ZANACORP

Investment Insight

July 2018

Like a first time visitor to a foreign city, the global economy seems to be somewhat confidently muddling its way forward. Investors are generally at ease taking in the sights. The weather is fine and the forecast favourable. The map being used, such as it is, is of the old city and its long recognised landmarks and reference points. However, the city now before us is new with unmarked hazards, one way streets and dead ends. From a distance it looks the same, but up close it is quite different. For investors the risk of taking a wrong turn is high and the consequences dire. With the best minds on the planet having difficulty peering through the financial haze, we feel it remains prudent to travel slowly and avoid side streets and the fast lane. An accident is imminent, though its location, cause and timing remain uncertain. We are approaching 12 o'clock on the world investment clock.

TICK TOCK... TICK TOCK... TICK TOCK...

In the 19th century, novelist Mark Twain insightfully wrote ***"history does not repeat itself, but it does rhyme"***. Possibly unintentionally, Twain encapsulated the relatively unchanging nature of human behaviour evidenced throughout recorded time.

Survival, fear, greed, security, power, spirituality, aspiration, learning, sharing and family are but some of the timeless drivers of both individuals and collectives. These motivations framed everything from the Egyptian pyramids and Greek philosophy to the space race and our digital age. Yet throughout the ages, each empire, revolution, or economic system has failed, not recognising known errors of the past.

This illogical but uncannily reliable anomaly, brings us to discuss a crucial tool used by the world's best economists and investors, both past and present: ***the investment cycle.***

By its nature, a cycle like a clock, assumes that over time, a pattern of economic behaviour simply repeats itself. Of course, as intelligent beings, we rarely repeat the same mistakes in the same way. That is foolishness. Instead, ***we find new ways to make the same mistakes believing the new approach will create a different outcome.***

The investment clock illustrates both the simplicity and complexity of the interaction of economics, business, investment and sentiment. The clock illustrated was first published in London's Evening Standard in 1937.

What Does The Clock Tell Us?

Although imprecise, the investment clock provides a general guide (to those that care to look) as to the signs that accompany favourable and unfavourable investment conditions. It shows how and when various asset classes respond to changing inputs and the (r)evolving general sentiment from boom to gloom. We should point out that ***not all economies are in sync*** or are at the same time. Unique factors affect the positioning of each country. Even each industry.

The Great Moderation

Many will have noticed that we regularly reference the fact that the world is now an economic experiment. This is not an accident.

Since the recession of the late 1980s/early 1990s, all central banks have sought to control the business/economic cycle by anticipating highs and lows and adjusting monetary policy accordingly. The **aim was to create lower highs and higher lows** and reduce the risks of devastating economic booms and busts. We all know how well that plan has worked out! Friedman's Monetarist theory was flawed.

Today, we are still dealing with the fall out of the last financial catastrophe (the GFC). From a distance the world appears to have recovered from the GFC, but closer scrutiny suggests otherwise.

The debt induced crisis was remediated by the issuance of unprecedented liquidity and even more debt at the lowest rates in human history. So ***how do we now manage an asset price boom in a world reliant on debt and formed on the basis of depression-like interest rates?***

Like a scientific experiment, previous policy failures may have taught us the measures that don't work, but not those that do. This is trial and error testing. A long process that often creates unprecedented problems, demanding untested solutions, leading to unknown outcomes.

In the current context, ***monetary policy intervention to moderate economic conditions has significantly distorted the underlying cycle*** and timing of the investment clock. So too has the rise of China and its massive global impact on industry, labour and resources (and by the way, ghost cities still exist).

The predictive capacity of the investment clock has been muted. Nevertheless, we will attempt to demonstrate its enduring value by way of example.

We will use the US as our benchmark since most investors will recall the milestone economic events of the past 15 - 20 years. So, let's put this tool to the test.

For illustrative purposes, let's start at ***12 o'clock*** and equate that time with the "irrationally exuberant" property and dot.com boom years of 1997 - 2000. The "old economy" was cooked and the US was riding Silicon Valley's "new economy" wave. Google had not yet listed, but "moderation" was clearly needed.

By 2001 the dot.com bubble burst and property and share prices were falling in response to rising interest rates. It was ***3 o'clock.*** Tectonic geo-political events then disrupted the economic cycle. The events were ***the 9/11 attacks and Gulf War***. Fearing recession, the FED precipitously cut interest rates and flooded the US with liquidity. Easy money and rising asset prices returned (out of sync) as Americans feasted on debt (like ourselves) and successfully implemented "shock and awe" in Iraq.

Although avoiding a recession it unwittingly had sown the seeds of a credit bubble. By 2005 the FED sought to cool the housing market and debt explosion by again raising interest rates. ***It was 12 o'clock again.***

Sadly, many US borrowers had binged heavily on low rate adjustable reset mortgages (interest only). By 2007 tighter money conditions and the maturity of reset mortgages at higher rates led to a cash flow crisis. ***The household credit boom became a household credit crunch.***

There was a purging of private debt in the US resulting in widespread asset value declines. The government intervened to avert system failure saving institutions considered "too big to fail" after the collapse of Lehman Brothers in 2008. Wow, it became ***6 o'clock*** in 5 minutes.

By 2009 interest rates were essentially reduced to zero. Curiously, share prices did not rise nor did commodity prices. The world was in

shock and awe of a different kind. Extreme times called for extreme measures and TARP (Troubled Asset Relief Program) and QE were needed to stem economic septicaemia. By 2012 US share prices and property prices began to stabilise. The "uneven recovery" of ***7 - 9 o'clock*** had switched to a "general recovery" ***10 - 11 o'clock*** by 2016.

The election of President Trump and his fiscal explosion and growth policies saw the US swiftly shift into strong recovery in 2017. US house prices and share prices are now reaching new all time highs. Again.

Today, with interest rates rising, ***it is past 12 o'clock in the US.*** To compound the issue this time around, US government debt has trebled from $7tr in 2007 to over $21tr today. This is not a good time for Uncle Sam to be at record levels of debt. Staring at trillion dollar budget deficits, adverse demographics and rising social security and health care costs, future administrations have an imposing challenge.

The Investment Clock suggests now to be a time to reduce debt, avoid investment risk and moderate spending. There would appear to be warning signs everywhere that investment conditions will change over the next 12 - 18 months. None of them for the better. It begs the question then that we see many self-directed clients doing the opposite.

Why Worry About America?

We are often asked why we are US centric in our discussion of economic and/or investment markets. Put simply, when conditions change in the US, they change for the world. The global impact of the US sourced GFC should have been a salient reminder of this.

Few clients will be aware ***the Chinese stock market has fallen 20% this year. Had the Dow Jones index fallen 20% there would hardly be a person on the planet unaware of it***, and their personal wealth would have been impacted. (Fortunately the Dow is up 14% since 1/7/17).

What Time Is It In Australia?

Like "The Matrix", our US analysis illustrates that both investment clock time and its outcomes fail to follow the uniform rules of the real world. Economic intervention and the emotional reactions of market participants shift the direction, time and speed of the clock.

Assessing Australia's current position we should recognise that in 2008 we were saved from the worst of the GFC by China. They both bought our raw materials and invested heavily in us, just when we needed it.

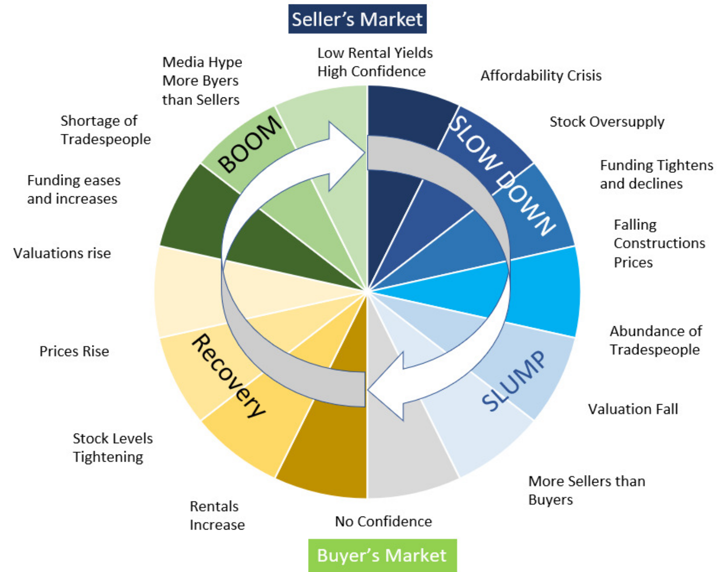
Whilst that may have been a good thing then, it has made us complacent to our intractable domestic difficulties. Since households continued to borrow unabatedly throughout the GFC in response to ever falling interest rates, ***Australian asset price valuations now far exceed those of the US before the GFC.*** We are heavily leveraged into those prices which have supported both private consumption and jobs.

Being reliant on exported materials and imported capital, we can now ill afford any substantial correction in either the price we obtain for our iron ore, LNG and other base metals. Nor can we afford a winding back of Asian property purchases in Australia as this would significantly disrupt our property prices. These events are beyond our domestic control yet impact our domestic financial health.

Accepting the above caveat, ***we tentatively hold the view that most assets prices have peaked and we are in the boom stage of the cycle.*** Barring any adverse external factors, ***we may stay here for some time***. However, the real take away from this article should be not to expect current conditions to remain intact indefinitely. Prepare for change.

Domestically our growth, employment and terms of trade positions appear sound and economically supportive. On the other hand, we note the RBA has expressed concerns over the Chinese banking system and ASIC has identified serious consumer credit card problems. Responding to ever rising private (household) debt, ***official rates have been kept at all-time lows of 1.5% for 21 successive months.*** RBA inertia suggests domestic economic optimism should be measured.

In the interests of relevance, since most Australians are more interested in their housing wealth than income assets, the following graphic attempts to particularly capture the property sector cycle:
A picture paints a thousand words, so there is very little need for our commentary. Study it. ***Draw your own conclusions as to where we are and how long it will last***. Whilst contemplating the latter, consider the extraordinary wages paid to mine workers during the mining investment boom, and how quickly and unexpectedly they evaporated.



Now consider Australia's biggest selling vehicle type for each of the last 3 years. Forget SUVs, small cars or sedans, think tradesmen's work utilities and 4x4s, many of which have been very nicely tricked up.

First Home Super Saver Scheme - (FHSSS)

Legislation has now been enacted to allow first home buyers (FHB) to save for a deposit inside superannuation through the FHSSS.

From 1st July 2018, a FHB will be able to withdraw voluntary contributions they have made since 1st July 2017 (up to $30,000 with individuals being able to contribute up to $15,000 pa within existing caps), along with a deemed rate of earnings, to help buy their home.

With some thought given to both capacity to save (pre or post tax) and the timing of a first home purchase, the new measures are considered to provide young buyers with $6,240 per person in tax savings. Parents, you may want to run this offer by a young loved one for their consideration. $6,000 for free should have some appeal, you'd think?

Older Australians - Home Downsizing Scheme

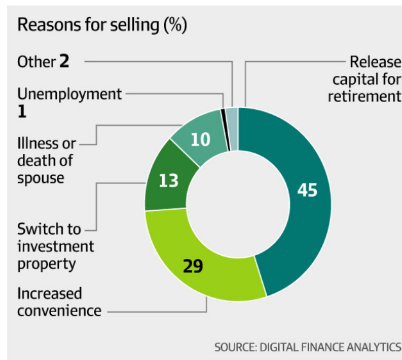
The government has finally passed the bills to encourage older Australians (over 65) to downsize their homes and unlock the possibly considerable capital tied up in their home. Eligible participants who sell their home after 1st July 2018 will be permitted to deposit (on a one time only basis) up to $300,000 of the proceeds (per person) into super, work test free and super cap free to generate tax free income.

Various integrity measures and conditions apply to the downsizer scheme including the requirement that the super contribution must be made within 90 days of settlement of the property. Importantly, and disappointingly, any amount contributed or available for contribution **WILL BE ASSET TESTED** by Centrelink for Age Pension purposes.

Preliminary modelling suggests the benefits available from downsizing are heavily skewed towards couples with few assets, due to the interaction of this scheme with existing Age Pension thresholds.
A retired couple with assessable assets of $100,000 optimising the measures, could expect a $27,759 boost to their annual income taking into consideration both the Age Pension and the tax free nature of the superannuation/income drawdown benefit.

Whilst we commend policies to both free up homes for younger families and release equity for retirees to enjoy, we believe the measures

introduced will not, of themselves, offer sufficient benefits to sway retirees into downsizing.



The carrot offered seems somehow small compared to the life changing event necessary to obtain it.

But, this graphic suggests that 45% of retirees already sell to release the capital.

Who knows, maybe this measure will suit many people, even if they lose some or all of the Age Pension. We will soon see.

Delayed Gratification (Pt 1) - The Marshmallow Test

Whether managing a country's economy, a business or a household budget, it is helpful to know just a little bit about what makes us tick.

Once again, the psychology of behaviour can isolate some of the reasons why, in finance, one size will rarely fit all. Many of us choose instant gratification whilst others choose delayed gratification. Put another way, some people are spenders and others are savers.

A series of studies was conducted at Stanford University in the 1960s and 1970s becoming known as "the marshmallow test". The purpose of the studies was to understand when the control of delayed gratification (the ability to wait for something that one wants) develops in children. (Walter Mischel, Ebbe B Ebbeson)

The studies observed children of a median age of 4 - 5 years under various control conditions. The children were led into a room with no distractions where a treat of their choice (an Oreo biscuit, marshmallow or pretzel) was placed on a table. The subjects were told they could eat the treat, but if they waited 15 minutes without giving in to temptation, they would be rewarded with a second treat. They were then left in the room alone for 15 minutes being monitored remotely.

The results of this study may surprise, even though they shouldn't. A minority of children ate the treat immediately they were alone. Of those that attempted delay, ***only 1/3 deferred gratification long enough to get the second marshmallow***. The YOLO *(you only live once)* group it seems is the vast majority, and they are not just young.

With the passage of time, follow up studies have been done on the original subjects later in life and have found that those who delayed gratification, later correlated in higher SAT (say ATAR) scores, educational achievement, body mass index (BMI), sense of self worth and a wide range of better personal and life outcomes.

Psychologists today remain divided as to the conclusions one can draw from the research. Is gratification an innate, environmental or learned behaviour? Clinical arguments may remain unresolved. However, simplistically and for our purposes, the tests suggest ***most people are more easily tempted than not***. They are less likely to forgo something they want now to attain something greater later on. We find this to be anecdotally true, in virtually every facet of life.

How many of us start a diet, to improve our health, but fail to see it through? Pay for a gym membership aiming to go regularly, to get fit and feel good, only to find we hardly go at all? How many people aim to quit smoking, to improve their longevity and quality of life, but stumble along their path? How many of us aim to accumulate enough money to be able to choose when and how we retire, but find something or someone got in the way? Like many, your writer will confess to struggling with some of these life issues. They are often difficult.

These behaviours, common to most of us are expressed in the results of the marshmallow test on pre-schoolers. It seems that from a very young age, and given our individual personalities, we tend to develop behaviours that reflect our values. For example, savers value the financial security of the future and are more easily able to forgo an experience or consumption today. So too, athletes and active sports enthusiasts at all levels give up their sleep, their energy and their time to train or practice at the skill or activity they want to succeed in. For many the goals are not financial, they may be relationship based.

To be really good or successful at anything in life demands purpose, sacrifice, patience and persistence. We can usually recognise and often admire these traits in ordinary people around us. They just seem to have it all together. Yet those people will have not arrived at that point without personal challenges or mishaps. Like the pre-schoolers that earned the 2nd treat, they most likely have developed the complex mental skills and neural pathways to be able to say no to those forms of instant gratification that would impede their goal. They can mentally grasp themselves in their future having achieved their goal.

These skills are becoming increasingly rare in our consumer led world. This topic demands more discussion, look for more in a future edition.

An Important Question For You

We are accountable to no one but ourselves. Even so, we should be aware of our financial predisposition. Take an honest introspective.

The marshmallow test and the many others like it that followed, suggest people are generally more likely to live for today rather than save for tomorrow. Ask yourself if that is you? If it is, consider taking action now to improve your future financial well being. It is never too early or too late to take stock. Zanacorp has developed numerous strategies to assist clients identify and achieve their goals. ***It is no fun outliving your money*** and don't assume the Age Pension will buy much of a life.

To our double marshmallow clients out there, congratulations we will have already assured you, your financial position is secure. Relax if you can, and enjoy the harvest you will have quietly sown over the years.

Old Europe - Old Problems

It is impossible to ignore the slow grinding demise of a once proud continent of independent states economically joined in a most unhelpful alliance. The problems of the indebted 2011 PIGS (Portugal, Italy, Greece and Spain) linger on and are arguably worse now than then. Further, there is little Mario Draghi can do to help. The Brexit debacle has been only a distraction from the structural economic straight jacket enshrined in the 1992 Maastricht Treaty creating the EU.

We can but scratch the surface of the EUs latest and largest problem child: Italy, its 3rd largest economy. Suffice to say the Italian people have had a gutful of austerity. They have elected populist right wingers to offer them respite in a mood not dissimilar to Trump and Brexit and to stop the boats. However a major problem is that Italy is no longer an economic sovereign having surrendered that privilege when it accepted the governance of the ECB and later the Euro currency

Although politically independent, Italy is mandated to the meet EU economic guidelines including a requirement of government to cap budgetary deficits. What the people voted for and what they can get will depend on Germany's largesse, something the are not known for.

Italy needs to devalue its currency, but cannot. It needs targeted domestic policies, but is bound by Brussels. It also needs lots of time and money. The politically based Maastricht Treaty was a thought bubble that ended up real. Few saw its shortcomings clearly enough.

Interest Rates

Our March 2018 Insight identified the FED seeking to raise US interest rates 4 times in 2018. June 2018 saw the 2nd hike. Strong domestic US growth, employment and spending makes the FED hawkish and is now reverberating around the world. Global money markets have increased the cost of wholesale money to the Australian banking system. With higher funding costs, it is inevitable that all banks will lift borrowing rates soon. Please be clear, the RBA will no longer solely control our cost of money, creditors also will. We ***do not at all anticipate aggressive rises, but households should be ready for some modest increase***.

Interest Only Lending, Cash Flow & House Prices

As if on cue to create a perfect storm, the banking Royal Commission has blasted our financiers for many poor lending practices. The institutions have responded immediately by adopting more stringent cash flow criteria on both new AND existing borrowers. ***Interest only lending is out*** of favour. Over 1 in 4 homeowners have interest only loans out of a ***staggering total of $420bn*** issued in the last 5 years, all maturing in the next 5 years at higher interest rates and with principal repayments bolted on. Future disposable income will be crimped in the years ahead, as more cash will be required to merely service existing debt levels. This augurs poorly for tepid future consumption spending - 60% of our economy.

We can only suspect everyone is aware of the recent softening in the housing market. No one knows how long this will last, but with money now harder to get, so too are the high and unaffordable prices of recent times. With the continuous pipeline of apartments being released, large developers are struggling to find the expected queue of buyers. Is this sounding familiar to anyone? Check the property clock, but before you do, ***take a peek below at our household savings record during our period of prosperity***. We absolutely seek to remain positive, but are compelled to monitor facts and remain observant of trends, good and bad.

Trade Wars

Although a relative side show to global economic shifts, Trump's trade wars are certainly making some governments and share markets nervous, China being a case in point. As a valued US partner, Australia has been granted relief from US tariff hikes, a move not unnoticed or particularly well accepted by our Chinese friends and partners. Are we a pawn?

We are not presently concerned with the economic impact of the tremors emanating from affected countries, but are alert to many "tit-for-tat" retaliatory responses. It seems clear that in the new world order, the concessions once granted by the US cannot be so easily withdrawn, especially in the absence of diplomacy. Expect business input costs to rise.

Economic Growth

Many readers may be confused by the apparent disparity between our poor investment outlook and economist growth forecasts of over 3%. This is partially explained by strong ore and now LNG exports, concealing sluggish domestic conditions including economy wide flat wages growth. Many already debt laden households, crippled by rising power costs and stagnant wages are simply unable to increase their rate of spending. Savings are now relatively non existent. Proposed tax cuts offer little relief to households and fail to alter generally weak discounted retail sales. Under these circumstances RBA policy paralysis appears understandable, albeit ineffective. Ten years ago, who could have imagined that official interest rates of 1.5% would fail to lift the roof off the domestic economy? Yet here we are and consumers are tapped out.

How Are We Investing?

Nothing has fundamentally changed since our March 2018 Investment Insight. Yes the clock is ticking, but the bull market remains broadly intact absent any immediate trigger that will fracture market repricing. ***US sentiment and economic drivers are positive being precisely the reason the FED remains intent on "normalising" interest rates***. We remain bullish on overseas markets fuelled by accelerating growth, particularly in the short term. We see Australian based assets as those most vulnerable to weakness as the calendar year closes out, yet they too show no signs of breaking down in the next 3-6 months. Volatility is likely to increase as investment risks rise and limited upside becomes more evident. Poor visibility into 2019 appears where risk lies.

Our investment strategy over the past 18 months has been, and will continue to be, strategically employing our dollar cost averaging (DCA) process combined with tactical asset allocation (TAA). Most clients will be quite familiar with this hedged approach which continues to generate solid investment returns in increasingly marginal markets.

Market Round Up

Shares, Bonds and REITS

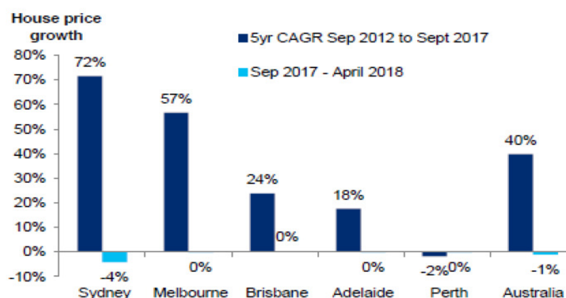
For 2017/18 the Australian All Ords chalked up a respectable 9% return. The materials, healthcare and energy sectors performed strongly at the expense of financials which were significantly lower. BHP rose 3 places in the ASX 200 Top 10 to rank 2nd in size behind CBA.

Bond proxies, ARIETS, utilities and infrastructure stocks delivered sub 5% returns, pressured by rising interest rate expectations.

From the table below, markets in the US, Japan and Hong Kong continued their multi-year rally producing annual returns above 10% pa. Meanwhile, the British and German markets foundered amongst the uncertainties of Brexit and the dysfunctional Eurozone member states.

Residential Real Estate

Australia's largest residential property market softened over the year with Sydney falling for the first time in 5 years after a spectacular run. Most other markets have flatlined. Is this a blip, or the beginning of something more sinister? What would Mark Twain think?



Source: Core Logic, Citi Research

MARKET FACTS	June 2018	June 2017	June 2016	June 2015	5 Years Ago 2013	7 Years Ago 2011	10 Years Ago 2008	15 Years Ago 2003
Australian All Ordinaries	6,290	5,764	5,310	5,451	4,775	4,660	5,333	2,999
Dow Jones (US)	24,271	21,349	17,930	17,619	14,909	12,414	11,350	8,985
FTSE 100 (UK)	7,637	7,313	6,504	6,521	6,215	5,945	5,626	4,031
Nikkei (Japan)	22,304	20,033	15,576	20,235	13,677	9,816	13,481	9,083
Hang Seng (Hong Kong)	28,955	25,765	20,727	26,250	20,803	22,398	22,102	9,577
Dax (Germany)	12,306	12,325	9,680	10,945	7,959	7,376	6,418	3,221

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