STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5
April 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.

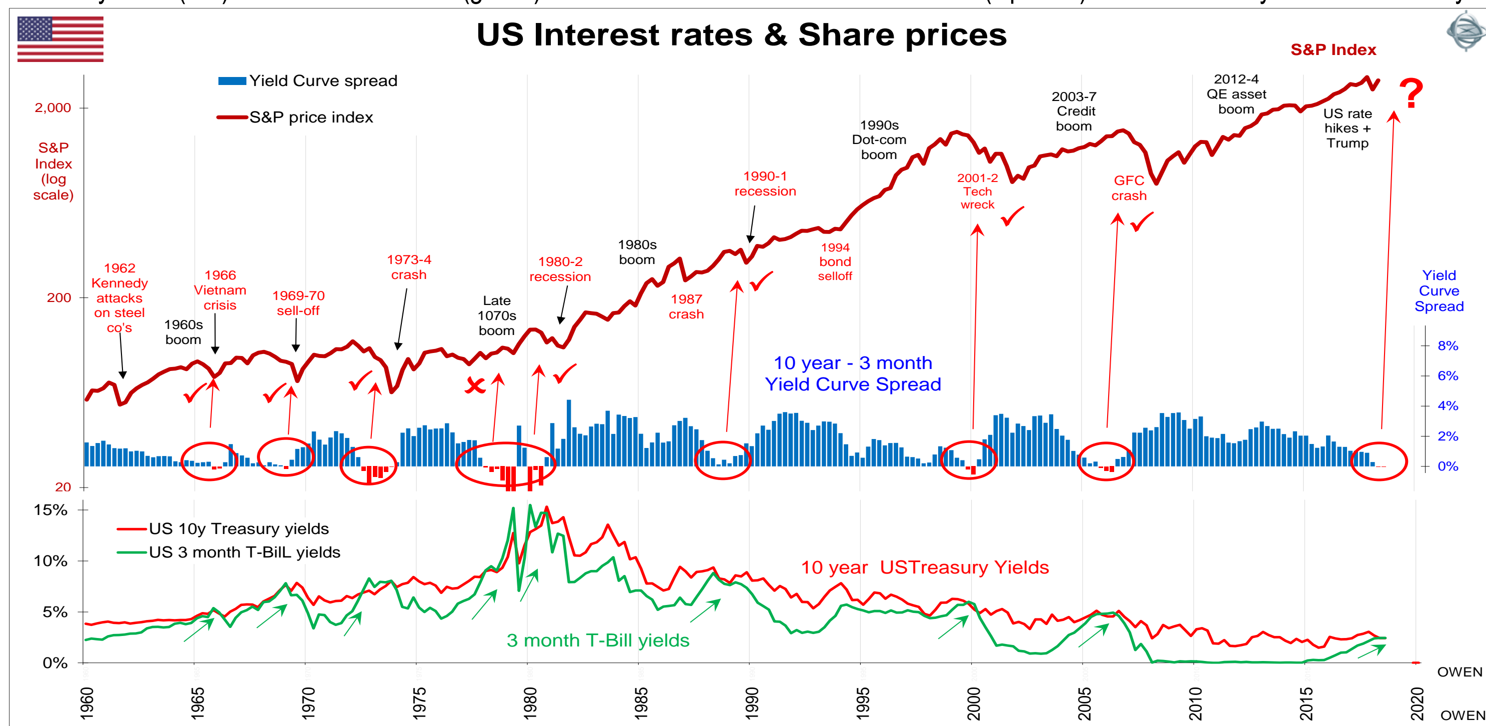
1 Negative 'Interest rate Spread' fears

One of the key events affecting global investment markets in March took place on the 22nd. The yield on 10 year US Treasury notes dipped to 2.44%, below the 2.45% yield on 3 month Treasury bills. This resulted in a 'negative' or 'inverse' spread between long term and short term interest rates. Long term rates are almost always higher than short term rates because investors in long term securities require compensation for the risk that inflation and interest rates may rise during period to maturity. When the 'negative spread' occurred, news headlines around the world warned that it pointed to an impending recession in the US, and share prices fell everywhere. Is this fear warranted?

Recessions are a primary concern for economists and policymakers, but as investors we are not directly interested in recessions as we don't invest in economic growth per se. We invest in assets like shares, bonds, real estate and currencies, and these work in different cycles.

The relationship between recessions and share prices is not straight-forward. There have been several big share market falls that were not related to recessions – in 1917, 1940-2, 1962, 1966, 1987, 2011 and 2015. Likewise the US share market fell 20% in late 2018 while the US economy was booming. Conversely, when the share market falls *are* related to recessions, shares usually fall before the recession even starts. By the time economists finally recognise recessions the share market is usually well into the rebound. Shares have enjoyed some of their best rallies during recessions – in 1919, 1927, 1945, 1953-4, 1958, 1961, 1974-5, 1982-3, 1990-1 and 2009.

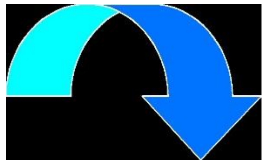
Therefore our primary focus is on share markets themselves and what drives them, rather than speculating on recessions. The chart shows US shares and interest rates since 1960. The upper section shows the S&P 500 index, and the lower section shows the yield on 10 year US Treasury notes (red) and 3 months T-bills (green). The centre section shows the difference ('spread') between the 10 year and 3 month yields.



The red circles highlight when the 10 year - 3 month spread turned negative. Out of the eight periods of negative spreads since 1960, seven of them were right before share sell-offs (red ticks). There was only one false alarm – in 1979 when shares kept rising for nearly two years until they finally fell in 1981-2 after the interest rate spread turned negative again (in the Volcker double-dip recession to kill off inflation).

In our portfolios we did not wait until now to turn bearish on US shares. We under-weighted shares last year before the 20% fall. Our multi-factor model for US shares includes five different factors to warn of short term dangers. One of these factors is based on interest rates (the other four short term factors relate to commodities prices, credit spreads, dividends and employment). By mid-2018 our models were pointing to a likely sell-off in shares and we acted on it to reduce shares in portfolios to limit the losses when the sell-off arrived in October to December. The reason our models picked up the prospect of a fall in share prices was that it looks at more than just the interest rate spread. It also takes into account the direction of short term rates, the direction of long term yields, and inflation.

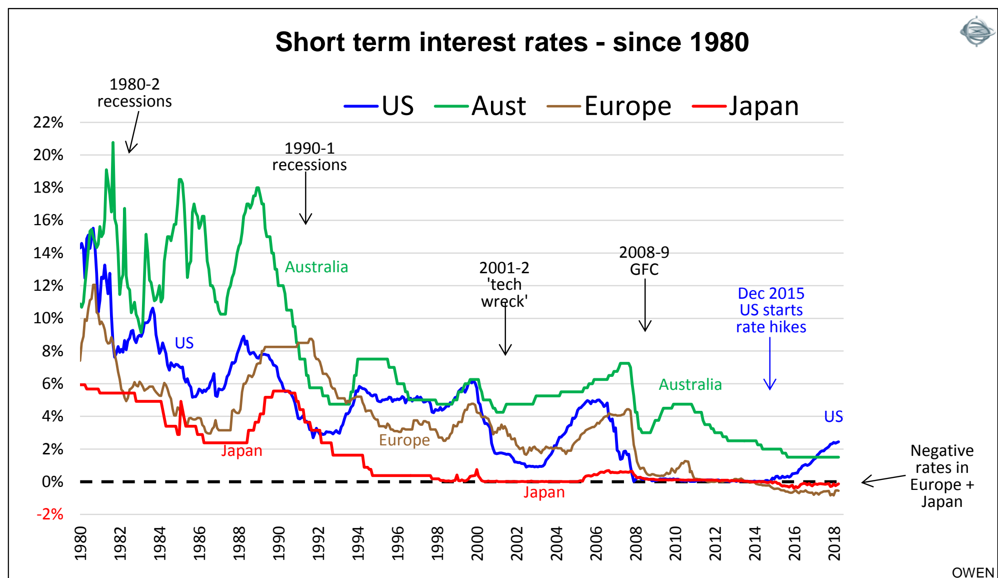
More important than the spread itself is rising short term rates – which was the primary cause of the negative spread. Rising short term rates were present well before each off the past share sell-offs (indicated by green arrows in the lower section of the chart). We under-weighted shares before the 20% sell-off in late 2018 because all 3 components were rising – short term rates, long term yields and also inflation. After the sell-off in the December quarter we increased share allocations in the January 2019 review – buying back in at cheaper prices. However we still remain cautious and defensively positioned in portfolios as the overall interest rate factor in our models is still bearish.



2 Central banks change course

The next two stories focus on the two ends of the interest rate spectrum – short and long – because dramatic changes at both ends over the past month affected shares, bonds, property and currencies. First, the short end. Short term rates are set these days by central banks to influence economic activity: rate cuts to stimulate spending, lending and employment; rate hikes to slow them down to try to control inflation.

The dramatic sell-off in shares late last year was caused by a combination of two factors – fears of slowing US and global economic activity, and also fears that the US Federal Reserve would keep raising interest rates progressively on its well-flagged, pre-determined upward trajectory despite gathering signs of a slowdown. Here is a chart of short term rates in Australia and the major global markets since 1980.



The recent 20% share slide was quickly halted when the Fed switched to a 'patient' wait-and-see stance from the start of January. In its March meeting, it went further – downgrading its economic outlook for the US to just 2.1% growth for 2019 and saying it did not expect to raise rates further for the rest of the year. It also mentioned pausing its 'quantitative tightening' program in which it was reducing its pile of bonds it bought in the 'quantitative easing' (QE) programs after the GFC.

The Fed has also started talking about a new 'inflation averaging' policy when setting interest rates. This new approach would involve allow inflation to drift above its 2% target rate for a while rather than act too quickly with rate hikes. The ten years since the GFC have taught central banks (mainly in Europe and Japan) that acting too quickly risks strangling the recovery. The problem is that the Fed (and other central banks) are notorious for going too hard too late to try to bring inflation back under control once the cat is out of the bag. Part of the problem is the long lead times between taking a policy action (like raising rates), then waiting for the resultant change in economic activity, then waiting for that change to show up in economic statistics, and then waiting for the next policy meeting to decide what to do next.

There are probably a few factors behind the Fed's change in stance. The reasons appear to go deeper than just the gathering signs of economic weakness. It could be the influence of Richard Clarida who was appointed by Trump to be Vice-Chair of the Fed's Open Market Committee (which sets interest rates). Trump nominated him in the midst of his relentless verbal and online attacks on Fed Chair Jerome Powell last year. Then on 23rd March Trump went further and nominated his conservative campaign advisor Stephen Moore to the Fed Board. This has attracted criticism from all just about all sides. He is yet to be approved but he will be very controversial if he gets through.

Regardless of the underlying causes of the change in the Fed's stance, it appears US rates are likely to remain very low for some time yet. This risks rekindling the global chase for yield, pushing asset prices higher again. It will also encourage more borrowing , adding to the potential collapse when rates eventually rise as the economy over-heats. US unemployment is already just 3.8%, wages are rising by more than 3% per year, and Trump's trillion dollar government deficits are fuelling spending. On the other hand inflation has come back from 2.8% pa in the middle of last year to just 1.4% now so the pressure for rate hikes has eased.

Elsewhere the monetary strings are also being loosened once again. In Europe the central bank ended its 'QE' asset buying program in December but on 7th March it re-started its lending stimulus plan under which banks are encouraged to borrow at 0% to boost lending. The European Central Bank downgraded EU growth to just 1.1% for 2019, saying the Eurozone is facing a serious risk of recession. Italy is in already contracting, Germany is on the cusp and France has stalled. Shares rallied briefly on the sugar hit then fell back.

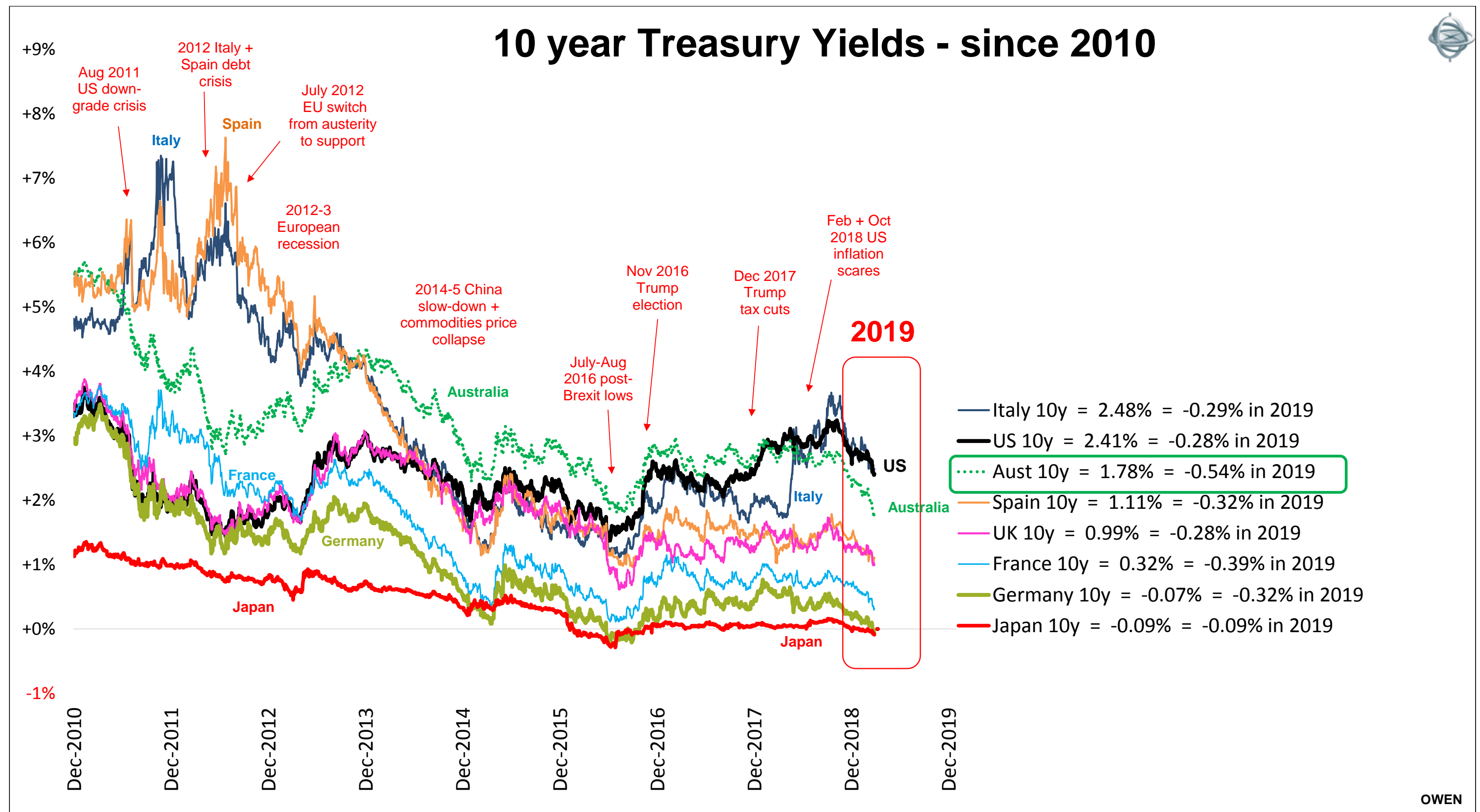
In Japan the central bank is also pessimistic once again. At its latest meeting it kept rates flat – with the short term target rate at (minus) -0.1%, and 0% for 10 year bond yields. (Japan is one of the few countries that targets bond yields directly as a primary policy tool. It was one of Australia's main policy tools from WW2 until the early 1980s). The Bank of Japan painted a bleak outlook for Japanese and global growth. Shares in Japan also rallied briefly on the sugar hit then fell back.

Australia's Reserve Bank also changed its stance on cash rates. In recent statements it has shifted from a 'hiking bias' to a 'cutting bias' – it now recognises it may need to add to the 12 rate cuts since 2011 that created the housing bubble, if house prices and confidence fall further.

All of this pessimism and ultra-loose monetary policy everywhere is likely to keep the share market party going for the time being.

3 Bond yields plummet

At the other end of the yield curve there are yields on long term fixed rate government securities. Securities with a maturity of shorter than 1 year are called 'bills', between 1 and 10 years are called 'notes' and longer than 10 years are called 'bonds'. We use the term 'bonds' here for convenience. Whereas short term rates are set by central banks as a policy tool, yields on long term bonds are generally set by investors in the market and therefore provide a barometer of consensus outlooks for growth and inflation.



In Japan the Bank of Japan has been artificially trying to holding yields on 10 year bonds up at 0% as a policy tool Since September 2016. If left to market forces, yields would otherwise have been negative without the artificial intervention. It has been reasonably successful in doing this but it has failed to generate any sustainable growth or inflation. Over the past month deteriorating outlooks have taken yields back below zero again – a sign that the weight of pessimism is even greater than the weight of the Bank of Japan. The Japanese economy has been virtually stagnant since the early 1990s and is slowing dying off - literally.

In Europe yields on German 10 year 'bunds' are also back below zero again, where they haven't been since the post-Brexit vote in mid-2016. US yields have also fallen this year but not down as far as the post-Brexit vote lows. The US economy has picked up significantly since then – reflected in strong jobs and wages growth. Nevertheless, the rapid decline in bond yields tells us the market is bracing for another slowdown.

On the other hand Australian yields have fallen lower than the post-Brexit vote lows of mid-2016 as fears set in of a broad slowdown resulting probably from a combination of the Chinese slowdown and the deflating local housing market.

The legend to the right shows the current level of yields for each country's bonds. It also shows the changes in yields so far in 2019. Bonds in all markets have done well this year as yields have fallen. The greater the fall in yields, the higher the returns to bond holders.

All of our portfolios have allocations to bonds. Not as exciting as shares – but government bonds provide an excellent buffer when their values rise as shares sell off in slowdown crises like the GFC, 2011 and again late last year. The green box on the chart highlights the fact that Australian bond yields have fallen more than other bonds and so their returns have been the best. We have favoured Australian bonds over foreign bonds in portfolios this year.

Declining yields on bonds not only produce good returns from bonds, it also provides a gauge for growth outlooks. This in turn provides investors with a clue to likely monetary policy moves by central banks. The hope is that the factors causing the declining bond yields may also drive central banks to cut short term rates. The prospect of rate cuts boosts share prices – at least in the short term. It's the sugar hit of more cheap money that blurs the fact that the reason for the rate cuts may actually turn out to be a big fall in spending and company profits.

4 Commodities prices rescue budget

It is budget time again in Australia, and the nation is heading for its first Federal government surplus since 2008, mostly from plain good luck.

Here is a chart showing the Federal Government's deficit and debt position since 1901. The upper section shows revenues (red line) and expenses (green). The middle section shows the resultant annual surpluses (green bars – look hard!) or deficits (red bars). The purple bars in the lower section shows the level of Federal Government debt. All are expressed relative to total national output (GDP) each year.

Federal Gov Deficits & Debt since Federation

The Federal government ran balanced budgets in the early years following Federation but it had very few functions prior to the introduction of Federal government pensions in 1909. World Wars 1 & 2 changed all that – requiring massive war-time deficits and debt build-ups. These were finally brought under control by the 1950s and 1960s booms. The government still ran small deficits (1-2% of GDP) but rising tax revenues from the booming economy were enough to pay for expanding services and nation-building projects, and still reduce the debt/GDP ratio down to low levels by the 1970s. The current level of debt relative to national output is the highest it has been since the late 1950s.

Producing a government surplus can be done in one of two ways – by cutting costs or increasing tax revenues, or sometimes both. Most of the time the surpluses have been a result of windfall revenue gains - mostly from fortuitous mining booms. The problem is that costs are controllable, but tax revenues depend on mining booms that are based on global commodities price cycles outside our control.

Only rarely have surpluses been achieved by cutting costs. This was the case with the 1930s surpluses. Australia did not follow Roosevelt's big spending approach in the US. Instead we had to endure harsh 'austerity' cost-cutting imposed by London bankers. The government wasn't able to borrow anyway after it defaulted on its debts in 1931. Arguably the austerity cuts prolonged the depression and stunted the recovery.

The only other period of surpluses produced by cost cutting was the four years from 1988 to 1991 by Hawke & Keating. Commodities prices and tax revenues were falling but they were able to produce surpluses by cutting costs by even more, resulting in the deep 1990-1 recession.

The Howard government had two spells of surpluses – four years from 1998 to 2001, and then another five years from 2003 to 2007 (or six years if you count the 2007-8 year during which Rudd came to office, when boom-time mining revenues were still flowing in prior to the GFC). Both of these surplus spells were driven by windfall tax revenue gains – first from the 1990s 'dot-com' boom and the second from the 2003-8 mining boom. Government spending was also reducing during the whole period – from 25% of GDP in 1996 to 21.7% in 2007. But because most of the gains were from boom-time tax revenue rises, the windfall surpluses quickly disappeared when the booms ended.

If the Federal government achieves a surplus in the current 2018-9 year it will be mainly thanks once again to fortuitous tax gains from the mining boom, not because of cost management. In the past 5 years the population has grown by just 8%, but government spending has risen by an incredible 21%. By sheer luck the mining boom has increased revenues by 27% but windfall gains like these are not sustainable.

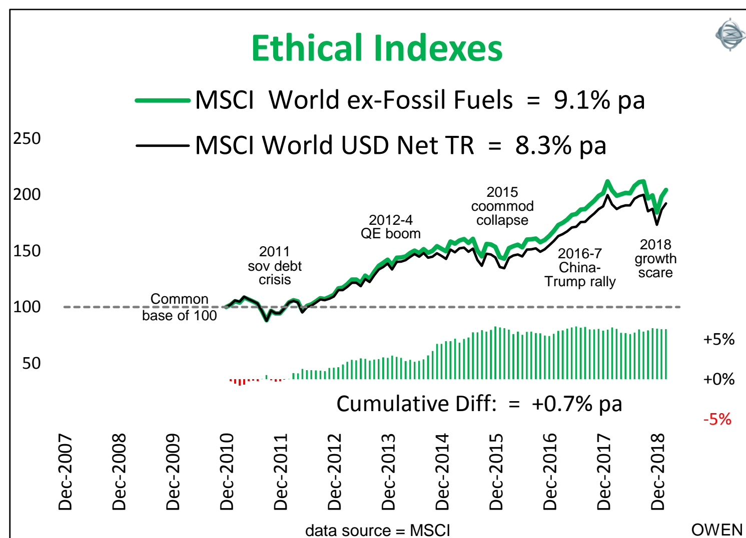
5 Fossil Fuels -v- Renewables - Avoid the bad, or seek the good?

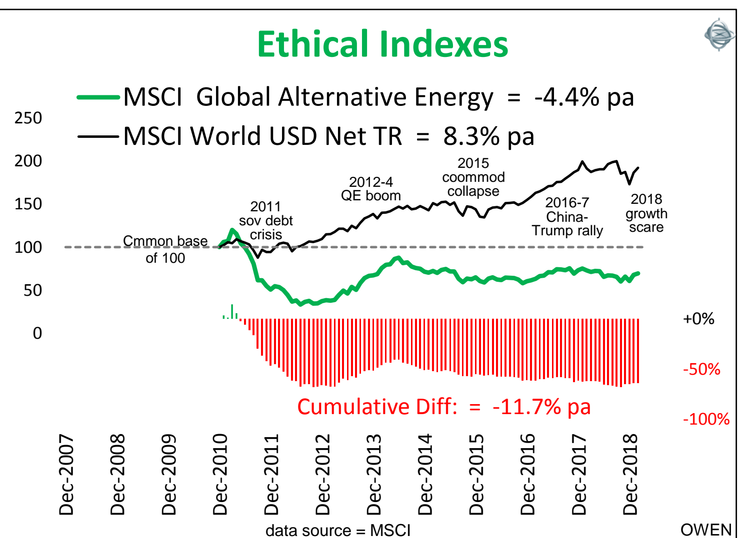
On 8 March the largest sovereign wealth fund in the world, Norway's trillion dollar 'Government Pension Fund Global' which was founded on Norway's oil & gas - announced it was getting out of oil & gas stocks. As the world's largest fund it owns about 1.5% of almost every investable stock in the world (including 310 companies on the ASX), and so it will be selling out of 134 oil & gas stocks. It will retain those that are developing renewable energy – like BP and Shell, but will sell those like Australia's Woodside, Santos and Oil Search which focus on old fossil fuels. It will however retain its stake in Equinor (formerly Statoil) – Norway's largest company and the source of the fund's wealth.

The reason they gave for selling out of oil/gas producers was not ethics nor concerns about global warming - after all they obtained their wealth from fossil fuels. The reason was to reduce the fund's reliance on, and vulnerability to, the long term decline in oil prices. It is notable that most of the world's largest sovereign wealth funds also made their money from oil. Seven out of the largest ten are oil-based – Norway, Abu Dhabi/Dubai, Saudi Arabia, Kuwait, Qatar, Canada, Alaska/Texas. (The others in the top 10 are China, Singapore, and Hong Kong).

Australia's 'Future Fund' is the 16th largest sovereign wealth fund in the world. It started out with the government's stake in Telstra. The Future Fund's investment policy doesn't mention any stance on fossil fuels. It does specifically ban companies that manufacture tobacco but is happy to own shares in companies that distribute and sell tobacco. It also bans companies that manufacture military weapons.

This raises an interesting question on the investment merits of fossil fuel companies versus 'renewables'. Measuring returns from different markets and sectors is made easier by index providers. The largest global index provider – MSCI – publishes dozens of 'ethical' indexes involving a host of different screens and exclusions - everything from tobacco, armaments, sustainability (pollution, carbon emissions), fossil fuels, socially responsible investing, diversity (eg companies run by women), and many more. The left chart shows MSCI's 'World ex-Fossil Fuels' index – which comprises the 2,500+ investable stocks in MSCI's broad 'World' index but excludes the 130+ oil/gas and coal stocks.





The World ex-Fossil Fuels index (green) beat the broad World index (black) by +0.7% pa since the index started in 2010. This is not surprising as oil, gas and coal prices have fallen heavily since the 2011 commodities cycle peak. While this index has a short history of just 9 years, over the long term fossil fuel stocks have also lagged the rest of the market. Although barriers to entry and profit margins are high, exploration and development costs are huge, and so are the costs of disasters like Deepwater Horizon, Exxon Valdez, Amoco Cadiz, and other major spills.

Quite apart from one's ethical position on whether or not to support and profit from fossil fuel companies, investors would have been better off avoiding them altogether because as a sector they have tended to generate lower returns and higher volatility than the rest of the market.

On the other hand – we could go further and try to profit from the growth of 'renewable' energy sources. In decade or so the dominance of fossil fuels will probably have been replaced by renewables like solar, wind, biomass, hydro, geothermal, wave, and probably a host of new technologies we don't even know about today. Chasing returns in these new areas is where big problems arise.

The right chart shows that if we had invested in the leading 'renewables' companies over the same period we would have lost out dismally. MSCI's 'Alternative Energy' index is diversified across 60 companies that derive at least 50% of their revenues from alternative energy sources. It includes leading companies from the US (including First Solar, Nextera Energy, Ormat Tech, Covanta), Denmark (Vestas Wind Systems - the largest stock in the sector, China (Everbright, Longyuan), Canada (Capital Power), Spain (Siemens Gamesa) and many others.

This is very much speculative 'hot stock' territory – trying to pick winners at early stages of development. For every winner there are going to be dozens of losers. There are going to be many Betamax's for every VHS. VHS won the Betamax/VHS battle, but it was quickly overtaken by even newer technologies – DVDs, then streaming, and who knows what next. For now it is better to avoid the bad than seek the good.

What lies ahead?

Keen readers will notice that I have avoided mentioning the most talked about topic in Australia – house prices (no, not MAFS!). I don't often comment on house prices as I have found over the years it is hard to argue with 25 million experts. I have been warning over the past couple of years in these reports that the housing / construction bubble in Australia will inevitably burst the enormous pile of debt on which it is built.

When asked whether it is the right time to buy a high-rise unit my response has always been the same (regardless of the year) – "Never buy air. Buy land – with a house on it. The closer the city the better – even if it's a tiny block. But if you really do insist on buying air – just wait a few years and buy two flats for the price of one today!"". When asked whether it is the right time to buy a house I have been saying for the past couple of years: "There is no rush – just wait for the mortgagee sales".

House prices are academic for most of us. They only matter if you are mortgaged to the hilt AND have to sell. For me, mortgages are a distant memory from last century. Having an Advance Bank mortgage on which interest rates peaked at 18% in the late 1980s was an extremely powerful incentive to pay it off as quickly as humanly possible in the 1990s. (Advance Bank was gobbled up by St George Bank to reduce competition, and St George was in turn gobbled up by Westpac to reduce competition further. Regulators have been asleep for decades).

For me and most of our investors, lower house prices are good news all 'round – they mean lower council rates, less stamp duty, less land taxes, less capital gains taxes, and cheaper prices for our kids to buy into. Even if you have a mortgage you only lose if you have to sell.

House prices peaked in around mid-2017 and have fallen back to the levels of 2015 or 2016, so up to 500,000 people who bought since then are sitting on 'paper losses' now. (Some cities are worse – Darwin prices are back to pre-GFC levels). They are only theoretical paper losses unless you need to sell. The problem is the 900,000 interest-only loans that need to be refinanced at higher rates and/or higher principal & interest repayments. Many thousands will not be able to pay, and the mortgagee sales will probably spiral prices down further. Meanwhile Chinese buyers are having trouble getting their money out of China to settle on purchases here. Credit rationing is making it harder to borrow.

For units the situation is worse and will get worse still. Up to 100,000 more new boxes of air are about to be tipped onto the market in the coming year – reducing rents, increasing vacancies and crunching lenders' valuations and re-sale prices even more. Many thousands of off-the-plan purchasers will lose their deposits and be pursued for the full purchase price by desperate developers or their liquidators.

Wherever you live take a look out of the window. There are 735 high rise cranes on the skylines of Australian cities, which is more than the whole of the USA. 72% of these cranes are for residential units, so the RBA's long hoped for shift from residential to commercial and infrastructure has not happened. The last time one country dominated the world crane market was Dubai in 2010 and that ended in Dubai's dramatic collapse and bailout. House prices in Dubai are still lower now than they were 10 years ago – and that's before inflation.

For Australia - so far this is only a problem for the forced sellers. The rest of the market is not affected. But if the wave of sellers becomes broad enough to spiral prices down further and start to affect broader spending and employment, then it affects the whole economy.

The next shoe to drop is the Federal election in May. If Labor wins, their long promised scaling back of negative gearing and increases in capital gains taxes can hardly be good for buyer confidence and housing prices.

Meanwhile, after having under-weighted Australian and global shares prior to the dramatic sell-off late last year, we increased shares at lower prices at our January review, but we still retain a defensive stance. 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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