SPECIAL ECONOMIC UPDATE: JULY 2015

There has been a high degree of volatility in global markets in recent weeks! Economic concerns emanating from Greece and China in particular, have had major impacts around the world. We asked our asset consultant Select Investment Partners to provide clients with an update on the situation. This document contains three items:

- A short overview of the current global macro environment
- A 'blog' piece on the latest developments in Greece
- A longer thought piece on what is happening in China.

Please bear in mind that things are changing very rapidly and by large amounts at present, and this document will become dated very quickly. If you have any concerns or questions about your investments, please don't hesitate to contact your Profile Financial Planner on (02) 9683 6422.

GLOBAL MACRO OVERVIEW

Select Investment Strategy Meeting - 7 July 2015

By Dr Bart Dowling, Investment strategist – Select Investment Partners

US – Will the Fed hold off while Greece is in turmoil?

The answer to the above is 'yes'. The Fed has demonstrated little appetite to be brave to date in tightening monetary policy post the GFC, so why should it start now? Better to hold off in terms of their rhetoric surrounding the September liftoff – at least until the picture from Greece becomes clearer. As for the US economy, it's toddling along just fine.

Australia – The RBA needs to cut.

We continue to hold to the view that 2% is not the bottom of the present cash rate cycle for Australia. What better time to cut than when the market least suspects it (ergo, to get an announcement effect) and when the $A is already on the decline (thus augmenting a declining trend). Don't be fooled by the May Labour force numbers, the economy is growing way below par – the annual result for Q1 GDP is a case in point (+2.3% yoy). The only bugbear for a cut is a red hot housing market in some segments of the economy - but prudential oversight standards are starting to have an effect here.

Eurozone – It's all Greek to me.

See this month's latest blog piece for details. We continue to hold to the view – GREECE MUST EXIT THE EURO. Rumour has it that the Greeks are presently building a very large wooden horse with the intention of placing some of its citizens inside it and pushing it into the middle of Berlin – apparently this strategy worked very well for them the last time they were in trouble.

Japan: Not a bad set of numbers.

Considering the turmoil going on elsewhere, Japan represented a virtual sea of serenity over the past month. Its economic numbers look OK. Pity other parts of the globe (in particular its largest trading partner – Europe) appear to have got themselves into a funk.

UK: Still on track to raise rates - eventually.

The on-again / off-again love affair that the market seems to be having with the BoE raising rates continues. At this stage the BoE is on track to raise rates pretty soon after the Fed. The problem is – as said in over coverage of the US – the Fed is on hold for now (at least until the pall clears surrounding Greece).

China – Everything including the kitchen sink.

China's policy elites have thrown everything at the economy recently. Yet another cut in the benchmark interest rate, a lowering of prudential requirements for banks, a hold-off in IPO's – and still, the equity market continues to fall. Why? Well, much was covered in our thematic piece from last month but in the immortal words of the 1st Bush presidency – "it's the economy, stupid". Economic growth has stalled below the much desired 7% target. Speculation has been rife on the stock exchange with very little in the way of earnings growth to support it. The net result? A nasty pull back in the performance of China A shares, which the authorities are desperately trying to grapple with.

BLOG UPDATE - BEWARE OF GREEKS BEARING GIFTS

By Dr Bart Dowling, Investment strategist – Select Investment Partners: 6 July 2015

Well, now the fun really starts. Frankly I don't know who is the least prepared for the 'no' vote – the Greeks themselves, or the rest of the developed world. The only constant in this whole sordid affair has been the lack of an ability to predict an outcome. Why should now be any different?

Still, given we are active market participants and are therefore required to form an opinion of such things (however precarious this occupation may be) it is incumbent upon me to put pen to paper. As I have said all along, GREECE MUST EXIT THE EUROZONE. Why? It simply can't address its fiscal / structural imbalances in any other (effective) way. Five years of austerity has gotten Greece absolutely nowhere – except deeper into the mire. The only way out for Greece now is to default on its debt and to undertake massive currency devaluation. The first stage is near complete. The second is yet to come.

Prepare yourself for plenty of horse-trading over the coming days / weeks. The Tsipras Government has been emboldened by the (reasonably strong) majority 'no' vote and will no doubt take the fight to both the Eurozone leaders and Greece's creditors. The only certainty for the market in all this is pure uncertainty. You don't need me to tell you that markets hate an informational vacuum so expect more turmoil to come.

What will the Greeks bring to the table? What they always have- they want an end to austerity and they want to remain in the Euro. The reality is that they can't have both. Frankly, I can't see the Eurozone elites capitulating to Greece's demands. How can they? To do so would send a signal that any member of Eurozone group can act recalcitrant without consequences. Further, it would render the austerity already undertaken by Italy, Portugal, Spain and Ireland (in getting their fiscal books in order) as high farce.

So expect more brinksmanship. The unfortunate truth is that now the stakes are even higher. The Greeks will push hard to get their 'best of both worlds outcome' and the European leaders will resist. At some stage I foresee ECB President Mario Draghi undertaking his 'Whatever it Takes' speech Mark II (only this time without Greece in the Euro) just to settle market nerves about possible contagion.

Given that the politics is obviously rapidly hardening on both sides I don't see much in the way of concessions being offered. Still, as the title to this piece testifies, I wouldn't be surprised that every now and then the media will chase the odd political hare that a compromise will soon be reached. Varoufakis' shock resignation is a case in point. Don't buy it. At the end of this messy process all I see is a new Greek Drachma in place (possibly running in parallel to the Euro to help bed down the transition) at a significantly devalued rate. Indeed, Varoufakis is probably building a very large wooden horse with the intention of placing some of Greece's citizens inside it and pushing it into the middle of Berlin – apparently this strategy worked very well for the Greeks the last time they were in trouble.

So where's the good news? Well, longer term I see a "GREXIT" as a great outcome for a stronger Greece and a stronger EMU. Given a massive currency devaluation, Greece will become the holiday destination of choice for Europe – thus aiding and abetting its economic turnaround. Negotiations with creditors for a much needed 'debt haircut' should also proceed more smoothly as a currency devaluation 'resets the bar', so to speak. For the rest of the EMU members, removing the proverbial 'brick around their neck' should come as some form of comfort post the GREXIT separation mayhem. Indeed, I believe kicking a 'non-paying' member out of the Euro club will only firm up the market's resolve that the Euro is here to stay for the longer term.

As for the markets, I'm certainly glad a majority of our international exposures are unhedged. Misery loves company, and China having its own internally-inspired troubles at the same time as Greece is running amok is bad for the $A and therefore good for our unhedged international positions. This will certainly help insulate our portfolios from the losses that are sure to come in international equity markets over coming days / weeks.

So, sorry, but right now I can only assure you of one thing – a bumpy ride. The final destination – Greece exiting the euro - may come as no surprise (at least with the benefit of hindsight) but the path taken to get there is by no means certain. In the interim, we'll all be collectively holding our breath yet again. The Greeks may have invented democracy but they're surely having a good go at developing anarchy at the moment.

PORTFOLIO THEMATIC REVIEW RESEARCH PAPER

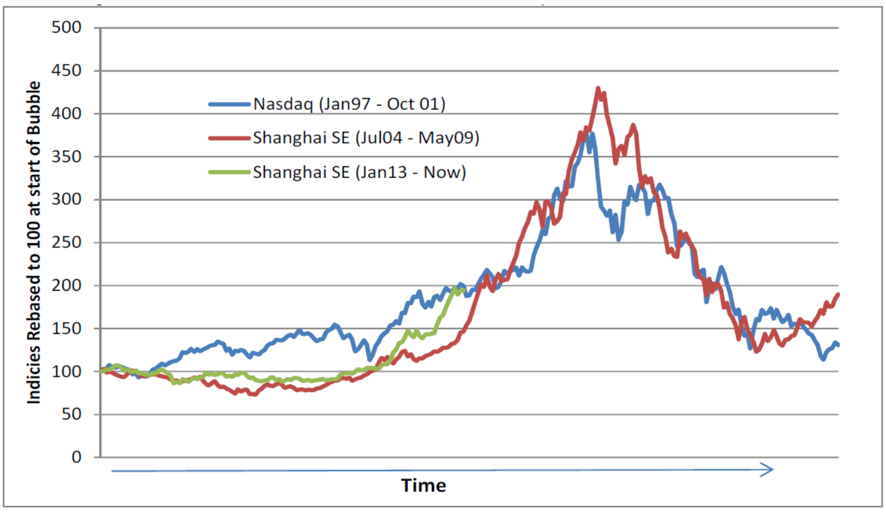
The Next Asia Crisis

By Dr Bart Dowling, Investment strategist – Select Investment Partners: June 2015

Main Points

- China's stock market appears to be replicating a bubble pattern it has displayed in the recent past. This is not good.
- Unlike the 2006/07 experience the ramifications of a dramatic unwind of a China stock market bubble could be significant.
- For starters, China's economy is in a much more fragile state than it was during 2006/07 – its GDP pulse has weakened by more than half and its current account surplus has been decimated.
- Add to this the fact that China's property developers (a sector already in trouble) are now seeking to finance their exploits through the stock market and that local government balance sheets are aided and abetted by this property market speculation and it's not hard to see a huge amount of balance sheet destruction in the face of a China stock market crash.
- The market appears to be hugely complacent regarding this issue given a belief that China's huge foreign exchange reserves (and its considerable scope to alter monetary / fiscal policy levers) are sufficient to offset what now appears to be inevitable balance sheet turmoil.
- I don't believe the market is rightly interpreting the scope of this substantive risk.

Chart 1: Hmmm…I think there's a Pattern Here. China's Stock Market has Doubled in a Short Space of Time and Going By Past History, Could Double Yet Again. But the End-Game is a Horrendous Crash. China's Economy Sailed through the Problem Last Time. I Don't Think it will be so Lucky This Time Around.



I'm becoming increasingly worried about China. And rightly so. It has barely shaken off the excess of a massive property bubble and now it has embarked on what looks like the formation of an equally large equity market bubble. Add to this the fact that China's economy is in a fragile state and you can quickly see why my concerns are elevated.

And I'm not alone. Quoting a recent IMF report:

'Looking at a sample covering 43 countries over 50 years, staff identified only four episodes that experienced a similar scale of credit growth as China's recent TSF (total social financing) growth. Within three years following the boom period, all four countries had a banking crisis.'

Source: IMF Article IV Consultation Staff Report China 2014

Indeed, if you have a penchant for the facts, the Chinese stock market has more than doubled in the past 10 months. In the last equity bubble – 2006/07 – it undertook almost exactly the same pattern but not only doubled in 10 months, it quadrupled in 18 months!

Great you say, let's all pile in and double our money in the next 8 months from a hard and fast 'China bubble' play. Such behavior is at best speculation - or at worst, gambling. In my book it is certainly not prudent investing.

This thematic piece examines precisely what is going on in China's stock market and the likely ramifications it will have when it all (inevitably) comes undone.

The 'Bull' Story (And Yes, I'm being Slightly Sarcastic)

What has put the Chinese stock market on such an upward trajectory? Well, the factors are many but some are briefly summarized below.

1. Market gossip has it that Chinese officials wish to stem capital flight from China and so have been aiding and abetting the stock market run up. Certainly plenty of Chinese capital has found its way abroad – Sydney and Melbourne property prices bear testament to this.i Certainly capital flight is making it hard to keep China's pegged currency in line with where China's officials want it to be and so they have been actively supporting a rise in the local share market (for other reasons as well which I will allude to a little later).

2. Add to this dynamic various market scuttlebutt about the potential for even more monetary stimulus in China over coming months given that China's economy is so fragile. Chinese Banks required reserve ratio has been recently cut (and looks likely to be cut further) and benchmark interest rates have also been lowered to depths not probed even during the GFC.

3. A further 'positive' factor is talk of reform of State Owned Enterprises (SOE's). This economic reform is needed to improve productivity performance and China's GDP growth potential. It is another reason why China's elite want the stock market going up – to make these SOE's look better to would-be buyers.

4. Finally, there is the perennial talk of MSCI inclusion of China A shares and the floating of renminbi.

All these factors are compelling and let me say at the outset that long term I believe the secular story of China's stock market grinding upward to new highs. But even taking into account these factors, one must necessarily ask – has China's stock market come too far too fast?

What particularly worries me is that at the moment we are being besieged by research from various analysts pointing to any one of these factors as a reason to 'buy China'. What I find especially galling are the reports using dressed up versions of the 'more monetary accommodation' argument as a 'fundamental' justification to buy Chinese equities.

It seems these analysts have learnt the lessons from the stock market response to US QE, ECB monetary accommodation in Europe and now China's monetary loosening that identifies that investors eagerly pile in when there is even the hint of more monetary stimulus.

My question to these pundits is – why is there monetary stimulus in the first place? Answer – the economy is weak.

Next question, how long does it take for an economy to turn around in response to the monetary stimulus? Answer – 2-3 years.

Last question – what's your investment horizon for making the recommendation? Answer – 12–18 months.

And that's the rub. I see most of these 'fundamental' recommendations for what they are – momentum trading. It seems that since central banks have embarked upon their policy of 'extraneous measures' to get the global economy going post the GFC, there has also been a Darwinian selection of analysts to come up with some (pretty weak) reasons to justify a 'fundamental' rationale for what is really momentum trading (or in other words, the greater fool theory of investing).

This 'buy it because it's going up and everyone else is piling in' mindset is particularly dangerous when it comes to China. Right now China's policy-makers are juggling a heady cocktail of economic reform, a deflating bubble in the property market and an emerging bubble in the share market. What are the chances of this all ending well?

The Law of Three

I believe it is a prudent rule for investing that anything you are holding that doubles in price in a short space of time warrants close examination – hence the necessity of writing this thematic piece on China's stock market. Indeed, any holding that triples in price in a short space of time and I believe you need a really sound excuse not to get out of it.

Why? Well, the law of averages for this 'rule of three' as I have come to call it illustrate that more often than not when something triples in a short space of time it ultimately ends in tears. Examples of this are many – and indeed cut across all asset classes – but just out of interest sake I have outlined a few case studies in the charts below.

Chart 2: Fortescue Metals Group – From Hero to Zero (and Back Down to near $2 today)

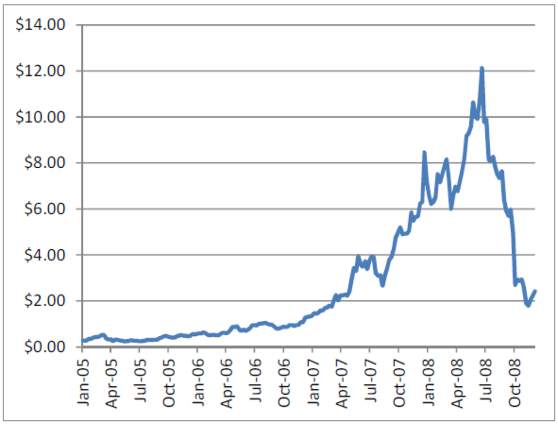


Chart 3: Hi-Ho Silver – The Massive Run-up in Silver during the Late 1970s

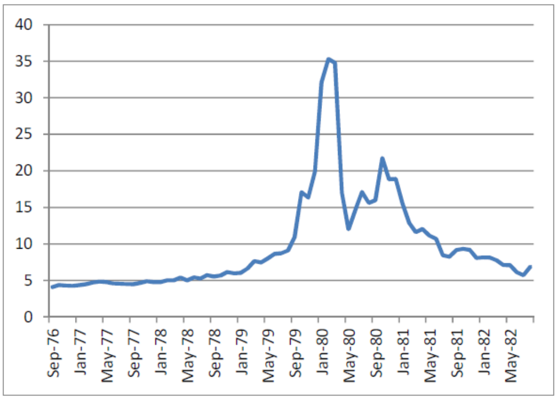
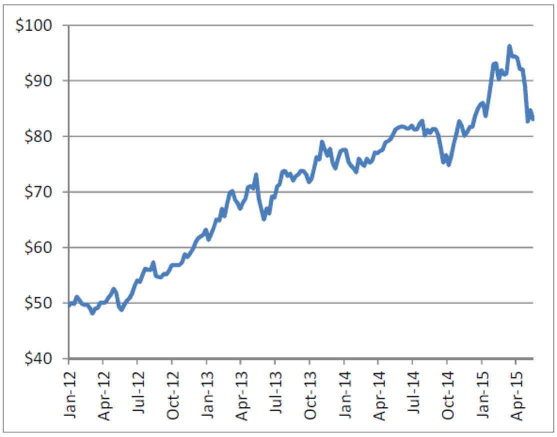


Chart 4: The Multi-Million Dollar Question – Is CBA Presently Tempting the Same Fate?



Examples aside, this law of three provides a grave foreboding for Chinese equities right now. That said, to form a complete picture we need to go through the economic facts as they currently reside – the good, the bad and the ugly.

In Those Immortal Words….This Time it's Different

China's economy sailed through an equity market bust without major issues in 2006/07, so what's to worry about this time around? To put things into perspective I have placed the arguments in accordance with the terminology above – the good, the bad and the ugly.

Chart 5: The Good - China's Valuations Aren't Overly Stretched (P/E and Price to Book Comparisons) – China A Sharesii

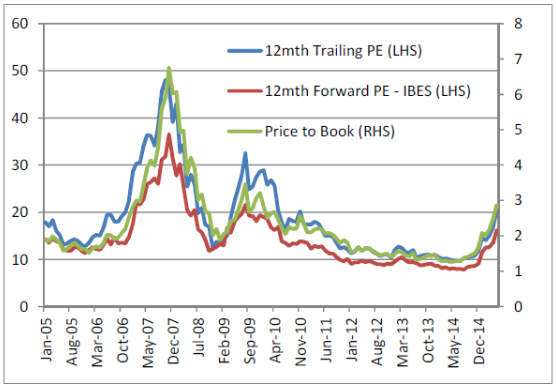


Chart 6: The Good - China Has Plenty of Reserves to Fight Off the Next Crisis

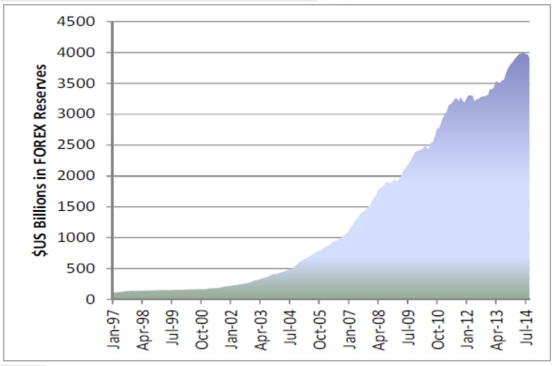
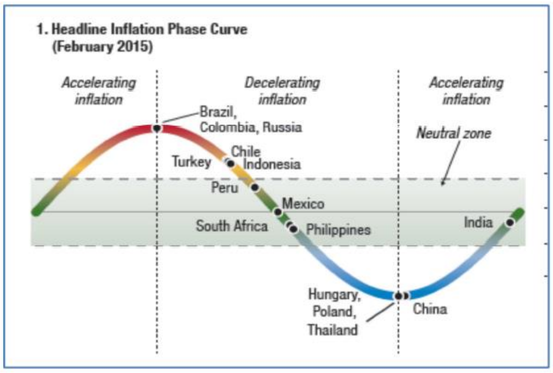


Chart 7: The Good - China has Plenty of Scope to Further Ease Monetary Policy as it has Little Inflation



Source: IMF Global Financial Stability Report April 2015

And now for the bad……..

Chart 8: The Bad – China's Economy is Much More Fragile Now Than in 2006/07 as its GDP Growth and Current Account Surplus have Shrunk Dramatically

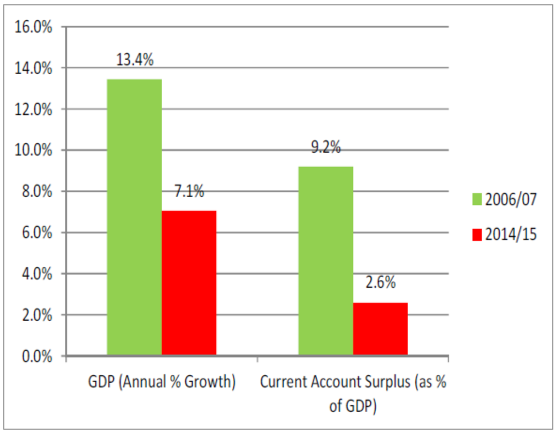
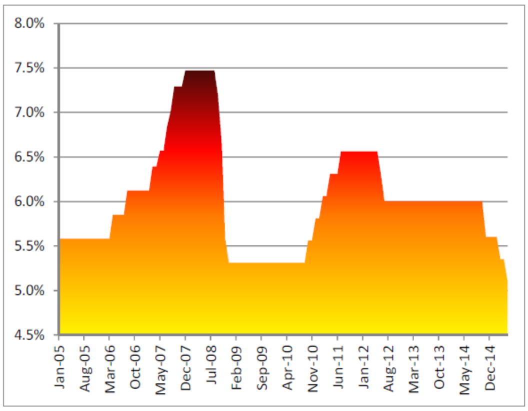


Chart 9: The Bad – Valuations May Not Be Overly Stretched When Compared with the 2006/07 Bubble But Calling Them 'Cheap' Using a Simple P/E Average Comparison (with the Bubble Loaded into this P/E Average) is Downright – incorrect….

Chart 10: The Bad - China's Prime Lending Rate Might Have Scope for Further Easing But it is Now Below that of Where it Resided During the Depths of the GFC. This Illustrates Just How Weak China's Economy Presently Is



And finally, the ugly……

Chart 11: The Ugly - China is Still Trying to Unwind the Excess of its Property Bubble and Property Prices Continue to Fall

Source: RBA Bulletin March 2015

Chart 12: The Ugly – As if to Make Matters Worse (and Commensurately to Spread the Contagion Around) China's Property Developers Have Rushed to the Rising Share Market to Seek Funding to Give Yet Another Leg up to an Already Over-Heated Property Sector (Source as above)

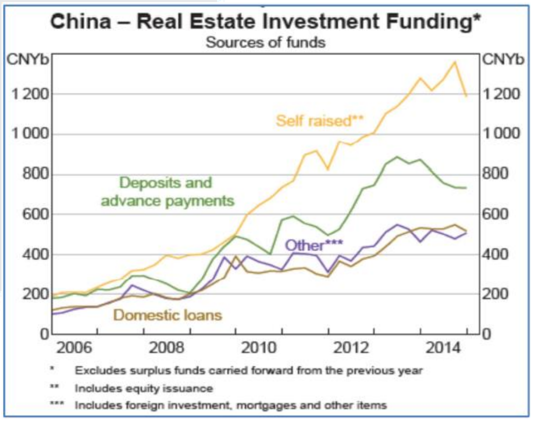


Chart 13: The Ugly – And They're Rapidly Increasing Gearing as Well……. (Source as above)

Chart 14: The Final (Very) Ugly – And It's Not Just Property Developers You Have to Worry About, China's Provincial Governments Are Highly Dependent on Land Sales for Funding. If the Stock Market / Property Market Blows Up, So Could Provincial Government Balance Sheets – This Could Leave a Very Big Black Hole to Fill. (Source: as above)

The chart above to me is the proverbial final nail in the coffin. Given the law three and the chances of a messy end game to China's stock market stratospheric recent rise, there are in my mind two fundamental questions investors need to ask themselves:

1. What are the chances of rampant speculation in China's stock market ending well? Answer – not good.

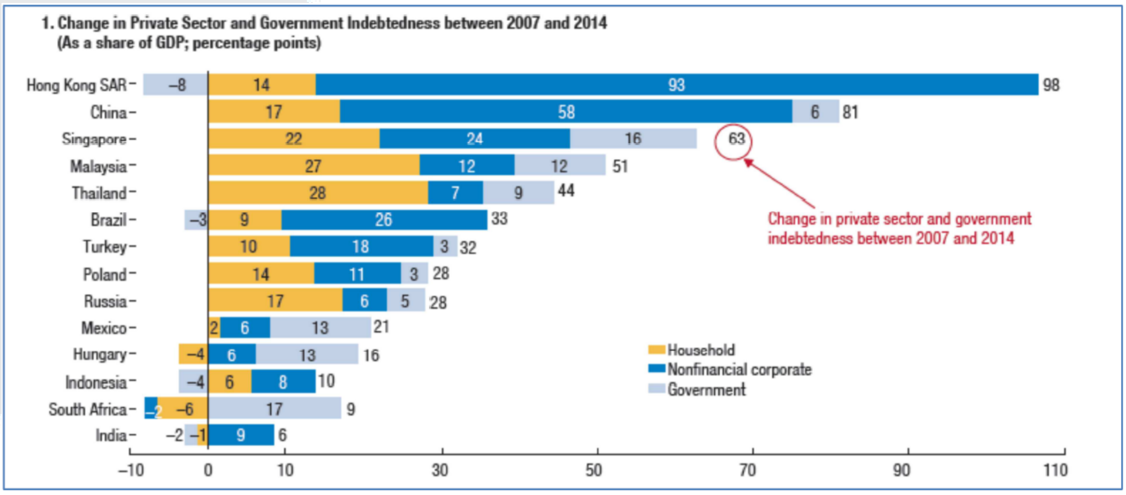
2. Are there sufficient reserves in China to patch up the problem this time around given that the balance sheet hole is unquestionably larger (as you need to throw the property bubble and local government financing into the pot)? Answer – Who knows????

And it's the question marks that surround the answer to this second question that worries me. Certainly the market is shrugging off a China share market crash as a 'big deal'. China's share market fell 6.5% in one day last week and the international capital market yawned. I don't think this is the right response.

So What Are the Implications of a Messy Unwind to China's Stock Market Bubble?

This is where it really gets scary. The chart below may come as a rude shock to some. Few realize that China has rapidly escalated its debt since 2007. This does not bode well for a seamless internal 'patch-up' to a massive balance sheet problem created by an imploding Chinese stock market / property market / provincial govt debt problem.

Chart 15: China's Debt has Escalated Rapidly Since 2007 – Not Many People Have Taken Notice



Source: IMF Global Financial Stability Report April 2015

What will China do if it needs funding? Here some sobering facts related to such a question that I mentioned in an earlier blog piece. These might send a chill down your spine.

1. China is the largest foreign holder of US treasuries – About $US1.2 trillion worth – indeed it is the 3rd largest holder of US treasuries overall behind the US Dept of Social Security and the US Federal Reserve.

If China's financial system gets itself into trouble this holding could be the first recourse of funding for recapitalization. Such a sell down would instantaneously spread the contagion from China's financial system to the world's financial system.

2. Although China's equity market is small, its economy (as measured in Purchasing Power Parity terms) now eclipses that of the Eurozone and is 2nd only to the US – and only just mind you – in terms of size. If its economy stumbles we're all in trouble.

3. Related to the above, according to some reports Australia is now more reliant on China for exports than it was on Britain after WWII or even Japan during the 1970s.

The last time an Asia Crisis occurred (in 1997) the countries that saw the largest inflows into their property sector (Malaysia, Indonesia etc from Japanese money) also saw a rapid capital outflow post the crisis. So much so that their currencies depreciated by up to 85%. This is like calling the $A at $US0.15 cents!!

Indeed, there are many haunting similarities between the Japanese inspired Asia Crisis experience of the late 1990s and that which is occurring in China today. Both had property and stock market bubbles intertwined, both had monetary accommodation, both had capital flight.

Let's hope the outcome for Australia is better for a China inspired Asia Crisis than it was for SE Asia after the Japan inspired Asia Crisis. While it mightn't be as bad, it certainly won't be good. Now you see why I'm worried.

i Note that the Chinese spent more on Sydney and Melbourne property last year than they did for either New York or London.

ii Note: A Shares are Shanghai listed and mostly domestically traded. H Shares are Hong Kong listed and mostly traded by international investors.

iii Chart taken from JP Morgan Asset Management publication with title 'MSCI China Valuations Relatively Undemanding'