Points of Interest

Baiocchi Griffin Private Wealth

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Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we look back at 2013 and consider some of the major economic themes which are likely to have an impact during 2014. There's also a reminder about estate planning and good news for owners of an iPad.

Executive summary

- The past twelve months have rewarded investors with pleasing investment returns, continuing the slow but ongoing recovery from the GFC.
- The mining sector continues to drag on Australian economic growth, although we are some way from the bottom of the current cycle.
- The US economy is expected to be the focus of global economic growth in the near term, with the actions of the US Federal Reserve again having a major impact on markets.
- Further reductions in monetary stimulus measures by the US Fed are likely to see the US dollar gain in strength, matched by falls in the value of the Australian dollar.
- The Australian stock market appears 'fairly valued' at this stage – neither too expensive, nor too cheap.

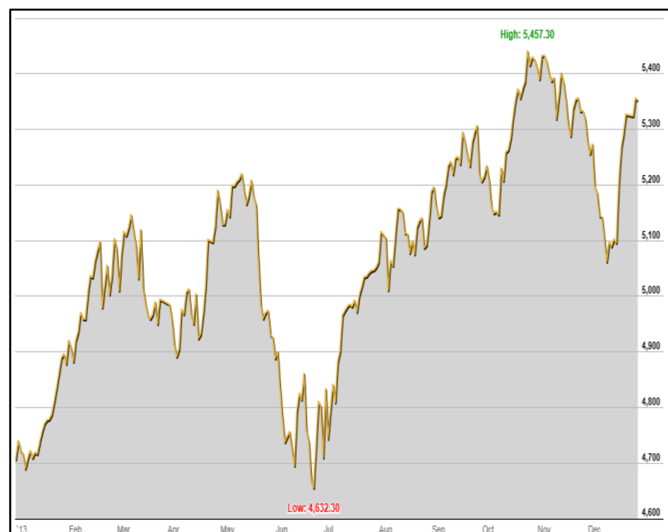
A look back at the year that was…2013

Investors were again rewarded with positive returns over the past twelve months, a welcome change from the lean years immediately following the global financial crisis. The returns were not evenly distributed however, with the mining sector continuing to struggle, while the banks and large industrials led the way in profit growth and investor returns.

The past year has been one of relative stability and substantial market growth. After the hurly-burly years immediately following the global financial crisis, investors can't be blamed for appreciating a period of relative peace and quiet, and the sense of satisfaction at seeing some quite attractive investment returns over the past 12 months. That's not to say that we're entering a 'Goldilocks' period of just right political, economic and market conditions however, but certainly the volatile days and events of the GFC are becoming more of a distant memory.

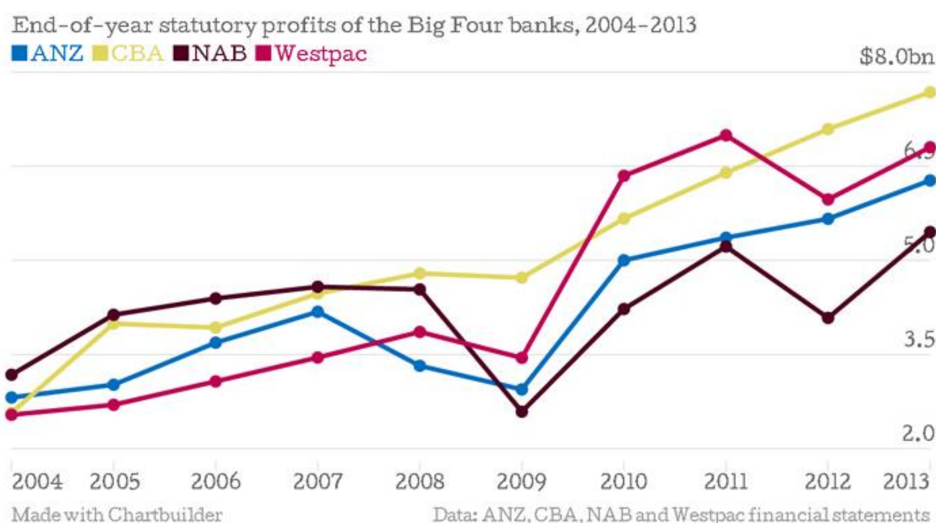
For stock market investors, 2013 provided the best annual gain since 2009, when markets rallied strongly from the bear market bottom in early 2009. The ASX 200 Index increased by 15.1% over the course of 2013, a solid performance on the back of a good year in 2012 (14.6%). Client portfolios may not necessarily have recorded the same growth however, given that our exposure to the stock market usually varies between say 30% to 90% of any given portfolio. This means our clients might not share in all of the

The ASX 200 Index for 2013 – a fair amount of volatility but a positive result for the year overall



Source: Commsec

growth on the way up, but then again, neither do our clients experience the full extent of market declines on the way down. Nevertheless, strong investment returns by the big Australian banks in particular would have helped client portfolios achieve substantial returns. During 2013 Commonwealth Bank of Australia rose 25.1% to $77.80, Westpac Banking Corporation climbed 24.1% to $32.38, ANZ Banking Group gained 28.5% to $32.23 and National Australia Bank increased by 39.4% to $34.83. As we have discussed in previous investment updates, the 'search for yield', whereby investors seek out those investments offering a reasonable income return, has remained a feature of the Australian market.

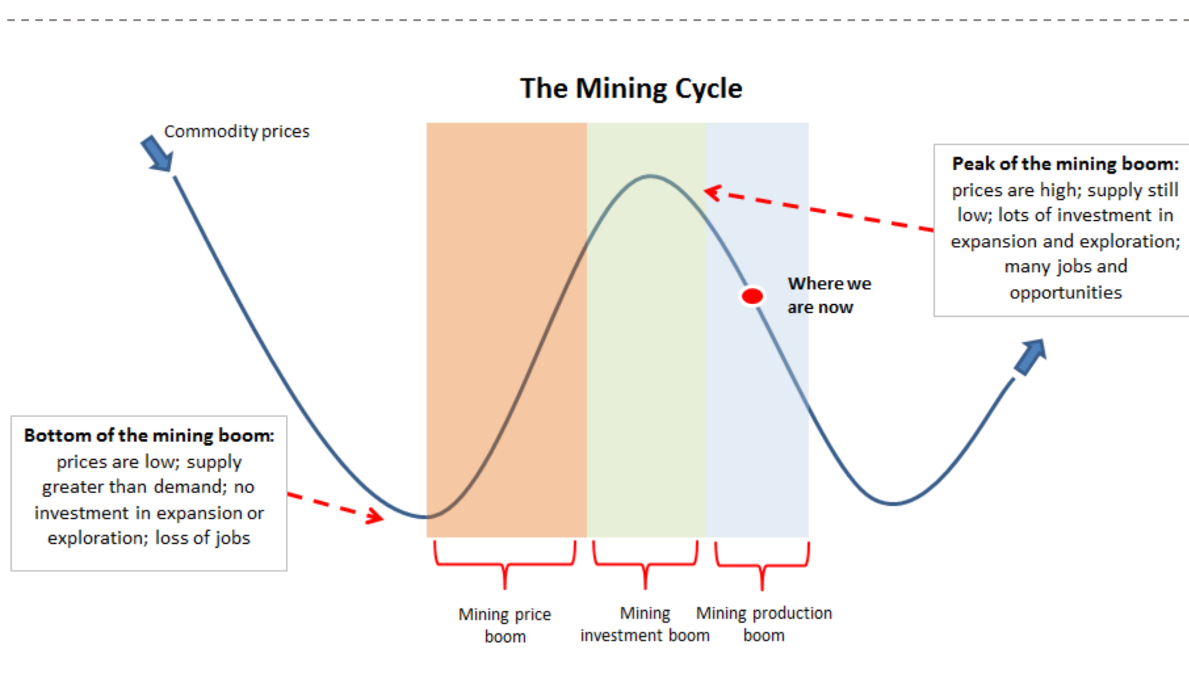


As the big banks are reliable and generous dividend-payers, it is no surprise that their share prices have benefited from this demand for income. This process is not necessarily permanent however, and at some stage we are likely to see a rotation out of high-yielding income investments and back into more cyclical, growth oriented investments. While such an occurrence may impact portfolio values, there is no need for undue alarm. Bank share prices may rise and fall quite significantly at times, but it is that reliable, steady dividend which makes the most important contribution to your portfolio's long term returns.

$21.2 billion **Australian bank dividends paid out in 2013**

It wasn't all good news in the market however, with the mining sector continuing to suffer during 2013. The mining sector appears to be in the final stage of the boom which has now

lasted the best part of a decade. The graphic below shows the mining cycle and the change in commodity prices (though it can work just as well as a proxy for the share prices of mining companies). Most mining booms are actually three booms in one. The first boom is a price boom, as commodity prices increase dramatically on the back of reduced supply and increased demand. This may continue for some time and is followed by an investment boom. At this point, seduced by high (if not record) prices for their commodities, miners spend billions in expanding their existing mines, searching for undiscovered deposits and buying and selling mines to each other. This is the era when people like Nathan Tinkler are able to make billions of dollars in just a few short years, and nurses and teachers resign their jobs to go and drive a mine dump truck for $150,000 per year.



Eventually this significant expenditure on expansion and exploration results in an enormous increase in supply, as new mines are brought into production and the work done to expand existing operations begins to take effect. This is the final part of this three-phase boom - the mining production boom. As supply steadily increases, commodity prices begin to fall, following the simple but reliable rule of supply and demand. At this stage the least cost effective mines begin to lose money and inefficient and unprofitable mines are sold or mothballed. This is the era when people like Nathan Tinkler start selling their assets in order to pay back the banks who lent them the money to get started in the first place. At this point in the cycle companies like BHP and Rio Tinto are producing more than ever, but selling it at a lower price. They're also able to buy up those mining companies and mines which have a higher cost structure and whom can't survive in an era of low prices. Eventually supply begins to fall, due to reductions in exploration and mine expansion, leading to an eventual increase in prices and before you know it, we're off on another mining boom cycle.

The red dot on the downward leg of the mining cycle is roughly where the Australian mining industry sits as we enter 2014. Prices are falling as the big miners begin to ramp up supply. At this point in the cycle it is wise to avoid smaller single-commodity mining businesses and restrict mining exposure to large, diversified miners with the lowest-cost operations. As should be expected, the ending of the mining boom will have a serious impact on the Australian economy. Besides the loss of jobs, the most obvious complication is a significant hit to tax revenue, both at a federal and state level. The fact that Australia is entering a period of semi-permanently lower tax revenue growth appears to be lost on our past and present elected representatives, but that is perhaps a story for another day.

The Great Taper

The other most important story of 2013, and one which will remain near the top of headlines in 2014, is the long-awaited decision by the US Federal Reserve to begin to unwind the significant monetary stimulus which it has been directing at the US economy for nearly five years. In our *December 2012* investment update we wrote the following :

"Looking ahead to 2013, our view could be generally described as 'conservatively optimistic'. That is, we recognise sufficient signs of recovery in the United States which gives us hope that the US, still the world's largest economy, might finally have turned the corner."

As it turned out, that view happened to be reasonably accurate, a pleasant surprise considering most research tends to show that flipping a coin is usually about as accurate at calling future economic and market events as listening to economists and commentators. In fact 2013 turned out to be a very good year for the United States, with ample evidence that their economy had finally reached a point where economic growth began to gain its own momentum. Challenges still remain however, with unresolved issues such as the ever-expanding numbers of long-term unemployed; an ongoing federal government debt problem; a deep and visceral divide between the two major political parties and a widening of income disparity between the rich and the poor, but without a doubt the US is in its best financial shape since 2007.

This evidence of sustained improvement in the US economy has prompted the US Fed to begin to withdraw its ongoing monetary stimulus. Since December 2012 the US Fed has been purchasing $85 billion worth of government and semi-government bonds each month, an action which helps to push down interest rates and keep them low. In theory the lower interest rates should encourage both households and businesses to borrow more or alternatively free up some of their money which would have been consumed through loan interest payments. Both of these actions should theoretically lead to an increase in economic activity and an eventual higher economic growth rate. At first this action by the Fed was severely criticised (largely it must be said by those who stood to gain the most from a slower economy and a change of president in the November 2012 elections), but it is now

generally agreed that the unusual and controversial policy may well have succeeded. It's difficult to prove a counterfactual, so there is no way of knowing how the US economy may have fared without the intervention by the US Fed, but at least some of the recovery in the US economy can be attributed to the actions of the Fed.

Size of the US Federal Reserve balance sheet

Debate has now shifted to the difficulties facing the Fed in winding back this stimulus without inadvertently putting the brakes on US economic growth. The first tentative step to taking the US economy off 'life-support' was a reduction in mid-December in the monthly bond-buying programme to $75 billion, a decrease of $10 billion per month. This decision was well-telegraphed to the market, resulting in little impact on financial markets. In fact, for the first time in years global stock markets reacted rationally to the news, correctly interpreting the decision as evidence of a growing US economy, rather than the Chicken Little approach of fearing the end of the world as we know it as a consequence of the actions of the Fed.

A gradual normalisation of interest rates in the United States would be most welcome, as interest rates of close to zero introduce significant distortions in financial markets and may be potentially sowing the seeds of the next market collapse. The US Fed (and other central banks) unfortunately has a reputation for making available cheap and easy money for far too long, usually leading to complications at some point in the future. The Australian dollar has been a casualty of the zero interest rate policy, with higher interest rates in Australia encouraging an inflow of foreign investment and capital, which increased the value of the Australian dollar against key trading currencies such as the US dollar, Euro and Japanese Yen. Fortunately this dynamic is slowly reversing, helped by the US Fed decision to begin reducing the level of stimulus. This process is likely to continue and we expect a lower value for the Australian dollar against the major currencies at the end of 2014.

Looking ahead to 2014

This brings us to 2014 and our views on the year ahead. Unfortunately we expect the Australian economy to struggle through much of 2014. The continuing slowdown in mining investment activity has yet to be replaced by a pickup in growth by the rest of the economy. Outside of a booming Sydney property market, there is still little evidence of the drivers for economic growth to accelerate above its current below trend growth rate. Eventually the interest rate cuts made by the RBA through 2012 and 2013 will begin to take effect, but we foresee an 'air pocket' of slower economic growth for possibly 12 to 18 months as the economy navigates the transition from the mining sector to the non-mining sectors such as travel, tourism, agriculture and manufacturing. As already discussed, the Australian dollar is expected to fall further over this period, which will provide some

assistance to those sectors which are hindered by a strong currency. With regards to currencies however, for every winner there is a loser, and we are likely to see price increases in items such as petrol, imported goods and the cost of overseas travel. A weaker Australian dollar usually has an inflationary impact on our economy, and this is a factor which we will be watching closely over the course of 2014 and beyond.

Long term chart of the Australian dollar compared to the US dollar

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In terms of the Australian stock market, the returns achieved in 2013 followed a similarly positive return in 2012. This recent positive performance has led to speculation of a stock market bubble, particularly with regards to the banks and other large dividend-paying companies. While it is true that some companies do appear to be quite expensive, on an overall basis the stock market is most likely at or close to 'fair value' – neither cheap nor particularly expensive. It would not hurt for the market to experience a period of consolidation around current levels, with the potential for capital growth at some later stage. It is interesting to note that since the beginning of 2007, the Australian stock market is still down around 15%, which is an indication of the severe impact of the GFC on our local market.

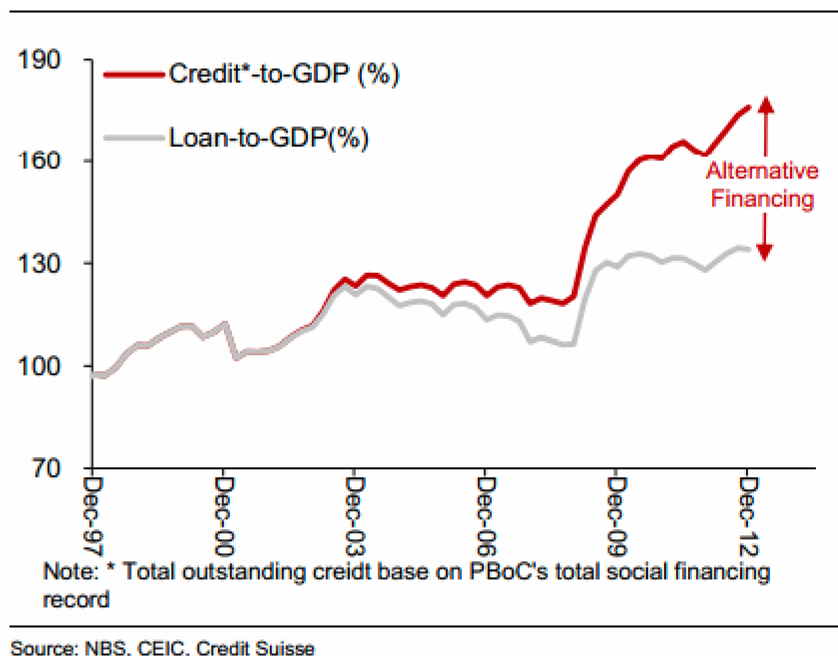
International events and developments

Unlike Australia, economic conditions overseas are generally more positive than has been the case in recent years. In previous newsletters we have outlined our view of the impact of cheap energy on the US economy. Coupled with the consistent improvement in a range of economic indicators, it now seems likely that the US economy will lead global growth in the near future. This is a significant turnaround from the period immediately following the GFC, where much talk focused on a shift in global economic (and political) power from West to East (and to China most specifically). The flexibility, durability and innovativeness of the US economy has been a feature of that country's economic

growth over much of the last one hundred years and it seems that China may need to wait a while longer before usurping the US as the world's most dominant economy. In fact it is arguable that China faces more pressing economic problems than the US.

Again, as we have mentioned in past newsletters and investment presentations, much of the rapid growth in the Chinese economy over the past few decades has been the result of a large number of debt-funded infrastructure and property construction projects. Much of this debt funding has occurred through the so-called 'shadow banking system', where businesses and local government authorities access finance outside of the regulated financial system. Shadow banking has grown in recent years as a response to the failure of Chinese authorities to reform their banking system, where interest rates are kept artificially low and cheap loans are made to state-owned enterprises (SOEs) with very little prospect of repayment. By some estimates the shadow banking system has grown to equal 40% of the size of Chinese annual gross domestic product, or around US$3 trillion. Chinese authorities face the problem of reforming their banking sector and controlling the shadow banking system without causing a collapse in credit availability and subsequent damage to the fast-moving property market.

The gap between the two lines shows the growth of the Chinese 'shadow banking' system



So far Chinese leadership, led by President Xi Jinping, have shown a remarkable ability to manage the demands of Chinese citizens for jobs, housing and greater economic freedom. The road to sustainable economic growth is never smooth however, and a few speed bumps should be expected along the way.

In summary, 2014 can be expected to be much like the years that preceded it – wars and elections; economic and political crises; bankruptcies and mergers; too much lending and too little lending; technological advances; currency shifts and market failures – but through it all our investment strategy remains relatively unchanged – invest in profitable companies with strong balance sheets; manage your investment risk conservatively; safeguard your capital and manage your cash flow.

Wills – have you checked yours lately?

This is a short reminder of the importance of ensuring you have a current and up to date Will, and you know where it is located. The complications and expense of dying intestate (i.e. without a valid Will) are considerable and an outcome that can be easily avoided. It is good practice to review your Will at least every few years, if not annually. This ensures that firstly, you know where it can be found, and secondly, that it correctly reflects your wishes and takes into account any changes which may have occurred in your personal or financial arrangements over time.

It is usual practice to retain a copy of your Will with your solicitor, however if you wish we are happy to keep a copy on file at our office along with your investment records.

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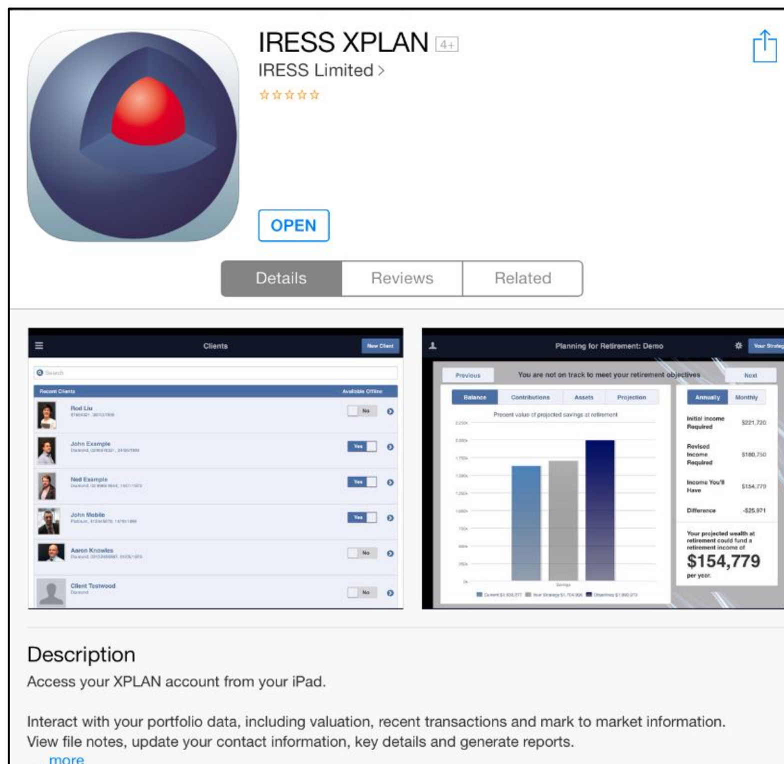
iPad access to your portfolio

A recent upgrade to the portfolio administration software used to manage client portfolios has included the ability to view your portfolio through a purpose-built iPad app. This adds to the existing access to your portfolio through our website. You will require online portfolio access to use the iPad app – if you do not yet have online access, and would like to view your portfolio either through the web or through the iPad app, please contact our office and we will make the necessary arrangements for you.

The Xplan app requires iOS 6.0 or later, so it may not function on older models, and it will not work on iPhones. To locate the app, simply search the App Store for ‘Xplan Touch’. You should see the following result (on next page):



Once installed, the app requires the following information to log on:

Site address: iressportfolio.xlpan.iress.com.au
Username: The same username you use to access your portfolio via our website
Password: The same password you use to access your portfolio via our website

Tick the box which says ‘I am a client’ and login. The image below shows what the logon screen should look like. Once logged in, feel free to try out the various functions – much like the website, it is one-way communication only, so it’s not possible to destroy or erase any information. If you have any difficulties or questions regarding the app, please feel free to contact our office.

iressportfolio.xplan.iress.com.au
I am an adviser
I am a client
username
Password
Login

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us.

With kind regards,

Justin and Ray

We wish all our clients and their families a healthy and prosperous 2014.

Facts & Figures at a Glance

	Rate/Value	Change from last reading
Australian inflation rate	2.2% (September)	-0.2%
Australian unemployment rate	5.8%	0.00%
RBA Cash rate	2.50%	0.00%
ASX 200 Index	5,352	+2.79%
MSCI World Index (ex-Australia)	1,676	+7.23%
Australian $ vs. US $	$0.8927	-4.44%
Australian $ vs. UK £	$0.5386	-6.69%
Australian $ vs. Euro €	$0.6480	-6.08%

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This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.