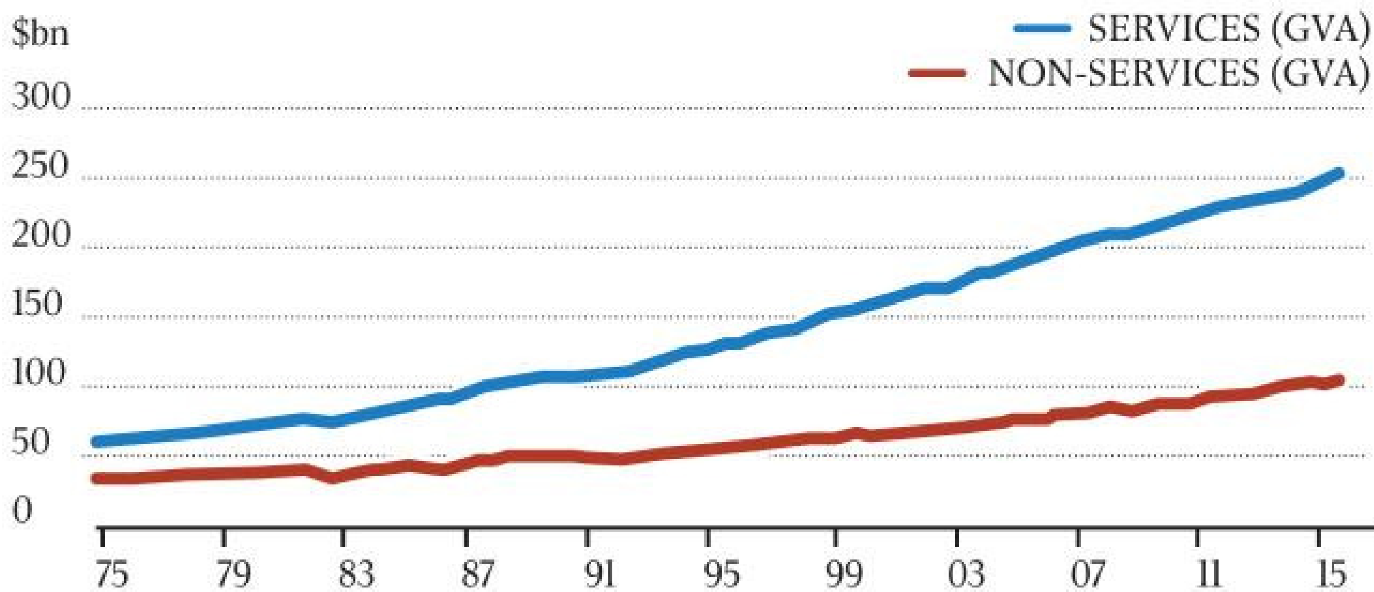
THE AUSTRALIAN

How to find returns in times good and bad



Services compared to non-services.

STIRLING LARKIN THE AUSTRALIAN 12:00AM August 13, 2016

International markets are not supposed to remain this stable and it is no secret that institutional participants are beginning to pre-emptively position for expected volatility ahead. For those with an eye on US and European markets, the following observations are timely:

• There isn’t any “kink” in the equities or bond volatility curves around the US election. This is unusual, but they didn’t price Brexit risk either, until two weeks prior to the vote.

• Bond fund flows have surpassed equity fund flows for the first time since 2013. Stereotypically, a predictor of recessions nearing.

• Libor is up at multi-year highs, likely driven by higher regulations placed on banks, but nevertheless a concerning sign.

For Australian global investors, this reality is complicated by the fact that what appears to be sources of instability — Brexit, China’s currency and domestic political chaos — are not actually significant influences on current market outcomes.

The saying "sheep that spend their whole lives fearing wolves usually get eaten by shepherds" has become ever more pertinent to investors because what will disrupt the current financial stability will not be predicted.

With international listed bourses surpassing record highs and Australian listed and quoted markets hitting post-GFC records, the emphasis for investors, then, is identifying what is inhibiting further upside potential and how to best pivot for profitable opportunities.

Since the mining investment boom peaked, there has been an increasing focus on the services sector in Australia. Since 2014, services sector employment growth has been particularly robust and this tilt towards services sector is sometimes cited as a reason for slower productivity growth.

However, prosperity derived from equity or fixed income markets always relies on improving productivity growth and if the services sector is also nearing peak level — as this week's graph highlights — then what can be done to stoke the economy and enhance investment market outcomes and weather global instability, when, inevitably, it returns.

Putting Australia's ASX within a global context, JPMorgan has correctly identified that developed market economies don't exhibit the necessary economic imbalances for an external shock like Brexit to trigger a recession directly. The Brexit shock is qualitatively similar to the US fiscal cliff in 2013, the European-Russian trade collapse (2014) and the sharp slowdown in China (2015), insofar as it can only "tax" developed market growth, not end it.

According to JPMorgan, "In a perverse way, it is the sub-par growth so far in this recovery that has prevented the major economies from accumulating domestic imbalances, and since subpar growth remains our central scenario for the remainder of this decade, we believe the next recession will likely come around the turn of the decade."

Specifically considering future upside potential of Australian S&P/ASX200 listed companies it must be remembered that:

• Although government is supposed to be the servant of the free economy and society, Australia has shifted so far left that at times ASX 200 entities become the servant of our government, its bureaucracy and their excessive involvement across our economy.

• This has seen government-protected listed companies prosper, such as the big

four banks ring-fenced by the “Four Pillars” policy, while others suffer due to the inability to innovate, grow or compete in this highly over-regulated and anti-competitive environment.

• Fintech, biomedical and technology businesses are increasingly embracing “inversion”, meaning they are moving their operations to more accommodative jurisdictions such as Singapore, San Francisco and Tokyo. Savvy global investors are keeping a close eye on the following investment options which seek to deliver returns irrespective of volatility returning:

1. Developed market investment-grade bonds as a core holding that both earns a reasonable yield and helps buffer volatility. For those willing to look through volatility, high-quality high-yield bonds over equities in Europe, offers better risk-adjusted returns.

2. Hybrid capital with a long duration bias: US Bank Preferred and European Corporate Hybrids have rallied considerably in recent years, but so have risk-free bonds. Akin to Australian “listed hybrids”, these income instruments are structured to reward risk-adjusted portfolios.

3. European dividend yields: the US Federal Reserve’s quantitative easing playbook is relevant to the European Central Bank’s corporate bond-buying program and thus high-dividend stocks tend to outperform, as the hunt for yield is high in an environment where corporate bond yields trend ever lower.

Australian investors remain collectively in a precarious position. But individually they must decide whether capital growth, yield and portfolio returns are important enough to remain active across international markets with unusually stable footings.

Larkin Group is a wholesale wealth adviser focusing on high yielding global investments.

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