2015: An Inflection Point?

As 2015 draws to a close the year we thought we'd recap the year and look at what's on the horizon for 2016 and beyond. Right now, we seem to be at somewhat of an inflection point, both here in Australia, and around the world. Why?

World

For one, the greatest monetary experiment of all time is widely (and wildly) about to come to an end in America when the Federal Reserve is expected to raise interest rates on December 15-16 for the first time in nine years. Manic monetary experiments will continue though in Europe and Japan with their respective quantitative easing (ie QE) programs, despite the fact that QE has been a dismal failure. For anyone curious, QE has failed because money printing does not create jobs, if money printing were an effective tool then Zimbabwe would be the world's most successful economy.

Secondly, we are sadly witnessing the slow and painful decline of one empire, America, and the emergence of another, China. America with its $19 trillion of public debt, plus another $5 trillion in off balance sheet, and more than $100 trillion in unfunded liabilities in coming decades, is for all intents and purposes broke. In Australia we worry about our budget deficit, America has had only a few budget surpluses since 1960 and has run trade deficits continuously since 1975! Faith in America is waning and subsequently the world has slowly been moving away from settling trade in U.S. dollars since 2009, yet nobody takes this issue seriously. Loss of confidence in America is further illustrated by countries such as Austria, Germany and Venezuela repatriating their gold from the Federal Reserve. Strangely, Germany can't get all their gold back from the Fed until after 2020! At the other end of the spectrum, China is gaining credibility with the inclusion of the Yuan in the IMF's SDR basket in October 2016 for yet another blow to U.S. dollar hegemony.

To illustrate the impact of China on the world these days we saw share markets around the world fall heavily in response to both the crash in Chinese equities, and the devaluation in the Yuan. Oddly, gold barely nudged, however one asset stood tall in response to Chinese Yuan devaluations, of which there have been many lately, and that was Bitcoin, which has roughly doubled from its low earlier this year and appears to be negatively correlated to the Yuan.

Thirdly, last weekend saw an historic climate deal supposedly signed in Paris, a process some twenty years in the making, a long time if the Earth is indeed threatened by global warming. It's generally accepted that the Kyoto protocol of 2009 was an abject failure and it's hard to see the Paris agreement being much better with it being non-binding (ie no penalties imposed on anyone that does not adhere). In this authors humble opinion, considering that VW in recent months was fined some US$18 billion for faking their cars emission standards, they can feel hard done by considering that the Paris agreement means countries (eg India & China) can continue to pollute as much as they want with impunity. If the climate change hype is correct, and there's plenty of evidence to suggest it's not, Australia has lots of work to do, being the second largest carbon polluter per capita in the world behind America.

Australia's major trading partner, China, is slowing down and in all likelihood that's happening much faster than they're letting on. More concerning though is the fact that it's entirely possible the world is headed for a deflationary recession or depression judging by international shipping rates as indicated by the Baltic Dry Index, and the CRB Index of Commodity prices here.

Australia

Our economy continues to suffer from the downturn in the mining sector although GDP growth remains strong which is much more than we can say for other leading resource producers Canada and Brazil, both of which are in recession. Brazil is faring particularly badly with inflation running at more than 10 percent and unemployment in excess of 7 percent.

Iron ore fell below $40 a metric ton earlier this month for the first time since May 2009 and is now down a whopping 80 percent since its high of close to $200 per ton in 2011. The metal is headed for its third annual decline and not surprisingly BHP is now trading at decade lows. For more perspective on commodities view the RBA's own Index of Commodity Prices here, and note the steep increase from 2003 until the peak in 2011, and back to 2006 levels.

For anyone trying to get a read on the Australian economy, then good luck, with some commentators suggesting we are already in recession and they make a very compelling case. GDP growth for the first three quarters of 2015 were 0.9 percent, 0.2, and 0.9 respectively and we recorded the highest two months of jobs growth since 1988 for the months of October and November with figures of 60,000 and 71,000 respectively. November's performance was also the largest monthly increase since July 2000 just prior to the Olympics. These numbers are simply fantasy, and the ABC for one had a field day dissecting them, as did the alternative media. Even more fantastic is the way in which the numbers are calculated, read about that here.

Home borrowers, real estate agents, and investors have ridden the property boom as the RBA cut interest rates twice in 2015 to a record low 2 percent, a full 100 basis points below the peak emergency setting following the GFC. People should be questioning why interest rates are at sub emergency levels if GDP is strong, and why savers are receiving less than the rate of inflation!

Investors and new businesses in Australia were given a leg-up recently with the unveiling of the Turnbull government's innovation agenda. The package was full of all sorts of goodies, most notably a 20 percent income tax rebate for retail investors capped at $200,000 per investor per year.

Coincidentally, at a time where we now have a Prime Minister that is pro-innovation it was fitting that we witnessed last week the most successful listing of an Australian company, a tech one at that, on an American exchange when Atlassian debuted on NASDAQ with a market cap of $8 billion.

Apart from Atlassian, investors have had little to cheer about in 2015, just ask anyone invested in Australian equities. Last week the ASX 200 fell 2 percent, posting a loss every day of that week, as commodities continued to tumble. At the end of 2014 the ASX 200 stood at 5,411 and will finish comfortably below that level for 2015 unless a powerful Santa rally miraculously materialises. For months the ASX 200 has been trading in a narrow range of 5,000 to just below 5,300, bravely trying to be holding above the 5,000 level. However, it has finally broken 5,000 and came close to breaking 4,900 on December 15, 2016 will probably see it accelerate to the downside. An indication of how badly the market has performed can be gleaned by looking at the big four banks all of which are roughly 20-25 percent below the highs reached earlier in the year when the market was hovering around 6,000.

Australia's economy has long been out of balance due to its love affair with property, and whilst Australian's may feel wealthier, the fact is we, like all other western economies, have been living a fantasy by borrowing more money to maintain our lifestyle, a reality borne out by the fact that our household debt as a percentage of household income is the highest in the world. Furthermore, the Federal government this week revealed public debt is headed for $600 billion by about 2020 and we should not expect a budget surplus until 2021. As you can see [here](), public debt is almost $400 billion at the close of this year. But why worry, it's not like we're the only ones that have been borrowing from the future to consume in the present for the past 40 years or so all on easy credit. Eventually, the bill becomes due.

A couple of things to ponder which show our economy is in desperate need of re-balancing. Firstly, at a presentation by a fund manager the other week we learned that financial stocks accounted for a whopping 48 percent weighting in the ASX 200, compared to just 16 percent on the S&P 500 in America. Remember, America is a much more mature economy than ours. Secondly, back in 2006 Australian banks owed more than 80 percent of our private foreign debt. Unfortunately I have been unable to find up-to-date figures, however I am sure that the banks account for a smaller percentage of our $1 trillion in private foreign debt, yet it would no doubt still account for the majority. And thirdly, the weighting of tech stocks in the ASX 200 is a mere 0.7 percent, compared to 19.8 percent in the S&P 500.

Future

Australians still have much to look forward to regardless of the picture painted above, and please, don't shoot the messenger. We have a great lifestyle, we're a long way from the geopolitical turmoil in various pockets around the world, unemployment is low, the cash rate is at a record low 2 percent, and GDP growth is still positive despite the resources crash.

Investors have much to look forward to with the tax rebate available to retail investors in start-ups, a prime minister that is pro-innovation, and a world that is trying to move away from fossil fuel dependency.

Summary

In conclusion, it's entirely possible that 2015 is an inflection point both for Australia, and the world.

In Australia, 2016 could possibly see interest rates go even lower in from their already record low levels. March will see the COAG meeting resume and everyone brawl again over the GST which might be hiked, broadened, or even both. The Feds, like most around the world, are struggling to plug a budget deficit hole that we have no capacity to plug right now. ASX 200 below 5,000 and possibly going much lower if indeed the world is headed for a global deflationary depression. Is the banks golden era of profits and record share prices finally over? What is the prospect for house prices in Australia at record levels whereby the average house costs 10 times the average wage compared to 5 for the rest of the world? Heavy job losses are expected once Ford and Holden cease manufacturing. Alternative investments are expected to come to the fore given the new tax regime, focus on innovation, and green technology.

For the world, 2016 could possibly see the end of zero interest rates in America and the ramifications that may have for all capital markets around the world. The implementation of the Paris agreement and its impact on jobs and growth. Will it succeed or take the same trajectory as Kyoto? China's Yuan being included in the IMF's SDR. Geopolitical tensions around the world. Presidential elections for America in November 2016. The rise and rise of Bitcoin, is it here for the long term? Is China headed for a protracted and steep recession? Alternatively, is India the next China? Possible global recession, certainly the Baltic Dry Index and CRB Index of Commodity Prices indicate a good chance. Debt; the world is drowning in it and barely keeping its head above water despite record low interest rates, in fact negative interest rates in Europe. The world can barely sustain a few small rate rises, and would be insolvent if interest rates reverted to the mean. Gold has been suppressed artificially since 2011 to stop the USD collapsing, so with all the headwinds going forward, keep an eye on gold to finally break-out to the upside.

So, on behalf of the whole team here, I extend the very best to all our valuable clients and readers for the festive season, and wish you all a very prosperous new year, with and/or without the tax breaks.

Colin Hillery

Investor Relations

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