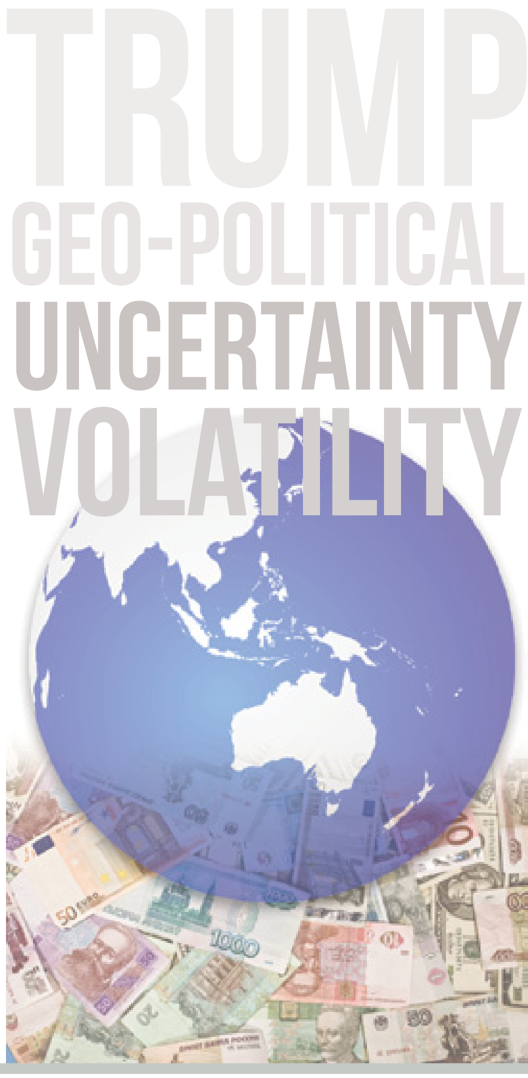
ISSUE 17

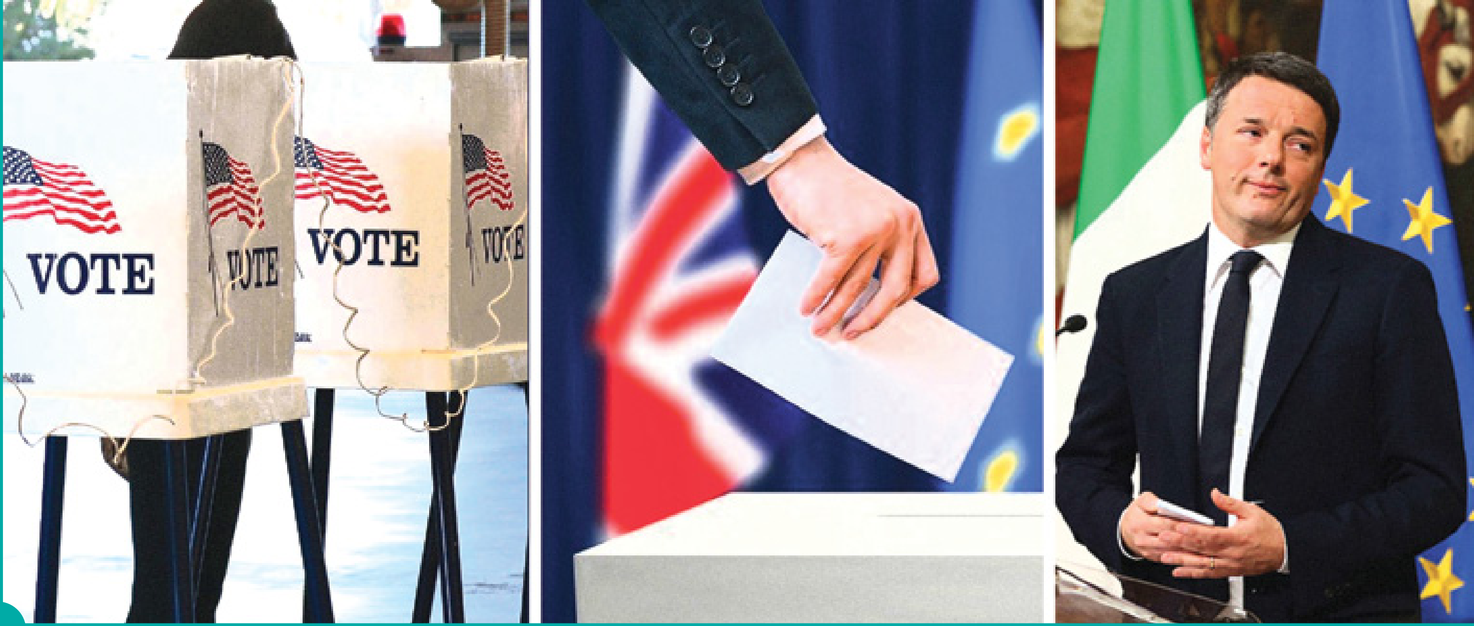
POINTS OF INTEREST
SUMMER 2017

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the past year, focusing on the political developments which had the most impact on financial markets. We also consider the surprising election of Donald Trump as the next US President and the likely impact of his pro-growth reform agenda.

EXECUTIVE SUMMARY

- The election of Donald Trump as the next US President surprised many, introducing an element of uncertainty to the geo-political situation.
- The stock market during 2016 was very volatile, driven by perceptions and reactions to geo-political events.
- Despite the uncertainty, markets recorded healthy gains in 2016, with the ASX All Ords increasing by 11.6%, including dividends.
- We remain cautious over the years ahead, concerned that Trump's economic policies may provide short term benefits but longer term problems.





2016 – A REVIEW

In our Summer 2016 newsletter, almost exactly a year ago, we wrote that "In terms of our expectations for the year ahead, we unfortunately expect a continuation of the volatility which has impacted markets since mid-2015". As it turned out, if anything we may have underestimated just how volatile 2016 would be, ranging from the worst stock market start to the year in history, to 'Brexit', a mini commodities boom and of course, culminating in the election of Donald Trump as the 45th President of the United States.

The past year was one where the market (and indeed the world) became 'event-driven'. That is, economic fundamentals and company performance mattered little when it came to determining the trajectory of share prices; rather, it all hinged on the outcome of a range of global events. The two most significant of these were of course the UK referendum in favour of leaving the EU; and more importantly, the outcome of the US election.

The stock market's fixation with these geo-political events was readily discernible. In last quarter's newsletter we showed how markets fell immediately after the Brexit vote, but had recovered all of the losses and more within just a few weeks. The US election provided an even more apparent example of the market's willingness to ignore fundamentals and focus on the potential outcome of the election. In the weeks preceding the election, favourable news for Hilary Clinton tended to push the market higher, while positive polls for Trump tended to push the market lower. Overall the market trended lower as the election approached. Then, against expectations, Trump won the election and the market rallied strongly, the opposite to what most people would have expected.

The following chart of the Dow Jones Index, shows the market weakness as the election nears, with the sharp rally following Donald Trump's victory.

Dow Jones Industrial Average 2016 -2017

For listed companies, whose CEO's are focused on revenue and profits, it must be disheartening to see the stock market completely ignore those factors, instead driving share prices higher or lower based on the news and sentiment. Indeed, for investors such as ourselves, such an environment is a difficult one, where a sound investment decision one day, can appear to be a bad one the next. In times such as these, taking active market positions is more akin to gambling than investing. Buying shares prior to the US election was in effect a gamble on the outcome of the election. If the right outcome (as far as the market is concerned) materialised, you stood to make significant gains; if the wrong result occurred, you would probably incur considerable losses. This is the very definition of gambling. In this type of environment, our approach is to limit our interaction with the market. For new clients we would of course be active in allocating capital in a judicious manner; however for clients with existing positions it was more a case of doing less, not more.

Yet, despite the volatility we experienced through 2016, the market's performance over the calendar year was more than acceptable, with the benchmark ASX All Ordinaries Index increasing by 7% over the period. This annual return put Australia very much in the middle of the pack, ranked 31st out of the 73 major global exchanges. For another year domestic returns lagged the United States, where the Dow Jones Industrial Average rose 14.3%. Even the UK, beset by Brexit fears partway through the year, managed a 14.4% gain. Once dividends are included however, the return on Australian shares registered an impressive 11.6% gain; a healthy overall return for a year which was so volatile.

As shown in the chart below, it was a rollercoaster ride for investors. The first six weeks saw shares fall by more than 10%, the worst start on record. In June Brexit knocked the market back for a while, and as discussed, the run up to the US election was weaker. Were it not for the post-election rally, the market would have ended the year lower than it started. In the next section we discuss the US election outcome and our views on the year ahead.

ASX All Ordinaries Index 1 Jan 2016 to 31 Dec 2016

The US election and other events

As we have written in previous newsletters and discussed in our economic presentations, a common thread binds together the disparate events of 2016. After many years of relative economic and political stability, many voters across the world have decided that change is needed and have, to varying degrees, rejected the mainstream political parties and their policies. UK Prime Minister David Cameron's argument to stay in the European Union was rejected by voters; in the United States outsider Donald Trump hijacked the Republican party and rode the wave to election victory; while in Italy Prime Minister Matteo Renzi gambled that the public would support his push to amend the Italian constitution and lost both the gamble and his job when voters said 'No'.

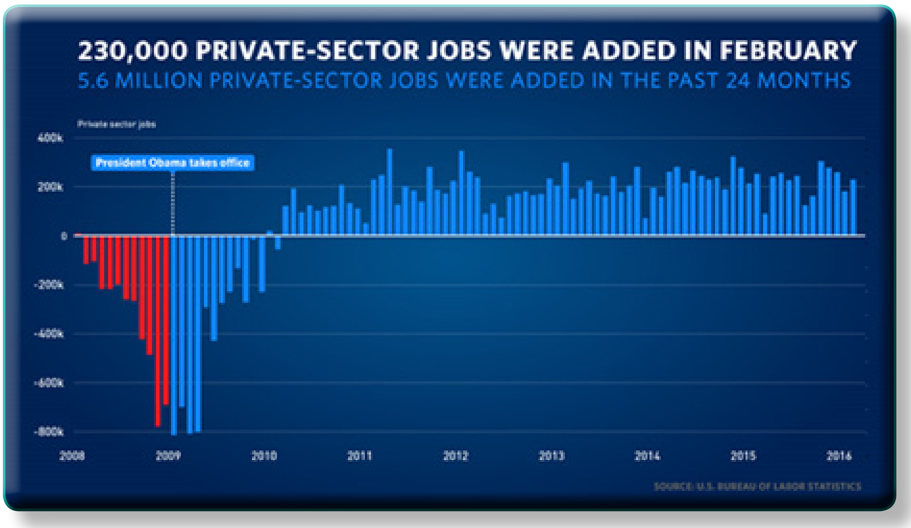
While these were strictly political events, their outcome and impact on economic direction and market stability demands we consider their implications on investment markets. In each case, voters rejected the 'establishment'; the status quo which has persisted in Western democracies for some time. One suspects that the West's political leadership can only look with envy at the Chinese political model of command and control. Giving people the right to vote can be a nuisance when they use it to upend the political order.

From an investment perspective, significant political change is not always welcome. Investment markets tend to struggle during periods of uncertainty as investors either cash up and wait for direction, or bunker in and try and ride it out. Given this, the market's reaction to Donald Trump's election victory is somewhat surprising. We freely admit that we had expected a Trump victory to be negative for markets. However, we had underestimated his determinedness to announce policies which are overtly stimulatory and pro-business. On the one hand, markets appear content to take Trump at face value regarding his plans to cut taxes, increase spending, deregulate the economy, and bring back factory jobs from China. On the other hand, the market seems to ignore his plans to introduce tariffs on Chinese goods, renegotiate NAFTA in favour of the US or withdraw from it altogether, forensically examine all US trade deals to ensure US workers are not being harmed, and finally, to withdraw from the Trans-Pacific Partnership, an ambitious Pacific Rim trade agreement.

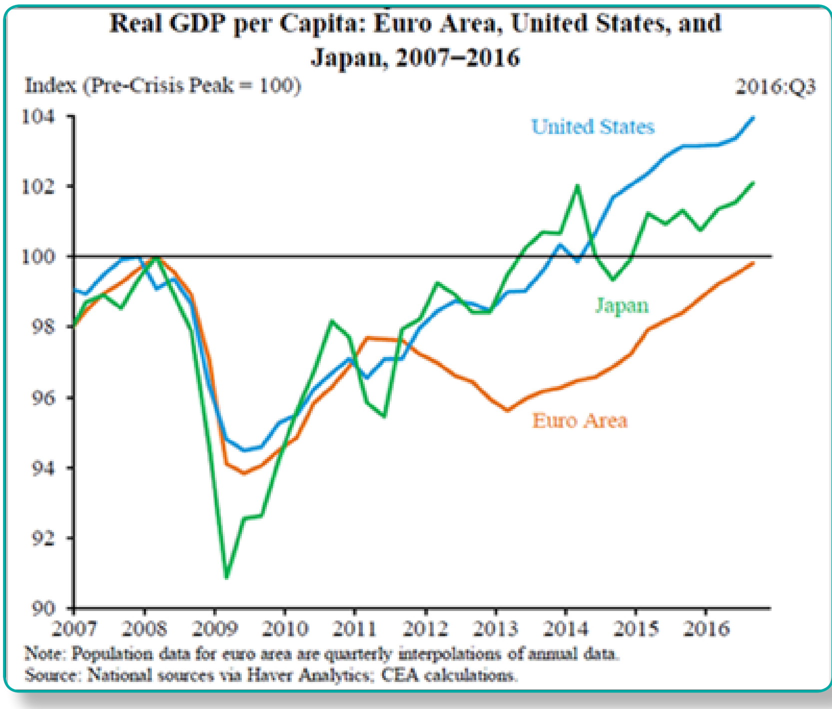
Many of the policies announced by Trump and his team are somewhat contradictory in intent, if not in nature. It will be interesting to see if the market's current infatuation with Trump's pro-growth policies lasts long under the weight of a range of initiatives more likely to harm global trade and destabilise the global economy. That is not to say we are willing Trump to fail. We do expect his policies to initially result in a boost to both US and global economic growth. Our concerns are more based on the longer term implications of his policies.

Despite his critics, outgoing President Barack Obama has presided over a gradual recovery in the US economy. While the recovery has been far slower than that which occurred following other recessions, it is important to remember just how severe the 2008 financial crisis really was. The real comparison is with the Great Depression in the 1930's, not the temporary slowdowns in the 1970's and 1980's. Nonetheless, the following few charts show the improvement in the US economic position post-GFC.

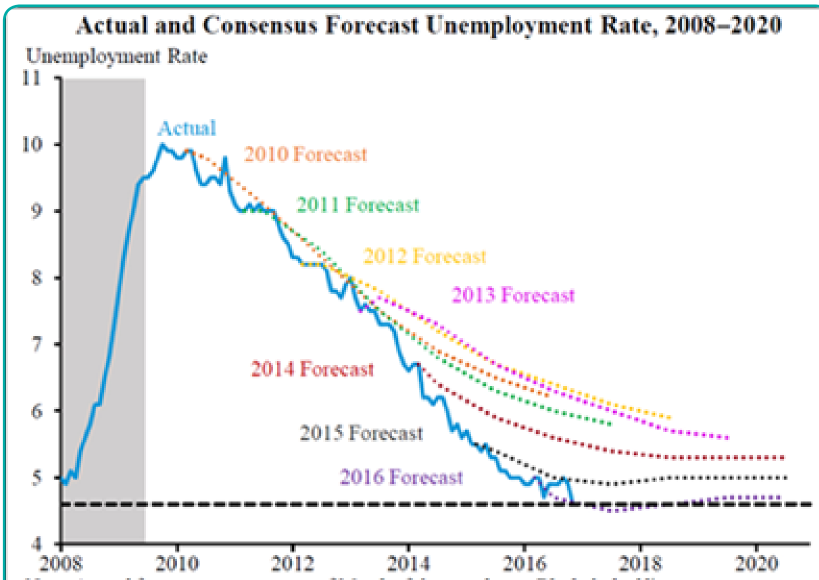
US Jobs growth, while not spectacular, has been steady since the recovery took hold in early 2010.



US Real GDP per capita has exceeded the pre-crisis peak in 2007, while Europe and Japan still lag.



US Unemployment has fallen consistently and faster than expectations since the GFC.



Note: Annual forecasts are current as of March of the stated year. Black dashed line represents November 2016 value (4.6 percent). Shading denotes recession.
Source: Bureau of Labor Statistics, Current Population Survey; and Blue Chip Forecasts

All in all, Donald Trump is inheriting an economy in reasonable health. That's not to say the Obama record is perfect – long term unemployment is a problem, wages growth is low and there is greater income and wealth inequality than ever before. However, into this reasonably healthy economy Donald Trump plans to inject a substantial fiscal stimulus, the size of which the Republican-controlled House of Representatives would never have allowed Obama.

Economic theory dictates that if an economy is close to full employment and growing GDP at a reasonable rate, additional stimulus, be it fiscal (increased spending or lower taxes) or monetary (lowering interest rates), will provide a short term boost to growth but a longer term boost to inflation. That is, we expect Donald Trump's policies to be positive in the short term, but highly inflationary in the medium to long term. Higher inflation will of course be countered by the US Fed with higher interest rates, as is standard practice. While rising interest rates are not necessarily a bad thing (in fact some normalisation of interest rates would be welcome), we are concerned about the lending and borrowing excesses which have occurred over the past near decade of ultra-low interest rates.

Past experience suggests that both households and businesses tend to over-leverage when interest rates are low, only to struggle to cover the cost of their debts as rates rise. Many of the most well-known corporate collapses in history were a direct result of companies being unable to service their debts – Bond Corporation, HIH, OneTel, ABC Learning, Babcock and Brown, Allco Finance, MFS…just a few of the companies that were undone by high levels of debt or a business model that could not survive higher interest rates. Our concern is that the next era of rising rates will unfortunately see yet more names added to that list of corporate causalities.

THE YEAR AHEAD

As has been the case for some time now, we approach the start of every year with a mix of hope and trepidation. While double-digit gains would be welcome, we temper our expectations with the knowledge that 2017 will no doubt be another year dominated by geo-political events and the accompanying uncertainty.

As already discussed, we see Donald Trump's policies as a risk to financial markets, although more likely in the years to come, as opposed to 2017. In Europe, elections in France, Germany and Italy are likely to lead to significant destabilisation, an additional challenge for a group of countries who have yet to even successfully resolve the long lingering sovereign debt crisis from 2012. As we have been communicating to clients, we believe that further fragmentation in Europe is possible, with all of the destabilising ramifications which would accompany such an event.

In Australia the economy continues to muddle through, lately helped by a substantial pick-up in commodity prices. Policy inertia and political uncertainty is weighing against any meaningful reform of the economy however, and we see no immediate catalyst for a return to economic growth rates closer to those experienced a decade ago. The property market is also a concern, although the main issues are largely confined to Sydney and Melbourne. Unfortunately, at some stage property prices in those two key markets will either stop rising or start falling, with a knock on effect on related industries and indeed property prices throughout the country.

However, that's not to say it's all doom and gloom. The economy continues to transition away from its reliance on mining investment as the prime driver of growth, although this process has been far slower than would have been expected. Government debt remains reasonably in hand, although the return to a federal budget surplus is also taking longer than anticipated. Both major political parties appear reluctant to make real cuts to spending for fear of upsetting vested interest groups. That said, cuts to the Age Pension which came into place on 1 January 2017 were a rare example of the government willing to court unpopularity in order to shore up its financial position. Retirees now with less money to spend however, could not be faulted for pointing to political perks and rorts as an area that might have faced the axe before attention turned to the Age Pension.

The stock market

Turning to the stock market, the Trump inspired rally appears to have pushed the market to a level which might be deemed to be slightly overvalued. The key will be whether or not corporate earnings will be sufficiently strong enough to justify the higher PE ratio reached by the major index at year end. That said, as we write this, with only days before Trump's inauguration, stock prices have begun to slip both in Australia and abroad. It remains to be seen whether this is a temporary dip or a more prolonged retreat in share prices.

As always however, we remain careful of placing too much emphasis on predictions and forecasts. On the wall of the office is stuck a chart produced by one of the many market commentators and forecasters that proliferate in financial markets. Produced in late 2015, the chart predicted a 30% market collapse during 2016, with a bottoming of the US S&P 500 Index in December 2016, at 1,330 points. Of course, as we now know, nothing of the sort happened and the S&P 500 Index finished the year at 2,239, a mere 68% higher than predicted.

In a similar vein, this time last year an analyst at the Royal Bank of Scotland (RBS), Andrew Roberts, issued an alarming research note urging clients to 'sell everything!..'. His advice was that 2016 would be a cataclysmic year, where markets would fall by a fifth and oil would collapse to just $16 a barrel and that the only course of action was to sell everything and invest all your money into government bonds. Again, none of this happened and Mr Roberts has mysteriously vanished from public sight. It may be that in fact he was referring solely to shares in his employer when he advised to 'sell everything', being that RBS shares are down nearly 40% since the start of 2016. Would that RBS shareholders had heeded his advice.

In summary, we expect another year of up and downs; crises and emergencies and both political and economic chaos and upheaval. While the years and the nature of the events may change, a sound and disciplined approach to investing should not.

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 (annual)	1.3% (Sep)	+0.3%
Australian unemployment rate	5.7% (Dec)	-
RBA Cash rate	1.50%	-
ASX 200 Index	5,719	+284 points
Australian $ vs. US $	$0.7236	-3.94c
Australian $ vs. UK £	$0.5892	+0.06c
Australian $ vs. Euro €	$0.6872	+0.07c

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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