STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5

September 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.

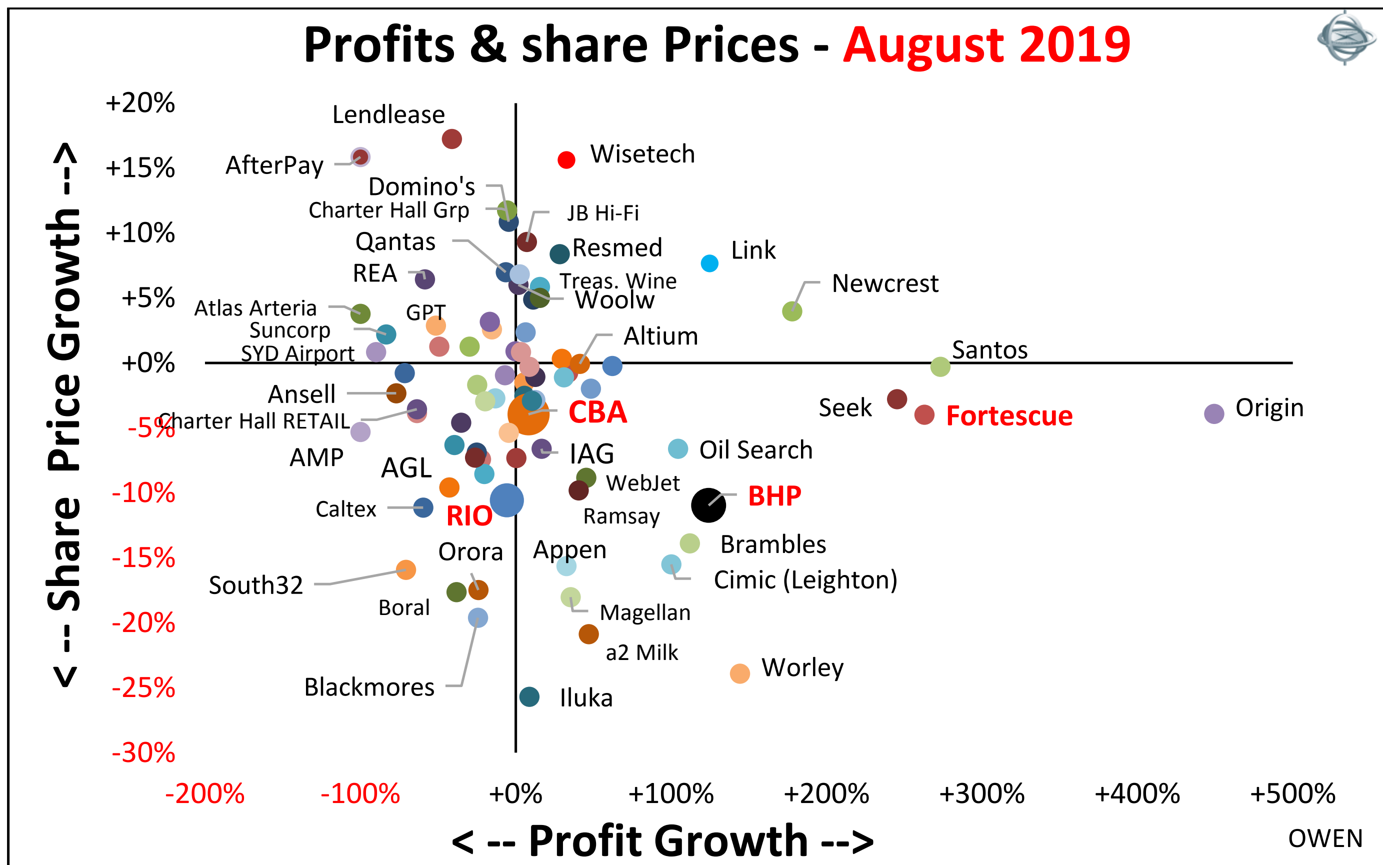
1 Company reporting season in Oz

August is the main reporting season for Australian listed companies. Most companies have financial years ending in June and they report their full year results in August. Some companies have December years and they report their half-year results to June in August. There are also a small number of companies with financial years ending in other months – like September (notably ANZ, NAB, Westpac), March (notably Macquarie), July or February, and so their results are not included in the August reporting season wrap-up.

The overall results were poor. Across the 90 companies that reported out of the top 100, aggregate sales revenues grew by 4.6% over the same period last year – from $500b to $523b. This is no better than the aggregate growth in the local economy (nominal national income).

Aggregate reported profits grew by just +2.5% from $57b to $58.4b (excluding Wesfarmer's $3.3b one-off gains from its sales of Coles and three other subsidiaries during the year, and also excluding Woolworths $1.2b gain from the sale of petrol stations). If we also exclude the profit growth from the commodities producers driven by windfall global commodities prices, profits for the rest of the market actually fell by 15%. The main culprits were AMP, Telstra, Suncorp, Crown Casino, Bendigo Bank, Challenger, Ansell, Blackmores, Transurban, Sydney Airport, Aurizon, Qantas, REA, Bluescope, Orora, AfterPay and most of the property trusts. There is always a lot of fiddling and fudging that goes on in profit reports and this year was no exception!

How did the results announcements affect share prices? The first chart shows the results for the 90 companies that reported in August out of the largest 100 companies on the ASX - share price growth for August (vertical axis) versus profit growth reported: full year results for companies with June financial years and half year results for companies with December years (horizontal axis).

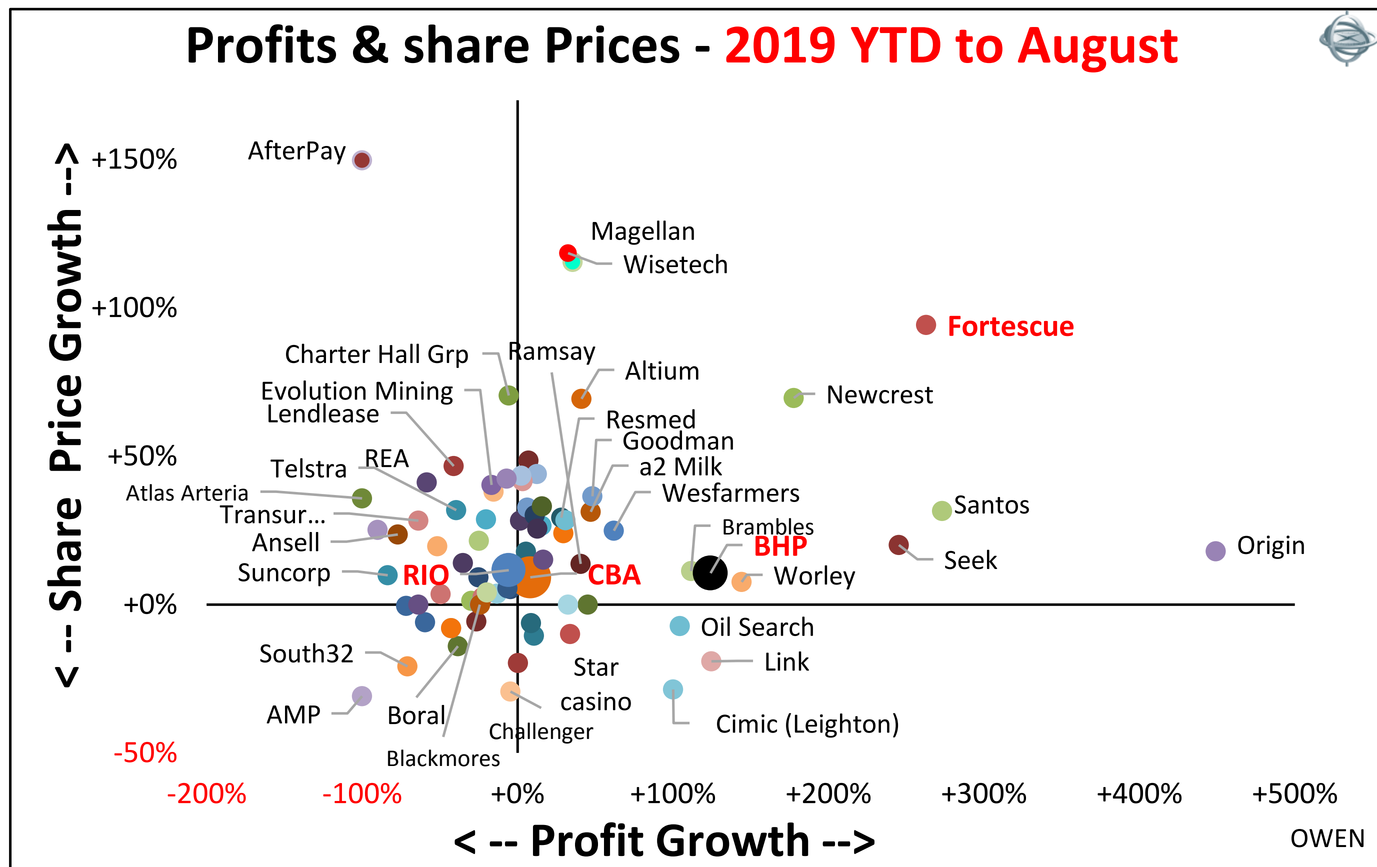


The chart illustrates that there is no relationship between profit growth and share price growth over short periods because share prices are driven largely by global sentiment. In August share markets everywhere including Australia were hit by Trump's escalation of his trade wars, currency wars and his war on Fed Chair Jay Powell.

Several companies posted high profit growth but their share prices fell (lower right segment of the chart) – including Origin, Fortescue, Seek, Worley, BHP, Oil Search, Brambles, Cimic (Leighton), Appen, a2 Milk, Link, Magellan and a host of others. Conversely, many posted profit declines but their share prices rose (upper left segment) – including LendLease, REA, Afterpay, Evolution Mining (gold), Crown Casino, GPT, Suncorp, Qantas and many others.

Aside from macro issues driving share prices, the other main issue is that profits are backward-looking but share prices are forward looking. For example iron ore producers RIO, BHP and Fortescue booked windfall profits from the iron ore surge this year after the mine closures in Brazil reduced global supply, but their share prices were hit when iron ore prices fell back 20% in August. A similar pattern in the oil price affected Origin, Santos, Oil Search, Worley and also BHP – oil prices surged 29% from January to July but fell back 6% in August.

Of course one month is not a sufficiently long period to assess share price growth and profits, so the second chart shows the same profit growth reported per company but this time compared to the total share price gains so far in calendar 2019 on the vertical axis.



Again we see that there has been no relationship between profit growth and share prices this year. Half of the companies posted profit declines (left half of the chart) but the vast majority of share prices have still risen this year (top half of the chart). It was once again due to global macro issues, with share markets everywhere rebounding in 2019 from the late 2018 global sell-off. The main driver has been the Fed's switch from rate cuts last year to rate cuts this year, and moves from other central banks toward more monetary stimulus – including two more rate cuts from the RBA. The sugar hits from more stimulus has overcome the negative effects of Trump's trade wars and their possible impact on slowing economic growth – so far at least.

Another global factor at work has been the decline in bond yields everywhere, which have lifted share prices despite falling profits (upper left segment) in many of the 'bond proxy' companies that are often perceived to have relatively 'safe' dividends – Telstra, Transurban and the property trusts. (However, just ask any long-suffering Telstra shareholder how 'safe' their dividends have been in recent years!).

Aside from the commodity stocks (which rise and fall with global commodities prices over which they have no control), the upper right segment of the second chart does highlight some local companies that have real value-adding businesses with rising profits being rewarded with above-market share price rises – including Seek, Magellan, Wisetech, Altium, a2 Milk, Goodman, JB Hi-Fi, Ramsay, ResMed, Cochlear and CSL.

2 High dividends hurt future growth

During the August profit reporting season the Australian Treasurer Josh Frydenberg made headlines when he called on Australian companies to retain and re-invest more of their profits instead of returning them to shareholders in the form of dividends and share buybacks. Australian companies on the whole have the highest dividend yields and highest dividend payout ratios in the 'developed' world. The more a company returns its profits to shareholders, the less it can retain to grow its business for the future.

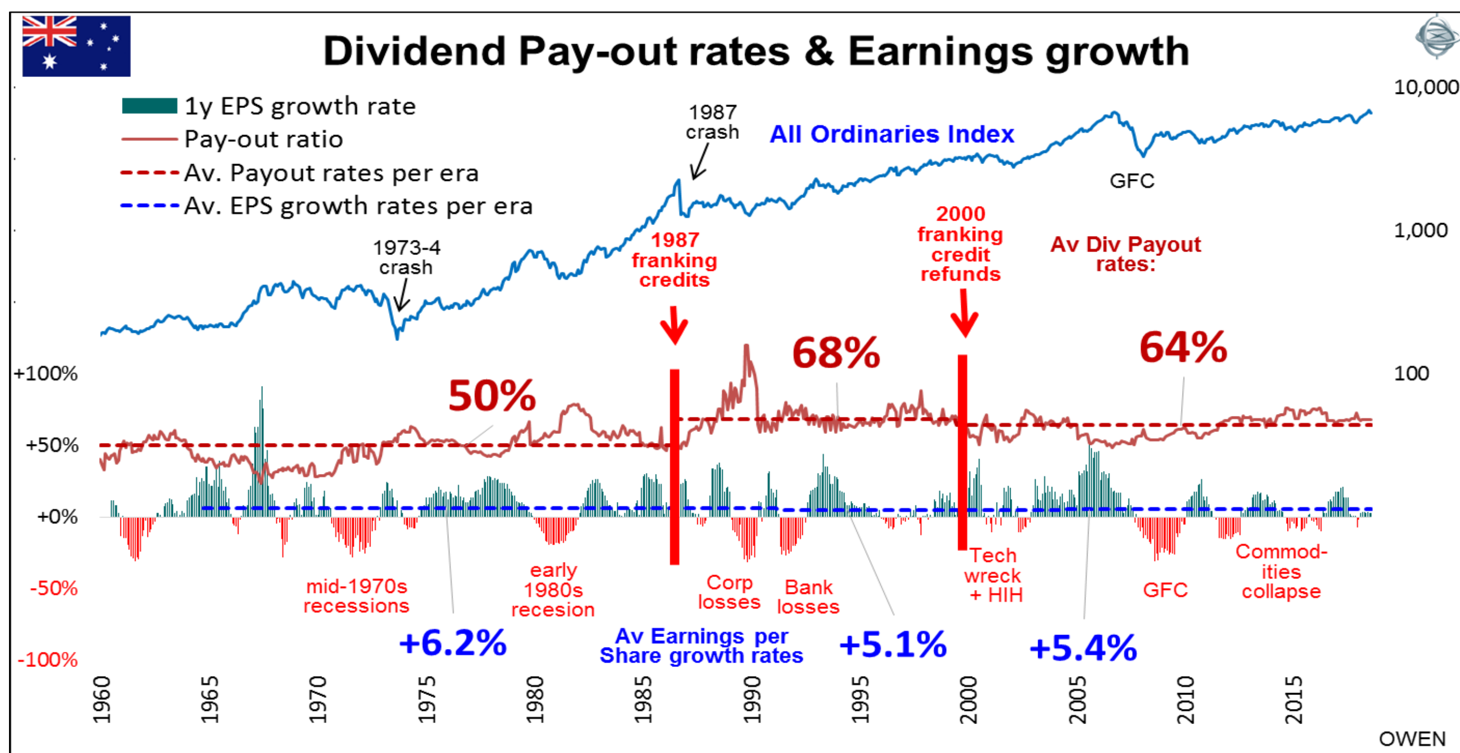
When countries start out as high risk, high growth 'emerging markets' with little in the way of shareholder protection laws, governance standards or regulatory mechanisms, shareholders demand company boards return profits to the shareholders as quickly as possible. The result is high dividend pay-out ratios and high dividend yields, but the downside is low profit growth rates and low share price growth because companies need to re-invest profits in order to grow. It usually takes many decades for shareholders to learn to trust directors enough to re-invest their profits wisely to generate future growth.

Australia and the US both started out as high risk 'wild-west' emerging markets in the 1800s with dividend pay-out ratios nearing 100%, and dividend yields of 8%+. Over the past 150 years the US developed into a mature, highly regulated market where shareholders allow companies to retain most of their profits to re-invest for growth. This results in relatively low dividend yields (around 2%), but the upside is relatively high profit growth. Over the same period shareholders of Australian companies still demand most of their profits are returned as dividends rather than let the board re-invest it. The result is relatively high dividend yields (around 4%) but lower profit growth rates.

Why have American and Australian companies diverged as they have? One reason is that Australian companies great and small have a demonstrated a long history of squandering shareholders' money on failed expansion plans and ill-advised, over-priced, ego-boosting acquisitions and overseas adventures – usually at the tops of booms and often with debt. Many or probably most of these boom-time follies have failed and have been written off in the busts that inevitably follow the booms.

This disease has afflicted nearly all of our big companies – the big banks, the big miners, insurance companies, Telstra, the retailers, property trusts, and even big conglomerates like Wesfarmers. In most 'emerging markets' the companies are relatively new and mistakes are therefore inevitable. The problem is that in Australia most of the big companies are more than a century old but it seems there has been very little organisational learning. Even the venerable BHP wasted more than $20b on its recent US oil & gas expansion at the top of the market and was recently forced by shareholders to return the $10b it salvaged from the wreckage, rather than trust the board to re-invest it.

There have been many successful adventures of course, but the failures have more lasting impacts on investor memories. Shareholders still don't trust most of the big Australian companies to invest their money wisely. The preferred approach seems to be: "Return all the profits to shareholders, then when you want some money to invest, bring us a detailed business case and we will give it you if we like it".



A second reason often given for our high dividend yields and dividend payout ratios is the franking credits system, in which Australian (but not foreign) shareholders in Australian companies receive a tax credit for Australian tax already paid by the company on the profits. This tax credit was introduced in 1987, and then in 2000 the tax break was extended to cash refunds and not just tax credits against other tax payable by shareholders.

The chart on the previous page shows Australian shares since 1960 as the blue line in the top section. The lower section shows the dividend payout ratio ie the proportion of company profits paid back to shareholders in dividends (maroon line). This ratio rises and falls through cycles because company profits are more volatile than dividends – illustrated by the blue/red bars in the lower section which show annualised growth in aggregate earnings (profits) per share. Company profits rise in booms and contract in the ensuing busts.

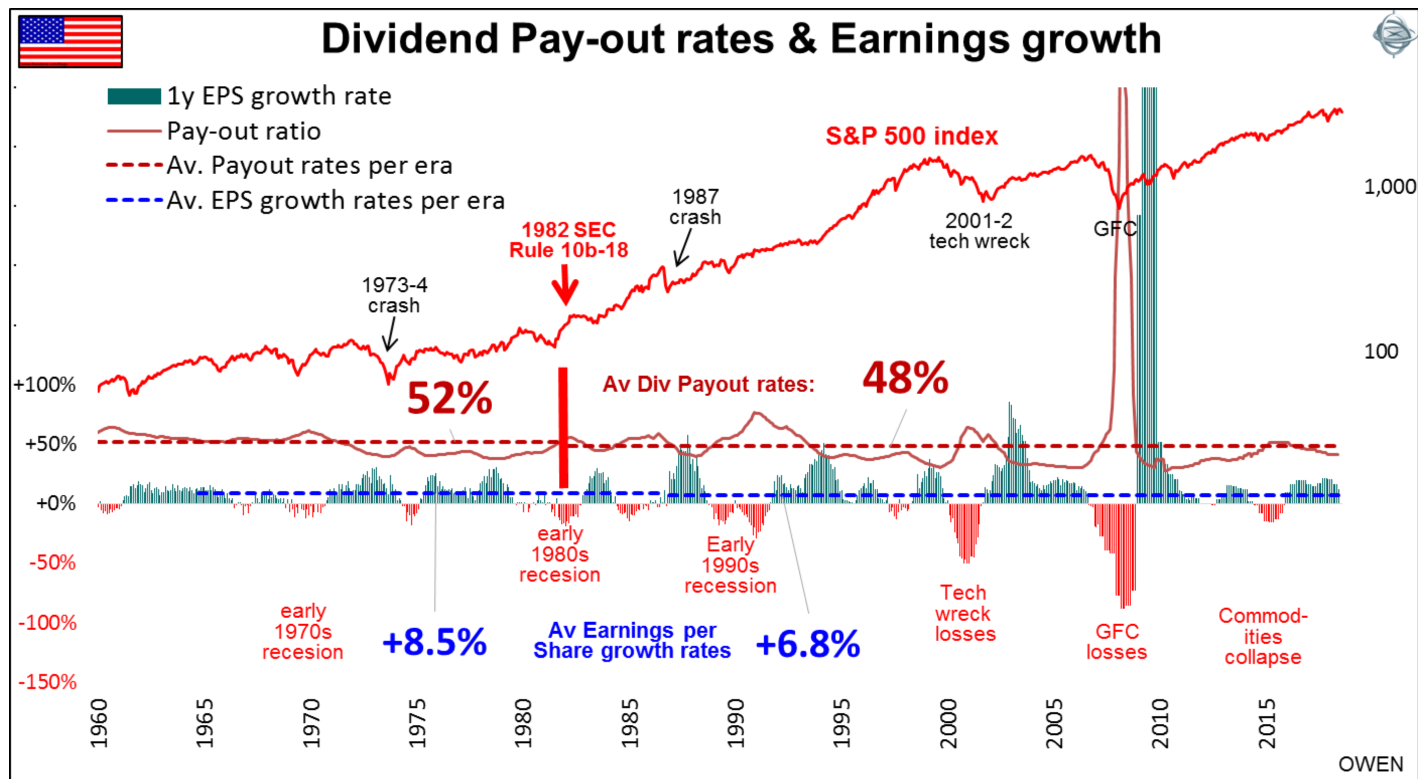
The dotted lines in lower section show the average dividend payout ratios (maroon dots) and average earnings per share growth rates (blue dots) divided into three eras. The first era (left section) is the period before imputation (franking) credits were introduced in 1987 - companies paid out an average of 50% of profits in dividends and companies grew their earnings per share by an average of 6.2% per year.

The second era (middle section) runs between the start of franking credits in 1987 and 2000 when credit cash refunds of franking credits were introduced. This shows that after franking credits were introduced, companies paid out more of their profits in dividends (68% on average) resulting in company profits growth rate falling to 5.1% per year.

Since the introduction of cash refunds for franking credits (the third era), dividend payout ratios have dropped back a little to 64% on average, and earnings per share growth rates have increased slightly to 5.4% per year on average. The volatility of company profits and pay-out ratios makes measurement vulnerable to timing of each cycle. As it turned out, cash refunds on franking credits were introduced right at the top of the 'dotcom boom' prior to the 'tech wreck', and we would conclude that the timing of the introduction of cash refunds in 2000 did not result in a significant change in either payout ratios or profit growth rates. The overall averages have been essentially unchanged since the 1987 introduction of franking credits.

How does this compare to the US market? The second chart below shows the same measures for the US market. There are no franking credits or refunds for tax paid on dividends in the US, but the big change in policy with the US came in 1982 with SEC Rule 10b-18 which made share buybacks much more attractive for US companies. Since the rule change US companies have returned more money to shareholders through buybacks than they have through dividends. Regular dividend buybacks have become common practice for a large number of US companies. In contrast Australian companies tend to have specific buy-back programs to distribute excess cash after one-off windfall profits or the sale of subsidiaries. This year we have seen buy-backs from Qantas, AGL, Aurizon, Amcor, Link and Brambles.

US companies use buybacks as the main way of returning capital to shareholders, whereas Australian companies primarily use dividends. Buybacks have the advantage of reducing the number of shares on issue, which boosts earnings per share.



We can see that in first era (prior to the buy-back rule in the US and prior to franking credits in Australia) – companies in both countries paid back around 50% of their profits in dividends. After the buy-back rule in 1982, average dividend payout ratios for US companies have reduced to 48% on average, compared to well above 60% in Australia. As a result of the lower dividend payout ratios in the US, and impact of buy-backs reducing the number of shares on issue, US companies have achieved 6.8% annual growth in earnings per share. This is significantly higher than the profit growth rate achieved by Australian companies since franking credits were introduced here.

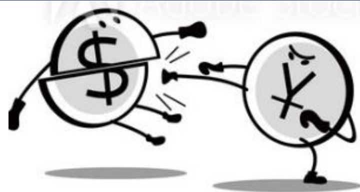
US companies spin off cash (through buybacks and to a lesser extent dividends). This is natural as the US is a mature developed market with globally dominant companies that are running out of room to grow. In August Google over-took Apple as the largest holder of cash in the world, with US$117b in spare cash it doesn't know how to deploy. It could buy 100% of our largest company CommBank with its loose change and still have spare money left over.

Australia on the other hand has remained an 'emerging market' in the sense that it has always relied on foreign capital to finance its growth. Unlike the US, Australia has very few companies that dominate global markets, it has enjoyed the highest economic growth rate in the developed world and has avoided a recession for 30 years, and so one would expect Australian companies should have ample opportunities for above average growth if they had the vision and skills.

The challenge is to sort through the chaff on the ASX to unearth companies that have skilled directors and CEOs who can re-invest capital prudently to generate superior long term growth.

How does this affect our portfolios? In our holdings of Australian shares we tend to favour fund managers with deep hands-on research methods where the portfolio managers and analysts conduct regular detailed discussions with company management, as well with each company's competitors, suppliers, customers and regulators. In particular the active fund managers we use have a bias toward 'quality' companies – where the key measures of 'quality' include high returns on equity, low debt levels and stable earnings per share growth rates.

In addition, when selecting fund managers one of the main tests for inclusion in our portfolios is downside protection – where the funds have a track record of holding up better in declining markets. Each of the active Australian share funds we use in client portfolios held up better than the overall market in the recent global growth scare in late 2018, as they have done in several market sell-offs in the past. Our aim is to provide investors with superior long term returns and a smoother path through the ups and downs along the way.



3 US-China trade & currency war

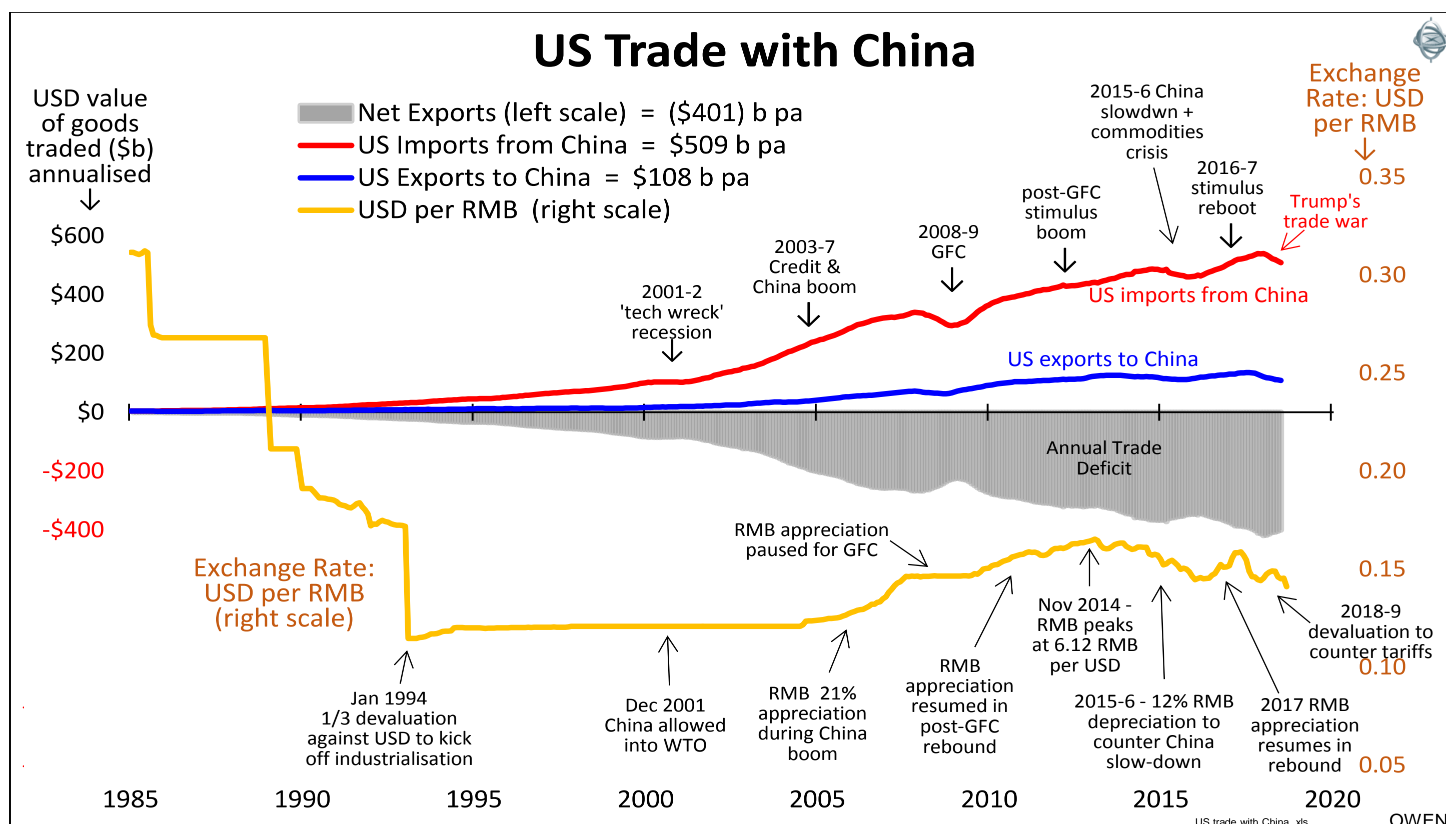
We warned in our last monthly report that the weakening Chinese currency against the US dollar was sure to anger Trump and lead him to widen his tariff war into a currency war as well. This came to pass in the first week of August when the US officially labelling China a 'currency manipulator' and called for the International Monetary Fund to take action. Trump also held strategy meetings with his advisers on how to weaken the US dollar – including unconventional methods like selling dollars generated from newly printed money from the Federal Reserve, or from new debt issued by Treasury. Trump is likely to favour direct unilateral actions like these rather than rely on multi-lateral agreements like the 1985 Plaza Accord or the 1987 Louvre Accord.

China has allowed its currency the Renminbi (RMB) to fall by 4% against the US dollar this year to counter Trump's tariffs, but it has not all been China's doing. The US dollar has also risen by similar margins against the Euro and the UK Pound this year, so there is more to it than just the Chinese devaluation.

The US has even less chance of winning a currency war than it does of winning a trade war. As we wrote in our June 2019 'Top 5' report, the US is unlikely to ever run a trade surplus with China or the rest of the world because Americans have been hooked on consumption and debt since the 1980s. Americans' addiction to borrowing and spending more than they earn is unlikely to change any time soon in the absence of a life-changing trauma like another 1930s-style depression.

On the currency front, Trump is also very unlikely to be able to bring down the US dollar down using his tariffs and his threats of trade and investment bans on US companies. The more Trump's tactics erode consumer and investor confidence, the more the US dollar is likely to rise, not fall. The reason is that the US dollar has been the global 'safe haven' currency since the First World War and it still is. As such the US dollar rises in global slowdowns and growth scares. Even when the US is the cause of the problem and the trigger for the crisis – for example in the GFC – the US dollar rises in a crisis as investors dump foreign assets and scurry back to the safety of US cash and bonds. This explains at least part of the US dollar's strength this year.

The chart shows the annualised value of trade between the US and China over the past three decades. US imports from China (red line) have been rising much more rapidly than US exports to China (blue), resulting in a widening trade deficit in favour of China (grey bars). Americans buy around $500b from China per year but Chinese buy only around $100b from America, resulting in a $400b annual deficit.



The chart illustrates how imports and exports rise and fall together – both rise in booms and then both fall in slowdowns. Imports, exports and the deficit have all been falling this year because of slowdowns in both economies, but all three will pick up again as growth resumes in the next cycle, which it will inevitably do.

The problem is that US imports from China have run at about four times the level of US exports from China over the past 25 years. Most of China's imports are raw materials from countries like Australia, but only around 6% of Chinese imports come from the US.

Because Americans spend more than they earn whereas the Chinese save more than they spend, the Chinese effectively finance the trade deficit by lending their Chinese savings to Americans to buy Chinese imports. It's basically vendor finance between countries.

It is similar to trade within Europe – where the spendthrift 'south' (Italy, France, Spain, Portugal, Greece, etc) borrow and spend more than they earn whereas the thrifty 'north' (Germans, Austrians, Dutch, etc) save more than they spend, so the Germans effectively finance the trade deficits of the debtor countries by lending their German savings to the people of Spain, Greece, etc to buy German cars. The difference in Europe is that they operate under a fixed currency – the Euro – which locks in a trade advantage to the Germans by keeping their currency artificially low relative to the debtor countries. If it weren't for the fixed Euro system, the German exchange rate would be much higher and the debtor country currencies would be much lower. One of the fatal flaws in the Euro system is that is has no mechanism for adjusting exchange rates and for this reason there will be regular debt crises in Europe as we have seen over the past 10 years.

The difference with trade between the US and China is that their exchange rates are variable – although in the case of China the RMB is highly managed rather than free floating. This variability adds flexibility – and politics.

The yellow line in the lower section of the chart shows the US-China exchange rate expressed in USD per RMB. China kicked off its industrialisation journey with a one-third devaluation against the US dollar at the start of January 1994. The Chinese economy was very small at the time (just one thirtieth of its current size in US dollar terms) and so nobody took much notice. China held its exchange rate more or less at the same level for the next 10 years but the RMB appreciated steadily during the 2000s China export boom, reflecting China's growing pile of foreign exchange reserves from its trade surpluses.

The RMB appreciation was paused during the GFC recession to assist Chinese exports in the global trade collapse, but the post-GFC stimulus boom resulted in the resumption of pressure for the RMB to rise. It then depreciated in the 2015 China slowdown and the accompanying commodities collapse and trade slowdown, then appreciated once again in the 2016-7 stimulus reboot and consequent global trade revival.

This brings us up to date. The 12% decline in the RMB against the US dollar since Trump started his trade war in April 2018 has riled the Trump camp as the devaluation has allowed China to essentially neutralise the impact of Trump's tariffs. Trump's 10-25% tariffs have only applied to around half of China's exports to the US to date, but the lower exchange rate has lowered the raw prices of all Chinese imports to America, so even after the tariffs are added to the price, the end prices to US consumers have changed little.

The media make much of the fact that the exchange rate has breached a magical 7:1 RMB:USD threshold but the chart shows that the recent RMB devaluation essentially does little more than reverse the appreciation in the 2016-7 stimulus rebound, and just takes it back to where it was ten years ago.

How will this impact Australia? Australian companies have benefited greatly from the urbanisation/industrialisation revolution in China over the past 20 years but this has passed its peak and growth rates are slowing. This is a structural shift to lower growth rates and not just a temporary cyclical change. If China depreciates the RMB further to help counter the slowing global demand for its exports it will probably have two main effects on Australia. First it would make the prices of Australia's exports more expensive to Chinese buyers – not just commodities but other major export revenue earners like tourism and education.

Second, further depreciation would also probably result in an acceleration of Trump's trade war, perhaps enough to trigger a downward spiral into a global trade contraction like the GFC. A difference next time will be that central banks and governments have very little gas in the tank to stimulate slowing growth – with interest rates still very low or negative, and governments already running huge deficits. Commodities prices would halve, the US dollar would keep rising and the Australian dollar would fall – as it has always done in global scares and slowdowns. While falls in the Aussie dollar would provide a natural buffer to local economic activity and employment, it does little to help share prices from falling as foreign investors dump shares and race for the exits – as they did in the GFC, and again in the global growth scare in late 2018.

What does this mean for our portfolios? We have been relatively positive about shares overall this year – and shares are up strongly so far. Within our global share allocations we remain biased to being un-hedged (which are benefiting from the declining Australian dollar last year and also this year).

Second, although we have been relatively bullish on global shares this year we have had no exposure to emerging markets shares this year (the largest of which is China). Emerging markets (including China) have lagged the rest of the global market this year as they are more affected by China's slowdown. We are unlikely to add back China and emerging markets until after the next sell-off when we go overweight global shares in the next cycle.

4 'Will we have a recession?' - Sure, but does it matter?

Probably the most common questions I receive from investors are about economic growth – 'Will Australia have a recession?', 'Is the world heading for recession?', 'Will China's economy slow', and so on. Recently, these questions have been getting more frequent and more bearish. This market 'noise' is actually a good thing for investors! Here's why.

The traditional 'top-down' approach to assessing returns on shares starts with the outlook for the global economy and works down to regions, industry sectors and then companies. The theory is that if global growth rates (ie growth in output, incomes and spending) are strong then this should trickle down into higher company revenues, profits and share prices. Conversely, when global growth is weak (or worse still, contracting in a recession) then company revenues, profits and share prices would also suffer. This the basic assumption adopted in every textbook on economics and investing. Every investment seminar and conference in the world always starts and/or ends with an economic outlook because of the widespread but mistaken belief that economic growth drives stock markets.

It sounds fine in theory but it does not work in the real world. It is pointless trying to estimate or forecast economic growth rates in the hope of discovering any insight into what share prices might do because this mythical relationship between economic growth and share prices has never existed in practice.

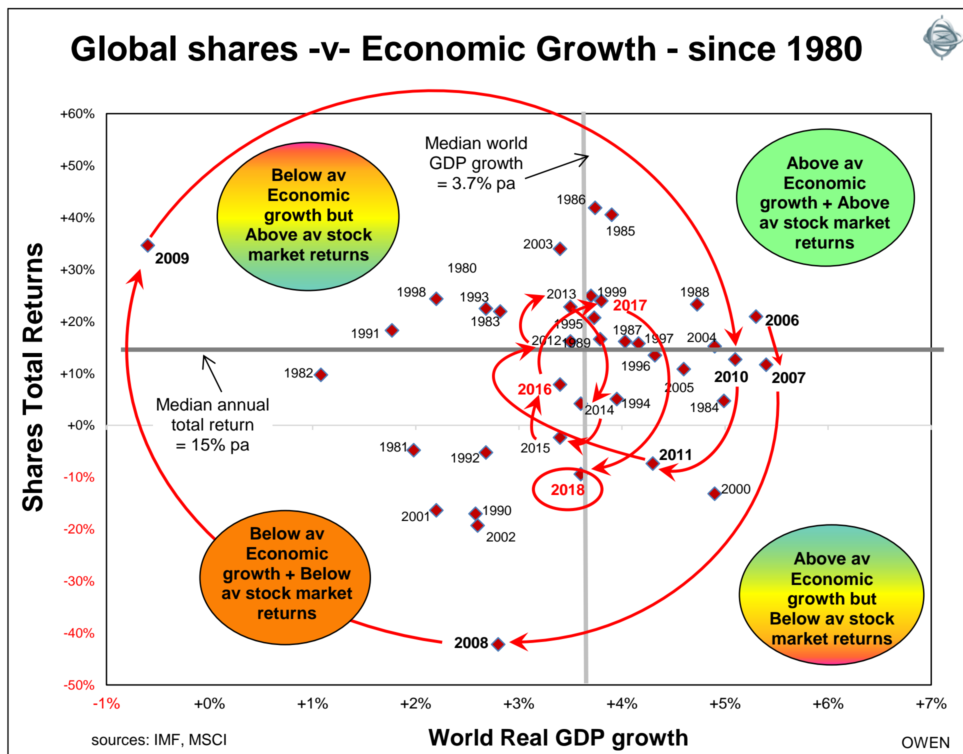
I have observed over many years that dire warnings about economic slowdowns from esteemed economic bodies like the IMF, World Bank, OECD - for example after the Brexit vote, then in the lead-up to the Trump election, and again at the end of 2018 - were usually followed by share price rallies. Likewise, bullish outlooks when economic growth is booming - were often followed by share price collapses.

A further problem with the economic 'top-down' approach is the fact that economic bodies rarely forecast recessions and they are notoriously late in recognizing them when they do occur. For example the NBER (National Bureau of Economic Research) – the peak US economic body that officially declares US recessions, didn't even recognise that the US was in the 2008-9 recession (supposedly the worst recession since the 1930s depression) until a full 12 months after it started – and then it was 15 months late in recognising when it ended!

In practice there is no statistical relationship between economic growth and stock market returns in the *same* period, either at a global level or in individual countries. We consider the global picture first, since economies and stock markets are highly interconnected and correlated.

Only rarely has *above* average world economic growth coincided with *above* average world stock market returns. In only 5 years in the past 38 years since 1980 has this been the case – in 1985, 1986, 1988, 2006 and 2017. Also, in only 7 years did *below* average economic growth coincide with below average stock market returns – 1981, 1990, 1992, 2001, 2002, 2015 and 2016.

In fact at least half of the time when economic growth was *above* average, stock market returns were *below* average, and at least half of the time when economic growth was *below* average (including in recessions), stock market returns were *above* average. This can be seen in the following chart of world real GDP growth and world stock market total returns in each year since 1980:

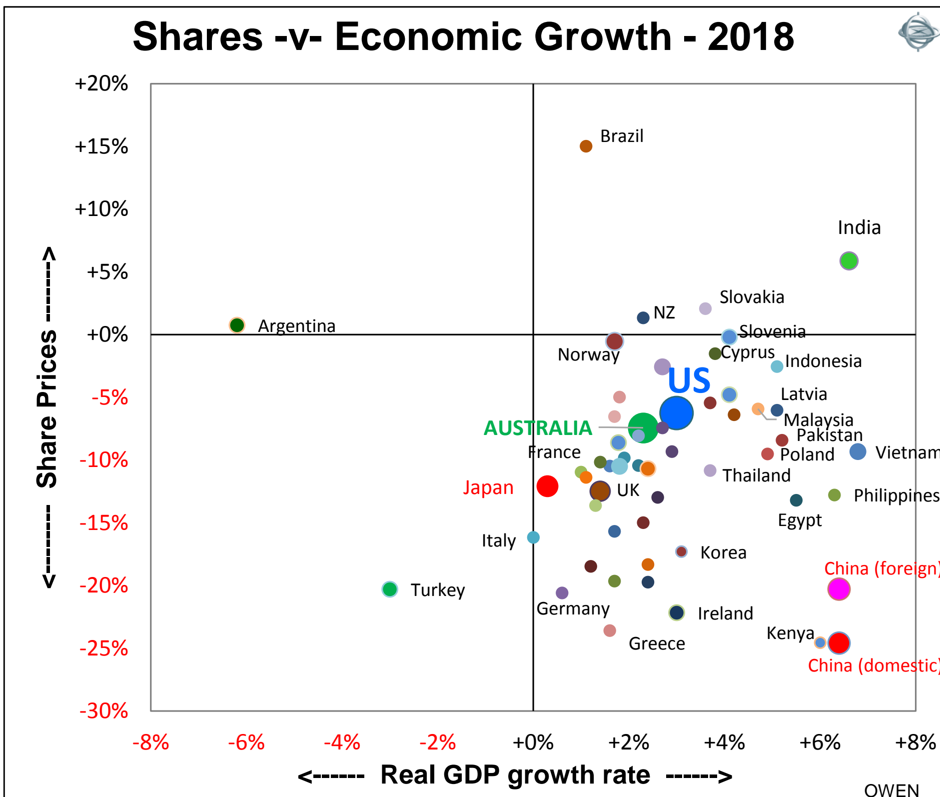


If the academic theories were true then most years should fall either in the top right section (good economic growth & share returns) or the lower left section (poor economic growth & share returns), but they don't. Some of the best years for shares were when economic growth was weak (2009, 1991, 1998, 1993, 1983), and some of the worst years for shares were when economic growth was strong (2000, 2011, 2018).

2018 (highlighted in the red circle) was a year where global growth was humming along a healthy 3.6% but share prices fell almost everywhere.

Individual Countries – how did yours fare?

There is a similar story when looking at returns from shares in individual countries in any particular year. The next chart shows economic growth rates in each country (horizontal scale) versus country stock markets (vertical scale) for 2018. Almost every country is huddled in the lower right section – growing economies but falling share prices:



If economic growth and stock market returns in the same year were positively related, the dots for each country would fall in a broad band extending from bottom left to top right, but this is not how it works in most years in the real world. Every year has a different pattern.

In 2018 some of the countries with the fastest growing economies posted some of the worst returns for shares – including China, Kenya, Philippines, Egypt, Vietnam, Poland, Pakistan. This is a very common pattern. China enjoyed the near-highest economic growth rate in the world but near-worst stock market returns. Conversely Argentina had one of the best stock market returns despite its deep recession.

Very few countries followed the theoretical text-book pattern: Only India and Slovakia posted positive returns and good economic growth, and only Turkey, Italy and Japan posted negative or flat-lined economic growth and negative share prices. 2018 saw economies (including Australia and the US) humming along nicely near their long term average growth rates, but shares tanked.

If there is no relationship between economic growth and share prices, then clearly something else is going on.

How the real world actually works

In the real world - share prices predict economic growth, not the other way around!

We have seen how there is no consistent relationship between share prices and economic growth in the *same* period (eg year or quarter). Nor is there any consistent relationship between economic growth in one year (or quarter or any other period) and share prices the *subsequent* year – so economic growth rates are not a predictor of share prices, and never have been – in any country or globally.

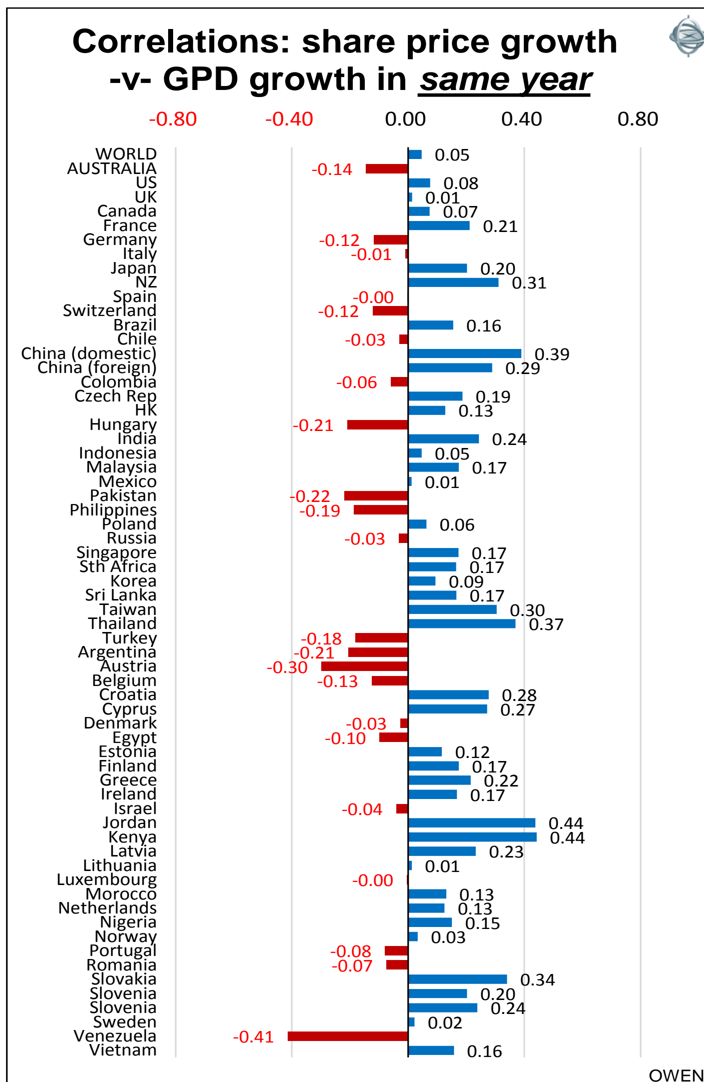
But it *does* work the other way around. Share prices have been a consistently reliable predictor of *subsequent* economic growth, as there have been consistent positive correlations between share prices in a given year and economic growth in the *subsequent* year.

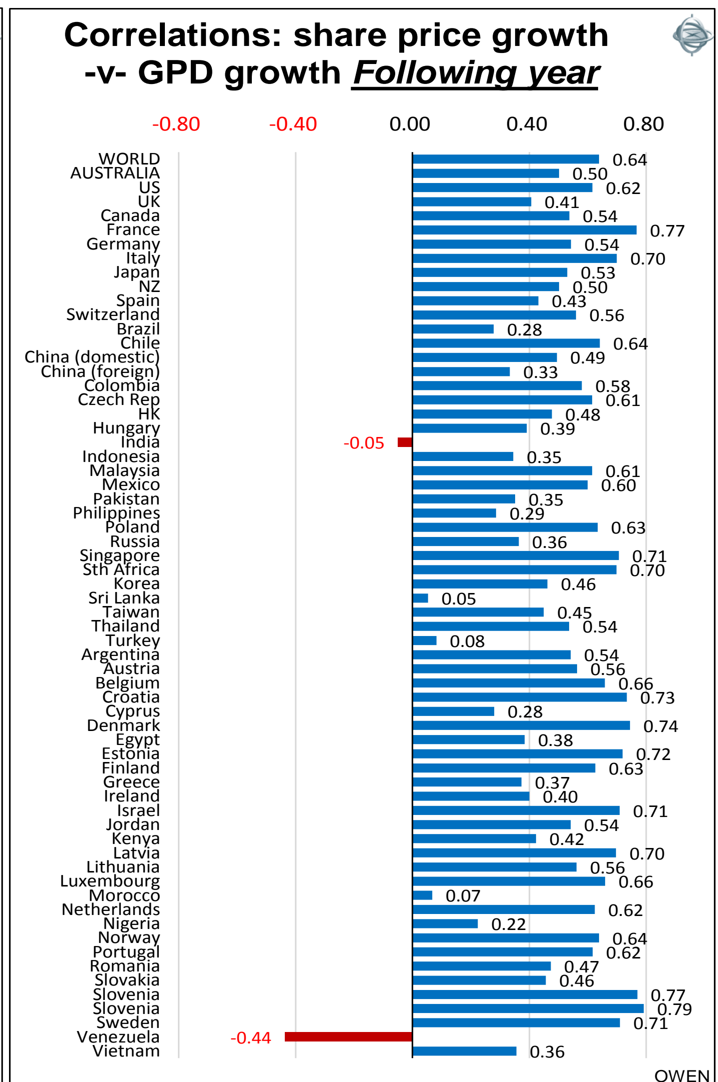
Same period correlations – left chart below:

The left chart below shows the relationship for each country between share prices and real GDP growth rates in the *same year* since 1980 in the 60+ countries I study. There are no meaningful correlations in most countries. Some relationships are positive (blue bars), some are negative (red bars). *Same period* correlations are only positive and statistically significant in a small handful of rapidly growing 'emerging markets' like Jordan, Kenya, Thailand, Slovakia and China (and New Zealand it turns out). But even in these markets the relationship is no use in predicting share prices unless one can successfully predict economic growth in advance. Economists have a very poor track record in this, and I am certainly not going to start now. I don't need to – I focus on investment returns, not economic growth.

Subsequent period correlations – right chart:

On the other hand the right chart shows the very high positive correlations in almost every country between share prices each year and economic growth in the *subsequent* year. This has worked consistently in nearly every market and also for the overall world aggregate for several decades. High share returns in any given year tend to be followed by high economic growth the *following* year, and poor share returns in any given year tend to be followed by poor economic growth the *following* year.





Positive correlations of +0.5, +0.6 and even +0.7 in the right chart are remarkably high and very consistent over time, and around the world.

What can we make of this?

First - this simple, easily observable but remarkably consistent relationship between share returns in one year and economic growth in the *next* year told us that 2019 is probably going to be a poor year for economic growth in Australia, the US and around the world.

Second – while this may be fascinating, it is only useful if you are trying to forecast economic growth (it's a better forecasting tool than a hundred Economics PhDs!), it is of absolutely no use in trying to use economic growth (present, past or future) to forecast share prices.

Third – we view economic outlooks as *contrary* indicators for share prices. For example:

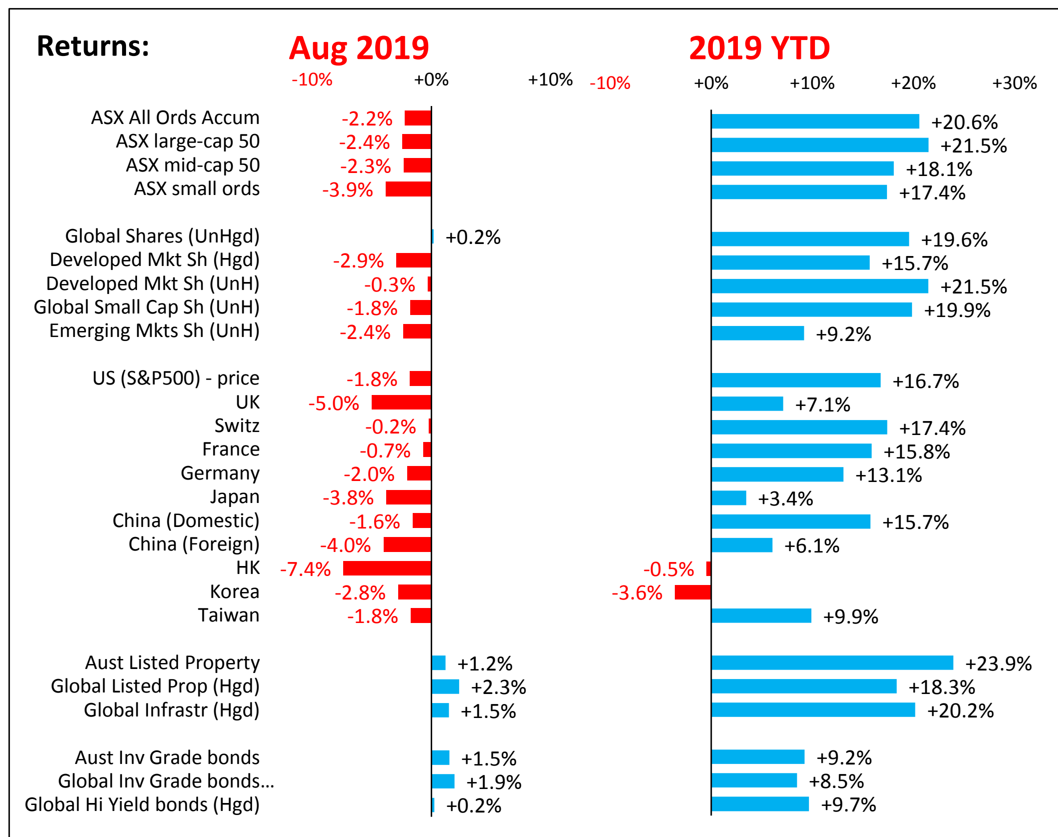
- Universally rosy economic predictions at the top of the boom in 2007 were immediately followed by the deepest economic recession since the 1930 depression and stock market crashes in every country. Likewise, good economic outlooks in 2010 and early 2011 (at the top of the commodities boom) were accompanied by very poor stock market returns in 2011. Upgrades to higher economic growth outlooks in 2014 were followed by poor returns in 2015. 2017 was the best year for the global economy in a decade but it was followed by share prices falls across the board in 2018.
- On the other hand - declining (and below average) economic growth rates and bearish economic outlooks in in 2009, 2012 and 2013 were all accompanied by very strong stock market returns in those years. The lowering of growth outlooks in the middle to late 2016 following the Brexit vote and in the lead-up to the Trump election were followed by strong rallies in global stock markets in 2017.
- Economic growth was strong in 2018 but share prices tanked. In early 2019 economists and esteemed economic bodies everywhere were frantically downgrading their growth outlooks for the world and every major country (including Australia). These dire downgrades to economic growth in early 2019 were a sign that 2019 was probably going to be good for shares.
- After being under-weight shares in late 2018 when economic growth was good but share prices fell, we returned to being over-weight shares in early 2019 while economic forecasts were being frantically downgraded. What have shares done in 2019? Surged of course! Australian shares and global shares have each returned +20% to the end of August!
- The lesson is to ignore the media noise and focus instead on how investment markets actually work in the real world.

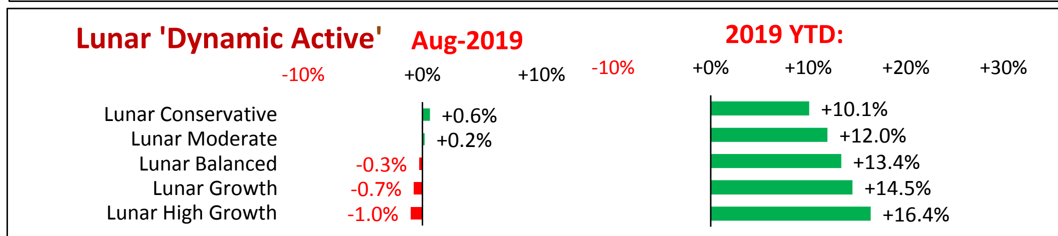
5 Portfolio returns for August

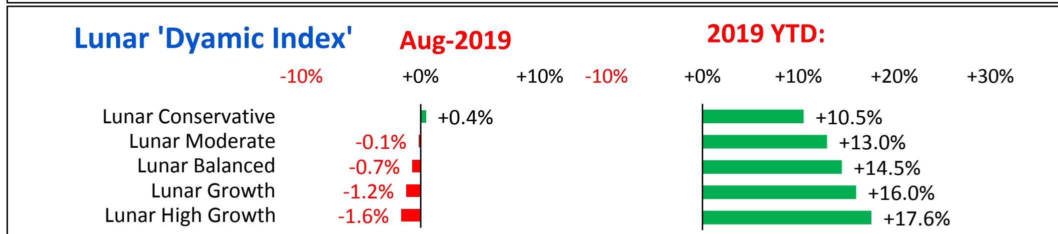
Our portfolios held up well in August as share markets fell back a little in Australia and around the world as Trump stepped up his trade and currency wars with China and also his attacks on Federal Reserve Chair Jay Powell. Only a month ago Trump was describing Xi Jinping as a 'friend' but that changed dramatically in August when he named both Xi and Powell as enemies of the US in his tweet: "…who is our bigger enemy, Jay Powell or Chairman Xi?". Powell's two rate cuts this this year have been the major factor behind the surge in share prices (along with rising profits), but Trump wants the Fed to cut rates to zero again to weaken the US dollar.

Australian shares fell a little further than global shares in August largely because the big iron ore miners were dragged down by the 20% slide in iron ore prices. The big banks were also a drag on the market in August – due to rising costs, declining profits and the prospect of even more margin pressure if the RBA cuts rates further.

The Reserve Bank of Australia turned decidedly bearish on the local economy when it talked up the possibility of more rate cuts and even experimenting with 'quantitative easing' – a tactic that proved ineffective over the past 10 years in generating and wage or price inflation in other markets that experimented with zero or negative interest rates and QE asset buying. What interest rate cuts and QE did do was boost asset prices everywhere – shares, real estate, and bonds. The prospect of more sugar hits have lifted asset prices again this year.







In August our portfolios remained virtually flat even though shares fell across the board. There are two main reasons for this. The first is that we hold infrastructure funds (AMP and Magellan), and also listed property trusts (MVA) – and these were up for the month because property and infrastructure tend to do well when bond yields are declining.

The second reason is that we are biased toward un-hedged global shares, which beat hedged shares as the Australian dollar fell a further 2.6% against the US dollar.

Our '*Dynamic Active*' portfolios beat their '*Dynamic Index*' equivalents in August because of the value added by active funds for the month – in particular Bennelong, Fidelity, Investors Mutual and MFS Global.

(The *Dynamic Index* portfolios consist of low cost exchange traded funds and no active funds, whereas the *Dynamic Active* funds contain a mix of ETFs and active funds)

Year to date all portfolios are well ahead of their long term goals and are heading for a bumper year. The main reason is that we have been over-weight Australian and global shares during this year's strong rebound from last year's sell-off when we avoided most of the pain by being under-weight shares.

What lies ahead?

As we (and many other commentators) foreshadowed a couple of months ago, the house price declines in Sydney and Melbourne have turned positive by a combination of the Morrison re-election, the RBA rate cuts, and the regulator APRA's easing of lending restrictions on the banks. Rising housing prices may sound good on the surface, but the cheaper mortgage rates and rising prices rises will just lead to an even bigger pile of household debt which will have to be dealt with eventually. Fortunately immigration remains strong and is likely to get a boost from the turmoil in Hong Kong. Anecdotally I am seeing a surge in interest from Hong Kongers and also Mainland Chinese in moving to Australia.

While the housing market is turning the corner, the high-rise market is another story for two main reasons. The first is that the continued flood of newly completed units hitting the market are lifting vacancy rates but lowering rents and valuations. This is leading to bankruptcies for highly leveraged multiple unit buyers and also highly leveraged developers and building firms. On top of this is the increasing reluctance of new buyers to take on unknown risks of flammable cladding and shonky construction that has plagued the high-rise construction industry in this latest cycle. This is a gathering storm that will probably cost tax-payers tens of billions of dollars in the coming years.

A second reason why the high rise market is important is the fact that new building construction has essentially stopped, and this will flow through to lower employment and incomes in the construction sector and then into the broader economy. The August reporting season for Australian companies reflected the relatively weak state of local spending by individuals and businesses.

We have been moderately bullish and over-weight Australian shares since early this year and this has boosted portfolio returns in this year's rebound. We retained this stance after the end of June review and shares have edged higher so far this quarter.

Globally, our moderate over-weight to global shares this year has also benefited portfolios. Despite the doom and gloom in the shrill media, shares in most markets continue to rise – driven by rising corporate profits and assisted by the renewed emphasis this year on further stimulus in the form of rate cuts and deficit spending in each of the main markets.

We have also benefited from having no specific emerging markets exposure this year. We were bullish on emerging markets in 2017 after the Trump election but we removed them when we went under-weight shares in 2018 before the global sell-off. Emerging markets suffered worse in the general sell-off (as they always do) but we did not re-add them to portfolios when we returned to over-weight global shares this year. Not only did emerging markets lag the rest of the world in last year's sell-off, they have also lagged in this year's rebound. Share prices in China and most of the rest of East Asia have suffered more from the Chinese slowdown and Trump's trade war antics.

The other main factor benefiting portfolios has been our bias toward un-hedged global shares – which benefit from weakness in the Aussie dollar. We were bullish on the AUD in 2017 as it rose, but turned bearish in early 2018 before it fell 10% for the year. We have remained bearish on the AUD this year and have been rewarded as it has continued to fall against all major currencies.

As mentioned in the last story, we have also benefited from our holdings of listed property and infrastructure. Both sectors have done even better than shares this year as bond yields have fallen across the board.

At our recent quarterly review after the end of June we retained these stances in portfolios as we see the current set of global and local conditions continuing for the time being. 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!

Ashley Owen, CFA
Chief Investment Officer
Stanford Brown

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