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Financial Advisers

Stanford Brown Monthly Top 5

DECEMBER 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.

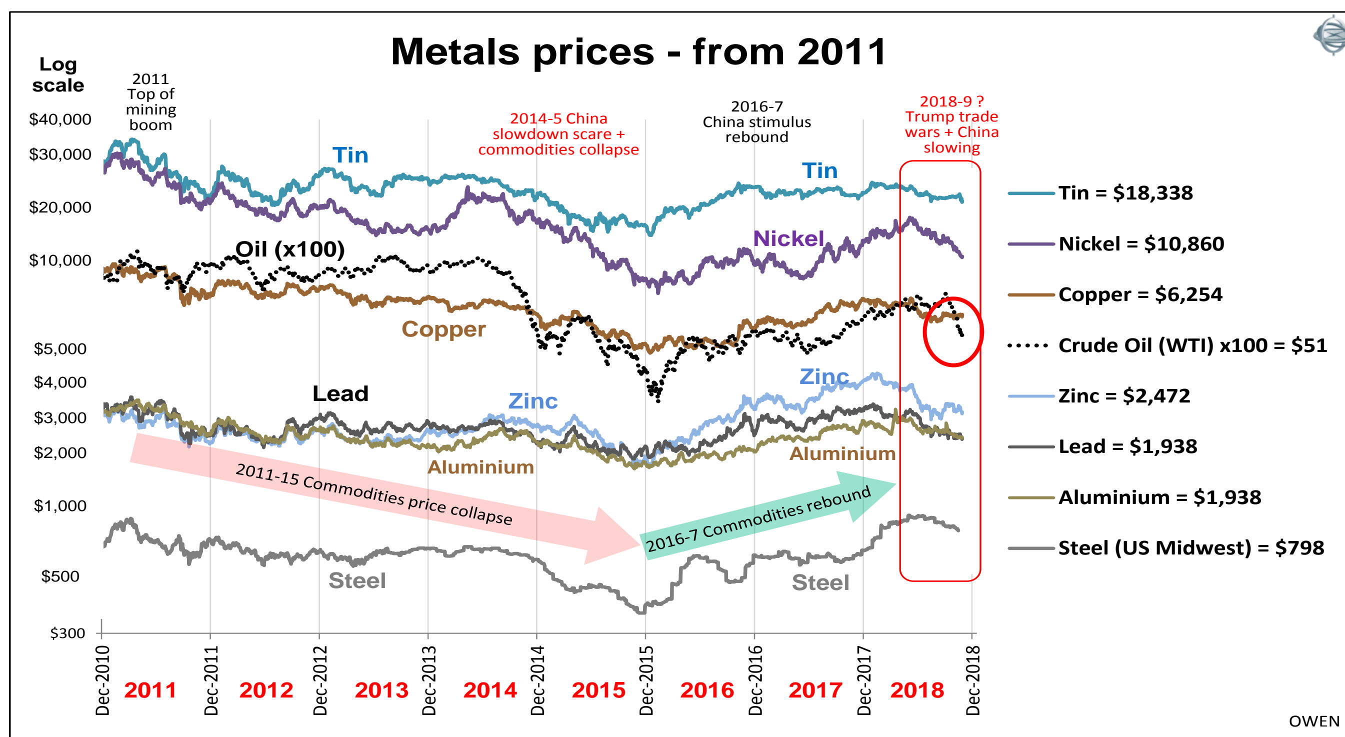
1 Slight tilt toward slowdown

When we took action to reduce allocations to Australian and global shares in portfolios earlier this year prior to the recent sharp sell-off, we were faced with the question of what to do with the money we took out of shares. We wanted to increase the defensiveness of portfolios but there was a dilemma: which defensive assets to use depended on which of two opposing scenarios we could see driving the weakness in share prices. Our two most likely scenarios were: 1) a sudden inflation scare (like 1994, 1977, 1973, 1969, 1951, etc); versus a global slowdown scare (like 2011, 2008, 2001-2, 1990, 1974, etc).

In last month's report we outlined the main factors pointing to each scenario. Briefly, the factors supporting the inflation scare scenario included: rising US bond yields, low and falling unemployment rates, rising US wages, rising US cash rates, oil prices holding up, Trump's tax cuts and his deficit spending sprees, and the global military build-up. On the other hand there were several factors supporting the case for growing fears of a global slowdown: weaker Chinese growth, China's monetary easing stance, falling commodities prices, falling emerging markets shares, falling Australian dollar, strong US dollar, and widening credit spreads. Each case was equally compelling.

When we made the changes earlier this year our view was that the inflation scare story would probably dominate in the short term (say 6 months or so) but the slow-down story would probably then overtake it before long. During most of 2018 the inflation scare story had the upper hand. Both of the sharp 10% sell-offs in shares (in February and October) were triggered by stronger than expected US wages and jobs reports and spikes in bond yields. However in November we started to see a subtle shift toward slowdown fears coming to the fore.

Commodities prices provide a clue, as they are a barometer of investor sentiment. Prices of industrial commodities had rebounded strongly for two years following the March 2016 Chinese stimulus announcements that ended the 2014-5 'China slowdown' scare. That rebound rally in commodities prices ended this year. The only exception was oil – held up mainly by the tensions between Trump, Iran and Russia.



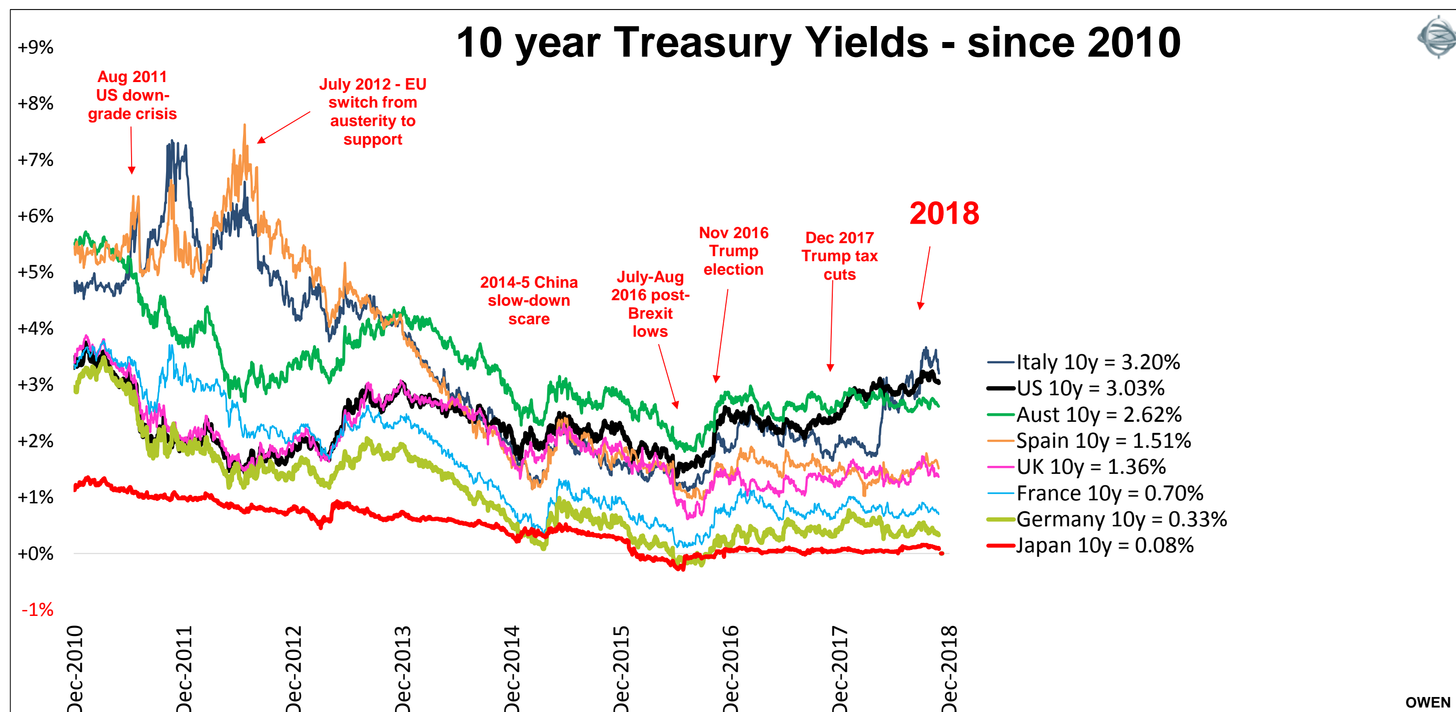
Oil prices have now fallen 32% since 2nd October when Saudi forces killed the exiled dissident journalist Jamal Kashoggi in the Saudi consulate in Istanbul. Ordinarily this would cause a sudden oil price spike but Trump clearly stated his view that the state-directed political killing of a journalist is not as important as protecting Saudi Arabia's role as a big buyer of US armaments and in keeping oil prices low.

Part of the oil price weakness relates to production supply remaining relatively strong. When Trump pulled out of the Iran sanctions deal and reimposed US sanctions on 3rd November he made the new sanctions almost meaningless by granting a raft of handy exemptions to US oil companies, several US allies, and even to China, which is Iran's largest oil customer. Just like Trump's new NAFTA being almost identical to the old NAFTA he labelled the 'worst deal ever!' (It is hard to keep track of what is Trump's latest 'worst deal ever'!)

The other main theme driving the price of oil and all other commodities even lower has been a steady lowering of growth expectations (and demand for oil and metals) in all of the main regions of global production and spending – China, the US, Europe and emerging markets.

2 Government bond yields dip

Another clue is the declining yields on government bonds around the world in recent weeks. Government bond yields are the main barometer of expectations of future economic growth and inflation. Prices of shares, bonds, properties and other assets are highly sensitive to sudden changes in inflationary expectations and bond yields. The chart shows yields on 10 year government bonds since 2010.



In the US – bond yields shot up in the February and October inflation scares but they have drifted back in recent weeks. On the 28th of November Federal Reserve Chair Jay Powell said that interest rates are now 'just below' the neutral level, in stark contrast to his statement in October that rates are 'a long way' from neutral. The sudden change in his language could be a result of Trump's relentless criticism and harassment of Powell, the Fed, and their recent interest rate hikes, but that is probably not the main reason.

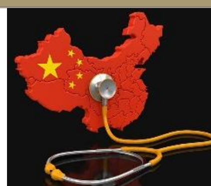
There is increasing evidence across the US indicating declining consumer confidence and spending including on big items like houses and cars. The Fed will probably keeping raising rates as the economy slows. Because of the long time-lags in the feedback loop between economic activity, statistical reporting of that activity, interest rate changes to influence future activity, and subsequent reporting of any changes in activity – it is likely that the Fed will follow a well-beaten path of central banks going too hard, too late with rate hikes. We will no doubt have a few more temporary inflation scares in the months ahead, but inflation is unlikely to jump to say 5% or more any time soon.

In Europe - yields are falling across Europe due to fading optimism over structural reforms and growth, and also the gridlock over immigration policy and rising populism. Yields are falling even though the central bank is scaling back its 'QE' bond buying program.

The exception is Italy. Italian yields have risen sharply since May but the reason is not fears of growth and inflation. It is due to fears of a Greek-style default on government debt. On 1st June the hung parliament following the indecisive 4th March election was finally resolved, with a coalition between comedian Beppe Grillo's *Five Star Movement* (which dominates the poor south) and the *League* (which dominates the rich north), led by Prime Minister Giuseppe Conte. Both of the coalition parties are populist right-wing, anti-EU and anti-immigration. The government's solution to the sluggish growth and high unemployment is a rapid increase deficit spending funded by an equally rapid increase in the already huge pile of debt (see story 4 below). Because these plans breach strict EU limits on deficits and debt, there is a major confrontation brewing between Italy and Germany/EU. This is not conducive to consumer & business confidence and growth.

In Japan - the stop-start 'Abenomics' stimulus programs are stalling again. The Bank of Japan has been artificially keeping 10 year bond yields near zero to try to stimulate growth and inflation. So far it has had little success in doing anything except artificially inflating asset prices. Yields managed to drift up to a whopping 0.15% in October but have now drifted back down again.

In Australia - bond yields here are also now falling back well below the levels reached in May. House prices continue to fall and credit rationing by the beleaguered banks is only tightening further. The housing/construction slump may be worse than many people expect.

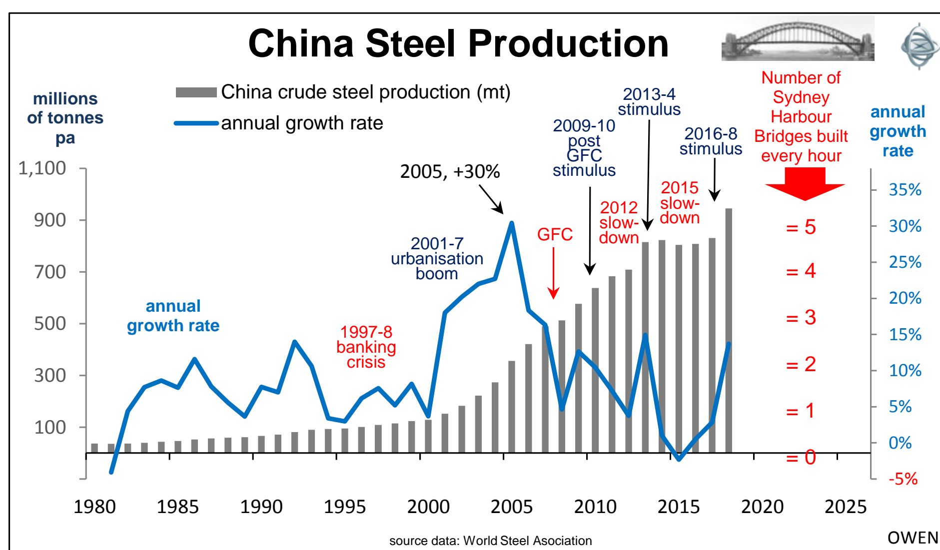


3 China check-up

The last global mini-correction in share prices was in 2015-6. The All Ordinaries index fell by 19% between middle of April 2015 and the middle of February 2016, and this was echoed in share market falls in most other countries. The main reason for the global sell-off was a 'China slowdown' fear. This led to a collapse in commodities prices which triggered a string of corporate losses (and several bankruptcies) in oil/gas and mining companies across the world. It led to a global corporate 'earnings recession' but not an economic recession.

This year there have been signs emerging of another slowdown in China. One problem is that official economic statistics in China are notoriously rubbery. Premier Li Keqiang, who is number 2 to President Xi Jinping, and the only trained economist among China's senior cadre, once described China's official statistics as 'man-made' – ie fictitious, so we look at a broad range of measures for clues.

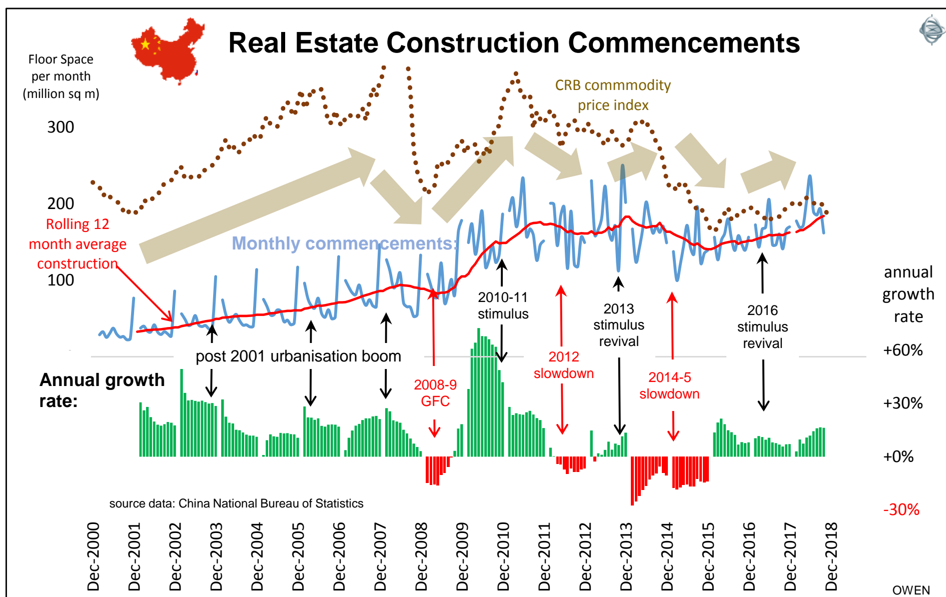
Despite early signs of a slowdown, some of the big drivers of total output are holding up. The first chart shows China's steel production holding up well so far since the last slowdown. The grey bars show the annual steel production in millions of tonnes per year, and the blue line shows the growth rate. China is on track to produce around 940 million tonnes of steel this year, a 15% increase on last year.



These vast amounts of steel are hard to comprehend so I think of it in terms of something we can all relate to. The Sydney Harbour Bridge was made from 38,000 tonnes of steel. It took 8 years to build and was opened in 1932 in the depths of the 1930s depression.

China producing 940 million tonnes of steel this year is the equivalent of building 5.7 Sydney Harbour Bridges *per hour* – every hour, 12 hours per day, 365 days per year. That's one Harbour Bridge worth of steel every 10.5 minutes. That's a lot of steel! This year's 940 million tonnes will finally exceed the 823 million tonnes (5 Sydney Harbour Bridges per hour) China produced in 2014 prior to the 2015 slowdown.

The second chart shows construction activity, the largest driver of China's overall growth. The red line shows the amount of total floor space built per year (in millions of square meters) including residential, commercial, industries, retail, etc. This year the total is set to finally exceed the peaks in 2010 and 2013, which were the result of stimulus spending sprees following the slowdowns in 2008-9 (GFC) and 2012.



It also shows how Chinese construction cycles drive global commodities prices (brown dots).

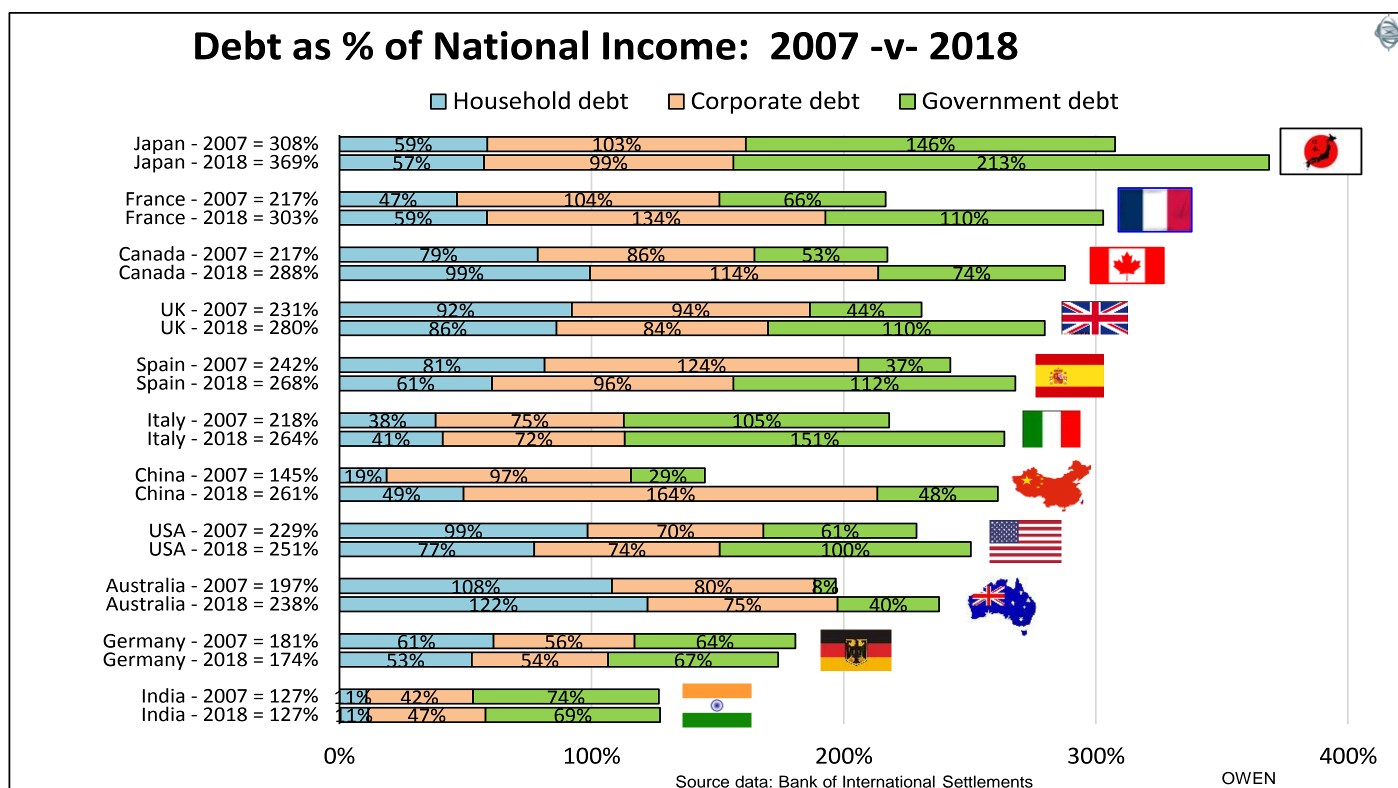
Sydney CBD contains 15 million square meters of floor space – including offices, shops, hotels, apartment blocks, etc. China is building the equivalent of one new Sydney each month! Construction appears to have peaked at 23 million sqm per month in the middle of 2018 (1.5 'Sydneys' per month) but appears to be slowing to 'just' 15 million per month now (1.0 'Sydneys'). Activity is still relatively strong but would start to contract into another red patch if it falls below 15 million per month over the next year.

Last year China passed the point of 50% of the population being urbanised. This will slow the long term growth trend from here on, but it will still probably follow the same type of cyclical pattern along the way. While activity is still strong now, a slowdown next year is likely.

4 The Debt Olympics

Much of the current fears about China relate to its level of debt – but is this fear justified? The chart shows total debts as a percentage of national income for several countries. Each country has a pair of bars – the upper bar shows debt levels at the end of 2007 right before the GFC, and the lower bar shows debt levels today. Debts are divided into the three main types of debtors - households, companies and governments. Japan retains the wooden spoon, in a death spiral due to its ever-increasing welfare bills for its declining & aging population.

Far from de-leveraging after the shock of the GFC, almost every country has loaded up on cheap debt over the past 10 years, with total debt loads relative to national income rising virtually across the board. The only exceptions have been Germany, which has reduced its debt load, and India has remained flat. They were the two lowest debt countries to start with and they are still the lowest today. Both have been criticised heavily for not borrowing and investing enough to fund critical productivity-boosting infrastructure to fuel future growth.



How does China rate? China has gone from having low debts relative to national income before the GFC, to middle-ranking debt levels today. It is well below most of Europe and a fraction ahead of USA. For China it is not the *level* of debt that is the problem, it is the rate of *growth* of debt. China has had the largest increase in total debt loads in the world (apart from Hong Kong, and Singapore is not far behind).

One of the first rules of lending is that rapid lending growth rates are always at the expense of credit quality. Lending growth rates have been extraordinarily high in all three sectors: households, companies (mostly state owned), and government. The build-up of debts in the corporate and government sectors is the result of three waves of frenzied state-directed lending at state-directed projects to prop up growth numbers and jobs following a series of slowdowns - the 2008-9 GFC, the 2012 slowdown, and then the 2015 slowdown. Each time the government announced grand plans to reduce debts and close down inefficient loss-making state-run operations, but each time it chose instead to refinance existing bad debts into the never-never, and announce yet another raft of new debt-funded stimulus projects.

Aside from China's likely looming bad debt crisis, the other big problem is in Europe (ex-Germany). Italy, France and Spain are locked into the Euro, low productivity growth and aging populations. They can't grow fast enough to pay off their mounting piles of government debt.

Where is Australia? The government entered the GFC with virtually no debt but soon became addicted to big spending sprees and big budget deficits financed by a build-up of debt. It will return to surplus from time to time due to windfall spikes in commodities prices, not frugal budgeting. Corporate debt levels have shrunk as the banks (which are now just bloated building societies) prefer mortgage lending to business lending because it requires less capital and no skill. The main problem is our level of household debt. It was the highest in the world before the GFC and has increased its lead even further over the past 10 years (exceeded only by Switzerland). Some countries have reduced their household debt loads – notably USA and UK - in painful corrections. Germany and Japan also reduced household debt levels – but they are afflicted by stagnant / declining populations, which is very different from Australia's relatively high population growth rate.

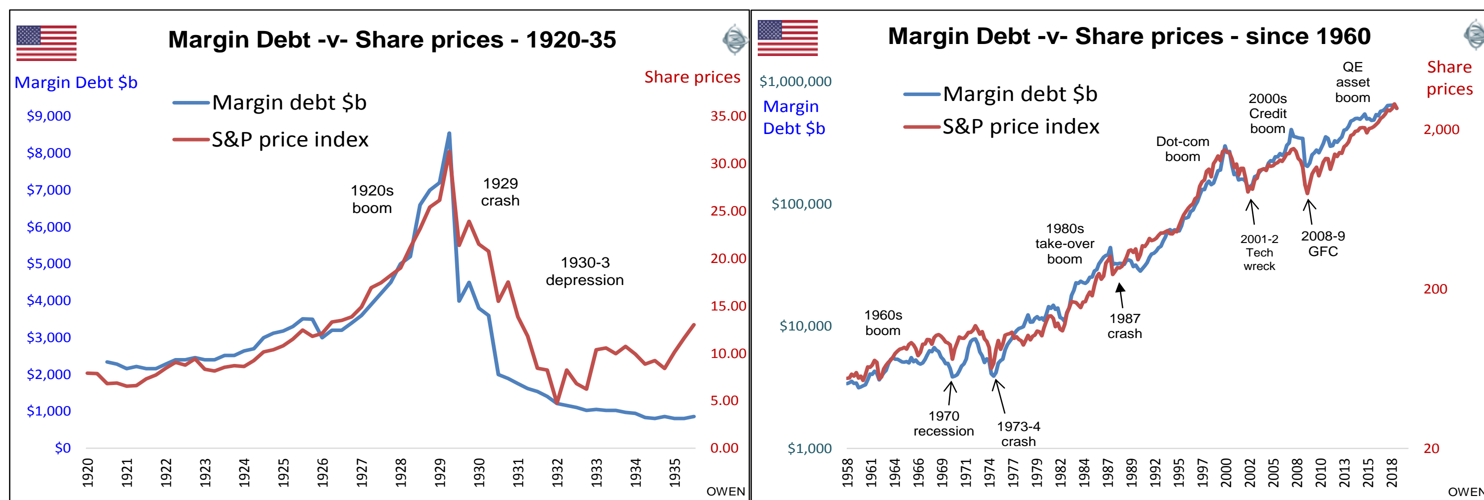
Margin Calls!

5 Margin debts: high but not fatal

One factor that accentuates the boom-bust cycles in share markets is margin lending. Speculative borrowing to buy shares is a practice that is as old as share markets themselves. Excessive debt-funded speculation always ends in tears, but how much is 'excessive'?

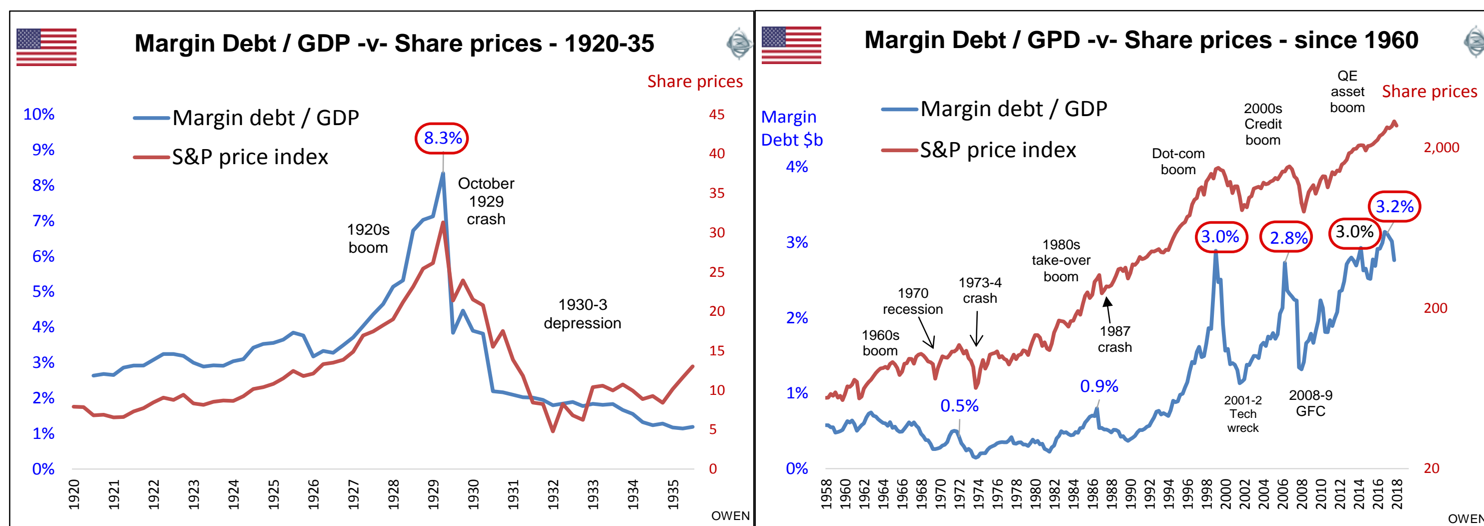
The total level of margin lending tracks the overall share market very closely. Actually the relationship is the other way around. The level of margin lending is a good measure of market confidence and speculation, which push share prices up to their speculative peaks. When the bubbles burst, margin calls triggered by falling prices accelerate the downward spiral of share prices, making the busts worse for all of us.

The first pair of charts show the level of margin debts in the US (blue line) tracking the market price index (red line) through the various booms and busts in the US. The right chart is since 1960, while the left chart shows the lead-up to, and aftermath of, the 1929 crash.



Is the current level of speculative confidence high? Yes. US shares have enjoyed a tremendous boom since the depths of the GFC in early 2009. The 330% rise in the S&P500 index has been accompanied, and partially driven, by a 225% rise in margin loans. Total margin debts in the US peaked at $669b in May this year but have fallen back by 9% since then – echoing similar falls in the broad stock market indexes.

The level of margin debt tells us that speculative fever is still high, but it doesn't tell is whether or not it is dangerously high. The next charts show the level of margin debts as a proportion of total US national income ('GDP'). The right chart shows that margin debts as a proportion of national income rose above 2.5% just before the last two big stock market crashes - at the end of the 1990s 'dot-com' boom prior to the 2001-2 'tech wreck', and at the end of the 2003-7 credit boom prior to the 2008-9 'GFC' (and also prior to the 2015 oil/gas sell-off).



When the ratio of margin debts to GDP rose above 3% in early 2018 it went higher and more vulnerable to fall than it was just prior to the last two crashes. But this argument is not as strong as it seems. Neither the 1987 crash nor the 1973-4 crash were preceded by high margin debt levels. Also the left chart shows that the level of margin debts stayed above 3% of GDP for years in the 1920s, and managed to exceed an incredible 8% of GDP before the speculative bubble finally burst in 1929 and fell by a devastating 89% over nearly 3 years.

The current level of margin debt (at 2.9% of GDP) makes the US market vulnerable to collapse, but nowhere near the scale of 1929.

What lies ahead?

Shares in Australia and most other countries had another poor month in November, following big falls in October and small falls in September. The US was a rare exception, up 2% in November after falling 7% in October. European markets continued their slide. Almost all developed markets are in the red for the year to date – except the US which is up a fraction. Emerging markets had a rare positive month – mainly Chinese tech stocks having a mini-recovery in a sea of red this year. Year-to-date almost all emerging markets are heavily in the red except Brazil, held up by high hopes under newly elected far-right populist leader Jair Bolsonaro, 'the Trump of the Tropics'.

The US remains the centre of attention for global markets. The mid-term Congressional elections went as we wrote in last month's report – the Democrats winning back the House and the Republicans retaining and gaining in the Senate. While the Democrat controlled House is less powerful than the Senate it can start to do a lot of damage to slow down the Trump train. Last month we opined: *'Trump's upcoming meeting with Xi will probably end the same way as his meetings with Kim Jong-un and Putin – lots of smiles and nice words at the meeting, then a babble of confusing and contradictory tweets, and then no actual action.'* The first step was achieved yesterday (2 December) and the rest remains to be seen. Shares will probably rise in the short term until the next inevitable Trump tantrum.

Locally, the Hayne Royal Commission into bank misconduct wrapped up its hearings and now starts to prepare its final report. This year we have seen round after round of widespread evidence and admissions of systematic theft, fraud, covering up hundreds of thousands of criminal breaches, market rigging, document forging, predatory lending, charging fees to dead people, selling products to people they knew could never use them, lying to regulators, and a host of other criminal activities rife across all banks and insurance companies. It is hard to know where to start. The government should do what Roosevelt did in the 1930s: break them up or close them down, then install brand new tough regulators to police them and send offenders to jail. Unfortunately our legislators and political leaders are probably too conflicted and too lazy to do anything. Meanwhile the bank CEOs will spend the Christmas break counting their bonuses. The big bank CEOs received an average bonus of $2m awarded to them by boards and shareholders in the latest profit round in October as a reward for their magnificent efforts this year. Profits were down across the board, and share prices are also down by 20-30% over the past two years – but here's an extra $2m each anyway! That's just the cash bonuses for this year – the total remuneration per big-4 bank CEO ranged between $11m and a $7m for the year – well done chaps! (I covered bank performance over the past 25 years in last month's report).

House prices are likely to keep falling in the major cities. Prices of newly constructed high rise units will also continue to be 20-40% below their inflated 'off-the-plan' purchase prices back in the boom. This is a slow train wreck that will continue for the next year or so. The only people *directly* affected will be those who bought on debt in the past few years at boom-time prices, and only if they are forced to sell – either unable to refinance debts, or unable to make the repayments because of falling rents and rising vacancies. Bad debts and bankruptcies will be only a very small minority of the total population – just as they were in previous property bust recessions (the last one being in the early 1990s). The rest of us will not be directly affected by lower prices because you only make a loss when you sell. Even for buyers with debt - anybody who bought a house more than a few years ago would still have 'positive equity' even if prices were to fall by even say 30% across the board. So the direct impacts of the housing correction will be very limited. However it is the broader *indirect* impacts on overall lending, spending and jobs that will affect us all.

We remain defensive in portfolios but as always we remain vigilant and willing to make further adjustments to protect capital and capitalise on opportunities where warranted.

'Till next time, happy investing!

Ashley Owen, CFA
Chief Investment Officer
Stanford Brown

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