The Telegraph

Time to stop dancing with equities on a live volcano

- AMBROSE EVANS-PRITCHARD

All it will take to bring the S&P 500 index back earth is a catalyst CREDIT: DIEGO PAREDES/AFP/GETTY IMAGES

Be very careful. The US economic expansion is long in the tooth and starting to hit the time-honoured constraints that mark the last phase of the business cycle.

Wall Street equities are more stretched by a host of measures than they were at the peak of sub-prime bubble just before the Lehman crisis. All it will take to bring the S&P 500 index back to earth is a catalyst, and that is exactly what is coming into view on the macro-economic horizon.

This does not mean we are on the cusp of recession or racing headlong towards some imminent reckoning, but we are probably in the final innings of this epic asset boom.

Didier Saint-Georges, from fund manager Carmignac, says the “massive and indiscriminate equity market rally” since February’s panic-lows is a false dawn driven by short-covering, telling us little about the world’s deformed economic, financial, and political landscape.

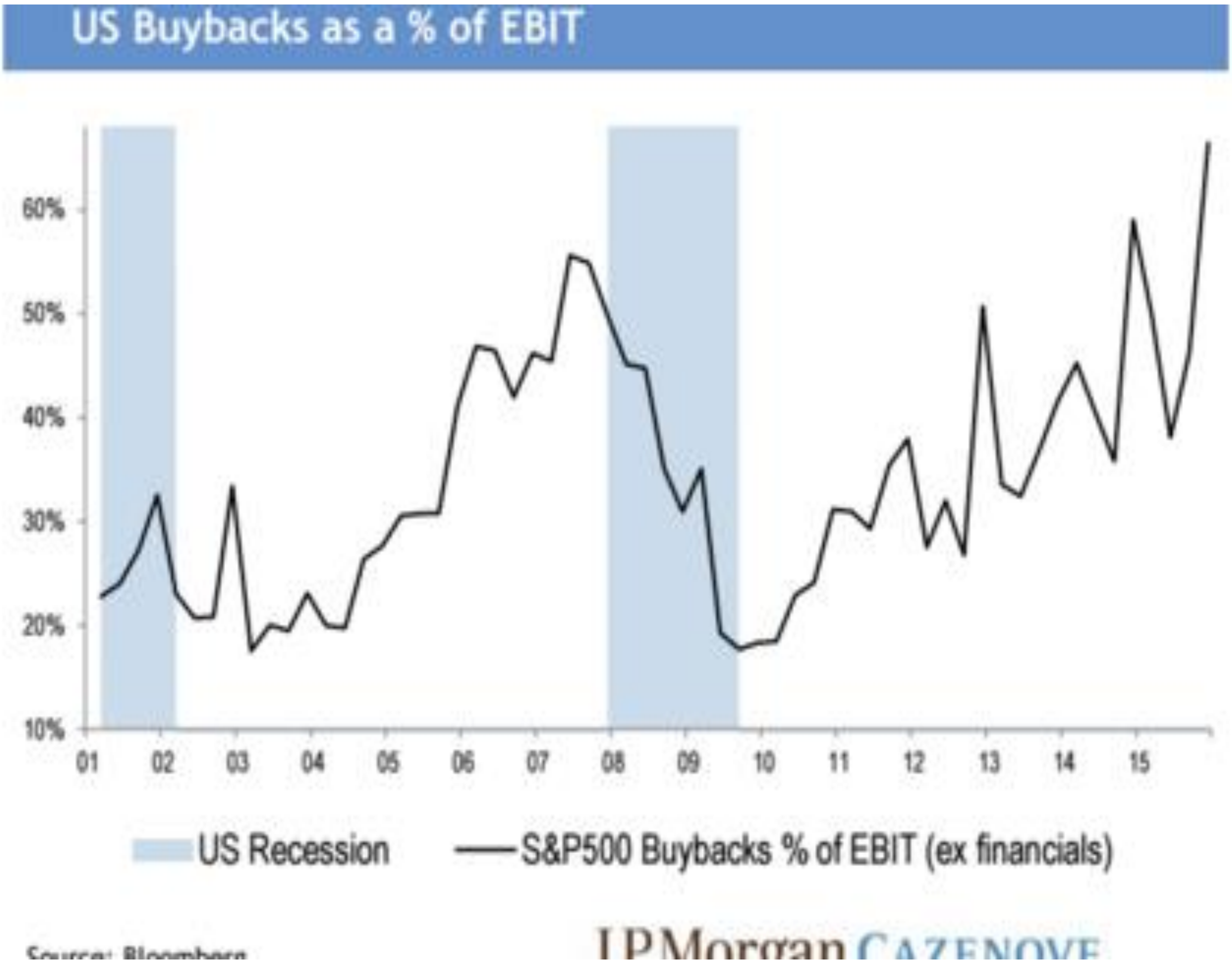
Corporate earnings peaked at $1.845 trillion (£1.3 trillion) in the second quarter of 2015, and recessions typically start five to seven quarters after the peak. "We will not be dancing on the volcano like so many others," said Saint-Georges.

If we are lucky it will be a slow denouement with a choppy sideways market going nowhere for another year as the US labour market tightens, and workers at last start to claw back a greater share of the economic pie.

The owners of capital have had it their way for much of the post-Lehman era, exorbitant beneficiaries of central bank largesse. Now they may have to give a little back to society. Yet this welcome “rotation” spells financial trouble.

Strategists Mislav Matejka and Emmanuel Cau, from JP Morgan, have told clients to prepare for the end of the seven-year bull run, advising them to trim equities gradually and build up a safety buffer in cash. “This is not the stage of the US cycle when one should be buying stocks with a six to 12-month horizon. We recommend using any strength as a selling opportunity,” they said.

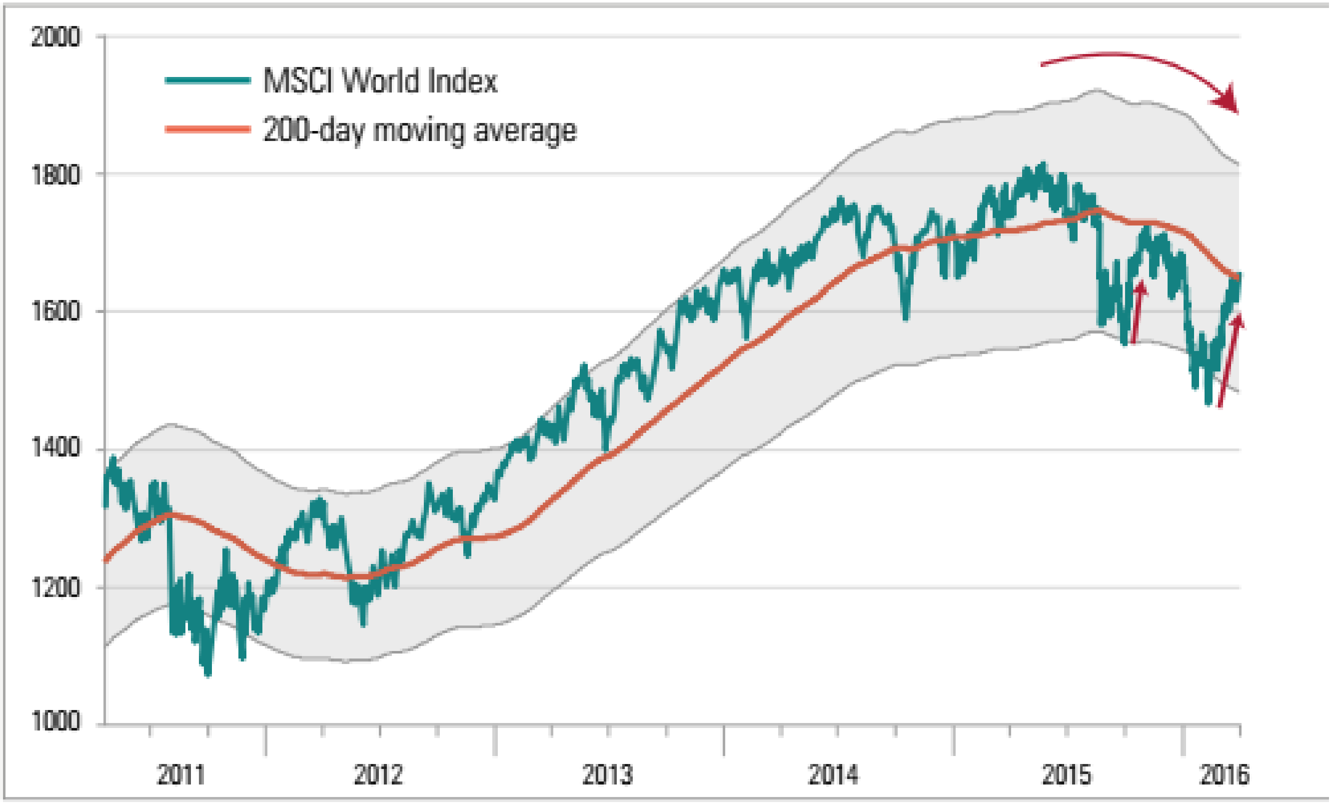
Their recent 165-page report on the subject is a sobering read. The price-to-sales ratio (P/S) of US stocks is higher than any time in the sub-prime boom. Share buy-backs are at an historic high in relation to earnings (EBIT). Net debt-to-equity ratios have blown through their historical range.



US companies have been borrowing to buy their own shares at a record pace

This is happening despite two quarters of tighter lending by US banks. Spreads on high-yield debt have doubled since 2014, jumping by 300 basis points even after stripping out the energy bust. The list goes on; the message is clear. “One should be cutting equity weight before the weakness becomes obvious,” they said.

Global equities are less stretched. Yet the MSCI world index - up 195pc - has a price-to earnings ratio (P/E) of 16.4, higher than in 2008. Technicians say the index has clearly rolled over after a forming a long ‘head and shoulders’ top. It is now locked below its 200-day moving average, on a declining path.



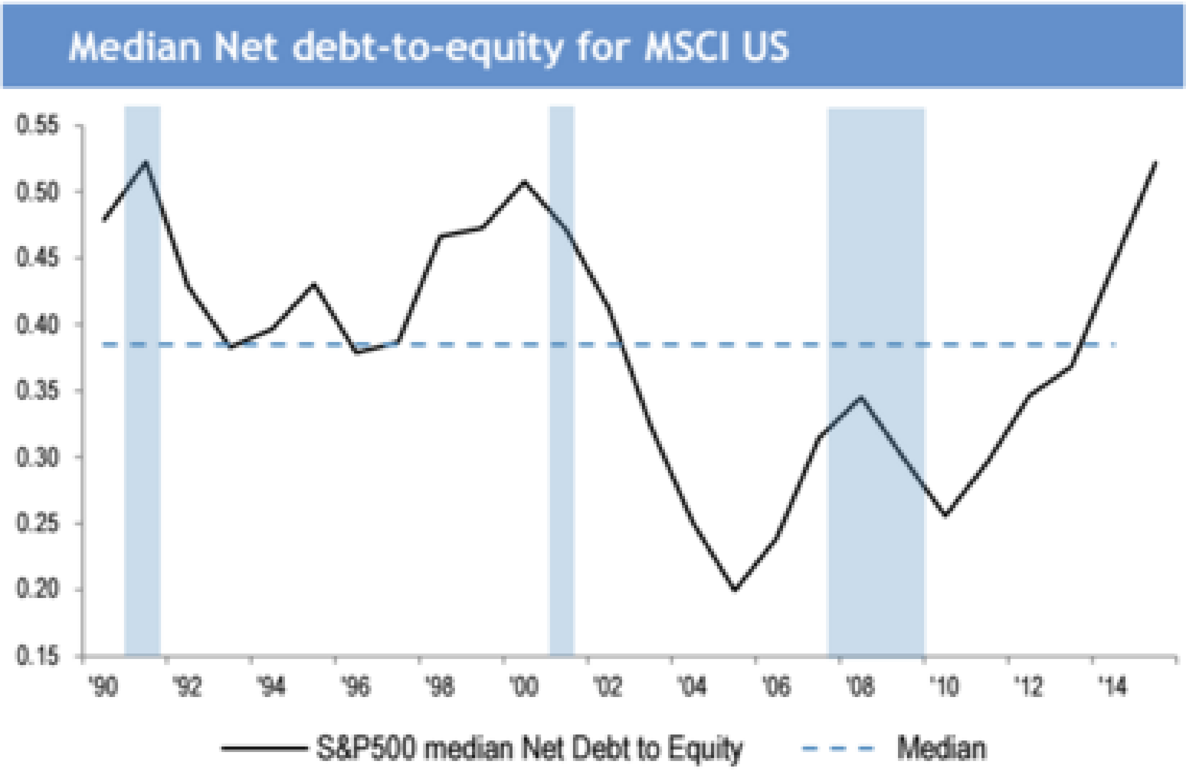
The MSCI index of world equities has rolled over

It is of course hard to know what constitutes value in a topsy-turvy world of zero rates, with $7 trillion of bonds trading at negative yields. Yet there is a risk that markets are clinging to the old deflation narrative for a little too long, lulled into a false sense of security by the dovish talk from the US Federal Reserve.

Contrary to general belief, global core inflation is near a 15-year high, though disguised by the oil price crash. The energy “drag” will start to fade from the price data by July. Headline inflation may smash through the Fed’s 2pc target by the end of the year.

The US labour market is tightening fast. The economy has added 1.4m jobs over the last three months - to 151,320,000 counting total numbers employed - drawing deeper from labour reservoirs of unknown depth.

Jan Loeys, JP Morgan’s chief US economist, warns that there is a nasty catch in these happy figures. Jobs are growing faster than the economy. Productivity - or GDP per worker/hour - is actually falling. “US companies are hiring people frantically because they are unable to get more out of their existing workforce. This is not a good omen,” he said.



Source: Datastream

The debt to equity ratio in the US is above the levels of the dotcom bubble

Indeed not. It means the US economic speed limit is collapsing, with dire implications for the debt trajectory and the pension system. Business is soaking up labour slack rather than investing in technology. The cycle will hit the inflationary buffers sooner.

This productivity malaise has been creeping up on the developed world for fifteen years, and has since spread to East Asia and Latin America. The International Monetary Fund bemoans the trend in its World Economic Outlook released on Wednesday. It calls for a burst of supply-side reforms, better training, and a fresh global effort to tear down trade barriers.

The pious aspirations could hardly be further from the realities of the US presidential campaign, where Donald Trump talks of walls and Fortress America, while Bernie Sanders wants to restrict trade to countries with "equivalent" wages and green laws, which amounts to the same thing.

What is clear is that the Fed and fellow central banks can do precious little to reverse a chronic decline in productivity. In this respect, we have reached the limits of central bank action.

Fed chief Janet Yellen is in a horrible predicament. She can keep running the economy 'hot' - and by her own admission real rates are 1.25pc below their 'neutral' or Wicksellian level - in a bid to build up momentum.

But in doing this she risks falling behind the curve on inflation, or more accurately 'stagflation', since that is where the US seems headed. She can pick her poison from one side or the other of the 1970s Phillips Curve - jobs or prices - but pick she must. “The longer the Fed dithers, the higher rates are eventually going,” said Paul Ashworth from Capital Economics.

ellen has a revolt on her hands in any case. The heads of the Atlanta, St Louis, and San Francisco Feds have all been talking up the inflation threat. Even the ultra-dovish Boston chief has gently cautioned markets to expect more than the one solitary rate rise priced in by futures contracts for this year.

he Fed may succeed in stretching this cycle until 2017. But sooner or later it will have to grasp the nettle, and then we will discover how much monetary pain can be taken by a dollarized global economy with post-QE pathologies and total debt ratios some 36pc of GDP higher than in 2008. My guess is not much.

o enjoy tactical rallies if you dare. But seven years into a profitless bull market is not a time for greed.