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 discuss the action taken by central banks in response to the 2008 Global Financial Crisis and how this may be sowing the seeds of the next crisis. We also round-up the major market events over the past three months.

Executive summary

- Central banks in most developed countries responded aggressively to events occurring during the 2008 Global Financial Crisis.
- Excess liquidity in the financial system as a result of these actions has impacted asset prices.
- There are warnings of a disconnect between asset prices and the true underlying state of the global economy.
- Central banks in the US, Europe and Japan in particular, will face considerable challenges as they attempt to return the global financial system to a state of normality.
- The June quarter saw markets take somewhat of a breather, not helped by the uncertainty created by Treasurer Joe Hockey's first budget.

Where has the money gone?

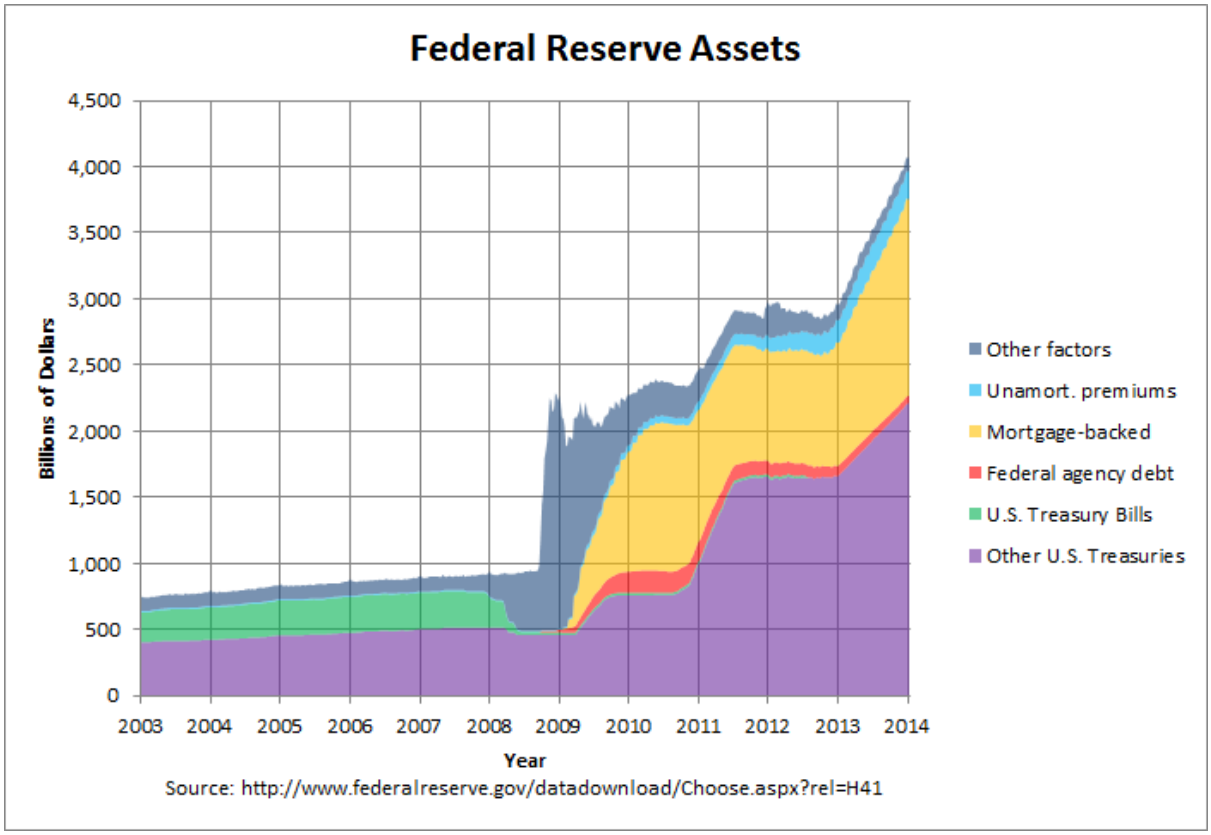
In an attempt to promote economic growth following the 2008 global financial crisis, central banks in many of the world's largest economies have been involved in an unprecedented experiment in monetary policy. Zero percent interest rates, extraordinary levels of monetary liquidity and extreme levels of market intervention…we consider the status of the global economic system and speculate on the likely nature of the next financial crisis.

By now most people are aware of the general causes of the 2008 global financial crisis (GFC). In a nutshell, too-low interest rates in the United States, coupled with government policies which actively encouraged home ownership in the middle and lower socio-economic classes, and assisted by predatory bank lending practices, all acted together to foster an enormous property bubble which nearly brought down the global financial system when it popped. Complex financial engineering was responsible for spreading the crisis far beyond the borders of the United States, to the point where local government councils in rural Australia became just one of many investors who lost money on investments they didn't understand. What was quite remarkable about the GFC however, was not only the scale of the crisis which struck the global financial system, but also the response. Central banks, governments and monetary authorities around the world adopted a co-ordinated approach to dealing with the crisis; a level of financial co-operation which probably hadn't been seen since the reconstruction of the global financial system in the aftermath of World War II.

Vital to this co-ordinated response was action taken by central banks to flood the financial system with liquidity, a necessary action to try and thaw the credit freeze which accompanied the crisis. As losses on mortgage-linked assets mounted, distrust between banks had grown to a level where inter-bank lending and bank-to-business lending almost came to a complete halt. As most businesses are reliant on credit financing in one form or another, the freeze on global credit markets posed a very real threat to the global financial system as we know it. Indeed, one of the more important tasks which confronted policymakers in Washington, London, Paris, Tokyo and other major financial centres, was to re-establish an orderly flow of credit from those who had money to lend to those who needed money to run their businesses. Nowhere was this task embraced with more gusto

than in the United States, where the US Federal Reserve was quick to use the full extent of its powers (and go beyond them according to some) to jump-start credit markets.

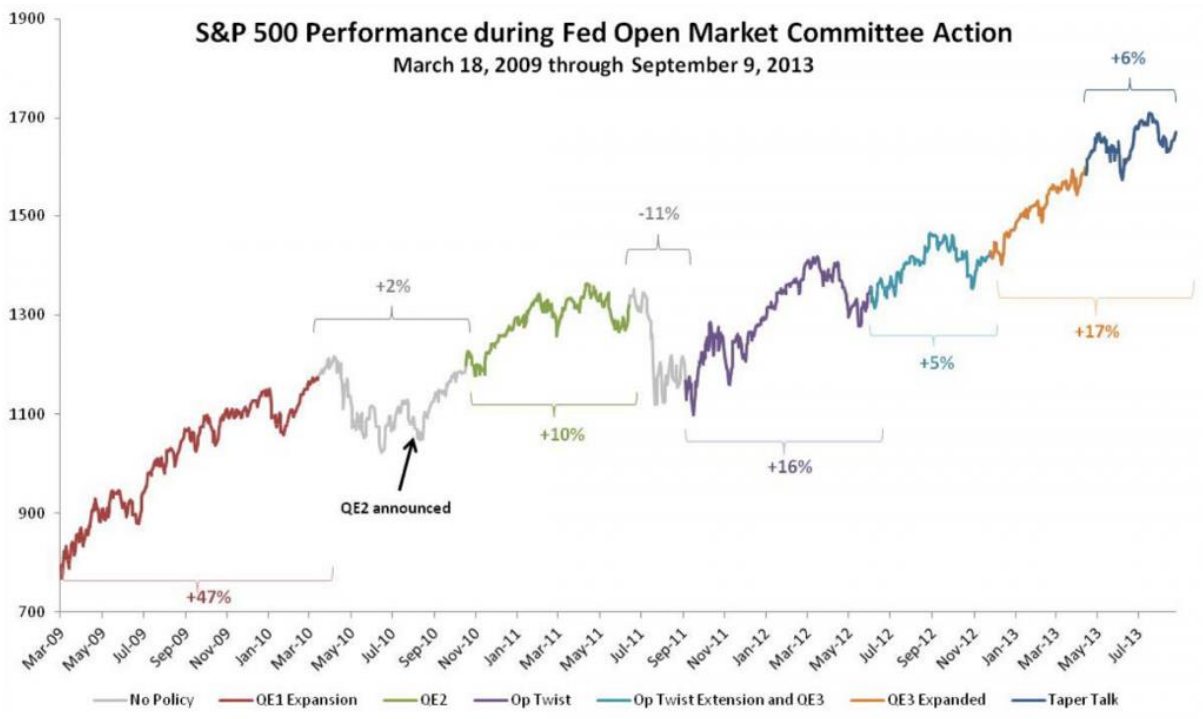
There's no need to go into the detail on the various actions taken by central banks in the US, Europe, the UK and Japan (and indeed in Australia too), except to say that in most cases the end result was record low interest rates and a flood of money pumped into the financial system. If we fast forward five years or so from these events, bringing us back into 2014, we can see where those actions have led us. In that regard we begin with the US Federal Reserve. The chart below shows the balance sheet of the US Federal Reserve. Note the remarkable expansion in assets held by the Fed part-way through 2008. The US Fed held around $900 billion of financial assets by mid-2008; by the start of this year this had ballooned to over $4 trillion.



In 2008 the US Fed began to 'print money' in order to have the funds to buy interest-rate linked investments such as US government debt and mortgage-backed securities (strictly speaking there was no money printing; it was more of an 'asset swap' of cash for bonds). Regardless of the technicalities, the primary purpose of this action was to push down interest rates - if there is a large demand for investments such as bonds, this demand results in a fall in the interest rate associated with the investment. The reasoning behind the action followed standard economic theory: lower interest rates encourage both businesses and

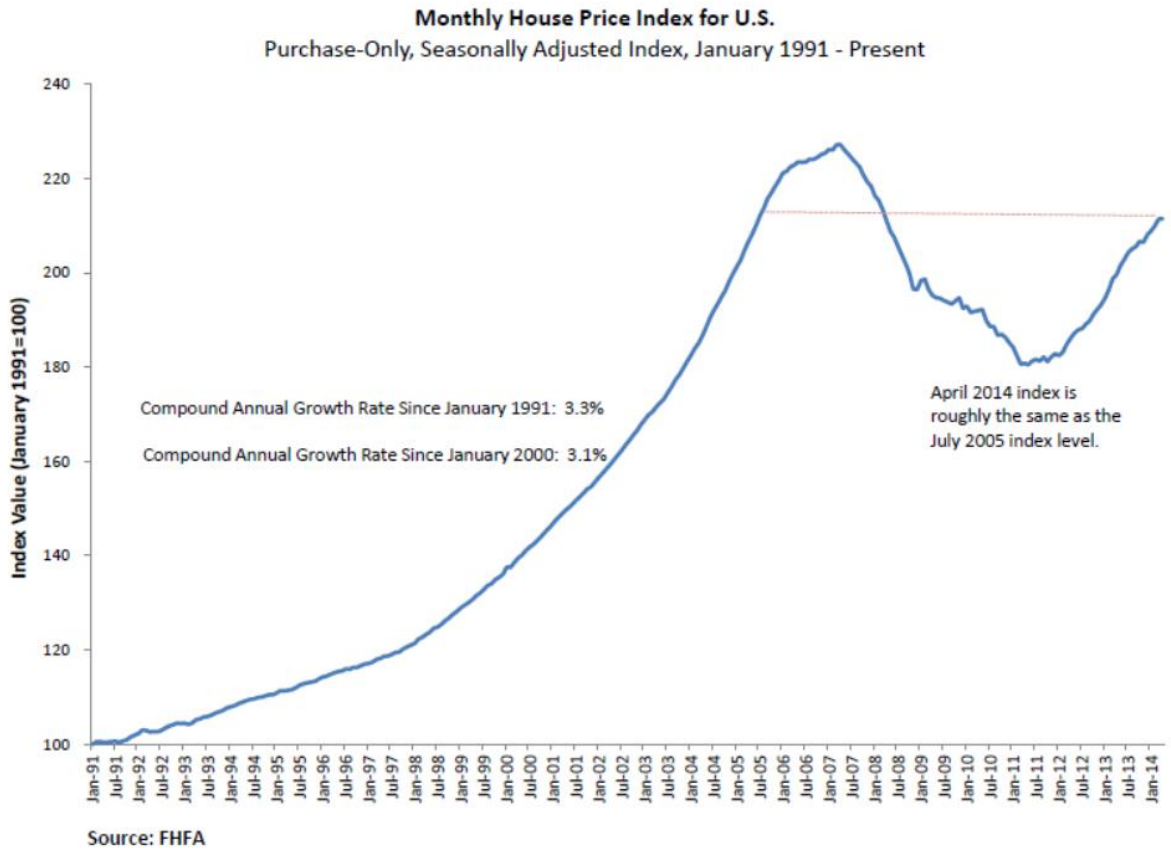
households to borrow more, save more (now that less money is needed to cover the cost of existing loans) and ultimately spend more. Through this process the economy can be stimulated, with economic growth hopefully returning to more normal levels. The actual process itself was somewhat unremarkable; it was the scale of the response which raises questions about the future of financial markets. The money flooding into the financial system as a consequence of the actions of the US Fed (and the Bank of England, the Bank of Japan and the European Central Bank) had to end up somewhere. For every asset bought by the Fed and its overseas compatriots, there was a seller (usually a bank or a government), and inevitably the money sloshing around the financial system began to find its way into the broader economy. The obvious places to look for the effects of this radical approach to monetary policy are stock markets and property markets.

The chart below outlines the relationship between the US Fed's various monetary stimulus programs and the performance of the US stock market. Each of the coloured lines on the chart represent one of the various programs announced by Fed – note the corresponding increase in the value of the stock market. It is important to note that correlation does not necessarily imply causation, however the evidence suggests that the stock market has been one of the prime beneficiaries of the actions of the Fed.



The other key market to benefit from loose monetary policy has been the housing market. Here the relationship between the actions of the Fed and property prices is not as clear, possibly due to the fact that house prices tend to move more slowly than stock prices, given the high transaction costs associated with purchasing property and the greater length of

time required to buy or sell property as compared to listed equities. Nevertheless, property prices in the United States have recovered since the financial crisis. This is illustrated in the chart below, which shows the US house price index from 1991 to April 2014. The sharp fall in property prices during the financial crisis is readily apparent, but so too is the rapid recovery since mid-2011. US house prices are still only at the same level as far back as 2005, but the trend is unmistakably upward.



So the past four or five years have seen major central banks make unprecedented use of their monetary policy tools in order to stimulate economic growth. A portion of the liquidity being pumped into financial markets has ended up in those areas you would expect: rising prices for land, property, shares, bonds, gold and almost every other asset traded or bought in financial markets. So what could go wrong?

Ironically, the most recent and credible warning comes from the Bank for International Settlements (BIS), which is in fact an organisation for central banks. The BIS has effectively warned of the dangers to the global financial system posed by the actions of its own members.

BIS' warning specifically focuses on the apparent disconnect between rising prices for most assets (for example, the S&P 500 index in the United States is up 115% over the past five years) and the still-fragile state of the global economy.

In the words of the BIS:

"Financial markets are euphoric, in the grip of an aggressive search for yield...and yet investment in the real economy remains weak while the macroeconomic and geopolitical outlook is still highly uncertain"

In other words, rising share prices and prices for other assets appear to contradict the very weak state of the global economy and the risk of a geopolitical crisis (with most concern currently focused on Iraq and the Ukraine). In the BIS' view, ultra-low interest rates are effectively fuelling a boom in asset prices which is unjustified based on the current levels of economic and geopolitical risk. The BIS specifically points to a potential banking crisis in emerging markets as one of the catalysts for a future financial collapse, with China fingered as one of the likely culprits (our *Summer 2014* edition of 'Points of Interest' canvasses the problems with the Chinese banking system in greater detail).

The BIS is also concerned that low interest rates are allowing highly-indebted governments to delay dealing with their debts and avoid the necessary but painful reforms required to fix their finances. In the bank's own words:

"Keeping interest rates unusually low for an unusually long period can lull governments into a false sense of security that delays the needed consolidation"

The bank raises the concern that countries such as Greece, Spain, Italy and Portugal have failed to adequately deal with the lingering issue of too much government debt, rather seeking a temporary reprieve through lower interest rates. The sovereign debt crisis of 2012 may not be behind us, but simply temporarily masked by the ultra-easy monetary policies of central banks. So what shape will the next crisis take? Nobody knows for sure, just like nobody could have fully predicted the exact course of the 2008 global financial crisis. A Chinese banking crisis? A repeat of the Eurozone debt crisis or an inexplicable market collapse like 1987? The truth is it could be any one of those or none at all. What is certain is that there will be another crisis and period of market volatility at some stage; the unknown questions are when and for how long?

What does this mean for client portfolios?

Given concerns regarding excess liquidity in financial markets, and the range of potential outcomes, what does this imply for your investment portfolio? It may not surprise you to hear that our investment approach remains focused on building and managing portfolios which favour the relative certainty of income over capital growth, at the same time subject to an appropriate level of risk. In some instances, we are happy to hold slightly higher cash balances than usual; in other instances where investment purchases are warranted, our preference is for companies with strong balance sheets, a history of reliable earnings and the prospect of income distributions.

This year marks 25 years since Ray began managing other people's money (and many of those clients at the beginning are still with the firm today); 25 years of booms, crashes,

invasions, wars, elections and countless other events which all impact financial markets. Our investment approach today is the culmination of those 25 years of experience, combined with a solid theoretical basis in portfolio management. Crises may come and go, but the principles of responsible investing remain unchanged.

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Estimated number of wars and conflicts in the past 114 years

Market update

The June quarter was a quiet one for the Australian share market, with the ASX 200 Index managing an increase of only 0.9 points (a gain of just 0.02%). Those companies which had been responsible for much of the growth in recent years saw significant falls, with lower prices for many of the banks and stalwarts such as Ramsay Healthcare and CSL Limited. There may have been an element of profit-taking, given that many of the companies which were sold off had performed strongly over recent years.

The Federal budget, which was unveiled by Treasurer Joe Hockey in May also deserves some of the blame. One commentator likened the budget to a 'wet blanket' which had been thrown over the economy. Certainly it was accompanied by a sharp fall in consumer confidence which was evidenced by some very poor retail sales figures in those months following the budget. We have little inclination to invest in discretionary retailers such as Myer or JB Hi-Fi, who continue to be hampered by a reluctant consumer and whose business models are under constant threat by e-commerce.

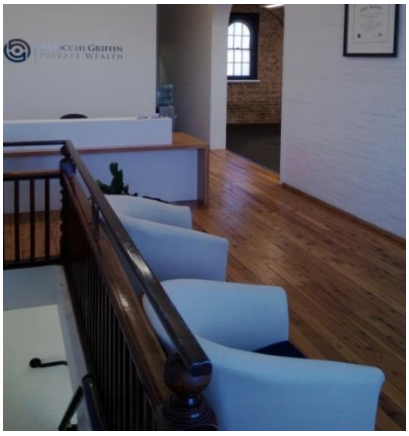
The mining sector continues to weaken as foreshadowed in previous newsletters - although the quantity of our mining exports continues to rise, the price per tonne of material exported remains well below levels reached in recent years. Sectors which have performed well include the commercial property sector, while international investments have continued to produce strong returns. Commercial property in particular has attracted strong interest, largely driven by investors seeking a reasonable income return. At the moment gearing levels are low across the majority of the sector, although this is one metric we watch very carefully for evidence of excessive risk-taking.

Commentators generally expect positive returns for the rest of the calendar year, although by now you should know that such forecasts are usually little more than guesses and should be treated as such!

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



Facts & Figures at a Glance

	Rate/Value	Change from last reading
Australian inflation rate	2.9% (April)	+0.2%
Australian unemployment rate	6.0%	+0.2%
RBA Cash rate	2.50%	**0.00%**
ASX 200 Index	5,395	+0.02%
Australian $ vs. US $	$0.9420	+1.59%
Australian $ vs. UK £	$0.5531	-0.45%
Australian $ vs. Euro €	$0.6906	+0.25%

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