POINTS OF **INTEREST**

Issue 27

Winter 2019

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the continuing strong growth of the Australian stock market, which benefitted from falling interest rates and the passage of the Federal election.

EXECUTIVE **SUMMARY**

- **The stock market continued its positive run which started in January, with the most recent three months taking the return for the first half of 2019 to around 18%.**
- **Markets benefitted from the actions of both the Fed and the RBA, while the outcome of the Federal election was also positive for some sectors of the market.**
- **Global issues, such as the ongoing trade dispute, continue to pose the greatest risk to returns over the remainder of 2019.**

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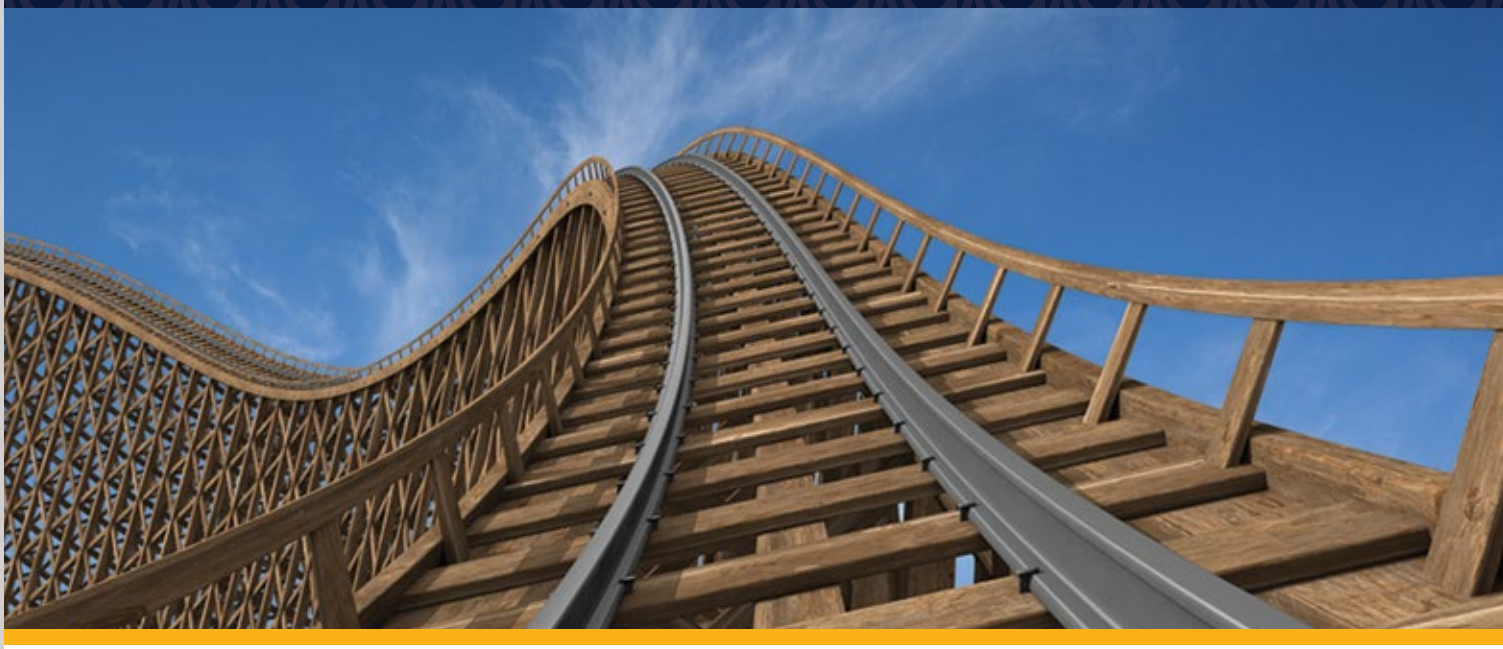


An eventful quarter

For investors, the past few months have proved to be both highly profitable and eventful. The stock market continued to build on the gains recorded during the first three months of the year, while passage of the Federal election and a recent cut in interest rates both contributed towards the positive market sentiment.

Of the many periods which have earned the epithet 'A year of two halves', perhaps no period has been more deserving than the past 12 months. In true rollercoaster fashion, over the past year investors have experienced both the highs and lows which can accompany investing. This volatility is clearly illustrated in the ASX All Ords Index chart for the 2018/19 financial year:

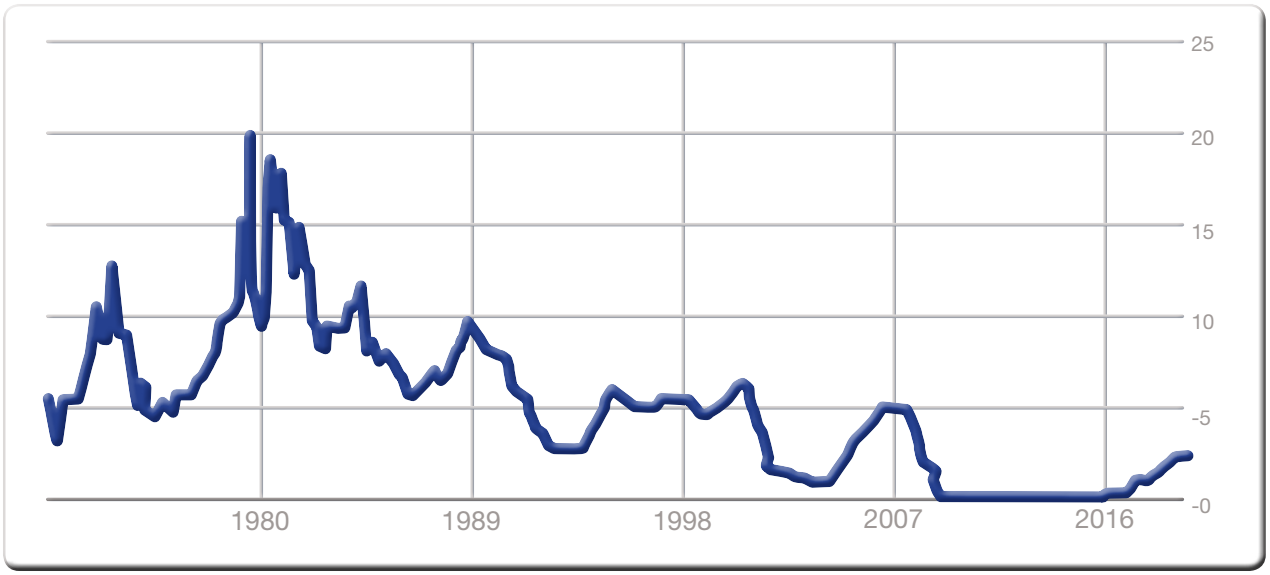
Forming an almost perfect 'V' shape, the market performed poorly in the final six months of 2018, before rallying strongly all through the first six months of 2019. Due to the weak three months at the end of 2018, the total return for the 2018/19 financial year was only around 7.14% (excluding dividends), even though the second half of the period managed an increase of 14.69%. As we write, the market is within a whisker of regaining its all-time high, set prior to the global financial crisis in late 2007.

The reasons behind the stock market's rapid reversal from December to June can be largely explained by three main factors: the direction of interest rates in the United States, the direction of interest rates in Australia; and the outcome of the Federal election in May. We discuss each of these in greater detail below.

Interest rates in the United States

By far the most significant global macroeconomic development over the past year has been the apparent back-tracking on interest rates by the US Federal Reserve (the 'Fed'). In December 2018, in a move that was welcomed by the Commander in Tweet, President Trump, the Fed indicated that they were done with hiking interest rates and the next move in rates might well be down. This abrupt turn-around came as something of a surprise to financial markets, who had largely expected the Fed to continue to 'normalise' interest rates, albeit perhaps at a slower pace. Essentially, the Fed declared that the current tightening cycle had come to an end, with interest rates peaking at 2.50%.

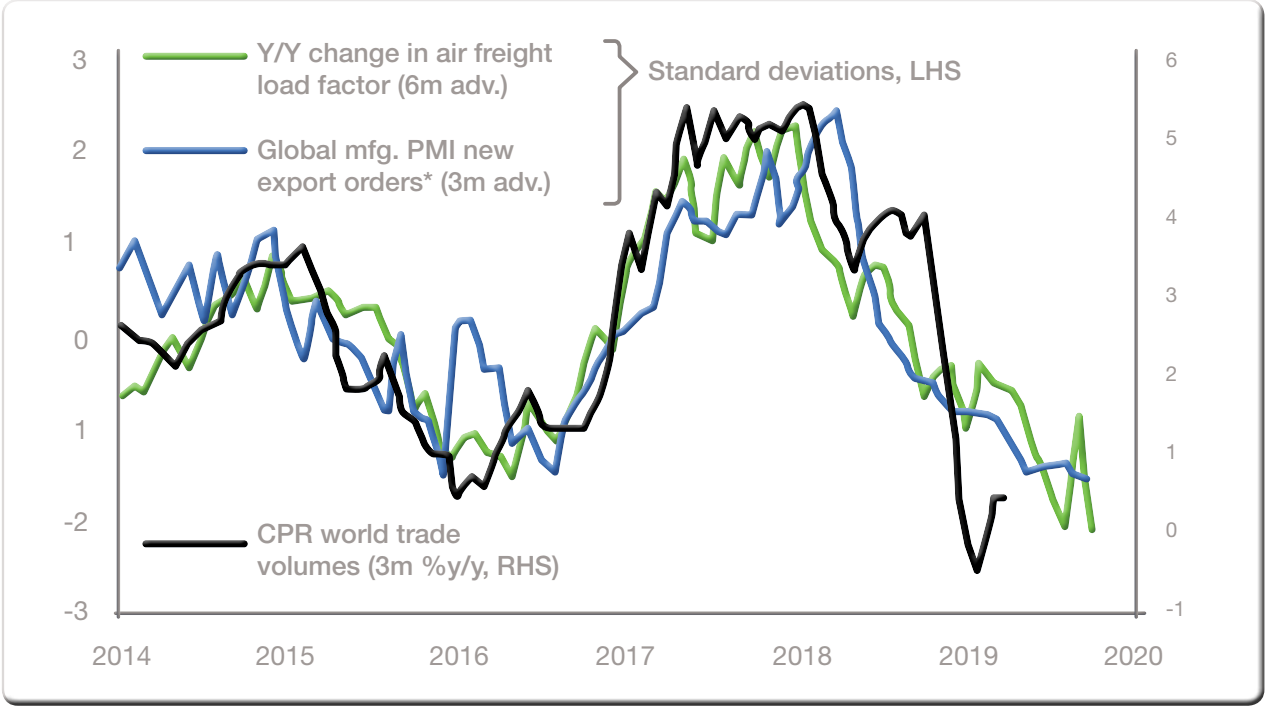
As shown in the chart below, if 2.50% did represent the height of the current rate tightening cycle, then it was a very low high indeed.



In consideration of US interest rate cycles, the top of each previous tightening cycle has tended to be considerably higher than 2.50%, usually around 5% in previous cycles and even higher in the 1970's and 1980's where interest rates were generally higher. The major concern of course, is that if interest rates have peaked at 2.50%, there is very little room for the Fed to cut rates to stimulate the economy, if this was required. The Fed's fear is that should the US economy begin to slow, then there is very little support they can provide through lowering interest rates, if they are starting from a relatively low level anyway. This fear is not confined to just the US Fed; here in Australia the RBA has been very keen to try and get interest rates to a high enough level which gives them some ammunition in the event of an economic slowdown (although as we discuss in the next section, it appears that the slowdown has arrived before the RBA could get rates to where they wanted).

Regardless of the US Fed's desire for higher interest rates, they have now conceded that interest rates are more than likely to be lowered, rather than increased. The Fed seems to have changed its views on the future direction of interest rates for two reasons: firstly, there is evidence that the trade war, principally between the US and China (although the European Union and other countries such as Mexico and Canada have also been targeted), has started to negatively impact the US economy.

The chart below shows the impact of the trade dispute on global trade. The black line represents world trade volumes, while the green line represents air freight load factors (effectively a measure of the available capacity of airline freight capabilities). In both cases, a falling chart is negative, indicating a reduction in the level of freight carried by air and the total volume of goods traded globally. The decline, which commenced in early 2018, coincides with the escalation of the trade dispute between the US and China.



The second reason the US Fed has reversed its earlier view that interest rates would be increasing, is based on the now global phenomenon of benign inflation. That is, one of the Fed's tasks is to ensure price stability (keep inflation under control). At the moment however, despite a near record unemployment rate of just 3.6%, there is little sign of inflation in the US economy, with the annual inflation rate sitting at just 1.8%. The Fed is now concerned that the inflation rate is too low and any further increases in interest rates would act to depress inflationary tendencies even further. Just as too much inflation should be avoided, too little inflation is also a problem (the ideal rate of inflation is a bit like Goldilocks' perfect porridge; neither too hot nor too cold).

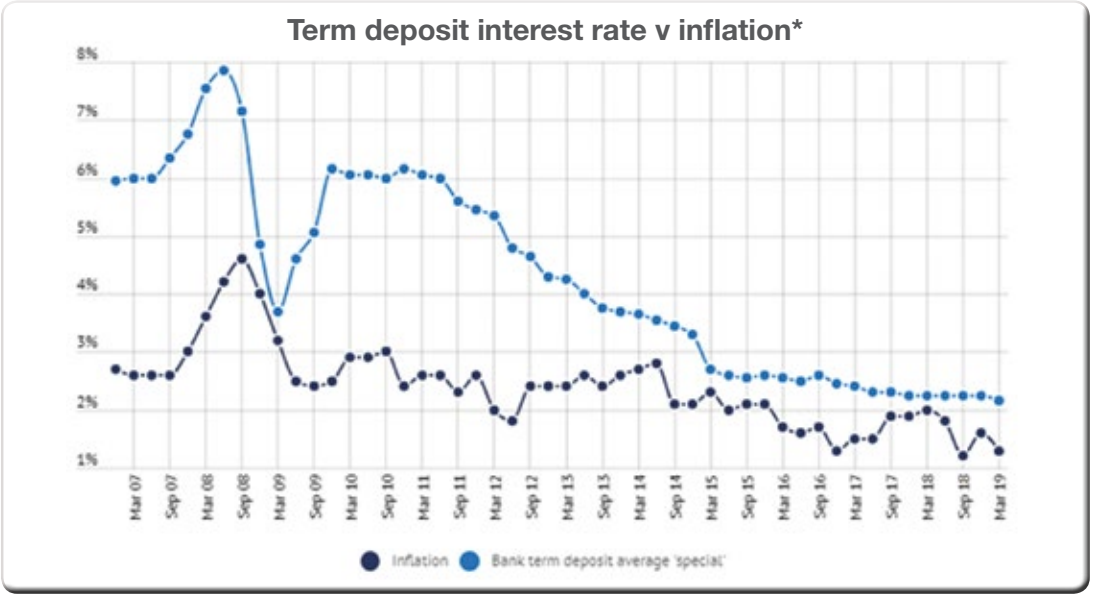
Indications from the Fed that interest rates have peaked provided fresh impetus to the stock market, where lower interest rates are typically seen as beneficial to the companies which comprise the stock market. This largely explains the stock market gains over the past few months.

Interest rates in Australia

In a very similar situation to that of the United States, actions by the RBA contributed to a strong performance by the stock market over the last few months of the financial year. The RBA has now cut interest rates twice, with the cash rate sitting at a record low of 1.00%. Clients who borrowed money in the 1980's and early 1990's may find it hard to believe that you can take out a mortgage today on an interest rate of around 2.99%, a far cry from the levels of around 19.00% back in 1989.

While the decision by the RBA to cut interest rates has also had a positive impact on the stock market, the reasons behind the RBA's decision are different to those in the United States. Unlike the US, interest rates are being lowered in Australia in an effort to kickstart our moribund economy, which has not managed to get out of second gear for much of the past decade. In Australia, unemployment is rising, economic growth is slowing and inflation is falling – all classics signs of recessionary conditions. The RBA itself has acknowledged that interest rates alone cannot get the economy moving again – they know that if a cash rate of 1.50% was not enough to stimulate the economy, cutting it to 1.00% is unlikely to be sufficient to do so either. RBA Governor Philip Lowe has quite openly requested that the Federal government implements the structural reforms that many believe are necessary to allow the economy to grow at a meaningful rate.

Nevertheless, the one direct beneficiary of recent interest rate cuts has been the stock market. As rates on interest bearing investments such as term deposits and bank accounts reach ever lower levels (a 12-month term deposit at the Commonwealth Bank for example, is advertised at 1.90%), the potential of a higher return from stock market investments becomes harder to resist. Falling interest rates effectively 'push' money away from bank deposits and term deposits and into the stock market, pushing up prices for shares. The real return (that is, your return after taking into account the impact of inflation) for those investors who prefer term deposits is close to zero. This is illustrated in the chart below, which compares average bank term deposit rates with the rate of inflation. The low interest rates offered on cash are essentially eroding the value of the asset over time, which is one of the reasons behind the flood of money into the stock market.



From our perspective however, the phenomenon of lower interest rates pushing up share prices is not always a welcome one. In essence, by lowering interest rates to such low levels, the RBA is artificially inflating share prices (and property prices and in fact the prices for any other investable asset). An increase in share prices should ideally be a reflection of an anticipated increase in company profits – that is, if investors expect a company will increase its profits in coming years, they would be willing to pay more for the shares now. At the moment, across most sectors of the economy, company profit growth is low or close to zero, which is simply a reflection of the weak state of the economy. In such an environment, company share price growth should be relatively modest, as to be expected when future profit growth is expected to be low. In terms of the current stock market environment however, that has not been the case, with the ASX 200 index up some 18.23% since the start of 2019.

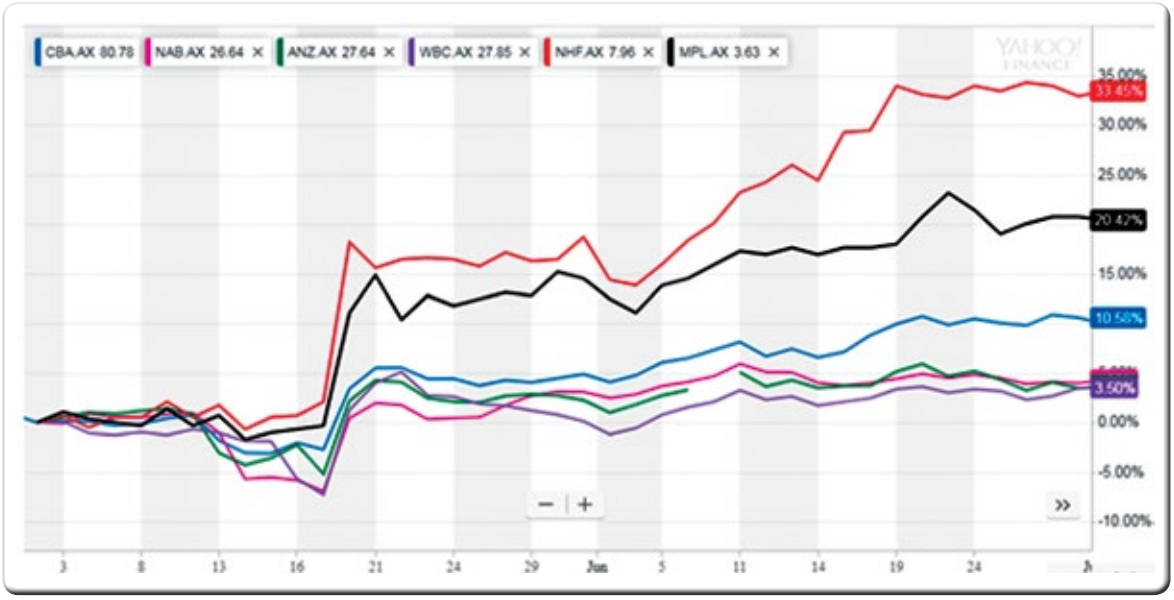
The other factor to consider is that interest rates are not a one-way street. Although we appear to be as far away as ever from higher 'normal' interest rates, there will come a day when interest rates begin to increase and the relationship between falling interest rates and a rising stock market will reverse.

The Federal Election

Although the outcome of the Federal election in May would only have pleased around half of the country's population, the stock market benefited from the result. The re-election of the Morrison government was seen as a favourable outcome for a number of key sectors within the economy. The main beneficiary, measured purely in terms of share price appreciation on the Monday following the election, were the private health insurers. Labor's proposed policy to cap private health insurance premium increases at 2% for two years was now off the table, which resulted in large gains for the health insurers. NIB finished the day up around 18% while competitor Medibank Private also performed well, gaining around 14%. Other health related companies, such as Ramsay Healthcare (private hospitals) also benefited from the result, with Ramsay up around $5.00 per share, or nearly 10%.

The large banks also rallied strongly on the day after the election result was known, not for any particular reason other than that a Coalition government tends to be viewed as being less hard on the banks (notwithstanding that it was then-Treasurer Scott Morrison who in 2017 announced the new bank levy that would apply to the big four banks only, in what really should have been called an unpopularity tax).

The increase in the share prices, following the election, of the private health insurers, private hospital operators and banks, is shown in the chart below. Note the significant increase in share prices on the 20th of May.



It is rare for the outcome of any election to have such an impact on the stock market and certainly any investors with exposure to the afore-mentioned list of companies would be pleased with the resulting returns. The other aspect to the election is that it does highlight the very high level of regulatory risk which investors must manage in the current political environment. Although the risk of adverse government laws and decisions has always been present, there is the sense that the current climate, for whatever reason, presents a higher level of risk than previous years.

This may be due to a number of factors; perhaps the general focus on short-term policymaking, the over-reliance on internal and external polling, an increased level of lobbying by special-interest groups and their supporters or perhaps just the ever-increasing role of government in day-to-day life. Regardless, the cost of being on the wrong side of an adverse regulatory decision has never been higher and one which is increasingly difficult to avoid.

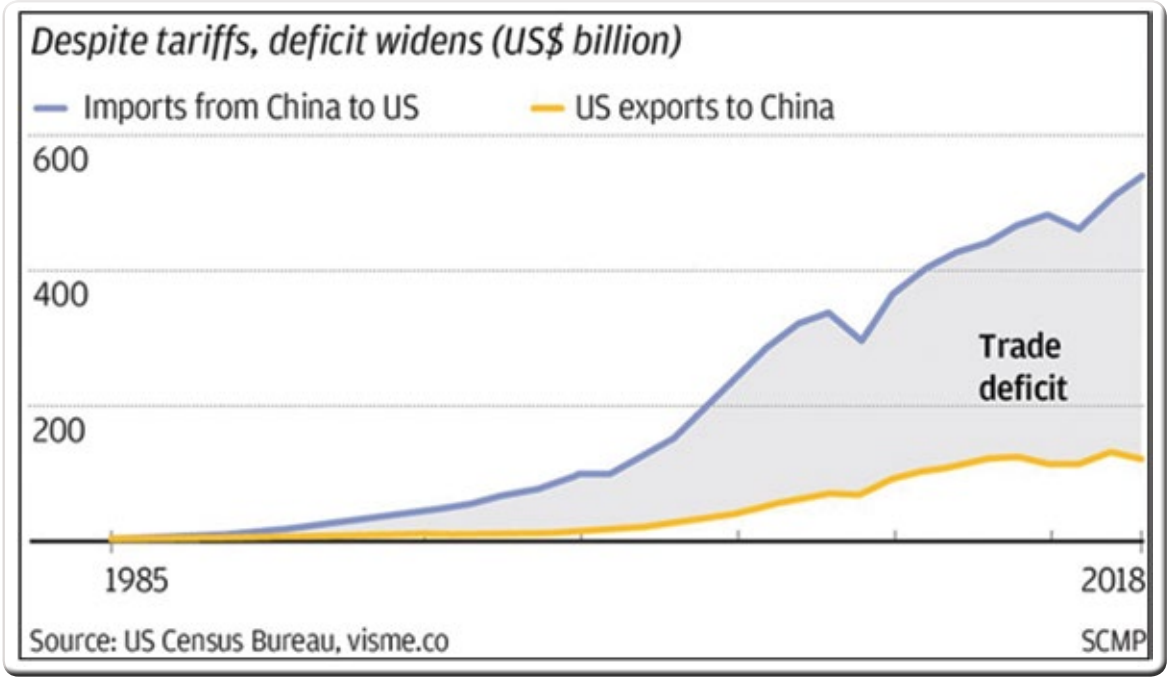
Looking ahead to the rest of 2019

Given the significant gains recorded by the local stock market over the first six months of the year, it would usually be difficult to see meaningful upside over the remaining six months. That view however, may not apply in the current environment. There is a saying in investing, which is 'Don't fight the Fed'. This means that investors do best when they invest in a way which aligns with the monetary policy of the Fed. That is, if the Fed is cutting interest rates, you should be buying shares, and if the Fed is increasing interest rates, you should be selling shares. While the US Fed certainly carries more global clout than our RBA, the same statement also applies here in Australia. The RBA is expected to cut rates even further through 2019 (some economists have picked 0.50% as the eventual cash rate), and this will continue to provide support for the equity market, as we have already discussed in the previous section.

That said, in the long run, share prices must eventually reflect the health of the underlying business and the broader economy and at some stage we will need to see company profit growth increase to a level that justifies higher share prices. The alternative of course, is a fall in share prices that justifies lower profit levels. The upcoming profit results season, where companies release their financial results for the first six months of 2019, will give us a clearer indication of the true financial health of corporate Australia.

The direction of the stock market for the remainder of the year will also be determined by the successful resolution (or otherwise) of a number of the current global issues. Most important of these is the ongoing trade war between the United States and China. At a much-anticipated meeting in Osaka, as part of the G-20 get-together, Trump and Xi agreed to hold off on new tariffs and restart negotiations over the trade issue. While there was no deal and certainly no actual progress in terms of ending the dispute, the two sides are at least talking again, which is an obvious requirement towards any eventual deal. In our view, the real problem is that there is no way for both leaders to emerge victorious from the current conflict, which reduces the odds of an eventual deal.

In fact, since the commencement of the trade war, the trade imbalance between the United States and China has worsened, not improved. This is quite understandable, as the US economy is growing strongly, which means that there is an increasing demand for Chinese-made goods. Trump's actions to stimulate the US economy are at the same time undermining his efforts to reduce the trade imbalance. A US recession would do the trick of narrowing the trade deficit, but it's unlikely Trump wants one of those so close to his re-election campaign.



The general view is that the global economy is heading for a period of relatively slow growth, with the trade tensions just another headwind. Central banks in the United States, Europe and other countries (Australia included), can be expected to respond appropriately, through lowering interest rates and in some cases, quantitative easing.

However, after the strong gains recorded by the market over the past six months, it is difficult to foresee another six months of similar returns. As a result, our investment approach over the remainder of the year will remain focused on ensuring portfolios retain exposure to high-quality businesses, with appropriate levels of risk.

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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% (Mar)	-0.5%
Australian unemployment rate	5.2% (May)	+0.2%
RBA Cash rate	1.00% (July meeting)	-0.50%
ASX 200 Index	6,618	+438 points
Australian $ vs. US $	$0.7013	-0.74c
Australian $ vs. UK £	$0.5535	+1.13c
Australian $ vs. Euro €	$0.6171	-1.39c

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