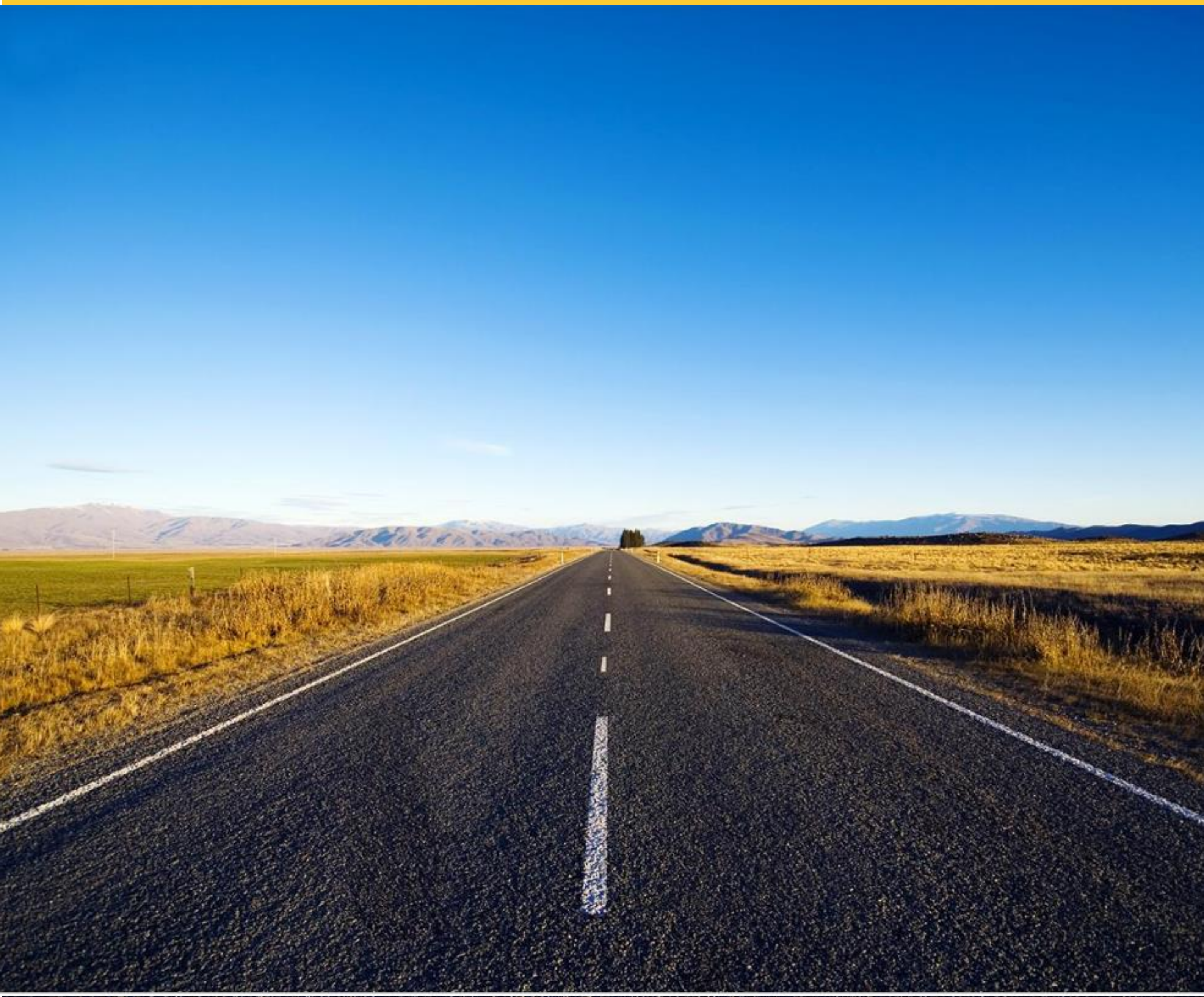
STANFORD BROWN
Financial Advisers

Monthly Investment Markets Report

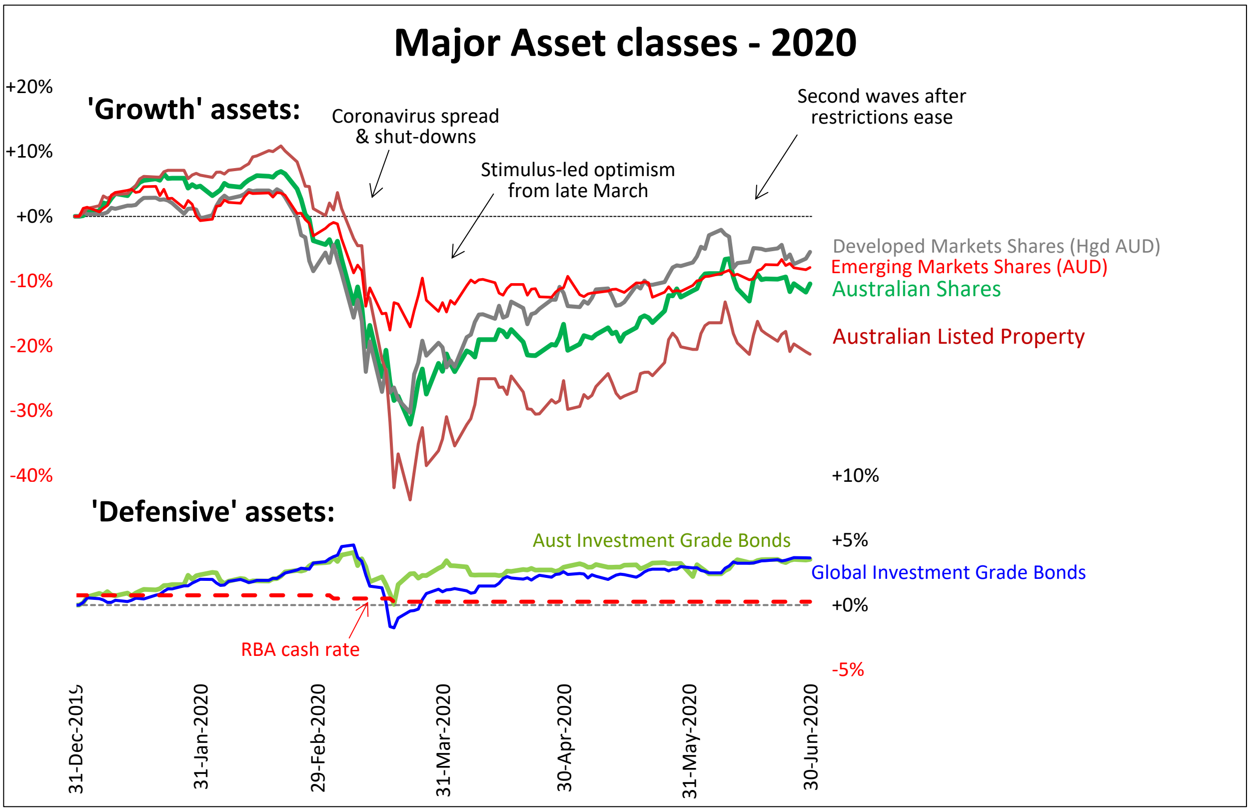
3 July 2020



Investment markets in June

June ended up a fairly flat month for investment markets. Shares jumped early in the month while governments eased lock-down measures, but most fell back for the rest of the month as second waves of infections and restrictions hit confidence. With a vaccine or cure probably many months away at best, this pattern may continue for some time. We cover the coronavirus progress in more detail later in this edition.

The chart below shows returns from the main asset classes this year. The upper section shows that ‘risk’ assets are on the way to recovering from the February-March coronavirus shutdown sell-off, although early optimism for quick end to restrictions appear to be fading somewhat. Current pricing still assumes a relatively rapid return to pre-covid levels of profits and dividends, with no lasting impacts.



The Australian share market ended a fraction higher, thanks to double-digit gains by retailers Wesfarmers, Coles, JB, and modest gains by the big banks, Macquarie, miners BHP and RIO, and also CSL. Afterpay was the star, up 28%. Down for the month were oil/gas stocks (despite higher oil prices), Telstra, and most industrials, transport and property trusts – reflecting fading optimism of quick rebounds.

Most international share markets were also up a fraction in June. European shares were a little better but remain lower than the US for the year to date. Most ‘emerging’ markets were stronger than the ‘developed’ markets – virtually across the board in Asia (where the virus has largely been contained) but also in Latin America (where the virus is still in its rapidly expanding first wave).

The big US online/tech stocks stood out in June – with double-digit gains by Amazon, Apple, Microsoft, and Adobe – all beneficiaries from the global lock-downs. Non-US tech stocks were also strong: - Tencent (China) and SAP (Germany). Also higher were ‘cyclical’ stocks benefiting from hopes of early lifting of restrictions, including aircraft makers Boeing and Airbus (France). The weakest sectors for the month were healthcare, alcohol & tobacco, utilities and oil/gas, even though the oil price recovered some more lost ground.

Although June ended almost flat for shares, the June quarter was a very strong quarter: +19% globally. It was the best quarter since the June quarter 2009 rebound in the middle of the GFC recession. In the June 2020 quarter, share prices while outlooks for company profits and dividends were being downgraded heavily, virtually across the board (just like in 2009), and economies everywhere plunged into their deepest depressions since the 1930s. This is consistent with the long term pattern we have noted in previous editions, where shares have some of the best gains in middle of recessions while economies are still contracting and profits and dividends are being cut.

The US NASDAQ market was the strongest, up +29% for the quarter, and most other markets around the world posted gains in the teens. Among the very few weak (but still positive) markets for the quarter were Hong Kong +5% (as it was subsumed into Communist China) and Switzerland +8% (due to its concentration of healthcare stocks, which had a weak quarter around the world).

In Australia, the broad market’s 17% gain for the quarter was driven by tech stocks - Afterpay +220%, REA +40%, Xero +33%, Computershare, +37% Carsales +51%. Building product makers like James Hardie +48%, Bluescope +36%, Boral +85%, retailers Wesfarmers +31%, JB +53%. The gambling dens were up strongly – Tabcorp +34%, Star Casino +43%, Crown casino +27% consistent with the numerous surveys and reports showing large shares of welfare handouts spent on gambling. Oil/gas stocks Santos +55%, Origin +33%, Oil Search +33%, Worley +42% - with the rebound in oil prices (back into positive territory!). Most of the miners were also up 15-25%. Property trusts had a strong quarter, with most up more than 20-30%, but they fell more severely in the crash, and are still down heavily.

The weakest sectors in the June quarter rebound included transport, but Qantas and Transurban were both up +17%. Big banks lagged the market (but Macquarie gained +38%). Healthcare lagged, with CSL the worst down -3%, but Ansell (medical protection gear) surged +35%. Telstra and Utilities had a flat quarter they held up well in the crash, and so are down only modestly for the year.

On the international front - the quarterly share price picture was dominated by the US tech giants - Nvidia +44% (gaming), Apple +43%, Amazon +41%, Facebook +36%, Microsoft +29%, Adobe +27%, Google +22%, Netflix +21%. Other global online/tech players were also strong - Tencent +31%, SAP +21%. Also rebounding strongly were US hardware retailers Home Depot +34% and Lowe's +57%, and German industrials like Siemens +85%.

There were no weak global shares sectors for the June quarter as all posted better than average quarterly returns in the rebound from the February-March crisis. However, oil/gas, banks and property companies are the most behind for the 2020 year to date, with both industries facing structural problems. We cover returns per asset class over the full financial year to June later in this report.

Defensive assets

The lower section of the above chart shows that even the safest of 'investment grade' bonds fell during the sell-off, but they too are now recovering smoothly thanks to buying support by central banks, and bond yields were almost dead flat in June almost everywhere.

The RBA kept its official target cash rate at 0.25% but has been running the actual cash rate at just 0.15% since the March crisis. It has also returned to 1950s-style interest rate pegging to keep bond yields low so the government can borrow the extra couple of hundred billion dollars of debt it needs to fund the temporary support payments to all and sundry.

On the currency front the Aussie dollar edged higher along with shares in June – especially against a weaker Yen and US dollar. The slide in the US dollar since March has caused alarm in some quarters but this is consistent with the usual pattern in most conditions. The USD generally falls during global share rallies, and rises in sell-offs. The slide 3-month slide in the USD appears to have paused in early June.

On the commodities front - iron ore broke above $100 per tonne for the first time since August of last year but it weakened at little late in the month as Brazil moved to lift restrictions that have been disrupting mining and exports. The oil price is back up to $40 with further moves toward production cuts to support prices, after its extraordinary negative price crisis in April. However, oil prices are still down by one third since the start of this year, and share prices of the major oil & gas stocks are down by similar amounts this year. Other industrial commodities were a little stronger across the board (except Lithium and steel) but all are still well down for the year so far, which is natural in a global slowdown. Gold rose a fraction in June but the gains were neutralised by the rising AUD.

Portfolio returns.

This table summaries returns from our model portfolios for the month and the quarter.

SOTERIA 'Dynamic Active'

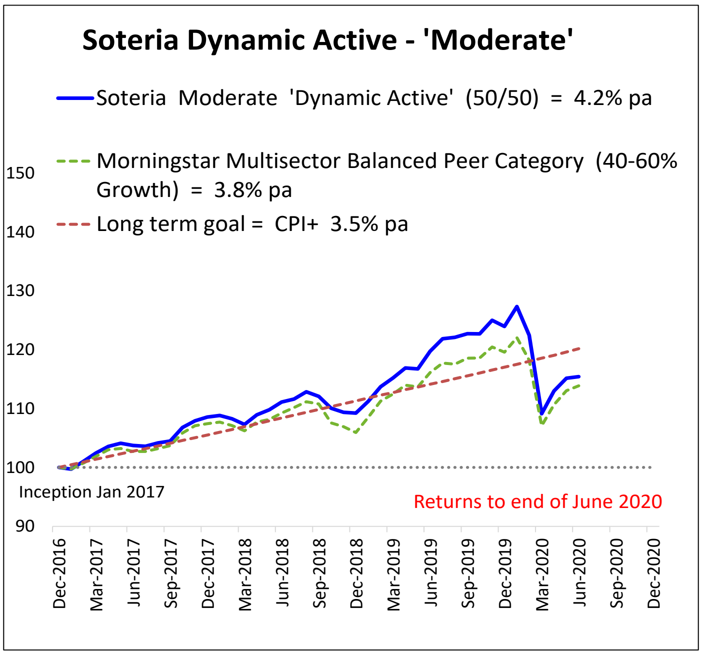
Model	Conservative	Moderate	Balanced	Growth	High Growth
'Neutral' growth defensive mix	30/70	50/50	65/35	80/20	95/5
Current growth defensive mix	27/73	43/57	56/44	66/34	82/18
Long term CPI+ goal	CPI +3%	CPI +3.5%	CPI +4%	CPI +4.5%	CPI +5%
June month returns	+0.32%	+0.25%	+0.27%	+0.11%	+0.13%
June quarter returns	+4.20%	+5.77%	+7.09%	+7.32%	+8.67%

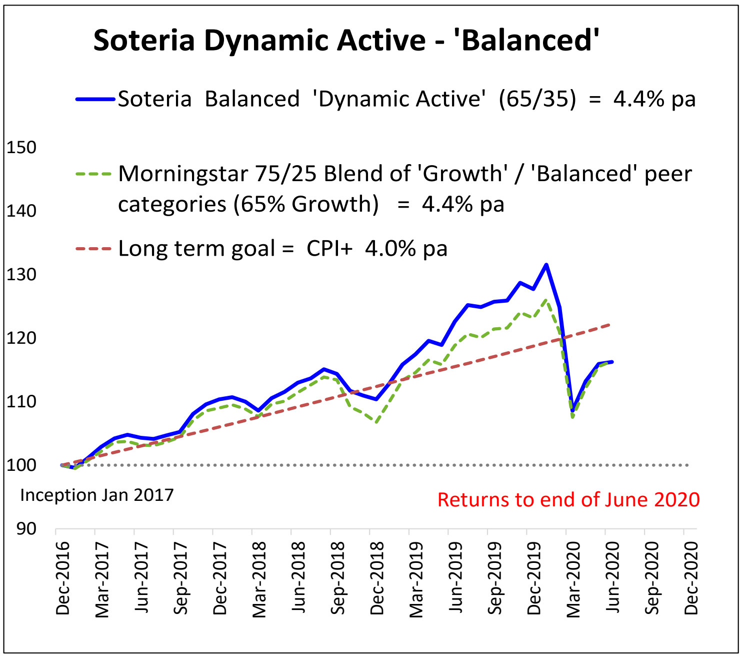
SOTERIA 'Dynamic Index'

Model	Conservative	Moderate	Balanced	Growth	High Growth
'Neutral' growth defensive mix	30/70	50/50	65/35	80/20	95/5
Current growth defensive mix	27/73	44/56	57/43	69/31	82/18
Long term CPI+ goal	CPI +3%	CPI +3.5%	CPI +4%	CPI +4.5%	CPI +5%
June month returns	+0.54%	+0.50%	+0.51%	+0.42%	+0.48%
June quarter returns	+4.92%	+6.41%	+7.54%	+8.13%	+9.94%

The next two charts show total returns (ie including re-invested income, and after fees) from our most popular portfolios 'Moderate' and 'Balanced' – since their inception at the start of 2017. (We offer a full range from 'Conservative' through to 'High Growth', and each of these have two types – '*Dynamic Active'* – which include passive index funds and active managed funds; and '*Dynamic Index*' – which use index funds only - but most of the investors' funds are in Moderate or Balanced '*Dynamic Active*' portfolios).

The dark blue line shows the cumulative portfolio returns over time. The red dotted line shows each portfolio's long term goal for returns above the rate of inflation. These are the main long term goals for each portfolio, and the actual portfolio returns will oscillate around these total return targets from time to time – for example during this year's coronavirus crisis.





The green dotted line on each chart shows the average returns from all 660+ diversified multi-sector funds currently available to retail investors in Australia (as measured and reported by Morningstar, which the largest independent fund research house in Australia and in the world). We measure each of our portfolios against the category of peer diversified funds that have similar mixes of growth and defensive assets.

During most periods our portfolios have been ahead of their peer fund category averages and near the top of each category. Returns from our portfolios will vary from time to time of course, and so will the relative performance against these peer fund categories, but our aim is to offer the best mix of returns and reliability for our investors to achieve their long term financial and life goals within their tolerance for risk and volatility.

2019-20 Financial Year returns in context

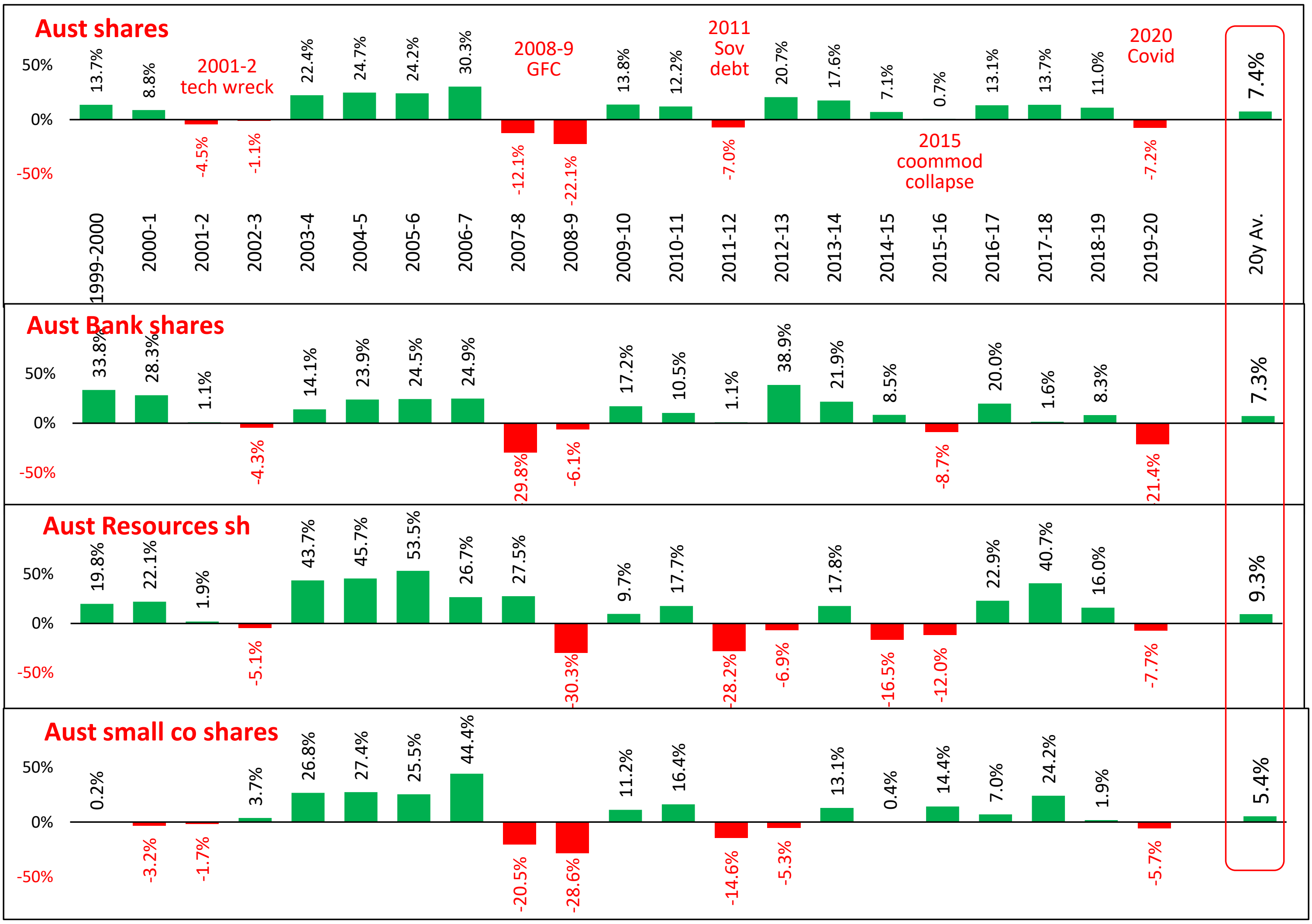
As June marks the end of another financial year, we review returns from the major investment asset classes over the past few cycles.

The 2019-20 financial year was a poor year across the board for diversified investors as each of the major asset classes posted lower than historical average returns. 'Risk' assets like shares and property were hit by the sharp coronavirus sell-off in February-March 2020, from which most shares and bonds have not yet recovered. In the case of 'defensive' assets like cash, term deposits and bonds, the low returns for the year were due to ultra-low interest rates in Australia and across the world.

Bad years happen from time to time, but we need to look at this in context. Regular readers will recall previous editions of this report which noted that the calendar years 2012 to 2017 constituted an extraordinary run of 6 consecutive years of above average real returns from all of the main asset classes – something that had never happened before in history. We noted at the time that this was highly unlikely to continue. Calendar 2018 turned out to be a negative year thanks to the 'global growth scare' in the December quarter, but markets rebounded strongly in 2019 to over-priced levels once again. Something had to give, but what we didn't know was the trigger – the coronavirus shut-downs.

The charts below show total returns (price gains plus re-invested income) for each June financial year since 1999-2000. The bar to the far right in each chart shows the average compound annual total return over the past 20 years.

First, we look at Australian shares – for the broad market (top chart), and also the main segments popular with investors – banks, resources, and small companies. On the whole, Australian shares posted their worst financial year return since the GFC, just pipping 2011-2.



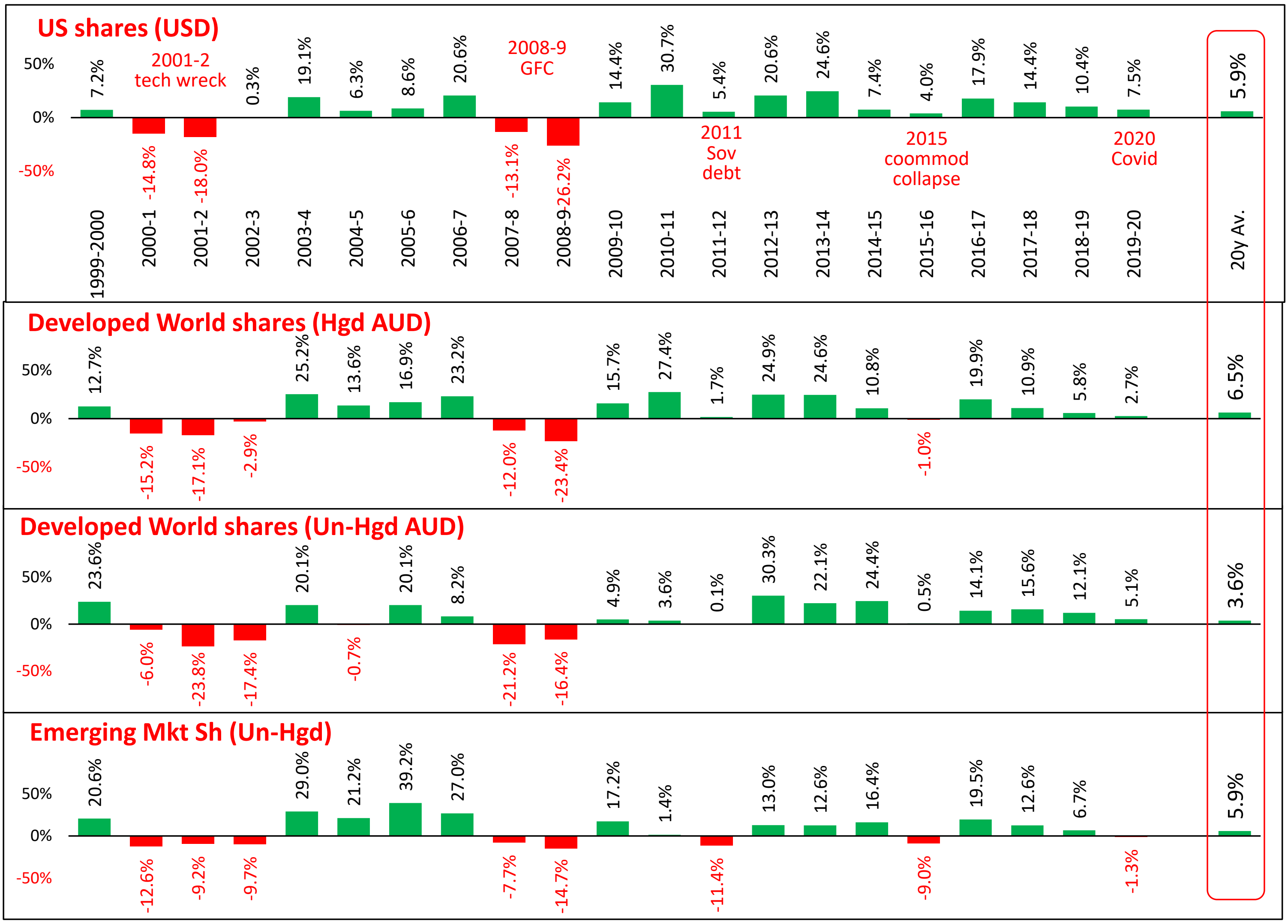
The biggest drag on the market for the latest year was the banks (2nd chart). Three of the big-4 banks down by one third. CBA was the best (down 16%), and Macquarie was down 5%. In several editions over the past couple of years we have said that the big-4 banks were vastly over-priced given their problems, and they would only be 'fair' value if their share prices were about one third lower. This has now occurred.

The big miners also lagged the broad market but by less than the banks. Fortescue was the star (up +53%) thanks to the surging iron ore price after the mine disasters in Brazil. BHP was down 13% and RIO down 6% on collapsing prices of coal, oil and most industrial metals in the global slowdown. The right bar on the Resources chart shows how they have beaten the banks and also the broad market over 20 years by a margin of +2% per year.

Small companies are speculators' perennial favourites but they are also perennial disappointments on the whole. This year some small stocks did well, riding the global shift to e-commerce and on online services, which has been accelerated by the coronavirus shutdowns.

International shares had a better year than Australian shares. The first chart below shows the US market (in US dollars, as that is what makes the media headlines). However, US shares lagged Australian shares over the 20-year period, mainly because they were harder hit by the 2001-2 'tech wreck'. The late 1990s 'dot com' boom was far more manic in the US than here, and so the US crash was much deeper.

The US was one of the few positive markets in the past year. US shares returned +7% for the year, mainly due to strong gains by 'big tech': Apple +84%, Microsoft +52%. Amazon +45%, Alphabet (Google) +31%, Intel +25%, Adobe +48%, Netflix +24%, Facebook +17%, Nvidia +140%. In contrast, 'big oil' stocks were down heavily: Exxon-Mobil and Chevron down -42% and -64% with the oil price collapsing -32%.



Below the US chart above we have 'developed' markets shares (US is more than half of the total, with the rest comprising Europe, Japan, UK, Canada NZ, etc). International shares come in two flavours: hedged and un-hedged Australian dollars. The difference in returns each year depends on whether the AUD rises or falls and also on differences in interest rates between Australian and the other countries. Overall hedged has beaten un-hedged over the 20 years, but un-hedged won over the past year as the AUD weakened against the main currencies.

'Emerging' markets have performed relatively poorly over the past 20 years and also the past year – although better than Australia. 70% of 'emerging markets' stocks are in Asia, and half of those are Chinese. Over the long term emerging markets shares have disappointed overall, with greater volatility and more negative years than developed markets shares. Over the past year the emerging markets sector was lifted by the two Chinese online giants: Tencent +41% and Alibaba +27%, both benefiting from the coronavirus lockdowns. Also up strongly were Taiwan Semiconductor +31% and Samsung Electronics +12% (Korea).

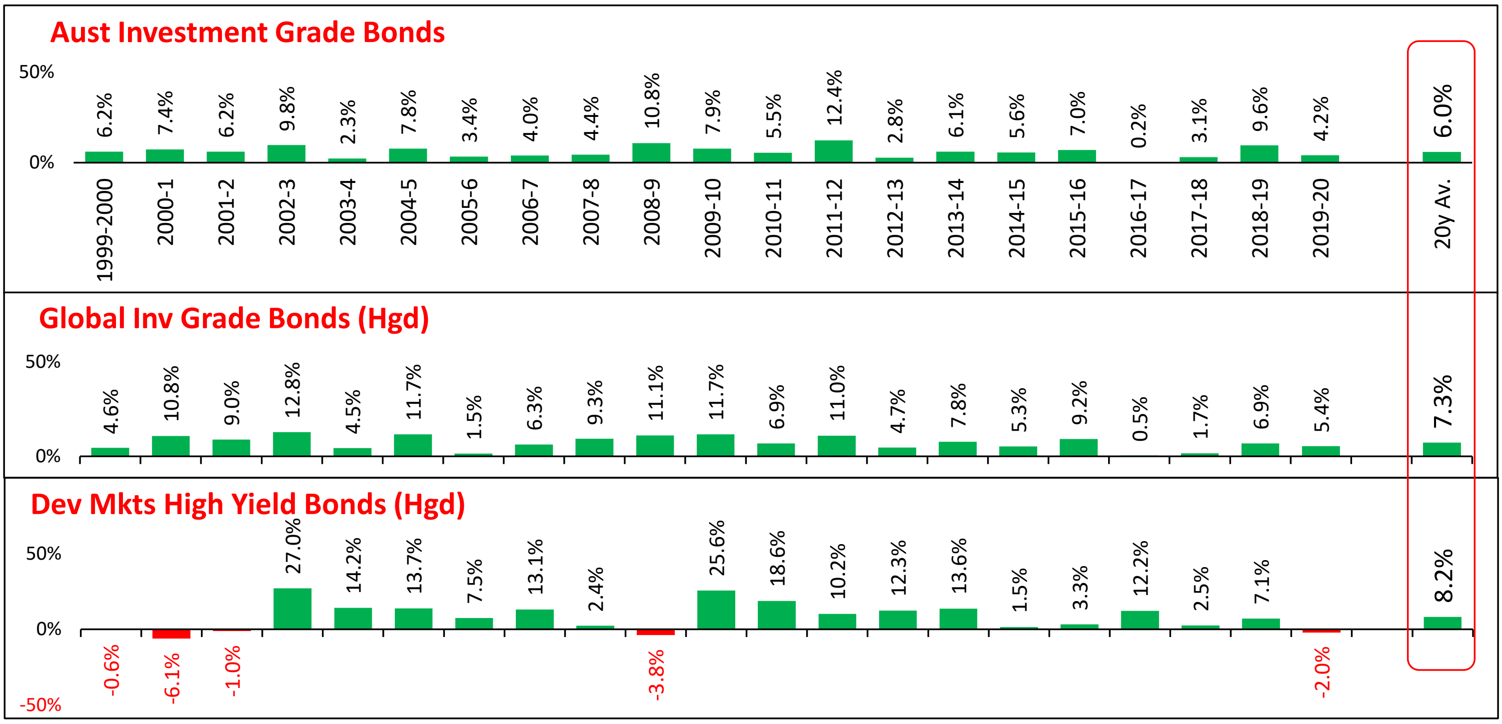
One thing that stands out from the above two sets of charts for Australian and global shares is that the last 12 months has been rather mild on share markets compared to the past two major recession sell-offs – the 2001-2 'tech wreck' and the 2008-9 'GFC'. Those were very mild economic contractions compared to the current much deeper coronavirus contraction, but share prices on both occasions suffered much deeper and longer set-backs than we have seen in the current coronavirus crisis thus far. Part of the difference is the monetary and fiscal support measures have been much larger and more extensive this time around, but even these extraordinary stimulus measures will probably not be enough to prevent company profits and dividends being cut by as much as they were in the tech wreck and the GFC.

A second observation from the charts is that local and global share markets have generated rather modest returns over this reasonably long period of 20 years. One would have thought that 20 years was long enough to ride out the occasional crisis sell-off, but it hasn't. There is a lot of red ink on these charts, despite the fact that the world has experienced a tremendous period of peace and prosperity during the period.

Next are 'defensive assets', so labelled because of their returns come mainly from regular income rather than capital gains.

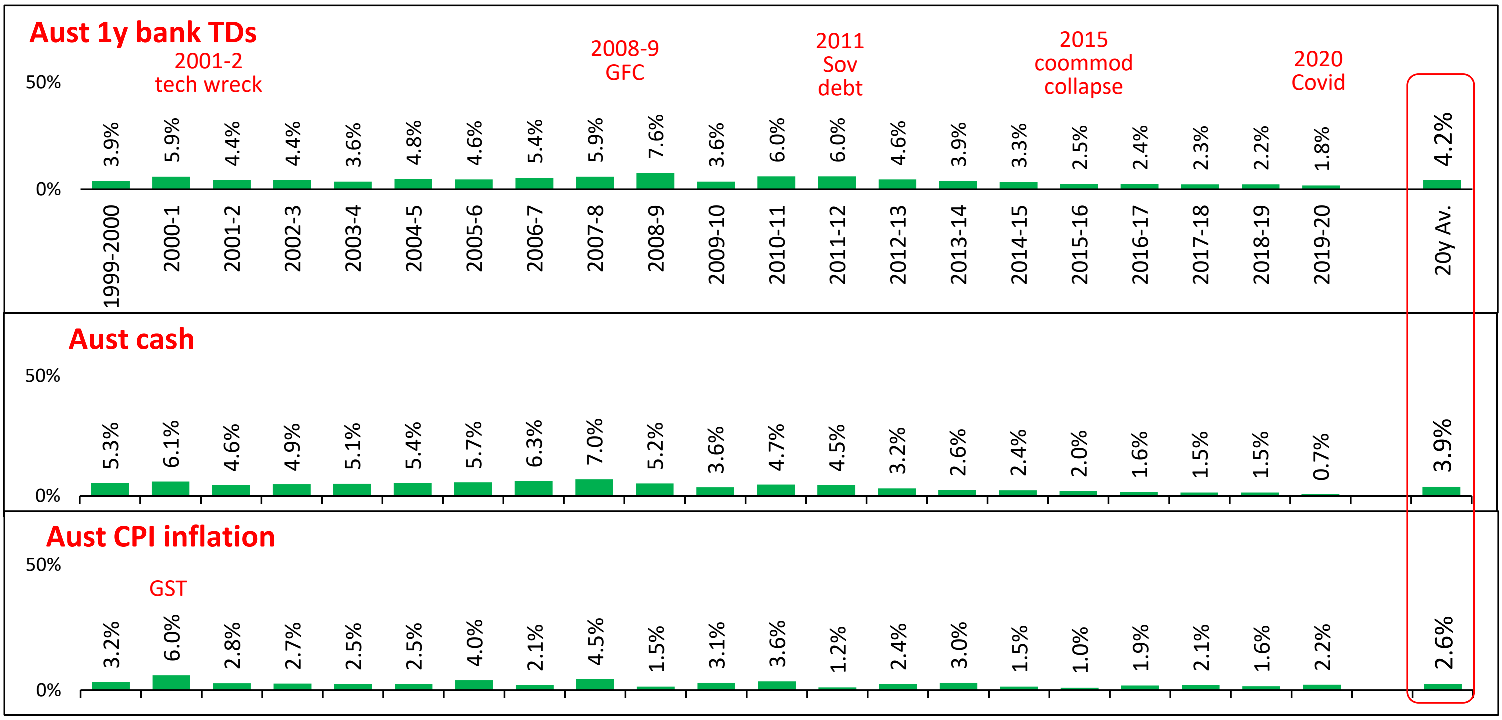
Australian investment grade bonds (top chart) have lagged global investment grade bonds (middle chart below) for two main reasons. First, global bond markets contain a greater share of corporate bonds and these have higher interest rates than government bonds which dominate the Australian bond market. Second, global bonds benefit from a 'currency hedge return' generated by hedging back into Australian dollars because interest rates have almost always been higher in Australia than in the main global markets. This hedge return for Australian investors has averaged around 3% per year over the past 20 years, but this has disappeared now that Australian interest rates are near zero like the rest of the world.

The third chart below shows global 'high yield' bonds. These bonds are rated below 'investment grade' by the major credit rating agencies. Their higher yield contributes to higher income returns than investment grade bonds, but they are also more volatile. The chart shows that they suffered negative returns in 5 years during the period, including the latest year, after they sold off heavily in the coronavirus crisis.



One remarkable aspect of the bond charts above is that the overall average total returns from bonds has been similar to the returns from shares over the period, but with much lower volatility. Investment grade bonds generated relatively smooth returns with no loss years (the last loss year for high grade bonds was 1994). This is mainly due to higher interest rates in the early years, and the fact that interest rates (and inflation) have declined over the period. This trend will not continue at the same rate, and so fixed rate bonds are not likely to match share returns in future as they have in recent decades.

Next are returns from bank term deposits and cash, and the bottom chart shows Australian inflation rates over the period.



These charts show the remarkable decline in interest paid on cash and term deposits over the period, but this has *not* been due to a decline in inflation. The CPI inflation rate in Australia was around 3% twenty years ago (ignoring the 6% figure in 2000-1 that was caused by the one-off introduction of the 10% GST), but inflation is still running at 2% today. Although inflation has remained around flat for the period, cash and TD rates have collapsed from 6+% to near zero now.

The interest rates received on cash and term deposits were traditionally higher than the inflation rate, so even holding cash kept savers ahead of inflation, before tax at least. Now cash and TD rates pay virtually zero, the returns are not even enough to keep up with inflation.

This attack on savings is the result of the radical central bank monetary policies since the GFC – a combination of zero/negative interest rates to depress short term rates, and 'QE' (quantitative easing) asset buying to depress long term rates. The RBA has also now returned to 1950s-style interest rate pegging to keep rates at artificially low levels. These extraordinary monetary policies since the GFC deliberately set out to punish savers and reward and encourage borrowers and spenders, and also to create inflation. Why? Because borrowing and spending leads to jobs, at least in the short-medium term. Inflation is effectively a transfer of wealth from savers to borrowers because it allows borrowers to repay their debts to the savers with devalued future dollars. Governments like inflation because it encourages spending (jobs) and it allows them to pay off government debts with devalued future money.

These radical monetary policies since the GFC led to a massive build-up of debt in Australia and around the world, across all sectors – governments, corporates and households, which in turn made the world more vulnerable to external shocks like the coronavirus shutdowns. Now after the coronavirus crisis, monetary and fiscal (deficits) policies are even more radical and extensive than ever before, and they are expressly aimed at encouraging even more debt. That's just what the world needs – more debt!

Later in this edition we look at how investors can maintain their levels of income in a world where interest rates have collapsed in the central banks' war on savers.

But first we check progress on the coronavirus, as that is what is driving the shutdowns that are crippling economic activity, and in turn driving the unprecedented fiscal and monetary policy responses.

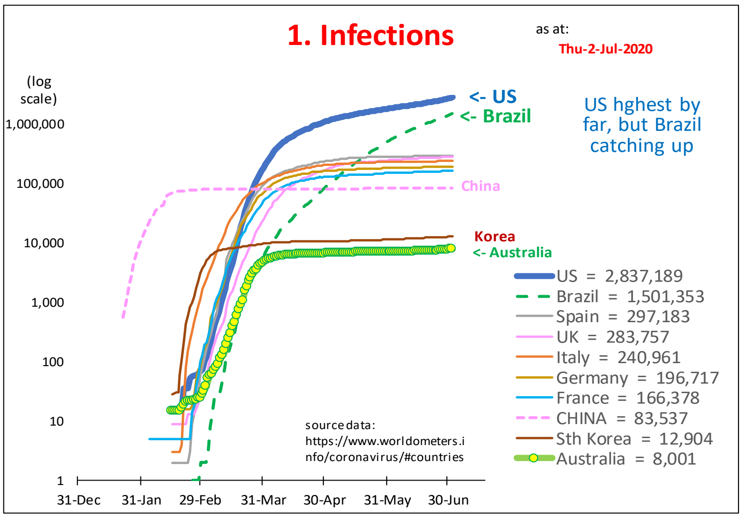
Coronavirus Update – second waves appearing after restrictions eased

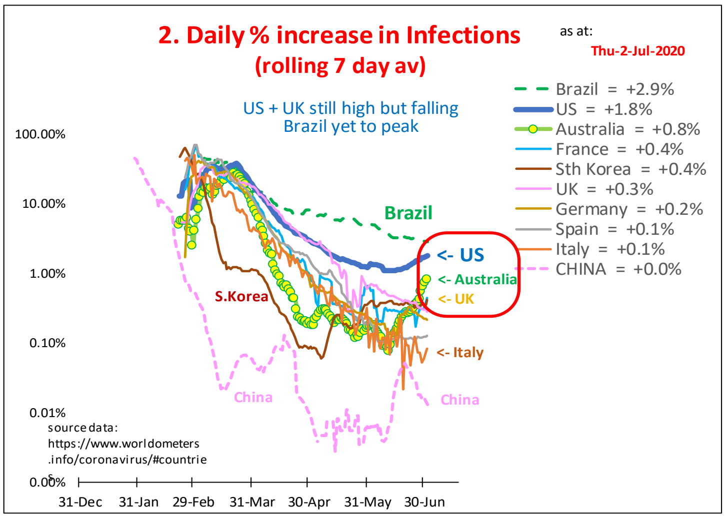
Global infections have now top 11 million, with 5 million of these coming in the past month. The death toll now exceeds 500,000, of which 135,000 were in the past month. The rates of new infections in aggregate are still climbing, and are running at about 200,000 new cases per day (up from 110,000 new infection cases per day a month ago). On the other hand, the rate of fatalities appears to have peaked in mid-April at 7,500 deaths per day, and is now down to around 5,000 deaths per day - but this is now on the rise again.

Over the past month, restrictions have gradually been lifted around the world and that has led to increases ('second waves') of new infections in most countries. This includes Australia, although the numbers are still relatively small here. Due to time lags between infection and death, the fatality rates have not yet started to rise again – but this may occur over the next month. It is possible that the second waves of infections will not automatically be followed by corresponding second waves of fatalities because in most countries the second wave of infections has been in younger people than the first wave, and the rate of fatality is much lower for younger patients.

While 'developed' countries (and China) now into second waves, the crisis is still in its first wave in many less developed countries where health systems are less equipped, social distancing is less practical, and reporting is more likely to be slower and less comprehensive.

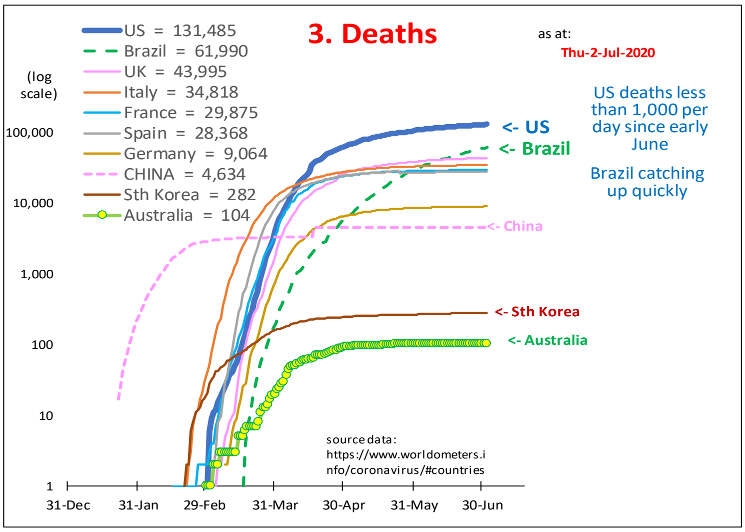
Here are updates on four key charts we use to track progress. Chart 1 shows the numbers of infections in various countries over time; chart 2 shows the daily growth rates of infections. China was the first to experience mass infections (January), the first to undertake radical and comprehensive shut-downs (February), the first to see the infection curve flatten (left chart) and the growth rate fall to near zero (right). It was also the first to start easing the restrictions, although these were followed by second waves and second rounds of restrictions.

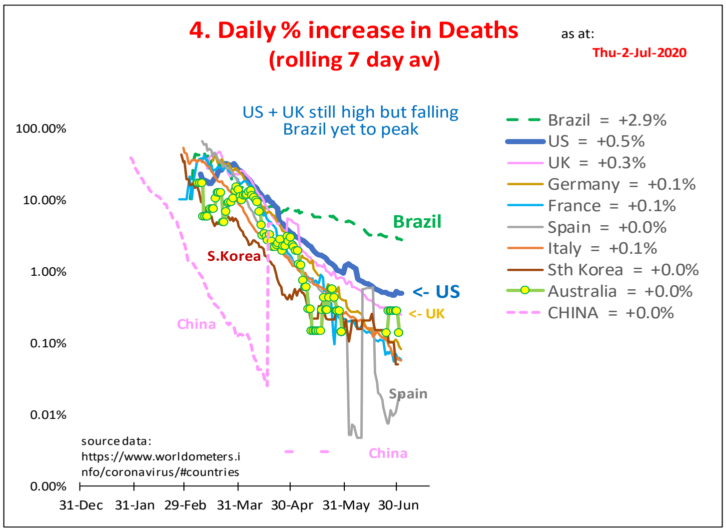




The above charts show how the US was a reluctant late mover in recognizing the problem and then in taking radical shut-down action. As a result it shot up rapidly to the highest numbers of infections (left chart) and growth rate in infections has spiked up again to more than 50,000 new infections per day (right). The US is the key for investors as it is the largest economy and it dominates global investment markets. The right chart above highlights the second wave appearing in the US and many other countries including Australia.

Charts 3 and 4 show the same statistics for deaths from the virus. The US took the lead in mid-April but Brazil is fast catching up.





In Australia the rate of new infections peaked on 29 March and the death rate peaked on 6 April (similar timing to Germany and France).

Although there is always a threat of second and third waves, it appears that early dire predictions by reputable bodies of millions of deaths may not be realised – at least not in 'developed' countries. However, the virus is only just starting to take hold in more densely populated, less developed countries with less extensive health care systems, and the US remains a worry.

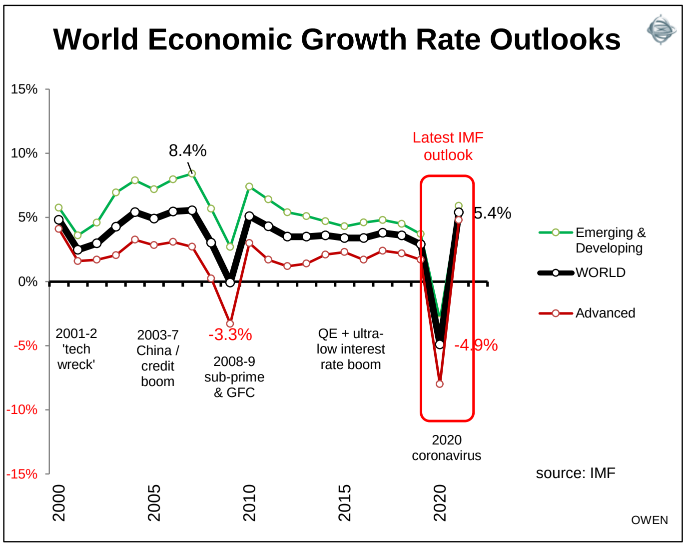
Economic growth outlooks deteriorate – but keep your eye on the pie!

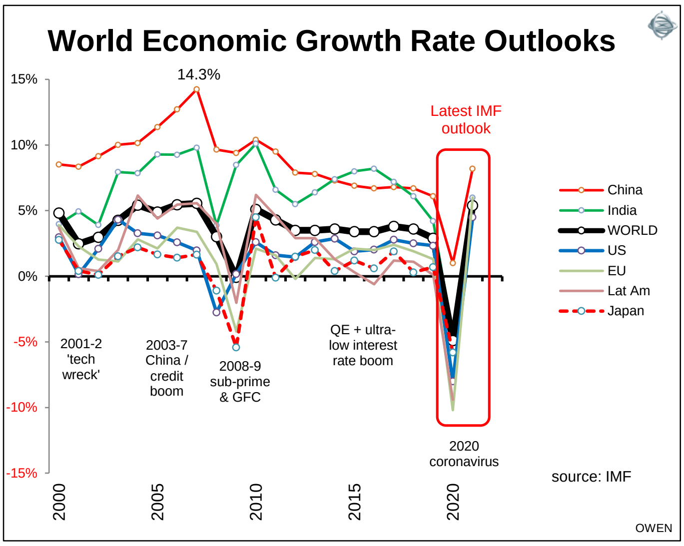
What drives company share prices is investor perception about the likely future prospects for company revenues, profits and dividends. Most companies only report on their activities every few months or so, but share prices jump around, often wildly, every minute of every trading day. Why is this? Long term investors like us only buy or sell shares very rarely, so it is not us that is driving the daily weekly, monthly or even quarterly gyrations in share prices. What drives the short term price gyrations is the frenzied buying and selling activities of short term traders and speculators. In the absence of any factual data on what each company is actually doing, what drives their buying and selling is their changing perceptions about possible impacts on company revenues, profits and dividends of changes in the economic environment.

When traders get spooked by an unexpected bad economic number – they immediately dump everything on the assumption that every company will be hurt, regardless of what each company might actually be doing. Conversely, when an unexpected good number comes out, everything jumps in price. The biggest 'macro' economic number of all is the growth rate of the entire economic pie – 'GDP' (gross domestic product, which is measured by either total output, total incomes or total spending) – of the major countries and the world in total.

As the virus-related shut-downs bite into economic activity, economic bodies around the world have been downgrading their outlooks for economic growth. In the last week of June the International Monetary Fund (IMF) was the latest with its doomy predictions, downgrading global growth forecasts for 2020 from -3.0% contraction in its April outlook to a more bearish -4.9%. It also downgraded its rebound forecast for 2021 from +5.8% to +5.4%, so it is expecting the contraction in economic activity to be deeper and longer than it thought in its April 2020 report. A 1% change in world GDP represents $1.4 trillion in aggregate output, incomes and spending – prime targets for companies.

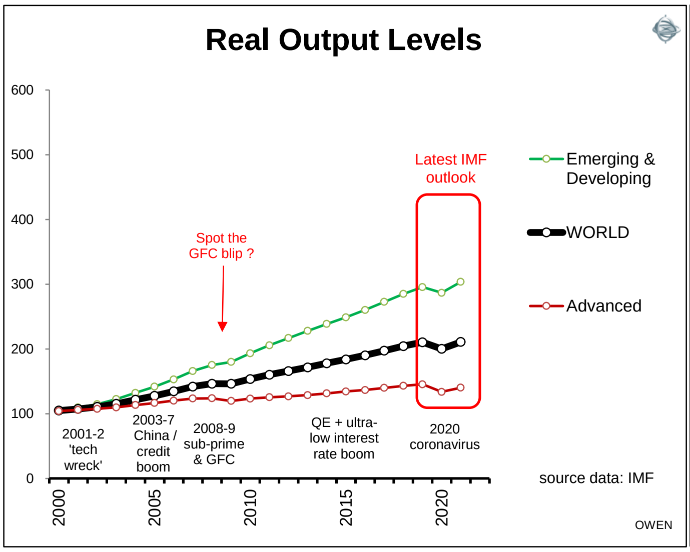
The first pair of charts summarise the latest set of economic growth outlooks from the IMF. The left chart shows growth rates for 'advanced' economies (red), 'emerging' economies (green) and the world total (black), and the right chart highlights some of the key countries.

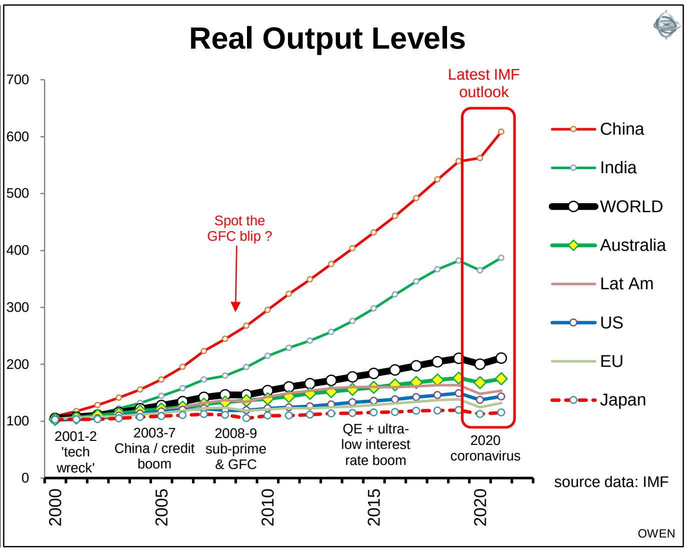




The first thing that stands out is that the contraction in 2020 is expected to be much more severe than the last two recessions – the 2008-9 GFC and the 2001-2 'tech wreck'. Second, the rebound in 2021 is expected to result in growth rates well above the growth rates experienced over the past decade. This is because they are starting from the low 2020 base.

The next pair of charts show economic activity not by the rate of growth each year but as aggregate levels of activity over time:

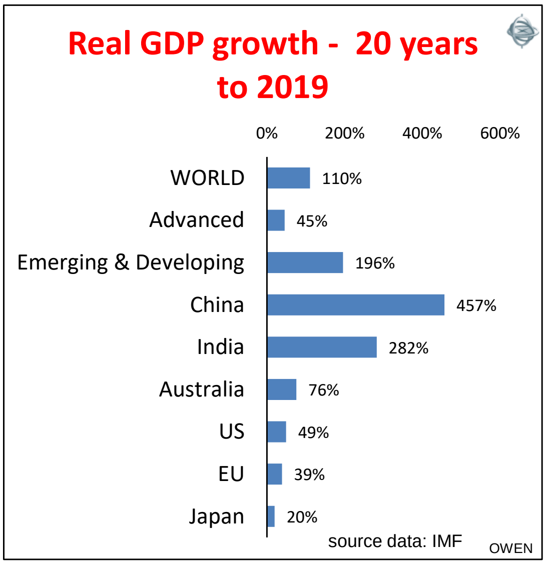




Because the expected 2021 rebound is starting off a low base in 2020, total world economic activity is still expected to rebound to 2019 levels by the end of 2021, but most of the heavily lifting done will be done by China, India and ASEAN countries. The developed countries are expected to be still well behind even after the expected 2021 rebound. (Looking at the above charts it takes a keen eye to spot the GFC dip in total output – which was supposedly the most serious economic recession since the 1930s!)

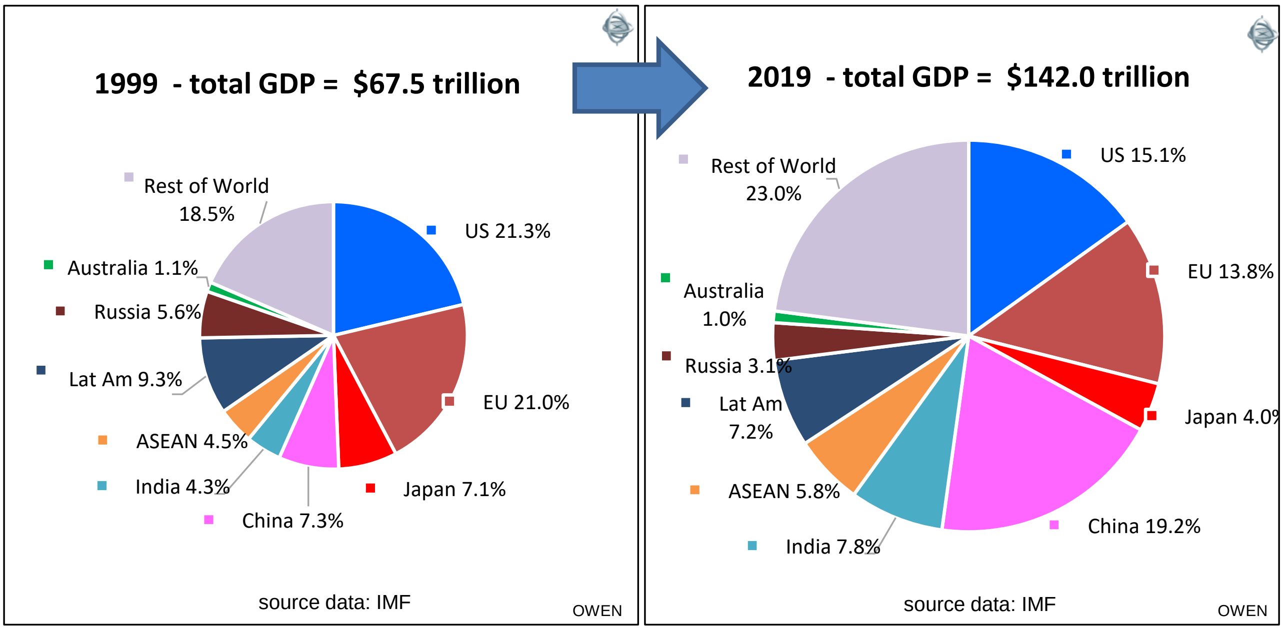
These latest IMF forecasts represent the 'bearish' case for investors – that economic activity in the developed world will remain well below 2019 levels for at least into 2022 and perhaps longer. In contrast, the recent rebound in share markets represents a rather 'bullish' case that assumes profits and dividends rebound much more rapidly.

The second pair of charts above provides a clue to the bigger picture – and that is that the total economic pie has grown enormously over the period, despite the occasional sharp setbacks along the way. The next chart shows how the total economic pie has grown over the past 20 years (not annualised but total aggregate growth in real terms after inflation).



Aggregate world economic activity – ie total production, incomes and spending – have more than doubled (+110%) in the 20 years to 2019. 'Developed' economies have grown by +45%, but 'emerging' economies have trebled in size, mainly because Chinese activity has grown more than 4-fold, and India nearly 3-fold over the period.

This is how the size of the world economic pie has grown over the past 20 years (adjusted for inflation, in today's dollars).



Slower growth 'old world markets' like the US and Europe have seen their shares of the world pie reduce but their economies have still grown. Some countries have remained stagnant – Japan, Russia and Italy, and this is the big risk facing the rest of Europe in future.

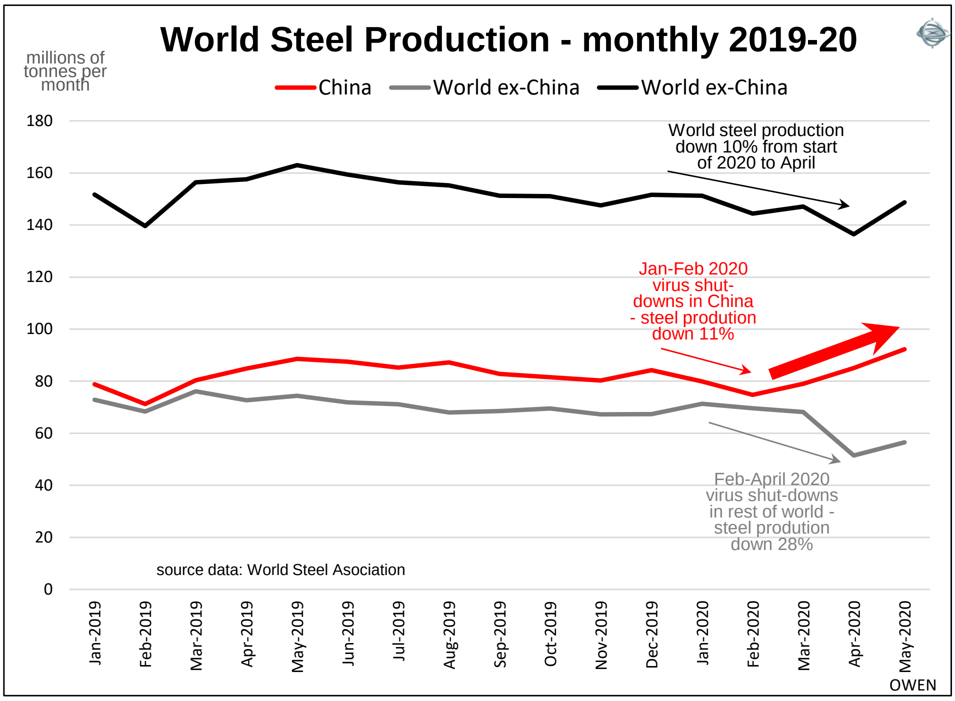
Long term investors should focus on the size of the pie over time rather than growth rates from year to year because the total economic pie represents aggregate revenues, profits and dividends from companies we invest in through our portfolios.

China has been the largest foreign source of foreign exports, dividends and tax revenues for Australia over the past 20 years, and it will probably remain that way for some time. Next we look at one aspect of Chinese activity with large direct and indirect impact on Australia.

Chinese steel production booming – good news for Australia

While virtually all of the economic numbers coming out of China are contracting sharply, the one bright spot is steel production, and so Australia's exports of rocks to China are booming. This flows through to mining dividends and also into government tax revenues.

By the time you finish reading this story, China will have produced another 'Sydney Harbour Bridge' worth of steel – using iron ore and coking coal imported mainly from Australia – as we shall see in a moment. The first chart shows monthly world steel production from the start of 2019 to the end of May 2020 – for China (red line), the rest of the world (grey), and total (black).

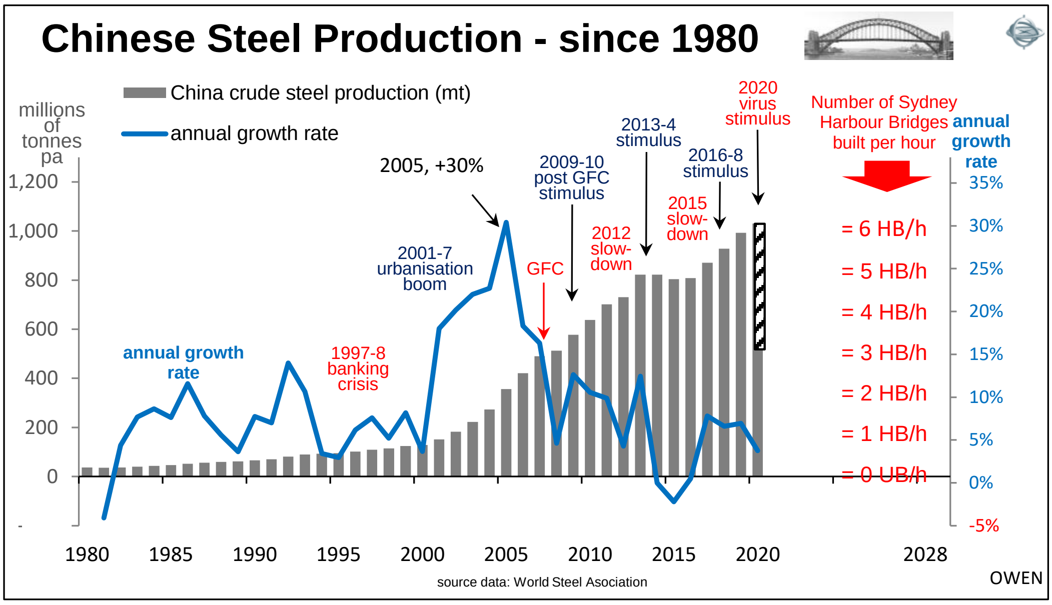


The virus-related shut-downs cut world steel production by 10% in the first four months of 2020 – from 152 million tonnes of steel in December 2019 to 136 million tonnes in April, but there were two clear stages.

China's shut-downs early in the year resulted in a 10% decline in Chinese steel production during January and February, while the rest of the world remained strong. Then the virus hit the rest of the world and shutdowns in March and April resulted in a 28% drop in steel production outside China.

Although demand and industrial production in China have contracted sharply, the Chinese government has ramped up infrastructure spending dramatically to fill the gap to support jobs and wages for the workers. We can see the result in the strong growth in Chinese steel production in March, April and May. The current stimulus boost will mean that China is on track to produce more than 1 billion tonnes of steel this year for the first time ever.

The next chart shows China's steel production since 1980. The grey bars show steel production in millions of tonnes per year, and the blue line shows the annual growth rate. China's industrialisation, urbanisation and export booms accelerated after its entry into the World Trade Organisation in 2001. We can see this in the dramatic growth in steel production between 2001 and the GFC. The chart shows the increases in steel production resulting from massive state-directed stimulus programs to counter each slowdown - the 2009-10 stimulus after the GFC, the 2013-4 stimulus after the 2012 slowdown, and the 2016-7 stimulus after the 2015 slowdown.



State-directed infrastructure stimulus programs are once again the go-to strategy for the Chinese government to shore up jobs and prevent unrest.

These vast amounts of steel are hard to comprehend so I think of it in terms of something we can all relate to. The Sydney Harbour Bridge was made from 38,000 tonnes of steel (mostly imported from Britain). It took 8 years to build and was opened in 1932 in the depths of the 1930s depression.

China producing 1 billion tonnes of steel this year is the equivalent of building 6 Sydney Harbour Bridges *per hour* – every hour, 12 hours per day, 365 days per year. *That's one Harbour Bridge worth of steel produced every 10 minutes*. Australia is by far the largest supplier of low-cost iron ore and coking coal to China.

The Chinese government has been actively trying to diversify its import sources to reduce its reliance on Australia, but Australia faces very little competition on this front for the foreseeable future. This is likely to be the case even after the eventual lifting of virus-related port restrictions that are disrupting exports of iron ore from Brazil and coal from South Africa.

Where do we go for income?

The story about asset class returns highlights the steady decline in interest rates over the past couple of decades. 'Risk-free' government-guaranteed deposits pay between zero and around 1% depending on the term. So-called 'risk-free' government bonds also have yields of around 1-2%. Even the best of these is not enough to cover the crippling effects of inflation (which governments and central banks everywhere are doing everything they can think of to *increase*), and so investors need to look further afield just to keep up with inflation and to maintain their level of income.

To do so we need to go back to basics. There are two main types of investments in the world –

- '**equity'** (which is ownership or part-ownership of assets like businesses or real estate, either directly or via unlisted or listed shares); and
- '**debt'** (where you have a contractual right to receive interest during the loan contract and then the principal sum at the end of the term, but you have no ownership in the underlying business that is borrowing from you, unless they default on the debt)

Interest rates on all types of debt investments (bank deposits, government and corporate bonds, debentures, mortgage funds, etc) – have fallen steadily over the past 30 years partly because of the decline in inflation, but mostly due to the deliberate policy of governments and central banks since the GFC to punish savers and encourage and reward borrowers and spenders, and to deliberately try to create inflation.

The problem for savers is that as the interest rates on all types of debt have declined over time, savers need to take on much more risk just to maintain a given level of interest income. Ten years ago, 3-year government-guaranteed bank term deposits paid 7% and ordinary bank savings accounts paid 5%, while inflation was 3%. Today, inflation is still 2% but bank accounts pay 0% and term deposit rates are barely 1%. It is still possible to obtain the same 7% we got from TDs 10 years ago, but we need to take a lot of risk.

To give you an idea of the level of risk required to obtain a yield of 7% on debt: ten-year Greek government bonds are yielding just 1.2% today. Greece is almost certainly going to have to default and restructure its debts (again!) which would probably involve loss of at least 1/3 to 1/2 of the principal (again). So to obtain a target yield of say 7% on a bond, you would need to take on about 5 times the risk of lending to the bankrupt Greek government which has an almost certainty of at least a partial loss of capital.

One way is high yield mortgage funds. As the banks have stopped lending this year, my inbox has been flooded with emails from property development finance companies offering around 7% for 'bricks & mortar' security. The risk is you are left as a low-ranking creditor to a $2 shelf company controlled by a bankrupt developer, and the 'bricks & mortar' security is just a hole in the ground or a half-finished or boarded-up block of flats or commercial property in a second rate suburban wasteland. (I made that sound so enticing – where do I sign?)

Another way is in high yield corporate debt. The highest rated companies can borrow at interest rates of around 1% but low-grade companies borrow at much higher rates to reflect their higher risk of default. For example - in November 2019 Virgin Airlines raised $325m from retail investors in low ranking unsecured bonds listed on the ASX. The bonds promised a healthy 8% yield. The bonds were sold to retail investors by marketing agents (like FIIG) that were paid sales commissions, but dressed up as 'advice'. The business was in trouble long before the coronavirus. It *lost* an average of $200m per year over the past decade – and then the coronavirus hit. The retail bond holders lost the lot, along with the shareholders, as the higher ranking creditors take what good assets there are left.

These are examples of individual assets or businesses failing. Investors can reduce the impact of an individual failure by diversifying across dozens of different risks – either directly investing in dozens of debt securities, or by using a diversified fund. These can still have problems. There are plenty of fancy-sounding funds promising 'term deposit-like' returns that invest in several different assets or businesses, but many still collapse – like 'Mayfair 101' and 'IPO Wealth' this year. Readers would recall collapses in the last property slowdown – including Westpoint, Fincorp, Australian Capital Reserve, Elderslie, MFS, Banksia, Wickham, LM, Gippsland Securities. All offered 'bricks & mortar' security and targeted yield-chasing retail investors ('*You can't lose money on bricks & mortar!*'). They were 'diversified' across many ventures but they were concentrated in one industry. We are probably going to see a lot more of these types of collapses in the coming year.

In our portfolios we use bond funds but they are truly diversified into many hundreds of different borrowers across a very broad range of industries, sectors and countries. They are closely monitored and managed by professionals, who are not merely paid marketing agents for the borrowers. These are the funds shown in the charts in the above story about investment returns over the past 20 years.

In between 'debt' and 'equity' there are 'hybrids' which are neither debt nor equity. Because of the risks they need to offer high yields. Like all investments it is much better to hold them in a professionally-managed, diversified fund. We have covered these in previous editions.

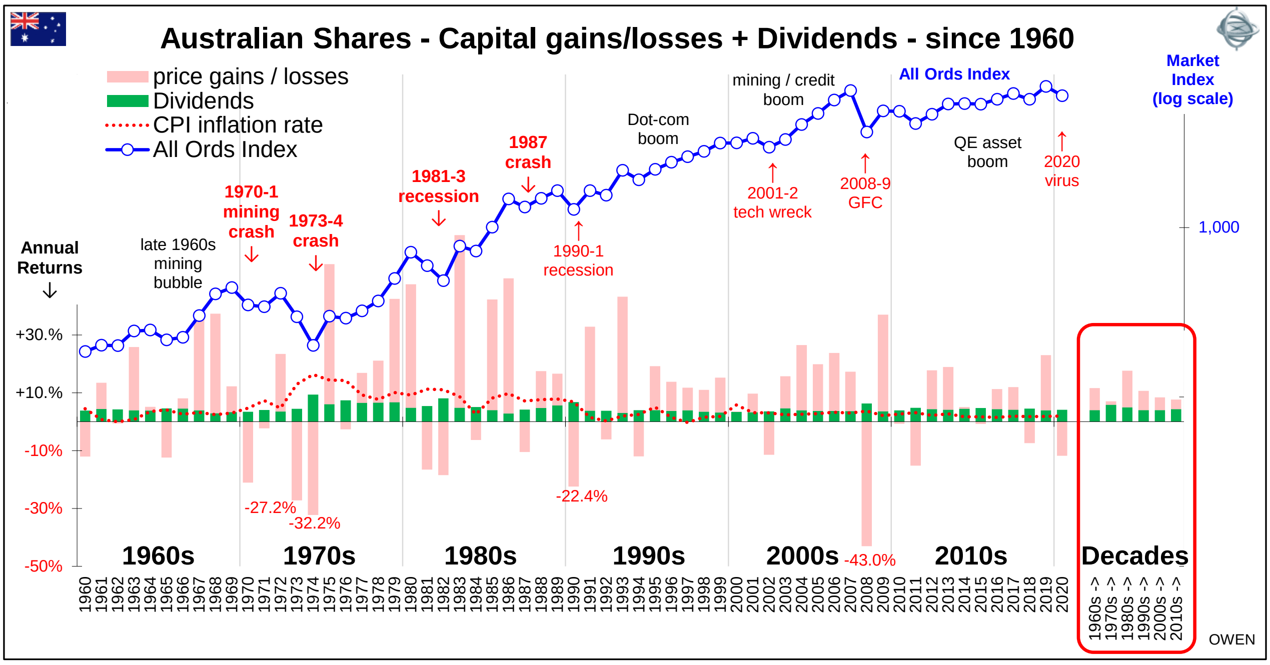
While debt securities and funds have their place in portfolios, they are not what generates reliable income and growth for long term investors. All types of Debt have some inherent disadvantages for long term investors - the main problems are the variability of interest rates, the need to increase risk to maintain income, the lack of tax benefits, lack of any growth potential, and lack of inflation hedge.

The good news is that dividend income yields from Australian and international shares have *not* decreased significantly in recent decades and this is likely to continue to be the case in future. Dividends fall in recessions and slowdowns, but not as much as cash rates have fallen.

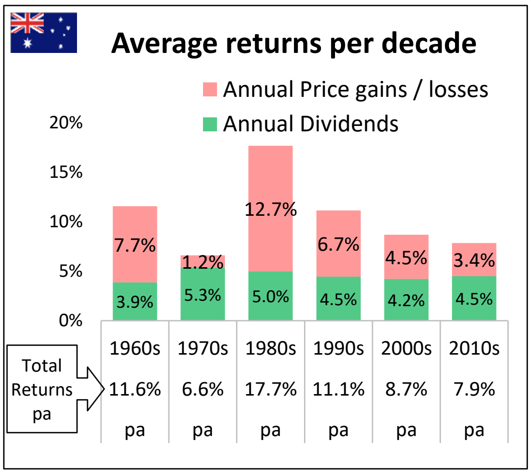
Shares come with added risks of course. The impact of individual companies collapsing can be largely eliminated by using broadly diversified funds, as we do in our portfolios. There is also share price volatility, but that can also be reduced by having other types of assets alongside them in portfolios – which we also do here.

Dividends from Australian shares

The next chart shows returns from the broad Australian share market over the past 60 years, highlighting the sources of total return each calendar year. 'Total returns' are a combination of price gains or losses, plus dividend income. The green bars in the lower section show the dividend yield each year and the pink bars show the change in the share price index each year. The price movements (pink bars) are very volatile from year to year – for example the -43% price drop in 2008 (GFC), and -32% in 1974 (credit squeeze and property/finance crash).



While the wild share price index moves make great media headlines, and they are important for short term traders and speculators, they are not important for diversified investors unless you have to sell. For long term investors like us, dividends pay the bills, not share price gyrations. The green bars show that the returns from dividend yields from the broad share market have been relatively consistent over time despite inflation (red dotted line) swinging wildly – up to 17% in 1975 and down to 0% and even briefly negative in 1962 and 1997.



The average returns per decade are highlighted at the right of the above chart, and these are expanded in the chart to the left.

Dividend yields were slightly higher in the 1970s, and that was also when inflation was highest. Yields were higher mainly because share prices were lower (inflation hurts share prices much more than it does dividends). Share prices then recovered strongly in the 1980s but dividend yields remained relatively constant, meaning the dollar amounts of dividends grew along with share prices.

Dividends do vary from year to year of course – companies increase dividends during booms but reduce them in slowdowns and recessions to preserve capital. Aggregate dividends across the Australian market have fallen by around 8% over the past year (mainly from the banks for reasons unrelated to the coronavirus shutdowns) and they are likely to fall by at least that much again as the shutdowns hit profits, but it will probably still leave returns from dividends near 4% over the coming year.

These above charts do not include the benefits of 'franking' credits for Australian owners of Australian shares. Franking credits (off-settable against other tax payable) were introduced from July 1987, and then refunds on franking credits were introduced from July 2000. This has added an average of +1.7% to yields since 1987 (it was +1.9% in 2019), bringing 'grossed-up' yields to above 6% for Australian residents.

<u>International shares – lower yields but also relatively stable over time</u>

Dividend yields in almost all other countries are lower than in Australia (for a variety of reasons, not just franking credits, as we have reported in previous editions), but they have also remained relatively stable over the past 30 years. US yields have remained relatively flat at around 2% in recent decades, but yields in some countries have actually risen in recent decades – including Japan, UK and Canada.

Australian and international shares form the core of our diversified portfolios, and these are expecting to yield around 6% (including franking credits) for Australia and around 2.5% for global shares, reasonably consistently in the coming years. In addition, our portfolios also contain small allocations to diversified commercial property and infrastructure - these also yield around 3-4%, with similar consistency.

Our diversified portfolios do hold varying amounts of cash and bonds from time to time, but the core shareholdings ('equities') are what generate long term income, inflation protection and real growth for long term investors.

What lies ahead?

For the past 12 years since the GFC the most important driver of investor sentiment and investment markets was central banks – led by the US Federal Reserve – how low they would send interest rates and how much new money they could print to buy up an ever-expanding array of assets that central banks had never bought before. Central banks wanted to prop up asset prices to protect real investors from losses, and they wanted to keep interest rates low to encourage already highly indebted governments, companies and households to borrow even more. All of this new debt just made the world more vulnerable to a real crisis when it hit.

Then the coronavirus hit and there are now three big factors in play. The first is the coronavirus itself. Each country is following its own path in a cycle of restrictions, easings, and then restrictions again if infection rates rise. The crisis has reminded us that some countries (like the US and Australia) are essentially just loose federations of States which can and do make their own rules and set their own path.

This cycle of waves of infections and restrictions may continue until a cure or vaccine is found – perhaps next year. The US is the largest investment market and the most important for global investors, and infection rates there have now re-spiked up to twice the level of the first wave in April. How Trump navigates the path to the election in November will be fascinating to observe – from a covid-safe distance!

The second key factor is government spending/borrowing. Formerly capitalist governments everywhere have now turned into welfare states in which they have become lenders, spenders, employers, and owners of last resort - to try to directly or indirectly ‘save’ jobs and votes. Investors will need to keep a close eye on how much governments can borrow before something pricks the confidence bubble. In Australia the Commonwealth was carrying a very low debt level of around $50b before the GFC. Then to counter the GFC it borrowed an average of $50b *per year* net for next 10 years, taking the level of debt to $560b before the virus hit. Since the virus shutdowns it is now borrowing around $35b *per month* to fund all of the welfare programs.

Australia has retained its rare AAA credit rating thus far, but this may change if debts blow out. The trick will be to turn off the welfare taps before investors lose confidence. Nearly all countries in the world (apart from Germany and India) are carrying much higher levels of debt now than they were a decade ago. Most at risk are highly indebted developing countries reliant on commodities and tourism.

That’s where the third factor kicks in – central banks. Since the GFC they have become buyers of last resort of government bonds, mortgage bonds, corporate bonds and even shares and property trusts (in the case of Japan). Our own RBA has spent $51b buying up government bonds since the March crisis. They say it’s tiny, but it is the same amount as the entire stock of government debt before the GFC! It is small relative to the US, Europe and Japan where central banks have dramatically increased their asset-buying programs since the March crisis.

Beyond the coronavirus lock-down / easing cycles - there are two bigger-picture themes that are developing – the first is the battle between orthodox economic policy (governments should repay their debts by raising taxes or cutting services) and ‘New Monetary Policy’, where governments can run big deficits forever by borrowing as much as they like in their own currency, then simply print new money to pay it off, rather than via taxes. Don’t laugh – it may soon be orthodoxy. There is no right or wrong – just different conditions for investors to navigate.

The second big theme is watching how the coronavirus crisis has accelerated some of the underlying themes already developing in the world – nationalism, protectionism, xenophobia, the decline of oil and the changing role of the Middle East, the rise of expansionist China (and perhaps an emboldened Europe) filling gaps left by US withdrawal from multi-lateral arenas, the cold war-style military build-up, and potential peripheral flare-ups with rogue states. These have significant implications for long term investors.

Meanwhile, in the coming months we will be keeping an eye on the virus numbers, as well as the unemployment numbers and loan arrears rates, and how governments react to them. The big question in the short term in Australia will be whether the government can turn off the welfare taps by September and also lift the ban on evictions and the temporary holidays on residential and commercial rents, and on mortgage repayments. Magically ending all of these policies smoothly by September will be a miracle.

Through this changing world, our portfolios remain on track to achieve their long-term goals for investors. We remain vigilant and ready to make further adjustments as conditions evolve, and we will keep you informed of developments and changes.

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