The October 2018 shakeout – what the?? …

Since 2009 there have been periods of market shakeouts, while the longer term trend remained intact.

We are going through another shakeout similar to January and similar to early 2016.

The generous monetary policy since 2010 has meant that the normal market wrinkles have been inflated out with surplus cash circulating through the system.

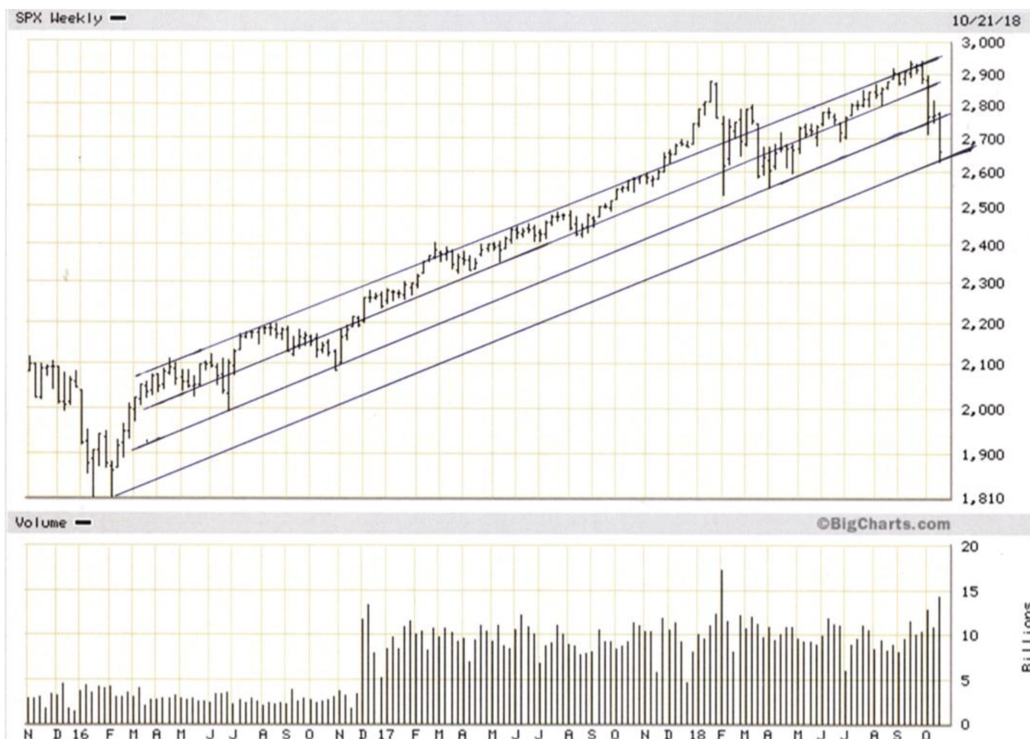
In the past, intermittent 5-10% market shakeouts occurred 2 – 3 times per year. We simply haven't seen that happening since easy money supply was generated by the central banks.

The US Federal Reserve is withdrawing excess funds from the market and as a result we now see more "normal" frequent market shakeouts.

- The chart below shows the US S&P500 (SPX) over the past 3 years since the last major shakeout in January 2016. This was a 13%+ fall that later recovered.

- The investment market oscillates about the long term trend line and can drop below the medium / mid-point of the trend channel. As we see here. Currently about 11% drop from the recent high. Since it spiked above the top 3rd of the channel – it could also do the same downwards – but note the short period before it was back to the top section.

- The underlying fundamentals however, have not changed and the US economy is growing strongly. Spurred on by tax cuts to business and individuals.



- Additionally – as indicated - in previous years pre the GFC recovery, particularly the 1980's and 90's – it was not unusual to have a mid-year shakeout of -15 or -20%, and still have an overall good year on the rebound, "old fashion" volatility.

- While there are concerns about the impending rate of inflation and interest rates increased so far to control it; the core thing to remember is that the interest rates are below the neutral rate and much of the hand wringing is simply over interest rates rises up to the neutral rate.

  The neutral rate is that where the interest rate is neither to low or too high to affect the economy – “the goldilocks” option.

- The US unemployment rate is now at a 50 Year low and many marginalised workers from the old rust belt are getting work – that has eluded them for years.

- The US economy is still growing very strongly and just last week (26 October) released GDP figures for the September quarter showing a 3.5% growth rate. A solid respectable number.

  BUT- the recent trade war with China has dragged the figure downwards. Normally, trade does not influence the data. This time round higher imports caused the GDP to appear lower. If this had not happened the real figure would have been **5.3%** p.a.!
  Last seen in the early 1960’s. As the tax cut effects fade the GDP will drop back to a much more modest level.

- While some may be wringing their hands warning of a bit of inflation, the rest of the economy is shopping and spending. If you haven’t had much money for nearly 10 years then a new job and new income is spent very rapidly, replacing clothes, TVs, and cars.

- A bit of inflation is far less worrying from an economic perspective than deflation – that threatened the USA back in 2008/09. Given the option between the two – you would take a bit of inflation – so then a lift to 3%+ for a short period is not in fact a major threat – yet you would think so from the way some commentators talk.

- The US will soldier onwards with reasonable growth in the short term 1-2 years, until the continued “tightness” from labour shortages then really bite. Retailers such as Sears and others are in the process of shedding staff, which keeps the labour markets fluid in the short term. Internet businesses may cause growth, but they still cause disruption and employment churning.

- The China vs USA tariff battle has more going for the USA than China.

  The argument that Trump has made is that China has continued to benefit from favourable World Trade Organisation categorisation, despite now being the second largest economy in the world.

  China doesn’t want to relinquish the favourable treatment.

  Additionally China has gamed the reciprocal trade rules to limit US exports, while also expecting US or European trade partners to establish joint arrangements with a Chinese partner and share sensitive commercial information, unjustifiably.

  Don’t forget that even the Australian CSIRO has had to fight off 30,000 hacks, 90% mostly from China trying to obtain confidential research and development results. China has been waging a cold war even on its “friends” for years.

  Frankly – on this issue – Trump is 120% correct.

- We also have of course a raft of other issues to be concerned about that has created the air of uncertainty: such as Brexit, Italian budget issues, and mid-term US elections.

  Plenty to make the nervous investors sell down the US market.

  However, the multiple average of the US valuation is around 16 times earnings.
  Now down from 18 x earnings – the capital value of the income generated.
  Not cheap, but quite reasonable on long term averages, with continued profit growth anticipated at 14% p.a.

So in conclusion – while parts of the investment world may react with more emotion than analysis - it is important to maintain discipline and a logical application of investment guidelines, some patience and a degree of tolerance for volatility.

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