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The US sharemarket will fly higher sooner, but watch out for later

Federal Reserve chair Janet Yellen and president-elect Donald Trump. Picture: AFP

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Thanks to Trump's accession, there is now a strong case for why the US sharemarkets could rally firmly heading into early 2017, with the S&P500 likely to ratchet up towards 2300 points nearing March — it is at 2187 today.

Historically, when US markets move upwards in such a fashion, Australia's ASX200 soon follows.

The premise for this remains straightforward, with savvy global investors recognising the following:

• Markets "silhouette" their respective underlying real economies — an economy's "business cycle" and the timing of the financial markets that overlay it, rarely, if ever, move in unison.

• The US's current economic expansion is the second longest in modern history, partly because unconventional monetary policies have successfully seen a cyclical US recession deferred, stretching the current expansion to 86 months since the GFC.

• US equity markets have, on the whole, moved sideways for the better part of 2016, with equity fund managers, hedge funds and private banks delivering their worst performances since the GFC. (UBS Wealth Management and Deutsche Private Bank shut down in Australia in the last year — though HSBC has also entered the market.)

• Institutional market participants are motivated to see financial markets move

upwards or downwards but never sideways.

• Equity markets have never "crashed" after moving sideways for an extended period — stockmarkets only "crash" immediately following a preceding rally: 1929, 1974, 1981, 1987, 2001, 2008.

Astute global investors have correctly recognised that these institutional participants have and will continue to find justifications for why the S&P500 should move upwards now that a pro-growth, deregulating and big spending president has been elected.

But what matters also to Australian ultra high net worth investors, whose portfolios remain broadly diversified across other important asset allocations, such as bonds and fixed income instruments, is the direct "nexus" between bellwether bond yields and current equity market valuations.

Despite a recent bond market correction, lead US bonds — US 10-year or 30-year treasury notes — remain significantly overpriced and in "bubble" territory.

According to Will Denyer of Gavekal Research, "The new US leadership was always likely to inherit a bond market correction" and he provides three reasons:

First, bonds were way overbought this (US) summer.

While they have corrected by a significant amount already, it is likely yields have further to rise.

Second, markets are about to get an inflationary wake-up call.

The base effects of sub-$US30 oil last January and February, along with big increases in Obamacare premiums, are likely to push headline consumer inflation up to 2.5-3 per cent year-on-year in the first two months of 2017.

Third, underlying US inflation really is accelerating.

This is particularly evident in US labour and housing vacancy statistics.

To understand how a Trump presidency could abruptly stop bond yields rising further and through the well-recognised bond-equity nexus may even trigger a stockmarket crash in early 2017 following this lift to 2300 levels, global investors would be wise to revisit how a previous bond market correction triggered the infamous 1987 stockmarket crash.

Following the hyperinflation lag of the 1970s, volatile foreign exchange and equity market movements stoked by Japan's unprecedented boom, European currency swings motivated by Cold War pressures and in Australia, volatility surrounding our 1983 currency float, global policymakers met, first at the Plaza Hotel, New York, in late 1985 and then in early 1987 in Paris to agree on a plan for co-ordinating monetary policies.

Known as the Louvre Accord, it was intended to limit the scope for financial shocks and unsurprisingly, global investors loved the idea, piling into risk assets which pushed stock and bond markets even further into bubble territory.

This abruptly ended in 1987 after a sharp rise in Japanese and UK-GILT bond yields spooked the West German Bundesbank to raise short-term interest rates — many recognised this as the end of the Louvre Accord. The next day, the Dow Jones Industrials opened down 27 per cent.

With the 30-year treasury bond yield rising over the 3 per cent threshold this week for the first time since January, many UHNW investors are rightly worried that Trump's stimulatory agenda, whether genuine or bluster, will spook bond markets once again, but this time trigger a meltdown across the bond-equity nexus.

Remembering that equity markets only crash after rallying and bond bubbles burst more often for reasons of geopolitics than financial fundamentals, prepared Australian global investors should remain ready for the upwards and downwards that 2017 clearly has in store for us.

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