SUPERVISED INVESTMENTS AUSTRALIA LIMITED

September Quarter, 2018

The Supervised Fund: Macroeconomic Outlook

Scope and purpose

Our tendency is to research small companies in considerable depth in order to pursue an analytical edge. We believe that, given there are inordinate economic organisations and think tanks, we cannot gain an advantage in macroeconomic understanding. Therefore, in our macroeconomic research, we seek to identify circumstances that could detrimentally impact financial markets and investor expectations. By doing so, we can organise our portfolio to maximise capital preservation in the case of unfavourable conditions. Accordingly, we are less concerned with using macroeconomic research to identify money–making opportunities, such as long/short positions in currencies and/or market indices.

This paper identifies risks to market conditions across major global economies, with a focus on the impact any issue may have on the Australian equity market. We take the broad view that the performance of Australian stocks correlates to those in the US, and to a lesser degree China and Europe. For the sake of clarity, our view is that the events hypothesised in this report will most likely not occur; however, we wish to construct the portfolio in such a way that we can continue to perform if these or other macroeconomic shock events do not happen, whilst cushion against any downturn if they do. The paper primarily examines the economies of Australia, the US, China, and Europe.

Australia

Over the last year, the ASX S&P 200 Accumulation Index, which includes dividends paid, increased by about 14% (Image 1), and by about 1.5% over the September quarter. These gains may be understood in the context of strong GDP growth of 3.4%[1], low interest rates, impending tax cuts and favourable global economic and equity market conditions, particularly in the United States.

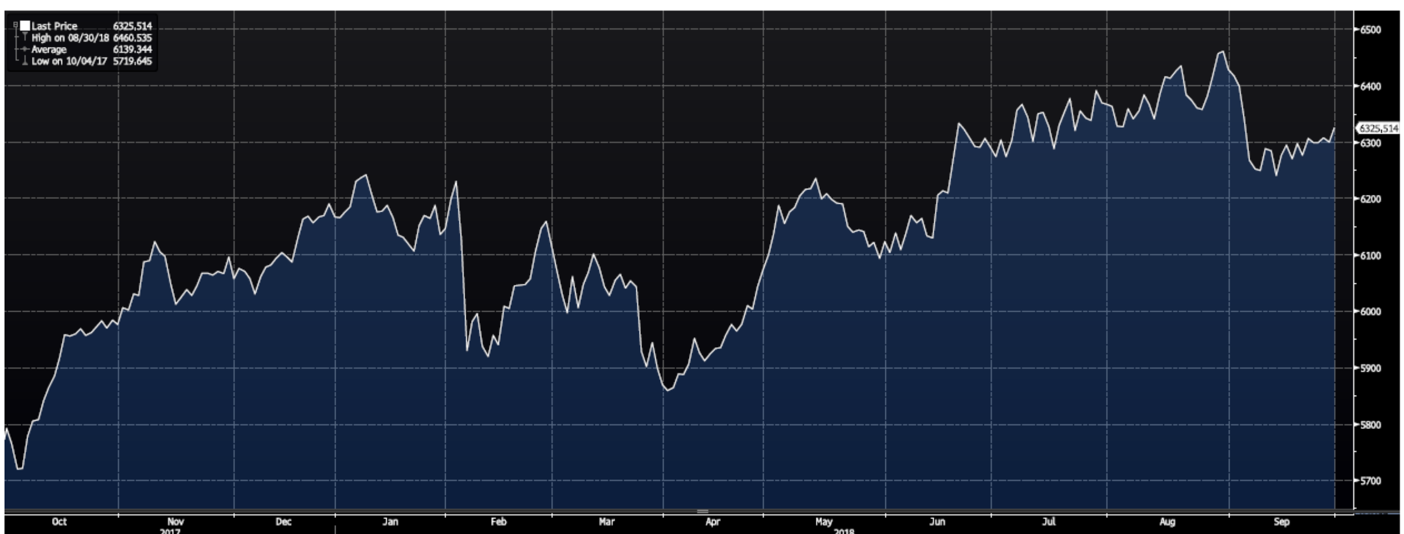


Image 1: S&P/ASX Accumulation 200 Index, October 2017 to September 2018 (source: Bloomberg)

[1] For the year ended June 2018; September data has yet to be released.

Currently, the tax rates of Australian businesses with turnover up to $50m are being progressively reduced from 30% to 25%. This reform package was due to be extended to larger businesses, but was discarded by the government after it failed to receive support from the Senate. As a consequence, certain small businesses, sometimes of the nature TSF invest in, may think twice before expanding beyond the $50m revenue threshold. Meanwhile, Parliament has legislated to simplify the Australian income tax regime, so that by 2028 the 37% tax bracket will be reduced to 32.5% and expanded to include all taxpayers earning between $40,000 and $200,000.

These reforms are threatened, however, by policies the Labor Party has proposed to implement should it win government at the next election. The ALP has promised to repeal the income tax package mentioned above, scrap franking credit cash refunds, abolish negative gearing for new purchases of existing property, and halve the capital gains tax discount from 50% to 25%. Without commenting on the merits or otherwise of these tax policies, they do constitute additional pressures on both the local share and property markets in the short-term.

Already, Australia's property market is in decline, with house prices across the five major capital cities having fallen 3.9% over the last year, including 6.1% in Sydney and 3.4% in Melbourne. The factors mentioned above, in addition to the ongoing Royal Commission, loom as catalysts for further downward price pressure. On September 28, the interim report of the Financial Services Royal Commission was submitted to the Governor General, which was particularly critical of the culture of the banks and the financial services companies, referring to: 'the pursuit of short term profit at the expense of basic standards of honesty.' The report also censured corporate regulators ASIC and APRA for their inadequate supervision of the banks. The incentives provided to bankers appear to have stimulated excessive lending to Australian consumers, who were often encouraged to take bigger loans than they could afford. The effects of the unwinding of these excess debt levels will take time to flow through the Australian economy, and to affect house prices, but eventually they will. To demonstrate, earlier this year APRA sent a letter to authorised deposit-taking institutions, providing guidance that new loans should not be given out if they exceed the borrower's income by six times. Banks were asked to meet this, in addition to other stricter lending criteria, within 12 months. Existing borrowers whose mortgages are interest-only (over 30% of borrowers), may therefore struggle to refinance their loans, as they are converted to principal + interest (which will largely occur between now and 2022). This, combined with banks tending to underestimate household expenses, could result in a decrease in consumer borrowing power of 20-30%. This would have substantial consequences for house prices.

However, reducing house prices will act to offset upward inflationary pressures, and inflation currently remains within the RBA's target range at 2.1%. The RBA has stated that although the next movement in the cash rate is likely to be upwards, there is little justification for any increase in the near-term. Thus, households, which are indebted at an average of 190% of their incomes, seem unlikely to experience steep increases in their financing costs in the short-term. Nonetheless, rising wholesale funding costs may force banks to continue to raise their mortgage rates 'out-of-cycle' with the Reserve Bank. In the last Quarterly Macroeconomic Report, we postulated that banks would raise their lending rates in response to such increases in funding costs; soon after, Westpac, ANZ and CBA did just that. The pressures which led to these hikes have not abated – the interest rate differential between Australia and the US continues to widen, and quantitative easing is being gradually unwound across the G4 countries, meaning that competition for capital is slowly but steadily increasing.

United States

Australia's low and steady RBA cash rate contrasts to the US Federal Funds rate, which has risen to 2.25% (Image 2) on the back of strong economic growth. US GDP growth in the second quarter was an annualised 4.2%, and unemployment has fallen to 3.9%, its lowest level since 1969. Share markets in the US have continued to rise, with the S&P500 Total Return Index up 7.7% over the quarter, and 17.5% over the last year (Image 3).

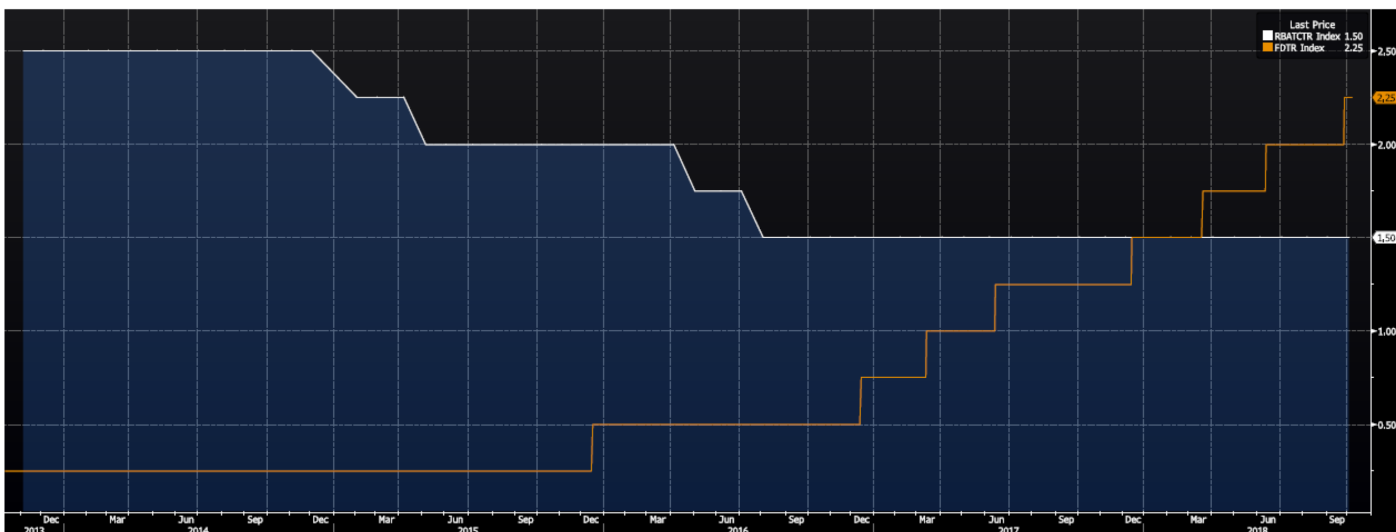


Image 2: RBA Cash Rate (white line) and US Federal Funds Rate (orange line) over last 5 years (source: Bloomberg)

Image 3: United States S&P 500 Total Return Index, October 2017 to September 2018 (source: Bloomberg)

While these figures are impressive, they also prompt concerns about an overheating US economy, characterised by tightness in the labour market, rising tariffs, and growing inflation and asset prices. With such a low rate of unemployment, competition between businesses in the labour market is beginning to show – Amazon, for instance, will increase its minimum wage for over 250,000 workers from US$11 an hour to US$15 an hour in November. Planned infrastructure spending, tax cuts and the ongoing trade war present additional risks for an inflationary breakout, which would cause a potentially damaging rise in interest rates, affecting heavily indebted US companies, consumers, and the government itself, whose net interest bill would soar.

Yields on the 10-year US Treasury pushed well past 3% in September (Image 4), and may well continue their upward trend in the face of rising interest rates. Brian Coulton, Chief Economist at Fitch Ratings, thinks markets have not properly factored in the possibility of another four rate hikes by the end of next year. As bond yields rise, the opportunity cost of holding equities also rises, and investors switch into the higher paying 'safer' alternative. Meanwhile, the profits of companies with debt will decrease.

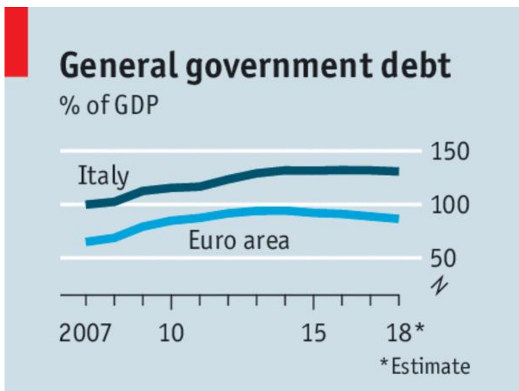
Image 4: US 10-year Treasury yield, October 2018 (source: Financial Times)

Capital markets in the US are also at risk due to their general frothiness, as Howard Marks (founder of Oaktree Capital Management) convincingly set out in a recent note to investors. He points out that after the 2008 global recession, the world's central banks flooded their economies with capital at artificially low prices, triggering near-zero yields on safer assets like government bonds, and greater competition for higher risk/reward investments (especially given many endowments and pension funds target annual returns of over 7%). Resultingly, investors abandoned their usually moderate appetite for risk, and became willing to pay big price tags for fast-growing companies. At one stage, to justify Netflix's valuation, its profits in a decade's time would have to have been equivalent to about half the gross operating profits made by American entertainment firms this year (The Economist). Other large companies such as Amazon also carried lofty valuations, while smaller technology businesses have been given more money than they ever asked for by SoftBank, a fund which managed to raise US$100bn for technology investment.

Global economy and emerging markets

The combination of strong US growth and rising interest rates is a cause for concern amongst many global economies. Vulnerable countries such as Argentina, Venezuela and Turkey have seen the value of their currencies slide whilst the economies struggle and investors withdraw capital in favour of US government bonds. Argentina, despite having recently raised interest rates to 60%, has seen its exchange rate decline over 50% against the US dollar, as investors seek a more stable home for their assets. Meanwhile, Venezuela is experiencing inflation of around 1,000,000%, and the Turkish government has shown extreme reluctance to combat inflation, as well as minimal fiscal prudence; its currency has fallen about 40% against the USD.

Italy, which at 131% of GDP exhibits the second highest level of public debt in the EU after Greece, has been playing a dangerous game of chicken with the European Commission (Image 5). Its new government, a coalition between the anti-establishment Five Star Movement and the far-right League, triggered political rumblings when it proposed a big-spending budget in September, in defiance of Brussels' previous requests to rein in its deficit and debt. Its intention was to boost spending and slash taxes, so that the budget deficit would increase to 2.4% of GDP, three times what the previous government had agreed with the European Commission, and nudging closer to the EU's ceiling. Bond yields predictably spiked, a problem that may become self-perpetuating by increasing the country's already significant interest bill. It is probably premature to consider the risk of default, but a Greek-like crisis would be calamitous for the EU, with the potential to tear apart the Euro and cause contagion amongst nearby countries with holdings of Italian bonds. The Euro has proven to be an inflexible currency arrangement, unable to adjust to the many and varied requirements of different economies within the eurozone. In Italy's situation, a lesser-valued currency would act as an automatic stabiliser, assisting the country's productivity and exports and reducing the value of its debt. Bound by an inflexible exchange rate, Italy's only viable alternative may be to introduce a policy of austerity, a solution which may yet be forced upon it.



The Economist

Image 5: Italian government debt vs Eurozone average government debt (source: The Economist)

Exacerbating European and global economic weaknesses, the G4 central banks (US Federal Reserve, ECB, Bank of England and Bank of Japan) are in the process of switching from quantitative easing to quantitative tightening. From 2009 to 2017 these central banks injected an average of $US1.2bn p.a. into global finance, but this is expected to reverse to a withdrawal of $US500bn in 2019. Such a sharp turnaround will have implications globally, as central bank funds are withdrawn from asset markets for the first time in ten years. Australian banks will experience higher wholesale funding costs, US bond yields will rise, and vulnerable economies will struggle to obtain the financing they need to fund government deficits and important projects.

Trade and China

Since the June macroeconomic update, US President Donald Trump and EC President Jean-Claude Juncker have agreed to work together towards zero tariffs and subsidies on non-auto industrial goods, and may yet extend this to services. Donald Trump has also struck a trade deal with Mexico and Canada, which makes modest revisions to the existing NAFTA agreement. Its trade-based attacks have therefore narrowed considerably on China, which Donald Trump accuses of unfair trade practices, including intellectual property theft. Indeed, a recent Bloomberg report detailed how operatives from a unit of the People's Liberation Army had been covertly inserting tiny microchips into computer motherboards produced by Supermicro. Customers of Supermicro included large organisations such as Amazon and Apple, which were consequently susceptible to having their data centres hacked and information stolen.

Partly in response to this alleged transgression, the US imposed $US200bn worth of tariffs on China, which are due to increase from a rate of 10% to 25% if a deal is not struck by the end of the year. If China retaliates, Donald Trump has vowed to extend the tariffs to another $US267bn worth of imports. Chinese equity markets have reacted understandably negatively; the Shanghai Composite Index is down 16% over the past year (Image 5).

Image 5: Shanghai Composite Index, October 2017 to September 2018 (source: Bloomberg)

The trade war appears to have negatively affected commodity prices as well, due to concerns surrounding Chinese growth and demand for infrastructure and manufacturing raw materials. While Australia's economy is somewhat exposed to resources demand, there is a possibility that 'trade diversion' will take place (whereby Chinese or US firms decide to buy from countries like Australia instead of each other), and it seems unlikely that Australia's place as a cheap and reliable supplier of minerals, energy and agriculture will be affected. Furthermore, China appears intent on combating such weaknesses in its economy through government measures, such as fiscal stimulus and regulatory change. Indeed, it has recently decreased the amount of cash lenders need to hold as reserves, which will reduce funding costs for businesses.

Conclusion

Although the US economy is growing strongly, numerous problems appear to be directly attributable to this fact. First, the US labour market is tight and wages are rising. The Fed is raising interest rates in response, which is bound to reduce the profits of heavily indebted companies and increase the US federal government deficit as bond yields are pushed up. It is also causing increased global competition for capital and consequently, draining funds from economies such as Australia, Turkey and Argentina. In Australia's case, this pushes up domestic bank lending rates, a concern for indebted property-owners, while in the cases of Turkey and Argentina, this could directly affect the financing of important projects. Adding to this, higher government bond yields will increase the opportunity cost of holding US equities, which, as a whole, appear overvalued already. Concurrently, the big central banks are unwinding their quantitative easing efforts of the last ten years. This will exacerbate the global drain of funds and detrimentally impact countries like Italy.

Australia does not need to worry about some of these points. It never undertook a quantitative easing program and its companies are not as heavily indebted as its US counterparts. And so far, it has avoided the worst of the trade wars engulfing many global economies. However, property market indebtedness, combined with an unusually long period of low interest rates, and changes in behaviour from regulators and financial institutions following the Royal Commission, reveal a country vulnerable to the whims of a fragile global economy.

The Supervised Fund takes a suitably cautious approach to investing by considering the risks posed by the wider economy and conducting extensive research into investment prospects. It deems, for instance, the risk-reward return to be unsatisfactory in regard to the Australian property market. As part of its capital preservation philosophy, The Supervised Fund avoids companies with high levels of debt, and maintains a sensible level of cash in the portfolio.

Since the September quarter

Subsequent to the date of this report, markets have been volatile, with significant sell-offs across Australian, US and European indexes. So far in October, the ASX S&P 200 Index has fallen by over 4% and the S&P by over 3%. This seems to be due to increasing interest rates in the US and trade tensions between the US and China. We are maintaining a close watch over the market and identifying any opportunities that arise as share prices decrease.

The Supervised Fund

17th October 2018