From the desk of James Abela

September 2018

Could rising debt spell the end for the fairy-tale bull market?

Reporting season? It seems the winners were global leaders leveraged to grow and win market share, healthcare champions and the software kings who despite some earlier valuation concerns have proved that fundamental strength remains and long term winners keep on winning!

As I travelled around Australia in July, meeting with clients, the excitement of high returns in the market had been tempered with caution about what happens next. Australian housing price growth was turning negative and uncertainty about the global stock market was a lot more front of mind. Only a few months later, caution has continued yet the market has climbed higher still.

For those of us grey-haired investors like myself who have lived through market and economic cycles before there are many parallels with today; construction booms, debt fuelled asset inflation, tight labour markets and wage inflation concerns, high and rising asset prices, not to mention a sense of synchronised global growth momentum that keeps on going "stronger for longer". Bond market signals indicate the cost and prevalence of financial risk in the system are rising. Complacency is slowing as the areas for caution grow:

1. Valuation of growth and quality stocks are at very high levels, especially in technology.
2. Rising cost of debt, inflation pressures, tight labour markets and risk spreads widening.
3. Emerging markets weakness and perhaps slowing South Korean exports are a lead indicator.
4. Financial system liquidity seems to be slowing.
5. A growing list of countries are facing currency and deficit issues.

There is, however, no universal agreement regarding the catalyst for market trends to change. The US and Asian tech sectors experienced some valuation wobbles in the last few months however, this doesn't seem to be a widespread signalling issue for the sector or for the world with the US GDP growth remaining very strong at 4.1% in the second quarter. Employment growth is strong and inflation remains very low.

Only rising debt costs, lower liquidity or a confidence shock seem likely to put the brakes on the current fairy-tale bull market.

Figures published by the Institute of International Finance in Q1 put global debt at US$247 trillion (318% of GDP).[1] Domestically, Australia is carrying debt of AU$6.9 trillion, which is 396% of our GDP.[2] If interest rates rise by as little as 1% on global debt, $2.5 trillion more interest will need to be paid, or 3.3% of global GDP. So can the world afford higher interest rates? Only time will tell...

Viability and sustainability (returns on capital, pricing power, cash generation, debt levels) should be heavily considered in the context of higher debt and lower liquidity conditions

For investors (of which I am one) in the Fidelity Future Leaders fund, my current focus is clear:

1. Growth/quality at a reasonable price.
2. Valuation sensitivity across the portfolio is critical.
3. Liquidity, earnings stability, debt levels will allow companies to survive economic turbulence.
4. Be very careful of momentum and risk assets.
5. Sustainable cash yields and sustainable earnings are the long-term drivers of a business.

In 2018 the portfolio has benefited from the expected success of quality global structural winners in technology and healthcare that are unique leaders in their fields. Long duration, global cyclical momentum stocks such as WorleyParsons have also performed as have companies in the transition and value phase such as Southern Cross Media.

Structurally, the portfolio is balanced and positioned to perform as the bull market continues, with strategic fundamental adjustments away from momentum and towards value to provide downside protection.

1 Institute of International Finance, July 2018 (iif.com).
2 Australiadebtclock.com.au, September 2018.

www.fidelity.com.au