Five questions for the Chief Investment Officer—November 2018

Video transcript

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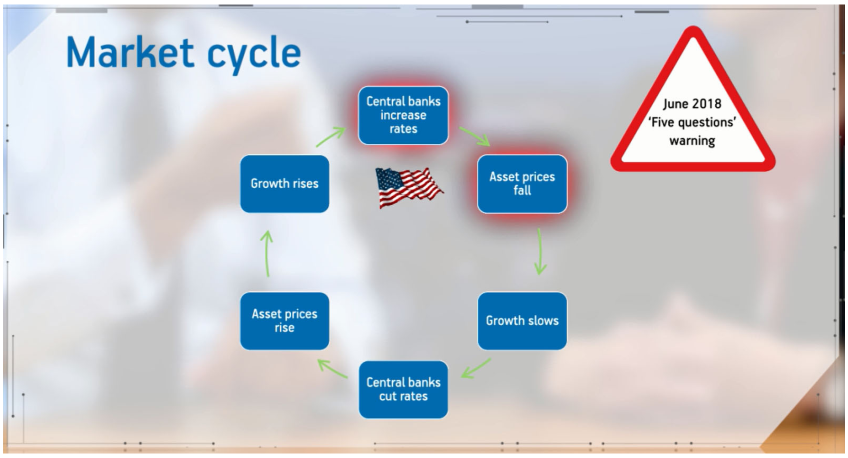
Victoria Place (VP): Welcome to *Five questions for the CIO*. My name is Victoria Place, and I'm an analyst working with our CIO John Pearce in the Investments team. As most of you know, October was a bad month for global share markets, so today's interview will focus on the factors and circumstances surrounding the recent turmoil.

John, I'd imagine many members are shocked by the recent volatility in share markets. Can you explain what's happened?

John Pearce (JP): It was a bit of a wild month, Vic. Markets in Australia and the US were down about 10% at one stage. They recovered slightly, but still finished down over 6%. So it's uncomfortable, but not altogether unsurprising. It's all about rising US interest rates. You might recall that in our June interview we looked at the market cycle. The market cycle describes the interrelationship between the economy, interest rates, and the share market. We described the US position as being at 12 o’clock.

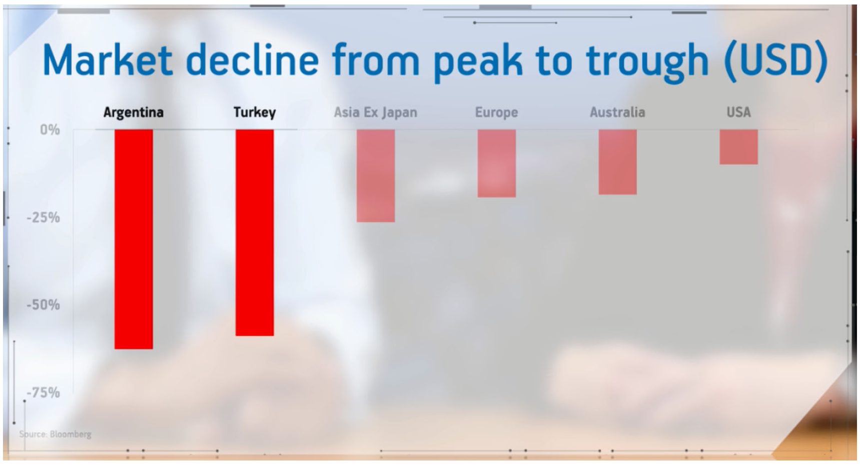


The Federal Reserve, or what we call the Fed, is tightening US rates and that's having ramifications around the world. When rates are rising, that makes products that are interest-rate-sensitive more attractive at the margin, relative to shares. And the cost of borrowing is also increasing. So these dynamics are playing on market skittishness at the moment.

VP: But rates are flat in most places. Why are rising US interest rates so important?

JP: There's a very simple reason. The simple reason is that the US is the largest financial market in the world by a longshot, so anything that happens in the US does have implications around the world. There's a slightly more technical reason, and that relates to the US currency as effectively the world's global currency.

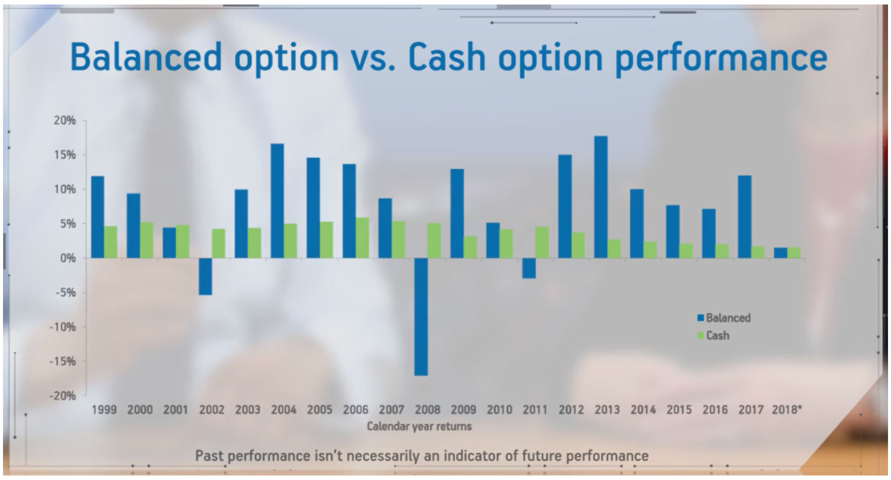
Consider these statistics. About 90% of every currency trade has the US dollar as one leg. About 65% of global reserves are in US dollars. 42% of all global borrowings are US-dollar-denominated. Corporates outside the US borrow about $11.5 trillion in the US. And this is a really important stat—about $3.7 trillion is borrowed by emerging-market countries in US dollars. It's because offshore investors won't actually accept their own currencies, so they have to borrow in US dollars. That creates a bit of an Achilles' heel for the financial system. Indeed, if you look at the performance of share markets from the peak to the trough, have a look at the two worst performers: Argentina and Turkey, two emerging markets.



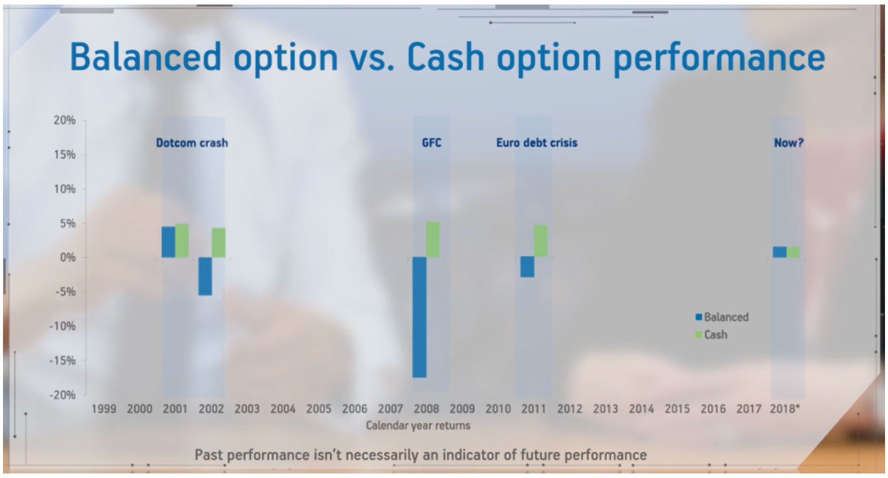
Australia's actually fared in line with other major markets such as Europe, and better than Asia. Somewhat ironically, one of the better-performing markets is the US, even though it's US rate rises that actually caused the selloff in the first place.

VP: Clearly all investment options with risky assets have been adversely impacted. The Balanced option return for the year is now on par with the Cash option and is also on track to record its lowest return in seven years. How is this impacting investment decisions?

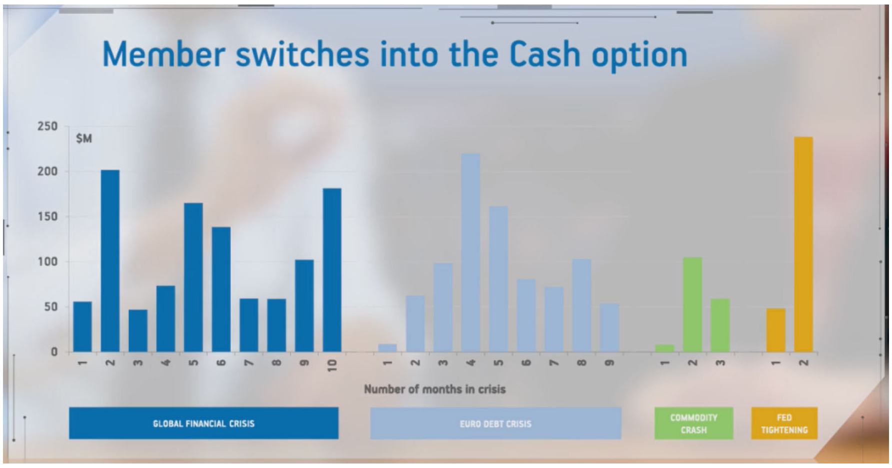
JP: Over the long term, the Balanced option is expected to outperform the Cash option. Indeed, if you look at this bar chart, you can see—even on an annual basis—the Balanced option outperforms.



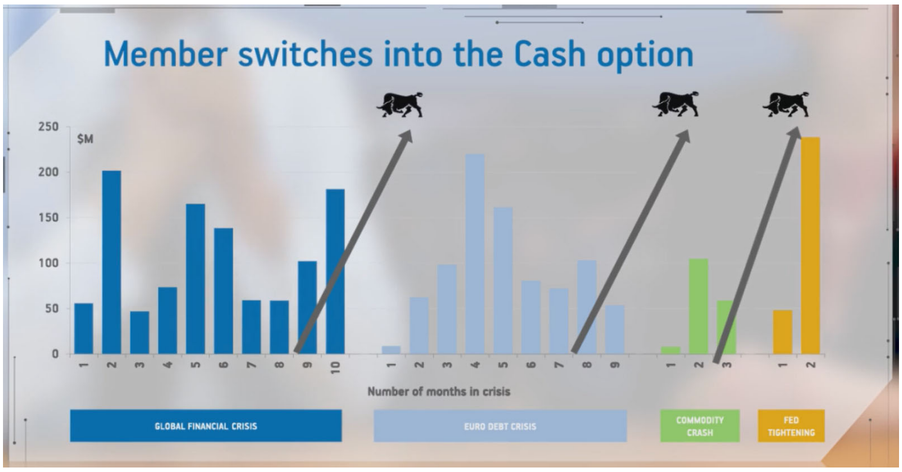
But then, of course, you have where the cash option will outperform. We saw it during the dot-com crash, we saw it once again during the GFC, and then the European debt crisis.



What is interesting is the behaviour of some of our members. This chart here actually shows, per month, the amount of money that's being switched from growth options to a cash option.



We see here during the GFC, during the European debt crisis, during the commodity selloff that we had in early 2016, and of course during the recent selloff—members moving to safety. And moving to cash is somewhat understandable because ultimately cash is the best preserver of capital. But clearly the danger is that members who stay in cash then miss out on the ensuing share market rally, and that's what we've seen quite often in the past.



In terms of our own investing, we're seeing some good opportunities—particularly amongst some mid-tier corporates that have been hit particularly hard—so we're using our excess cash levels to top up holdings there. We're also using the liquidity we have, to accommodate the member switching without having to sell into a weak market.

VP: I'd assume that Trump's trade war with China is adding fuel to the fire?

JP: It's certainly not helping, but I will stress that it has far less to do with what's happening in the markets than monetary policy. In fact, I would consider that Trump's fiscal policy or tax cuts is having much more impact than his trade policy. Let me just quickly explain. The tax cuts in the US are providing enormous stimulus to an economy that's already very, very hot. This is maybe causing the Fed to be a bit more aggressive with the tightening of rates than it would normally otherwise have been.

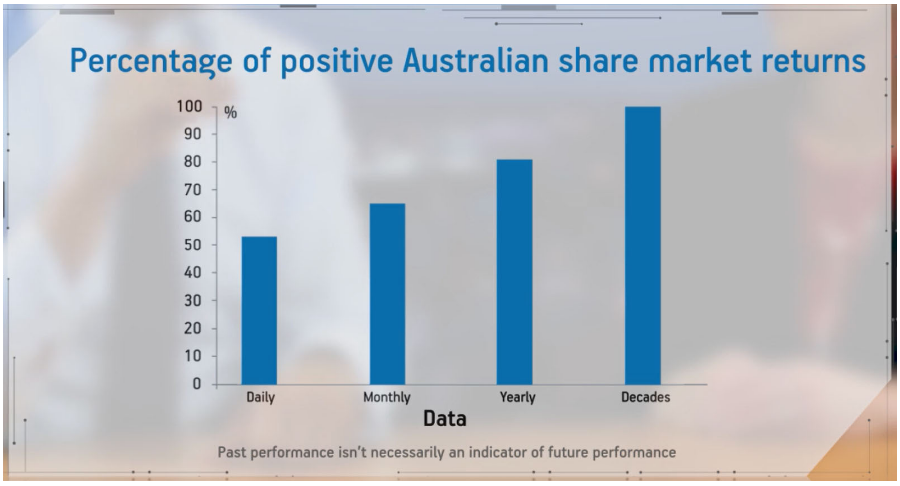
So Trump is there criticizing the Fed for hiking rates and undoing his good work, but in a sense, Trump is actually putting the Fed in a corner here. I personally believe that in five years' time, we could be looking back on these tax cuts in the US and consider them as a real failure of economic policy.

VP: Right. So is there light at the end of the tunnel?

JP: There always is. The bad news is that the Fed will continue to tighten. I think we can be pretty sure of that. The good news is that we have to understand the context in which the tightening is taking place. It's taking place because the US economy is so strong. Companies are growing their profits, and ultimately that will lead into higher share prices. The Fed is actually getting back to some position of normality, and we really shouldn't be too frightened of normality.

A bit of statistical trivia here for you. Since 1900, the S&P 500, which is the US market, has had declines over a month of 10% 46 times at times when the US has not been in recession, as is currently the case. The average 12-month performance after that decline is 13%. So that's positive. Of course, the range is quite great—it ranges from -18% to +155%—so we shouldn't take too much comfort from the 13%, but that's the average.

Then, of course, we always come back to the long term, and there's many different ways we've shown long-term performance. Here's another way of looking at it. If you look at the percentage of times the market was either up or down over different periods, this bar chart is interesting.



On a daily basis, it's actually a toss of the coin—markets are up just as many times as they are down on a daily basis. On a monthly basis, they're up 65% of the time—and obviously, October wasn't one of those months. On an annual basis, they're up about 80% of the time. And over 10-year periods, the Australian market has never been down. So I think that's something for the optimists.

VP: Thanks for answering these five questions, John. If you have any questions you'd like answered, please email **superinformed@unisuper.com.au**. Thanks for watching.