ZANACORP

Financial Markets Update

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There is currently a disquieting calmness amongst investors around the globe. Ironically, bad economic news is now interpreted by markets as good news since it delays the tapering of US quantitative easing, keeps interest rates low and ensures the continued flow of free and easy money to support elevated asset prices. The global investment party stoked by years of unprecedented liquidity and negative real interest rates can go on. Stock markets post new highs weekly, house prices continue to rise and economic stability simply seems a foregone conclusion. Yet all may not be as good as it seems...

The Boom gains momentum, but the countdown clock is ticking

A New Age of Speculation

Reflecting our times, a recent Westpac/Melbourne Institute survey of the "wisest place for savings" has shown "**real estate**" moving from 14% to 28% (the highest level in 13 years) and "**repay the mortgage**" slumping from 26% to 14% (the lowest level since 2007 being pre-GFC) with "**shares**" enjoying a rise of over 20% from recent lows.

Wow! It doesn't take very long for people to forget the past, does it? These results are on the back of Australian interest rates at 50 year lows. Can investing times get any better than this? Not wanting to be a party pooper, in your writer's experience, investing in real estate means taking on a 20-30 year mortgage. Outside of the family home, investing when interest rates are at their lowest, is about the worst time to dive headfirst into a hot property investment pool. Chances are in 3-4 years, interest rates will be higher, buyers will be fewer and prices will (at best) remain pretty flat from their current lofty levels.

The point being made here is that investors' appetite for risk has reversed itself quickly from the fearful days of the GFC. Our economic growth relies on confidence returning, particularly amongst consumers, but this is not the case. What has returned is speculation of rising asset prices and the making of "easy money" often employing debt. Like a voice in the wilderness, Reserve Bank Governor Glenn Stevens is warning both property lenders and borrowers alike to be prudent in their expectations. Yeah, like that will change people's minds.

We would ask readers to close their eyes, take a deep breath and ponder from their own perspective the following thought…do you see the current investment world as strong, robust and stable or risky, uncertain and fragile? **Please stop reading and think about this for at least 15 seconds, then continue**.

There is no right or wrong response to this question. Each reader should assess their own individual investment risk tolerance and, amongst other things, keep in mind the thoughts they just had.

If nothing else, you will have just completed a rudimentary form of risk profile for yourself (and given away your age). All Zanacorp investors have made handsome returns over the last 18 months, and would naturally like to make more. But the **law of diminishing returns** has now come into play. Investing at present requires people to take on increasingly greater investment risk for increasingly lower returns.

Astute investors aim to be aware of as many risks as possible before investing capital. Today's rarefied economic conditions appear fraught with risk. Unsurprisingly, the most active speculators today are not baby boomers over 60, but rather high risk takers of every generation below that age, fearlessly rolling the dice on their financial future.

Where is the World Economy Now?

In a post GFC world understanding where we are now, how we got here and where we are heading confounds even the best economists. Stimulus or austerity, deficit or surplus, QE or tapering, currency depreciation or structural reform are all discrete decisions which have led each country along different paths to their current reality. As in 2008, each country stands alone, yet is dependent on the decisions of the other for continued stability. For now, global uncertainty abounds.

Australia has fared better than most developed nations since the GFC. But our continued prosperity cannot be taken for granted. Investors should be conscious of the ongoing economic conditions which have underpinned our economy and recognise when they are changing.

THE GOOD NEWS

Liquidity/QE/Low Interest Rates Avert Deflation

Oversimplifying cause and effect, the global economy and global stock, property and currency markets have all succumbed to relentless liquidity, stimulus and low interest rates. This pungent cocktail was developed to avert asset deflation by promoting demand side growth. While it was successful in this end, its extended duration has unwittingly resulted in an inefficient supply side excess of capital.

The developed world seems trapped in a secular deleveraging cycle. It is characterised by low growth and sluggish consumption/demand. These conditions are not conducive to increasing global employment and most certainly do not favour asset price rises.

To keep things rolling, governments have spent heavily and assumed debt (at their peril) whilst the business/private sector has generally sought to reduce debt. Similarly, central banks have also stepped into markets to stimulate growth by buying bonds and other debt securities (money printing) and maintaining low interest rates.

In a deleveraging environment, with negative real interest rates one could ask the question, "So why are asset prices rising?". The answer, at least in part, lies in the old inflationary adage of "too much money chasing too few goods" with "goods" being high yielding assets.

The compound effect of years of stimulus and liquidity long after the crisis passed, has been that early astute investors used cheap and plentiful money to buy quality income producing assets at bargain prices. They "bought in gloom" as the saying goes. Asset prices stopped falling and began to recover. Over time, more investors recognising the same opportunity did likewise. Asset prices rose further. Finally, if one keeps making money available cheap enough and for long enough "the man in the street" cottons on to the idea.

Now that's **when valuation problems start** to emerge. It's an old tune.

Today, with low interest rates, almost everyone recognises long term money in the bank is dead money. **Safety of capital** is no longer a concern but **return on capital** is. Money is now used to buy property or shares, where the income paid is the same or higher than bank interest. With asset prices rising, investors may also get capital growth for nothing, on top of their income. It is obvious isn't it? The crisis is over, just look at what has happened over the last 18 months, right?

If only it were so. Two years ago, all asset prices were cheap and there for the taking. We consistently encouraged people to buy. There was no talk of "fully valued" or "bubbles", the mood was more of disappointment and loss. Today, both shares and property are no longer cheap. So investing is more difficult than even a year ago - and more risky. Yields are falling quickly because prices are rising sharply and the risk/return trade off challenges value investors like ourselves.

History is littered with examples of what happens after periods of prolonged low interest rates. They lead to unsustainable asset price booms. (For those unable to recall, the last boom we had was 2003-2007. We all know how that ended). Which is where we are now at.

The only uncertainty today is how long will it last. The good news is that momentum currently favours the brave with all markets moving strongly and progressively upward. In the absence of any unexpected shocks, markets could easily continue to ratchet upwards by 8% - 15% before reaching extreme valuation levels. Relative to cash, that is a tempting return for 6-12 months luring the final unsuspecting investors who really missed the boat but cannot resist jumping on board.

> *Veteran American market timer, Jim Rohrbach, once said:*
> ***"There are really only two good feelings in investing. One is being in the market when it is going up and the other is being out when the market is going down".***

THE BAD NEWS

Quantitative Easing Will End

Ignoring the brinkmanship of US politicians arguing in Congress about debt, spending and Obamacare, the reality is that markets are far more concerned with when the FED will start to unwind quantitative easing (the taper).

Until the recent economically damaging US debt crisis, markets were anticipating the FED to commence the withdrawal of QE late in 2013. That expectation appears to have been pushed back to either March or June 2014, allowing bankers/investors and the market to breathe a collective sigh of relief. But the **relief will be only temporary**.

It is not possible to overstate the force of the global economic measures taken over the last 5 years. Such has been the scale of the liquidity pumped into markets to "normalise" conditions, with China heading the table. Nations averted the nightmare of global deflation by spending and printing seemingly limitless amounts of money. They have artificially pushed up markets affording time for legislative reforms to be put in place. Sadly however, bereft of leadership, politicians across the world, including our own, have been unwilling to engage in the necessary structural reform to fix the underlying problem of global imbalance. Reform required them to pass on an increased share of the economic burden to voters. It has proved to be a path too hard to walk. Remember the European debt crisis? It has not gone away, it is merely old news, unless of course you live there!

At current levels, **markets have not priced in the risks of anything except an orderly exit from QE**. We believe this to be unrealistic as the removal of stimulus is fraught with timing, measurement and consequential difficulties. When it commences, markets will again be faced with both economic uncertainty and price volatility, both of which are the true menace of rational behaviour.

There is unlikely to be such a thing as perfect timing for the end of QE. Predicting the date will be less important than preparing for it.

Once commenced, the impact of US and then global tapering will be set in motion. Although impossible to pre-determine, we would expect the following outcomes:

(i) An immediate strengthening of the $US/falling $A
(ii) A flight of capital away from emerging markets
(iii) Increased US interest rates at both short & long ends of the curve
(iv) A short term fall in US and global equities/bond prices
(v) A new period of uncertainty awaiting economic clarity
(vi) Something else (X factor)

Experienced investors will recognise the relevance of item (vi) as we all should be aware (or beware) of unexpected events/consequences.

Where to From Here for Asset Allocation?

Zanacorp investment clients will have noted that we remain cautious with our investment portfolio asset allocations. Having taken part profits in May, we anticipate a further round of profit taking in early 2014 reflecting the new consensus that QE tapering will be deferred.

We are somewhat comforted by the knowledge that Zanacorp clients will be invested in value driven Australian equity funds which will "weather a storm" well. On the same basis, all clients will be invested in our preferred international funds which have returned stellar performances in excess of 40% for the last 12 months. Yes, over 40%.

So our Tactical Asset Allocation bias firmly turns to capital protection in anticipation of a challenging 2014 investment year.

Overseas Assets Favoured by Falling $A

While Australia had some unique characteristics favouring domestic investment, the tail winds of the last 5 years appear to be headwinds of the next 5, Dutch disease if you like.

We feel investing offshore is the best way to capture growth and insulate portfolios against imminent losses. The RBA is intent on delivering a lower $A to rebalance our economy, but their only tool is interest rates. Market forces may themselves deliver this objective. Our comfort is that a lower $A increases the value of overseas assets thereby mitigating price declines.

The current renewed strength of the dollar provides us with another opportunity to position underweight client portfolios into overseas assets where we can get more "bangs for the buck".

Housing Bubble or Housing Trouble?

Topical at present, is the discussion on Australia's residential housing market in the context of whether a bubble exists or is forming.

We believe strong immigration, overseas buyers, quality supply scarcity, low construction levels and low interest rates are clearly factors driving prices strongly upward, particularly for existing property.

We do not accept that the market is in bubble territory. Prices are stretched, but as with equities, they can correct without collapsing. The Reserve Bank still has room to lower interest rates further to support borrowers or a stressed market. Our banks are relying on that.

Our considered view, particularly for retirees is that as an illiquid asset requiring massive leverage and ongoing maintenance, we prefer to avoid property in favour of more flexible assets. For us, net yields of sub 3% are a deal breaker. In response to a common question "**Which is better, shares or property**?" Long term, returns are almost identical.

Our parting thought directed to those who flippantly dismiss property price concerns, consists of a simple fact. 2013 IMF data shows the mighty **US government** (supposedly in crisis) has a **107%** Debt/GDP ratio. Meanwhile, **Australian Household debt**, (supposedly not in crisis) stands at **95%** of GDP (and rising) and at 148% of household income (an all time high). People die and must retire their debts in their lifetime, but governments don't. Is it not fair to question which is in crisis?

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