SUPERVISED INVESTMENTS AUSTRALIA LIMITED

31 March 2018

The Supervised Fund: Quarterly Macroeconomic Outlook

US & Australian markets

Below is shown, for context, the total returns of stock markets in Australia and the US since 1992 (including dividends). It is clear to see that growth since the crash of 2008 has been phenomenal, where in the US the S&P 500 Total Return Index has risen 4.4x since its trough of early 2009, and in Australia the S&P 200 Accumulation Index has risen 2.4x. Recent volatility and market nervousness is evidenced in the ~8% drop in US markets since the highs of January this year.

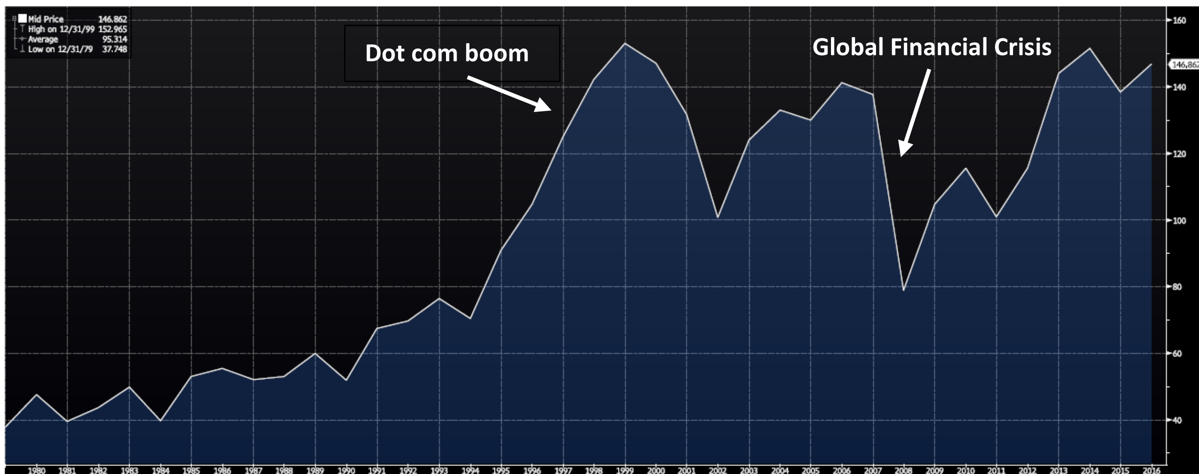
United States: S&P 500 Total Return Index since 1992 (source: Bloomberg)

Australia: S&P ASX 200 Accumulation Index since 1992 (source: Bloomberg)

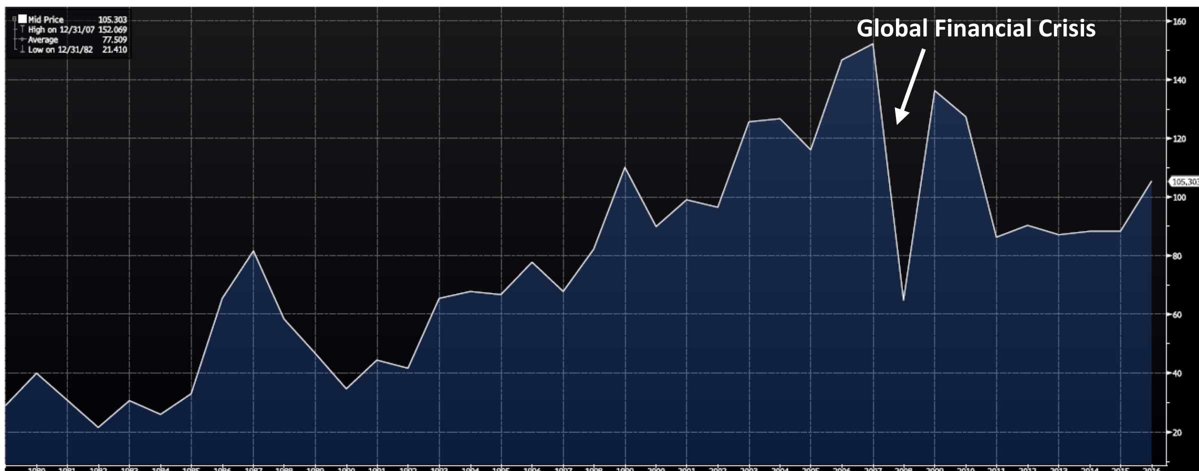
Market capitalisation as a % of GDP

Here, we look at how large a country's entire market capitalisation is compared to the size of its economy; a crude measure designed to provide a sense of whether stock markets are outpacing economic growth. The below graphs, available from 1980 to the end of 2016, show the United States' market capitalisation to GDP ratio at 147%, and Australia's at 105%. Of course, 2017 saw incredible equity market growth, so we can expect these ratios to be even higher now. In Australia, we are at a similar point to before the dot com crash, but still some way off from the levels seen before the 2008 GFC. By contrast, the United States is at its highest market capitalisation to GDP in recent history, above even 1999 and 2007 (after factoring in 2017 growth, which is not included on the graph below).

United States market cap as a % of GDP since 1980 (source: Bloomberg / World Bank)



Australia market cap as a % of GDP since 1980 (source: Bloomberg / World Bank)

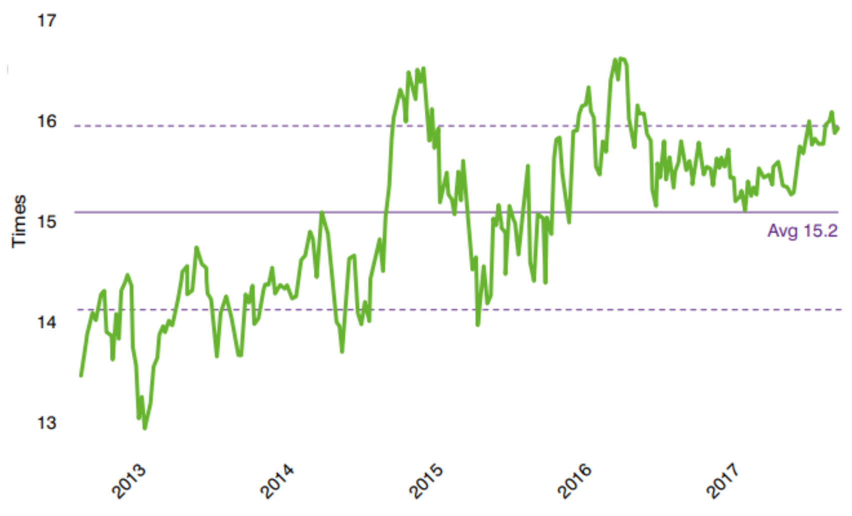


P/E ratios

We can see from the graphs below that equity valuations based on trailing P/E ratios are at high, but not outstanding levels. The reason for this is earnings have been increasing, and are expected to continue to do so particularly in the US as company tax cuts are introduced.

United States S&P 500 historic Price/Earnings ratio since 1980 (source: Bloomberg)

Australia S&P 200 historic Price/Earnings ratio since 2013 (source: AFIC 2018 half-yearly review)



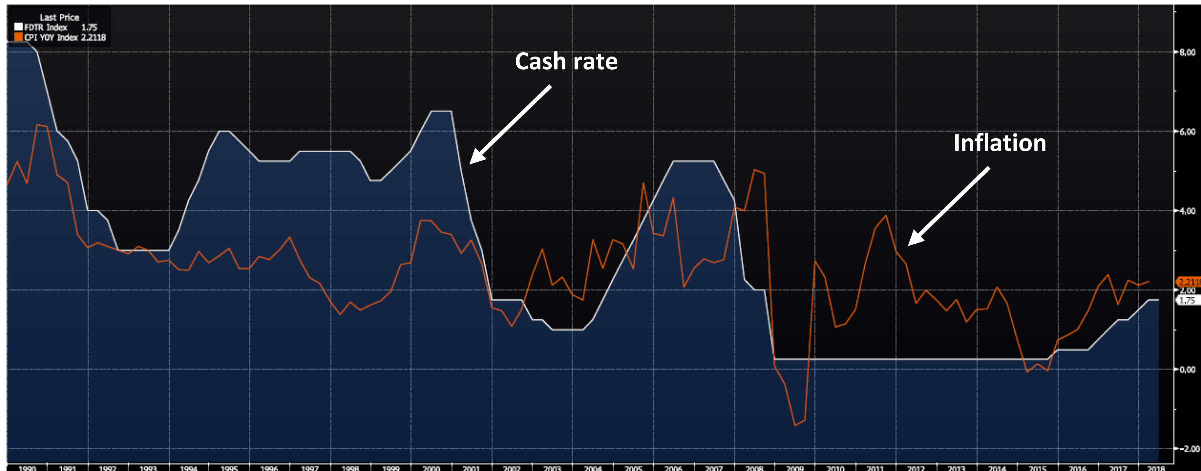
The above chart is taken from an early 2018 AFIC report (Australia's largest listed investment company). The following accompanying comments were made:

'It is difficult to find stand out value in the current market. Companies that are displaying prospects for strong growth are being sought by investors and are fully valued.'

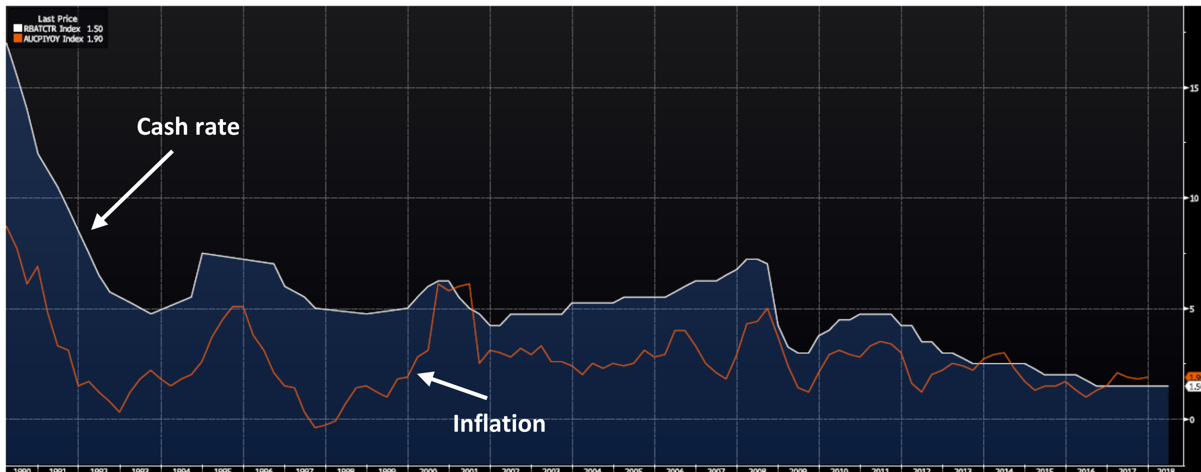
Inflation, interest rates and debt

As illustrated, interest rates have remained at historic lows for about 10 years in the United States, and six years in Australia.

United States historic interest rates and inflation since 1990 (source: Bloomberg)



Australia historic interest rates and inflation since 1990 (source: Bloomberg)



The concern here is that low interest rates are likely to have encouraged excessive speculation and borrowing, and caused people to become complacent about having access to cheap credit. Should inflation rise, which many commentators see as a distinct possibility in the US, interest rates would likely increase in response; the historic correlation is evident in the charts above. Higher interest rates would make equity investing less attractive, reduce spending across-the-board, and potentially burst real estate and equity bubbles, especially where participants are leveraged.

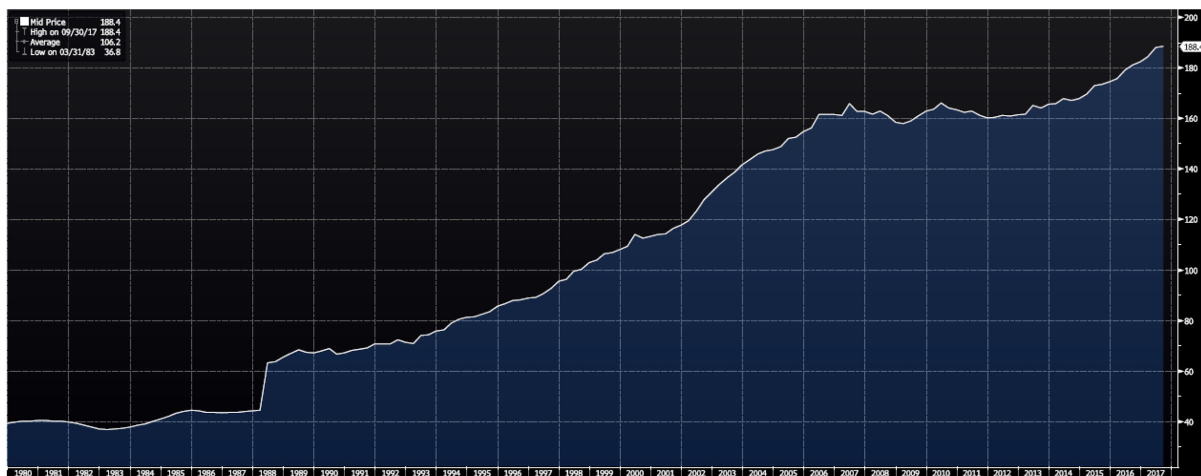
Fortunately, it appears companies in Australia do not hold unsustainable levels of net debt. However, the same cannot be said for corporations globally. S&P Global Ratings noted in a report

released February 2018, that the proportion of companies whose debt exceeded their earnings by five times, had climbed to 37% in 2017, compared to 32% in 2007 (before the financial crisis). In the US, the ratio of non-financial corporations' total debt to GDP rose to 73% during 2017, a record high, although corporate debt is more evenly distributed now, so the number of firms at immediate risk of default may be lower.

Should rates rise slowly and predictably, while earnings continue their march upwards, a benign scenario may play out. However, any shocks to the global economy, including faster-than-expected rate rises, might cause harm to overvalued and indebted global markets. Ominously, the three-month Libor, a benchmark measure of inter-bank borrowing costs, has risen to 2.3%, doubling in the space of a year and out-pacing the Federal Reserve's 1.75% target rate. This may point to future rate rises, as well as inflicting immediate pain on indebted businesses.

Meanwhile, in Australia the household debt to income ratio has soared from 40% in 1980, to 188% today (see line chart below). Therefore, indebted Australian consumers are likely to be quite sensitive to increases in interest rates and/or falls in the value of real estate and equity investments.

Australia household debt to income % since 1980 (source: Bloomberg / RBA)



Warnings from prominent investors

Warren Buffett noted the following in his latest shareholder letter, released February 24, 2018:

'In our search for new stand-alone businesses, the key qualities we seek are durable competitive strengths; able and high-grade management; good returns on the net tangible assets required to operate the business; opportunities for internal growth at attractive returns; and, finally, a sensible purchase price.

The last requirement proved a barrier to virtually all deals we reviewed in 2017, as prices for decent, but far from spectacular, businesses hit an all-time high. Indeed, price seemed almost irrelevant to an army of optimist purchasers.'

Hamish Douglass of Magellan in Australia recently wrote:

'If the Federal Reserve is forced to act more swiftly and forcefully than expected, it is reasonable to assume that US longer-term bond yields could jump meaningfully (above 4% compared with about 2.90% for the US 10-year Treasury bond today), which could trigger the biggest slump on world share markets since the global financial crisis. In our view, a 20% to 30% global stock market correction is within the range of outcomes in these circumstances.'

Implications for The Supervised Fund

TSF takes a suitably cautious approach to investing, with cash and gold currently comprising almost 25% of the portfolio, and an emphasis on companies that are not heavily burdened by creditors.

However, we still see it as worth reinforcing a few principles at this time:

- Avoid companies that exhibit high levels of net debt.
- Focus on companies that are not entirely reliant on discretionary spending, as such companies may be less sensitive to general economic pain.
- Don't stray from the ethos of investing in companies that are truly undervalued as opposed to speculative in nature.
- Maintain a high cash balance in the portfolio, so that should a downturn occur, we might be in a strong position to pick up some bargains.