CMC CONSULTING & MENTORING

Quarterly

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March investment review from DNR Capital

BY **Jamie Nicol**

This month we discuss the recent scrutiny of technology stocks and bank shares and the implications of this scrutiny on market valuations and portfolio positioning.

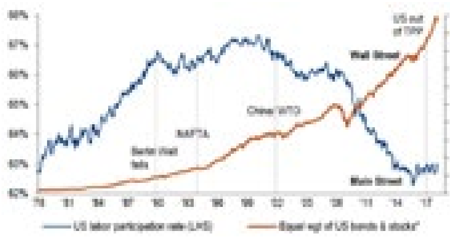
The start of 2018 has been a difficult one for the market, with concerns regarding inflation in the US and the unravelling of quantitative easing key issues. Add to this concerns regarding banks and technology stocks and pressure has been building on the market. However, the pullback and the market volatility are beginning to create opportunities, which we also discuss.

ASX 200 *Source: IRESS*

MAJOR ISSUES:

1. We continue to observe signs of rising inflation. After an extended period of declining interest rates and fears of deflation, every central bank across the globe has been seeking to reboot their country's economy. At the same time, a period of rising asset prices and stagnating wages has created a volatile political climate. The policy responses are inflationary – either Keynesian in the form of infrastructure spending and tax cuts, or protectionist in the form of tariffs. China has also recently changed tilt, incentivising party leaders not just to promote growth but to promote growth while considering other measures like environmental issues, which has resulted in capacity cuts in production that consequently drives prices up. The following chart highlights the benefits that have accrued to capital (bonds and stocks) while interest rates have fallen, compared to the labour participation rate, which has been soggy. A rise in inflation has consequences for certain market segments, including bond proxies and potentially higher price/earnings ratio (PE) stocks.

Labor Participation v Assets



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

2. At the same time as inflation fears are rising, the US Federal Reserve is beginning to unravel its quantitative easing program. Central bank asset purchases of US$4 trillion in 2016 and 2017 drops to US$0.4 trillion in 2018 and the growth of liquidity turns negative by year's end. The European Central Bank (ECB) will begin to taper from September 2018. The consequences of this are difficult to forecast. We have observed some surprising moves in short-term rates and the market is likely to be surprised as liquidity is removed. Sectors and stocks that have benefited most by quantitative easing would appear to be the likely losers, with assets that benefit from deflation like bonds, credit and growth stocks outperforming inflation assets like commodities, cash, banks and value stocks.

Federal Reserve monetary base

Source: BofA Merrill Lynch Global Investment Strategy, Federal Reserve

3. Over the past five years, growth stocks have traded up strongly and the dispersion between the highest value stocks and the lowest has rebounded to high levels. In many respects this is understandable – in a world of technology disruption many traditional business models have failed and the market is prepared to pay more for strong business models.

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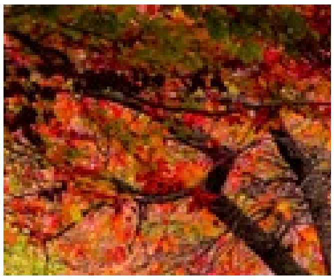

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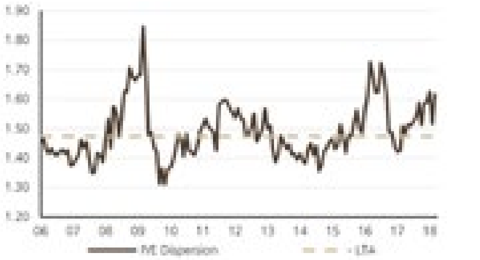
P/E Dispersion *Source: Datastream, UBS*

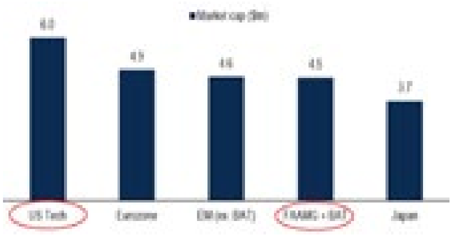


Growth stocks (technology stocks in particular) have seen higher and higher valuations. US technology stocks have a larger market valuation than the whole of the Eurozone. Valuations have incorporated bullish scenarios and, in an era where capital is cheap, many of these companies have not needed to deliver profits but rather just demonstrate sales growth. We have seen a large number of technology stocks continue to trade on >10x sales despite tremendous growth in the size of these companies, which must surely stretch management bandwidth. The movement has parallels to the strong run in growth stocks during the 1960s that became known as the "Nifty Fifties". These were strong growth stocks that traded on large multiples thanks to surging sentiment, but subsequently underperformed in the 1970's bear market.

Increased scrutiny is now being placed on these technology companies, with both sides of politics having reasons to feel aggrieved. Facebook's slow response to the recent problems with Cambridge Analytica was telling, and Europe and the UK are seeking increased regulation in response to the immense market power of companies like Google and Facebook. President Trump is being critical of Amazon via Twitter, and Tesla is using Twitter to make jokes about bankruptcy.

This added scrutiny makes us consider what are the appropriate valuations for these companies, and whether the market will be as willing to allow them to reinvest as much of their profits, and indeed whether there will be a regulatory response. From an Australian market perspective, a pullback in technology stocks might well trigger a reassessment of some of the higher valuations in the market. Furthermore, higher bond yields generally are negative for assets where a large proportion of the value is in the terminal value.

Market value of tech sector versus other markets



Source: BofA Merrill Lynch Global Investment Strategy, DataStream, as of 3/23/18. Note: FAAMG+BAT = Facebook, Amazon, Apple, Microsoft, Google, Baidu, Alibaba, Tencent

4. Our thoughts on the banks are mixed at present, with a range of potential positives and negatives.

Positives:

- The banks have rarely looked cheaper, offering a very attractive dividend yield of close to 7% fully franked (the franking is still worth something).
- Some of the impacts from the banking inquiry will ironically be positive for the banks. The inquiry has highlighted lending standards and we are likely to see the banks give greater scrutiny to the expense history of customers, which may cause a sharp slowdown in lending growth (which is mixed but can be positive for banks because they need less capital to support their loan base). Commonwealth Bank of Australia (ASX:CBA) is also pushing for a crackdown on mortgage brokers and volume payments, which would push volume through the bank-owned channel.
- The banks have faced heightened scrutiny since the GFC—this inquiry may well be the last for a while and so once it is behind them they will likely have some respite from a regulatory perspective. Overall, the banks have underperformed for some time now.

Negatives:

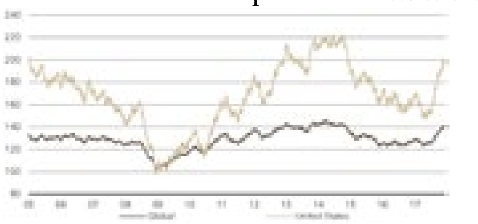
- Banks are over-earning on mortgages and retail banking, and the greater scrutiny means pressure on revenues into the future. Furthermore, new players are seeking opportunities to cherry pick earnings—latitude into personal lending and credit cards, small lenders into mortgages, online players into payments.
- Regulators risk overshooting. Should the inquiry drive a significant tightening in lending standards then this will restrict customers' ability to access credit and possibly drive down house prices. This would increase risks to the economy and banks in particular.
- The inquiry has highlighted risks around alleged irresponsible lending. The banks will obviously have higher costs associated with undertaking any required changes to their processes (this should be manageable). The bigger cost will be where banks are found to be responsible for customers who find themselves in difficulties (where they should not have lent money). This could increase the cost of bank bad debts. In addition, there could be some financial penalties imposed with respect to the irresponsible lending.

We are becoming more interested in the banks as they sell off but see the outcome of the inquiry as critical, given upside risk is capped by the modest growth environment, and downside risk scenarios are presented by regulatory, credit and competitive pressures.

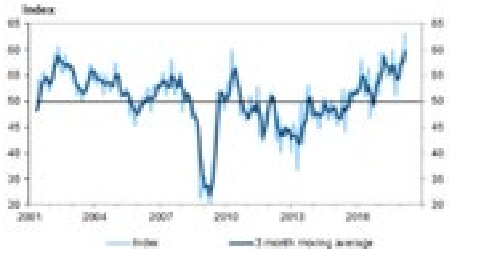
REASONS NOT TO DESPAIR:

1. Global growth continues to surprise to the upside and the Australian economy remains robust, with the recent Purchasing Managers' Index (PMI) survey remaining supportive. Tourism remains strong, agriculture will benefit from recent rains, mining is recovering and so far housing has experienced a soft landing. We retain concerns about household leverage, but there are reasons to be positive about the local and global economy.

UBS Global Growth surprise index *Source: UBS*

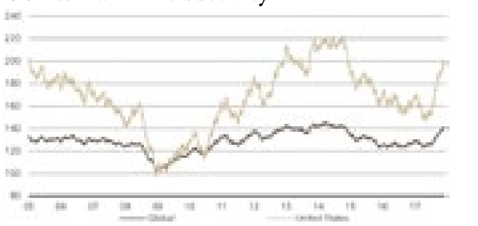


Australian PMI: Headline Index *Source: UBS*



2. Global growth is still robust and productivity improvements could drive earnings. Productivity gains have been surprisingly soft since the GFC. Some of the technology improvements could be utilised to drive stronger productivity improvements.

US Nonfarm Productivity



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

3. Valuations have come back into range for many sectors and companies. The overall valuation of the market at 15x is largely in line with long-term averages and the growth forecast of the market at 5.8% does not seem overly optimistic. Alternatives like term deposits and housing do not appear too attractive.

	PE 19	Growth	Dividend yield grossed up
Industrials ex property	15x	5.80%	6.70%

Expensive money: Why the RBA may not raise rates any time soon

BY **Andreea Papuc and Stephen Spratt**

There's fresh reason to think that the Reserve Bank of Australia, as Treasurer Scott Morrison anticipates, may not be raising interest rates anytime soon.

Short-term borrowing costs in Australia's financial system have been surging, and will tighten financial conditions if it lasts, even without action by the central bank's policy makers.

The jump in a key benchmark, the three-month bank-bill swap rate, has been something of a head scratcher, though most explanations centre around the impact of overseas dynamics:

- For one, the Federal Reserve's interest-rate hikes and a surge in US Treasury bill issuance to fund American budget deficits has been sending US dollar funding costs higher, in the US and offshore.
- That matters for Australia because its banks are net borrowers of US dollars, so local lenders may need to tap more cash locally -- sending those rates higher, too.
- Foreign investors hold more than half the Aussie government debt market, and appear to be lending the bonds more via repurchases, in effect draining liquidity. Some point to Japanese life insurers being behind this, seeking to boost returns. Higher repo rates have in turn driven up other short-term funding costs.

It's all put funding costs for Australian banks on track for the biggest monthly rise since 2010, the year the RBA last raised rates. Key for market strategists is whether the increase proves to be more than just a quarter-end phenomenon, or starts to accelerate -- forcing banks to decide to pass it on to their clients and raise the cost of credit.

'MONEY IS MORE EXPENSIVE'

"Money is more expensive," said Martin Whetton, senior rates strategist at ANZ Bank. Banks "can either absorb it or pass it on."

The nation's largest bank, CBA, sources about 12 per cent of its funding from short-term wholesale markets, illustrating the potential impact of higher costs. Local banks hold $4.6 trillion in assets, more than double the size of the economy, leaving them reliant in part on foreign funding.

"I am watching this closely," said Philip Brown, a senior fixed-income strategist at CBA in Melbourne. "Most business loans that are on floating rate are either directly or indirectly tied to BBSW [bank bill swap rate]. If BBSW settles in at this new wider pricing in a sustained fashion, that will likely slow the delivery of any future RBA hike," Brown and his colleagues wrote in a note this week.

BBSW is a key rate at which banks lend to each other. It influences the cost of business loans, and the regulator has previously called it of "systemic" importance.

RATE OUTLOOK

CBA forecasters currently expect the RBA to raise interest rates in the fourth quarter. Also in that camp, for now, are the strategists at the local unit of Nomura Holdings. But a sustained rise in bank funding costs could change the outlook.

"If we have structurally higher lending rates in the real market place, then that could potentially impact RBA thinking about how much tightening [raising rate] they might need to do," said Andrew Ticehurst, a rate strategist with Nomura in Sydney.

Source: www.smh.com.au/business/the-economy/expensive-money-why-the-rba-may-not-raise-rates-any-time-soon-20180323-h0xuuu.html

Eating out or in, which is better?

BY **Belinda Williamson**

How much is eating out really costing you? It might surprise you to learn that most of us spend about $100 every week on lunches.

Did you know that an average household spends approximately $100 per week eating out?

That means 50 million meals out in Australia each week, or 2.5 billion in a year. Even just a $15 lunch with the co-workers a few times a week can really start to add up.

Thankfully, you can save your wallet and develop healthier eating habits – saving you time to spend on the fun things in life.

So which option is cheapest? Eating out, homemade lunches, or pre-packaged meals like YouFoodz, Thrive and Lite'n'Easy?

Homemade lunches

Canstar's febfast research showed if you swap your five-day a week $15 lunches, which adds up to $300 over four weeks, for a $5 lunch ($100 over four weeks), then in one month you could save around $200.

It may seem daunting, but planning a weekly menu and making your own lunches to bring to work can be easier than you think.

We get it. Grocery shopping and cooking is an effort, but if you find a couple of recipes you like (Pinterest food crush inspo, anyone?), you can make a list of ingredients and buy the same ones regularly.

Pre-packed meals

The 21st century brought the beginning of meal delivery services, offering convenient and healthy meal options for busy workers – and they seem to be effective.

A survey conducted by Canstar Blue found that 39 per cent of respondents who use meal delivery services choose them for convenience.

Almost one-third of survey respondents said their main motivation for using healthy meal delivery services is weight loss.

But can they save your wallet as well as your waistline?

Eating out or a home loan?

Time to put our money where your mouth is. Let's say that at a minimum, you were able to save $100 per month by changing your eating habits.

If you have a home loan and put the extra savings towards your monthly repayment, you may be able to save yourself some serious money!

For example, if you have a $300,000 home loan with an average standard variable comparison rate of 4.5 per cent, you could find that contributing the extra $200 to your monthly mortgage repayment you could save almost $20,000 in interest by the time your home loan is repaid, and you may potentially repay your home loan more than two years earlier:

	Without extra savings	Put savings towards home loan
Monthly repayment	$1,659 per month	$1,759 per month
Interest paid over 25 years	$197,698	$175,658
Interest saved	$0	$22,040
Time saved	0 years – full 25-year loan term	2 years, 5 months

Source: www.canstar.com.au. Based on $300,000 loan amount, 25-year loan term, and average standard variable comparison rate of 4.45% p.a..

Depending on how you manage it, both homemade lunches and pre-packaged lunches could save you money.

If you're having trouble saving money because you're constantly eating out, it's worth experimenting to find the right meal method for you – you mind find that a combination of pre-packaged and home-made is a good recipe!

Source: Financy, February 2018 (www.financy.com.au)

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