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US, China hold growth promise for investors

STERLING LARKIN THE AUSTRALIAN NOVEMBER 28, 2015 12:00AM

NZ's dairy exports to China in 2014 matched its exports to the US, Japan and Europe combined. Picture: Zoe Phillips

What do we do as investors if we see the global economy slowing and Australia appears to be leading the charge among the vanguard?

The golden rule has always been to take a step back from the noise of markets and look to the underlying economic fundamentals, to determine for ourselves who's doing business and who is being dragged along for the ride.

There is no question that leading global stockmarkets are “expensive”.

However, expensive markets can reflect a macro-environment that has growth, low inflation and supports valuations.

The premise of “expensive”, similar to that of “inflation”, can actually present as welcome signs for markets that may have crystallised the view that growth is imminently ahead.

It is too often forgotten that inflation often accompanies economic expansion, which is the desirable outcome we all seek.

But most importantly, as the narrative for developed markets, such as the US, has not materially changed this year, it is imperative to recognise that it has significantly shifted for emerging markets and in this context that means China.

With both major markets and underlying economic blocs showing signs of tepidness, the questions then are: what impacts Australia more in 2016?

Where will growth and investment opportunity be found?

And, how do we identify and support the ultimate winners?

With the US Federal Reserve, most likely, but not certainly, raising interest rates on December 15 to begin their path to monetary policy normalisation — which will see sequential rates rises moving forward — Goldman Sachs, which is arguably one of the paramount equity market thought-leaders, this week shared the view that the US S&P 500 will end 2016 at “2100”, which would see us almost unchanged from current levels.

They shared the view that “Fed hikes will begin in December and continue steadily for several years. When investors realise tightening will be more sustained than most expect, the P/E multiple will contract and offset the positive impact of higher EPS.”

As Australian ultra high net worth investors always seek out areas of particular value within international equity markets, two important facts then become material when understanding why the S&P 500 has become “expensive” in this way.

1. Technology companies have accounted f or 50 per cent of the overall S&P 500 expansion during the past five years and within this, Apple (AAPL: US) alone is directly responsible for 20 per cent of this lift.

2. US large and mid-cap firms that have returned cash to shareholders via buybacks and dividends have outperformed for 25 years on the S&P 500.

That pattern was repeated this year and the trend may very likely continue in 2016.

Remembering the golden rule that market noise does not necessarily represent underlying economic success, the attached table then perfectly frames where our thinking needs to focus.

Since 2001, when China joined the World Trade Organisation, it is no secret that the global trade picture dramatically altered.

Recognising that companies such as Apple drove the S&P 500's market performance since that time, determining who contributed, and ultimately profited, from these economic success stories then becomes the science within the art of savvy investing.

Knowing that the conventional measures of headline trade data are misleading because they suggest that China today accounts for 27 per cent of global aggregate imports, allows us then to identify who in truth is in fact re-exporting "finished goods" and where are they being exported.

Apple, Foxconn (2354: Taiwan) and Lenovo (992: Hong Kong) for instance, all import computer "CPU's" into China but then export approximately 92 per cent of these finished goods to Europe, North America and Asia-Pacific, which includes Australia.

However, what Australian equity investors, who are attempting to invest in these blocs, have learnt is that at the end of a commodity super-cycle, volumes do not always translate into investment market success.

On this, Peter Nathan, chief executive of a2 Milk Company (A2M**) believes that "Australian capital markets are just waking up to the reality that the sweet commercial outcomes in the vast China food export opportunity are actually about the power of premium differentiated brands and not about food commodities, which is in fact, very competitive and gross margin challenging".**

For a2, the primary driver behind their reported 300 per cent sales increase for the first four months of this year were predominantly found within their baby formula campaigns within China.

Nathan believes that "it is clear that Chinese consumers are highly engaged with premium aspirational brands such as A2 Platinum, as opposed to Chinese label brands that maybe sourced from Australia or New Zealand but are not perceived as being aspirational like brands that are actually used by Australian consumers."

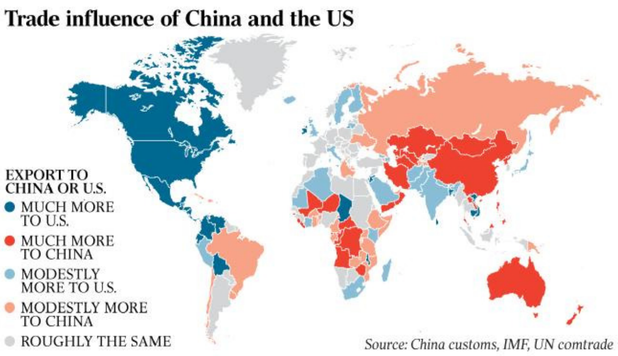
For Australian global investors, identifying underrated "brand" value also means recognising higher level trading patterns between China, the US and other economies.

And as the table astutely shows us, today the US only accounts for more exports from Japan, Vietnam and Cambodia, as compared to China, which has clearly become the dominant trading partner for New Zealand, Laos, Singapore, Taiwan and Australian businesses.

Interestingly, due to the rising demand for milk powder from China, exports by New Zealand to China in 2014 were roughly the same quantity as those exported to Japan, Europe and the US combined. Recognising that the global economy is slowing and that existing developed market stockmarkets, on a whole, are expensive, the astute global investor needs to remain focused on economic fundamentals.

This also involves accepting that as US monetary policy begins to normalise, well-known valuation distortions will also dissipate and the winners that will remain will be those who continue to trade with the world's two largest economies.

Larkin Group is a wholesale wealth adviser focusing on high yielding global investments. www.larkingroup.com.au



Trade influence.