Five questions for the Chief Investment Officer—August 2019

Video transcript

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Victoria Place (VP): Welcome to *Five questions for the Chief Investment Officer*. I'm Victoria Place and I'm a Senior Analyst working with our CIO, John Pearce, in the investments team.

John, we've had some great publicity after our Balanced investment option topped the performance rankings, returning 9.9% for 2018-19. In a recent article, you pointed to the stellar performance of some of our key holdings, such as the Australian Stock Exchange (ASX), Transurban, and Sydney Airport.

By some measures, these companies are now looking very expensive. What are your thoughts?

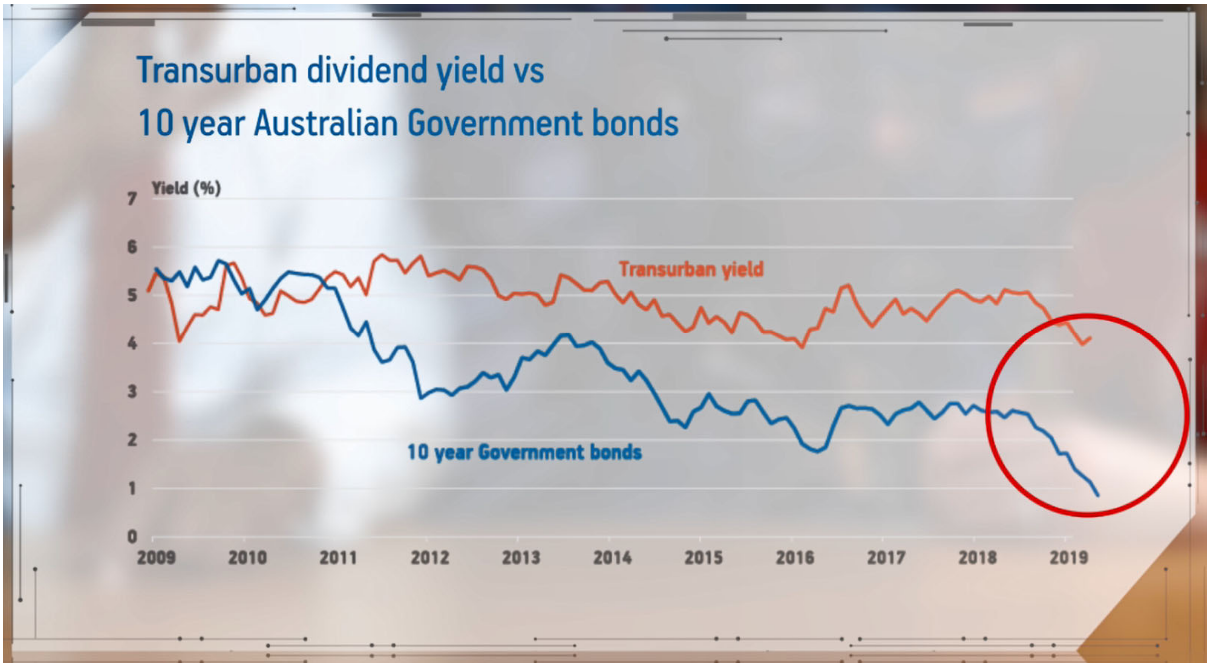
John Pearce (JP): Yes, Vicky. Once again, our fortress assets have underpinned very strong performance for the year and their share prices are hitting all-time highs. Whenever that happens, people do question whether the prices are moving beyond their fundamentals. There's another school of thought that says people are buying these assets because they see them as a substitute for bonds, given the certainty of their dividends—and as bonds have rallied, so have these shares, and as bonds sell off, so will those shares.

I would like to take issue with this school of thought and explain my position, referring to Transurban. Transurban is our biggest holding. It's spread across all of our growth options and really is a stable star, so to speak. Firstly, it is true that Transurban's share price has rallied as bond yields have fallen. But that's also true for—pretty much—the stock market in general. What's more important though, is the earnings profile of Transurban.

The blue bars are Transurban's earnings, or profit per share. The orange line is Transurban's share price. We're seeing that the shape of the share price movement has really followed its profitability.

What's more important, Transurban has converted that profitability into growing dividends, and that's what's really important to us.

Look at this line graph, Vicky. What we're seeing here is Transurban's dividend yield. Despite the growth in share price, Transurban's dividend yield is still around 4%. It's fallen from just over 5% to 4%. Look where the bond yield has gone—from close to 6% to below 1%. We're seeing a huge gap between the yield offered by Transurban and bonds.



We believe its dividends will grow because, like all of our ‘fortress assets’, it has a business model that will grow with economic growth and it also has pricing power. Bonds simply don't have that, and that's why we believe it's limiting to think of these assets as bond substitutes.

VP: Moving on to more pressing matters, is it right to say that our worst fears of an escalation in the trade war are indeed unfolding?

JP: I think that's a fair call. Trump just announced the extension of tariffs to a further $300 billion of Chinese goods, although the timing of implementation is somewhat fluid. We probably shouldn't be too surprised, and I want you to look at some historical context here. In the 1980s, we were talking about the emergence of not China, but Japan, as an economic superpower. We also saw the emergence of a young Donald Trump. I managed to retrieve from YouTube a video of a Donald Trump interview with Oprah Winfrey. He must have been a big deal at the time to get an interview with Oprah Winfrey, of course. The target of his vitriol at the time was Japan. He accused Japan of dumping everything and of knocking the hell out of US companies. But he did have the proviso that he did really respect the Japanese.

Roll the clock three decades forward and the target is now China. We're not talking about a daytime show here—Donald Trump is now the president of the US. Having said that, his language hasn't really transcended from the brashness of his youth. The stakes are a lot higher now, but of course, he also says that he loves China.

Getting back to Japan and how that played out. Trump wasn't alone. He had the whole political class behind him against Japan, and the US actually got Japan to the negotiating table at what is now known as the famous Plaza Accord. The result of this was that the Japanese and the US agreed to take actions to weaken the US currency and strengthen the Japanese Yen, therefore making US exports more competitive.

They indeed did this, but it hurt the Japanese economy and, very quickly, the Japanese central bank started to lower rates. We know what happened then. It fuelled one of the biggest asset bubbles in history, which led to one of the biggest busts in history—which, quite frankly, the Japanese haven't really recovered from. You could say in one sense that the Americans learned how to win a trade war from that experience, and the Chinese actually learned how you can lose one. The Chinese are not going to make the same mistake.

Bear in mind, the Chinese—unlike the Japanese—are not political allies of the US. In fact, since Trump announced the increase in tariffs, the Chinese have responded by lowering their currency, the Renminbi, below a critical level—seven to the US dollar. So the Chinese are basically saying, "We're in for a fight."

VP: Can you elaborate on the implications?

JP: Firstly, we can expect more equity market volatility. And if people are feeling that the market has become somewhat immune to Trump's tweets, think again. Here are three occasions where Trump has tweeted about tariffs. We've seen on every occasion that the market has swiftly responded in a negative fashion.

The next thing, of course, is that everyone is now lowering their expectations of global growth. That's having a flow-on effect of reducing bond yields (now around $14 trillion of bonds trading at negative yields), and central banks around the world are reassuring everyone that they're ready, willing and able to keep rates low and even lower them further.

But it does beg the question as to how potent or impotent monetary policy is becoming, because once rates get to such a low level… reducing that any more, are consumers and businesses going to go and borrow money and invest and buy things? I've certainly got my doubts. I believe more and more onus is going to be brought to bear on governments to loosen the purse strings and spend money.

Then you've got critics saying, "Well, what about government debt?" and people are saying we've got to actually just push that button. Indeed, we're now seeing the emergence of a new theory, modern monetary theory. I'm really oversimplifying this, but the proponents of this theory are basically saying 'if your country can print your own money and you've got a flexible currency, don't worry too much about the level of government debt because you can basically square the books by printing money'.

Personally, I'm a bit of a sceptic, I'm a bit old school. Debt matters to me. But some serious people are taking this theory seriously, so you can't dismiss it out of hand. I think we're going to be hearing a bit more about it.

VP: We've previously talked about the precarious position this puts Australia in. How are we faring?

JP: I think this cartoon from the Australian Financial Review sums it up perfectly.

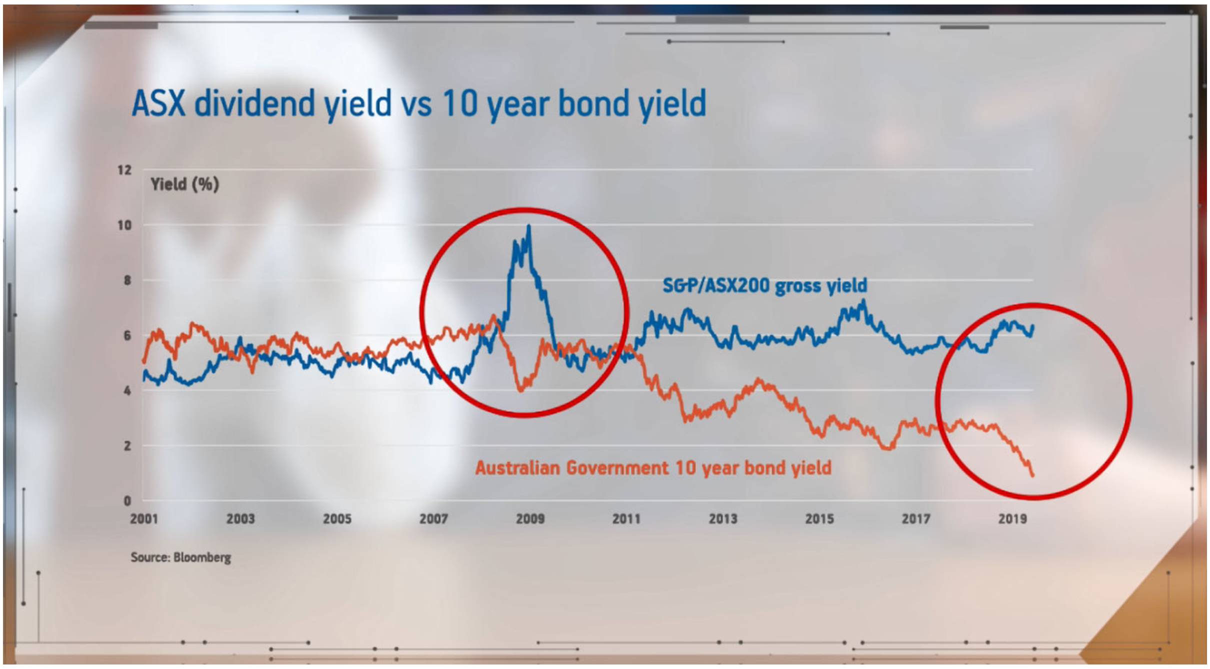
That's Prime Minister Scott Morrison walking a tightrope held by Xi Jinping and Donald Trump. And it's clear that, based on the language you're hearing from the Prime Minister, he's trying to reset the relationship with China after it deteriorated under the previous government.

In terms of the Australian economy—look, we're doing OK. Certainly not strong, though. Unemployment at 5.2% is not too bad by historical terms. Jobs are growing and the housing market looks like it's stabilising. On the negative side of things, we've got huge household debt and that's really restricting people's confidence to spend—so retail sales are low and borrowing is also low, and that's going to take some time to work through.

Our government, however, is in good shape, so we do have the ability to open the purse strings in Australia. Also, the Reserve Bank of Australia (RBA) is definitely ready willing and able to cut rates further. Somewhat surprising to me, the RBA's governor recently suggested that they wouldn't rule out unconventional monetary policy, which is unusual for Australia.

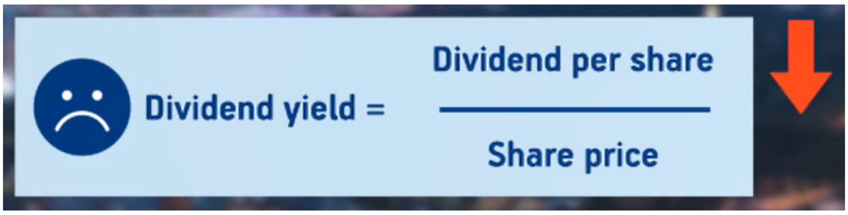
VP: So we can take some comfort that the RBA is willing and able to cut interest rates, which, generally speaking, should support the Australian share market. But things are never that simple, right?

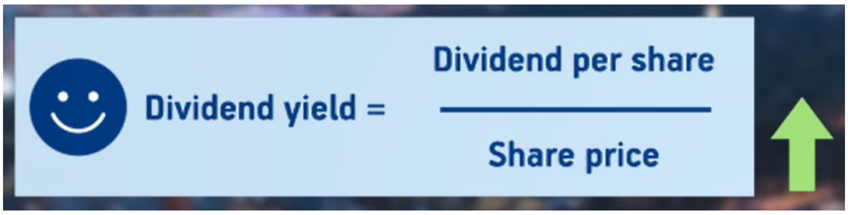
JP: There's always a sting in the tail. Referring back to the Transurban dividend yield discussion, let's talk about it in a broad market context. In the top line of this graph, you have the dividend yield of the total Australian market, and we're seeing that's hovering at about 6% if you include franking. Bond yields are around 1%. That 5% gap is massive. It's actually approaching GFC levels, which is denoting a crisis.



Now, we're not in a crisis, so I fully expect that gap is going to narrow.

If you look at the equation, there are basically two ways that the dividend yield can fall. The negative way is of course that we can get into a recession, dividends are cut, and the yield falls. The more positive interpretation is that share prices actually rise.





We're not contemplating a recession as our base case, so we do believe with the gap between dividend yields and bond yields at the moment, that there will be support for the share market, and indeed, we've been deploying some of our considerable cash levels selectively among stocks.

VP: Thanks, John, for answering these five questions. If you have any questions you'd like answered, please email us at **superinformed@unisuper.com.au**. Thanks for watching.