Investment Insight

ZANACORP

End of Decade Edition - November 2019

In the equivalent of a heartbeat, the decade of the 2010's is closing. It will be remembered as one of the few decades in the modern era devoid of any defining social, economic or financial mishap. In this time, the masters of global economic management have apparently re-engineered economics to orchestrate the flattening of the business cycle, control of inflation, maintain GDP growth, full employment and forever rising asset prices. By and large, people feel better off and more secure in 2019 than they were in 2009. By reducing the cost of money to zero, central bankers have either pulled off the biggest miracle in 2000 years or successfully executed the greatest global economic hoax in history. Alas, the mirage is fading as consumer confidence wanes. After a full decade of inertia, governments are now being forcibly drawn to step up to the plate with meaningful fiscal policy. Bereft of innovative ideas, they appear destined to perpetuate the biggest deception of all.

And For Our Next Trick - Introducing Modern Monetary Theory

Crystal Ball Gazing Into the 2020's

Investing demands capital to be allocated after forming an opinion of both opaque future financial conditions and investor reactions to them. In an unknowable future, this task is prone to error with many moving parts. Knowledge, experience and instinct are helpful tools. However, **the biggest obstacle to forecasting is not anticipating economic outcomes per se, but rather the policy responses of regulators to them.** They can set and change the rules of the game, to suit their purpose.

The Pavlovian power of regulators to induce economic behaviour should not be under estimated. Nor should their primal instinct for self preservation and the survival of the system. For example, post GFC cheap and easy credit has lead to increased debt, spending and asset prices around the planet. Catastrophe averted. But was it resolved or merely postponed?

Reminiscing over Zanacorp newsletters framed in the late 2000's provides some insights as to how much the world has changed since then. We were concerned by people borrowing up to 5 times their income to buy houses. Now of course loans of 7-10 times income are the norm. Debt that sank borrowers in the 1990's, gentrified them in the 2010's as asset prices rose. Who in 2009 could really have believed RBA rates could fall from 6% to 0.75%? Or that in 2019, bankers would perversely invest U.S.$16tn into **NEGATIVE YIELDING BONDS** simply in the absence of any safer alternative. Are these the sign posts of GFC 2.0 or the new normal? Time will tell.

With the coming of the new decade there is clear evidence that the fabric of old world cohesion is stretched. Finally divorcing itself from the 20th century, many familiar western stalwart systems, structures and values are failing, crushed by a tenuous social and politically correct civility.

Once proud European nations will become meek, international defence alliances will be tested, global living standards may be challenged and polarising social, political, environmental and economic views will be common place as the "haves and have nots" jostle for control. The world will become increasingly bifurcated by the needs of the old and aspirations of the young. In Australia, 2 million mostly older people will die, replaced by 5 million immigrants and births continuing the evolution of our nation.

Globalisation over the last 40 years and its poorly understood consequences will be unwound elevating geo-political tensions caused by underlying trade imbalances, falling global growth, employment and nationalism.

In most of the developed world, **unrepayable national debt** is now accepted and "normalising" interest rates and fiscal responsibility are no longer concerns. As such, any future crisis may involuntarily trigger a debt jubilee or adoption of an alternative monetary system (gold or crypto based).

Disenfranchised millennials are now voters and a force to be reckoned with. Estranged from the property ladder and facing compromised long term job/income security, this well educated but inexperienced tech savvy cohort have harnessed social media to push back at capitalism and industrialisation favouring more idealistic social and green agendas.The evil 1%, the polluters, the corporate profiteers and dishonest tax evading global institutions are under siege, **presumed guilty** and publically vilified on Facebook for moral crimes they may or may not have committed.

To young eyes, capitalism apparently takes from the poor to reward the rich just as industry takes the health of mother earth in exchange for nothing more than global growth. **"How dare you!"** cries Greta Thunberg.

The 2020's look destined to usher in the rise of political and economic socialism – the great leveller. Appeasing boomers who until 1989 feared communism, the new wave will be called **"democratic socialism"** and delivered with hubris by wealthy elites to a captive audience of believers.

Zanacorp's 2010 Messages In A Minute

Over the last 8 - 10 years, prosperous for investors as they have been, we have shared with clients our thoughts on the GFC, the mining boom, the housing boom, the apartment boom, Grexit, Brexit, negative interest rates, baby boomers, the EU, behavioural finance, the Trump Effect, the population boom in Oz, global debt, fiat currencies, the Investment Clock and the rise of China. In each editorial we monotonously referenced the use of ever more creative unconventional economic policies and the post GFC experiment. That experiment is about to go to viral in the petri dish.

"All the forces in the world are not so powerful as an idea whose time has come" - Victor Hugo

MODERN MONETARY THEORY

The economic world is fatigued by a decade of QE and unconventional monetary policy now barely able to keep a broken financial system afloat. A fresh economic idea is gaining traction. It is an idea once considered lunacy but now revolutionary. **A 2020's panacea to the world's problems**: Modern Monetary Theory or MMT.

We have researched MMT extensively over many months. Grappling with its conceptual core, its compelling simplicity and tantalising appeal.

We have yet to form a conclusion on the merit of MMT, but be on notice, what you are about to read is quickly becoming mainstream thought in the halls of government around the world and in particular, in the minds of U.S. Democrats seeking to win the U.S. Presidential election of 2020.

In a nutshell, MMT goes like this: -

Since sovereign governments are monopolies and control their currencies, they are not fiscally constrained as households and businesses are.

Traditional thought is that governments tax or borrow and then spend. MMT suggests governments spend first, then tax and borrow. Thus, governments can simply "print" money (via computer entries) to spend and invest in their economy to meet their social objectives for jobs, education, healthcare and welfare for all. Magically, this system can even pay for all the economic costs of climate change. **The money never needs to be repaid, as it was simply created on a government computer, then spent!**

David Copperfield, eat your heart out, making an elephant disappear comes nowhere near the scale of this illusion.

Adopting this hypothesis, government deficits create a private sector surplus thus producing greater private (personal) prosperity. In a keystroke, MMT unites the interests of government control and equity with the profit motive that drives private enterprise. **"Bloody brilliant!"** said Ron.

To counter the **inflationary risks** of potentially limitless spending, taxes (not interest rates) can be used to control the prices of goods and services flowing within the economy. When full employment is reached and **everyone who wants a job has one**, taxes are increased on higher income earners to soak up the excess liquidity and moderate price rises. Money becomes the ballast apportioning equity with interest rates at zero, so those with debt do not pay interest to those with capital. Sound fair?

Some economists argue that elements of MMT are already in play in Europe, Japan, China (even the U.S.) all of whom run massive fiscal deficits without any measured inflation. Frighteningly, this may in fact be true.

Consider now if you will, sovereign governments around the world adopting full blown MMT. Domestic welfare programs and retirement pensions become affordable. Infrastructure building, education and healthcare cost burdens are no longer funded by taxpayers, current or future. The economic costs of introducing renewable energy and compensating those who suffer from it, come out of a computer. Surely this is just a Utopian dream that not even Sir Thomas More could have conceived?

Imagine you are a politician looking to buy (sorry win) votes, promising the earth to every millennial or down trodden, overlooked, under employed or climate concerned citizen in your constituency. How could MMT not be a slam dunk for any well intentioned political aspirant?

From this briefest of introductions it is hard not to be drawn to the sheer simplicity, boldness and apparent equity of MMT. But hang on a minute...when I was a kid (with the same wish list that every kid ever born has had), I remember my mum telling me over and over again, **"money doesn't grow on trees".**

I love my mum. I trust my mum. Like most people who grew up poor in the Depression years, she knew and taught me the value of money. During the war years her family used coupons for sugar and butter and she toiled long and hard over her lifetime to secure a well earned retirement. I did not experience these hardships, nor did Wall Street Trader **Warren Mosler** or Glen Huntly born **Bill Mitchell** who **dreamed up MMT in the 1990's in the comfort of Pax Americana**. To avoid any confusion in this matter, MMT demands society suspend all belief in the lessons of history to adopt an untested theory turning governments into gods.

There are a number of serious flaws in the MMT theory. In a globalised trading system, sovereign currency control is not as easily earned or retained as MMT assumes. The U.S. dollar **currently** still enjoys Reserve Currency status. Should any politician presume others will continue to exchange their hard earned efforts for a computer generated fiat currency, they may well find they have created the latest incarnation of the Roman Denarius (200 AD), Chinese Flying Paper (700AD) or German Papiermark (1923). All failed currencies of former glorious nations and all victims of hyperinflation. Why would MMT be any different? Creating money debases currency until it is worthless, thus it has been and thus it will always be.

We will no doubt revisit MMT in further detail in 2020. Presidential candidates including front runner Liz Warren have run with MMT to fund Alexandria Ocasio-Cortez's popular **Green New Deal** program. Stay tuned.

Marx, Lenin and Mao would feel gratified that their ideological framework has finally captured the hearts and minds of their nemesis, the U.S. **The failure of the capitalist economic system people so trusted, to deliver the outcomes they so wanted, has made them open to believe in an old idea that promises all they desire.** How do you think this will end?

Australia is 3-5 years behind the rest of the world. We are only just discovering Zero Interest Rate Policy (ZIRP) and Josh Frydenberg is single mindedly pursuing a budget surplus to establish his economic credentials. How orthodox. Never mind he will be converted to MMT in time.

For the moment, with the government MIA, the RBA is using lower interest rates as the mechanism to prop up the Australian economy and resurrect the confidence of homeowners to borrow and spend. Especially spend. This strategy increases the gap between rich and poor inflating the prices of those who own financial assets and increasing the debt burden for those who don't. Unfortunately, the economic impetus of lower interest rates has dissipated, just as the so called "wealth effect" of higher house prices is increasingly ineffective. They are old tricks, seen before.

Brain Teaser

Take no more than 30 seconds to complete this simple problem using only your mind and not a calculator:-

You have 1000.
Add 40, add 1000, add 30.
Add 1000 again, add 20, add 1000 again, and finally add 10.

What is the result?

Answer may be found on the foot of page 4.

To those who failed to correctly answer this simple question, recognise the propensity for error when making decisions with inadequate time.

Where Do You Fit In?

As tax accountants, we prepare many hundreds of tax returns each year. In this capacity, we rarely see working age taxpayers in the lowest (tax free) tax bracket. They have no need for tax agent services and usually no investments to speak of and are usually students.

Eliminating the lowest earning group, we commonly note many working clients see themselves lower on the relative pay scale than they actually are. Whether measured by peer groups or simply by looking at the way others live, they believe other people earn significantly more than they do.

To put this matter into a more accurate perspective, we have reproduced below the ATO's most recent taxpayer data series (2017).

Brackets of Australians

Number of Australians By Income Tax Bracket

Taxable Income	2016-17	%
$18,200 or less	2,652,106	19.1%
$18,200 -$37,000	3,127,215	22.5%
$37,000-$80,000	5,590,402	40.4%
$80,000 - $180,000	2,072,569	14.9%
$180,000 or more	428,453	3.1%
Total Taxpayer Returns	13,870,745	100.1%

Source : Taxation Statistics 2016-17, ATO

Looking at the table it is clear the biggest taxpayer group (40.4%), by a long margin earns between $37,000 and $80,000. Only 18% of the community earns more than this and of those, only 3.1% earn over $180,000 to enjoy the privilege of paying nearly half their marginal income in tax.

As a consequence of failing to understand what most taxpayers earn, many people believe they earn too little to be at risk of an ATO audit or review. This is also simply not true. The ATO casts a wide net when determining which taxpayers to select for review to maintain the integrity of the system.

We wish to remind all clients that this year, ATO computer system enhancements now transmit granular detail of all tax claims made by taxpayers. Improved sorting of taxpayers by both income level and occupation classification have also been implemented.

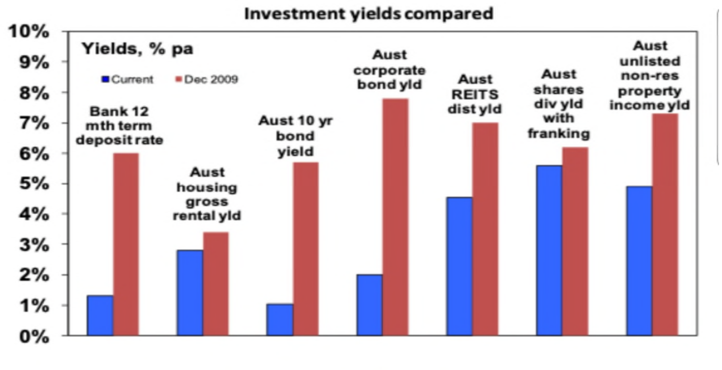
Finally, greatly expanded computer data matching is providing the Tax Office with surprisingly broad access to both share and property sales information to identify potential capital gains tax liabilities and income earned from overseas sources reported by other countries.

Our initial observations this tax season are that, although we as tax agents are being provided with better information from the ATO, including prelodgement **warnings of possibly excessive taxpayer claims**, they are more proactive in reviewing claims. Now more than ever, good record keeping should be the objective of all taxpayers including investors and few people should believe they are immune from review. Computer generated audits cost the government nothing, after all they even own the postal service that will deliver you your questionnaire (3 days late).

The Search For Yield - Then And Now

In 2009 investors chastened by significant capital losses from growth assets following the GFC, retreated to the safety of bank term deposits yielding around 6%. Although generating less return than other assets, **return *of* capital was more important than return *on* capital.** Fast forward ten years and term deposits have been binned and investors have been forced to take higher risks again to achieve a reasonable return on capital. Return of capital has once again been relegated in the search for yield.

Take some time to digest the chart below. The red bars are the yields of 10 years ago (2009). The blue bars are current (2019) investment yields. It is enough to make an investor cry. No major asset class today will earn 6% even assuming elevated capital risk. Continuously low interest rates served to drive up prices thereby reducing yields. Thus most investments now unavoidably carry risks and we are all in them to some extent.



Source: Bloomberg, REIA, RBA, JLL, AMP Capital

The Zanacorp house view has not changed over the course of 2019. We remain firmly of the opinion that **a major financial reset is imminent.** However, with Australia unexpectedly moving towards ZIRP, that risk has been pushed out a further 12 months. In response, we have maintained current client portfolio weightings to growth assets rather than reduce them.

We concede that a year ago, we did not expect the Haynes Royal Commission **responsible lending measures to be wholly abandoned** within 9 months. **Yet they have**. We concede we did not expect the ALP to **lose the unlosable election** and their negative gearing/CGT and franking credit measures to simply go away. **Yet they did**. Finally, we concede we did not consider plausible the actions of APRA, the RBA and Treasury to reduce interest rates to a level **below 1%,** or repeatedly and publicly express the view that **Australia will print money** (via QE) in 2020, or regulate for **10 year interest only loans** for borrowers. **Yet they have**.

Given such a determined effort to underpin spending, we concede that asset prices are likely to remain extremely elevated for a while yet.

Sydney & Melbourne House Prices – On A Tear

In 1897 Ivan Pavlov demonstrated repetitive conditioning can induce unnatural behaviour in animals. Australian bankers of 2019 know this too. Drop interest rates by 50%, relax lending rules (again) and watch borrowers queue up for loans. It's very simple stuff and has fuelled one of the most **blistering periods of house price growth** in years up 5% in 3 months.

Acknowledging volumes remain low and high end houses have significantly outperformed most others, nothing has fundamentally changed in the last 3 months except the reduced cost and increased access to debt.

After the August interest rate cut to 1%, the RBA will infamously be remembered as saying :**"We can be confident that lower interest rates will push up asset prices and I think that later on we will have problems because of that "** (Dr Philip Lowe, ABC 26.08.2019). Yet they still did it – knowingly lighting the wick that will burn an economy. **These heroes in a boom, will be exposed as villains in a bust.** Leading the naïve into peril.

We welcome policy support to moderate house price declines and limit losses and confidence. The property market was finally self correcting to a sustainable level and offering first home buyers a reasonable entry point. After a very long period of sustained price rises, buyers and sellers were arriving at a rational meeting point. With the stroke of a pen to meet short term goals, the RBA wiped out any lessons that moderate debt was smart.

Investment Costs, Advice and Tactical Asset Allocation

Zanacorp has professionally managed investors' money spanning the last 4 decades. We are paid to provide sound advice and deliver financial results. We have seen mighty investment houses rise and fall, investment fads come and go and soaked up as much knowledge and experience from industry luminaries as we possibly could. That quest is unending.

Passive versus Active Investing (Lower Cost for Higher Risk)

In Australia and around the world, the investment industry is grappling with the vexed question of investment costs and fees and their relationship with investment returns. This issue is not new nor truly resolved. Curiously, this debate often arises late in a bull market cycle after markets have reached unexpected levels and favouring index funds/ETFs that must remain fully invested, irrespective of heightened market risks.

Simplifying a complex analysis, index funds and ETFs are low cost as they are computer driven models tracking an index. There is little human intervention. Dominating fund flows which itself drives up indices, they are now an embedded part of the pricing problem. **Investors often unknowingly, assume all market risks** with no mechanism to quarantine losses. This will likely be identified when markets suffer a sudden fall and capital is destroyed. Active fund managers manage both risk and return. Most good active investment managers are currently hedged to protect their investors' capital against the risk of loss. Naturally, being more conservatively positioned, many (not all) have underperformed. The duration and extent regulators have gone to distort investment fundamentals and prop up unsustainable asset prices has made many of **the most respected asset managers appear foolish,** even Warren Buffet, at least for now.

In our experience, the best active investment managers consistently produce more reliable and superior net returns in the long run. Having seen investor fear many times during periods of market turmoil, systems that protect capital are invariably valued more than lower costs. **On the Titanic, those people wanting to be near the lifeboats looked stupid, until the ship hit an iceberg**. We expect the next market correction will be horrific. Many investors without life vests will drown ruing their blinkered pursuit of low fees. We do not apologise for erring on the side of investment caution, steering clients to safety with the assistance of the best investment managers and tools available albeit at a modest cost.

Investment Advice Trends in The 2020's

Zanacorp believes investment advice is deeply personal and should not be "bulk billed". Responding to increased compliance burdens, large advisory institutions and industry funds are adopting "**robo-advice**": low cost, pre-determined compliant advice, based on online interactions and questionnaires. It may be the delivery system of the future, but is unlikely to deliver the best result as it is transaction based advice, not strategic advice. Robo–advice is cheap and unidimensional protecting the institution from litigation, but its value in genuinely fulfilling the long term goals of clients is arguable. We often see new clients late in life that could have greatly benefitted from strategic investment advice much earlier in life but **didn't know, didn't ask or didn't pay**. A costly error.

We feel we have a bond with every client who has trusted us to manage their investment capital. With each person or couple or family, we have shared our mutual experiences and insights and developed defined objectives and investment strategies to best meet their specific goals. Our role is as a complete financial adviser not an investment order taker.

An important bi-product of our personal client relationships is that we offer a sounding board for our clients to help them deal with the very unique issues that confront them. We provide financial guidance to clients who may have lost a loved one, suffered an illness, need advice with aged care, financially assist a child, shift house or simply buy a car. Caring, impartial advice, when it is needed most. This is part of what we do and how we believe we make a positive difference to people's lives.

As the founding director of our business, your writer is proud to lead all the staff employed by Zanacorp. Our team is not only passionate about our client service to you, they are inquisitive and constantly challenging our ongoing methodologies and processes to improve our service offering. All that said, we never lose sight of the fact that **we are paid to use our investment skills to enhance the financial outcome for clients.**

Asset Allocation Determines Outcomes

Despite the digital revolution of the 21st century, the basics of successful investing have remained constant as they have for centuries. The internet helpful to some, has often been more an impediment to success than a pathway to it, focussing on ideas instead of long term strategies.

Cash, bonds, equities, property, infrastructure and debt are the pieces on an investor's chessboard. Although we all play with the same pieces, the rules of the game are fluid. In Australia, for many, many reasons, 80% of Australians retire without attaining their personal level of financial security, but mostly they lacked a plan and/or a process.

Within the asset class universe, being at the right place at the right time as often as possible and having the courage to step away from an overheated market before it tumbles, are timeless secrets generating value.

Assigned the task of making money for clients, we learned many years ago that most balanced investments funds are not what they seem and nearly always cause investors grief once in a decade. Zanacorp rejects the "one size fits all" mantra and designs "tailor made" solutions for each client matching asset allocations to risk tolerance and employing dedicated, best of breed single asset class fund managers as satellites to enhance the returns from our core conservative asset base. Each of our clients' positions is a bespoke solution incorporating our best ideas both at the time of their initial investment and all reviews thereafter.

We pay for strategic asset advice so that our clients can profit from it.

It is no coincidence that our client portfolios included infrastructure assets, long before they became popular. Nor should it surprise that in 2012, with both the A$ and the U.S.$ at parity and overseas markets ridiculously cheap, we moved clients out of defensives and Australian shares into overseas assets to capture their strong rebound. When listed property assets tanked our asset allocation shifted to buy at discount prices and then most recently our shift into conservative bond funds have delivered equity like returns from even the most low risk assets. **This is buy low, sell high in action.** It does not just happen on its own, it must be contemplated and executed. Easier said than done, it has been our modus operandi for decades. Most clients know that.

Over the years our personal service investment offering has enabled us to tease conservative investors into growth assets and tempt higher risk takers into assets that delivered superior returns with lower volatility. In each case, expanding narrow investment views enhanced client returns.

So how have clients done? Broadly speaking, all Zanacorp clients (incl conservative retirees), have enjoyed investment returns **AFTER** fees of 7% pa to 10% pa over the last 7 years. This places Zanacorp returns in the top 15% of all managed investment funds in Australia.

It is not often we sing our own praises, but as this decade concludes, we feel every client should be assured they are in steady hands and always will be due to the outstanding efforts of all Zanacorp team members. We are proud to be of service to clients and proud of our achievements.

As eluded to in our March 2019 newsletter, adviser fee arrangements applying to investments are being altered effective in 2021. We have proactively engaged with clients since March and have been humbled by the appreciation shown by our longest serving clients. To all those clients we offer our sincerest of thanks for your loyalty, trust and support.

The Shape Of Global Things To Come

Our June 2019 Investment Insight featured a commentary on the rise of China and decline of the U.S. Muddying the waters somewhat, this update approaches the issue from a different perspective - deglobalisation, global security, global energy and demographics (a Zanacorp favourite).

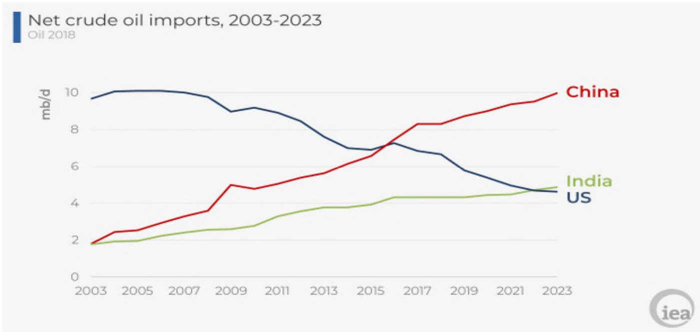
Defying popular (and ill-informed opinion), **the U.S. is not a major importer or exporter relative to its GDP. It imports approximately 15% of GDP and exports 12.5% of GDP the lowest of any G20 country** and roughly half of the Australian import/export equivalents.

As the U.S. shrinks its global footprint, **its economy is better able than any other to be more self -sufficient** needing strategic trade deals with fewer countries and reducing its reliance on China. The de-coupling of the U.S. from China is real and permanent. The U.S. was duped by strategically superior successive Chinese leaders. Now Xi Jinping has made it clear that China seeks economic power with no interest in democracy. Hong Kong and then Taiwan present non U.S. ideological hotspots for China.

In terms of global security, the U.S. has largely singlehandedly funded and operated NATO and the UN since WWII. The rest of the world enjoyed free and secure trade with Sth Korea, Saudi Arabia, China and Germany being the main beneficiaries. It served a common interest both protecting Allies and containing communist creep. In the 2020's we expect things will change. **The mighty U.S. Naval Defence system has protected global maritime trade routes for decades** facilitating the safe flow of oil and goods around the planet. **This maritime protection will in future, come at a cost.** As such, countries will need to decide where their future allegiances lie.

With material and intangibles trade becoming increasingly fractious, **technology (including 5G) will be the chief battlefield on which trade wars and political conflicts will play out.** Many countries dependant on both the U.S. and China (Australia in particular) may become embroiled in this battle for the future, fulfilling a classic re-enactment of Thucydides' Trap.

Energy Independence & Demographics

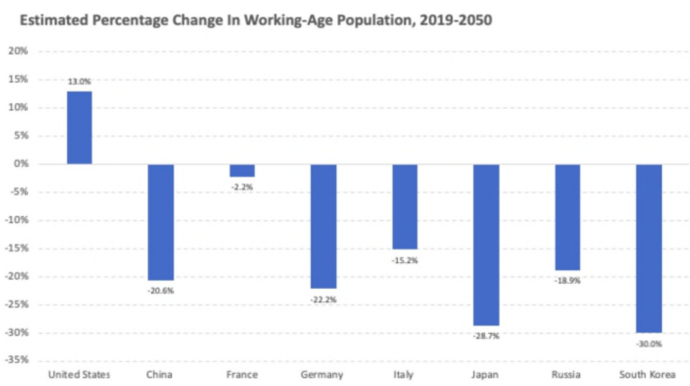


Our June 2012 investment update gave clients a heads up on the new U.S. development of shale oil and gas. The chart above reveals what this revolution has become. In less than 10 years the U.S. is oil self-sufficient. A recent U.S. petroleum industry article went under the banner **"Shale oil now means you don't have to send your kid over there to get killed".** Think about that for a moment. Not only has OPEC (Oil Producing Exporting Countries) lost billions of export dollars, **in future oil dependant countries will need to deal with the Middle East alone.** Problematic for the U.S. dollar, the pillar of MMT, **future oil trading and exchange between U.S. adversaries may be settled in petro-yuan, not petro-dollars**.

Global trade, security and environmental issues just got complicated for all of us. P.S. Don't expect Uncle Sam to bring in the cavalry (for nothing).

Reproduced below is a projection of the % change in working population over the next 30 years for developed nations. Only one country has a growing workforce. **China better get moving before they become Japan**.

Every country is getting old, some faster than others. Demographic shifts will significantly impact future economic might. Is China the safe bet?



Source: Census Bureau International Database

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