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“For any investor the mantra you recite each morning must now become ‘cash flow, cash flow, cash flow’.”
ROGER MONGOTMERY, MONTGOMERY FUND

Orthodoxy overturned as gold stocks slump

TIM BOREHAM
CRITERION

The Trump ascendancy has left not only the pollsters and political pundits with rotten egg on their visages: the gold bugs are wiping away lashings of yolk as well.

Ahead of the fateful plebiscite, the orthodox view was that a Trump win would be a boon for bullion given the blustering billionaire's aggressive foreign policy posturing.

Instead, the gold price has had its worst month since 2013 and in US-dollar terms is 13 per cent off its early August highs.

The Australian-dollar gold price is 12 per cent off its record high of $1820 an ounce peak in early July. Yet the ASX gold sector has slumped 27 per cent, with sector leaders **Newcrest Mining (NCM)** and **Evolution Mining (EVN)** collapsing 35 per cent.

If the overall stockmarket lost more than one-quarter of its value in the space of a few weeks, the business commentariat would be hyperventilating about the next global financial crisis and the demise of the Western world.

With gold, it's more a case of embarrassed silence because the experts forgot about the interest signals sent by Trump's expansive fiscal policy.

Over time, there's been an uncanny linkage between the US-dollar gold price and US bond movements. The recent bond sell-off implies higher interest rates, which lessens the appeal of non-income yielding bullion.

While gold might be the pre-eminent store of value in turbulent times, it doesn't generate any income gathering dust in a vault.

For the time being at least, investors are fixated on the US economic recovery rather than the geopolitical mayhem angle.

There's little concern our new leader of the free world having a bad hair day — or should that be an even worse hair day? — and declaring war on Mexico/China/Iran or those pious Hollywood celeb Democrats.

For Aussie gold stocks, the jury is out as to whether they are compelling value after such a correction — we'll avoid the term crash — or whether the turning of the global rates cycle will force them even lower.

It's hard to deny the macro risks, with Trump's promised fiscal stimulus likely to further increase interest rates. Where things get complicated is that the trillions of extra spending could spur inflation, which on (disputed) conventional thinking has been seen as supporting gold.

"A further risk is if central banks (Bank of Japan and the European Central Bank) also start to change their tone on quantitative easing," Deutsche says.

For the Aussie gold diggers, the mining slump means that production costs (especially labour) remain benign and they should be making decent coin on the prevailing margins of $400-$600 an ounce.

If they're not, there's something seriously wrong with their project. There's a natural currency hedge, too, because higher US interest rates should push up the US dollar and force the Aussie dollar lower. With gold sales denominated in greenbacks, this means higher returns on conversion.

Is sell-off overdone?

Deutsche says: "We believe the 25 per cent sell-off of the ASX gold sector in the last four months more than captures the fall in the US dollar gold price and expectations of further weakness."

Not everyone agrees, with Goldman Sachs this week downgrading its long-term gold forecast to $US1250 an ounce.

"While gold has already sold off sharply and real rates have risen substantially to reflect this thinking, we see the very near-term price risks as skewed to the downside."

However the firm's key concern is not Donald's doings, but the potential for liquidation of the vast physical gold stocks backing exchange-traded funds.

Another measure of value is how forecast earnings would vary if the current Australian-dollar spot price were to prevail in perpetuity.

In the case of Evolution Mining, brokers have chalked in consensus current-year earnings of $371 million. According to UBS, on a spot scenario this profit would reduce to $275m, which means overly rosy gold price assumptions are being used.

For the biggest miner Newcrest, the current-year variance is not dramatic: consensus calendar 2016 earnings of $US613m compared with the "spot" scenario of $US613.

But the gap for 2017 is more dramatic: $US715m consensus expectation compared with only $US404m for spot earnings.

Don't underestimate the effect of Aussie dollar movements on share valuations.

On Deutsche's sensitivity analysis, Newcrest's net present value would increase to $22.20 a share if the Aussie batler was to fall to US60c and tumble to $15.17 if it rose to US80c. This is based on the current gold price.

Given the macro uncertainties, stock selection hinges on factors such as the grade and size of reserves and the potential for new projects to deliver (or erode) value.

There's also potential for the sector to recover from January, when the miners confirm the attractive prevailing margins in their December quarter reports.

The fate of gold contrasts sharply with copper, which is on a tear and at 16-month highs. That makes a copper-gold miner such as **OZ Minerals (OZL)** and **Sandfire Resources (SFR)** a "bob each way" proposition, although their output is biased towards the red metal.

Newcrest's Cadia goldmine produces 65,000 tonnes of copper annually as a byproduct, which is substantive given our biggest copper producer OZ produces about 120,000 tonnes a year. The gold price is driven by sentiment, which can turn on a dime.

The Weekend Australian accepts no responsibility for stock recommendations. Readers should contact a licensed financial adviser. The author does not own shares in the stocks mentioned.

US stocks for the Trump era

CLAY CARTER

The surprise arrival of Republican Donald Trump as ultimate overseer of the US economy has offered a powerful boost to US stocks — every key index (including the tech-heavy Nasdaq) has hit a record high in recent days.

No wonder Australian investors are looking afresh at US stock opportunities.

As a long-term global investor, I find the current proliferation of articles proclaiming to point out the specific stocks and sectors that will automatically benefit from a Trump presidency premature at best.

Campaign promises and sound bites seldom end up as concrete policy and we only have an inkling as to what the Trump administration will actually do.

That "wall" on the border may well end up as a "drone array" rather than a physical structure. So do we buy drone makers or construction companies? You get the idea.

So what do we know? Certainly, life for pharmaceutical and biotechnology companies will get easier and drug pricing will undergo far less scrutiny. The financial services sector and particularly the large banks will not face a flurry of new regulations. It is also quite likely that under a Republican administration defence spending will increase.

In the absence of negative news flow regarding drug pricing and regulation (a Clinton favourite), investors can now concentrate on the pharmaceutical companies that are early in new product launch cycles and have significant product pipelines.

The Republican sweep is also very supportive for the defence industry. Republicans have long been open to raising defence spending far above recent levels. Overall, the industry retains the characteristics that have made it attractive to investors in the recent past: visible cash flows, healthy cash return yields.

Donald Trump has caused Australians to take a fresh look at US markets AFP

Separately, financial services and bank stocks are up sharply since the elections, led by expectations for more Fed rate rises and a steeper yield curve, growth from fiscal stimulus and, of course, a more capital-friendly regulatory environment.

Here are my seven for the Trump era:

Bristol-Myers Squibb

Bristol-Myers Squibb manufactures pharmaceuticals in several therapeutic areas, including cancer, HIV/AIDS, cardiovascular disease, diabetes, and related disorders. Bristol also has potential important catalysts over the next 12-18 months, particularly relating to its revolutionary immunotherapy platform. While Bristol trades at a high multiple on near-term earnings 17.8 times, analysts are forecasting a 22 per cent earnings per share compound annual growth rate through 2020 — one of the highest in the industry.

Pfizer

Pfizer is a global biopharmaceutical company, which manufactures vaccines and injectable biologic medicines. It is among the world's largest pharmaceutical companies. The company has key franchises in cardiovascular, infectious diseases and vaccines. It has growth drivers working in its favour over the next few years — Ibrance, Eliquis and Xejianz as well as an improving pipeline. Pfizer is attractively valued — it is on a discount of about 15 per cent to its US major pharma peers.

Celgene

Biotechnology company Celgene is one of the most fundamentally sound biotech companies in the industry. Celgene has more than a dozen Phase 3 trials expected to read out over the next couple of years. The fundamentals for Revlimid and other key franchises (Pomalyst/Abraxane/Otezla) are strong, and CELG's partnered products and recently acquired potential blockbuster assets will be important contributions to longer-term growth and a lack of exposure to whatever macro development is worrying the market at a given time.

Lockheed Martin

Another name to consider is Lockheed, the largest dedicated defence contractor by market capitalisation. LMT is well positioned to benefit from the Department of Defence's shift in spending behaviour that favours technology versus procurement. LMT is poised to outgrow competitors over the next several years due to a presence in missile defence and especially fighter jet platforms (F-35).

Bank of America

This is one of the largest US banks and has some $US2.1 trillion in assets and $US252 billion in shareholders' equity. Bank of America is expected to shine in the new banking environment due to the benefits from expense savings, potential for an increased capital return, higher asset sensitivity, as well as an attractive valuation. Normalised earnings should benefit from cost cuts, interest rate rises, and a reduction in legacy asset servicing expenses.

Raytheon

RTN is an important part of the defence value chain spanning diverse products including radars, sensors, and integrated electronic systems. The Patriot missile awards provide a firm basis for future growth. RTN is the biggest missile maker in the world and a major presence in drone manufacturing.

Citigroup

This major US-based global bank is also attractive due to its large capital return potential. Citigroup has an attractive franchise as a leading global bank with about 200 million customer accounts and does business in more than 160 countries. Citi believes there are good long-term growth opportunities in emerging markets and it will also benefit from the higher potential returns generated as deferred tax assets are used. In addition, the Costco co-branding deal win improves revenues in key credit card business and will add to net income.

These seven stocks should benefit under any Republican administration — even one as difficult to predict as Donald Trump's.

Clay Carter is a senior research analyst at online brokers www.macrovue.com.au

Why bonds and property are now on the nose

ROGER MONTGOMERY

For any investor — though especially If you are retiring soon — the mantra you recite each morning must now become "cash flow, cash flow, cash flow ".

You'll say this regularly, because income from your savings and investments must now be relied upon to produce the cash flow you require to satisfy your lifestyle and healthcare needs.

Property investors in particular should be careful. With record levels of mortgage and household debt in Australia (you can ignore the argument that households also have record cash balances because the people with the debt aren't the same people with the cash), and with record high property prices, rising bond rates will come at a time when highly-geared property owners can least afford it.

Your investment strategy needs to be fit for the era in which you are investing.

The record low rates are not the new normal. They are entirely abnormal. Now is the time to be selling property — as John Symonds and John Gandel have recently been reported doing — and the time to be reducing debt.

What's more, now is also the time to be reducing what they call "duration". Think of it this way, cash is producing the same returns as 10-year bonds so why commit to 10 years of 2.7 per cent when you can get the same rate for 90 days and retain the flexibility to take advantage of lower asset prices that will inevitably transpire as bond rates rise?

And as any salesman will tell you, if you appeal to a customer's most immediate needs, the job of selling is that much easier. It is no surprise then that many retirees have been told to invest in fixed interest bonds; start receiving regular income immediately and avoid the volatility or risk that comes with gambling for capital gains that might never accrue. With less years to recover any losses, you don't want to be gambling with what you have left.

The only problem of course is that with long-term bond rates only just up off the floor of multi-century lows, retiring today is not as enjoyable as it once was.

One way of comparing the difference in returns compared to 20 years ago is to look at how much capital is required to produce the same income. Back in the 1980s $1m gave you all the income you needed for a decade. Today you need $5.9m invested in a 10-year government bond to produce the same $160,000 of income per year. In other words you need six times as much money squirrelled away, or you would have had to work for six times as long, to produce the same income.

As I have been saying for months, these low rates were artificially engineered by central bank buying and I prefer to take a leaf out of economist Herb Stein's book, who said "If something cannot go on forever, it will stop."

And even though Trump's victory has given the run up in bond yields since June a short-term shot in the arm, there are three reasons to think that bond rates will eventually rise even more.

First, low rates and flat yield curves are not having the desired effect on investment and spending. Where rates have been negative for the longest period, such as in Denmark, consumption as a percentage of GDP is falling and savings rising — the opposite of what central banks were trying to achieve.

Second, corporate investment has declined because low long-term rates provide no incentive to accept longevity risk. As a result, companies in the S&P 500 have acquiesced to shareholder demands for more dividends and increased their payout ratios from 25 per cent in 2011 to almost 40 per cent today. In Australia that payout ratio has risen from 57 per cent in 2010 to over 80 per cent. High payout ratios leave less capital available for growth, limiting the effectiveness of extreme monetary policy.

Third, ultra low rates aren't justified on an economic basis. Economic conditions simply don't justify the outcomes of the greatest monetary experiment in history.

It should be no surprise that rates were beginning to rise even before Trump was elected. Just as we have warned, US 10-year yields began rising from 1.36 per cent on July 8 this year to 1.8 per cent before Trump's victory. And since then on to 2.35 per cent. In Australia 10 year bonds have risen from 1.8 to 2.7 per cent since mid-2016. In both cases a circa-100 basis point move.

Nevertheless, traditional financial advice was authored at a time when bonds offered a valid alternative to shares for income-hungry investors.

Today they don't, and committing yourself to a decade of hard labour (returns of circa 2 per cent) when rates could rise in that time, might produce not only envy if rates do rise further, but also capital losses in the interim.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund. www.montinvest.com

THE COACH

My 14-year-old daughter who is in Year 9 at high school is keen to start earning her own money. What should she be aware of in terms of legal requirements? Also, any tips on encouraging her to save the earnings?

The minimum age for employment varies from state to state. The minimum age is usually 13, but in NSW and the ACT this doesn't apply. The entertainment industry and family business are nationally exempt.

Generally she will be restricted to light work, such as running errands, office work, gardening or shop assistant. If your daughter were 11, she would be limited to delivering newspapers and advertising material or making pharmaceutical deliveries.

As she is under 15, it is against the law for an employer to require her to work on a school day more than one shift a day, more than a four-hour shift and after 9pm.

As she will be employed and is older than 12, she is required to have a tax file number, which can be obtained via the secondary schools TFN program. Contact her school for details.

It is important to be aware of any industrial awards applicable to the industry she is working in and minimum pay rates. As she is under 18 and legally unable to enter into a contract, she should not be registering for work via Airtasker as it would breach its terms and conditions.

For tax purposes, her employer is obliged to issue an annual group certificate. If her income is high enough, tax should be withheld. Tax is levied at normal marginal tax rates as she is generating her own income. She is not obliged to submit a tax return if she is below the lowest tax threshold of $18,200. However, she can lodge an annual tax return and claim expenses as an adult taxpayer.

As she is under 18, and working less than 30 hours a week, she is not entitled to receive employer superannuation support unless this is specified in an award.

Goal-setting is vital in a savings plan. Balancing short-term and long-term objectives will always be a challenge. Large, longer-term objectives such as a car may be hard for her to contemplate. Encourage your daughter to form the habit of prioritising spending now away from instant gratification.

If you are looking to encourage her to save for a larger purchase, consider matching savings she makes. For example, for every $20 she saves, match or part match into her bank account.

Demonstrate the basics of compound interest and she will get a greater appreciation of the value of saving.

Open a high-interest savings account, demonstrate how interest works and equate it back to hours worked to earn that money. For longer-term savings objectives, consider looking at investment trusts with exposure to higher-growth assets such as shares. As she is under 16, they will need to be held in trust.

For further information on financial literacy for secondary school students, visit www.moneysmart.gov.au.

Visit the Wealth section at www.theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

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