STANFORD BROWN
Financial Advisers

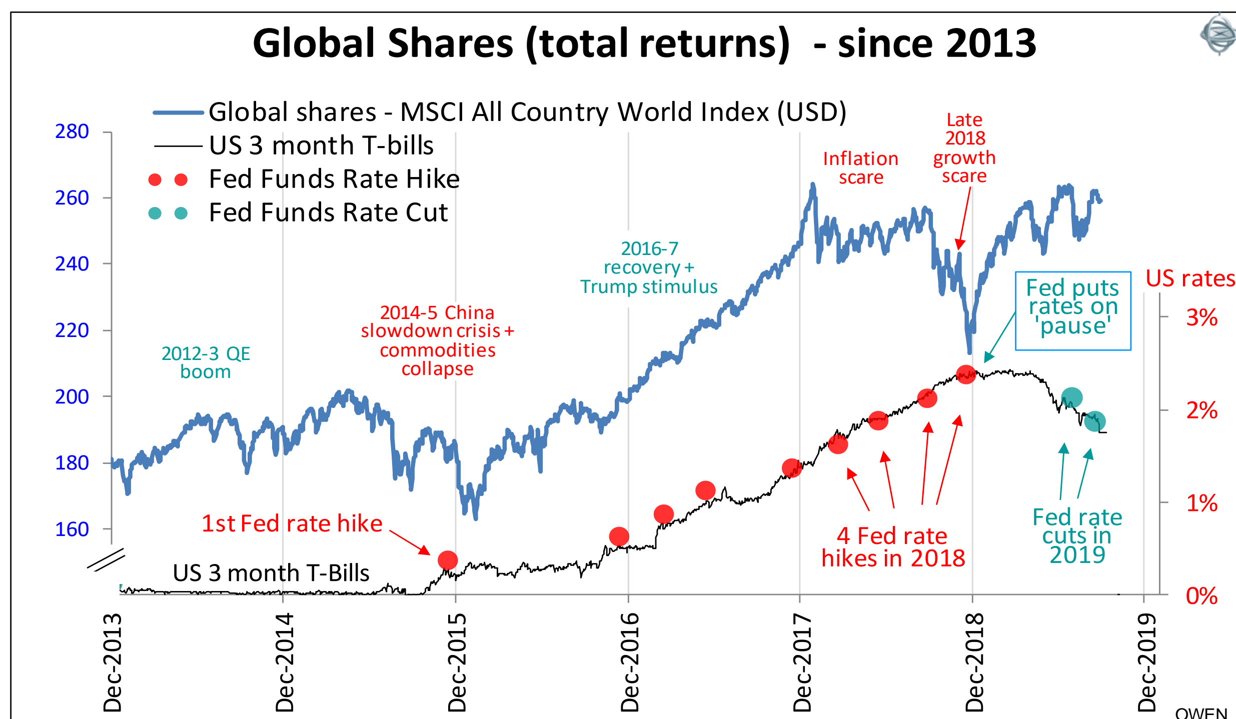
Stanford Brown Monthly Top 5

October 2019

1 Rate cuts galore

2019 has been a tremendous year for returns from investment assets of just about every flavour except cash. The single most important driver of financial markets in Australia and around the world has been US interest rate policy. Share markets sold off sharply in late 2018 and the main cause was the US Fed's four interest rate hikes during the year, together with their stated intention to keep on raising rates several more times despite gathering signs of economic slowdown and fears of negative impacts from Trump's escalating trade wars.

Then from the start of January this year the Fed suddenly did a backflip and put further rate hikes on 'pause'. Short term rates started to drift down in anticipation of Fed cuts, and shares suddenly switched from the sharp sell-off late last year to a strong rebound in 2019. The chart shows global share prices over the past 5 years through the US rate hikes (red dots) and now the rate-cut rebound (green dots).



Under intense pressure from President Trump, the Fed started cutting rates on 31 July. When it cut rates again on 8 September, Fed chair Jay Powell noted: 'Trade policy tensions have waxed and waned and elevated uncertainty is weighing on US investment and exports' - without actually naming Trump. Ever since nominating Powell to the Fed role, Trump has attacked him for not cutting rates back to zero.

The Fed is also coming under pressure to re-start its 'QE' bond-buying program. Trump's trillion dollar deficits need funding, and that means the government is scaling up the issue of new bonds. The sheer volume of new bonds, plus the fact that China is now selling down bonds, will put pressure on yields to rise, unless Fed starts buying them again. Share prices surged during the last 'QE' boom in 2012-4, and the prospect of more QE is also supporting share prices this year.

In Europe, the central bank had ended its 'QE' last year but with European economies, inflation and jobs growth still stagnant, on 12 September it resumed its rate cuts (further into negative territory) and announced a re-start of its 'QE' program of direct bond buying. It didn't work last time so there is little reason to think it will work this time. But it certainly did artificially boost returns from bonds and shares.

In Australia the Reserve Bank has also cut rates three times more this year (including 1st October), bringing the total to 15 rate cuts in the current cycle that started in November 2011. It is running out of room to move. The banks are not likely to pass on any more rate cuts to borrowers as they are already facing margin squeeze and declining profits. The RBA has even talked up the idea of 'QE' bond purchases.

Several other countries have also cut rates as Trump's trade wars continue to escalate and growth prospects dim. (There are exceptions to this global trend – Norway has hiked rates 4 times to try to rein in rampant debt-funded property speculation). With interest rates on deposits being cut almost everywhere, investors have stampeded back into shares, commercial property, infrastructure and bonds this year – boosting returns on all asset classes – except cash.

Although investment returns have been boosted across the board this year, it is unsustainable of course because interest rates can't continue to be cut into negative territory forever. More on this later.

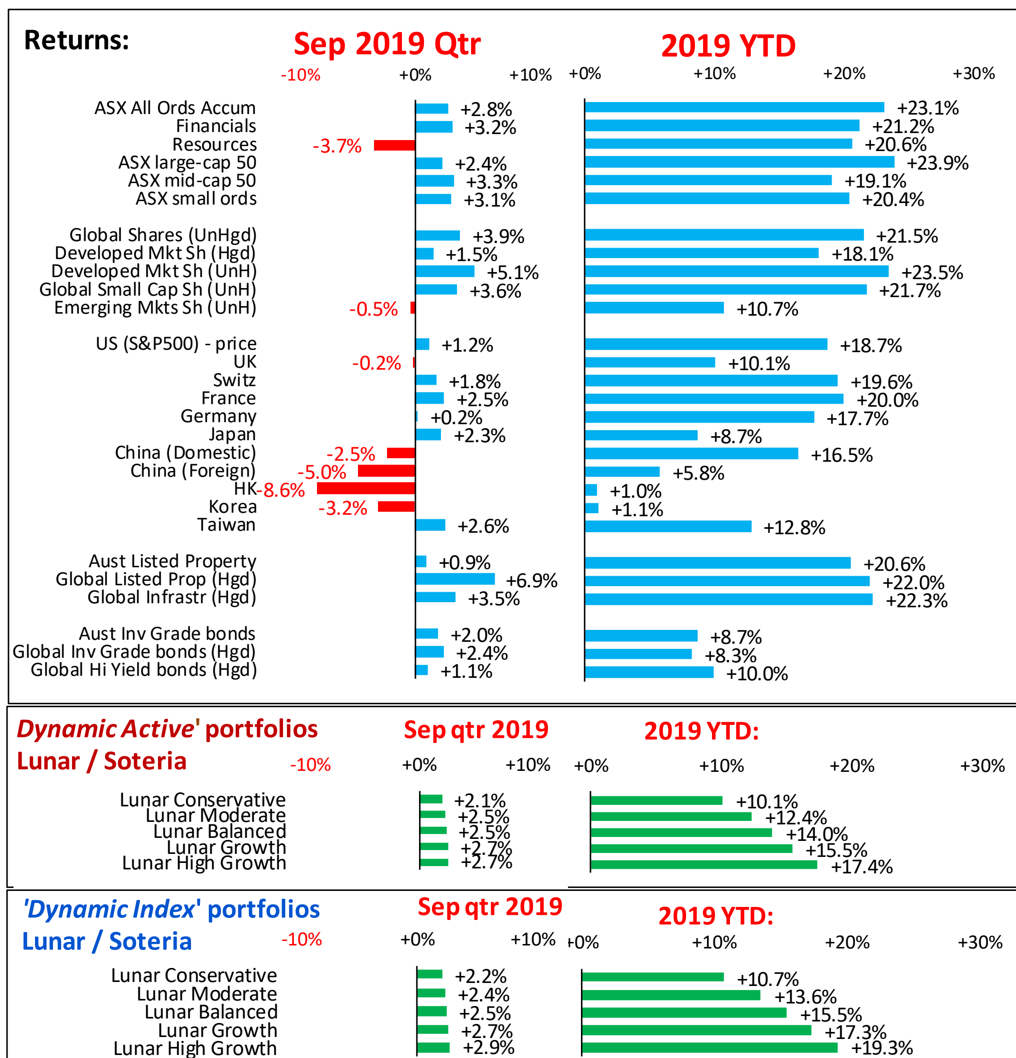
2 Another good quarter for returns

Our investment portfolios posted good returns once again for the September quarter. We have been over-weight Australian shares for the rebound this year and they enjoyed another good quarter. The best share price gains were from companies benefiting from the recent tax cuts – retailers Woolworths, Coles, Wesfarmers (K-mart, Target, Bunnings), JB Hi-Fi, gambling houses Tabcorp and Crown casino, and other spending related stocks like Flight Centre and CarSales.com. Healthcare stocks were also strong, especially ResMed and CSL. The big banks were lifted by NAB with great hopes for its new CEO, and the housing recovery generally, which also lifted RealEstate.com.

At the other end of the scale, most of the big resources stocks were down heavily during the quarter, dragged lower by falling prices of oil, iron ore and other industrial commodities.

On the global scene, 'developed markets' shares (where we have been over-weight this year) continued with this year's rebound. Apple, Alphabet (Google), Intel, Microsoft and several of the large retailers had a strong quarter, offset by weakness in Amazon, Facebook, Disney, Cisco, Netflix, most industrials and oil/gas stocks. In contrast, most of the 'emerging markets' have been weak, especially in East Asia as they are more vulnerable to a slowing China and Trump's trade wars. We removed emerging markets shares from all portfolios in early 2018 before the sell-off. They lagged the rest of the world in the 2018 sell-off and have also lagged in the 2019 rebound as expected.

The Australian dollar has also kept falling this year. Our portfolios have been positioned to benefit from the falling AUD, as we favour un-hedged global shares over hedged. Also on the currency front, the USD dollar has kept rising this year, triggering Trump's currency war threats and his increasingly vocal attacks on the Federal Reserve to cut interest rates back to zero to bring down the strong US dollar.



Bonds had another good quarter as yields continued to fall back in Australia and around the world. Falling bond yields have also boosted returns from listed property trusts and infrastructure, which we hold in all portfolios. The one asset class that has not done well this year is cash – but our portfolios carry only minimal cash, so falling cash rates have minimal direct impact on returns.

All portfolios remain ahead of their long term targets and also ahead of their multi-sector peer funds on risk-adjusted returns.

3 70 years of Communist Party rule in China – can the growth continue?

The 1st October 2019 marks 70 years of Communist party rule in China. Whatever else can be said about the Chinese Communist Party, it has lifted at least half a billion Chinese people out of poverty. China and India used to share the honours as the richest countries in the world (in terms of wealth per person and also total national wealth) for much of the thousand years between the fall of the Roman Empire and the European Renaissance, but by the middle of the 20th century they were both amongst the poorest in the world. How did this happen?

For India it was 400 years of British rule, and for China it was domination and exploitation by eight different foreign powers in various areas. Without debating whether and how foreign domination actually caused their impoverishment, one cannot deny that China and India went from being the richest counties in the world to the poorest by the time the European colonial empires collapsed in the 20th century.

When Mao took over in 1949 China was the 12th poorest country in world in terms of national output and income per person. It was the 3rd poorest in Asia, just ahead of Burma and Mongolia, but below war-torn Cambodia and Bangladesh, and 27% below impoverished India.

This chart contains a thousand stories, but we will focus on the rise of China relative to its low start and relative to its neighbours in Asia.

220 years of rising living standards:
Growth in GPD per capita since 1800

GDP per capita in PPP International dollars
source data: OECD, IMF, World Bank, Owen analysis

1990 PPP international dollars

OWEN

The steepness of the line for each country reflects the rate of growth in national output and income per head of population. The first observation is that China's growth has been no steeper than other fast-growing 'emerging markets' before or since.

For example, at the left of the chart we see the first great 'emerging market' in the post-1800 period: Australia! Wealth per person started from convict poverty but soared upward past the other emerging markets of the day (which were mainly in Latin America), then past France, US, UK and the Netherlands to be the richest country in the world per person by 1890. Australia's incredible growth in wealth came mainly from our booms in wool from the 1830s, gold from the 1850s, and then base metals from the 1870s. New Zealand followed a couple of decades later (they always follow Australia – never lead!) with a similar steep curve upward, overtaking every other country, including Britain, the US and Australia, to be the richest in the world per person before WW1.

After WW2 we see the two great post-war 'emerging markets' - Japan and German - follow similar steep upward growth curves out of the rubble of war. These were followed by a series of steep upward lines from the next waves of emerging markets – including Singapore, Brazil, Korea, Taiwan, Philippines, Malaysia, Thailand, etc, and more recently Indonesia, Vietnam, Cambodia, Sri Lanka, etc. Each of these countries had to escape firstly from colonial domination, and then from their post-independence war leaders who imposed various combinations of socialism, communism, and/or authoritarian dictatorships, often with large doses of corruption, cronyism and nepotism.

China's steep growth curve has been longer than most, mainly because it started from a lower base and had further to catch up. When Mao's victory ended the civil war and united the country in 1949, China's growth path started from near the bottom of the pack, but quickly soared upward to the right, overtaking more than a hundred other countries over the next 70 years. There we some early hiccups and setbacks during the Mao's 'Great Leap Forward' (late 1950s to early 1960s) and the 'Cultural Revolution' (mid-1960s to mid-1970s), but growth rates really started to take off after Nixon re-opened trade and diplomatic links after his Vietnam War retreat.

China's tremendous urbanisation, industrialisation and export manufacturing booms accelerated after its entry into the 'GATT' (now World Trade Organisation) in 2001. Australian export industries (not only mining but also tourism, education and food products), as well as government tax revenues, have benefited enormously as a result of China's growth.

From its very low base, China overtook most of its Asian neighbours, even though they were also growing rapidly at the same time. China overtook Bangladesh, Burma and Nepal in 1964, Afghanistan, Cambodia and Laos in 1970, Vietnam in 1973, India in 1978, Mongolia in 1982, Pakistan in 1984, Philippines in 1992, North Korea in 1994, Indonesia in 1999, Sri Lanka in 2001, Thailand in 2014, and is now not far away from over-taking Malaysia.

Can China's economy continue to grow? Yes, but not at the same pace. The chart shows that a country's growth rate tends to slow when its citizens become 'rich'. As a country develops, its population ages as there are fewer reasons to produce offspring; the size of government grows and so do taxes, regulations, and social welfare spending. On face value, it appears as if there is still plenty of room for Chinese growth. The level of wealth and output per person has not yet reached the levels at which growth rates in other countries slowed. China as a whole is not a 'rich' country per yet. Japanese growth rates only started to slow in the 1970s when it had reached 65% of US wealth per person. German growth rates slowed in the 1990s (mainly due to the costs of re-unification with East Germany) when it reached 70% of US wealth. Korea and Taiwan are still in steep upward growth curves even though their wealth per person is around 70% of the US level.

China is still only in the middle of the pack in terms of national output and income per person – at still only one third the level of Hong Kong and Singapore, and only around half those of Japan, Korea, Taiwan and the US. One of the main problems is that China's population is aging rapidly and no amount of encouragement for couples to have children can reverse the effects of Deng Xiaoping's 'one child policy'.

Another problem hampering further growth is geography. China has three distinct regions. Around one third of the total population live in the coastal provinces (Beijing, Tianjin, Liaoning, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian and Guangdong) and these are as wealthy as the much of the 'developed world'. The next one third of the population live in the central provinces (Inner Mongolia, Heilongjiang, Jilin, Hebei, Shaanxi, Henan, Anhui, Chongqing, Hubei, Hunan, Jiangxi) and these are around the same level of output and wealth per person as most 'emerging markets' like Malaysia and Thailand. The remaining third is in the west where the most people are still at subsistence levels.

The problem is that most of the past growth has been on the coast where raw materials are imported and finished goods are shipped out. Extending this growth inland was always going to be a problem for an export-led growth model. Now that more than half of the population has been urbanised, extending this to the rest of the country – especially in the poor west - will be much slower from here on.

One positive for growth rates – especially for China's demand for rocks from Australia - is Xi Jinping's 'One Belt One Road' plan. China's humiliating descent from the richest country in the world to the poorest was at the heart of central mission that drove Mao and Deng – for China to rid itself from foreign domination and to regain respect in the world.

Seventy years later these ambitions have been accomplished, but Xi has taken the original mission far further than Mao and Deng ever intended. Xi's vision now extends to territorial expansion and regional domination. Xi is increasingly relying on military and infrastructure spending not only to boost the slowing domestic growth, but also to further his expansionist vision. With growth slowing further and military tensions escalating, this is likely to keep supporting the demand for Australian rocks for some time yet.

4 Recession? – Why do you ask?

By far the most frequent question I have received from nervous investors over the past year has been ‘Will we have a recession?’ My answer is always the same: ‘Of course we will! We are probably going to have several more recessions in our lifetimes. Why do you ask?’

They ask of course because everywhere they look they are bombarded by media ‘experts’ and politicians carrying on about it. Recessions can be a negative for some people – eg. unemployed people looking for a job, or geared up rental property owners looking for tenants, but recessions are mostly good for investment returns – especially from government bonds and shares in most cases.

Our worst share market sell-offs were not caused, nor accompanied, nor triggered by economic ‘recessions’ – for example the -55% fall in the GFC, the -50% fall in the 1987 crash, the -60% fall in 1973-4, the -40% fall in 1981-2, nor a host of other falls.

There is no actual definition of an economic ‘recession’ but the most widely used measure by economists is: two or more consecutive quarters of negative growth in real (i.e. inflation-adjusted) gross domestic product (total output of an economy). On this definition the last economic recession in Australia was in the March and June quarters of 1991 – Paul Keating’s ‘recession we had do have’.

What happened to shares during that recession? They surged! In Australia, the US and several other countries that had recessions at around the same time - the start of their ‘recessions’ marked the start of their share *rebounds* – almost to the day.

Apologies for the complexity of the chart below – but there were a lot of factors driving markets – and it wasn’t economic growth numbers. In the upper section of the chart, the red line is the Dow Jones Industrial Index of US shares and the green line is the Australian All Ordinaries Index. (I include US shares because Australian markets almost always follow the US, regardless of local events and conditions).

The middle section shows cash rates - green dashes for Australia and red dots for the US. The RBA started cutting rates in January 1990 and the US Fed started cutting in June 1989. In both countries cash rates were being cut for more than a year before their recessions hit. The lower section shows quarterly economic growth rates for both countries. The green and red boxes highlight the two consecutive quarters of negative real GDP growth – green for Australia and red for the US.

After the 1987 crash, Australian shares had been clawing back part of their losses during 1988 and into 1989 but share prices started to fall again from September 1989. The 32% sell-off lasted 18 months and was peppered with almost daily announcements of bankruptcies and collapses of a host of over-geared 'entrepreneurs' like Skase/Qintex, Bond, Linter/Goldberg, Hooker/Herscue, Westmex/Goward, Fairfax, etc, as well as the finance houses that fuelled the boom - Rothwells/Connell, Spedley/Yuill, etc, and also some of the aggressive property lenders like Pyramid, Countrywide and Estate Mortgage. There was even a run on deposits at the Bank of Queensland.

When the negative growth number was released in respect of the September quarter 1990, Treasurer Paul Keating uttered those famous words: "This is the recession we had to have!" on 29 November 1990. (The September quarter 1990 turned out to be a single one-off negative quarter. An isolated single negative quarter is not a rare event and does not qualify as a 'recession' unless it is followed up by a consecutive run of two or more quarters. The last single one-off negative quarter for Australia was the March quarter 2011, and shares rose during that quarter.)

What impact did the 1990-1 'recession' have on shares? The 32% share market fall that started in September 1989 turned around almost immediately after the recession began. During the two quarters of our 'recession' the broad Australian market jumped +17.7%, starting just 12 trading days into the recession. US shares also rose +10.6% during the same period - not as much as Australian shares, but the US recession and the accompanying US recession surge in share prices had started one quarter before ours.

The US economy also had a two quarter recession – indicated by the red boxes – starting and ending one quarter before Australia. US shares had also been falling before the recession – mainly after Iraq invaded and annexed Kuwait on 2nd August, but the US market also had a recession surge in share prices. The Dow Jones index jumped +18.8% during the US recession, starting just 11 trading days after recession started.

What happened after the recessions ended? In both the US and Australia, the recession surges in share prices lost momentum when the recessions ended and the economies started growing again. Shares in both markets kept drifting up further after the recessions ended but the recession surges had done their job in ending the share sell-offs.

For sceptical readers - this was not just an isolated case of shares surging in a recession. Before the 1991 recession, Australia's next most recent recession was a big one – four quarters from September quarter 1982 to June quarter 1983 inclusive. What did Australian shares do during the recession? They surged +27.9%! The 1982-3 recession surge ended a -40% sell-off that had begun in April 1981. The rebound started on 9th July 1982 – just 7 days after the 'recession' started, and the share market kept on surging through the recession. There were a host of factors at work of course – but that's another story for another day.

Still sceptical?

Before the 1982-3 recession there was a recession in the September and December quarters of 1977 – shares *rose* +4.3%.

The recession before that was in the September and December quarters of 1975 – shares *rose* +19.7%.

The recession before that was in December quarter 1971 and March quarter 1972 – shares *rose* +31.8%.

The recession before that was in the June and September quarters of 1961 – shares *rose* +4%.

Each of these recessions has its own story of course, but the message is clear.

The next time someone asks you 'Are we going to have a recession?' you can now say 'Sure, bring it on!' Unless of course the person asking the question happens to be unemployed looking for a job, or a geared-up property investor looking for tenants, or both!

5 Nickel boom – feeling lucky?

The prices of most industrial commodities have been weak over the past 18 months due to Trump's trade wars and slowing growth in China, but nickel has been one of the exceptions. This year the price of nickel has jumped by 60%. The demand side has been driven in recent years by the strong growth of electric vehicles and lithium-ion batteries, but the global car market has contracted this year. The reason for the price spike is the supply side. Global supplies of nickel are drying up - stockpiles are running down, Indonesia (the largest exporter of nickel ores) has re-imposed its export ban, and leakage problems have closed a major Chinese mine in PNG. Supply has also being hampered by a slowdown in exploration and development in recent years due to low prices after the last China slowdown in 2014-5.

With the supply/demand equation now out of balance, the nickel price has shot up and so have the share prices of a host of ASX-listed nickel stocks – including Western Areas (WSA), Mincor Resources (MCR) and Poseidon (POS).

Before we jump on the bandwagon to try to profit from this latest price spike, a little context may be instructive. Although the current nickel price of US$17,000 per tonne is double what it was in early 2016 at the bottom of the 2014-5 China slowdown crisis, it is still two thirds below its 2007 price at the top of the 2003-7 China boom. In fact the nickel price today is no higher than it was 50 years ago at the top of the late 1960s mining boom, and that's *before* inflation. In real terms (*after* inflation) the current price is only one seventh of its peak 1969 value.

September 2019 marks the 50th anniversary of the start of one of the greatest share market bubbles and busts in Australia's history. At the centre of that bubble was a company called Poseidon, which was the genesis of the same Poseidon Nickel today, and it is still trying to exploit the same nickel deposit at Mt Windarra in Western Australia.

The original Poseidon was named after the 1906 Melbourne Cup winning race horse. The company certainly turned out to be a gamble, making a fortune for insiders and a few lucky punters, but losing a lot of money for the gullible public.

It became the poster-child for corporate skulduggery by directors, promoters and brokers in the 1960s that led to a host of reforms and regulations including the criminalisation of insider trading. Poseidon was certainly not the worst offender. It was different to most in that it actually had a real mine with real metal in it. Many outright fraudulent companies had neither.

1969-70 Poseidon Nickel boom & bust

Nickel (Producer price £ / ton) — Nickel Free Market price (Av £ / ton) — Poseidon

Nickel Price (£ / ton): £0, £1,000, £2,000, £3,000, £4,000, £5,000, £6,000, £7,000, £8,000

Poseidon share price: $0, $30, $60, $90, $120, $150, $180, $210, $240, $270, $300

Dec 1968, Mar 1969, Jun 1969, Sep 1969, Dec 1969, Mar 1970, Jun 1970, Sep 1970, Dec 1970, Mar 1971, Jun 1971, Sep 1971

March 1969 free market price surges - supply running out

29 April 1969 Poseidon report on surface finds

July 1969 start of miners' strike at Inco

Aug 1969 mines' strike at Falconbridge

Insider buying before assay report released

1 Oct 1969 Reports false assay results - shares up to $12

15 Nov 1969 Inco strike ended

13 Feb 1970 Poseidon closes at $278

March 1970 Patricks brokers sells most of their shares to London buyers

Poseidon

6 July 1970 Poseidon outlines plans for production

Oct 1970 Reports of ICM nickel find in WA

Dec 1970 New Caledonia to ramp up nickel production

Jan 1971 false rumours of takeover of Poseidon

Nickel Price (£ / ton)

OWEN

Poseidon's share price shot up by 58,000% from 48 cents at the start of 1969 to $280 in February 1970. At the height of the frenzy the company had a market value of $700m, three times the size of the Australia's largest listed bank at that time, the Bank of NSW (now called Westpac). Unfortunately, Poseidon never made a profit nor paid a dividend. It ran out of money and went into receivership five years later.

Why the bubble? Nickel was a hot commodity in the late 1960s. As a key ingredient in making stainless steel and armour plating for military armaments, its strong demand growth was driven by the Vietnam War and also by the aerospace boom that peaked with the Apollo 11 moon landing in July 1969. As with most mining cycles, supply was not able to keep up with demand because of the long lead times for exploration, development and bringing new mines into production. Demand growth was running down stockpiles in Russia and the US, and miners' strikes at the two largest nickel producers in the world (Inco and Falconbridge, both Canadian) brought the global supply of nickel to a virtual halt in late 1969.

The chart shows the long term contract price of nickel (solid grey line). This rose steadily as contracts were renewed between major producers and buyers. The grey dotted line is the 'free market price' (outside of long term contracts). This suddenly shot up seven-fold in the second half of 1969 after the workers' strikes started in Canada. The price hike triggered a surge of new interest in exploration and this led to a miraculous spate of new nickel 'finds' being reported and new companies hastily thrown together to exploit them.

Poseidon was formed in 1958 and listed on the Adelaide exchange. It started out with a low grade, unprofitable wolfram (tungsten) mine in the Northern Territory. When it ran out of money the shell was picked up by Sydney trader Boris Ganke and Adelaide mining engineer/broker Norm Shierlaw in 1968. They raised some more money and starting exploring for nickel in the area around Western Mining Corp's existing nickel find in Kambalda in WA. They discovered nickel in surface samples near Mt Windarra, 350km north of the Kalgoorlie gold fields, released a report to the Adelaide stock exchange on 29 April 1969 and started drilling for underground samples. They also listed the stock on the Sydney exchange and appointed London agents in order to access a larger pool of gullible share speculators.

The directors released a misleading report on the drilling samples to the exchange on 1st October 1969 that greatly exaggerated the actual results. In the days *before* the release the directors, insiders and their associates bought up shares from unsuspecting shareholders (insider trading was not illegal back then!). The October report and subsequent over-hyped announcements, together with further insider trading, sent the share price sky-rocketing during the next four months. As is often the case with Australian companies, a large share of the gullible punters were in the UK. One London broking house Panmure Gordon & Co valued Poseidon at 'conservatively worth $300 and more optimistically $382' per share! The Times of London even named it 'the share of the year – if not of all time!'

Nickel mania spread to other nickel explorers, then to other mineral stocks generally, and then to a host of other stocks that had nothing to do with mining or nickel. Although Poseidon's shares were not included in the stock market indexes, the general euphoria surrounding the Poseidon boom lifted the broad indexes of Australian exchanges to new highs in late 1969 and early 1970 despite the fact that stock markets in the US and UK were falling heavily. It was one of the rare occasions when Australian shares did not follow the US market down.

It did not last long. Poseidon's share price collapsed in 1970 along with the rest of the miners and the broad stock markets. By October 1971 the share price was back down below what it was in October 1969, and it ended up in receivership, worth nothing.

Why the collapse? First, the price of nickel collapsed. When the Canadian strikes ended in November 1969 the free market price quickly fell back to pre-crisis levels as supply resumed, and the price kept falling to even lower levels as new sources of nickel were discovered – in WA and also around the world, thanks to the burst of exploration that was triggered by the temporary 1969 price surge.

Second, the Poseidon nickel find turned out to be far less than the initial inflated reports. The ore was only 1.5% nickel instead of the claimed 3.5%. Third, the company ran out of money trying to develop the mine because the directors were reluctant to share the spoils by raising more capital that would dilute their shareholdings. They did a small placement of new shares to insiders at $5 per share in December 1969, well below the market price of $110 at the time. The sheer scale of skulduggery was breathtaking.

Poseidon ran out of money and couldn't find a buyer for the mine so in 1974 it handed it over to Western Mining Corp) (bought by BHP in 2005). The mine ended up producing 5 million tonnes of ore yielding 80,000 tonnes of nickel. The problem was that by the time production started the nickel price was just £1530, which was lower after inflation than the 1969 producer price. Low nickel prices rendered the mine unprofitable so it was mothballed in 1989 - where it still sits today - waiting for the nickel price to rise to a level that might make it profitable.

The lessons? Take time to understand the cycles driving demand and supply. Most people tend to focus on the demand side (eg. growth in China, growth in the car market, etc), but most of the reasons for commodities price surges and collapses are usually on the supply side.

Never buy anything merely because the price is going up, or because 'everybody else is doing it!'

The revived Poseidon is trying to re-work the same nickel deposit at Mt Windarra now that the nickel price has risen due to temporary supply constraints. The company is still losing around $10m per year but the share price has more than doubled over the past three months (from 2 cents to a whopping 5 cents) after some fancy-looking drilling reports were announced. Do you feel luckier this time around?

What lies ahead?

So far this year shares in Australia and around the world (except most emerging markets) have more than recovered from the late 2018 sell-off. We reduced allocations to shares in portfolios before the sell-off and then we went back over-weight shares earlier this year for the rebound (but we did not add back emerging markets, and they have lagged the rest of the world). This has been good for our portfolio returns, especially in risk-adjusted terms. Sharp sell-offs like these are inevitable and they are part of the way markets work. They come around only every few years, so it was good to be able to adjust portfolios to lessen the impact of the sell-off and then to capitalise on the rebound.

But it does not mean that it is back to business-as-usual. We cannot become complacent just because shares are doing well again. The rebound this year has been due mainly to artificial and non-sustainable sugar hits from central banks – cash rate cuts to lower short term rates, and bond buying programs to lower long term rates. Meanwhile, out in the real world, economic activities like spending, lending, capital investment, trade and hiring, are slowing across the board.

Despite deteriorating 'fundamentals', we are enjoying a boom in shares, bonds and 'bond-proxy' assets like commercial property and infrastructure (they are called 'bond-proxies' because their prices are driven largely by changes in bond yields, like bonds). The asset price boom is due purely to ultra-loose monetary policies (ultra-low short and long term interest rates) and ultra-loose fiscal policies (large government deficits). It is true that Australia has managed to produce a rare budget surplus (and an even rarer current account surplus) – but these have been due to unsustainable windfall gains from export commodities prices rather than spending cuts. On the contrary, government spending in Australia has kept on increasing at several times the rate of population growth and inflation, and in recent years the government has been the largest driver of employment growth. Outside of the government sector, the rest of the economy has been very weak.

What lies ahead is probably lower interest rates in Australia and in the major global markets - US, Europe and Japan – at the short end and also at the long end. This will most likely be accompanied by increases in government spending in Australia and the US, although there is less scope in Europe and Japan. These sugar hits will probably support asset prices as they have done in past rounds of rate cuts and QE.

It cannot last of course because central banks cannot keep cutting rates forever and buying bonds from the market forever. Likewise, governments cannot keep increasing their spending ahead of the growth in tax revenues required pay the interest bills.

Two types of scares rattle investment markets - inflation scares and slowdown scares. We have seen many examples of both types of scare in the past and we will see many more in the future. Some will be major (like the big slowdown scare in the GFC, and the big inflation scare in 1994 and several in the 1970s) but most will be less serious. 2018 was a good example of both types of scare. In 2018 we had three quite distinct 10% global sell-offs in shares. The first two were inflation scares (in February and October, both after bullish US jobs reports), but the third scare (in December) was a slowdown scare (caused by the Fed rate hike policy and Trump's trade wars).

The difference between the two types of scare is their impact on shares and bonds. Both shares and bonds suffer in inflation scares (both sold off in the February and October 2018 inflation scares), but in slowdown scares share markets fall but bond prices rise, as they did in the December slowdown scare. Inflation scares are the more difficult for investors as they hit both shares and bonds (including bond proxies).

The good news is that inflation scares (where both shares and bonds are hit) are less likely to be on a global scale now. The only risk of serious (say 5%+) inflation is in the US and Australia (and some other small markets like Canada). We are unlikely to see serious inflation in Europe or Japan for many years – or perhaps ever, under their current political regimes. (Hyperinflation is not ruled out entirely – recall that Germany suffered hyperinflation in 1923 and Japan in 1947 – but both were in very different circumstances to today). The problem (or *good* news for bond investors) is that Europe and Japan are dying – literally – with aging and declining populations, declining tax-payer bases, but rising welfare bills. One solution is immigration – but this is proving politically impossible. The likely future is decay and deflation, not inflation.

On the other hand slowdown scares are more likely but they are less of a threat to investors because bonds (especially government bonds) tend to do very well in big slowdown scares like the GFC, 2001-2 tech wreck, 1990-1 contraction, early 1980s, etc. We can navigate portfolios through slowdown scares by using bonds to cushion the share falls. For example, before the late 2018 slowdown scare we reduced shares in portfolios and significantly increased allocations to bonds, especially government bonds, to cushion the impact of the share price falls.

It is now time for our next quarterly review of portfolio settings. 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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