Decision time for investors

By **Stirling Larkin**

GREAT fortunes are often built during uncertain times. Uncertainty generates opportunities and risks alike and having the ability to differentiate between them is the hardest skill to master. Global investors respect this expertise and know that hard decisions are made with equal parts of rationality and intuition.

They also recognise that we are now sitting amid the greatest period of uncertainty in our modern times. This is not hyperbole but an acknowledgment that the time is now to decide which fork in the road we follow. Sitting at the crossroads is no longer an option.

For ultra high net worth investors, there is no longer a clear road map in their search for relatively stable yield.

As spreads continue to grind tighter thanks to shrinking volatility, investors will be forced to consider riskier investments.

Increasingly, the ways in which we assess “risk capital” are being distorted thanks to unconventional, almost radical, global monetary policies. The news this week that the European Central Bank cut the deposit rate to minus 0.1 per cent, the main refinancing rate to 0.15 per cent and the marginal lending rate — or emergency borrowing rate — to 0.4 per cent is proof that too many elves are tinkering in the toy shop.

Also, this imposition of negative nominal rates grossly contradicts the basic tenets of capitalist economics, which our global economy has been based upon since the times of Adam Smith.

Coupled with the continued expansionary policies of the US Federal Reserve, Bank of Japan and Bank of England, this experiment is still only “half baked”. It is also crystal clear that chairwoman Janet Yellen and her cohort have not come this far only to now quit.

As both the US stockmarket and US 10-year Treasury notes reach records highs, Credit Suisse, one of the world’s premier UHNW and Family Office intermediaries, highlights that the S&P 500 has done the exact same thing for 11 out of 12 days this past fortnight. It has dropped within the first 45 minutes of trading and then rallied towards the end of the day.

Coinciding with this, the Chicago Board Options Exchange (CBOE) VIX index, which measures the US stockmarket volatility levels, has plateaued and stayed below a reading of 12, which is broadly accepted as being a concerning sign. This is a near record low and interpreted as a degree of complacency in the market that hasn't been seen since 2007.

Of equal importance are the first-hand accounts coming out of Beijing and Shanghai this week telling us that the moods in both the business and government sectors are turning very sombre and that growth is clearly slowing. It is also very important to note that even though the official purchasing managers' index (PMI) still sits above 50, representing an expansionary bias, this index is known as a lagging indicator meaning it is, by definition, out of date.

However, this in itself is not a bad situation as the entire premise of China joining the West in globalisation over these past 30 years has been about them progressing from a manufacturing to a consumption-led economy. In this respect, China is evolving exactly as hoped and is doing it well.

The timely conversations that The Australian's business editors Geoff Elliott and Damon Kitney led last week during the Australia in China's Century Conference emphasised the point that the Chinese economic car now moves a bit slower as it becomes larger. Those conversations highlighted that 1 per cent GDP growth in 2000 is not the same as 1 per cent today.

In the Australian markets, residential house prices have begun to moderate and in the stockmarket, last month had a notable lack of large capitalisation downgrades — significantly, the first time for the month of May in five years.

Maybe, also prophetically, the banking sector in May underperformed the ASX 200.

This is significant because the big four banking stocks plus Telstra are regarded as the dividend-yield backbone for our domestic pensioners' community. The decision that the global investor now needs to make is whether we follow the path that leads us to higher grounds or conversely, batten down the hatches for the precipitated storms.

Clearly, this is not an easy decision. The catch-22 of record price levels across markets, which exhibit tight price spreads combined with low levels of asset volatility plus small trading liquidity, is that if markets about-turn, the exits will become very crowded, very quickly.

We saw this scenario play out during the GFC, when credit markets imploded and then froze. Realising that it would be a Pyrrhic victory, the US government then pumped immediate liquidity into the system via the TARP package. Even though this saved the global economy, it set a dangerous precedent and came at a great cost.

If we hold the world view that China is evolving, albeit slowly, exactly as prescribed in the model adopted 30 years ago and that Yellen and her cohort will stop at nothing to ensure the global economy kickstarts again, we should then deploy our capital towards growth opportunities that position us for higher inflation levels and growth metrics.

If, however, we hold a contrary world view that China is in fact waning and that the magnitude of unconventional monetary stimuli around the world is only pumping more liquidity into an already overinflated system, then we should take immediate decisive steps to protect capital and employ downside protection strategies.

The reality may also be somewhere in between.

In either school of thinking, there is a growing acknowledgment that the GFC was the tipping point of the 75-year-long build-up in the long-term global debt cycle and, even though the GFC was sharp, it didn’t deleverage the system enough. Reinflating it now may indeed cause a greater crisis down the line.

It is, however, now, without any doubt, decision time.

Stirling Larkin is chief investment officer of Australian Standfirst
www.australianstandfirst.com