Five questions for the Chief Investment Officer—February 2018

Video transcript

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Alexia Jackson (AJ): Hi. Welcome to *Five questions for the Chief Investment Officer*. My name is Alexia Jackson, Private Client Adviser at UniSuper. I'm here with John Pearce, our Chief Investment Officer. Hi, John.

John Pearce (JP): Hi, Alexia.

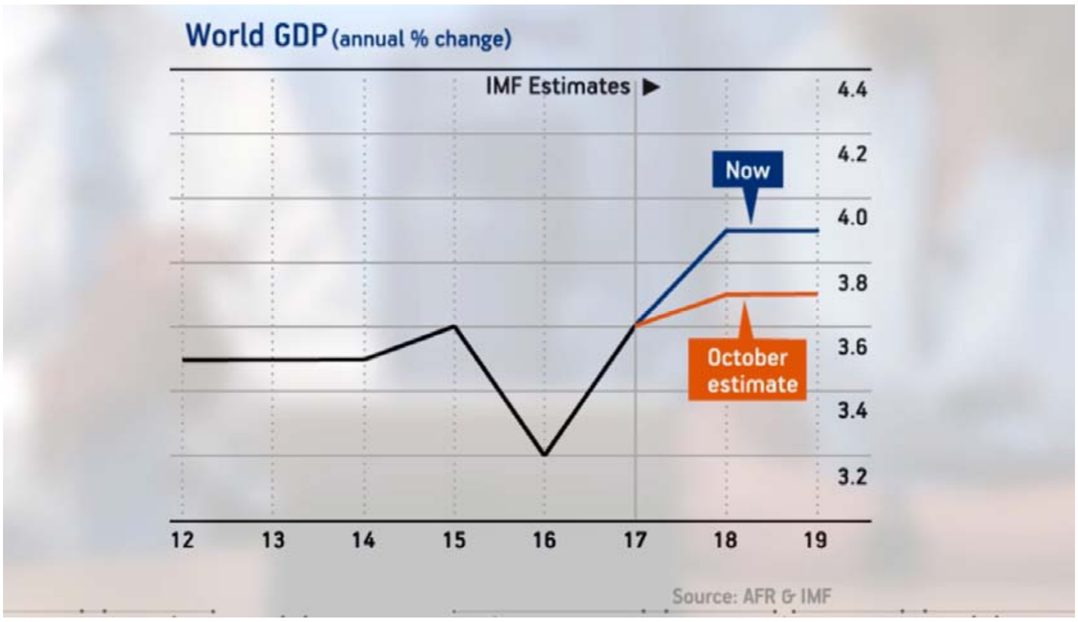
AJ: It seems that the calm that we've had through 2017 was shattered last week. What happened?

JP: We've certainly had some turmoil. A couple of statistics—the Dow Jones, which is the American market, fell 1,175 points on a single day. That's actually a single-day record. The Australian Stock Exchange (ASX) on the same day had about $60 billion wiped off its market capitalisation. These make for pretty scary headlines, but we have to put things in perspective. I think it's more important to talk about percentages rather than absolute numbers. In percentage terms, those numbers equate to about a 4% decline, which obviously is meaningful, but certainly a far stretch from a crash.

When you think about a crash, think about 1987. The market fell 25% in a single day. So, I see this as more of a healthy correction on a couple of counts. Firstly, the market has had a really long, uninterrupted run. Think about the US market in 2017—12 consecutive months of positive returns. That is the only time it's happened in the history of the US market. This can't go on forever, and in fact, it's unhealthy because many of our members—about 80% in fact—are in the 'accumulation phase', so they're constantly accumulating assets at high prices. If you were buying property, for example, you would want to see a fall in the property market, not a rise in the property market—and the same really applies to the share market.

Most importantly, however, look at the context of global growth. We are now experiencing the best global growth we've experienced for at least five years and economists keep revising up their expectations of growth in the future.

On the below graph, we have the International Monetary Fund (IMF) forecast, and that's consistent with the other forecasts we're seeing. And this is leading to higher company profits.



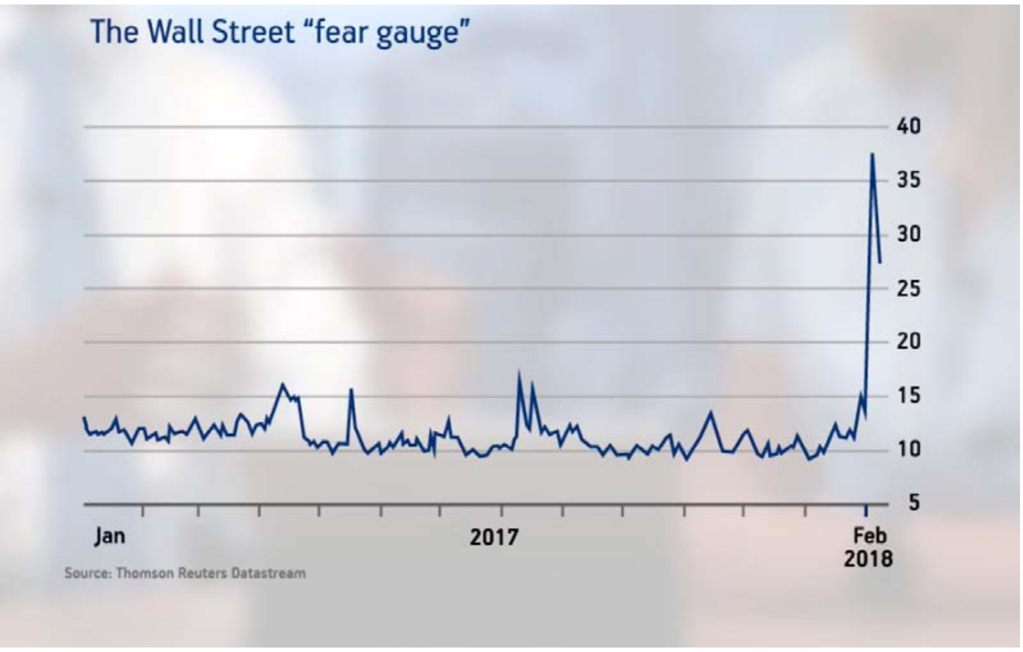
[On the following graph], the orange line looks at company profits. We can see that share prices over a reasonably long term have generally followed the rise in company earnings. Even over the last year, when we've seen such a sharp rise in share prices, we've also seen a sharp rise in company earnings.

I think this is evidence that the rally that we've seen in shares is actually built on reasonably solid grounds.

AJ: You refer to a healthy correction, but with wild swings, does that mean that there's panic out there?

JP: There's definitely evidence of panic out there. Typically in these situations, the first out are those that have over-extended themselves—or may have even borrowed—and it's pretty much a case of sell at any price. Adding fuel to the fire is program trading, where you've got computers generating sell orders when certain market triggers are hit.

And then you've got another element, which I'm going to call an implosion of ‘exotic investing’ or ‘exotic trading’. I’d like to refer to the Vix index (below), which is a measure of volatility in the US share market. It's also commonly known as the Wall Street ‘fear gauge’. We can see how calm it's actually been for the better part of the last 12 months or so.



Now, with the wonders of modern finance, products have been developed and instruments are there to enable people and institutions to actually trade this index. And players are actually joining this game that they probably shouldn't be playing.

There was an article last year about an ex-Target employee from Florida who turned $500,000 into $12 million and then started up a fund. So, amber flashes were going then, in my mind. When you see such a long period of stability, what you tend to find is complacency, and investors get emboldened. They assume that this is going to last forever, so they can actually increase their bets.

Of course, this all blew up last week. A lot of money was lost, and it gets exacerbated by the same players having to sell to hedge their positions. So you get this market downward spiral almost feeding on itself. It's a perverse situation here, whereby the Vix Index—which is supposed to be just a *measure* of volatility—becomes a *source* of volatility.

UniSuper doesn't actually engage in these types of exotic instruments. But we do suffer some of the consequences of the unwinding.

AJ: So, John, if the global economy is doing so well, why are the markets reacting with such fright?

JP: I can understand the confusion, and sometimes there's a case that good news for the global economy turns out to be bad news for the share market. Let me try to explain.

We'll go back to the trigger for the current turmoil. On 2 February 2018, data was released in the US which showed US wage growth at around 2.9%. This was above market expectations, and there was a chain reaction to this: fears of higher wage growth, leading to higher inflation, led to a sell-off in the bond market (because bond yields are ultimately a reflection of future inflation expectations).

Then you have the relationship between the bond market and the share market. It's nuanced and it changes over time, but generally speaking, when you have a sharp rise in bond yields, you will have a negative reaction in the share market. Let me try to explain why, in very simple terms.

If you think of yourself as an investor and you've got a choice between shares and bonds, you know that bonds are less risky. Well, as the yields rise on those less risky assets, that makes them relatively more attractive. Hence, we have this negative correlation between rising bond yields and falling share prices.

There's a saying that goes, "Bull markets don't die of old age. They die of a bullet in the head delivered by rising bond yields."

AJ: So, it looks like we should closely follow the bond market. What are your expectations for the foreseeable future?

JP: Once again, we'll refer to inflationary expectations in the US, because that drives bond yields, and what we see is countervailing forces. We have short-term, cyclical pressures that are all putting upward pressure on inflation. Tightening labour markets, higher wage growth, generally strong demand, high commodity prices, etc., are all pushing up inflation.

But then we have these long-term, structural deflationary forces—demographics, globalisation. Then, of course, we have the powerful force of technology. Think of Amazon. Amazon is a powerful deflationary force.

In summary, I can see—in the short term—bond yields continue to gradually rise up. But it's very hard for me to see a sustained spike in yields because I do believe that inflation will ultimately be contained.

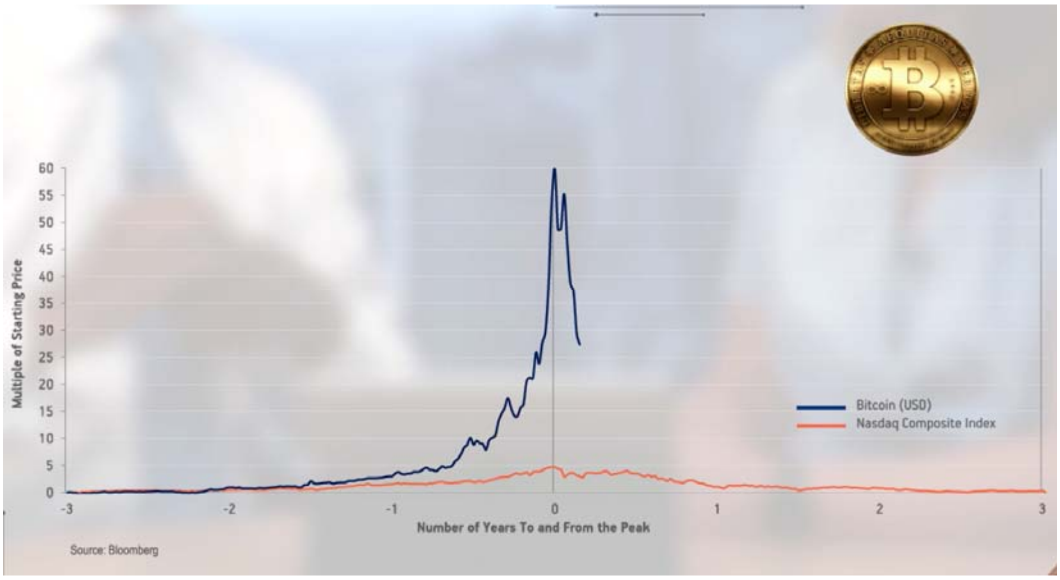
AJ: And talking about turmoil in markets, what's your current view on Bitcoin?

JP: Have a look at the volatility of Bitcoin below. It almost got to $20,000 (USD), then it fell below $6,000 and now it's above $8,000.

Now, that sort of volatility really calls into question the legitimacy of Bitcoin as a currency.

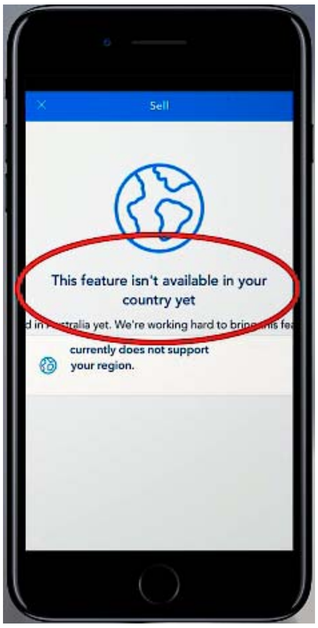
To be a legitimate currency, you have to serve two purposes—one: a medium of exchange, and two: as a store of value. To my mind, Bitcoin fails badly on both these tests because it's just way too volatile.

The last time we spoke, I described Bitcoin as a speculative bubble and I even mentioned the term 'pyramid scheme'. In terms of a speculative bubble, the biggest bubble I've been involved with in the share market was the dotcom bubble and bust of 2000. That's probably best represented by the Nasdaq index below, which basically represents the technology sector — that's the orange line. Overlay that with the Bitcoin price movement (in blue) and you can see it absolutely dwarfs that [dotcom] bubble.



I could put Dutch tulips there, I could put the GFC there and you'd still see that Bitcoin is one of the biggest bubbles in history.

In terms of a pyramid scheme, let me share an anecdote with you. Recently, I was at dinner with a friend of mine who said he dabbled in Bitcoin. So obviously he hasn't listened to anything I've said, and I asked him, "Well, what was the experience like?" And he said, "Well, it was mixed. Let me explain. No problems finding an app that enabled me to buy Bitcoin." And he actually showed me a copy of the confirmation of his buy order. Then the price rallied, and he thought it was time to take a bit of profit. So, he got the app and tried to sell. This is what the app told him: "Sorry. It's not available."



So, here's an app that enables you to buy Bitcoin, but not sell. Does that sound a bit fishy to you? It does to me.

I've not met a serious investor that takes Bitcoin seriously. And once again, members should rest assured that UniSuper is not going to be dabbling.

AJ: Thanks, John. If you have any questions for John, or for us, please send your feedback to **superinformed@unisuper.com.au**. Thanks for watching.