Five questions with the CIO—August 2016

Video transcript

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Danielle Clarke (DC): Hi, I'm Danielle Clarke, UniSuper's Communications Manager. And I'm here with our Chief Investment Officer, John Pearce, for the latest edition of *Five Questions with the CIO*.

John, last time we filmed, it was right after the British public voted to leave the European Union. That result came as a bit of a surprise, but global markets seem to have continued to perform strongly. Does that surprise you?

John Pearce (JP): You might recall, Danielle, during that interview, we actually urged our members not to panic and change their positions because of Brexit. The feeling at the time was the markets would take this in their stride, and life goes on. I must say though, I am surprised that the strength of the recovery in global share markets, the Australian share market up about 5% since the beginning of the financial year, even the British market, the London Stock Exchange is up by about 5%. That's where the trouble is. So what's the reason for this?

Well, we know what one of the reasons was, and I can show you, it's this graph here. I find this graph staggering, quite frankly. Here we have the volume of negative yield in government bonds in the global bond market. About two years ago, apart from say, Switzerland there weren't any. Now, over $10 trillion, which is about 25% of all government bonds on issue, offering a negative yield. Now, quite frankly as an Australian, I find that extraordinary. You put $10,000 down and in 10 years' time, you're getting less than $10,000 back.

Against this backdrop you can see why the share market is so strong. Bonds are not considered to be a viable investment for many people. But of course, it takes a lot more than just negative yields to spur on the share market over a long term. We do need corporate profitability. We do need economies to grow. And on that front, it's not all bad news. The American economy, which is the largest economy in the world and really underpins the growth of the global economy, is showing really robust signs. Unemployment is low and the economy is growing at a pretty steady clip, so we should take some comfort from that.

DC: So the American economy is performing well, but the Reserve Bank of Australia recently cut rates to 1.5%. Does that mean the Australian economy is in trouble?

JP: I think 'trouble' is probably too dramatic an expression. The Australian economy is rebalancing now. It is still growing. It's still creating jobs. But it's happening at a slower clip than the Central Bank would like.

However, I must say I've got a slightly more cynical view as to why the Reserve Bank has cut rates this time. I believe the Reserve Bank is being too much goaded into a game that they prefer not to play. And what is this game? The game is one in which central banks around the world keep cutting their rates. Sometimes it's a negative territory. They're embarking on other programs, unconventional programs which, quite frankly some would consider crazy. The impact of this is, their currencies are depreciating. Of course that means the Aussie dollar is appreciating in relation to those currencies. And a strong loss in dollar is not conducive to this rebalancing effect that we want.

So the Reserve Bank would like to see a weaker Aussie dollar. Of course, no central bank in the world wants to be accused of manipulating their currency. So you never say, "We're cutting rates to lower our exchange rate." So they talk about inflation targeting.

For the Reserve Bank, there's a window of opportunity. Our last inflation print came in at 1.5%, which is lower than the 2% the Reserve Bank has targeted as a minimum. There was an opportunity there to cut rates and say, "We're trying to get inflation up," when maybe my cynical view is that they just prefer to see the currency lower.

DC: So would you prefer rates to remain on hold?

JP: I do have empathy with the Central Bank, as I implied. What I strongly believe is required now is, some sort of central bank coordination. And that might sound far-fetched, but that's exactly what happened in response to the GFC, so it can be done. And the central banks, the major central banks around the world, basically have to sit down and say, "What we are doing is not working. We are pushing on the proverbial string. Cutting rates to negative territory is not spurring businesses to go and invest." As a matter of fact I'd argue, some businesses are losing confidence because of that advent.

We have to bear in mind too, there are winners and losers. We tend to focus on the winners when rates are cut. And sure, if you're a net exporter that's relying on a lower currency or if you're a net borrower, like the governments around the world are all massive borrowers, you are benefitting from cutting rates. If you're a net importer or indeed, if you are a lender or financial institution - or if you are a retiree that is relying on interest income to support your retirement - well, the last thing you want to see is lower rates.

I think central banks have to be more cognisant now of the big losers out of this low-rate environment. They've basically got to admit that monetary policy has run its natural course. It's now time for governments to step in, start expanding fiscal policy. You also have to bear in mind that mild recessions are inevitable. It's a natural part of the economic sight line. I'm so concerned now that the slide has a hint of bad news. And everyone rushes to the printing press to try and avoid what could be just a mild recession. We've got to get out of that cycle.

DC: So the 2016 financial year delivered solid returns for UniSuper members. In fact, SuperRatings recently placed our Balanced option, that's our largest investment option, in the top three out of 170 funds, returning close to 6%. Can you talk us through some other highlights for the financial year?

JP: Obviously very pleasing result, Danielle. And for those members who want to read a bit more about the drivers and not just the highlights, but some of the lowlights as well, they should go to the website because the ***July investment update*** is on the website.

The highlights would clearly—it's the same old story, really—be our big exposure to infrastructure assets, such as Transurban, Sydney Airport, APA; our big exposure to the best quality shopping centers in the country via Scentre, GPT and Vicinity; and also positions in companies such as the Australian Stock Exchange. When the market was trading relatively flat throughout the year, some of these stocks were actually hitting at all-time highs, which benefit us because we're the largest shareholder in many of these companies.

Of course, there is now a growing chorus of a bubble and I'd like to look at listed property, we focus on listed property as an example. A couple of graphs I'd like to show. Now these can get a bit technical, so I'm gonna try and simplify them as much as possible. And I'll also say that while we talk about listed property, the same dynamics are driving most property markets. So whether you're talking about a commercial property, office property, or even residential real estate, your own home, you see house prices in Sydney, Melbourne, etc., is being driven by similar sorts of dynamics.

Let's look at the left-hand graph. Now what this is saying is, that market value of the listed property is materially higher than the book value. Now what does this mean in simple terms? Think about book value as an accounting value or, this is what an independent valuer would value the net tangible assets in your portfolio. What the market is saying, "We're actually gonna value those assets at a 40% premium to what your independent value would have them." That's a pretty big call. And if you look at history, what it's signaling is, that this is quite a heated sector, that maybe it is highly overvalued and time to sell.

However, if you look at the right-hand side, that graph is kind of painting quite a different picture. This is comparing the dividend yield we're getting from this listed property, which you can compare to, say the rental yield you might be getting from a housing portfolio, to the bond yields. And we've talked about how low bond yields are, and what we can see here is, that the dividend yields are around two and a half percent higher than bond yields. And don't forget with property, you've always also got that potential of capital appreciation. So the right-hand graph is saying, "Property still looks cheap."

So we're in a bit of a quandary. Do we look at the left-hand or the right-hand valuation?

We're sitting on the fence. While we're not increasing our property exposure at the moment, because we see that there's limited capital upside, we're certainly not selling at the moment because it is supported by pretty high dividend yields. And as we've said before, there are scant alternatives.

DC: And John, no one has a crystal ball, sadly but what do you think the 2017 financial year might have in store for us?

JP: Ah yes, oh for the crystal ball. And nobody knows. I can, though list my three big hopes. My first is that the American economy keeps going as it is and that will provide the Federal Reserve, the American Central Bank, the ability to start increasing interest rates. So it would be great to see the world getting back to some sort of normality in terms of the interest rate cycle.

The second is China, and we talk pump priming well, whenever China has some blip in growth, they revert to the same old, same old. And that is, borrowing money to invest in infrastructure, to invest in...which is not so much as a problem as more, investing in inefficient state-owned enterprises that're increasing the glut of commodities in the world, adding to deflationary problems, etc. It would be great to see the Chinese taking some tough decisions and rebalancing their economy.

Of course, the third is Australia. And while I'm not expecting the economy to take off, it would be nice to see us, the economy, being resilient enough, so that our banks, which is such a big part of our market, being able to weather any storm to the point that the bad debt cycle is not severe enough to significantly impair their earnings.

I don't want to stray into politics, but let's just say I'd prefer not to see a Trump victory in the U.S.

Of course, these are all hopes. They're not predictions. And whether or not they're realised, time will tell.

DC: Thanks, John.

We hope you've enjoyed our latest update. If you've got any questions or suggestions that you'd like us to cover in future updates, please email us at **superinformed@unisuper.com.au**.

Thanks for watching.