

BACK TO BUSINESS

 **THE VIEW**
RICHARD HARRIS



Easing towards reality



Illustration: Henry Wong

No longer are stock markets breaking record highs on a daily basis. Even the bullish story on China seems to have gone a little bearish

Observant investors will have noticed a real change in market behaviour in the last few weeks. No longer are stock markets breaking all-time highs on a daily basis, no longer are analysts' over-worked eyebrows raised at expensive bonds and cheap oil. Even the bullish story on China seems to have gone a little ... well ... bearish. The Chinese stock market has been ailing, losing a sharp 10 per cent in late April. Investors at least know that they have some periodic protection as interest rates are slowly reduced.

The US dollar has relaxed its pummeling of the euro which hit a low in March but which is now trading some 6 per cent over that level with few signs that it wants to go stronger. And we've seen a healthy jump in commodities prices in recent months with copper up 20 per cent, and oil already 22 per cent above its "dead cat bounce" level.

The biggest wobble has been the sell-off in the global bond markets. Indeed, under normal conditions, the European bond markets would be regarded as having crashed – with German bonds losing in the last two weeks all that they had painstakingly gained in four months. German long bonds are now yielding – wait for it – 0.6 per cent a year, having touched lows around 0.05 per cent. That's the equivalent (if you foolishly bought at the top) of a couple of decades worth of bond income.

Yet the stock markets have not reacted as if the final bond meltdown was upon us despite some intraday volatility. The VIX indicator of option risk in the equity



A quiet summer for markets may be a buying opportunity. Photo: AP

markets is showing a notable lack of fear.

Nevertheless, some observers have wrung their hands with dire predictions of the end of the enormous bull market that is more than two decades old. They ask: "Are the price adjustments marking a major turning point?"

"Could these bond price falls lead to knock-on effects that push markets into oblivion?"

These big corrections have generally occurred in markets that have been extremely crowded. For instance, global investors dived into the dollar on a conviction that the Fed would soon increase US interest rates.

A similar conviction in January that, according to the scaremongers, oil was going to fall to perhaps US\$20 caused investors to crowd into the short side of that trade, pushing the price down by over half from its previous levels.

Indications that the US Federal Reserve has bottled the decision to raise interest rates has extended the timeline for investor expectations and may have led them to take profits even though the fundamentals hadn't much changed.

I have yet to find a good reason why bonds were overbought in the last three months and few have an explanation for their fall now. In fact, the excuse doesn't matter; prices in many markets had got ahead of the underlying


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fundamentals and markets needed a reason – any reason – to ease back towards reality.

Looking at any investment occurrence in perspective is critical. The bond markets have returned to where they were in the third quarter of 2014, before they started to soar on the back of the European Central Bank injecting liquidity into the markets. The fact they have returned to a more normal level is perhaps less frightening than if they had fallen in isolation or on more serious news.

Looking further back illustrates each price movement as a reaction to previous movements as trends and momentum ebb and flow like the waves on the sea. Prices never go back to what they were – markets overshoot, undershoot and evolve – but this time it looks as if we have returned to a more normalised scenario.

The overall investing scene still looks very healthy for business, as economic fundamentals are very good, especially in dollars. Labour skills are still cheap, energy prices are low, interest rates are low, it's cheap to borrow short and to lend long, inflation is low, there is some economic growth, and a more positive attitude in most major economies – even if we would all like a little bit more demand.

It looks like the markets are looking for an excuse to "sell in May and go away" over the summer months. A quiet summer might be a buying opportunity for these markets as they summon themselves for another leg upwards. That's usually preferable than a strong summer – which historically portends a sharp correction in the autumn.

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