STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5

November 2019

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 All portfolios posting strong returns

October was a flat month for investment markets but 2019 has been a boom year so far for nearly all types of investment assets except cash. One regular question I receive from investors and media is how to generate returns with such low cash rates – especially for retirees. The answer is that we hold very little cash in our portfolios for our clients (most of whom are retirees), and so the ultra-low cash rates have very little direct impact. Even when we were very bearish on shares last year, we didn't increase Australian cash holdings. Instead we bought US dollar cash and it jumped 10% in the crisis as the Australian dollar fell. So we do use cash in portfolios when we need to, but not always for income.

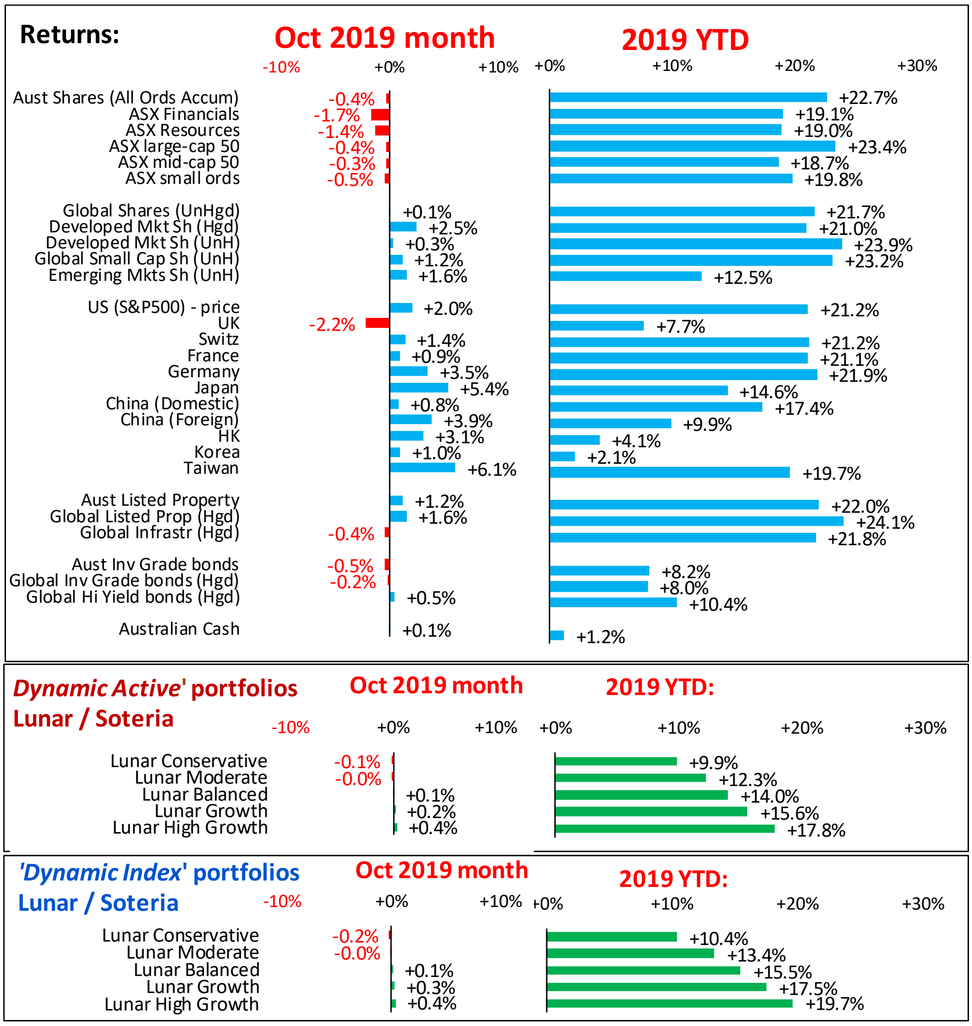
While low cash rates have very little direct impact on our portfolio returns, the indirect impacts of low cash rates are very clear. The unusually low cash rates have been the main driver of the unusually high returns from shares, bonds and real estate (commercial and residential) since the global financial crisis. Cash rates are likely to head even lower in Australia and almost everywhere else in the world, before they rise again.

Monetary policy (cash rates and central bank bond buying) continues to be the main force driving investment markets here and around the world. This year's strong rebound in shares was kicked off at the start of the year by the US Federal Reserve's sudden switch from rate hikes to a rate 'pause', then into three rate cuts in July, September and October, and also a re-start of its bond buying program. Central banks in Europe and Japan also loosened monetary policy even further, and the Reserve Bank of Australia chipped in with three more rate cuts.

Last year our portfolios were under-weight shares prior to the 'global growth scare' sell-off. We reduced exposures to small companies and removed emerging markets shares as they always fall more in broad sell-offs. We reduced currency hedging on global shares in anticipation of the Australian dollar falling. We added government bonds, US dollar cash and Australian dollar gold to further cushion the fall. As a result of these changes, our portfolios had a relatively smooth ride through the 2018 turmoil.

Earlier this year we switched to being over-weight Australian and global shares for the rebound. We didn't add back emerging markets shares or increase small companies. Both have lagged in the rebound. Usually when bullish on global shares we would increase currency hedging to more than 50%, but we saw further falls in the AUD so we remained below 50%. This added value as the AUD fell further this year. On the defensive side we retained our bias toward Australian bonds over global bonds – as our yields have fallen more than global yields.

All of our portfolios are ahead of their long term goals and are beating their peer multi-sector funds on risk-adjusted returns.



2 1929 crash – Australia's biggest stock market crash, but not as deep or as long as America's

It has been 90 years since the start of the 1929 stock market crash. The themes back then were the same as today – a speculative tech boom, high debt levels, monetary policy, currencies, regulatory attacks on monopolies, tariff protection wars and threats to global growth.

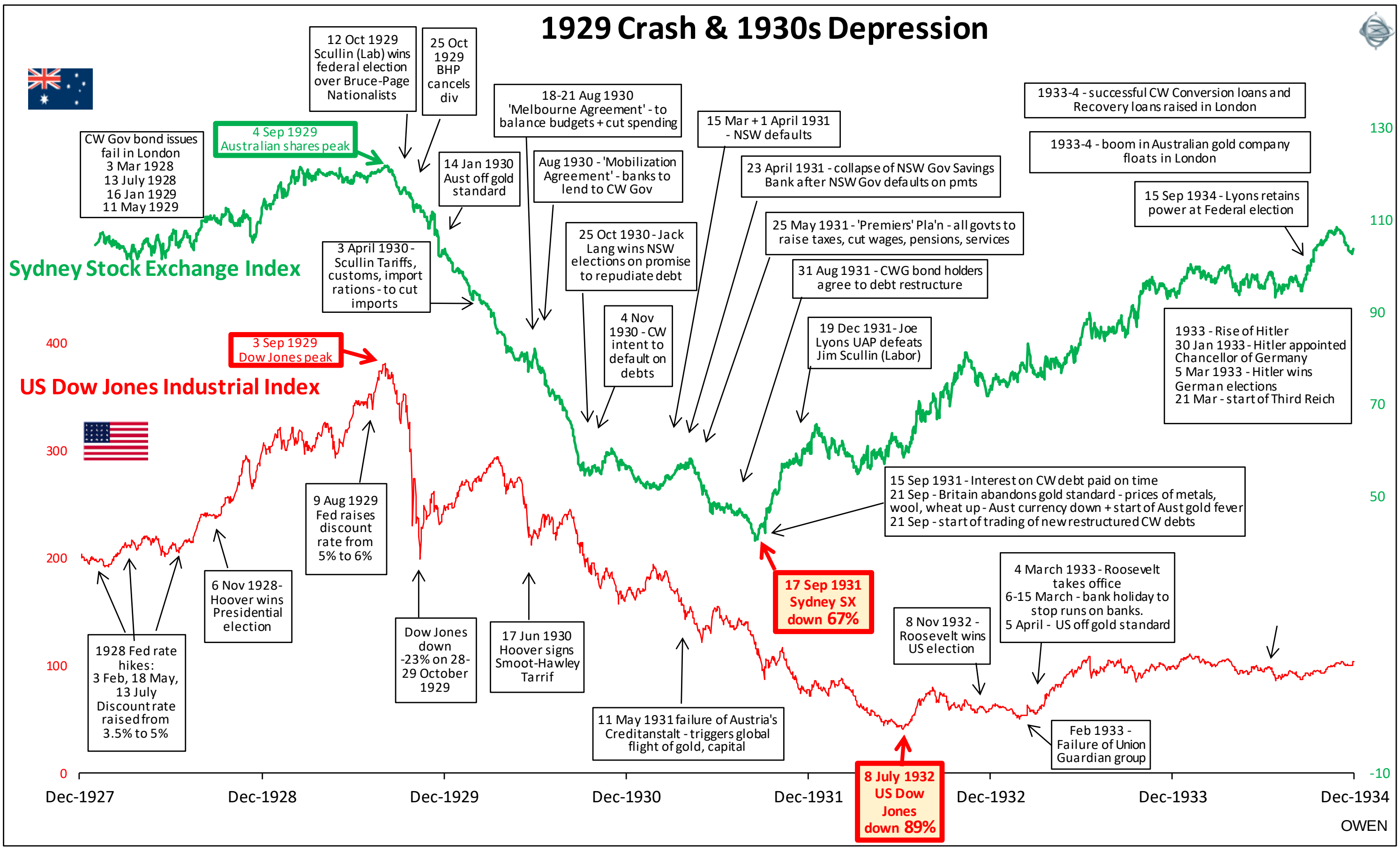
90 years ago the US Dow Jones Index of industrial shares fell 24% over two days: -13.5% on Monday 28th and -11.7% on Tuesday 29th October 1929. That was just the start of a slide that lasted nearly three years. The 1929-32 stock market crash was America's deepest and longest. The Dow fell by 89% over 34 months and it took 25 years to recover its 1929 high. (The GFC crash was rather mild by comparison - 53% fall over 17 months and took 5 ½ years to recover).

For Australian shares it was also our worst crash but it was not as bad as the US. We didn't have such dramatic one-day falls. The US market had 25 days with falls worse than -5% during their crash (compared to just 9 days worse than 5% in the 2008-9 GFC for US shares). Our worst single day fall during the crisis was less than -3%, on Wednesday the 16th of September 1931 – the day before the bottom of our crash, when the commercial banks refused to lend more money to the State and Federal governments to pay interest on their debts or to create jobs.

Australian shares fell by less than the US: down 67% over 24 months here, and 'only' 7 years to recover. (Australia's worst ever one-day fall was -25% on 20 October 1987 following Wall Street's -23% fall on the 19th, but the total fall from top to bottom in that cycle was -50.1% in Australia and it took 6.5 years to recover the high. Australia's other big crashes were -59.7% in 1973-4 and -54.6% in the 2008-9 GFC.)

Hundreds if not thousands of books and PhD theses have been written about the 1929 crash in America but virtually nothing has been written about Australia's biggest ever stock market crash. Here is a quick snapshot.

The chart shows Australian shares (Sydney Stock Exchange) in green and US shares (Dow Jones Industrials) in red. For the US market the high point was the 3rd of September 1929. In Australia the high was the next day – Wednesday the 4th of September 1929.



The main trigger for the start of the falls in the US were: The Federal Reserve's rate hike to 6% on 9 August after three hikes in 1928; the collapse of the fraudulent Clarence Hatry companies in London on 20 September; and the government's regulatory attacks on Thomas Edison's Boston electricity utilities on the 15th of October (electric utilities were one of the hot 'tech' sectors in the late 1920s boom).

In Australia the triggers were Labor's Jim Scullin winning the federal election over the Bruce-Page Nationalists on 12 October; and BHP's surprise cancellation of dividends on the 25th of October (BHP was by then a steel-maker and cancelled dividends after coal miners' strikes cut steel production).

Stock market crashes, tariffs, depression & deflation

The 1929 crash is often blamed for triggering the 1930s depression but it probably had only a minor role. It certainly shattered consumer and investor confidence and ended the 1920s boom in tech stocks (car, electric utilities, telephones, radios were the hot new 'tech' sectors of the day). The collapse in confidence reduced spending and investment, but they were already falling years before the crash.

Likewise, America's 'Smoot-Hawley' tariff law in 1930 is also often said to have caused the depression, but this too over-states its actual role, as global trade had already collapsed by the late 1920s. The Fordney-McCumber Tariff had raised US tariffs to 38.5% from 1922, and Smoot-Hawley added another 20%. The stock market crash in 1929-32 and the tariff hikes in 1930 prolonged the depression, but were not the causes.

There were two underlying causes of the collapse in global trade, production, prices and jobs in the late 1920s and early 1930s. Both had their origins in the First World War and in Europe – and both impacted Australia directly and indirectly in several material ways.

Agriculture

The first was agriculture. Heading into WW1, America was the largest agricultural producer and exporter in the world. Agriculture was America's largest industry, employer, and source of national incomes. The War severely disrupted European farm production and this dramatically boosted farm produce prices and export revenues for American farmers. The massive rise in incomes spurred increased investment in new farm lands (which would otherwise be marginal or loss-making at lower prices), investment in new machinery and technology (like trucks and tractors), and also debt levels as farmers geared up in the boom to take advantage of the high prices.

All of this reversed from the mid-1920s. The over-investment in the late 1910s resulted in over-production in the 1920s, leading to lower prices and incomes. Prices and incomes fell even lower when global supplies increased after European farming recovered after the war and returned to world markets. The over-investment and over-borrowing followed by falling prices and incomes resulted in wide-spread bank collapses across the US, mainly in the farm belt. Between 1929 and 1933, 10,763 of the 24,970 commercial banks in America failed. Most were small town and regional banks. 2,100 banks were liquidated and depositors eventually recovered only 62 cents in the dollar on average – many years later. The 'Lehman Brothers moment' in the 1930s depression came in February 1933 when the federal government's bail-out fund (the Reconstruction Finance Corp) failed to rescue the Detroit-based Union Guardian group (Union Guardian Trust Co and Guardian National Bank of Commerce - both backed by Henry Ford). This accelerated the bank runs, closures and financial hardship across the country.

Monetary policy

The second underlying cause of depression and deflation was monetary/currency policy. From 1900 onward the 'gold standard' had become a world-wide mechanism for controlling money supply and inflation by restricting governments' ability to print money. During WW1 nearly every major country abandoned the gold standard in order to print more money quickly to pay for the war effort. This led to massive war-time and post-war inflation spikes (eg 14% in Australia, 20% in US, 25% in UK), and there was a concerted effort to return to the gold standard to limit money supply and contain inflation. Although this aim was well-intentioned – especially with Germany's 1923 hyper-inflation crisis fresh in their memories, returning to the fixed gold standard meant savagely contracting the supply of money back to levels that were supported by the amount of physical gold held.

The deflationary return to the gold standard affected different countries in different ways. France was cunning in fixing a very low exchange rate (effectively an 80% devaluation) – which boosted exports and domestic incomes in France but left the US dollar over-valued. Britain did the opposite – it was determined to return to its pre-war level of $4.88 per pound - largely as a matter of national pride as the former ruler of global capital markets. Just as the artificially low French franc boosted exports and incomes for the French, the artificially high British pound penalised British exports and incomes (and Australia with it, as our Australian pound was tied to the British pound). The result was continual current account crises for Britain in the 1920s, and contractions in investments in Australia, as British investors were our main sources of capital.

What are the risks today?

The risk of another global banking collapse is as great as ever. The collapse of the global financial system in 2008-9 was partly due to distortions resulting from regulations introduced after the 1930s bank crisis (government guaranteed bank deposits, government sponsored mortgage lenders, amongst others). Inevitably the reforms in the wake of the GFC will lead to distortions and flaws that will feature in the next financial crisis. The risks are probably greater now because global financial markets are more complex and inter-connected than ever before.

On the monetary and currency front - the gold standard was restored in the 1940s but was abandoned altogether in the late 1960s to early 1970s after less than 20 years because it wasn't flexible enough to adjust for imbalances. Likewise the Euro system is destined to fail for the same reason. We will see more intra-European disputes between the northern creditor countries and the southern debtor countries.

Global trade is also highly vulnerable today but in a different way. 90 years ago it was primarily agriculture but today it is a vast web of global supply chains in which every product involves inputs from dozens of different countries along the supply chain including raw materials from mining exporters like Australia, all the way through to finished products including software and services. It is a complex system in which a disruption in one part of the chain can have debilitating impacts in many other countries very quickly, as happened in the 2008-9 GFC.

An added problem is Trump's strategy of trying to change each bi-lateral trade relationship separately as if they are un-connected to other countries in the supply chains. The uncertainty has led to companies everywhere to shelve or delay investment plans, hampering growth rates.

3 Australian conditions were very different - but shares still fell heavily

The Australian share market fell by 67% in the 1929-31 crash - its worst-ever fall - but local conditions were much better than in America.

Australia did not have a speculative 'tech' stock boom like America. Our market was dominated by boring manufacturers protected by high barriers – Colonial Sugar (CSR), BHP (steel), British Tobacco, brewers Tooth, Toohey's, Carlton, Fosters, Castlemaine, and the banks (which were ultra-conservative lenders after having learned from their wild excesses and collapses in the 1890s depression). We did have a minor boom in New Guinea gold stocks and Malaysian tin stocks but they made up only a very small slice of the local share market at the time.

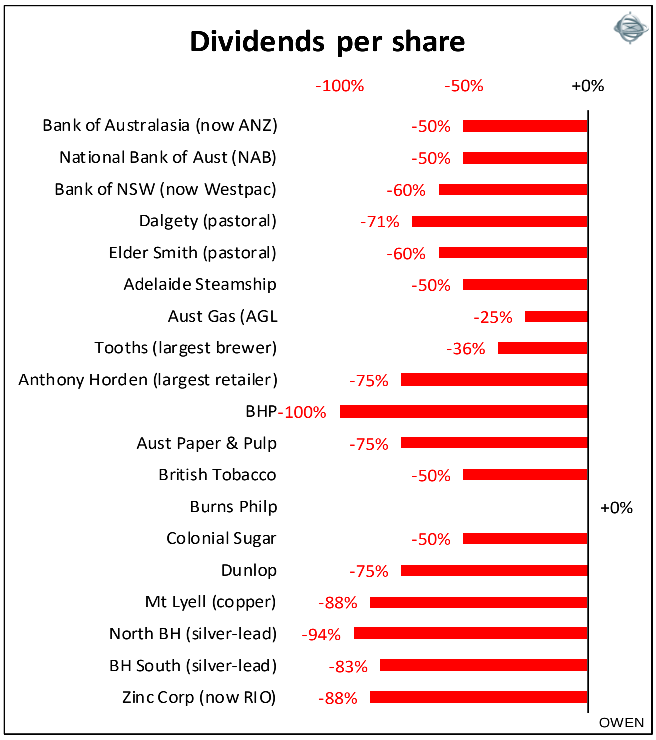
Australia didn't have a boom in margin lending or 'call money market' deposits like in America ('Call money market' accounts were unregulated 'shadow bank' deposits in the US that were on-lent to share speculators). Nor did we have a mutual trust boom like America. The hottest of hot stocks on Wall Street were unregulated geared-up trusts that bought listed shares and units in other geared-up trusts – adding even more layers of gearing and over-pricing.

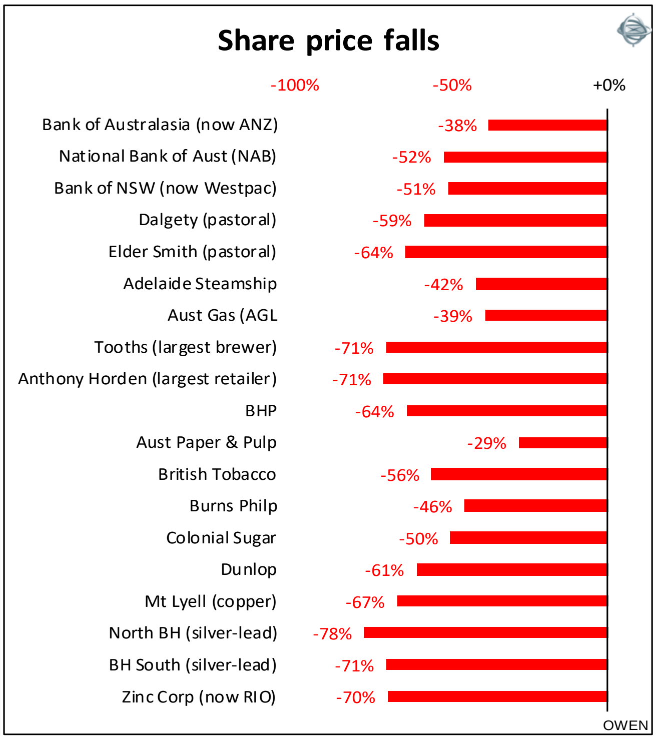
Nor did Australia have a banking crisis like the US. Unlike the widespread collapses of Australian banks in the 1890s depression, Australia had only one major bank collapse in the 1930s – the Government-owned Savings Bank of NSW. The cause was political, not economic - the NSW government defaulted on its bonds, bills and notes, including those held by its own savings bank. Deposits were frozen until taken over by the Commonwealth Bank.

Australia did not have a government regulatory attack on business – like Roosevelt's attempts to break up and nationalise the monopoly electricity utilities which were speculators' favourites on Wall Street (this is a risk today with regulators attacking the big US tech giants).

Nor were Australian shares over-priced before the crash. At the peak of the market prior to the collapse, dividend yields in Australia were still high at 5.4% for the market as a whole. This was no lower than it was over the previous two years. Yields were 5% to 5.5% for the big banks, around 4.5% for the big industrials, brewers and retailers, 5.5% for the big pastoral houses, and 7% for BHP. Contrast this with US dividend yields of just 2.7% at their peak, which was its lowest ever yield up to that point and half the level of yields three years prior.

Despite all of these differences between the relatively sober and boring Australian market and the wild speculative fever in the US, Australian shares still collapsed across the board to our worst fall ever. All stocks in all sectors were down heavily. Here is a snapshot of the major listed companies in Australia:





Dividends were cut by an average of 45% across the Australian market (not as bad as -55% in the US, but worse than Australia in the GFC). Almost every dividend-paying company in Australia either reduced or cancelled their dividends. Companies cancelling dividends included BHP (cancelled for 3 years), Anthony Horden, Aust Iron & Steel, EZ industries, Sulphide Corp, Mt Lyell Copper, Hoyts and many others. All of the big banks reduced their dividends by 50-73%. The only major company not to cut dividends was Burns Philp (shipping).

There were no major corporate collapses or bankruptcies in the Australian market – just much lower profits, dividends and share prices.

Main causes of Australia's crash

The main trigger or cause was not economic recession or depression. The economy was already in recession in 1926, 1928 & 1929 due largely to collapsing wool and wheat prices and revenues. Real GDP growth actually turned positive in 1930, when share prices fell the most, but the economy was back in recession in 1931, when the strong share rebound started. The economic depression was at its deepest in the middle of 1932 – when real GDP contracted by 9% and unemployment hit 30% - but shares had already risen +50% from their lows by then.

Aside from merely following US contagion, there were two main reasons for the severity of the Australian crash. One was external: the global commodities price collapse; and other was self-inflicted: the government borrowing binge and resultant defaults on state and national debts.

On the commodities front, world prices of Australia's two largest exports – wool and wheat - collapsed from the mid-1920s, as did prices of base metals and all other industrial commodities. But mining stocks made up less than 20% of the local stock market at that time – the lowest share in Australia's history. The main driver of the recovery in commodities prices was currency devaluation – this is covered in the next story.

Government debts and defaults

The main problem for Australia was self-inflicted. Australian governments had gone on a wild borrowing and spending spree to build infrastructure in the 1920s – aided and abetted by a flood of global money chasing returns. Total Australian government debts reached 205% of national GDP – which is on a par with Japan's current astronomical government debt levels and worse than Greece, Italy, Portugal, or any of the other big debtor countries today. Half of the government debts were raised locally from Australians and listed on local stock exchanges. The other half was raised from foreigners (mainly British and Scottish investors) through the London market and listed in London.

Debt levels and interest rates rose during the 1920s and by the late 1920s an incredible 40% of all government revenues were consumed with just making the interest payments on debts (compared to just 5% debt service ratio today). The Commonwealth and State governments were no longer able to raise more debt on the London market, and the local banks (including the government's wholly owned Commonwealth Bank) refused to lend them more money to make payments on existing loans, or to deficit spend to stimulate the economy.

There was no way out for the government. Tax revenues were falling, welfare costs were rising, foreign debt markets had closed their doors on Australia, local savings had dried up or were locked up in frozen deposits, banks wouldn't lend to the government, not even the government's own Commonwealth Bank (this was the first defiant step toward central bank independence in Australia). Something had to give. Interest payments were falling due and maturing debt needed to be repaid or refinanced. It was a scramble to cut costs (including wages and pensions) to pay the interest on every due date. During the crisis, yields on Commonwealth bonds rose to above 10% reflecting fears of default.

On 30 April 1931 the NSW government defaulted on interest payments due in London and on 30 June the Commonwealth government's account in London run out of money. The Bank of England had to make an emergency bail-out loan so Australia could pay maturing treasury bills in London. With more repayments due in August, the government had to decide who not to pay – Australian bond holders or foreigners.

The government decided that Australian bond holders should suffer losses to ensure that foreign investors were paid in full. It was a matter national pride. The Commonwealth legislated a Greek-style debt restructure in which all Australian holders of government debt took a 'haircut' on their bond holdings. Interest on all bonds was reduced by 22.5% and repayment of principal amounts were delayed for up to 30 years. A vote of local bond holders was taken and 93% of them agreed to take the haircut so foreign investors could be paid in full.

Trading in the existing local bonds was suspended on the 15th of September 1931 and the new re-structured 'haircut' bonds started trading on Monday 21 September. Yields on local 10 year bonds fell from 8.4% on the old bonds prior to the restructure, to 6.4% on the new restructured bonds when they started trading. Share prices hit their low point on the 17th and rebounded strongly the next day in a huge sigh of relief that default in London had been averted. Two days later Britain had to abandon the gold standard to de-value the British pound – taking the Australian pound with it – and this accelerated the rebound in local share prices.

What are the risks today?

The first lesson is that share prices can fall heavily across the whole market even when they are not expensive. Australia was, and still is, a far-flung 'emerging market' which is subject to fickle foreign money rushing in to chase quick profits in the good times, then rushing out just as quickly at the first sign of trouble anywhere in the world. Australian shares fell more heavily than US shares in the GFC even though the US was the source of the problem and we didn't have a sub-prime problem nor even a recession. In the next global crisis, Australian shares will fall heavily regardless of local conditions or local pricing.

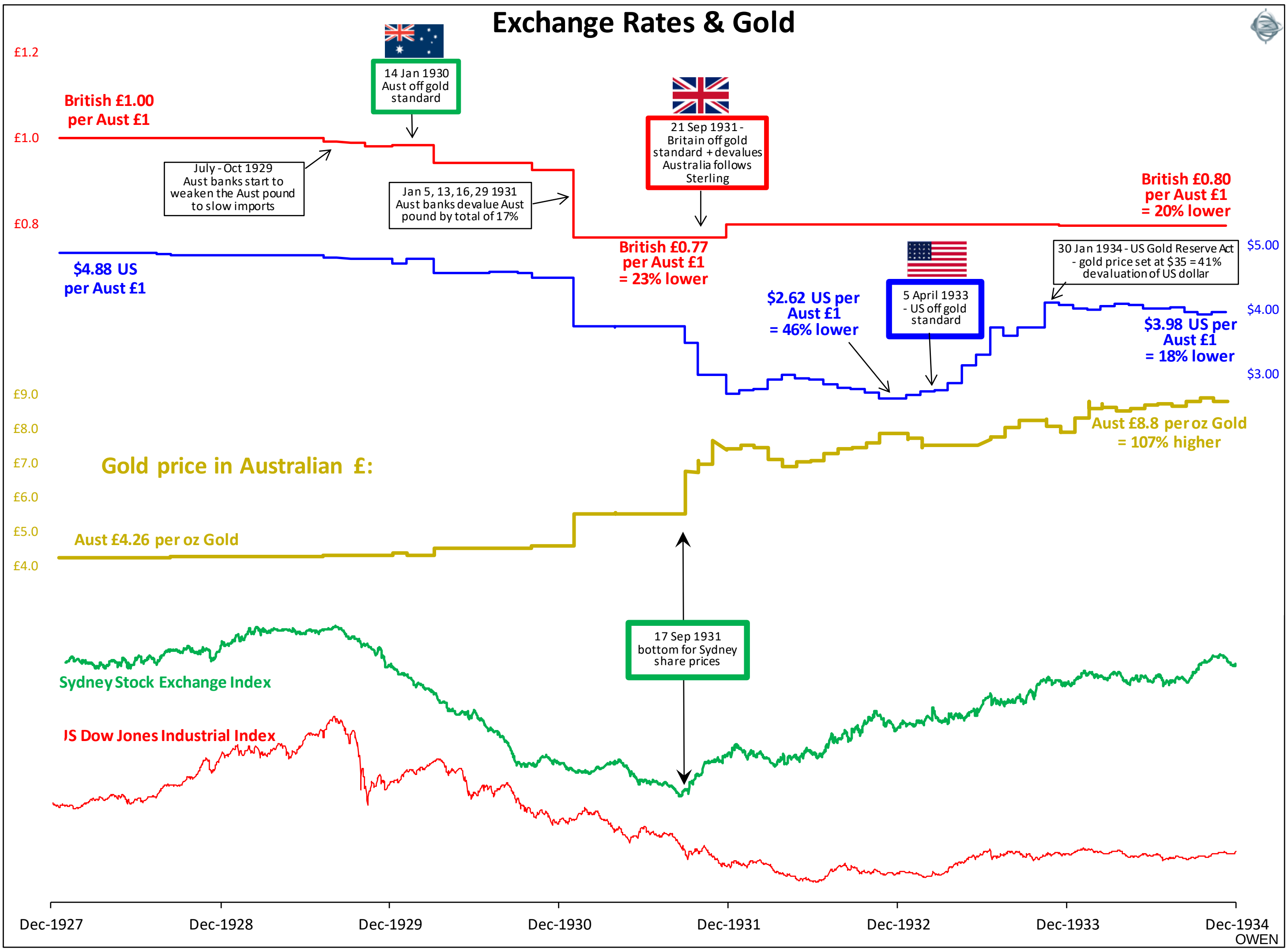
On the issue of government debt – this is a strength today but was a weakness in 1929. Today Australia is one of the very few remaining countries with a 'AAA' credit rating. Government spending is still booming but it is being supported by windfall iron ore tax revenues.

In the next global crisis, commodities prices and revenues will collapse again, but the government has the capacity and the means to increase spending to support local jobs. The 1930s depression was prolonged and deepened by banks' refusal to lend to governments to run deficits, and governments' inability to borrow due to already high levels of government debts and high interest rates. None of these constraints exist today. Even Japan with its mountain of debt is able to borrow as much at it wants at near zero and even negative interest rates. Greek bonds traded at yields above 30% in the 2012 crisis but Greece has no trouble borrowing at 1% today even though it will inevitably default yet again.

4 Currency Wars – Australia won in 1931 – The US couldn't win then – or now

Despite the global commodities price crash and our Greek-style default and restructure of our national debt – Australian shares recovered much earlier and much more strongly than US shares in the early 1930s. The main reason is that Australia was able to devalue its currency much sooner. Lower exchanges rate boosted commodity export prices and revenues, and flowed through to company profits and dividends.

The chart shows the Australian pound exchange rates against the British pound (red), against the US dollar (blue), and the resultant gold price in Australian pounds (gold). Australian and US share prices are in the lower section for reference.



Australia went off the gold standard in January 1930, more than a year and a half before Britain (September 1931) and more than three years before America (April 1933). The US dollar, being the global safe haven currency since WW1, effectively rose during 1931 to 1933 as other currencies devalued, because exchange rates are a zero sum game – everyone can't devalue their currencies at the same time. The stronger US dollar increased the pain for American exporters, farmers and households.

This is the same problem Trump is having today. The US dollar is still the global safe haven currency 90 years later, and so it is kept strong by demand from other countries that buy US dollars as the main reserve currency. In a crisis the US dollar strengthens even more as foreigners rush in to buy US bonds and dollars as safe havens, and as Americans dump foreign follies and switch back to US dollar assets.

The reserve currency status of the US dollar makes US devaluation the last and least effective. This delayed and dampened the 1930s recovery in the America's stock market and real economy.

<u>How did Australia de-value sooner?</u>

The Australian pound was officially pegged to the British pound at parity (ie. equal value), but the actual exchange rates for importers, exporters and other people wanting to buy or sell foreign exchange were set by the commercial banks, not the government or central bank (which was the Commonwealth Bank prior to the Reserve Bank's establishment in 1960). The commercial banks were the conduit for exporters collecting money from the sale of exports and for importers making payments for imports. The banks settled international transactions using money held in their London accounts, backed by gold. Whenever their London account balances ran down by imports exceeding exports, they reduced the exchange rate on the Australian pound to slow imports so they wouldn't run out of gold. Conversely, when they were flush with funds from a bumper export season they increased the exchange rate to reduce domestic inflationary pressures and to restore their London funds.

The banks also set interest rates on deposits and loans to manage lending growth and inflation. Until WW2 the commercial banks acted as a semi-competitive cartel to manage the economy via interest rates, lending volumes and exchange rates, not the government nor the central bank (In WW2 the government seized control of these critical bank functions and has never let go. It tried to deregulated banks in the 1980s but that ended badly. Today the same old banks still operate their semi-competitive cartel but now it is simply to line their pockets).

On 14 Jan 1930 Australia abandoned the gold-backing for the Australian pound when the Treasurer ordered the compulsory requisition of all gold in exchange for notes. It banned the export of gold without approval - to prevent people from shifting their gold to safe havens to avoid confiscation. The government sent the confiscated gold to London to meet interest payments on its foreign debts. It had no choice. Commodities export priced had collapsed in the late 1920s but governments went on wild debt-fuelled spending sprees (mainly for infrastructure like roads, railways, bridges) but could no longer keep up with interest payments. The Commonwealth and State governments were no longer able to raise more debt on the London market, and the local banks (including the government's wholly owned Commonwealth Bank) refused to lend it more money to make payments on existing loans, or to deficit spend to stimulate the economy.

<u>New mining boom to the rescue – again!</u>

As a result of these moves, by late 1931 the Australian pound had fallen by 23% against the British pound and by 45% against US dollar because the over-valued British pound also weakened against the US dollar. Even though the world prices of our key export commodities – wool, wheat and base metals – had fallen by 50-70% from their 1920s highs, the London prices of all commodities started to shoot up immediately after Britain abandoned the link to gold and devalued the British pound in September 1931.

The benefits started flowing very quickly to Australian companies. Although the September profit reporting season for the year to June 1931 was a sea of red ink, several companies started to increase dividends almost straight away – starting with North Broken Hill on 30th October.

The commodities price rebound triggered a new mining boom in Australia and gold was the star. The gold price in Australian pounds jumped 105% in value from A£4.23 per ounce in 1928 to A£8.70 in 1934 after the US government compulsorily acquired all the gold from its citizens and gave them 40.9% devalued paper dollars in return. Australian share prices surged across the board, and a flood of new gold mining exploration companies were hastily thrown together by Australian brokers and promoters and floated on local exchanges and in London.

Just as the new gold finds in Victoria and California came to the rescue to end the 1840s depression, and the new gold finds in Coolgardie/Kalgoorlie (Western Australia), Witwatersrand (South Africa) and the Klondike (Canada) came to the rescue to end the 1890s depression, the sudden doubling of the gold price came to the rescue for the Australian share market in the 1930s depression. New gold discoveries and production meant more gold in the system. This increases the money supply and allows banks to lend out more, which in turn increases spending, demand, production and employment. The new mining booms also led directly to more infrastructure spending in the form of new towns, transport links, utilities and services to support the new mines.

Meanwhile, the devaluations by Australia, Britain, France and many other countries meant the US dollar kept rising in the early 1930s. This crippled export prices and revenues for Americans, and US share prices kept falling. The US market finally stopped falling in July 1932 but it took 25 year years to recover its 1929 high. Australian shares started recovering more than a year earlier, and took seven years to recover.

<u>What are the risks today?</u>

Australia's flexible exchange rate has been a key player in global crises ever since. In a global panic, foreigners dump their Australian shares - savaging share prices here and also depressing the Australian exchange rate as they sell Aussie currency to scurry back to safe havens. For example, in the 2008-9 GFC, Australia didn't have a sub-prime crisis nor even a 'recession', but Australian shares fell by 55% (more than the US which was the source of the sub-prime crash and banking crisis), and the Aussie dollar fell by 35% against the US dollar.

While this is bad for local share prices, the currency collapse directly boosts commodity prices and revenues for local companies, making them great value for investors brave enough to buy up bargains from the panicking sellers as they race for the exits. A lower Australian dollar also boosts returns from foreign assets we hold in portfolios.

Today most currencies are free-floating in theory (the Chinese RMB is tightly managed) but the same pressures are still at work. The major central banks are desperately trying to devalue their currencies to boost exports and jobs at home – essentially by selling their own currencies and buying US dollars. The US is still the main reserve currency and the currency used for global trade, so it is hard to devalue. Worse still for Americans, the US dollar generally strengthens in a crisis. There have been a few isolated occasions when the US dollar weakened in a crisis. One was in the 1987 crash – where the trigger was US moves to depress the US dollar. Another was in the 2011 US down-grade and debt ceiling crisis when the US lost its 'AAA' credit rating and there were fears of a possible default on its debts. Therein lies the key.

One of the few pre-election promises that Trump has not acted on is for the US to repudiate its foreign debts. If Trump is brave enough (probably not prior to the 2020 elections) this would be a sure-fire way to bring down the US dollar. We held gold in our portfolios in 2018 and it shot up 10% in the 'global growth scare' sell-off. If Trump started down the repudiation path, that would be another trigger to buy gold.

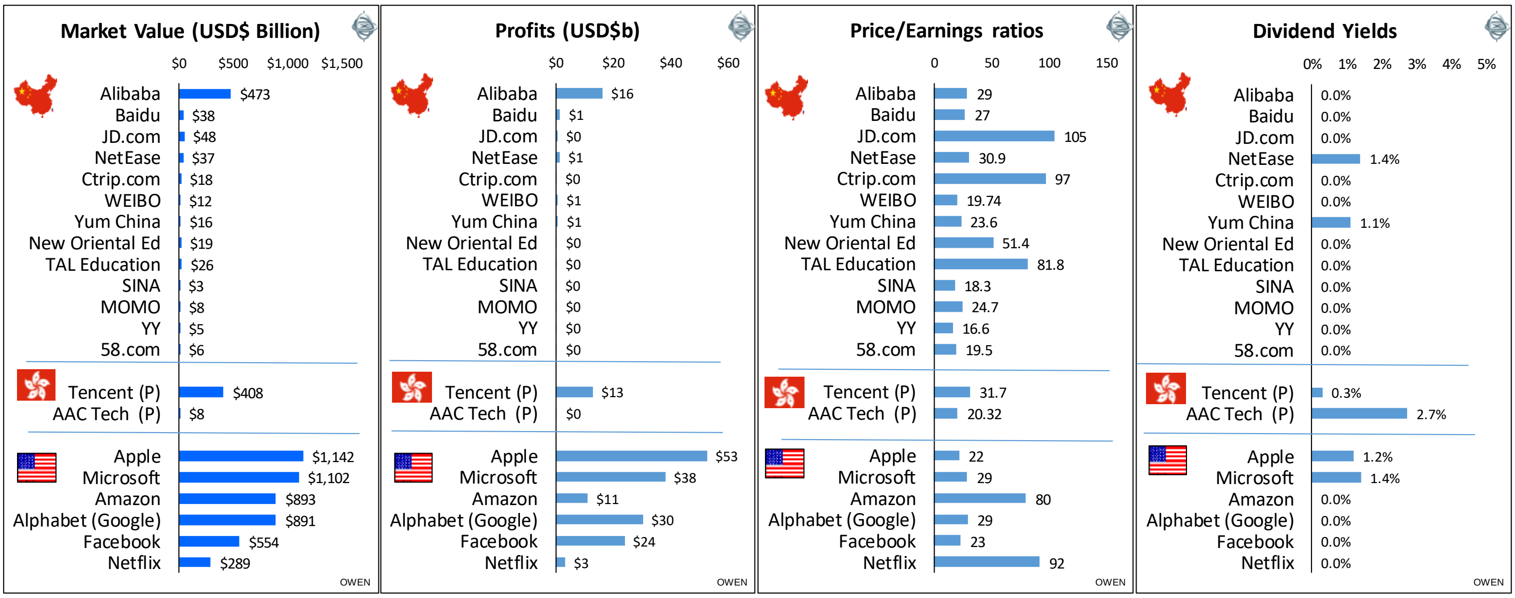
5 Today's tech boom: where are we now?

It is clear that the same issues and problems that featured in the 1929 crash (and several other prior crashes) are present today - a speculative tech boom, high debt levels, monetary policy, currencies, regulatory attacks on monopolies, tariff protection wars and threats to global growth.

We are in the latter stages of another speculative 'tech' boom in a long line of speculative tech booms over the decades and centuries. The big new ideas that are the subject of each boom are different of course – whether it is tulips or telephones, railways or radios, canals or cars, South Sea riches or smart-phones. Each boom captures the public imagination and leads to over-investment, over-speculation, and over-gearing, but each boom ends in tears and losses. For every winner there are dozens or hundreds of losers. That goes for companies and for speculators.

The last tech boom (the late 1990s 'dot-com' bubble) was spread across the US, Canada, UK and Europe. This time it is mainly in the US and China. The two largest Chinese tech stocks are Alibaba (listed in New York) and Tencent (listed in Hong Kong). Based on share prices, together they are about the same market value as Amazon or Google, and not far behind Microsoft or Apple. But on revenues, profits and dividends, they are still tiny, and so they are far more over-priced than their US counterparts. (Australia joined in with its own 'mini-me' tech boom in the late 1990s, and has again this time around, although in both cases the impact on the overall Australian market is minimal).

The charts below show the main US and Chinese tech stocks. New York listed Chinese stocks are in the top panel (known as 'N-shares'), Hong Kong listed Chinese stocks in the middle ('P-chips'), and the larger US tech stocks are in the lower section.



The Chinese tech bubble has been even more explosive than the US tech sector. All tech stocks around the world bore the brunt of the 2018 'global growth scare'. The broad market sell-off was mainly due to fears of a US and/or global recession if the Fed kept on raising interest rates, and also Trump's trade war antics. The tech sector was affected more than other sectors because of two additional factors. The first was their relative over-pricing, and the second was fears of regulatory backlashes, against Facebook initially but also possible anti-monopoly actions against all of the US majors, mainly in Europe. In the 2019 rebound the US majors have recovered well but their Chinese counterparts peaked in early 2018, fell more heavily in 2019 and have lagged in the 2019 rebound.

How did this affect our portfolios?

Chinese tech stocks make up the largest sector in 'emerging markets' indexes. We had them in portfolios in 2017 when they boomed ('emerging' markets shares beat 'developed' markets shares in 2017), but we removed them in April 2018 before the sell-off. Emerging markets sold off more in 2018 and we did not add them back for the 2019 rebound as the Chinese tech sector was still more over-priced and more vulnerable than the US tech sector.

Pricing of tech stocks

The third chart above shows that pricing relative to profits remains very high across the board (especially for the perennially over-priced Amazon and Netflix, although Amazon's price/earnings ratio is at least below 100, which is rare!). Other smaller US tech stocks are also very expensive – including Adobe and Nvidia, while some are more reasonable – Intel, Cisco, Oracle and IBM. Chinese stocks are even more expensive despite their falls over the past 18 months.

The fourth chart shows the almost complete lack of dividends – apart from Microsoft and Apple. This remains a concern in both markets today but is a stark contrast to the late 1990s dot-com boom which was almost entirely devoid of profits or dividends.

The Chinese tech sector also faces an additional direct threat in Trump's trade wars. Alibaba and the rest of the stocks in the top section of the charts are listed in New York and owned and traded mainly by Americans, not Chinese citizens in China. Trump has hinted he could simply outlaw American citizens from investing in Chinese companies. He dropped one such hint on 27th September this year and Chinese N-shares fell 2%. Banning Americans from investing in Chinese companies would be a natural and logical step in the broader trade war.

Although the Chinese tech sector is more over-priced and highly vulnerable to a range of risks and threats, it is much smaller than the US tech sector and its collapse in isolation would probably not trigger a global sell-off in tech stocks or global stocks generally. It is probably not systemic.

Systemic threat to global markets

On the other hand, the US tech sector does pose a systemic risk for global markets. Although the current US tech boom on the whole is not as over-stretched as the 'dot-com' boom, this time around the big US tech stocks have become the largest companies in the world, so their impact on overall global returns is much greater now.

When the late 1990s 'dot-com' boom collapsed in the 2001-2 'tech wreck' it dragged down the tech-heavy NASDAQ index by 74% - which is understandable given the astronomic pricing at the time. It didn't end there. The problem was that the negative wealth effect and pessimism of the tech collapse dragged down the entire S&P 500 index by 45% as well. It sent the US economy into recession, and it also dragged down every other stock market around the world whether they had a tech sector or not. The crash took the NASDAQ index 15 years to get back to the same level, and the S&P 500 index seven years.

Where are we now?

There are signs the current boom is fading. Examples include the poor performance of the Lyft and Uber floats this year and the cancelled float for WeWork in October. These indicate speculators are becoming more selective and sceptical of business models that offer no credible outlooks for profits any time soon. The profitless growth model worked for Amazon for 20 years but even it is now posting token profits instead of the usual endless losses. Amazon is still vastly over-priced and it has lagged the others in this year's rebound. In a full-throttled frenzied boom, profits and dividends don't matter – but now they do.

A share price collapse due to extreme over-pricing (ie a sudden retreat in speculative sentiment) remains a threat but not as serious as it was at the top of the 1990s boom. This time the trigger for a major sell-off is more likely to be anti-monopoly regulators moving to break up one or more of the majors (Google, Microsoft, Amazon, Facebook) – as Franklin Roosevelt's attempt to break up the electric utilities featured in the 1929 crash, or Theodore Roosevelt's attempts to break up the steel and oil monopolies in the 'Panic of 1907'. This was the first global financial crisis in the 20th century and it deepened the US recession into a depression only surpassed by the 1930s depression.

Monopoly break-up is a very real threat. European regulators are well into preparations on a number of fronts, as are several other governments – including California, the home of tech! Trump is a wild card in this game as he has a long-standing vendetta against Amazon because Jeff Bezos also owns the Washington Post – Trump's arch enemy. Trump has dropped several hints at direct attacks on Amazon.

Breaking up the tech majors is also a key policy for several front-running Democrat contenders for US presidential elections. Although the Democrats are facing an uphill battle for the 2020 election there is no doubt there is a growing global groundswell of support for ending the power of the big global monopolies, and the US tech giants are prime targets.

This theme is likely to take many months or even years to play out but the global shift is definitely underway.

What lies ahead?

I have spent much of this report on the 1929 crash and 1930s depression but it is not for historical reasons. Financial markets are driven by human fear and greed – they always have and always will, because these basic human emotions and instincts are hardwired. We don't learn from history. After each crisis we react by changing the rules in the hope of preventing the same mistakes and problems in the future. But there are no real 'solutions' – the so-called solutions introduced in the wake of each crisis often create distortions that sow the seeds for the next.

Will we have another global stock market crash and recession? Of course. Will it start in the next quarter, or the next year, or the next decade? Probably no, possibly yes, and almost certainly yes. Does this mean we should panic, cash in everything and hide under a rock? No. Share markets spend two thirds to three quarters of their time rising and only one quarter to one third of their time falling. Compared to the long booms, most of the falls are short and sharp, and are driven by a host of factors that are years in the making and offer clues of trouble brewing.

We are constantly on the look-out for threats and opportunities. After the end of each calendar quarter we re-balance portfolios and make adjustments to protect investors from risks and capitalise on opportunities based on what we see at the time. Last year we significantly reduced shares and increased defensive assets to protect investors from the 2018 sell-off (which included the worst December for US shares since 1931). This year we have been over-weight shares for the strong rebound. These changes were made at our regular quarterly reviews.

We also have the ability to make portfolio changes at any time between these quarterly reviews if the need arises. For example, when shares sold off sharply after the Brexit vote in June 2016 and the Trump election in November 2016 we reviewed the situation immediately. In each case the market noise and media chatter was very negative and share prices were falling but in each case we made no changes in the heat of the moment. Our process is designed to remove emotion and market noise from decision-making and focus on fact-based analysis. We remained bullish on shares on both occasions. Shares rebounded quickly and turned into what we now know as the 2017 'Trump boom'.

The US Fed and Reserve Bank of Australia have made three rate cuts this year and in each case they may be the last cuts for the time being unless conditions deteriorate further. Both central banks have indicated their willingness to act quickly with more stimulus if needed, and both have room to move. The Fed can cut rates and can ramp up its newly revived asset-buying program. The RBA can also cut rates further, but not by much more for fear of hurting bank profitability. The big banks are already posting declining profits, cutting dividends and cutting franking credits on dividends. They also face soaring costs of remediation, customer refunds and regulatory penalties for a dizzying array of misconduct. That part is purely self-inflicted. They have admitted to costs totalling $8b so far but that is probably just the tip of the iceberg.

The RBA could also start buying up bonds (to bring down bond yields), or mortgage backed securities (to bring down home loan interest rates), or even provide low-interest loans to the banks to on-lend to business (like the ECB has done in Europe for several years but to no avail). The ECB and Bank of Japan have also been busy cutting rates and buying up bonds this year. This frenzy of central bank activity over the past 10 years has done little to boost economic growth or inflation in Europe, Japan, the US or Australia, but it has been tremendous for asset prices, and that is our primary interest.

Trump's trade wars appear to have stalled for the time being. On 11th October he declared a 'Love Fest' with China and announced a 'Phase One' deal in which the US delayed its planned tariff rise from 25% to 30% on $250b of Chinese imports, and China agreed to buy $50b of US farm exports. There were no details or enforcement mechanisms or next steps. It appears to be an attempt from both sides to save face.

We remain moderately bullish on Australian and global shares as we have been for this year's rally. Corporate profits are rising reasonably strongly in the US, but profits are weak in Australia and likely to weaken further. For the big banks, housing loan growth has finally started to re-appear, but costs are rising and margins are being squeezed by low rates and rising regulatory, compliance and remediation costs. For the big miners, ore is back down to $80/tonne, down from over $100 mid-year. It is still up 20%+ for the year and double what it was in early 2018.

As always we remain on the look-out for possible sources of risk and we are ready, willing and able to make adjustments to protect investors and to capitalise on opportunities where warranted.

'Till next time, happy investing!

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