Points of Interest
AUTUMN 2016

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we consider two opposite views of the state of the global economy: the pessimistic view that we are on the verge of another financial crisis, and a more optimistic view of the future. We also review the stock market's performance over the quarter, which once again recorded a disappointing negative return.

EXECUTIVE SUMMARY

- A glass half-empty view of the world holds that extensive government and central bank intervention has left the global economy vulnerable to another financial crisis.
- Optimists point to the improvement in the US economy, cheaper energy prices and an increased level of financial and banking regulation.
- The stock market recorded another disappointing quarter, falling by 4.02% for the three months ended 31 March 2016.

CENTRAL BANK
INTERVENTION
GLOBAL ECONOMY
ENERGY PRICES
REGULATION
STOCK MARKET

HALF-FULL OR HALF-EMPTY?

Since the onset of the global financial crisis in late 2007, we have witnessed a period of extremely high levels of uncertainty and volatility in global financial and economic markets. Stock market falls, sovereign debt crises, negative interest rates, quantitative easing, and the end of the mining boom…the past few years have been both frustrating and challenging for those exposed to financial markets. In this section we review the state of the Australian and global economies and attempt to answer the question of whether economic conditions are improving and heading in the right direction, or whether policy mistakes and global imbalances risk pushing us into another financial crisis.

There are generally two broad views in global economics at present – those that believe that the global economy is reasonably well positioned, largely on the back of significant levels of intervention by central banks in many countries; and those that believe the monetary manipulation and excessive 'financialisation' of most economies has made us more economically vulnerable, not less. We consider each of these views in turn.

The half-empty view

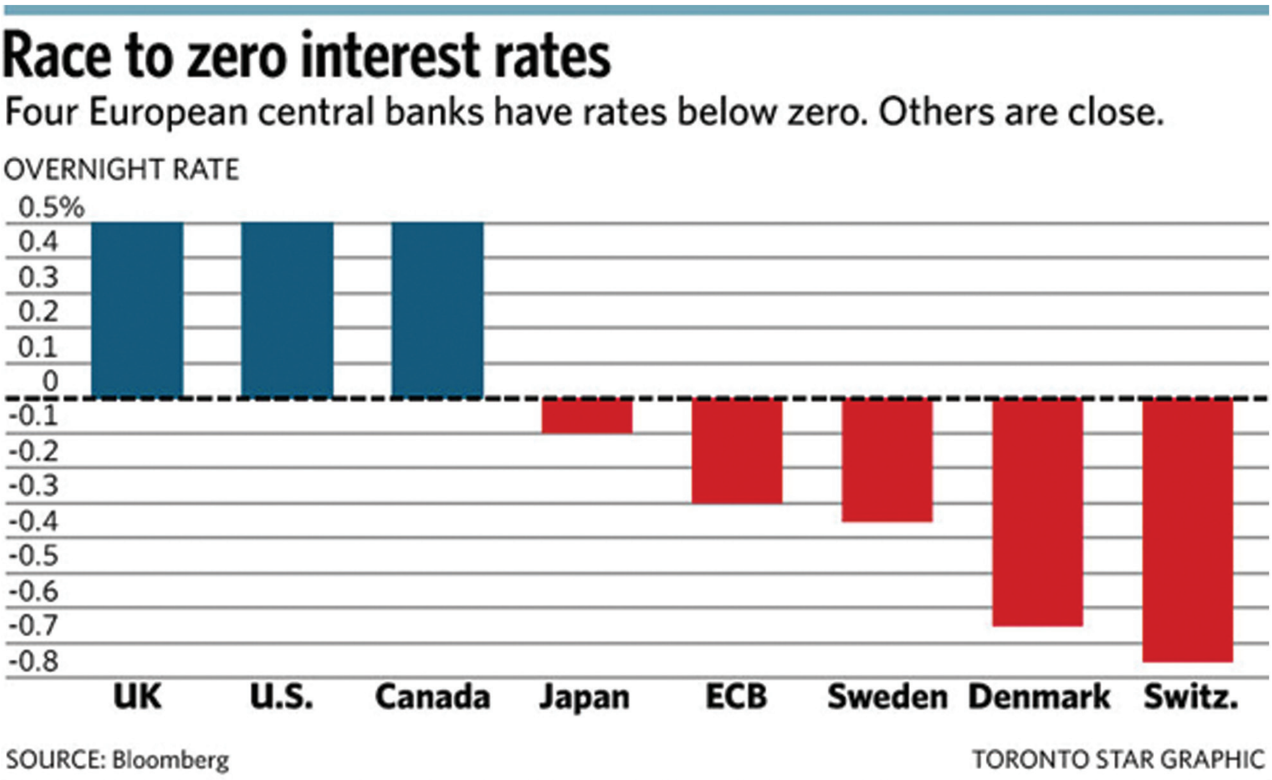
Economists, investors and market commentators who hold a glass half-empty view of the global economy rest their case on three key areas of concern:

- Actions by central banks to push interest rates close to (and below) zero percent,
- Policy decisions during the financial crisis which, in their view, have prolonged, rather than dealt with the crisis, and
- Excessive debt levels in most major economies, but particularly in regards to China, Japan and Europe.

The pessimists see these three key areas coming together in a resulting economic crisis of tremendous proportions – the global banking system, financial markets and global trade grinding to a halt and collapsing under a wave of hyper-inflation, sovereign and corporate defaults, currency wars and protectionism. Not a very pretty picture, but just how realistic and likely is such an outcome? While we profess to be no better or worse than others at predicting the future (and happily acknowledge that most forecasts and predictions are no better than wild guesses or coin tosses), it can be worthwhile to walk through the areas of concern and attempt to evaluate their reasonableness or likelihood of posing a problem.

Negative interest rate loans, every borrower's dream

On the issue of zero and negative percent interest rates, we do actually agree with the view of the pessimists that this is a serious threat to financial stability. We have written at length in previous newsletters on the dangers posed to the financial system by interest rates close to and even below zero and still see this as the primary threat to financial markets. Broadly speaking, central bank policies of maintaining ultra-low interest rates has led, and continues to lead, to asset price inflation. This works through two means. Firstly, interest rates at 0% or even lower, encourage excessive leverage. If banks are willing to lend money at or below 0%, invariably a range of borrowers, be they individuals or corporations, will start filling out the loan application forms. As you would expect, this money finds its way into the residential and commercial property markets (pushing up property prices), and the stock market (pushing up share prices). In fact, any asset that can be bought with borrowed money has its value artificially inflated by the wall of leverage unleashed by cheap money.



That's not to say that low interest rates don't have a positive role – it also makes the cost of borrowing for business expansion cheaper; say for building a factory or launching a new business. This is the type of lending activity central banks hope to bring about through low interest rates – the problem lies in the fact that interest rates are a blunt policy tool. Central banks can only set one reference interest rate for the economy, be it the RBA cash rate as in Australia, or the Federal Reserve fund's rate as in the United States. While slight differences in interest rates can be achieved through other policy settings, a low central bank interest rate generally results in low interest rates across the economy, be it for mortgage lending, personal loans or credit cards. Undesirable lending for purposes such as property or stock market speculation flourishes just as much as lending for business expansion or other economically positive activities.

The second way in which low interest rates pose a threat to financial stability is through the impact on asset returns. Low rates of interest on interest-bearing investments such as bonds and cash effectively forces investors to search for alternative and higher income returns, usually through property or stock market investment. As money flows from cash and interest-bearing investments to these assets, prices are pushed higher, as would be expected. To a certain extent low interest rates distort asset prices by artificially diverting money into those assets, money which would have otherwise remained invested in bank accounts or bonds. The challenge lies in determining what portion of asset price growth is due to the impact of low interest rates, and what part reflects the usual and expected increase in property or share prices over time.

Policy mistakes or policy perfection?

The second area of concern for those with the glass half-empty view of the world focuses on the actions of policymakers during and immediately after the global financial crisis. While this includes moves by central banks to dramatically cut interest rates in order to prop up their respective economies, it also includes actions such as quantitative easing, the bailing out of banks in the United States and Europe, the numerous debt bailout packages advanced to countries such as Ireland, Greece and Iceland, and the determination of central banks to 'do whatever it takes' to protect their fragile economies.

The pessimists maintain that the excessive levels of intervention in the financial system in past years has only worsened the state of the global economy, leaving it highly vulnerable to any negative shocks. Their view, influenced by the Austrian school of economics, maintains that financially distressed banks should have been left to fail; that countries such as Greece should have been left to default on their debts; and that the various interventions such as quantitative easing, TARP (Troubled Asset Relief Program) and ZIRP (zero interest rate policies), have only prolonged and worsened the inevitable and impending future financial crisis. This view holds that capitalism thrives on creative destruction, that failing businesses (and countries) should be left to fail, that the excesses of credit or asset booms must be washed away or purged through the process of bankruptcy and failure and that recessions are a required component of sustainable economic growth and should be embraced, not feared. The pessimists point to Japan as an example of where the reluctance to let companies (and banks in particular) fail has led to more than 20 years of economic stagnation.

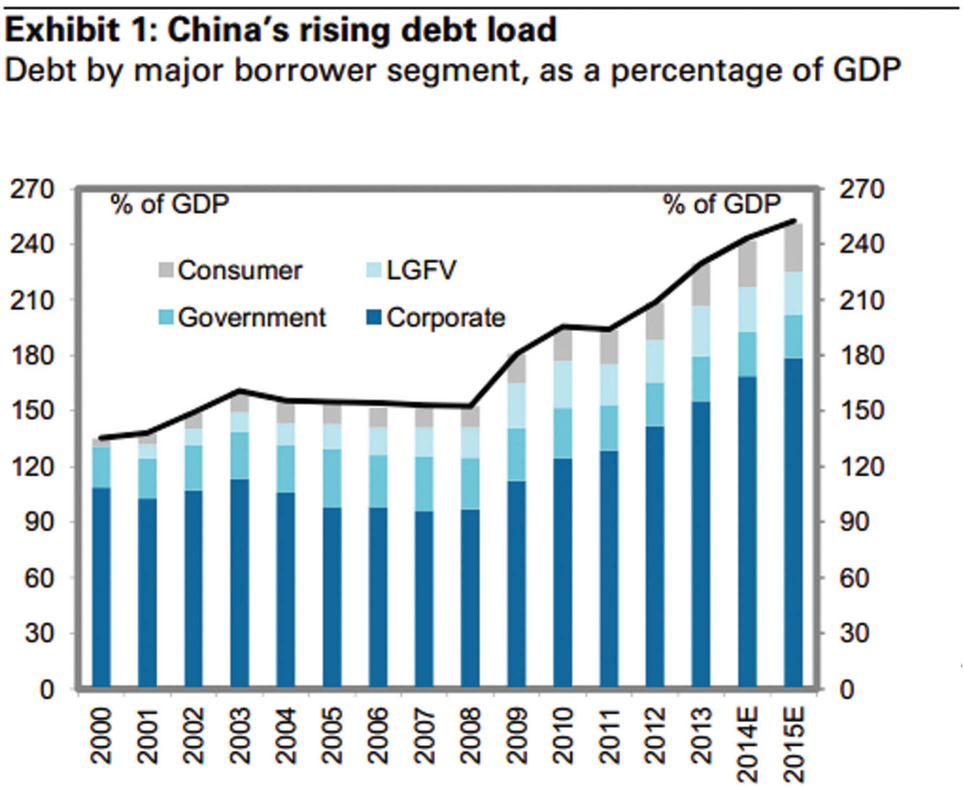
As would be expected, this 'laissez-faire' approach to financial and economic cycles is very controversial and not necessarily embraced by policymakers and central bankers, who believe that direct intervention allows for business cycles to be managed such that their impact on factors such as unemployment and economic growth are lessened. On this issue, we tend to side with the policymakers and central bankers. While still concerned over the long term implications of zero and negative percent rates, our view is that the global financial crisis would have been significantly worse, had banks and financial institutions such as the Royal Bank of Scotland, Lloyds TSB and Merrill Lynch been allowed to fail. While critics rightly argue that banks have become too big to fail, the solution to the problem is not to let them fail, but to use regulatory powers to appropriately 'right size' the banks.

As it was, the recent global financial crisis was probably the most severe economic meltdown in the post-World War II period. Would we have been better off letting unemployment soar to 20% or 30%? Would the recovery have been that much faster if the economy had been left to contract by 10% or 20% during 2008/09? Claims that the anaemic economic recovery since the global financial crisis would have been much better if policymakers and central banks had been less interventionist is classic counterfactual thinking – our tendency to create possible alternatives to events that have already occurred. It's impossible to prove that the economic recovery would have been quicker and more resilient had over-indebted corporations and countries been left to fail, but that doesn't stop many commentators from claiming so.

Too much debt is a real concern

The third and final area of concern for the pessimists relates to the high levels of debt in countries such as Japan and China and through much of Europe. Indeed, Australia can be included within this grouping, having the highest level of household debt within advanced economies. When talking debt however, not all debts are equal. Corporate debt is generally viewed as posing a high level of systemic risk to financial markets and economic growth. High corporate debt levels, as were accumulated prior to the global financial crisis, can quickly result in the undoing of many companies previously thought to be financially sound. The closure of debt funding markets or rapid and unexpected increases in interest rates can have fatal implications for over-indebted corporate entities. Generally however, corporate debt levels have remained under control, with memories of the difficulty in rolling over credit facilities during the financial crisis no doubt very fresh in the minds of many CFO's.

While a few areas of credit, such as the junk bond market in the United States, have seen significant and worrying growth, investment grade lending in most markets has been reasonably constrained, with many companies making use of strong equity markets to raise capital. One real concern, from an Australian perspective, has been the growth in corporate debt in China. As with much of the information which emanates from China, it is difficult to tell whether the debt is manageable or poses a risk to the Chinese economy.



Note: financial institution credit is excluded and only half of entrusted loan amounts are included due to double counting
Sources: PBoC, China Bond Online, Gao Hua Securities Research

The sovereign debt matter is different, with continued and well-known problems in places like Greece, Italy, Spain and Japan. High levels of sovereign debt can act as a dampener on economic growth (as has been witnessed in Greece) and in certain cases can precipitate a financial crisis. In theory sovereign governments have tools to manage their debts which are not available to corporations or households, ranging from increasing taxes and cutting spending, to debt renegotiation and outright default. In practice political and policy implications reduce the scope for meaningful sovereign debt reductions in the short term, relying instead on slow, incremental debt reduction (the backlash to the first Abbott/Hockey federal budget is an example of the difficulties which policymakers encounter when embarking on fiscal repair, though it must be said that much of negative reaction was more based around the perceived inequality of the process).

Japan, with government debt at an astounding 250% of national GDP, poses the greatest risk. A full-blown solvency crisis in Japan is simply inevitable, as the country attempts to stave off a disinflationary trap. With the Bank of Japan expected to own over half of all Japanese government debt by 2017, Japan risks bankruptcy should interest rates be allowed to return to normal levels. Naturally a debt crisis in the world's third largest economy will have serious implications for the rest of the world.

The glass half-full view

The optimistic view of the global economy is based on a more general list of positive developments which support the view that global growth is stronger than it appears. Falling unemployment in the United States, low levels of inflation (although this also reflects weak economic demand), continued technological innovation, the ongoing modernisation of countries like China and India; all of these and more are used to reinforce the argument that the global economy is stronger than it seems. Stricter global banking regulations have also theoretically led to a stronger global banking system, though in many ways this only helps prevent the crisis we've already had, not the one that's going to happen next. Lower oil prices are also seen as beneficial, although oil-producing nations and companies derive no satisfaction from oil prices closer to $30 than $100 a barrel.

The real problem facing policymakers and central banks is that the next crisis is likely to be very different from the most recent crisis or any past crises. By their very definition financial crises are unpredictable and generally not identified in advance of their eventual arrival (if every crisis was able to be identified ahead of time we would never have a crisis, a fact which is contradicted by the long history of financial crises). What is certain is that there ***will*** definitely be another financial crisis, the only unknowns are in regards to the cause and the timing. If a crisis can't be avoided, its effects on markets must be managed and ameliorated. Astute investment selection, the avoidance of undue risks and a balanced and diversified approach to portfolio construction are key tools available to investors in dealing with the fallout of the next financial crisis, wherever and whenever it occurs.

THE STOCK MARKET DURING THE MARCH QUARTER

Unfortunately the stock market continued to disappoint over the three months ended 31 March 2016, with the benchmark ASX 200 Index falling by 4.02%, or 213 points, over the period. This brings the 12 month performance, from 1 April 2015 to 31 March 2016, to -14.14%, a significant turnaround after the two previous years of double-digit returns.

ASX 200 Index – 1 April 2015 to 31 March 2016

The poor quarterly and annual performance was recorded despite a reasonable profit reporting season during February and March. With most companies reporting their half-yearly results (for the six months ended 31 December), revenue and profit growth was solid without being spectacular. For many companies, a feature of the reporting season was profit growth through cost-cutting. While this partly reflects a relatively weak economy, it does raise some cocerns, as costs can only be cut so far. Sustained profit growth ultimately relies on consistent revenue growth, the missing ingredient for many Australian companies.

On a sector basis, the commercial property sector again provided reasonable returns, continued to be buoyed by low interest rates. The banks and other financial institutions struggled, with the banks in particular being victims of a punitive public relations campaign orchestrated by hedge funds who were shorting bank shares. Concerns have been raised over an increase in bad debts at the banks and while any loan losses are always a concern, it is important to remember that loan defaults are at very low levels and are more likely to increase than to fall further.

Unfortunately, even those companies who recorded real positive growth in revenue and profits (Ramsay Healthcare for example), were not rewarded by the market. In mid-February Ramsay announced a 16.20% increase in net profit after tax for the six months ended 31 March 2016 – yet its shares fell by 9.69% over the quarter, no doubt a significant disappointment for management. Blood plasma company CSL suffered a similar fate, with its share price falling 3.67% over the quarter despite announcing an increase in net profit after tax of 7%.

Yet again global macroeconomic events tended to overshadow actual company performance, creating opportunities for patient investors. While there is no guarantee that markets will improve through the year, selective company valuations are at attractive levels. We trust that in time, the value inherent in many of these businesses is recognised by the market and reflected in their share prices.

"The challenge for Australia is how do we transition from an economy that is being led, fuelled, by a massive mining construction boom to one that is able to embrace all of the extraordinary opportunities of these, the most exciting times in human history."

Malcolm Turnbull

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	1.7% (December)	+0.2%
Australian unemployment rate	5.8% (February)	steady
RBA Cash rate	2.00%	steady
ASX 200 Index	5,082	-213 points
Australian $ vs. US $	$0.7618	+0.312c
Australian $ vs. UK £	$0.5299	+0.037c
Australian $ vs. Euro €	$0.6744	+0.0062c

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.