The current equity market declines – An outlook

12th January 2016

Why are markets declining?

The current equity market weakness, which has seen the S&P/ASX 200 Index fall -5.8% since year-end with the US equity markets off 6% (at the time of writing), has been driven by a combination of both economic and political factors. On the economic front, the sharp falls in the Chinese equity market (-9.7%) and currency have led to increased concerns about the Chinese economy and its growth. These concerns were also prevalent in our update of July last year. Given China's importance as a user of commodities any concerns about Chinese growth flows through to commodity prices and to those emerging markets that are dependent on commodities. Another factor contributing to growth concerns was news from the US that manufacturing was slowing. From a political perspective increased tension in the Middle East and further issues around North Korean nuclear weapon development also contributed to negative market sentiment.

Is it likely to continue?

While equity markets may yet experience further weakness as markets always tend to over-shoot, a more reasoned analysis provides some comfort that downside risks are not as severe as sentiment is indicating. Chinese regulators have suspended their market "circuit breakers", a mechanism that closed the market when it fell 7.0%. This tended to accelerate declines as investors tried to sell before the market closed. Now that the circuit breakers have been suspended selling pressure is likely to decline. As regards the currency weakness, which has seen the Renminbi fall 6% since July, it is likely that the People's Bank of China will act to stabilise the exchange rate. While the news of slowing manufacturing in the US is a concern it must be seen together with other data that indicates that the US economy will continue to show stable growth of around 2.0% p.a.

The tensions in the Middle East have been increasing for some time and while they are negative for investor sentiment they are unlikely to lead to an outright conflict which would impact oil prices on a sustained basis. The issues regarding North Korea are of concern but need further clarification as to their seriousness and, importantly, they have had a basic nuclear capability since 2006.

What is the outlook for markets?

With global growth still fragile and commodity and energy prices declining, it is likely that inflation will remain low and in this environment global interest rates are likely to remain at current levels. Low interest rates will be supportive of equity markets.

In Australia, a combination of low inflation, soft economic growth, weak commodity prices and a soft housing market make it likely that the RBA will cut interest rates again this year. The environment of low interest rates, reasonable valuations, a declining Australian dollar and moderate economic growth is likely to support equity markets and reduce the risk in fixed interest portfolios.

It is likely that volatility will remain high as investor sentiment changes on each piece of news but the critical point is that the conditions for a bear market – economic recession, high valuations and rising interest rates – do not appear to be in place. The flat close on US markets on Monday may be indicative of some stability returning back to markets.

The current volatility can increase concern and uncertainty but also create opportunities. Please do not hesitate to contact your Charter adviser should you wish to discuss recent market events or any aspect of your investment strategy.