focus

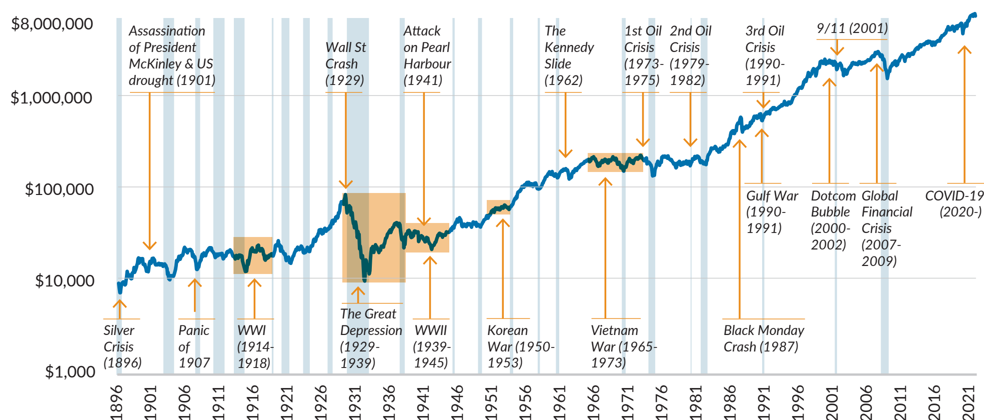
Markets not having the **happiest new year**

For investors in equity markets it has been a tough start to the new year. In fact, in the United States — by far the largest equity market in the world, the S&P500 index has had the worst start on record dating back to 1929.

No one enjoys watching the price of their investments jump around, so it's understandable if some investors feel unsure and nervous. Unfortunately, however, volatility in markets is normal. It's the price we pay to earn higher returns over the long-term.

FORSYTH BARR

DOW JONES INDUSTRIAL AVERAGE: VOLATILITY IS THE PRICE PAID FOR HIGHER LONG-TERM RETURNS



Source: Refinitiv, NBER. Dow Jones Industrial Average Capital Index, Forsyth Barr analysis

We've had a stellar run

Since the lows of the COVID crash in March last year share market returns have been stellar – the MSCI World Index has nearly doubled. For 22 months the market has "climbed the wall of worry" shaking off concerns around COVID (the first pandemic in over a century), surging inflation, climbing interest rates, fractious US politics, a wobbly Chinese property market and more. 2021 closed with a Santa Claus rally leaving investors feeling comfortable and content.

It's always surprising how much things can change in just a few weeks. Investors returning from holidays have found the market to be in quite a different mood than when they left. Things that previously the market was not overly worried about are now headline concerns. It just serves to remind us that, underneath it all, markets are made up of people prone to emotional swings.

What's worrying the market?

At any point in time there are generally plenty of things to worry investors. That certainly has been the case over the past couple of years, and it is today.

First and foremost is surging inflation and higher interest rates

In the past six months inflation has soared to levels not seen in decades. Changes in consumer spending – surging demand for goods, less spent on services – coupled with COVID restraints on manufacturing and logistics, has put immense pressure on supply chains. When demand exceeds supply, prices typically rise. Shipping costs have soared, and so have the prices of many goods and commodities.

Omicron has added to these pressures. Whilst it is less deadly than previous COVID variants, it is much more infectious. Skyrocketing cases – and the resulting worker absenteeism – is exacerbating the difficulty for businesses to supply goods. This is particularly the case in China, "the world's factory", which (for now) is sticking to its zero-COVID policy.

While much of these inflationary pressures are COVID related that will abate in time, the magnitude and persistence has raised the risk of inflation becoming embedded in price and wage expectations. That has forced central banks around the world to begin tightening monetary policy, including raising interest rates, earlier than they had previously anticipated.

Interest rates impact the value of stocks

The COVID crisis saw the lowest interest rates in human history. Those super low rates have been used to justify high valuations across many assets including shares and property. And all that cheap money fuelled a surge in speculative activity. Higher rates are pressuring both.

Theoretically, the value of an asset is the expected future cash flows it will produce "discounted" back to today's valuation. That discount rate is the rate of investment return (or cost of capital) expected each year by investors.

For example, say I have an investment that will pay $100 in one-year's time and a cost of capital of 5%. Today I'd value that investment at around $95. All-else-equal, if interest rates rise it lifts the cost of capital, and lowers the value of future cash flows. And the further out those cash flows are expected to be produced, the more their value today is influenced by the discount rate.

It's therefore not surprising that the market downturn has been led by long-term growth stocks, which don't generate much (or any) profit today. Of all the major global market indices the tech-heavy NASDAQ is down the most. Around 40% of stocks

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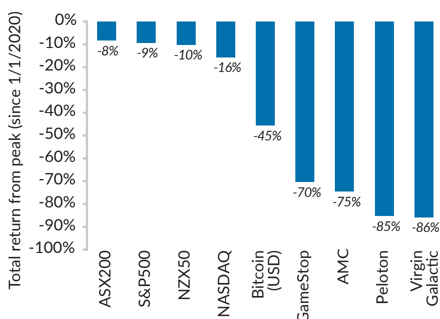
on the NASDAQ are off by 50% or more from their highs. The most speculative segments of the market have been hardest hit. Many “stay at home stocks” that were market darlings during lockdown, “meme stocks” hyped by online communities, and crypto currencies have crashed.

RETURNS VS. MARKET HIGH: THE FROTHIEST PARTS OF THE MARKET HAVE COME UNDER MOST PRESSURE



Source: Refinitiv, Forsyth Barr analysis

Strained relations between Russia and the West

Adding to investor nervousness has been rising tensions between Russia and the West. Russia is concerned the West is creeping into its sphere of influence. It has amassed troops near the Ukrainian border and demanded guarantees that NATO will not embrace Ukraine or any other ex-Soviet nation. If concessions aren’t forthcoming Russia may take sterner action that could trigger an international crisis, potentially including a military conflict, constraints on supply of Russian energy into Europe, and/or extensive sanctions on Russia by the west. Russia is a major energy provider. Oil prices have climbed to seven-year highs further putting pressure on inflation, consumers, and central banks.

A return to (normal) volatility

Volatility is normal in equity markets. For investors who’ve only been in the market over the last decade or so it might not seem so. Outside of the COVID crash in 2020 investors have had an unusually smooth run. But looking back through history, on average a bear market, or a -20% decline in stock prices, happens once in every five years. A “correction” or a -10% decline happens about every 19 months. Volatility is the price investors pay to earn the “equity risk premium” – a higher expected return over the long-term from investing in the share market versus lower-risk assets like bonds.

The obvious question is “why don’t we avoid the downturns – sell at the top, buy again at the bottom?”. That would be nice. Unfortunately, the evidence is clear. Whilst there will always be someone who successfully calls the top of the market each time, there are extremely few (if any) who can do it consistently.

“Far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves.”

Peter Lynch, legendary investor

“The idea that a bell rings to signal when to get into or out of the stock market is simply not credible. After nearly fifty years in this business, I don’t know anybody who has done it successfully and consistently. I don’t even know anybody who knows anybody who has.”

Jack Bogle, investor, founder of Vanguard

...Having and sticking to an investment plan is the best measure to navigate choppy markets...

So what can investors do? Having and sticking to an investment plan is the best measure to navigate choppy markets. Investors benefit from owning good businesses which grow their underlying value over the long-term. Through history, good businesses have provided inflation protection by being able to maintain the real value of their cash flow and earnings. It is quite possible that we'll see more volatility ahead. But equally, the last two years highlights how quickly the market outlook and mood can change. Long-term investors understand the need to navigate challenging times to capture the benefit of the good.

At any time if you have any queries about recent market events or wish to discuss the nature and composition of your portfolio please don't hesitate to contact your Forsyth Barr Investment Adviser. They're happy and available to discuss your investment plan at any time.

Matt Henry CFA
Head of Wealth Management Research

Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

0800 367 227

forsythbarr.co.nz

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