Points of Interest

Baiocchi Griffin Private Wealth

Issue 3 Spring 2013

Welcome to our redesigned and renamed quarterly newsletter, *Points of Interest.* Though the style and name has changed, our coverage of global and domestic economic issues which may affect your investments remains the same. In this issue we also gaze into the crystal ball and try to make sense of the changing nature of the Australian economy.

Executive summary

- The Australian economy looks set to slow as the impact of the end of the mining boom hits home.
- Interest rate cuts by the Reserve Bank of Australia may not be over, with perhaps one more cut expected later this year or early next year.
- The housing market will be the main beneficiary of lower interest rates, which the RBA hopes will lead to an eventual pick-up in both residential and commercial construction.
- Global economic conditions have improved, but both the US and China, the world's largest and second-largest economies respectively, face challenges.
- There are early signs that investors are rotating out of high-yielding assets which have performed strongly over the past year or more.
- This month we will be sending out the first *Fee Disclosure Statement,* a new legal requirement that all financial advisers must meet as from 1 July 2013.

From Mining to Housing…

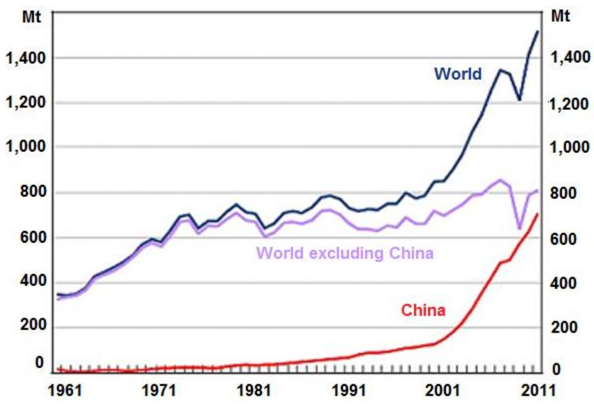
There is little doubt that the Australian mining boom of the past decade has ended. The ending of the boom as we knew it, has foisted upon the Australian economy a period of significant structural change. Considered and far-sighted leadership will be required to ensure our economy emerges unscathed on the other side. We focus our attention on the outcome of the ending of the boom and the challenges facing Australian policymakers.

The past decade may well represent a watershed moment in Australian economic history. Through the lucky combination of being in the right place at the right time, and with the right combination of rocks and dirt underfoot, Australia rode the back of the Chinese urbanisation wave. It is estimated that as many as 300 million Chinese citizens moved from the countryside to cities from 1990 to 2010. This mass migration kick-started an enormous demand for the raw materials needed to build the housing, roads, warehouses, office blocks and other infrastructure necessary to support the new city dwellers. With insufficient local supply of the raw materials needed to implement these major infrastructure projects, China turned to countries like Australia, Canada and Brazil to make up the short-fall.

Due to its proximity to China and the relative competitiveness of its mining sector, Australia became a key supplier of materials such as iron ore and coal, with minerals and energy exports making up around half of all Australia exports.

The initial beneficiaries of the demand for our resources were the mining companies and their employees and shareholders. Eventually however the increased mining activity led to rising profitability and increased federal

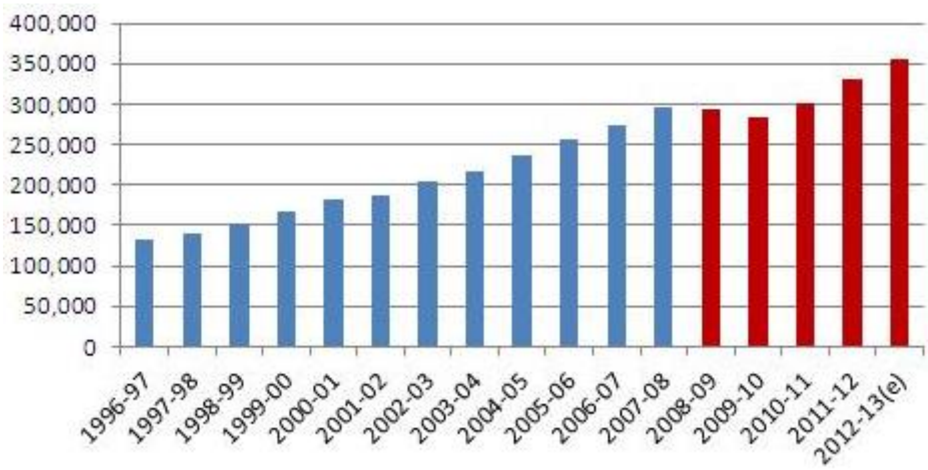
Chinese Steel Production – a significant source of demand for iron ore



Source: The Eureka Report

government tax revenues. For much of the past decade, the federal government found itself in the unusual situation of having more money than it knew what to do with.

Australian Federal Government Tax Revenue



Source: Budget papers

Countries that were in a similar situation in the past, most notably Norway, made the far-sighted decision to lock up the tax revenue from their resources boom in a sovereign wealth fund, to be invested wisely as a 'rainy-day' fund for when the resources eventually ran out. The Norwegian government, in tandem with the other political parties, acknowledged that Norway's gas and oil reserves were finite. Rather than fritter away the tax revenue raised through the development and exploitation of the oil and gas fields, Norway established the *Statens pensjonsfond – Utland*, translated into English as the 'Government Pension Fund – Global'. The fund is now worth over $700 billion, and is expected to reach $1 trillion in assets by 2020. Each year the fund makes a contribution to government revenue, a contribution which is expected to rise as revenue from the oil and gas declines over the coming decades.

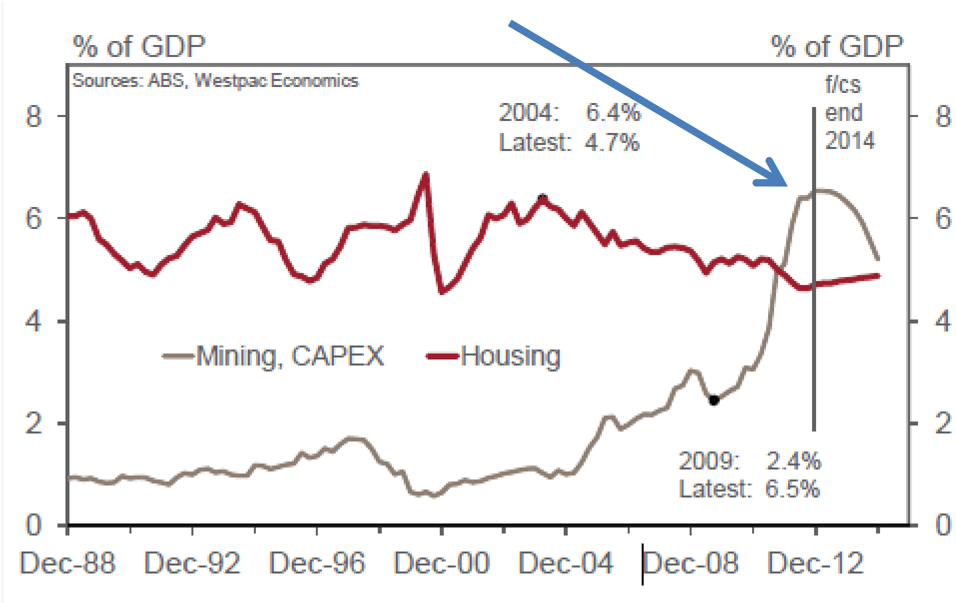
Unfortunately or fortunately, depending on your viewpoint, Australian politicians failed to exhibit the same degree of fiscal restraint. The large increase in tax revenue attributable to the mining boom was largely spent on income tax cuts and expansions in welfare and other government spending.

$148,471 **Average annual salary in the mining, oil and gas industries**

Opponents of a sovereign wealth fund argue that taxpayers and businesses would make better use of the tax revenue flowing from any mining boom; to argue otherwise means one must assume that the government would do a better job of managing the money than individuals or business. Nevertheless, it's now history that the benefits of the mining boom were not 'saved', but spent on lower tax rates and greater government spending.

While politicians on all sides might have expected the mining boom and associated revenue bonanza to continue indefinitely, the inevitable occurred and the boom began to slowly fade away. It was classic boom-bust cycle, where high initial demand resulted in high prices, which results in increased supply, which eventually results in low prices and the end of the boom.

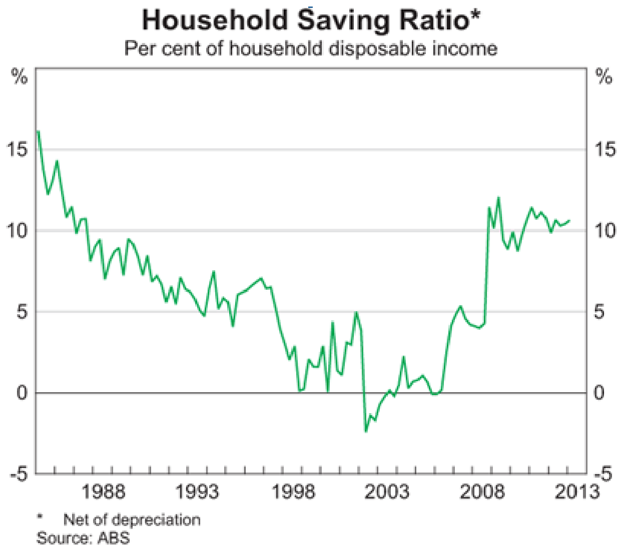
The end of the mining investment boom



The immediate future of the Australian economy

With the end of the mining boom, the set of circumstances facing the Australian economy is an unenviable one. Much of the non-mining economy struggled through the boom years, victims of a rising exchange rate and a lack of both consumer and business confidence. Recognising this, the Reserve Bank has lowered interest rates to record lows, as it tries to encourage both individuals and business to borrow to invest, and to free up cash flow for consumption or investment. This traditional approach to monetary stimulus is not as effective as in the past however, as both consumers and business remain stubbornly averse to risk-taking. This is illustrated by the level of household savings which has remained at historically high levels. Despite the efforts of the RBA, the household savings rate has remained at 10% of disposable income. This compares to a savings rate of around 0% for most of the previous decade.

Australian households are saving at a rate last seen in the 1980's – good for households but bad news for the retail sector



Preferring to save rather than shop, consumers have self-imposed their own version of fiscal restraint. While we remain focused on paying down our debts and keeping the credit card under control, the RBA will struggle to engineer the level of economic activity it desires.

The RBA's focus is on the housing sector, where it hopes to stimulate housing construction, traditionally a significant component of economic growth. The downside of this approach is that rising house prices normally precede any pickup in housing construction. So the RBA must run the risk of a housing bubble as it waits for lower interest rates to be reflected in an increase in the level of housing construction. The concern is that rising house prices could lead to an increase in inflation before the recovery of the construction sector (and manufacturing sector to a lesser degree). If this were to occur the RBA would have little choice but to increase interest rates, likely suffocating any potential recovery.

29 days **Average time taken to sell a house in Sydney**

The new federal government, led by Tony Abbott, will have an important role in determining Australia's near-term economic situation. Concerns over the level of government debt while in opposition appear to have been over-ridden by the realisation that significant cuts to government spending may not be popular with voters, even with the next election being three years away. From an economic perspective, there is little to be gained in the short-term by steep cuts to government spending, which would only place further pressure on the economy. Longer term however, government spending will need to more closely match federal tax revenue, which implies significant cuts to most areas of government spending.

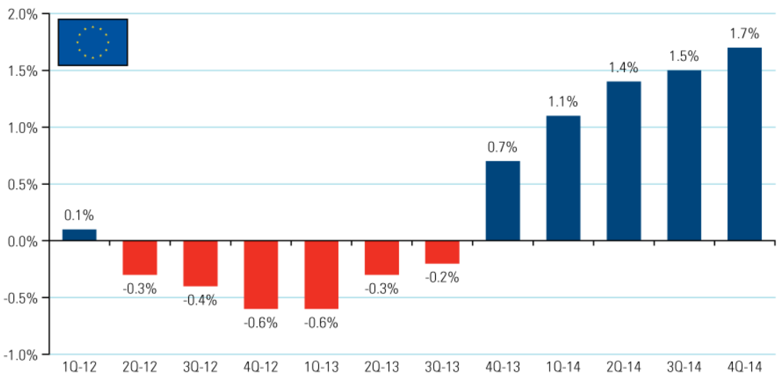
Our view is that the Australian economy will continue to be relatively weak over the next few years. The RBA is likely to need to cut interest rates further, despite their indications to the contrary. Rising unemployment and a stubbornly strong Australian dollar will likely keep economic growth below trend, although the property market will benefit from lower interest rates. Inflation will need to be watched carefully – although it is not a concern at the moment, higher inflation would put the RBA in the difficult position of choosing between keeping inflation under control or keeping the economy growing.

Global Economic Conditions

Unlike the somewhat cloudy outlook for Australia, the general outlook for the wider global economy is reasonably positive. Key to this improving situation has been the continuing recovery of the US economy and the more surprising improvement in Europe. While the Mediterranean countries of Greece, Spain and Italy are likely to struggle with bloated government debt and low or zero economic growth for some time, on an overall basis Europe is heading in the right direction.

A weak Euro has helped to boost exports from the major European economic powers Germany and France, with a beneficial flow-on effect for the rest of Europe. While it is too early to state that the European sovereign debt crisis is over, it would appear that the worst of the crisis has now passed. A slow and gradual recovery in Europe will add to the ongoing improvement in the United States.

European GDP Growth – an improved outcome in 2014



Source: EU Commission

Aiding the global recovery is a commitment by central banks in Europe, the US and Japan, to keep interest rates at record low levels. While this is undoubtedly assisting the normalisation of economic growth, the risk is that the central bank actions are sowing the seeds of future problems.

Too much of a good thing

The recent decision by the US Federal Reserve to continue with its bond-buying programme has been viewed by some as adding to the risk of future problems. Critics contend that record low interest rates are leading to an increase in debt levels and rising asset prices; a process which they argue is at risk of getting out of control. At some point, they argue, interest rates will need to rise, thus ending the debt and asset bubble, with predicably nasty consequences for the global economy.

The recent global financial crisis was in part caused by the actions of the US Federal Reserve in keeping interest rates too low for too long. This allowed the creation of a credit-fuelled bubble, which when it burst nearly brought down the global financial system. The Fed has to walk a tightrope between leaving rates too low for too long or raising them too early and pushing the US economy back into recession. Faced with such a delicate task, perhaps Fed Governor Ben Bernanke should be asking for an increase to his relatively low annual salary of $211,000 (he might look to Australian Reserve Bank Governor Glenn Stevens, who by comparison seems overpaid, given his annual salary of $995,142).

The situation in China is less promising than the US, although the reliability of the data coming out of China is of its usual questionable standard. Chinese authorities have explicitly targeted an economic growth rate of 7.5%, which is coincidentally exactly the rate at which the economy grew in the second quarter of 2013. Regardless of the true rate of economic growth, it is certain that the Chinese economy is growing at a slower rate than at any time in the past decade.

$3.3 trillion **Estimated Chinese local government debt (US$)**

For many years China has over-invested in large scale infrastructure projects and property developments. An analogy would be if Tamworth built a new airport which could accommodate hundreds of flights per day, in anticipation of the day when Tamworth's population reaches a million citizens. While the act of building the airport would generate a certain level of immediate economic activity, it also means that it would be decades (if ever) before any more money needed to be spent on the airport. This creates an 'economic void' at some date in the future, where future spending to upgrade the airport would no longer occur.

As we have mentioned in previous newsletters and presentations, China needs to shift from an investment-based economy to a more balanced consumption-based economy. Consistent economic growth is difficult to sustain indefinitely through spending on major construction projects. It can be achieved however by encouraging the development of the services sector of the economy. In effect the Chinese economy needs to look more like the US and Australian economies and less like the 'command and control' economy of old. This transition is difficult to achieve however, and is a process which we will be watching carefully over the coming years.

Investment markets and portfolio returns

The past quarter has seen a slowing of the breakneck rise of the stock market over the past 12 months or so. While twelve month returns are still in double-digit figures, the past six months has seen lower capital growth, a reflection of the strong gains since June last year. This is not unexpected when we consider the 12 month returns of some of the investments held within many client portfolios (below).

Company	**12 month return** (excluding dividends)
ANZ Bank	**24.49%**
National Australia Bank	**34.64%**
Ramsay Healthcare	**50.75%**
Telstra	**26.79%**
Westpac Bank	**31.71%**
Wesfarmers	**20.05%**

It is most unlikely that large companies such as Telstra and Westpac Bank can grow at 20% to 30% year after year. Those types of growth rates are usually the preserve of smaller, more speculative companies, where the risk is that much higher to match the reward. The 'search for yield', which we discussed in our Autumn newsletter, may also be winding down and we are seeing some rotation of investors from high-yielding, defensive assets, into more cyclical growth assets (an example of this process would be an investor deciding to sell their shares in Woolworths and invest the sale proceeds in Fortescue Metals Group, which – by the way – we do not recommend).

It is likely that this rotation into cyclical assets may impact client portfolio returns over the short to medium term. Avoiding this would require a radical shift in the investment profile of client portfolios; out with the banks and large profitable industrials and in with the small, speculative companies that promise either +200% or -100% returns. As you can probably guess, we will not be making any such radical changes to our investment approach. Our prudent and considered approach to managing your assets is based on firstly protecting your wealth, and secondly on selecting those investments which offer a consistent income stream and reasonable prospects of capital growth. Chasing the latest fad or placing big bets on small probability outcomes is more akin to gambling than investing. The list of successful professional gamblers is short; evidence of the long run success (or lack thereof) of such an approach.

Fee Disclosure Statements – coming soon

On the 1st of July this year a number of new legislative arrangements regarding the financial planning industry took effect. These changes were largely as a result of hearings into the conduct and operation of the financial planning industry. Among others, it was found that some clients of financial advisers were either receiving poor or inappropriate advice, or were paying for services which they were not receiving.

A common scenario could be where someone approached an advisor regarding investing in a certain product and once the initial transaction was complete, never heard from the adviser again. Unbeknownst to the client however, was that the adviser was receiving an ongoing payment from the investment; a payment which would continue for as long as the client had money invested in the product. This resulted in some advisers signing up many thousands of clients, with no means (or intention) of providing any on-going service to those clients. In order to curtail this type of behaviour, it was ruled that clients must be provided with an annual statement showing all the fees that had been paid to their adviser.

Under the new legislation we too are required to send you an annual statement showing all fees paid to *Baiocchi Griffin Private Wealth* over a 12 month period. As we accept no commissions, brokerage payments or any other type of remuneration from third parties such as investment institutions, this is simply the sum of monthly management fees paid from your portfolio's cash management account over the past 12 months. These statements, known as a 'Fee Disclosure Statement', will be sent out before the end of October. Please note that they are only for information purposes and are not an invoice or bill to be paid. Should you have any questions regarding the statement once it arrives, please do not hesitate to contact us.

Open to new clients?

In the past there may have been a perception that we were not open to accepting new clients. We can assure you that this is not the case and we welcome the opportunity to assist your family or friends in managing their financial affairs. We're always appreciative when existing clients value our services highly enough to recommend us to family or friends.

TEAM BG-JTF
Baiocchi Griffin JT Fossey

During the past quarter we were pleased to be part of the launch of Tamworth's first sponsored cycling team. Many of you would know of Ray's long association with cycling through his late father, Jack Griffin, and through Ray's own cycling exploits in his youth.

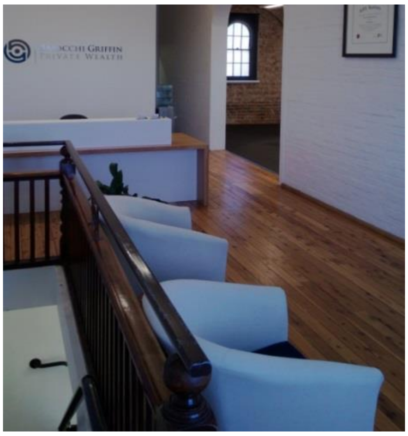
Building on this background, Ray conceived and brought to fruition *Team Baiocchi Griffin JT Fossey,* of which we are proud to be a foundation sponsor. With seven riders (including Ray himself, lending his considerable experience to the younger team members!), the team has significantly raised the profile of cycling in Northern NSW, with a number of successes in just the short period since its launch.

Ray hopes to eventually structure the team as a development team for young promising cyclists within the region, who might one day go on to professional teams here in Australia or overseas. If you are interested in finding out more about the team, have a look at the team website www.teambgjtf.com.au

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

Kind regards,

Justin and Ray



We thank you for your support and look forward to working closely with you in the years to come.

Facts & Figures at a Glance

	Rate/Value	Change from last reading
Australian inflation rate	2.4% (June)	-0.1%
Australian unemployment rate	5.8%	+0.1%
RBA Cash rate	2.50%	-0.25%
ASX 200 Index	5,218	+8.66%
MSCI World Index (ex-Australia)	1,553	+7.62%
Australian $ vs. US $	$0.9342	+2.18%
Australian $ vs. UK £	$0.5773	-3.81%
Australian $ vs. Euro €	$0.6901	-1.77%

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