Financial Markets Update

ZANACORP

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Despite temporary gyrations at both higher and lower levels, global investment markets appear to have stagnated. Over the year to date, they have neither risen or fallen, strengthened or weakened, calmed or alarmed. It is a somewhat uncomfortable point in time for investors, particularly the most insightful who are aware of both the potential rewards and hazards that accompany each investment class at this moment. We find neither conviction or clarity on the part of governments, central bankers, borrowers or lenders to be confident that 2016 will favour investor caution or bravery. Problems, of which there are many, have not fractured confidence, but neither have they been resolved. 2015 is likely be remembered for events that did not happen rather than for those that did.

Have You Ever Seen The Rain?

"Someone told me long ago, there is a calm before the storm
I know, it's been coming for some time
When it's over so they say, it'll rain a sunny day…..
I know, been that way for all my time."

In 1970 Creedence Clearwater Revival lead singer and lyricist John Fogarty penned this simple yet ambiguous song, now recognised as a classic. The chorus line went on *"Have you ever seen the rain, comin' down on a sunny day?"*

Speculated to be an allegory of the Vietnam War, the song is actually themed on the ambivalence he felt on the implosion of the band, just at the time they were at the peak of their popularity. Put simply, it reflected the **bittersweet** emotion experienced at a point where the euphoric satisfaction of success collided head long with the insight that it was also over.

The current investment and economic climate has a similar mood about it. Many celebrate the triumph of today's central bankers in having averted a 1930's type global depression by employing creative economic tools such as quantitative easing (QE) and zero interest rates. Significantly, a rapidly growing China/Asia and fiscal stimulus were also key factors.

On the other hand, many reputable economists simply view the deep rooted problem of global systemic imbalance was kicked further down the road. They find departure from the conventional yet **painful boom/bust economic cleansing** has failed to reset the necessary respect of debt and the risks that it brings. Indeed, the remedial monetary policies adopted to avert depression have actually escalated global debt and risk, with a slowing China being a headwind not a tailwind.

With the 2008/09 turmoil behind us, there is a general sense that the period of financial danger has passed and better times are ahead. Arguably what has really happened is that like experimenting scientists, central bankers have altered the natural order of things. Economic DNA was changed. **The risks of excess debt were artificially separated from the risk of loss**, or so it appears. The money men that saved the planet, have spawned a global debt and liquidity based beast that they now fear and are unable to control. Appeasing markets has become a de facto objective.

Today's apparently prosperous times of cheap and easy money coexists with fragile and unsettled economic conditions in an unlikely truce. We have "Rain on a sunny day" so to speak. Let us also not forget the key ingredient of **our modern day dilemma** is ordinary people, many close to you who have borrowed heavily against their future incomes, not for a home to live in, but rather a perceived short-cut to financial independence. Our collective destiny is now in their hands.

The "new normal" of ultra low interest rates, tepid growth, subdued wages and elevated asset prices does not ring true as a sustainable state of affairs. Temporarily **spooked by worrying data from China**, uncertainty led to market volatility that in August/September 2015 saw share prices around the world collapse between 10% to 20%. For a fleeting moment, investors were reminded that **markets move quickly, indiscriminately and without notice.**

Lacking both the weapons and the know how to deal with market (call that "human") volatility, bankers are becoming more irrelevant to our future well being. Each investor will need to look after their own best interests and be prepared to accept that **chasing higher returns could also lead to a greater loss of capital**.

Tax Reform is not just a Tax Hike

For the past 6 or 7 years Australia has been bereft of the economic leadership and courage necessary to address our country's needs. Although that still remains the case, noises from Canberra seem to indicate reform is coming to Australia's revenue and expenditure policies.

Successive reports into our tax and financial system by Ken Henry and David Murray, presented many reform options that fell on deaf ears.

We do not favour GST rate changes as they simply perpetuate their current deficiencies. We may get more revenue, but we don't fix any problems and must then grapple with equitable compensation. A tax hike does not constitute tax reform, but it is easier to get done.

Similarly, tinkering with the tax rates or access points on superannuation/income streams, while appropriate, of itself is not tax reform.

"If you do not change direction, you may end up where you are heading"
Lao Tzu

Genuine tax reform implies the introduction of new measures designed to achieve specific objectives. For example, Fringe Benefits Tax was designed to capture so called "business rorts". Capital Gains Tax was designed to capture investment profits and Goods & Services Tax was designed to capture most consumer spending. These taxes introduced by both sides of politics, represent genuine reforms that were, with hindsight needed to steer people, capital and resources in the right direction whilst funding both the State and Federal government spending needs of their day.

Without limiting its scope, we feel today's reforms need to revisit all existing major taxes and assess whether they continue to meet their objectives. **Reform, by definition needs to be bold and embrace change**, including tackling the unintended consequences of previous tax laws that make asset speculation more attractive than job creation. Concessions funded out of our country's limited public purse

should be targeted to encourage future growth, participation and innovation. Appropriate incentives are needed to define, support and nurture investment in those industries where we have a natural advantage. Could US start-up **Airbnb** (founded in 2007 by 2 guys unable to pay their rent) now valued at US$25b have come from Australia?

Certain forms of negative gearing, CGT, stamp duty, payroll taxes, the antiquated land tax system and our burgeoning welfare system need attention. No one likes change. However, **changes clearly articulated, soundly based and equitably applied are necessary and will most likely be accepted**. Since Australia's current economic trajectory is demonstrably downhill, action or re-action is unavoidable.

We hope that with the challenge laid down before the people, our political leaders will courageously present and debate genuine tax and spending reforms in pursuit of a better, fairer and sustainable future for both our younger citizens and our senior citizens who have little opportunity to alter the decisions made that impact their lives.

Behavioural Finance 103: Prospect Theory

In our continuing education series on behavioural finance, our article in this bulletin seeks to capture the November "Melbourne Cup" vibe.

As always, an investor's worst enemy is often himself/herself, failing to understand why we make the decisions we do. In a process known as Prospect Theory, Kahneman & Tversky (1979) demonstrated **our willingness to take risks is influenced by the way in which choices are framed.** Consider the following classic decision problem:

(a) A certain win of $250
(b) A 25% chance to win $1,000 & a 75% chance to win nothing?

How about:

(c) A certain loss of $750 versus
(d) A 75% chance to lose $1,000 & a 25% chance to lose nothing?

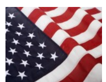
Kahneman & Tversky found that when framed as a ***gain*** a greater proportion of people opt for the riskless alternative (a), while for the second ***loss*** problem people are more likely to choose the riskier (d).

This happens because ***we dislike losses*** **MORE THAN *we like* an equivalent gain**. Giving something up is more painful than the pleasure of receiving it. How did you go?

Most Zanacorp clients over the years will know we have recommended keeping the best assets in a portfolio and cull underperforming assets. This advice is predicated on the principle that in the end, we want to retain our best assets rather than be disadvantaged by the mere hope that poorer choices will miraculously come good. It is a variation on the "John West" advertising theme. *"It's the ones John West rejects that makes John West the best."*

Around the World in 80 Seconds

Let's take a quick tour of the economic dynamics around the world:



United States

Although not without its deep rooted problems, the US is recovering firmly with average jobs growth in excess of 200,000 per month for over 3 years, underpinning >2% GDP growth. The FED missed the opportunity to "normalise" monetary policy in September. Confronted by confused markets and worsening global trends it is now fearful of its own actions but must raise interest rates. Depressed oil and gas prices have assisted consumer spending whilst containing inflation. However, the strong US$ has crimped the earnings of exporting titans resulting in subdued corporate profits.

China

The cool winds of inevitable change have arrived in China. Chinese growth rates of recent decades were never sustainable. Whilst China is expected to grow significantly in the years ahead, the rate of growth will decline. Its transition from export led growth to domestic consumption will not come easily as ageing and population stagnation now undermine this goal. Regulators have proven to be human and fallible in recent times, with **naïve market intervention, fiscal and monetary policy**. Six interest rate cuts in 12 months, the resumption of inefficient infrastructure spending and the scrapping of the one child policy after 36 years, reflect an uncharacteristic policy panic. **Relying on old tricks to resolve new problems appears ill-fated** as is the attempt to halt the flight of capital. The response may be too little too late to reverse their short term pain.

Japan

After promising much hope, Abenomics has failed to re-ignite Japanese growth. Corporates are enjoying spectacular profits on the back of the lower Yen, but domestic conditions remain decidedly anaemic. The "3rd arrow" (structural change) has not eventuated and Japan's demographics have proved to be a major headwind. High energy costs, the legacy of the Fukushima disaster, continue to undermine domestic consumption, spending and growth.

Europe

Greater **Europe's welfare state** and basic inability to successfully introduce structural reforms remain its greatest impediment to economic recovery. The Syrian humanitarian refugee tragedy has not helped. But of greater economic damage will be **VW's diesel software scandal**. The final financial cost of this episode is yet to be summed, but it threatens German manufacturing and integrity, **weakening the pulse of one of the only EU nations still with a heart beat**. The region is mired in a recessionary coma of sub 1% growth.

Brazil, Russia, Australia, Turkey and South Africa (the BRATS)

In what may become a new acronym, the BRATS countries, (which should include Canada), represent those regions directly impacted by either low oil prices, low base commodity prices, a slowing China, political inertia, or a combination of each.

These countries, to varying degrees, have Dutch Disease (outlined in our June 2013 newsletter) struggling to replace their recent resource based booms. **Brazil is in recession, Russia is in recession,** Australia is not in recession but is slowing, **Turkey and South Africa are approaching recession**. Such is the effect of over reliance on a few industries or products. Canada (an economy akin to ours) has recently limped out of a technical recession of 2 quarters of negative GDP.

The most important question remains unanswered and that is can Australia avert a recession? The construction boom is doing its job but will likely run out of legs. **Tourism and education are re-emerging as vital parts of our economy,** but employment remains weak and productive full time jobs are making way for casual, relatively unproductive healthcare jobs. Jobs filled by our rising pool of Asian immigrants who are prepared to do the work our home grown people will not.

We are confident that Australia will side step a technical recession, but in reality we are already in an **"income recession"**. We will discuss this distinction in later newsletters from an investment perspective rather than an economic one. The difference being quite significant.

So there you have it. Global conditions are OK, but hardly booming and there are things we could seriously worry about, if we wished.

Investors should expect volatility (not collapse) in the short term since data reads are inconsistent. Keep some powder dry, have cash or defensive assets at hand, 2016 may throw up the sort of 20%+ price decline that will only assist those in a position to buy quality assets at cheap prices. Like a marathon, the investment winners are likely to be those holding cash and willing to buy when everyone is selling, or is tapped out.

I see a Bad Moon Rising.

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