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Financial Advisers

Stanford Brown Monthly Top 5

February 2020

1 Coronavirus – thoughts for investors

Investors are naturally concerned about the spread of the 'novel coronavirus' (2019-nCoV) that was first reported in Wuhan, China in December 2019. At the end of January there were about 10,000 cases identified but it has been spreading at a rate of around 30% per day, and appears to have a mortality rate of about 2%. Many have compared it to the SARS outbreak in 2003, which had a mortality rate of 10%. We look at the impact of the SARS crisis on share prices in the next story.

For investors, aside from the inevitable knee-jerk panic selling (and then equally inevitable panic buying on any positive news), the impacts on company revenues and profits will be mixed. On the ground it appears that the immediate impacts – in both China and also in Australia via the tourist market - are on small businesses: restaurants, retailers, accommodation and tourism operators. The effect on large companies that we have in portfolios is more indirect and complex.

Some short term impacts

The crisis would cause some spending to be brought forward from the future – ie people buying things now that they otherwise would have bought later. An example of this would be people stockpiling supplies, not just in China but around the world. Much of this additional spending now might not decrease later spending if people decide that keeping a stockpile of non-perishables is a good idea, so some of the stockpiling may result in a net gain to total sales for the year. Past experience is that most people soon revert to their prior spending habits.

The crisis may accelerate the take-up of online retailing and/or social media communications for people who would otherwise have been slow to convert. For example, shares in Alibaba (largest online retailer in China) have held up, and so has Tencent (largest social media platform). Other examples include shares in companies like Ansell (medical gloves and protection), which have risen in the crisis.

Conversely, purchases of other items would be delayed temporarily – ie lower activity now but picked up later. One example is industrial production. Wuhan is a major industrial factory centre producing many types of products, especially cars. Lost factory production (and workers' wages) during factory suspensions would in most circumstances be made up for when production resumes, so there may be little net change over a year or so. In the case of the SARS crisis in 2003, China's aggregate production and spending slowed in the June quarter of 2003 but made up for it in the second half of 2003, so there was very little net impact over the year. Another example is airlines – eg. Qantas share price has fallen due likely short term sales impacts. But will it result in *permanently* lower revenues and profits? Highly unlikely.

Rapid construction of hospitals, medical centres and other infrastructure would benefit Australian miners, but probably only in the short term. So far the temporary increase in construction is probably being more than offset by decreases in general demand for industrial inputs due to factory suspensions. If there is a broader slowdown in China, the Chinese government has the capacity and means to dramatically boost infrastructure investment to support employment once again – just as it did in 2009-10 and 2016-17. In each case the Chinese stimulus programs boosted global commodities prices and flowed through to higher revenues and share prices for Australian miners.

If the virus were to spread further to impact the whole Chinese economy more seriously, and then the whole world economy, central banks would be prompted to cut rates further and increase 'QE' asset buying to try to stimulate lending and spending. The past 12 years have been a rollercoaster ride of stop-start stimulus efforts to boost lending and spending every time economic growth rates falter, and each new bout of rate cuts and QE asset buying boosted share prices here and around the world.

Longer term implications

No doubt there would be plenty of trading opportunities for short term traders – like those mentioned above. The potential gains might be high if they get into the right stocks before the crowd, but the potential for getting it wrong is also high, as are the trading costs. We are not short term traders, nor are the fund managers we use in portfolios. Long term investors focus on longer term impacts of more permanent changes in behaviour or spending patterns as a result of the crisis.

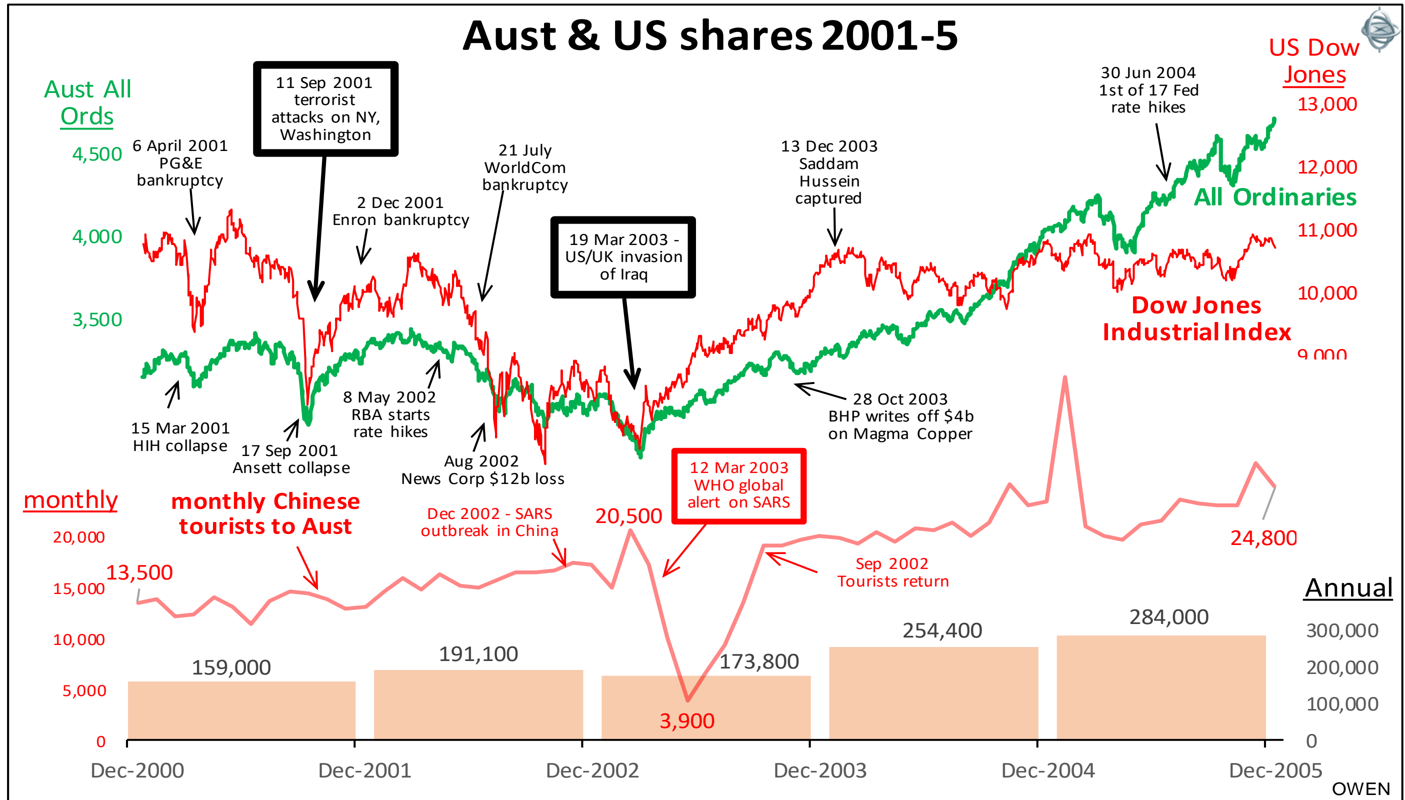
When valuing a company, long term investors discount estimated cashflows well into the future. Changes to the first year or so make very little difference to a company's overall valuation. For example if a company suddenly announced that it will cancel its next year's dividend but then resume the following year, it should only make a 3% difference to the calculated discounted cash flow value and therefore the theoretical share price we would be prepared to pay. But in practice its share price would probably fall by 30% or even 50%, driven by the crowd panicking and extrapolating one year's lost dividend into imminent bankruptcy. Long term investors stand back from the panicking crowd to pick up bargains that are over-sold.

We do not pick stocks, we use specialist fund managers in our portfolios to analyse and select the best companies that are likely to survive and thrive in all sorts of global conditions and challenges they may encounter. These fund managers are long term investors like us, and we have selected them for their proven ability to look past the short term panics and add value particularly in market crises and downturns.

2 'SARS', tourism & share prices

One of the most immediate and visible impacts on the Australian economy of a virus outbreak from China would be on tourism, as 15% of inbound tourists are from China. In the 2003 SARS crisis, Chinese tourist arrivals fell by 80%, but what impact did it have on share markets?

The upper section of the chart shows the All Ordinaries Index of Australian shares in green and the US Dow Jones Industrial Index in red. The lower section shows monthly tourist arrivals from China into Australia (pink line) and the annual totals (pink blocks).



Tourism - During 2002 Chinese tourists were arriving in Australia at the rate of 16,000 per month. In December the first cases of SARS were being reported in Guangdong, then it spread rapidly across China and around the world in early 2003. The World Health Organisation declared a global alert on 12 March 2003 and Chinese tourist arrivals into Australia promptly fell by 81% between February and May 2003.

The virus was contained from May and tourist numbers quickly rebounded. In annual terms, the crisis cut Chinese tourist arrivals by -9% in 2003 from their 2002 numbers, but they jumped +46% in 2004. Arrivals in 2004 were 33% higher than in 2002. So, yes, tourism numbers and the revenue harvested from tourists did almost disappear completely during the crisis, but they rebounded quickly to even higher levels and higher growth rates than before the crisis. It was a case of a temporary disruption that was more than made up after the crisis passed.

Share markets - The middle of March 2003 was the height of the SARS crisis when media headlines were extrapolating the infection rate to take over the entire world population in a matter of months (as they are again today), but it was also the turning point for share prices in Australia and around the world. The middle of March 2003 marked the end of the 'tech-wreck' (the sell-off following the late 1990s 'dot-com' boom) and the start of the great 2003-07 global share rally that was driven by credit / China /commodities booms. What was the trigger for the start of the share boom in the midst of the sea of corporate red ink, bankruptcies and the SARS virus panic?

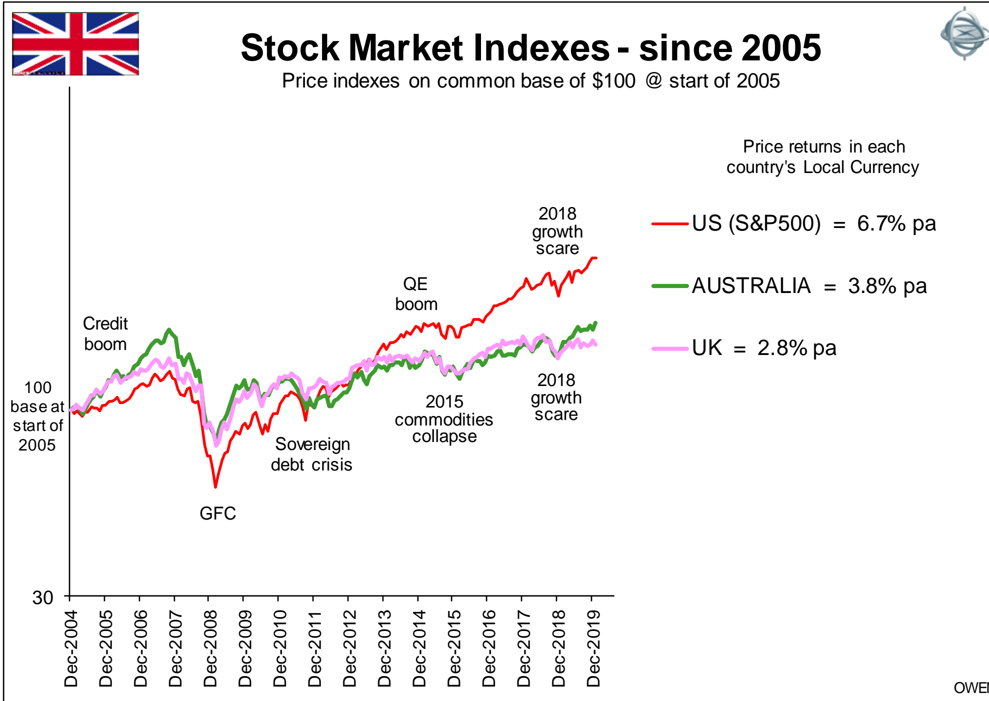
The upper section of the chart highlights the two key events. The first was the 11th September 2001 terrorist attacks on New York and Washington. Wall Street was closed for the week and suffered a sharp 14% sell-off when the market re-opened, but it was recovered in less than two months. Meanwhile corporate bankruptcies kept sending share prices lower. In the US we had PG&E, Enron and WorldCom, and in Australia we had HIH, Ansett Airlines and News Corp's $12b loss.

The second key event was the turning point for shares. It was the start of the US/UK invasion of Iraq on 19th March. US shares jumped 33% and Australian shares jumped 21% from the mid-March bottom up until Saddam Hussein was captured on 13th December. Then after the initial surge, share prices kept drifting upward as the invasion force became an occupation force, and kept rising even after the US Federal Reserve started raising interest rates in June 2004. It turned into what we now look back on as the great 2003-07 share boom.

The SARS virus was contained within six months but the current coronavirus is yet to be contained. However the SARS example is still instructive as it highlights how the impacts on tourism, spending and economic growth were over-shadowed by broader global events.

3 Brexit: impacts on British shares?

British shares represent about 5% of the global market, but the health of the London market is important for Australian investors as it has always been a major source of investment for our capital markets and for our development as a nation. How do our share markets compare?



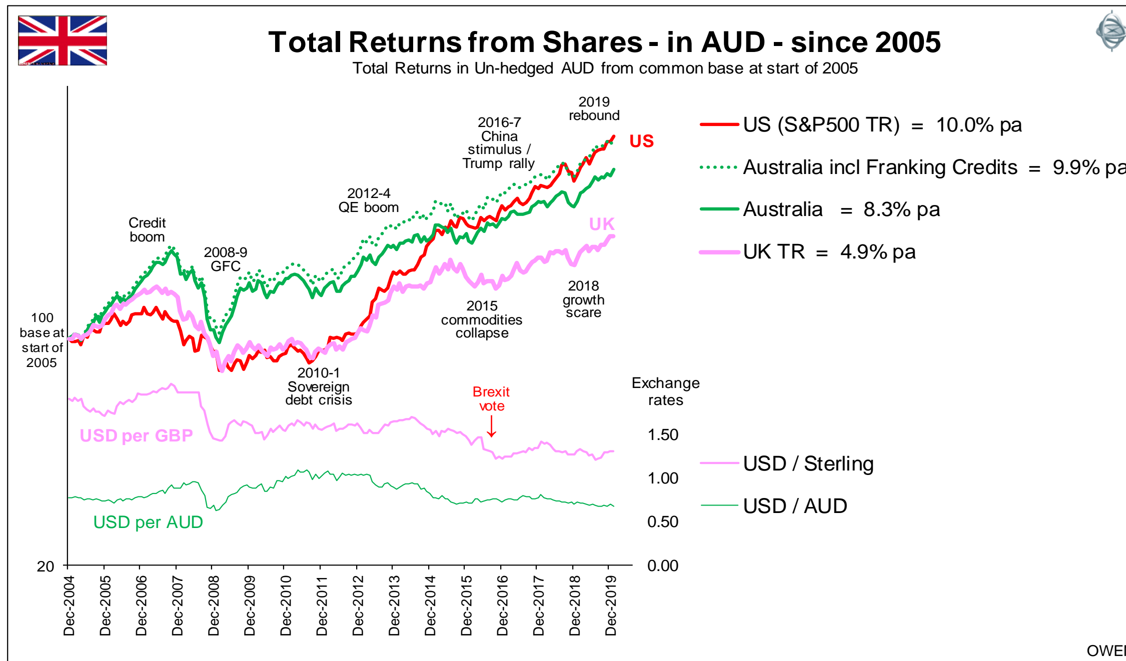
The first chart shows the FTSE-100 index of UK stocks (pink), Australia's All Ordinaries (green), and the US S&P500 index (red).

Two striking observations stand out. The first is that the US has led by a big margin over the past 15 years. The second is that Australia and UK have followed almost identical paths (although the UK lagged Australia in 2019 mainly due to Brexit fears).

The main reason is that the Australian and UK markets are both dominated by big banks and miners. The largest two miners - BHP and RIO - are listed in both markets and comprise large shares of both indexes.

The US market has a much smaller banking sector and virtually no miners. However all three do have some oil/gas giants (US has Exxon Mobil and Chevron; Britain has BP and Shell; we have Woodside and Santos).

While the above chart shows share price indexes, the next chart is more meaningful for Australian investors as it shows total returns including dividends (plus franking credits for Australian investors), and all returns are un-hedged Australian dollars. The AUD dollar and British Pound are shown in the lower section. The impact of dividends and currencies paints a very different picture for Australian investors:



The inclusion of dividends and franking credits lifts returns from Australian shares to match the returns from US shares in Australian dollars for the period.

Both have returned 10% per year, despite the decline in the Australian dollar, which boosted returns from US shares.

British shares have done reasonably well in local currency terms (pounds) for British investors but the heavy falls in the Pound over the period – not just since the Brexit vote - has reduced returns to non-British investors.

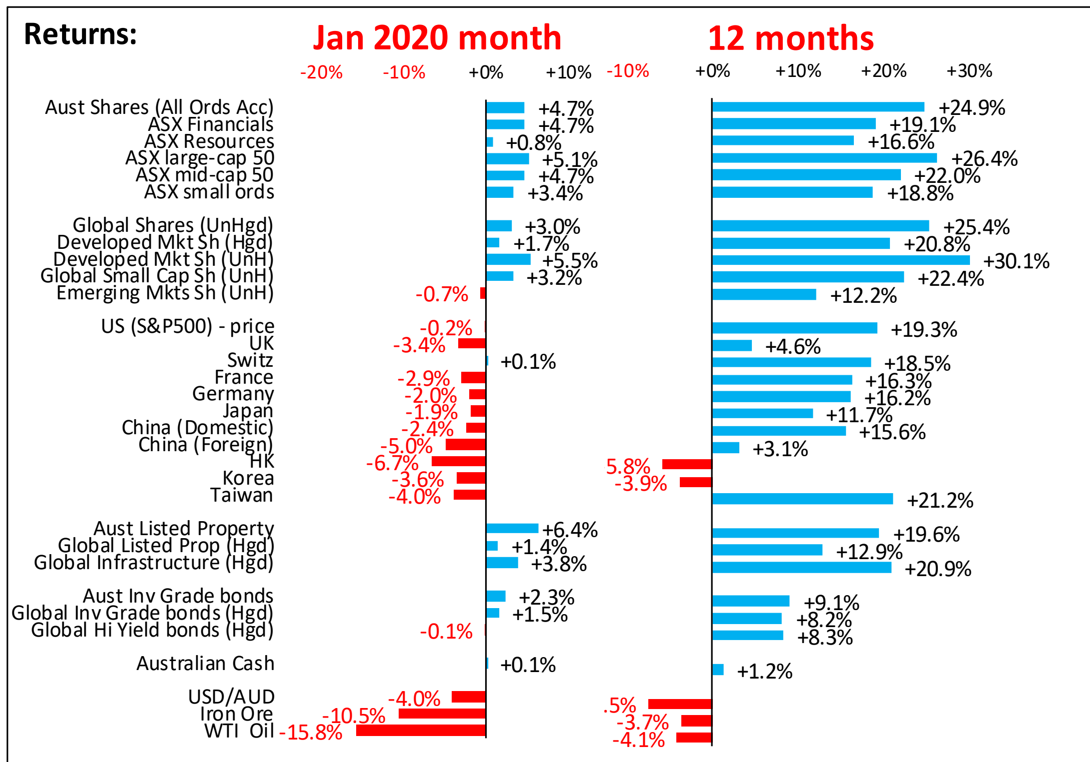
Since 2007 the Australian dollar has lost 24% of its value against the US dollar, but the Pound has lost 35%. The Bank of England has been more successful in depressing its currency with ultra-low rates and QE – and this may continue after Brexit is done. Europe and Japan face crippling deflationary problems with their deteriorating demographics and suffocating institutional rigidities, but Britain has the uncertainty of how the playing field will look when bilateral trade deals are completed. This could take years and London may continue to lose its place as a global / regional centre.

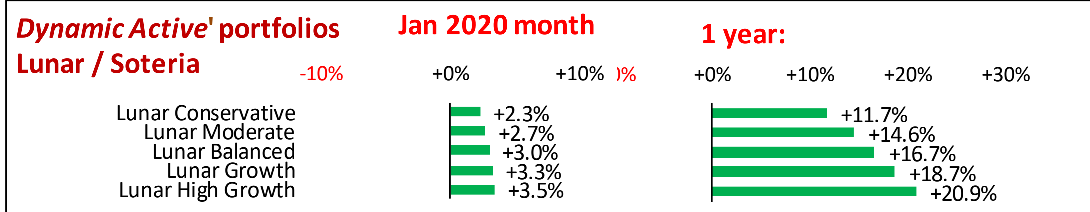
Britain has some fine global companies outside of its dinosaur banks and miners – including Diageo (dominates global spirits), Unilever, Reckitt, Burberry (household/personal products), AstraZeneca, Glaxo (pharmaceuticals). Superior returns from companies like these may continue to be eroded away for foreign investors by further weakness in the Pound. One thing is certain - it's never dull!

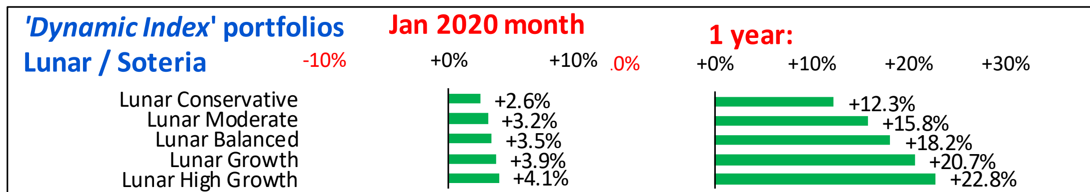
4 Portfolios post good start for 2020

January was a good month for our investors, as each of our diversified portfolios posted their best monthly returns since inception. They also posted their highest rolling 12 month returns since inception. Annual returns of 12% for 'conservative' portfolios and 20% for 'growth' portfolios are not 'normal' of course and should not be extrapolated into the future. January was really just a continuation of the tremendous 2019 rebound from the 'global growth scare' sell-off in 2018. Portfolio benefited when we reduced our holdings of shares significantly for the 2018 sell-off, and they also benefited from our shift to being over-weight for the 2019 rebound.

Most global share markets were flat or down in January, especially in east Asia due to the coronavirus scare. However it was a particularly good month for Australian shares. This was essentially due to the big banks being re-bought after they were sold off in the previous month, mainly by foreign investors. The big miners were weaker because the prices of iron ore, oil and most other industrial commodities fell in January. The temporary supply-led price spikes in iron ore and oil that drove up mining share prices in the middle of 2019 have now faded.







Our portfolios benefited from being over-weight Australian shares, Australian listed property and global infrastructure, and also by not holding emerging markets shares or global listed property. Our view on currencies has also been a major contributor to returns in January and over the past year. Since early 2018 the portfolios have been positioned to benefit from declines in the Australian dollar. This boosted returns as the dollar declined, and it fell another 4% against the US dollar in January. The Aussie dollar now has fallen by 15% since we went bearish on the dollar, but we have now adjusted our positions as we are no longer as bearish on the dollar in the current environment.

The reason why even the 'conservative' portfolios have posted such good returns is that 'boring old bonds' have done well for the month and also the past year. This has been the result of bond yields falling back to very low levels as all of the major central banks in the world have cut interest rates and stepped up or restarted their bond-buying programs over the past year. We see this continuing for some time yet.

5 Tracking down sustainable returns

Share prices across the Australian market have risen by an average of 20% over the past 12 months. This looks like great news on the surface but we need to look deeper to see where those gains came from and whether they are sustainable. People have a tendency to mentally 'lock in' past gains and assume they are 'in the bank'. We tend to assume that the past gains are locked in and behind us, so we clear the decks mentally (especially after the end of year break) and look forward to the next year afresh.

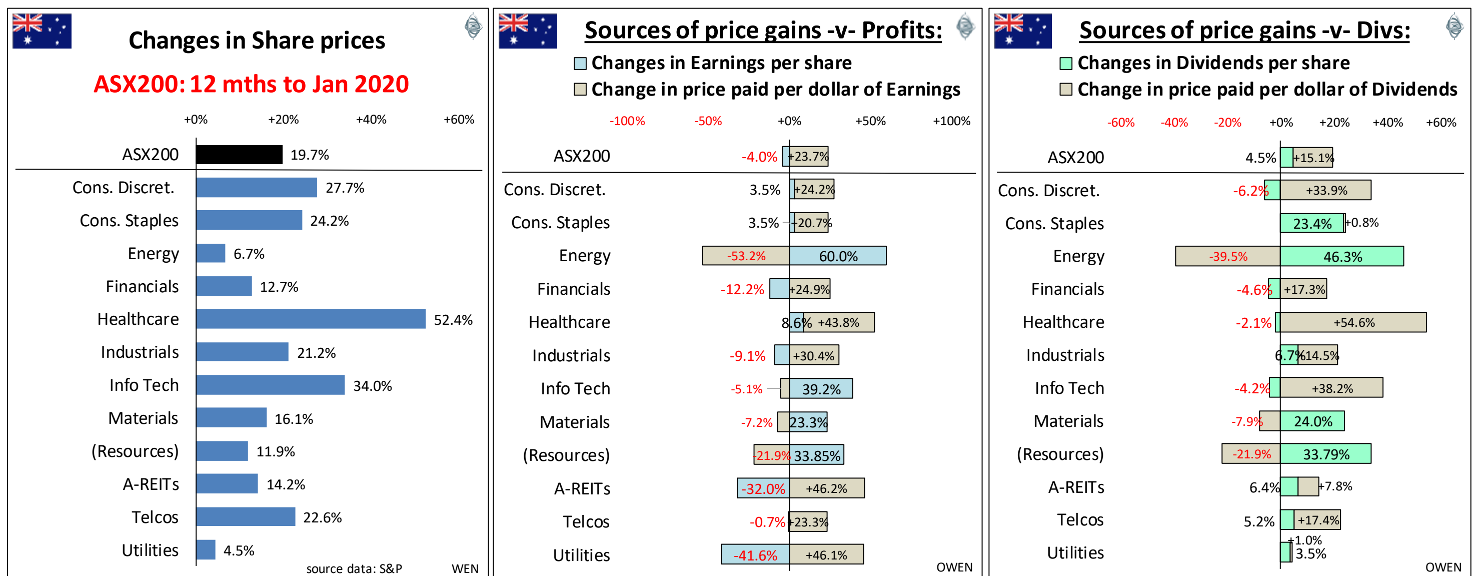
The problem is that almost all of the 20% share price gains over the past 12 months were fluff – much of it is probably only temporary and should not be assumed to be 'locked in' at all. Why do we consider them 'temporary'? Because the 20% share price gains were not underpinned by 20% higher company profits nor 20% higher dividends. Profits per share across the market actually fell over the period, and dividends per share rose by only 4% (and most of the dividend increases were due to temporary commodity price spikes from the miners).

Twelve months ago investors across the whole market were prepared to pay $16.25 per dollar of company profits, but over the last year they bid the price up to $20.40 per dollar of profits. They are now paying 25% more *per dollar* of profit than they did a year ago. Twelve months ago investors were prepared to pay $23 per dollar of company dividends (ie dividend yield of 4.34%) but over the last year they bid the price up to $26.40 per dollar of dividends (dividend yield of 3.8%). They are now paying 14% more per dollar of dividends than a year ago.

What caused this miraculous 25% increase in the price paid for a dollar of profits and 14% increase in the price of a dollar of dividends?

The main reason is confidence levels. At the start of 2019 people were very pessimistic and feared the late 2018 'global growth scare' might turn into the next GFC or possibly worse, especially as the US Fed was still raising interest rates despite signs everywhere of slowing growth and Trump's trade wars. Investor pessimism quickly turned to confidence when the Fed switched from rate *hikes* in 2018 to rate *cuts* in 2019. This makes no sense! The Fed was raising rates in 2018 because of their bullish outlook for growth – hence the need to raise rates to slow spending and inflation. Then the Fed switched to rate cuts in 2019 because they suddenly became bearish on growth outlooks. Central banks raise rates when they are bullish on the economy and cut rates when they are bearish. The crowd (investors) do the reverse!

The charts break this down by market sector. The left chart shows price gains over the past 12 months; the middle chart splits this into changes in earnings (profits) per share and changes in the price paid per dollar of profits; and the right chart does the same for dividends:



Looking at the two big sectors – First: Financials. Profits per share fell (across the big-4 banks plus other disasters like AMP) but share prices rose 13%, so investors *en masse* boosted the price per dollar of profit by 25%, and the price per dollar of dividend by 17% (dividends also fell). The crowd bid up the price per dollar of profit and dividend because they assume the current banking woes are temporary and they will miraculously return to the golden years of double digit profit growth. Our view has been that those golden years are gone. The banks are facing not only cyclical pressures (margin pressure from ultra-low rates, and bad debts from property developers/investors) but also more lasting structural pressures (crippling regulations, expensive remediation & compliance, higher capital costs, deteriorating demographics).

The other big sector - Resources - saw profits and dividends rise by 30%+ per share – a combination of recoveries from big write-offs from prior years, plus the fortuitous spikes in iron ore and oil prices. Investors have sensibly discounted this and only bid up share prices by 12% because they know this profit and dividend growth is not repeatable. Many of the miners are probably under-priced at current levels.

The market is now in expensive territory - with price/earnings ratios above 20 (more than $20 being paid per dollar of profits) and dividend yields below 3.8% ($26.40 per dollar of dividends). In order to hold onto the recent price gains, either profits and dividends need to rise substantially in 2020, or central banks need to keep cutting rates and buying up assets – ie central banks need to remain horribly bearish and pessimistic so that the crowd remains overconfident! In our view the latter is considerably more likely this year than the former.

What lies ahead?

In last month's report we outlined three major themes for investors for the next decade. This month we bring it back to practicalities. There are a host of issues and possible risks that fill the papers, airwaves and online media each day, but one way of describing how we see the road ahead for investors over the next few months is to outline the recent adjustments we made to portfolios. These reflect how we see the risk/reward equation for long term investors in the immediate future.

We have been relatively bullish on shares since we increased the weight of shares in portfolios from early 2019 for the rebound. We are retaining our relatively bullish stance on Australian and global shares. We are not changing the overall 'growth/defensive' balance, but we are adjusting the mix of shares a little. Over the past couple of years we have been biased toward Australian shares over global shares. Australian shares held up better than global shares in 2018 and then have rebounded more strongly since the start of 2019. We have now shifted the mix back to 50/50 as the broader industrial mix of global shares offers more potential for upside in the current conditions.

We are also adding back 'emerging markets' shares. We had them in portfolios when we were bullish in 2017 after the Trump election, and they beat 'developed markets' shares in 2017. We removed them for the 2018 sell-off (they sold off even more heavily than developed markets in 2018), and we did not re-add them for the 2019 rebound (they lagged the developed world in 2019). Emerging markets are now likely to perform relatively better now with Trump's trade wars not yet settled but at least perhaps on a less volatile footing this year.

We remain relatively under-weight fixed rate bonds in portfolios as we are wary of the risk of bond yields rising from their ultra-low levels and potentially hurting bond returns. We are shifting the mix of bonds back to a more balanced mix of global and Australian. Both have performed well over the past year but global bonds offer more diversified industry mix and deeper markets, especially with investment grade corporate bonds. All our bond holdings are investment grade as we are wary of a possible bubble in the 'high yield' (sub-investment grade) bond market.

In our story on returns (story 4) in this issue we outlined the recent shift in stance on the Australian dollar as we are no longer as bearish on the dollar as we had been since early 2018.

February is half-year reporting in Australia and we are expecting rather less optimistic outcomes than the rest of the market. The Reserve Bank kept interest rates at 0.75% this week (4th February) and pointed to early signs of improvement in the local and global economies. The RBA seems committed to cutting rates – and even resorting to QE asset buying experiments – to bring the unemployment rate down to its goal of around 4.5%, so we can probably expect accommodating monetary policy to continue for some time yet. Likewise we expect a continuation of extremely loose and supportive monetary and fiscal policies in the US, Europe, Japan and China. The more bearish and pessimistic central banks are, the more they support share and bond prices.

As always, we remain vigilant for risks to long term investors and we are willing and able to make changes to portfolios in a timely fashion to minimise downside risks and carefully capitalise on opportunities when they arise.

'Till next time, happy investing!

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