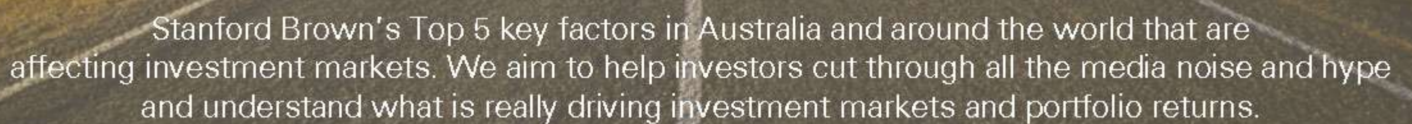
(STANFORD BROWN)
Financial Advisers

Stanford Brown Monthly Top 5

MARCH 2018

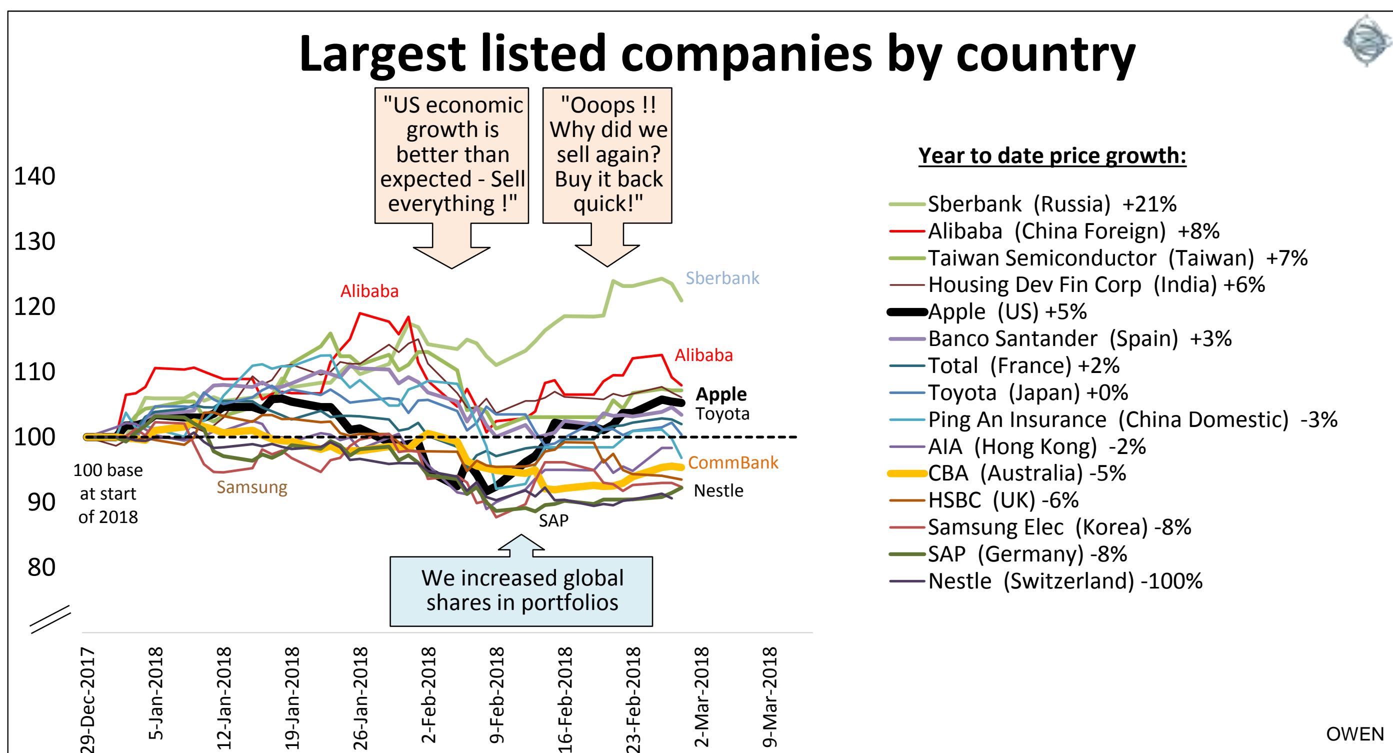

Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.

1 The Return of 'Volatility' (or just knee-jerk reactions?)

The main headline-grabbing event during the past month was a bullish report on US wages on Friday 2nd February which provided evidence that the US economic growth may be stronger than many people expected. This triggered a 4% sell-off in US shares on the next trading day - Monday 5th. It was the largest 1-day sell-off since the US downgrade crisis in August 2011. The 4% fall on the 5th February after the wages report triggered a wave of knee-jerk selling around the world as each market opened on the 6th. Australia followed the US panic selling without thinking – as usual.

As we wrote at the time, the panic selling made no sense at all – in either the US or in other markets. Stronger US growth should be good news for just about everything – better growth, more investment, more jobs, higher wages, increased spending, higher company revenues, profits and dividends. But it also means that interest rate hikes may have to be stepped up a little to counter the inflationary pressures. Interest rates in the US were zero from the Lehman bankruptcy in 2008 up to December 2015; they are now 1.5% and heading higher to perhaps 4% or more. The only question is the pace, and the wages report suggested that it might speed up a little. That was what triggered the panic selling.

The chart shows share prices of the largest listed company in 15 countries (plus Australia) – all off a common base of 100 at the start of the year. This is more tangible than the usual chart of country indexes, as most of the leading companies in each country are household names – Apple (US), Toyota (Japan), Samsung (Korea), Nestle (Switzerland), HSBC (UK), etc.



Everything was sold off following the US lead in the 2nd week of February. Then everything suddenly turned up again in the 3rd and 4th week as the sellers realised there was no reason to panic after all, and they scrambled to get back in again.

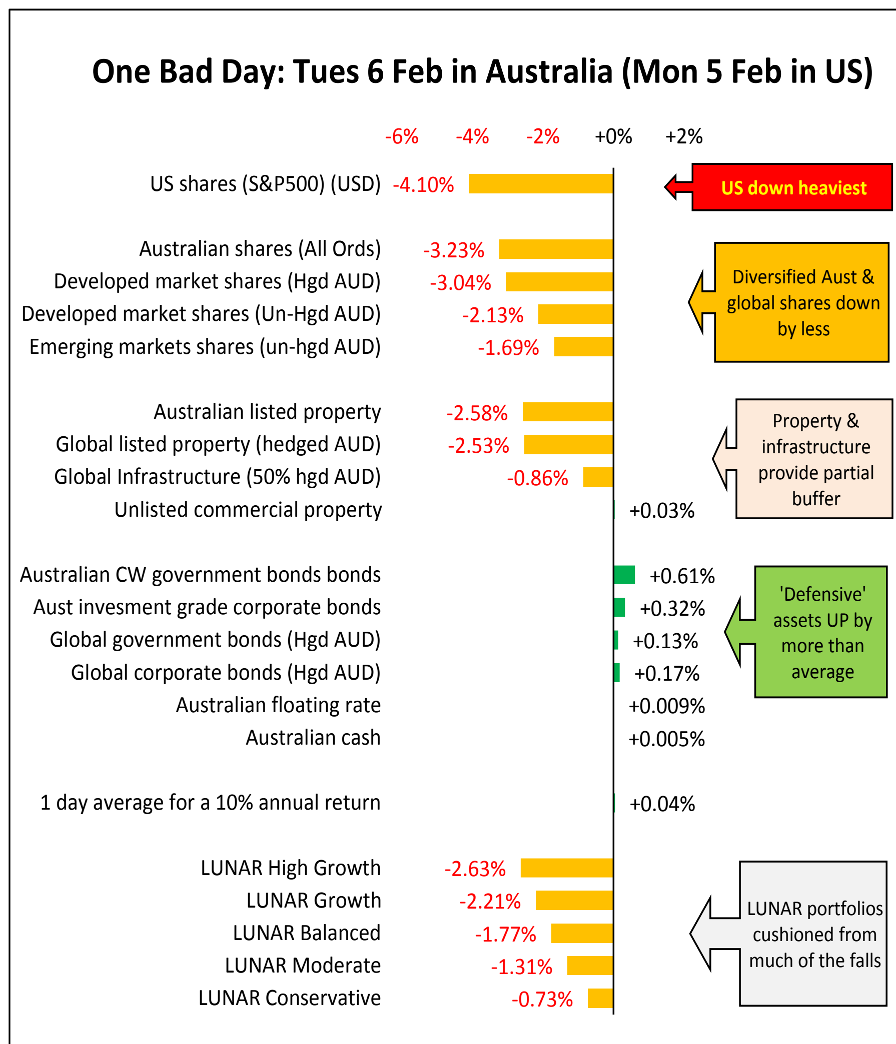
We did not sell in the general panic. We didn't panic sell after the 'Brexit' vote in June 2016, nor after the Trump election in November 2016 (we increased shares in portfolios after Trump). Rather than selling in the latest bout of panic, instead we increased global shares in portfolios in the week commencing the 12th Feb while share prices were down.

We have written many times that rising inflation and interest rates are generally good for shares – as long as inflation and interest rates are low or moderate (below around 5%). What is bad for shares is when inflation and interest rates are high (above 5% or so). The US and the world are a long way from runaway inflation just yet.

2 Headline falls -v- portfolio returns

While stock market sell-offs make for great headlines, newspaper sales and online chatter, investors should ignore the media noise and focus instead on what it means for their overall portfolios. Easier said than done! The latest bout of panic selling in early February led to the usual increase in phone calls and emails from investors asking if this was 'The Big One' (like the GFC or 1987 crash, etc) and whether it was time to 'get out and wait on the sidelines until things settle down'. While this sounds like a good idea at the time it inevitably leads to selling low (when market are volatile) and buying high (when markets are calm) – which is the exact opposite of what successful long term investors do.

Despite the big headline sell-off in US shares, actual investor portfolios were down by only a fraction of this. Below is a snapshot of what happened to asset class returns on the 5th (for US and European markets) and on the 6th (in Australia and Asia) – due to the 1 day lag as the panic swept around the world.



The top section shows that while the US stock market lost 4% on the worst day, most other developed and emerging markets were not hit as hard, so they did not make the headlines.

The block of positive green bars in the middle show how bond markets generated better than average positive returns for the day because bond yields fell as share prices fell.

Bonds are 'bumper bars' in portfolios as they generally provide a counter-balance when shares sell-off. They do this even when fears of rising inflation and interest rates are the cause of the problem – as was the case here.

This is completely illogical because if people were worried about higher growth and inflation, bonds should have sold off in the panic (yields should have risen, not fallen as they did). But bonds rallied as yields fell in the US on the 5th, and yields also fell in Europe when shares sold off on the 6th. Illogical, but markets are driven by emotional knew-jerk reactions, not rational logic!

The bottom section shows estimated returns for our diversified portfolios for that split day on 5th and 6th. For example our 'Balanced' portfolio contains 65% 'growth assets' but it was down by less than half of the headline 4% US fall on the day.

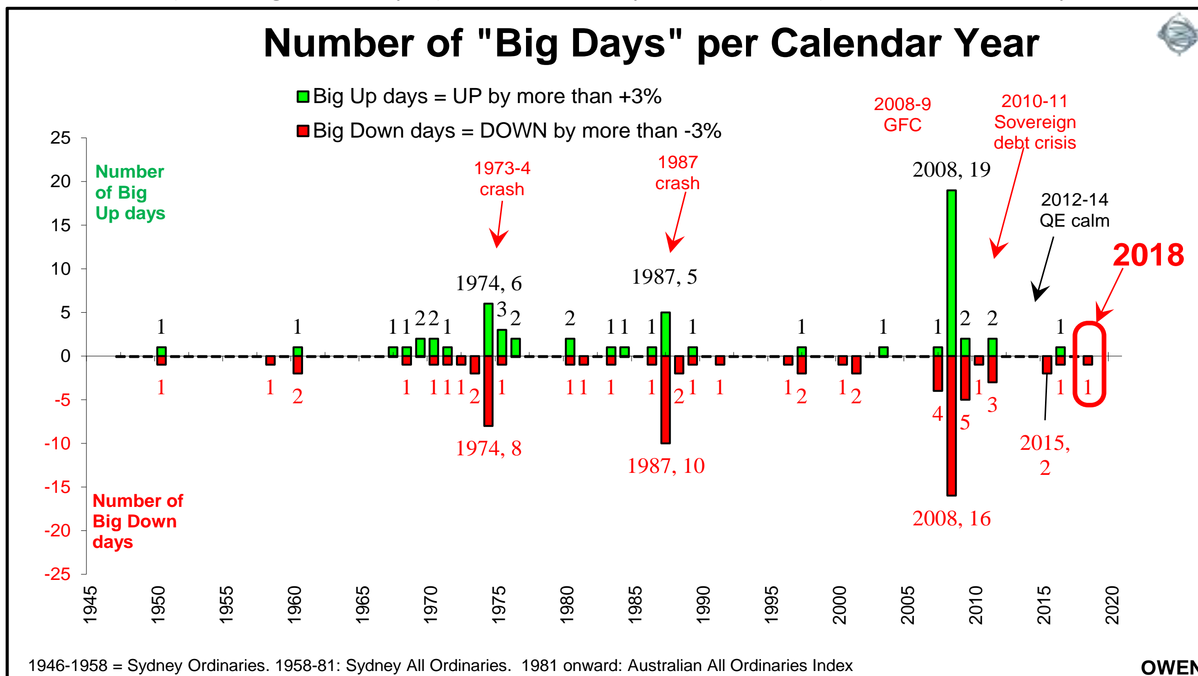
Although our portfolios were down for the critical day, they have all recovered to post positive returns for the year to date. The bottom line is that although our risk management processes monitor daily exposures and portfolio impacts, we are firmly focused on long term returns, avoiding panic selling in busts and panic buying in boom, but adjusting portfolios sensibly when opportunities arise.

3 'Volatility?' What volatility?

Ever since the very brief stock market sell-off in early February, media headlines everywhere have been ablaze with shock-horror stories about the return of 'volatility'. Stock markets (and all other including bonds, currencies, commodities, etc) here and in most other countries had been dead calm since the 2008-9 GFC and 2010-11 sovereign debt crisis. As usual the headlines are just another media beat-up to sell papers. As Mick Dundee would say: "That not volatility!"

There are many ways to measure volatility. The most often used measure is the so-called 'standard deviation'. It sounds impressive but anybody who knows how the maths works would understand how its numerous flaws make it almost meaningless when used in the way it is bandied about by most so-called 'experts'.

In addition to the usual theoretical measures of volatility I also use a range of more practical and meaningful measures. One simple measure is the number of 'big days' for the overall stock market, and we can set any threshold for what is a 'big day'. Here is a chart of the number of 'big up days' (defined here has days when the All Ordinaries index was up by more than 3%) and 'big down days' (All Ords down by more than 3%) – in each calendar year since WW2.



The first thing to observe is that the single 'bad day' we saw a few weeks ago was nothing compared to the numerous bad days that occurred during the big market sell-offs – notably in the 1973-4 crash, the 1987 crash and the 2008-9 GFC. In 2008-9 we had 21 days worse than -3%, including 11 worse than -4%, 4 worse than -5%, and 3 worse than -6%. Now THAT was volatility! These periods really tested one's discipline to keep a cool head and not get caught up in the market panic.

We can also see that periods of relative calm – with no big up or down days at all, like the 2012-4 QE calm - are relatively common. We have had similar multi-year periods of dead calm in each decade. Next we see that we have had one or two 'big down days' in around one third of all years (24 years out of the past 72 years). This includes 2015, 2016 and 2018.

We can also see that there are nearly as many 'big up days' as there are 'big down days'. Most of these big up days were in fact merely rebounds from the big down days. Whenever you get big down days, you also get big up days in the rebounds that follow. But big up days and rebounds don't make the headlines because they don't sell papers!

Financial markets have become more volatile over time – as markets and countries become more inter-connected, and as markets have become dominated by large, complex and heavily inter-connected institutions that are driven increasingly by short term gains and faster computers. Volatility will be higher in future, but the waters are still calm at present.

4 Australian company profits – recovering but no warning signs yet

The mostly commonly used measure of pricing of companies and overall indexes of companies is the 'price/earnings' ratio. They come in two main flavours: the 'trailing' p/e ratio (current price divided by the most recent year's published profits), and the 'forward' p/e ratio (current price divided by the estimated *next* year's profits). Both are riddled with problems.

The main problem with forward ratios is having to forecast next year's profits. Companies have very little idea about what next year's profit might be, and analysts have even less of a clue! Australian companies and analysts are notorious for over-estimating and then rapidly downgrading their forecasts as the year progresses. (It is the reverse for US companies).

'Trailing' p/e ratios should be better in theory because they are based on companies' published accounts. Unfortunately they are just as problematic because what is reported as 'profits' is a very rubbery concept. The current trailing p/e ratio for the overall Australian market is anywhere between 15.5 and 19 depending on what you count as actual 'profits'.

The other main problem with p/e ratios is what to do with the ratio you come up with. There is a common myth that a high p/e ratio (higher than say 20) means the market is 'expensive' and therefore likely to fall, and that a low p/e ratio (eg lower than say 15) means the market is 'cheap'. The problem is that low p/e ratios often mask chronic over-pricing right before busts (eg 2007 before the GFC sell-off), and high p/e ratios often occur right before strong rebounds (eg in 2009) because they focus on the 'price' and not the 'earnings'. In fact most of the major market sell-offs have occurred when p/e ratios were not high, including the 1987 crash, the 1929 crash and many others.

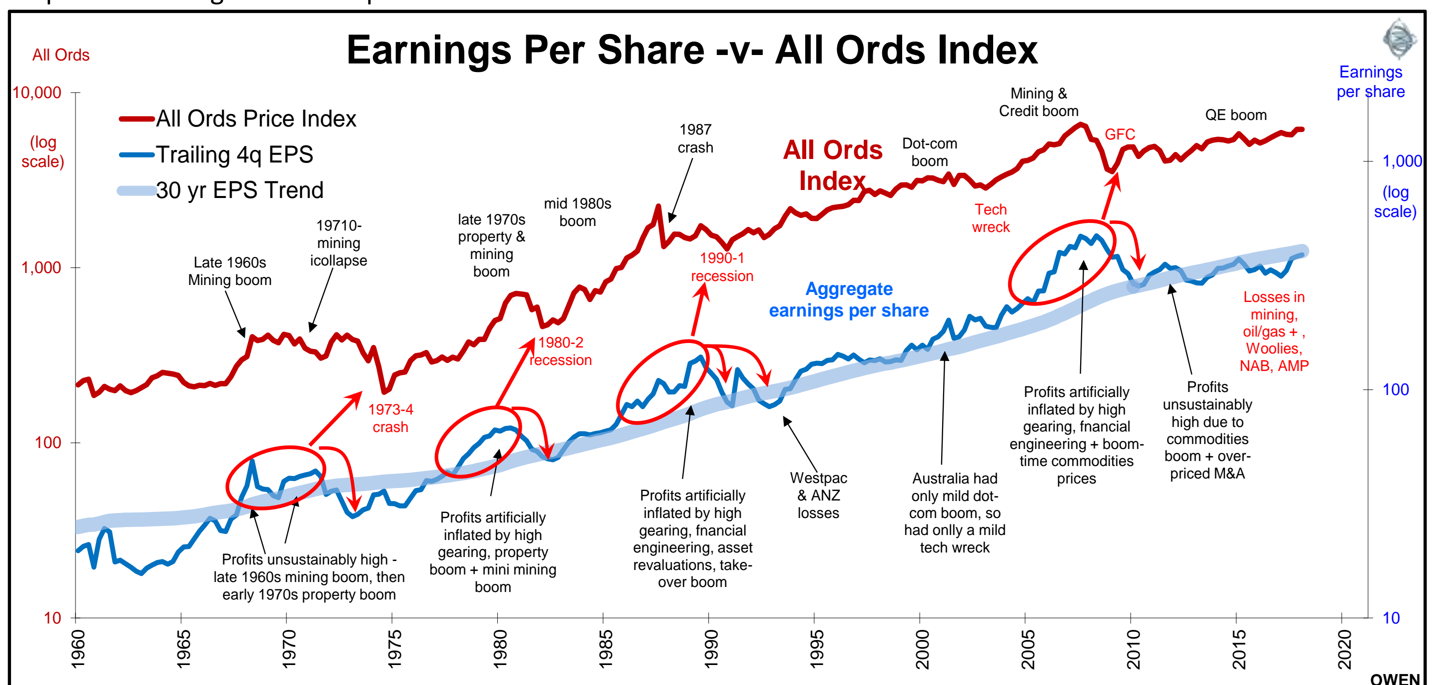
Ignoring the 'price' focuses the attention back on the 'earnings'

Our 'market earnings model' doesn't consider share prices at all but just looks at the level of aggregate company profits generated across the market. This model is particularly useful in identifying market bubbles even though it ignores prices.

Overall company earnings in a given market tend to rise with economic growth – driven in turn by population growth, inflation, productivity growth, export growth, etc. These fluctuate from time to time but in Australia (but not many other countries) they have remained on a reasonably consistent path by managing to avoid major internal wars and revolutions, and also maintaining relatively strong and stable political and administrative institutions.

If we ignore share prices and just look at what is reported as 'earnings' we see that whenever 'earnings' grow significantly above their long term trend it is unsustainable and snaps back in savage market sell-offs and economic contractions.

The following chart shows the last 60 years of cycles of artificially inflated and unsustainable earnings growth followed by collapses in earnings and share prices.



In Australia these regular cycles of unsustainably high earnings growth have been caused by gearing and financial engineering in two sectors – mining and property finance. Sometimes mining and property have boomed together but usually there is a mining boom first followed quickly by a property boom as mining profits are ploughed into property, always assisted by a lending boom. This has been the case since the great 1880s mining boom and late 1880s to early 1890s property boom which collapsed into the 1890s depression. This mining boom then property boom pattern has repeated several times over the past 140+ years right up to the recent mining boom and current property boom.

In each boom, the reported 'earnings' were artificially inflated by companies (and signed off by lazy conflicted auditors) – using a variety of techniques including accounting trickery, accelerating future revenues, deferring and/or capitalising expenses, hiding debt and expenses off balance sheet, inflating asset values, using excessive gearing, financial engineering and often straight-out accounting fraud. In every boom much of the so-called 'earnings' being reported turns out to be artificially inflated, unsustainable and soon disappear, triggering broad stock market collapses and economic slowdowns.

Whenever aggregate market-wide earnings (thin blue line in the chart) rise above the long term earnings growth trend (thick blue line) it is because of the same old culprits — usually in the same old sectors - mining and property.

The US market has the same pattern but their booms tend to be in new technology – including the railway booms in the 1800s, the car and radio boom in the 1920s, and the aerospace boom in the 1960s. Their biggest post-war bubble was in the 1990s 'dot com' boom. Australia did not have a big dot com boom and so we didn't suffer a big 'tech wreck' stock market crash and economic recession like the US. We are now in a US-led global smart phone boom.

On the other hand Australia had a bigger mining boom in the 2003-7 credit and mining boom plus a good dose of shenanigans, paper shuffling and straight out fraudulent accounting especially in commercial property and infrastructure. (Remember all of those artificial houses of cards miraculously created by paper-shuffling, artificially inflated valuations and layers of debt, engineered by the likes of Babcock & Brown, Alco, Record, Centro, Macquarie, ABC Learning, etc?). This all collapsed in the 2008-9 GFC. Our 'earnings model' shows that local stock market was heading for a crash after the 2003-7 artificial 'earnings' boom even without the help of the US sub-prime crisis.

Current position

Aggregate earnings fell in 2016 and 2017 when commodities prices collapsed in 2014-5 after the mining boom peaked in 2011. Big losses were posted by the big miners and oil/gas companies writing off over-priced acquisitions they bought at top-of- the-market prices back in the boom, and also by Woolworths (writing off its failed 'Masters' project), NAB (writing off its failed UK misadventures), and AMP (underwriting losses).

Earnings have recovered in the latest full year reporting season (August 2017) and half year (February 2018) but this has merely brought aggregate earnings per share across the market back up near the long term real earnings trend line.

Clearly we are not in an earnings boom at present – artificial or real. However the banking sector is in an unsustainable and artificial earnings boom. The big 4 banks are booking handy short term profits from loans to property developers and property investors, and are boosting their profits by shaving their already wafer-thin bad debt provisions. This is unsustainable and will disappear (and reverse) when the housing/construction boom deflates in the coming year or so. The good news is that in the current cycle the big banks are not nearly as exposed to property developers as they were in the property booms of the late 1880s, early 1970s, late 1970s or late 1980s. The collapses of those booms brought down the whole property market, the economy and the banks and/or property finance companies with them.

Although the banks make up one third of local stock market, the rest of the market also has weak earnings. Mining and oil/gas companies are still suffering low revenues and margins due to commodities prices that are still much lower than in the last commodities boom. Retailers are also suffering weak revenues and margins in the wake of sluggish retail demand, low wages growth and online competition. Export industries are also being hampered by the high dollar. The world is currently in the middle of a smart phone boom – driven mainly by US and Chinese tech stocks. Australia does have a small number of companies successfully tapping into the global boom, but they are few and far between.

In summary - this model provides no current warning sign of an impending market sell-off due a collapse in artificial or unsustainable aggregate earnings as in previous cycles.

The recent rebound in company profits and dividends looks good on paper but is mainly just recovering the losses and dividend cuts made in 2016 and 2017. Company profit growth is now back on track with its historical trend line. There is plenty of scope yet for earnings to grow further before sounding alarm bells of an impending market collapse.

5 Fiction corner: Economic growth and share prices

One consistent theme over the past few months has been the steady stream of economic growth upgrades from a raft of economic bodies and 'think tanks' (IMF, World Bank, OECD, ECB and many others). While this has been welcomed as good news by media outlets everywhere I see it as a bearish sign for investors, and for good reason.

Every investment seminar and conference in the world always starts and/or ends with an economic outlook because of the widespread but mistaken belief that economic growth drives stock markets. It doesn't. It is pointless trying to estimate or forecast economic growth rates in the hope of discovering any insight into what share prices might do.

I have observed over many years that dire warnings about economic slowdowns from esteemed economic bodies (most recently after the Brexit vote and in the lead-up to the Trump election) are often followed by share price rallies, and that bullish outlooks (notably after rallies eg in 2007, 2011) are often followed by share price collapses.

A further problem with the economic 'top-down' approach is the fact that economic bodies never forecast recessions and crashes, and they are notoriously late in recognizing them when they do occur. For example the NBER (National Bureau of Economic Research) – the peak US economic body that officially declares US recessions, didn't even think the US was in the 2008-9 recession (supposedly the worst recession since the 1930s depression) until a full 12 months after it started!

Share prices predict economic growth, not the other way around!

There is no consistent relationship between share prices and economic growth in the *same* period. Nor is there any consistent positive relationship between economic growth in one year (or quarter or any other period) and share prices the *next* year (or quarter, etc) – so economic growth rates are not a predictor of share prices, and never have been.

But it does work the other way around!

Share prices have been a consistently reliable predictor of *subsequent* economic growth, as there have been consistent positive correlations between share prices in a given year and economic growth in the *subsequent* year.

The left chart below shows correlations between share prices and real GDP growth rates in the *same* year since 1980 in the 60+ countries I study (no meaningful correlations in most countries), but the right chart shows correlations between share prices and real GDP growth rates in the *following* year (present in nearly all countries).

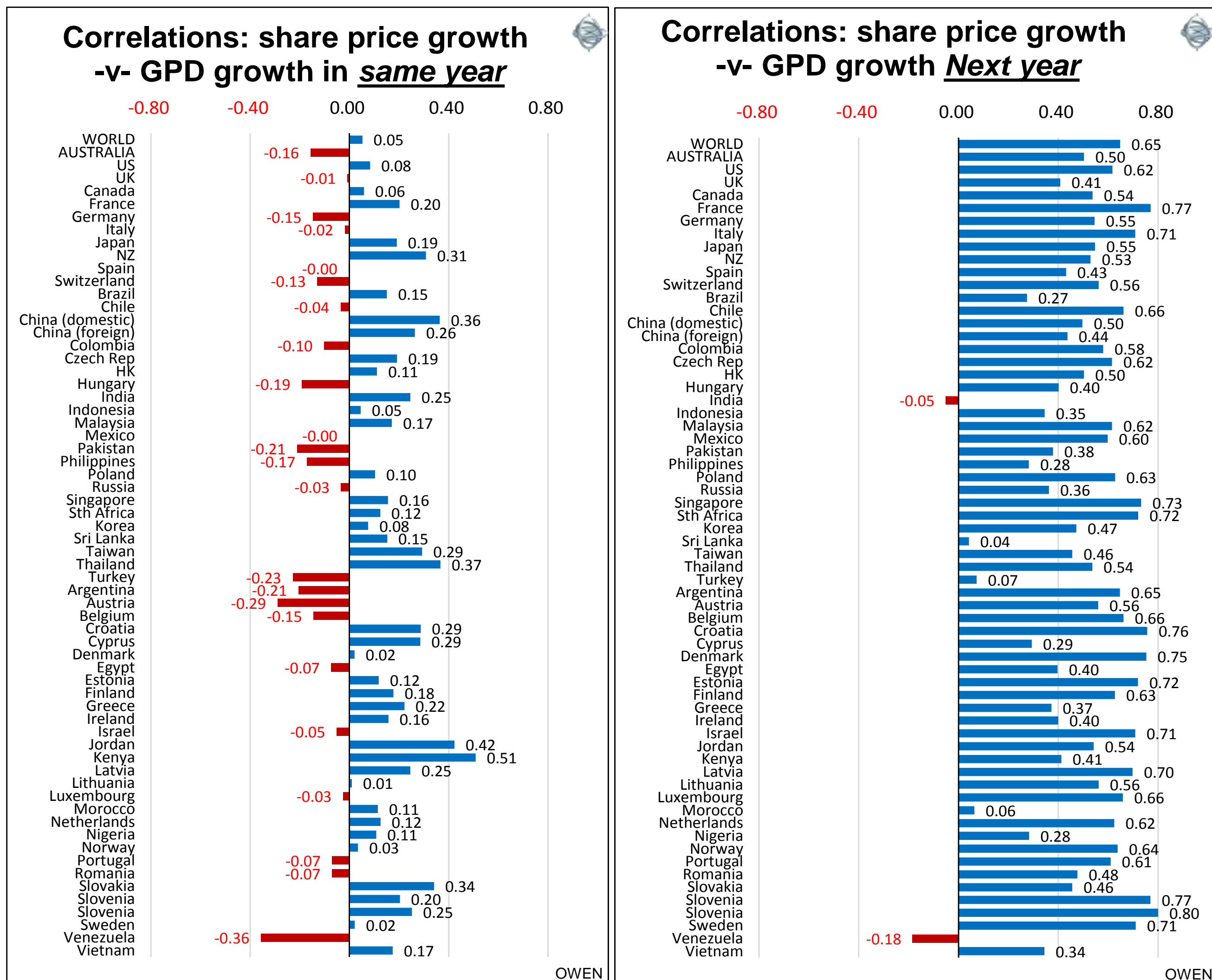
Same period correlations – left chart:

The left chart shows that in developed markets and the majority of 'emerging markets' there has been no relationship between share prices and economic growth rates in the same year. *Same* period correlations are only positive and statistically significant in a small handful of rapidly growing 'emerging markets' like Jordan, Kenya, Thailand, Slovakia and China (and New Zealand it turns out). But even in these markets the relationship is no use in predicting share prices unless one can successfully predict economic growth. Economists have a very poor track record in this (and I am certainly not going to start now).

Subsequent period correlations – right chart:

On the other hand the right chart shows the very high positive correlations in almost all countries between share prices each year and economic growth the *subsequent* year. This pattern has worked consistently in all major markets and also for the overall world aggregate for several decades.

While this is interesting and no doubt useful for people who are trying to forecast economic growth (just look at share prices in the prior year!) it is of no use in trying to use economic growth (present, past or future) to forecast share prices.



So what role do economic growth numbers and outlooks have in formulating our outlook for shares?

We do not blindly assume that high/improving (or low/deteriorating) economic growth rates will lead to, be caused by, or accompany, good returns from shares (or poor returns in the case of low/deteriorating economic outlooks), as most market economists and market commentators do.

Instead we see the economic outlooks as *contrary* indicators of share prices. For example:

- Universally rosy economic predictions at the top of the boom in 2007 were immediately followed by the deepest economic contraction since the 1930 depression and stock market crashes in every country. Likewise, good economic growth in 2011 (at the top of the commodities boom) were accompanied by very poor stock market returns in 2011. Upgrades to higher economic growth outlooks in 2014 were followed by relatively poor returns in 2015

- On the other hand - declining (and below average) economic growth rates in 2009, 2012 and 2013 were all accompanied by very strong stock market returns in those years. The lowering of growth outlooks in the middle to late 2016 following the Brexit vote and in the lead-up to the Trump election were followed by strong rallies in global stock markets ever since.

Current position - The recent swag of rosy reports and upgrades to growth outlooks are a warning of possibly weaker stock markets ahead. However global growth is only just back to its 3.7% long term average, not as bullish as in 2007, so it is not a strong warning signal yet. Thus it is not yet a strong case to under-weight shares, but a useful reminder that that the market more often than not does the opposite of economic predictions suggest.

What lies ahead?

We made two relatively minor changes to portfolios in February. The first was to take the opportunity to increase global shares while prices were down after the sell-off. We did this by adding un-hedged global shares and trimming our hedged shares positions a little as we wanted to shift the bias from being more than 50% hedged to being less than 50% hedged. Our bias toward hedged global shares worked well since the start of 2017 (hedged shares returned +20% in 2017, beating +15% for unhedged) as the US dollar fell and the Aussie dollar rose.

The Aussie dollar continued to rise in 2018 but we were looking to reduce the hedging on global shares as the Aussie ventured back into expensive territory (it hit 80 US cents in late January) and we saw the Aussie more likely to fall than rise much further from there.

As it turned out, global shares rebounded strongly after the early February sell-off, and at the same time the US dollar turned and started to rise once again (and the Aussie dollar fell), resulting in un-hedged global shares beating hedged since the switch.

The second portfolio change was to remove Australian listed property (shifting it to global shares – see above). We had no global listed property in portfolios over the past year – which is good since the whole sector has under-performed global shares. Australian listed property has also under-performed Australian shares over the past year and we see this relative weakness continuing over the coming months. So we removed it and shifted it to un-hedged global shares, as we see shares as being less over-priced and offering more upside and less downside in the current environment.

Since the change Australian listed property has lagged Australian shares, and global listed property has continued to lag global shares.

Shares in some markets (particularly in Europe and some sectors of the US and China) are expensive relative to profits (depending on what you count as actual profits), but not expensive relative to cash dividends. There is steadily improving global demand from consumers and businesses, while input prices (raw materials, commodities, wages, interest rates) are still relatively low, so company revenues, profits and dividends are rising.

US demand is the key variable. Rising interest rates and mortgage payments are dampening spending growth but Trump's un-funded tax cuts and spending increases are resulting in a return to trillion dollar government deficits (like 2009, 10, 11 & 12). What the Fed is taking away (with rising interest rates and reducing its pile of 'QE' bonds), Trump is giving back with trillion dollar deficits.

On the other side of the world China is also playing a key role – first in continuing to lend money to the Trump government to spend, and second in keeping up infrastructure spending of its own. As expected Xi Jinping is now manoeuvring to make himself president for life so only another revolution can remove him. As he promised late last year he is also moving to clean up the shadow banking system and zombie financing structures to limit the wider impacts of an inevitable unwinding of the post-GFC spending/lending boom.

'Till next time, happy investing!

Ashley Owen, CFA
Chief Investment Officer
Stanford Brown

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