Sunshine breaks through clouds

The recent rally is hard to justify, so investors should expect more volatility

ROGER MONTGOMERY

Summer has brought with it a combination of insights and developments that have befuddled investors and confused commentators, but the outlook for 2019-20 remains mostly unchanged.

A terrible drought, retreating house prices, evaporating consumer confidence, a wobbling Chinese economy, consecutive downgrades to global growth by the IMF, decelerating domestic economic growth and a slower pace of US corporate earnings growth all suggest higher share price multiples are difficult to justify.

And yet, the US stockmarket, as measured by the S&P 500, has rallied 15 per cent since Christmas Eve to mid-February to register a CAPE ratio (Robert Shiller's cyclically adjusted PE) of 29.75. There have only been two occasions since 1870 that the US stockmarket was equally or more expensive.

Australian consumers' confidence has been described by Westpac as having "evaporated".

It's perhaps no surprise that consumer confidence and spending is declining.

Record debt used to fuel a property boom has emptied consumer pockets and now the property boom is turning to bust with an estimated 350,000 households in negative equity if property prices decline another 10 per cent, as they did in 2018.

A plunge in consumer confidence, the impact of elevated levels of household debt, anxiety about this year's federal election outcome and forecasts of a deeper downturn in property are enough to detract from reasonable rates of economic growth and strengthening employment conditions.

Due to tightening credit conditions, vanishing foreign property buyers and heavy indebtedness, Australia is now experiencing its biggest property price falls since records began almost 40 years ago; Sydney house prices are falling the fastest in two decades and, with fears of a Labor victory, the slide isn't expected to stop any time soon.

While the long-held belief among many economists is that a tightening jobs market will produce higher wages, followed by inflation and then higher interest rates, borrowers may be able to breathe a sigh of relief because it's unlikely to happen any time soon. In fact, if there is one thing sure to cause a market meltdown ahead, it's a recession.

To be fair, moving past "peak growth" (the US economy is estimated to be growing at close to 3 per cent a year) is not the same as an economic "contraction", but the downgrades to growth are becoming louder.

Goldman Sachs recently cut its 2019 GDP growth forecast to just 2.1 per cent, from 2.4 per cent previously. In another report, Reuters polled 100 economists cutting their first-quarter forecast to an annualised rate of 2.1 per cent.

And finally, according to the Beige Book, which reports the anecdotal information on current economic conditions from bank and branch directors and interviews with key business contacts, economists and market experts, collected by each of the district Federal Reserves, US company optimism is waning with firms retreating from investment plans and pulling back 2019 forecasts.

Residential and commercial builders in the US say they are "beginning to scramble for new projects to keep their workers employed". And then we come to China.

Chinese retail sales growth rates have plunged from roughly 11 per cent 2017 to just 8 per cent today. Meanwhile, total import growth is negative and semiconductor imports have fallen by a third in US dollar value.

China's GDP in the fourth quarter grew at 6.4 per cent, if their numbers are to be believed, which is the slowest in a decade. The annualised rate, 6.6 per cent, is the slowest in almost three decades.

Of course, *The Australian* has been replete with stories of President Xi Jinping warning of "serious dangers" — presumably to his hold on power — as risks mount.

The effects of China's slowdown are being felt not only in the Chinese halls of power, but across the globe, including in Europe where Germany recorded economic growth of just 1.5 per cent last year, the slowest in half a decade.

The Chinese slowdown has prompted Harvard professor, chess Grandmaster and world expert on financial crises, Kenneth Rogoff, to warn that China is in the grip of a "dangerous downturn" that "is rapidly becoming the greatest single threat to the global financial system".

The world's monetary and fiscal policies are hardly prepared for another shock, but Rogoff fears China's latest malady could be "the third leg of the global debt supercycle, after subprime in the US and the eurozone crisis" and, while nobody knows the precise path that will be taken, "it could be on the scale of 2008 and will be very bad for Asia".

Which brings us back home. Thirty per cent of our exports go to China each year, and with retail and property in the doldrums and business anxiety about a Labor victory stifling investment and optimism, it seems the January stockmarket rally is difficult to justify. I would expect 2019 to see several bouts of stockmarket volatility before the year is out.

Some see that as risk, but if you are a net buyer, think of it as opportunity.

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

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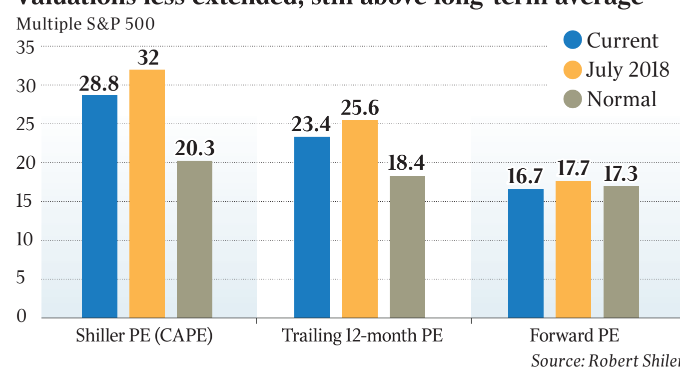
Valuations less extended, still above long-term average



Source: Robert Shiler

Activist shareholders playing a greater role

TONY KAYE

As the Hayne financial services royal commission conducted its public hearings across Australia last year, a parallel round of private meetings took place involving the world's biggest investors.

Collectively managing more than $US16 trillion ($23 trillion) in assets globally, and holding key stakes in Australia's listed banks and insurance companies, representatives from the "asset stewardship" teams of BlackRock, Vanguard and State Street took turns visiting senior executives from the major banks and AMP.

It should be noted that regular high-level meetings between the so-called "big three" fund managers and our larger companies are not irregular. In fact, they happen at least once a year, and focus on what measures are being taken to deliver long-term growth to shareholders.

But, in the shadow of the royal commission and the flood of damning evidence exposing widespread financial misconduct at the banks and AMP, the round of Australian stewardship meetings in 2018 had a very different backdrop to the catch-ups that normally occur.

An insight into Vanguard's meeting with AMP is contained within its 2018 investment stewardship report, under the heading: "After failings and turmoil, resignations from a board".

Without naming AMP, Vanguard states: "After numerous governance failings and a public investigation at an Australian financial services company, we engaged with the board to understand its perspective on the firm's business practices and organisational culture, and specifically on how the board would ensure a rigorous oversight process moving forward," Vanguard states.

"Our engagement occurred during a time of great turmoil among the board and executive ranks. We challenged the board on its awareness of and responsiveness to these matters. Given the severity of the situation, we concluded that the board lacked sufficient oversight of — and — accountability for management."

Only days later, in May last year, AMP announced the resignations of its chair Catherine Brenner, chief executive Craig Meller, and several other directors.

The "big three" wield a lot of power, but ultimately they are long-term investors. As such, they are not shareholder activists in the same vein as those who buy stakes in companies with the aim of forcing boardroom and operational changes so they can later exit their positions with a healthy profit.

Yet, a new report released this month — coincidentally on the same day as the joint resignations of NAB chair Ken Henry and its CEO Andrew Thorburn — shows shareholder activism in Australia is on the rise at all levels, and investors are ready and more willing than ever to vote against company boards.

Another clear sign of that came in December when an overwhelming majority of shareholders in both Westpac and NAB (including the "big three") voted down the banks' remuneration reports at their annual general meetings.

The Activist Investing Annual Review 2019, produced by US-based shareholder activism research group Activist Insight and specialist law firm Schulte Roth & Zabel (SRZ), shows that Australia experienced a record high number of activist engagements in 2018, with 78 companies targeted — a 28 per cent increase on 2017. Not only that, Australia ranked second in the world in 2018, with the highest number of activist engagements outside of the US.

Mining targets

While large ASX companies were key investor targets here, nearly two-thirds of them had market values of less than $50 million. The bulk of these actions were launched against small mining companies.

In its forward to the report, law firm SRZ says the rise in investor activism, led by 491 actions in the US, is largely a case of success begetting success.

"As activists continue to secure board seats and strategic and operational improvements in the US, developments in European activism have accelerated," the report says. "Companies targeted by activists have become more likely to settle rather than risk losing a costly proxy fight. And activists have embraced M&A-related strategies to increase share prices."

There was an upsurge in M&A-related activism in 2018, with activists frequently speaking out against acquisition offers they felt undervalued the targets in a bid to secure a higher sale price for shareholders.

Activist Insight quotes Sydney-based activist group Sandon Capital, which has been involved in campaigns against Fleetwood Corporation, Specialty Fashion Group, Watpac, Iluka Resources and Tatts Group, among others.

Sandon boss Gabriel Radzyminski, says he hopes to resolve some ongoing campaigns in 2019 and believes Australia will present "phenomenal" opportunities, thanks to a combination of "pockets of undervaluation" and a potentially strong M&A market.

"The private equity guys will be able to offer significant premiums to the market, but even those premiums will be a discount to the true worth of those companies," Radzyminski says.

Analysts and advisers expect an increase in transactional activism, specifically in the mining and energy industries. Also, as markets become more volatile, combinations of activism may become more achievable.

"With a lot of stocks getting beaten up, there's certainly opportunity for activists to push companies for M&A activity," says Paul Schulman, MD and executive vice-president at MacKenzie Partners.

Activist Insight predicts that environmental, social and governance issues will remain a consistent theme in 2019, and that activists may push for transactions "at an even more furious pace as credit markets tighten and the outlook begins to darken".

So far this year, in Australia at least, the level of investor activism remains sedate, aside from the campaign around the ALP's proposal to scrap dividend franking credits. The votes for and against that plan will be cast in the polling booths.

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

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Expanding Indonesia Asia's hottest market

ASSIF SHAMEEN

Investors in emerging markets might be surprised to learn that with a nearly 16-fold gain, Indonesia has been Asia's best performing market over the past 20 years. In fact, Indonesia's record through to the end of January far outpaced China and India.

The Jakarta Stock Exchange came out on top over 10 and 15 years. Last year, even with a 2 per cent decline, it beat Shanghai's 25 per cent fall and finished second to India's 7 per cent gain. And Indonesia could widen its long-term lead this year.

Among the positives is the likely re-election of President Joko Widodo in some two months. He's a strong favourite to win a second term over conservative former army general Prabowo Djojohadikusumo, an ex-son-in-law of the dictator Suharto. The President, known as Jokowi, narrowly defeated him five years ago.

If Jokowi wins, there will be two investment themes that will dominate his second term: rebuilding infrastructure and gaining a bigger share of foreign direct investment in Asia.

"Jokowi is a decisive leader committed to boosting GDP growth and competitiveness. In his second term he is likely to pursue unpopular but necessary policies such as labour market reforms," says Manu Bhaskaran, director at independent research house Centennial Asia Advisors in Singapore.

The fourth most populous country behind China, India, and the US, Indonesia saw its economy grow 5.2 per cent last year, following 5.1 per cent growth in 2017 — well below India's 7.2 per cent and China's 6.5 per cent.

"Indonesia can easily achieve 6 per cent growth over the next few years," argues Mr Bhaskaran.

"But it really should be doing better — 7 per cent or more."

Indonesia weathered last year's emerging markets turmoil better than its peers in Latin America.

"Good monetary policy translated into greater resilience to emerging markets stresses and its fiscal policy has improved," Mr Bhaskaran said.

Focused on winning a second term, Jokowi has been on an economic tightrope since the 2016 mayoral election in Jakarta, which the opposition party won.

Post-election, Jokowi is likely to move aggressively on tax incentives to woo manufacturers.

Indonesia, alongside Vietnam, Thailand and Malaysia, is seen as a key beneficiary of manufacturers' move from China to cheaper locations amid the US-China trade battle. Jokowi has helped push through an improved tax holiday for foreign investors.

"Previous tax incentives were been too small to make an impact," says Sriyan Pietersz, a strategist for Matthews Asia in Singapore. Taiwanese contract manufacturer Pegatron, which makes iPads and HomePods, and Korea's Lotte Chemical are among those relocating facilities.

"Post-election, we will see a revision of investment laws to facilitate relocation of manufacturing from China as well as a cut in corporate tax from 25 per cent to about 20 to 22 per cent," he says.

Jakarta's market is priced at a middle range to its history, trading at just over 15 times this year's estimated earnings. Analysts expect corporate earnings to grow 12.5 per cent this year after 10.5 per cent growth last year. Local consumption is picking up.

"The rupiah is strengthening again, which leads to more affordability from a consumer standpoint," says Mr Pietersz.

"There is also a 30 per cent increase in social spending for the rural sector and lower income group in this year's budget, which will help consumer spending."

Among the most-favoured stocks is Astra International, which owns the country's largest car-distribution network, palm-oil plantations, manufacturing ventures and a bank. The stock trades at 13.7 times this year's estimated earnings and has a 3 per cent dividend yield.

Come to grips with arm's-length SMSF laws

MONICA RULE

One area of the superannuation law I am frequently asked about is self-managed superannuation funds (SMSF) investing with other members.

Superannuation law does allow SMSFs to invest with their members, but it is mostly restricted to 5 per cent of an SMSF's value. For example, an SMSF that has a total value of $500,000 can invest up to $25,000 (5 per cent) in a member's business by either buying shares in the member's company business or lending money to the company.

In a situation where an SMSF owns a residential property, it can lease the property to a member as long as the value of the property does not exceed 5 per cent of the total value of its assets, which would suggest it is restricted to funds with substantial assets. However, if it is leased to a member who uses the property wholly and exclusively for their business than the value of the property can exceed the 5 per cent limit.

An SMSF can invest more than 5 per cent in a related non-geared entity such as a company without any borrowings if it satisfies the requirements of the law.

The principle to observe is this: all investments with related parties must be entered into and maintained at arm's length.

The interpretation of what is "arm's length" under the superannuation law caused a lot of confusion back in 2010. This is because the law states that as long as the terms and conditions of the investment transaction is "not more favourable to the other party" then it is allowed.

The ATO, at that time, expressed its view of the super law definition when it gave an example of an SMSF that borrowed money from a related party on terms that were clearly favourable to the SMSF.

The example involved a member borrowing money from a bank at a 5 per cent interest rate and then loaning the money to their SMSF at 5 per cent.

If the SMSF had borrowed the money directly from the bank, it would have been charged an interest rate of 6 per cent or higher.

The ATO paper on the issue states this arrangement is acceptable as the loan is not more favourable to the member, who in this case is the other party.

So, from 2010 to 2016, there were many clever trustees who took advantage of the ATO's interpretation. Their SMSFs borrowed from members, and the loan arrangements consisted of borrowing 100 per cent of the asset value; no repayments being made for years and an interest rate of zero per cent.

The commissioner of taxation is responsible for ensuring taxpayers comply with the superannuation law and the income tax law. So the problem he had was the definition of a "Non-Arm's Length Income" (NALI) under the income tax law states if a taxpayer received income from an investment that is more than what it would have gained if the investment transaction was with an unrelated party, then the income will be treated as NALI and taxed at the highest marginal rate (45 per cent).

> I'm always impressed with how clever people are able to exploit interpretations of the law

So in 2016, the ATO issued two publications (PCG 2016/5 and TD 2016/6) to explain its position on the income tax law definition and how it would apply to SMSFs.

In the PCG 2016/5, it states that if an SMSF borrows from a related party, the borrowing arrangement needs to be at arm's length where the interest is charged at a commercial rate; the amount borrowed does not exceed 70 per cent of the asset's value; a registered mortgage is placed over the property; principal and interest is paid monthly; and the borrowing period is not more than 15 years.

TD 2016/6 gave an example where a hypothetical borrowing arrangement is compared with the actual arrangement entered into by an SMSF with a related party. It states if the SMSF could not have entered into the hypothetical arrangement (an arm's-length loan arrangement) then the income earned by the SMSF will be treated as NALI and taxed accordingly.

So if an SMSF trustee is thinking of borrowing from its members to acquire an asset for the SMSF, they need to ensure that the loan arrangement is at arm's length to avoid the investment income being taxed at 45 per cent.

I'm always impressed with how clever people are able to exploit interpretations of the law.

I guess, as our example shows, the challenge for legislators and bureaucrats is to clearly express a law's intent without making it indecipherable to us mere mortals.

Monica Rule is the author of The Self Managed Super Handbook — Superannuation Law for SMSFs in Plain English

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NBN rival leaves comfort zone to expand fixed-wireless broadband network

FLOAT WATCH

Uniti Wireless Limited

ASX CODE: UWL
SHARES ON OFFER: 72 million
LISTING PRICE: 25c
MARKET CAP: $37.9m
LISTING DATE: February 13

Adelaide-based telecommunications company Uniti Wireless will hit the ASX boards this week as it concludes a capital raising to expand its fixed-wireless broadband technology across Australia and challenge the National Broadband Network.

Uniti Wireless provides connections over its own wireless access network to residential and business premises via telecommunication towers. The technology is seen as an alternative to the NBN network and ADSL connections.

Currently operating in Adelaide, the company plans to invest up to $6.8 million to deploy its network across Sydney, Brisbane, Melbourne and Perth.

The listing is conditional on completion of the $8.1m acquisition of FuzeNet, a broadband and data connectivity company. The merged entity forecasts pro-forma revenues of $23.1m and EBITDA of $2m.

With a market cap of $37.9m and enterprise value of $29.9m, the IPO is valued at 14.5 times forecasted earnings.

During 2018 Uniti added about 300 customers per month, surpassing 6000 installed active wireless customers. Successful expansion into metropolitan areas with an increased network footprint has the potential to accelerate customer acquisition and growth rates.

However, the telecommunications sector is a highly competitive market as traditional fixed-line providers including Telstra or Optus as well as the NBN and other "disrupters" compete for market share.

The $51 billion NBN rollout — Australia's largest-ever infrastructure project — is highly controversial, not least because of its outdated technology and poor connection speeds in some areas.

With the continuing evolution of wireless technology, it is expected that speed and performance will soon surpass some of the existing fixed-broadband services, thus creating additional demand for alternative services.

Uniti has decided it is time to leave its comfort zone: the company has established a strong presence in Adelaide, but as it expands its network into other areas the risk of cost overruns will increase. Expansion strategies typically involve increased expenditure, and cost overruns are a common occurrence in project management.

While failure to deliver ongoing growth could adversely affect the company's financial forecasts and future shareholder returns, IPO investors will put their trust in the board and executive management's strong telco track record.

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