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Fear fuelling our red October

STIRLING LARKIN THE AUSTRALIAN OCTOBER 25, 2014 12:00AM

Steve Miller, BlackRock's head of fixed income, says volatility is corrective. Source: Supplied

There appears to be a hunt for red in October.

Fuelled more by accusations than proof, headlines and not trendlines have propagated fear.

It is easy to say that the globally minded Ultra High Net Worth investor remains resolute but it is then incumbent to explain why and walk through the clear and present dangers in front of us all.

Richard Coppleson, Australia's foremost markets commentator, recently shared with Larkin Group his thoughts regarding events in October.

“Volatility and fear are driving the markets right now and the US is still gyrating all over the shop — like a 1990s rocker — with QE3, Ebola headlines, Europe and broken technical levels, many are going to worry and fear is still out there. When people are fearful they sell first and see later if that was the right decision,” Coppleson says.

“Stocks have gone down via the lift, but will go back up via the stairs — so getting back in early doesn't really help you if the markets have another down leg”.

However, Coppleson believes that once “macro issues” have played out, “we’ll see a sensational December rally that may begin in late November and will go through until the first week of January 2015”.

Chief among these “macro issues” is the widely expected end of unconventional monetary stimulus, known as QE3 in the US, on Wednesday.

UHNW advisers have reminded their clients that when QE1 ended, the US S&P 500 index fell approximately 20 per cent in a three-month period before QE2 was announced.

Again, when QE2 ended, the S&P 500 once more fell 20 per cent, in a three-month period before the next stimulus facility, QE3, was released.

However, globally minded UHNW investors remain resolute today because they recognise that the US — engine of the global economy — is finally showing resilient signs of sustainable growth.

They accept that the red seen in markets today is likely attrib-utable to fear and not fundamentals. The correction to date brings the US and some emerging economy equity markets closer to fair value, while questions remain in Europe and Japan.

Another fear that has rattled markets has been the “inelasticity” of global oil prices to rebound from their current lows.

Several Australian family offices, in particular, have kept a close eye on this, primarily because their logistic interests, reaching far into Asia and abroad, deeply rely on energy price stability.

Contrary to the popular headlines suggesting cheap oil is solely a sign of a troubled global economy, UHNW investors have been advised there may be other key contributing factors at play.

One of these has been that Saudi Arabia is reluctant to cut production in a geopolitical and not necessarily economic attempt to hurt Iran, Russia and the Islamic State Caliphate, who are all seen as high-cost producing competitors, sitting on the periphery or outside of OPEC.

Also, accordingly to JPMorgan, “the oil price decline is a demand story, related to falling Chinese oil demand growth, from 800,000 to 200,000-250,000 barrels per day and a world which is still only growing at 3 per cent five years after the global recession”.

Australian shareholders in Woodside Petroleum, Oil Search and BHP Billiton have witnessed this first hand in October.

BHP’s US shale gas assets have also been hit particularly hard by the rapidly falling marginal costs of production for US shale oil seen recently.

According to Steve Miller, head of fixed income in Australia for the world’s largest asset manager, BlackRock, “our view is that the recent market volatility is corrective and reminiscent of the end of very low volatility periods”.

“It is easy to refute global growth fears, Ebola, falling commodity prices and falling inflation individually as game changers,” he said.

“But, collectively, they have disrupted the paradigm and it feels much more like a mid-cycle correction into a continued expansion than an end-of-cycle blow out as none of the end-of-cycle indicators are flashing any warning signs.”

The Australian investment experience in October suggests that with China’s supply-to-consumption-led transition directly cooling the Sino economy, paradoxically, China’s growth

slowdown is having a bigger impact on Australian equity markets than on China itself, given how cheaply Chinese equities are currently priced. Framed rationally, Australian UHNW investors are broadly of the view that these sustainable elements bode well for their portfolios in the years ahead.

This is because a robust American economy with a clear economic plan and toolkit to improve productivity growth, a Chinese neighbour successfully transitioning to a more stable economic architecture, cheap energy and a modest return of volatility are seen as real opportunities and not imminent liabilities. This sentiment is seconded by Australian businesses facing the region.

According to Radek Sali, CEO of Swisse Wellness, who recently signed a landmark agreement with Procter and Gamble to distribute their Australian-made products across Europe, Asia and Latin America, "any leading Australian business needs to ensure their alignment to what is on our doorstep in Asia. It's where our future lies".

Acknowledging that problems never come alone, to remain above the fray, it is imperative for Australian investment communities to recognise that the rolling thunder is merely market winds blowing hot and cold and is not a perfect storm in formation.

Predicting markets is like trying to pick the weather, and the reason why those who have based their investment decisions around fundamentals have underperformed this year, in particular, has been because market equilibriums are now clearly distorted with historically significant levels of central bank stimuli.

The classical presumptions within market microstructure theory no longer apply.

This helps explain why more than 85 per cent of US mutual and global macro hedge funds have lagged their benchmarks, returning 1 per cent this year while the benchmark itself; the S&P 500 has returned 5 per cent.

With volatility returning, allow fear to tell us where the edge is and help us define our terms of success.

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