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No recession in US but bears hold high ground

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One of the oldest investment adages that resonates in today's fragmented global investment landscape is that markets are always rational and ultimately correct when viewed through a rear-view mirror.

This in particular applies to exchange-traded markets because the information and colour garnished from these allow us to ascertain what investors collectively think at any moment.

With the US S&P 500 earnings reporting season now finished, we realise one particularly interesting reality — corporate America's profit margins remain strong and do not present as recessionary.

But those who question whether a recession is ahead may have missed the fact that markets have already decided one will exist.

Rational investors also respect the following:

• Corrections run longer than we expect and that has been seen across global markets over the past six months.

• Market and macro expansions also tend to run longer.

• Geopolitical risks are rising and will further weigh on sentiment.

• Anything that markedly influences interest rates will affect the price of all risk assets. That means higher volatility, greater sector and security dispersion and, on the margin, less certainty for the first half of 2016.

Even though the phrase "profit recession" has been used to characterise what was a particularly challenging period for US earnings over the past year, this misnomer was meant to refer to the flat aggregate growth of these multiples and not their net position.

Acknowledging that global corporate profitability and margin multiples, represented by high prices across all major asset classes, remain historically high, Australian ultra high net worth investors are understandably recalibrating their mix of US and Australian equity exposures.

While the ASX 200 is now down close to 20 per cent from last year's peak, aggregate valuations look only fair in a historical context — trading at a price-earnings ratio of 14.5, in

line with its 20-year average.

Despite this, dispersion across valuations sits close to record highs with growth stocks trading at elevated earnings multiples while value names are relatively unsupported. Economist Mohamed El-Erian last week put all of these into context and shared his view that the market reaction to macro developments has been overdone, owing to a combination of monetary policy divergence and lower liquidity that continues to amplify volatility. El-Erian highlights that with the Chinese slowdown and commodity oversupply providing a "one-two" punch to the global commodity complex, the market's other major concern, lower-for-longer commodity prices, must be a key risk to watch in 2016.

This warning resonates with UHNW investors who accept that asset allocation, at its core, is about measuring and managing investment risk and the further along in a cycle they are, the more important this, of course, becomes.

And that is maybe why there has been a lot of talk in high-level financial circles this past fortnight about a paper written by London-based Goldman Sachs analyst Sumana Manohar, who presented the bear versus bull arguments for the flagship US stockmarket.

When debating whether global profitability can continue to be sustained in a period of prolonged, below-trend GDP growth and rising competition, combined with whipsawing volatility spikes, the following base cases were presented:

The bull argument: margins can stay high absent a demand rebound as industries consolidate, corporates cut costs and leverage technology.

● Consolidation eases competition: large-scale M&A has resulted in favourable market structures in many major industries.

● Holding on to price deflation: producers have not fully passed on input cost deflation to end consumers.

● Technology reinforces dominance: incumbents that use technology well will be able to raise entry barriers.

● Tighter purse strings: there is room for further cost cutting as corporates face prolonged top-line weakness.

The bear argument: margins will drift down in a world of low demand, overcapacity and more intense competition.

● Dogged overcapacity: many industries are plagued by oversupply, exacerbated by the rise of emerging market competition and capacity.

● Tech lowers entry barriers: new asset-light competitors are disrupting industry profit pools.

● Negative externalities: corporates will be asked to bear higher wages and regulatory costs,

such as emissions and data privacy/security.

● Tailwinds are fading: some of the levers that boosted profitability, such as cheap offshoring, FX and cost cutting, are losing steam.

Manohar's verdict? Over the next two to three years, he expects the bear to overpower the bull arguments and weigh on high versus historical margins. That's food for thought.

Larkin Group is an ultra high net worth wealth adviser focusing on high-yielding global investments.

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