ago. The trade wars are having a material impact on global economic growth, with growth rolling over in Europe and Japan more recently, and manufacturing and other business data down quite sharply as a result. Business and investor sentiment and confidence has been sapped.

On US technology stocks, the falls that we've recently seen were somewhat inevitable given the unnecessary rally we saw this year up until September. Case in point, Amazon's share price went from $1,189 to $2,039, before closing at $1,516 yesterday. Did much change at the company level in that time? NO. Is anything fundamentally wrong with these technology stocks? NO. They generally have little to no debt on balance sheet, sky high margins, significant volume growth, and earnings growth compounding annually in the high teens to early twenties. Nothing wrong with that picture. However, more recently investors have begun to question how sustainable those earnings are into the future, and the recent company reporting season showed investors move their attention to revenue growth (top-line) rather than earnings growth (bottom-line), effectively using revenue growth as a barometer for sustainability of those earnings. We agree that technology stocks should demand a premium price and hence valuation, but that does need to be kept in-check from time to time. Extrapolating recent or current growth into perpetuity is plain stupid.

On panic / algorithmic / ETF selling, whilst panic selling is not new, and we're definitely in the midst of it right now given equity valuations look rather compelling, the paradigm shift comes from algorithmic and ETF selling. Algorithmic (automated) trading, simply, involves computers programmed to follow a defined set of instructions at a speed and frequency that impossible for a human trader. ETF buying and selling involves indiscriminate buying and selling of whole markets - regions, countries, sectors, sub-sectors, themes, etc. Once panic or trends set in, indiscriminate selling results in quicker and sharper down movements, which can be hard to reverse. We're seeing more and more this of late.

Is there any need for concern?

Potentially, especially if trade wars escalate from here and/or if the US central bank mis-reads conditions and goes too hard on rates. However, we see the recent downturn as a somewhat rational pull-back (for those not panicking) and plenty of opportunity for those with excess cash, those who have been waiting for a better price point to buy in, and those employing a dollar-cost averaging investment framework.

As mentioned above, equity valuations remain undemanding and some markets look very cheap at present, all with a long term view in mind obviously. For example, the US equity market is trading slightly above its average on a 1 year forward basis, the Australian equity market is at fair value as is the European equity market, whilst Asian and Emerging Markets look cheap versus their long term history. All this whilst earnings growth looks more than reasonable.

What should I do?

Don't panic. Whilst volatility will continue to rise from here, that will also mean opportunity. Fundamentals look sound even in light of some economic and political headwinds arising. Where appropriate, look to put some excess cash to work. Ensure your portfolio is adequately diversified across and within asset classes, market segments, and investment styles/approaches. Don't get too caught up in the near term and avoid selling low and buying high at all costs. Analysis shows that missing the best 50 days over the last 20 years in Australian equities resulted in a 0% return versus a near 9% return for those that remained invested.

If concerned or unsure, please speak to your financial adviser.