November 2018 — Over the Horizon Market Commentary by David Offer

Our wild ride on the Australian share market continued in November, with the All Ordinaries index off 2.77% to close at 5,749 points. This weakness has continued into December and at the time of writing we are off a further 1.25%. From our August high of 6,481 points, our share market has now fallen 12.4% and is approaching a 2 year low.

Marcus Padley from Marcus Today puts in perspective the current correction. 'Since the GFC ten years ago (down 54.25% in 339 days) we have seen the following Australian market corrections:

Minus 16.34% in 55 days.
Minus 22.75% in 122 days.
Minus 21.51% in 239 days.
Minus 9.96% in 72 days.
Minus 5.13% in 111 days.
Minus 6.63% in 57 days (the correction in February).

If you average those, then the overall average correction is 13.72% and takes 109 days. The current correction has been 13.2% and it has taken 59 days. On that basis we have already completed an average correction in half the usual time. It's been pretty savage as corrections go.'

Within this correction there have been some absolute standouts. None illustrates this more than Lend Lease, which from a price of $21.50 in August, has almost halved on the back of downgrades stemming from cost overruns on engineering projects and is presently trading at $11.60. We view Lend Lease, along with many other shares as being oversold at this time and as such feel the current correction is starting to provide some compelling buying opportunities, a number of which were summarised in last month's letter.

Share markets hate uncertainty and at the current time there are a number of unknowns. The first is the impact of the current trade war between the US and China. Notwithstanding this may create opportunities in the short term for Australian businesses to trade directly with China at the expense of American competitors, the larger concern is that the trade war impacts economic growth within both American and China. Given these are the world's largest economies, this then has a subsequent negative impact on global growth.

Given the number of moving parts to this dispute and given the personalities involved, forecasting any outcome with conviction is futile. However, one wonders if Trump is perhaps playing a similar negotiating strategy to North Korea, in ratcheting up the rhetoric at the start of the negotiating process to subsequently give ground in seeking a resolution. Trump is two years from an election and will be mindful of actions that could crimp a strong US economy, something he views (rightfully or not) as one of his major achievements.

An indirect positive stemming from concerns over the underlying strength of the US economy is that the US Federal Reserve may slow the rate of ongoing interest rate hikes in the US and this would be positive for maintaining low interest rates globally.

Next is the ongoing Brexit saga. Good luck England (and more specifically Theresa May) in sorting that out to the satisfaction of the masses! Whether England has a soft or hard exit, the answer will be known by 29 March 2019. Once this date is behind us, for better or worse, the market should finally have certainty regarding the Brexit outcome. The other outcome that could eventuate is that England remains within the European Union, which would be humiliating for England and could result in considerable civil unrest given the wishes of the masses in voting for Brexit would appear to have not been respected.

Closer to home the Financial Services Royal Commission has sent shockwaves through the banking and finance sector as well as wider corporate Australia. All listed businesses in this sector have been hit hard as the worst of business practices have been highlighted publicly over the last 12 months. With ASIC now starting to progress criminal charges in instances where criminal misconduct has been highlighted by the Royal Commission, the whole sector has curtailed ongoing business activities. This has extended to a reluctance for our Banks to lend and as such, Australia is experiencing a self-imposed credit crunch. Commissioner Hayne is due to provide his final report on 1 February 2019 and while this will not likely improve the availability of credit short term, it will provide guidance to the wider industry on expected conduct going forward as well as likely legislative changes. All things equal, this improved certainty will likely be viewed positively by the share market.

With respect to our major Banks, our expectation is that they will be required to take major remedial action for perhaps 2 - 4 years and that this will impact on profits and, in turn, dividends paid. Assuming a 20% reduction in profits (which would amount to around $2 billion a year by CBA alone in remedial action, penalties and increase in bad and doubtful debts – more below) and a reduction of dividends paid by a similar amount, this could result in the following corresponding reduction in dividend yield for our major Banks;

Bank	Current Cash Div	Current Grossed Div	Revised Cash Div	Revised Grossed Div
ANZ	6.35%	9.07%	5.08%	7.25%
CBA	6.18%	8.83%	4.94%	7.05%
NAB	8.29%	11.84%	6.63%	9.47%
WBC	7.40%	10.57%	5.92%	8.45%

On a historical basis, the revised lower dividend yields still remain attractive and as such, consider that much of the bad news is now likely factored into our major Bank share prices. While we have no expectation of underlying revenue growth for the foreseeable future, simply getting to the end of the current remedial action process will provide scope for capital growth in Bank share prices as earnings normalise. We are also mindful of our major Banks capacity to cut costs as they simplify into the future.

Also stemming from the Royal Commission equity crunch is the changing fortunes of the East Coast property market. How this may play out in the broader economy is also impacting on share market sentiment. That East Coast property prices would at some point cool should surprise nobody, with Sydney in particular being simply unaffordable. Sydneysiders are now having to adjust to the reality of no housing price growth for the last 3 years! While this is viewed as something of a shock to our fellow Eastern States citizens, it is hard to have much empathy from WA, where we have seen 12 years of property decline thus far and falls in the order of 25% from 2006 highs.

Our view is that Sydney property, which has slid 10% to date from its peak approximately 18 months ago, has further to fall with total falls of 20 – 25% probable. Should this eventuate, we would once again consider Sydney property affordable. While no doubt an unpleasant experience for those that paid too much during the boom, we do not view East Coast housing becoming affordable as a bad thing!

We don't support doomsday scenarios (though many would argue a fall of 25% fall is a doomsday scenario) as plenty of East Coast economic stimulus remains with State and Federal Government infrastructure spending about to go into overdrive, low unemployment with signs of wage growth in a number of sectors as well as interest rates remaining historically low.

A 25% fall in house prices would likely result in an uptick in bad debts for Australian banks, however, we don't believe this is likely to be significant. For example, Australian banks appear to have successfully managed the significant downturn in property prices experienced in Western Australia to date.

The final factor potentially impacting markets is a likely change in Federal Government in May. While the share market has tended to historically favour/prefer Liberal over Labor Governments, with the near certainty of a Federal Labor Government by May 2019, it is likely our share market is already beginning to factor in a new Labor Government and may in-fact go up, post a Federal Labor win. With Labor's negative policy on refunding of franking credits, this will no doubt dismay many share investors. However, for franking credit refunds to be abolished, Labor will still need to get its policy through the Senate and presently faces considerable opposition from sitting Independents who have almost uniformly opposed the policy.

With many of the above issues likely to be worked through in the first half of next year, the level of market uncertainty currently being experienced is likely to diminish. If so, we would expect our share market to rebound and as such view current weakness as a buying opportunity. As always, a reserve of cash to provide investment flexibility should be retained and there is always the prospect of other negative issues presenting and impacting adversely on share markets.

On a separate note, as part of meeting our ongoing Australian Financial Service License compliance obligations, please find enclosed our updated **Financial Services Guide** (FSG). In providing our updated FSG to you, we stress that there is no change in how we presently operate. The key change in our updated FSG provided is a link to Pershing's FSG; Pershing being our in-house broker for all ASX and international share trading.

Finally, on half of everyone in our office I take this opportunity to wish you a Merry Christmas and safe and prosperous New Year and we look forward to continuing our relationship with you in 2019.

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