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The smart money is on returning to markets now

STIRLING LARKIN THE AUSTRALIAN SEPTEMBER 06, 2014 12:00AM

Chicago, Chicago … chief among the leading or flagging indicators on the health of the global economy is the Chicago Fed National Activity Index Source: Supplied

NOW is the time to re-enter markets and position oneself well for 2015. The following allegory provides some insight as to why this is the case.

In horse racing, one of the most important processes in priming good racehorses is allowing them time to wander the paddocks grazing on grass, often for weeks or months at a time. It allows their muscles to rest, strengthen and mature.

The same process could be said to be true for healthy markets, particularly where we've seen markets plateau and volatility remain prostrated for the past two quarters of 2014.

However, and most importantly, in horse racing a sign of a good trainer is one who knows when to bring the horse back from the paddocks and return it to the racetrack.

In wealth management, that same acumen is key and the proactive among us know that the time for investors to return to markets is now. Australian ultra-high-net-worth investors have a common disposition to seek out their own leading or flagging indicators on the health of the global economy, and chief among those is the Chicago Fed National Activity Index or CFNAI.

It almost goes without saying the US remains the propeller-head of the global economy.

Within it, one of the most reliable, all-encompassing and accurate gauges of actual real economic activity and future expectations is measured by the US Federal Reserve.

Due to the nuances of US history, the US Federal Reserve is represented by 12 constituent member banks that are intended to represent the different districts within their union. Ultra-high-net-worth and

institutional investors focus on the Chicago, Philadelphia and Richmond Federal Reserve members because they are thought to best represent the industrial heartland of the US economy and therefore appear to be the most accurate bellwethers.

The CFNAI in essence represents a weighted average of 85 indicators of national economic activity including production, income, employment and, most importantly, sales, orders and inventories.

When the CFNAI value moves below minus 0.70 after a period of economic expansion, there is an increasing likelihood that a recession has begun. Conversely, when the value moves above minus 0.70 following a period of economic contraction there is an increasing likelihood that a period of sustainable growth is ahead, and as long as that value does not move above +0.70 for more than two years then inflation can be averted.

What this indicator is telling us now is that as the US Federal Reserve continues to withdraw stimulus throughout the remainder of 2014, the US economy, all being considered, is sitting in a very strong position. It is also showing many signs in advance that 2015 has the real potential to be a strong year, even in light of the fact that monetary stimulus will have been withdrawn.

Combined with this, the eventual return of volatility in equities, foreign exchange, bonds and credit markets should be viewed as a strongly positive outcome not because it brings back greater trading opportunities, but because, for investors, it helps facilitate the most important component of efficient markets and investing, which is “price discovery”.

This is because healthy markets that value the importance of “price discovery” on the whole deliver stronger returns, greater distributions and more accurate valuations that are considerate of inflation, taxes and incalculable risks.

The Australian dollar is also likely to remain resiliently strong in 2015 and 2016, which, albeit painful for Australian exporters, is a boon for domestic investors looking to partake in global markets.

Until the global currency wars abate — and that is unlikely before 2018-19 — the likelihood of our currency reverting to its historical “mean” is small.

Therefore, rather than viewing our strong dollar as a weakness, the globally minded Australian investor is taking advantage of this position right now and onwards into 2015.

Richard Coppleson, Australia’s foremost markets commentator, recently shared with me his thoughts on current conditions and expectations heading into 2015. Interestingly, he highlighted that something unusual has happened — the S&P500 outperformed the ASX200 in August and it was the first time that has happened in eight years.

He believes that “even though it’s hard to see what will push our sharemarket higher — as banks are fully valued and resources under pressure — a massive amount of cash is coming back to the market, possibly around $22 billion in cash dividends”. And he believes this could “fuel a strong September rally” in Australia.

Already we have seen strong volumes return to the ASX, with $86bn value traded in August and all signs pointing to a strong September as well.

Importantly, he believes that if our market breaks higher the international commodity trading advisers who trade “breakouts and breakdowns” may see this as a “breakout” and buy the “ASX SPI200 futures” — which will cause all the Australian banks and big resources to rally on our stockmarket.

Referring to my previous article that suggested institutional participants really drive markets,

Coppleson makes the complementary observation that as institutional Wall Street traders return from summer holidays in the US they may very likely add volatility and thus volumes to global markets in September and October.

The concerns surrounding eurozone deflation or “lowflation”, geopolitics in Iraq, Ukraine and Africa and the known unknowns surrounding the end of US quantitative easing no doubt weigh heavily on investors, but it should never be forgotten that markets keep moving and the opportunity to position well for 2015 appears to be right now.

George Soros said “markets are constantly in a state of uncertainty and flux and money is made by discounting the obvious and betting on the unexpected”.

Uncertainties and fluxes are many in 2014, but when peeled away the fundamentals of the global economy and respective markets look stronger than first thought, and the smart money is looking to re-enter markets and position well for 2015.

When I started my career as an options market-maker, I was told that you can be reactive or proactive, but you should never be neither. Now is that time to be proactive and return from the paddocks to stretch our legs on the racetrack.

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