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Lead and lag indicators vital for picking US investments

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'For 240 years it's been a terrible mistake to bet against America'. Warren Buffet in Omaha, Nebraska.

Behind the investment market sits the real economy that manufactures, serves or consumes anything and everything that industrial and consumer customers require.

This enduring relationship has continued, in one form or another, since Ancient Rome, but what has evolved within modern times is how we assess, gauge and analyse these commercial dynamics.

Now, we must acknowledge the US real economy is stepping down off an ageing bull business cycle which began immediately after the nadir of the Great Recession in 2009 and has run full course until today. And we must also recognise that the US benchmark S&P 500 stock index is hovering just below all-time record highs. Keeping that in mind, it is time to pay heightened attention to what the trusted “lead” and “lagging” indicators from the US are telling us.

US indicators matter to all global investors, whether they be Australian Ultra High Net Worth families, Middle Eastern institutional sovereign wealth fund participants or North American “Mom and Pop” 401(k) pension funds.

And that is why every investor should note that the aggregated average month-to-month improvement across US Federal Reserve district manufacturing indices in March has been the largest on record for a single month — ever.

This alone is significant for the global investor seeking reassurance that the propeller-head of the global economy — US manufacturing — continues to be resilient in the face of global recessionary forces.

All major US Federal Reserve surveys, reflecting the regions recognised for manufacturing, rose meaningfully in March, with Philly Fed (+15.2pt to +12.4), Empire State (+17.2pt to +0.6), and Richmond Fed (+26pt to +22) expanding manufacturing activity for the first time since mid-2015.

The Kansas City and Dallas Fed also improved, even though they remain contractionary due to the stark reality that they suffer higher exposure to US shale and coal industries.

Regardless of how impressive these metrics appear viewed in isolation, the financial tradecraft for global investors is found when these are framed through an investment lens that provides opportunities to tactically position portfolios within and across core S&P 500 constituents.

Global investors need to also consider the following at this time:

- S&P 500 earnings growth is without doubt beginning to slow, reiterated by consensus estimates for 2016 US earnings growth collapsing from 12 per cent last US summer to just 2 per cent today.
- Earnings growth is expected to be negative year-over-year in first and second quarters, with earnings weakness seen beyond US shale. In the past, when earnings rolled over, it was a sign that the cycle was ending, however, in five prior cycles dating back to the 1930s, profits did rebound after rolling over.
- US freight transportation data, helpful in assessing economic activity in goods-producing sectors of the US economy, has turned significantly higher in February and March.
- Furthermore, railcar volumes show that non-coal transportation volumes are higher on a year-over-year basis after falling steadily for most of 2015.
- Trucking activity, which is nearly four times as large as rail, rose by 7.2 per cent in February, the largest monthly increase since December 2012.
- Seaborne US container traffic volume data available for February also shows a meaningful increase, rising 11 per cent on a seasonally adjusted basis.
- Resilience identified in US non-energy companies, with business capital spending and payrolls remaining stable.
- Within US energy sector, default rates have spiked to 12 per cent of outstanding issues, but non-energy default rates remain stable at 2 per cent, roughly the same level they've been at since 2011.

For Australian global investors attempting to find value within listed US stockmarkets, it is

important to note that the S&P 500 Industrials subset has outperformed the S&P 500 by nearly six percentage points since January's retracement and, similarly, equity prices of transportation firms within the broader Russell 3000 index — which covers 98 per cent of public US firms — such as railways and truckers, have also sharply outperformed the broader Russell 3000 index.

In his 2015 shareholder letter, Warren Buffett stated: “For 240 years it’s been a terrible mistake to bet against America, and now is no time to start. America’s golden goose of commerce and innovation will continue to lay more and larger eggs.”

Accepting that US politics may have a material impact on the nation’s fiscal realities post November’s presidential elections, now appears to be the time for Australian global investors to assess how and where they allocate portions of their core portfolios or indeed SMSF’s towards the US economic machine.

For those content with the market performance, or “beta” of the US’s bourse, it is difficult to look past BlackRock’s iShares S&P 500 Australian Dollar Hedged ETF (IHVV: AU), Core S&P Mid-Cap ETF (IJH: AU) or their Russell2000 ETF (IRU: AU).

But for those seeking active returns or pockets of untapped value, a more sophisticated approach remains the best option.

And whichever of those are chosen, the facts remain the same, meaning that all that is left to decide, is how to assess, gauge and analyse these commercial dynamics and, accordingly, proactively invest.

With further risks laying ahead should the US dollar appreciate as we approach further rate hikes later this year, the important question that should be asked is not whether we invest in the US economy today but when should we seek a timely and profitable exit.

Larkin Group is an Ultra High Net Worth Wealth team focusing on high-yielding global investments.

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