Intelligent Investing

KINNELL & CO

Growing Pains

Global equities began 2018 in ebullient mood with the almost daily grind higher accompanied by very low intraday volatility, a characteristic of the past 18 months or so. However, the first two weeks of February delivered a dose of reality. Equities are not a one way bet except in the long term and then usually only when you own quality businesses with sustainable competitive advantages. So, what caused the 10% correction and why was it so sudden?

Essentially the equity market is suffering from some growing pains. Nine years after the GFC many are questioning how long the bull market can continue. Expectations of stronger growth fuelled by the largest US tax reforms in over 30 years, infrastructure spending, and years of low interest rates, have finally sparked fears of higher inflation. This has seen US 10-year yields rise from 2.4% before Christmas to 2.9% a few weeks later. The tipping point for equities was evidence that wage inflation might be kicking in as the US labour market tightens and higher yields leads investors to question how much they should be paying for a companies' future earnings. However, the speed of the correction was driven by leveraged speculators being liquidated from high risk bets on continued low volatility.

Selling volatility has been a favourite trade of speculators over the past 18 months. Markets have been calm and those selling volatility received premiums for doing so and it all worked a treat. This is not much different than picking up pennies from in front of a freight train except you don't know when the train will arrive. It arrived early February. Market volatility is commonly tracked by following the VIX index which measures the cost of buying options on the S&P 500 index. Once equity markets began to retreat the cost of those options began to rise. The only way to limit the damage if you have sold volatility is to then sell stocks as they retreat to cover your losses. Naturally this begets more selling and the cost of buying options, measured by the VIX rises. The VIX rose from 9 (historically low) to 50 in a matter of days, the highest the VIX has been since the GFC. Those that had sold volatility just had to keep selling to limit their losses. With valuations quite high historically and the speed with which the market was falling buyers took their time to come to the fore. The effect is a little like hitting an air pocket at 30,000 feet – the result makes you feel uncomfortable but is usually short-lived. So, what to do?

The major global economies are strong and the outlook for continued corporate earnings growth is good. We see the recent market volatility subsiding and thinks stocks will continue to reflect the sound fundamentals for earnings growth. The recent sell-off is a warning though of what higher inflation, if it eventuates, can deliver, if it is not accompanied by continued strong economic growth. Its when inflation outpaces growth, like the late 1970's, that it becomes a serious problem for owners of stocks and bonds, and inflation moving from 1-2% to 3% is not that scenario with global growth running at 4-5%. We would also question whether in an environment of much technological change which is leading to the elimination of many existing jobs that wage inflation can really take hold?

Closer to home things are a little different. The US have hiked rates 5 times since December 2015, with another 3 hikes likely in 2018. In the meantime, NZ rates have been stuck at 1.75% and look likely to remain on hold well into 2019. NZ bond yields remain subdued with the NZ 10-year at 3.00%, only 0.10% above the US 10-year, the tightest spread in over 25 years. The NZ equity market, which is dominated by utility, property, and generally high dividend stocks has retreated far less than global equities, and for good reason. Low NZ interest rates, and the prospect of this continuing for some time, continue to make holding high-income producing utility and property stocks attractive. We will have to deal with higher NZ rates at some point, but it is hard to see when that point is going to arrive. However, if the US keeps hiking rates this year without causing an economic slowdown then the NZ dollar might finally retreat to levels the RBNZ is much happier about and boost returns for those holding unhedged global equities.

The companies mentioned above are named to further the discussion. This should not be construed to be personalised advice nor a recommendation to invest in these companies. Please contact Kinnell & Co. regarding how best to take advantage of the trends discussed above.

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A Disclosure Statement relating to Michael Kinnell FSP177824 is available on request and free of charge.