

Stanford Brown Monthly Top 5

# March 2020



Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.



# 1 'Will China slow?' – Of course! – but why the panic?

I have covered the possible impacts on investment markets of the coronavirus in recent editions of this report, but the 'big elephant in the room' dominating the chattering media seems to be – 'What if it affects Chinese growth rates?'

For many years now, one of the most frequent questions I receive from investors, readers and the media has been 'Will China slow?' My answer is simple – 'Of course! – but so what?' (The other most common question is "Will Australia have a recession?" – same answer. Economic 'recessions' have mostly been positive for Australian shares – but that's another story I have covered in other reports).

Why the obsession with Chinese growth rates? Because of the common perception that Australia is enormously sensitive to Chinese growth and therefore slowing Chinese growth would be disastrous for Australia and/or Australian shares. Why?

The reasons appear clear - China is Australia's largest export buyer; it is second largest economy in the world; has the second largest stock market in the world; it has been the great 'emerging market' in recent decades that has been the engine of world growth; it has been the largest contributor to the growth of demand for commodities for energy and construction; the largest foreign contributor to government tax revenues (indirectly via export company taxes and directly via mining & export taxes), and the largest source of growth in tourists to Australia. Naturally, given our heavy reliance on China, any slowdown in Chinese growth would surely be disastrous! Let's take a look.

Official Chinese statistics are notoriously doctored (even Premier Li Keqiang admitted they were '[man-made](#)' and unreliable – reminiscent of the astronomic fictional output figures produced during China's disastrous 'Great Leap Forward'). At best the official numbers are an indication what the Communist Party would like them to be, rather than what they actually are. At the top of the great 2003-7 China/credit boom Chinese economic growth rates peaked at 14% in 2007 (which was probably more or less true) but have been declining ever since. Officially the growth rate was 6% in 2019 (lower than it was in the depths of the GFC) but is probably lower than that in reality.

The focus on Chinese growth rates has increased lately because of the widespread suspensions of factories and other activities in China due to the coronavirus scare. What if Chinese growth fell to....[cue dramatic music]...4% or....[shock horror!]...even 3% or 2%?

Let's take it further to the end game. What would be a 'worst case' nightmare scenario?

What if China's economic growth stopped DEAD – with ZERO growth FOREVER – starting TOMORROW morning? What if its stock market crashed 90% - and NEVER recovered – EVER? What if it suffered a massive banking crash – with all of the major banks insolvent, closed down, their liabilities restructured and assets sold off for a fraction of their cost? What if its property markets (residential and commercial) collapsed 80% across the board and never recovered – ever? What if its population stopped growing and started to DECLINE – forever?

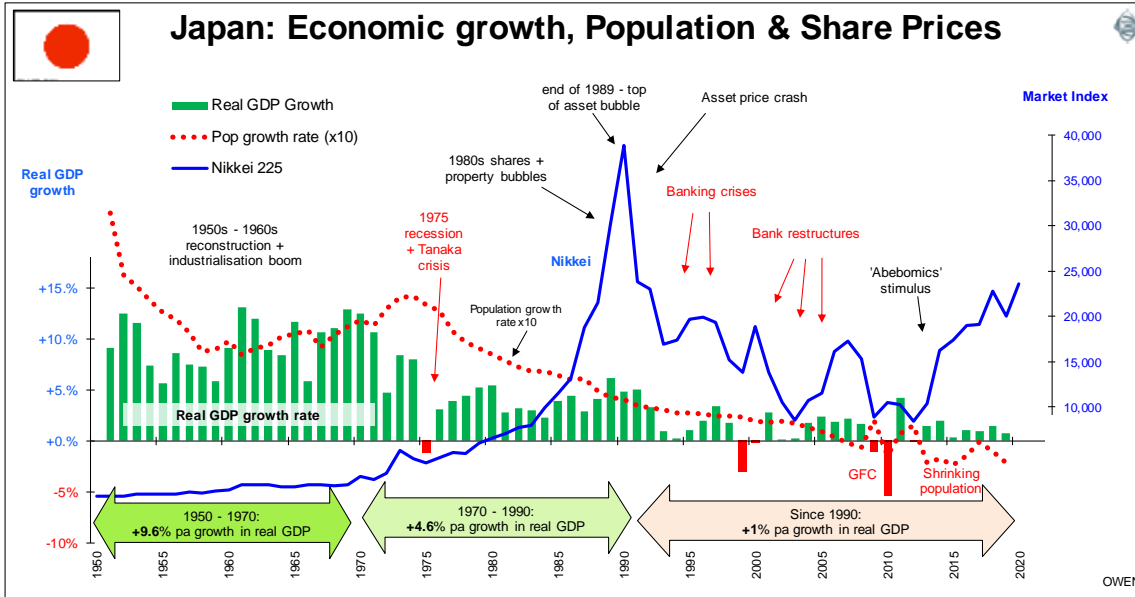
Sounds scary! A great plot for a horror movie! Surely the impact on Australia would be disastrously bad – for mining company revenues, government tax revenues, tourism revenues, commodities prices, share prices – surely everything would collapse.

We don't have to look far for an almost exact replica of this so-called worst-case nightmare scenario happening to Australia. This is precisely what happened to Japan after 1990. Let's look at the importance of Japan to Australia and the world at the end of the 1980s:

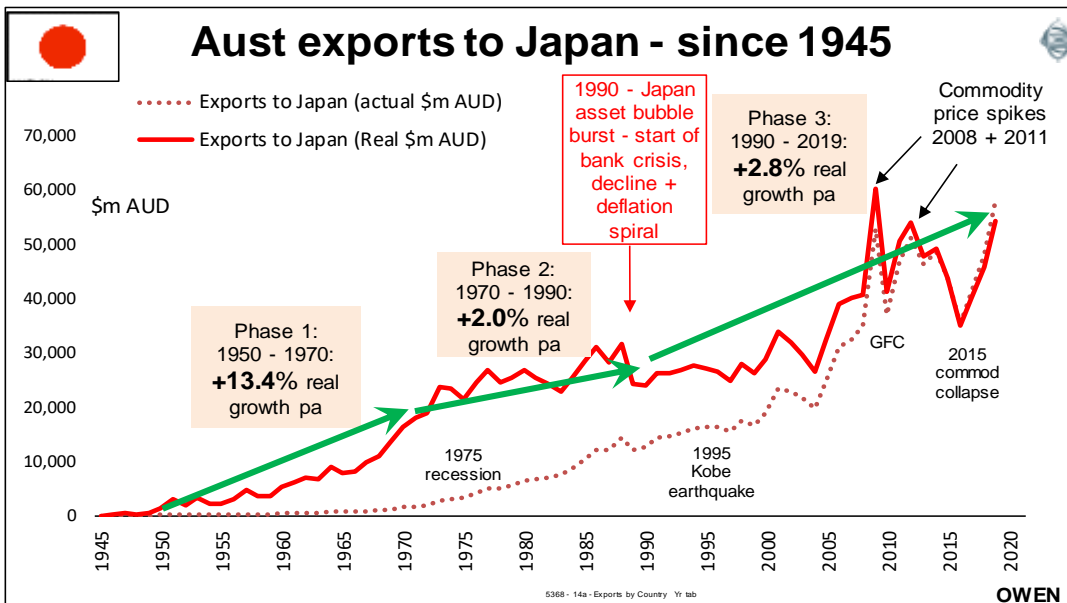
- Japan was Australia's largest export buyer (same as China today, except Australia's reliance on Japan as our largest export buyer ran for more than four times as long our reliance on China).
- Japan was the second largest economy in the world (same as China today),
- Japan had the second largest stock market in the world – same as China today. Actually the Japanese stock market was much larger in relative terms and it was actually the largest in the world in 1988-9 – even larger than the US market because Japan avoided the 1987 crash – until its own terminal crash in the 1990s).
- Japan was the great 'emerging market' since the 1950s (along with Germany) and was the engine of world growth – for much longer than China's emerging market growth period in the 2000s and 2010s.
- Japan was the largest contributor to the growth of demand for commodities for construction and energy – same as China today.
- Japan was the largest foreign contributor to Australian government tax revenues (indirectly via export company taxes and directly via mining & export taxes) – same as China today
- Japan was the largest growth market for tourists to Australia - same as China today (remember when street signs on the Gold Coast in Qld were in Japanese alongside English?)

This is an identical word-for-word replica of the importance of China today. But what happened to Japan? It all came to a complete stop from the beginning of the 1990s. Japan's economy stopped dead – with virtually ZERO growth FOREVER (even after nearly 30 years of 'QE'). Its stock market crashed 90% - and never recovered. It suffered a massive banking crash – with all of the major banks insolvent, closed down, their liabilities restructured and assets sold off for a fraction of their cost. Japan's property markets collapsed 80% across the board and never recovered. Japan's population stopped growing and started to DECLINE – forever! This too is an identical word-for-word replica of the so-called 'worst-case' nightmare scenario for China I painted at the outset.

This chart shows Japan's economic growth rates since WW2 (green/red bars), the Nikkei 225 share index (blue line), and population growth.



What was the impact of Japan's sudden halt on Australia? Japan's switch from growth engine of the world to zombie actually accelerated the growth in export revenues for Australia! Despite Japan's sudden collapse into terminal decline with virtually zero economic growth and declining population, Australian exports to Japan kept on growing and are still booming today. Australia's export revenues from Japan grew at a faster rate after 1990 than they did before 1990 when Japan was booming! From 1970 to 1990 Australian export revenues from Japan grew by an average of 2.0% per year in real terms after inflation, but since 1990 they have grown by 2.8% per year after inflation.



What replaced Japan when it hit the wall? China? No. Nothing replaced Japan. Australia's export revenues from Japan actually accelerated after it hit the wall in 1990, and Japan remained our largest export buyer for the next 20 years after the 1990 crash. Japan was finally overtaken by China as our largest export buyer in 2010. Not bad for a zombie death spiral!

So what happened to Australia? - economy, company revenues, profits, share prices, government revenues, tourism, etc? Australia **prospered** like never before! We had a brief recession in 1990-1 (triggered by RBA rate hikes to slow the massive speculative lending and spending boom caused by bank de-regulation, not the Japanese collapse). After the brief self-inflicted recession,

- Australia promptly entered its longest period of continuous economic growth in post-settlement history
- unemployment fell from 10% to just 5%
- inflation fell from 8% to less than 2%
- cash rates fell from 18% to less than 1%
- Australian shares returned an average of 4.2% per year above inflation in the 30 years before 1990, but rose to 6% per year after inflation in the 30 years since 1990. So Australian shares did better after our major export buyer went into in terminal decline.

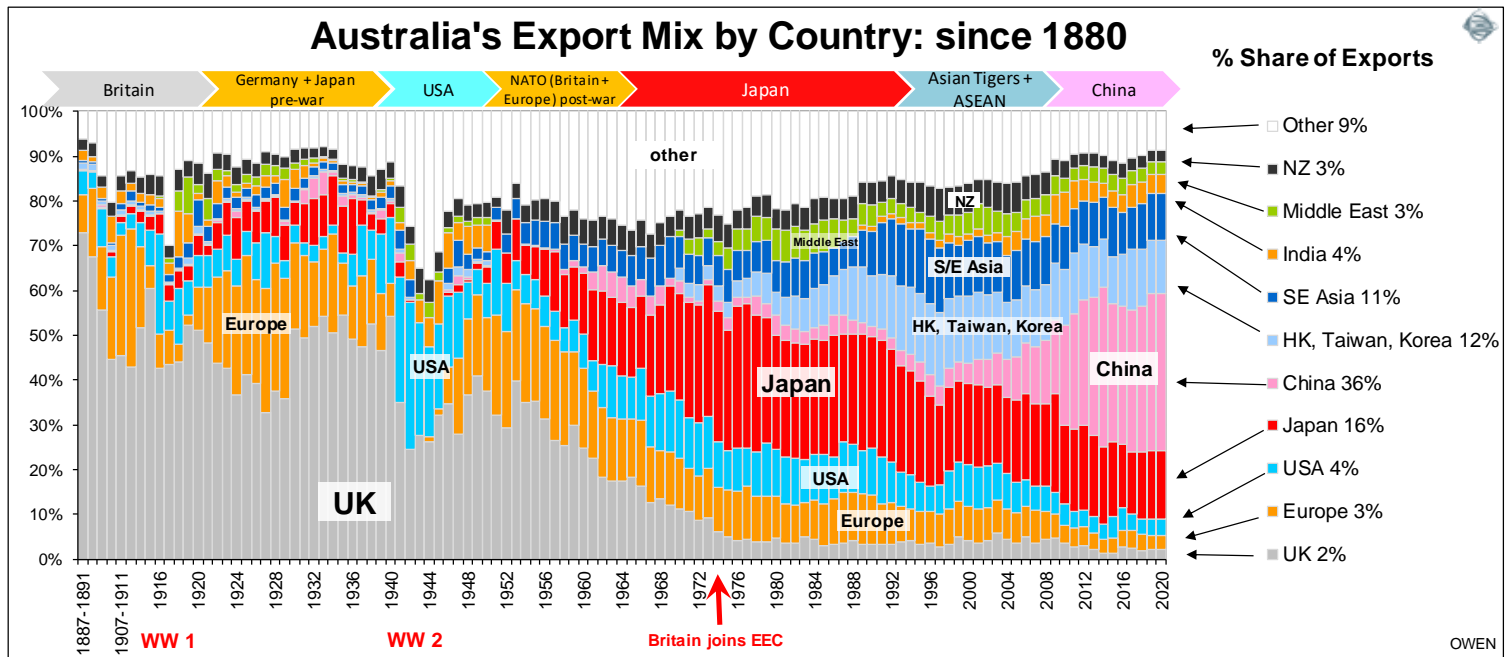
Japan's downfall did not cause Australia's prosperity since 1990 of course, but it did not harm it.



# 2

## 'Bye-bye Britain – again!

The loss of Japan as our largest export customer was not the only prior example of Australia losing its largest export buyer and thriving. Before Japan, Britain was Australia's largest export buyer for the previous 180 years. Britain accounted for a higher share of our export revenues, higher share of foreign government revenues, higher share of foreign capital, etc - for more of our history than Japan or China ever were. But, just as it abandoned Australian troops in Singapore in 1942 fleeing the invading Japanese, Britain again abandoned Australia to join the EEC (now the EU) and toddled off into irrelevancy. Britain buys just 2% of our exports today, a mere rounding error.



Did Australia suffer when Britain joined Europe, as was widely feared at the time? Not at all. What replaced Britain? The very same Japan!

What will be Australia's next Britain, Japan and China as our primary benefactor?

Most likely it will be the next wave of 'emerging markets' – including Indonesia, Vietnam, Cambodia, Laos, and of course India. All are in various stages along the path of industrialisation and urbanisation – and they need our commodities exports just as Japan and China did. All have very large populations and all are very close to Australia. It's just pure good luck that the next wave are right next door to us.

Despite these great growth opportunities on our doorstep, it is highly likely that China will continue to be the major export earner for Australia for many years just like Japan was for another 20 years after it hit the wall in 1990. Even if China's economy went to zero growth forever from tomorrow morning (like Japan from the early 1990s), China will still need Australian iron ore, coal, and other minerals to build housing and infrastructure to keep improving living standards for the population to keep them quiet and compliant, and it will still need our energy sources like coal, oil, gas and maybe even uranium and exportable renewables to power it all.

A zero growth Chinese economy, and any political turmoil that it would probably trigger, would also probably accelerate the exodus of people and capital out of China. Australia would be a major destination and it would raise the prices of assets here, including housing. The more internal turmoil and instability there is, the more the government will need to spend on commodities for infrastructure like housing, roads, rail, hospitals, schools etc to quell the masses and keep them employed. It's a win-win for Australia. Like Japan in the late 1980s, China today is the world's largest creditor with trillions of dollars to spend if it needs to.

One difference between China and Japan is sheer numbers. There are eleven times as many Chinese than Japanese, and even after adjusting for the differences in average wealth, there are still at least four times as many wealthy Chinese than total Japanese. That means many times more people to house, feed, clothe, heat and cool, and many times more tourists and tourist dollars for Australia.

Another difference is that Australia has whole new export industries now that it didn't have before – like education, which is now our largest export earner after iron ore, coal and gas.

So there is plenty of upside to look forward to if or when this so-called 'worst case scenario' played out for China. The lesson for long term investors is to look beyond the shrill media headlines to understand what really drives markets.



# 3 The two great 'emerging markets' of the 19<sup>th</sup> century: Australia & Argentina

China was the high-growth 'emerging market' star over the past two decades and is now slowing. In the decades following the Second World War it was Japan & West Germany – both grew from war-time rubble to become rich, and both have now slowed to a crawl.

In the late 19<sup>th</sup> century the two stand-out high-growth 'emerging markets' were Australia and Argentina (I am currently in Buenos Aires). Both grew rapidly to become the two richest countries in the world per head of population by 1890, surpassing even the United States briefly.

In a later story we look at how and why they have fallen back from once leading the world in living standards per person. But first we look at the phenomenon of 'emerging markets contagion' – how a crisis in one 'emerging market' quickly infects other seemingly unrelated emerging markets across the world. This is as powerful today as it was in any past era, and it has direct implications in our portfolios.

One common characteristic of 'emerging markets' is that their economic growth is very often fuelled by an influx of foreign capital from rich, slow-growth 'old world' markets chasing high returns in the 'new world' - un-regulated, high-risk, 'wild-west' new territories. In the 19<sup>th</sup> century the 'old world' money came from English and Scottish investors (yes the archetypal 'Scottish widows' funds) along with French and Dutch money. Funds were channeled through banks in the London market and invested in far-flung 'emerging markets' chasing high returns.

The hottest emerging markets in the late 1800s were Argentina and Victoria (British colony, now part of Australia). In Argentina the attraction was rich farmlands for livestock and grains. In Australia, Victoria was the richest of the colonies, not only from farmlands for wool and grains but mainly from the 1850s gold rush, followed by the rich silver-led mines in Broken Hill (which was actually in the New South Wales colony but benefited Melbourne and Adelaide more than Sydney due to proximity).

In both Argentina and Victoria (and also in NSW and other colonies to a lesser extent), the primary resources booms were also accompanied by railway construction booms to open up new territories to speed transportation of people and produce, and also suburban land and building booms in the cities. Buenos Aires and Melbourne grew quickly to become the two richest cities in the world per head of population.

These infrastructure and building booms were fuelled by a rush of foreign capital. Individuals and governments competed fiercely to build the most lavish, extravagant mansions and public buildings to show off their wealth to each other and to the world. The two peaks of the ostentatious displays of new-found wealth were the two grand buildings below – both built at the height of the 1880s building booms.



On the left is the government water & sewerage works in Buenos Aires, the grandly named 'Palacio de Aguas Corrientes' (Palace of Running Water). Today it's still a water treatment plant and a toilet museum (without doubt the most grandiose toilet museum in the world!). On the right is Melbourne's Exhibition Building, built at the same time to showcase Melbourne to the world. It is also still standing (sans toilet museum).

With every astronomical debt-fuelled boom comes an inevitable cataclysmic bust and resultant pile of bad debts and losses. Although the Melbourne building boom was bound to collapse eventually, the trigger came from Argentina, which was a much larger borrower in the London market. Argentina was the 5<sup>th</sup> largest sovereign borrower in the world, accounting for 11% of the London market for new debt issues and an incredible 40-50% of all new lending outside the UK (compared to 30% of the London debt market for total US borrowings).

The main issuer of debt in the London market was Baring Brothers & Co, the oldest merchant bank in London and banker to the royal family (yes, the same bank that was finally bankrupt by Nick Leeson in another 'emerging market', Singapore in 1995). The problem was not only the amount of debt that Argentina had borrowed, but also the type of debt. Argentina borrowed using debt that was repayable in gold and silver, but Argentina's own currency was paper money, not backed by gold or silver.

When Argentina's revenues and economy slowed in 1889 due to crop failures caused by a drought, there were riots and strikes over rising inflation from paper money-printing, then a failed *coup* attempt (*Revolución del Parque*). Locals rushed to swap their increasingly worthless paper pesos for gold and silver. This selling pressure caused the value of the paper pesos to collapse even further and it drained all the gold and silver out of the banks. The Argentine government ran out of gold and silver and it defaulted on £48 million of its debts in London (it was the largest sovereign default in the world in the 19<sup>th</sup> century). The Bank of England saved Barings by organising a consortium of banks in London, France and Russia to spread the losses.



# 4 'Emerging Markets contagion' – 1890s

The Argentine default and Barings failure in November 1890 triggered the global '*Panic of 1890*'. UK and European investors suddenly pulled their money out of emerging markets everywhere - including the Australian colonies and even the US (which was still a capital-importing emerging market reliant on foreign debt from UK and Europe). The sudden withdrawal of capital was partly to cover their losses in Argentina but partly just blind panic selling driven by fear of similar problems in other highly indebted emerging markets. Mindless euphoria very quickly turns into mindless panic at the sight of the first losses.

This 'emerging markets contagion' effect is still just as powerful today. Whenever and wherever there is a problem somewhere in the world, the 'old money' (now mainly US investors) suddenly panic and dump everything everywhere – regardless of merit and regardless of local conditions or valuations. They just dump everything and retreat to the safe havens – which is now the US dollar and US treasuries. The further away the investors are from their money, the more they panic to get it back when sentiment turns sour.

When the Panic of 1890 hit, the problem for Australia was it was also heavily reliant on foreign debt. Australia's colonial government were less reliant than Argentina, but Australia's banks were more reliant. 40% of all bank deposits in Australian banks were raised in the UK. Every Australian bank had opened deposit gathering branches in London and/or Edinburgh to harvest money from gullible yield-chasing 'old world' investors hoping to cash in on the booming 'new world' speculative frenzy. After the Baring crisis, UK investors refused *en masse* to roll over their term deposits in Australian banks and this sudden withdrawal of foreign debt capital triggered the largest banking crisis in Australia's history. The sudden rush of foreign debt into the market fuelled the boom, and the sudden withdrawal of capital triggered the collapse.

The sudden withdrawal of British deposits from Australian banks forced the closure of the Australian banks that were the most reliant on British investors. This in turn triggered panic runs on the banks in Australia, and by 1893 it escalated into a national banking crisis.

Out of the 64 institutions in Australia that called themselves 'banks' (including 'land banks' which were more like finance companies and building societies), 54 closed, and 34 of these closed permanently with heavy losses of capital for depositors and total losses for shareholders.

There were 23 real banks (ie deposit taking institutions that issued their own bank notes that were used as currency by the public). 18 were forced to close their doors to prevent depositor withdrawals – including most of the banks that comprise what are now Westpac, ANZ and NAB. 56% of the total bank deposits in Australia were frozen and converted into various combinations of bank preference shares, long term debentures and notes that were locked up for up to 15 years, and some were even converted into 'perpetual' notes with no redemption date.

In Australia the impact of the resulting economic depression was severe for asset prices across the board – including houses and shares:

Impacts of the 1890s banking crisis and depression on prices in Australia	Peak year	Trough year	Price falls	Recovered	Years from peak to recovery
Melbourne house prices:	1891	1903	-37%	1917	26
Sydney house prices:	1890	1898	-41%	1913	23
Bank shares on Sydney exchange:	1890	1894	-59%	1922	32
Industrial & Commercial shares on Sydney exchange:	1889	1894	-31%	1913	24
Mining shares on Sydney exchange:	1890	1895	-80%	1910	20

(sources: Stapledon for house prices, Lamberton for share prices)

Although Argentina was more indebted than Australia, the economic depression here was much deeper and longer than in Argentina. National output fell by 11% in Argentina, but recovered to pre-crisis levels in just two years. Australia's economic depression was nearly twice as deep and took three times as long to recover. Why?

Argentina defaulted on its debts and devalued the peso by two-thirds by 1895. This boosted export revenues to Argentine exporters and benefited the overall economy including jobs. Australia did not devalue but stuck with its 'hard-currency' Australian pound, which was tied to the gold-backed British pound. Australian colonies did not default on their London debts out of loyalty and obligation to Britain, our colonial master. In contrast, Argentina was a former Spanish colony with no innate loyalty to Britain or British investors, so they had no qualms about defaulting on their foreign debts (and have also done so several times since, including 2001 and 2018).

Argentina's default and restructure of debts, together with the currency devaluation allowed the construction of the rail networks to continue, resulting in continued expansion of agricultural development and farm output. In Australia, spending on infrastructure and construction virtually stopped and unemployment soared. House prices and share prices took another 20 to 30 years to recover.

This sudden withdrawal of capital also triggered bank failures and depression in the US and even in Britain, making it a global depression.

This pattern of emerging markets booms fuelled by frenzied inflows of foreign capital chasing high returns, followed by contagious emerging markets collapses caused by just as sudden panic withdrawals of foreign capital – is just as common today as it has ever been in the past.



# 5 'Emerging Markets contagion' – the past 30 years

Today's batch of 'Emerging Markets' comprise around 10% of the world's total \$60 trillion worth of listed company shares, making it an important sector of global equities. (Australian shares represent just 2% of the global total). Today about one third of 'emerging markets' shares are in China, another one third is elsewhere in Asia (mainly South Korea, Taiwan, India, Thailand, Malaysia, Indonesia) and the other one third is in other areas like the former Soviet Union, South Africa and Latin America.

Australia is classified as a 'developed market' but Argentina is now so poor that it has submerged and fallen out of most emerging markets indexes. In 2018 it required yet another bailout when it defaulted on its restructure agreement arising from its 2001 default. Today it is in yet another inflation and currency crisis. I am now in Uruguay and not even wily Uruguayan shop owners will take my left-over Argentinian pesos – at any price – as they have long experience with Argentinian inflation and currency collapses.

In theory, investment returns for company shares should be driven by the 'fundamentals' of each company – including customers, competitors, suppliers, revenues, profits, dividends, debt levels, etc. Unfortunately, this is not the case in practice. Share prices – especially in emerging markets - are driven primarily by global sentiment. They are essentially a 'high beta' bet on global shares. When global investors (mainly US) feel good they throw money around the world chasing high returns in high-growth emerging markets. In global rallies and booms, emerging markets shares almost always rise more than 'old world' developed shares, regardless of merit or pricing or local conditions. Conversely, when old world money gets nervous, they quickly pull money out of emerging markets and bring it back to 'safe havens', which is mainly US bonds.

As a result, emerging markets shares have sold off in every major global sell-off. In every case they fell more than developed markets – even when the causes of the sell-offs had nothing to do with emerging markets. This table shows emerging markets sell-offs since the 1987 crash.

	A	B	C	D	E	F
	Sell-off period	EM shares (in USD)	DM shares (in USD)	Emerging better or worse than Developed markets	Cause: Global or EM	Comments
1	Oct - Nov 1987	Down 21%	Down 20%	EM only slightly worse	US	1987 crash triggered by US events but EM sold off more, especially in Malaysia, Thailand, Taiwan (all down 30%+). Emerging markets affected not only by the 'hot money' effect, but also fears of impact on trade due to weakening USD
2	Aug to Nov 1990	Down 29%	Down 13%	EM much worse	EM, US	Aug 1990 Iraq invasion of Kuwait Nov US inflation peaks, Thatcher replaced by Major
3	April to Nov 1992	Down 14%	UP 5%	EM down but DM up	US, UK	Bottom of US recession - Fed's 22 <sup>nd</sup> , 23 <sup>rd</sup> , 24 <sup>th</sup> (final) rate cuts, US unemployment peak, failed FX intervention to support the USD, UK pound collapse, US-German currency war
4	Aug 1997 to Jan 1998	Down 32%	UP 6%	EM down but DM up	EM	Asian currency crisis – EM shares down heavily as contagion spread
5	May 1998 to Aug 1998	Down 44%	Down 12%	EM much worse	EM	Russian default – infected US hedge funds – LTCM rescue. Contagion spread across emerging markets
6	March 2000 to Sep 2002	Down 44%	Down 47%	EM worse in early stages, not as bad in later stages	Global + EM	Dot com boom and Tech wreck was in developed markets (US, UK, Germany, Japan) – but all markets fell. Also Argentine 2001 crisis + default led to regional contagion fears
7	May- June 2006	Down 11%	Down 3%	EM worse	US	US Fed's 16 <sup>th</sup> + 17 <sup>th</sup> rate hikes to 5.25% at top of market. + RMB appreciates below 8 to the USD for the first time since Jan 1994 deval. + Iran plans to enrich uranium.
8	Nov 2007 to Feb 2009	Down 61%	Down 54%	EM worse	global	Sub-prime was purely a US problem but infected all banks globally. Shares down everywhere but EM worse than DM as hot money withdrawn
9	May to Dec 2011	Down 22%	Down 20%	EM only slightly worse	US, Europe	Global sell-off caused by Greece 2 crisis + US downgrade crisis (Aug). ECB rate hikes (April + July), Portugal bailout (May), China tightening policy to slow housing boom,
10	March to May 2012	Down 15%	Down 9%	EM worse	Global, EM	Bernanke's initial QE taper scare (Feb, May), Greek debt haircut swap deal (March), China cuts GDP growth target to 7.5% (March), Argentina nationalises Repsol (April), JP Morgan \$2b derivative trading loss (May), China property slowdown + RRR cuts. + French + Greek election fiasco.
11	Feb to Aug 2013	Down 11%	UP 7%	EM down but DM up	Global	QE taper fears (Feb Fed), Italian election chaos, (Feb) Moody's downgrades UK (Feb), + falling commodities prices + Greece debt
12	Sep 2014 to Feb 2016	Down 29%	Down 9%	EM much worse	Global + EM	Global sell-off was caused by several factors – but mainly originating in China. – (1) Fears of China slowdown, oil/gas/steel bankruptcies (caused by commodities price collapse caused in part by China slowdown fears, as well as over-supply), (2) Deutsche bank crisis (not China related). (3) Another factor was the fear that the China stock market bubble would cause wider China slowdown. (4) fears of other emerging market crises caused by collapse in commodities prices (China cause)
13	Oct to Dec 2018	Down 14%	Down 13%	EM a little worse	US	Late 2018 'growth scare' caused mainly by fears of Trump's trade war impacts on global trade and growth + fears that the Fed would continue to hike US rates even in the face of signs of slowing US growth

In every case, emerging markets shares (column B) sold off more than developed markets shares (C) even though the triggers for the global sell-off had *little or nothing to do with emerging markets*. The most recent case was the late 2018 global sell-off (episode 13) triggered by the US Fed's four rate hikes and Trump's trade war antics triggering fears of a US recession.

Episodes 3, 4 & 11 were not global sell-offs but are shown here because emerging markets fell while developed markets did not.

- Episode 3 (1992) was a global currency war where emerging markets were a casualty, while developed markets kept rising
- Episode 11 (2013) was mainly triggered by the US QE taper scare, but emerging markets fell while developed shares recovered and rose.
- Episode 4 was the Asian currency crisis – the only sell-off with purely emerging markets causes – emerging markets fell heavily but developed markets shares shrugged it off quickly and rose.

In addition to the share sell-offs in the above table, emerging markets shares sold off more than developed markets shares in numerous other minor scares – including the Brexit vote and Trump election. These were developed markets triggers, but emerging markets sold off more, even though they were not as expensive as development markets shares.

In summary:

- Emerging markets have sold off in all developed markets sell-offs – regardless of the cause or trigger for the sell-off, and regardless of fundamental merits or pricing or local conditions
- In all global sell-offs emerging markets did worse than developed markets, even when emerging markets were cheaper than developed markets on a range of different valuation measures
- Emerging markets can also sell off for reasons triggered locally or from regional contagion
- There have been several periods when emerging markets fell but developed markets rose
- But there have been no sustained periods when emerging markets rose but developed markets fell
- The reason is that emerging markets share prices are driven by global 'hot money' sentiment cycles, rather than investment fundamentals.

### Emerging markets shares in our portfolios.

Because of these consistencies patterns in emerging markets performance relative to developed markets, emerging markets shares should be seen merely as a high volatility, high beta exposures to global market cycles, rather than some theoretical text-book notion that emerging markets shares should do well because their economies, populations, living standards and spending levels are growing more quickly than in developed markets.

In 2017 after the Trump election we were bullish on global shares and included emerging markets shares in portfolios because they usually do better than developed shares in general global rallies – and they did.

From April 2018 when we turned bearish on global shares prior to the 2018 'global growth scare' selloff, we under-weighted global shares and removed emerging markets from portfolios because they usually suffer worse than global shares in general global rallies – and they did.

From early 2019 after the late 2018 sell-off we returned to being bullish and over-weight global shares but we did not add emerging markets (ie we went against the usual pattern) because we thought they would lag developed markets shares in the 2019 rebound – and they did.

In the January 2020 review we retained our slight over-weight to global shares but we shifted an allocation within global shares to emerging markets (using the 'IEM' exchange trade fund for broad exposure) because we believed they would do well relative to developed markets shares in the current conditions. In the February coronavirus scare, emerging markets did hold up better than developed markets – developed markets ETF ('VGS') was down -7.8% but emerging markets ETF ('IEM') was down -4.1%.

We are continually reviewing sources of risk in portfolios and we will make any necessary adjustments after the end of the March quarter.





## What lies ahead?

February was a bad month for shares around the world, due to the sharp sell-off in the last week, triggered by new reports of coronavirus cases in Italy and Iran, and by inconsistencies in statements from Trump and various US agencies about the US position.

During February shares in the US, Australia and global markets generally saw falls of around half of their late 2018 falls. For example in the US, the S&P500 index was down -8.4% in February, compared to -20% in the late 2018 sell-off (20 September to 24 December 2018). February was the worst month for US shares since December 2018. For Australian shares the broad market was down -8.6% in February this year compared to -15% in the late 2018 sell-off. It was the worst month for local shares since October 2008.

Why the panic selling of shares? It appears it is due to fears that the epidemic will result in widespread, permanent reductions in company profits, rather than merely temporary reductions that are recovered in later years and logically should not affect share prices significantly.

This brings us to a discussion about permanent versus temporary effects, and logic versus emotional reactions.

The coronavirus has certainly led to a variety of temporary effects – for example, temporarily accelerating sales of things like masks, protective gear, pharmaceuticals, stockpiling of food and other supplies; and conversely temporarily delaying other items like travel and other discretionary spending items. These throw up a host of short-term trading opportunities but we are not short-term traders.

As long-term investors we need to ask – will the coronavirus lead to a significant general permanent reduction in corporate profits?

- The 1919-20 Spanish flu resulted in a 3% reduction in world population (around 50 million killed including 675,000 Americans and 15,000 Australians). That was a permanent removal of millions of spenders and workers, but the epidemic marked the start of the 1920s share boom.
- The 1957-8 'Asian Flu' global epidemic reduced the world population by 0.7% (killing around 2 million, including 70,000 Americans but no Australians). It had no impact on share markets, which continued to rally during the post-war nation building boom.
- The 1968-70 'Hong Kong Flu' global epidemic reduced the world population by 0.3% (killing around 1 million including 34,000 Americans and 2,400 Australians). It had no impact on share markets, which continued to rally during the 1960s aerospace/mining boom.
- The 2009-10 'Swine/Mexican Flu' global epidemic reduced the world population by 0.3% (killing around 200,000 including 12,000 Americans and 1,600 Australians). It had no impact on share markets, which continued to rally during the post GFC rebound.

There were other major events that resulted in big reductions in populations of spenders and workers – for example World War 2 killed around 75 to 85 million, or 3.5% of the world population, but share markets in US and Australia boomed. It is a little unfair to compare the impacts of wars on share markets as examples here because wars have a host of positive benefits for companies that disease epidemics do not share.

Will the current epidemic keep spreading to kill say 5 or 10 million people world-wide, or even 200 million (which would be today's equivalent of the 1919-20 Spanish flu as the world population today is more than 4 times what it was in 1919)? There is a remote risk of this - but even if it did occur it would probably have little or no permanent impact on corporate profitability and share prices if history is any guide. Most companies would adapt to the new conditions. Some would fail to adapt and struggle, but others would rise to take their place. The more challenging the conditions, the more opportunities there are for nimble and/or new companies to adapt and thrive.

If we rule out the remote possibility of the coronavirus killing more than a few hundred million people, we are left with merely temporary reductions in profitability and share prices. The 2008-9 global financial crisis was temporary – and shares rebounded strongly in the ensuing years. The late 2018 growth scare share sell-off was also temporary and shares rebounded quickly to higher levels in 2019.

Should long-term investors sell into the panic selling now? There are four main circumstance where this might be wise:

- 1) If you need the capital now for a specific purpose (but if you need capital in the short-term you should not be invested in shares anyway);
- 2) If you believe the virus will engulf the world and kill more than a few hundred million people and permanently reduce overall company profitability;
- 3) If you believe you will be killed by the virus and want to spend or distribute your money now in the short time you have left; or
- 4) If you believe you can sell now and buy back in at a cheaper price after the market has fallen further, or after the market has 'settled down'. This sounds fine in theory but rarely works in practice. If you are panicking now at current levels it is highly unlikely you will be able to go against the crowd and even more shrill negative media headlines when share prices have fallen even further. By the time the market 'settles down' it will have rebounded and you will have missed the upside. For example, investors who panic sold in the late 2018 scare to wait for things to 'settle down', missed out on the great 2019 rebound. This is the classic 'buy high – sell low' pattern for retail investors.

Investors in the last group may be in the wrong portfolio mix for their risk tolerance, and more focused on the media headlines than their actual portfolio returns and their long-term goals. They should talk to their adviser about a more appropriate portfolio mix for their long-term goals, and talk about the trade-off between returns and risk on the one hand, and income and lifestyle expectations on the other.

I am writing this report from the home of high yield investing – Argentina. You can get yields ranging from 9% to about 15% on bonds issued by the Argentina government, Buenos Aires provincial government, and even the Buenos Aires city government. These yields look very attractive compared to returns of less than 1% on Australian cash and less than 2% on Australian term deposits.

With high yield comes high risk of loss of course. You may receive a couple of years or so of 15% interest but then nothing when, not if, Argentina defaults again. Navigating the streets of Buenos Aires requires frequent detours to avoid gathering hordes of protesters rising up to throw out the government yet again. Six months ago they threw out the pro-business Mauricio Macri government after failing to bring necessary but painful reforms, and they returned the Fernandez/Kirchner populist/nationalists. Neither side has a solution for the crippling debts, inflation and collapsing currency.

Next stop is Brazil, and on the way I am sailing past numerous empty iron ore bulk carriers that are moored miles out to sea as they lie idle waiting for the Vale mines to be re-opened. The catastrophic tailings dam disaster at Vale's main iron ore mine in Brazil at the beginning of 2019 took 300 lives in downstream villages, but it also took 95 million tonnes of iron ore out of the supply trade to China. This led to a price spike in iron ore that produced windfall price and volume gains to Rio Tinto, Fortescue Metals and BHP, which in turn contributed to windfall gains in aggregate profits and dividends for the Australian share market in 2019. It also catapulted the Australian Federal budget back into surplus, and the current account into its first surplus in a generation. All of these effects are temporary of course, because Vale's mines will be re-opened and the iron ore price has already fallen back in anticipation.

It is a good reminder of how everything in the world is connected in a complex network of causes and effects, and the difference between temporary and permanent impacts. The current virus crisis *du jour* will probably pass, just like numerous prior crises. It will probably not escalate into a significant permanent reduction in global company profitability that would warrant permanently lower share prices, and so it is probably temporary. In the meantime, it will be enough to shake out nervous sellers and provide buying opportunities for long-term investors.

'Till next time, *buena suerte!*

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