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Diversification helps navigate market volatility

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What have market movements been since the start of the year?

Since the start of this year, major share markets have been displaying a heightened level of volatility.

The trend has been downwards, with market movements from 1 January to 9 February including the following: the broad US market (S&P500 index) down 9%, the technology-laden Nasdaq down 14%, the UK, German and French markets down respectively by 10%, 16% and 12%, while in Asia, the Japanese, Chinese and Indian markets fell by 16%, 22% and 7%.

The domestic Australian market also fell by a hefty 9%, while the $A also fell by 3% against the $US over this period.

Why have markets been so weak?

This market weakness undoubtedly reflects growing investor concern about the outlook for global growth. Whether investors have over-reacted is another matter.

While the International Monetary Fund (IMF) marginally reduced its global growth forecast on 19 January (to 3.4% for this year and to 3.6% for 2017, each down by 0.2% from its October forecasts), these forecasts still point to a higher rate of growth this year than last year.

However, there are three key issues that the IMF has focused on as presenting what it terms ‘challenges’ to the global growth outlook for this year.

These challenges include:

1. a continuing rebalancing of the Chinese economy (although so far this transition is being relatively well-managed, with growth coming in at a higher than anticipated 6.9% for 2015)
2. lower commodity prices, especially for oil (which, in itself, is related to the shift in emphasis away from manufacturing towards services in China), and
3. ‘the exit from accommodative monetary conditions’ in the US.

In the latter case, this exit began in December when the Fed raised official interest rates from around 0% to around 0.25% and also foreshadowed further likely interest rate increases this year.

In the IMF’s view, it is essential that these ‘transitions’ as it terms then be managed carefully as, ‘if these key challenges are not successfully managed, global growth could be derailed’. In our view, a rebalancing of the Chinese economy is proceeding at a reasonable pace and growth still appears on track to come in close to last year’s solid growth rate and at least in line with the IMF’s forecast for this year of 6.3% for the year (a growth rate that remains impressive when compared with that of any other economy and especially given the size of the Chinese economy which is now the second largest in the world).

As far as commodity prices are concerned, lower prices in themselves are a benefit to the world as a whole, with lower oil prices alone likely to add up to 0.5% to annual global growth. Of course, lower commodity prices do have a negative effect on commodity-dependent economies and have already pushed Russia and Brazil into recession, not to mention the severe blows dealt to Middle Eastern oil-exporting countries in particular.

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Recent economic data out of the US has been relatively weak, including the ISM manufacturing index for December, which fell to 48.2, indicating that the sector is contracting, while (partly due to a high $US) aggregate corporate profits have been declining and net exports have been soft.

Furthermore, US GDP grew by only 0.7% (at an annualised rate) in the December quarter. All of this appears to be signalling that the ‘Fed’ may have to defer further interest rate rises for quite some time, especially as one side-effect of too much tightening would likely be an even higher $US, which could be expected to slow industrial output in the US even more. In our view, however, we believe that the ‘Fed’ is well aware of this situation.

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As it noted itself in its 27 January statement, 'the actual path of the federal funds rate will depend on the economic outlook as informed by economic data'.

In other words, the US central bank is not going to be putting interest rates up further unless the US economy is showing genuine strength.

Are stock markets too expensive?

In terms of stock market valuations, the recent global pull-back has significantly improved what were already fair market valuations in our view (compared with historical average market valuation data and even more so compared with valuations of other investment opportunities, such as bonds and property).

Across the world, monetary policy remains essentially expansionary, with 'quantitative easing' very much in place in Europe, Japan and other economies, while interest rates almost everywhere remain at all-time historical lows.

On top of this, fiscal policy is also becoming more expansionary after a lengthy period of attempts to rein-in government deficits, especially in Europe and even the US and China. All of these programs are aimed at boosting investment and even consumer spending and this is very likely to be effective in time.

As and when it becomes clear that such policies and programs are lifting growth, we are likely to see stock markets reap the benefit and return to an upwards trend.

What is Fiducian doing about the recent market decline?

In the current environment, where even the IMF is stating that 'risks to the global outlook remain tilted to the downside', despite our generally positive view of the overall outlook, we have been taking a cautious stance in relation to our diversified funds in particular.

Overall investment strategies should include properly diversified portfolios for capital growth, income and risk minimisation constructed with the help of a financial planner

We are currently around benchmark for domestic shares and listed property, although we remain slightly overweight for international shares (partly due to the potential for the $A to fall further and give a lift to the $A value of overseas share holdings).

Exposure to fixed interest sectors remains underweight, while cash weightings are currently significantly above benchmark.

Apart from our overweight position in cash in our diversified funds, most of our sector funds also hold considerable levels of cash which can be put back into share markets at short notice.

What should investors do in the current volatile environment?

We continue to recommend that investors maintain their investment strategies and hold any positions they may have in share markets with the aim of achieving solid returns over the medium to longer-term.

Overall investment strategies should include properly diversified portfolios for capital growth, income and risk minimisation constructed with the help of a financial planner.

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