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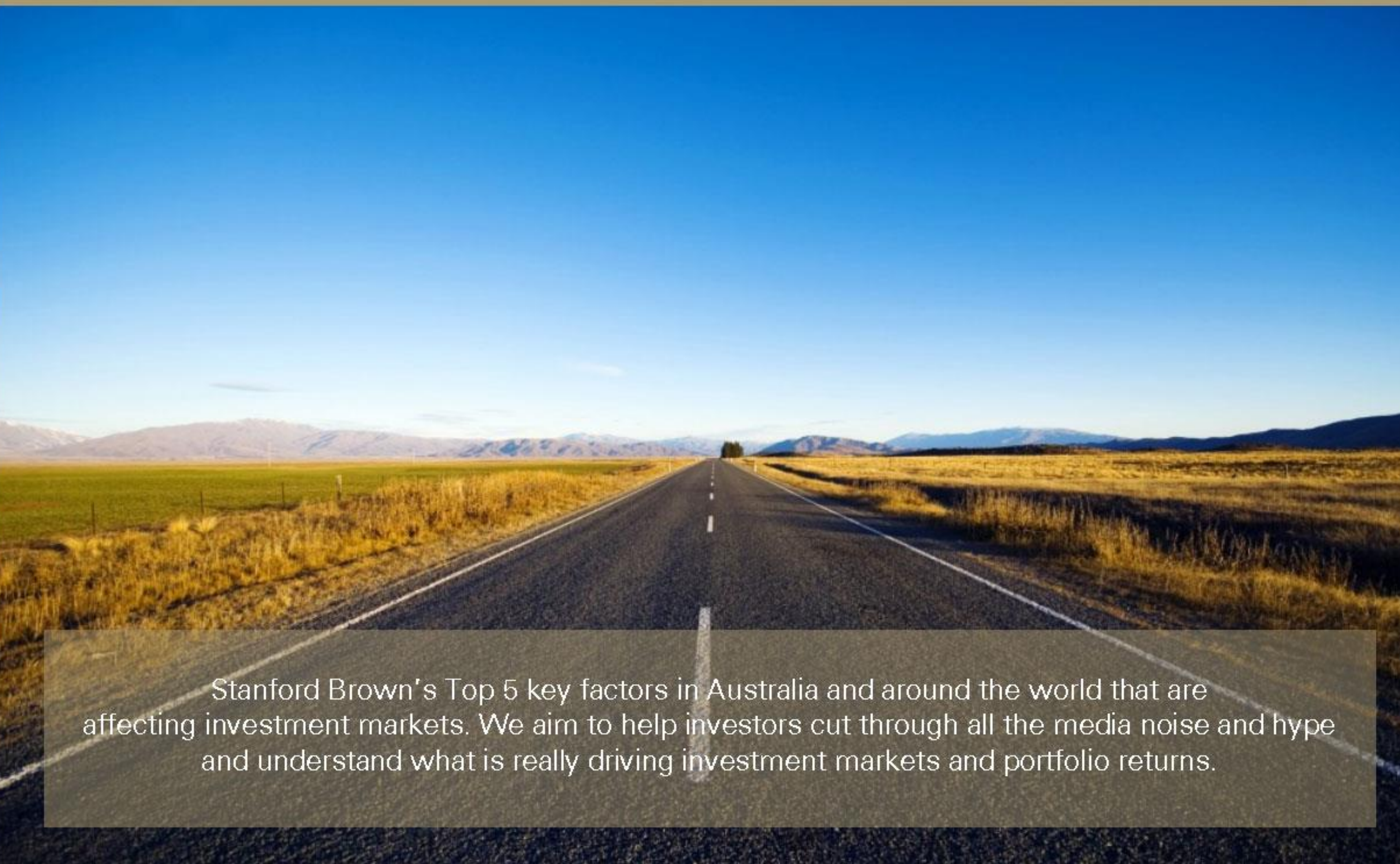
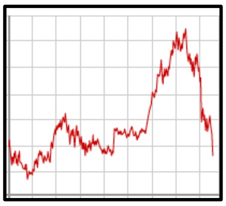
Financial Advisers

Stanford Brown Monthly Top 5

NOVEMBER 2018



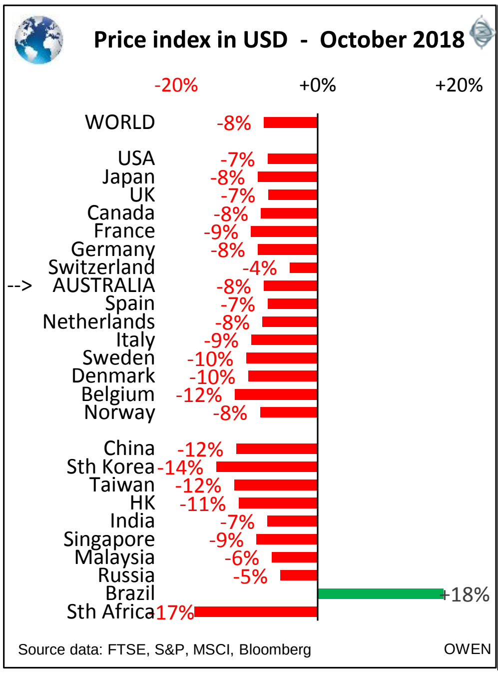
Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.

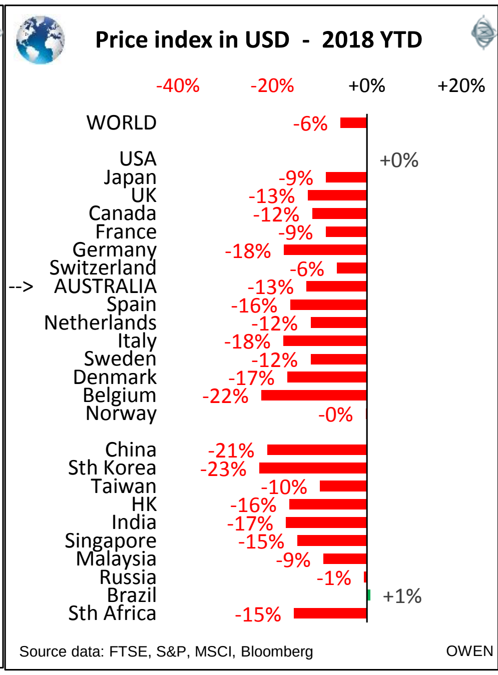


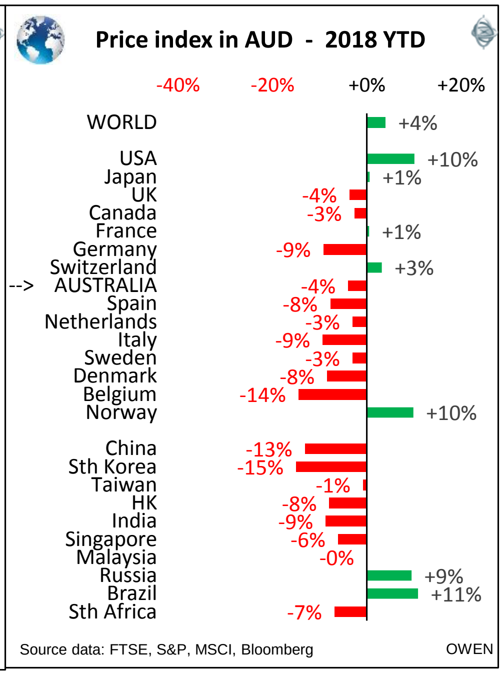
1 October share falls

There was much excitement in investment markets in October - shares fell across the board in almost every country. We had been relatively bullish about Australian and global shares over the past couple of years since the Brexit vote and Trump election. The 2016-7 rally took asset prices (shares, property, bonds) almost everywhere in the world to very expensive levels that relied on increasingly unrealistic assumptions of continued blue skies forever. The global euphoria peaked in early 2018. We saw the situation turning so in April we switched from being bullish on shares to being significantly more defensive. We cover this later but first we look at the October falls.

The first chart below shows the October's results for the major share markets around the world – expressed in US dollars to put them on a common footing. The countries are ranked in order of market value – the so-called 'developed' countries in the top section led by the US, and the main 'emerging' markets at the bottom led by China.







The middle chart shows that the October falls sent almost all countries into negative territory for the year to date. The only major country not in the red this year is the USA – the source of the problem. Oil producers Norway, Russia, Brazil, and some other smaller oil producers outside the list also held up thanks to strong oil prices due to the tensions between Trump, Iran and OPEC. Brazil tops the list – with the election win by far right wing populist Bolsonaro and high hopes he will end a decade of scandal and crisis under the Workers' Party.

Despite the sea of red ink in the middle chart (expressed in US dollars), the chart to the right shows the same year-to-date picture as the middle chart but this time in Australian dollars. This is not nearly as bad as the US dollar picture because the Australian dollar has fallen by 9% against the US dollar this year. Falling prices of foreign assets were largely offset by currency gains due to our falling Aussie dollar.

When investing outside one's home country, investors can decide whether to 'hedge' the currency risk (hedged returns for Australian investors are along the lines of the middle chart), or they can leave the currency 'unhedged' (right chart). When the investor's home currency (AUD) is rising relative to world currencies you want to be hedged, but when it is falling you want to be unhedged.

The un-hedged Australian dollar results in the right chart show that US shares (which make up more than half of the world total by value) have done quite nicely this year for Australian investors (up 10% for the year so far, not including 2% in dividends). The global aggregate is up by 4% (plus an additional 2% in dividends) for the year even after the October falls.

What did we do in portfolios? After the January highs we turned from being bullish on the Australian dollar (and primarily hedged) last year when it rose 8%, to being bearish on the dollar, so we adjusted portfolios to benefit from a falling dollar. In February we reduced the currency hedging on global shares to below 50%, then we reduced it further in April to 24-30% hedged. As a result, the returns on unhedged global shares in client portfolios received an 8% boost thanks to the falls in the Australian dollar since the changes.

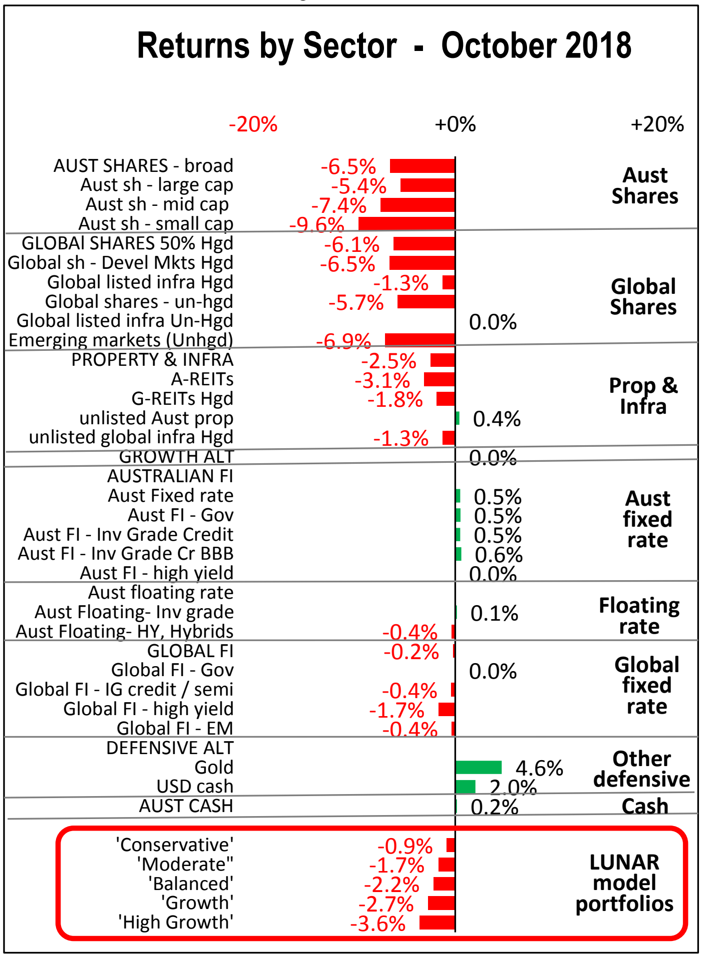
2 Defensive settings in portfolios

Our decision to underweight shares in portfolios before the sell-off raised an unusual dilemma. Deciding to reduce the weighting of shares is one thing, but where do we put the money when almost every asset in the world is overpriced?

Ordinarily when underweighting shares in expectation of a slowdown, the traditional approach is to increase allocations to bonds – particularly government bonds – as they benefit most when bond yields fall in economic slowdowns. This has worked well in numerous slowdowns in the past – in the 2008 GFC, the 2011 sovereign debt crisis, the 2015 oil/gas crisis, the 2001-2 'tech wreck', the early 1990s recession, and so on. Government bonds provided strong (often double-digit) positive returns while shares fell heavily.

However we formed the view that the next market downturn (which is now upon us) may well be quite different from the past several cycles. Global markets are walking a tightrope between two main competing scenarios. One scenario is an escalation in inflationary expectations. This is bad for bonds and also bad for shares if inflationary fears rise rapidly. Central banks in the US, Europe and Japan are watching inflation rise but they are very reluctant to raise interest rates for fear of hurting their economies and/or boosting their currencies which hurts their exporters. Even the US Fed is raising rates very slowly and is still erring on the side of caution. There is a risk that further rises in inflation (e.g. due to rising oil prices and tariff-affected goods) could catch central bankers off guard.

A second likely scenario is a traditional broad slowdown – triggered most likely by the escalating trade war that could rapidly cripple confidence, spending, investment, production and employment (bad for shares but good for government bonds). Trump is showing no signs of backing down and a retaliatory trade war can escalate quickly and be hard to reverse once it hits local jobs. China is already in a cyclical slowdown and most commodities prices are falling once again, a sign of slower demand. Rising US interest rates and US dollar are causing increasing debt stress and rapid capital flights from several 'emerging' markets. In Australia the housing / construction slowdown is already underway and the effects on overall confidence, spending and employment may be more severe and sudden than expected.



Because of the risk of scenario 1 where rising US inflationary fears would hurt bonds (the traditional safe haven), when we underweighted shares in anticipation of the current sell-off we shifted the allocation instead mainly into high grade floating rate notes and other non-traditional defensive assets – US dollars, and Australian dollar (unhedged) gold. We dramatically reduced the currency hedging on global shares as we were bearish on the Australian dollar. We also removed emerging markets shares, which had boomed in the 2016-7 rebound but have sold off heavily since we removed them.

These changes protected client portfolios from most of the pain of the recent correction. The chart shows the returns from the major asset classes and sectors in October.

The table at the bottom of the chart shows the returns from our model portfolios for the month (NB. individual client results may vary due to their individual level of customisation and the timing of cash flows in and out of their portfolios).

Even the 'High Growth' portfolio (which is ordinarily 95% shares) was down by just 3.6% - which is around half the extent of falls in Australian and global shares. The other portfolios were down by much less and barely felt a ripple. The main reason is that the USD cash holding was up 2% for the month (as the Australian dollar fell), and Australian dollar gold was up 5%. The other holdings of Australian bonds (4th panel) and floating rate debt (5th panel) appear minor but they combined to further cushion the blow from falling share prices.

Despite our defensive stance, all portfolios are beating their peer multi-sector funds, and are on track to achieve their long term goals.

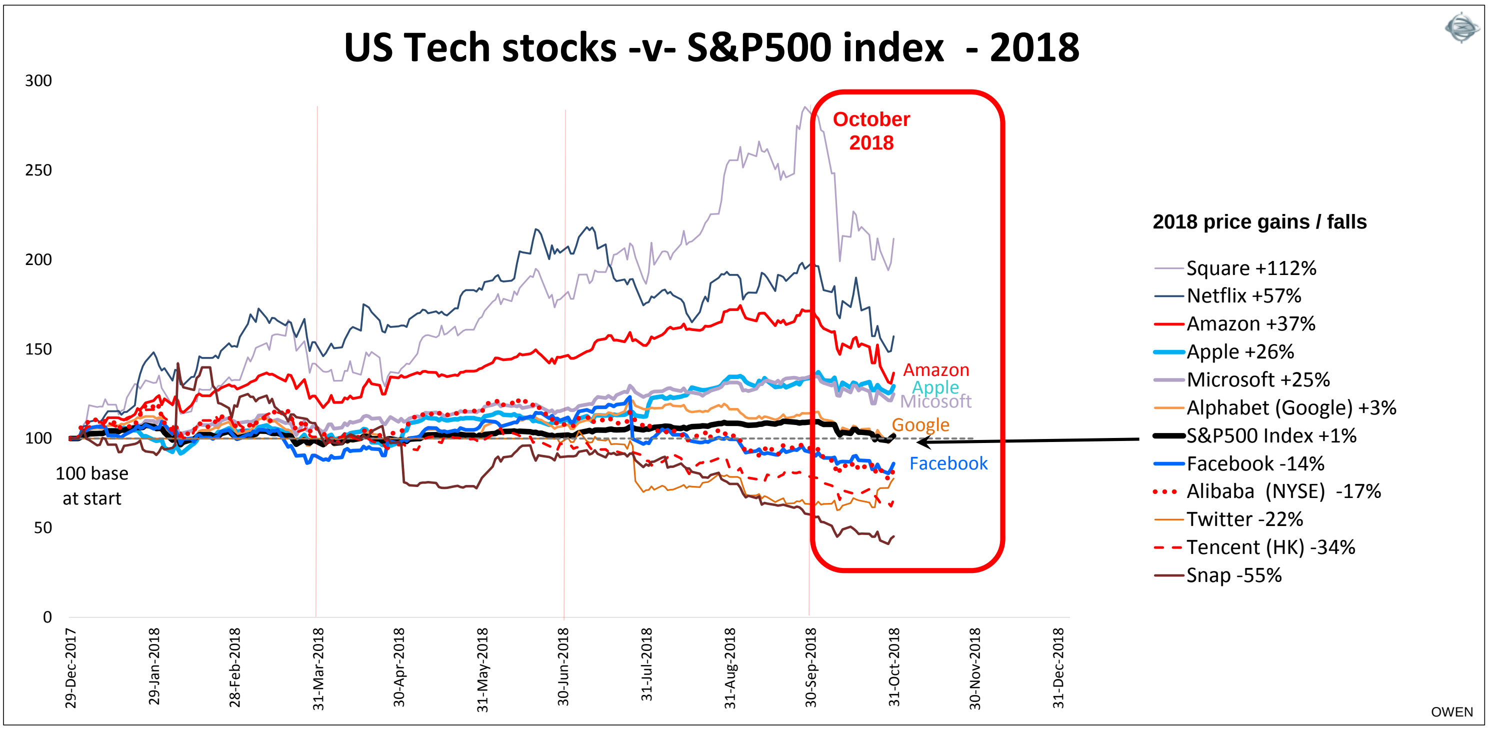
3 Update on US tech stocks

Last month we reported on the boom in US tech stocks that had been propping up the rest of the US stock market this year. We pointed out the importance of the sector due to size and influence over the entire US and global stock markets. We noted that the 5 largest stocks (Apple, Amazon, Alphabet, Microsoft and Facebook) accounted for 6% of US revenues and 10% of US profits, but they accounted for 16% of the total value of the US S&P500 index because they were even more overpriced than the rest of the US market.

The big 5 tech stocks were trading at 40 times their combined profits while the rest of the US stock market was priced at 20 times aggregate profits, which was still overpriced at that level. We commented last month:–

> *The problem is that the current levels of pricing assume continuous exponential growth forever, but the reality is that they are running out of room to grow at the same pace as they have in the past. Apple is now a slow-moving mature behemoth that has halved the pace of new products since Steve Jobs departed. Apple's revenue growth is coming mainly from jacking up the prices per phone rather than increasing unit sales.*
>
> *Amazon already accounts for more than half of all US online retail sales and is running out of competitors to destroy and countries to invade. Privacy breaches and hacking scandals continue to dog the online giants.*
>
> *Microsoft has a more sustainable business model but it is trading on more than 50 times its profits (or about 30 times after adjusting for the one-off loss in December last year, but 30 is still far too high).*
>
> *Growth is also being hampered by threats of new regulations - on the privacy front and also by competition rules especially in Europe. On top of this, Trump's tariffs will increase the cost of iPhones even more for American buyers because they are imported from China.*

What a difference one month makes! Here is last month's chart - updated to show the dramatic price falls in October:



October is reporting season for American companies for their September quarter results. Overall the results for the big US tech stocks (and most US companies in general) were very positive – driven largely by US tax cuts and increasing consumer spending in the US, China and most other countries. The problem is that level of pricing required a never-ending continuation of the past astronomical growth in sales and profits. The good results that were announced were probably never going to be enough to keep the speculators bidding up share prices.

Despite the recent price falls, Amazon is still up 37% for the year, Apple + 26%, Microsoft +25%. The lower share prices now are better value than they were one month ago, but they are still vulnerable to negative developments – rate hikes, tariff wars, regulatory crackdowns, etc.

I have also added the two giant Chinese tech stocks to the chart – Alibaba and Tencent (dotted red lines). These are more or less the Chinese equivalents of Amazon and Facebook, and they are two largest Chinese companies in the 'Emerging Markets' index, which China dominates. We were bullish on the sector last year when we held a broad emerging markets fund in portfolios during the rally, but we removed it in April of this year. They have both fallen heavily since then (as has the entire Emerging Markets sector).

4 Slowdown or Inflation scare?

Investors have been blessed with six consecutive years of positive real returns from each of the major asset classes since the 2011 sovereign debt crisis. As we have noted here before, six years is a record. The previous record was four consecutive years in the late 1920s (followed by the 1929 crash and 1930s depression) and also four consecutive years in the mid-2000s (followed by the 2008-9 GFC).

(Readers may ask how this six year run of positive real returns from the major asset classes somehow forgot about the 20% fall in Australian share market in the 20015 oil/gas/steel / China slowdown crisis that caused the global earnings recession. It was lucky timing! We did indeed have a rather serious 20% fall in the All Ordinaries index between mid-April 2015 and mid-February 2016 but since the six year measure is based on *calendar* years we scraped through – just. The All Ords and the US S&P500 indexes actually recorded slight losses in calendar 2015 (-0.5% for the All Ords and -0.7% for the S&P500). But when you add dividends in both markets and deduct the very low inflation rates for 2015, the real total returns are just positive. A very lucky escape – but it's a very slippery log!)

The recent six year run may continue into a miraculous seventh year in 2018, but let's not forget that the long boom was driven largely by unprecedented zero/negative interest rates in the major global markets, plus massive central bank asset–buying sprees ('QE')'. Both of those are now unwinding in the US, which dominates global markets. We may stay on the slippery log for a little while longer, but the risks of falling of the log are increasing. Certainly global bonds will record a loss this year, so that will end the positive run for them.

For shares, when we slip off the log it is likely to be in one of 2 ways – either a traditional slowdown or a serious inflation scare – as described in the second story above. A significant escalation on each side would be bad for share prices but each scenario has very different implications for asset allocation especially in the defensive side of portfolios. How we position portfolios depends very much on which side of the log we slip off. We look at several indicators for guidance. The picture is never crystal clear of course, and it changes over time. Here is how the main factors are looking at the moment:

Slowdown	Inflation scare
China growth rate - slowing	Inflation rates – rising slowly
China monetary / fiscal policy - loose	US bond yields - rising
Industrial Commodities – falling since April	Unemployment rates – very low + falling
Emerging Mkt shares – falling since early 2018	US wages – rising since 2015
Australian dollar – falling since early 2018	US cash rates – rising probably too slowly
US dollar – rising since early 2018	Oil prices holding up - Trump/Iran/OPEC
Credit spreads – rising since early 2018	Trump tax cuts
China debt crisis/credit squeeze – rising risk	US deficit spending
Gold price (USD) - flat	Global military build-up - rising

Slowdown **Inflation scare**

In addition there are qualitative factors that are hard to quantify. The main factor on the 'slowdown side' is the escalating trade war shenannigans by Trump. To a large extent these fears are already showing up in weakening commodities prices and rising credit spreads.

US interest rates are interesting – the Fed's go-slow since its first rate hike in December 2015 could see inflation get away from the Fed (inflationary scare), but a swift and sharp reaction or overreaction by the Fed could tip the economy into recession. History is littered with numerous prior episodes of Fed miscalculations and overreactions triggering inflation break-outs and also crashes and recessions.

The two scenarios are not mutually exclusive of course. In fact our portfolios are currently positioned for a path that sees a continuation of the inflationary scare bias in the short term (up to say half a year) which could see share prices recover but puncuated by a few more inflation scares, followed by a Fed overreaction (going too hard too late) – which would risk triggering a slowdown and almost certainly a collapse in share prices. The longer the Fed delays, the more severe the likely consequences.

Our non-traditional portfolio positions at the moment are designed to work best in either scenario but we can make adjustments if changing conditions tip the scales one way or the other.

5 ‘To worry or not to worry…’

This month’s report is mostly about our investment portfolios, what adjustments we made to them, how and why – so apologies are due for it being a little more detailed and specific than usual. The world is full of reports and papers and ‘blogs’ (whatever they are) by so-called ‘experts’ and armchair pontificators about all sorts of fascinating topics – whether it is share prices or Trump or Brexit or China or the elections and so on. But talk is cheap – what counts is what we do about it as investors.

People are always asking me whether I am ‘worried’. A 10% global sell-off always catches peoples’ attention and increases the number of emails and phone calls I receive. Am I ‘worried about the economy?’, or am I ‘worried about Trump’ or ‘worried about rising interest rates’ or ‘worried about inflation’, or ‘worried about Chinese debt levels’, or ‘worried about Brexit’ or ‘worried about falling house prices’, or ‘worried about political fragmentation in Europe’, or ‘worried about the Middle East’, or ‘worried about [insert current Prime Minister’s name here]‘. The world is always full of things to worry about!

I am certainly fascinated by all of these things, but there is no point worrying about something if I can’t change it. I can offer my views on all of these wonderful topics but that is not important. What is important is what it means for investment portfolios. The focus is on looking at everything that is going on in the world to see if we need to make changes to investors’ portfolios so they stay on track to achieve their long term goals, to reduce risks, avoid disasters and capitalise on opportunities where they make sense.

These are long term portfolios we are talking about. Even if an investor or a couple is 60 or 70 years old today, one of them is probably going to live to 100. So even if people are ‘retired’ they still need to think in terms of their money lasting for several decades. In that time there are going to be plenty of real things to ‘worry’ about – there will be massive booms and busts, deep economic depressions, speculative frenzies and crashes in which great fortunes are made and lost. There will be nation-destroying civil wars, huge political upheavals, nuclear wars, global plagues, pandemics, catastrophic natural disasters and so on. We have had all of these things before and we will have them again.

Nothing can be taken for granted and history never repeats – each cycle and each set of conditions is different. That’s what makes investing so interesting and rewarding.

With everything in the world so interconnected and interdependent, it is usually not a case of a binary decision about what to do. The two main scenarios currently facing global markets at the moment – a serious inflation scare or a slowdown – call for two quite different approaches in portfolios. We are not in the business of betting the house one way or the other. That is speculation. We aim to steer portfolios through changing markets in a way that offers the least risk and the greatest opportunities if either of the scenarios evolves. I say ‘evolves’ rather than ‘eventuates’ because there is no ‘eventual’ end point. Conditions are constantly changing and so we must remain vigilant at all times for new risks and opportunities as they arise.

We do a full review of global markets every quarter, but we generally only make significant changes to portfolios about every year or so. The last major shift was in 2016 after Brexit vote and the Trump election when we were relatively bullish while most of the rest of the world was running for the hills. The ensuing two year global rally took us to into early 2018. During the current year, after the strong two year rebound, we became more cautious and moved to a more defensive positioning. The boom was not likely to last much longer and the risks and possible triggers for a correction were piling up.

The changes we made cushioned portfolios from most of the damage of the October sell-off. In the recent review after the end of the September quarter (undertaken during the October sell-off) we stayed with our defensive stance in all portfolios. We made only one minor change – reducing global corporate bonds, using some of it to increase Australian bonds and the balance to increase high grade floating rate notes. We remain underweight fixed rate bonds overall as there is still a risk of rising US bond yields and also rising credit spreads.

The reason for shifting a little from global bonds to Australia is that we see the forces pushing global bond yields higher as stronger than the forces pushing up Australian yields. The main impetus for rising bond global bond yields is in US bonds, which make up half of the global investment grade bond market, and more than 60% of the corporate bond market. The rest of the bond market (which is mainly Japan and Europe) is flat as Japan and Europe have slowed once again after showing some signs of life last year. The only other market with rising bond yields is in Italy (5% of the global market), but that is because of rising default fears following the election of the Five Star / Northern League coalition, not inflation. Regardless of the cause – whether it is rising inflation or risk of default - rising yields hurt bond prices and returns.

The rest of the allocation is going into high grade floating rate securities in Australia, which are not hurt by rising bond yields but will benefit if and when short term interest rates rise, and they offer very steadily and reliable income well above the current cash rate.

These minor adjustments reflect a slight shift in the balance toward the ‘inflation scare’ scenario in the short term, but the portfolios retain their overall defensive stance.

What lies ahead?

In the upcoming US mid-term elections, the Democrats will probably win back the House but the Republicans look set to retain the more powerful Senate. Either way, Trump's trade wars are escalating steadily – with broader and higher tariffs kicking in. 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 look like they are digging in for a long battle.

Trump points to the booming economy as proof of his success but it is largely smoke and mirrors – supported by huge tax cuts, spending sprees, ballooning trillion-dollar deficits, artificially low interest rates and heavy reliance on foreign debt from its main banker and enemy – China – to finance it all. Retaining the Senate, plus perhaps even winning another seat or two, may spur Trump into stepping up his frenzy of announcements. Meanwhile, the inflationary fears gather pace. The tight jobs market and rising wages are likely to continue to be the main source of inflationary scares that rattle share and bond prices from time to time.

Australian capital markets most of time merely follow the US lead in how they react to global events. Our booms and busts tend to follow global cycles because our economy and capital markets have always been financed largely by foreign capital, and this has been the case ever since the first British settlement here in 1788. In the global booms, foreign money floods in to fuel our own local booms, and then in the global busts the foreign money races out again, triggering our local busts. Although our cycles run largely in parallel there are often timing differences. In the current cycle the flood of money in the recent 2016-7 rebound is now receding. Money is flowing back to the US as interest rates there are now higher than they are here (a very rare occurrence), and Chinese investment here is also slowing significantly. These forces are weakening the Aussie dollar and deflating the local housing / construction market.

These trends are not likely to reverse soon. The Fed is almost certain to raise interest rates more quickly than the RBA, and the Chinese government is stepping up efforts to boost investment at home to prop up its declining growth rate, and shift foreign investment away from non-core areas (like property) and more toward strategic military partnerships in Asia, the Pacific and Africa. Although our overall economic growth rate is above 3% and the headline unemployment rate is a low 5%, inflationary pressures are weaker here than in the US, so we see bond yields staying below US yields. The RBA is also unlikely to raise interest rates now with the dollar still in the 70's and the local banks raising mortgages interest rates and restricting credit by themselves.

As Australian share prices tend to mirror US moves, when the US inflation / slowdown shock hits the US markets it will be echoed here, even though it has nothing to do with us. Recall that in 2008-9 our local share market fell more than the US and more than any other major global market even though we didn't have a sub-prime crisis or even a recession. Our market had further to fall because we had a bigger 2003-7 boom (like our larger 1987 crash following our larger mid-1980s take-over boom). This time the US has had a much bigger tech boom and is more over-priced than our market and so it has further to fall (like the 2001-2 'tech wreck' following the late 1990s 'dot-com' boom).

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