HORIZON INVESTMENT SOLUTIONS

April 2018 — Over the Horizon Market Commentary by David Offer

Last week the Federal Government released its 2018/19 Budget followed by the Labor Party's response.

Increasingly 'Budget week' has less to do with managing the Nation's finances in the year ahead and more to do with reaffirming the aspirational political goals of our major political parties. These are increasingly based on some future point in time so far away that the reality is no economic forecasts today will have any relevance by the time we get there. Likewise, the people making these long term aspirational predictions will most likely have either retired or be in another occupation by the time these dates eventually roll around … and so conveniently don't have to take responsibility or can blame subsequent decision makers as to why their assumptions fell short.

In terms of the 2018/19 Budget serving as a reaffirmation of party values, in the Blue Corner, the Liberal Party made two key statements. The first is that the level of government spending relative to the broader economy needs a cap. A benchmark of tax to GDP ratio of 23.9% has been set. What this means (especially in a downturn when revenue falls and government spending tends to rise), why this percentage figure, and the practicalities of implementation and sticking to it are hard to quantify. However, at least they are focused on controlling Government spending so that's something.

The second is that through bracket creep and existing marginal tax rates, too much tax is being paid by too few and this is unfair. This is highlighted by the reality that 6% of taxpayers (say 3% of the population) are paying 36% of the Nation's tax while those on a taxable income of $41,000 or less, which equates to 2.7 million taxpayers, are contributing just 2% of the Nation's tax. The Liberals will seek to address this by raising marginal tax rate thresholds over a 7-year timeframe, with most of the change occurring in the final two years.

In the Red Corner, Labor's budget reply promises are about wealth redistribution through higher taxes for the benefit of the majority of Australians. This is through creating a $200+ billion war chest via maintaining the corporate tax rate, maintaining the existing high marginal tax rates for high income earners (49% for the top personal income tax bracket), cessation of negative gearing tax breaks, reduction in capital gains concessions, reduction of tax benefits of using family trusts and reducing or ceasing franking credit refunds. Labor knows that the people most impacted by their policies are unlikely to be Labor voters and as such are fair game. They are unashamedly playing class politics and if this gets them across the line then it will be (arguably) a good political strategy.

Current Sportsbet odds are paying $1.50 for a Labor win and $2.40 for a Coalition win at the next Federal election.

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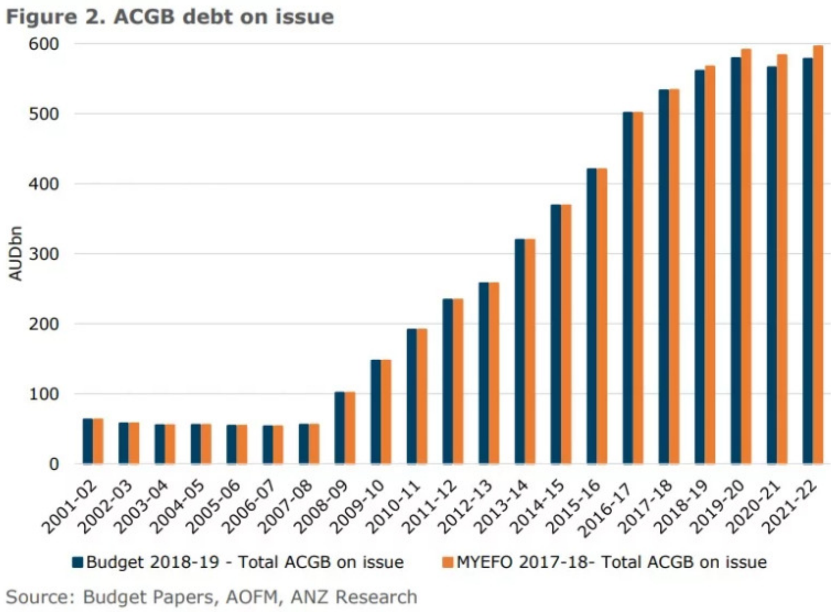
Irrespective of one's political persuasion, I take some heart that returning the Federal budget to surplus is increasingly a priority for both major Federal parties. The concerns of voters are perhaps being heard, as evidenced by a recent Australian Financial Review survey showing 32% of respondents wanted improved revenues spent on retiring government debt, versus 27% asking for personal tax cuts and only 10% wanting a company tax cut.

My optimism that actual surpluses will be achieved is however diminished by the duration and extent of overly optimistic growth assumptions used by Treasury for our economy. From 2.4% growth over calendar-year 2017, Treasury forecasts economic growth to lift 2.75% this year and remain at 3% thereafter; a sustained improvement on the past five years. It is improbable that growth will be steady and stronger for the entire 7-year duration of time on which current forecasts are being made. It also ignores the reality we are post growth two of the Nation's major economic growth levers; mining and housing construction. Our Nation is also well down the path of using the 3rd lever of government spending which presently sits at 'pin your ears back' levels. (We do expect a modest rise in mining activity in the years ahead but not to the same extent as the prior mining boom.)

It is interesting Treasury are forecasting 10-year government yields to rise to 5% by the end of the Liberal's forecast period in 7 years. This would infer at least 9 0.25% interest rate rises. This is a big call given interest rates have remained unchanged since August 2016 and some forecasters are now suggesting rates will remain unchanged to 2020. While rates could rise due to external factors, namely rising US interest rates, under such circumstances this would be a negative for our economy. We strongly doubt such a large number of interest rate rises occurring going forward due to economic growth … our Nation is simply swimming in too much debt both at an individual and government level.

As such, the optimistic assumption by both major Political parties that the Budget will return to a sustainable surplus is likely to be misplaced. Last week I received an enthusiastic email from Senator Dean Smith touting the fiscal prudence of the Liberal Party. In his words he stated 'nothing tells a story better than a graph' and provided this link to illustrate his point. Tellingly, the one graph he omitted was the actual Federal Government debt, which is as per below;



Source: ANZ Bank

While this graph shows a slight improvement this year on last thanks too higher than expected commodity exports, that Australia's debt will continue to hover just shy of $600 billion is hardly reason to celebrate. Ultimately, if we do return to surplus, this will be largely dependent on commodity prices and in no small part due to the massive mine and oil and gas expansions in Western Australia over the last decade. Even if we do return to sustained surpluses, from net debt of $600 billion, it's a long road back.

Last week Peter Costello stated in an interview to Leigh Sales on the 7.30 Report that both he and she would both die of old age before Federal Government debt was extinguished. I agree that a material ongoing Federal Government debt is the one certainty of our Nation's finances. That our Nation's finances have been trashed in little more than a decade and during the biggest economic expansion in history by China and Asia, for which Australia was a core beneficiary, is nothing short of a national disgrace. A few key political leaders have been responsible for an immense amount of economic vandalism and wealth destruction.

Away from the Federal Budget macro themes, we attach the key proposed Budget changes and what they mean to you.

One change of note is the proposal to replace the annual SMSF audit with a three yearly audit. This will represent an annual cost saving for SMSFs and as such this is a proposal we support.

Against the background of the Royal Commission into banking and finance, we do view the timing of this proposal surprising. The Royal Commission has found plenty of anecdotal evidence that it has been big business for Financial Planners and other trusted Advisors to recommend to clients to establish a SMSF so as to borrow and invest in residential real estate. Should East coast property markets soften as we expect, with leverage involved, these SMSF stand to suffer material falls in value. This will cause much investor angst and cast a negative light on the SMSF sector. As such, it is a surprising time to reduce scrutiny.

As a firm, we are strongly against direct borrowing in superannuation and in particular against residential property. It is not a strategy we have ever recommended and we are unlikely to ever do so.

On a more positive note, we have recently had a new staff member in Ben Talbot join our firm. To date, Ben has had a varied career in aviation, business advisory services and more recently property and business development. Ben's roll within the business is to assist in building our knowledge base across smaller 'Green Chip' and emerging companies. As a business, our goal is to build a detailed understanding of a large number of businesses that fall outside the ASX top 50 largest listed companies. While relatively few large companies dominate the ASX, our view is the majority of these large Companies are now ex-growth (banks), cyclical (resources) or the few exceptions that offer growth (Macquarie and CSL) their high valuations more than reflect this.

In addition to third party research and company announcements, our core method of building company awareness is through talking directly to senior management such as the Chief Executive Officer, Chief Financial Officer or an Executive Director of a company. These conversations are documented for future reference and if appropriate, summarised in a format to share with you. As an illustration, attached are three such summaries concerning Metals X, G8 Education and Thorn Group. These are three companies we feel have material upside from current levels.

Depending on individual client risk profiles and composition of existing portfolios, in time we will selectively look to build our weightings in smaller and emerging companies within portfolios with the goal of boosting long-term investment returns.

Our firm is also in the process of establishing a unitised managed fund that will be both seeded and managed exclusively by our office. Depending on overall market conditions, this fund will have between 60% and 100% of available funds invested with the balance held in cash or fixed interest. Of the funds invested, approximately half will be invested in the largest 100 ASX companies, predominately for dividend income, portfolio stability and identified trading opportunities. The balance will be invested in smaller and emerging company opportunities such as the three identified above.

Initially this fund will only be available for sophisticated investors; defined by the Corporations Law as investors having either $2.5 million in net assets for an annual income greater than $250,000. However, once the fund has an established track record, our intention is to make the fund available to all investors.

Ben will also assist in portfolio communication and will look forward to providing updates on shares we research should they be in your portfolio.

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

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