January 2018 — Over the Horizon Market Commentary by David Offer

The US share market hit a record high of 26,617 points on 26 January. Since then and into February, it has been a tumultuous period for US shares. On 8th February, the US experienced its biggest one-day points fall in history, falling 1032 points. Coupled with some additional falls, the US market is presently down 7.5%. At its worst, the US market was off 12.2%. The Australian share market, like share markets globally, has followed the lead of the US market but not having experienced recent US share market exuberance, our downside response has been more tempered. For January, the All Ordinaries Index declined 0.3% to close down 21 points at 6,146. Currently our share market is down 227 points for February, a fall of 3.7%, with our market presently trading at 5,919 points.

The reason for the sudden but, from our perspective, not unexpected volatility in US markets can be attributed to a rapid change in market expectations on the future pricing (yield offered) on US Government debt. This is significant as US debt acts as the benchmark rate for sovereign debt globally and in turn the pricing of debt instruments in general.

As per the chart below, 10-year US debt has seen a spike in yield offered from a low of 1.4% in mid-2016 to 2.86% at the current time. As bond yields go up, this puts pricing pressure on other forms of investment such as shares and this has made an extremely expensive US share market vulnerable to being repriced (read fall in value).

The rising cost of US debt is due to two reasons.

Firstly, the market's changing expectation of future US interest rates. To date, markets have correctly predicted that US interest rates would remain benign despite ongoing hawkish comments from the US Federal Reserve. However, with America at full employment, the current US tax stimulus package being enacted runs the risk of overheating an already buoyant US economy.

2018 may be the year when the US labour market finally leaps into life as firms are forced to pay more in wages. There is emerging evidence that a very timid post GFC US employee is starting to look further afield than their current employer for job opportunities. When companies look to replace employees who have left, it appears that replacement salaries are now having to be bumped approximately 10% to attract suitable replacement staff. Rising wages are inflationary. It will also be a negative for Corporate profits.

Secondly, markets are now starting to price in risks associated with rapidly escalating US government debt. Currently, US Federal Debt is approximately $62,805 per person and, as per the table below, has been growing rapidly over the last decade.

Federal Debt in trillions										
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
$8.95	$9.99	$11.88	$13.53	$14.76	$16.05	$16.72	$17.79	$18.12	$19.54	$20.24

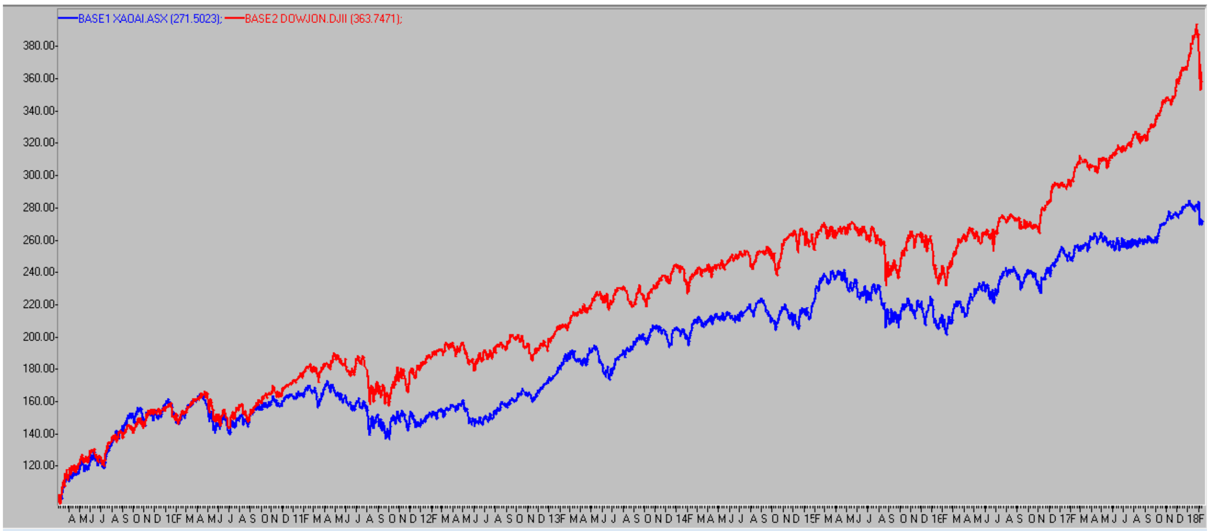
Despite a strong US economy, significant tax cuts are now being implemented in the US. There doesn't seem to be any plan to reduce debt into the future. If US debt continues on its current trajectory and in 4 to 5 years is (say) $25 trillion, and interest rates are a hypothetical 4% (to factor in increased sovereign risk and a more inflationary environment), servicing of this debt alone would amount to $1 trillion per annum. It is not hard to see why there are grounds to justify increased sovereign risk and bond markets appear to be starting to price this risk in. Increased awareness of American sovereign risk would also explain the weakening $US at this time, which runs contrary to market expectations to date that rising US interest rates would result in a stronger $US.

In contrast, Australia's National Government Debt position of approximately $610 billion is much meeker! With a population of 24,772,247, this equates to debt of $24,624 per person. While we have continually lamented the lack of Federal Government leadership on management of our Nation's finances, economic mismanagement is clearly not limited to Australia. We are starting to change our view that a rising $US against the $A is inevitable.

It is hard to see how the current focus by national governments on corporate tax cuts is going to be sustainable in the longer term.

The extent of repricing of US Federal Debt and subsequent impact on pricing of debt instruments globally will be the key factor that determines broader share market investment returns in 2018. Strongly rising bond yields if they occur WILL adversely impact on the US share market and, in turn, WILL impact on share markets globally.

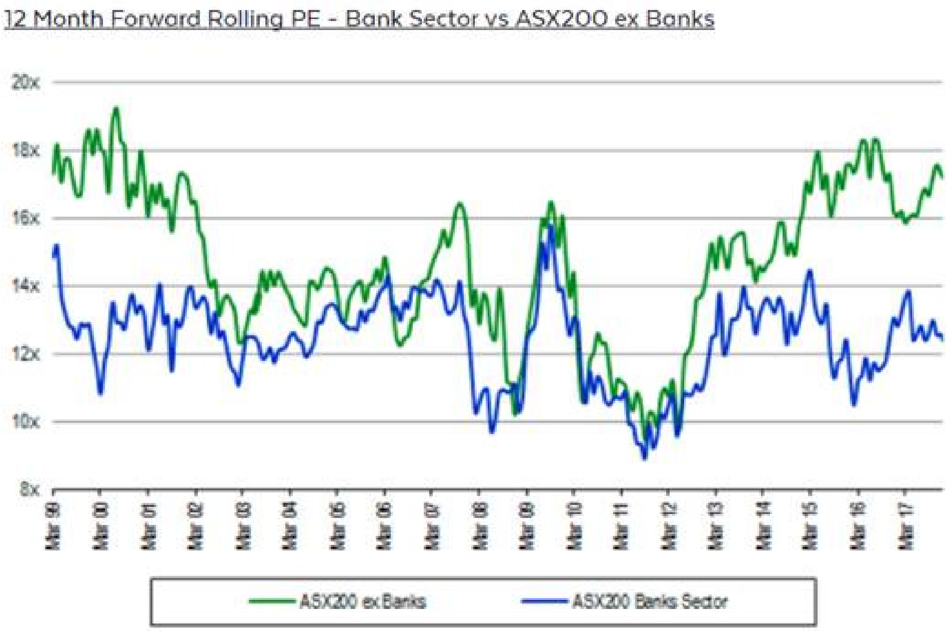
In recent years, Australia has not shared in the euphoria enjoyed by the US share market. However, if the worm turns (or more specifically global interest rates), the Australian share market should fair better. If a US lead global share market crunch did occur, we would view 10 – 12% as the likely maximum downside for our market. This would see the All Ordinaries back at around 5,450 but still holding within it's 10-year uptrend. If our market fell to these levels, valuations would become compelling and we would once again become bullish towards equities.



The chart above shows the relative outperformance of the US market when compared to the Australian market (with the reinvestment of dividends) from 1 April, 2009. Relative outperformance of the US market has escalated in the last 15 months post the US election.

Even now, within arguably a fairly valued market, value is starting to emerge. Many industrial shares are presently providing a dividend yield that provides good insulation against a falling share market. Our major Banks, perhaps due to the negativity associated with a Royal Commission that is unlikely to uncover anything new, is one example where value is starting to emerge.

For example, Westpac at $30.21 is yielding 6.2% fully franked yield. This equates to a gross (before tax) yield of 8.9%. This compares to say 2% that would be achieved in cash. Accordingly, to be worse off holding Westpac as opposed to leaving your funds in cash, the Westpac share price would need to fall to $28.21 in the next 12 months. It then has to continue to fall by nearly 7% each year thereafter. While we expect minimal profit growth from Westpac and the other banks, we certainly don't expect profits to contract 7% per annum in perpetuity. As such, Westpac (and share investments in general) should continue to provide reasonable overall returns and certainly outperform passive investment alternatives such as property and cash over the medium and long term.



We continue to endeavour to balance rising macro market risk associated with a rising interest rate environment and ultimately seek to take advantage with selective purchases as opportunities present.

If you would like to discuss your portfolio, particularly in light of the current increased volatility in the market, please do not hesitate to contact our office.

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