POINTS OF **INTEREST**

Issue 22

Autumn 2018

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we consider the prospect of a global trade war. We also discuss the recent proposal to deny the refund of franking credits to certain individuals and superannuation funds. We conclude with a look at the performance of the stock market over the quarter, which was a poor one for investors.

EXECUTIVE **SUMMARY**

- **The prospect of a trade war between the United States and China has led to increased levels of geo-political uncertainty, with an attendant impact on global equity markets.**
- **While the threat of a trade war may simply be a negotiating tactic, the risk of a miscalculation remains high.**
- **Bill Shorten's proposal to deny franking credit refunds to certain individuals and superannuation funds has received wide spread criticism. While the proposal itself is controversial, there are further questions around the integrity of the tax and superannuation system.**
- **The past quarter was the worst stock market return since the middle of the GFC, with heavy losses in the banks and other large cap companies.**

Baiocchi Griffin Private Wealth

Investment Portfolio Managers

TRADE WARS AND BATTLES

In the Summer 2018 edition of this newsletter, we began with a discussion of past events during 2017, concluding that the year was not as bad as it could have been. Central to this conclusion was the fact that US President Donald Trump had yet to act on many of his election campaign promises. The first few months of 2018 however, has been very different, with rising concerns over recent decisions taken by President Trump.

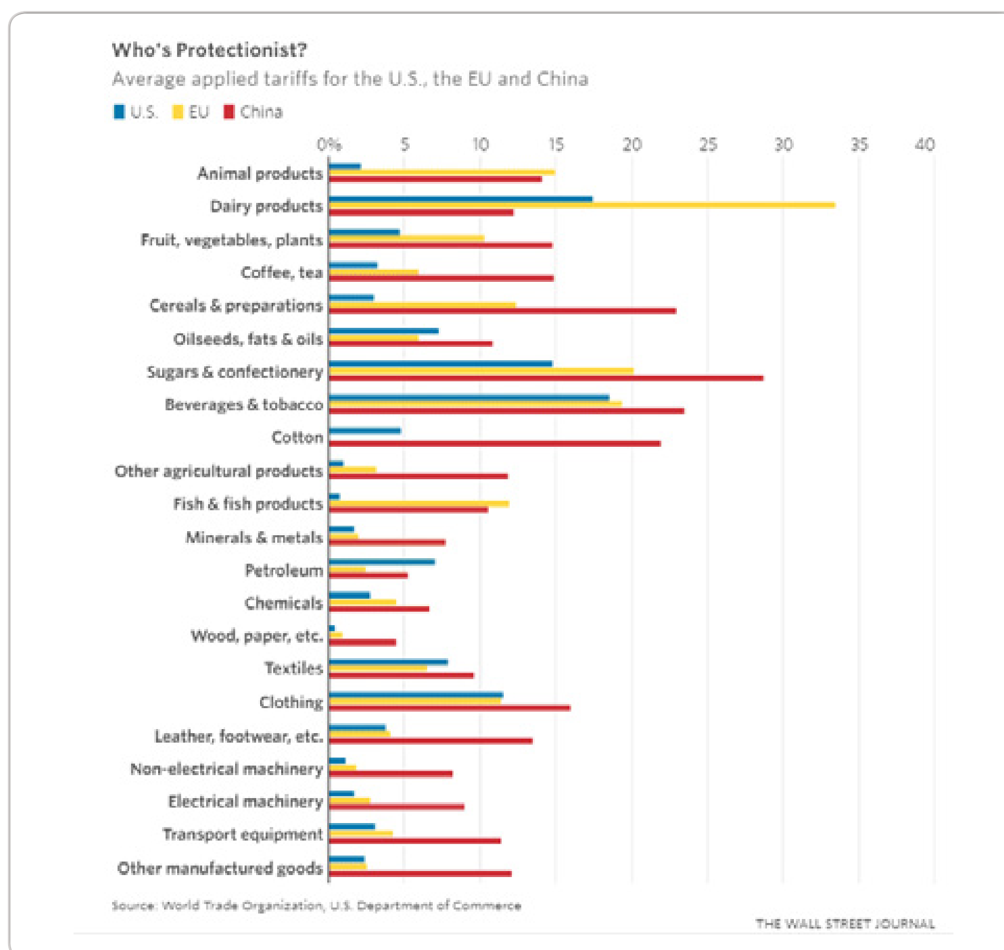
The most serious of these concerns centres on Trump's determination to 'punish' China on the basis of the significant trade imbalance between the two nations. It's not only here in Australia that most everyday items are sold with a 'Made in China' stamp on the bottom – the United States exported around US$130 billion worth of goods to China in 2017, but imported a far larger US$506 billion worth of goods (the similar figures for Australia are US$78 billion in exports to China, with US$50 billion in imports from China – our mining exports means that Australia is one of few countries to run a trade surplus with China).

In President Trump's view of the world, trade is a zero-sum game: if I'm importing more from you than you are importing from me, then I'm 'losing' and you're 'winning'. And of course, Donald Trump always wants to be a 'winner'. The truth is, global trade is far more complicated than simply a comparison of how many pallets of goods are shipped west versus east. The central benefit of free trade is based on the theory of comparative advantage. One of the oldest economic theories, the theory essentially states that every country has a comparative advantage in the production of at least one good, and by specialising in that good and trading surpluses for other goods, everyone is better off. The benefits of comparative advantage are somewhat theoretical and hard to observe in practice – not so the other benefit of trade: increased competition. Trade opens up domestic markets to foreign competitors who compete with domestic monopolies or oligopolies who would otherwise be able to keep prices high. While the domestic producer may suffer, the country as a whole is better off as a result of lower prices.

The unfortunate state of the Australian car manufacturing industry is an example of this phenomenon. Holden and Ford no longer make cars in Australia as they were simply unable to produce them at a price which was competitive with imported models (plus a few questionable design and production decisions). While this is undeniably bad news for workers at those firms, Australians now enjoy access to a wider range of cars and at lower prices than ever before. While there certainly can be 'losers' from trade, the truth is that the 'winners' are both far more numerous and far better off.

Back to Trump's 'War on Trade'. To a large extent, the large trade deficit between the US and China simply reflects the fact that Americans are, on average, far wealthier than their Chinese counterparts and are quite willing to spend vast sums of money on Chinese-made goods. Goods made in China are of course far cheaper than locally made goods, mostly as a result of much lower wages in China. Unfortunately (or fortunately, depending on your point of view), nationalism often takes a back seat to a bargain. Even 'Buy Australian!' campaigns have their limits when the choice is between a locally-made product for $20 and an overseas-made one for $10. Trump's trade war, which will be conducted through the implementation of tariffs on select goods and services, is in effect a mandatory 'Buy American!' campaign. That is, US consumers will be compelled to pay higher prices for imported goods, possibly leading to a situation where they opt for the similarly priced domestic product, thereby underpinning local jobs. It's not free of course, every extra dollar spent over and above what the cheaper, imported good used to cost, is effectively a transfer of money from consumers to the local companies and workers. That might not sound like a bad outcome, but research has typically found that the costs outweigh the benefits, leaving everyone worse off on an overall basis.

That is not to say that China is blameless. For many years China has been accused of intellectual property theft through trade policy – companies wishing to do business in China are often required to partner with a Chinese firm and transfer valuable intellectual property to their new partner. Furthermore, free trade is hardly fair when it is allowed in only one direction and China has past form in using and misusing tariffs and other trade barriers to keep imported products out. Then again, China is not alone; Europe has long been prone to using tariffs to protect domestic industries (Australian farmers can attest to this). The chart below compares US, Chinese and European tariffs across a range of goods, clearly showing that the US has some cause for complaint regarding a not-so-level playing field.



While President Trump may have a valid complaint over tariff levels in trading partners such as China and Europe, his approach to resolving the issue is problematic. Trump's solution is to impose tariffs on imported goods (not just from China, but the principal target is China) as a means to addressing the trade imbalance. Naturally China's response has been to impose or raise tariffs on selected goods it imports from the US – a much more serious version of playground tit-for-tat. The problem is that both countries are deeply enmeshed in a global trade and finance web: China is the single largest holder of US government debt (around US$1.2 trillion of it); China is America's single largest trading partner and the fastest growing market for American exports and the third largest destination for US exports.

Any trade war would no doubt significantly harm the Chinese economy, as a broad sell-off of US debt held by China would also harm the US economy. The drying up of hundreds of billions of dollars of trade would cost untold jobs; raise the cost of living in both nations and risk an upward lurch in US interest rates, potentially ending the post-GFC boom. Clearly, a broad-based trade war is in nobody's best interests. It may be that Trump's strategy is to use the threat of a prolonged trade war as a means to drive China to the negotiating table, where lower tariffs and easier access to domestic markets would no doubt be demanded. It can only be hoped that this strategy works, as the alternative – a full-blown global trade war – is something the world should hope to avoid.

THE END OF FRANKING CREDIT REFUNDS?

Most people would be aware of the announcement by Bill Shorten on the 13th of March, that a future Labor government would legislate to end the practice of franking credit refunds. As a quick reminder, franking credit refunds are a result of dividend imputation, the policy that declared dividends are not taxed twice. For example, if a company pays a dividend, it has already paid tax of 30% on that money. If your tax rate, as the shareholder, is also 30%, you will pay no extra tax on the dividend. If your tax rate is 40%, you will pay an extra 10% tax on the dividend. And more importantly, if your tax rate (or your superannuation fund's tax rate) is 0%, you will be refunded the 30% tax which has already been paid on the dividend.

Bill Shorten's proposal would remove the refund component, such that an individual on a tax rate of 0% would not be paid the 30% tax back, instead it would be retained by the government. After a fierce backlash, the policy was amended to exclude those people who were recipients of a part or full Age Pension, or those Self-Managed Superannuation Funds where at least one member was in receipt of a part or full pension as at 28 March 2018. Notwithstanding these changes, the move is still expected to save $10.4 billion over the forward estimates (though it's not clear if the projected savings take into account the fact that investor behaviour may vary as a result of the changes, thereby lowering any future benefit to the government).

While it is accepted that taxes must be paid in order to provide us with the services we take for granted in living in Australia, there are some problems with the proposed changes. These include the following:

- The proposal represents yet another isolated change to the taxation system, without due consideration of the entire tax system as a whole. Both main political parties are guilty of this, indulging in a haphazard, cherry-picking approach to tax laws, meanwhile the entire tax system urgently needs a measured and comprehensive approach to reform.
- The proposal adds another layer of complexity to an already overly complex taxation system.
- Out of all the superannuation vehicles, Self-Managed Superannuation Funds (SMSFs) stand to lose the most, solely due to the requirement that they are allowed no more than four members. Larger funds with many members can offset the franking credits against other tax obligations, an option not open to most SMSFs.
- Justification for the change was tenuous at best. Examples given were of SMSFs who received franking credit refunds of up to $2.5 million in 2014-15, which ignores the fact that such an outcome is not possible anymore due to the imposition of the $1.6 million cap on money funding a pension in superannuation.
- Frequent changes to the taxation and rules surrounding superannuation in particular, act to undermine faith in the system. By its nature superannuation involves a level of long term planning, yet both major political parties are guilty of making major and frequent policy changes.

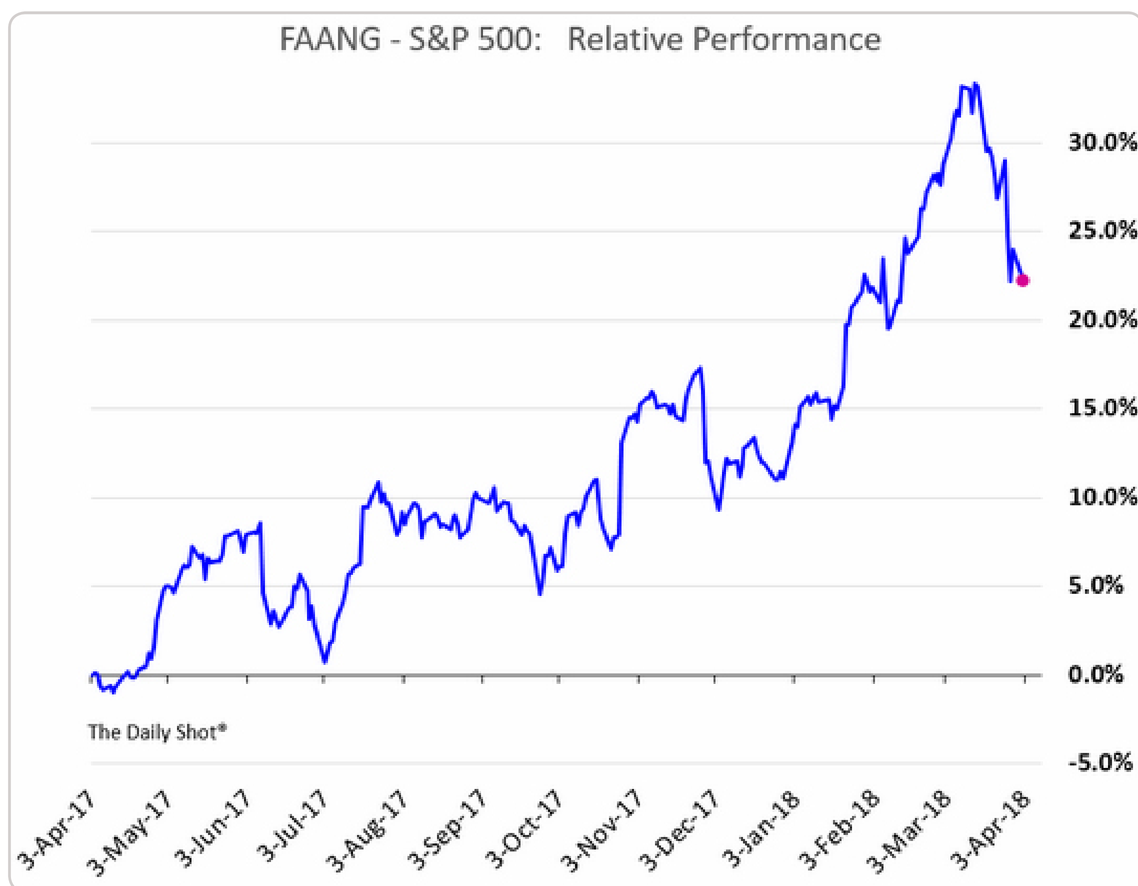
Of course, there are many hurdles which must be overcome before the proposal is passed as legislation, including a federal election and dealing with a fractious Senate. At this stage our approach to investment selection and portfolio construction, in addition to our views on the benefits of Self-Managed Superannuation Funds remains unchanged. However, should it look likely that the proposal may come to pass, we will investigate and recommend any changes to investments or overall strategy as is required.

THE STOCK MARKET OVER THE PAST QUARTER

Unfortunately, the past three months were very poor for investors. After a strong performance during late 2017, markets went into reverse through January, February and March. The benchmark ASX 200 Index fell by 5.05% over the period, which in fact was the third worst quarterly return in 25 years. Only a 15% fall in the same period in 2008 and a 6.4% loss in 1994 were worse than the past three months.

The reasons behind the poor performance were a mix of both domestic and global concerns. Globally, the central issues which weighed on the market were the potential for a global trade war (which was discussed earlier); concerns over the prospect of rising interest rates in the United States; and a significant sell-off in the high-flying tech sector (with companies such as Facebook, Google and others leading the falls). We have covered the risks from rising interest rates in previous issues of Points of Interest (notably the Summer 2018 issue), so will not discuss it here, except to say that we remain of the view that the market may be underestimating the rate at which interest rates may rise. Such an outcome would prove to be very uncomfortable for equity markets, both here and abroad.

The significant falls in the previously high-flying tech sector are a more localised issue, with most of the damage occurring on the tech-heavy NASDAQ Exchange. The following chart highlights the performance of the so-called FAANG stocks as compared to the S&P 500 (FAANG = Facebook, Apple, Amazon, Netflix and Google).



The strong relative performance of the FAANGs prior to the start of the year is quite evident in the chart, as is the more recent and sudden falls. In terms of significant losses, Facebook, Google and Tesla, recorded falls of -15.65%, -5.50% and -21.23% respectively. The losses extended also to the broader market, with the Dow Jones index falling by -2.85% over the same period.

Domestic market losses

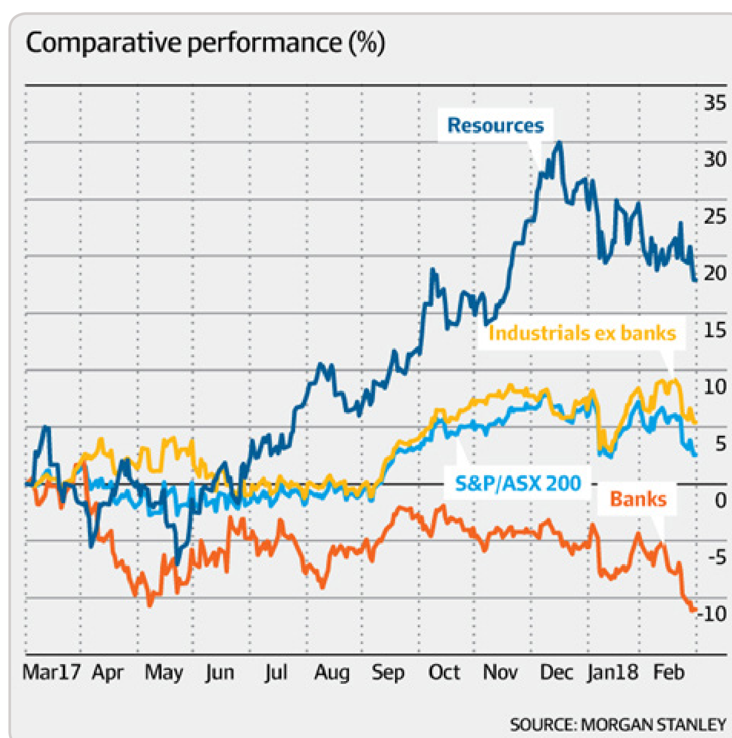
In regard to the Australian market, losses were led by the large caps, with market heavyweights such as the big four banks, Telstra, Wesfarmers, Woodside and QBE all struggling. In some cases, losses were company specific – for example, the ongoing uncertainty and issues with the NBN impacted Telstra, along with all other telecommunications companies. Wesfarmers' woes were self-inflicted, with the company's decision to take Bunnings to the United Kingdom proving to be a poor one. Despite two years of apparent research and investigation, the company made a number of simple mistakes in its execution, including mis-reading the UK DIY market; poor product selection and mis-managing cultural issues. While the dollar losses are small in the context of the broader Wesfarmers group, it is disappointing that Wesfarmers has joined a long list of otherwise illustrious companies which have embarked on an overseas adventure, only to meet with humiliation and failure. From a shareholder's perspective, the rumoured likely total cost of $4 billion will rankle.

The Royal Commission

In terms of the banks, the problems are broader and principally stem from the ongoing 'Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry' (to give the Royal Commission its rightful name). Much of March was spent dragging CBA, ANZ, NAB and Westpac over the coals, with the airing of plenty of dirty laundry, some of it old, some of it new. Share prices of the banks reflected the battering they were taking in the Royal Commission, with falls of -10% (CBA), -8.8% (Westpac), -6.5% (ANZ) and -3.6% (NAB). In our view, the Royal Commission is likely to continue to negatively impact bank shares for the immediate future, as investors react to the uncertainty which now pervades the banking sector. Longer term however, we are not overly concerned over the impact of any recommendations of the Royal Commission. We expect that there will be increased oversight and regulation, a state of affairs which all businesses who operate within financial services in Australia are quite familiar. There may also be enforced structural changes to the banking sector – 'vertical integration' may be a casualty of the process. This refers to the arrangement where the large banks both manufacture financial products and also distribute them through their network of financial planners. The conflicts of interest inherent in such a system led to many of the banks' problems with their financial planning divisions, and nearly all the major banks have already taken steps in winding back such arrangements.

A further casualty of the Royal Commission may be the mortgage broking industry. There seems to be sufficient evidence to suggest that the industry suffers from some of the ills which previously plagued the financial planning industry. These include a tendency for some brokers to steer clients towards loans which offered higher commissions or other benefits; a lack of transparency with regard to the mortgage application process and an apparent willingness by some brokers to assist (or even initiate) fraudulent loan applications. As nearly half of all home loans written in Australia are done through mortgage brokers, and there are more than 16,000 Australians who work as mortgage brokers, any changes will need to be thought through carefully.

The chart below puts the comparative performance of the big banks into perspective.



The banks have been significant relative underperformers for the past twelve months, with the most recent quarter especially weak. While disappointing, the banks' performance in recent months is no reason for panic. In making a decision to invest in any of the banks, our motivation is to gain access to the steady income stream derived through the regular dividends paid by the banks. We rightly do not view the banks as growth companies, where a business can be reliably expected to increase revenues and profits by 10% to 15% per year. The large banks are essentially mature businesses, that offer the relative certainty of a regular cash-flow, but with only limited growth options. In that sense, they perfectly fulfil their role within client portfolios, notwithstanding recent falls in their share prices.

In terms of the broader market weakness, we do not necessarily expect any immediate or rapid change in fortunes. While the Australian economy remains firmly stuck in second gear, with a high level of political uncertainty and little vision or leadership on both sides of the political divide, rapid gains on the share market remain a low probability. Rather, in our view, a carefully constructed investment portfolio, with exposures to a range of asset classes, remains the most appropriate means to achieving your financial objectives.

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)	1.9% (Dec)	+0.1%
Australian unemployment rate	5.6% (Feb)	+0.2%
RBA Cash rate	1.50%	-
ASX 200 Index	5,759	-408 points
Australian $ vs. US $	$0.7665	-1.35 c
Australian $ vs. UK £	$0.5444	-3.53c
Australian $ vs. Euro €	$0.6217	-3.13c

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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