

## This market correction should create buying opportunities.....the question is when?

Following an extended period of unusually low volatility, share markets have experienced a sharp drop over recent days. At the time of writing (the morning of 12<sup>th</sup> October), the United States S&P 500 Index had declined 6.4% since the start of the month, with the local S&P ASX 200 Index down 5.4%. These declines have brought the U.S. market level back to where it was in mid-June; with the Australian market now trading around levels last recorded in mid-April.

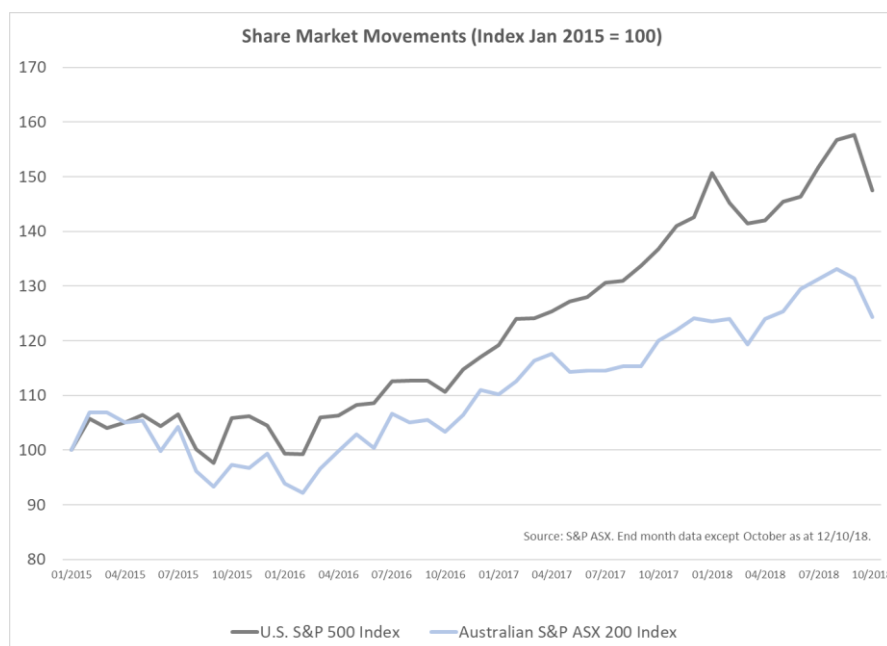
### What caused share markets to fall?

With no apparent fundamental trigger to what was a relatively sudden correction, commentators are struggling to identify an agreed cause of the recent sell-off. High share price valuations combined with the ongoing U.S. - Chinese trade dispute are the commonly cited reasons. However, both these factors have been with us for some time; so, whilst they may have been contributory factors they don't explain the timing of the correction.

As was the case with the pullback in February and March, concerns over rising inflation in the U.S. may have

also been a factor in triggering the latest price fall. Oil prices hit a 4-year high last month. In addition, the decision by Amazon to lift the minimum wage paid to its employees to \$US 15 (from a general minimum of \$US7.25) could have been more significant than the market first viewed. The decision potentially highlights the inevitability that strong economic growth and tight labour markets in the U.S. will eventually feed through to higher inflation. Share markets are concerned about rising inflation because it is likely to force interest rates higher, thereby making equity valuations less attractive on a relative basis.

The view that inflation is near the top of the list of market concerns is also consistent with the surprising lack of downside movement in commodity prices over recent days, and the fact that bond yields have been relatively steady. The U.S. 10 year Government bond yield, at 3.16%, has fallen just 0.05% over the past two days - but remains well above its month opening level of 3.06%. If the correction was only due to worries that trade tensions would ultimately lead to lower economic activity, then falling commodity prices and falling interest rates would be expected to have accompanied the equity price decline. The fact that neither commodity prices nor interest rates have



fallen materially, suggests factors other than fears of an economic slowdown or recession are behind the correction.

### Where to from here?

Short term movements in share markets are notoriously difficult to predict, given the role played by sentiment and emotion. Now that price falls have been triggered, the desire of investors to take profits from what has been a very extended bull market could result in further downward momentum in prices. Within this environment, the share market is likely to have heightened sensitivity to any news of further upward pressure on U.S. wages or inflation.

However, whilst there may be reasons to be negative about the short term outlook for the share market, the latest correction needs to be viewed in perspective. Periods of price weakness on share markets are a very normal phenomenon. The volatility corrections create is ultimately the reason why share markets are priced to create long term returns well above the risk free rate of interest. In addition, it should be stressed that the current climate has few similarities with the GFC period. Profitability in the financial and corporate sectors remains strong and there are no signs of any major dysfunction in markets. The absolute level of interest rates is still low and liquidity in markets is strong.

Should share prices weaken further, then opportunities will emerge for investors to redeploy capital from defensive investments and Alternative asset classes into equities. However, caution is required in considering any entry into a falling market. It is perhaps still any early phase of this correction and it may be difficult for confidence to fully return prior to the U.S. mid-term elections in November. Given the extent to which the policies of the Trump administration have been associated with a strong share market, any dilution in the administration's authority resulting from these elections may have a negative impact on equities. Alternatively, any confirmation of the status quo could be the catalyst for a return of investor confidence.

### Opportunities for active managers

In addition to providing opportunities to potentially buy equities at a lower price, share market corrections also typically generate large disparity in price movements between different types of stocks. Over recent days for example, we have seen a large sell-off in the information technology sector – both here and abroad. Generally, higher “growth” stocks trading with high price to earnings multiples have been hardest hit. This disparity in price movement between stocks creates opportunities for active managers to add value. The recent experience of some active managers underperforming because their “value” disciplines have steered them away from more expensive stocks may be reversed through this period of correction. The Australian resource sector may stand out as an area of interest for active managers. Commodity prices have held up relatively well and the \$A is priced attractively for exporters at around U.S. 71 cents. Therefore, the pull back in price within the Australian resource sector could be seen as an opportunity for active managers looking to capitalise early on cheaper valuations.

### Important Information

*The following indexes are used to report asset class performance and calculate the benchmark returns for this model portfolio: ASX S&P 200 Index, MSCI World Index ex Australia net AUD TR (composite of 50% hedged and 50% unhedged), FTSE EPRA/NAREIT Developed REITs Index Net TRI AUD Hedged, Bloomberg AusBond Composite 0 Yr Index, Barclays Global Aggregate (\$A Hedged), Bloomberg AusBond Bank Bill Index, S&P ASX 300 A-REIT (Sector) TR Index AUD, S&P Global Infrastructure NR Index (AUD Hedged). FM Financial ABN 80 074 824 749 is an Authorised Representative of Hillross Financial Services Limited, ABN 77 003 323 055, AFSL 232705 The information in this article is not advice and is for general use only as it has not taken into account your objectives, financial situation or needs. If you have any questions on the article please contact your financial planner before taking any action*

