



From the desk of Amit Lodha

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## Mr Market's memo

Market turbulence is warning us that things are changing.

### All economic cycles are mortal

While in Taiwan this week, meeting with executives of the technology/smartphone value chain, my hotel room shook with earthquake tremors. It struck me that nature has a unique way of sending us mortality messages every so often.

In a similar vein, hidden in all the volatility last week, 'Mr Market' sent us a memo of questions to consider on the mortality of this economic cycle.

As always, his message was cryptic, so let me try and paraphrase the memo, as best I can, into three areas:

- (1) What has changed?
- (2) What should we consider?
- (3) Is it time to be 'buying the dip' or 'selling the rallies'?

### What has changed?

- Good news has gone from supporting the market to weighing on the market. For example, if economic growth remains strong, then the US Federal Reserve will raise rates faster, which will kill the economic cycle faster than the market currently discounts.
- Rising rates are initially positive (and good news) as they signal normalisation. However, beyond a threshold (maybe 3% for the 10-year US treasury yield), the market starts to worry that this will have an impact on the availability and ease of obtaining credit. Falling money supply generally is a precursor to an economic slowdown, and a flattening yield curve (moving towards inversion) is not helpful. So, while economic data has been very strong until recently, the prognosis if rates continue to move higher is a bit poorer. Concerns about inflation, wage pressures, and the availability of labour have risen, which all point to good news (for example, for wages) becoming bad news (for corporate profitability).
- Throughout most of 2017 and January 2018, markets were in the grip of FOMO ('fear of missing out'), or simply put, greed; making money had never been easier. In the first week of February, we swung into a 'wealth preservation' or fear mode; uncertainty, and hence risk, have risen.
- It is well known that equity markets generally take the stairs on the way up but seem to prefer the elevator (or more uncharitably, the window route) on the way down. What was surprising last week is that bond markets, which historically tend to be better-behaved cousins, decided to dance to an equity-like tune.
- This has significant implications for all of us in terms of how we invest and how we think about asset allocation. One change is that cash (which was the worst asset to hold in 2017) is back as a viable asset class.
- We all look towards economic markets to drive financial markets and most of the time this is true. However, at significant turning points, the tail does wag the dog. Just look back: the bursting of the stock market dot-com bubble triggered the economic downturn in 2001, the US mortgage crisis (and crazy use of derivatives) caused the great recession of 2008, and the widening of eurozone sovereign credit spreads led to the region's recession of 2011. As we look towards 2018/2019, there are more than enough potential financial market culprits, from the explosive (is there any other way to put it?) price action in bitcoins to the elevated global equity and debt market valuations – compounded by the zero/negative interest rate policy regime across the world of recent years.
- If you are feeling a bit poorer after market action this week, spare a thought for the holders of the XIV (short volatility ETF). Investors in the XIV saw a drawdown of 90% in the space of three days, forcing Credit Suisse, its sponsor, to announce the closure of this exchange traded note. For those of us who believe market price action rhymes through history, this has to be an event which – no pun intended – bears at least a semblance of resemblance to Bear Stearns' issues with two of its credit funds pre-Lehman.
- To plagiarise a famous comment, instruments like the above, along with leveraged ETFs and their brethren, have seemed to us much like bugs in search of a windshield.

## Things to consider?

These are the things I think Mr Market is asking us to think about:

### Positives

- Until now, the dollar has been weak, in spite of rising US interest rates, leading to very strong performance from commodities and emerging markets.
- Who would have thought oil would be back near \$70 per barrel so soon?
- The world economy has been in a synchronised recovery for the first time since 2009, with growth in all key economic areas.
- Judging by my company meetings around the globe, everyone seems to think this is the best economic environment they have experienced since 2007.
- US President Trump's tax cuts have led to the best three-month consensus earnings revisions in history. While a lot of this is tax related, earnings and return on equity have mathematically gone up (which is supportive of stockmarket valuations) and there is justifiable hope that the next step of economic growth will be led by a capital spending binge by US corporates.

### Negatives

- The rate of credit growth in China is slowing. If you believe Chinese economic growth and their mini-stimulus of 2016 led to the current strong global growth, you would justifiably be worried as you look forward into the second half of 2018 (as illustrated by the recent dip in the Li Keqiang index.)
- Wage growth in the US has recently accelerated and, along with high oil prices, is stoking inflation fears. Markets fear the Fed is already behind in terms of its interest rate normalisation cycle in an economy that's already running hot. Barring any unforeseen macro shocks, most economic cycles come to an end in tightening interest rate cycles. Rising rates are also generally a precursor to credit and asset quality troubles.
- In spite of the recent mini-correction, valuations on most measures remain elevated and the prospective future returns of bonds and equities are similar, which would suggest that investors would probably start shifting asset allocation more towards risk-free bonds (i.e. US Treasuries).
- Things are so good; can they get any better? Economic indices, lead indicators, and earnings revisions all seem to be at levels from where the only way is down.
- Lastly, ETFs and passive flows have been significant drivers of the market in the risk-seeking environment on the way up. If the tide moves in the opposite direction and risk aversion returns, these valuation-agnostic investors could propel the market towards an overshoot on the downside as much as they did on the upside.

## Buy the dip or sell the rallies?

Looking at market performance this week, my sense is that investors have continued to buy the dip. Growth has continued to outperform value even in the correction with technology continuing to beat defensives and energy. The FANG stocks (Facebook, Apple, Netflix and Google) have generated among the best alpha in this correction.

However, I think one should really consider the question of economic growth in deciding more granularly what to buy and what to sell.

If your view is that world economic growth continues to chug along then, paradoxically, you should exercise caution. In this scenario, the Fed will continue on its path of raising rates leading to higher discount rates. Emerging markets and cyclical stocks – especially financials and selective industrials/miners – would be your choice of investment. In a strong reflationary economic environment with rising rates, it is these sectors that historically exhibit temporary pricing power.

Conversely, market darlings, i.e. the high-growth, high-flying names in the technology space, would see valuations drift down simply because long-dated cashflows will need to be discounted at higher discount rates. For some cash guzzlers, like Tesla and Netflix, this environment cannot be good news. Under this scenario, growth investors will have much poorer outcomes than value investors.

If you believe in this scenario and think volatility was high last week, you ain't seen nothing yet. The real volatility and pain lies ahead as investors will scramble to shift their portfolios from a growth to a value tilt.

If your view is that we are entering a period of slower economic growth, and it is likely that the pace of interest rate rises will be below market expectations, then you paradoxically buy the dip. This would take you away from cyclical stocks towards more defensive, quality growth in consumer staples, utilities and telecoms stocks, and maybe even some pharmaceuticals. High-growth technology names would continue to do well under this scenario, and given their strong thematic underpinning, would probably be the strongest outperformers.

Flexibility of view in this environment remains of paramount importance. To paraphrase John Maynard Keynes, the famous early 20th century economist: if the facts change, I will change my view (and write you another memo from Mr Market to update).

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