ZANACORP

Financial Markets Update

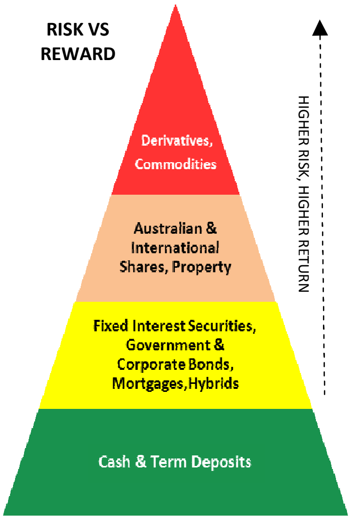
March 2015

Since the Global Financial Crisis began in 2008 the world's political leaders have failed miserably to embrace the structural changes needed to restore broad based prosperity. The world is now governed by central bankers. For better or worse, bankers have very little intrinsic power, they merely control the supply and cost of money. So, when the only tool you have is a hammer, everything is a nail. To fix the world's range of problems, global bankers have flooded the planet with money and reduced its cost to zero. What else could they do?

Money For Nothing, Capital Misallocation for Free

Return ON Capital vs Return OF Capital (Part 1)

If you keep hearing economists and the broader financial professions debating about whether equity markets are too high or not, or whether we are in a property bubble or not, it is with good reason. Both share and property markets now defy all historical fundamental price metrics. We have entered a new paradigm.


RISK VS REWARD
Derivatives, Commodities
Australian & International Shares, Property
Fixed Interest Securities, Government & Corporate Bonds, Mortgages,Hybrids
Cash & Term Deposits
HIGHER RISK, HIGHER RETURN

As a result of interest rates being reduced to ultra low levels, investors (read "savers") looking for capital security are being punished by real returns approaching 0%. For Australians, cash earnings of 2% - 3% are effectively reduced to nil after allowing for inflation of 2% - 3% p.a. Those investors who are required to pay tax on interest (usually people under 65) obtain a **NEGATIVE REAL RETURN** by holding cash.

The idea behind low interest rates was that it would encourage spending, productive investment and employment. It was also expected to assist ordinary people to manage their household finances and debt. That is what the text books say, ***ceteris paribus*** (all other things being equal). However, in a world riddled with economic imbalances, uncertainty and denial, all other things are **NOT** equal and the result of low interest rates has not matched the theoretical expectation.

In the 21st century, global interest rate policies have resulted in an abhorrent mutation of the allocation of capital and the concept of the trade off between investment risk and investment return. Global liquidity and cheap money has led to global asset price distortions.

As the so called "risk free" return on long dated government bonds draws ever closer to zero, the **RELATIVE** return of alternative assets becomes more attractive, and investors are required to pay ever increasing prices to secure them. It's a situation that resembles the pre-GFC world, with the same implied assumptions from both borrowers and lenders, although formed in a fundamentally different way.

Ultra low interest rates punish savers and reward borrowers

The continuing **hunt for yield** has left nearly all investors with few sensible options other than to invest in the higher yielding, but infinitely more risky, share and property markets. This phenomenon is called **speculation** and it has now entrapped even the most conservative of investors, who sense no risk from paying high prices today for assets they avoided when they were cheap.

Perversely, ultra low interest rates enable borrowers, especially those with collateral, to borrow huge sums of capital and invest in the very same share and property markets as investors. Requiring very little cashflow to finance the difference between rent/dividends and the ever decreasing cost of debt, speculating for capital gains is now a sport engaged in by the average man/woman in the street.

With both savers and borrowers investing in the same markets at the same time for scarce assets, prices propel upwards. This generates a **"positive feedback loop"** which encourages even more savers and more borrowers to invest in the same manner, in anticipation of the same outcome. Like a tornado sucking in everything in its path, this loop also drags anxious 1st home buyers to consider borrowing previously unimaginable sums from banks or parents (or most commonly both) to enter the market . At their peril, Gen X and now Gen Y have learned no respect for debt.

Some readers may fail to see any danger in this cycle, since savers get their desired higher yield and borrowers get their desired capital growth. A classic win/win for both groups. Unfortunately there is fatal flaw in this logic, since unlike cash/term deposits, the price of both shares and property can rise AND fall. Alarm bells should ring when most investors only see upside and fail to discount prices for potential downside risk. Remember 2007.

We expect future newsletters will be drawn to add considerable depth, data and discussion regarding Australia's post-GFC borrowing binge. Hence we will conclude this "RETURN ON/OF CAPITAL" introductory topic with an observation: -

In 2009, investors shocked by the ferocity of their GFC risk based asset losses simply yearned for the return OF their capital. They cared nothing for the return ON their capital. They panicked and sold assets cheaply seeking the safety of cash and term deposits. Today, investors yearn for a return ON their capital and **scarcely give a thought to the potential loss OF their capital**. This is classical boom/bust behaviour.

We are confident that client portfolios managed by Zanacorp are suitably invested to both profit from continued market strength and be sheltered from any unexpected market mishaps. **Be alert, not alarmed.**

The recent collapse in oil prices to 2006 levels is the equivalent of a 0.5% interest rate cut for every economy in the world. It has helped us all. You will have noticed the benefit the last time you filled your car with petrol. Although unexpected, this windfall gain serves to support and prolong elevated world markets by increasing our disposable income. But this is only a temporary reprieve.

There is considerable divergence of opinion as to how long the current boom will last. Like most, it has already been stronger for longer, fuelled by loose monetary policy and bereft of any global fiscal restraint or pain. It would take a brave person, or a foolish one, to predict the duration of any boom. We are neither. Our reading of present benign risk conditions is such, that asset price speculation may still have further to travel, until the day it ends. And end it will.

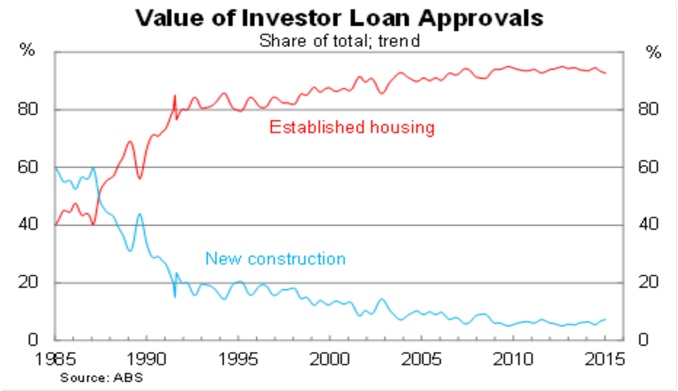
When this boom ends, China will not save Australia, just as Germany will not save Greece. The next crisis will look different from the last.

First Home Buyers & Superannuation

The acute housing affordability problem in Australia has recently led opinion down the path of whether first home buyers should be permitted to access their employer funded super contributions to assist with the deposit for their first home.

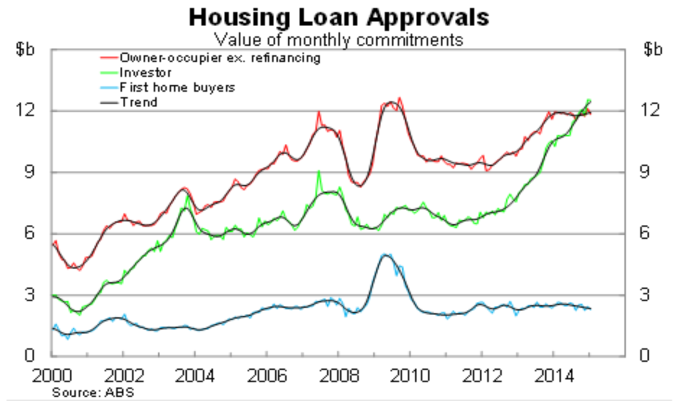
In support of the proposal, comparisons are invariably made with existing schemes operating in other countries such as Canada, New Zealand and Singapore. Whilst comparisons may be of interest they are somewhat irrelevant as the savings, retirement and taxation systems of other countries are entirely different from that of our own.

At the risk of oversimplifying a most complex problem, the remedy to the affordability question was, and always has been more a supply side issue than a financing issue. The “Big Australia” policy adopted since 2008, issuing visas to over 200,000 immigrants each year, whilst positive for growth, paid scant regard to the infrastructure and housing requirements these people require, or those of first home buyers.



Source: ABS

The chart above shows that **loans** for new housing construction are at all time lows. This is true, even though construction levels have increased significantly over the last 2-3 years. This anomaly is explained by the massive increase in prices of existing stock, as opposed to newly constructed homes and the avalanche of small apartments, of which over 40% are purchased by externally funded overseas buyers.



Source: ABS

For the first time in Australian history, investors are now the biggest component of the home lending market eclipsing owner occupiers, for all the reasons outlined earlier. This suits the banks just fine, since they take security over both the family home and the investment property, converting the last drops of any undrawn home equity into debt, to drive the huge bank profits and dividends we all love. God help us all if prices fall. In the meantime, first home buyers miss out, or are pushed further into the future poverty trap of our cities’ newly created outer suburbs where the tyranny of distance and time spent on the road quickly outweighs the satisfaction of home ownership.

Based on recent ABS data, over 50% of all new lending is allocated to investors and only 10% to 1st home buyers. The pricing, affordability and construction problem is encapsulated in that statistic.

Australia’s Employer Funded Super System

All Australians have benefitted from the Hawke/Keating introduction of compulsory superannuation contributions in 1992. Employer contributions and tax incentives have encouraged people to save (without debt) for their own retirement. In the absence of employer contributions, many current retirees or near retirees would more than likely have no capital and would be entirely welfare dependent.

As intended, the lowest income earners are the main beneficiaries of our system since they contribute the least to their own super. But like all good ideas, the system lost its way such that of Australia’s much envied $1.93 trillion super pool, over 62% is held by Australia’s wealthiest 17% of individuals or in public sector superannuation funds. As a legitimate tax haven with tax rates of either 15%, 10% (CGT) or 0% in pension mode, wealthy and smart Australians are enamoured by its tax efficiency and have invested accordingly.

Thus, 83% of Australians control only 38% of the super pool. In this 83% are the majority of young Australians who are unable to save sufficient funds to buy a home. It beggars belief that we even contemplate permitting the least financially affluent people to raid their super accounts early in life and be left welfare dependent later in life.

Singaporean Model - Central Provident Fund (CPF)

To put context into our discussion, we must compare our super system with one of those models used overseas. We have chosen the Singaporean model as it is the most robust and sensible.

In Singapore, compulsory superannuation requires between 11% and 35.5% of salary to be contributed per annum depending on age. Of this amount, **EMPLOYEES** must contribute up to 20% of their own salary with employer contributions capped at 15.5%.

The entire retirement capital of the country is stored in the Central Provident Fund of Singapore and separated into 3 separate accounts for home ownership, healthcare and retirement.

In this regime, young Singaporeans save **THEIR OWN** wages as well as employer contributions and quite rightly are able to access their own money. It is a form of forced savings where all 3 accounts enjoy the magic created by capital, compound interest and time.

Each person in old age provides for their own healthcare costs and retirement income. If their CPF is insufficient to meet their mandated minimum capital and monthly income levels, their property bought with their CFP savings is **AUTOMATICALLY PLEDGED** to the government to make up to half of their minimum sum!

That is their system. It matches their compliant culture and their pursuit of self sufficiency. Australia bears no resemblance to Singapore. In Australia, we have yet to debate whether an older person living in a $3 million home should continue to be entitled to receive an old age pension! That is an issue for another day.

Australia needs to stop the 1st home buyer/access to super debate immediately and formulate a system that works for us, to encourage young people to save early. It used to exist in the form of First Home Savers Accounts (FHSA), which we proudly confess to recommending to younger clients.

Unfortunately, unlike in Singapore, saving money early has not been a feature of our culture or society, and the FHSA scheme was abandoned in 2014 without a replacement, due to lack of interest. That the Big 4 banks couldn’t make money out of it, doomed its fate.

Accessing super for housing perpetuates the affordability problem rather than alleviates it. It is akin to borrowing today from your future self. In theory it sounds fine, but in our experience, most people’s future self will try and find a way of getting out of paying the price and the government will be on the hook again. Our Age of Entitlement will be entrenched in our system, begging the question - **Who pays for it?**

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