STANFORD BROWN
Financial Advisers

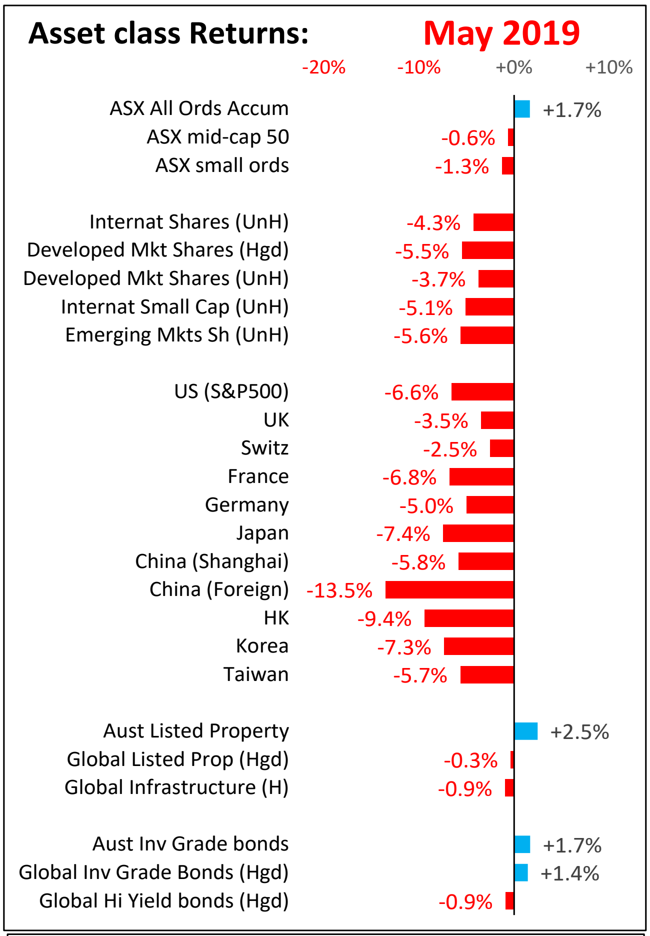
Stanford Brown Monthly Top 5

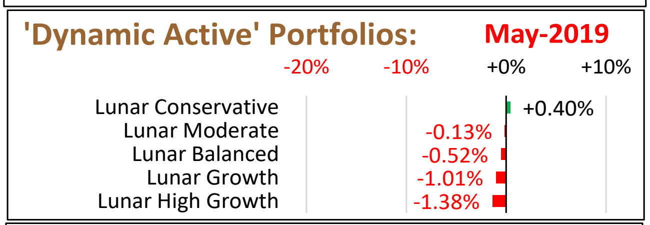
June 2019

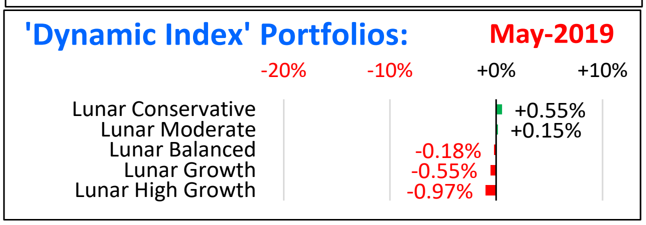
Stanford Brown's Top 5 key factors in Australia and around the world that are affecting investment markets. We aim to help investors cut through all the media noise and hype and understand what is really driving investment markets and portfolio returns.

1 Portfolios defy global sell-off

Despite a sea of red ink on world stock markets in May, our portfolios barely felt a ripple. Tech stocks in the US and China led the global falls, triggered mainly by Trump's escalating trade wars, in which technology is increasingly the main focus of attention. Trump started the month by threatening to raise tariffs on $200b of Chinese imports from 10% to 25% from 10 May, and hinted at imposing 25% tariffs on another $325b of imports from China not already taxed. He ended the month by imposing 5% tariffs on Mexican imports for as long as illegal immigrants crossed into the US, and he also penalised India by removing it from the Generalized System of Preferences program.







Apple shares were down 13% for the month, Alphabet (Google) down 7%, Facebook down 8%, Amazon down 8%, and Microsoft down 5%. Mind you, even after these falls in May, they are all still well ahead for the 2019 year to date – up +11%, +7%, +35%, +18%, and +22% respectively. These five US tech giants account for 15% of the total US market value and their losses were enough to drag the US market index down 7% for the month. It was not a good environment for Uber's float on Friday 13th (surely a bad omen!). Uber's shares ended down 10% by month-end. Not a great start, but don't forget that Facebook's share price fell 52% in the months following its listing almost exactly seven years prior (18 May 2012), but has risen by an incredible 900% in the seven years since then. One difference is that Uber is facing mountains of losses and no sign of profits, but Facebook was profitable from day one and has posted steadily growing profits each year.

Chinese tech stocks were down by even more in May. The two heavyweights - Alibaba (listed in New York) and Tencent (listed in Hong Kong) were down by -20% and -16% respectively (but they are also still ahead for the year to date). Chinese mainland markets were down 6% and other East Asian markets reliant on Chinese trade were also down – Hong Kong down 9%, Korea down 7%, Taiwan down 6% and Japan down 7%. Aside from tech stocks, energy stocks were also hit hard by a 16% fall in oil prices, mainly due to trade war fears affecting global demand.

These widespread losses in global shares had only limited impacts on our portfolios. The first reason is that we hold a significant amount of our global share allocations in infrastructure funds from Magellan and AMP, which were both up in May. The infrastructure sector held up well because of falling global bond yields. Second, we are mainly un-hedged on the currency risk for our global shares (as we have been bearish on the Australian dollar since early 2018), and so the share price losses were partially offset by a 2% fall in the Aussie dollar against the US dollar and 4% against the Yen.

A major contributor to portfolio returns in May was our sizeable tilt toward Australian shares, which returned +1.7% in May while the rest of the world fell. There were three main positive factors at work here: the unexpected re-election of the Morrison government; the continuing fall in the Aussie dollar (which helps exporters); and the gathering prospects of another rate cut or two this year from the Reserve Bank.

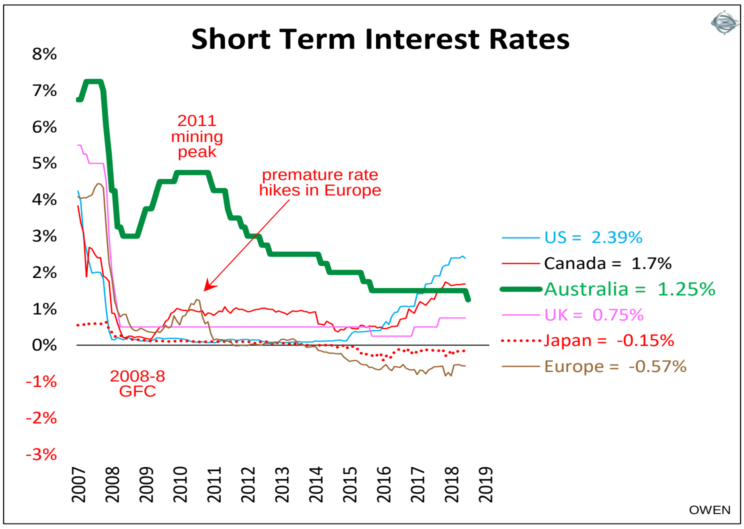
Bank shares jumped after the Morrison election win as it meant that Labor's proposed tax hikes aimed at property investors are now off the table. The main gains were in CBA +5.4% and NAB +4.5%, although ANZ leads the banks this year at +14% (even beating Macquarie!). Despite the gains in May, the big banks are still lagging the broad market this year due to their heavy exposure to the housing slowdown.

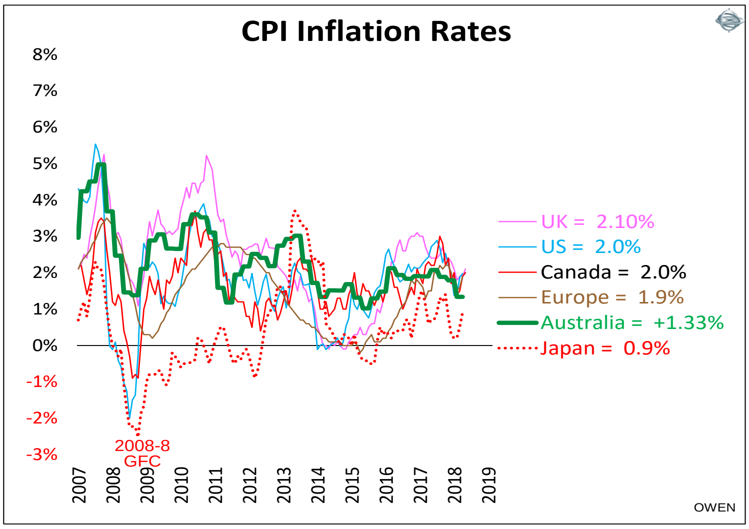
Another significant contributor to portfolio returns in May was our holding of Australian listed property trusts in all portfolios. The sector returned +2.5% for the month, benefiting from the continued decline in local bond yields, but our holdings in MVA returned +4.2%, making it the best performing asset in portfolios in May.

2 13th cut for Aussie cash rates

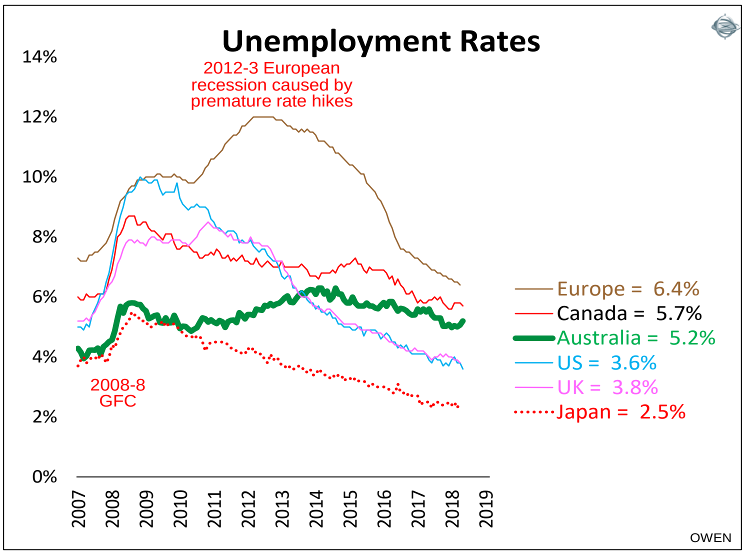
Australia's Reserve Bank cut rates today (4 June) to a new record low of 1.25%. It was the 13th rate cut in this cycle that started in November 2011 when the RBA set out to create a housing boom to fill in the hole that was going to be left by the end of the mining boom which peaked in 2011-2. The rate cuts certainly did their job in triggering an almighty housing boom funded by the biggest pile of household debt per capita not only in the world today but in any time in human history on this planet. Seriously. While the RBA was frantically cutting rates to encourage borrowers to take on even more debt, fortunately the prudential regulator APRA took action to counteract the last few unnecessary rate cuts by forcing the banks to ration lending. With the boom unravelling and prices of houses (and especially high-rise units) falling, APRA has eased its curbs, but the RBA is now trying to restart the crazy lending spree once again with even lower mortgage rates.

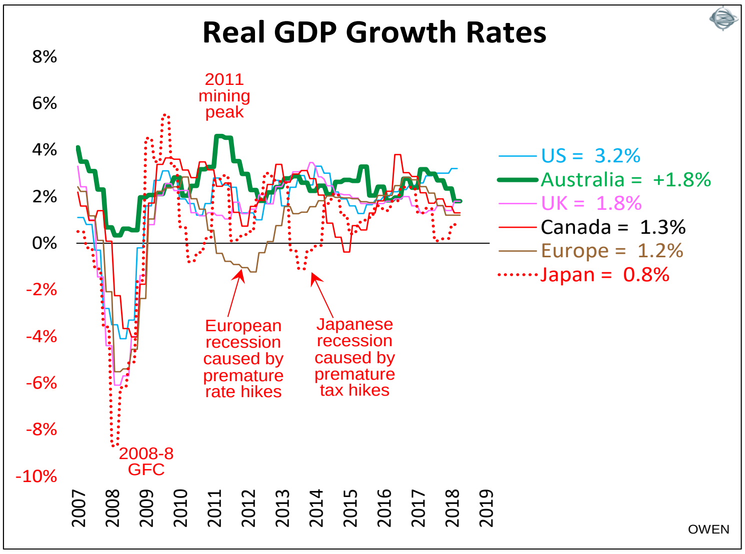
The following four charts show key data for Australia compared to the US, UK, Europe, Japan and Canada. Although cash rates are at record lows in Australia, the first chart shows that they are not low by world standards. Among the major markets, only the US and Canada have higher cash rates now. The US, Canada and UK have been raising rates in recent years to head off early fears of inflationary revivals.





The right chart above shows that inflation rates have been rising everywhere since the Chinese stimulus in early 2016, even in Japan. But Australian inflation has been falling back over the past couple of years as house price falls have dampened confidence and spending.





The third chart shows how unemployment rates have been falling steadily in Australia and other markets, even in Europe. Australia, UK and the US are in 'full employment' in theory, but there are high rates of under-employment and people who have given up the search for work

The final chart of economic growth shows how Australia avoided a recession in the GFC thanks to China's massive stimulus programs. Premature rate hikes in Europe in 2011 caused a relapse into recession in 2012-3. Likewise, the premature sales tax hike in Japan in 2014 also set the economy back there. The US recovery has been more robust. The Fed's nine rate hikes since December 2015 have not been enough to cause a relapse into recession yet, but this year there have been signs of weakness, especially with Trump's trade wars.

Australia's economy slowed in the March quarter to 1.8% pa, mainly driven by government spending. Big rises in government spending masked steep declines in housing investment and mining investment. If this continues, the 13th rate cut may not be the last in this cycle.

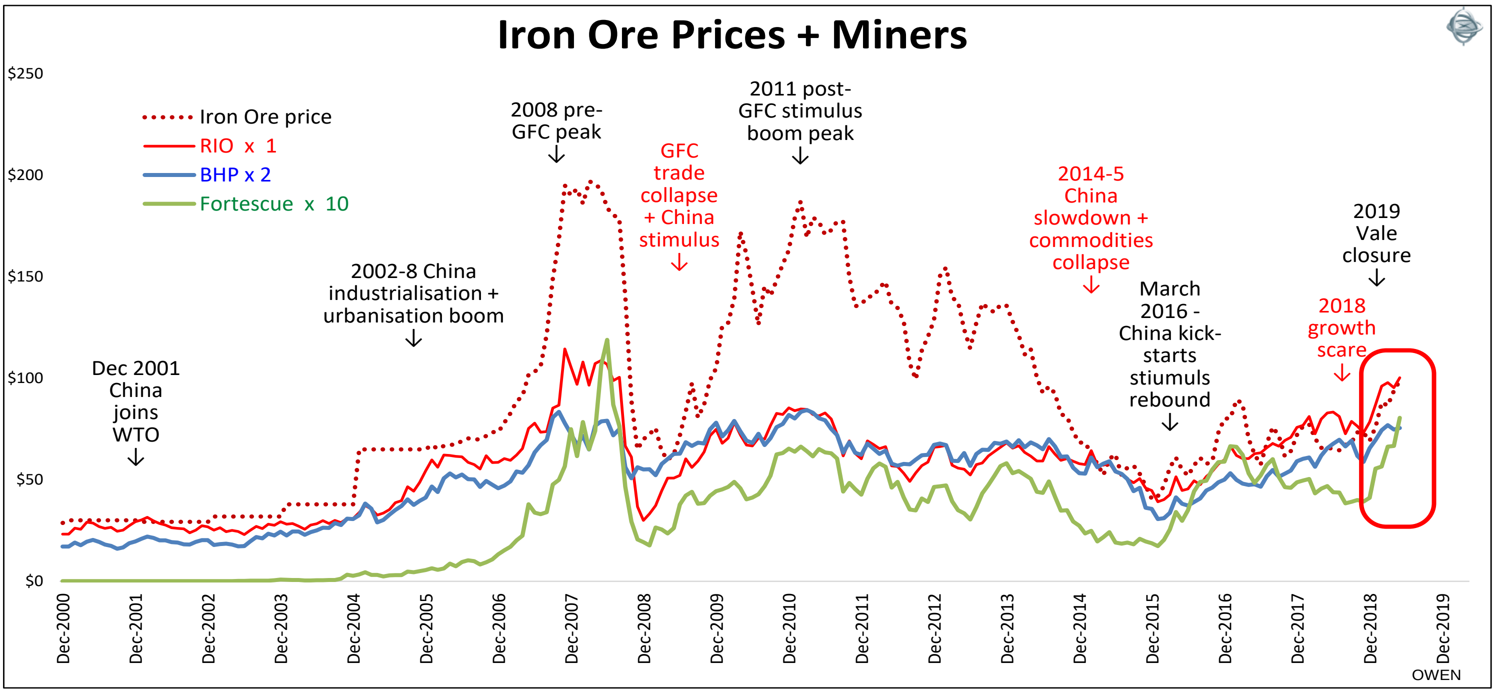
3 Iron ore bucks the trend

While the prices of most commodities have been falling over the past year in the face of slower global growth prospects and Trump's escalating trade wars, iron ore prices have been rising strongly. The iron ore price surge has created unexpected windfall revenues for Australian iron ore miners and their shareholders who have benefited from huge rises in share prices and cash dividends this year. The price surge has also fortuitously brought the federal budget back into balance even though government spending has been ballooning.

The price of iron ore is driven, like everything else, by demand and supply. On the demand side, slowing global growth has been a negative, but one positive has been increases in steel production in China as it ramps up stimulus projects to prop up slowing growth rates.

However most of the action has been on the supply side. On the 25th of January a disastrous dam collapse at Vale's iron ore mines in Brazil killed around 300 people and closed down the mines. This took Vale's 90-100 million tonnes of production out of the market, and it looks like the closure will continue for some time. Then cyclone Veronica hit the Pilbara iron ore region of WA and disrupted supplies in March.

The chart below shows iron ore prices since 2000 and the share prices of Australia's main iron ore miners. Their share prices have been scaled to show their moves relative to iron ore prices more clearly.



Iron ore prices hit $100 per tonne in late May. The last time it was $100 was exactly five years ago before the last China slowdown scare led to collapses in global commodities prices in 2014-5. This triggered a wave of bankruptcies and losses in the oil/gas and steel industries around the world, and led to a global 'earnings recession' which affected every country including Australia, the US, UK, and Europe. The crisis was ended when the Chinese government ramped up stimulus spending dramatically from March 2016, triggering a sudden rebound in commodities prices and mining share prices that lasted until the slowdown scare in late 2018. Since the Vale disaster, share prices of the main iron ore miners have soared. So far in 2019, RIO is up 28%, BHP is up 15% and Fortescue is up 95% (to the end of May).

Australia digs up and exports around 850 million tonnes of iron ore bearing rocks per year. Around 70% is shipped to China, 20% to Japan and 10% to South Korea. In addition Australia also exports 400 million tonnes of coal (thermal coal for electricity generation, and coking coal for steel production), plus another 50-100 million tonnes of rocks and dirt containing other useful minerals like bauxite, nickel, zinc, copper and uranium. This brings the total to around 1.4 billion tonnes of rocks and dirt shipped overseas each year.

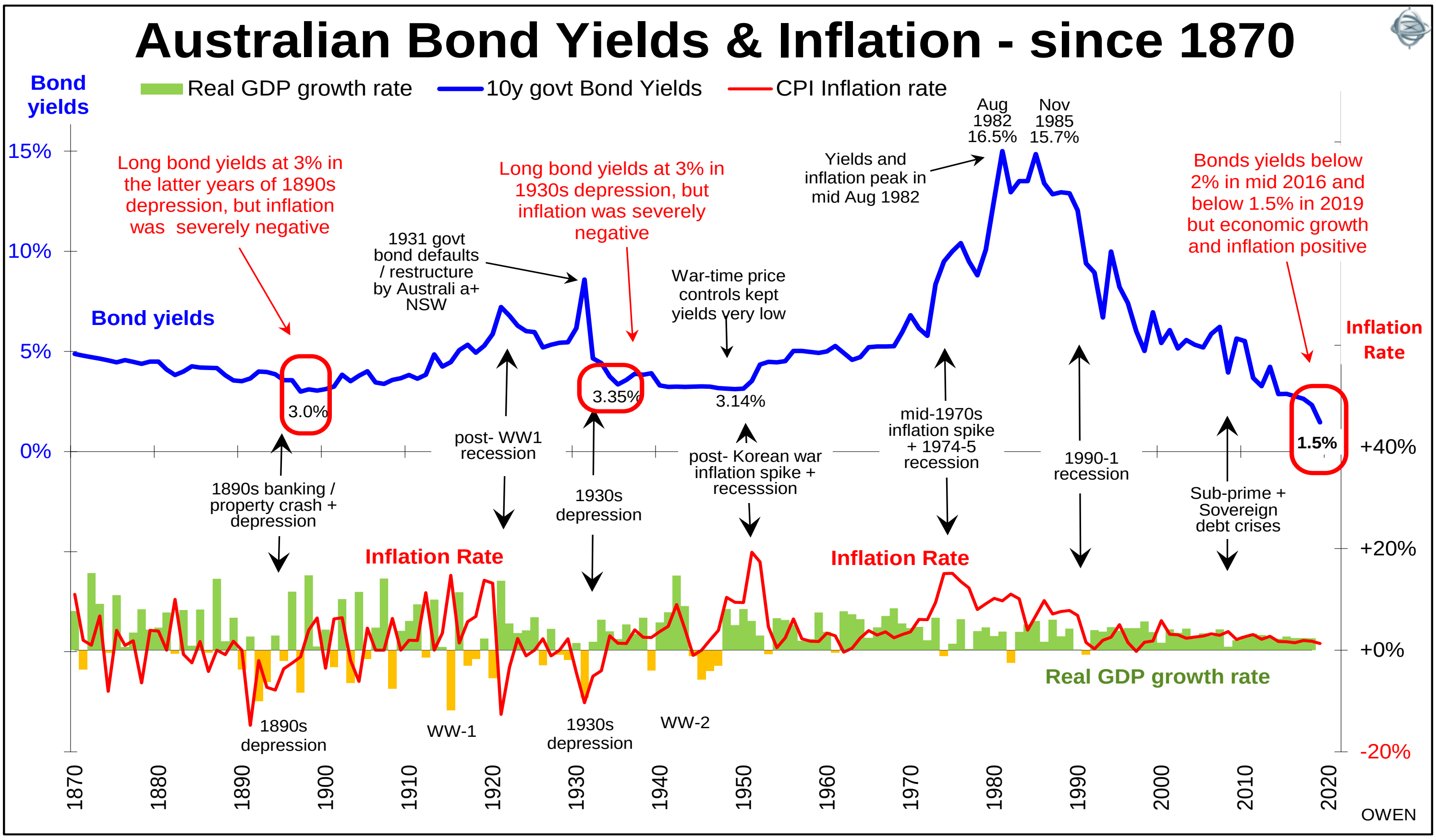
How big is 1.4 billion tonnes? It is the same as one 'Uluru' (which weighs 1.475 million tonnes) or about 250 Great Pyramids of Giza (which weighs 5.75 million tonnes). That's a lot of rocks! (Uluru is 348 metres high and 9.4 kilometres around its base. It is mainly sandstone, not iron ore, coal nor other minerals, but I use it as a way to visualise the sheer volume of rocks and dirt that is shipped overseas each year).

It is too bad Australians can't do more with rocks and dirt than just load them on the nearest ship to be sent overseas so that people who know what to do with them can magically transform them into amazing products that we buy back at thousands of times the price. Even at $100 per tonne, that is just 10 cents per kilo, or 1 cent per mobile phone. Australia once had thriving manufacturing industries but they were protected by high tariff barriers erected after WW1. The industries disappeared when the protection was removed in the 1980s and 1990s. So we still rely on rocks and dirt as our main export earners. With 'Mr Coal' back in the Lodge as PM, our current leaders figure that Australia is so large that one Uluru per year won't make too much of a dent for a while yet. The next generation can deal with that!

4 Aussie bond yields lower than depression era levels

Yields on Australian government bonds have kept falling this year. At the end of May they dipped below 1.5% for 10 year bonds, the lowest they have ever been in history. Yields on 10 year government bonds peaked at an incredible 16.5% in mid-August 1982 and have been declining along with inflation rates ever since. The chart shows bond yields, inflation and economic growth rates in Australia since 1870.

As bond yields represent the market's collective view on the outlook for economic growth and inflation, the current ultra-low yields are extremely pessimistic. Yields are now lower than there were in the depths of the 1890s depression and the 1930s depression, when economic growth and inflation rates were deeply negative. But since economic growth and inflation are positive now, why are yields so low?



At first sight it appears that the current all-time low yields are a sign that 'the market' is expecting worse outlooks for growth and inflation than in the 1890s depression and the 1930s depression. However this is misleading. Prior to the 1990s Australia was regarded as a high risk 'emerging market' and so yields on bonds were higher to reflect a higher risk of default. Indeed the Commonwealth government defaulted on its entire stock of domestic bonds in 1931 (having taken over responsibility for the State debts, and in particular the defaulting NSW). Australia only regained respectability in international credit markets after the long post-WW2 boom which allowed the debt to be repaid, and after the reforms in the 1980s including dismantling tariff barriers, privatisation, deregulation, and floating the dollar. Australia's good standing in credit markets now partially explains the lower overall level of yields in the past few years compared to the prior 100 years.

Even allowing for this change in status of Australia as a creditworthy borrower, the current yields are still far too low. Australia may be heading for a local slowdown and possibly recession in the coming year or so, but the current yields are suggesting we should expect virtually zero growth and inflation for the next decade. This is far too pessimistic for a country with the fastest growing population, the most favourable demographics, the lowest government debt levels in the developed world, strong public institutions and a stable government.

The main reason for the low yields is that most Australian government bonds are owned by foreigners scouring the world for yield, and Australia is one of the very few countries left with a 'AAA' credit rating. Australian yields may be low relative to our history, but they are still higher than many other countries. Japanese and German yields are still negative thanks to years of massive central bank 'quantitative easing' bond buying programs. UK yields are not far above zero, and French and Spanish bonds are below 1%. Australian yields are now even lower than in Canada. Canadian yields are being kept relatively high by the close links to the US, where the economic recovery boosted by the Trump tax cuts has kept US yields above 2% since their post-Brexit lows in 2016.

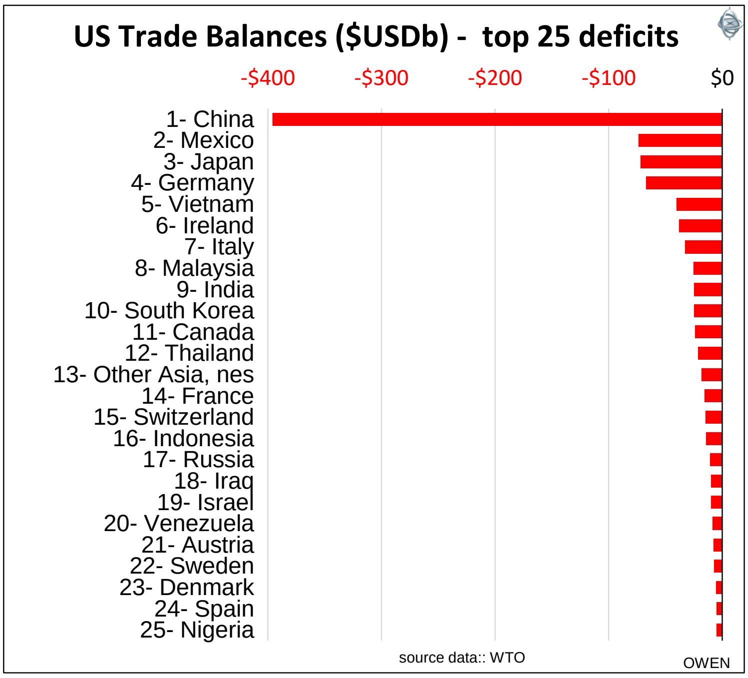
What does this mean for investors? Although we believe Australian yields will rise in the medium term, we have significant allocations to Australian bonds in portfolios as we had been expecting yields to fall in the short term. The declining yields generated above-average returns of around 6% for 2019 to date (and they beat shares by 8% in 2018). Not bad for boring old bonds in a so-called 'low return world'!

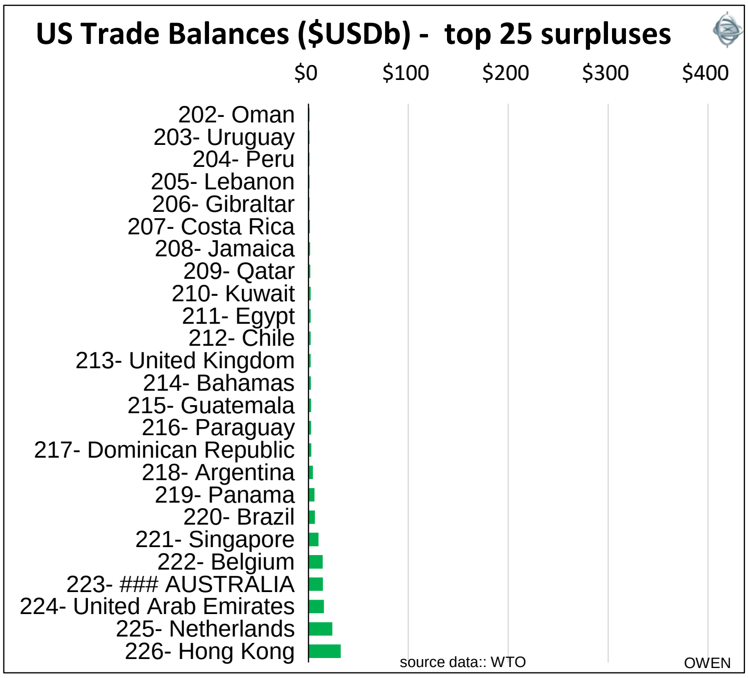
5 Trump's American trade dream

Part of Donald Trump's 'Make America Great Again' vision is a return to the early-mid 20th century golden era of American manufacturing and export leadership. It is a grand vision – similar to Brexiteers' vision of Britain returning to its 19th century golden era of 'Rule Britannia' – but is it achievable?

Trump's primary beef is with China, but China accounts for less than half of America's overall trade deficit. In addition to China, there are also 105 other countries that export more to the US than they import from the US. The US does run trade surpluses with the remaining 120 countries in the world but the surpluses are tiny compared to the deficit countries. The surpluses with the surplus countries total $170b, but the deficits with the deficit countries total more than $1 trillion per year.

The left chart below shows the top 25 countries with which the US has a trade deficit – this is Trump's target list for trade wars. China is the largest, followed by Mexico, Japan and Germany. The right chart shows the top 25 countries with which the US has a trade surplus (Note that the 4th largest surplus is with Australia). The scale is the same on each chart to highlight the relative sizes of the surpluses and deficits.





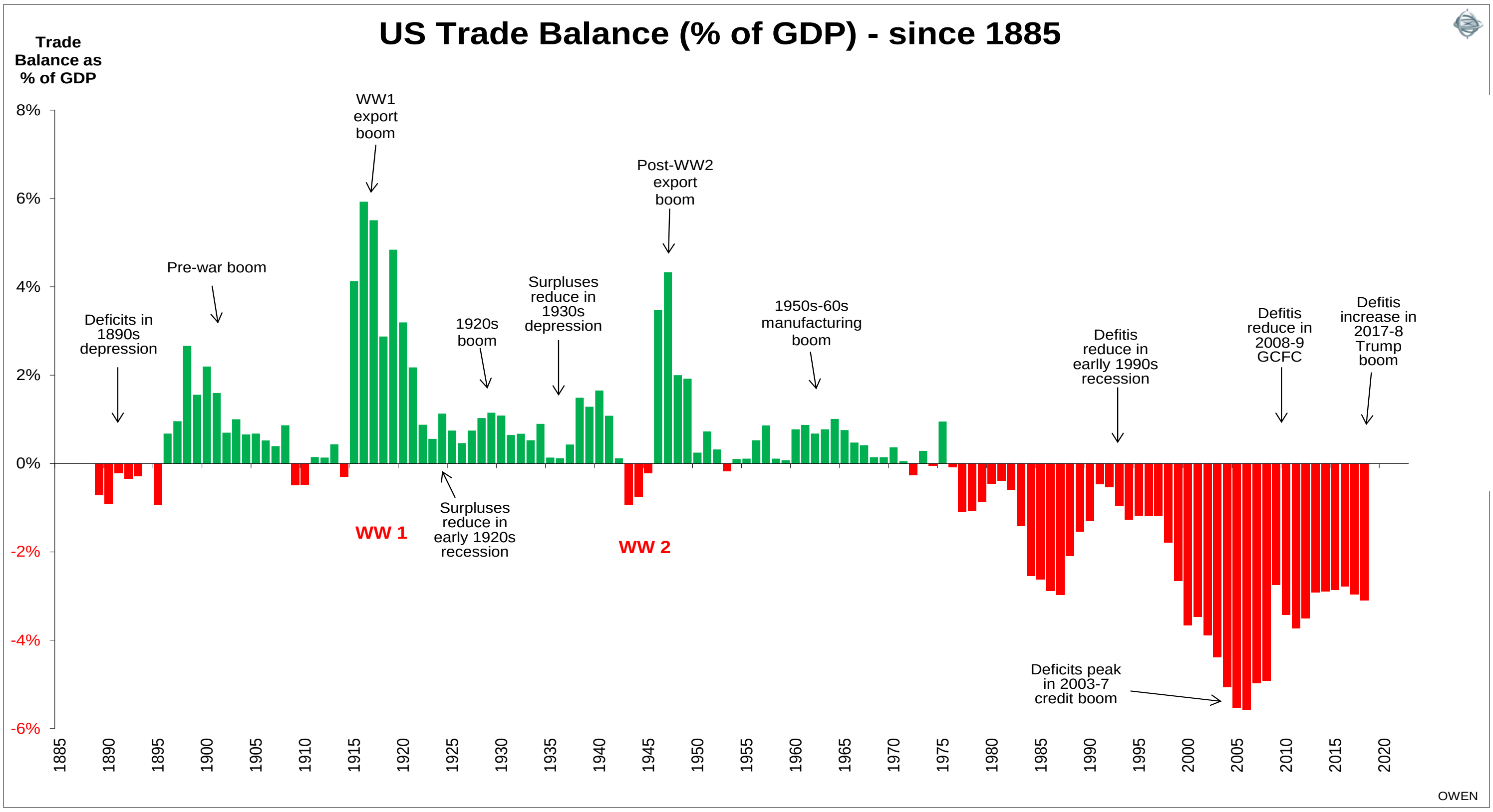
Trump's strategy is to bypass multilateral processes like the World Trade Organisation, OECD, the World Bank and also the plethora of multilateral treaty arrangements, and instead attack each 'problem country' on a bilateral (one-on-one) basis. There is a logical problem with this bilateral approach because not every country wants to import what the US might be selling. There are more than just two countries involved. A car or a mobile phone is not made entirely in one country any more. Every item is made from numerous parts and inputs that are imported from dozens of other countries, and each of those other countries relies on trade with suppliers in dozens more countries.

There is also a larger structural problem. America can only return to trade surpluses with the rest of the world if its citizens become frugal savers once again, rather than the profligate borrowers and consumer spenders they have become. That's the bottom line.

America has progressed through three great economic phases over the past 150 years. First, America in the late 1800s was a capital importing, commodity exporting, mainly rural 'emerging market' – based on the Jeffersonian small-town model of society. This all changed around the turn of the 20th century when great productivity gains from electricity and transportation transformed America from a capital importing, commodity exporting, rural 'emerging market', into a capital exporting, urbanised, manufacturing exporter. It led the world in innovation, productivity and manufacturing quality, and ran persistent trade surpluses from the late 1890s onward. In the First World War, America emerged as the military and economic superpower, and New York replaced London as the capital market for the World.

America's golden era for manufacturing and exports lasted until the late 1970s, when it was overtaken by the next wave of emerging markets – Japan and Germany in the 1960s, 1970s & 1980s, and then China more recently. Americans invented debt-fuelled consumerism in the 1950s and 1960s and became a victim of it in the 1980s. Today's American consumer society is being funded by capital imported from the frugal savers and lenders - the countries on Trump's target list – China, Japan, Germany, South Korea, Taiwan, Vietnam, etc.

The next chart shows the US trade balance with the rest of the world as a percentage of its total national output (GDP) since 1885.



It shows the era of trade surpluses from the 1890s to the 1970s, especially during the war-time and post-war booms. America's golden era of trade faded in the 1970s and it has run large deficits ever since. The only periods of respite are in economic recessions and slowdowns when consumers curb their imports temporarily, resulting in smaller deficits for a year or so until the spending boom returns. In the current phase, Americans' trade deficits, spending and borrowing are being financed by capital imports from the frugal savers and lenders of the world which run trade surpluses. From a US viewpoint the US runs deficits with them, so they appear on the US deficits list.

Americans are unlikely to change from being profligate borrowers and spenders, and return to being frugal savers and lenders once again, and so it is unlikely that America will return to running trade surpluses, especially with Trump cutting taxes and running trillion dollar government deficits. Change is not impossible of course – but it would probably take a traumatic event on the scale of the 1930s depression or another American Revolution or Civil War or another world war. Gradual self-generating change is unlikely.

While Trump's vision of trade surpluses is an impossible dream, his trade shenanigans are about more than just trade. Despite his constant rhetoric on trade with China and other trade targets, it is clear that trade is only one lever in a larger issue at stake – the military and strategic power shift toward China that represents a challenge to America's role as the world's sole super-power. Trump is approaching the trade question with each country very differently, depending on its role in his broader agendas. For example Japan is number three on the trade deficit target list, but Trump has been very lenient with Japan. The US is far more interested in Japan's role as US sheriff in the North Pacific against the rising China. In WW2 China was an ally and the Japan was the enemy. This century the roles are reversed.

Note that Australia is well positioned in the US trade war stakes. The US needs Australia as its sheriff in the South Pacific, and fortunately Australia is one of the few countries in the world with which the US runs a trade surplus (is a net importer from the US) but China runs a trade deficit (Australia is a net exporter to China). Although it means that Australia is not on Trump's trade war target list, we are vulnerable because we rely on China for the largest proportion of our export revenues. Australia has not been as reliant on one country for its export revenues since the mid-1950s when Britain was our largest export customer. Britain was an ally but it is very different with China. As US-China tensions escalate, China could easily hurt Australia by cutting back imports from Australia (as it has done with thermal coal imports this year). China currently relies on Australian iron ore and coal to build its military bases and weapons, but it has been carefully widening its sources of supply, and also buying up mines in Australia and key stakes in mining companies so it has more direct control over supply.

Mexico is the second largest target on Trump's trade deficit target list, however Trump's recent trade war moves against Mexico seem to be aimed more at his anti-immigration agenda rather than the trade agenda. The next largest trade deficit target – Germany - is a different matter. It is well known that Trump is obsessed with Germany's trade relationship with the US – especially cars. Americans buy millions of German cars but Germans buy virtually no American cars. (It's no great mystery – just drive an American car for 5 minutes and you'll see why!). The US needs NATO less after the fall of the Soviet Union – although Russia remains a lesser threat – so it would not be surprising to see Trump ramp up trade disputes with Europe and Germany in particular.

What lies ahead?

The re-election of the Morrison government in Australia triggered an immediate easing of pessimism in the housing market, as it removed the threat of Labor's promised tax changes designed to 'make housing more affordable' (ie to lower prices). Following the election, weekend auction activity and lending demand were already starting to show signs of improvement even before the RBA's latest interest rate cut and APRA's loosening of mortgage debt service rules. These moves are sure to boost confidence even further. "Gee, we can borrow even more money on the same level of income, so let's gear up even more!"

On top of that will be the government's ill-informed scheme for taxpayers to bear the losses on first home buyers with just 5% deposit, effectively replacing mortgage insurance with unfunded and uncompensated tax-payer losses. Obviously the government hasn't learned anything about moral hazard from the GFC, nor understood what Fannie Mae and Freddie Mac did to the US housing market. Whatever the eventual impact of the scheme in the long run, it will probably be a positive for house prices in the short to medium term.

As a result of these recent developments, the declines in house prices are likely to be less severe and less prolonged than they would have been had Labor won the election. The high rise market is where most of the problems lurk. Construction activity and jobs are slowing as each new building is completed and not replaced by further developments. Tens of thousands of investors who committed to buy units off the plan years ago at boom-time prices are now facing lower completion valuations. I have seen many cases of completion valuations coming in at discounts of 30% and even 40% below their boom-time purchase prices. Many buyers won't be able to obtain finance at all, and for those who can, the bank will lend less on the lower valuations, so the purchasers need to find hundreds of thousands of dollars from other sources in order to complete the purchase. Then they face lower rents and higher vacancy rates than they were sold in the fancy marketing brochures.

The latest economic growth numbers for the March quarter revealed a slowdown in overall growth to +0.4% for quarter and +1.8% per year. This is well down from +2.3% pa for the 2018 calendar year, and a post-war average of +3.5% pa. Housing investment was down -2.5% for the quarter and down -3.1% pa, while mining investment was also down sharply. The overall numbers are being propped up by booming government spending, which is the largest contributor once again – up +0.8% for the quarter and +5.1% pa.

It is still an open question whether the housing / construction slowdown will remain a localised problem for the overcommitted borrowers and developers, or whether it will expand into a broader slowdown in confidence and spending that affects the rest of the economy in general and the banks in particular. The good news is that the windfall gains from the iron ore prices have fortuitously brought the government budget back into balance, so it has plenty of money to spend on more stimulus projects if necessary.

We were bearish on shares last year when we under-weighted shares in portfolios prior to the sharp sell-off late in the year. This year we have been more positive on shares but remain wary of more sudden moves from Trump. In Britain the Brexit fiasco is still continuing with no end in sight, but the European elections were encouraging as they resulted in a strengthening of the moderate parties and a weakening of the shift toward the extremist right and left.

Meanwhile we remain on the look-out for possible sources of risk and are always willing to make further adjustments to protect capital and capitalise on opportunities where warranted.

'Till next time, happy investing!

Ashley Owen, CFA
Chief Investment Officer
Stanford Brown