STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5

APRIL 2018

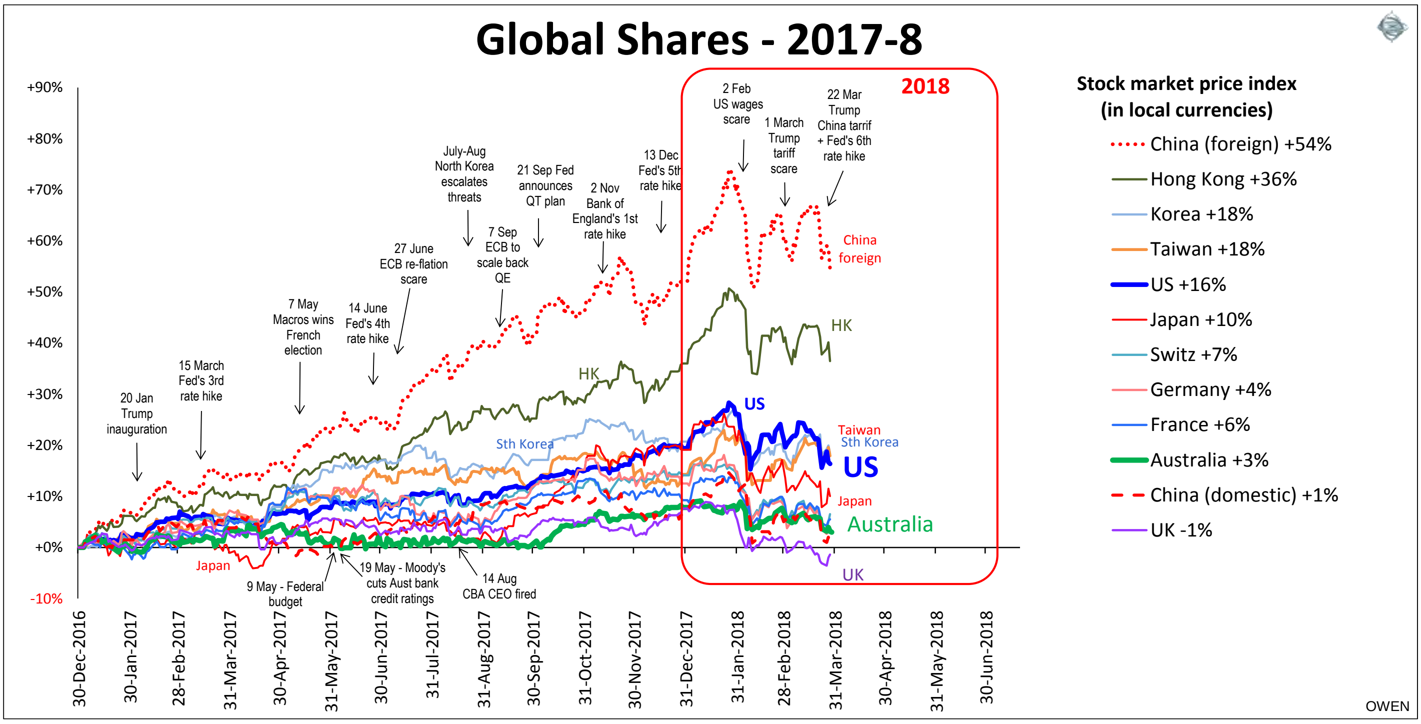
Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.

1 Global shares awake from slumber

Shares in most countries have had a good run over the past couple of years since China re-booted commodities prices and ended the global oil/gas/steel bankruptcy crisis with its stimulus announcements at the March 2016 Peoples' National Congress. There have been a few hiccups along the way of course. Investors have become accustomed to unusually calm markets during the past few years, but the recent volatility is merely a return to what markets are like most of the time.

So far in 2018 there have been three quick jolts. All emanated from the US, and the effects echoed around the world. The first was a bullish US wages report on the 2nd February (caused by cold weather in January when firms used fewer low cost worker shifts and this temporarily lifted the average wages paid for the month). The 2nd and 3rd jolts related to Trump's trade protection announcements – the steel and aluminium tariffs on 1st March, and the China tariffs on the 22nd March.

The chart shows the main share price indexes in the main countries since the start of 2017:

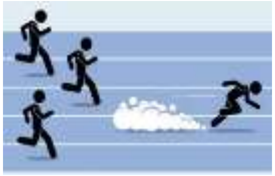


We have been committed to global shares since the Trump election, and the overall global share market has returned 25% since that time. The strong share price growth has been assisted by rising corporate profits and dividends.

Within the allocation to global shares in portfolios we have been biased toward 'emerging markets' shares. This has paid off as emerging markets have beaten 'developed' markets shares over the period, and also for this year to date. Chinese 'foreign' shares (ie listed outside mainland China, primarily in New York and Hong Kong) have been particularly strong – led by Alibaba, Tencent, Baidu and JD, which are more or less the Chinese equivalents of Amazon, Facebook, Google and eBay. The emerging market sector is dominated by Asian markets. Aside from China (which comprises 30% of the emerging markets index), another 40% is elsewhere in Asia, including Taiwan, South Korea and Malaysia – all of which have been relatively strong. Latin American markets have also been strong.

We have shifted our currency hedging position recently. From the start of 2017 we were biased toward being hedged on global shares, and this paid off as the Aussie dollar rose 8% against the sliding US dollar in 2017, meaning hedged returns beat un-hedged. But in mid-February this year when the Aussie dollar hit 80 US cents we shifted the bias back toward un-hedged. This is working so far as the AUD has fallen back since then, benefiting un-hedged returns.

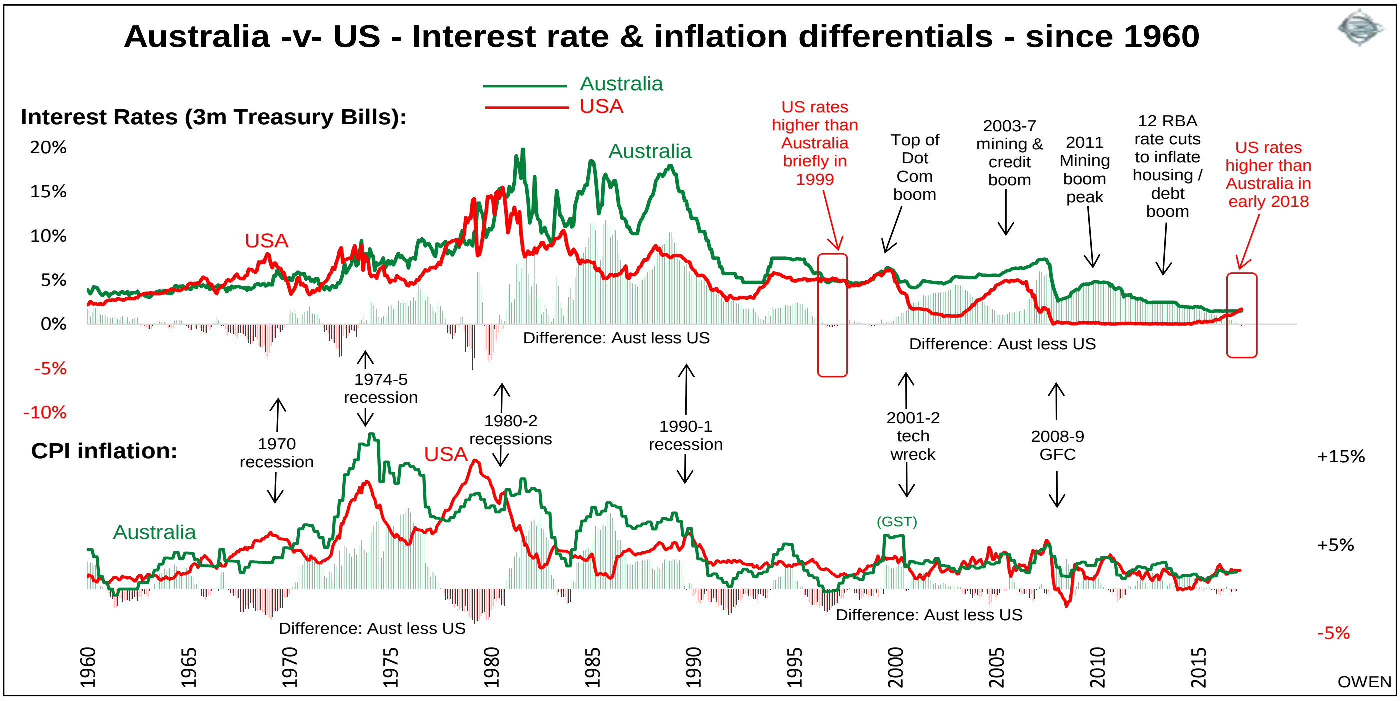
We remain vigilant for signs of sustained trouble and we are ready to move when downside risks outweigh upside potential.



2 Australia -v- US on interest rates

US short term rates are higher than Australian rates for the first time since 1999. This means the end, for the time being, of the ‘free carry’ return to Australian investors in US assets. We have become accustomed to this added bonus for the past 15 years when local rates were higher than US rates. With US rates are higher again it now costs money for Australian investors to hedge US assets like shares (more than half of all global shares are American), as well as bonds and property.

The top section of the chart shows interest rates in Australia (green line) and in the US (red line), and the bars show the difference (Australia less US). Positive green bars mean Australian rates are higher than the US. The bottom section does the same for consumer price inflation rates – because inflation and interest rate cycles work in tandem.



Inflation has averaged around 1% higher in Australia than in the US over the past century due to a several structural factors – notably the labour market (eg centralised wage fixing, awards), and competition (concentration of pricing power within several industries like banking, utilities, transport, retail, etc). Because interest rates are a primary policy tool used to control inflation in both countries, Australian interest rates have also averaged around the same 1% higher than in the US.

The main direct result of our higher short term rates has been the currency hedge return on US assets like shares, bonds and property. (Currency hedging is done using forward contracts based on the difference between short term interest rates in each country). Since the start of the 2003-7 mining & credit boom, and especially since the GFC, Australian investors have been become used to receiving a ‘free carry’ bonus of the currency hedge return of 2% to 3% from hedged global shares. If US shares were up by say 10%, AUD hedged returns were a couple of per cent higher. This is over for now.

Global inflation and interest rate cycles move more or less together in markets with relatively open capital markets like the US and Australia. But if these are global cycles, why are our inflation and interest rates now lower than in the US?

The answer is that there are always timing differences in each country. The US is finally recovering from the GFC 10 years ago. The Fed cut rates to zero in 2008 and only started raising them over the past 2 years. In contrast Australia enjoyed a China stimulus boom in the GFC and the RBA raised rates back up to 4.75% by 2010 while US rates were still zero. Then when the mining boom ended the RBA cut rates 12 times to engineer a housing construction & investment boom financed by a mountain of cheap household debt. Now it is reluctant to raise rates for fear of pricking the bubble it created.

US rates are likely to keep rising more quickly than Australian rates in the coming months, even if there is a global slowdown from the trade war.

3 Nine layers of Nonsense

This week I found myself answering a reader's question that raised an age-old market myth – the soothing notion that stock markets may have their ups and downs but they always bounce back to reach ever higher levels – so just 'hang on tight for a little while and all will come good!'

There are two main problems with this 'buy & hold', 'set & forget', 'time in the market' approach to investing:

1) You need to be lucky to get the timing right – if you buy at the wrong time you can suffer losses for decades; and

2) It doesn't work at all in most countries – you have to be lucky to pick (or be born in or allowed into) the right country!

First – getting the timing right. Most (if not all) textbooks and commentators quote statistics from the US market. They are used by the 'buy & hold' brigade who believe in textbook theories like 'efficient markets' and 'relational expectations'.

The problem is that the passive 'buy & hold', 'set & forget', 'time in the market' approach is built on at least nine layers of nonsense! They assume that that share prices move around in a random manner (nonsense #1), are 'normally distributed' ie follow a nice neat 'bell curve' (nonsense #2). They always 'come good' (nonsense #3) and keep trending up forever (nonsense #4) – driven by long term perpetual steady growth in population (nonsense #5), productivity (nonsense #6), economic growth (nonsense #7), and rising corporate share of national income (nonsense #8). In this theoretical fairyland world there are no wild bubbles and busts because bubble prices at the tops of frenzied booms are simply the result of logical and rational calculations based on all the available information in the market, and likewise the fire sale prices at the bottom of the frenzied sell-offs are also just rational and logical calculations of value at the time (nonsense #9). Somehow hundreds of finance textbooks and several 'Nobel Prizes' have been based on all this nonsense!

In the real world none of these grand assumptions are supported by the facts. The 'buy & hold', 'set & forget', 'time in the market' approach does not work – unless you are lucky and get the timing right, or wait decades to get your money back.

The problem is that most people buy at the wrong time. They wait and watch the market rising steadily for a few years before finally plucking up the courage to jump in – spurred on by ever-louder media headlines of easy money to be made. Unfortunately that is usually at or near the tops of the market in the boom-time buying frenzies. Worse still, many people are lured into gearing up and 'panic' buying with borrowed money in the booms. If you panic buy at the tops of booms you usually need to wait a very long time to recover the losses in the subsequent busts and get back up to square one again.

In the US it took 25 years for the Dow Jones Industrial Average to regain its 1929 peak. Even if you include dividends and adjust for inflation it still took 20 years after the 1929 peak to recover the losses.

In Australia it has been similar. The market index (All Ordinaries and its predecessors) took 10 years to recover its 1987 peak, 10 years to recover its 1969 mining boom peak, 12 years to recover the 1889 mining boom peak, 10 years to recover its 1937 mining boom peak, and 10+ years (and still counting) to recover its November 2007 peak. That's a long time to wait to claw back to square one before starting to make any positive returns. Most people do even worse because they don't buy the broad market index, they buy the 'hot stocks' of the day, and most of those disappear without a trace.

After inflation the waits are much longer. The ASX price index adjusted for inflation took 47 years to recover its 1969 mining boom peak. (The market index comprised largely the same old companies as it does today - the same big banks, BHP, CRA (now RIO), CSR, Myer and many other familiar names). Including dividends and adjusting for inflation the waiting times are still long: 17 years from 1969 to 1985, 9 years from 1987 to 1996, 10 years and still counting after the 2007 peak.

For Japanese investors it is even worse – the Nikkei 225 index is still 47% below its December 1989 peak and will probably never recover. Japan is literally dying off – with a declining population, declining workforce, declining tax-payer base paying rapidly rising welfare bills for the world's oldest population. Japanese share prices are being propped up mainly by the Bank of Japan's QE asset buying programs and these will probably be unwound soon and the BOJ will starting selling.

All of the above assume that investors 'hang on' and ride out the losses and wait for the recovery. But many don't – many succumb to the equally frenzied bottom-of-the-market doom & gloom headlines and panic sell (or worse still, get sold out at the bottom by margin lenders). That's a permanent loss of capital. Selling well is even harder than buying well.

4 Born in the right place

Second – getting the country right.

Australia and the US are lucky in that they happen to be two of the very few countries in the world that have survived for a couple of centuries or so in relatively peaceful and stable isolation with more or less continuous economic progress (although it would have been very different for US investors had the Confederates won the American Civil War). New Zealand and Canada are also rare members of the lucky country club. Step outside these four countries into any of the 200 other countries on the planet and people will fall about laughing if you suggest 'buy & hold' as a serious strategy!

Few other countries have managed to avoid major wars on their home soil, invasions, revolutions, colonial plunder, confiscation of private property by despotic rulers, nationalisation, and other destroyers of wealth. Other countries don't offer the same protection of property rights, rule of law, consumer and investor protection, freedom of speech and dissent, and relatively stable political, administrative, regulatory and judicial systems. These are rare in the world, but they are absolutely critical for investment. We are lucky to have been born in (or allowed into) a favourable country for investors.

It is no accident that the US, Canada, Australia and NZ were all sparsely populated former British colonies. Britain was the last of the European colonial powers to rule the world. By the time Britain got its turn the closer targets were all taken by earlier empires – mainly Portuguese, Spanish, Dutch and French, and so Britain was left with the far-flung remnants. What we now call Australia, US, Canada and NZ were further away and harder to get to, but as they were sparsely populated, the natives were easier to displace with colonists and settlers, and it was easier to impose colonial rule and lasting colonial institutions. As far flung remnants they were also lucky enough to avoid large scale destruction in the major global wars.

In stark contrast, the rest of the world (Latin America, Africa and Asia) were carved up into colonies by the other European powers. Their natives were too numerous to be displaced and dominated by the colonists and so they rose up and threw the colonial rulers out – in the 1810s & 1820s in South America, but mostly in the post WW2 wars of independence across Africa and Asia.

The legacies of these colonial empires have not been good – in terms of health, welfare, human rights, political stability, living standards, let alone private wealth. Most newly independent nations were (and still are) plagued by the effects of failed communist experiments, revolutions, civil wars, brutal dictatorships, capricious autocrats, suppression of human rights, hyper-inflation, corruption, nepotism, pilfering of national resources, nationalisation of businesses, and civil unrest.

Britain did of course have some colonies where they were not able to displace the natives. There too the natives rose up to throw out their colonial overlords, only to get bogged down in a litany of failed communist experiments, revolutions, civil wars, brutal dictatorships, corruption, unrest, etc. Today these former British colonies are still relatively poor and are now quaintly labelled 'developing' or 'emerging' markets – still struggling to emerge from colonial rule - including India, Pakistan, Bangladesh, Sri Lanka, Myanmar, Egypt, Kenya, Iraq, Libya, Nigeria, Somalia, South Africa, Uganda, Yemen, Zimbabwe, and so on.

What do investors make of all this? The lesson is that the simplistic, passive, 'buy & hold', 'set & forget', 'time in the market' approach only works (a) if you get the timing right and (b) if you get the country right.

Never simply 'buy & hold' or 'set & forget'. We need to be active, learn to look through the daily market 'noise', ignore the sensationalist media headlines, the market chatter, and well-meaning friends and neighbours (and websites) spruiking the latest 'hot stock' or 'hot fund'. Recognise changing conditions, understand cycles, but recognise also where changes may not be cyclical but longer term or even permanent. Make adjustments, never panic buy in booms, never panic sell in busts, and be prepared to go against the crowd - regularly. Investing is a never-ending learning experience.

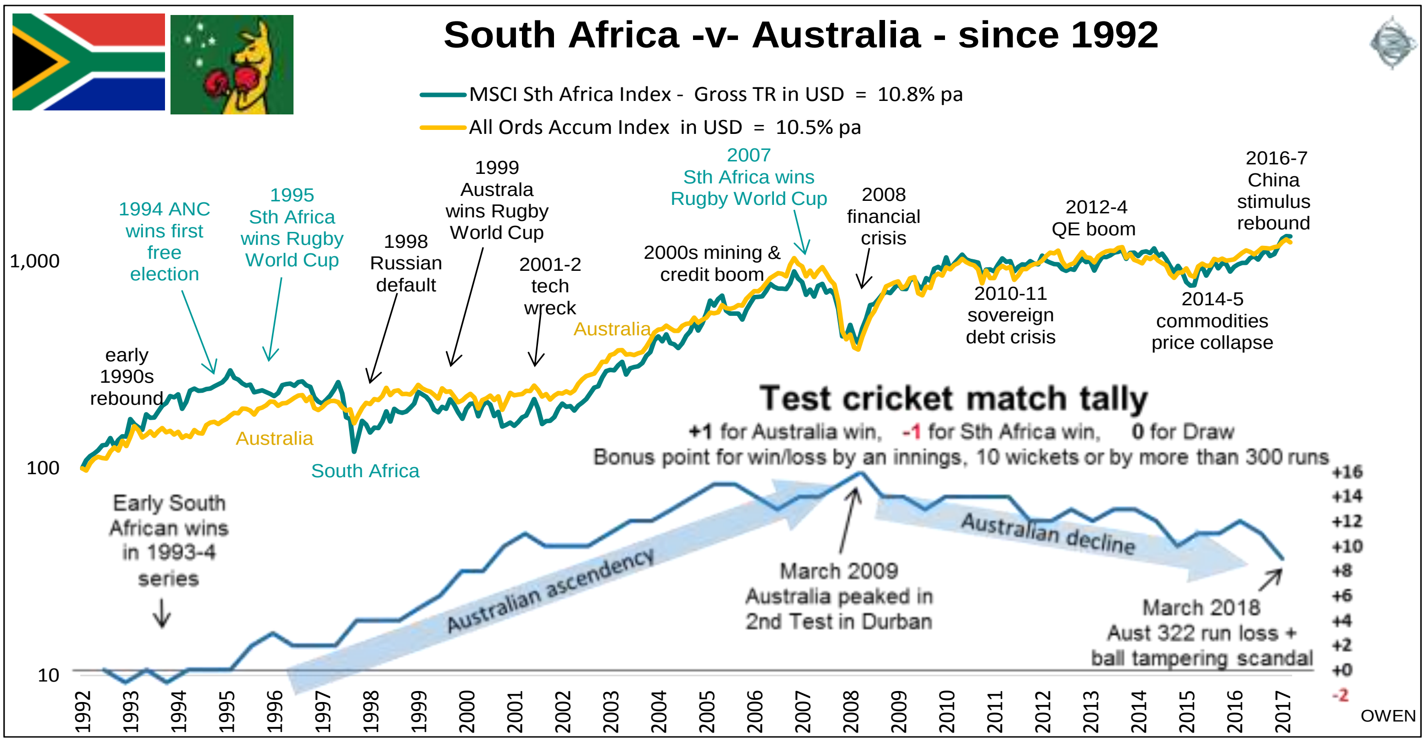
(p.s. That is me above – lucky enough to be born in one of the very few British colonies in Asia or Africa that recovered from colonial domination to make it into the 'rich nations' club, and then I was lucky again to be allowed into Australia!)

5 South Africa wins – just!

The only topic to capture more headlines in the past week than Trump's trade wars has been the Australia - South Africa cricket test series – for all the wrong reasons. Even Trevor Chappell has said he is relieved that after 37 years he is no longer the most hated man in Australian sport! So let's look first at the stock market performance of the two countries.

Australia and South Africa are former British colonies whose development was driven by commodities exports, with stock markets that have always been dominated by mining companies. The chart shows total returns (including reinvested dividends) from the broad stock market index in each country. Both are expressed in US dollars to show them in a common currency, starting from a common base from 1993 when South Africa re-joined the world following the end of Apartheid.

Both markets are highly cyclical and reliant on commodities prices and foreign 'hot money' capital flows driven by global sentiment. South African shares have done much better in local currency terms (averaging 15% pa in Rand versus 10% for the ASX in Aussie dollars) but returns in US dollar terms have been virtually the same and have followed the same path.



South Africa got off to a flying start as foreign money rushed into the newly minted 'emerging market' in the early 1990s, but it fled just as quickly in the 1997 Asian currency crisis and especially in the 1998 Russian default crisis. Both had a very mild 'dot com' boom and tech wreck, but both had a huge 2003-7 China-led commodities boom and subsequent GFC bust. They fell together in the 2015 commodities price collapse and then rose together in the 2016-7 China-led rebound.

Now to cricket. The lower section shows the test cricket match tally between the two countries since South Africa re-joined the sporting world in 1993. We have played a total of 97 matches in 26 series since 1902. (Australia is winning the tally with 52 match wins out of 97, and 16 series wins out of 26). Here we focus on the 44 matches in the post-Apartheid era.

The blue line shows a running tally of test match wins and losses. +1 for an Australian win, -1 for a South African win, and a bonus +1 or -1 point for a win or loss by an innings, 10 wickets or by more than 300 runs. After a couple of early wins by South Africa in the Nelson Mandella-inspired post-Apartheid euphoria, Australia gained the ascendency from the late 1990s to 2007 under Taylor, Waugh and then Ponting. Australia peaked with a 175 run win in the 2nd Test at Durban in 2007 - with two centuries by opener Phil Hughes (the youngest ever player to achieve this, at age 20, on his debut tour).

That match started on 6th March 2009, the same day the ASX reached its lowest point in the GFC. Australia won the match on day 5 - Tuesday 10th March – which was the exact day global stock markets started their rebound from the bottom of the GFC. That day was also the start of a long decline in Australian cricket. (Tragically, Hughes died in a cricket match in 2014). The long road out for Australia cricket surely starts now!

Meanwhile the main chart is a reminder that share prices are driven more by global cycles than local issues.

What lies ahead?

I have been relatively bullish on shares since Trump won the US election in November 2016, but I have argued since then that the most serious risk to markets under Trump is a global trade war. Trade protection was one of Trump's main election promises – to put America and American jobs first, and to eliminate trade deficits on a bilateral basis by penalising imports from countries with a trade surplus with the US. 63 million Americans voted for it in 2016 with their eyes open.

Trade wars are easy to start but very difficult to stop. By the time leaders realise they must reverse their protectionist measures, unemployment will be rising due to declining factory orders and production. Cutting protection barriers while unemployment is rising is political suicide. In the 1930s it was only the military build-up to WW2 that ended the global production slump caused by the trade protection wars started by the Republican Senate and President Hoover in 1930.

Trump has been busy lately getting all his ducks in a row – with his recent replacement of Rex Tillerson with hard liner Mike Pompeo as Secretary of State, his replacement of H R McMaster with China hawk John Bolton as National Security Advisor, and his increasing reliance on Peter Navarro as his main trade advisor. Thus far it seems Trump is backing his skills as a deal-maker. He is throwing hand grenades with the aim of getting Xi Jinping to the negotiating table, rather than intending to start a reciprocal tit-for-tat trade war like the 1930s. The 25% tariffs on steel and aluminium announced on 1st March were dressed up to exploit the 'national security' loophole in trade agreements, and the 25% tariffs on $60b of Chinese imports on 22nd March were aimed at China's theft of intellectual property. The former was a bit stretched but the latter has much more credibility. Thus far Trump and Xi are waiting for one to blink first.

Here in Australia the local news was dominated by three main issues: franking credit refunds, house prices and the banking Royal Commission. I will leave house prices and the Royal Commission to next month, but mention franking credits briefly.

On 12th March the Labor opposition said it would end cash refunds of franking credits to Australian shareholders who receive dividends from companies on which Australian company tax had been paid. It was a reversal of the policy that had been introduced in 2000 by the Howard-Costello government, designed to end double taxation of company profits. The problem is that hundreds of thousands of retirees with tax-free pensions rely heavily on these cash refunds for their income. It would effectively reduce their cash income by 30% from dividends, including income on 'hybrid' securities.

Since the announcement Labour has back-peddled with ever-widening exemptions – starting of course with their own pensions (funded by the Future Fund)! It seems everyone will be exempt except self-funded retires who have saved enough and don't burden the public purse. The policy didn't cost Labor votes in the Batman by-election, which it won easily the following Saturday, so it will probably stand until the next Federal election. (Yes there is a seat in Melbourne called 'Batman'! – named after the original founder of Melbourne. And yes Melbourne was actually founded by Batman!).

Ordinarily we would not take much notice of opposition party policies so far out from an election, but the current Liberal-National government has been lagging further and further behind in the polls, and PM Trumbull seems to be heading for a leadership challenge.

'Till next time, happy investing!

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