THE AUSTRALIAN

A sober eye to the realities of our global boom-crash opera

STIRLING LARKIN THE AUSTRALIAN AUGUST 09, 2014 12:00AM

Whether they are investment bank trading desks, hedge funds or sovereign wealth funds … institutional participants really drive markets. Source: AFP

RENE Rivkin, an old family friend, taught me when I was very young that in the stockmarket, “Bulls make money, bears make money, but pigs rarely do.”

He was of course back then referring to the “money-drunk” speculators who were decimated during the Poseidon Nickel crash of the 1970s.

Jumping forward to today, with markets again considered “drunk” by many, the question again becomes: Are we nearing the summit of this mountain or have we still ways to climb?

What happened earlier this month may help answer this.

After seeing the American S&P 500 index reach new all-time highs this year, in August we then saw this index drop its sharpest since the dark days of 2012.

However, more bizarre than the drop itself was the explanation provided for why it, allegedly, had happened.

It wasn’t due to bad news; it was, apparently, due to very good news which told us that US labour costs recorded their largest gain in more than 5½ years in the second quarter of 2014 combined with the news that the Institute for Supply Management declared service-sector growth in the US also hit an 8½-year peak in July on strong growth in new orders and employment.

This apparently triggered alarm bells among institutional market participants who then feared that such good news would give the US Federal Reserve cause to raise interest rates earlier than currently expected.

Coined by some as a “taper tantrum”, this fear, allegedly led to the market sell-off because it is widely thought that raising rates will be bad for markets.

This counter-intuitive logic is nonsense and poorly masks what Australian and other Ultra High Net Worth (UHNW) investors have known all along — that institutional participants, whether they are investment bank trading desks, hedge funds or sovereign wealth funds, really drive markets.

When these participants choose to take some money off the table to book profits, markets, even those as large as the S&P 500, fall.

Previous experience has shown UHNW investors and their advisers that, subsequently, after these institutional profits are booked, markets in short measure thereafter begin to rise again due to the recognition that these institutional participants are back at the table, with new aims and, now, deeper pockets.

UHNW investors also know that these helmsmen (or helmswomen) were the people who decided and ultimately triggered when the GFC or “Great Recession” started.

The thought was that, spontaneously, one of these institutional participants decided that there was no longer enough upside to be had and that, tactically, for them, it made sense to turn on the market and either sell down, short sell or invert their directional flow. This about-turn, witnessed by other institutional trading desks, then spread — as exampled in the 2011 fictitious Hollywood film Margin Call.

Whether it be 2007, 1987 or 1929, you don’t have to know the machinations of “game theory” to understand that this behaviour always leads to a stampede — which is what we saw when markets turned sour in 2007.

The power of this insight, however, should not be used to single out who caused the GFC or who might next push markets upwards or downwards.

Instead, it should be embraced as a source of enlightenment to us about what these market players view as a narrowing of the road for them and cause for, tactically, turning downward on markets.

This alternate mindset, knowledge and awareness has allowed many within the UHNW investment community to weather storms and identify when the elephant has become too big for the tent. It also, importantly, allows them to dismiss the noise surrounding why we see occasional market sell-downs with no real explainable or legitimate cause.

If we among the broader investment communities also acknowledge this sober reality then we also can welcome this outlook and spend less time watching the ball and more time watching the players on the field.

When one does this, the view also becomes far more panoramic.

Referring back to the adage that says “pigs rarely profit”, we need to decide whether remaining exposed to these, well-priced, markets is greedy or shrewd.

No one, including institutional participants, enjoys a crystal ball, but they do have industry insight that can help them decide whether markets are reaching their summits or whether, possibly, there is a heightened likelihood of a cliff-face around the next bend.

Sovereign wealth funds, such as Norway’s Government Pension Fund, United Arab Emirates and Abu Dhabi’s Abu Dhabi Investment Authority, Singapore’s Government of Singapore Investment Corp and even Australia’s Future Fund often flag to markets and institutional participants their future

intents well in advance, and these “tea leaves” should be read with the respect and gravity that they richly deserve.

Decisions made in Abu Dhabi, Riyadh and Oslo can affect US, European and global markets quite profoundly and with great haste.

Glenn Stevens and his cohort watch these participants with keen interest and recognise that the doubling of foreign ownership of Australian bonds — which has grown to a record 76 per cent in less than a decade — is directly attributable to the actions of sovereign wealth funds.

Their decisions may also partly explain the adherence of the Australian dollar staying in the range of $0.90-$1.10 to the US dollar, which is referred to as “top and tail”.

This is because it is widely acknowledged that sovereign wealth funds increased exposure to our currency in November of 2012, when the IMF added the Australian dollar to its highly regarded Composition of Foreign Exchange Reserves (COFER) report. This addition led to the “price compression” of our dollar within this range, due to the effects of “top and tail” portfolio rebalancing’s by sovereign wealth funds in late 2012.

Playing the man and the ball is imperative to our ultimate success.

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