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December 2018 Quarter in Review

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Legislative changes

On 6 December, the Senate passed bills clarifying the ability of superannuation funds to pay reversionary (death benefit) pensions, regardless of whether the recipient has met a “condition of release”.

By the time Parliament rose at the end of the year, it had not passed the budget measures dealing with opting in or out of insurance in superannuation and automatic consolidation of small accounts.

Another non story on legislation is the Australian Financial Review's 12 December article in which it listed senators who are opposed to the ALP's signature franking credit and negative gearing proposals. The proposals have little chance of success before the new Senate commences in July 2019. Assuming the cross bench is and remains uniformly opposed to the measures, the ALP and Greens will need to secure 25 of the 40 Senate seats that will be in play in the election next year for the legislation to pass.

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Personal investment [e-zine NestEgg.com.au](http://e-zine.NestEgg.com.au) published an article reminding its readers of the ALP's negative gearing and capital gains tax policy. From a nominated date, the losses on most new investments will not be offset against non investment income, but carried forward to be offset against future investment income or the capital gains on those investments.

The use of income to offset capital gains is new.

Old style negative gearing will still apply to new housing. In this sense, housing is a favoured investment.

The AFR of 3 October contained an article suggesting the capital gains on former homes of expatriate Australians may be subject to capital gains tax if sold while an overseas resident. This is a matter that was announced with the 2017 budget but only recently gained attention.

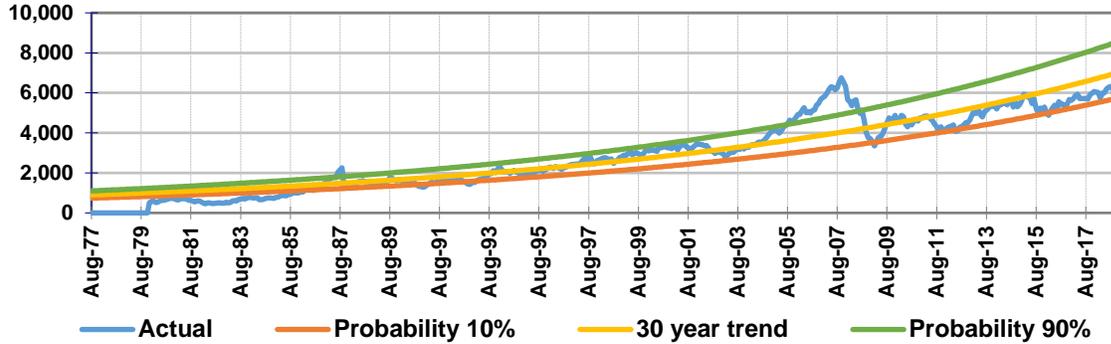
Markets and trend lines

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 quite good value and the USA is marginally below its trend line. On other measures, however, the US market remains high. For example, US share prices measured as a proportion of ten year average inflation adjusted earnings are 64% above the long term average.

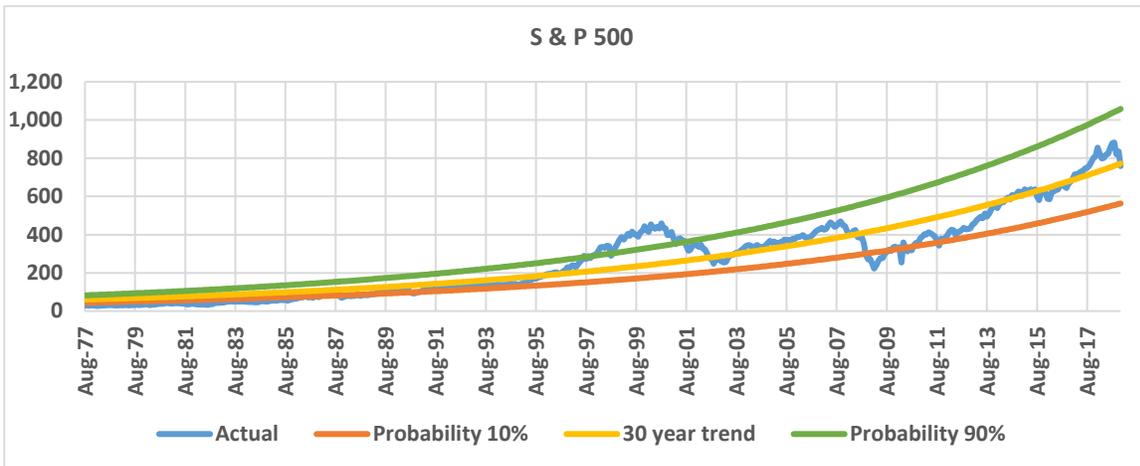
As written in previous Quarters in Review, the 30 year trends encompass a period of steadily falling interest rates, which is at or near its end. These make conclusions from the trend charts optimistic. Recent falls have reduced any extent of overvaluation.



S & P ASX 200



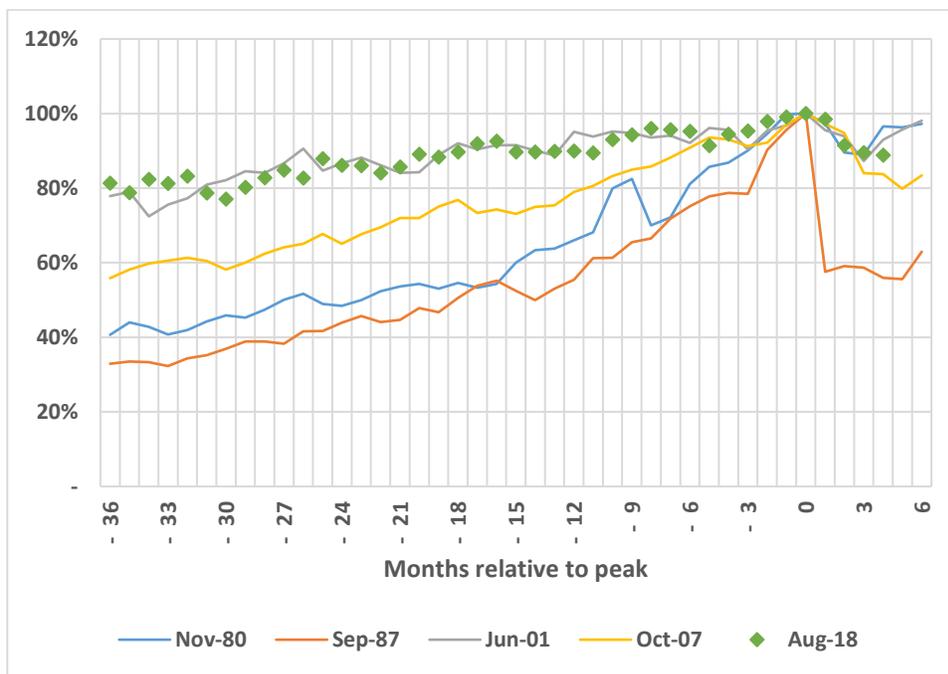
S & P 500



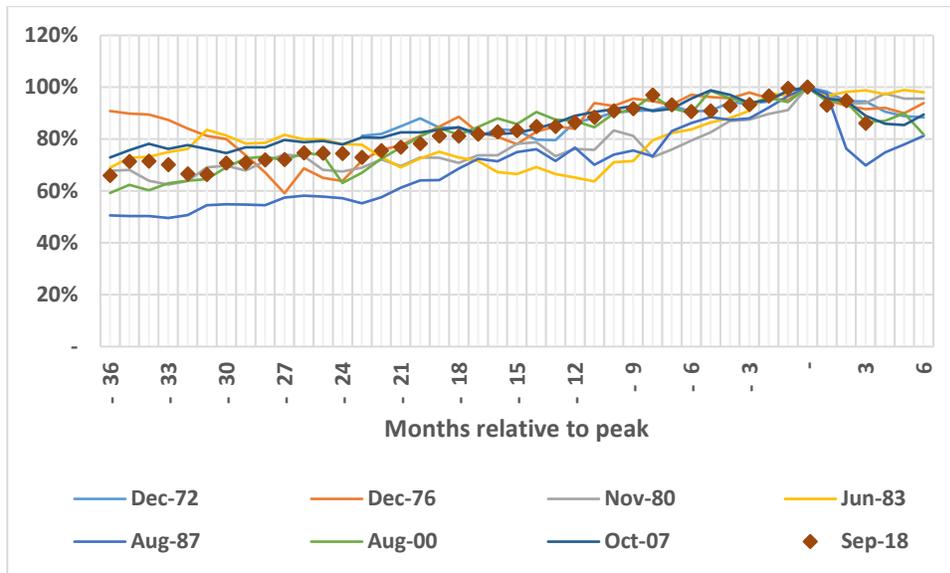


Another graphical view of the markets is a comparison of the movement in the three years leading up to the most recent peak and the following months and the three years before and six months after significant peaks.

The following chart relates to Australia and the diamonds of recent progress are above the lines representing the lead up to all other peaks. The parallel with 2001 noted in the September 2018 Quarter in Review, continues into a relatively shallow decline.



The USA is different, the fall since September is the second worst three month decline in over forty five years.



It remains true that the USA stock market’s three year growth far exceeds that of Australia, UK Germany and Japan. The same conclusion holds for five years. The US stock market is around 20% higher relative to the German market than it was five years ago and the corresponding figure for Australia is nearly 30%.

With the exception of the USA, major stock markets are not overpriced. Concerns are still being expressed for the US market. It remains true that a further deterioration of the US market could be mirrored by other markets, particularly if the deterioration is sharp.

The Australian housing boom is unwinding in an orderly way. The risk is that it 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 remain exposed to the risk of a Chinese slowdown either internal or trade spat related.

Economic milestones

Not a milestone passed, but a milestone in sight. Treasurer Frydenburg announced on 17 December that the Federal Government would operate in surplus in 2019/20, the first time since 2007/08.



The Australian housing market continues its orderly unwinding with no predictions of an early end to the decline, indeed mutterings that it may get worse.

On 31 October, the Australian Bureau of Statistics (ABS) released the September Consumer Price Index (CPI) showing annual inflation had fallen to 1.9%. The slowing of inflation was attributed to falling child care costs flowing from oversupply of places in that industry.

On 24 October, the Bank of Canada announced the fifth increase in the overnight rate (akin to our Reserve Bank rate) since July 2017 to 1.7% the highest rate since 2008.

On 20 November, after a week of falls following two months of gravity defiance, Bitcoin passed through 25% of its peak price. Six days later it briefly passed below 20% of its peak. On 6 December, it emphatically repassed that level, but, by year end, had rallied somewhat.

On 26 November General Motors announced retrenchment of 14,000 employees across North America.

On 5 December, slower than expected Australian economic growth for the September quarter was announced.

The environment

On 28 December, the Chinese People's Daily reported the world's first solar highway opened to the public in eastern China's Shandong. The 2-kilometre long road can convert sunlight into electricity and directly transfer it to the power grid. The highway can also charge electric vehicles.

An interesting example of continuing innovation in the energy sector is [Capricorn Power's](#) engine which converts waste heat to electricity. The engine fits within a shipping container and can be placed near the source of the heat. The first two trials of the technology involve a crematorium and a sewage treatment plant. Heat can be stored and used to generate electricity when demand is strong. Other potential sources of heat for the engine include flares, landfill, solar capture and, interestingly, the waste heat from turbine power generation. *Disclosure: Associates of Capricorn Power are relatives of Associates of Andep's parent company.*

Athlete tracking site, Strava.com, reported that run and cycle commuters saved 0.7 million tonnes of CO2 emissions - about 0.002% of global emissions.



Economic and market statistics

The following table shows key economic and market statistics.

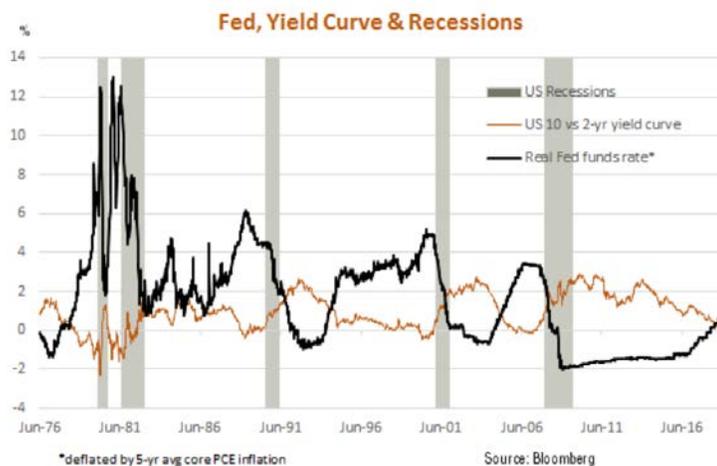
	Latest date	Now	1 year ago	3 years ago	7 years ago
S&P /ASX 200- Australia	Dec 18	5,646	6,065	5,296	4,057
Annual change to latest date			-6.9%	2.2%	4.8%
S&P /ASX 200 dividend yield	Dec 18	4.52%	4.08%	4.79%	5.11%
S&P /ASX 200 P/E ratio	Dec 18	13.7	16.20	15.10	12.20
Topix- Japan	Dec 18	86.2	104.80	89.20	42.00
Annual change to latest date			-17.7%	-1.1%	10.8%
S&P 500- US	Dec 18	759.1	809.6	619.0	380.8
Annual change to latest date			-6.2%	7.0%	10.4%
GDAXI- Germany	Dec 18	10,558	12,898	10,486	6,459
Annual change to latest date			-18.1%	0.2%	7.3%
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	Sep 18	113.50	111.40	108.00	99.45
Annual change to latest date			1.9%	1.7%	1.9%
Unemployment	Nov 18	5.1%	5.40%	5.84%	5.20%
Gross domestic product \$ m per quarter	Sep 18	460,827	430,343	410,619	369,737
Annual change to latest date			7.1%	3.9%	3.2%
RBA cash rate	Dec 18	1.5%	1.50%	2.00%	4.25%
3 year Commonwealth bond	Dec 18	1.9%	2.03%	2.10%	3.13%
10 year Commonwealth bond	Dec 18	2.4%	2.58%	2.85%	3.83%
USD/AUD	Dec 18	0.7058	0.7800	0.7306	1.0156
Annual change to latest date			-9.5%	-1.1%	-5.1%



Other peoples' views

Fund Manager, [India Avenue](#) noted the resignation of the Governor of the Reserve Bank of India after a period of tension between him and the government and that he was replaced by the former Economic Affairs Secretary and Revenue Secretary in the Ministry of Finance. It opined that *“The new appointment should lead to a more coordinated effort between Government and Central Bank.”*

In a website post of 12 December 2018, BetaShares' Chief Economist, David Bassanese noted that each of the five most recent recessions in the USA have been preceded by the yield on US government 10 year bonds being less than that of 2 year bonds. This is called a “yield inversion” and every yield inversion in the USA has been followed within an average twenty one months by a recession. He further notes that the US share market has peaked an average eight months after an inversion.



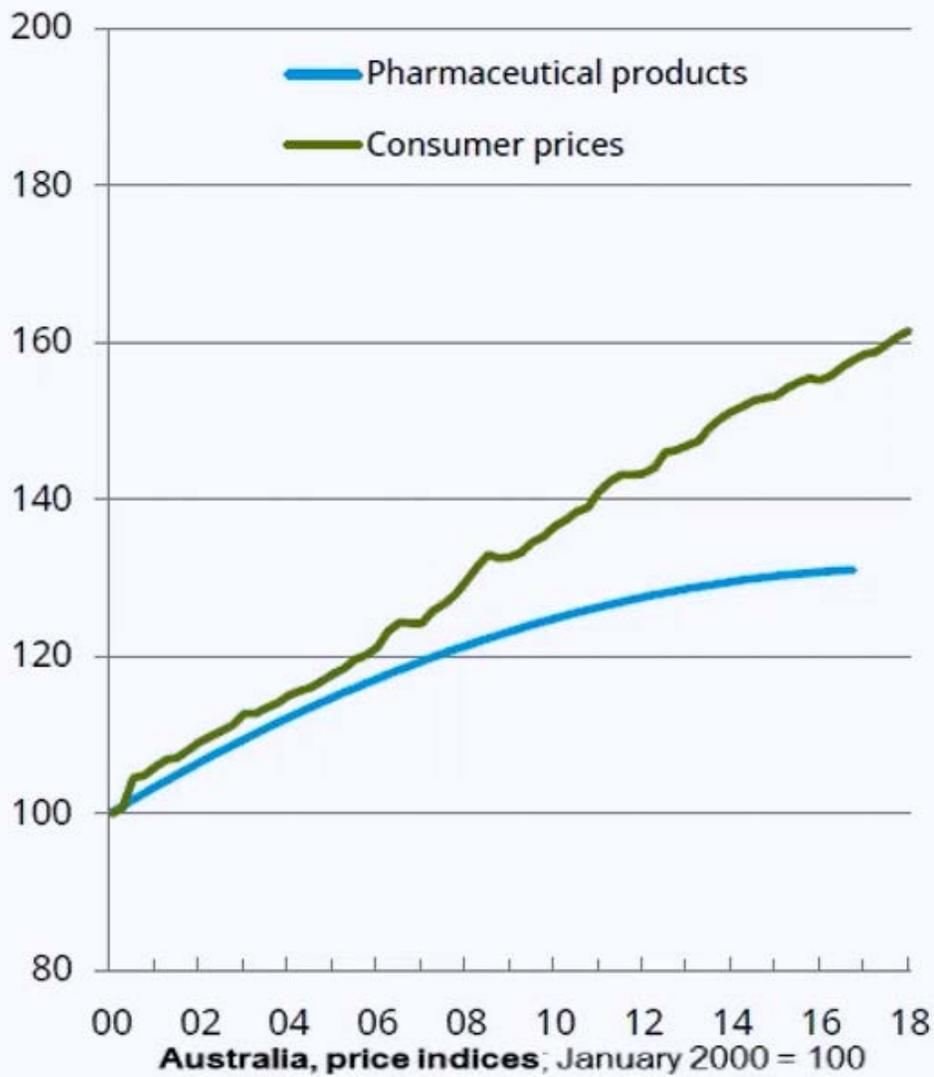
Currently three and five year bond rates have inverted, but not yet two and ten. Mr Bassanese argues that all other recessions have occurred when interest rates have been higher relative to inflation than they are now. He evidenced this with the above chart. One could note that rising interest rate are also a recession precursor.

Mr Bassanese went on to note that recessions have also been preceded by sharp rises in jobless claims and sharp declines in the [Conference Board leading index](#), which are not yet evident.

At a webinar hosted by a platform provider, Hub24, Andrew Fleming from investment manager, Schrodgers, identified the fact that contrary to the USA situation, drug prices in Australia and the UK have risen slower than consumer price generally. He attributed this to the purchasing power of governments. His chart demonstrating this for Australia follows.



Australia



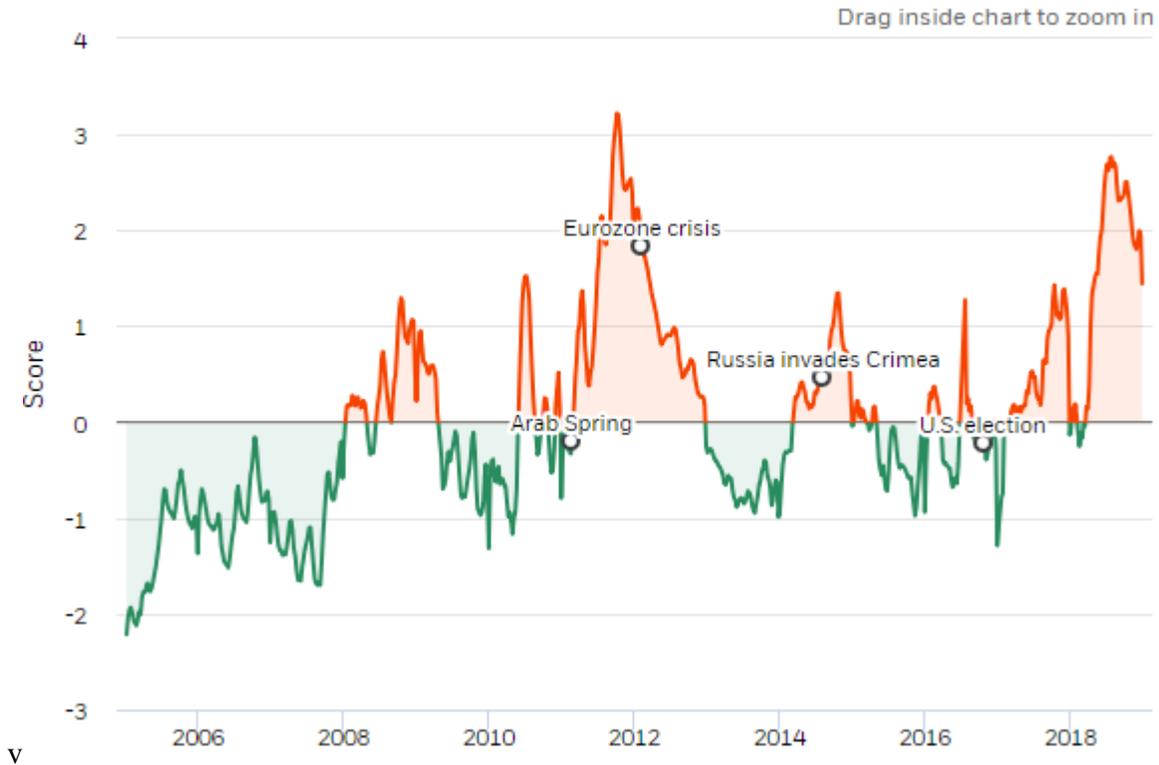


Investment house BlackRock quarterly quantifies geopolitical risk and its likely effect on world share markets. The following charts show the December 2018 situation and the history of the index.





Global index



Source: BlackRock Investment Institute. December 2018. See Andep's June [2018 Quarter in Review](#) for an explanation of this chart.

Products

On 17 October 2018 [BetaShares Chief Economist, David Bassanese suggested](#) that due to the recent pullback, it might be an opportune time to consider a tilt towards more value orientated investing. Most traditional investment vehicles such as LICs like AFI and ARG, weight their holdings based on the largest companies in the portfolio. While this method does have its



advantages, an alternate approach to this can be done through Fundamental Indexing, which overweights relatively cheap stocks while underweighting relatively expensive stocks (relative to their price-to-book and price-to-earnings long term average). As David explains, this type of strategy is likely to outperform growth orientated investing if there is a rotation back to “value” stocks. An example of an investment vehicle which operates in this manner is the [Betashares FTSE RAFI Australia 200 ETF \(QOZ\)](#), which is a broad market Australian ETF with a value tilt.

Politics

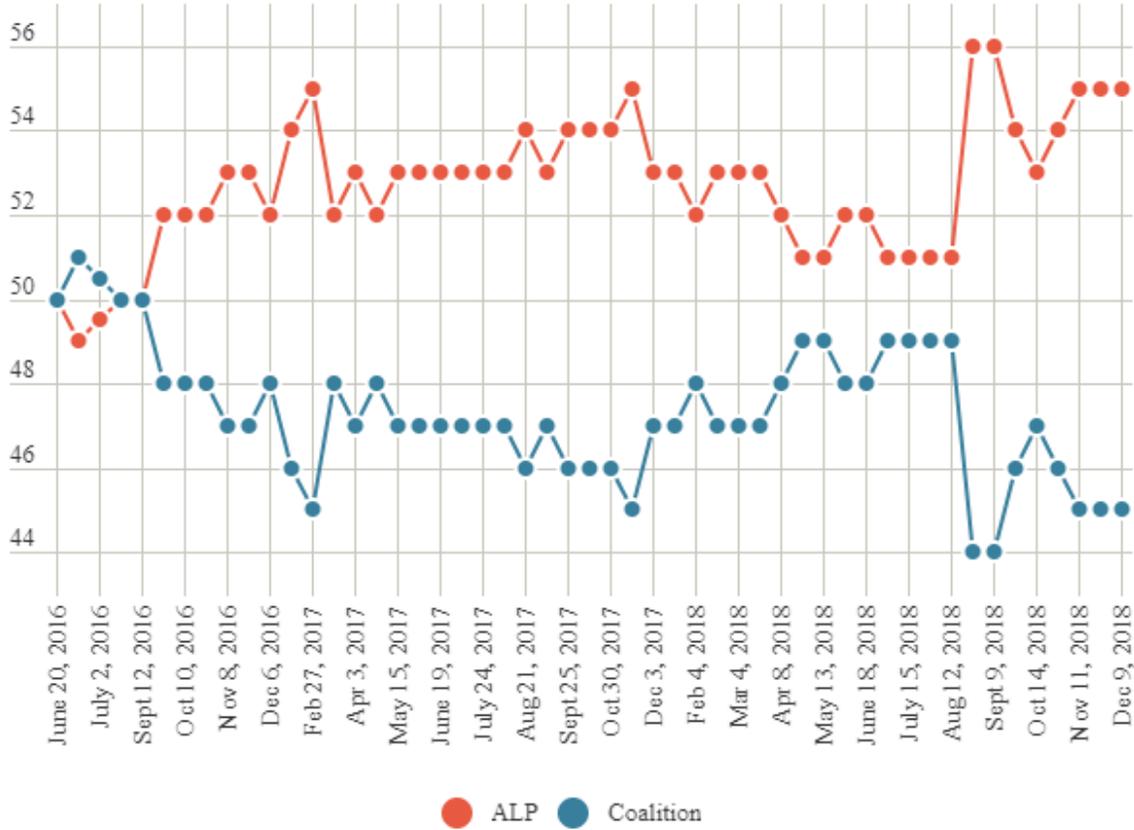
Elections decided in the quarter included.

Jurisdiction	Result
Brazil	Jair Bolsonaro from right wing to far right Social Liberal Party elected president
United States	Democrats secured control of the lower house and seven state governorships
Victoria	ALP retained power with a majority increased by 8 seats
Wentworth (by election)	Won by independent candidate depriving the Coalition of its parliamentary majority.

The following chart shows two party preferred voting indications published by the Australian newspaper.



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Courts

The AFR of 4 October revealed that in Queensland, AMP and another property developer, in a fit of arrogant hubris, have hired lawyers to explain to valuers that their professional judgements of values of a development now approaching completion are wrong. Apparently, they don't accept that the property tide has turned. On 1 November, the same paper reported investors bulk purchasing units where pre sales had fallen through for discounts up to 25% of off the plan contract prices.

The matter has now flowed over into the Royal Commission with a submission from the Australian Property Institute formally alerting the Commission.



In early December, the Federal Court imposed a fine of \$200,000 personally on the former managing director of the Murray Goulbourn Cooperative for misleading farmers about the price the Co op would pay for milk.

Miranda Brownlee of Momentum Media [reported](#) in the E-zine “SMSFAdviser” that “In the 2017/18 financial year ASIC removed a total of 155 SMSF auditors from the register including twelve that were disqualified for breaching auditing standards and independence requirements.”

Stung by criticism for its passivity regulator ASIC is in the courts fighting to see documents related to the notorious Clayton Utz much revised “independent” report into the AMP “fee for no service” scandal.

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