POINTS OF **INTEREST**

Issue 24

Spring 2018

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we provide a global economic update, considering the risks posed by rising interest rates in the United States. We also discuss the performance of the stock market over the past quarter.

EXECUTIVE SUMMARY

- **The major factor impacting global financial markets are rising bond yields in the United States.**
- **Bond market investors are concerned over the risks of rising inflation, driven by President Trump's trade war and the strength of the US economy.**
- **An inverted bond yield curve is possible, which has historically presaged a recession.**
- **The stock market fell by just over 1% in the past quarter, with the annual reporting season providing little reason for confidence.**

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ECONOMIC UPDATE

The global and domestic economic environment is best described as 'delicate', with both positive and negative factors playing a significant role in determining the longer-term trend. We discuss a number of these key issues below.

Of the major factors which are relevant to the state of the global economy, perhaps the most significant is the direction of interest rates in the United States. It was US-based political commentator, James Carville, who said *"I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market"*. Carville's point was that the bond market, which effectively sets the cost of money for individuals, companies and entire countries, was more powerful and intimidating than even the US President.

The power of the bond market was evident in the European sovereign debt crisis of the past few years, which reached a crescendo in 2012. At that time, the reluctance of bond market investors to invest in Greek government debt meant that the Greek government effectively had to pay an interest rate of nearly 50% in order to compensate investors for the perceived risk of holding Greek debt. In June 2005, in comparison, the Greek government was borrowing at only 3.21%, yet only seven years later the same debt was viewed as worse than 'junk' status. In order to assuage bond investors' fears, the Greek government was forced to embark upon its now notorious austerity measures – massive public sector job losses, wage cuts, pension cuts, government spending cuts, widespread privatisations and across the board increases in taxes. In effect, the radical remaking of an entire country was a direct result of the bond market – this is the power that James Carville so dearly wished to be bestowed with upon reincarnation.

The power of the bond market is expressed through the rise or fall of bond yields. The bond yield is effectively the interest rate which bond investors demand as compensation for the risk of investing in a particular bond. The higher the perceived risk, the higher the required yield. So, the Australian government, for example, as one of only 10 countries in the world to hold AAA-rated status with all three major ratings companies, can borrow at around 2.75% on a 10-year basis. If we considered a country such as Nigeria however, which would be considered a riskier investment proposition on nearly all benchmarks, the government there has to pay an interest rate of 15.12% on a 10-year bond. Responsible, well-organised and well-behaved borrowers are rewarded with attractive lending rates; untrustworthy or unreliable borrowers must pay a much higher rate – through this mechanism the bond market exerts its power.

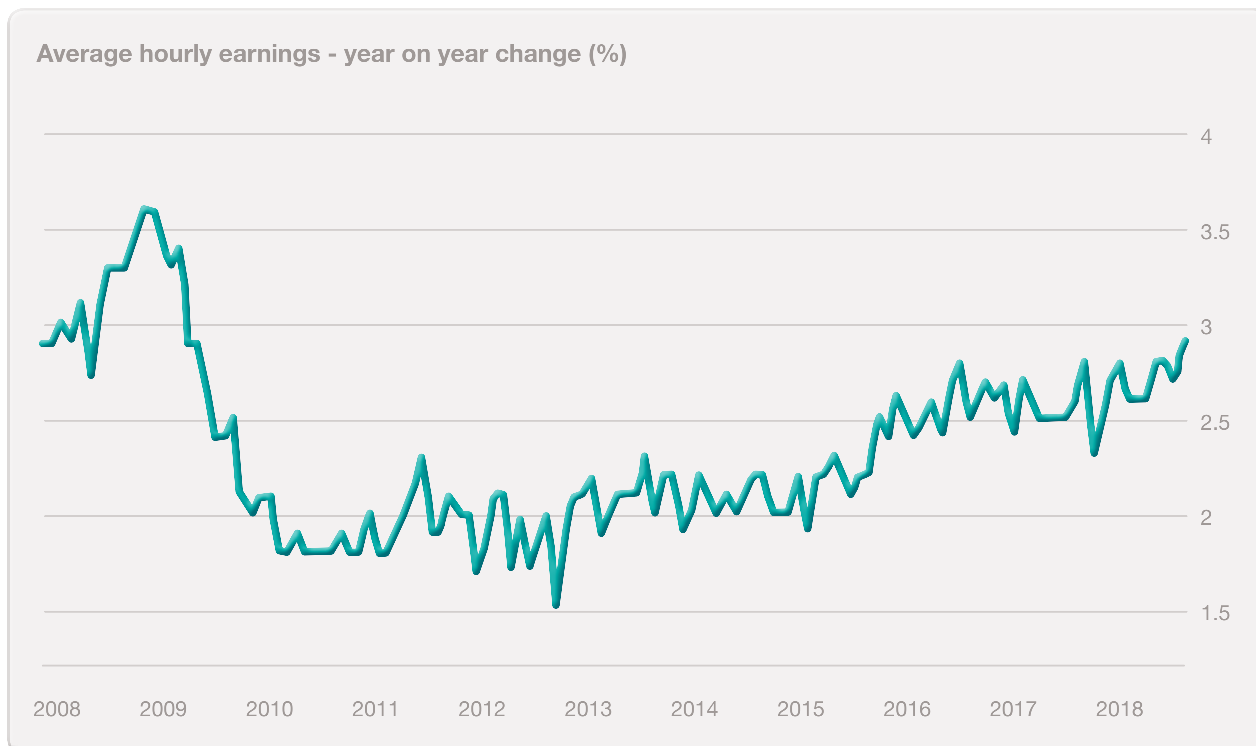
The reason why bond yields matter, is that the prevailing bond yields influence the level of domestic interest rates. In Australia's case for example, the government borrows at 2.75%; would-be homeowners take out a mortgage of around 4.25%; small businesses borrow at around 7% and a personal car loan might cost you around 8% or 9%. If we consider Nigeria again, the government borrows at 15.12%, while a mortgage on a home in Lagos for a borrower with less than a 20% deposit would attract an interest rate of around 22%. As a generalisation, the lower the bond yield the better, as this means correspondingly lower interest rates throughout the economy.

At present global financial markets are closely watching US government bond yields, which have been steadily rising in recent years. The chart below shows the yield on the US government 10-year bond over the past five years. After reaching a low of less than 1.50% in mid-2016, the yield has increased steadily, now sitting a little below 3.25%. In effect, the cost of money in the United States has more than doubled in just over two years.

There are a number of reasons why bond yields have increased in recent years. One of the main causes is investor expectations (or fears) of rising inflation. Bond investors are typically very sensitive to changes in inflation rates – rising inflation erodes the purchasing power of the fixed interest payments made to bond holders. Bond investors naturally demand a higher return when prices begin to rise, which translates into a higher bond yield.

Since the global financial crisis, the US economy has steadily improved, to the point where there is now a very real risk of overheating. Paradoxically, for any economy, too much growth can be just as bad as too little growth, and the US economy is starting to show signs of over-reach. This is best illustrated by consideration of wages growth in the US. In a strongly growing economy, wages will increase as employers are forced to compete to attract staff from an ever-dwindling pool of potential employees. If employers are forced to offer higher wages, these additional costs are typically recouped through an increase in the price of the goods or services provided by the company. Through this process, prices throughout the economy will begin to rise, evident in a pick-up in the headline inflation rate.

The chart on the next page shows the year on year change in average hourly earnings in the US over the past decade. The impact of the GFC is quite clear, where the recession (and surge in unemployment) impacted wages growth; however, it is the steady increase in wages growth over the past years which is important. This reflects the economic recovery since the GFC and the accompanying fall in unemployment. Wage rises are not yet back to their pre-GFC levels, but at current trends that milestone will be reached reasonably soon.



An additional factor which is impacting inflation in the US, and thus the actions by bond market investors, are President Trump's trade policies. Trump has imposed tariffs on US$250 billion of goods imported from China and has threatened to target the remaining US$250 billion of imported goods. One of the obvious implications of a tariff is that it increases the price of the imported item. For example, washing machines imported from China attract a tariff of 20% on the first 1.2 million machines and a 50% tariff on all subsequent imported machines. An American who wants to buy a washing machine, will find that many of the available choices (being the imported models) are now 20% or even 50% more expensive.

In theory the price of a US-made washing machine should now be 20% cheaper than the imported models, but that assumes that the domestic manufacturer doesn't increase their prices. In reality, domestic manufacturers are likely to increase prices to a certain extent (say 10%), allowing them to increase both their profitability and market share. The average American out shopping for a new washing machine is thus likely to pay at least 10% more than they were prior to the implementation of tariffs. Replicated across the entire US$500 billion of imported Chinese goods and it's easy to anticipate the increase in inflation.

On a more longer-term basis, bond investors are also concerned about the implications of companies shifting production away from China in order to avoid the US tariffs. The relocation of a significant proportion of global manufacturing to China over the past decades is one of the reasons for generally benign global inflation rates in recent times. If that process begins to reverse (which is arguably one of the goals of Trump's tariffs) as companies shift their manufacturing back to the US to avoid the import tariffs, we should expect an environment of generally higher inflation as compared to past years. This would compound any sell-off on the bond market, pushing bonds yields and US interest rates higher.

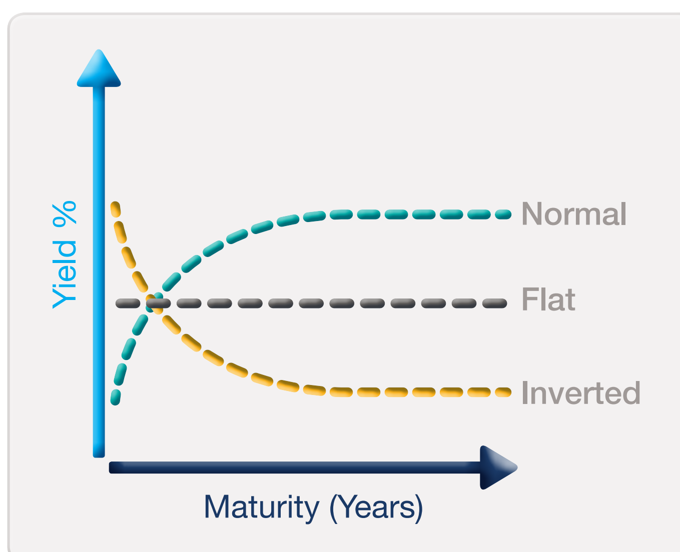
Why bond yields matter

As already discussed, rising bond yields have a direct impact on domestic borrowing costs. As the United States is still the world's most important economic power, changes in US interest rates can have a global impact. Australian banks, for example, source a large proportion of their funds from global capital markets. The cost of funding in these markets is influenced by US interest rates, as many of the lenders are US-based institutions. If the cost of money that Australian banks are borrowing from offshore is rising, this will require them to increase the interest rates which are subsequently paid by the bank's customers. In this manner, the monthly interest payment on a mortgage paid by a homeowner in Dubbo, is directly impacted by the expectations and demands of bond market investors in overseas capital markets.

As rising bond yields translate into higher domestic interest rates, the increased cost of credit has a negative impact on the rate of economic growth. A slower economy means reduced sales and lower profits for listed companies, which has an impact on the stock market. The cost of corporate debt is also higher, crimping company profits just as the weakening economy impacts sales. Therefore, rising bond yields are typically matched by falling share market prices, which explains much of the recent volatility (and losses) on global stock markets. For investors in nearly every asset class, be it shares, bonds or property, rising bond yields are usually a warning sign of lower future investment returns, particularly in the special case of the inverted yield curve.

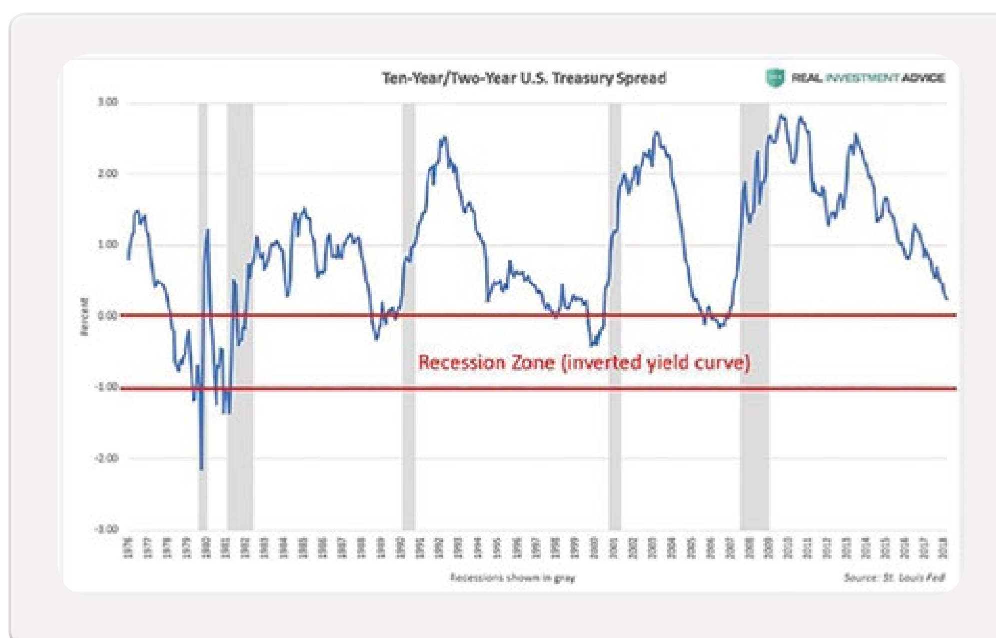
The inverted yield curve

Any discussion of bond yields is incomplete without consideration of the dreaded inverted yield curve. An inverted yield is where long-term debt instruments (a 10-year bond for example) have lower yields than short term debt instruments of the same quality. It is called 'inverted' as the normal situation is for longer term bonds to have a higher yield than shorter term bonds. This makes sense if you consider that a ten year loan is riskier than a two year loan – over a ten year period all manner of events might occur which could impact the ability of the borrower to pay the interest and principal on the loan. A two year loan, on the other hand, is short enough that one could be reasonably confident that nothing untoward might happen to impact the security of the investment. Therefore, short term bonds should have lower yields than long term bonds. The graphic below shows the relationship between bond yields and the time to maturity, with the three main types of yield curves.

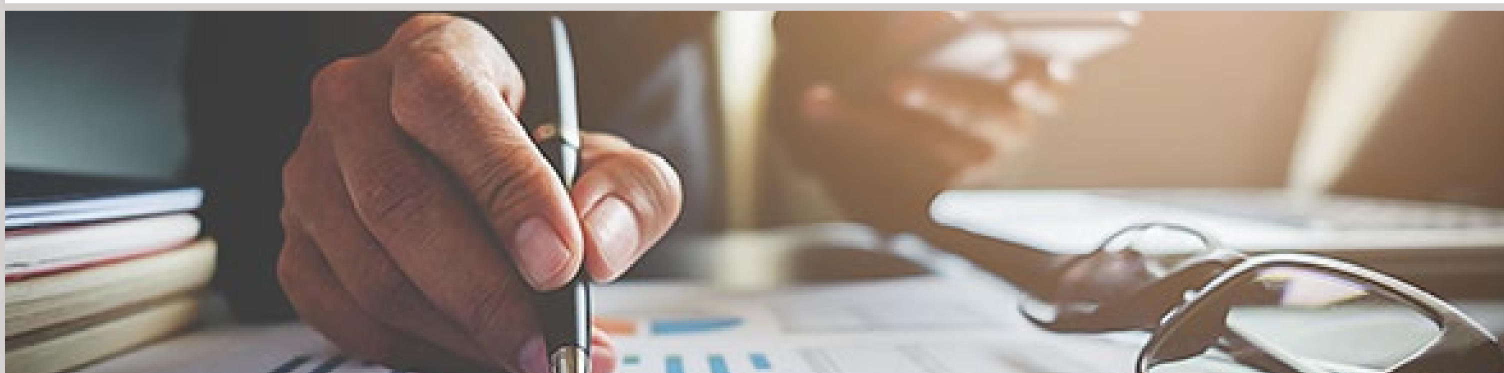


An inverted yield curve is special as it is a very reliable predictor of an impending recession. If bond investors expect interest rates to be lower in the future (as evidenced by lower yields on longer term bonds), it is because they expect weaker economic conditions in future, if not an outright recession. In fact, of the past seven recessions in the United States, an inverted yield curve appeared immediately prior to each of them, making it a far more reliable predictor of future recessions than most economists or financial commentators.

At the moment the US yield curve is perilously close to entering an inverted state. The yield on 2-year T-bills (US government debt) is 2.83%, while the yield on 10-year T-bills is only 3.15% and falling. Once the 10-year yield falls below the 2-year yield of 2.83% the yield curve is said to be inverted and the US economy likely to enter a recession in the near future. This is illustrated in the graphic below, which shows the possibility of an impending inverted yield curve.

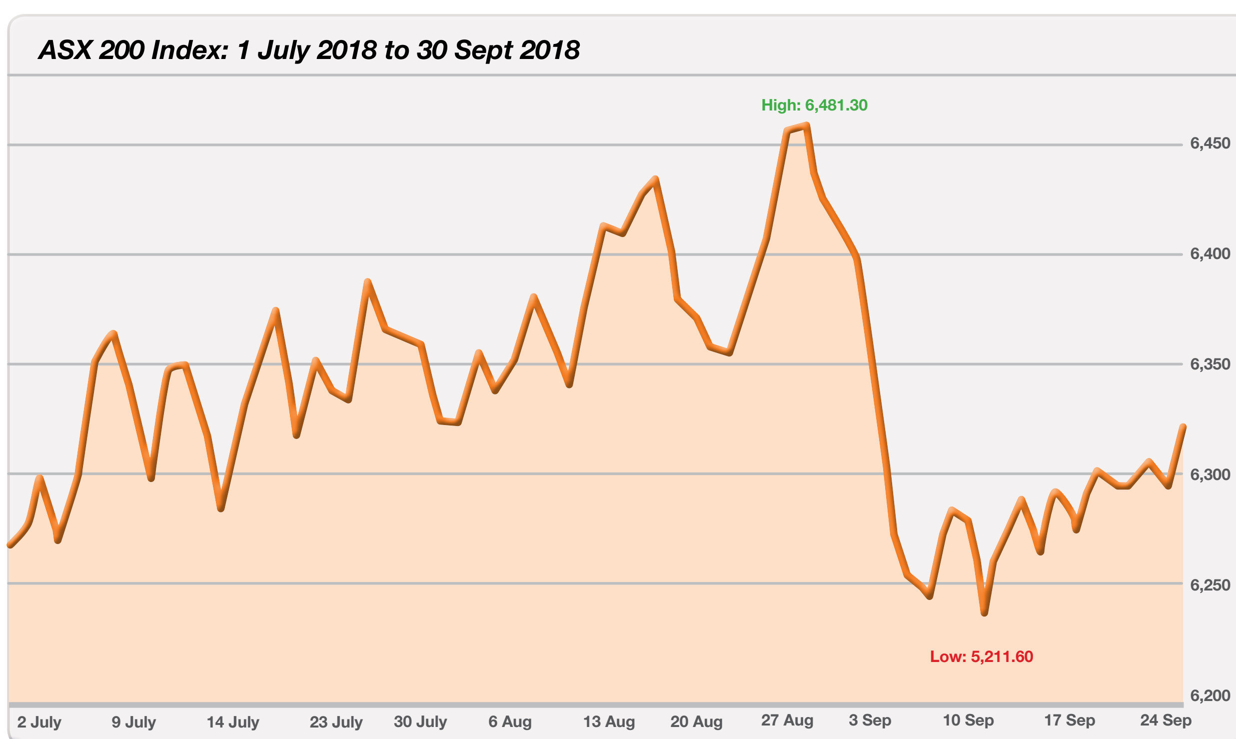


Although one should be careful of placing too much weight on just a handful of indicators, particularly in their use in making investment decisions, it is clear that rising bond yields and the possibility of an inverted yield curve are warning signs for investors. Consistent with our cautious outlook for investment returns over the immediate future, we believe that we may be entering a period where return ***of*** your investment capital may be the primary concern, never mind return ***on*** your capital.



THE STOCK MARKET OVER THE PAST QUARTER

The past three months were uninspiring insofar as equity investors were concerned. The benchmark ASX 200 Index opened the quarter at 6280 points and closed the quarter at 6207 points, a fall of 72 points or 1.16%. This masked a significant level of volatility however, with a wide variation in performance over the quarter, as shown below:



The market reached a post-GFC high of 6,481 at the end of August, which was the highest close since late 2007; a period of more than ten years. The gains could not be maintained however, with steep losses in the first week of September.

The past quarter was also notable as it included the reporting season for company results for the 2017/18 financial year. The impact of reported results on share prices can be extreme, with same-day gains or losses for even large companies sometimes being 10% or more. In most instances it is the management outlook which accompanies the financial results announcement which is of most interest to investors. Investors would naturally be keener to know what might happen to the business in the next 12 months, as opposed to an explanation of what happened in the preceding 12 months. Generally, unfortunately, company outlook statements were restrained, with much commentary around 'uncertain outlook' and 'subdued demand'. This continues a trend in recent years, where corporate profit growth has been uninspiring, outside of one or two sectors.

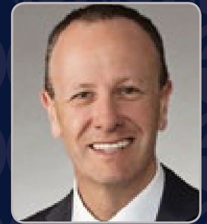
Other factors also impacted the market over the past quarter, of these the banking Royal Commission played a major role. It's fair to say that the impact of the Royal Commission (thus far), has been far more significant

than might have been expected. Even though Commissioner Kenneth Hayne has only just released his interim report, the impact of the Royal Commission is akin to a tsunami through the financial services industry. Careers have been ended, businesses have been shut down and whole sectors of the financial services industry have been rendered unviable. The big four banks have been severely impacted and face the prospect of dealing with a number of class action lawsuits in relation to their actions. All of the banks will be spending significant amounts of money on legal and compliance related matters as a result of the Royal Commission.

While it is undoubtedly appropriate that light is shed on the worst of the financial services sector, there are certain unwelcome consequences. Chief among these is the impact of the Royal Commission on the availability of credit. That is, the Royal Commission has scared the banks to the point where their willingness to lend money has almost entirely evaporated, due to the risk of being seen to make inappropriate loans. The Royal Commission is unfortunately pursuing a path where a borrower's inability to service a debt is seen as the bank's fault, and not the fault of the borrower. While there certainly have been situations where the banks and other lenders have inappropriately lent money to borrowers who were not in a position to service the debt, such situations are more the exception than the rule. Regardless, the response of the banks has been to tighten lending standards to the point where the restriction of credit now poses a threat to the economy.

For equity investors in general, the past ten years have been difficult ones. The stock market is yet to regain the highs reached prior to the GFC and volatility has been elevated in recent years. The risks to financial markets are growing and asset prices are vulnerable to a significant correction. At this stage in the investment cycle, we believe that a prudent approach to capital preservation and management of the downside risks is the most appropriate approach.

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)	2.1% (Jun)	+0.2%
Australian unemployment rate	5.3% (Aug)	-0.1%
RBA Cash rate	1.50%	-
ASX 200 Index	6,207	-72 points
Australian $ vs. US $	$0.7222	-1.69c
Australian $ vs. UK £	$0.5519	-1.44c
Australian $ vs. Euro €	$0.6200	-1.15c

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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