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Investors must watch the burning fuse of global bourses

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There beats a dark heart at the centre of each of several possible global financial scenarios that may very likely play out this year and all of them find their lifeblood circulated from China.

It is well known to global investors that this dark heart, being China's high levels of leverage, albeit predominantly domestically held, is beginning to appear more as a "powder keg", than as a "pecunious foundation".

Leverage is similar to the concept of "inflation"; some is desired as it's stimulatory but too much is undesirable, as it causes distortion and additional stress. Chief among these predicaments is the ever-important relationship between the US greenback and the Chinese renminbi; this relationship remains extremely important for Australian investors in particular, as our Australian dollar is sensitive to both US and Chinese currency fluctuations.

In assessing the likelihood of either a Trump or Clinton US presidential candidature, Deutsche Bank recently argued that even though the channels through which the coming election will influence the US dollar are complex and sometimes contradictory, the US-led increase in global risk is already sparking concerns about trade disputes between the US, China, Europe and the world.

Clearly, these must concern Australian domestic and global investors as without sustained global trade, the Australian economy itself would suffer tremendously, seen immediately via lower ASX 200 valuations. These assessments suggest that if a Trump presidency did proceed, those countries that are intervening to stop their currencies appreciating — namely Taiwan and South Korea — would face direct sanctions by a Trump-appointed Treasury secretary.

The easiest way for this Treasury secretary to assess such intervention is by reviewing the "US Treasury monitoring mechanism", which, in short, confirms which foreign sovereign entities hold significant parcels of US Treasury instruments.

Thereafter:

• Under a Trump presidency, a heavier hand would likely be applied and why this concerns sophisticated global investors is that this would have an unpredictable but immediate impact on China

• It would push the Chinese to tolerate a more market determined exchange rate, which would likely lead to a weaker renminbi with negative implications for all Asia foreign exchanges, including the Australian dollar.

• A weaker renminbi at face value sounds positive for a domestic Chinese economy hyper-leveraged but is, in fact, a worry for the Australian economy.

But for the global investor at large, China's high levels of gearing presents another worrying concern linked to the much more globally important US economy and specifically, the US S&P 500 stock index.

Firstly, we now know that the recovery of oil prices since February has been one of the important drivers of the subsequent US equity market rally. However, the question today has become how far does oil need to rally to become a headwind for US equities?

Oil-equity correlation is largely driven by two opposing effects:

(a) At very high prices, oil impacts the consumer and results in negative oil-equity correlation.

(b) At very low prices, it negatively impacts a number of sectors and reflects weak demand, resulting in positive oil-equity correlation.

The magnitude of this correlation also has a strong impact of the US dollar and it is thought that oil would need to go above $US75 a barrel before it starts negatively affecting equities. (It is about $US47.60 today.)

China's economy, which continues to be stoked by hyper-leverage, is linked to this in three ways:

1) A China buoyed by leverage can continue to purchase more global oil, which props up oil prices and assists the global energy recovery;

2) A stronger renminbi, which in relative terms, currently exists, also drives up these purchases plus capital flight from China to US markets, seen in the shadow Sino economy. This is also arguably being seen in Australian domestic real estate markets.

3) US S&P 500 is sensitive to the robustness of China for all the reasons already known.

The lesson in this is that Australian global investors need to not only monitor Chinese dynamics but also keep an extra close eye on US S&P 500 metrics as over the past month.

In today's predicament, if volatility were to increase, liquidity would dissipate rapidly and if the US VIX index increased above "20", market liquidity could likely halve within milliseconds. Such relationships between market volatility, liquidity and sovereign risks lead to "powder keg" scenarios which can only lead to dreadful outcomes for the Australian economy and investors alike.

The fierce consequences of this begs the question — why remain invested in global bourses currently orbiting near record highs?

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