Investment Insight

ZANACORP

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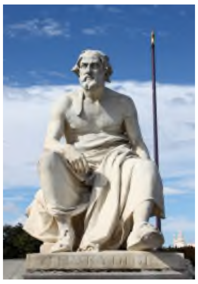
With equity and property prices recovering in expectation of lower interest rates, the disconnect between investment hope and economic reality widens. In a Faustian bargain, markets continue to trade off short term gains against longer term risks. Having seen a preview of what tighter credit settings can do in Q4 2018, regulators buckled and are returning to the "safety" of cheap and easy money. In Australia, ScoMo's miracle election victory amplified the echoing sound of the world's silent majority. Brexit, Trump and now ScoMo represent the push back of individuals against progressive governments and socialist policies stifling incentive. Add a 21st century style trade war, income tax cuts and an extraordinary unfunded domestic infrastructure program into the punch bowl and we now have ourselves a seriously toxic economic cocktail…be prepared for the hangover.

Clash Of The Titans



Thusydides' Trap in the 21st Century

Thusydides is not well known, but was one of the world's first historians. Living at the time of the Golden Age of Greece (c.460BC), he recorded the conflict between Athens and Sparta and prophetically foretold future history when describing the nature of battle. He provided insight into the recurring sequence of events and the downfall of empires ***when a ruling dominant power is displaced by a new and rising one***. Thusydides spoke of the incumbent's fear of the new foe, its anger, arrogance, retaliation and ultimately submission.

"Thusydides' Trap" was an expression coined by political scientist Graham Allison when reflecting on the astonishing rise of China over the last 40 years and the gradual demise of the US as an economic power.

Over the next decade, we seem destined to witness a changing of the guard. A profound shifting of power, culture and values from the West to the East. It has already begun. The hollowing of the family unit, self indulgence, decadence and the distrust of both church and state are classic signs of a dysfunctional, faltering empire. Weakened, the bold ***Made in China 2025*** program **seeks to win a bloodless, global economic war.**

A Brief History of China

Since Australia relies so heavily on China for our standard of living, we believe it is important we understand just a little about its history.

For over 2 millennia most Western nations including our own, owe their culture to Judeo-Christian values, democracy, colonisation, exploration, industrialisation, immigration and assimilation. The rule of law and individual rights have been at the core of capitalism and modernisation.

Now consider China, a nation whose past could not be more different. Long before the 1921 formation of the Communist Party of China, the dynasty led nation was proudly the pioneer of human settlement, civilisation, husbandry, philosophy (Confucius), engineering and innovation.

Unlike the West, China did not conquer territories to change them. You see at the heart of Chinese history sits the concept of one nation, one civilisation, one race and a sense of being the centre of humanity and the centre of the world. The Chinese name for China is **Zhōngguó** which in Mandarin means **Middle Kingdom**. A place one would stay, not leave.

It would be fair to say that over thousands of years, China believed itself to be superior to all other races. The eastern countries absorbed into its empire were permitted to retain their own language, their own beliefs and their own identity in exchange for paying a "tribute" to the mainland. This recognises China as head of the cultural hierarchy. Non-Chinese territories may be part of China, but are not equal to it.

In 1820 China represented 30% of global GDP, far outstripping that of the UK and the US. Left behind as a result of the industrial revolution in the West, its wealth and dominance evaporated into thin air, like the vapour bellowing from its opium dens. By 1930 social disorder, civil strife and economic isolation saw China become an irrelevant nation.

Despite **Mao Zedong's** 1949 Great Leap Forward and the formation of the People's Republic of China, the nation suffered extreme and widespread poverty and famine. Its economy was in tatters with 88% of people living on less than $2 per day and represented less that 1% of global GDP. Communist China, it seemed, was a failed model with the introduction of its one-child policy in the 1970s, designed to quarantine despair.

However, following the death of Mao in 1976, **Deng Xiaoping** assumed the leadership of the country and in 1978 introduced the concept of the socialist market economy. He opened the country to foreign investment and lowered many trade barriers. He proclaimed **some people should be allowed to get rich first**, a concept foreign to Mao's model, but one which aligned the endeavours of the individual with the higher common goals of the State, the enduring and trusted guardian of Chinese values and culture. Adapting the Japanese and SE Asia economic path, this visionary **State led/profit-based hybrid system became a game changer**.

The Western world, particularly the US, naively believed that China was going to embrace its mores and open itself to western development and modernisation. Xiaoping implicitly nurtured this belief. Accepted into the World Trade Organisation in 2001, China enjoyed the privileges of tariff/subsidy concessions designed to assist and fast track its development.

Under strict conditions, foreign companies were given access to **China's largest asset, cheap labour**. A condition of access was that the new privately owned ventures must be **49% owned by Chinese interests** and that Western **technologies and IP would be compulsorily transferred**.

Unsurprisingly, China was swamped with interest by large US and European corporations. The allure of cheaper costs and higher profits was irresistible. OH&S and environmental care were not priorities of China or its workers. Exporting jobs to China left a devastating trail of unemployment, factory closures and steel/clothing mill carcasses across the planet causing much resentment and financial hardship. China became the factory for the developed world to exploit, or so it was believed.

"Begin by seizing something which your opponent holds dear, then he will be amenable to your will" - Sun Tzu

Apple iPhone Factory Line - China

After many years of factory building, urbanisation and social restoration China, not known for its strong intellectual property rights, was able to either **forcibly take, reverse engineer or if necessary steal much of the western knowhow and technology.** It then built its own factories and developed its own higher order technology products, leaving overseas suppliers unable to compete. Its workforce became increasingly skilled and affluent.

Even today, China retains the right to restrict and firewall outside businesses which it believes are not compatible with its interests. You won't find **Google, Amazon, Facebook, Twitter, eBay** or many other social media platforms in China. **They are banned**. Instead are their "home grown" juggernauts, nurtured with subsidies such **Alibaba, Tencent, WeChat, Baidu, Sina Weibo** serving its 1.3bn people and in time the world. Hardly a level playing field, but don't expect China to give away its advantage. China leads the no-cost peer to peer digital transaction frontier and intend to on-sell it.

Although China has a massive population, it is relatively bare in natural resources. Thus over the last 15 years as China's income has risen and its workforce urbanised, the building of cities (in scale equal to every city in Europe) has underpinned the economy of Australia and other resource rich countries. Its booming economy and massive 2008 stimulus program saved us from the GFC. Although still incomplete, like Japan before it, its reliance on Australia will diminish. China is now an innovator of leading technology, with dominance in wind and solar power, AI, electric vehicle manufacture and crucially 5G communications, the backbone of e-commerce.

Marvel at Shenzhen 2019. The Silicon Valley of the East. LED displays built into its structures are a flagrant exhibit to its people and the world at large that China is now capable of anything.

Nationalist leader Xi Jingping has milestone plans set for 2025 and 2035 to assume global dominance. He has a dream, a dream he has shared with his people. Unlike Western leaders, his tenure is secure and the people have supreme confidence in its government that has elevated them from poverty to prosperity in 2 generations. This is a unified nation, a proud nation, a rich nation and a nation with a vision. Think Clubber Lang (Mr T) in Rocky 3, it did not end well for Rocky.

The profound transformation of China is complete. The next stage of China's advancement is already visible and somewhat inevitable.

Its "String of Pearls" sea ports and "Belt and Road Initiative" (BRI) are tangible examples of how the new China intends to strengthen its grip on the world's economic future. Knowing its population is ageing fast, it is propagating its economic model into Africa and poorer eastern nations. Having shown itself as capable of making poor Chinese people rich, it offers developing nations a piece of that dream. Building massive infrastructure and communications systems in these countries and improving education, it not only secures priceless goodwill, but also 2 billion "tenant farmers" to take over its factory work. To add icing to the cake, this program also protects and enhances its supply of natural resources, food chains and military defence systems around the globe.

For completeness, China's "benevolence" extends way beyond developing nations. EU nationalist outliers Italy and Poland have signed up to the BRI with Chinese funded road, air and sea projects linking freight movements to and from Europe and China. China's intricate global network is being systematically built, one piece at a time. **Money talks**.

While the West has been distracted by many 1st world problems such as gender equality, income inequality, political correctness, human rights, open borders and the attack on terror (to name just a few), China has been focussed on a much narrower, self serving agenda. China appears happy to allow the US to keep the old world safe, so long as it is permitted to exploit the riches of the new world. **Sun Tzu would be so proud.**

US/China Trade War

Which brings us finally to the point of this discourse - the trade war currently frothing between the US and China. **This is a big deal** and potentially disruptive to our collective financial future. From the US embargo on Huawei, to China's threat of withdrawing rare earths elements, the profits of many global companies are now uncertain and the future security and supply chains of innumerable goods and services compromised. **Uncertainty ravages markets.** Impacting many sectors, especially US tech, this potentially puts all share prices at risk.

In the absence of a US/China trade agreement, Google will withdraw its Android operating system from all Huawei handsets within 90 days. Drum roll...so Huawei now reveal they have been secretly developing its Oak OS to replace it! Within days, China also secured a deal with our Russian comrades who have decided to support Huawei including its 5G structures. ***"The enemy of my enemy is my friend"- Kautilya 400BC***

The US has an annual trade deficit of between $300bn and $500bn with China (larger than the Australian Government Annual Budget). Over decades, the exporting of both jobs and IP has been staggering. The US President is attempting to address this, but like many chronic challenges, there is no easy fix. Kicking off with Chinese tariffs and citing security concerns has become problematic since Chinese products are now embedded in the economies and systems of many of the US allies. This has meant that some US Allies are potentially hurt by the assault on Chinese goods, with **many European Allies unwilling to take sides in a no win situation for them**. Do they respect the nation that saved their past, or appease the one that will protect their financial future? With no certainty as to a trade war victor, and facing ever more disenchanted voters every 3 or 4 years, this is a tough call.

Chinese owned Huawei has 190,000 employees, 50,000 of whom are not in China. The workforce is well resourced and amongst the world's best engineers and R & D spending is huge, putting Huawei years ahead of Ericcson and Nokia in 5G technology. On this point, Huawei is building a state of the art NBN for both Mexico and Brazil strengthening its alliances in South America while also having a leading presence in many European countries. It is 2nd only to Samsung in global handset sales having increased shipments from only 3 million units in 2010 to 206 million in 2018, overtaking Apple. Quality improvements allow it to stand toe to toe with the best phone makers on the planet. All in 9 years!

Corning's gorilla glass, Qualcomm and Intel's semiconductor chips and Apple's Chinese factories are just some of the US pawns in this spat that could see their prices slashed overnight potentially leading to global market turmoil. This is not our base case, but it has been elevated as the single greatest threat we presently see to the stability of global markets.

In the weeks and months ahead do not be confused by the media's simplistic discussions about tariffs. This trade dispute goes much deeper. It is a battle between East and West to control and dominate the world's economic future. Thusydides would see a familiar ring about our 21st century political and economic conundrum. With a headline cast of egotists made up of Trump, Jingping, Putin, Abe and Kim Jong-un, we suspect he would see no way of avoiding a military conflict. Lets hope not.

How about a change of pace…

Brain Teaser

A baseball and bat together cost $11. The bat costs $10 more than the ball. How much does the ball cost?

Take a look at the answer at the foot of page 4, before reading on.

Intuitive Decision Making - System 1 is Our Default

Most of us like to think we are rational people. When processing information, we arrive at our decisions having logically considered the merit of alternatives. Right? Economic theory is likewise based on a fundamental precept that people behave rationally. If it were not so, the basic economic problem of allocating scarce resources would be impossible.

The above brain teaser is a simple example of how many of us make decisions based more on intuition than the facts. This is particularly true where we choose to, or have to make decisions quickly.

For those who got the answer right, you probably thought for a little more than 10 seconds to arrive at the correct answer; having immediately thought of the "obvious" answer $1, then testing it and finding it didn't work. For those who got the wrong answer, do not despair. Across many studies, around 50% of people used the same "intuitive" process to get the same result, including Harvard University students.

Based on research first completed by Nobel Prize winner Daniel Kahneman and Amos Tversky in the 1970's, it has been found that we each have 2 decision processing systems:

System 1 is intuitive, unconscious, designed to be extremely efficient, powerful and energy saving so that we can quickly deal with the many decisions we must make often on an ongoing basis. It applies rules of thumb and prior learnings to narrow down the range of alternatives we must choose from. Although efficient, this system often leads to error.

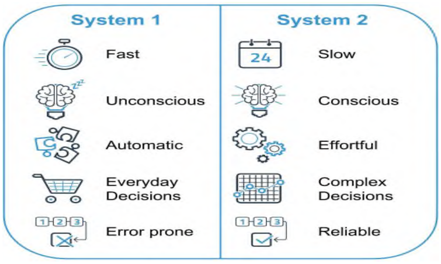
System 2: This decision system is that most recognised. Using conscious fact finding, identifying issues and deriving a logical, considered conclusion. Typically, this system is activated when considering critical decisions, with no time constraint. We believe we do this, but do we?

Knowing we are often prone to take short cuts when making decisions is critical to the first rule of investing - **Investor Know Thyself**. In the financial world, the decisions we make including when and how we arrive at them, can profoundly affect long term financial success or failure, triggering powerful unconscious emotions of achievement or regret.

The vast information pool available on the internet and **the time-poor world we live in has trained us all to use intuitive decision making to get to a quick outcome,** accepting that it is only probably right. We can only encourage investors to resist this urge**. The chasm of difference between information and knowledge** is important – **YOU DON'T KNOW WHAT YOU DON'T KNOW** and context can change everything.

As financial advisers we are often confronted by clients who seek assistance in whether to hold or sell an asset. Most commonly, the asset has failed to meet the client's expectations. They have reached a point of indecision and are looking for specialist advice to tip them one way or another incorporating broader issues such as cash flow, capital gains tax and/or opportunity costs.

Although not always the case, when asked about the process used to buy the asset in the first instance, people rarely sought professional advice. The explanations tend to include examples of other people who bought similar assets and were successful **"and so I decided"** (with insufficient thought or expertise), **"because it sounded right"** they went on their way. Their first reaction, as in the brain teaser, was to arrive at a conclusion without undertaking proper due diligence.



In matters of finance:

Stop, Ask Yourself Why (and Why Not), Process, Seek Advice, Assess Pros/Cons, Consider, Take Time-Out, Consider Again, and then Act.

Whether you are young or old (descriptors we will not define), we believe it is important to assess the full course of any investment covering the reasons why we should buy, to the circumstances where we would intend to sell, and everything likely to occur in between.

For example, **negative gearing**, of itself is neither good nor bad, it is an outcome of an investment, not a reason for it. This strategy is usually associated with property investment, where leverage is high, as are the potential costs, risks and rewards. Many investors generate strong returns using the strategy and many don't. There is no magic formula.

The ultimate secret of success is not the gearing component, but the investment itself. Should one buy inner city, off the plan, established house or newly constructed? Should you buy now or wait? How much leverage is right? These are just some of the generic issues good investors look into deeply before they buy: and they don't spend 3 or 4 weeks collecting their facts. They talk to real estate professionals, consider unfamiliar locations with the right investment fundamentals and attend many auctions until they know their market. This **intensive due diligence is completed before making a decision** (System 2 thinking). With huge entry/exits costs you want to get it right the first time. Negative gearing is easy, but identifying a good investment property is not. Most property investors in the last 18 months have been taught that lesson.

Although requiring different skills, **investing in equities demands similar due diligence**. Errors associated with buying shares are more commonplace than property since anyone can jump online and start with relatively little money, little knowledge and no advice. Thereafter all forms of behavioural bias can take over. Hot sectors/stocks, broker tips, "high yield", "blue chip" and "fully franked" are common but superficial criteria, often hazardous to one's financial health. Despite this many do.

People often have no plan and no strategy, just an impulse or thought that they can be as successful as a seasoned investor. **System 1 thinking.**

We are frustrated seeing people in their late 40's (or older) who without any prior strategy or success, arrive at our office seeking a short cut to financial success simply because they have identified their needs too late **trying to make up for lost time and earlier poor decisions.** Act as early as you can, small amounts saved over long periods of time demand little financial sacrifice as long as they are afforded a generous time horizon.

Big Brother Using Big Data

Without wanting to alarm any taxpayers, we feel obliged to report on changes being introduced in all tax returns in the coming 2019 tax season. The ATO believe tax revenue leakage of as much as $8.7bn is occurring as a result of incorrect, overstated or fraudulent claims in individual income tax returns.

To identify high risk taxpayers, 2019 will be the first year where granular tax data will be reported to the ATO by both tax agent and self prepared tax returns. Data matching and data mining algorithms will be employed to compare claims against occupation and industry codes.

Car travel, laundry and rental property deductions are being highlighted for special attention in this first year. We recommend any claims made under these categories should be diligently substantiated.

Tax Cuts - Some Good News

In a politically wily move, the LNP coalition 2018 Federal Budget announced significant personal tax cuts over 7 years commencing in 2018/19 which would only take effect if the coalition was re-elected in 2019. Surprising most, including your writer, they now have to deliver.

For 2018/19, a new non-refundable Low and Middle Income Tax Offset (LIMCO) of $1080* is being introduced in addition to the existing $445 Low Income Tax Offset (LITO). Further, the 32.5% marginal tax rate threshold of $87,000 is to be retrospectively increased to $90,000*. In an interactive matrix, based on Taxable Income, those with incomes of $90,000 pa. will enjoy the maximum tax benefit of around $1,215 with benefits of at least $1,080 to all taxpayers with incomes above $48,000. On a sliding scale, every taxpayer below these levels is better off, as is every taxpayer earning up to $126,000. This is very welcome news.

*Subject to Senate approval and Royal Assent. C'mon Albo, it's time to move on.

Melbourne Property Prices Stabilise

Melbourne residential property prices stabilised in June 2019 after a 12-18 month period of soft trading, seeing prices fall around 10% on fears of the election of the ALP property tax agenda. With the RBA reducing interest rates to 1.25%, APRA relaxing lenders' loan serviceability tests, easy money for property borrowers is re-appearing everywhere. Again.

On Mother's Day, the government announced a most short sighted First Home Buyer Offer to underwrite 15% of loans extended to 10,000 borrowers who have a deposit of only 5%. This will increase lower end prices by around $25,000, effectively donating the benefit to vendors. **When will we ever learn?** Imagine if this policy were in force 12 months ago. With a 5% deposit, and ignoring stamp duty, every borrower would today have lost 100% of their deposit and be uncomfortably sitting on negative equity, wondering why they were lent the money in the first place.

Although pleased market declines have stopped, we are disturbed that the main reason appears to be a return to the bad old days of simply throwing ever cheaper money at young borrowers. This proves our often repeated conclusion that **house prices are now determined by the supply of money, not the supply of property**. We caution would be property investors looking to jump into the market and expecting large capital growth returns. After a boom, **you are not buying cheaply, just cheaper.**

Retirees Dealt Another Blow

Continued interest rate falls are decimating retiree incomes. We have been researching low risk alternatives for clients and are expecting to publish a comprehensive paper on this soon. Watch this space.

Rare Earth Elements (REE) - The Next Gold Rush

Our rise of China discussion referenced rare earth elements. These are 17 elements on the periodic table that have unique properties necessary to our pursuit of cleaner, more efficient energy and appetite for digital/electronic products.

Despite its name, rare earths are not rare, however they are extremely inefficient and costly to extract and process using chemical treatments. A paradox of switching from polluting carbon based fuels to greener electron based fuels is managing radioactive waste. Environmental concerns may have held back the Western world but not China, prepared to devastate large areas of land and exhaust local clean water in its pursuit of global manufacturing domination.

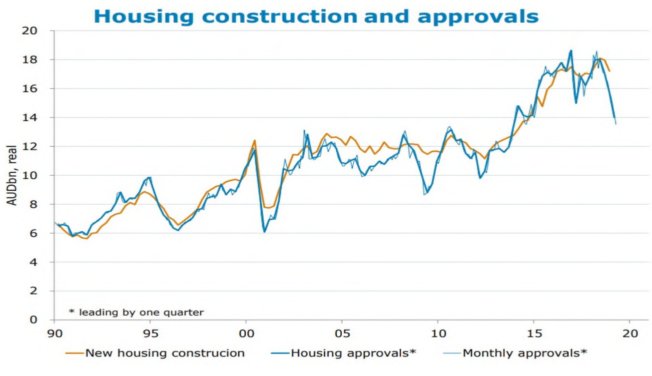
Described as the "vitamins of industry" by Australian REE industry expert, Alister MacDonald of Alkane Resources Ltd, REE can be found in every corner of modern life. In the form of lightweight super magnets, it is found in hybrid/electric motors, wind turbines and aerospace systems. REE are also used in minute quantities, but integral to the function of mobile phones, fibre optics, TV/LCD screens, LED lights, computers, digital cameras, headphones, even MRI's and the contrast injected into patients to obtain the clearest images of human tissue and organs.

In the REE market, China is essentially a monopoly player producing 80% of the world's processed REE and consuming 70%.

That may all be about to change as a result of the current trade war. The US finds itself to be a victim of its own making, having abandoned production decades ago, handing the dirty, capital intensive industry on a platter to their now Nemesis. Japan was similarly placed a decade ago, and financially aligned itself with Lynas to secure continuous supply from the only existing significant non Chinese producer. A smart move.

Trump calling Australia... although it may take 2-5 years to generate processed product, Australia is in the enviable position of having "shovel ready" projects and able to build mines, subject only to finance. Let's hope we can capitalise on this situation to profitably assist our own economy and protect the broader supply interests of the world.

Want to See the Future? - Study This



The above chart illustrates housing construction approvals - a lead indicator of actual construction to be commenced over the next 12 –18 months. Observe the orange tail. This indicates that while current construction is at all time highs, a serious drop off may occur 2020/21.

Market Round Up

Overseas Shares

A glimpse at the Market Facts table below may be of surprise to many. After years of solid returns, all of the UK, German, Hong Kong and Japanese markets marked time over 2018/19. The only market to rise over 2019 was the Dow Jones. Along with the tech heavy Nasdaq, US markets have surged to unsustainable levels**. At 31st December, 2018** when the FED was "normalizing" interest rates and the economy was humming, **the Dow stood at 23,327**. With the FED pausing over slowing growth concerns, **it has risen by 14% to 26,600**. If that makes no sense, you may be onto our theme that interest rates drive asset prices.

Although concerned by current market levels, we are seeing a synchronized global decline in interest rates responding to soft GDP growth. Under such stimulatory conditions, markets are unlikely to fall in the short term, unless by an (unlikely) external Black Swan event. **In the very short run, bad economic news is good for markets** since central banks will lower rates. However, **in the long run, bad economic news is bad for markets.** It always is. For now we are holding our nerve and applying DCA strategies recalling an old adage, **"Don't fight the FED".** Our preferred international asset managers, like us, remain cautious.

Australian Shares

The May election result resurrected the Australian All Ords index which is weighted heavily into our high dividend paying financial sector. Investor relief over the retention of franking credits was a key driver.

After 12 long years, the All Ords is approaching its pre GFC high of 6,853 last reached on 1st November 2007. Interpreting this data, those low cost passive stock index investments you hear about, would have earned a peak to peak compound return of 4.2% pa (the dividend rate of the index) BEFORE FEES. Zanacorp's active equities managers, over the equivalent time period have averaged over **6.3% pa AFTER FEES.** We believe good fund management, like good advice, pays for itself.

For the second year running, Australian shares returned over 10%.

Residential Property

Having briefly discussed the post election rise in confidence, lending and house prices, all property owners can breathe a sigh of relief, especially investors. But don't imagine we are at the beginning of another boom. Those days are over. While present conditions are better for younger home buyers, the monetary shenanigans and debt concerns we have previously outlined remain and overseas property buyers have gone AWOL. **Cheap money may sustain prices but is unlikely to increase them**. Our next Insight will provide readers with an update on Melbourne's most glorious residential development, Australia 108.

Interest Rates

We are mystified as to why the Reserve Bank is intent on lowering interest rates when the economy is supposedly doing fairly well. Are they keeping secrets? Or are they saving the property market? Our concern is that should conditions really deteriorate, the Bank has no where to go. **The tax cuts to be received by all taxpayers will be a significant boost to the economy** and support current rates. The challenge remains continued cost of living increases in the face of little to no wages or productivity growth. Sadly for savers, expect deposit rates to keep falling. Borrowers you are being protected, take advantage of it. But **keep spending, your country depends on it**. Good luck to all.

Brain Teaser Solution: 50 cents

MARKET FACTS	June 2019	June 2018	June 2017	June 2016	5 Years Ago 2014	7 Years Ago 2012	10 Years Ago 2009	15 Years Ago 2004
Australian All Ordinaries	6,699	6,290	5,764	5,310	5,382	4,135	3,948	3,530
Dow Jones (US)	26,600	24,271	21,349	17,930	16,826	12,880	8,447	10,435
FTSE 100 (UK)	7,425	7,637	7,313	6,504	6,743	5,571	4,249	4,464
Nikkei (Japan)	21,276	22,304	20,033	15,576	15,162	9,008	9,958	11,859
Hang Seng (Hong Kong)	28,542	28,955	25,765	20,727	23,191	19,441	18,378	12,285
Dax (Germany)	12,398	12,306	12,325	9,680	9,833	6,416	4,809	4,052