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Anton comments on the recent correction on Wall Street

INVESTMENT INSIGHTS

By Anton Tagliaferro | 03 February 2018

Last week Wall Street fell over 1,000 points, reversing the sharp rises of earlier in the month. Many are now asking if this is the start of a new trend on markets and what it all means for the Australian sharemarket.

Anton Tagliaferro, IML's Investment Director provides his comments:

- The falls on Wall Street last week have to be kept in perspective of the strong rises in this market over the previous 12 months. The Dow was below 20,000 at the beginning of 2017 and rose to over 26,000 in January 2018 – a rise of over 30%. What is remarkable about this rise is that it came about after 12 consecutive monthly rises in the US market – the first time in history that this has ever happened. It has also happened with volatility at record lows – with the US VIX index sitting at record low levels for months on end during 2017.

- While the trends for global economic growth continues to be positive with many upgrading their outlook for 2018, this does put pressure on Central Banks around the world to reverse the very easy money conditions that we have seen since the GFC. The US Fed has increased the US Fed Funds rate 3 times over 2017 with further rate rises expected throughout 2018. In our view, at some stage in 2018, the European Central Bank (ECB) - which continues to merrily pump 50 billion Euros a month into the system through its QE programme - also has to acknowledge the improving trends in the European economy and amend its very easy money policy of zero rates plus QE (money printing). The current lax ECB policy has led to the ridiculous situation where European junk bonds or the bonds of financially troubled countries like Greece are now trading at yield below US Government bonds. This situation will have to correct itself at some stage.

- The overall Australian sharemarket has severely lagged the gains on overseas sharemarkets over the last 12 months. Having said this, certain sectors of the Australian sharemarket have had strong returns as many investors chased the riskier end of the market to take advantage of the growing bullish sentiment overseas. Thus the Resources sector gained over 20% over 2017 with BHP and RIO leading the charge as the iron ore and oil prices rallied strongly over the year. The bullish and sometimes irrational sentiment of many investors was also reflected in the spectacular gains in sectors linked to the 'Chinese daigou' system or other speculative areas, such as smaller technology companies, where PE's of 40 or 50 times earnings are currently the norm. This sentiment is also reflected in the speculative small Resource sector where anything linked to lithium exploration has also shown spectacular and mainly irrational gains.

- Other areas of excesses were apparent in the last 12 months as many markets globally rose on a combination of easy money and strengthening economic growth. Emerging markets soared over 2017 as many investors sought exposure to the upside in world growth. The ridiculous rise in Bitcoin over 2017 exemplifies the excessive bullishness and large amount of loose money floating around the world with many investors throwing caution to the wind in the chase for higher returns.

- We have been expecting a reality check for some time and have been surprised by the uninterrupted strength of many markets over the last 12 months. While the Australian sharemarket will weaken in line with overseas markets, we believe the main pain will be felt in areas such as the Resource sector and all the speculative smaller stocks.

- We believe that while there remains a strong case for continued US rate rises and a reversal of the ECB's excessive easy money conditions, we believe it will be some time before we see rate rises here in Australia. The Australian economy continues to be heavily weighed down by a heavily geared consumer and with house prices showing weakness recently, we believe the Australian economy will continue to grow at below the level we had seen in previous years. While the Australian ten year bond has sold off in line with its US counterpart, we believe rates in Australia are set to remain low for some time yet – meaning stocks with good yields will remain very appealing to Australian investors.

- We are adding to many companies that we patiently held over 2017 and which have lagged the sharemarket's rise. We are happy to be accumulating stocks like Spark Infrastructure (SKI) and Shopping Centres Australasia (SCP) on yields of 6% with growth expected in this yield in coming years. In addition, recent weakness in the share prices of other defensive sectors – such as the Packaging sector on input price concerns – presents an opportunity for a value investor like IML to increase its exposure to some of the quality names in this sector.

Conclusion

While it is always hard to forecast what sharemarkets will do in the short term, we conclude that:

- The current correction is well overdue following 12 consecutive months of gains in the Dow and it is highly unlikely that we will see the same gains on overseas markets that we saw in 2017.

- While sharemarkets will likely rebound at some point, we believe it is likely that the combination of high valuations for many sectors as well as rising bond yields will lead to significantly increased volatility in sharemarkets over 2018.

- We expect the correction in Australia will be mainly felt in high flying areas like the Resources sector as well as many lower quality smaller companies where we have seen excessive speculation.

- While rates in the US may increase further in 2018, we believe the RBA will keep Australian interest rates on hold for some time yet given the high leverage of Australian consumers as well as the continued strength in the Australia dollar against the US dollar.

- At some stage in the next year or two, we expect the Australian dollar will weaken as US rates are lifted further, as US growth picks up, while the RBA keeps rates on hold because of our highly leveraged households.

- Many quality Australian Industrial companies on yields of 4, 5 and 6% with growth continue to be the core of the IML portfolios. In our view these companies will continue to look attractive for some time yet given our expectation of low interest rates here in Australia. We will be looking to use the cash in our portfolios to add to our positions in these types of companies in market weakness.