STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5

JANUARY 2019

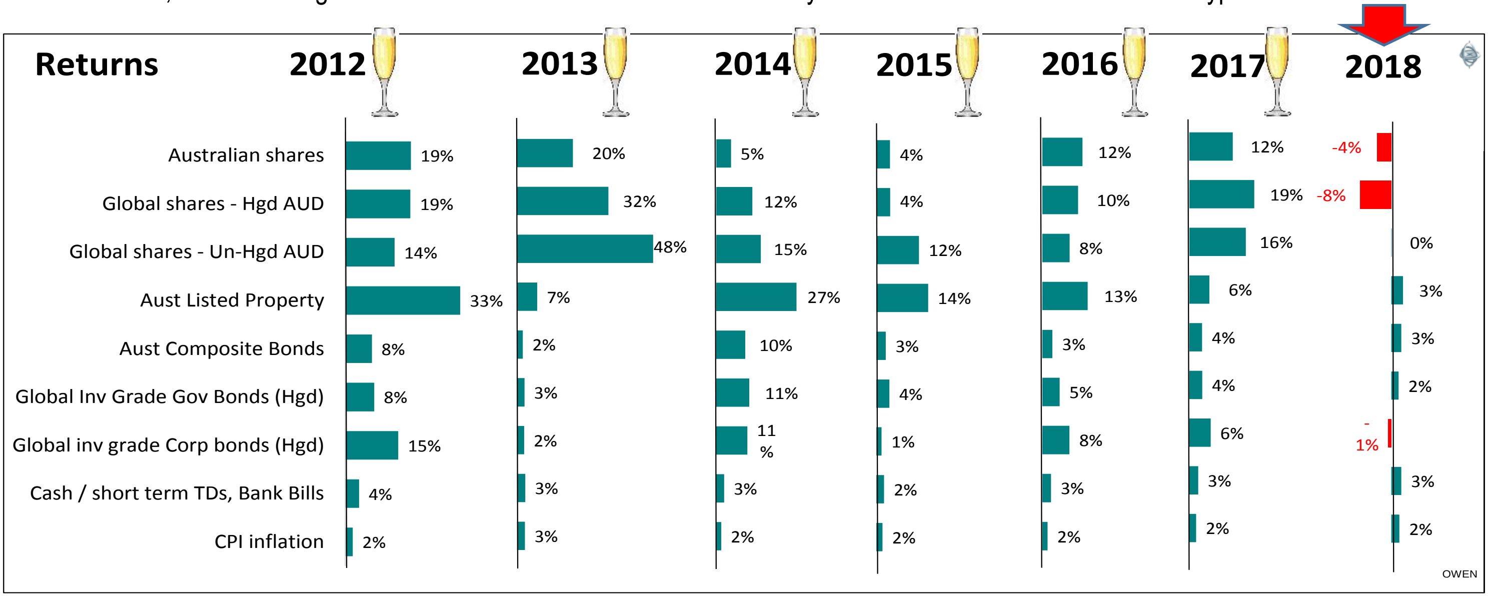
Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.

1 End of the great 6 year rally

In this report twelve months ago we wrote that 2017 topped off an unprecedented six year rally in every major investment asset class. Never before in history had each of the main asset classes enjoyed positive 'real' (after inflation) returns for six consecutive years. The previous record was four consecutive years from 1925 to 1928 and that was right before the 1929 crash and 1930s depression.

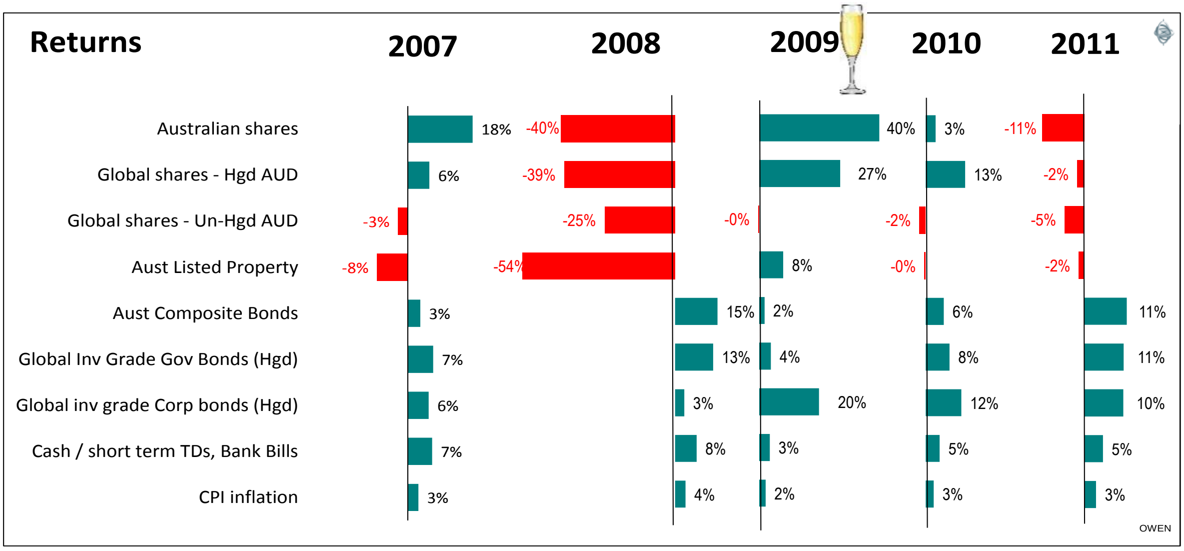
We also noted that the 2012-7 rally was unlikely to continue into a seventh year because the main drivers of asset returns were starting to fade. Central banks were scaling back and reversing their 'QE' (quantitative easing') asset buying programs, the US Federal Reserve was raising interest rates, and Chinese growth rates were slowing. Asset prices had risen everywhere in the boom but it was all an illusion - a house of cards propped up by ever-increasing piles of debt built up by governments, companies and households since the GFC.

As it turned out, 2018 saw negative returns from share markets almost everywhere and lower returns from other types of assets.



During the six-year boom many investors became complacent and started to believe that asset prices would keep rising forever – just like the euphoria of previous booms before they burst. People forgot about asset allocation because everything went up!

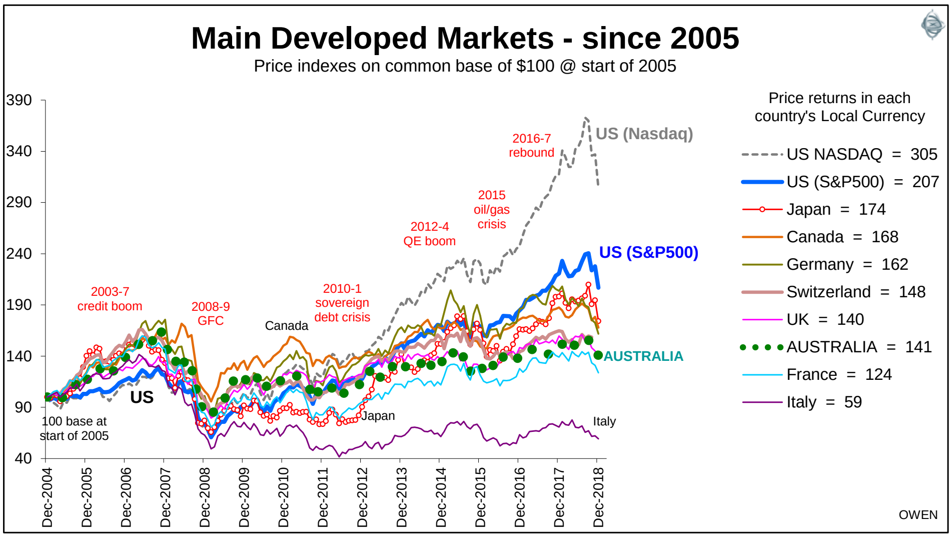
In reality the six year rally in everything was very unusual. The previous five years from 2007 to 2011 were more like the usual pattern, with a mix of positive and negative returns. There was only one year when everything went up - 2009, the rebound from the 2008 crash.

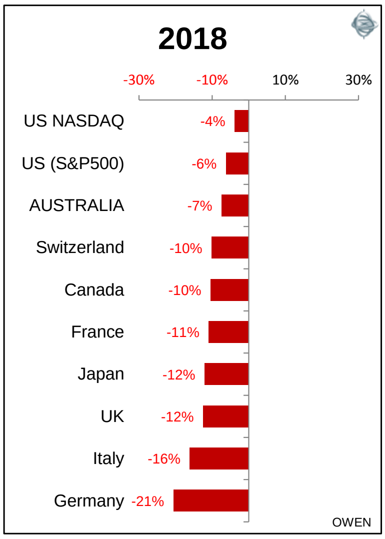


With QE now over in the US and Europe and interest rates still rising in the US, 2018 was really just a return to the more usual pattern of mixed returns. 2019 will probably also be another year of mixed positive and negative returns from different types of investments. China is slowing again, Europe has stagnated again, the Fed is still raising interest rates, a new 'cold war' between the US and China is brewing, Trump will have to deal with a hostile House, and Australia's housing construction boom is over. Asset allocation is well and truly back!

2 Shares tumble almost everywhere

2018 was a year of surging corporate profits and record-breaking dividend payments around the world but shares sold off almost across the board, mainly late in the year. The first charts show the main 'developed' world share markets – the left chart shows the broad market index for each country starting from a common base of 100 in 2005, and the right chart shows the changes in 2018.

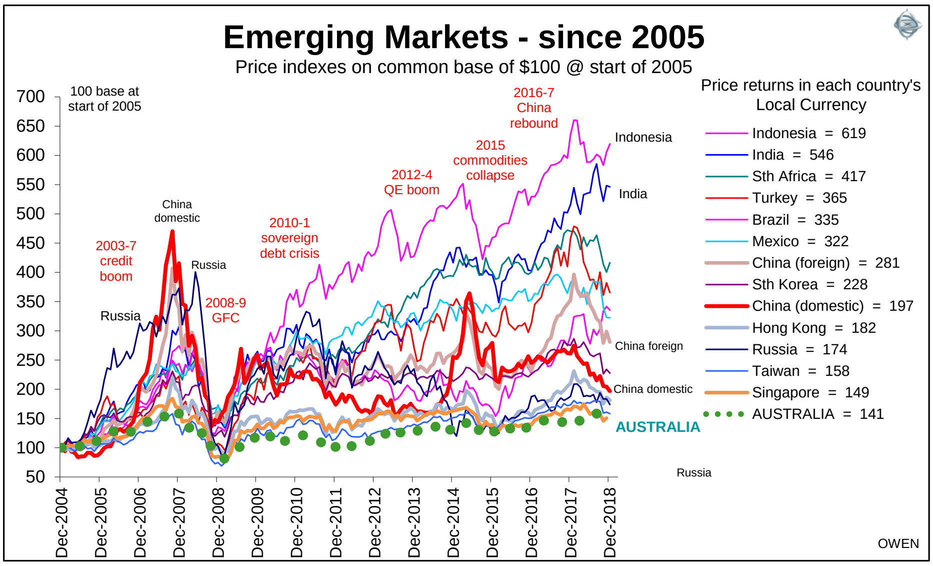


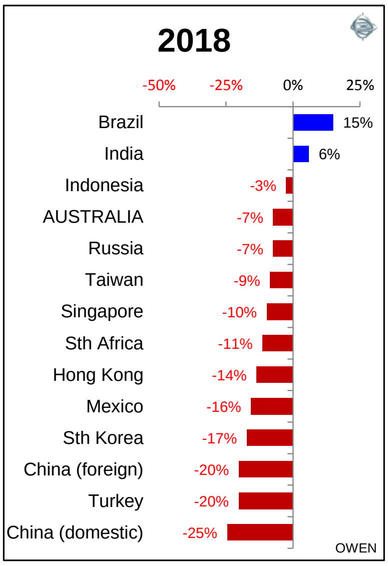


The Australian market remains near the bottom of the table of 'developed' markets since 2005 but it held up better than most in 2018 thanks largely to our falling dollar. The big banks and AMP were the main drag on the overall market as a result of slowing lending, falling house prices, rising funding costs, falling profits, and widening fears about the rising costs of regulatory penalties, customer remediation programs and compliance burdens that are likely to result from the Hayne inquiry.

The US remains in the lead, especially the tech sector, the largest sector in the broad US market and dominates the NASDAQ index. US stocks and tech stocks in particular led the market sell-off in late 2018 but they still remain ahead of other global markets.

'Emerging' markets fell through most of 2018, not just in the general global rout late in the year.





Emerging markets are driven primarily by global 'hot money' flows and they suffer in every global sell-off, regardless of local conditions, but there are three main reasons for their additional weakness in 2018. First, the cyclical slowdown in China affected not only Chinese markets but also China's trading partners in North Asia. Second, the boom in Chinese tech stocks (Alibaba, Tencent, Baidu, etc) was even more over-priced than US tech stocks. Third, rising US interest rates and rising US dollar triggered foreign debt crises in several countries where collapsing currencies and local interest rate hikes exacerbated the problem.

Emerging markets beat developed markets in 2017 and we had specific allocation to them in portfolios. However when we reduced our overall exposures to global shares during 2018 we removed emerging markets shares altogether as they always suffer worse than developed markets in general sell-offs.

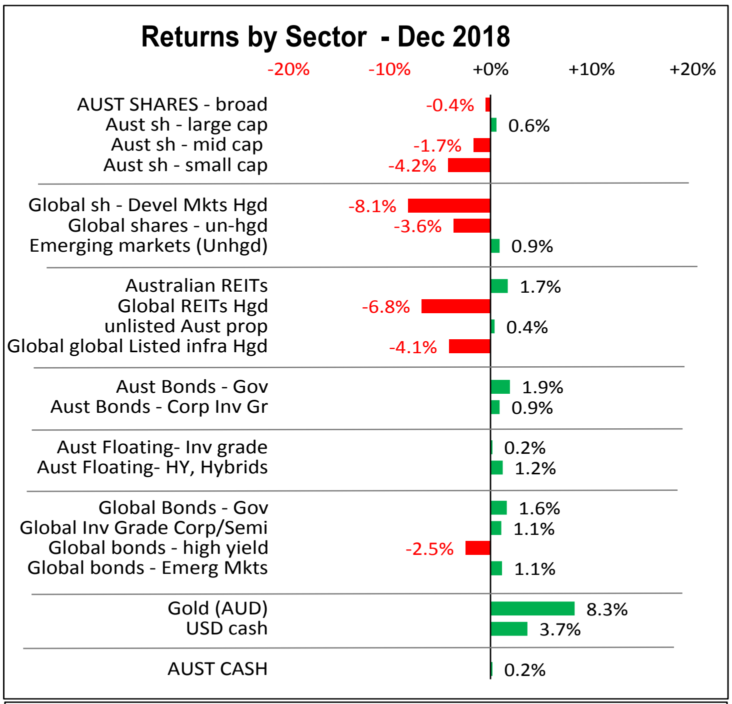
3 Volatility . . . What volatility?

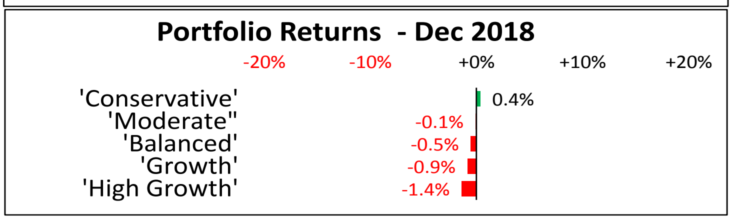
US shares had their worst December since 1931 and the rest of the world was down heavily as well, so how did that affect our portfolios?

After having been relatively bullish on shares since the 2016 Brexit vote and Trump election, we took action to reduce allocations to Australian and global shares in portfolios during 2018. As we wrote at the time, when we reduced share allocations 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 the dilemma was that what defensive assets to utilise 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); and 2) a global slowdown scare (like 2011, 2008, 2001-2, 1990, 1974, etc).

Early in 2018 we favoured an 'inflation scare' scenario (the main signs being rising US wages and bond yields). However in our July and October adjustments to portfolios we shifted to favour a 'slowdown scare scenario' so we removed exposures to global corporate bonds and increased government bonds. Earlier in the year we also removed exposures to emerging markets shares – they were the stars in 2017, but they have sold off heavily since we removed them. We also dramatically reduced the currency hedging on global shares from February 2018 in order to prepare for a fall in the Aussie dollar, and we added US dollar cash and gold.

Despite the heavy falls in global share markets in December our portfolios felt very little pain. The top section of the following chart shows returns from the main asset class and sectors for December. The bottom section shows returns on our model portfolios.





Even our most aggressive 'High Growth' portfolio – which ordinarily is 95% global and Australian shares - was down by just 1.4% for the month – hardly a ripple. The other portfolios were down by just a fraction, and our 'Conservative' portfolio actually gained a little. There are three main reasons for these outcomes. The first is that we reduced allocations to shares by up to 20% in our portfolios prior to the sell-off. Second, our low currency hedging on global shares smoothed the pain because the falls in global shares were partially offset by currency gains as the Australian dollar fell, as it almost always does in global sell-offs. Third, gold (in Australian dollars) and US dollar cash were the best performing assets in December and also for the whole of 2018. When we added them to portfolios last year we wrote at the time that they were not traditional long term holdings in our portfolios, but the unusual global conditions called for unusual strategies.

All of our portfolios remain ahead of their peer multi-sector funds – with higher returns, lower volatility, and higher risk-adjusted returns. They remain committed to delivering on their long term objectives, with fewer, shorter, shallower setbacks along the way.

4 Another GFC-like crash ?

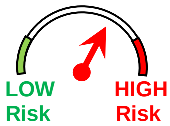
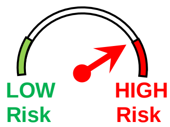
The most common questions I have received over the years have fallen into two main categories. In the booms the most common questions relate to a fear of missing out – 'Should I gear up?', 'Should I use a line of credit or margin loan?', 'Which do I like better: [bubble stock A] or [bubble stock B]?', Which is the best emerging market?', 'Should I buy flats off the plan in Melbourne or Brisbane?', 'Which is better: Bitcoin or Ethereum?', and the like.

However as soon as there is a wrinkle in the markets the questions turn to impending disaster – 'Is this another GFC / 1987 / 1929?', 'Is this the end of the world as we know it?', 'Should I sell everything and move to Fiji?', and so on. A year ago the markets were booming – especially in tech stocks, crypto currencies. 'fin-tech' and emerging markets - and the questions were almost all about how to get in on the action. Now after the price falls in recent months the questions have turned from the first to the second category.

Over the past 35 years I have studied many different types of market bubbles and busts – including stock market crashes from the 1720s Sea Bubble to the 2008-9 GFC, the 2010 'flash crash' and the 2015 Chinese stock market crash, as well as the numerous crashes in the local Australian stock market; commodities bubbles from the tulip mania in the 1630s to the gold bubble in 2011; property booms and busts in Australia from the 1890s crash to the early 1990s, banking collapses from the *Bardi* and *Peruzzi* in 1345 (caused by England defaulting on its debts) right up to the recent European crises including *Banca Carige* last week (also Italian – what is it with Italian banks?). There have also been a host of other bubbles and busts in everything from Chinese unions to Bitcoin.

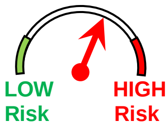
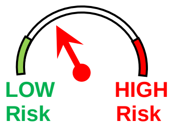
<u>Conditions present in before crashes</u>

I have found that there have tended to be four main elements present in almost all bubbles that ended in busts. Here is a summary, together with brief comments on the current environment, and a 'risk rating' for each:

Factor	Examples	Position today ?	Risk rating
1. Over-pricing – or at least a strong run-up in prices	• A sustained and/or explosive rally preceded every major bust • But markets can crash even if not vastly over-priced – eg 1929, 1987, 2008	• Over-pricing in US and Chinese tech stocks, healthcare, consumer brands • Over-pricing in Commercial property / infrastructure assets (on artificially low rates) • Aust housing / units - collapse would be enough to cause broad banking crisis like 1991-3, 1890s	
2. Speculative fever	• Present in the lead-up to nearly all major sell-offs. • Usually related to new technology – canals, railroads, cars, radio, aerospace, internet, crypto currencies, A.I. • Speculation in one market can spread to a broad crash – eg US 'dot com' crash led to broad US market 40% collapse in 2001-2	• US and Chinese tech stocks • Crypto currencies (probably not broad impact into other markets) • Hot sectors (eg green tech, fin-tech – but probably not broad impacts)	
3. Leverage	• Present in most crashes – eg 1929, 1973-4 , 1987, early 1990s, 2008, tulips, South Sea • Leverage could be in the underlying assets (eg US housing in GFC) or at the security level (eg margin loans on shares or trusts)	• US margin lending is on par with top of booms prior to tech wreck + GFC, but not as high as 1929 • Chinese state-directed debt, rising bad debts • Household debts – Aust, Europe • Emerging markets USD debt burdens	
4. New financial instrument – untested, not understood, unforeseen consequences	• Investment trusts in 1907, 1929 • Call money market in 1929 • finance companies in late 1950s, 1973-4 • Portfolio insurance in 1987 • Option-ARMs, MBS, CDSs, CDOs, in 2008	• ETFs – now control nearly half of all shares – many using derivatives, gearing • Derivatives, interconnected counterparties • HFT, '*algo*' trading • Hackers could close down global systems	

Triggers for the collapse

Prices can continue to boom for several years despite deteriorating conditions before the market finally collapses. The events that triggered the collapses have been many and varied but they have tended to fall into one of the four categories:

Trigger	Examples	Position today ?	Risk rating
1. Rising interest rates	• 1929, 1951, 1973-4, 1987, 1994, 2001-2, 2008, 1994 bond crisis	• US rates rising – affecting US spending + emerging markets debt • emerging markets rate hikes probably have only local impacts	
2. Government / regulatory attack	• Attack on monopoly trusts in 1907 • Attack on utilities in 1929 • confiscation of assets after invasion, revolution, coup, etc	• US tech stocks attacked by anti-trust regulators, privacy, hacking • Trade war actions • Australian banks (but politicians probably not brave enough to bring radical change)	
3. Loss of trust in a fundamental component	• Bank collateral in 1929 • US dollar in 1987 • bank assets in 2008, • sovereign default fears in 2010, 2011	• Global trade • European banks • ETFs, counterparty risk • Hackers could close down global banking or payment systems, or stock exchanges	
4. Military attack	• Usually not the cause of the sell-off, but can be the initial trigger for panic selling that cascades into broader selling • Eg 1914, 1939, 1942, 1987	• Sudden strike could come from US, China, North Korea, but more likely Russia, Iran, Israel • More likely a field error that escalates out of control	

Common Red Herrings

There are also some common red herrings as to what causes collapses. One is economic recessions. Market commenters love talking about them but they are almost irrelevant to understanding stock markets. Recessions don't cause stock market collapses. Recessions sometimes occur afterwards, and often not at all. Australia's worst three stock market crashes – 2008, 1987 and 1973-4 were not caused, triggered, or preceded by recessions. In 2008 Australia had neither a recession nor a sub-prime problem but the Australian stock market fell more than any other global market. In 1987 there was no recession until 3 years after the crash; and in 1973-4 the recession came a year after the crash. In 1929 the economy was in recession two years prior to the 1929 crash.

Another red herring is corporate profits. 2008 was the strongest year for corporate profits and dividends in Australia but the market crashed. Likewise with 2011 – strong profits and dividends from the mining boom but shares tanked right in the middle of the booming profit reporting season. 2018 saw global profits rising by 20% and record-breaking dividends paid, but shares sold off. The problem is that profits and dividends are back-ward looking but share prices are forward looking.

5 Where are we now ?

<u>Looking at each of the conditions in resent in booms that collapse:</u>

1. Over-pricing? Moderate to High risk. Before the late 2018 sell-offs many markets were clearly over-priced – including US and Chinese tech stocks, and also in other sectors including healthcare and global consumer brands. The price falls in recent months do not reduce the risk of collapse. Over-priced markets never drift back quietly and calmly to fair pricing – they tend to swing wildly from over-shooting savagely on the upside to over-shooting savagely on the downside. Markets are driven by wild emotions, not quiet logic.

3. Speculative fever? Moderate to High risk. US and Chinese tech stocks have led the recent boom in share prices. In addition we have the recent boom in dozens of new 'crypto-currencies' and 'initial coin offerings' that have jumped on the Bitcoin bandwagon, and also the booms in 'fin-tech' and 'green tech' stocks that are as revenue-free and profit-free as the 1990s dot-com boom. Busts in crypto, fin-techs and green-techs are unlikely to expand into broad market collapses unless losses start to trigger broad selling and margin selling in the broader market, as they did in the 2001-2 tech wreck, and in 1929.

In Australia the boom in high rise units is certainly on a par with similar speculative property booms in Australia in the 1880s, early 1970s, late 1970s, and late 1980s, all of which ended in banking crises, widespread bankruptcies and corporate losses, deep economic recessions and broad share market collapses. Prior busts were triggered by sudden withdrawal of capital and/or interest rates hikes. This time it is the sudden withdrawal of capital from China and from the local banks.

3. Leverage? High risk. US margin loan volumes are on a par with the peaks prior to the 2008-9 GFC and 2001-2 tech wreck, but not as high as in 1929. We wrote about this in last month's report. This is a clear sign of extreme debt-fuelled speculation.

The extremely low interest rates since the GFC have led to a massive build-up in debts at all levels in almost all countries – government debt, corporate debt, housing debt, personal loans, and margin loans. This makes the entire system highly vulnerable to interest rate rises. The likely impact of rising US interest rates and rising US dollar on emerging market governments and companies was the main reason for removing emerging markets shares from portfolios before they collapsed in 2018.

4. New financial instruments? - High risk

Not only is this a 'high risk' condition present in the boom, it is also a likely candidate for the trigger for a broad crash. In 2008 it was the sub-prime financial innovations like Option-ARMs, MBSs, CDSs, CDOs and the like that under-pinned the 2000s boom, and they also triggered the US banking crisis and in turn the sudden collapse in bank finance, the instantaneous global banking contagion and the broad stock market collapse in every country.

The explosive growth of Exchange Traded Funds (ETFs), High Frequency Trading (HFT), and 'algo' (algorithmic trading) now dominate markets and present a likely trigger for collapse – see below.

<u>Looking at the likely triggers:</u>

1. Interest rate hikes – High Risk. Looking at numerous past cycles, interest rate hikes are usually brushed off by stock markets while interest rates, inflation, bond yields and economic growth rates are still low – i.e. early cycle rate hikes. That applied to the early US rate hikes starting in December 2015 and continuing into 2016 and 2017. We were bullish on US shares during those early rate hikes. However late cycle rate hikes – i.e. when interest rates, inflation, bond yields and economic growth rates are higher – are more damaging to share prices. Trump's tax cuts and deficit spending are inflationary, but further Fed rate hikes to counter inflation could rattle markets.

2. Regulatory / government attack on business – Moderate to High Risk. This could be in the form of the EU ordering a break-up of Google, Facebook, Apple, Microsoft, Amazon, etc, or restricting their access. China could easily restrict or ban access to a host of US companies and instantly cripple their largest source of growth. Trump could fire Powell. Trump or Xi could quickly escalate their trade war into broader retaliatory spiral like 1930-2.

3. Loss of trust in a fundamental component of the market – High Risk. ETFs now control nearly half of all investment markets globally. Everybody assumes they are risk-free in the sense that they can instantly sell all holdings necessary to meet any sell orders. They also assume that every one of their thousands of counterparties around the world are equally risk free and infinitely liquid in a crisis. Many rely on derivatives and/or gearing, which are untested in a crisis. There may be a sudden collapse of a major counterparty that everybody assumed was safe. Another problem that remains unresolved is the European banking system – which is still sitting on untold losses that the ECB is terrified of making public but regularly papers over with its sham 'stress tests'. Hackers could close exchanges or banks.

4. Military attack – Low to Moderate Risk. Sudden attack by US, China, North Korea, Russia or Iran is not likely, but there may be a field conflict or error (eg plane mistakenly shot down) that quickly escalates into retaliatory conflict. Even a relatively small incident may be enough to trigger nervous sell orders that cascade into a spiral of panic selling (eg 1987), especially with ETFs in illiquid markets.

What lies ahead?

Returning to 2 big questions – firstly: 'Are we going to get another GFC-like sell-off?' – That's an easy one: Of course we will! We have had several 40%+ sell-offs in the past (about one every couple of decades) and we are sure to see many more in the future.

The second big question is – 'Are we at the start of one now?' That is more difficult. All we can do is manage portfolios based on what we see at the moment. The conclusions from the above analysis are: (a) Many of the conditions in past cycles are present now - markets are still over-priced – shares, bonds and properties (commercial and housing); speculation is rife in a number of areas; there are high levels of debt at all levels in almost all countries; and there are also a number of financial 'innovations' that could present unknown risks or unforeseen consequences. (b) There are also several potential candidates for triggers for a broad collapse – rising interest rates, government or regulatory attacks on business; a possible collapse in trust in a major element underpinning market confidence – like ETF liquidity, counterparties, derivatives, or bank assets; and also the possibility of military strikes rattling investors and triggering a spiral of sell orders.

While all of this is fascinating to study and debate, the acid test is: - what are we doing about it in portfolios?

In our reviews of markets during 2018 we went from being bullish to bearish on the outlooks for shares, in particular US and emerging markets shares. We reduced exposures to US and global shares and we removed emerging markets shares altogether. We also reduced the currency hedging on global shares dramatically – to capitalise on a falling Australian dollar. At the same time we reduced Australian shares even though they were not overpriced. They fell along with all global markets as they almost always do in broad sell-offs, regardless of local conditions and local pricing. We also added some non-traditional assets like gold (in Australian dollars) and US dollar cash. These turned out to be the two best asset classes in 2018 – up 8.4% and 10.8% respectively.

In the quarterly review of markets we will undertake in January we are unlikely to make major changes these broad settings. We don't have some magic crystal ball that predicts markets. All we can do is assess the conditions as we see them, identify the sources of risk, and steer the ship toward areas where the opportunities are greater than the risks. Usually this means going against the herd.

The US and China remain the centre of attention. In the US - Trump will run into more trouble with Congress with the Democrats back in control of the House. There are gathering signs of slowing consumer confidence and spending, and the Fed is likely to raise rates further.

China is clearly entering another cyclical slowdown – like 2014-5, and this is dragging down commodities prices. This is bad for commodities exporters like Australia and it could also trigger another bout of global bankruptcies in oil/gas/steel companies like in 2015. Chinese corporate defaults are also rising rapidly. Xi has anointed himself Emperor for life but he is coming under increasing pressure from within the party to play hardball with Trump as he is being blamed for the trade war. Chinese stimulus announcements rebooted global markets in March 2016 but this time Xi appears to be favouring military expansion over internal stimulus.

We wrote in this report two months ago: *'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.'* Trump and Xi called a temporary truce in December and are due to meet again in the coming days. Shares will probably rise in the short term until the next inevitable Trump tantrum.

Locally, the Hayne Royal Commission is due to publish its final report shortly. The recommendations are sure to call for radical and far-reaching changes to the current system of cartel price gouging unfettered by lax regulation and almost no enforcement. Much depends on the outcome of the Federal election which is due by May. This is likely to see major changes to both the government and the make-up of the legislature, in particular the Senate. On current numbers Labor is likely to win back government but is likely to be hampered by a fragmented Senate which may make it hard to implement many of their radical policies including scaling back negative gearing, increasing capital gains taxes and removing franking credit refunds. These will have direct impacts on property and share markets if enacted.

Prices of Australian houses and especially high rise units will probably keep falling. The main sources of funding are likely to continue to restrict supply - banks restricting lending and the Chinese government restricting capital outflows. Bad debts and bankruptcies will gather pace but it is likely to take some time to build to crisis levels that impact broader spending and demand.

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