STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5

February 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 When conditions change – so do we

The experience of the past couple of years has been a good reminder for investors not to chase last year's winners. Different types of investments perform differently in different conditions so when conditions change we adjust our asset allocation to protect investors against risk and to capitalise carefully on opportunities. We only make major changes every couple of years or so, but 2018 was a turning point that marked the end of the six year global 'QE' rally. The chart shows total returns from the main asset classes since the start of 2018.

Asset Class Returns - 2018-9

Total Returns to end of January 2019

'Defensive' assets:

Gold (in AUD) +10.8%
USD cash (in AUD) +8.4%
Aust Investment Grade Bonds +5.3%
Aust Cash +1.7%
Global Inv Grade Bonds (Hgd AUD) +1.9%

'Growth' assets:

Global shares (Un-Hgd AUD) +5.0%
Australian shares +0.4%
Emerging Mkts Shares (Un-Hgd AUD) -0.8%
Global shares (Hgd AUD) -1.7%

January rally after Trump's tax cuts on 20 Dec
2 Feb US wages scare
22 March Trump starts trade war + Fed's 6th rate hike
13 March Start of Hayne inquiry hearings
8 May Aust Federal budget tax cuts
13 June Fed's 7th rate hike
6 July 1st round of US-China tariffs start
24 Aug Morrison replaces Turnbull as PM
27 Sep Fed's 8th rate hike
October US inflation scare + tech sell-off
19 Dec Fed's 9th rate hike
December global growth scare + share sell-off
January rally

Dec-2017, Jan-2018, Feb-2018, Mar-2018, Apr-2018, May-2018, Jun-2018, Jul-2018, Aug-2018, Sep-2018, Oct-2018, Nov-2018, Dec-2018, Jan-2019

The unusual combination of falling share prices, ultra-low interest rates and low or negative returns on bonds caused by US inflation fears lifting bond yields, meant that all of the traditional asset classes suffered poor returns in 2018.

The best returns for the year came from two non-traditional assets - Gold (in Australian dollars) and US dollar cash (also in Australian dollars). We added both to portfolios in April 2018 as part of our defensive strategy in preparation for the global share sell-off. They had been the worst performing assets in 2017 (when we didn't hold them) but their positive returns during the global share correction in the second half of 2018 neutralised much of the negative impact of the share price falls. We are retaining both in portfolios for the time being.

Conversely the highest returning asset classes in 2017 - hedged global shares and emerging markets shares - were the worst in 2018. In 2017 after the Trump election we were bullish on shares and bullish on the Australian dollar, so we 'hedged' the currency risk on most of the global shares in our portfolios in order to protect them from a rising Australian dollar. We also held emerging markets shares in portfolios in 2017. Hedged global shares returned 21% in 2017 as the Aussie dollar rose 8%, and emerging markets shares returned 27%.

But then things changed. We turned bearish on the Australian dollar in February 2018 and so we started reducing the currency hedging on global shares in preparation for a falling AUD. In April 2018 we also turned bearish on shares so we reduced allocations to Australian and global shares and we removed emerging markets shares, to protect portfolios from the impending sell-off. We also reduced the currency hedging on global shares further in anticipation of further falls in the AUD. Emerging markets (-6%) and hedged global shares (-8%) turned out to be the worst performers in 2018 after being the best in 2017. However our un-hedged global shares held up and ended the year square because the fall in the Aussie dollar offset the falls in global share prices. Although shares fell heavily in late 2018 we remain cautious.

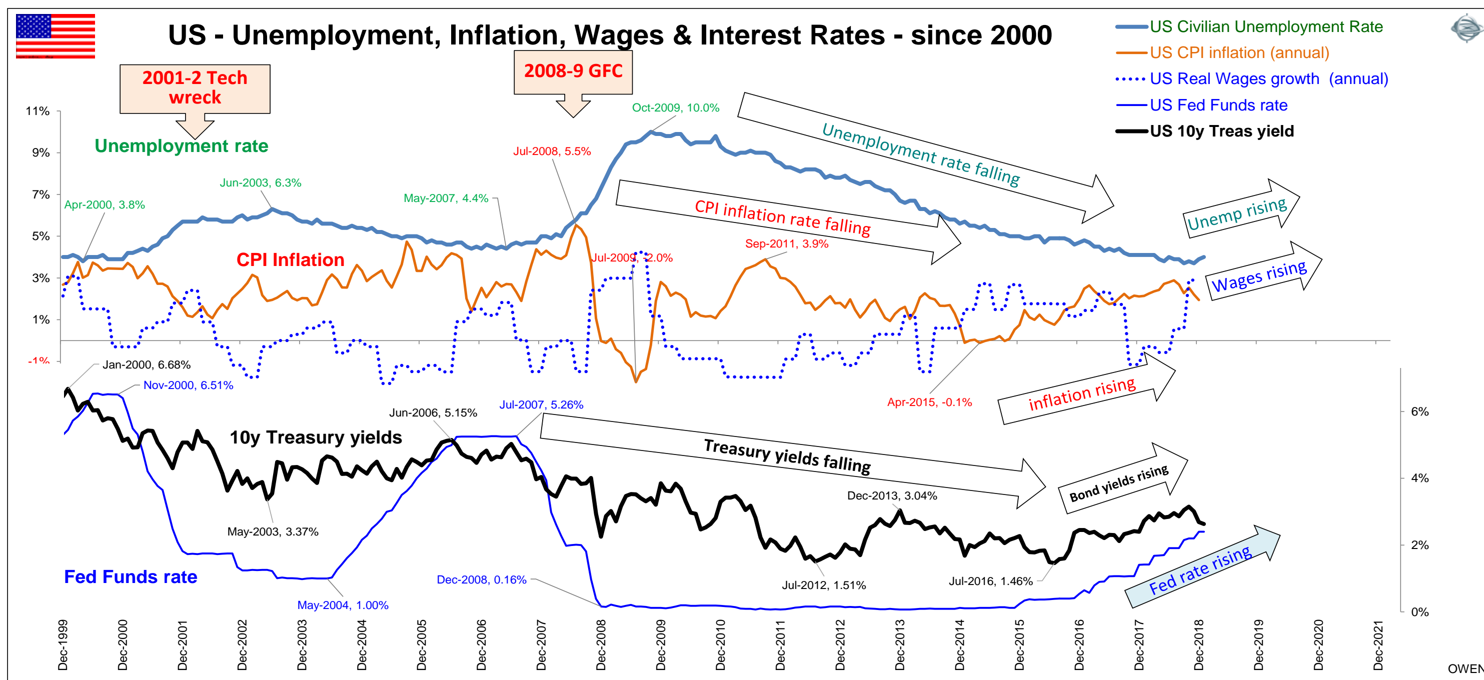
2 US Fed wakes up

January marks the month when the US Federal Reserve Board woke up. This was the main event for global financial markets so far this year.

Anyone looking out of the front or side windows of the US bus could see signs everywhere that activity was slowing. But the Fed only has a rear view window and so it only sees things once the bus has well and truly passed them. Fed members not only sit facing backwards, they also wear sound-proof earplugs. The Fed was happily sitting on the rear-facing seats of the bus, raising short term interest rates based on what they could see in the past. They raised rates four more times in 2018, bringing the total to nine rate hikes since December 2015.

The unemployment rate had fallen below 4% (below 'full employment' levels), inflation was running at above 2% (above the Fed's target range), real gross domestic product as growing by 3% (beating the post-1980 average rate of economic growth), and corporate profits were surging by an incredible 20% for the year. Out of the rear window the economy looked fine, even perhaps running a little too hot, so the Fed's task was to increase interest rates back to more 'normal' levels. After the 9th hike on 19th December the Fed rate was still a very low 2.4%.

Here is our snap-shot of the key indicators for the US. Things looked very rosy (at least on the surface) until late 2018.



One of the main triggers for the sharp 20% fall in US share prices (and 23% fall in the NASDAQ index) in late 2018 was the sound of the Fed members snoring, and the fear that they would just keep on raising rates in their sleep, back toward historical levels of around 4% or 5%.

The problem is that the backward looking numbers hide what is really going on. The unemployment rate of 3.7% was the lowest it had been in 40 years but so is the labour 'participation rate' (the proportion of adults in work or looking for work. The headline unemployment rate is low because millions had simply given up looking for work). Also, many who 'work' are not in stable jobs - driving for Uber or Uber Eats, or running a YouTube or Instagram channel are not really 'jobs' that qualify when you want to apply for a housing loan or business loan.

The strong wages growth in 2018 was mostly a rebound from the fall in 2017. The robust inflation numbers were caused mainly by the rebound in oil prices and rising mortgage costs as bond yields rose. The high corporate profit growth was mostly a combination of the rebound from the oil/gas losses, and recovery from one-off Trump tax payments in the prior year. The rising US dollar was dampening US exports, business confidence and factory orders were declining. Consumer confidence was also already declining (even before the Government shutdown), house prices across the US had stopped rising and were starting to fall, as were new building permits and construction spending. Long bond yields had turned bearish and started declining from early November, unemployment rates have risen over the past couple of months, and the inflation rate has also slowed. With the Fed blindly raising rates, investors panicked and dumped shares everywhere.

Finally on 4th January Fed Chair Jay Powell woke up from his sleep-walking rate hikes and announced that the Fed would henceforth be 'patient and flexible' with further rate hikes. Nervous investors breathed a huge collective sigh of relief and sent share prices up 7% in January in the US and around the world, clawing back some of their losses from the sell-off. The 'patient' wording was repeated by the Fed on 23rd January. Given the delay from the time things occur to when they appear in the Fed's rear window, we probably can expect a couple more scares this year like we saw a year ago. Recall that share prices also soared in January 2018, then fell back sharply in February.

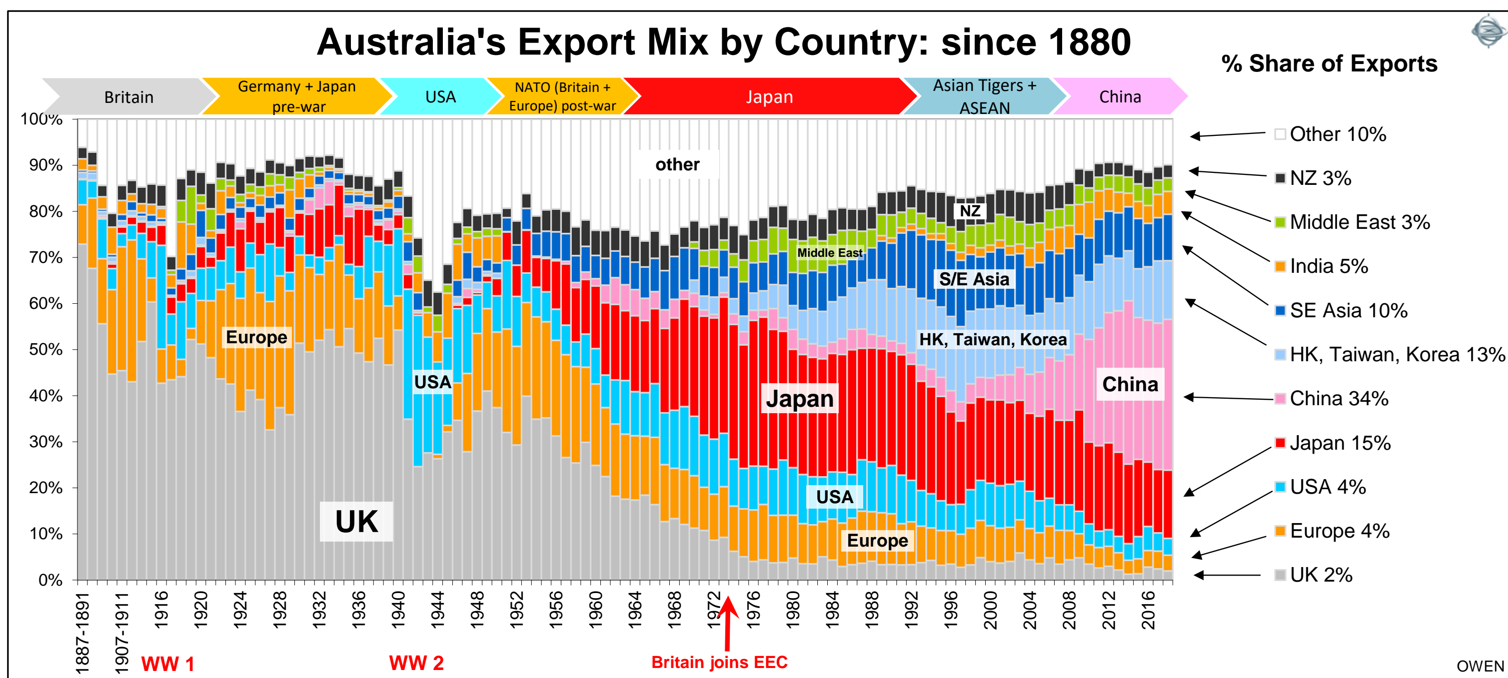
3 Does 'Brexit' matter down under?

Australia's worst stock market crash was in 1973-4. It was deeper than the crashes in 2008-9, October 1987, and even 1929-31 (which was America's 'big one'). The double-barrelled 1973-4 crash ended the late 1960s mining boom and also ended the early 1970s property construction boom. (A mining boom/bust followed by a property boom/bust is a common pattern in Australia - we are in one right now).

The main trigger for the 1973-4 crash was a massive credit squeeze to fight inflation and end the out-of-control high-rise building boom (sound familiar?). Another element was the fear of the 'Mother Country' Britain abandoning Australia and turning toward Europe. Britain had started applying unsuccessfully to join Europe as early as 1961 but was finally admitted in 1973 when France relented after Charles de Gaul died.

This was seen as a major blow to Australia, which was founded as a British colony, populated by British prisoners, British military personnel and British free settlers, and financed by British capital. Australia had been part of the 'Sterling zone' trade block where its role as a colony was to supply the mother country with cheap raw materials and then be a captive market for the sale of British manufactures. There was widespread fear leading up to 1973 about the impact of the loss of what for most of our history had been our main export buyer.

These fears were unfounded. By the time Britain joined the EEC (now the EU) it was buying just 9% of our exports. Britain had taken nearly all of our exports in the 19th century (then mostly wool and gold), but the chart shows the changing mix of our export customers since then:



This highlights Australia's central role in helping build industrial (and military) capacity in a series of countries as they 'emerged' one by one.

Britain's role as the main export buyer started to fade in the early 1900s when Australia ramped up exports to help build Germany's industrial and war machine for World War 1, and again exporting to Germany, Italy and Japan leading up to WW2. When war broke out America came to the rescue and also took over as our main export buyer, followed by NATO in the 1950s and 1960s to rebuild war-torn Europe.

Japan became our biggest export customer when it overtook the UK in 1967 and Australia started losing markets to protected European producers that Britain was so eager to join. Australian coal, iron ore and other metals helped build Japan's rebirth as an industrial powerhouse through to its 1980s peak. Then in the 1990s our mineral exports built the next breed of rapidly expanding 'emerging markets' - the 'Asian tigers' (Hong Kong, Singapore, South Korea, Taiwan) and then the ASEAN countries including Malaysia, Thailand, Philippines, and Indonesia.

The latest 'emerging' country built with our rocks is China. Before China joined the World Trade Organisation in 2001 it bought just 5% of our exports, but the WTO entry kicked off its incredible urbanisation and industrialisation boom, built using our mineral exports. China overtook Japan as our largest export buyer in 2010 and it now buys 34% of total exports. Our rocks are building not only the gleaming new Chinese cities and railways but also the war machine it may use against us one day, just like Germany, Italy and Japan did in the two World Wars. We have not been as reliant on one country for our export revenues (and tax receipts) since 1955 when Britain was still the main buyer and ally.

Britain now buys just 2% of our exports, which is little more than a rounding error. Britain leaving Europe will not lead to a major change in our export revenues but Britain is still important to us of course. 28% of Australians were born overseas and the largest share of these are British born (5%), beating New Zealand, China and India (around 2% each). This mix will be very different in coming decades.

4 The Bogle effect

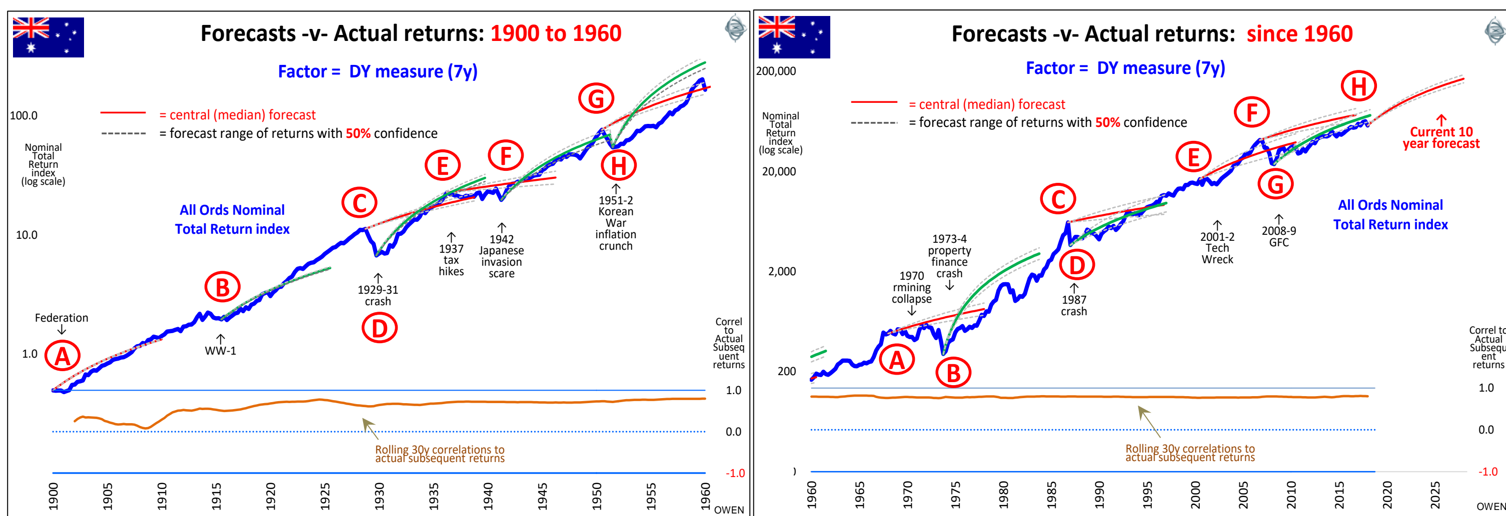
Sadly, one of the legends of the investment world died in January. Jack Bogle's revolutionary low-cost 'passive' Vanguard index funds completely changed the way the world invests. They are called 'passive' index funds as they just buy and hold all of the assets (stocks, bonds, etc) in a chosen index rather than pick stocks to try to 'beat the market'. "Don't look for the needle in the haystack. Just buy the haystack!"

The low-cost passive index fund revolution started by Bogle's Vanguard funds in the 1970s provided a way for ordinary investors to beat the vast majority of expensive 'expert' fund managers who try to beat the market but fail in just about every market and sector in every country. Passive index funds run by Vanguard and many other providers like State Street ('SPDRs'), BlackRock ('iShares'), VanEck and others - have overtaken active funds and now dominate almost all investment markets. A small minority of active funds do actually add value after fees and costs, but there are devilishly hard to find, and their out-performance usually doesn't last long. There have been some brilliant stock pickers over the years but most of their funds are run for private money and/or are not open to retail investors. Warren Buffett's Berkshire Hathaway has beaten the US market consistently for six decades but shares in Berkshire now cost $310,000 USD each! (I am a long term holder).

In our portfolios we use a combination of passive funds (including some Vanguard funds) and we also use some active funds – but only those that have a proven track record of beating the index in their particular market or sector over many years, after fees and costs.

But Jack Bogle has another more direct impact on our portfolios. In the early 1970s while working for Wellington Management in Philadelphia before he started the Vanguard funds, he wrote a paper about how to assess whether a stock market is expensive or cheap by looking at dividends. It was far more robust than just looking at the simple dividend yield (which is the aggregate amount of dividends paid by all the companies in the market divided by the total value of all companies). Instead of using just the latest year's dividends he took a long term average level of dividends and then adjusted it for inflation. This removes the short term noise, the cyclical effects and inflation, and arrives at a ratio that provided a more reliable long term return forecast for the market. It is very similar to Nobel Prize winner Robert Shiller's 'Cyclically Adjusted Price/Earnings' ('CAPE') ratio developed in the 1980s, except that Bogle's ratio uses dividends instead of earnings (profits).

In the models for the US and Australian stock markets that we use in the asset allocation process for our portfolios, we use five separate factors to arrive at long term return forecasts – and these include both Shiller's CAPE ratio and Bogle's long term real dividend yield factor. The charts show the Bogle model's long term return forecasts from the tops and bottoms of past booms and busts for the Australian market.



At the tops of booms the forecasts were low and subsequent returns turned out to be low. In the left chart: points C (Sep 1929), E (1937), and G (1951). In the right chart: A (1968 at the top of the mining boom), C (Sep 1987), and F (Dec 2007 before the GFC). Conversely, at the bottom of busts the forecasts were high and subsequent returns were also high. In the left chart: points B (1916 in the middle of WW1), D (1931 at the bottom of the Depression), F (1942 during the Japanese bombing of Darwin and Sydney), and H (1952). In the right chart: B (at the bottom of the 1973-4 crash), D (December 1987 after the October 1987 crash), and G (March 2009 at the bottom of the GFC crash).

Currently, Bogle's model is forecasting total returns (including dividends) for the Australian market of around 10% pa, which is around historical average returns, indicating the market is not over-priced on this measure. The US picture is far more bearish. The long term forecast from current levels (even after the recent US sell-off) is just 6% pa from the Bogle model, and an even lower 4% pa from the Shiller model.

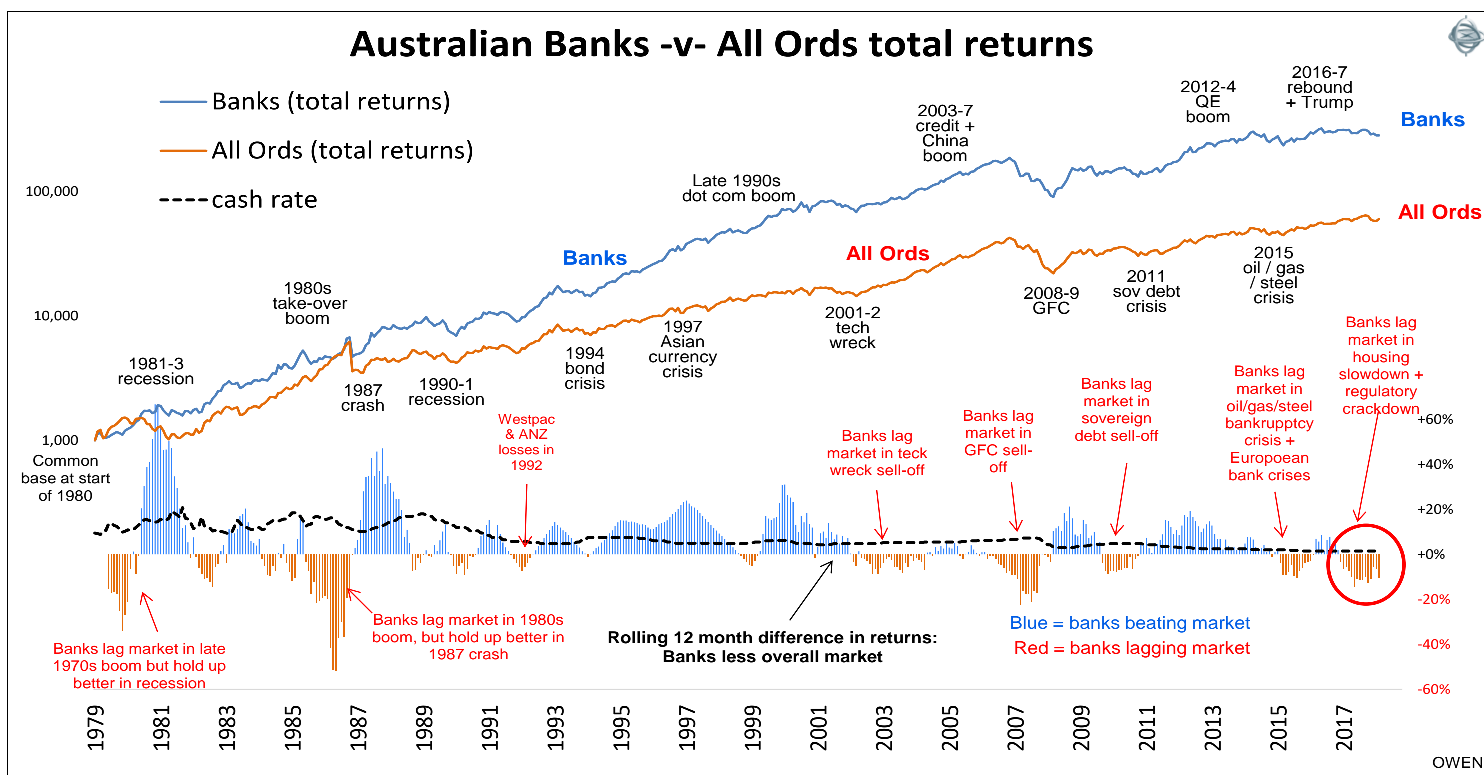
These are long term forecasts but our process also uses medium term and short term warning systems. While the long term outlook for the Australian market is much rosier than it is for the US market, short term movements here tend to be driven by the US. Because our market always falls when the US falls, we went under-weight both US/global shares as well as Australian shares before both fell sharply in late 2018.

5 Banks lagging: cyclical or structural?

Australian banks have provided shareholders with tremendous returns in excess of the overall share market in recent decades. Bank shares have returned an average of 15% pa (including dividends) since their 1980s deregulation compared to 11% from the broad share market. This would not happen in a normal competitive market. The banks' excess returns have come partly from exploiting their cosy cartel structure, and also from their institutionalised theft, over-charging, predatory lending, market rigging, fraud, forgeries, lying to regulators, mis-selling of conflicted internal fee-laden products, anti-competitive gobbling up of competitors, over-selling of products they knew their victims could never use, charging for services they never intended to provide, and a host of other unsavoury practices at every level from boards to branch staff. Bank directors, executives and staff pocketed much of the spoils but they left some tasty crumbs for shareholders.

The out-performance of the banks over the broad share market has varied over time. Banks have lagged the market in every slowdown since the early 1980s recession. Banks fell further in the 1990-1 recession because of corporate losses (from Bond et al) and the massive losses by Westpac and ANZ (mainly on property construction loans). Banks also lagged in the 2001-2 'tech wreck' after the 'dot com' boom. In the GFC crash the banks fell more than the rest of the market because of fears they held infected sub-prime assets. Banks fell further than the broad market in the 2011 sell-off (Greece 2 plus US downgrade crisis), and also in the 2015 sell-off due to fears of losses on resources lending.

The chart shows total returns from bank shares (blue line) compared to the broad market (red line), and the rolling 12 month difference in the lower section. Blue positive bars are when banks were beating the broad market, and red negative bars when banks were lagging behind.



Over the past 18 months – highlighted at lower right - banks have lagged the market by a total of 18% since July 2017. Total returns (including dividends) of minus -8% from banks versus +10% from the broad market. Banks shares lagged in the Trump tax cut boom, but they failed to hold up as 'safe havens' in the late 2018 sell-off, and they also failed to participate in the January 2019 mini-rebound.

In portfolios we have been under-weight the banks (by favouring mid-sized and small share sectors). They face a host of problems. Part of the problem is cyclical – the end of the housing/construction bubble that will inevitably lead to a rise in bad debts – especially given their unprecedented reliance housing, and on the myth that "house prices never fall". There will be thousands of foreclosures – mostly highly geared buyers of 'off-the-plan' high-rise units. Like past cycles most of the bad debts will probably be to property speculators and developers.

But the banks also face structural problems. Their cosy cartel and vertical integration structures are being broken up and regulators will hopefully be given teeth to jail the crooks. The banks (ie the shareholders) are facing penalties, compensation and compliance costs that may run into tens of billions of dollars. While that is diverting their attention, the banks face future competition from the *real* global monopoly threats – Google, Apple, Microsoft, Facebook, Amazon and the like. That will be fascinating to watch – preferably from the sidelines!

What lies ahead?

The final report from the Hayne Royal Commission is hot off the press. It is a depressing look into the breathtaking depth and breadth of misconduct in the Australian financial system that has been allowed by sleepy regulators to spread like a cancer for years. Amazingly it looks like the banks will escape almost scot-free and will just carry on as usual – with a few minor PR tweaks here and there. Much will depend on the outcome of the Federal election due by May which is likely to see major changes to both the government and the make-up of the Senate. If Labor wins in the House, as polling suggests, it may be hampered by a fragmented Senate, making it hard to implement the Hayne recommendations, and also many of Labor's policies including scaling back negative gearing, increasing capital gains taxes and removing franking credit refunds. These will probably have more immediate impacts on property and share markets if enacted than any Hayne reforms.

With or without Hayne's credit reforms or Labor's tax increases, prices of Australian houses and especially high rise units will probably keep falling for now. The main sources of funding are likely to continue to restrict supply - banks restricting lending pending possible tightening of the credit laws, and the Chinese government restricting capital outflows. There are 900,000 interest-only loans that need to be rolled over into principal & interest loans that require higher repayments than the interest-only starter loans and honeymoon rates, and 40% of these are investor loans. Higher repayments, plus falling rents, and valuations coming in much lower than the purchase prices – points to foreclosures, fire sales and bad debts for the banks and mortgage insurers. Add to this a slowdown in jobs with a deceleration of the construction boom.

China is also slowing – with or without Trump's trade wars. This has added implications for investors because of Australia's heavy reliance on China for windfall export revenues and tax revenues. On the trade war front, we wrote in this report three 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.'* This turned out to be the case – nothing much has happened, apart from more tit-for-tat arrests and charges that kicked off with the arrest of Huawei founder Ren Zhengfei's daughter and Chief Financial Officer, Meng Wanzhou. In our last report we said: 'S*hares will probably rise in the short term until the next inevitable Trump tantrum.'* Shares did rise in January, but the underlying issues remain unresolved.

Trade is no longer the main issue. Both Trump and Xi want trade, just on better terms. China won't budge on its non-negotiables – the role of the communist party, state subsidies, lack of democracy or protection of free speech or human rights, but it is willing to make concessions on tariffs, increased market access to US companies and perhaps at least some surface changes to intellectual property transfer rules.

US-China trade is not a big deal by itself. China's exports to US amount to just 4% of China's GDP (total output) and just 3% of US GDP, while China's imports from US are a tiny 1% of China's GDP and less than 1% of US GDP – both mere rounding errors. China's massive trade surpluses of a decade ago are no longer an issue as they have now disappeared. Exports and imports are both slowing but the problem is that China's the trade surplus with the US is as large as ever. This offends Trump's very bi-lateral view of the world and is perhaps at the core of why Trump is now extending the dispute into something much broader than trade.

Trump's Secretary of State Mike Pompeo's 4th October speech in Washington and 7th October speech in Beijing laid out Trump's new 'cold war' agenda – focusing not just on trade but on China's military build-up, its territorial expansion into the new island bases it is building in the South China Sea, its strategic/military alliances extending from Pacific Islands all the way to Africa under its 'One Belt One Road' banner, its global 'Made in China 2025' technology ambitions, along with US allegations of intellectual property theft and espionage. This is potentially over-shadowing progress on the narrower trade issues, which are solvable.

We have recently taken the opportunity to capitalise on lower prices after the late 2018 sell-off, but we remain defensive in portfolios. 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
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