Investment Insight

ZANACORP

June 2020

Pinch me! I must be in some strange dream. What I am seeing simply cannot be real. It's 2020 and a virus struck the world. City streets were emptied and economies shut down, with businesses devastated and millions worldwide destined to lose their jobs. People have become fearful of each other, yet life is fine so long as you have an internet connection. Governments have dropped "helicopter money" as far as the eye can see paying workers more to stay at home than to work. Blissful "JobKeepers" now watch TV or do stupid things on TikTok for the amusement of others. The Australian Government has sunk us into debt for the next 25 years to protect us from hurt and to renovate, whilst money was not found to solve the social housing crisis. Despite future income uncertainty, online spending has exploded . Afterpay, the Buy Now Pay Later fintech that makes no profit, is worth more than Australia's busiest airport that makes billions. We were not allowed to visit mums on Mother's Day, but 10,000 protestors could fill the streets ignoring social distancing laws with impunity. AFL is played with no crowds. No one cares about the consequences of money printing, except what is in it for them. Flooded with excess liquidity, indebted companies that should fail, are saved. Assets prices that should fall, rise. Debt has reached all time highs and interest rates all time lows. Statues telling history are felled to blot out the past. Reality it seems, has been suspended. Amidst this madness, Zanacorp's singular goal is to protect clients' capital.

2020 The Year of Living Dangerously

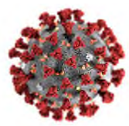
Watch Your Step

In a poignant example of how life imitates art, we are reminded of the filming of an old Charlie Chaplin meme. There are two ways to film **"the banana skin joke"**, said Chaplin. The first begins with a wide shot of a man walking along the footpath. Cut to the banana skin. Go to the close up as the foot meets the peel. Then pan out to reveal the man landing on his backside. Ha ha ha.

The second version is like the first except the man spots the banana skin and carefully side steps it. Proudly blind to other hazards, he smiles to the camera and immediately falls down an open manhole.

The second version could be considered funnier, since it carries a deeper truth: a mishap avoided can result in a calamity down the road. So it was in the movies and so it is in real life.

Japan dodged the banana peel of the 1987 Wall Street crash, only to disappear down a manhole four years later. The emerging Asian tigers averted the 1994 Mexican financial crisis only to be consumed by their own equivalent in 1998. Britain side stepped the US Y2K dot.com bust only to fall heavily in its own debt malaise of 2009. China has artfully avoided every trap of growing emerging economies bypassing many banana peels, at least until now. Watch this space in future editions.



COVID-19

Since February 2020, the world has been consumed by COVID-19, first evident in Wuhan, China. The draconian efforts adopted by the Chinese Communist Party (CCP) to lock down 105m people in Hubei province including welding the doors of the infected, sent a message that those in power were fully aware of the contagious nature of the deadly virus.

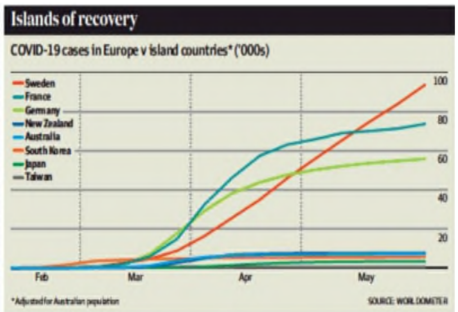
The CCP and World Health Organisation (WHO) for whatever reason, played down the transmission threat, permitting people to depart China leaving the rest of the world more vulnerable and less fearful than was appropriate. But what has past has past and cannot now be undone.

Today every country on earth clearly sees the health threat corona chaos poses and nothing else. **That is the banana peel.**

To avoid the health threat posed by COVID-19, countries across the world shut down their domestic economies, barring essential services, at the direction of government. With the loss of domestic jobs, production, income and spending **governments became obliged to fill the economic void they themselves created**. Trillions of borrowed dollars have been spent (often poorly) to keep industries, businesses and workers afloat during the lockdown period. All this new debt added just as the **global economy begins its plunge head first into recession or worse.**

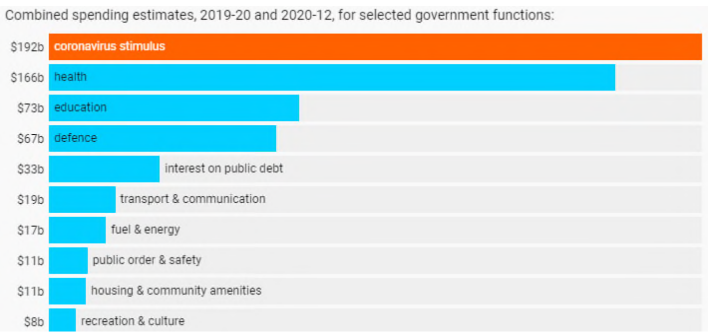
Australia, being on the far side of the developed world, has sheltered itself from COVID-19 extremely successfully. Amongst many responses, swift action by ScoMo to stop flights from China (for which he took WHO heat) was vital in restricting the entry of the virus into the country. Before we pump our chests, many other countries such as Taiwan (sceptical of China), Japan, Sth Korea and New Zealand have equally quarantined their exposure as the chart below illustrates.

Island countries have a natural geographic advantage. Simply restricting the entry of airplanes, ships and foreigners proved extremely effective. Europe made up of many countries and land based travellers could not be so easily isolated.



Notwithstanding our natural advantage, **Australia has doomed future generations to pay the cost of our COVID-19 response**. 2nd only to the US, we have spent over 10% of our GDP (so far) on government stimulus measures (eliminating the infamous $60bn arithmetic error).

Putting these figures into context, the chart below shows our COVID-19 budgeted costs as being greater than the annual cost of our entire health system. Actual costs already exceed budget, with more to come.



All lives matter more than money, including future lives. Weighing the price of COVID-19 dollars spent today against the many preventable deaths already lost worldwide is problematic. We used to have a target of "**flattening the curve"** to allow our health system to manage many months of anticipated outbreaks. Now small clusters create panic. With all eyes and all financial resources fixed on COVID-19, an unintended global economic catastrophe lies not far ahead. Think global depression type stuff. **That is the manhole.** Should it eventuate, we fear tapped out nations and global debt and poverty will see millions of future lives lost to treatable diseases, famine, financial despair, domestic violence, crime, suicide and homelessness. **No one will be laughing**.

THUSYDIDES AND PANDEMICS IN HISTORY

In last year's Investment Insight we introduced clients to Thusydides, arguably the world's first historian. Our context last year was the Clash of the Titans and the economic confrontation of the U.S. and China.

More relevant this year is Thusydides' account of the Plague of Athens documented during the poleponesian war. Sourced from North Africa and Persia (modern day Iran), a pandemic believed to be typhoid was brought into Athens and spread like wild fire. In the second year of the war, many peasants from the countryside and other wartime refugees migrated to Athens. Their squalid living conditions became a bacterial breeding ground contaminating the city's food, water and daily life.

Not only altering the course of the war, the lethal pandemic profoundly changed Athenian society. With death often occurring within a week, many people abandoned religious beliefs becoming hedonistic pleasure seekers. Looting and violence increased as lawlessness arose. Many villages became isolated and close personal contact even with family and friends was shunned, lest death be the price to pay. A form of xenophobia also took hold as locals blamed the outsiders for bringing the pestilence with them. A once social order fell into disarray.

(Readers may be interested that the practice of quarantine was only first adopted in 14th century seaport Venice. Ships arriving in Venice often from other plague infested ports were required to anchor offshore for 40 days before landing. The Italian words for 40 days are "quaranta giorni" hence the word "quarantine").

Thusydides' account from the time of antiquity reinforces the fact that, basic human desires, fears and responses have not changed over time. Throughout the course of history, malaria, bubonic plague, cholera and many other then uncontrollable diseases led to hardship and fundamental changes in the functioning of society. Will COVID-19?

It is too soon to tell whether COVID-19 will be defeated by modern medicine, or become the latest incurable disease leaving a long and tragic trail of death, economic turmoil and social disorder in its wake.

Investment markets have rebounded strongly since their March lows, pricing in limited, if any, financial loss resulting from COVID-19. **Markets are apparently convinced that a vaccine will soon be available and the re-opening of business will lead to the recovery of boom time profits**. We believe both assumptions to be foolishly optimistic.

SARS-CoV-2 is the novel coronavirus that causes COVID-19. We would do well to remember that SARS-CoV-1, the cousin of COVID-19 broke out in 2002 and has no human vaccine. Whilst initial phase trials for a COVID-19 vaccine are promising, a widely available, effective and affordable vaccine remains a long way off. Thus the possibility of further viral waves, prolonged health concerns and extended declines in business profits and investment returns is decidedly real.

Re-opening businesses will not necessarily restore damaged cash flows impaired balance sheets, disrupted supply lines or induce consumers to buy. **Share prices initially fell for good reason:** the expectation of significantly reduced future profits and dividends. Since the world is still on government life support, we see little evidence that would change that outlook. The financial cliff ahead is likely to be more apparent only when the temporary and artificial support is withdrawn.

On that basis, we believe markets have under estimated the longer term impact and timing of recovery from the economic lockdown.

By the time this newsletter is printed, **all fee paying Zanacorp clients will have already received or are in the process of receiving a personalised Record of Advice with investment recommendations specifically addressing their portfolio positioning.** We feel very comfortable preparing for changed future conditions at a time when broader markets are intent in believing they can orchestrate a return to the past.

History teaches us that it is impossible to predict the future. Also, that **investors should not risk that which they cannot afford to lose**. It really pays not to forget those things others paid a high price to learn.

BRAIN TEASER

Bill is a simple investor. Following the onset of COVID-19 his ASX200 ETF investment **fell by 34%** in just 30 days. Resisting the urge to sell, the ETF subsequently **rose by 30%** over the next 60 days.

How much did Bill's investment end up falling?

(a) 8% (c) 14%
(b) 4% or (d) 11%

Answer on foot of page 4

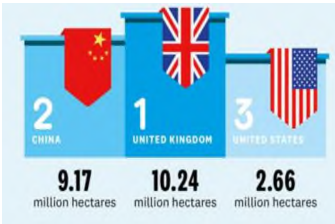
WHO REALLY OWNS AUSTRALIA?

We all adopt relatively simple cognitive approaches to data to help us process the complex and rapidly changing world around us. Having got the "feel" for something, we tend to believe we "know" it. But do we?

If we were to ask which overseas country owns most of Australia's assets, one country would immediately spring to mind. The country that over the last 20 years has emerged from economic wilderness to become the powerhouse of global growth, the workshop of the world. The place of origin of many of our hard working neighbours. Of course based on recent events most people think China has taken us over.

Land Ownership

Wrong! Depending on one's perspective, modern Australia was founded in either 1788 (the arrival of the First Fleet) or 1901 (when we became a Constitutional nation). Over the last 252 or 119 years and **long before the rise of China**, overseas people and interests have settled or invested in Australia. From the original British settlers and sheep producers to the gold prospectors, from the great post WW2 European migration to the more recent Asian migration wave, our wealth of rural, mining and business assets have been highly sought after.



As far as land interests go, readers may be surprised to learn that **British interests** although declining, remain as the **biggest foreign sourced land owners of Australia**. Bigger than both China (2nd) and the U.S. (3rd) having had decent head start. Land holdings make the U.K. Australia's 2nd total biggest foreign source of investment.

Broader Foreign Direct Investment (FDI) in Australia

OK, so which nation owns our businesses, services, financial and non land based wealth? Surely that must be China? Well actually no.

In the 1960's, 70's and 80's those readers old enough to remember will recall the rise and dominance of Japan. Based on our 1957 Trade Agreement, Australia has partnered with Japan for over 60 years in mining, energy, agribusiness, tourism and finance. This relationship has been built on mutual benefit and mutual respect. To this day, Japan remains a most trusted trading partner. The table below is drawn from Austrade data to 2016, **Japan has since increased investment**:

Japan is our 2nd largest export market.

2nd largest FDI

3rd largest two way trade partner

Recently acquired CUB, Dulux and CFS Global Asset Mgt

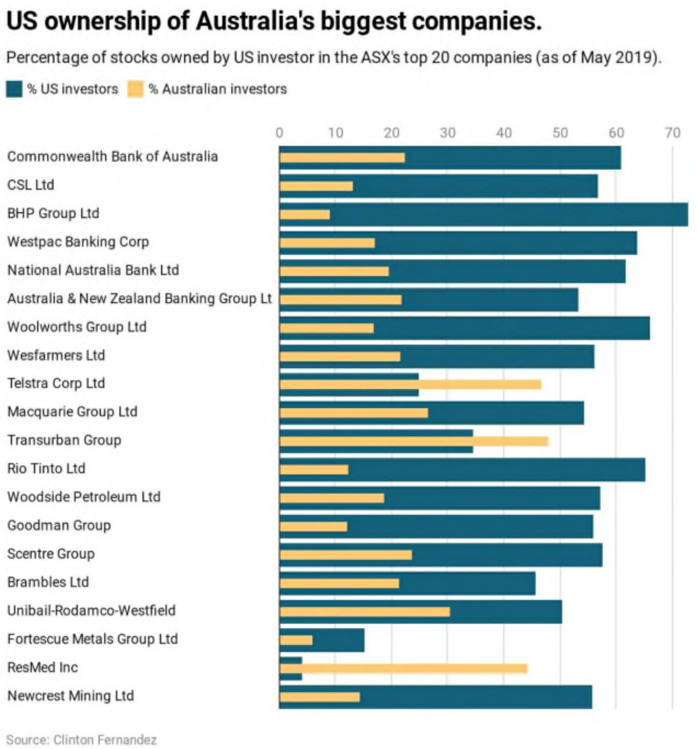
Yet Japan is **NOT** number 1 or number 3 in foreign ownership, neither is China.

Number 1 should come as no surprise. Care to guess before looking?

There are many characteristics that define a global super power. They are more than military might, more than financial muscle, more than know-how, more than population and much more than GDP. **The world currently has only one genuine super power.** A nation that changed the course of world wars, the course of science, the course of manufacturing, industrialisation and technology and course of modern western lifestyles. That nation is the **United States of America**.

Since the Bretton Woods Agreement of 1944, the U.S. has controlled the air, controlled the seas and controls the flow of money being the Reserve Currency of the world. 76 years of co-operative global alliances stretches a lot further than 20 years of shrewd cost undercutting.

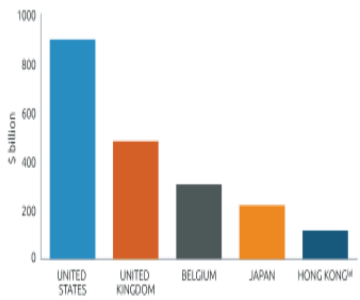
Now let's take a simple look at what you thought you knew, but didn't. The table below shows the ownership of Australia's biggest companies including CSL and the Commonwealth Bank (who in 2019 swapped places for top billing). The blue bars represent U.S. ownership of our businesses. The yellow bars represent Australian ownership.



Surprised? If anyone looked at the Top 20 shareholders lists on each company's Annual Report you would find the names **JP Morgan** and **Citibank** amongst numerous US Nominee Companies.

In terms of Total Investment in Australia, the US at over $900bn is more than $350bn ahead of the UK followed by Belgium. Money talks.

Australia's Top 5 Foreign Investment Sources 2017—DFAT



What Does Belgium Do For Us?

Alert readers will be aware that we have often referenced Aussie interest rates being set by the EU.

Our banks buy money off Europe to lend to us so that we buy can buy our over priced houses.

Belgium is the clearing house for Euroclear. As is evident from the illustration, our debt to Europe is our 3rd biggest national liability. Now you know why Australian banks are not interested in offering savers attractive term deposit rates.

China is our 9th largest investor and although important, is mostly over estimated by ordinary Australians due to its recency. We confuse Chinese migrants buying our homes with Chinese (CCP) ownership of our nation's wealth. China has become a **major owner of Australia's rural land and water assets** and will continue to do so**.** We are a key part of their growing food chain of grains, livestock and seafood.

For us , China's importance lies in their massive import of our mining products, their tourism and foreign student enrolments in Australian Colleges and Universities. Without Chinese buying of our mining and services products, Australia would indeed be financially "stuffed".

Knowing this, China has attempted to bully Australia by placing tariffs on our barley and beef and by issuing warnings to its citizens that Australia is not safe to visit or study, overtly implying we are racists. Relations have soured greatly between the nations. The state-run Global Times referred to us **"like gum stuck on the bottom of China's shoe"** since we sided with the U.S. re Huawei 5G tech, our National Security concerns and our push to have an independent enquiry into the origin of COVID-19. Distrust has not been helped by Victoria's "secret" deal with China, which Daniel Andrews refuses to make public.

We must tread carefully in balancing our relationships with both the U.S., our traditional ally and China on whom our future financial well being depends. We are uncomfortably placed as a pawn moved across a chess board by both Trump and Jinping and their competing interests.

Talking Tax

Matching its technology improvements, the ATO is taking granular (detailed) reporting of items on Income Tax Returns to a new level this year. 2019 saw deduction details electronically transmitted for the first time since the introduction of the tax self assessment rules in 1997. This provided detailed data to the ATO on all tax deductions claimed.

For 2020, the granular reporting regime has been extended to income items, with tax returns now containing 22 new or modified worksheets introduced and 250 new income fields. **These changes greatly increase both the data matching and data mining capabilities of the ATO** and the time/cost involved in completing a tax return. Tax agents and taxpayers have been alerted that the new format greatly improves targeting taxpayers who omit income including the "sharing" industries Uber, Airbnb, Airtasker and home rentals including holiday houses.

Although these changes may appear benign, we warn clients that powerful AI tools are effective and last year identified tens of thousands of over claimed deductions. The new income fields may do the same.

With COVID-19 forcing many workers to work from home **the ATO is anticipating many errors** and have created a new **Working From Home (WFH) Deduction worksheet.** Differentiated WFH rates apply to pre/post COVID-19 dates with device/office items also being tracked. Diaries must be maintained evidencing WFH activities and dates.

Finally, we advise early lodgers not to rush as no refunds will be issued prior to 16th July. Where returns include items ordinarily included on pre-fill reports (eg.dividends) refunds will be withheld until 31st July.

Rainy Days? Why Not Cash In Super

APRA data to mid-June 2020 has revealed over 2 million Australians have withdrawn $14.8bn from their super.

The latest ABS figures as of May 2020, put the "official" jobless rate at 927,600 or 7.1% **EXCLUDING** the **3.3m people on JobKeeper** and the **1.64m on JobSeeker** payments(!). Economists estimate the true unemployment and underemployment rate at a staggering 10% to 20%.

1 in 5 people (20%) are earning more from benefits than from job. A further **1 in 3** (33%) are earning the same amount not working, as they did from working. Can it be that "**it is not worth working"** has finally come true? Has the value of purpose and contribution to society gone?

It is likely that most people who accessed their super, also receive government support payments. Many would also be enjoying temporarily reduced rents or relief from mortgage payments. But then what?

Viewed from this perspective, we should be concerned by the number of Australians living from pay to pay, with little to no savings. Without judging, it is disturbing to imagine the financial predicament of these people when the relief measures are lifted. Cynics may say **"nothing is more permanent than a temporary government hand out"**. Even so, a genuine economic recovery must lift these people with it productively back into the workforce . At the moment, that looks like a big ask. If that is the case, what chance have we really got to return to "normal"?

THINGS THAT NEED TO BE SAID

Continuing our Orwellian narrative, there are a number of complex economic concerns we cannot disregard that need referencing. **It feels strangely like 1999 all over again.** Alarming credit risk and euphoric technology share prices are driving markets to crazy levels ignoring the deep structural imbalances the pandemic has exposed.

We do not eliminate the possibility prices may rally one more time, but taking a 1-3 year view we see no other direction for global asset prices but down. **COVID-19 has been the catalyst, but not the cause** of extreme monetary, fiscal and other aberrations including:-

- Demanding market valuations at a time of profit uncertainty
- Liquidity measures masking underlying solvency problems
- Expiration of global job subsidies, mortgage & other supports
- Worldwide job losses capping consumer income, demand and the debt servicing capacity in developed markets.
- Broad economic/Industry risks in travel, tourism, hospitality
- Expanding FED balance sheet distorting corporate credit risks
- Corporate failures from excess debt and evaporating cash flow
- COVID-19 2nd/3rd waves disrupting major financial markets
- Scarred consumer confidence/behaviour post health threat
- U.S. Pension system stresses
- De-globalisation and escalating geo-political conflicts
- Emerging Inflation/deflation or stagflation risks
- ZIRP, NIRP, MMT (and once mythical leprechauns).

We are not paranoid, but we will choose our battles. There are simply too many banana skins to dodge for our liking. For 10 years **policy makers have led us into an economic Bermuda Triangle.** The normal functioning of markets, capital, savings and pricing appears lost.

COVID-19, Investment Risk and Investor Returns

COVID-19 is unlike a financial, political or economic event where we can identify its source and deal with the problem. The virus presents as an invisible human threat potentially transmitted by everyone to anyone else. **It knows no borders, no race and no privilege and no amount of money can fix a virus.** Yet a virus can inflict more human and economic damage than any amount of money can repair.

Given the vaguaries of our time, we believe investors must ask and answer a quite basic question. **At this time, is the likelihood of making money ,greater than the risk of losing money?**

As investment advisers the answer to this question frames the basis of our guidance to clients. The decision however, must ultimately be made by the individual as it goes to the heart of their personal investment goals and risk tolerance. With the stakes being so high and the potential investment outcomes being so different, we fail to see any middle ground. **We are unlikely to "muddle our way through"** a contagious global virus. It will either be cured or it won't, and only a cure could return us to anything like pre COVID-19 investment conditions.

The dilemma for those investors that cannot bear missing out on making money is that **each roll of the dice** may make them 10% or 20% or cost them 40%, potentially ruining their lives. Those who seek to protect the capital they already have, must accept that their **investment returns over the next 2-3 years may be low single digits, or even a small negative** depending on the severity of asset price declines.

Our carefully considered thoughts and strategy outline have been conveyed directly to clients. When facing uncertainty, weighing up risks does not lead to a right or wrong answer. Like taking out insurance (or not), it leads to an outcome one chooses to live with.

We insure our car, not because we expect to have an accident, but rather because we want protection against the potential cost, should we have an accident. There is a price to pay, either way.

ALL THAT GLITTERS IS GOLD

Speaking of insurance, financial insurance is somewhat hard to come by. For higher net worth clients not requiring income, we have recommended physical gold as a true hedge against a market melt down and rampant money printing.

We hope to explore the features of this age old precious metal in future Investment Insight issues. Conservative investors may wish to undertake some research into this fascinating asset class. For reference, the shiny metal rose 29.4% this year.

Market Roundup

Australian Shares, AREITS and Residential Property

2020 saw the biggest fall in Australian share prices since 2012. The All Ords closed down 10.5% to6,001 points. With our indices overweight banks, sharp profit declines and the suspension of dividends resulted in **NAB, Westpac and ANZ** share prices plunging over 30%.

Since March 2020, COVID-19 carved our index into 2 halves, big winners and big losers. **Afterpay, Zip, Kogan and JB HiFi** blitzed the tables with their online business models. AREITS were punished by COVID-19 as retail malls and office buildings turned into ghost towers, with major tenants getting never before witnessed regulated rent reductions.

Property is a very tough market to call. The "haves" will not sell and the "have nots" may find it harder to borrow. A tight market will keep-prime real estate prices high. Apartments and outer suburbs? Ouch!

Overseas Shares

Repeating the pattern of many years, and validating our prortfolio asset weightings, overseas shares strongly outperformed Australian shares, even in tough conditions. Japan, Germany and US markets were broadly flat. Key to this outcome is that fact that unlike Australia, these markets have many technology, software, and communication services juggernauts, basking in the shift to IT and online services.

Focussing on the U.S., the broader market indices saw a few big winners obscure widespread losses. **Over 20% of the U.S. S&P 500 is now made up of only 5 companies** its highest concentration ever. The magic mix of **Microsoft, Apple, Amazon, Alphabet (Google) and Facebook.** The market cap of Microsoft and Apple is over US$1.5tr while Amazon and Google each exceed US$1tr. The Top 3 hold US$570 bn in cash. The scale of these businesses far exceeds any other on earth. More frightening is that they are future based and still growing.

Outside of the companies above, lie many **U.S. zombies**. Remnants of the past, cutting costs and margins to stay alive. Expect a few "names" to make the headlines for all the wrong reasons. Saddled with debt, no cash and challenging markets. Will they detonate the pricing bomb?

This newsletter **"calls it as we see it"**. We still believe in gravity. We believe regulators make mistakes. We believe all bubbles burst. Investors you now have a decision to make. Have no regrets. Choose wisely.

MARKET FACTS

	June 2020	June 2019	June 2018	June 2017	5 Years Ago 2015	7 Years Ago 2013	10 Years Ago 2010	15 Years Ago 2005
Australian All Ordinaries	6,001	6,699	6,290	5,764	5,451	4,775	4,325	4,229
Dow Jones (US)	25,812	26,600	24,271	21,349	17,619	14,909	9,774	10,374
FTSE 100 (UK)	6,169	7,425	7,637	7,313	6,521	6,215	4,917	5,109
Nikkei (Japan)	22,288	21,276	22,304	20,033	20,235	13,677	9,382	11,584
Hang Seng (Hong Kong)	24,427	28,542	28,955	25,765	26,250	20,803	20,129	14,201
Dax (Germany)	12,311	12,398	12,306	12,325	10,945	7,959	5,965	4,583

Brain Teaser Answer (c)