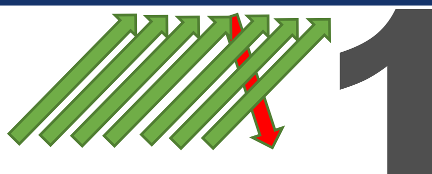
STANFORD BROWN
Financial Advisers

Stanford Brown Monthly Top 5

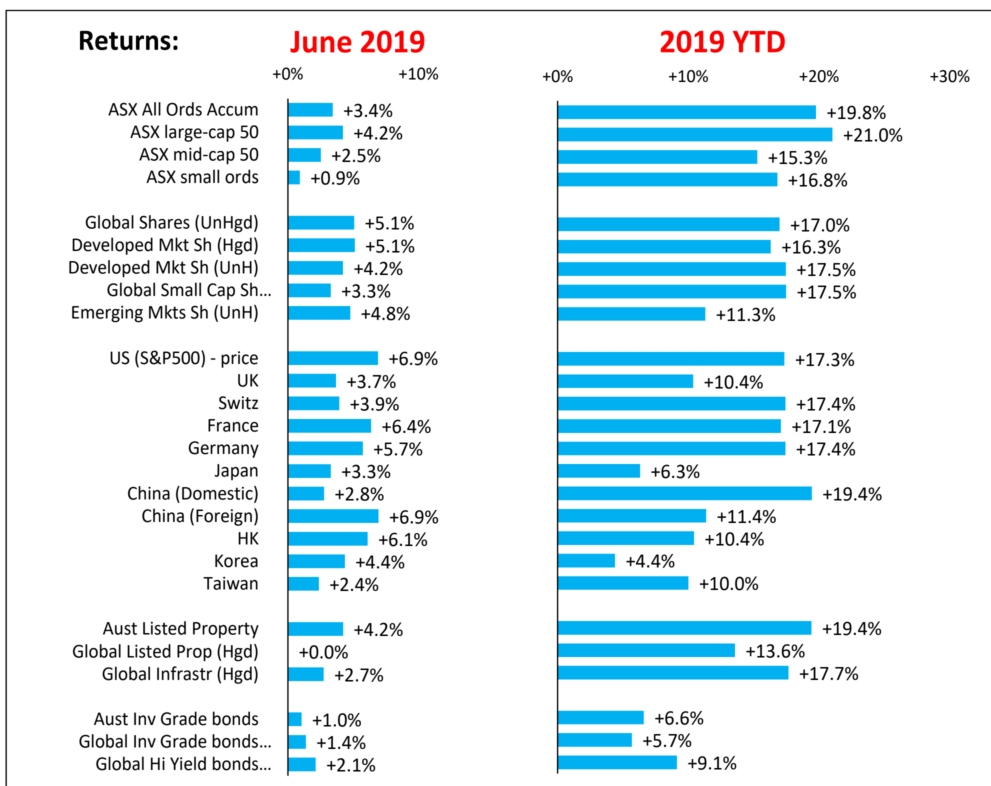
July 2019

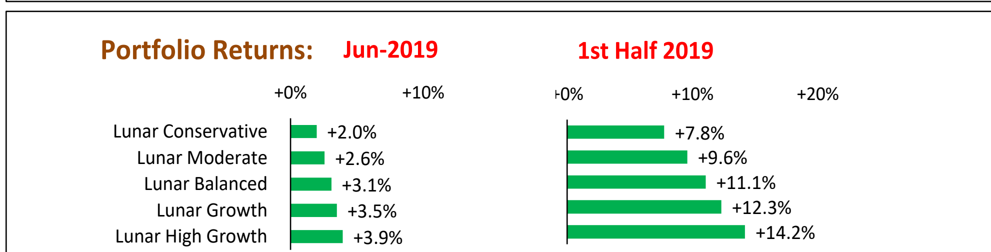


Everything up – except cash

June capped off a rare half year when all of the main types of investment posted higher returns in the first six months than their long term annual averages for a full year. Everything has gone up except cash and residential property (we look at each of these later in this bulletin). The Reserve Bank has cut cash rates twice this year – on 4th June and again on 2nd July, bringing the local cash rate to an all-time low of 1%.

The great returns so far this year are a welcome rebound from the sharp global growth scare in late 2018 (refer to next story). As we shifted to being over-weight Australian and global shares in portfolios this year, the rebound is benefiting our portfolio returns. Returns for our five diversified portfolios for June and for the year to date are shown in the bottom section of the chart. (Individual investor returns may vary depending on the level of tailoring and customisation to suit their particular needs, and the timing of cash flows in and out of their portfolios.)





Australian shares have beaten most other countries this year. The returns here were driven largely by three broad themes:

1) Collapsing local and global bond yields,

2) Hopes of a housing turnaround following the re-election of the Morrison government, APRA lending restrictions being eased, and more rate cuts from the RBA; and

3) One-off commodities price rises despite most commodities prices remaining weak.

First, the collapse in bond yields has helped utilities companies (mainly APA +36% this year, and Ausnet +26%), infrastructure (Transurban +30%, Atlas Arteria +27%), listed property trusts (mainly Mirvac +46%, Goodman +45%, Dexus +29%, Stockland +25%, but the retail trusts were very weak), and also Telstra (+36%).

Hopes of a rebound in housing has helped the banks, especially after the election. Shares in the big 5 are up 13-15% each.

Miners have done very well this year despite the general global slide in most commodities prices with the global slowdown. Iron ore miners have benefited from rising iron ore prices caused by mine closures in Brazil (Fortescue +119%, BHP + 25%, RIO + 32%), and rising gold prices lifted the gold miners (led by Newcrest +47%). The mini-recovery in oil prices this year thanks largely to the escalating Trump/Iran conflict has also benefitted oil/gas stocks (Santos +29%, Woodside +16%).

Most global share markets have also been strong this year. The US tech giants have led the rebound: Apple +25%, Amazon +26%, Facebook +47%, Microsoft +32%, Netflix +37%, and even Uber has climbed back above its IPO price after a poor start. Only Alphabet (Google) has been flat this year (+4%). Every other global sector, and every major country (apart from Japan +6%), has also returned more than 10% this year – ie more than their usual annual averages in just the first half.

Bond prices and returns here and around the world have also benefited from the continued broad decline in bond yields across the board.

But there is a major disconnect here. The global collapse in bond yields is a direct reflection of increasingly grave fears of slower growth and even possible recessions in Australia, US, Europe, Japan and many other countries, but share prices everywhere have been surging in anticipation of more sugar hits in the form of lower interest rates and more stimulus to try to arrest these slowdowns. These two are incompatible of course and cannot last for years. We will no doubt have another 'global reflation' scare or two (like February and October 2018), and share prices are sure to correct once again as they are starting to run ahead of weakening profit growth rates.

2 A game of two halves

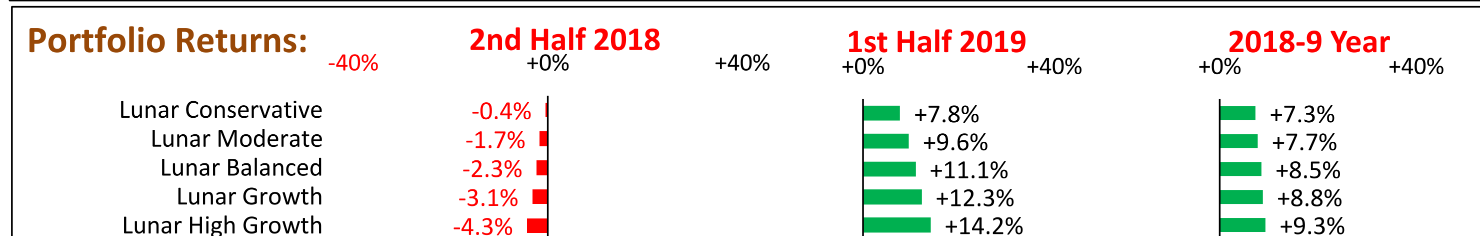
If an investor had been living on the moon or under a rock or just somehow managed to ignore the endless flood of shrill media headlines and tweets over the past year, they would have returned at the end of June, looked at their portfolio balances for the first time in a year, and said something like, ‘What a great year – everything must have been good in the world. I’ll have another one of those thanks!’

All they would see is the returns for the full twelve months – shown in the right-hand set of bars in the chart. These twelve month returns for the main asset classes were at least as good as their long term average annual returns. The broad Australian share market returned 11%, as did un-hedged international shares. Bonds also returned better than their long term averages: 9% for Australian bonds, and 7% for global bonds. Returns from the Australian listed property market were nearly double their long term average.

Returns for our five diversified portfolios over the full twelve months are shown at the bottom of the right-hand set of bars. They range from 7.3% for ‘Conservative’ to 9.3% for ‘High Growth”. (Individual investor returns may vary depending on the level of tailoring and customisation to suit their needs, and the timing of cash flows in and out of their portfolios.)

These returns were better than average expected outcomes for these portfolios, especially with inflation so low at just 1.3% for the year.

Asset class Returns:	2nd half 2018	1st half 2019	12m to June 2019
ASX All Ords Accum	-7.3%	+19.8%	+11.0%
ASX large-cap 50	-5.7%	+21.0%	+14.1%
ASX mid-cap 50	-10.0%	+15.3%	+3.7%
ASX small ords	-12.7%	+16.8%	+1.9%
Global Shares (UnHgd)	-4.7%	+17.0%	+11.4%
Developed Mkt Sh (Hgd)	-9.0%	+16.3%	+5.8%
Developed Mkt Sh (UnH)	-5.1%	+17.5%	+11.5%
Global Small Cap Sh (UnH)	-12.0%	+17.5%	+3.4%
Emerging Mkts Sh (UnH)	-4.2%	+11.3%	+6.7%
US (S&P500) - price	-7.8%	+17.3%	+8.2%
UK	-11.9%	+10.4%	-2.8%
Switz	-2.1%	+17.4%	+15.0%
France	-11.1%	+17.1%	+4.0%
Germany	-14.2%	+17.4%	+0.8%
Japan	-10.3%	+6.3%	-4.6%
China (Domestic)	-12.4%	+19.4%	+4.6%
China (Foreign)	-18.4%	+11.4%	-9.1%
HK	-21.8%	+10.4%	-13.6%
Korea	-12.3%	+4.4%	-8.4%
Taiwan	-9.3%	+10.0%	-0.2%
Aust Listed Property	-0.1%	+19.4%	+19.3%
Global Listed Prop (Hgd)	-5.7%	+13.6%	+7.1%
Global Infrastr (Hgd)	-2.7%	+17.7%	+14.4%
Aust Inv Grade bonds	+2.8%	+6.6%	+9.6%
Global Inv Grade bonds (Hgd)	+1.3%	+5.7%	+7.1%
Global Hi Yield bonds (Hgd)	-1.5%	+9.1%	+7.5%
Gold (AUD)	+6.5%	+11.4%	+18.7%
USD cash (in AUD)	+4.5%	+1.8%	+6.4%
AUD Cash (bank bills)	+1.0%	+0.9%	+1.9%



Although the overall returns for the twelve months turned out to be good, it was very much a ‘game of two halves’ – a sea of red ink in the first half and strong rebounds in the second half.

In the first half (July to December 2018) share prices fell sharply in a global slowdown scare – driven by fears of Trump's trade wars slowing global growth rates, China's reluctance to stimulate its slowing economy, two more rate hikes from the US Fed, and fears the Fed would continue to raise rates despite early signs of a slowing US economy. Australian shares followed the global rout, although by not as much as the sharp -20% fall in the US market from late September to late December. It was the worst December for US shares since 1931. In the midst of this global panic I fielded numerous calls and emails from worried investors asking if this was 'the next GFC' or even worse.

Our client portfolios hardly felt a bump through all of this turmoil. We had turned very defensive from April 2018 - we reduced allocations to Australian and global shares to prepare for a fall, reduced our currency hedging on global shares to benefit from the falling AUD, increased bonds, and added gold and US dollar cash. These changes helped cushion investors from most of the pain of the sell-off in shares. The portfolio returns at the bottom of the left-hand set of bars show that our portfolios hardly suffered at all in the global sea of red ink.

Then in 2019 after the sell-off we increased our allocations to shares and shifted portfolio settings back toward a moderately bullish stance. The first half of 2019 turned out to be a complete turnaround for markets. The Fed stopped raising US interest rates and even starting talking about possible rate cuts, the Bank of Japan and European Central Bank also talked up the prospect of providing more support, and China ramped up its stimulus efforts with spending increases, tax cuts and subsidies.

In Australia the RBA also shifted its stance toward lower rates (which arrived in June and July). Bank shares benefited from being let off very lightly by the Hayne Royal Commission and the re-election of the Morrison government. Resources shares were boosted by mine closures in Brazil (sending iron ore prices soaring), and the Trump/Iran tensions did the same for oil prices.

We will review portfolio settings at our regular quarterly investment committee meeting in July to assess whether changes are required to protect investors from risk and capitalise on opportunities as they arise.

A note on low cash rates and how we use cash in portfolios:

Yesterday (2nd July) the Reserve Bank made its well-flagged and widely anticipated 14th cut to the target cash rate, bringing it to 1%. This is the lowest we have seen in Australia since cash rates became a primary monetary policy tool in 1959. The RBA's main aims with the latest cut are: 1) to reduce the Aussie dollar to assist exporters (especially now that the US Fed has paused its rate hikes); 2) to reduce interest rates on mortgages so that mortgage holders have more spare cash to spend, and potential buyers can borrow more money and hopefully arrest the decline in house prices; and 3) to reduce interest rates on deposits so that investors shift their savings into to more risky investments that are more likely to flow into growth in jobs and wages.

Short term bank deposits and cash accounts are considered by many as the most conservative of all investments. The problem is that cash gives people a false sense of security. While the capital value is safe (often guaranteed by the government), there is no protection from the ravaging effects of inflation (refer to the story on inflation later in this bulletin) and for people relying on the income from cash deposits, cuts to interest rates can be devastating. In recessions and economic slowdowns the interest income is generally cut by much more than dividends from a diversified group of companies or rents from a diversified group of commercial properties.

Conservative investors who have been relying on the income from cash deposits (mainly retirees) have seen their income fall by 80% over the past eight years as cash rates have declined from 4.75% in 2011 to just 1% today. And we haven't even had a recession yet.

So how do we use cash in investment portfolios? Our long term portfolios are designed for long term investors, about two thirds of whom are retirees who rely on regular cash flows that need to grow ahead of inflation, and capital that will last at least as long as they and their families need it to last. Even though we are conservative investors with mostly conservative clients, our portfolios contain very little cash at all. They only hold the bare minimum level of cash that is required for liquidity purposes – ie to make regular cash withdrawals. Our cash levels in all portfolios is just 3% - even in the most conservative portfolio - and that is generally where it sits in most types of conditions.

Most of the time we have the bulk of our 'defensive' allocations invested in government bonds and high grade corporate bonds. These pay significantly higher income than cash but the downside with bonds is that their capital values can be volatile (although much less volatile than shares). We also invest in high grade floating rate notes which pay higher interest rates than cash but have extremely low volatility and minimal risk of loss. These are very liquid and much more cost-effective than cash deposits in almost all market conditions.

Even when we were very bearish on shares last year before the big sell-off, we reduced our allocations to shares (we were 20% under-weight 'growth assets') but we didn't put it in cash. Instead we put it into government bonds, US dollar cash, and gold.

These three ultra-defensive assets generated positive returns well above cash while shares were being hammered in the late 2018 global growth scare. Government bond prices rose strongly as bond yields fell; the Australian dollar value of the US dollar cash rose strongly as the AUD dollar fell (as it always does in a general global sell-off); and gold also provided strong returns in Aussie dollar terms.

We are always on the look-out for risks, and we have wide lee-way to increase cash significantly when required. There will be times in future when we favour cash as the ultimate 'safe haven', mostly likely when cash rates and inflation are both high and the Australian dollar is low. The last time cash was the best asset class in Australia was in 1929.

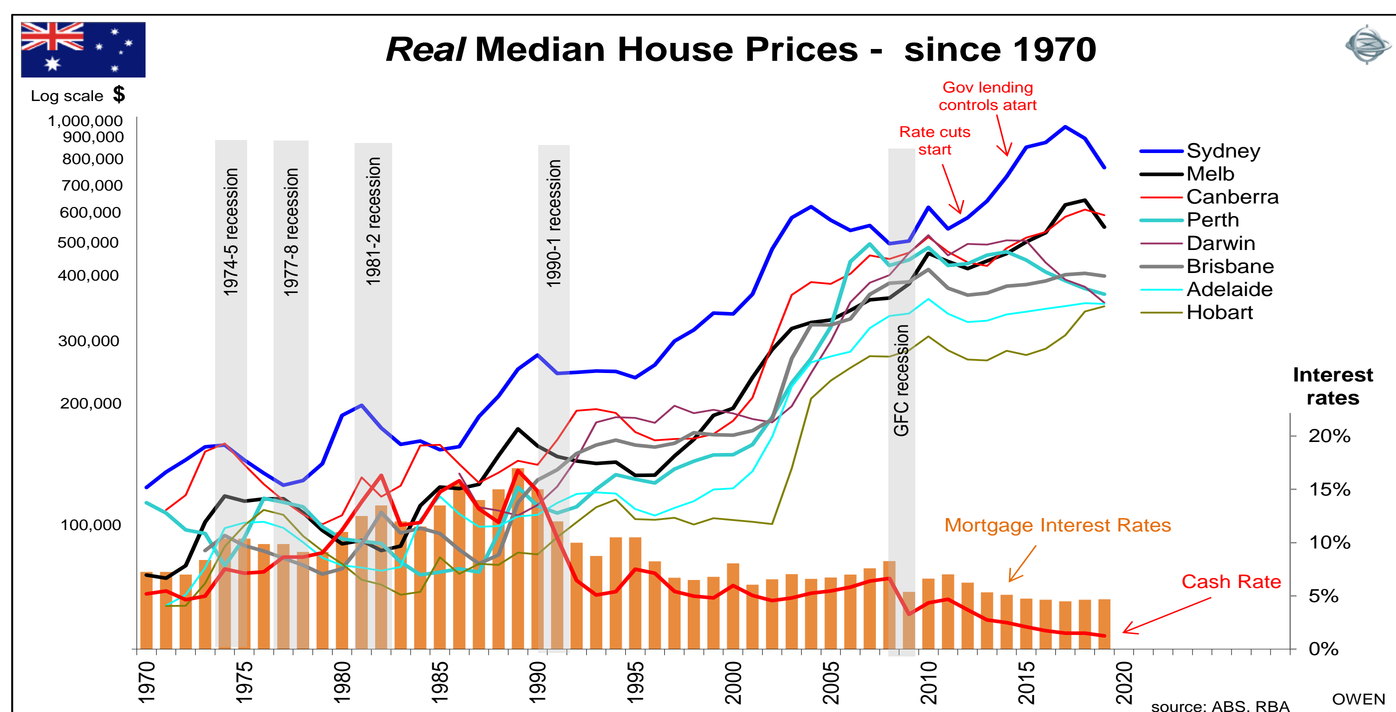
3 House price reprieve

Australian house prices may be about to turn the corner. It is a different story for high rise units, as many face an extended period of falling rents, rising vacancy rates and falling prices (some even falling over, or at least requiring costly repairs or re-building). More on this below.

The housing market received a major reprieve with the surprise re-election of the Morrison Liberal/National government in May. This ended the prospect of a Labor government that promised several tax measures that were aimed at cutting house prices even further ('making housing more affordable' as they put it). A second shot in the arm for housing was the RBA's 4th June rate cut (and again on 2nd July), most of which was generously passed on by most of the banks in the form of lower rates on variable mortgages.

Third, the continued collapse in bond yields this year has significantly lowered rates on fixed rate loans. These are a trap – they encourage even more debt because the repayments are lower as they cover interest but no principal. This then increases the rude shock at the end of the fixed term (usually 2 or 3 years) when they have to be re-financed into principal & interest loans with higher repayments.

The chart shows median house prices in the main cities since 1970, adjusted for inflation to remove inflation distortions especially in the 1970s and 1980s. The next time I publish this chart it will probably have a nice little uplift in the tails to the right.



We don't invest in housing in our investment portfolios (housing is more of a lifestyle expense bought for emotional reasons, than an investment asset), but almost all of our investors have a vested interest in housing for one of three main reasons.

First – the vast majority of clients own their own home and most have either paid off their mortgage years ago or have minimal mortgages remaining. Although they have large amounts of 'equity' in their homes and are not at risk of foreclosure, many are 'asset-rich' but 'cash-poor' and are looking to release some of the equity to boost their cash-flows in retirement using a variety of techniques like equity sharing to reverse mortgages. Current values and interest rates matter when considering how and when to use these structures.

Second – an increasingly alarming proportion of home owners with plenty of equity are under pressure from their 'adult' children to 'help them get into the market'. (I use the term 'adult' loosely. They are not adult if they are still enjoying free or subsidised rent or loans). This of course was one of the reasons behind the price rises in the 2012-7 boom. More money to put toward the purchase just drives prices higher. My advice to parents has always been the same: "Keep the money. You're going to need it yourselves - one of you will probably to live to 100."

Third - a large proportion of clients own one or more investment properties. Unfortunately a significant proportion of these were high rise units purchased at boom-time prices a few years ago, and many of them were bought with high levels of debt. For these, the recent falls in value put them into 'negative equity'. This sounds bad but it only matters if you need to sell. Repayment stress is on the rise as rents are falling, interest rates on deposits are falling, and many are being hit with higher repayments as honeymoon rates are refinanced.

The good news is that more rate cuts are probably on the way because the RBA knows the banks probably aren't going to be in a position to pass on the rate cuts fully. This makes rate cuts less effective, so it will do more. Second, the US Fed rate hike pause has also paused the recent slide in the Aussie dollar. The RBA wants a lower dollar to help exporters and there is only way it can do that – cut rates further.

4 Inflation – lower for longer? Don't bank on it

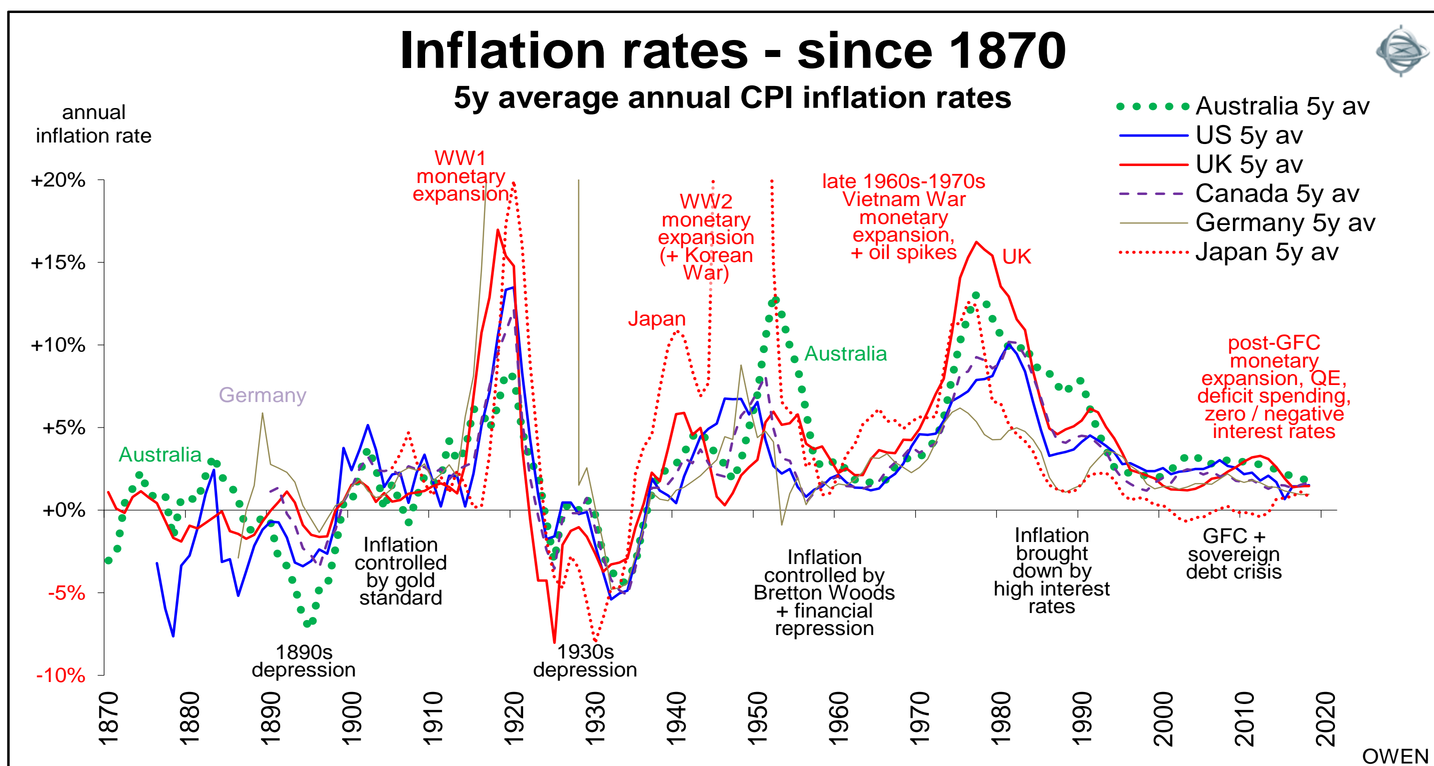
Recently I was debating whether the current era of low inflation in Australia and around the world meant that we should reduce our long term outlooks for inflation in our portfolio management processes. It is an important issue for managing investments as our inflation assumptions underpin our long term return outlooks for all types of assets including cash, bonds, shares, property, and currencies.

We need to set long term expectations as we are managing investors' money with very long term financial goals in mind – building wealth during several decades of working and earning, and then generating regular cash flows for what could be several decades in retirement. Under-estimating future inflation runs the risk of spending too quickly and running out of money too soon. Money eroded by inflation is a permanent loss of capital and you can only replenish it by taking more risk – but that raises the risk of losing even more. Over-estimating future inflation risks preserving too much for the future and having too little cash flow to live off now. Inflation assumptions are crucial.

It is also the subject of hot debate inside the Reserve Bank this year – whether it should reduce its long-standing 2-3% inflation target range because the world simply doesn't believe the RBA can achieve it anymore. Reducing the target may restore confidence in the central bank.

How things change! During the late 1970s to the 2000s central bankers around the world focused their entire attention on trying to bring down inflation, but now that battle has been won they lie awake at night dreaming up new ways of increasing inflation again. Governments and central banks have tried everything over the past decade - zero and even negative interest rates, direct purchasing of assets with newly printed money ('quantitative easing'), special low or zero interest rate loans to banks to encourage lending, and massive government deficits – all to no avail. Europe and Japan are still drifting in and out recession and zero inflation, and in Australia and the US it is still down near 1%.

This chart shows inflation rates in Australia, the US, UK, Japan, Germany and Canada (our commodity cousin) over the past 150 years:



A first observation is that inflation is a global phenomenon – rising and falling around the world in big global swings from high to low and back again – aside from occasional bouts of hyper-inflation (for example Germany in the early 1920s and Japan during and after WW2).

Australia has followed these global inflationary cycles because it has always been financed by foreign capital and it has followed the global monetary theories and mechanisms *du jour*. Within these big global swings, there have been local differences – for example our 1890s depression was more severe because half of our banks closed and froze customer deposits for years, crippling the economy further. Our post-WW2 inflation spike was also worse because of the impact of the Korean War on export prices and revenues (especially wool).

So how do we set our long term inflation expectations when we are subject to these massive global swings every couple of decades?

In the middle of the 1890s depression it would have been tempting to say: "Gee inflation is very low with no end in sight, so let's lower our long term inflation expectations - it is low now so it will stay low forever". That would have seemed logical at the time – the gold standard was restricting lending growth, bond yields were at ultra-low levels, agricultural and mineral commodities prices had halved around the world and

were still falling, unemployment rates were high and companies weren't hiring, borrowing or investing. Logical to assume inflation would stay low - but very wrong. Just a couple of decades later Australia and the world was battling to control 15+% inflation after WW1.

Similarly in the high inflation post-WW1 years it would have been just as tempting to say: "Gee inflation is very high with no end in sight, so let's raise our long term inflation expectations – it is high now so it will stay high forever". It would have been logical at the time – bond yields were soaring, Europe and Britain (and therefore Australia) were off the gold standard, Germany was hyper-inflating, prices of everything in Australia and elsewhere were rising rapidly as war-time controls were lifted and soldiers returned home and started a baby boom, and we were caught up in a global boom in housing construction, suburban expansion, motor cars, telephones and radios (the 1920s 'tech boom').

Logical to assume inflation would stay high - but very wrong. Just a decade later Australia and the rest of the world was in the grip of deflation in the 1930s depression – again seemingly with no end in sight. Logical to assume that the 1930s low inflation (and even deflation) would stay forever – but again very wrong. Within a decade we were battling high inflation again, including 15% inflation here in Australia.

Then low inflation in the mid-1950s to early 1960s under the Bretton Woods system, then high inflation in the late 1960s & 1970s. And so on.

The big danger is to be lured into thinking "Gee inflation *[or insert any other variable here]* is low *[or high]* now, so it will stay that way forever!" The problem is that conditions change, fundamental underlying assumptions about how economies work change, political imperatives change, societies and their expectations change, and monetary mechanisms change.

Inflation has been low since the 2008-9 global financial crisis but not nearly as low as it has been in numerous depressions in the past. It simply does not make any sense to assume that the current conditions, theories and mechanisms *du jour* will remain static. They never do.

Despite the short term outlook for low inflation for a while, here are a few of the factors that may lead to higher inflation in the future:

- Military build-ups – for many thousands of years this has been the number one cause of price inflation. Spending increases in military build-ups and wars were the main cause behind each of the three inflation spikes in the above chart. In the century before that it was the US Civil War and the Napoleonic wars, and so on back throughout human history. We are probably entering another sustained period of competitive military build-ups between the US (and allies like Japan), and China, as well as peripheral players like Russia and India.
- Rising protectionism and mercantile bilateralism is replacing globalisation – Globalisation of manufacturing driven by lower tariffs, post-war cross-border reconstruction programs, multi-lateral agreements and mechanisms was one of the main drivers of declining price inflation since the 1980s and especially since the early 2000s after China entered the World Trade Organisation.
- Xenophobia limiting the globalisation of workers – The increasingly free movement of people between countries since the 1980s – both short term and migration - lowered wages and prices. The backlash now is rising xenophobia in the US, UK, Europe and Australia.
- Nationalism and populism will probably continue drive military competition, protectionism and xenophobia long after Trump has gone. Trump didn't create it, he simply tapped into it. Behind it is increasing disaffection with the dominant economic order since the 1980s which benefit the rich and elites more than the workers, who have seen declining real wages, declining job security, and higher debts.
- Demographics – Australia (and NZ) for the past two centuries, and still now, has had the highest population growth rate and immigration rate in the world (outside of Africa). This boosts spending growth and demand for capital and in turn inflation and interest rates. However offsetting this is weakening global demographics – with the world population aging and likely to stop growing in a few decades' time.
- China's urbanisation and industrialisation boom is past its peak now that more than half of the population has moved to the newly built cities. The great shift will continue but not at the same pace as the past 20 years, and so growth rates in demand for commodities and the supply of cheap factory output will not be as high.
- Oligopoly structure of industries – Most companies in Australia pass on inflation to consumers rather than compete fiercely to reduce costs. This has always been an inflationary feature of the Australian economy. In contrast the US used to be the bastion of competition since the 'trust-busting' era, but that is fading fast with the rise of the global US giants that dictate prices and buy up competitors.
- New theories – What passes for monetary orthodoxy (monetary theory *du jour*) does not last long before it is abandoned and replaced with a new theory. Keynes' big deficit spending idea was dismissed as laughable in the 1920s 'sound money' years but was embraced enthusiastically as orthodoxy in the 1930s. Then Monetarism was laughed off during the Keynesian era but became orthodoxy in the 1980s and 1990s to kill off the 1970s inflation. There is growing support from the left for a 'new monetary theory' in which governments can run big deficits and big debts forever and simply print more money endlessly to pay off the rising interest bills. At the other extreme there is also growing support from the right for a return to the gold (or other commodities) standard. Both are laughable to the current establishment, but one thing is certain – what passes for monetary orthodoxy today will be radically different in the next decade or so.

So, back to the original question – because inflation has been low for a few years is it time to reduce our multi-decade inflation outlooks on the assumption that it will stay that way for several decades?

No. We do not assume that the current conditions, mechanisms, and theories *du jour* will remain static for long. The current system is no longer working. Big changes are under-way.

5 Inflation and share returns

Inflation is important because it has huge impacts on every type of investment asset. Because Australian shares comprise a significant part of our long term portfolios we need to understand how returns are affected by different inflationary environments.

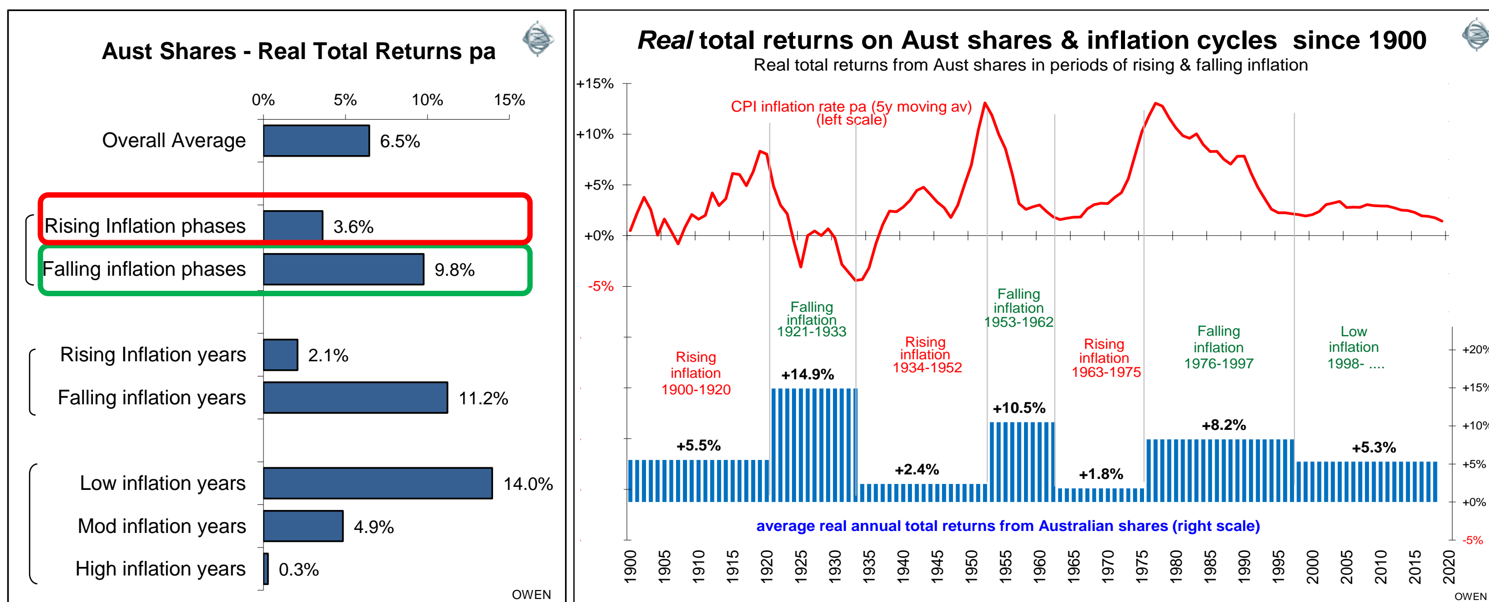
Since 1900 the broad Australian share market has generated total returns (ie including dividends) that have averaged 10.5% per year, or *real* (inflation-adjusted) returns of 6.5% per year over and above consumer price inflation that averaged 3.8% per year.

As investors we are primarily interested in *real* returns because our wealth needs to keep well ahead of the impact of inflation eroding the purchasing power of our money. If our 'nominal' (or headline, before inflation) returns are say 12% in a particular year it sounds good on the surface, but if inflation was running at 15% during that period we have gone backwards in terms of what we can actually buy with the money.

Real total returns averaging 6.5% per year from shares over such a long period is outstanding and almost un-matched anywhere in the world. However this is an average over the whole period. The problem is that returns have been very different in different types of inflationary conditions. We cannot simply assume that these high returns will continue without understanding what inflationary conditions we face.

When inflation has been low, real returns from shares have been highest - an incredible 14% (yes that's after inflation) per year on average. But when inflation has been high, real returns have been very poor – in fact zero on average. I define 'low inflation' as below 2% (the bottom 1/3 of all years), 'high inflation' is above 5.5% (the top 1/3 of years), and 'moderate inflation' is between these two (the middle 1/3 of years).

Average real returns in different 'low', 'moderate' and 'high' inflation years are shown in the lower section of the left chart.



The left chart also shows that returns in 'rising inflation years' has averaged a very poor 2.1% per year, but returns in 'falling inflation years' have averaged a very healthy 11.2% per year. Shares do well when inflation is low or falling, but very poorly when inflation is high or rising.

Because inflation and shares are volatile when viewed one year at a time, it makes sense to measure different phases or eras of rising or falling inflation. The right chart divides the whole period into 'rising inflation phases' and 'falling inflation phases'. The red line shows Australian consumer price inflation over the period since 1900 with the peaks and troughs we saw in the previous story. Inflation in Australia peaked in 1919-20 in 1951 and in 1974&5. The low points in the cycles were in 1931 (-10% ie deflation), 1962, 1997 (a fraction below zero in both cases), and we have been living in a mostly low inflation phase since then.

The blue bars at the bottom of the right chart show the average real total returns from shares for each of these rising inflation and falling inflation phases. The pattern is clear: - well above average real returns during each of the phases when inflation was falling, but very poor average returns each of the phases when inflation was rising.

The best conditions for shares are when inflation is low or falling. The last great phase of falling inflation we enjoyed ran from the late 1970s to late 1990s when shares posted real returns averaging 8.2% above inflation. This was a tremendous outcome as the period included big shares corrections in early 1980s recession, the 1987 crash and the early 1990's recession.

The next phase will not be another period of high real returns because inflation will not fall by 10% or more as it did in the previous 'falling inflation' phases. The most we might expect in the coming years may see inflation fall a little further (eg in a global recession triggered by trade wars). However once inflation starts to rise again – as it inevitably will in time – shares will generate very poor real returns once again.

What lies ahead?

We live in a world where the biggest single determinant of investment market prices and returns is Trump's policy-making on the run via his tweets. This is likely to continue for as long as he is president, and there is a good chance that will be another six years. The main issue is not with his agendas or policies but his approach, which is highly volatile and unpredictable. Even when he strikes a 'deal' on a particular issue he usually undoes it again, often within hours. This environment is not conducive to long term decisions that companies need to make – where to build factories, where to invest, which companies to acquire, which mines to develop, and so on. These types of decisions do not require absolute certainty about the future of course, but they require at least some clear boundaries or basic assumptions about what the future might look like beyond the next few months.

The problem is that in the current environment companies everywhere are simply putting off making major decisions. It is a little like the 'Brexit' hand-brake effect on UK corporate decision-making but on a global scale. The effect of this global trend is not sudden. It is more likely to be a slow grinding down of investment activity, flowing through to company profitability, jobs growth and spending.

This is probably the biggest threat to global markets in the medium term, rather than whether tariffs are raised or lowered, or whether tax rates or interest rates are raised or lowered, or whether the US bombs Iran or not, etc. These types of events can have quite severe impacts in the short term but markets tend to recover quite quickly once they are absorbed.

Here in Australia the markets will follow the US as they always have done, regardless of local conditions and events. Locally, the big question is still whether the housing / construction slowdown will remain a localised problem for the many thousands of overcommitted borrowers and the hundreds of developers who face foreclosure and bankruptcy, or whether the flow-on effects expand into a broader slowdown in confidence and spending across the rest of the economy in general and the banks in particular. The RBA appears intent on cutting rates even further, especially since the federal government is unlikely to help out with deficit spending even though it is being blessed with windfall revenue gains from the recent commodities rebound. The States on the other hand are spending and borrowing big-time. The largest component of jobs growth and overall economic growth over the past couple of years has been the government sector. The private sector is looking rather weak and the overall national picture would be looking much weaker if it weren't for government support.

This edition highlighted the benefit of ignoring the seemingly important daily headlines and opinions of the endless stream of 'experts' in the chattering financial media. It is not easy for investors to simply switch off and review their portfolios only every half year or so, hence our focus on cushioning portfolios from the worst of the pain of the short term volatility. We need to make tactical changes to portfolios to smooth the path because we know from past experience through numerous cycles that many people get spooked by price falls and media noise and abandon or switch strategies at precisely the wrong time. I still come across people who panicked and sold out at the bottom of the GFC and ten years later are still sitting in cash, which pays a lousy 1% and doesn't even cover inflation.

We also mentioned some of the more important longer term themes – including inflationary cycles, changing fiscal and monetary theories and mechanisms, nationalism and protectionism eroding globalism, changing demographics, geo-political re-balances, and shifts in the distribution of wealth in society. As long term investors we will need to navigate through all of these as changes and more in the years ahead – in addition to the usually booms & busts, and bubbles & crashes along the way.

Meanwhile we are still moderately bullish in our portfolio settings, but as always 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
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