Analytical advice since 1982.

# September 2018 Quarter In Review

## Contents (Alphabetic)



## Legislative changes

The quarter is noteworthy for the dearth of major legislation affecting personal finance or major economic issues.

On 21 September, the Governor General assented to changes in the Corporations Act dealing with crowd funding.

The Trans Pacific Partnership trade legislation passed the lower house and awaits Senate approval.

Legislation to bring lending disruptor AfterPay under the Australian Securities and Investments Commission (ASIC) regulation started its legislative journey in the quarter.

Before the Senate is the Superannuation (Objective) bill requiring bills and regulations relating to superannuation to be accompanied by a statement of their compatibility with the defined primary and subsidiary objectives of the superannuation system.

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**Andep Investment Consultancy**

ACN 009 169 573 ABN 38 009 169 573 Australian Financial Services License 230 176

**Level 13, 251 Adelaide Terrace Perth WA 6000**

**P.O. Box 3584 East Perth, WA, 6892**

**Telephone: +61 (08) 9225 5899**

**Facsimile: +61 (08) 9225 5877**

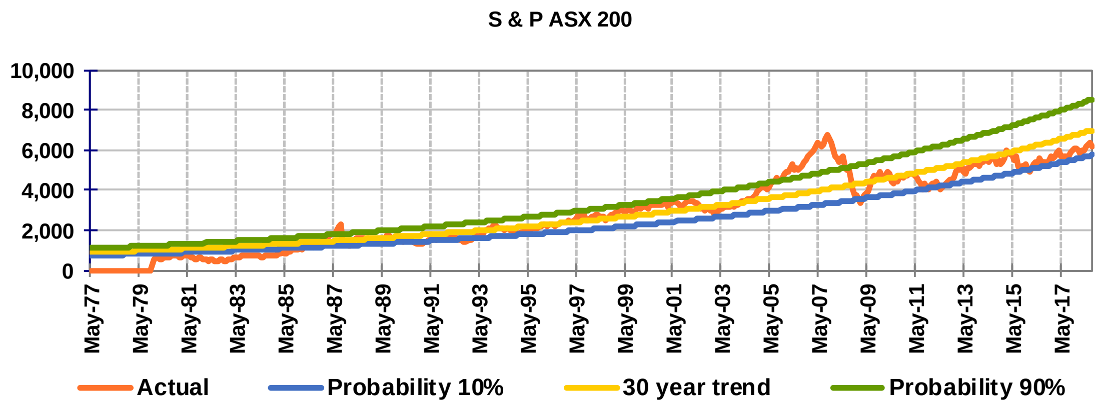
**Info@Andep.com.au**

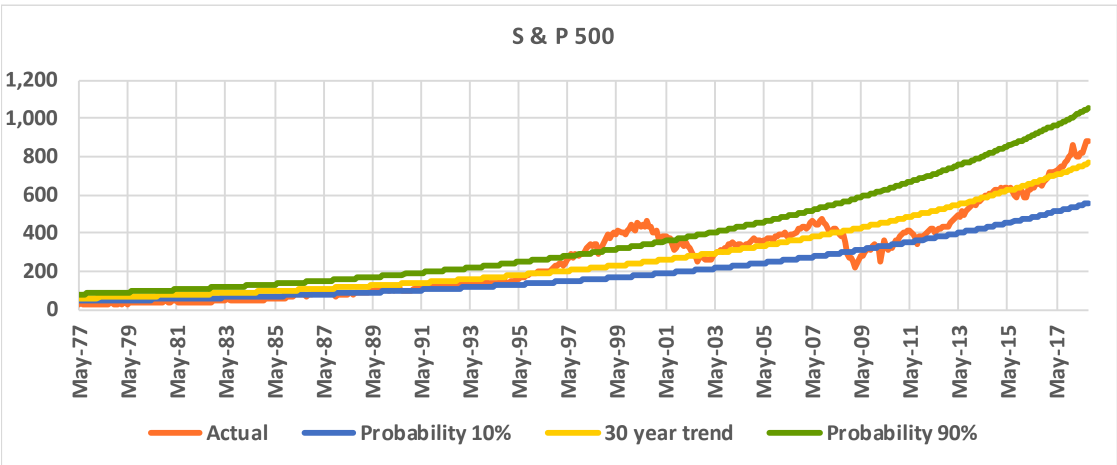
www.Andep.com.au

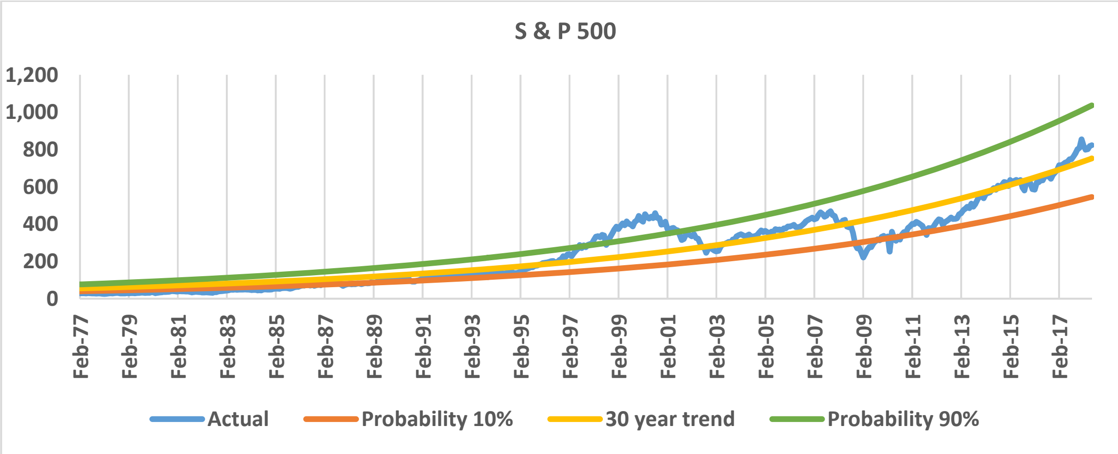
## Markets and trend lines

The following charts show, respectively, the best fit of constant compound growth in the Australian and United States of America broad market indices together with some statistically derived probability percentiles. On this statistical basis, the Australian market provides reasonable value and the USA is a little elevated. On other measures, however, the US market, in particular, remains high. For example, US share prices measured as a proportion of ten year average inflation adjusted earnings are double the long term average.

The 30 year trends encompasses a period of steadily falling interest rates, which is at or near its end. These make conclusions from the trend charts optimistic. Respected commentators are cautious that markets may be too high. Andep's view is that the elevated valuations strengthen the case for dividend paying stocks and LICs that concentrate on dividends.

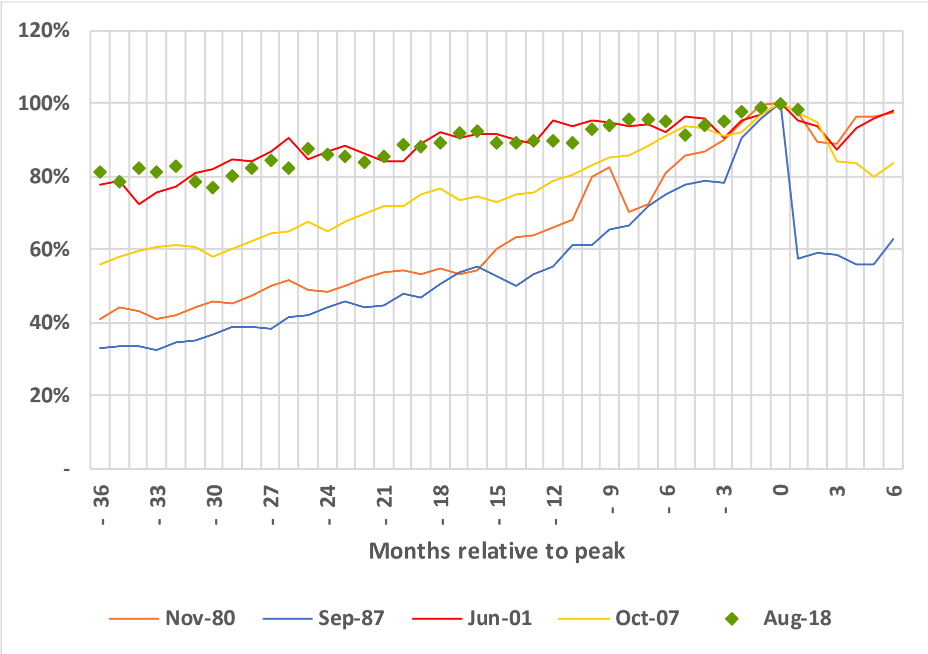


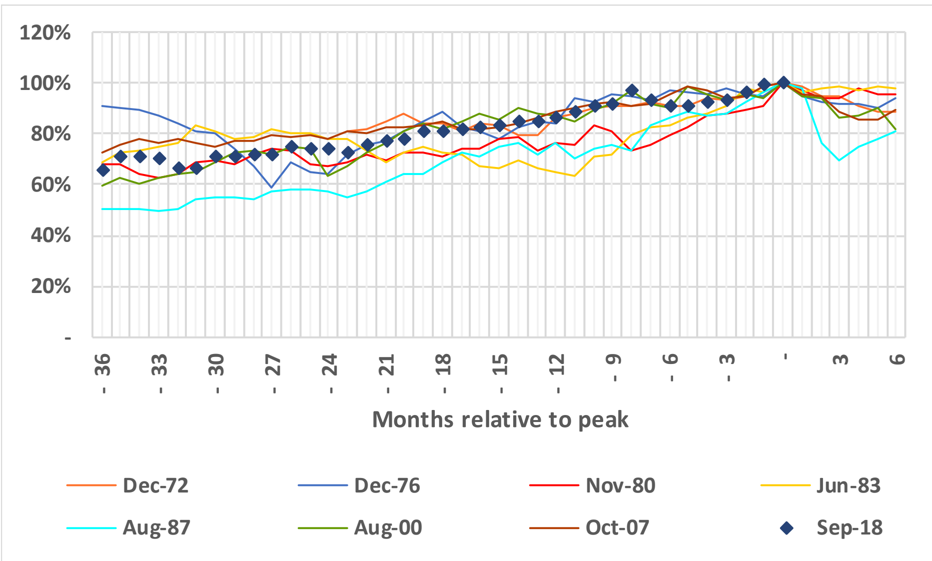



Another graphical view of the markets is a comparison of the movement in the three years leading up to the most recent peak and the three years before and six months after significant peaks.

The following chart relates to Australia and the diamonds of recent progress are above the lines representing the lead up to all other peaks. Australia has not recently seen the rapid increases that preceded earlier peaks. The parallel with 2001 is more than numeric. 2001 was the culmination of the dot com boom which had a greater effect on markets with more “tech” stocks. A similar situation prevails today.




The USA is at its highest ever. However, the recent rise is one of the steadiest in two generations.




It remains true that the USA stock market's three year growth far exceeds that of Australia, UK Germany and Japan.

As was the case last quarter, while many Australian based international fund managers have reduced their exposure to the USA. That market is vulnerable to rising interest rates and a trade spat. The US market continues to ignore these vulnerabilities. The risk remains that a USA fall could flow on to other markets.

The Australian housing boom is unwinding in an orderly way. The risk is that is will become disorderly influenced by reduced credit growth as Royal Commission scarred bankers tighten lending standards. Any disorder could flow to the stock market.

Australia's exports are exposed to the risk of a Chinese slowdown either internal or trade spat related.

### Economic milestones

July was the first month in which the dividend yield on the Australian stock market was below 4% since April 2010.

Push came to shove in the trade spat between USA and China as the USA announced plans on 11 July for a further USD200 billion after China announced tariffs on USD34 billion, themselves a response to a like amount imposed by the US on 29 June. Context is provided by 2017 numbers of US imports of USD506 billion and exports of USD130 billion. China owns around 5% of the US government debt.

On 18 September the US government announced the starting date of the anticipated 10% tariff on almost 50% of China's exports to that country. The major reaction thus far to the trade fears has been a decline in the value of the Chinese currency and stock market.

On 5 July, the Federal Treasurer announced a new GST sharing arrangement and additional federal funding to address the vexed question of Horizontal Fiscal Equalisation. The arrangements include an ultimate floor on the share of GST returned to the states of 75%. Reaction has been favourable.

On 9 July, the AFR reported significant foreign interest in Sydney University quantum computing company Q-Ctrl, which we mentioned in our review of the March 2018 quarter.

On the same day, the AFR also reported insurance premiums for directors and officers have surged by as much as 300 per cent in the last six months following a sharp rise in the number of class actions launched against Australian companies.

On 19 July the Australian Bureau of Statistics (ABS) announced an unchanged seasonally adjusted unemployment rate and an increased seasonally adjusted workforce participation rate.

On 16 August, it reported the rate had fallen by 0.1% and this was steady in the 13 September release.

On 27 July, the fastest quarterly growth in the US economy since 2014 (4.1% annualised) was announced.

On 25 July the ABS announced the Consumer Price index had risen 2.1% over the year to June, 2018. Commentators suggested this would influence the Reserve Bank to hold interest rates steady.

The Turkish Lira dropped 20% against the USD in the week ending 10 August. In the same week, US quarterly consumer price inflation at the annual rate of 2.4% was announced.

On 16 August, the Australian Bureau of Statistics (ABS) released the July unemployment rate of 5.3%, the lowest since November 2012.

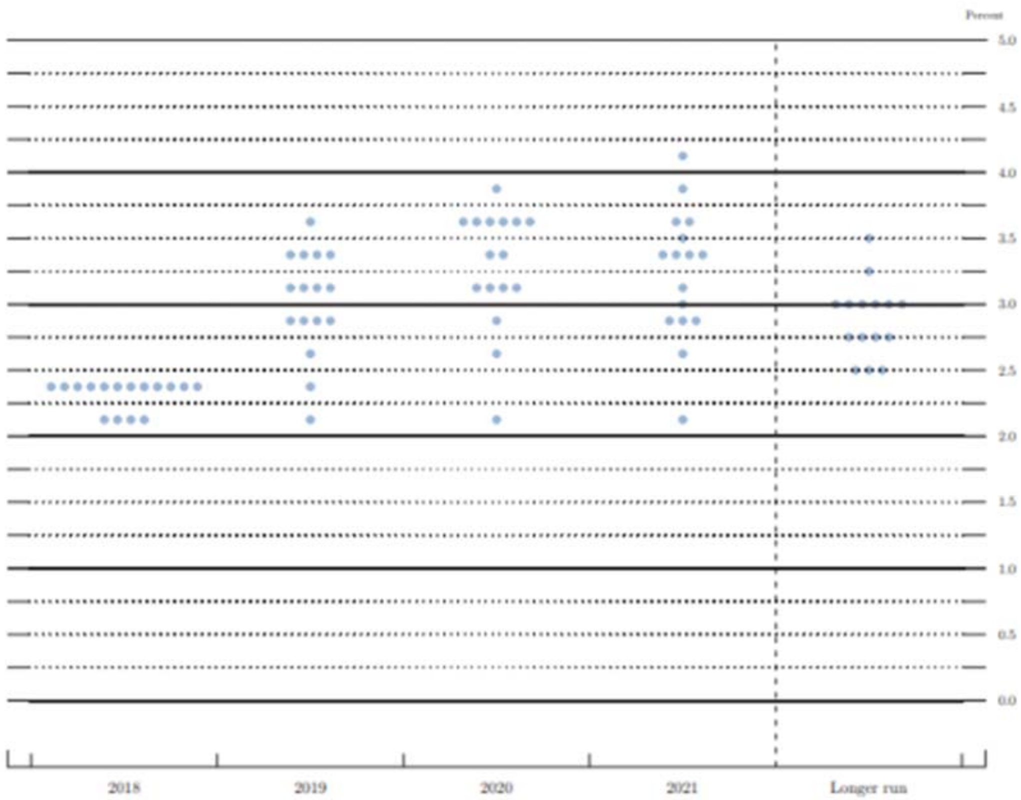
On the same day, the AFR reported a land developer saying that speculators in en globo land are "panicking" to unload sites for which they have paid deposits and on which banks are reluctant to lend. The source was quoted as saying "speculators have priced normal developers out of the market."

On 31 August, the Australian Prudential Regulatory Authority (APRA) released June 2018 statistics showing that industry superannuation funds, for the first time exceeded retail funds' total assets, accounting for $632 billion of the $2.709 trillion superannuation assets. Self managed funds had the most assets at $750 billion, but industry funds grew faster in the previous year.

On 5 September, the Australian Bureau of Statistics (ABS) announced surprisingly strong annualised growth of 3.4% in Gross Domestic Product (GDP). Weak wages growth meant that the GDP growth was supported by households that saved only 1% of their income – the lowest proportion for almost ten years.

On 26 September the US Federal Reserve Board increased its short term interest rate target to 2 – 2.25% per annum and released the following "dot plot" chart of board member's expectations of future rates.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate




## The environment

Recognising the effect of the environment on financial performance, we add a new section to our Review this quarter.

E-zine Renew Economy notes that in South Australia, "*the renewables boom has brought down prices, and lowered emissions – and it is now looking at a revitalisation of its manufacturing base, powered by cheap renewables.*" It further wrote "*South Australia is now clearly one of the leading grids in the world in the uptake of both wind and solar, the integration of that output, and the adoption of various storage and other smart technologies to manage it.*" This again poses the question we asked in our March 2018 Review, "Is this to be South Australia's future?

Renew Economy reported on 21 September that a large part of the Yorke Peninsula in South Australia is “off the grid”.

## Economic and market statistics

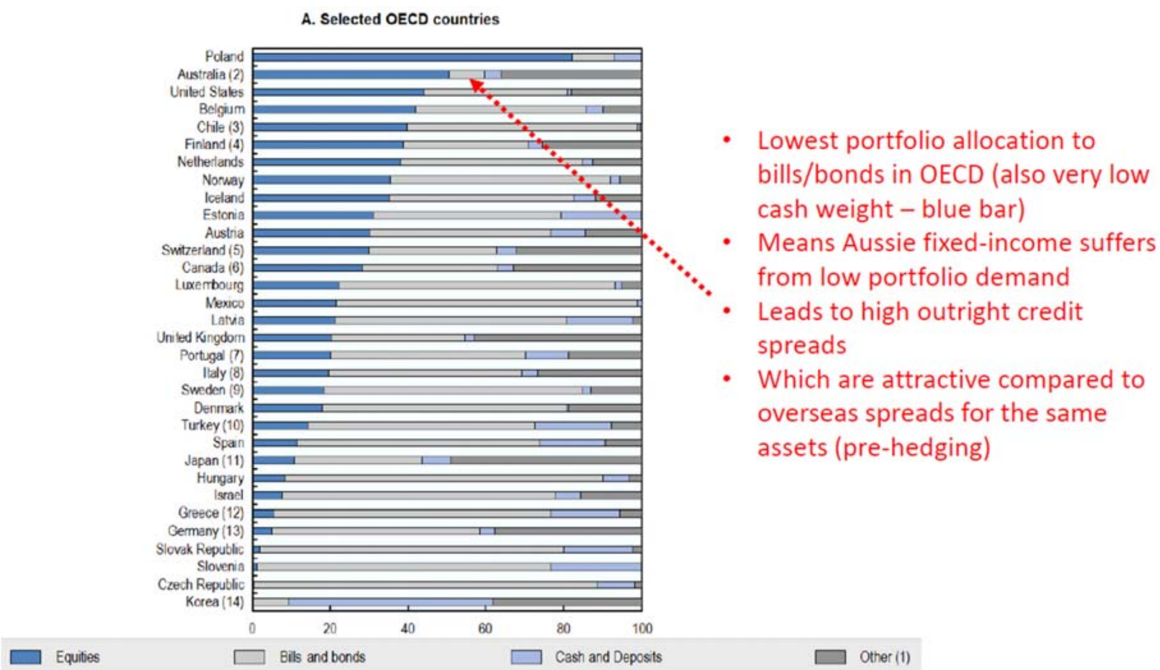
The following table shows key economic and market statistics.

| | Latest date | Now | 1 year ago | 3 years ago | 7 years ago |
|---|---|---|---|---|---|
| S&P /ASX 200- Australia | Sep 18 | 6,208 | 5,682 | 5,022 | 4,009 |
| Annual change to latest date | | | 9.3% | 7.3% | 6.4% |
| S&P /ASX 200 dividend yield | Sep 18 | 4.10% | 4.37% | 5.31% | 5.09% |
| S&P /ASX 200 P/E ratio | Sep 18 | 15.4 | 15.40 | 14.60 | 12.20 |
| Topix- Japan | Sep 18 | 104.8 | 96.60 | 81.40 | 43.90 |
| Annual change to latest date | | | 8.5% | 8.8% | 13.2% |
| S&P 500- US | Sep 18 | 882.4 | 762.9 | 581.4 | 342.6 |
| Annual change to latest date | | | 15.7% | 14.9% | 14.5% |
| GDAXI- Germany | Sep 18 | 12,253 | 12,866 | 9,757 | 6,141 |
| Annual change to latest date | | | -4.8% | 7.9% | 10.4% |
| Average weekly earnings $ | Jun 18 | 1,586.20 | 1,543 | 1,483 | 1,305 |
| Annual change to latest date | | | 2.8% | 2.3% | 2.8% |
| Consumer price index | Jun 18 | 113.00 | 110.70 | 107.50 | 98.84 |
| Annual change to latest date | | | 2.1% | 1.7% | 1.9% |
| Unemployment | Aug 18 | 5.3% | 5.60% | 6.20% | 5.20% |
| Gross domestic product $ m per quarter | Jun 18 | 441,942 | 427,384 | 406,378 | 365,268 |
| Annual change to latest date | | | 3.4% | 2.8% | 2.8% |
| RBA cash rate | Sep 18 | 1.5% | 1.50% | 2.00% | 4.75% |

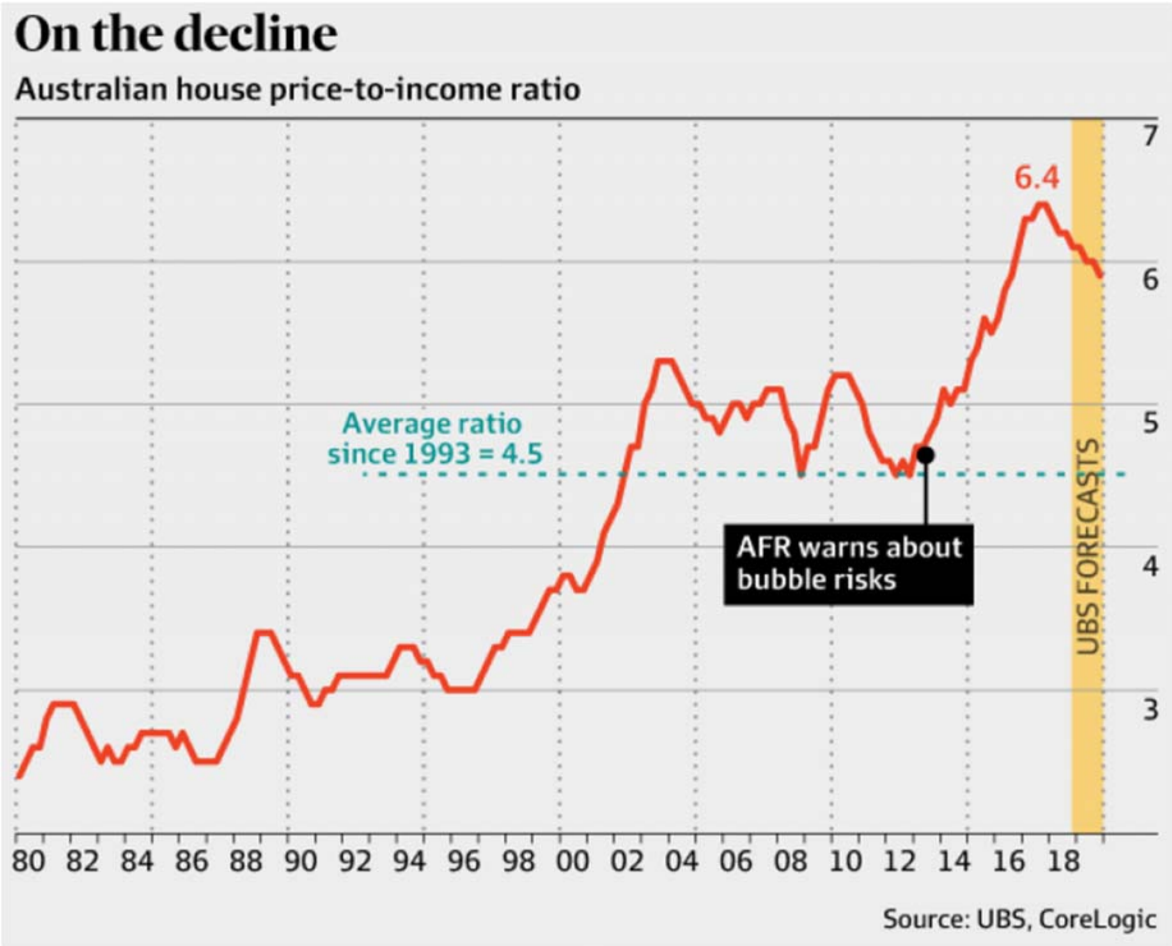
| | Latest date | Now | 1 year ago | 3 years ago | 7 years ago |
|---|---|---|---|---|---|
| **3 year Commonwealth bond** | Sep 18 | 2.1% | 2.06% | 1.86% | 3.54% |
| **10 year Commonwealth bond** | Sep 18 | 2.6% | 2.70% | 2.70% | 4.20% |
| **USD/AUD** | Sep 18 | 0.7222 | 0.7839 | 0.7010 | 0.9781 |
| **Annual change to latest date** | | | -7.9% | 1.0% | -4.2% |

## Other peoples' views

Fixed interest fund manager and part time AFR writer, Chris Joye of Coolibah Capital produced an interesting chart of the asset allocation of pension and superannuation funds in the OECD.  Australia is second only to Poland in the proportion of funds committed to equities.



Another chart in the same presentation puts housing prices in historical perspective.




UBS Global Real Estate Bubble Index 2018 regards Sydney as 29% overvalued.

E-zine Shed Connect reported on the performance of active fund managers compared with the indices against which they want to be measured as at June 2018 as follows.

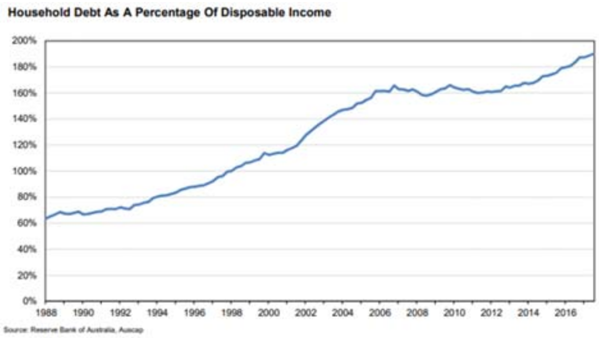
| | Small to mid capitalisation | SD&P /ASX 200 | International equities |
|---|---|---|---|

| | | | |
|---|---|---|---|
| **Funds surveyed** | 120 | NA | 238 |
| **Proportion beating index one year** | 55.1% | 42% | <30% |
| **Proportion beating index three years** | 30% | 33% | <20% |

Of 303 funds that outperformed their respective indices in the five years to June 2013, 27.7% did the same in the next five years.

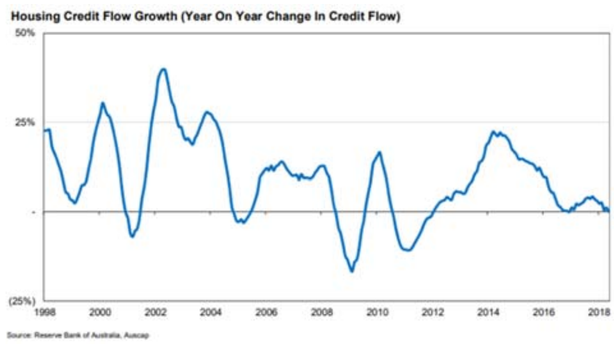
David Bassanese, Chief Economist at BetaShares, has called the US Federal Reserve's job done, noting that inflation in that country has reach the top of the band prevailing over the last generation. Mr Bassanese has previously noted the return to normalcy involved in ten year US bond yields breaching 3%. We have reached the situation where the last vestige of the Global Financial Crisis is the pool of money sloshing around following the central bank money printing spree.

Speaking at the launch of PM Capital's PTrackERS (see Products section), fund manager Paul Moore showed a chart indicating no net inflow of money into US Equity Mutual Funds since 2005, 2007 and 2011. Put another way "Mums and Dads" have not rushed into the stock market and such a rush is a usual precursor of major falls. This is in interesting juxtaposition with a report in the AFR of 25 July that Magellan Funds Management is preparing for the possibility of "*….a 30% selloff in global equities [in 12 to 18 months]*".

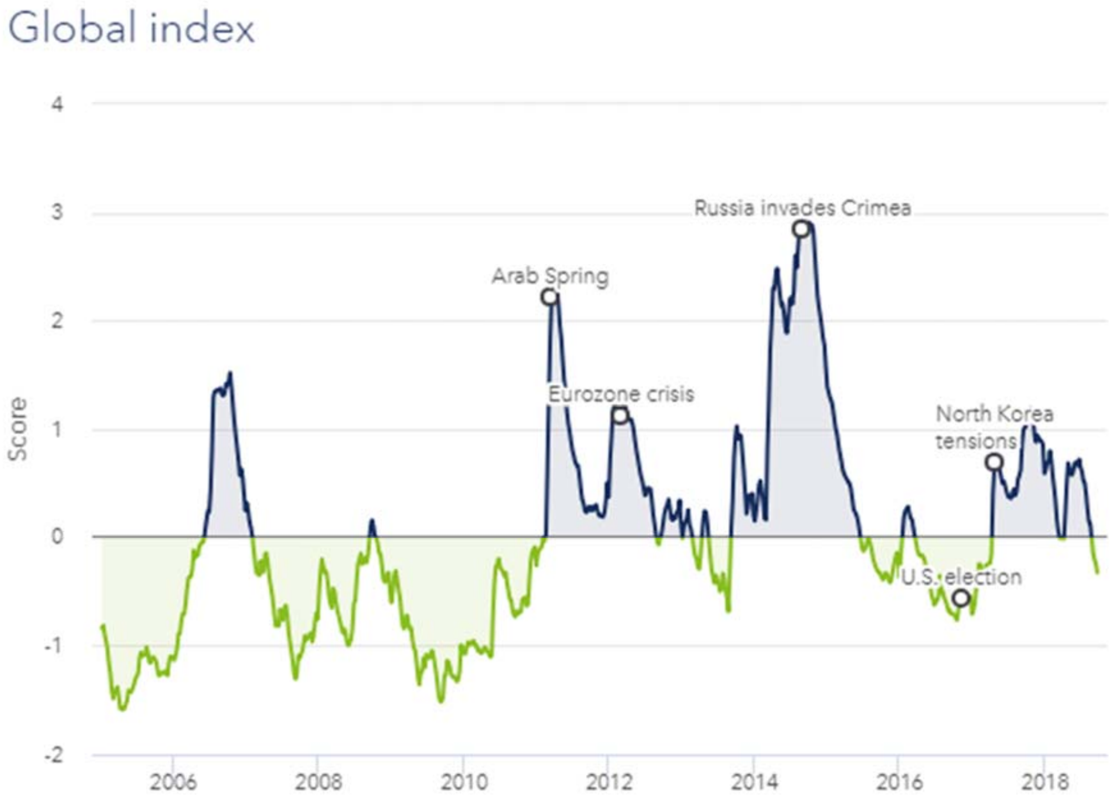



Fund manager Auscap Asset Management's July newsletter showed the continued growth in household debt and posed the question whether this is about to reverse. It noted that the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has noted that banks were using a particular statistic to estimate borrowers' expenses, the "Household Expenditure Measure". The intent of the measure is to provide a floor where potential borrowers under report costs, but some banks have simply used it as the expenses borrowers suffer.

The banks are now on notice from the regulator not to rely on this. Auscap argues tightening lending standards will crimp credit growth with possible adverse effects on a housing reliant economy.




Investment house [BlackRock] quarterly quantifies geopolitical risk and its likely effect on world share markets. The following charts show the September 2018 situation and the history of the index.




Source: BlackRock Investment Institute. September 2018. See Andep's June 2018 Quarter in Review for an explanation of this chart.

## Products

After a 34% spike in its price over the first three weeks of July, Bitcoin resumed its downward trajectory then bounced off a level a few dollars above its 30 June price and ended the quarter higher than it started.

The troubles of the retirement village industry continue. On 24 July, E-zine the Weekly Source reported the Hills Shire council in North Western Sydney will oppose all future applications to establish retirement villages, including seven applications currently in train. Global fund manager, PM Capital has introduced an innovation alongside its listed investment company, PM Global Opportunities Fund (PGF). The innovations is called PTrackERS – Portfolio Tracking Exchangeable Redeemable Securities. The PM Capital PTrackERS takes the form of a new listed investment company (LIC) that is intended to invest in the same way as PGF but have the option to redeem the investment in seven years for its Net Tangible Asset (NTA) backing or to convert to PGF shares. This arrangement is likely to bring the market price of both investments closer to the NTA, particularly as the redemption date approaches. This addresses a major disadvantage of listed investment companies. Unfortunately, the markets saw things differently and the float failed to obtain the minimum subscription.

On 16 July, e-zine SMSF Adviser reported that after clearing its current applications pipeline Westpac will no longer make loans to self managed superannuation funds, convert those loans to interest only or extend interest only periods. This follows a similar action by Westpac subsidiary, St George.

CBA made a similar announcement no longer accepting applications after 12 October. No "Big 4" bank is now lending to SMSFs.

## Politics

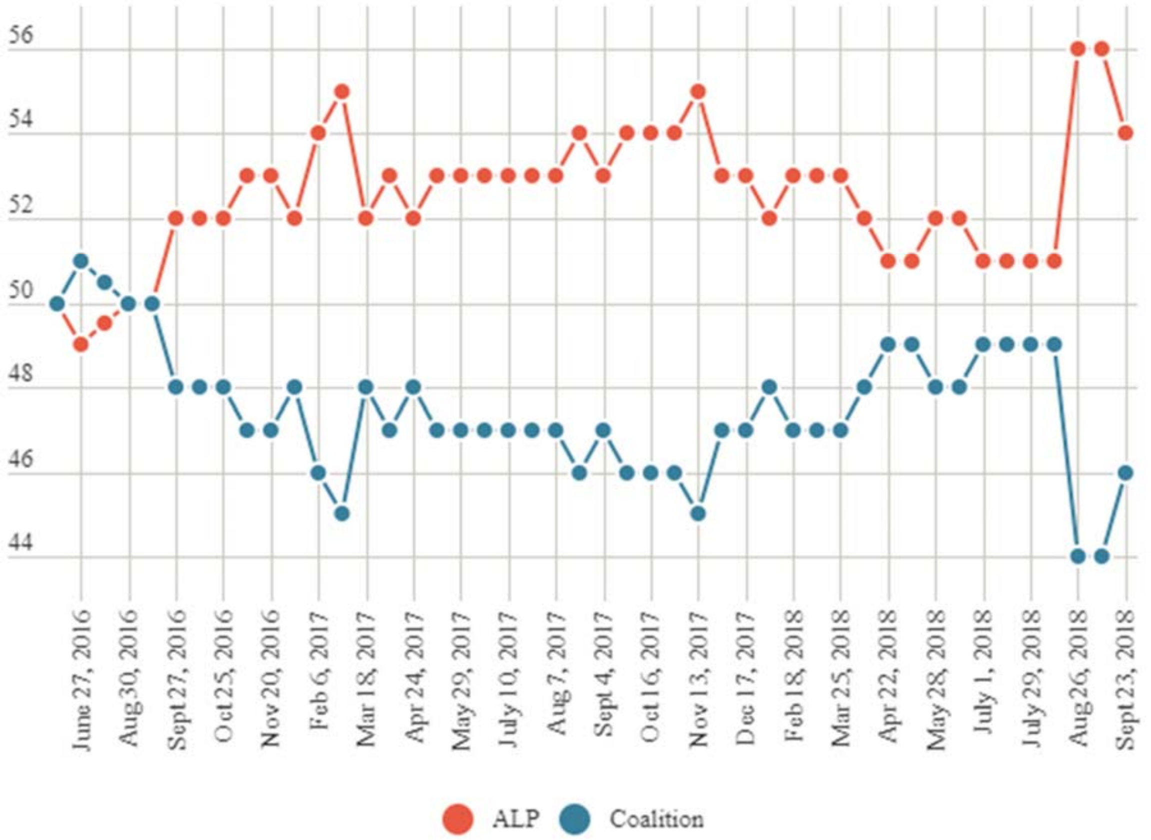
In Sweden, the 9 September election failed to produce a majority for either the centre left government or centre right main opposition Alliance. The Swedish Democrats (self described as social conservative with a nationalist foundation) won 12% of the vote and 11% of the seats.

In Australia, the dual citizenship saga concluded on 28 July with the re election of all of the ejected members in a strong performance by the ALP against the expectations of the commentariat. From this flowed a leadership challenge within the Liberal party. Scott Morrison emerged as the Steven Bradbury of prime ministers on 24 August.

In Pakistan, Imran Kahn's party secured a plurality of votes and seats (32% and 44%) sufficient to secure the prime ministership for him in coalition with smaller parties

The net that we noted last quarter closed on the former Malaysian prime minister, Najib Razak with his arrest on 3 July.

The following chart, from theaustralian.com.au/national-affairs/newspoll, tracks two party preferences.




## Courts

The Royal Commission into Banking and Financial Services misconduct continues to reveal behaviour that can be described as venal and disregard and disrespect for the law and its enforcers. The misbehaviour is on an industrial scale.

The enforcers are also being exposed as weak and irresolute.

The sector less scathed by the Commission is the industry superannuation funds sector, but even these have evidenced snouts in the trough.

Also noteworthy has been the practice of Chief Executives sending underlings to face the music.

All in all, a very sorry tale with the Commissioner having the interim last words *"Too often entities had been treated in ways that would allow them to think that they, not ASIC, not the parliament, not the courts would decide when and how the law would be obeyed or the consequences of the breach remedied,"*

A positive note from the Royal Commission is the announcement by insurer TAL that it will be *"reviewing all claims avoided by TAL on the basis of non-disclosure of mental health conditions in the period 2013-2016*". TAL also appointed a head of mental health in July 2017, increased the training of case managers in matters relating to mental health and provided access to the Remedy "Mindstep" programme for customers with depression.

The NSW Court of Appeal found that an auditor who accepted an assurance from an investment manager, who was a trusted friend of the trustees of a Self Managed Superannuation Fund, (SMSF) that investments in unsecured loans were "cash" was found liable for losses. The liability was limited to funds contributed after the assurance as the Court held the trustees would not have removed misdescribed funds from the management of the friend.

The Supreme Court of Queensland considered but has not decided a case involving a SMSF with a faulty paper trail of deed amendments, pension creation minutes and trustee appointments. It also must decide if a binding death benefit nomination can be extended under an enduring power of attorney. Enduring powers of attorney cannot be used to change a will but may be able to affect the disposal of the larger part of the deceased's assets.

Another case involving SMSFs was decided in the Federal Court. A SMSF invested in a sub fund of the fractional property fund, Domacom, in 2015. Domacom allows investors to buy proportions of particular properties, in this case, a unit in inner western Sydney. The Court held that when the trustees' daughter became a resident of the property in 2017, the "sole purpose" test was not failed.

Treating Royal Commissions as courts, a Royal Commission into the aged care sector was announced on 16 September. Respected E-zine The Weekly Source noted that the share price of the three major listed operators have been in decline for over two years against the backdrop of "*federal government ACFI funding cuts to aged care, and regulatory uncertainty*" and an industry campaign. The Weekly Source noted "*Looking forward two to three years, it is highly plausible that Regis, Japara and Estia will benefit from the Royal Commission. There is no alternative for the government but to allow customers to be charged more for aged care services. It is the only equitable way that workforce wages can increase and more people can be employed.* "

Following the exposure of the restrictive retirement ages of "final four" accounting firms reported last quarter, Deloitte announced it would allow partners to remain beyond age 62.

Following the damming results of the Australian Securities and Investments Commission (ASIC) examination of advice around Self Managed Superannuation Funds (SMSFs) reported in Jun Quarter Review, came the first penalty arising from the investigation. On 19 July, the Australian Securities and Investments Commission (ASIC) released a statement that it had banned James Cribb from providing financial services for four years after it found that he had failed to investigate the individual circumstances of his clients, adequately investigate alternative strategies and products that may have been suitable for his clients' objectives and prioritise his clients' interests over his own.

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