True retail bargains may be some way off still

ROGER MONTGOMERY

To my mind, all investing is value investing, and while it can be extremely rewarding it also can be dangerous. It's often tempting, for example, to search for value among beaten-down stocks, those that have fallen a great deal, in the hope of a great deal. The trick, however, is to try to establish whether the worst is over for the business underlying the stock. Accomplishing this task reduces the chances of catching so-called falling knives.

A quick scan of the retail sector reveals both tough times and the possibility of value.

JB Hi-Fi's shares have fallen 24 per cent since August 2016; Harvey Norman's shares are down 37 per cent since September 2016; shares in jewellery chain Lovisa are 40 per cent lower than their highs in June this year; Beacon Lighting is down 48 per cent since May 2015; and Nick Scali is 29 per cent lower than March last year.

Then there is Myer, which has to deal with potential irrelevance as well as a declining retail cycle, down 82 per cent since March 2014.

In anyone's language it's a crash. But it is darkest just before the dawn and investors should invest by looking through the windscreen rather than the rear-view mirror. With that in mind, let's take a look at retail conditions and whether they may be likely to deteriorate further or improve next year.

The executive summary is that the outlook for discretionary spending doesn't appear to be looking good. There's a lack of real (inflation-adjusted) wage inflation, there's a fall in the savings ratio and, if our political discourse is to be listened to, there's potentially lower immigration.

Real net national disposable income provided in the Australian Bureau of Statistics national accounts for the September quarter provides a picture of how much cashflow households actually have available to spend.

A look at the aggregate figures reveals a relatively steady uptrend, but the per capita basis — which arguably more accurately presents an individual's ability to absorb price increases — reveals a less positive picture. The data shows the average household has not had a real income increase for six years.

My colleague Andreas Lundberg, reckons this is a worry for two reasons.

- First, a lack of any meaningful increase in disposable income for individual households means there is virtually no ability to absorb price increases, thwarting any attempt by retailers to pass on rising costs.
- At the same time for many retailers, costs are rising. Therefore, it is quite possible that in addition to slowing top line sales, profit margins will come under pressure.

Australia's population growth is primarily driven by immigration (about 80 per cent) and while both sides of politics have hitherto accepted high rates of immigration as beneficial for the economy, public discourse is clearly shifting.

A more restrictive stance appears to be emerging, especially in NSW and Victoria where infrastructure — and by implication, living standards — is under significant pressure.

Without making a political statement about its appropriateness, any adjustment to immigration rates would be negative for retail volume growth.

Elsewhere, the savings ratio, which tracks the portion of income households save for the future, is falling rapidly.

Households are cutting back on savings to maintain their consumption habits, but this can be sustained for only so long.

While the ratio is falling, it is still positive. Were the ratio to move into negative territory — and we aren't far off at present rates of decline — households would be drawing down on their savings to spend. If consumption continues to be propped up by any further falls in the savings ratio, it simply cannot be sustained for long.

Record levels of household debt also suggest financial flexibility is severely restricted. Perhaps that was hinted at by the 22 per cent jumped in bad and doubtful debt reported by energy group AGL in its 2018 full-year results.

Further evidence that consumers are already spending less was revealed in last month's new vehicle sales statistics. A decline in new car sales accelerated last month, with Australian car sales falling for the seventh month and by 7.4 per cent year-on-year, well below the 5.3 per cent decline in October.

Audi NSW sales fell 20 per cent last month after a 33 per cent decline in October.

Mercedes-Benz, Ford, Volkswagen and Honda recorded national declines, with Mercedes-Benz and Ford falling about 40 per cent.

Record levels of debt, falling savings and retail companies reporting tough conditions all indicate the retail picture is unlikely to change.

On top of this, further falls in house prices are likely, and the negative trend in retail is then likely to continue.

Consequently, we believe true value for retail stocks remains below current prices. Of course, further falls, if they emerge, could produce bargains, and investors would be wise to look well ahead and see the present deteriorating conditions as a reason to sharpen the pencil and keep an eye out for true retail bargains.

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Firms hoard $45bn franking credits

There are calls for cash distributions before Labor wins

JAMES KIRBY
WEALTH EDITOR

A staggering $45 billion worth of franking credits are being hoarded by some of Australia's biggest companies and demands to release them before an ALP government comes to power are rising fast.

New research on some of our biggest stocks reveals companies such as Rio, Fortescue and Caltex have a treasure trove of stored up franking credits. In an extreme example, Harvey Norman's franking credits are equal to 14 per cent of the retailer's $3.7bn market value.

But these credits will be useless to a significant shareholder segment if the ALP wins the next election, as the opposition plans to scrap the cash rebates retiree investors receive on franking credits despite franked shares making up the backbone of most small shareholder portfolios.

"If franking credit was a listed company, it would rank as the seventh biggest company in Australia," says Hasan Tevfik, a senior analyst at MST Marquee who has run the numbers on the ASX. Tevfik's research shows major companies are hanging onto franking credits when there appears to be very little reason to do so.

JB Hi-Fi, Woodside, Woolworths and Flight Centre — all favourites with retail shareholders — also appear high on the list that has been compiled excluding financial stocks since banks generally distribute all their franking credits on a regular basis.

BHP and Rio have already made some effort to release their excess franking credits but the report shows that, even including their planned measures, they still have franking credits that are relatively high — representing about 7.4 per cent of the market capitalisation at BHP and 10.3 per cent at Rio.

In an ideal world, listed companies would have little or no franking credits stacked up on the balance sheet but, citing conservatism, many blue-chip groups use them as a buffer to be used in tough times.

The problem now is such conservatism could carry a high cost that will be shouldered by older investors if the ALP goes ahead with its controversial plans. Opposition Treasury spokesman Chris Bowen has repeatedly said he will not budge on the issue.

Typically, companies can get the franking credit value off their books and into small shareholders' pockets through special dividends or buy-back programs.

The new research follows a similar exercise a year ago by Macquarie Bank. That report, based on results in the year to June 2017, showed the worst companies in terms of franking credits had been Salmat, The Reject Shop, New Hope Corporation, Cabcharge and BHP.

Macquarie Bank has been collecting franking credit data for more than a decade as investors have always kept an eye on credit balances to ensure capital management was optimised.

Analysts argue that companies with franking credits banked up on their books may not be acting in the best interest of shareholders if they resist actively distributing those credits.

"We know some of these companies have resisted and boards have waved off questioning shareholders ... but we find the excuses poor," says Tevfik.

"The ALP policy will make franking credits worth less to the aggregate shareholder."

Under existing arrangements, the vast majority of retirees are tax free. When Australian companies pay dividends they have franking credits attached — the system was originally introduced by the Labor government. Shareholders who have tax bills can offset their franking credits from their annual tax.

However, retiree shareholders — who are tax free — don't have a tax bill to offset. To solve this issue, the Howard government introduced a rebate plan where retirees could get a cash cheque in lieu of their shareholder rights in relation to franking.

The ALP opposition has proposed scrapping this arrangement with no compensation — retirees who are on pensions or part-pensions are exempt.

It is estimated the average retiree investor gets about $6000 a year in franking credits.

In recent weeks the issue has become a key area of political debate as fund managers led by Wilson Asset Management's Geoff Wilson protest against the scheme. Opponents suggest the plan is discriminatory as it isolates a specific section of the community — older independent investors — on a tax measure.

Wilson, who raised a petition against the change, believes the ALP measure is essentially unfair and penalises investors who have constructed their portfolios on what many had taken to be a settled government policy.

Earlier this year he suggested: "What disturbs me is that I don't think people understand how crippling these changes will be to people who have abided by all the laws for the last 20 years."

The debate has been inflamed by union-backed industry super funds suggesting they would not be affected by the measure.

This is because franking credits are not being terminated — rather, it is the right of independent retirees to receive cash for those credits that is being terminated. As a result, most large-scale funds — industry or retail — will not be affected since they can still use the franking credit offsets.

With $45bn worth of credits yet to be distributed, time is running out for the biggest hoarders.

My investment plan for 2019: exploit sharemarket rallies

WILL HAMILTON

First things first: as 2018 draws to a close it looks as if most mainstream asset classes will deliver negative returns for the calendar year.

Thankfully, we don't get to see a 12-month period such as that one too often.

In fact, London-based Capital Economics just reported that for the first time in more than 25 years, 2018 will be the year when its list of 10 major asset classes each delivered a negative return.

What happened? Well, we had trade wars and Brexit and, crucially, fears over the stage of the US economic cycle — but also the monetary cycle.

Looking ahead, I believe 2019 will see significant regime change. This is where quantitative easing will turn to quantitative tightening. QE — more commonly known as governments printing money — became the rising tide that lifted almost all risk asset prices. The reverse, though, is not necessarily the case.

Let's look at which asset classes will be affected by monetary tightening, or QT, in next year, and how they will be affected.

It's predicted that the balance sheets of all the major developed world central banks will experience declines as the process of QT becomes reality.

Given the distortions that recent monetary policy has wrought, the process of normalisation will be difficult.

It will be rendered more so by the somewhat complacent expectations about the future path of policy.

During the past decade, investors have become conditioned to expect central banks to repress financial volatility at the first sign of market vulnerabilities.

The reality is that we are moving towards a world of tighter (or increasingly tight) liquidity.

As we enter 2019, I see shares as cheap, especially after the recent sell-off. This was and still is the least overvalued asset class — and it remains cheap relative to mainstream fixed income.

It's hard to ignore the marked outperformance of the US equity markets over every other region — in particular our own domestic market — during the past decade.

Looking forward into equity markets, this is a period for conviction management. Beware thoughtless or passive portfolio construction strategies with heavy FAANG (mega-cap tech) exposure, as these strategies should be the most affected in regime change.

As a reflection of where we are in the economic cycle, I have adopted a cautious approach.

As I have said, I believe shares are cheap at present.

However, as we move into the later stages of 2019 we will be planning to reduce exposure to

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equity markets in rallies, as opposed to buying the dips.

What might drive this final rally — or rallies — in the year ahead? While US President Donald Trump's tax benefits are behind us, one positive as we go through 2019 will be the benefit from reduced regulation. These generally have not been felt yet.

In fixed income, liquidity is an issue as debt issuance looks to increase next year. An eye must be directed towards quality.

Furthermore, QT will signify monetary conditions are tightening and creditworthiness will start to be explored more often. As an advisory house, we have minimal exposure to government bonds, and where we do we look at low duration. That means given where we are in the interest rate cycle, some duration exposure will have to be explored.

If the US Federal Reserve ends its rate rises with one more increase before the middle of the year, and markets start to factor in the Fed decreasing rates in 2020, we will start to put duration into our portfolio for the first time in many years. We expect US Treasury yields to fall by the end of next year. On the back of this scenario, we also would envisage mild US dollar weakness.

One last thing: we don't favour credit markets. When we talk about credit we are less concerned at the domestic landscape. This is more a global concern, particularly regarding the US. Investors should worry less about dynamics in the equity market — even if selling the rallies makes logical sense — and more about the widening of these credit spreads.

The lowest interest rates in modern history have created an unnatural divergence between corporate debt levels and corporate default rates. Credit spreads (the difference between the yield on 10-year US government debt relative to that offered by junk bonds) have begun to widen, reaching their broadest since late 2016. Investors thus need to watch these credit spreads, especially if they look to stretch further.

Many investors have short memories and so may have forgotten what a bear market feels like. That means 2019 is a year where watching markets closely for the signs and signals covered here will be important. Watch fixed-income markets closely, too.

The endgame is to ensure portfolios become appropriately positioned throughout 2019 to set up for the next couple of years.

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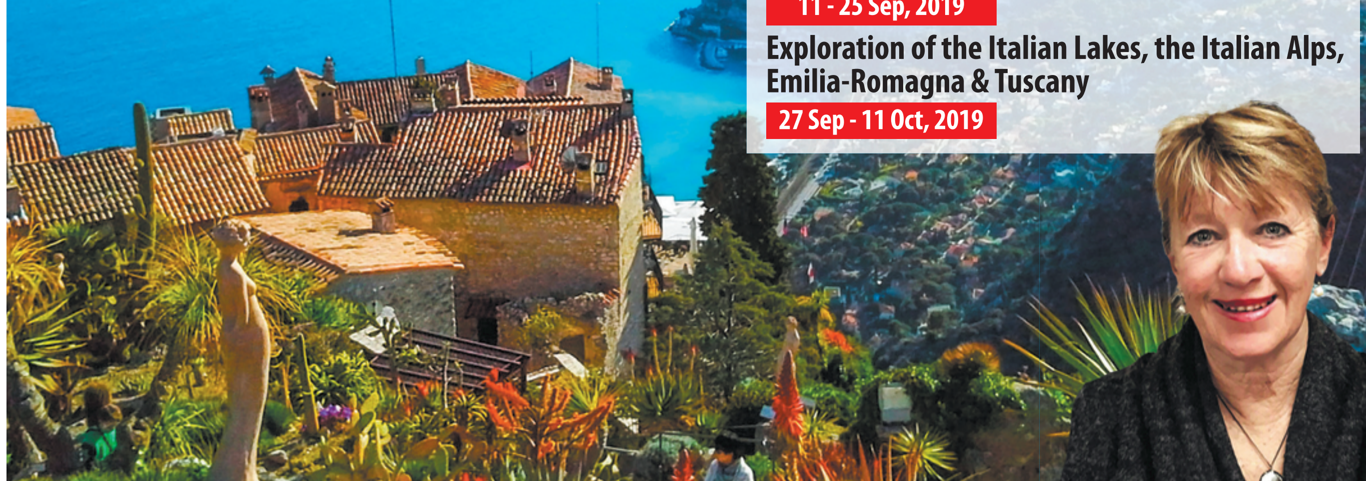

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