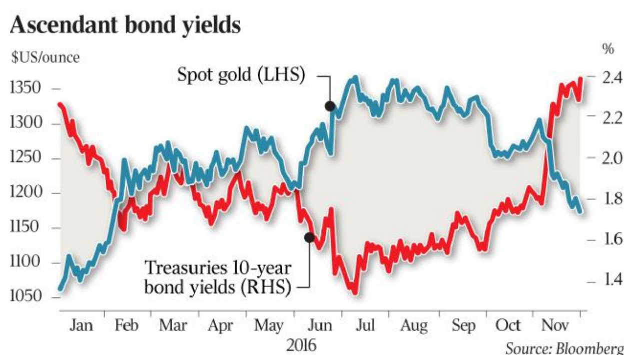
THE AUSTRALIAN

Will the instos-driven Donald Trump rally last long?



Rising bond yields

STIRLING LARKIN THE AUSTRALIAN 12:00AM December 6, 2016

Markets have come to love president-elect Donald Trump, with investors happy to accept more risk across the board, with the unusual trifecta of an expensive US dollar, record-high US stockmarket and onshore bond market valuations all at the same time remaining fully priced.

Importantly for global investors, this recent "risk on" market resurgence has the fingerprints of market technicians all over it, meaning that those asset classes enjoying rallies are being driven higher by a small number of influential institutional participants.

For Australian domestic and global investors, this is important to appreciate for several key reasons:

1. The institutional "momentum trade" collapsed in February and March of this year, leading to the worst annualised performance year for international hedge funds, specialist managers, commodity trading advisers and sovereign wealth funds on record.

2. Because of the inertia that followed, these institutional participants have had to find algorithmic and formulated methods of stoking market movements, which has led to a resurgence in popularity of relative value credit (arbitraging price difference between related credit linked financial instruments) and lower equity beta (lower volatility) strategies.

3. Because of this, non-institutional investors have witnessed that traditional "risk on" and "risk off" assets have begun to move within a rather predictable range and experience what is referred to as "price compression". For instance, this has seen our Australian dollar bounce between the lower bound 72.8 to the upper

bound 77.9 cent range for over three years.

Accepting that this renewed range-bound pattern will extend well into 2017, savvy Australian investors are identifying which current risk assets appear cheap — or are at the bottom of their observed range — and which remain expensive and fully priced.

The most obvious “risk off” asset that currently remains both “cheap” and trading nearer to the bottom of its recent range is gold bullion:

• Gold this year has traded in a particularly strong inverse correlation with US 10-year bonds; as gold drops, treasury yields have risen and vice versa.
• When any of the three trifecta markets retrace, likely in February or March 2017, gold will reprice towards the 52-week high of $US1375 an ounce (from its current $US1170).
• Australian investors can participate in bullion pricing movements via relatively dependable proxies such as iShares Gold Trust (IAU: AU), the US SPDR Gold ETF (GLD: US) and the triple leveraged (three times geared) VelocityShares 3x Long Gold ETN linked to the S&P GSCI Gold Index (UGLD: US).

For global equity investors, both China’s CSI300 stock index and Japan’s Nikkei225, look like they are being directly affected by this current institutional trading rally.

Interestingly, the Japanese yen, which traditionally has been used as a surrogate for “risk on”, appears to have become sidelined due to a surging US dollar, and thus, Japan’s equity bourse, has moved to the top of its Abenomics-era valuation, currently sitting at 18,500 points.

For those who believe risk factors will return in 2017, and subsequently push the Nikkei225 back to its 2016 “risk off” lower bound of 15,800-16,200 points range, then ASX quoted short products such as Citi’s Nikkei Futures MINI shorts or AUD-JPY FX Currency Pair MINI Shorts may be worth keeping an eye on.

Regarding Japan, Richard Madigan, chief investment officer at JPMorgan Private Bank, says: “After Brexit, as markets moved higher, we reduced equity exposure in Europe as we questioned its impact on European earnings as well as valuations. We are therefore currently overweight Japan and believe international developed mid-cap exposure can also do well, on a relative basis.”

The best performing stock composite bourse since the US Election has been China’s CSI300 and as positive a sign as this may appear to Australian domestic ASX investors, caution must be heeded.

With global markets driven by a small number of influential institutional participants spread across the world, China's CSI300 has been spurred higher by domestic Chinese support, namely behind names such as Alibaba (BABA: US) and Tencent (TCEHY: US).

During this year's Singles Day in China, now being dubbed "Double Eleven" (November 11), Alibaba scooped international headlines with 120.7 billion yuan ($23bn) in online sales on one day, a 32 per cent increase from the 91.2 billion yuan in sales in 2015.

Strong domestic sales and e-commerce successes such as these are evidence that China is in fact successfully transitioning from an industrial-led to consumption-driven economy. Chinese markets liked this narrative and drove the CSI300 to its highest level since the Great Retracement of 2015.

But "risk off" will suddenly return and for those preparing for 2017, the question is not when but how best to be positioned across your portfolio, come what may.

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