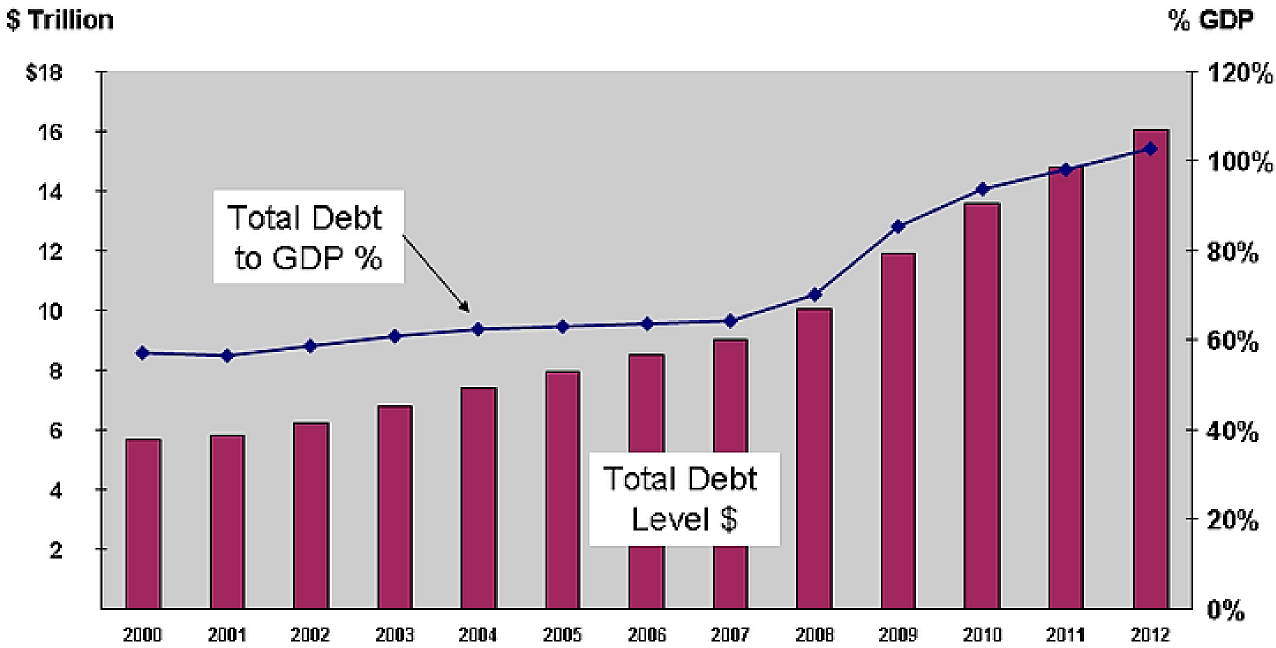
Will “Kicking the Can” Leave Us All In A Ditch?

Hub Wealth Update October 2013

The United States politicians finally agreed to pass the budget and raise the debt ceiling last week, after protracted negotiations and a 16-day Government shutdown of “non-essential services”. To put it mildly, this was not a good look, as politicians pushed the American economy into slowdown, and left the country on the brink of defaulting on loan repayments. The consequences of such a default could be hugely significant. The US Treasury Department stated that default would “precipitate another financial crisis and threaten the jobs and savings of everyday Americans – putting the United States right back in a deep economic hole …”

However, the deal is only to “kick the can down the road” in Obama’s words. After all of that, the Government is now financed until January 15th, and the debt ceiling is raised until the 7th of February. To quote Obama again: “We’ve got to get out of the habit of governing by crisis”. Due to a lack of clear mandate for either party in Congress, there has been no detailed budget plan approved since the 2010 budget.

Chart: US Total Debt as a % of GDP. Source: US Treasury Department.



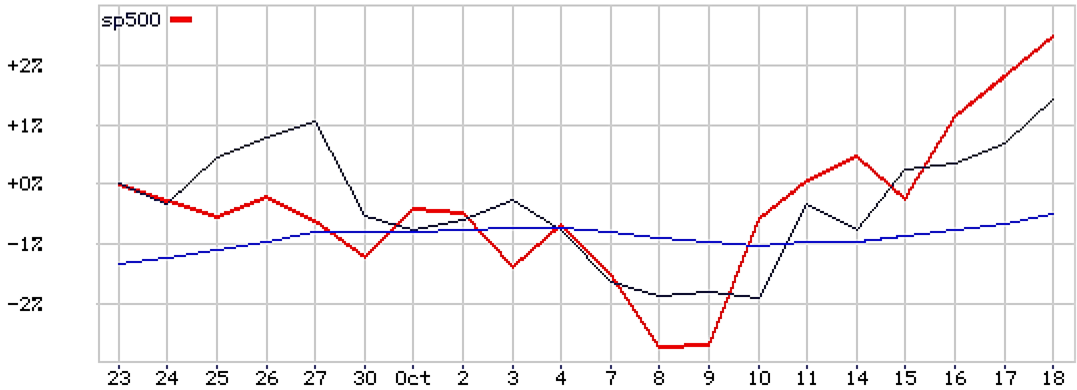
Background

While not widely recognised, this was the 18th time that there had been a US Government shutdown since the modern budget process was established in 1974. An analysis by ratings agency Standard & Poor’s estimated this shutdown cost the US economy US$24 billion. The debt ceiling (includes accumulated Government debt) had already been raised 10 times since 2001.

Less widely known is that **Australia has its own debt ceiling**, currently at the level of $300 billion, or less than 20% of our Gross Domestic Product (GDP). By contrast, the US debt ceiling is at 105% of GDP. New Treasurer Joe Hockey has flagged that he will seek to raise Australia's ceiling to $500 million to avoid the scenario that has just played out in the US.

Economic and Market Implications

Interestingly, from 1 - 18 October, **share markets in the US (in red) and Australia actually rose in value**. (see chart below, where the red line is the US market, black is Australian ASX200 index, and blue is the moving average). Trying to trade these situations can be counterproductive.



There is no doubt that recent events have reduced confidence both within the US, and overseas. Economic growth will be reduced in the US due to the slowdown by approximately 0.3% in the December quarter. This is not ideal at a time when the International Monetary Fund (IMF) recently reduced global growth forecasts for 2013 and 2014 to a modest 2.9% this year and 3.6% next year. The medium-term implications are difficult to say with certainty.

The Positives

However, there remains cause for some optimism based on the following considerations:

- **US Congressional elections** are due in mid-2014, and this may help to reduce the potential for further political impasse in the December/January negotiations in the US. Also, if there is further inability to pass the budget in January, automatic sequestration will occur: spending cuts will automatically come into effect.

- The political situation is very likely to see the **US Federal Reserve delay any potential "tapering"** of its quantitative easing. This means this stimulus will be in place to boost markets for longer, especially with likely new Chair Janet Yellen in control.

- **European economies** are still struggling, but there are some positive signs with the current account positions of high-risk economies such as Greece, Portugal and Spain improving sharply over the past year.

- Recent data from **China** has been largely positive, with the economy growing at an annual rate of 7.8%. The November meeting of the Central Committee may further open up Chinese markets, possibly improving the ability of private enterprise to compete with state enterprises.

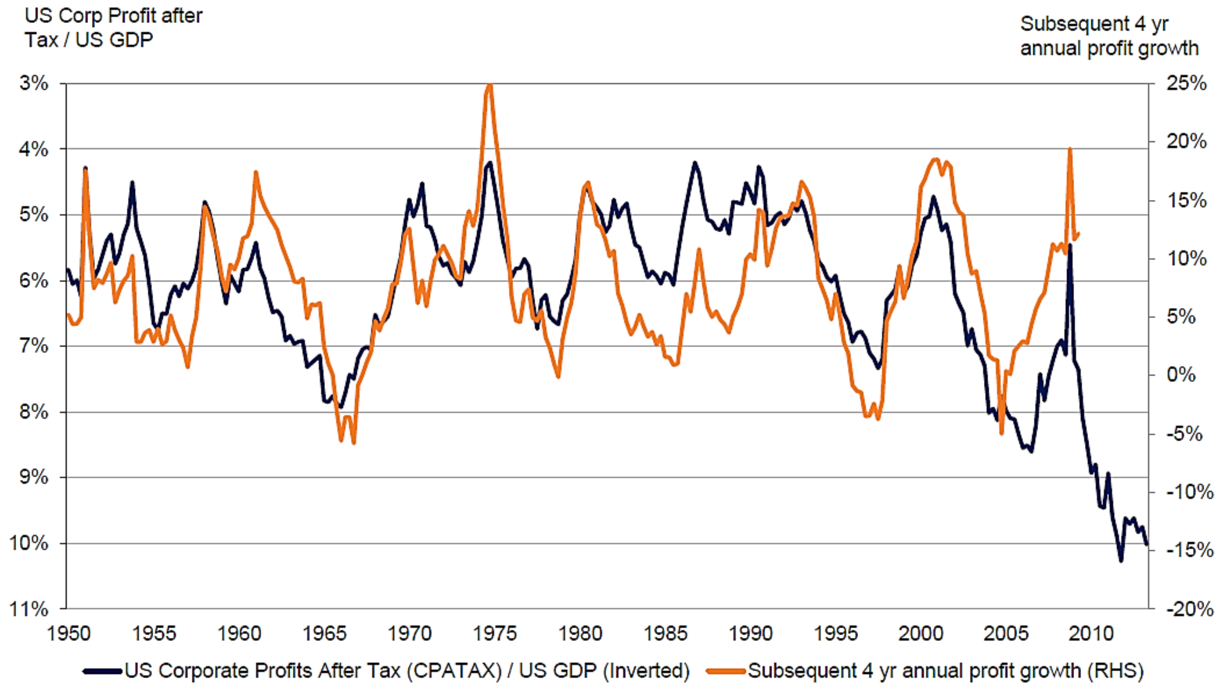
- Prime Minister Abe has increased **Japanese** sales tax from 5% to 8% in an effort to reduce growing debt. Offsetting this is a stimulus package, including infrastructure, tax cuts on home purchases, and a modest corporate tax cut. The aggressive economic stimulus continues in a bid to create inflation and some sustainable growth.

Reasons for Caution

Conversely, global share markets have risen substantially over the past two years, particularly in response to very low interest rates. Much of the reason for this has been increase in price/multiple, rather than fundamental growth in profit. Therefore, on most measures, shares markets no longer appear "cheap", despite the fact that dividend yields remain above bond yields.

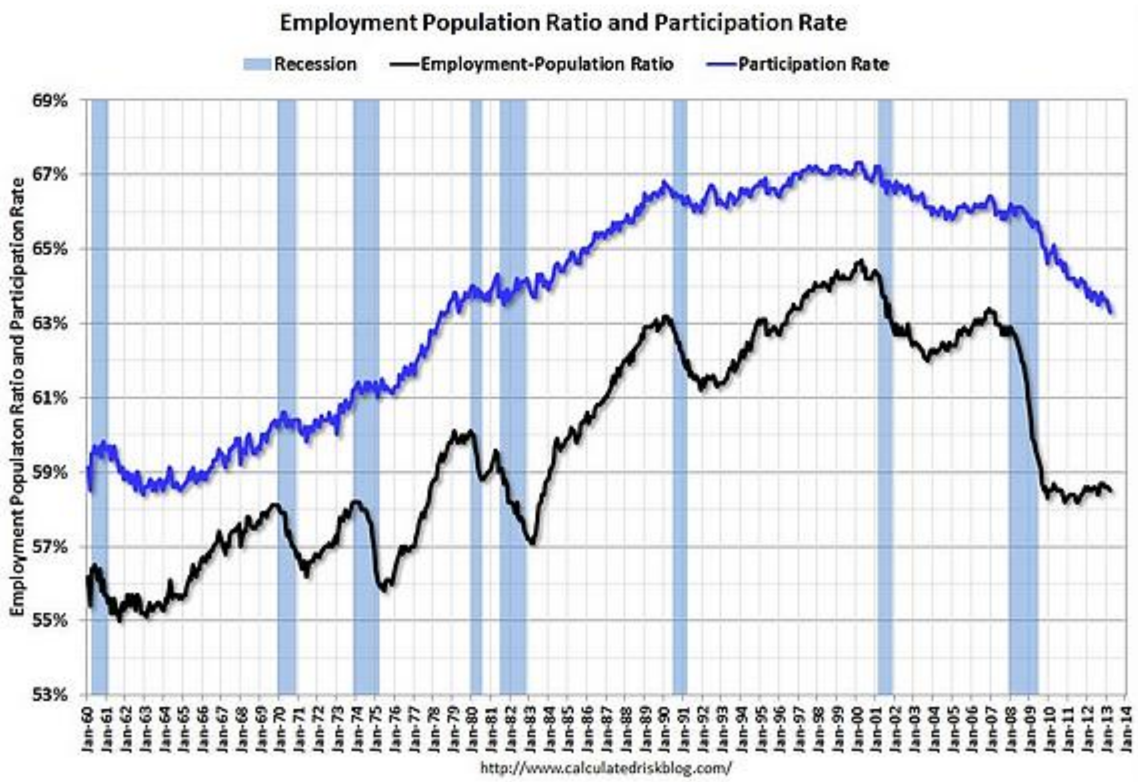
This particularly applies to the US, where corporate earnings have also been boosted by cyclically high profits. That is, companies have been taking advantage of cheap labour, cheap borrowing costs, low energy costs and other factors to boost profits to levels that are at the higher end of historical levels of profit to GDP ratios (see table below).

Chart: Is High Profit Share a Risk to Future US Share Price Growth? **Source: Datastream**



The chart above shows the relationship between US corporate profits as a % of GDP, and subsequent profit growth. In most instances, a high proportion of profit to GDP is followed by a fall in subsequent profit growth – a negative for share prices, and important considering the US makes up more than 50% of global share markets by value.

The flipside of strong recent corporate outcomes in the US is also that the labour market remains sluggish. Job growth has not accelerated, and wages and consumption remain soft. Some of the data needs to be reviewed with care. For example, the headlines that the unemployment rate is falling hide the truth that the level of underemployment is rising: fewer people are working, unemployment is lasting longer, more people are forced to work part-time (see table below).



What About Australia?

There are clear signs that the Australian economy is slowing, as recognised by the Reserve Bank lowering the cash rate to 2.5% in August, while also lowering its growth forecast to 2.25% for 2013. The fall in the $A in May-June was a positive, but this has reversed somewhat in recent months. The key remains the outlook for commodity prices, and the ability of the broader economy to transition successfully through the next phase.

On the positive side, the Reserve Bank sees upside for our economy over the next few years through a decline in the currency and the low interest rate settings it has engineered. Neither factor appears to have had significant influence from available data as yet, other than strong indications that housing prices have received a boost in recent months – not necessarily a positive for the economy unless it also translates into higher consumer spending, new building activity etc.

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A New Australian Government

The Tony-Abbott led coalition is now in power. They have not yet outlined too many specific changes from current approaches, but have indicated the following:

- They will delay increasing the Superannuation Guarantee Levy
- There will be a review of current contribution caps to superannuation when the federal budget is in surplus
- There will be a review of the current levels of minimum income payment from retirement income stream products to assess their appropriateness
- There will be a broad enquiry into the Australian financial services system
- There will not be any reform of Fringe Benefits Tax.

Portfolio Outlook and Positioning

Overall, there have been some improvements in the global economic and political situation over the course of 2013. However, fundamental structural economic, environmental and social issues remain a feature globally. Many major governments also suffer from a lack of clear political mandate, making decisions and action difficult.

Global governments continue to struggle with a massive debt burden, reducing their ability to undertake restructuring and budgetary measures. Economic growth remains modest, and unlikely to escalate rapidly. Central banks globally have undertaken policies of massive stimulus, which have underwritten a rise in global asset prices, but future outcomes and windback are uncertain.

We remain cautiously optimistic of avoiding a "ditch", but expect lower portfolio returns over the next 12 months after strong recent rises in share and property markets. The impact of the Australian dollar will remain quite significant for share returns. While notoriously difficult to predict, any hint of "tapering" in the US may result in a strengthening $US. Income holdings offer modest yield, but our focus is typically to manage risk in this area.

Hub Wealth clients have individually tailored portfolios, but our current themes include the following:

Asset Class	Positioning and Comment
Alternatives	We use modest exposures to strategies that do not only rely on markets rising to generate returns. This can provide both risk and return enhancement.
Bonds	Portfolios have an emphasis on short duration and flexible approaches. We remain concerned about future rises in bond prices, and low bond yields.
Property	Our portfolios hold modest exposure to listed property in Australia and overseas, with a bias to companies with reliable yield. We also include infrastructure for its long-term, defensive characteristics.
Australian Shares	We retain a bias to "value" and small companies, and prefer to diversify away from the relatively concentrated broad market index.
International Shares	We retain a bias to value" companies. Preferred active managers have a defensive bias, some Asian exposure, can hold cash and manage currency.
Overlay	We continue to believe it is important to have an active overlay for portfolios, capable of tilting portfolio strategy at times of greater risk/opportunity.

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More Information

Please don't hesitate to contact the Hub Wealth Management team if you would like to discuss your own circumstances and portfolio with us.

Please call us on 02 9279 3400 or email us through our website at www.hubwealth.com.au

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