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Investment Insight

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The social, political and economic experiment now defining the 21st century has taken yet another unnatural twist. Proving fact to be stranger than fiction, billionaire Donald Trump will be inaugurated on the 20th January 2017 as the 45th President of the United States. The so-called leader of the free world. How on earth did we get here? 2016 has all but passed relatively uneventfully, except for Brexit. The year ends much as it began, with continued ultra low interest rates, benign equity markets, booming property markets, nose bleeding debt levels and rising discontent amongst Western baby boomers. 2017 promises to be far more interesting, if not more surprising.

The Trump Effect - Deliverance or Delusion?

The Promises

In a nutshell, Donald Trump's economic recipe to "Make America Great Again" consists of massive infrastructure spending, significant corporate and personal tax cuts, the re-introduction of tariffs and trade protectionism, targeted immigration/deportation and 4% + GDP growth. One would be excused for thinking that the U.S. must have its cash reserve coffers full and be firing on all cylinders. The truth is it has neither, but political campaign rhetoric has an enchanting way of temporarily disengaging voters from reality. Remember "Jobs and Growth"?

Putting the outcome of the U.S. election into some economic perspective, the yet to be clarified promises of businessman come President-elect Trump have managed to achieve in less than a month what global central bankers have failed to achieve since the GFC - **raise growth and inflation expectations.** He has enunciated a daring framework of fiscal reform and stimulus that the U.S. has been denied by spineless economic leadership and political gridlock.

Who cares that Uncle Sam is hopelessly bankrupt and reliant on Chinese capital? Who cares that tariffs/protectionism may trigger a global trade war? Who cares that U.S. labour costs are unable to compete with those of competitors? **Austerity just got fired** by hope, or possibly delusion.

We suspect the would be "champion of the forgotten middle class" has not quite come to terms with the machinations of government, its egalitarian composition and inherent resistance to genuine reform. Sure **control of both the House and the Senate may deliver more decisive action** than in the recent past, but not all Republicans agree with Donald's recipe. They have constituents as well.

Since Trump's win, walls have become fences, Obamacare "ain't all bad" and climate change "might be" man made. Elected on a platform of easy to understand "black and white" remedies, the solutions have predictably already turned grey. What else may change? Time will tell. Whilst discussing how reality bites, lofty political promises of "Jobs and Growth" for Australia have morphed into a Senate full of egotistical independants who cannot even find a way to agree on a simple tax rate for backpackers! What hope have we got of resolving the issues that really matter for our country?

Despite expectations of the opposite, **investment markets enamoured by the prospect of change, appear to have quickly priced in its successful execution** by rallying strongly. Be wary of goldilocks outcomes.

As long term investors, we remain willingly on the sidelines to assess what actually happens over the coming months, rather than what is promised. Aside from the **inevitable prospect of rising interest rates**, beyond that premature speculation on outcomes is pointless. For now, we believe it best to respect Trump's victory, the enormity of the task ahead of him, the development of specific policies and importantly the time it will take for ANY policy changes to impact economic fundamentals. His 100 day Presidential honeymoon period will pass quickly.

Observation, assessment and patience remain strong allies of all successful investors. Just as the problems and difficulties of Brexit are only beginning to be unveiled, so too will be challenges of restoring sustainable U.S. growth and rising living standards in an ageing economy.

How We Got Here

Most chronic human illnesses rarely result from a single cause or event. More commonly they are the outcome of a convergence of factors, a predisposition to disease and a very long period of time. Economic illnesses, such as those currently confronting the world, are no different.

In a grossly simplified and truncated synopsis, much of today's global economic woes are seeded in the 1980's with the widespread adoption of economic rationalism, liberalisation (deregulation) and globalisation, colloquially known as Reaganomics and/or Thatcherism.

Context is everything. In this case, one must recall the 1970's economic carnage caused by the outbreak of global inflation, widespread unemployment, declining productivity and the energy price shock. It was a crisis. The Golden Age of **regulated capitalism** had apparently failed.

By the early 1980's, although the crisis had passed, its memory lived on. The analysis that followed suggested that the then economic problems of the West were the result of government regulation in markets. Thus the obvious solution was to deregulate them. Proposed by economists, this theory won the ear of politicians. In a trail blazing wave led by Reagan and Thatcher, all major economies began to deregulate their Central banks, their currencies and their markets. Australia was up there too.

Globalisation Means Efficiency Not Equity

Akin to spiritual enlightenment, governments became convinced that markets work better free from their **well intentioned post-Depression intervention.** They preached this to the people. Neo-classical economic high priests now dictated policy, proclaiming their keystone principles of competitive advantage, market driven credit and globalisation would bring prosperity to all. In theory if we produce just what we are good at and let others do the same, everyone can share from a growing and bigger pie. Debt and **greed was good.**

Unfortunately, 30 years on, the reality has proved to be somewhat different. Westerners, both skilled and unskilled, who worked in displaced industries and factories lost their jobs seeing fewer new ones created. Unforeseen **technological advancement** and **digitisation** also claimed people and jobs as victims of progress. The final plank of globalisation, free trade, heralded greater movement of goods and services around the globe. **Immigration** became the catch cry that would deliver economic growth and newly created wealth would trickle down to ordinary folk restoring their economic status and worth. It didn't happen.

After years of promises, governments, big business and "establishment" have let down the masses in the US, Europe and UK who are often older, less educated, more vulnerable and seemingly forgotten in puritanical economics. In 2016, these faceless people stood up to be counted.

BRAIN TEASER

John's son Peter, is exactly one fifth of John's age.
In 21 years time, John will be exactly twice Peter's age.
Betty is exactly seven times the age of her daughter, Paula.
In 8 years time, Betty will be three times the age of Paula.
How old are Peter and Paula now?

The world has become more efficient, improving the quality of life for billions of people in lesser developed countries. The flip side is that it widened the divide in 1st world nations between the rich and poor. The larger affluent middle-class got squeezed in both directions, but mostly lower.

Brexit and Trump voters represent the voices of the often hard toiling people who, having followed "the system" missed out on their piece of the pie, whilst others gorged on it. They are delivering **retribution** on those in charge demanding change, even change that may take their countries and children backwards instead of forwards, to a place they once knew.

Economic efficiency was destined to create winners and losers. Economics is based on the rationing of resources, not equity. The right skills, education or resources (human or natural) have given some people and countries prosperity with the converse also being true. Once proud workers have lost their jobs and even their dignity as an economic consequence.

To the exasperation of many, over the years not all countries played fair. Some developing nations used internal regulations, trade barriers & subsidies to build their domestic industries until they became sufficiently skilled and scaled to destroy their offshore counterparts. Human nature, progress and trade, as the millennia of history teaches us, is not always just.

The world is still relying on old tricks to manage new problems. We believe this is destined to fail, since the world of today is so vastly different from that of the 1970's and 1980's. Today, people and countries around the globe have already borrowed more than they can reasonably expect to repay if interest rates "normalise". A new solution is required, most likely one with more painful side effects. Many voters may end up disappointed.

With a tsunami of fiscal stimulus being proposed by Trump, we expect healthy inflation will return to the U.S. economy and **interest rates to rise gradually** in response. Barometric conditions have irreversibly changed. Expect markets and prices to follow.

> ***"Everything is fine until it is not. We have to be mindful of when the winds turn against us"***
> ***John Fraser, Treasury Secretary***

Our 2017 gaze decidedly shifts to the consequential effects on global bonds and asset prices resulting from the withdrawal of long term accommodative interest rates. A now old U.S. truism **"Don't fight the FED"** comes to mind. The expression means that as the FED tightens, asset prices fall. We'll soon see if this holds true again. Any jugglers coming into Congress?

Superannuation Changes - Now It Is Complex

The sunset is finally falling on super, after more than 25 years of the most generous tax and investment regulations imaginable. We are pleased to have assisted many clients with either the means or the foresight to secure their capital in arguably the only tax haven left outside of the family home.

From 1st July 2017, new rules will apply capping the ability of affluent taxpayers to avoid and minimise tax. The changes, like most over the last two decades, have **very little impact on over 96% of working investors**, though you can be sure that will be where most of the noise is heard. The goal is to ring-fence bigger or smarter investors, in a form of social equity.

Simple Super will become complex super starting next year. Amongst the major changes effective 1st July 2017 are:

Concessional (pre-tax) cont cap	$25,000 pa *for all taxpayers
Non-concessional (after tax) cont cap	$100,000 pa *for under 65s
Non-concessional conts prohibited at	$1.6m balance^
Tax free Account Based Pension (ABP) cap	$1.6m balance ^
Tax on Excess ABP balance	Taxed as accum fund at 15%
Transition to Retirement Pensions (TRIS)	Taxed as accum fund at 15%
Div 293 (30% tax) Adjusted Tax Threshold	Reduced from $300k to $250k
Tax deductibility of personal conts	Access up to $25k concess cap
Work Test (applied between ages 65-74)	Retained - 40hrs in 30 days

Access to all existing concessions remains intact up to 30th June 2017. We advise all clients, younger and older, to review their strategies. The future will no longer look like the past. Some old roads may lead to dead ends.

***Complex Transitional, Bring Forward & Catch-up rules also introduced**
^CPI Indexation to apply ($100,000 increments)

What is Australia's AAA Rating Worth?

Presently there are only 9 countries on this planet that enjoy a AAA credit rating from each of the 3 ratings agencies, Standard & Poor's, Moody's and Fitch. This very select club is made up of:

Australia	Canada	Denmark
Germany	Luxembourg	Norway
Singapore	Sweden	Switzerland

The last time Australia was downgraded by Moody's was in 1986 when then Treasurer Paul Keating infamously uttered the "banana republic" phrase. It took the "recession we had to have" and 16 years to reclaim our AAA crown in 2002. A long and painful period.

Having ridden the resource investment boom and squandered its spoils, the Australian government's finances are increasingly coming under scrutiny from the credit ratings agencies, with S&P applying a "negative" outlook indicating a one-in-three chance of a rating reduction.

Soaring and unabated household and government debt are exposing the country to economic shocks. Treasury Secretary John Fraser told a Senate economics committee in October 2016 that he lamented the state of the property market and the trend among many older Australians to dip into their savings to fund their children's housing needs. He said "...the bank of Mum & Dad is becoming more and more prevalent", possibly leading younger people into higher debt and older people into a retirement capital deficiency. Mmmm, that can't be good.

So what would it mean if we lost our AAA rating?

Unlike the 1980's where both interest rates and inflation were both high and rising, in today's Australia, a downgrading would have much less impact. That said, in response to this very question, Fraser said "a downgrade ... would affect everyone in Australia" and that "all things being equal such a cut would result in higher borrowing costs".

Theoretically, a credit downgrade would increase the borrowing costs on Australia's $400b Federal debt, compounding budgetary pressures and therefore potentially leading to either higher taxes or a contraction in spending. In reality, we believe such an impact to be unlikely. Indeed, since in relative terms Australian sovereign debt is far more highly regarded than many other countries, it is possible that no additional cost to government will arise. Ironically it will be only the States, business, personal and residential borrowers who wear the cost.

A consequence of a sovereign downgrade is that all domestic borrowers are also downgraded, including banks and corporates. Since our banks source over 35% of their lending from overseas, higher bank borrowing costs would either **REDUCE PROFITS** or lead to **A RISE IN INTEREST RATES**. Take a punt on which is more likely? Would the rise be significant? Probably not. Experts believe home loan interest rate rises would be contained to between 0.1% - 0.2% which most borrowers could manage.

Of equal concern would be the dent to business and consumer confidence which are already flagging and the rising trend of full time jobs being replaced by part time or casual jobs, particularly amongst younger people. Underemployment increasingly represents a genuine threat for Australia.

Could a small problem cascade into a larger one? Possibly, but we do not see a downgrading of credit as Australia's biggest threat. It is merely another symptom of that larger problem we continually refer to, being the level of unproductive private debt underpinned by inflated asset prices.

If US interest rates were to rise, and it is just an if right now, Australia will have a serious problem to contend with. Until recently, almost everyone on the planet has assumed interest rates will stay lower for longer or even fall further. Big, one sided bets have been placed on that outcome. There's now a new Sheriff in town and he is not handing out milky bars.

Brain Teaser Answer - Peter is 7 years old and Paula is 4 years old