POINTS OF **INTEREST**

Issue 20

Spring 2017

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the performance of the Australian stock market, which has traded within a narrow band for some time. We also update clients on our strategy to gain commercial property exposure through a direct approach, as opposed to through the stock market.

EXECUTIVE **SUMMARY**

- **The Australian stock market has lagged its global peers and registered only minor gains over the past 12 months.**
- **A weak economy, cautious consumers and political dysfunction are just some of the factors which are weighing on the market.**
- **We have spent the past seven months in search of appropriate commercial property investments, however valuations have been the major impediment to a successful transaction.**

BAIOCCHI GRIFFIN
PRIVATE WEALTH

INVESTMENT PORTFOLIO MANAGERS

WHAT IS WRONG WITH THE ASX?

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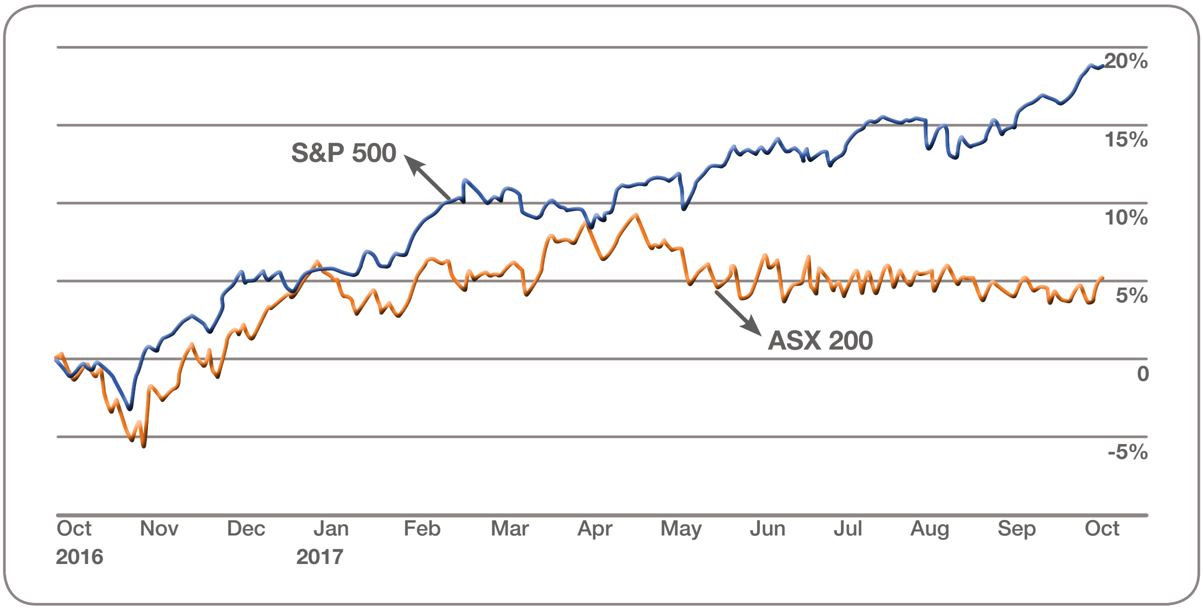
Over the past year or so, investors would be forgiven for wondering what has happened to the Australian stock market. While markets overseas continue to lock in record highs, the local market has remained stuck within a narrow range, offering little to excite investors. In this section we consider the relative underperformance of the ASX and explore possible reasons for the market's malaise.

Investors who keep a keen eye on market movements will be aware of the lacklustre performance of local shares in recent times. However, the simplest way to put the performance of the ASX into perspective is to plot the market's gains, relative to the United States. This is shown in the chart below, which compares the 12-month return for the ASX 200 Index, with the benchmark S&P500 index from the United States.



The chart makes for poor reading for domestic investors, with the ASX's 12-month return of 5% significantly lagging the S&P500's return of just under 20%. The deviation in performance is particularly obvious from around April of this year. In our view there are a number of possible explanations for this disparity.

Economic growth trajectories

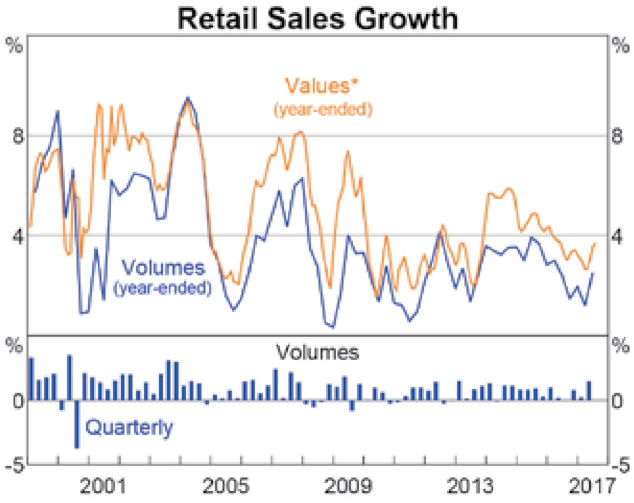
The first of these is the simple fact that the US economy is performing significantly better than here in Australia. While it is true that economic growth and stock market performance are seldom closely correlated, the reality is that an expanding economy usually leads to an increase in company earnings, which is of course generally good for company share prices. For the year ended June 2017, the US economy expanded at an annualised rate of 3.0 per cent, while the Australian economy could manage only 1.8 per cent growth over the same period. It may not sound like a significant difference between those two figures, but just one percentage point can mean the difference between an economy that is struggling and one that is growing handsomely.

The problems facing the Australian economy are well known, principally the continued drag from the end of the mining boom. Although the Reserve Bank of Australia (RBA) would have us believe that the economy has successfully managed the transition away from a reliance on mining investment for growth, the truth is that nothing else has yet come close to replacing the economic tailwind which propelled the Australian economy over the period from the early 2000's to around 2015. A booming property market in Sydney and Melbourne, coupled with an increase in new housing construction activity has had some impact, but far less than was generated by the level of mining investment over the past few decades.

Looking ahead, much faith is being placed on a significant increase in infrastructure spending at both the state and federal level, although relying on these types of one-off spending events to drive economic growth is less than optimal. An investment driven strategy to boost economic growth only lasts as long as the money keeps flowing, and even China has shown that such an approach can only ever be temporary in nature.

Unhappy consumers

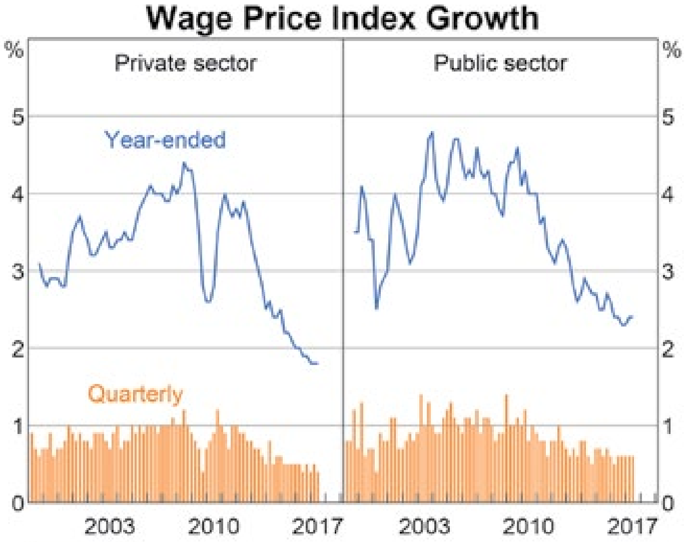
Related to the relatively weak state of the Australian economy, is the lack of confidence amongst consumers. This is important as consumption (going to the movies, buying a new television, eating out, for example) makes up just under 60% of economic activity. Therefore, changes in the level of consumption have a significant impact on the level of economic activity - and in this regard, the news is not good. Despite record low interest rates, consumer confidence (and thus their willingness to spend) is low. This is best reflected in the very weak retail sales growth figures, shown in this chart:



* Percentage change over year to latest three months
Source: ABS

It is noticeable that the orange line, which represents the dollar values of sales, has seldom managed to reach 4 per cent per annum since the end of the Global Financial Crisis. This is in contrast with the years between 2000 and 2009, when retail sales regularly grew at 6, 7 and even 8 per cent per year.

In a way, the weak retail sales growth figures are both a symptom and a cause of a sluggish economy. Retail sales are also very closely tied to the level of wage increases. As would be expected, workers who earn more tend to spend more. This was particularly evident during the mining boom, where a scarcity of skilled workers led to rapidly increasing wages. Much of this money was spent on consumption related activities, hence the phenomenon of retail sales growing at 8 per cent per year in the boom years. If growth in retail sales relies on growth in wages, the outlook for the retail sector is worrying. The chart below outlines how wages growth has simply stalled in Australia in recent years.



Source: ABS

The private sector in particular, has seen wage increases practically disappear. It stands to reason that stagnant wages have led to a collapse in retail sales, with a corresponding negative impact on economic growth. If wages growth is needed to drive retail sales, which is an important factor in the consumption component of GDP, the central issue therefore, is why are wages not growing?

This is of course a question which has vexed the RBA, who see rising inflation, driven by rising wages as a key pre-determinant of higher interest rates. A 2015 research paper issued by the RBA ("Why is wage growth so low?", Jacobs D & Rush A, 2015) attempted to address this very question. The author's conclusions were unfortunately not as clear as could be hoped, with possible causes of low wage growth being a long list including a weak economy, subdued growth in labour demand, below average expectations of consumer price inflation and the decline in the terms of trade. The simple fact is that low wages growth reflects an environment where both households and businesses see little prospect for substantial short term economic improvement.

Workers are reluctant to ask for large salary increases, while businesses are reluctant to offer them (there's little need to do so in a relatively weak job market).

The cycle is somewhat circuitous – weak wages growth leads to weak levels of consumption, which lead to stagnant company earnings, which precludes businesses from offering higher pay increases, and so on. A circuit-breaker of sorts is needed to break this unhealthy stasis - some dynamic political leadership perhaps?

Uninspiring political situation

It's fair to say that nobody should consider holding their breath in anticipation of a politically driven solution to Australia's economic woes – such an approach would most likely be fatal. A lack of genuine leadership, party in-fighting, political points-scoring and the absence of any clear vision for the country, are just some of the factors which make a policy-driven recovery unlikely. Even worse, what passes for policy, such as superannuation tax grabs, populist bank levies, ill-conceived gas export moratoriums and housing 'affordability' measures, are often worse than doing nothing.

That's not to say that any one party is better or worse in this regard – the focus on 'politicking', as opposed to helping make Australia a better place, afflicts both side of politics. Far from helping, the current level of political uncertainty and general disillusionment with the major parties simply adds to Australia's economic woes. Of course other countries, the United States for example, have their own political issues, not least the current US President. In this case however, Trump is unabashedly pro big business and will do what he can to boost company earnings and make the wealthy (including himself) even wealthier. This has been music to the ears of the US stock market, which has marched higher on the back of the promised (but possibly never delivered) tax and regulatory reform. Here in Australia however, political dysfunction is certainly having a negative impact on economic conditions.

So, with a weak economy, worried and nervous consumers, and an absence of political leadership, is there any wonder the Australian stock market has underperformed its peers? But is there any light at the end of the tunnel?

The good news?

Taking all of this into account, it is important not to be too pessimistic about the current environment. As we often say, our job is to not be overly pessimistic or overly optimistic, but rather to be realistic, when assessing financial markets and investment opportunities. We don't believe that the global financial system is on the verge of collapse, but neither do we believe that the Australian economy is about to boom and the share market is going to increase by 30% in the next twelve months. The reality, as always, is somewhere between these two extremes.

Key to outcomes over the near term is the direction of interest rates. The RBA has certainly given the impression that interest rates have bottomed (a sentiment that we agree with) and that interest rates will be going up soon (a sentiment we disagree with). In our view the RBA is unlikely to begin hiking rates until 2019 at the earliest. Few of the preconditions for rate hikes exist at the moment - no labour market pressure (unemployment is at 5.5 per cent, with substantial remaining slack in the jobs market); economic growth is slow; and most importantly, inflation is low (an annual rate of 1.9 per cent is below the RBA target of 2 to 3 per cent). We have no doubt the RBA would like rates to be higher, if only to help douse property markets in Sydney and Melbourne, however we see little prospect of action at this stage. As it is, the banking regulators have applied sufficient pressure on the banks to start slowing the housing market, while capital controls in China are proving equally effective in restricting property purchases by overseas investors.

Low interest rates (albeit only domestically – we see higher rates ahead for the US and Europe) will help underpin markets and eventually provide the lift which businesses need to increase their capital expenditure plans. In our view, traditional monetary policy (using interest rates to increase or slow the rate of economic growth) still works, it's simply that the impact of such policy now takes longer to bear fruit. Globalisation, record levels of household, corporate and government debt, the economic rise of China, the 'Amazonification' of retail, disruptive innovation (think Uber and others)…all these have led to a different economic structure to that which persisted fifty or sixty years ago. However, the basic principles remain the same – the cost of borrowed money has a direct impact on the level of demand for funds. If you keep it cheap enough for long enough, it will be used in ever greater quantities, hopefully for productive investment. The challenge of course, is not to keep it too low for too long, a mistake which was made in the run up to the GFC and one which central banks will be keen to avoid repeating.

Overall, our view on the short to medium term prospects for Australia can be best described as cautiously optimistic. While acknowledging the challenges and problems which confront the Australian economy, we feel that we may be at the low point in terms of the performance of the economy over the past few years. If nothing else, reasonable levels of economic growth in key markets such as the United States, Europe and China, will assist in dragging the Australian economy forward.

That's not to say that such an improvement will necessarily be reflected in the stock market. As we have said on many occasions, there is only a weak correlation between economic growth rates and the stock market. Still, a stronger economy typically results in higher company earnings, which certainly is one precondition for a stronger stock market. At the moment, share valuations are not overly stretched, so some scope exists for capital growth. The next six months or so will confirm whether we have 'turned the corner', or if the market will continue to trade within a narrow band.

COMMERCIAL PROPERTY – AN UPDATE

Clients would recall changes we made to the majority of portfolios earlier this year, where amongst other changes, we sold out of most of our listed property companies in favour of a new, direct approach to commercial property exposure. Many clients now have significant funds awaiting investment in direct commercial property, part of our strategy to reduce stock market exposure (where appropriate that is – this does not necessarily apply to every client).

Since the start of 2017, we have spent a significant amount of time searching for appropriate properties for purchase. While we have had no problems finding desirable properties, the major issue has been the price. That is, nearly all of the properties we think are suitable to be recommended to clients for investment, sell at prices beyond which we consider to be reasonable.

As an example, we recently attended a property auction in Newcastle, with the intention of bidding on a ground floor commercial property on behalf of clients. An independent valuation report valued the property at $3.5 million, a figure which matched our own internal analysis. We therefore set a maximum price we would pay for the building at $3.55 million. You can therefore imagine our surprise when the building was sold for $4.7 million at the conclusion of the auction. At that price level, the purchaser was investing at a gross yield of just over 4 per cent. Taking the risks of property ownership into consideration (for example, the potential loss of the tenant, repairs and maintenance and capital growth or the lack thereof), there was no way, in our view, that the investor was being adequately compensated.

Much like the residential property market, low interest rates are conspiring to push commercial property prices to levels where they seldom make financial sense. While we are very keen to invest the funds which we have set aside for property investment, we are not willing to invest purely for the sake of it. That is, we have no wish to pay over and above the appropriate valuation for the properties simply to get the deal done. We are conscious that we may be near the top of the current commercial property cycle and any investment we do must generate our desired returns. As a result, it may take us longer than we had expected to find the right property, but in this instance, we believe that patience is a virtue.

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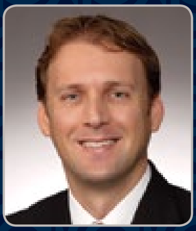

Justin Baiocchi

Ray Griffin

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)	1.8% (Jun)	+013%
Australian unemployment rate	5.5% (Sep)	-0.1%
RBA Cash rate	1.50%	-
ASX 200 Index	5,681	-40 points
Australian $ vs. US $	$0.7839	+1.47c
Australian $ vs. UK £	$0.5845	-0.68c
Australian $ vs. Euro €	$0.6658	-0.72c

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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