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US questions loom for local investors

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George Washington said that "worry is the interest paid by those who borrow trouble." And with US Presidential elections one month away and heightened fracas between US Reserve Bank Presidents about the plight and pace of interest rates, investors might wonder why, when combined with historically unjustifiable valuations across US S&P500 equity, bond yields and even the US dollar itself, so many American and global investors are deeply apprehensive about what they see as trouble brewing.

Australian ultra high net worth investors have also been wary of an additional factor which is that both listed and off-market stock and fixed income markets — shares and bonds — have continued to experience atypically low levels of volatility:

When an investor has a fungible portfolio — that is, savings which are able to be spent and liquidated rapidly — of or greater than $100m, diversification is often sought in less volatile asset allocations such as private equity, venture capital or fixed term instruments.

But with primary markets continuing to deliver consistently low volatility, this too adds additional "worry" for this investment community because low volatility across all investment allocations can only mean one thing: lower realised returns over the longer term.

So the only question confronting Australian global investors looking at lead US indicators is: Are we seeing the US finally head into a cyclical recession, or is this a lull within a continuing but slow bull market recovery?

Remember that the S&P500:

•Rose 3 per cent in the third quarter

•Returned 6 per cent year to date (8 per cent including dividends)

•But regardless, still traded 43 consecutive days without a move greater than 1 per cent, cementing the observation that volatility especially during third quarter is unusually dormant.

The question for the global investor is whether the US real economy itself can continue to grow, enhance corporate revenues and maintain a longer term expansion, as this week's graph highlights.

On this, Andrew Mitchell, Portfolio Manager at Ophir Asset Management, who has returned 376 per cent since inception in August 2012 and was the world's best performing fund manager in 2015, believes that "even though this bull market has been going for eight years now, which is long by historical standards, with interest rates at record lows around the world we think it can go longer."

With all the current focus on the Federal Reserve and markets, it's easy to overlook the increasingly ugly state of the underlying US economy. There are three key segments that Gavekal Economics highlight:

1. Manufacturing remains weak. Manufacturing has been sucking wind since early 2015, as a strong US dollar has made factories less competitive, and an inventory overhang has weighed on production.

2. The service sector is slowing. Solid service sector activity has supported overall growth in recent quarters despite sector-specific recessions in manufacturing and energy. However, the ISM services PMI dropped to just 51.4 in August, its lowest since 2010. With the manufacturing PMI also weak, the average of the two is at its softest so far in the recovery.

3. The rebound in construction has lost steam. Because it is so sensitive to interest rates and lending standards, residential construction is one of best leading indicators for the overall business cycle. Worryingly, building permits have been flat all year, and actually fell in July.

The only positive and dramatic rebound was seen this week with ISM service sector PMI, jumping from 51.4 in August to 57.1 in September, which continues to support US GDP and the possibility of a return in inflation.

Though there are signs CPI could soon start rising towards 2 per cent, until recently the market had remained relaxed about the risk of inflation-induced tightening, confident that the Fed would retain its dovish stance.

Exemplifying this was a note published last week by Deutsche Bank, stating: "In the wake of a relatively hawkish statement following the September FOMC meeting, serious doubts persist among many of our colleagues in the market as to whether the Fed will ever raise rates again."

The key takeaways for Australian global investors at this stage are quite clear. Firstly, keep close watch on what happens to the currently high US dollar, accept that democratic and peaceful geopolitics like Brexit and US elections may make noise but rarely affect markets immediately, and lastly and most importantly, never underestimate the financial significance of inflation.

** Australian Standfirst is an Ultra High Net Worth Wealth team focusing on high yielding global investments*

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