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Market Overview - 25 August 2015

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Overview

The last few weeks - and especially the last few days - have seen an extraordinary level of instability and volatility in global financial markets – especially in equities and some emerging market (EM) currencies.

Key factors behind the market volatility

Much of what has taken place in global financial markets in recent days/weeks has been driven by fresh concerns over the pace of growth in China and further volatility on Chinese equity markets.

Chinese policy makers appear to be prioritising the slowing economy and stabilising the currency over protecting the equity market – as a result of the apparent lack of immediate policy action on the latter, the Chinese equity market continues to fall sharply and this has led to falls in global equity markets. There have been no other signs of a broader global economic slowdown.

Outlook for the Federal Reserve and US monetary policy

The start of the US monetary policy normalisation process (ie raising interest rates) was always going to be challenging for financial markets.

Since the onset of the Global Financial Crisis (GFC) in September 2008, all the world's major central banks had been working in the same direction – easing monetary policy by lowering interest rates and when rates reached zero, they undertook Quantitative Easing (QE) programs of various shapes and sizes (ie in the US, UK, EU, Switzerland and Japan).

The ongoing recovery in the US economy, especially through 2014, meant that the US could cease its QE program (in October 2014) and then start thinking about raising interest rates.

Of course, the US Federal Reserve (the Fed) has not yet raised interest rates – although Fed officials are still talking about a potential rate hike this year.

An equity market event

It is important to note that recent market developments have primarily been an equity market event – rather than a bond market event. Yes, bond yields are lower, but this likely reflects declining Fed tightening expectations and lower commodity prices and not something that is broader.

So it seems accurate to describe recent events as a correction in equity markets (and a severe one at that), not the start of another GFC.

Expect further policy easing in China

While there is evidence of a slowdown in the Chinese economy, the Chinese authorities still have plenty of room to ease policy. Further interest rate cuts, reductions in the Reserve Requirement Ratio (which would allow the banks to lend more money) and further currency depreciation are all in play.

Markets should expect further policy easing from the Chinese authorities in the days, weeks and months ahead.

The other positive for markets is that although the Fed has ended its QE program and is expected to begin raising interest rates before year-end, both the European Central Bank (ECB) and the Bank of Japan (BoJ) are still undertaking aggressive QE programs and if anything, these asset buying programs could be increased in the months ahead. The scale of the ECB and BoJ QE programs will more than offset the end of the US QE program.

Recent developments

Here is the state of markets as of Tuesday morning Sydney time:

- The oil price has fallen to $US38 a barrel, the lowest since 2009, exacerbating the sell-off already taking place in energy stocks and global commodity markets.
- Global equity markets also weakened significantly. The US S&P500 was down 3.2% on Friday and a further 3.9% on Monday on high trading volumes. The S&P500 has fallen 10% in August.
- On Monday the Dow Jones Index fell 1089 points on the open before closing 588 points down and has now recorded its biggest three-day fall in record.
- The lower oil price impacted bond markets with 10-year US bond yields moving below 2% (from its high of 2.48% in June) in early trading on Monday, the lowest since April 2015 as markets push out the prospect of the Fed lifting rates in September.
- European markets have also fallen, with the Euro Stoxx 50 down 5.4% on Monday to 2.3% for the year.
- The ASX200 fell 4.1% on Monday and is down 12.3% for August (worst month since 2008) - its lowest level since July 2013. It is up almost 3% at 1pm on Tuesday.
- The AUD has fallen to around $US0.72, its lowest level since April 2009 and has been on a steady depreciation path for the past year.
- Significantly, some currencies have seen a 'flight-to-quality' rally, with the Japanese Yen around $US118.80 against $US125 at the start of August. The EUR is back up around $US1.1570 from closer to $US1.10 at the start of the month.
- Pressure has also been felt, however, in a number of emerging market currencies, with the Vietnamese authorities allowing the Dong to depreciate by 3.1% against the USD over the course of August, while the authorities in Kazakhstan allowed the Tenge to freely float leading to a depreciation of around 30% in the currency last week. The Malaysian Ringgit has depreciated by around 35% so far this year and is approaching levels last seen in the 1996 Asian-crisis period.
- There has been some widening in US High Yield credit, mainly led by widening in energy names.

It is important to note apart from China there has been no signs of renewed economic weakness in the US, Europe or Australia.

What does the market volatility mean for your investments?

Accumulators:

It's time in the market, not timing the market, that's important. So if you can ride out the volatile times, you could have a smoother return over the long term. Diversifying your investments can help to defend against volatility and reduce risks. You can diversify across a variety of investment options.

It's also important to manage your expectations. A slower global economic growth rate means a period of lower returns on traditional asset classes. Returns in the decade leading up to the recent Global Financial Crisis were abnormally high, so it's important you don't use these returns as the norm. It's also a good idea to be aware of your own tolerance to risk so that you can assess new investment opportunities as they arise. So don't be discouraged when you hear the word "volatile". Talk to your financial advisor today, to see what type of action best suits your investment plan.

Pre- and post-retirees:

If you're in retirement or nearing retirement, it is understandable you want to protect your investments. After all, your investment returns play a vital role in funding your retirement. In times of volatility it's easy to react emotionally. But now is the time to keep a level head and stick to your long term investment strategy. Trying to time the markets and responding to every market movement could leave you considerably worse off. It's a good time to speak to your financial adviser and remind yourself that markets do recover. Don't let short-term volatility get in the way of your longer-term needs.