ISSUE 19

POINTS OF INTEREST

WINTER 2017

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we consider the rise of regulatory and sovereign risk in Australia, and how this impacts our investment process. We also discuss the geo-political situation in key markets, where continued uncertainty exists. We conclude with a brief discussion of the stock market over the past quarter.

EXECUTIVE SUMMARY

- The introduction of the bank levy in the May Federal budget heralds a new form of regulatory and sovereign risk in Australia.
- The policy of domestic gas reservation, while laudable in its intent, also represents the long-term failure of government planning and management.
- Events in Europe, Asia and the United States are worrying and we remain concerned over the global macro environment.

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RISK
GLOBAL

Risk and Return

When it comes to assessing the merits of any investment opportunity, the two most important factors are naturally the expected return and the anticipated risks. The two are always considered in tandem as they are inextricably linked. The return should always be considered in relation to the risks, and vice versa.

When it comes to identifying and assessing an investment's risk, there are a wide range of differing risks which may, or may not, apply. These include risks such as liquidity risk (the risk of not being able to sell or liquidate your investment in an orderly manner); currency risk (where your investment might be denominated in a foreign currency); credit risk (the risk that a bond issuer is unable to make interest payments on the bond) and interest rate risk (the risk that interest rates can decline, causing a loss in the value of fixed-rate debt instruments), just to name a few.

One risk which we seldom have needed to consider here in Australia, is that of sovereign risk. The strict definition of sovereign risk is the risk that a government defaults on its debts, however it can also be taken to mean the general risk of investing in a particular country. Unstable, volatile countries can be expected to have a higher degree of sovereign risk than correspondingly stable and steady countries. Clients would no doubt be surprised, and certainly a little concerned, if we announced plans to invest in Iraq, for example; a country suffering from extreme uncertainty and volatility. Australia, on the other hand, is a stable and secure investment destination, governed by long standing rules and laws and accepted norms. Or so one would believe.

The announcement by Scott Morrison, during the reading of the 2018 Federal budget, that the liabilities of the 'big 4 banks + Macquarie' would be subject to a new bank levy, introduced a new level of sovereign risk that we have not seen in Australia for some time, at least from a foreign investor's perspective. Overseas investors who may have been willing to invest in or lend money to the large banks, on the basis of reasonable earnings growth and a stable regulatory regime, found that over a billion dollars of annual profits had suddenly vanished overnight. For domestic investors such as us, this represented the emergence of a different risk: regulatory risk. But the impact on shareholder returns was the same.

Due process

While we have no wish to defend or apologise for the big banks, our concerns lie more in the nature of the levy and how it was conceived and applied. As clients will be aware, one of the more important risks we pay attention to is that of regulatory risk. This is the risk of adverse changes to the laws and regulations which impact any potential investment opportunity. For this reason, we are reluctant to invest in gambling companies, whose business model is hostage to both state and federal government decree. Regulatory risk also applies to investment strategies, not just the investments themselves. Superannuation, which is effectively a simple tax-efficient investment vehicle, is a prime example of regulatory risk. It is a rare occasion where the Federal budget does not entail some change to the legislation pertaining to superannuation, usually for the worse. While we do advocate use of superannuation as a vehicle for wealth creation and income generation, we do so knowing that the risk of adverse government decisions is high. In most cases the attractive tax benefits offered by superannuation are sufficient to offset the risk of government meddling, but not always and possibly not indefinitely.

The real issue with the bank levy was that it exemplifies the worst type of tax policy: policy made on the run and arbitrary in nature. The justification given by Treasurer Scott Morrison for the new levy started with the fact that the banks were so profitable; then it became based on the fact that the banks were unpopular; attempting to increase competition was also used as justification, until eventually the Treasurer settled on the fact that the government provided an implicit guarantee to the banks based on being ‘too big to fail’. Of all the various reasons put forward by the government, it was only this last reason which provided sensible justification for the bank levy. Yes, the government would be expected to bail out the large banks if the worst was to happen, and this expectation is reflected in the fact that the large banks are able to borrow at lower cost in overseas capital markets than the smaller banks. So yes, it would be appropriate to charge the banks a ‘fee’ for this ultimate guarantee. But if that was the case, why not simply lead with this fact as the rationale for the levy? Unfortunately, this is what happens when policy is made on the run.

Domestic gas issues

A further example of regulatory and sovereign risk came to a head a few weeks prior to the May Federal budget. For many years, successive governments of all stripes have failed to adequately deal with the energy security of the Australian economy. This failure should not be too surprising when one considers that major energy projects are usually entered into on the basis of it being a 20 to 30 year proposition. That sort of time

frame is simply too many election cycles away for the average politician to comprehend. As a result, the farcical situation arose where domestic gas prices were higher than the prices which the major gas companies had contracted to sell their proceeds from Australia's blossoming LNG industry to buyers in Japan and other countries. As overseas demand for our LNG exports continued to grow, supply proved insufficient to meet demand, pushing up gas prices in Australia as domestic gas was diverted towards overseas markets.

The government, which had allowed and encouraged the development of a large-scale LNG export industry (think of all those multi-billion dollar plants near Gladstone), benefiting from the tax revenues and associated economic growth – then turned around and insisted that a proportion of the gas be reserved for domestic use. It's not the reservation policy itself which is at fault, the blame lies with successive governments for encouraging the massive investment in new capacity, with scant regard for the longer-term implications for the gas industry. The quick fix of domestic gas reservation simply adds to the level of regulatory and sovereign risk which investors now face in Australia.

Risks require management

We mention these two examples of sovereign and regulatory risk solely to highlight the many factors which must be considered in making any investment. The risks involved are one of the most important considerations, but are still just one of many. The objective is to ensure that you are being adequately compensated for the risks which you have taken on board. The risk/return relationship is well understood – we all know that a casino, for example, offers the promise of high returns but also at high risk. In that instance, the risks are easily identified and measured. You know that the wrong bet on a number on the roulette table means you lose your money. Easily understood and easily measured. Problems occur however, when risks are not so clearly identified, or if they are, they are incorrectly measured. This is where we focus the bulk of our efforts in assessing potential investment opportunities. In many ways, correctly identifying and assessing an investment's risk is more important than accurately working out the future returns. Without reference to the risks, the returns are meaningless.

Recent decisions by the Federal government may have heightened the level of regulatory and sovereign risk, but a robust investment decision-making process should be well equipped to handle any such changes in the investment environment. We draw comfort that our investment approach has withstood many such changes and variations, and expect it to continue to do so.

Global events – an update

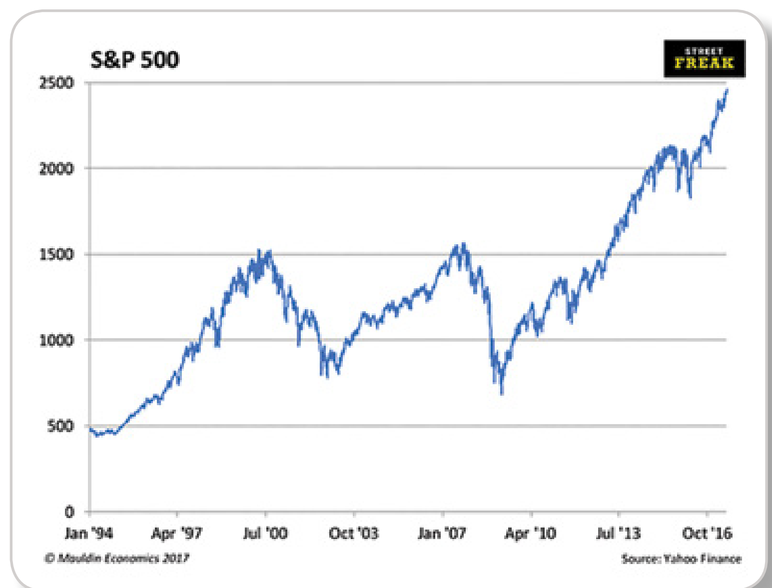
Clients are aware that we have been somewhat concerned over the global environment for some time – concerns which include not just political events but also market and economic developments.

Europe and the US

This year has thus far seen the favourable resolution of at least two of the political concerns, with the 'right' outcome in elections held in France and The Netherlands. However, the results of the UK election, held in early June, were an unwelcome reminder of the political volatility which still bedevils much of Europe. Although Theresa May won the election, the result was poor enough that it was viewed as a moral defeat. A hung parliament has meant a continuation of the uncertainty which has dogged the UK since the unexpected vote in favour of Brexit.

Other political developments remain equally unpredictable. In the United States, President Trump, while not being the outright disaster many had feared (yet), is making very little headway in advancing his policies of tax reform, deregulation and massive infrastructure investment. We are somewhat concerned that US stock markets have 'banked' the gains from these policies long before they have looked like being successfully implemented.

Should President Trump fail to implement a significant proportion of his policies, we would expect market disappointment to be swift and severe. The US stock market looks particularly vulnerable to a sizable correction, as shown in this chart:



Europe still has further hurdles to overcome, with the German election in September the next key event. An improvement in the polls for the ruling CDU/CSU coalition (led by Angela Merkel) has raised hopes of a re-election victory for Chancellor Merkel. In a world where stability seems to be all too rare, a Merkel re-election victory will go some way to normalising the global geo-political environment.

Asia and China

Closer to home, risk levels remain high. Readers would of course be aware of developments on the Korean peninsula, where the risk of conflict between the United States and North Korea is not an impossibility. The South Korean economy is the 4th largest in Asia and the 11th largest in the world, so besides the humanitarian cost, any armed conflict in that region would have major economic implications.

Corporate credit in China

2008 — 100% of GDP

2016 — 170% of GDP

We also remain wary of the economic situation in China, where a significant increase in debt, at all levels, now poses a risk to continued Chinese economic stability. Corporate credit in China has increased from 100% of GDP in 2008, to around 170% at the end of last year (as a comparison, the same figure for Australia is around 83% - our problem is excessive household debt, not corporate debt). Authorities in Beijing are aware of this problem and are adopting a gradual approach to managing the issue, but the risk of an adverse outcome remains high.

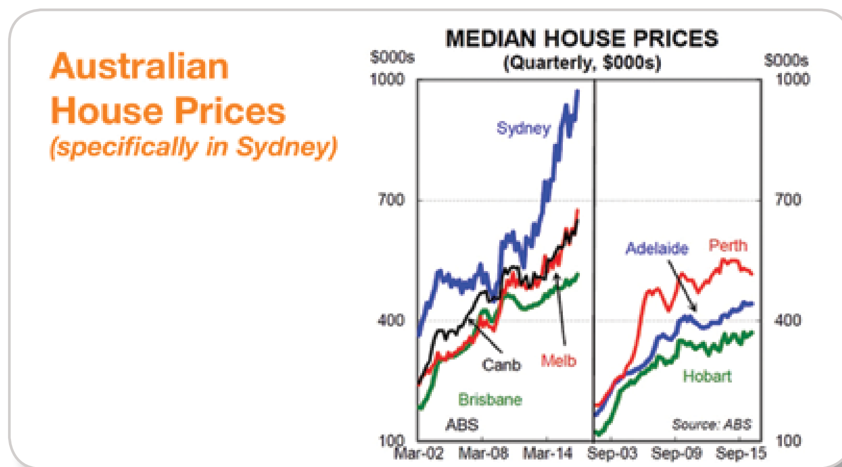
Global risks

The main risk which global markets face today, as we have been saying for some time now, is the reaction to the withdrawal of the monetary stimulus which has flooded global markets since the GFC. Trillions of dollars of liquidity have found a home in almost every conceivable asset class. A simple list of overvalued assets might start as follows:

1. **Real estate in Canada, Australia, and Sweden**
2. **Real estate in California**
3. **Cryptocurrencies (Bitcoin etc.)**
4. **FANG, plus Tesla and a few others (FANG being Facebook, Amazon, Netflix and Google)**
5. **Corporate credit**
6. **Emerging Market's sovereign credit**
7. **US Automobile sales**
8. **Exchange Traded Fund inflows**

In the words of an unknown author, we now appear to be in the age of the 'Everything Bubble'. Excessive liquidity has created a unique environment where nearly every asset class appears overly expensive (that is not to say that every individual 'investment' is overvalued – pockets of value do exist, they are simply becoming harder to find).

A few charts will suffice to illustrate this point:



That is not to say that a collapse in share, property, commodity or Bitcoin prices is imminent. Markets (and prices) can continue to increase long after any further gains seem at all rational. Identifying a bubble is one thing, successfully picking the top is entirely different. While we are conscious of the impact excessive monetary liquidity has had on asset values, we still see opportunities for prudent investment.

Equally, we try not to be too pessimistic. A pessimistic, glass-half-full approach to investing would not have borne fruit over the past hundred years or so, where the Australian stock market has provided reasonable, if somewhat volatile, returns. Again, we trust that our investment approach, based on a careful mix of exposure to selective assets and asset classes, continues to be appropriate in the current investment climate.

The stock market - April to June 2017

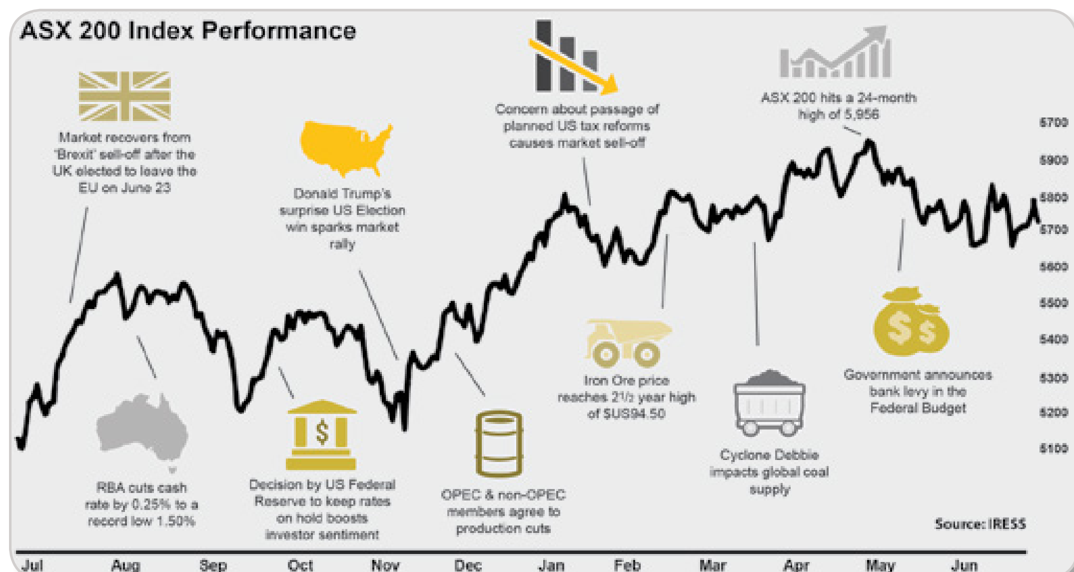
We conclude this newsletter with a brief look at the performance of the stock market over the past quarter.

The chart below shows the change in the benchmark S&P/ASX 200 Index, which recorded a fall of around -2.45%, or -134 points.

Unsurprisingly, bank stocks did not perform well during the quarter, as a result of the government's new bank levy. Of the other major companies, Telstra continued to struggle while blood plasma company CSL Limited was one of the stronger performers. A few former market darlings (which we typically do not include in our portfolios) such as Domino's Pizza and Blackmores struggled, down -10.39% and -14.83% respectively.

Trading around the end of the financial year is usually quite volatile, as investors opt to sell for tax reasons or in some cases, fund managers attempt to switch holdings ahead of the all-important end of financial year reporting. As we have already mentioned, global geo-political events also played a role in introducing a level of uncertainty and volatility to markets.

The chart below presents a more complete picture of the performance of the ASX 200 Index over the 2017 financial year. On a 12-month basis returns are still positive, although the recent quarterly decline is still evident.



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)	1.7% (Mar)	+0.3%
Australian unemployment rate	5.5% (Dec)	-0.2%
RBA Cash rate	1.50%	-
ASX 200 Index	5,721	-134 points
Australian $ vs. US $	$0.7692	+4.56c
Australian $ vs. UK £	$0.5913	+2.10c
Australian $ vs. Euro €	$0.6730	-1.42c

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.