Trump's turns, Italy's trials and your portfolio

DON STAMMER

With Donald Trump continually offering surprise moves on trade and an evolving crisis in Europe with a new government in Italy, it is not easy to take a view on the outlook for bond yields and interest rates.

But we must try. For an investor it is necessary because bond yields have a big impact on investment returns; not just returns from bonds but also from other major asset classes including shares.

The challenge arises because bond yields are affected by a wide range of influences, which can change over time. Also, bond yields have moved over a wide range, as these glimpses of history bear out: in the US and Australia, yields on 10-year bonds were 3 per cent in the late 1940s, 16 per cent in the early 1980s, and not far from 1.5 per cent in 2016.

Since then, 10-year yields have about doubled.

In much of the past six months, the general expectation has been bond yields in most countries will move modestly higher over coming years, with the scale and timing of the increases dependent on:

1. How quickly inflation reappears, particularly in the US (the majority view has been "not yet");
2. The pace at which the US cash rate is raised (the dominant expectation has been for quite aggressive increases, with another six or seven hikes by the end of next year);
3. The impact as the major central banks turn down their quantitative easing programs (a move already under way in the US and which the European central banks could implement from late this year).

The thing is ... we suddenly have not one, but two elephants in the room: Italian politics, which could hold down the level of bond yields in the short run; and the blowout in the US budget deficit, which could put strong upward pressure on bond yields over the medium term.

Italy's political crisis was triggered by President Sergio Mattarella's concern that the newly elected populist government would include a finance minister who favoured taking Italy out of the eurozone; the President proposed a "technocratic government" headed by a former economist at the International Monetary Fund, Carlo Cottarelli.

For the moment a constitutional crisis has been averted after Cottarelli, who was to lead a caretaker government, stepped aside and paved the way for an unlikely coalition of left-wing Five Star and right-wing League populists — dotted with Eurosceptics — who have now formed a government under Giuseppe Conte, a law professor.

Five Star and the League have combined in an attempt to challenge the EU and overhaul a wide range of regulations they blame for many of the country's troubles.

Although Five Star and the League insist they are not considering Italy leaving the eurozone — a U-turn from previous election rhetoric — they threaten a profound rift with Brussels.

As *The Wall Street Journal* put it: "Italian voters who generally want to stay in the Euro, were probably more attracted to the coalition's promises of a crackdown on immigration, universal basic income and a flat tax, but ... (ultimately) the new government could tap anti-Europe sentiment to legitimise leaving the Euro."

Italy clearly has the potential to further destabilise the eurozone. If so, funds would flow to the "safe harbour" of US government bonds, and lower US bond yields; and stresses in global financial markets could reduce expectations for US cash rate rises.

The second new influence on bond yields is what Goldman Sachs calls the "great fiscal divergence".

In each of the next four or five years, the US government will run budget deficits of 4-6 per cent of GDP, while countries such as Germany,

> Australian bonds will trade with a 'negative spread' to US yields

France and Australia have foreshadowed budgets that are balanced or in surplus. Lawrence Summers, a former US Treasury secretary, says Trump's fiscal largesse will result in the US experiencing "the most rapid increase in the (government) debt-to-GDP ratio during peak business cycle times that has ever been seen in peacetime".

Gavyn Davies, of Fulcrum Asset Management, adds this worrying point: "It is unlikely that future US presidents and congress will voluntarily agree to narrow the budget deficit unless forced to do so by an impending fiscal crisis; and such a crisis seems improbable in the intermediate term."

What would this great fiscal divergence mean for investors in Australia?

Our government bonds usually offer higher yields than their US counterparts. But the gap has narrowed over time and, currently, our bonds carry lower yields than US bonds.

In my view, Australian bonds will frequently trade with a "negative spread" to US yields, over the next year or so at least. That's because of several factors: the US economy is operating closer to full capacity than we are; measured unemployment in the US has declined from a peak of 10 per cent to 3.9 per cent but unemployment here has fallen only from 6.4 per cent to 5.6 per cent; in the US, wages and inflation are starting to push higher earlier than Australian wages and inflation; and the Fed is aggressively raising its cash rate while the Reserve Bank seems on course to leave our cash rate unchanged for another 12 months or so.

For our bond yields to stay below US yields, the recent narrowing in our current account deficit would need to persist. Sentiment would change swiftly were fears to develop of a marked slowdown in China.

Don Stammer is an adviser to Altius Asset Management and to Stanford Brown Financial Advisers. The views expressed are his alone.

don.stammer@gmail.com

Cash doesn't mean a crash

It lets us invest in under-priced, quality businesses

ROGER MONTGOMERY

Anyone who knows me would be aware that in my funds we have been holding a larger proportion of our portfolio in cash than many if not most of our peers. This cash weighting (sometimes known as a cash "drag") is not a function of sticking a wet finger in the air and "sensing" an imminent crash. It is important to understand that just because we have a lot of cash, it doesn't mean we think markets are about to tank.

We have, in fact, held a relatively large proportion of the fund in cash since its inception. If we were predicting crashes using cash, you'd correctly conclude we're no good at it.

No: the cash is rather the remainder of a process that seeks to invest in high-quality businesses — those with bright prospects, trading at a discount to intrinsic value estimates.

Since its nadir in March of 2009, the US bull market is now 110 months old. I was recently informed the current bull run is also the second-longest bull run ever (a bull run is defined as any period without a 20 per cent decline). Incidentally, the longest-ever bull run in the US was 114 months, and that one ended with the dotcom crash of 2000. Some analysts are therefore suggesting the current bull market is very long in the tooth and due to end shortly.

All records exist until they are broken and so I don't attribute a great deal of meaning to such statistics, especially when they ignore financial fundamentals or economic settings.

That a bear market is in place when the index in question has declined 20 per cent is an arbitrary definition chosen by the media (and now apparently adopted by the financial community). So, what if the media had selected 19 per cent as the signal? The S&P500 lost 19 per cent in 2011 during the debt ceiling "crisis". That would make the current bull market nearly 82 months old — a long way from any record being threatened.

You see, the argument that the bull market is long in the tooth relies on some subjectivity.

Perhaps less subjective is earnings and revenue multiples. The S&P500's market's value, as measured by the CAPE Schiller price to-earnings ratio, is at 31.42 — a level exceeded only once since 1870 (during the dotcom boom).

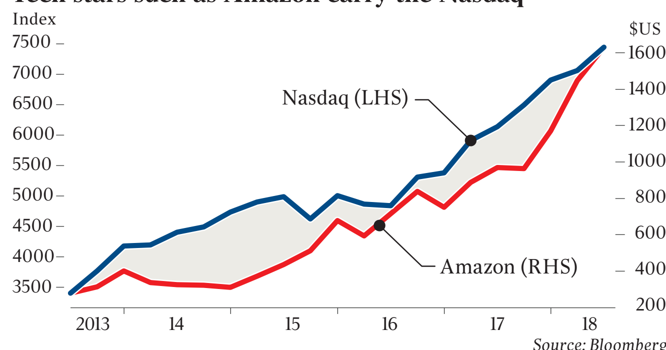
While some suggest this very high number is skewed by the sharp fall in earnings back in December of 2008, which the CAPE Schiller ratio does take into account, if one excludes the December 2008 earning slump from the beginning of the series, and adds 10 per cent growth to the end of the series, the resulting CAPE Shiller Ratio is still the second-highest ever.

Looking at multiples of revenue — which is less likely to be manipulated to the same degree as earnings — the S&P's price-to-sales ratio sits at 2.2 times. This is a level that even the dotcom boom failed to reach.

In other words, this market is one of the most overpriced in history.

GETTY IMAGES

Amazon and six other technology companies now account for 50 per cent of the US Nasdaq 100



What to do

Nevertheless, as investors it is vital to always ask questions and I am conscious that I have previously written 2018 could see a resumption of boom stockmarket conditions and even new highs before an inevitable downturn.

There's plenty of evidence to suggest high prices are currently justified. For example, despite the regulatory backlash awaiting tech companies, the more immediate impact of Trump's tax cuts coincides with their earnings growth in the first quarter registering more than 40 per cent, year on year! Industrial company earnings growth is also up over 40 per cent and telcos aren't far behind with earnings rising 32 per cent. Even Twitter is making money, reporting a profit of $14 million over the past 12 months, and its first profitable year ever.

Moreover, even though profit margins tend to "mean revert", they have been exceptional for US S&P500 companies for some time. At this stage it looks as though they will report another aggregate record in the last quarter.

In other words, the Trump tax cuts will be seen in corporate earnings, but the boost will be one-off in nature and companies will be cycling much higher numbers next time around.

Seven tech companies now account for 50 per cent of the US Nasdaq 100: Apple, Amazon, Microsoft, Facebook, Alphabet, Intel and Cisco.

Facebook has reported year-on-year revenue growth in the first quarter of 49 per cent, Amazon reported 43 per cent growth, Google 26 per cent, Apple 16 per cent, Microsoft's revenues grew by 12 per cent, and Intel 9 per cent. Cisco was the outlier with year-on-year revenue growth of just 1 per cent in the first quarter.

Sticking with knowns (revenue and earnings) rather than unknowns (antitrust regulation), it's easy to see why prices haven't slumped further following the recent bout of volatility, and why investors are focused more on tangible earnings and revenue growth rather than the less tangible possibility of negative impacts from regulation.

According to one global bank, global earnings per share growth hit 14 per cent in 2018; it's 14 per cent in the Asia-Pacific and 6 per cent in Australia. Meanwhile, current expectations are for another year of above-trend global earnings growth of 9 per cent in CY19 and earnings estimates for 2019 are still rising in the US.

The strength of the current earnings season cannot solely be relied upon to argue either the bullish or bearish case, which is why we also focus on valuations for individual companies. In our global portfolios we own Google, Facebook, Apple and others but we also remain content holding the relatively high levels of cash that our process requires.

Roger Montgomery is founder and chief investment officer at the Montgomery Fund

www.montinvest.com

DIVIDEND DETECTIVE

Keep the hedges growing

Navigator Global Investments (NGI)

ASX CODE: NGI
SHARE PRICE: $4.55
INDUSTRY: Investment management
FORECAST FY2019 ORDINARY DIVIDEND: 27c

JONATHAN WILSON

US-based hedge funds investor Navigator Global Investments has finalised the acquisition of Mesirow Advanced Strategies (MAS) — the multi-manager hedge fund division of Mesirow Financial. As expected, the transaction will deliver a step-change in NGI's assets under management and future earnings power, adding $US5.2 billion to its pre-acquisition AUM of $US10.5bn, a 50 per cent increase.

NGI appreciated steadily following the March announcement of a definitive agreement with Mesirow. However, in the days before the update, shares were still trading on relatively modest pre-acquisition multiples of 15 times our estimate of fiscal year 2019 free cash flow, or 13 times, adjusted for cash and investments on the balance sheet. In other words, little value was attributed to the potentially significant value gained from the transaction.

NGI is the parent of Lighthouse Partners, a multi-manager hedge funds business based in the US. Lighthouse's "managed accounts" platform offers some clarity within the notoriously opaque hedge funds and alternative investments space.

Essentially Lighthouse owns the underlying assets and appoints specialist investment managers to trade them within certain guidelines. This allows Lighthouse to collect real-time data on portfolios to track managers and assess adherence to mandates, providing more transparency, protection and stronger investment governance than traditional fund-of-hedge funds.

Lighthouse and MAS are highly complementary in our view.

MAS will benefit from Lighthouse's managed accounts platform while adding expertise in less liquid strategies such as credit and other lending strategies to the existing offering.

Financially, MAS should increase underlying cash earnings by at least 20 per cent in the 2019 fiscal year.

At today's share price this should drive a healthy yield of about 6 per cent.

Beyond MAS, there are opportunities from further institutional mandate wins, as well as sales of its management accounts platform as a product to other investors, which could make up a large part of the business in five years' time.

We will have to wait and see what these growth options bring, but they are not reflected in our post-MAS acquisition valuation of $5.17 for FY19.

Jonathan Wilson is an analyst for the Clime Smaller Companies Fund.

www.clime.com.au

Pitfalls and benefits in reverse mortgages and their cousins

JAMES GERRARD

Reverse mortgage products are back in the spotlight following the expansion of the federal government's in-house reverse mortgage, the Pension Loan Scheme. For investors, reverse mortgages and their near cousins, home equity release schemes, both offer attractions and dangers in almost equal order.

Let's look at both, keeping in mind reverse mortgage products are widely available, while only one bank — Bendigo bank through its Homesafe subsidiary — offers equity release products.

Retirees who may take out either of their products fall into three broad categories:
1: Those who require a regular top-up of income but do not need larger lump-sum amounts;
2: Those who require a mix of lump sums and regular top-ups and plan to sell the family home within the next five to 10 years;
3: Those who require a lump-sum payment and do not intend to sell the family home for 10 years or more.

The main limitation of the Pension Loan Scheme is that it operates purely on a top-up basis, providing up to 150 per cent of the full rate of Age Pension as a loan, but no lump sums — handy for those wanting that regular top-up to maintain their standard of living but a dead end for those wanting to draw out larger lump sums to buy cars, caravans and travel.

For lump sum-seeking retirees, next up are reverse mortgages and Homesafe's wealth release product.

If you plan to sell the family home in the next five to 10 years, a reverse mortgage may be the first line of inquiry.

There are several providers in the market and most allow a mix of regular drawdowns and lump-sums. Once an initial credit limit is set and a facility put in place, it's simply the case of drawing out as much as you need, when you need it. It is important to note that you only start to accrue interest on drawn funds; undrawn funds do not attract any interest.

The main drawback from reverse mortgages is the capitalisation of interest on the outstanding loan.

Interest is charged on interest, leading to exponential growth of the loan balance, particularly over longer periods.

In contrast, Homesafe offers a wealth release product where the homeowner agrees to sell a share of the future sale proceeds of their home in return for a lump-sum payment.

The retiree remains the title owner, and retains complete control over what happens to the property. The home is sold only when the homeowner chooses, or after the death of the surviving homeowner, with surplus proceeds returned to the estate.

The key to understanding the Homesafe product is that you are not simply selling a percentage of the current value of your property.

You are not getting $200,000 for a 20 per cent stake in your $1 million property. You are selling a share of the future value of the property.

Homesafe calculates the lump-sum payment offered today by using several actuarial principles and assumptions. It then applies a discounted cashflow model resulting in a lump-sum offer that will be different for each applicant.

Neither reverse mortgages nor home equity products are ideal: the main thing to remember is there is no such thing as a free lunch and under each option, there is a payback down the track that will reduce the proceeds of sale when the family home is ultimately sold.

James Gerrard is the principal and director of Sydney financial planning firm FinancialAdvisor.com.au

Interest rates are moving higher, whether the Reserve Bank plumps for 'stability' or not

TONY KAYE

The Reserve Bank board will meet again later today and will leave the cash rate frozen at 1.5 per cent, marking 22 months since we last saw any change in monetary policy.

That's my firm tip, along with many others pundits, and don't expect an official rate rise any time soon for that matter.

However, the RBA's dogged stance on rates hasn't stopped a bevy of lenders, including the major banks, from moving their interest rates higher over recent months.

Data commissioned from financial comparison site Canstar shows there have been more than 500 individual mortgage-rate product moves by banks and other lenders since the start of this year. That's a phenomenal number of rate changes in an environment in which official rates have not moved anywhere for almost two years.

The retail rate changes have included about 240 adjustments on owner-occupier mortgage products, and a further 300 on investment property loan products.

Of these changes on owner-occupier loans, 62 per cent were increases, with most of these rises tied to fixed-rate loan products of varying durations. There have also been rate rises in a number of variable-rate products, including on owner-occupier principal-and-interest and interest-only loans.

Number of home loan rate movments Jan-Apr 2018

	Owner-occupied	Investment
Total number of movements	237	301
% that increased	62%	44%
% that decreased	38%	56%

Source: Canstar

On average, lenders have been increasing their fixed and variable rates by about 10-15 basis points. However, some have lifted them by as much as 30 basis points (0.3 per cent). While it is still possible to grab fixed-rate loans below 4 per cent, even on periods of up to three years, they are becoming harder gems to find.

In the interest-only investment loans space (the prime target of the Australian Prudential Regulation Authority's lending clampdown), the rate moves have been mixed, ranging from cuts to rises. Most interest-only loans are between 4.5 per cent and 5.5 per cent, but some are being priced closer to 6.5 per cent.

For property investors, what's interesting is that in the investment-loan space, the trend has largely been down, with 56 per cent of the total changes recorded as decreases. But that has evolved in a climate in which lenders have been forced to reduce their investment-loan books through tighter approval processes, including lowering their loan-to-valuation ratios.

Fixed-rate option

So, what's really going on?

A lot of the changes are purely a reflection of retail price competition, with lenders often playing a cat-and-mouse game to win new business, either directly or via mortgage brokers.

Yet, especially in terms of fixed-rate loans, there is also the added dimension of increasing offshore funding costs stemming from the recent rises in US official interest rates.

The Canstar data shows that variable rates are generally down for owner-occupied principle-and-interest loans, but borrowers with owner-occupied interest-only loans are the part of the market most vulnerable and most likely to feel any RBA rate rises.

So although variable rates are still a preference for borrowers, fixed rates are worth considering.

"This year and next, our central scenario remains for the Australian economy to grow a bit faster than 3 per cent," RBA governor Philip Lowe told a dinner in Adelaide this month.

If there were a gradual lift in wages and inflation, and a lowering in unemployment "it is reasonable to expect that the next move in interest rates will be up", Dr Lowe added.

"The board's view is that while this progress is occurring, the best contribution we can make to the welfare of the Australian people is to hold the cash rate steady and for the Reserve Bank to be a source of stability and confidence."

But the official view on rates is certainly not deterring lenders from taking matters into their own hands, and raising them as they see fit.

For current and potential borrowers, including investors, it will be just as important as ever to shop around and consider locking into a low fixed-rate loan to counter further upward moves at the retail level.

Tony Kaye is the editor of listed financial services group InvestSMART.

www.investsmart.com.au