Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

The US recovery will surprise on the upside

Hamish Douglass

Many commentators suggest that US economic growth will remain subdued. However, a number of indicators are suggesting it will surprise on the upside. If it does, there will be significant implications for policy, investment markets and portfolio construction.

In our opinion, a wide range of indicators point to a likely acceleration of US economic growth in 2014:

- **Improvement in the US labour market is real** – Jobs are being created at a rate of 2.1 million p.a., the unemployment rate has fallen to 6.6% and average weekly earnings are rising. Although some economists believe that declining labour force participation indicates that unemployment is worse than headline figures suggest, it is important to note that participation has been naturally declining since 2000 as a result of the ageing of the US population, not just since the financial crisis.

- **Housing will help drive the economy** - Recoveries in key indicators such as home prices, housing starts and mortgage debt are encouraging. We believe that private residential fixed investment remains depressed at around 1.5% of GDP, below its long run level (excluding multiplier effects) and will inevitably revert to more normal levels. Furthermore, the share of residential mortgages in negative equity has fallen considerably over the past couple of years which may encourage more households to draw down on home equity for consumption.

- **Credit conditions are favourable** – Household debt has fallen considerably from its peak of 96% of GDP in 2009 to 77% today (the same as 2003), providing scope for rising consumption in the future. Furthermore, US banks are well positioned to deliver credit growth with common tangible equity to common tangible asset ratios having approximately doubled since 2008.

- **The competitive position of the US is improving** – US manufacturing hourly labour costs have fallen significantly relative to other countries (in USD terms) over the past 10 years. The shale boom has also provided the US with a massive energy cost advantage, while also helping to reduce the trade deficit.

- **Fiscal drag is decreasing** - The government expenditure component of GDP has been contracting in recent years following the large stimulus provided during the financial crisis. Economists estimate that expenditure cuts and payroll tax increases reduced GDP growth by 1.5-2.0% in 2013. However, a dramatic recovery in the federal budget deficit suggests there is declining pressure for further cuts, and the fiscal headwind is expected to be just 0.5% in 2014.

It is our view that, in the absence of a material negative shock, the US economy will experience accelerating economic growth over the next 12 to 24 months, and is likely to surprise on the upside.

What does a US upside surprise mean for markets?

A strengthening US economy will require the Federal Reserve to reduce the unprecedented monetary policy support it has provided since the global financial crisis in order to ward off excessive risk-taking in the financial system and to protect against future inflation. The Fed's exit from QE poses risks for equity and other asset markets (particularly currency and bond/credit markets) as long term interest rates start to move closer to pre-crisis levels, potentially causing a dramatic redistribution of global money flows. We continue to view the Federal Reserve's exit from QE as the major current investment risk.

A faster-than-expected US economic recovery, with strong demand for credit, could lead to high inflation as banks start to lend from their massive pool of excess reserves, currently USD2.4 trillion. While the Fed has a number of tools that could reduce the size of excess reserves or neutralise their impact, there is no reliable historical precedent that can guide investors (or the Fed itself) as to what will happen to markets as QE unwinds.

We continue to believe that there are two main scenarios that could play out:

1. An orderly unwinding of QE. This is our base case, predicated on a steady but not sharp US recovery, with a gradual increase in credit demand, and contained rises in short and longer terms US yields. Under this scenario we would expect the US 10 year Treasury yield to rise to around 4.5-5.5% over the next one-and-a-half to two-and-a-half years. We would expect elevated market volatility and potentially some dramatic re-pricing of certain asset classes. This scenario does not overly concern us from an investment perspective.

2. A disorderly unwinding of QE. Under this scenario, longer dated bond yields could start increasing rapidly as investors lose confidence in the Fed's ability to exit QE in an orderly manner (it is not unthinkable that US 10-Year Treasury yields could hit 8-10% over the next one-and-a-half to two-and-a-half years). This could lead to massive market dislocations, including large and rapid falls in asset prices, major moves in currency markets and the withdrawal of liquidity from certain emerging markets, as well as increase global systemic risk. A rapid rise in longer term US interest rates would also be highly likely to drive up longer term interest rates around the world, potentially re-igniting the European sovereign debt crisis.

We assess the risk of a disorderly unwinding of QE to be a 'fat tail', or low-probability, scenario. However, as we have repeated on many occasions, low probability does not mean zero probability.

Implications for portfolio construction

Although a rise in US economic growth presents a tailwind for businesses positively exposed to the US economy, it is important to recognise that economic growth is neither the only nor most important determinant of equity market returns. Indeed, we believe long term interest rates have historically been more important to aggregate stock market performance; higher interest rates will reduce valuations via the discount rate on companies' expected future cash flows, leading to lower equity price-earnings multiples in aggregate. Investors should be asking themselves 'what effect will higher interest rates have on markets?' We are paying very close attention to this critical question as it has implications for the positioning of our global equity portfolios.

Hamish Douglass is CEO and Portfolio Manager at Magellan Asset Management.

Stock market Olympics – and the winners are …

Ashley Owen

Which countries won the medals in the race to beat their pre-GFC stock market highs?

Global stock markets peaked in late 2007 at the top of the global credit boom, before plunging 50% or more in the 2008-2009 GFC. Since then some countries have done better than others. At one extreme, the Venezuelan market has kept on rising without missing a beat throughout the GFC and the 2011 sovereign debt crisis, despite suffering severe domestic political and economic crises. Other markets have just kept going down (with the occasional minor recovery), like Greece, Cyprus, Slovakia, Slovenia, Jordan, Morocco, and Italy. Most markets are still somewhere between their late 2007 highs and their early 2009 lows.

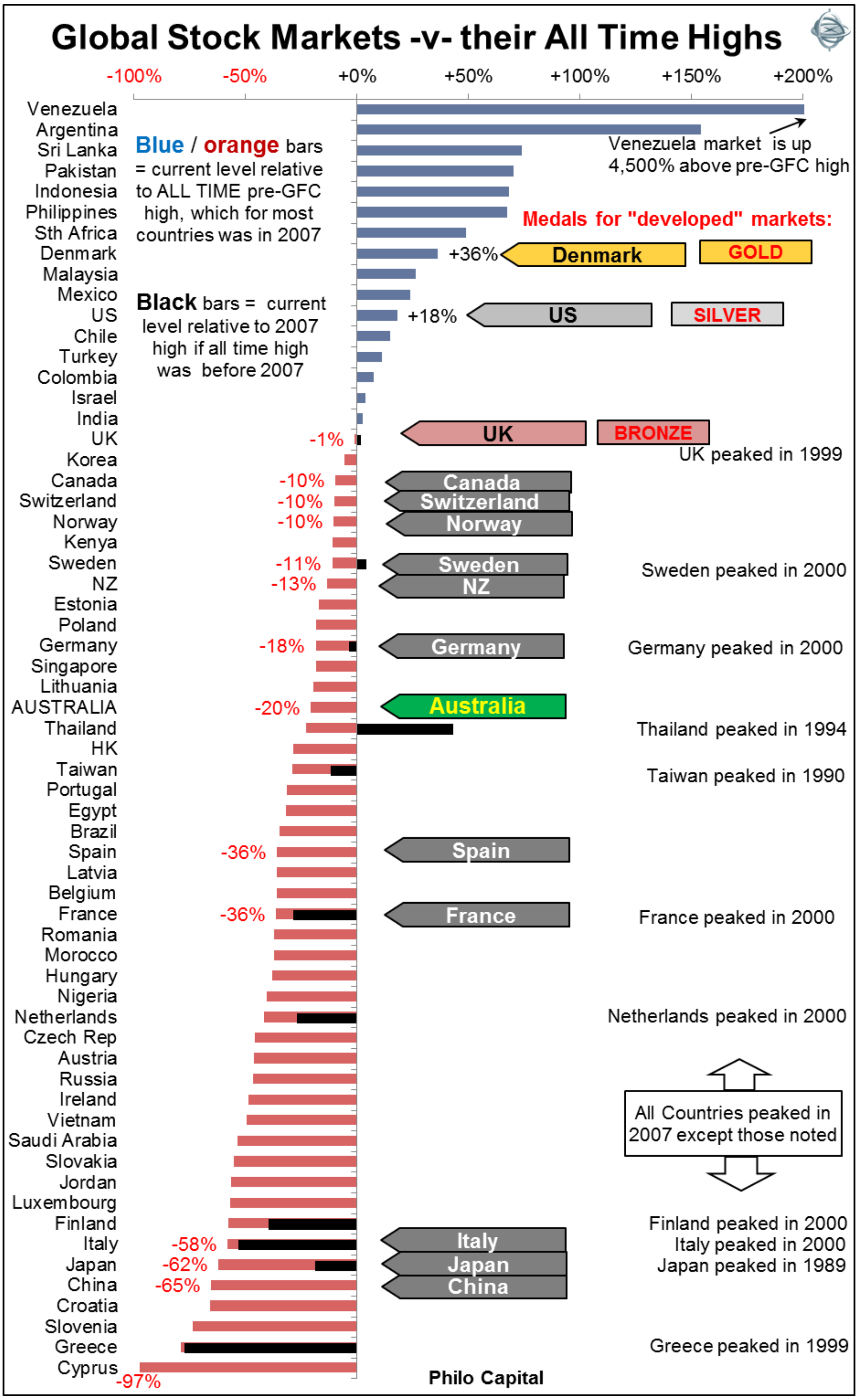
The medal table

The following chart (next page) shows the current index levels for 60 major stock markets (as at Monday 24 February 2014) relative to their pre-GFC all-time highs.

The blue/orange bars indicate the current level of each stock market index relative to its all-time pre-GFC high, which for most countries was in late 2007. The black bars indicate the current level relative to the 2007 high if the all-time high was before 2007. For example the Thai market (FTSE SET index) is currently 43% above its 2007 peak but still 23% below its 1994 all-time peak (before the 1997 Asian crisis hit).

Many European markets had their all-time peaks in the 1999-2000 dot-com bubble, and today are still below both their 2007 peaks and their dot-com peaks. On the other hand Japan peaked at the end of 1989 and it may never see those levels again.

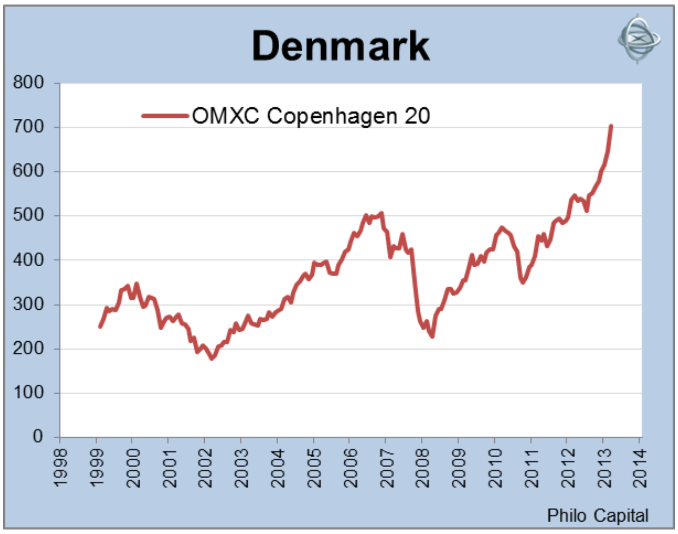
Australia is currently in 11th place among the developed markets (even NZ is beating us!). Since Australia is considered a 'developed' market with a mature economy, we are primarily interested in how we have gone against other developed markets.



(This study excludes the impact of dividends, inflation and exchange rates, and instead uses broad price index returns in local currencies in each country. In this way it reflects how local investors saw their local share price index move over time in nominal terms, which is the way most people think about stock markets in their own country).

Here are the medalists. We will cover each of the medal winners in more detail in later articles in this series.

Gold medal: Denmark



In January 2013 Denmark became the first of the 'developed' country stock markets to reclaim and beat its pre-GFC high. It had peaked on 11 October 2007 at the top of the global credit bubble right before the GFC hit.

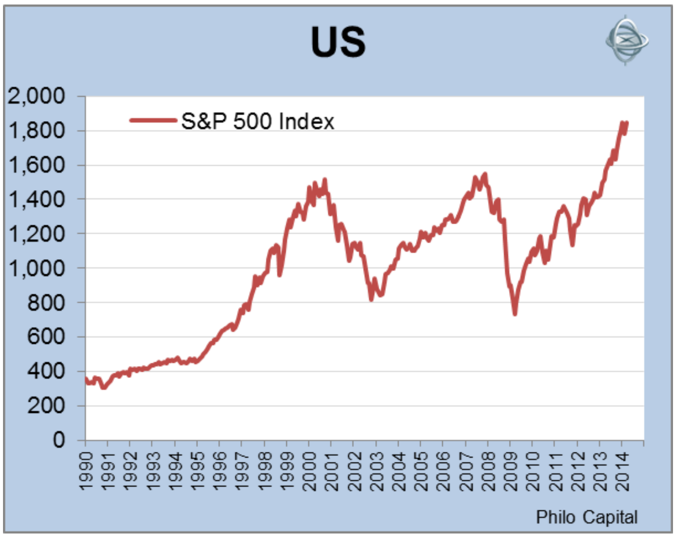
The Danish stock market had a similar experience to most other markets over the course of the past decade. After surging in the late 1990s dot-com boom it collapsed in the 2001-2002 tech wreck, rose strongly from early 2003 to October 2007, plunged 50+% in the GFC, rebounded strongly in 2009, but fell back in the 2011 sovereign debt crisis, and then surged during the 2012-2013 rally.

On paper, Denmark should not be a good place to do business, as it has:

- an old and rapidly aging population
- very high dependency ratio
- the world's highest minimum and average wage levels
- the highest pensions in the world (as a percentage of pre-retired incomes)
- the highest tax rates (top marginal tax rates above 60%, plus 25% VAT)
- high social security costs (social expenditure takes up a mammoth 30% of GDP)
- a huge government sector (the government employs more than one third of all workers)
- heavy unionisation
- mountains of stifling European regulations
- a fixed currency
- lack of natural resources
- a location stuck on the edge of a decaying Europe in structural decline.

However it still manages to be a world class high-tech manufacturer and exporter with the best performing stock market in the developed world.

Silver medal: USA

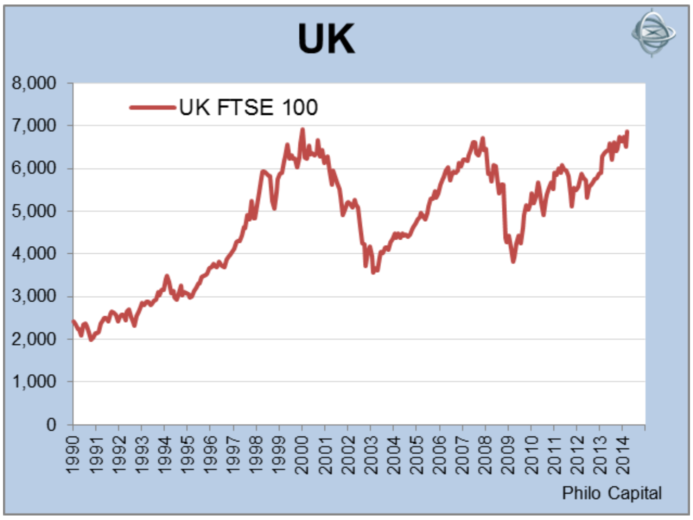


The US was the second developed world stock market to reach new highs after the GFC. The S&P 500 index peaked at 1,527 on 24 March 2000 at the height of the dot-com frenzy, and then just beat that level with a new high of 1,565 on 9 October 2007. It then promptly plunged in the GFC to a trough that was lower even than the bottom of the 2001-2002 'tech-wreck'. In March 2013 the S&P500 index finally recovered and exceeded its dot-com and 2007 highs.

Like Denmark, the US suffered a sharp and deep domestic contraction (the longest and deepest since the 1930s depression). The economy has only been saved from deflation and further contraction by the Federal Reserve's zero interest rate policy and its unprecedented asset buying programs.

Unemployment levels reached 10% in the sub-prime crisis and are still too high five years later. Economic growth is still relatively weak and bond yields have been rising since July 2012, but the stock market is soaring.

Bronze medal: UK

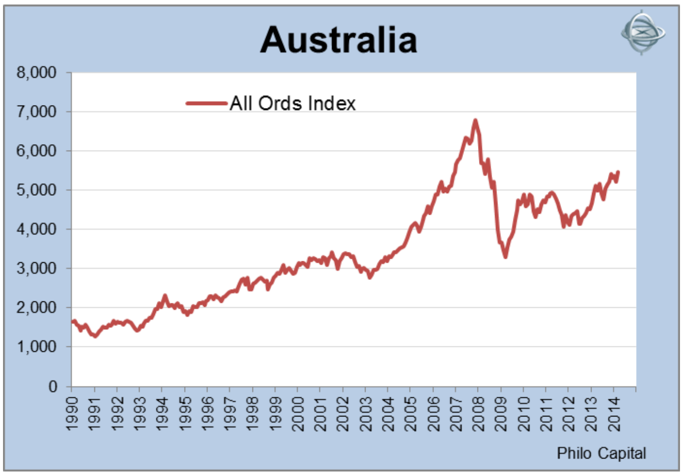


Like the US, the UK market also had an astronomical dot-com boom in 1999-2000. The all-time peak for the FTSE-100 index was 6,930, reached on the last day of December in 1999. This was not even beaten in the great 2003-2007 credit bubble, although it came within 3% of the 1999 high on 9 October 2007.

Finally, 14 years after its peak, the long wait for a new high is almost over. On 22 May 2013 the index got to 6840 which was just 1% away from its dot-com peak of 6,930, and it is now (late February 2014) once again closing in on the peak.

The UK economy has drifted in and out of recession since 2008 and has suffered massive bank losses and nationalisations, high unemployment, weak consumer spending and sluggish business investment throughout the period, but share prices have soared.

In subsequent articles in this series we will take a look at the gold, silver and bronze medal markets in more detail and compare them with Australia's performance (shown below).



Some conclusions

Most of the time economic growth has little to do with stock market performance. For example, Chinese economic growth has been the highest in the world over the past 20 years but it has had one of the worst performing stock markets for just about any period over the same 20 years (apart from a couple of bubble years which collapsed quickly). On the other hand Australia was the only developed economy not to suffer a recession in the GFC and it has had the highest level of economic growth during and since the GFC, but it has had one of the worst performing stock markets during and since the GFC.

A country like Demark can overcome seemingly insurmountable obstacles and unfavourable business conditions and still manage to be a world class high-tech manufacturer and exporter with the best performing stock market in the developed world.

Australia does have some world class companies that compete and win on the world stage (such as CSL, News, Orica, Amcor, Computershare, ALS, Ansell, Ainsworth). However, because they are so rare they tend to be over-priced much of the time. The local stock market is still dominated by big miners and big cosseted oligopolies that control virtually every domestic market segment, including banking, insurance, retailing, food, telcos, gambling, gas, electricity, transport, airlines, and just about every other domestic industry in which listed companies operate. They are protected from real competition by high barriers to entry and by the same tyranny of distance they complain about.

Australian investors have a long standing home bias in favour of local companies and this has often been justified by pointing to the fact that our economic growth rates have been higher than the rest of the developed world. That is all well and good but it doesn't translate into stock market returns. There are many fine global companies that are based in other countries that operate in a whole range of sectors and industries that are not even represented on the local Australian stock market.

In Part 2 of this series we will take a closer look at the gold medallist Denmark and compare it with Australia.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

My 8 rules for both wealth and health

Noel Whittaker

This morning I was doing a workout at the gym, something I have been doing for more than 20 years. Keeping your body in good shape and building your finances requires similar strategies, as exactly the same principles apply to each.

Today, in the interests of good health and wealth for us all, I'll share the principles with you.

Rule 1. You must have a concrete goal.

It is as pointless to say "I want to lose a few kilos" as it is to say "I want to have more money in the bank". It is essential to have a specific goal and a timeframe.

Rule 2. Focus on the benefits.

This is what will help you stay on track when the inevitable temptations arise. Shedding a few kilos will certainly improve your health and make you feel better; retiring with a substantial superannuation balance will open up a whole new world of freedom and choice.

Rule 3. It must be a permanent lifestyle change.

Dr Gary Egger of Gutbusters said the word DIET was short for Diabolical Ineffective Expensive Timewaster. Most people who go on a crash diet put all the lost weight back on when the diet inevitably becomes too hard. It's exactly the same with money. Scrimping and saving for a month is pointless. Becoming wealthy is usually the result of a process of managing your money well over the long haul and letting compound interest work its magic.

Rule 4. Understand the 70/30 rule.

Seventy per cent of a successful weight loss program will be attributable to your eating habits, and thirty per cent to exercise. Seventy per cent of building wealth consists of managing your money to spend less than you earn, while the rest of it consists of good asset selection and tax effective strategies.

Rule 5. Don't try to do too much too soon.

The reason most New Year's resolutions fail is that they are normally made in a moment of alcohol-induced euphoria and are not carried through in the harsh light of day. The trick is to start small and build on it. To lose weight you might decide to have two healthy-eating days a week. To get your finances in order you could start with a simple budget coupled with moving your home repayments from monthly to fortnightly.

Rule 6. Expect roadblocks.

There will be times, especially around Christmas, when your budget and your belly will take a battering. By all means, prepare for these occasions to the best of your ability but don't give up if you have a setback. Just treat it as a period of consolidation while you prepare to start moving forward again.

Rule 7. Keep track of your progress but don't do it too often.

Both your weight and your portfolio are going to be bouncing around for the rest of your life, and getting excited or depressed because of a good or bad day can put you on an emotional roller coaster which could lead to impulsive and flawed decisions. As long as you are making steady progress towards your goal you are on the right track.

Rule 8. Mix with people who share your goals.

It's much easier to refuse dessert when nobody else at the table wants it than it is to watch everybody else eating it. It's easier to live within your income if your circle of friends shares your financial aspirations.

The great thing about having a variety of goals is the way you can make them work together. Much of our discretionary spending these days is on food and alcohol, and cutting back on these will save you dollars as well as kilos. It may be difficult at first while you are slowly changing lifelong habits but eventually new habits will form. Then you can enjoy the results.

Noel Whittaker is Australia's foremost financial adviser, a well-known media commentator and international best-selling author, including 'Making Money Made Simple'. He is Adjunct Professor with the Faculty of Business at the Queensland University of Technology. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

One day, you'll be glad you feel old and tired

Roger Montgomery

During the last week, some very smart investors have been writing about Facebook's acquisition for AUD21 billion of an app that, up until the announcement, I hadn't heard of. One successful fund manager wrote, "Clever people are doing things I don't understand and I am just feeling old and tired."

The comment reminded me of those made by Warren Buffett in 1969 who, after the heady go-go days of the bull market, shut his private partnerships and handed all the funds (and Berkshire stock) back to investors, saying:

> *"The investing environment … has generally become more negative and frustrating as time has passed. Maybe I am merely suffering from a lack of mental flexibility … Quite frankly, I just don't see anything available that gives any reasonable hope of delivering*

such a good year and I have no desire to grope around, hoping to "get lucky" with other people's money. I am not attuned to this market environment, and I don't want to spoil a decent record by trying to play a game I don't understand just so I can go out a hero."

One observer commenting on security analysts over 40 stated, "They know too many things that are no longer true".

Something is up. Money is cheap and there's oodles of it that has to find a home. Arguably, there's even more looking for a shrinking universe of safe harbours as it flees the emerging markets.

Coincidently, local commentators are excited that Joe Hockey has, apparently singlehandedly, aligned the G20's leaders to 'go for growth', and then suggested it will translate into further gains for the stock market.

Ashley Owen's articles in Cuffelinks (linked here) support Warren Buffett's research that there is no relationship between economic growth rates and stock market performance. It is interest rates and corporate profits as a percentage of GDP that drive longer-term returns.

In this environment, it comes as no surprise that you have Facebook buying WhatsApp for more than the international debt of Sri Lanka, Tunisia, Cuba, Ecuador and a litany of other countries.

And you have Xero, the New Zealand cloud-based accounting software provider trading on a market capitalisation of $4.6 billion, even though it is yet to turn a dollar of profit from it 250,000 customers.

You might remember the tech boom of the late 1990s which peaked just as earnings multiples and book values had finally succumbed to new valuation metrics that relied on clicks and users, with little thought paid to how this traffic would be monetised.

Facebook has paid AUD46.70 for every one of the 450 million monthly WhatsApp users who send each other text messages, photos and videos via the internet, bypassing the costly mobile phone networks. You have to wonder how you are going to extract money from those who can't afford to pay or don't want to pay to send a text message on a mobile phone network.

Xero is trading on an eye-watering market-cap of $18,400 per user. According to Xero's website, the most popular package is $720 per year. The annual revenue run rate might be $180 million if everyone was subscribing to the most popular package. The company is trading at 26 times revenue and there's no profit as of yet.

You don't need to be old and tired to realise that unlike the gold rush of the 1800s, online real estate is not in short supply. It is abundant and probably infinite and even if you secure the competitive advantages associated with the network effect by being a first-comer, online customers can still prove to be disloyal and fickle. And switching costs are low, as my team demonstrated recently by changing back to MYOB from Xero without a hitch.

Despite this, Xero's market capitalisation is about the same as Flight Centre or Bendigo and Adelaide Bank, whose 2013 profits were $269 million and $359 million respectively. Xero's market cap is higher than TPG, Platinum Asset Management, Boral and Tatts Group.

There have been some spectacular failures over the years in the internet space and I am not suggesting that Xero or WhatsApp will join the list. However, you do need to think about investing to the slow and gentle chime of an old grandfather clock, not to the rapid and almost hyperactive beeps of a Formula 1 team's stopwatch.

It seems the pendulum is still swinging towards the cheap and easy money, and the delight of big deal-making will spur investment bankers to encourage others to do deals. These, in turn, will draw a crowd and prices will move ahead.

As I have said here previously, we haven't seen the bubble yet but the seeds are germinating nicely.

When the investment pendulum swings back however, just as surely as it does on the grandfather clock, heady takeover premiums will give way to big write-downs and investors who savoured the best of the party will carry the worst of the hangovers. Then the previously old and tired might gain a bit of a spring in their step.

Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'

How bank transfer pricing affects everyone

Graham Hand

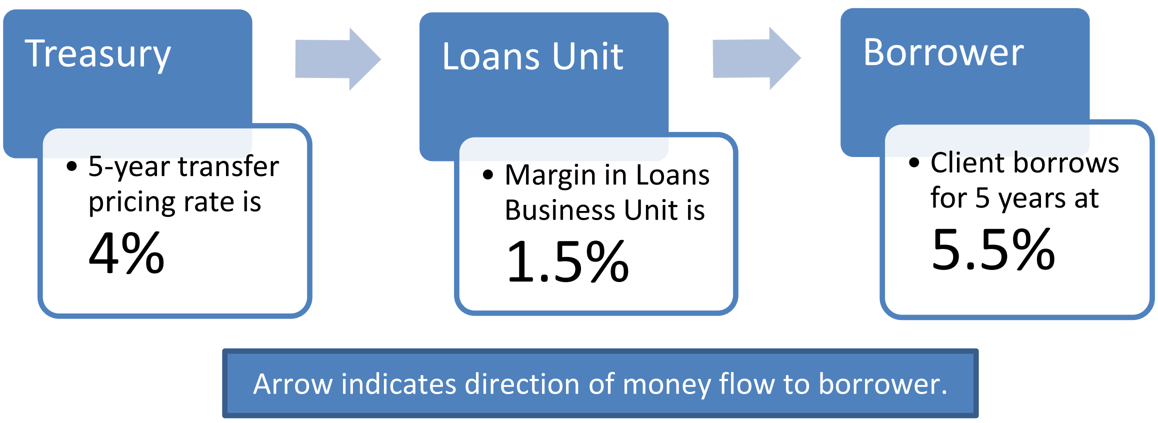
At least once a week, in every bank and non-bank across the country, pricing committees have their regular meetings. These discussions determine the rates and fees on every financial product in the market. Each meeting is presented with enough data to make Edward Snowden jealous. Market rates, competitor rates, product profitability, capital costs, liquidity costs, changes in regulations … it can go for hours. I have sat on the pricing committees of four banks and numerous non-banks, and while each has a different emphasis, they all have common elements. This article is a simple explanation of how they affect all borrowers and depositors.

Many bank executives spend their entire multi-decade careers specialising in product pricing, and over the years, it has become extremely complicated. Entire consultancy firms have built their fortunes on advising banks, and the complexity of capital allocation and liquidity management plays beautifully into their hands.

At the heart of the pricing process is a Funds Transfer Pricing System (FTPS). The FTPS is usually controlled in a central unit such as the bank's Treasury. Every asset writing or deposit raising unit in the bank must negotiate its own relationship with the FTPS and Treasury. The basic rules are:

- all lending units borrow from the FTPS (or Treasury)
- all fund raising units deposit with the FTPS (or Treasury)
- Treasury manages the resulting interest rate mismatch and liquidity requirements centrally.

The FTPS allows the bank to isolate the performance of every business unit by measuring the margin between the FTPS rate and the customer rate. For example, on a five-year fixed rate loan:



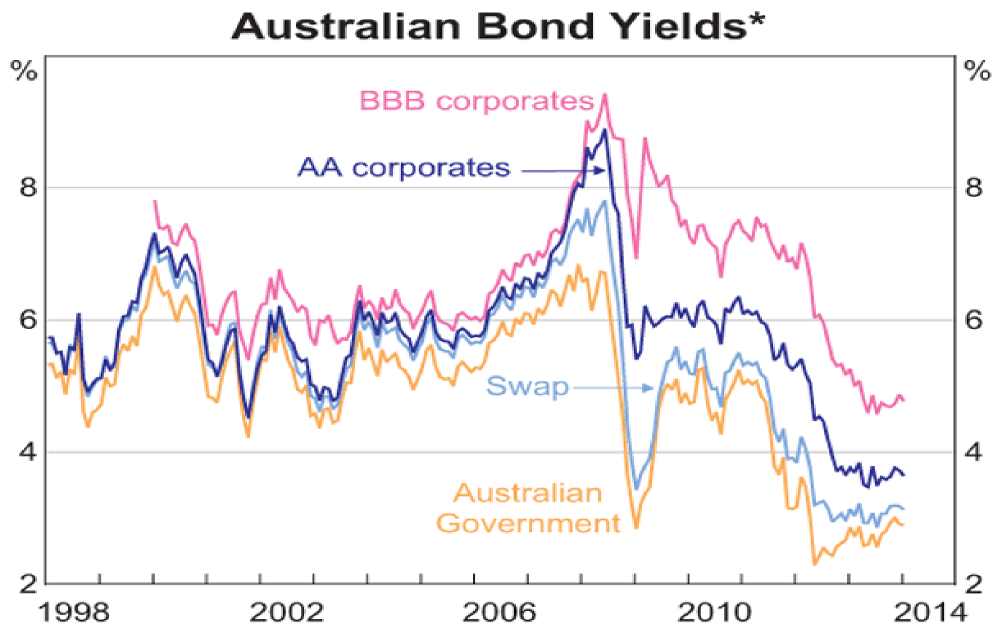
By locking in the 1.5% margin, the lending business unit does not have to worry about interest rate mismatch or how to fund the loan. The transaction is combined with millions of others in the bank and the mismatch and funding is managed as one centralised risk position.

That's the easy bit. Behind the scenes in the FTPS rate calculation, Treasury will ensure any capital or liquidity charges are passed to the relevant business unit. If a regulation changes, such as a requirement to hold more capital against a certain type of loan, the cost of business and the rate charged to the borrower rises.

Maturity transformation and pricing signals

One of the roles of banks is 'maturity transformation'. Most borrowers want money for long terms (housing, plant and equipment, buildings) while depositors want access to money at short notice. Banks facilitate this by borrowing short and lending long, but it introduces risk into their balance sheet which events such as the GFC expose.

Regulators impose rules which control the extent of maturity mismatch or supporting capital required, and those rules have costs. Treasury will tweak the FTPS rates to recover the costs. For example, the new Basel III liquidity rules mean deposits that may mature within 31 days must have high quality liquidity (essentially, government debt) held against it. Such liquidity usually carries an opportunity cost and as the table below shows, it is the lowest-yielding investment in the market.



* Australian Government yields and swap rates are for 3-year maturity. Corporate bond yields are a weighted average of senior bonds with remaining maturities of 1 to 5 years; they include financial and non-financial corporates.
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Asset writers are generally charged for the capital they use. Each bank will estimate a different cost of capital, based on a variety of factors such as its view on how much capital it needs to hold to retain its credit rating, and the Prudential Standards for Capital Adequacy. The Australian Prudential Regulation Authority (APRA) grants approval for the more sophisticated banks, such as the Big Four, to use an internal ratings-based approach, using estimates of defaults and loss-given-default.

Every asset on- and off-balance sheet is given a risk weighting, and the lower the risk weight, the less the capital charge. It's one reason why banks love residential mortgages: the risk weighting is low, and even in the simple models, a standard eligible mortgage with a Loan To Valuation ratio less than 60% is risk weighted at only 35% of its actual balance. Corporate loans can be rated 150%.

In response to changing regulations, banks adjust their pricing signals to encourage or discourage certain activities. For example, a product developed in response to pricing signals is the growth of Notice

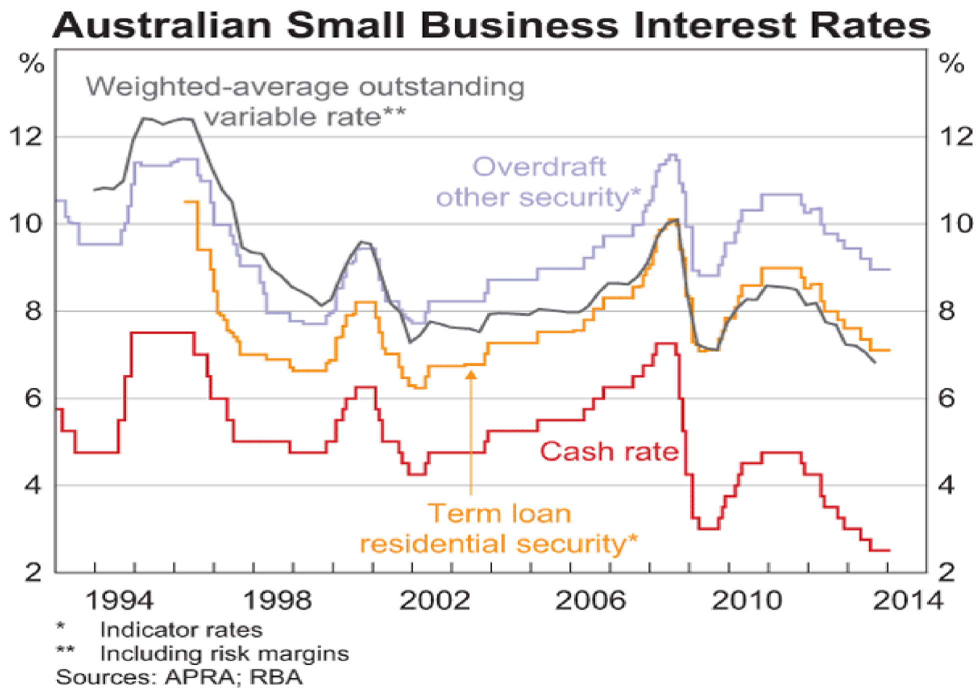
Accounts on deposits, where a higher rate is paid if the depositor agrees to a 32-day notice period. This avoids the Liquidity Coverage Ratio (LCR) charges imposed on short term deposits.

Obtaining the best rates from the bank

Although most customers are price takers, a knowledge of how FTPS works may give some negotiating edge in certain circumstances:

1. The less capital used on a loan, the lower the lending margin.

Housing loan rates are the lowest, and whatever the purpose, an offer of housing security can reduce costs. For example, borrowing on a margin loan to buy shares, even with the security of BHP and CBA shares and an LVR of 50%, will cost about 7%. A line of credit against the home is less than 6%, while mortgage rates are around 5%. Similarly, a small business that offers a residential property as security will achieve a lower rate, as shown below by the difference between the orange and blue/grey lines.



2. The classification of a deposit as 'retail', and therefore long-term and 'sticky', should achieve a higher deposit rate.

This issue has been discussed in Cuffelinks at length. A practical application is that a direct deposit with a bank into a retail deposit account will usually achieve a higher rate than a deposit with a super fund, as the fund itself is not considered 'retail'.

3. The longer the maturity of a deposit, the more a bank is willing to pay above the swap rate.

Banks prefer the funding security of long term liabilities, and will generally pay higher margins above swap for longer maturities. In addition to the LCR mentioned above, APRA will be introducing a Net Stable Funding Ratio (NSFR) calculation that will gradually influence FTPS rates. It is the equivalent of the 31 day LCR at the one year maturity. Banks will want to avoid maturities of deposits of less than one year and this will feed into better long term deposit rates.

4. Watch for early repayment interest costs.

Anyone borrowing for a fixed rate over a long term must understand how the bank may charge for early repayments. It's far riskier than repaying a variable rate loan, and can easily be lost in the fine print. In my past life, I have briefed QCs and appeared as an expert witness in court disputes over the costs of prepayments of fixed rate loans. It can be a very messy business if market rates have fallen significantly since the loan was written.

As far as a bank's Treasury is concerned on a fixed rate loan, the business unit has entered a long term contract to borrow money to lend to the client. If the loan is repaid early, Treasury will charge the business unit an interest adjustment if rates have fallen, and this will be passed on to the client.

How much? An easy way to estimate the possible cost is to multiply the estimated rate change by the number of years remaining on the loan. After one year on a five-year loan, if interest rates have fallen by 1%, the interest charge will be a little less than 4%. On a loan of $500,000, that's $20,000. Many people think the simple act of repaying a loan early will result in some fees, but that's not the main problem. I have seen early termination fees on large loans following the rapid rate falls in the 1990s run into millions of dollars.

The other tip is to make sure the documentation works both ways. That is, on a loan, if interest rates rise, then the payment should come to the borrower. It must be symmetric to be fair.

And the reverse of all this should apply for deposits.

Think about what is happening in the bank's FTPS when you borrow or lend, and you may be able to improve your deal by taking advantage of each bank's approach to pricing.