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Financial Markets Update

November 2014

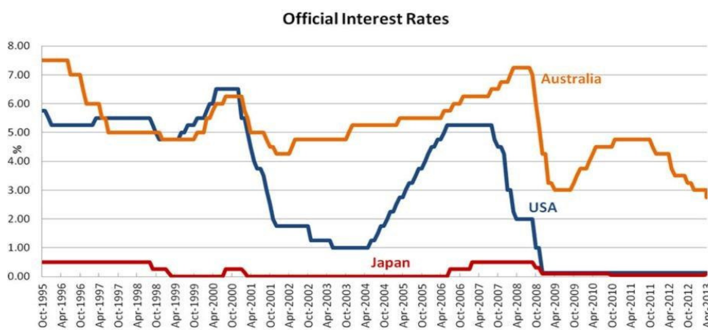
Since our June 2014 newsletter, investment markets have provided Australian and International investors with a taste of stereotypical Melbourne weather, "four seasons in a day" so to speak. Over the last 4 months markets have gyrated from being white hot to bitterly cold and back again, with everything in between. Best described as "volatile and uncertain", investors can no longer be assured or confident of the level or direction of future interest rates. Investors who misread these future outcomes will be left the poorer for it, but as of now, reading the tea leaves is difficult for us all.

To Raise Interest Rates or Not? That Is The Question

Interest Rates - The Potential Demon of the 21st Century

If you ever needed to see a "sneak peek" of how vulnerable we are to investment markets you saw it in September/October 2014. The somewhat fearful 8% flash crash decline in markets was a reality check for all who fail to understand how violently markets can move, without notice and without discrimination. The previously benign fear index, the VIX (referred to in our last update), suddenly spiked like an earthquake to remind the world that the basic emotions of people have not changed.

Alert investors will have noted the sectors vulnerable to international money flows. Sadly, we expect many DIY investors will be oblivious to this important detail, despite its importance to their financial future.



Source: RBA ***Arguably the most frightening graph of this century - 0% interest rates***

At the heart of recent volatility it appears that institutions have woken up to the fact that interest rates have been kept at "emergency" levels for long enough and must eventually rise. In unison, they collectively saw that their capital spread across the world making easy money, was no longer going to reward them. With their computers, the repatriation back to the US has started, as has the hunt for the next golden goose.

The upshot of global QE was the realisation that "trickle down economics" does not work. The economic notion that if the rich can get richer their affluence will trickle down to the poor, is a failed experiment. All that was achieved by ultra low interest rates was the rich got substantially richer (via inflated asset prices) and the poor remained poor.

Viewing the interest rate graph above (which could include Europe's current all time low rate of 0.05%), the question confronting the world in 2015 is how in the hell do we get interest rates to a level that encourages low risk savings instead of high risk speculation? Moreover, how can this be achieved without creating another crisis?

Unlike pre-GFC 2007, recent oil, gas and technological innovations together with productivity gains have absolutely created a positive supply side shock to the US economy. This game changing combination provides the US with potential GDP growth utilising unused capacity, with little risk of inflation. Paradoxically, moderate inflation is a necessary ingredient to stimulate investment, production and employment. Raising interest rates therefore may bring things back to "normal" but may also stifle growth. What to do?

The FED must now walk an economic tightrope with little margin for error. If it fails to raise interest rates it may find itself doing **TOO LITTLE, TOO LATE** and the US economy may bubble out of control requiring rapid interest rate rises which may burst the asset price balloon. On the other hand if it tightens **TOO MUCH, TOO SOON** it may cause the fragile US economy to lose its growth momentum and stagnate yet again. The FED and economists, confounded by continuously conflicting data have been unable to confidently provide guidance as to which path will be followed. We expect rates will remain unchanged until mid 2015.

On this basis, although there may be periods of market volatility (5% - 10% movements in either direction), the fundamentals underpinning world asset prices appear likely to remain intact until 2015/16 reflecting a tepid US economy. Thus, our June 2014 outlook remains unchanged.

Although the US is recovering, it is without conviction and a slowing China, stagnant Europe and (dare we say) falling iron ore prices exacerbating our global and domestic concerns.

Dividends...But at What Cost?

In April 2013 our newsletter banner shouted **Yield, Yield, Yield …. I Want Yield!** It was, of course, only 18 months ago. Many self directed investors remain besotted by income yield.

The context of the narrative was that all over the world, investors were seeking certainty. If capital growth could not be relied upon, then yield (dividends) could, because they come out of profits not market pricing. We noted that because dividends are relatively predictable, ***investors would pay a premium*** to secure them. And indeed they have. High yielding stocks remain the only game in town and substantially underpin (sometimes) unrealistic share prices.

To appease shareholders, company boards have increased payout ratios and undertaken capital management initiatives to release cash. They have been rewarded for doing so, no more than in Australia where franking credits have been ***rivers of gold*** for investors. The banks, Telstra, retailers, even capital hungry miners BHP, Woodside and Rio, have succumbed to their shareholders wishes.

Often unknown to mum and dad shareholders - today's experts, Australian ***ASX200 companies pay dividends at nearly DOUBLE the rate of the world average***. Research by Boston Consulting Group confirmed our addiction to dividends with 2013-14 profit payout ratios in Australia at 70% of earnings compared to 39% in the rest of the world.

So what is wrong with this policy? Dividends can help pay bills, capital growth cannot. If only business was so simple. There is a reason why Australian ***earnings per share amongst the ASX 200 have fallen 15%*** below the rest of the world in the last 10 years, this is one of them.

In July 2014, Reserve Bank Governor Glenn Stevens bemoaned the lack of "animal spirits" amongst Australian companies, citing their reluctance to invest capital (at risk) for future growth. Instead, they paid out dividends. Retired shareholders want returns now, not later.

Rumesh Karnani, the study's co-author, said that Australia's high dividend payment ratios "cannot be sustained for long" and given the business cycle "only postpone an inevitable crunch".

In essence, for companies to continue to meet ongoing challenging conditions and competition, they must protect their businesses by reinvesting more of their profits, not paying them out to shareholders. The risk of high payouts is that if future business profits level off or even fall, the capacity to pay dividends falls, and then share prices fall. Companies must invest in new technology or areas to grow profits despite there being no guarantees of success in doing so. Such is life.

Nick Glenning, fellow co-author of the study warned that "without growth the equities market will recalibrate the company's share price". Whilst acknowledging growth was difficult, he was able to name a string of companies that generated superior Total Shareholder Returns (TSR) by investing for growth e.g. CSL, News Corp & Cochlear.

The current mantra of investing for yield is appropriate for our low interest rate era and will not go away. However, blinkered investors investing just for yield, risk both losing capital and falling dividends.

Amongst our preferred Australian equity fund managers, above average TSR have been achieved by adopting broader investment themes.

How Low Can the Australian Dollar Go?

As long time students of global economics, we vividly recall the day in 1976 when the Australian dollar was devalued by a whopping 17.5%.

Akin to the wild west, they were heady times when politicians drove both monetary and fiscal policy. No such thing as a floating exchange rate, or independent Central Bank then. The RBA was forced to buy/sell our currency to defend its regulated price in global markets.

In the mid 1970's the Australian economy was a shambles. Gough (RIP) may have been a tremendous visionary leader, but a very poor bean counter. Suffering from a spending hangover, the replacement government formed the so called cabinet "razor gang" to cut spending and stabilise the economy. Sound familiar?

"No country has ever become prosperous as a result of devaluing its currency, but many a country has been spared economic turmoil."

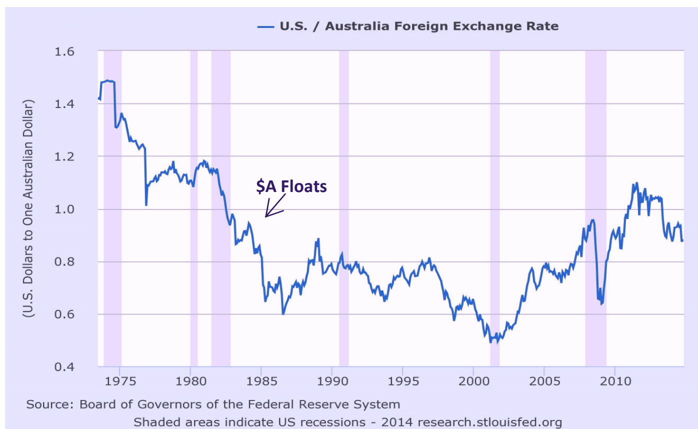
Devaluing the dollar in 1976 was one of the most important things the Fraser cabinet did to restore the nation's fading international competitiveness after the 1960's mining boom.

It is no coincidence then, that in 1983 the Hawke/Keating government devalued the $A by 10% in March 1983 and finally floated the dollar in November 1983, allowing markets to set its value.

The floating of the dollar in 1983 led to the infamous Keating "banana republic" comment in 1986. The dollar tanked from $1.48 in 1975 to just 0.60c in 1986. But Keating was no fool, his remarks were deliberately made public as part of a series of measures designed to reform our out-dated economy. Through the Wages Accord, real wages were managed, markets were opened up, banking was de-regulated and Australia began to make its mark on the world stage as a provider of financial and education services rather than just a rural based backwater with a backyard full of mineral resources.

The recent fall in the Australian dollar is as much attributable to a recovering $US as it is to deteriorating prospects in Australia. However, irrespective of the underlying reasons for movements, we believe Australia will be better off in the longer term with a lower dollar.

How low can it go? In years to come expect ***a number starting with 7***.



Why Economists Want a Lower Australian Dollar

Thanks to China and the mining investment boom, Australia's very favourable Terms of Trade between 2004-2011 lifted our income and our standard of living. But it came at a price. Australia is now regarded globally as a very expensive country in which to do business. Our embedded labour costs, although normal to us, are hopelessly out of kilter with our overseas partners. The high dollar helped to keep inflation in check during the boom, but also starved us of broader economy wide growth. Australia has Dutch disease and needs a remedy.

Now that the boom is all but over, the dollar needs to fall to bring our relative costs in line with our overseas competitors. In the short term, we will be a less wealthy country, our standard of living will fall as all imported goods and services will be more expensive to buy. In theory, we should import less & produce more home grown goods. We'll see.

However, a lower dollar will assist all our exporters, particularly miners and agricultural producers, offsetting lower commodity prices. It should cushion the economy's fall from the boom. Importantly, a lower dollar will encourage travellers to stay at home and spend money locally. Our battered tourism industry will finally get more inbound guests as we become a cheaper destination for overseas travellers to visit and our schools of higher learning will be price competitive again.

Finally, but no less important, a lower dollar takes the pressure off the RBA to keep interest rates too low for too long with the resultant artificial distortions to the domestic economy and incumbent financial risks. This is not to say the RBA will increase interest rates soon, but at least it can, if and when needed.

Higher inflation & fuel costs may be less desirable features of a lower dollar, but are costs the economy must absorb. Rebalancing our economy for future employment growth, particularly for younger workers, is critical to our common well being. Rising youth unemployment needs attention now.

Readers will note this editorial has focused on economic monetary tools. History will record that over the past 6 years, ***global central bankers have had to do all the heavy lifting*** to save the world from collapse. Governments of every country have been found ***wanting in political courage*** to either frame or implement the structural reforms needed to fix the systemic problems of the Western world. Shame on them and shame on us for being unprepared to share the burden. Although regressive, ***a hike in the GST rate*** appears the only tax that Australians may bear. ***The tax that targets no one but hits everyone***.

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