March 2018 — Over the Horizon Market Commentary by David Offer

The Australian share market was down 4.1% in March, closing at 5,868 points. This was in part due to following the lead of global share markets, with the US share market off 3.7%. Financial headlines suggest the primary reason for recent market weakness is a potential trade war between America and China.

President Trump's knickers are in a knot over the value of Chinese goods imported into the United States versus the value of American goods exported to China rising to a record $375.2 billion in 2017 in China's favour. This gap equates to a value of $1,152 per US resident. Interestingly, America runs a trade surplus with Australia that last year reached $US14.55 billion/$AU19.1 billion. This equates to $767 per Australian resident. *Under Trump's logic, should Australia declare a trade war on the US …* On this topic, it is worth noting that Australia runs a trade surplus with China of approximately $AU31 billion that is worth $1,248 per Australian. Thankfully, this only equates to $22 per Chinese resident and so has probably slipped under the Chinese radar. We certainly do not want China to declare a trade war on us! With President Xi starting to make conciliatory overtures to the US, I suspect that a genuine trade war will be diverted.

If there is further short term US share market weakness, the overriding reason is likely to continue to be excessive US share market valuations losing out to rising global interest rates that start to provide investors with alternative investment options.

For the Australian share market, the Financial Services Royal Commission has put a further dampener on finance related shares and our Big Four Banks in particular. The brief given to the Banks selected by Royal Commissioner Kenneth Hayne was for all dirty laundry to be provided so that he and chief laundry assistant Rowena Orr could kindly air it. Credit should be given to the services provided by Hayne and Orr as they have very effectively made highly paid Bank executives look extremely incompetent and on that measure we can say the Royal Commission will be a success. On the day I listened in, CBA was taking a grilling for selling personal insurance that some policy owners would never be able to claim on. While this occurred years ago and premiums have since been refunded, CBA's delays in changing insurance policy documentation and providing refunds as well as general reluctance to cooperate with ASIC made for a tough day in the box.

While anyone paying for something that has no benefit would rightly be upset, the significance of this issue within the CBA business amounted to insurance premium refunds of approximately $10 million or 0.25% of one year's profit. I suspect the Bank's apparent reluctance to deal with such issues may not just be one of perceived arrogance, but equally one of priorities and difficulties of dealing with a regulator (ASIC) that values press releases justifying its existence over criminal prosecution. The Big Four Banks have become big ships to turn and with their incumbent bureaucracy in place, in part due to the immense regulation they face, the most straight forward of decisions become complex and any changes that need to be made become extremely difficult to implement.

It is surprising that a Royal Commission on our Banks would be called at a time of record low bad and doubtful debts and with loan defaults at historically low levels.

Other than making arguably overpaid Bank management look stupid and incompetent, unless you are an East Coast lawyer feasting on the $1 billion in associated costs this Royal Commission will generate, at this point it is still unclear what overriding long term positives this Royal Commission will bring. There are plenty of potential negatives, some of which include;

- In an excessive regulatory environment, Banks will go back to basics. CBA, National Australia Bank and ANZ have all stated they will exit their wealth management businesses with a number of businesses already sold. Coupled with technology disruption, our Big Four are set for massive job losses as automation makes jobs redundant and regulatory driven policy prohibits staff from making decisions of substance or value. NAB has already stated that 4,000 jobs will go by 2020, a reduction of 12% on its current workforce of 33,422. We suspect this is just the beginning and that ultimately Bank work forces could easily halve. If so, this would represent job losses of 70,000+ people across Australia's Big Four.

  Any such reduction in staff is likely to have an immense impact on existing Bank branch networks. In a region like South West WA, where there are approximately a dozen branches per Bank, it would not surprise to see these reduce to three to four and only be represented in major centres. While job losses would boost profits, it is not good news for the broader economy … or those who have lost their job!

- Banks appear to be increasingly obliged to take responsibility for when loans go bad. To offset this risk, borrowers will need to demonstrate an increased ability that they will be able to repay their loans. Currently the Banks consider serviceability after the 'basic' Home Expenditure Measure benchmark, currently a low $32,400 for a family of four. The 'lavish' HEM benchmark of annual expenses at $58,200 is arguably more realistic. However, if the higher benchmark was implemented, homebuyers borrowing limits are likely to be cut by approximately 40% with those on lower incomes the most severely impacted. Lower income earners will be increasingly restricted from accessing the housing market. (Perhaps the Government can start lending to our newfound disadvantaged so that taxpayers can then foot the bill when loans are not repaid.)

- In ensuring loans can be repaid, this suggests that greater restrictions will apply for those approaching retirement. It will be interesting to see how far this will go. For example, with our national retirement age now 67, would it be appropriate for a Bank to lend on standard 25-year repayment terms to anyone over the age of 42? Alternatively, the Banks could lend with a higher prepayment schedule to ensure debt is repaid faster. However, in this scenario of curtailing the borrower's cash flow, this could potentially be at the expense of other wealth accumulation measures such as salary sacrificing into superannuation or funding basic commitments such as health and children's education.

- With Banks either unable or unwilling to lend, shadow banking will become more prevalent with those involved potentially exposed to exploitation. Think of small businesses that are forced to borrow money at excessive rates because a regular bank will not lend to them or the naive investor who is promised 10% in regular income but loses everything when their asset, being a loan, goes bad.

Overall, Banks are likely to be much more gun shy in lending money going forward and this will add to already tightening credit conditions. This will be a further negative for our inflated, but starting to sag, Eastern States property markets.

At some point Australia will need to move on with our obsession with ever increasing bureaucracy and regulation. We need to remind ourselves that it is the outcome and not the process that ultimately counts. As we increasingly prioritise box ticking and documenting to ensure we and everyone else can demonstrate 'doing the right thing' in lieu of people no longer taking responsibility for themselves, this comes at the expense of productivity. Ultimately this will impact on everyone's standard of living.

As a final point, last month we made mention of Labor's proposed canning of franking credit refunds. Since then Labor have amended their policy with an existing 'pensioner guarantee'. For existing people (as of now) on the Age Pension who are eligible for franking credit refunds they will continue to be eligible. For those who become pensioners in the future, they will not. That people in the same situation can be treated vastly differently simply because of their date of birth or past circumstances sums up aptly the pathetic level of Government policy development for our Nation at this time. I suspect (and certainly hope) that Labor will materially revisit their franking credit policy. Hopefully, they will acknowledge that double taxation is not fair and abandon this policy altogether.

If you would like to discuss any aspect of your portfolio, please do not hesitate to contact our office.

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