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Mar 2016 Investment Newsletter

What to do in the current market environment

1. Market sentiment is pessimistic

There are a number of risk appetite indices* in the market, and they all tell the same story: risk appetite is weak now.

Chart 1 shows the Credit Suisse Global Risk Appetite. We can see that investors are in panic mood, with the index dipping below 'panic' levels. Historically, this would indicate a time to go into risky assets. However, we also note that the index went even lower in 2008 and 2011.

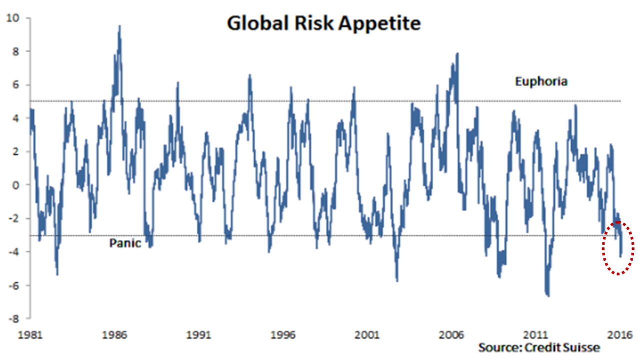

Chart 1: Credit Suisse Global Risk Appetite. Markets are in 'panic' mode.

The economic picture, however, is not as bad as the stock markets would suggest. The US economy is in good shape, with the Atlanta Fed GDPNow model estimating growth around 2.1% for Q1, driven by strong retail sales, robust employment and rebound in industrial production. While Eurozone and Japan growth are not as rosy as the US, they are not dire either and are also underpinned by supportive monetary policy.

Over in China, I believe that the Chinese government is tackling its economic issues cogently and there will always be some turbulence as China shifts from a manufacturing-based economy to a consumption-based economy. China's new securities chief would also be addressing the country's financial stability issues. The strong loans growth in January however, could be a cause of concern in the long run.

In summary, the panicky sell-off in risk assets do not seem to reflect the economic fundamentals. The risk is that when the stock market falls significantly, credit spreads widen, funding costs for banks and firms increase, hiring is curtailed — all these are negative for growth.

* Here are some risk appetite indices: JPMorgan Liquidity, Credit, and Volatility Index, the UBS Investor Sentiment Index, the Merrill Lynch Financial Stress Index, the Credit Suisse Risk Appetite Index and the Westpac Risk Appetite Index.

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2. Investor Psychology

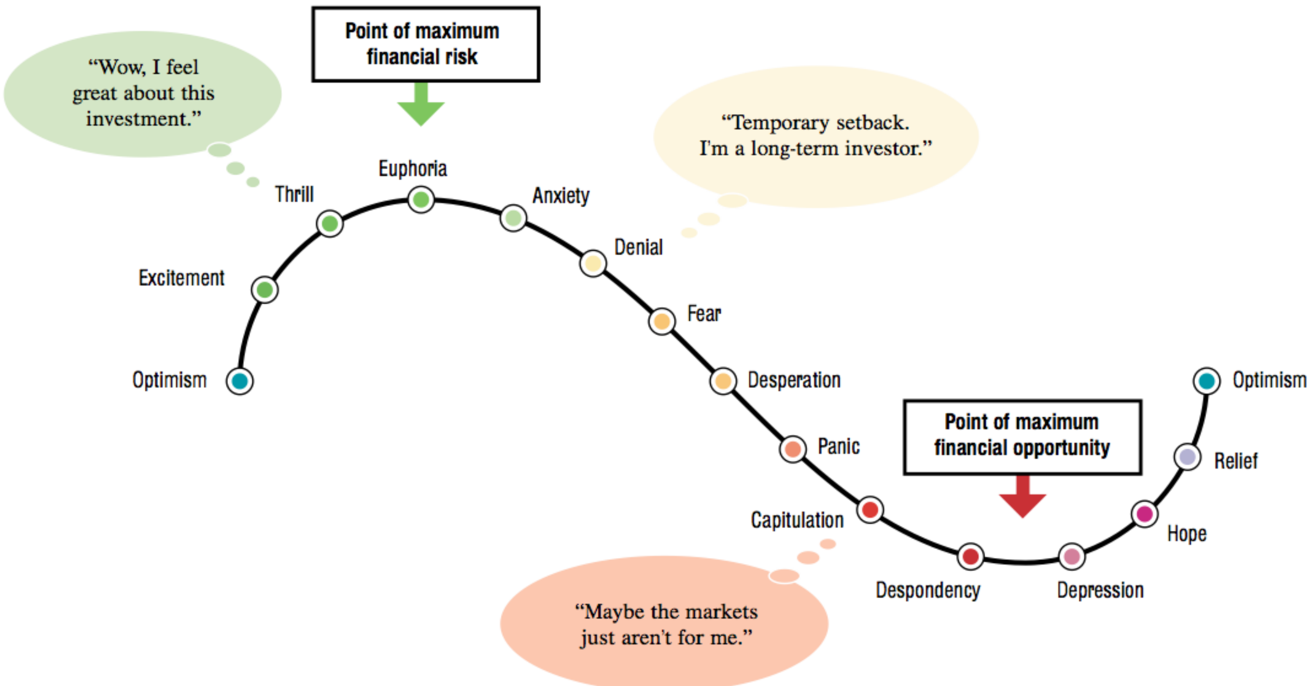

Chart 2: This is a great summary of investor psychology. (Image courtesy of OptionAlpha.)

February continued to be a volatile month with many markets dropping sharply during the Chinese New Year week where China was on holiday. For a time it was very tempting to jettison assets.

It is thus important to understand how our emotions affect investing, and chart 2 is a good example. Often times, psychology can defeat investors. Investors should understand how closely their emotions track the market, and how such emotions often lead them to do precisely the wrong thing.

When the market is going up, investors feel optimistic and starts to put on more investments. As it continues to go up, the investor feels thrilled and would even lament he is making *only* 10% while his neighbor is making 15%. If the market goes up further, he reaches a point of maximum financial risk when he becomes reckless and overcommit, perhaps with leverage.

The mood changes when the stock market peaks and then starts to decline. As losses continue for a extended period, doubt grows to worry and then fear, which interferes with rational investment analysis.

If losses continue to grow, fear can become so strong that long-term considerations are tossed aside. Psychologically, the pleasure from finding $50 is a lot less than the pain caused by losing $50. The panic can lead to capitulation, a state that is characterized by an overriding desire to end the pain of market loss. Very often, the investor sells at, or close to, the market bottom, just months before the market starts to retrace its path upward.

3. Market outlook

In conclusion, the markets seem to be pricing in a 'Lehman' kind of crisis, but I have to admit I just don't see that happening and thus this could be a value opportunity. Have we reached capitulation point yet? While markets are in panic mode, it can still possibly get worse before it gets better, and I would expect returns to be tougher in this environment.

Energy shares have been so thoroughly crushed that I believe there is opportunity there, especially if we see energy prices stabilizing over the coming months. Shares in China, HK and Singapore have also been significantly oversold and are below their historical valuation levels.

Overall, in terms of asset allocation, I prefer to stay neutral global equities and explore alternative investments which have low correlation to equities and bonds. For example, private equity funds can be a viable alternative where valuations are more stable and are not dependent on market sentiment (although valuations can be peakish too as abundant capital chases returns), while long-short equity funds can take advantage of the expected market volatility for the coming year.

Data sources: Bloomberg, BCA Research, Credit Suisse, OptionAlpha

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