RETIREWELL
WEALTH MANAGEMENT SOLUTIONS

eNewsletter
Exclusive Client Email Newsletter
28 August 2019

To Clients and Friends of Retirewell,

Are We Heading for a Recession? What Might it Mean for the Stock Market?

NOTE: We recommend you print out this 4 page eNewsletter, for easier reading. If you have trouble printing this email, we have attached a PDF version. (Go and make a cup of tea or coffee and sit down for a good read!)

Summary

There's been a lot of talk globally and in Australia, about the possibility of a recession. Shane Oliver, Head of Investment Strategy and Economics and Chief Economist at AMP Capital, acknowledges the many concerns of the moment, but believes that while risks have increased, he remains of the view that recession is unlikely, in either the US or Australia. He regards the recent falls in share markets as another correction and not the start of a major bear market. Given that shares are cheap relative to bonds, AMP Capital continues to see share markets as being higher on a 6 to 12 month horizon.

Introduction

Only last month, share markets in the US and Australia were at record highs. However, since President Trump ramped up US - China trade war again at the start of August, financial markets have taken fright and bond yields have plunged to record lows in many countries. This eNewsletter explores what is driving market concerns, the risk of recession and what it means for investors.

There is an old saying in relation to shares, that "Markets are always climbing a wall of worry". The "wall of worry" is the financial markets' periodic tendency to retract, then surmount a host of negative factors and keep ascending. How an investor chooses to deal with the incessant "wall of worry", often directly correlates to their risk tolerance.

Share Market Implications of a Recession

Aside from a recession – which is defined as two consecutive quarters of negative economic growth – being serious in its own right, it also plays a significant role in what happens with share markets and the value of most investor's investment portfolios.

If you look historically we often have share market falls but whether there is a recession is very important in determining whether those share market falls are a correction or mild bear market – where the market comes down say five, 10 or 20 per cent but is higher a year later – or whether it turns into a major bear market where share prices come down 20 per cent and a year later the index is down another 20 per cent.

So whether we have a recession in the US, in particular, but also in Australia, is critically important in terms of the depth of any downturn in the share market.

Reasons for Concern

There are a number of reasons for concern.

First, the US – China trade war shows no signs of letting up. The trade war is weighing on business confidence. It's hard to make firm investment plans when they could be dashed by a new tweet from President Trump - this is showing up in a slump in global manufacturing business orders, though the global demand for Services remains firm.

Second, Chinese policy stimulus to counteract the trade war isn't working and China continues to slow.

Third, inverted yield curves (where short-term interest rates are higher than long-term rates) have preceded many postwar US recessions, so the recent inversion can't be ignored. [However, various factors unrelated to US recession risk may be inverting the curve, such as increasing prospects for more quantitative easing pushing down bond yields, negative German bond yields dragging down US yields and investor demand for bonds as a safe haven from shares. As well, yield curves may be more inclined to be flat or negative when rates are low.]

Fourth, after a 20% + run up since December and the annual share market weakness usually seen in the August to October period, markets are vulnerable to a correction.

Finally, the turmoil in Hong Kong, Brexit, tensions with Iran and the political uncertainty in Italy, are not helping.

Reasons for Optimism

While risks have increased, there are a number of reasons not to get too concerned.

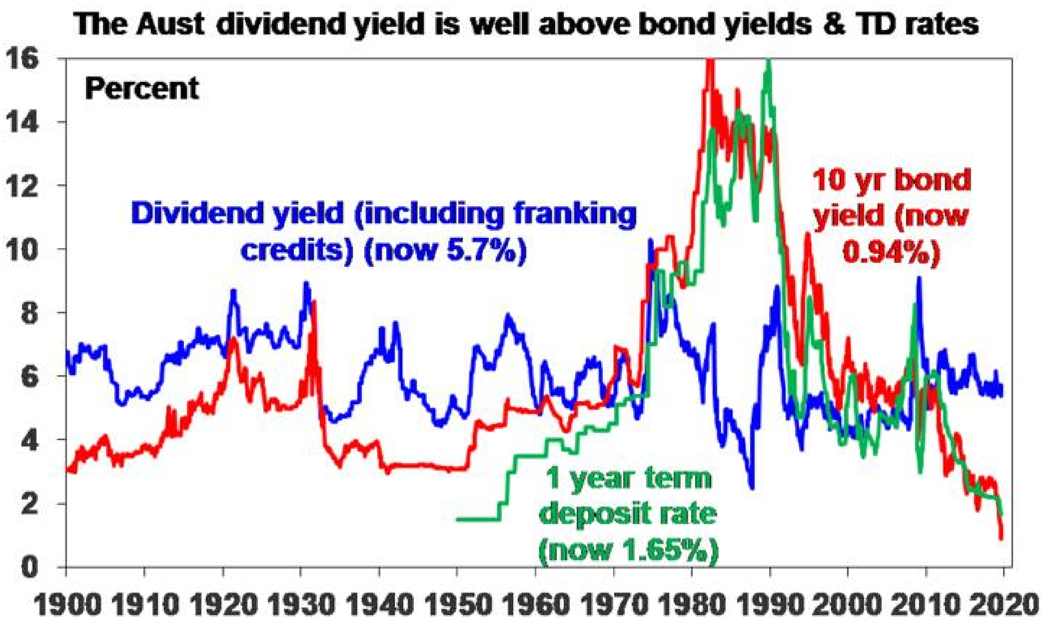
First, President Trump is getting twitchy about the negative economic effects of the trade war. He is facing re-election in in the US in 2020 (whereas China's President Xi Jinping is President for life) and can't afford to see a major bear market or recession in the US between now and then. So at some point, Trump will seek more seriously to resolve the trade war with China.

Second, policy stimulus is being ramped up. Numerous Central Banks (including the RBA in Australia) are now cutting interest rates and indicating that more rate cuts are on the way, including from the US Fed. The European Central Bank looks like it will soon return to quantitative easing. Both China and Germany are looking at some sort of fiscal stimulus - and there is talk of more US tax cuts.

Third, while risks have increased, a US or global recession remains unlikely. The Services sector is the dominant part of most major economies and the global demand for Services is holding up well. There has not been the excesses that precede global and notably US recessions – there has been no investment boom,

private-sector debt growth has been modest and inflation remains low. We haven't seen high levels of cyclical spending on things like housing, investment or consumer durables – so Central Bankers have not slammed the brakes on. Monetary and fiscal stimulus will provide support.
Finally, the decline in bond yields is making shares relatively cheap. The gap of 4.8% between the grossed up dividend yield on Australian shares of 5.7% and the Australian 10 year bond yield of 0.94% (that's less than the 1% RBA Cash rate!) is at a record high. Similarly, the gap between the grossed up dividend yield and Bank term deposit rates of less than 2% is very wide. In other words, relative to bonds and bank deposits, shares are very cheap – which should see them attract investment flows, provided recession is avoided.

This divergence between the dividend yield on Australian shares and the yield on bonds and Term Deposit rates, is illustrated in the chart below.



Source: Global Financial Data, Bloomberg, AMP Capital

Australian Outlook

When you look at Australia, beyond the housing market there is not a lot of excess in the economy. There are also other parts of the Australian economy which will help keep us going - infrastructure spending is doing very well, there's still solid demand for our exports and business investment, particularly mining investment, seems to be showing signs of turning the corner. All of these things should help offset the downturn in housing construction.

What Does It Mean For Investment Markets?

In the short term, share markets could still fall further as trade and growth uncertainty remain and as we go through the seasonally weak months ahead. This could be associated with further falls in bond yields. In fact, further share market weakness may be needed to get President Trump to get serious about resolving the US – China trade war. So - provided AMP Capital's view is right and recession is avoided, a major bear market in shares (i.e. where shares fall 20% and a year later down another 20% or so) is unlikely, and given that shares are cheap, relative to bonds,

AMP Capital continues to see share markets as being higher on a 6 to12 month horizon.
So the bottom line is, yes the risk is there but Shane Oliver thinks we will avoid a recession in Australia and globally, and therefore any pull back in share markets is more likely to be a correction rather than a major bear market.

Some Final Thoughts

1. Periodic sharp setbacks share markets are healthy and normal. This volatility is the price we must accept, in exchange for the higher long-term return from shares.
2. Switching to a more conservative strategy after a fall, just locks in the loss. Stick to your long-term investment strategy. Turn down the noise – in times of crisis, negative news reaches fever pitch, which makes it very hard to stick to a long-term strategy.
3. When growth assets fall, they are cheaper and offer higher long-term return prospects. Pullbacks provide opportunities to buy good assets at a cheaper price. When everyone is negative and cautious, it's often the time to buy.
4. While shares may have fallen in value, the dividends from the share market haven't – the income flow remains stable and attractive. Retirees need to consider what is most important – absolute stability in the value of investments, or a decent, sustainable and growing income flow.

Source: *Acknowledged to Shane Oliver, Head of Investment Strategy and Economics and Chief Economist at AMP Capital, from Investment Insight Reports dated 14 August and 20 August 2019, plus Retirewell internal research sources.*

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