Asset Management

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https://blog.en.erste-am.com/is-now-the-right-time-to-invest-in-equities/

Is now the right time to invest in equities?

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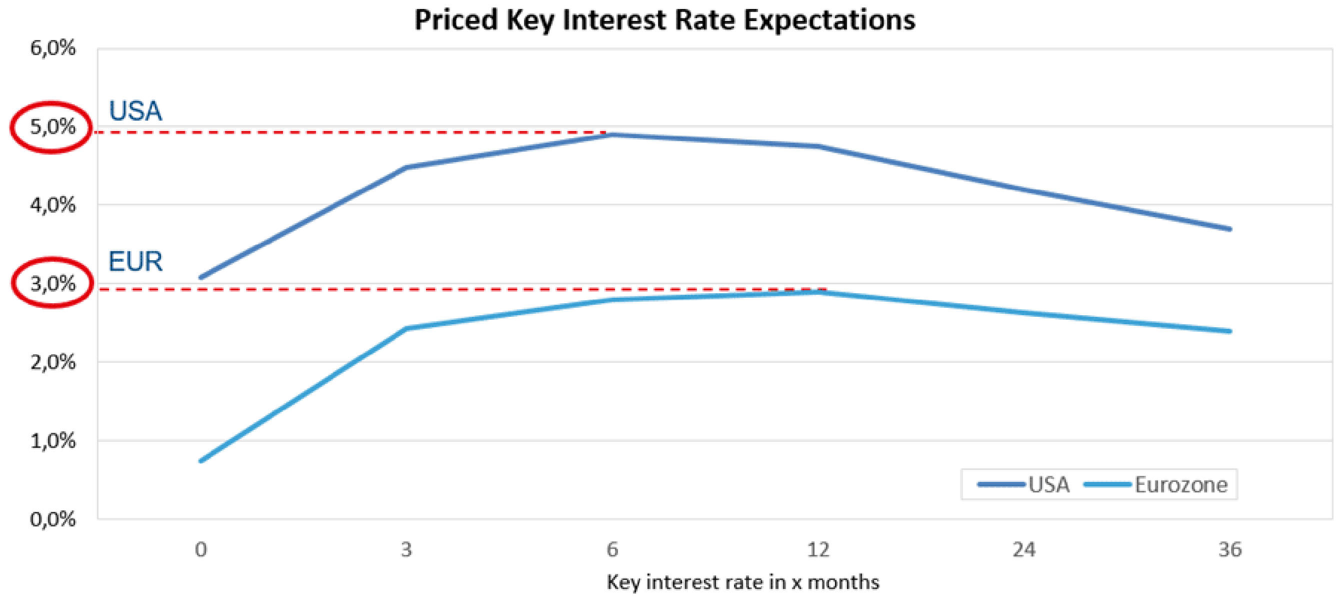
Global equity markets have been under pressure for several months. The leading US indices, Dow Jones Industrial Average, S&P 500, and NASDAQ Composite have lost 18.5%, 24.8%, and 34.0%, respectively, in the year to date (as of 14 October 2022). The brief recovery in summer was followed by a September during which the three aforementioned indices shed more than 5% again. What are the reasons for the current bear market? And how can a retail investor know when it is the right time to invest in equities?

Various reasons for bad sentiment

The main drivers of current developments are diverse and partly stem from regional differences. The central banks have to manage their interest rate policy in such a way as to reduce the pressure on the upward spiral of consumer prices. In the United States, the Federal Reserve Bank (FED) is at the forefront with its aggressively restrictive interest rate policy (manifested by Fed funds rate hikes). The European Central Bank (ECB), while acting somewhat more cautiously, has ultimately also raised the key-lending rate significantly. You can read why higher interest rates cause falling stock prices in the recent blog article of my colleague, Harald Egger.

The forward guidance provided by central banks is another important parameter taken into account by the market participants. The FED has already signalled that it will maintain higher interest rates for an "extended period". At the moment, key-lending rates are expected to peak in the coming six to twelve months (USA: ~4.9%, Eurozone: ~3.0%). Current market prices already reflect these key interest rate expectations.



Quelle: Bloomberg, own calculations; Data as of 17 October 2022

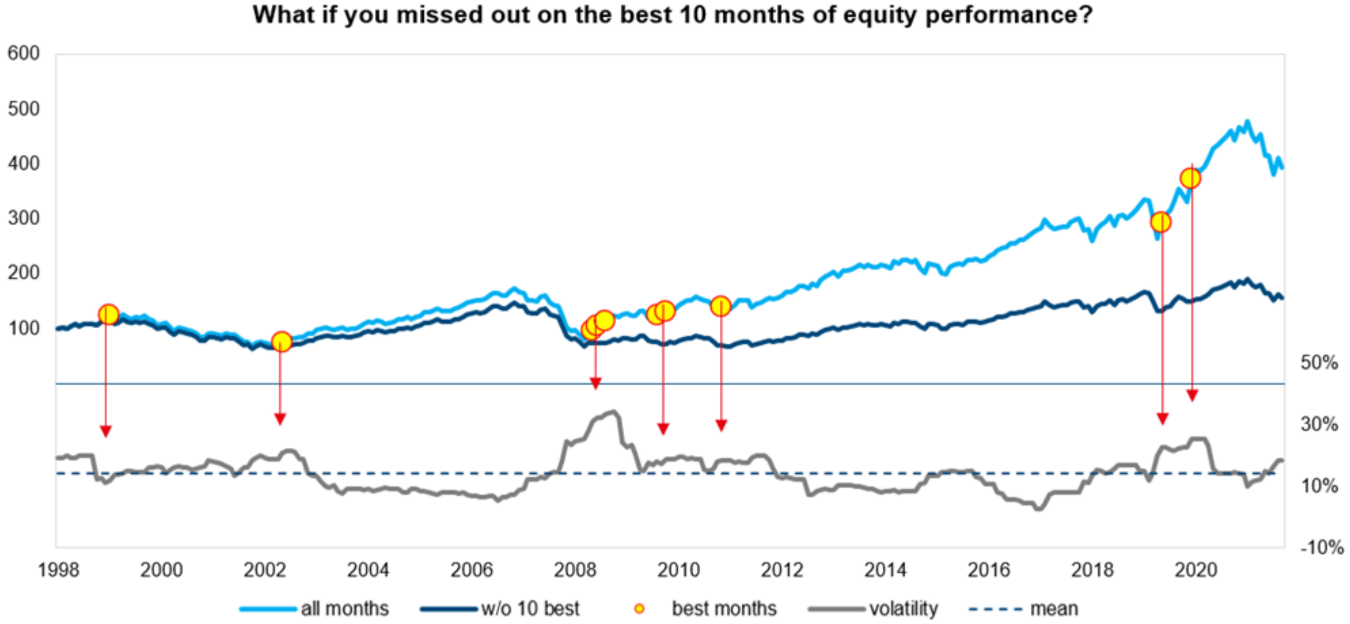
Note: Prognoses are not a reliable indicator of future performance.

News flow as driver of uncertainty

The points mentioned do not only sound negative – they are. However, one should not forget that none of them are news that can surprise the market. So, would now be a good time to invest in equities, since everything negative is already priced in? – Unfortunately, it is not as simple as that…

By definition, news comes unexpectedly, often surprisingly. Risks that may not yet have been priced into the markets – such as even higher key interest rates than mentioned above, larger than expected declines in company earnings, or a prolonged recession in 2023 – could, among other factors, further hurt the equity markets. It is impossible to predict when, if at all, we will see a surprising negative news flow and how strong or weak an impact it will have on market prices.

In times like these, the question is often asked whether it would not make sense to simply hold cash or money market instruments and wait. The following chart shows that this approach could come at a a high price.



Quelle: Bloomberg, own calculations; Data as of 23 September 2022; normalized to 100%

Note: Past performance is not a reliable indicator of future performance of an investment.

The light blue line in the chart shows the performance of the global equity market since the introduction of the euro. The dark blue line illustrates what the performance would have been if one had not been invested in equities for the ten months with the highest return (marked by yellow dots). The resulting difference in return is obvious. The grey line in the lower part of the chart shows the annualised standard deviation on a rolling basis. Almost all of the best months occur during periods of above-average volatility.

Conclusion: long-term holding strategy often outperforms market-timing

What does all this mean, then? Volatility rises *because of* the uncertainty in the market. Having to ride out fluctuations does not feel good. As a result, investors may refrain from investing their money in equities. However, as seen above, this could result in missing out on capital gains. The well-known quote “Time in the market beats timing the market”, i.e. that being invested for the long term is usually better than trying to guess the right entry and exit times, seems apt here.

Historically, holding cash and “waiting for better times” has been a costly mistake – especially during times when being invested in equities didn’t feel good. Is it the same this time?

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