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Points of Interest

Baiocchi Griffin Private Wealth

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. We have redesigned the newsletter layout and style; we hope you enjoy the new look. In this issue we consider the significant market volatility which impacted investment returns during this quarter. Interest rate concerns and foreign exchange fluctuations look set to play an important role for some time to come.

EXECUTIVE SUMMARY

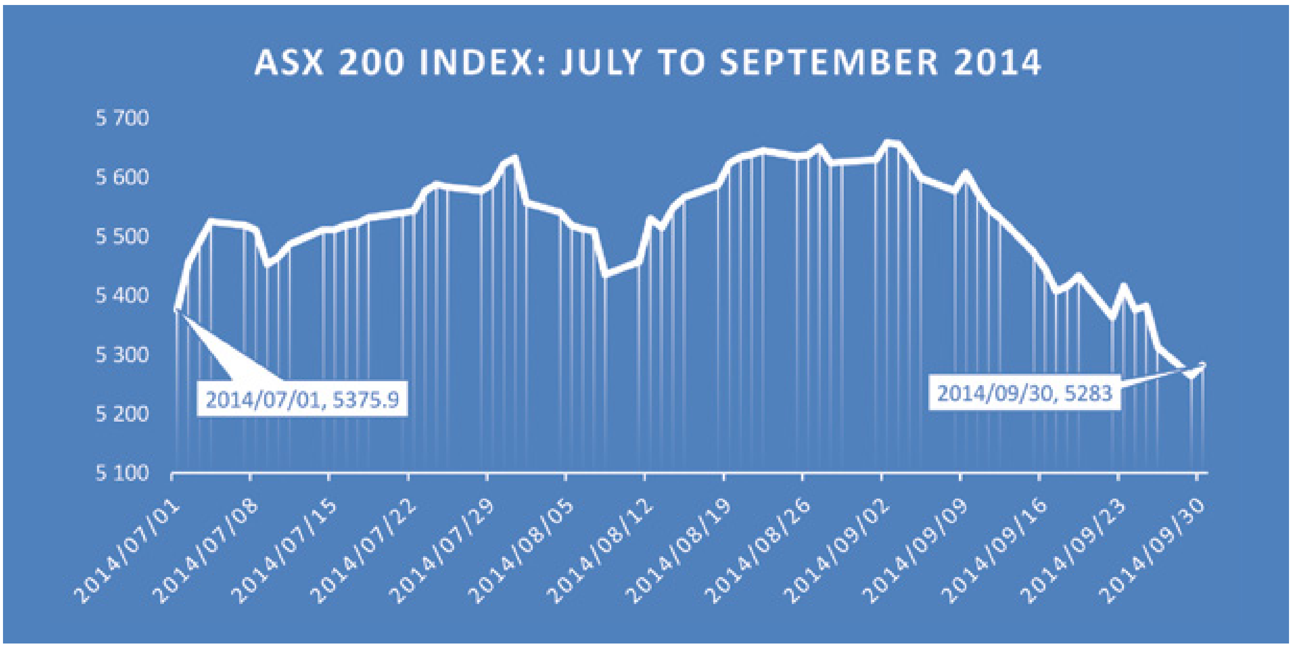
- Steep falls on the Australian stock market are in large part due to selling by overseas investors.
- The prospect of rising interest rates in the United States, most likely to occur mid-2015, has increased volatility on global financial markets.
- On a long-run basis, the Australian stock market is neither over nor under-valued, with recent selling potentially generating opportunities for patient investors.
- Geo-political issues are also of concern, with Hong Kong, the Middle East and West Africa all potential sources of additional market volatility.
- Given current global uncertainty, we have adopted a cautious approach to portfolio management, preferring to build and maintain cash reserves where appropriate.

VOLATILITY RETURNS TO THE MARKET

After more than six months of continued market gains and a lack of any real market volatility, September finally saw the long-awaited stock market correction. The declines were led by those companies which had previously provided the greatest gains, with the big banks and companies such as Telstra, Woolworths and Wesfarmers falling sharply. Fortunately for patient investors, the falls are not a reflection of operating problems or profitability issues, but are a consequence of a number of important macroeconomic events. We consider these matters in detail.

It is fair to say that most commentators expected the stock market to have some form of a correction this year. 2014 had been characterised by reasonable capital growth, with the absence of any real volatility. Share prices had tended to drift upwards, with only minor variations from day to day. All this changed however in the first few days of September, as share prices started falling rapidly and have continued to do so. The chart below, which shows the ASX 200 Index from 1 January 2014 to 30 September 2014 clearly illustrates the dramatic reversal which occurred in the final month of this quarter.

The market falls have been led by the big banks, with many other companies that enjoyed strong gains over the past two years also falling in value. These companies tended to be those which were viewed as offering a reliable and attractive dividend – Telstra, Wesfarmers, Woolworths and Transurban, just to name a few. The property sector was also negatively impacted, with large commercial property trusts such as GPT and Dexus Property Group losing value, in addition to more conservative operators such as BWP Trust.

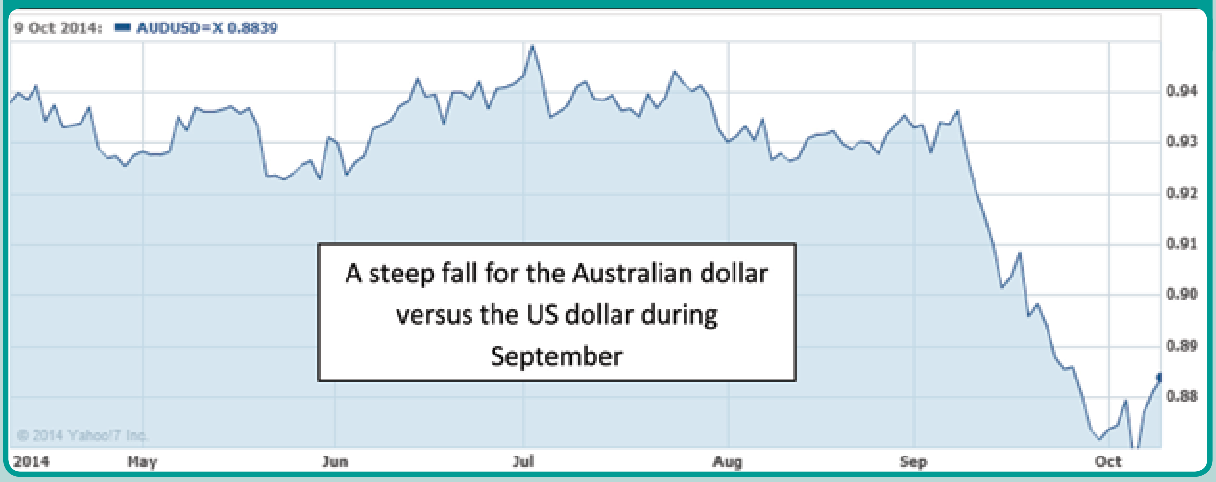


There are a number of key reasons behind the recent market falls, with the most important being selling by overseas investors, who are moving to liquidate Australian share investments and repatriate their invested funds back home. This action is related to the second primary reason for the recent falls, being the expectations of both higher interest rates in the United States and a weaker Australian dollar.

It is not hard to see why Australia has been (until now) an attractive destination for overseas investment capital. Investors based primarily in the United States, Europe and Japan (to a lesser degree) have found it very difficult to generate an appropriate income return, which is a legacy of near zero percent interest rates. Due to actions taken by central banks in those jurisdictions, traditional sources of income such as bank accounts and corporate and government bonds have offered very unattractive returns. In some instances the return offered by US and German government debt has been negative! Where this occurs investors have effectively been paying governments for the chance to lend them money, which is certainly not the usual approach to lending money (nor a profitable one). As a consequence of this situation, pension and investment fund managers were forced to seek out alternative, more attractive investments which offered the prospect of a reasonable income return. This was particularly important for the large pension funds which had obligations to their retired members which had to be met.

As you might expect, Australia proved to be an obvious target for much of this money looking for an income return. We offered a stable political and legal framework, a well regulated financial system and more importantly, a tendency for listed companies to pay out a significant proportion of their profits as dividends. As a generalisation, the Australian stock market has always offered a higher dividend return than other markets in developed economies, particularly compared to the US where companies prefer to reinvest the majority of profits in their business as opposed to returning the money to shareholders as dividends. This disparity between Australia and the other advanced economies presented a clear opportunity for overseas investors to shift their money to Australia and invest in large, profitable companies which offered the prospect of dividend yields of around 5% or 6%. A double benefit was gained by these investors who benefited as the Australian dollar gained in strength over the past few years. This process, which began not long after the US Federal Reserve pushed US interest rates close to zero percent in 2009, provided a significant level of support to the Australian stock market, even as it became apparent that the end of the mining investment boom would have a profound impact on the health of the Australian economy. This comfortable arrangement began to be threatened earlier this year however, once it became clear that the US economy was growing strongly and the US Fed would look to increase interest rates sooner rather than later. The ongoing recovery of the US economy signalled that more than five years of zero percent interest rates was coming to an end, with initial action taken by the Fed to wind down its quantitative easing (‘money printing’) program. The determination of the Fed to withdraw its ongoing monetary support from the US economy will have two direct consequences: higher interest rates in the US and directly related to higher interest rates, a stronger US dollar. Those investors in the US (for example) are aware of these coming changes and are moving money out of Australia in order to avoid the impact of a lower Australian dollar, which effectively devalues their investments in US dollar terms. Rising interest rates will also result in a greater number of attractive investment opportunities back home as bond yields rise and begin to offer the returns needed to meet investment objectives. This further erodes the attractiveness of Australian shares as an investment destination for overseas investors.

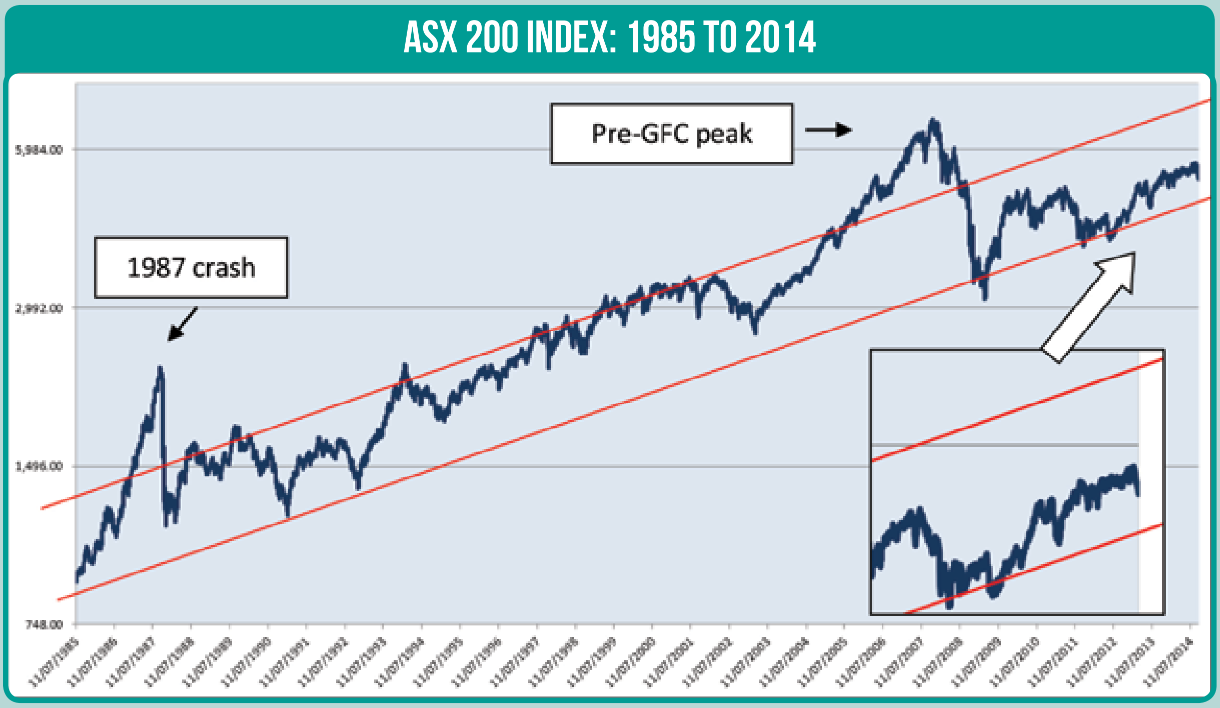
AUSTRALIAN/US DOLLAR EXCHANGE RATE



In many ways what we are experiencing is simply a more modern and sophisticated version of the 1990's Japanese yen carry trade, where the so-called 'Mrs Watanabe' investors borrowed Japanese yen at very low interest rates in order to invest in term deposits in Australia which offered significantly higher rates. If you borrow at 2% and invest at 5% you can easily and simply pocket the difference. The only issue of course is that any fall in the value of the Australian dollar relative to the investor's home currency (be it the US dollar, yen or euro) can easily erode the 3% interest rate differential, hence the need to liquidate the investments when such currency changes are expected.

The bad news, from our perspective, is that those companies which have been sold off most heavily by overseas investors, are generally those companies which we prefer to hold within portfolios. This is usually for the same reasons as to why overseas investors also invested in those companies: strong balance sheets, a history of profitability and an attractive dividend yield. Of course the dividend is not the sole benchmark on which to base any investment decision, however extensive research has shown that over the long term, the dividend component of the total return from holding shares greatly exceeds the gains made from any increase in the share price (a number of studies have estimated that over the long term around two-thirds of your total return is due to dividends, with only a third of the return the result of increasing share prices). The good news however, is that the ability of these companies to pay investors a reasonable dividend is unaffected by the actions of overseas investors. The recent share price falls will have almost no bearing on the income-generating capacity of portfolios.

To put the recent market falls into context, we have included a chart which appeared in our client Investment Update function held during September. Those clients who were able to join us at the function will recognise the chart, which simply shows the logarithmic long-term performance of the Australian stock market, from July 1985 to the end of September 2014. The two red lines on the chart are simply trend lines: in general the stock market grows at an average rate between the top and bottom red lines. When the market grows too quickly, it gets above the top red line, effectively signifying it has run ahead of itself and is probably due for a fall (or a period of low growth). When the market falls too quickly, it drops to the bottom red line (or below it), signifying that the market is now undervalued and is probably due for a future period of reasonable growth. You can easily see how in 1987 and 2007 the market was extremely over-valued, followed of course by significant falls.



It is interesting however when we consider the current level of the market, which we have shown by the 'zoomed in' box in the right hand corner of the chart. The data tends to indicate that the Australian stock market is neither particularly overvalued and neither particularly undervalued. If anything one could argue that it's probably closer to the bottom red line than the top red line, signifying a slightly 'cheaper' market. Even though it is a relatively simple indicator, this chart does give some comfort that we are not facing another 'global financial crisis' moment.

Of course, that is not to say that the market cannot fall lower still. We believe that the intent of overseas investors to reduce their exposure to the Australian stock market still has some way to run. Interest rates in the United States have not even yet begun to rise, yet investment capital is on the move. We expect to see further volatility in our local market over the next three to six months as we get closer to the US Federal Reserve actually letting US interest rates rise. At some point however, our market will simply become too attractive to ignore and domestic investors are likely to step in and provide support for share prices.

Given these events, our approach to managing client portfolios over the past two months has been to let cash accumulate in portfolio bank accounts where appropriate. Where investments have been needed, we have acted to restrict these to fixed-interest investments or those shares which offer the prospect of a reliable dividend. We are conscious of the futility of trying to time the market (a view based on a multitude of academic research papers) and are aware that holding large cash balances does not result in appropriate long term returns, however given our view of likely events over the next few months, in this instance discretion is the better part of valour.

GLOBAL UPDATE

The impact of overseas investors on our local market is just one of many current concerns being faced by investors. Most people would be well aware of the serious nature of a number of geo-political issues which have arisen in various parts of the world. While wars, disasters and political upheaval have always been a feature of stock market investment, recent events have justifiably heightened investor concerns, with a desire for investment safety and security having a predictable impact on market returns. In this section we consider a number of these current global geo-political issues and their potential further impact on stock markets both in Australia and overseas.

STUDENT DEMONSTRATIONS IN HONG KONG

While not an immediate concern, the recent outbreak of student demonstrations in Hong Kong has particular relevance for Australian investors, given our extensive trading relationship with China. Broadly speaking, authorities in Beijing and Hong Kong appear to have adopted an approach that revolves around simply waiting for the student protestors to run out of energy and stamina. China's main concern of course is that any political concessions granted in response to the demonstrations would give hope to mainland activists, potentially leading to new protests over political reform closer to home. Given that the Chinese economy is already experiencing a period of slower economic growth and any internal disruption could potentially further derail any recovery, Australian exporters to China (principally in the resources sector) would be hoping for a quick resolution to the problems in Hong Kong.

CONFLICT IN THE MIDDLE EAST

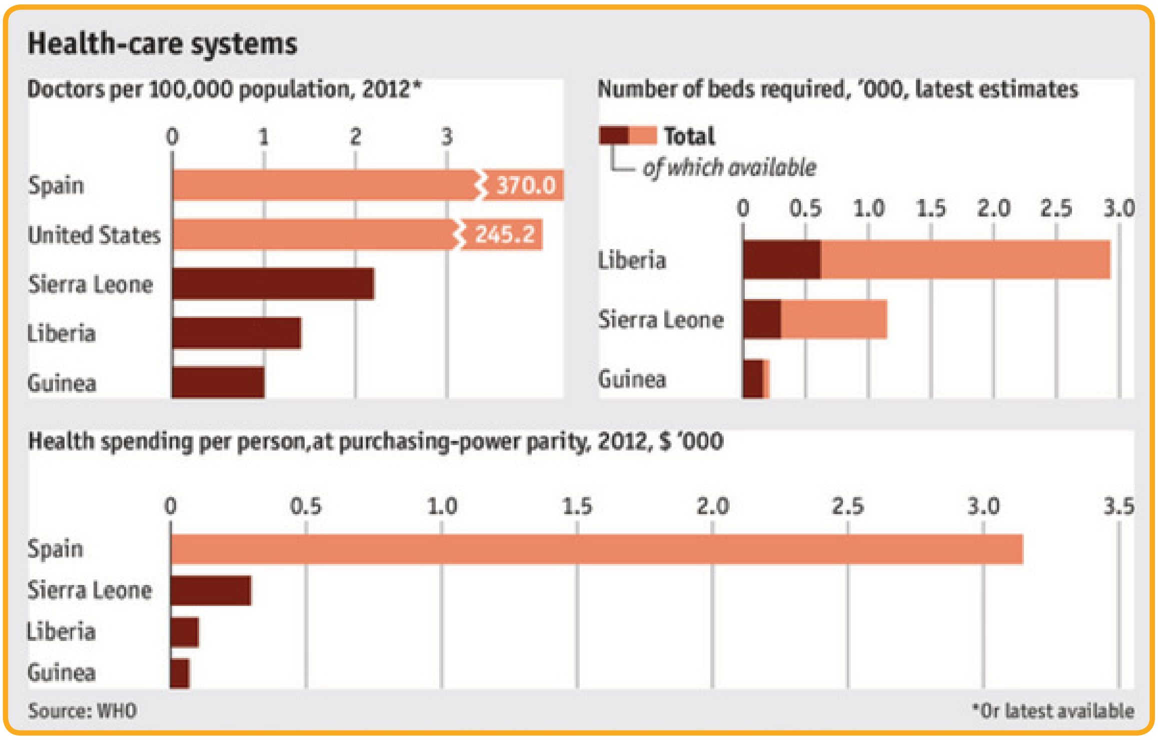
The conflict in the Middle East, at this stage confined principally to Iraq and Syria, has not yet had any major economic or market impact. In fact global oil prices have fallen in recent months to a 17 month low, largely on concerns over increased supply (courtesy of increased oil production in the US) and weaker demand (as a result of tepid economic growth in Europe and China). It would require a significant escalation of the current conflict before markets began to worry about oil supply security, which would have to involve the spread of the fighting to countries such as Iran, Saudi Arabia, the UAE and Kuwait. Although the future course of events is highly uncertain, at this stage any direct economic impact is somewhat limited.

THE EBOLA VIRUS

While significant in terms of its human impact, the spread of the Ebola Virus in West Africa is yet to have an economic or market impact. The recent spread of isolated cases to the United States and Europe is concerning, although the medical infrastructure in advanced economies is likely to be more effective in halting the further spread of the virus. Greater concerns focus on the potential for the virus to mutate and become airborne, which would result in a significant escalation in the threat to both human lives and economic development. At the time of writing however this has not eventuated and the application of greater medical resources to tackling the outbreak at its source should begin to yield results. A significant spread of the current outbreak would be required before any economic impact could be expected.

Malaria-related deaths per day in Ebola affected countries (compared to 13 deaths per day from Ebola)

The chart below, courtesy of The Economist, highlights the gulf in medical facilities between countries in West Africa at the source of the outbreak and more advanced economies.



GLOBAL UPDATE

In the midst of these varied geo-political issues, the global economy continues with its tepid recovery since the global financial crisis. Of the world's major economies, only the United States appears set to record any meaningful economic growth, largely driven by a resurgence in manufacturing and the ongoing benefits of an oil and gas boom. Financial markets have experienced significant levels of volatility as participants prepare for the eventual normalisation of US interest rates, although this may be delayed for longer than many expect. The US stock market remains vulnerable to a correction, with the S&P 500 Index having gone more than two years without a correction of 10% or more. While this is not unprecedented, there is a growing view (which we share) that the US stock market will experience a sizable correction at some stage in the future. The important question, as always, is to the timing of such an event. While there is no crystal ball to aid in making future predictions, our concern over the US stock market is another factor behind our willingness to hold slightly higher levels of cash within portfolios, as outlined earlier.

Of greater import for the Australian economy, and hence Australian investors, is the ongoing economic slowdown in China. As we have described in previous newsletters and investment updates, the Chinese economy is suffering through the hangover which followed a decade-long infrastructure expenditure party. The building of bridges, highways, airports and 'ghost cities' may have achieved the desired goal of boosting economic growth through the last decade, but as China is now discovering, such a strategy cannot lead to sustainable economic growth. The Chinese economy is now attempting to make a somewhat painful transition to a more consumption based economy, which is having a number of undesirable consequences in the short to medium term. Chief amongst these is a predictable slowdown in construction-related activity, with a corresponding fall in demand for the resources and commodities needed to support such activity. This has been reflected in prices for commodities such as coal and iron ore, which is having a predictable impact on the Australian mining sector. As commodity prices fall or remain soft, we can expect to see greater job losses within the Australian mining sector and downward revisions to the expected royalties and income tax earned by state and federal governments respectively. Our political leaders in Canberra in particular may well yet regret not locking up a portion of the mining boom windfall in a sovereign wealth fund or similar arrangement, as opposed to squandering much of the benefits in vote-buying tax cuts and handouts.

With regards to Europe, the other large economic player on the global market, the news is also not promising. Europe has been unable to make significant progress in resolving its many economic ills, primarily it seems through a lack of political will. Few politicians in Europe seem willing to be the bearer of bad news to the general voting public: that the days of early retirement, generous pensions for life and excessive social and welfare assistance are over. The general malaise within Europe is even now impacting previously impregnable Germany, which has seen steep falls in industrial output, poor consumer confidence levels and widespread job losses. As the primary engine of economic growth in Europe, a struggling German economy is further bad news for the rest of Europe. It is now increasingly likely that the European Central Bank will have to implement some form of quantitative easing, as was unveiled by the US Federal Reserve in 2009. German objections to quantitative easing, based on their past experiences with hyperinflation, will be harder to maintain in the face of a Europe-wide recession, an outcome which now seems increasingly likely. We remain somewhat bearish on prospects for the European economy, a view which we see little reason to change in the short to medium term.

In summary, the global economic outlook is mixed, with both good news (the United States) and bad news (China and Europe), mixed in with the concerns over wars, disease and demonstrations. As we regularly point out, our investment approach of focusing on income producing assets, with exposure to financially-sound companies with respectable dividend yields, has proven its durability in previous times of volatility, and we see no reasons not to expect it to do so again.

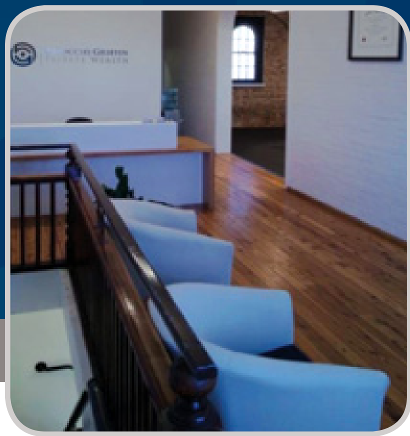
Earlier this year we sent out a document folder for managing the paperwork generated by your portfolio, in addition to two copies of our '*Private Wealth Organiser*'. We still have a number of spare annual document folders available (and Organisers), so if you are running out of space or would simply like another folder, please contact the office and we will be happy to forward one on to you.

We have begun distributing next year's annual documents folder, although this will be done on a face to face basis as we meet for regular reviews over the next six months or so.

Portfolio Tax Reports for 2013/14

Portfolio tax reports for the 2013/14 financial year are in the process of being prepared and despatched. If you have previously given instructions for us to send your tax reports direct to your accountant we will have forwarded all the relevant information to your accountant prior to the end of October. After this point you can safely contact your accountant regarding the preparation of your annual tax return. Should you have any questions regarding the tax reports, please do not hesitate to contact our office.

BAIOCCHI GRIFFIN
PRIVATE WEALTH



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	3.0% (June)	+0.5%
Australian unemployment rate	6.10%	+0.1%
RBA Cash rate	2.50%	0.00%
ASX 200 Index	5,283	-103 points
Australian $ vs. US $	$0.8752	-6.68c
Australian $ vs. UK £	$0.5384	+1.47c
Australian $ vs. Euro €	$0.6898	-0.08c

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