POINTS OF INTEREST
SPRING 2016

ISSUE 16

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the major events which impacted markets over the past three months, including the uncertainty associated with the US election. We also consider the relatively weak state of the Australian economy, where a past reliance on mining as a source of growth has left the economy in a difficult position.

EXECUTIVE SUMMARY

- The US election is having a significant impact on markets, more so than was the case in previous elections. The potential election of Donald Trump poses a number of threats to global growth.

- The Australian economy continues to struggle, still suffering the after-effects of the GFC and the end of the mining boom.

- In other key nations, growth also remains weak and we are particularly concerned over the ability of Japan to escape its demographics trap.

- Despite significant volatility, the market managed a positive return for the quarter.

US ELECTION
GLOBAL GROWTH
AUSTRALIAN ECONOMY
DEMOGRAPHICS
VOLATILITY
STOCK MARKET

WEAK ECONOMIC CONDITIONS PERSIST

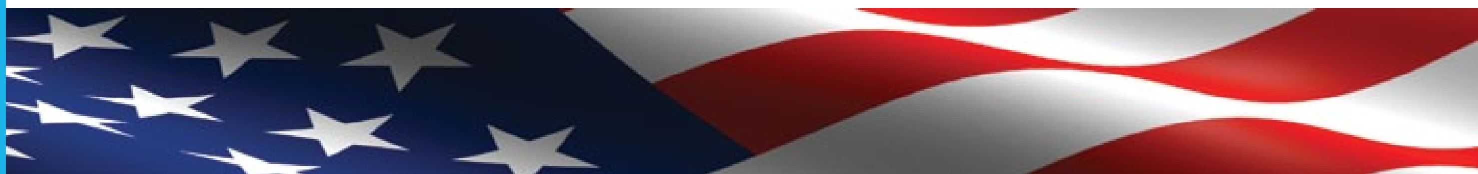
For investors looking for a sustained improvement in markets and the global economy, the past quarter offered few signs for optimism. It's fair to say that the global economy remains in somewhat of a malaise, with political uncertainty, central bank actions (or lack of action) and geo-political events acting in concert to keep business and household confidence at low levels. We explore a number of these issues in greater detail in this section.

The September 2016 quarter provided little change from the conditions which have persisted for some time in economic and financial markets. For a number of years now our view has been that the Australian economy (and much of the global economy) has been stuck in 'second gear', and in that regard the most recent three months were very much a continuation of that trend. Domestically consumer demand is weak, while businesses remain reluctant to invest. Weak business conditions are in turn reflected in little or no wage growth for most employees – an unpleasant feedback loop which leads back to weak levels of demand and so on. It's clear that the 'hangover' from the global financial crisis and the ending of the mining boom is far more pronounced and durable than many had expected. After all, not many would have predicted cash rates in Australia would fall to a record low of 1.50%, with even that historical marker having little positive influence on economic conditions.

As far as interest rates go, even the Reserve Bank of Australia (RBA) has thrown in the towel, with both the outgoing (Glenn Stevens) and incoming (Philip Lowe) heads of the bank openly admitting that monetary policy was having little effect on the economy. Central bankers have been saying for some time that lowering interest rates could only do so much (and had in fact got to the point where the cure was becoming worse than the disease) and sensible fiscal policy was what low-growth economies needed most. However, in a world where sovereign debt remains a dirty word(s), the prospect of any meaningful fiscal assistance remains remote.

At one level, a significant increase in government debt (at record low cost) to fund productivity-enhancing infrastructure makes sense. From a political perspective however, any such proposal would garner scant attention. Hence the widely-held view that a low-growth, low-inflationary environment is now the ‘new normal’.

While it is true that the years following the global financial crisis have been characterised by the existence of the low-growth, low-inflation phenomenon, we are cautious of extrapolating current events well into the future. One of the most over-used (and most dangerous) phrases in finance is “…this time it’s different…” Investors, commentators and economists often make the perilous mistake of assuming the current state of affairs is the one most likely to persist into the future. When markets and economies are booming, it’s always assumed that the boom will never end (“…this time it’s different!...”,said with a jubilant tone). When recession strikes, job losses mount and house prices crash, it’s always assumed that it’ll never get better; that there has been some type of structural change which has permanently affected our ability to improve our living standards (“…this time it’s different….”, said with a mournful tone). The reality is quite different however. There are simply too many variables involved to be able to accurately predict the path and pattern of events over the next ten, twenty or thirty years. While there is no doubt that short term challenges abound, it is too easy (aided by a willing media who love a bad news story) to become overly pessimistic about the future of the global economy and the impact on financial markets.



The US election

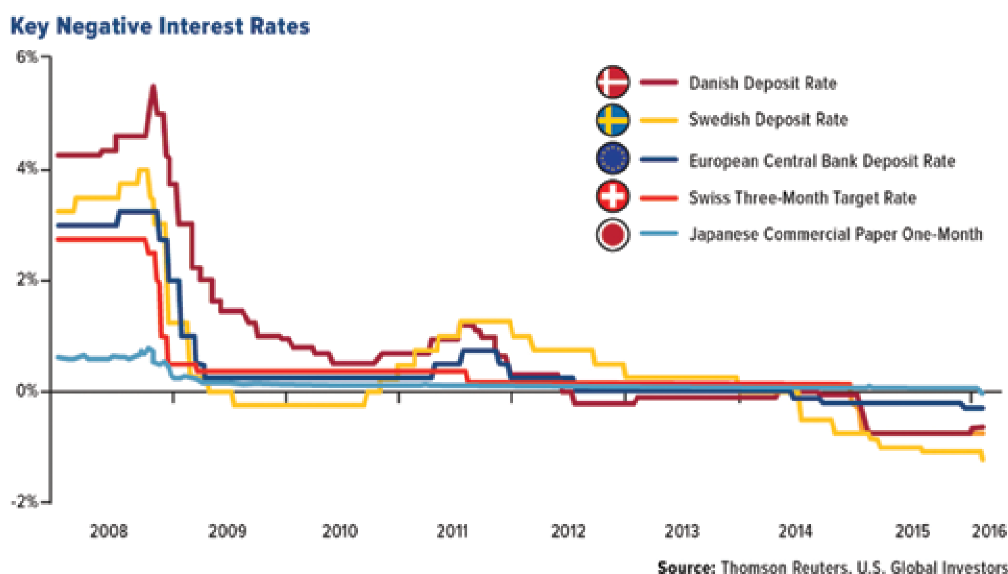
One current issue which is of concern, is the impending US Presidential election. While political events are rarely of any major significance to financial markets and are certainly seldom factored into the investment decision-making process, the 2017 US election is a little different. From an economic perspective, the policies and views announced by Donald Trump are worrying. The gist of the various announcements by Mr Trump lead one to conclude that, under his leadership, the United States would become far more insular and inward-looking, with an emphasis on protectionism and mercantilism. A Trump government would likely be less pro-trade and less interested in sustaining the benefits and promoting the growth of globalisation.

While advances in free global trade and the spread of globalisation have led to the economic betterment of literally billions of people, there have been losers, predominately blue-collar workers whose jobs in manufacturing have gradually shifted overseas to locations which offer an enticing package of lower wages and lower taxes. It is this demographic which Mr Trump’s policies are most clearly aimed at appeasing. Much has been written and said regarding the US election, so we will not go into any further detail, however it does present as one of those instances where geo-political events outweigh company fundamentals (at least in the short-term). As a result, over the past few months we have been willing to largely let cash accumulate in client portfolios. An opportunity to put this cash to use may well arise in coming months.

'Second gear'

Insofar as the performance and outlook for the Australian economy goes, the analogy we have been using is of an economy stuck in second gear. We're certainly not going backwards in economic terms, but forward progression is painfully slow. As mentioned, the RBA has done what it can to stimulate the economy, lowering the cash rate from 2.00% this time last year, to the current historical low of 1.50%. At this stage markets are pricing in a further reduction in 25 basis points (0.25%) early next year, with rates to be on hold from that point onwards, followed by possible increases in 2018. Again, we are wary of the risks in making long-term prognostications, whether it be in regards to interest rates, currencies or equity markets. No doubt many in Europe thought interest rates would go no lower than 1.50%, which they reached in 2012. This proved to be an incorrect assumption, with rates now at 0% and in many cases falling below zero. It does seem however, that Australian interest rates must be reasonably close to the bottom of this interest rate cycle. One or two further cuts may be forthcoming, but presumably the RBA has closely studied the experiences of the US Fed and European Central Bank, where even 0% rates have been unable to generate meaningful levels of economic growth.

As we have written previously, the dangers of ultra-low interest rates are many. The key concern however, is the distortionary impact of low interest rates on asset prices. This is really just a fancy way of saying that low interest rates push up prices for property, shares and just about anything else that can be bought with money. In some cases this is by design. Deflation is a serious risk for many advanced economies and central banks have used interest rate cuts to attempt to create a reasonable level of inflation (inflation is a bit like Goldilock's porridge: too much inflation is as bad as too little, it needs to be just right). A reasonable level of inflation for goods and services, and even in wages, can be a good thing. Inflation in asset prices however, can pose a major threat to economic stability. This is not necessarily a problem when prices are rising, but when the artificial stimulus is eventually removed and asset prices revert to a more normal level. Again, this is just a fancy way of saying that the bubble gets popped and property and/or share prices collapse, much in the style of 1987, 1994, 2001 or 2008.



The challenge for central banks around the world, including our own RBA, will be to increase interest rates to a more normal level, but in a way which does not precipitate a property and/or stock market crash. However, careful study of history suggests that, despite the accumulated years of wisdom and experience at the top levels of central banks, this process is more often than not badly managed. To be fair, there are literally millions of moving parts in an economic system and all the central banks can do to try and engineer the perfect landing, is to wiggle the only lever available to them, the interest rate lever. Trying to guide an unstable and complex system with just one policy tool is a difficult and thankless task. Glenn Stevens, the outgoing RBA head, may well have just launched the perfect hospital pass to the new chief, Philip Lowe.

Australian economic problems are compounded of course, by the fact that our major trading partner, China, no longer wishes to pay us handsomely (and over the odds) for the rocks we specialise in digging out of the soil. This illustrates the danger of relying too heavily on the export of one's natural resources to drive economic growth. Demand for commodities such as copper, zinc, iron ore and even coal, can fluctuate considerably over time and we are now witnessing the side effect of our reliance on raw materials: for every boom there also has to be a bust. As the Chinese economy changes, reducing its reliance on major infrastructure spending as the primary source of economic growth, so must the Australian economy change.

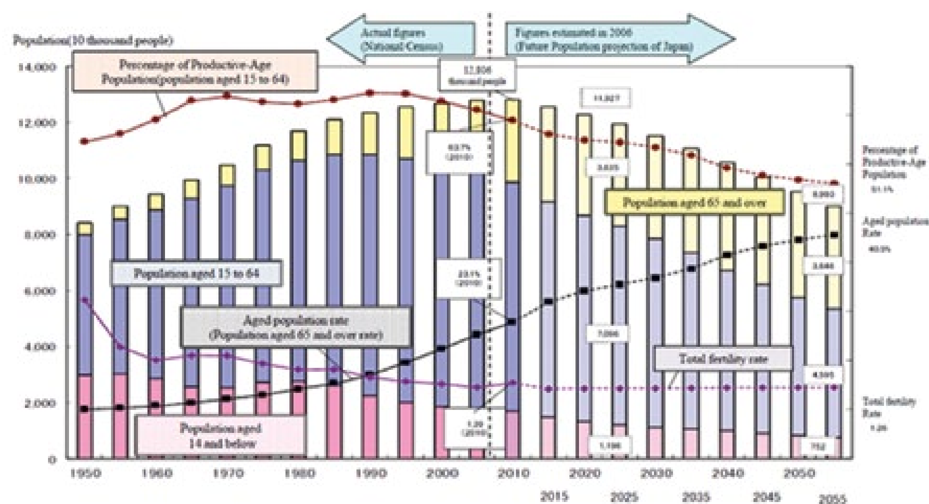
Our future lies less in mining and its associated activities and more in the technical and advanced end of fields such as medicine, financial services and education. The Prime Minister, Malcolm Turnbull, has been the subject of a level of ridicule for pushing the concept of an 'ideas boom', where government seeks to foster excellence in innovation and science. We view this criticism as unfounded. Setting aside the question of whether or not the government can actually deliver on its promises, at least Mr Turnbull recognises that the Australian economy must change if it is to thrive in the next 30 years. That's not to suggest that mining will no longer play an important role – we will always need the raw materials with which Australia is bountifully blessed and mining will always make an important contribution to economic growth. However, the urbanisation and infrastructure booms of the past 50 years are unlikely to be repeated in the next 50 years and Australia must adapt to this new reality or be prepared for a gradual erosion of national living standards. The 'ideas boom' may not be perfect, but at least it's a start. At the very least it has started the conversation about Australia's future and how we fit, and can thrive, in a more technologically advanced world.

Elsewhere in the world, little has changed in recent months. In Japan, the 'Three Arrows' policy unleased by Prime Minister Shinzo Abe, coupled with aggressive monetary stimulus from the Bank of Japan, has failed to measurably lift economic growth. Abe's big gamble was to massively increase the level of Japanese government debt as part of a spending binge, hoping to shake the Japanese economy out of its decades-long torpor. This would be matched with 0% interest rates and aggressive sales tax hikes, to try and foster a respectable level of inflation.

Unfortunately, the problem for Abe and the rest of Japan is that the relentless demographic trend in Japan is pushing in the other direction. As we discussed during our September client function, Japan has the worst demographics of any major economy. Not only is the population shrinking as a whole, but so is the number of working age people in Japan relative to the number of retirees. An ageing population results in rapid growth

in spending on services such as health care and in increased expenditure on pensions. Without the tax revenue generated by a substantial base of working-age citizens, the Japanese government faces the very real risk of being unable to afford to provide these basic services.

The busy chart below highlights Japan's problem. The blue-shaded area represents the proportion of working-age citizens, while the yellow area shows the proportion of Japanese aged 65 and over. By 2055 is it expected that over 40% of Japanese will be older than 65, nearly outnumbering those in the 15 to 64 age bracket. With most retirees paying little or no tax, the impact on the government's tax revenues will be considerable. Japanese government debt already amounts to nearly US$10 trillion, which is around 225% more than the size of the Japanese economy (to put that into perspective, Australian government debt is around US$349 billion, not an inconsequential sum, but only equivalent to around 21.50% of the size of the economy). An interesting aside is that Australian government debt accrues interest of $355 per second, while the Japanese government's interest bill increases at more than ten times that amount, at US$3,661 per second.



The other area which is key to global markets is Europe, which has been rocked by a number of events, including the decision by the UK to leave the EU; the rise of far-right parties in countries such as Austria, Poland, Hungary and even France; and the conflict over the continent's approach to dealing with refugees and illegal immigrants. Meanwhile from an economic perspective, the economies of many European nations, such as Greece, Italy and Portugal, remain hostage to high levels of government debt and weak economic growth rates. Europe's financial woes require a substantial commitment to structural reform (longer working hours, less generous state pensions, reduced red tape and bureaucracy), which European politicians have so far been reluctant to embrace. The current state of affairs in Europe perhaps offers us a glimpse into the potential future for Australia, should we be unable to control government spending and undo the sense of entitlement which has slowly come to define Australian social policy over the past few decades. That's not to suggest that policies such as welfare payments to the needy and unemployed don't have their place; they certainly do, but there is a perception that the pendulum may have swung too far and action needs to be taken to encourage a greater sense of self-reliance than that which currently exists in some sectors of the population.

THE MARKET OVER THE SEPTEMBER QUARTER

Despite the distraction of the US election and weak global economic growth, the September quarter was a reasonably positive one, albeit with a significant level of volatility. The ASX 200 Index opened the quarter at 5,233 points and finished at 5,435, a gain of 3.86%.

Hidden within the quarterly return figure however, is the continuation of a trend which has been in place for some time now. This is the rotation by investors out of large-cap companies such as CBA, ANZ, Telstra, Wesfarmers and others, and into the smaller, more risky end of the market.

Our view is that while superior performance may be generated in the short term by increasing the level of exposure to small companies, this strategy carries with it an unacceptable level of risk. When the next financial crisis or stock market collapse occurs, the smaller companies will suffer disproportionately greater losses. Our preference for larger companies (as measured by market capitalisation) is based partly on a desire to ensure preservation of investment capital. While it is of course possible for large companies to suffer financial stress and even outright failure, the likelihood of companies such as Telstra, Commonwealth Bank or Wesfarmers falling into bankruptcy (or worse) are acceptably low. While the investment return associated with these types of businesses may be lower than a small company, the risk of loss of capital is also significantly lower. We expect that the current mania for small company investments will last only as long as it takes for the next inevitable market collapse to eventuate.

The past quarter also saw the completion of the reporting of full-year financial results for most companies. Overall the reporting season met expectations, although the bar was not set very high. In many cases companies are increasing profits through cost-cutting, with few companies able to achieve respectable top line growth in revenue or sales. To a certain extent this reflects the relatively weak domestic economic conditions, which we discussed earlier in the newsletter. Signs of an increase in corporate profits through increased revenue may well provide the catalyst needed to drive the market higher, although the odds of this occurring in the very near term appear low. Our focus on generating a sustainable income stream is an appropriate response to current market conditions, while we wait for an improvement in economic conditions.

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 (annual)	1.0% (June)	-0.5%
Australian unemployment rate	5.6% (June)	-0.2%
RBA Cash rate	1.50%	-0.25%
ASX 200 Index	5,435	+202 points
Australian $ vs. US $	$0.7630	+2.04c
Australian $ vs. UK £	$0.5886	+3.37c
Australian $ vs. Euro €	$0.6802	+1.03c

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.

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