Photo: AP Images

Your Money Weekly

Forecast 2019–20
Danger lurks in high-altitude markets as central banks invite investors to take more risk

Introduction
One year on, the words of French writer Jean-Baptiste Alphonse Karr ring loudly—"plus ca change, plus c'est la meme chose"—"the more things change, the more they stay the same."

In **Forecast 2018–19 of 5 July 2018**, the headings were:
Australia: Households and RBA hold domestic attention.
United States: Markets face the three Ts: Tariffs, Trade and Trump.

The more things change, the more they stay the same.

What a roller coaster ride financial markets have experienced since July last year. After a sharp selloff in the December quarter, which saw the Nasdaq Composite enter a bear market, down over 20% from its 2018 high and the S&P 500 not far behind, markets have recovered all the lost ground with the S&P 500 recently touching a new peak. I underestimated the strength of the recovery as the US Federal Reserve (the Fed) went from raging lion to a toothless pussycat.

Markets had recovered from a mild correction earlier in the year and surged to new peaks in September 2018. But the landscape changed quite dramatically in October as one after another, the five previously bullet-proof stocks responsible for most of the market hype, the FAANGs (Facebook, Apple, Amazon, Netflix and Google), stumbled. Without exception they fell by over 20% from their highs in a relatively short time, leading market benchmarks sharply lower. US/China trade tensions added to uncertainty, while the Fed continued to tighten monetary policy in response to strong economic data, particularly the labour market, with unemployment reaching a near-50 year low.

As markets bottomed on Christmas Eve, the Fed changed tack. Intimidation from the White House was confronting and raised questions on the Fed's independence. From the aggressive stance up to and including the 18–19 December meeting of the Federal Open Market Committee, when the

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Peter Warnes
Head of Equities Research

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Contact Details
Tel: 1800 03 44 55
Email: help.au@morningstar.com
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Morningstar Rating for Stocks

Significantly overvalued	★
Overvalued	★★
Fairly valued	★★★
Undervalued	★★★★
Significantly undervalued	★★★★★

Any feedback on this week's Overview is always welcome. Send your comments to YMW@morningstar.com. We'd love to hear from you.

Exhibit 1: Markets Snap Shot 30 June 2018

Markets	30/06/18	31/12/18	% Change 1H	30/06/19	% Change 2H	% Change full year
Dow Jones	24,271	23,327	-3.9	26,600	+14.0	+9.6
S&P 500	2,718	2,507	-7.8	2,942	+17.4	+8.2
Nasdaq	7,510	6,635	-11.7	8,006	+20.7	+6.6
FT 100	7,637	6,728	-11.9	7,426	+10.4	-2.8
DAX	12,306	10,559	-14.2	12,399	+17.4	+0.8
Nikkei	22,305	20,015	-10.3	21,276	+6.3	-4.6
Shanghai	2,847	2,494	-12.4	2,979	+19.4	+4.6
S&P/ASX 200	6,195	5,646	-8.9	6,619	+17.2	+6.8
S&P/ASX 200 Accum	63,015	58,710	-6.8	70,292	+19.7	+11.5
Commodities						
WTI/bbl	US$74.37	US$45.87	-38.3	US$58.12	+26.7	-21.9
Brent/bbl	US$79.42	US$54.36	-31.6	US$64.37	+18.4	-19.0
Copper/lb	US$2.97	US$2.65	-10.8	US$2.70	+1.9	-9.1
Iron Ore 62%/t	US$64.44	US$72.73	+12.9	US$118.02	+62.3	+83.1
Bond Yields						
US – 2-year	2.53%	2.49%	- 4bps	1.76%	-73bps	-77bps
10-year	2.86%	2.68%	-18bps	2.10%	-58bps	-76bps
30-year	2.99%	3.01%	+2bps	2.53%	-48bps	-46bps
Aust – 2-year	1.98%	1.89%	-9bps	0.97%	-92 bps	-101bps
10-year	2.63%	2.31%	-32bps	1.32%	-99bps	-131bps
15-year	2.79%	2.45%	-34bps	1.54%	-91bps	-125bps

Source: Morningstar

federal funds rate was increased for the fourth time in 2018, the Fed did a 180. Chairman Jerome Powell said, "Many FOMC participants had expected that economic conditions would likely call for three more rate rises in 2019. We have brought that down a bit and now think it is more likely that the economy will grow in a way that will call for two interest rate increases over the course of the year."

As the fiscal stimulus at the start of 2018, in the shape of unfunded tax cuts, was larger and more front-end loaded than most had anticipated, this led to a slightly faster pace of policy normalisation than previously expected. Powell noted on several occasions the US was on an unsustainable fiscal path, in contrast to the strength of the economy, unemployment at a 50-year low and tightening monetary policy. White House-driven fiscal policy was in direct opposition to the Fed's policy. There was no co-ordination, but aggressive confrontation.

Powell continued in his statement after the 18–19 December FOMC meeting, "what kind of year will 2019 be? We know that the economy may not be as kind to our forecasts next year as it was this year. History attests that unforeseen events as the year unfolds may buffet the economy and call for more than a slight change from the policy projections released today." How profound. The possible "slight change" turned out to be perhaps the greatest about face in the history of the Fed. And the rest is now history.

The word "patient" was introduced into Fed speak. And with the likelihood of no more rate hikes and the deactivation of the "auto pilot", reducing the Fed's balance sheet at the rate of US$50bn per month, the rebound in the US share market in the six months to end June has been spectacular. Australia has matched the US performance (Exhibit 1) but after the savaging late in 2018, for our financial year ending 30 June, the total return as measured by the S&P/ASX 200 Accumulation Index was lesser, but still rewarding 11.5%. Don't expect a repeat in 2019/20.

Markets have been driven by record low global bond yields on the back of super dovish central bank commentary, in response to benign inflation and slowing economic growth as the US/China trade war affected global output and trade volumes. These record low bond yields, highlighted by US$13 trillion in negative-yielding global debt, have pushed investors to seek higher yield than that available from risk-free cash and sovereign debt. Equities markets have been the major beneficiaries, with bond proxies a feature.

So, with both equities and bond markets now at or near record levels, the $64 question is: where to from here?

Firstly, in my 50 years of financial markets experience I have never observed central banks collectively easing monetary policy while bond and equities markets are at or near record levels. This action is inviting and encouraging investors to take more risk. The easing is reducing the price of a record level of liquidity already in the global financial system and allows inefficient companies more latitude. This environment is unlikely to help productivity, as there is little competition for this scarce resource and hurdle rates are lowered.

Secondly, we have a truce in the trade war between the US and China following talks at the G20 summit in Osaka between Presidents Donald Trump and Xi Jinping. A truce, not an end to the war. There was no surrender which usually marks the end of war. "Cooperation and dialogue are better than friction and confrontation." In my opinion, hollow words designed to soothe and placate nervous markets. Given the egos of the personalities involved, surrender is unlikely. There is no "I" in team, nor is there a "we" in Team Trump.

This latest truce is reminiscent of the 90-day cease fire reached at the G20 summit in Buenos Aires seven months ago. The trust between the two parties is non-existent and more flare-ups are likely, almost certain. This will be unsettling for global financial markets, as it has been since the first shots were fired in June 2018. Does the truce alter the stance of the Fed, whose language has convinced investors that lower interest rates will continue to support the market? Will the truce remove any of the uncertainty driving the Fed to its easing bias and disappoint the market?

Danger at high altitudes—mountains and markets

The world has witnessed the traffic jam of thrill seekers trying to reach the roof of the world, Mount Everest—Sagarmatha in Nepalese or Chomolungma in Tibetan. To reach the peak climbers most likely need support—in this case oxygen. At high altitudes danger lurks and the irrational, adrenalin-driven-mentality—"I'm going to get to the top no matter what"—takes over. Is this in any way analogous to the current mentality of investors in equities and bond markets? Support (financial oxygen) is being provided by global central banks, via record low interest rates, as investors climb the steepening risk curve. Ultra-accommodative monetary policy, in the form of aggressive interest rate cuts, is the oxygen investors require to survive at the current altitude. A different type of adrenalin is pumping through investors' veins, but behaviour has become irrational and risks are being taken. There is little or no recognition of the dangers of high-altitude financial markets.

Having left the relative safety of base camp, the expectant Everest conquerors are exposed to uncertainties and their physical health is at risk. Similarly, investors traversing the risk curve in search of higher yield are exposed to uncertainties and their financial health is at risk. Having seen and experienced major market corrections in 1974, 1987, 2001 and 2008, the truism is, markets go up until they go down.

The picture of the overcrowded group of thrill seekers on Mount Everest is also synonymous with the overcrowded presence of buyers in the equities and bond markets. In the case of the mountaineers the descent can be as dangerous as the ascent. Risk curve climbers can also experience capital losses on the market descent, the magnitude of which will likely overwhelm the yield so desperately being sought, perhaps by multiples.

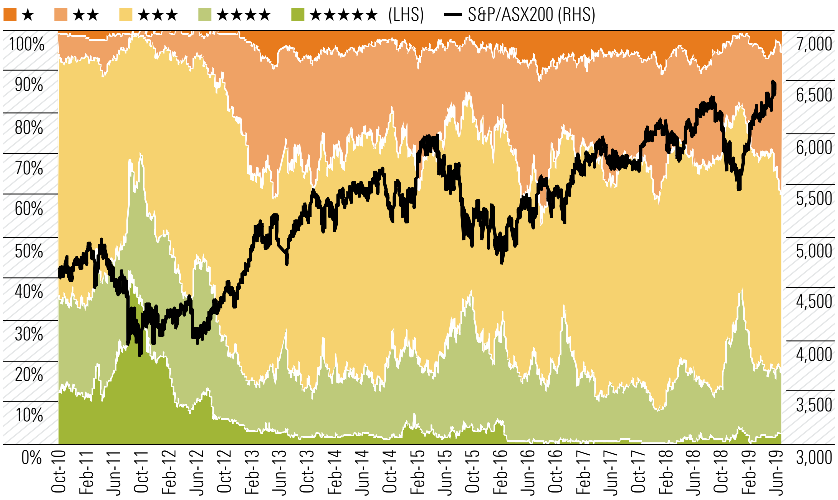
Where to now for the market leaders?

The FAANGS have driven the Nasdaq Composite and been responsible for a disproportionate increase in the S&P 500. But instead of innovation, as was the case in the last bull market for technology stocks, disruption has driven the benchmark to stratospheric levels. The "disruptive technology" has destroyed companies and launched others. Possibly more destructive than constructive, although Amazon's chief Jeff Bezos would disagree. Amazon has just turned a profit after 25 years since incorporation in 1994 and as Twitter turns 13, the joke resonates—"at 13 I hadn't made a profit either." But this reflects the huge investment in marketing and R&D. Beyond Meat is not in the technology innovation category but it is disrupting the US beef industry. The jury is out as to whether this group of companies can lead the markets higher in 2020. I think they will struggle as their share prices are in rarefied air.

Is a late year correction possible?

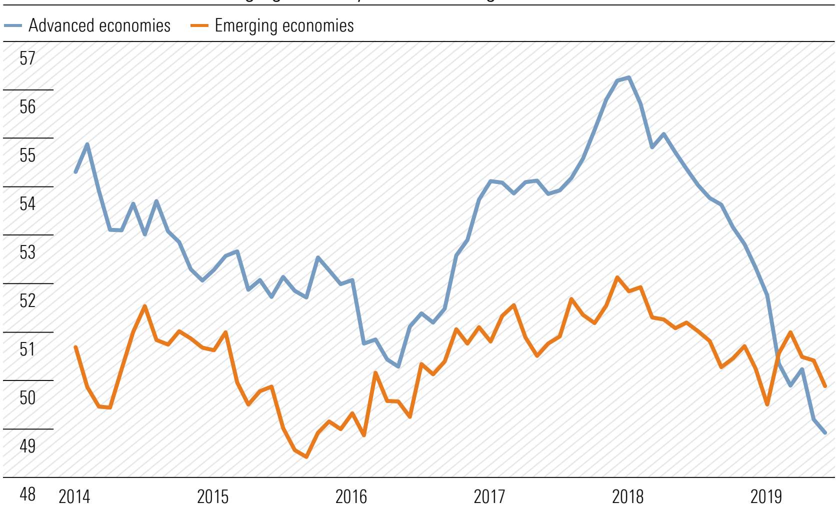
Could the December half of 2019 replicate that of 2018? I suggest it is very possible. Potential disappointment lurks. I believe analysts' earnings and margin forecasts are too optimistic against a backdrop of global manufacturing Purchasing Managers' Indexes (PMIs) near or below 50 (below 50 indicates industry is contracting), struggling GDP growth and intensifying competition. Few, it seems,

Exhibit 2: Equity research overview - recommedation dispersion



Source: Morningstar

Exhibit 3: Advanced & emerging economy manufacturing PMIs



Source: Refinitiv, Markit, Capital Economics

are forecasting any interruption in their ever upward sloping forecasts. And being of the old school, I am more comfortable with valuations based on sustainable earnings growth than lower bond yield-driven discount rates.

The current US expansion has been the most sluggish since 1945 and shortly will become the longest in US history. More evidence of the altitude.

The timing of the next market correction is unknown. But I suspect it may be sooner rather than later. While aggressive easing in monetary policy may continue to support the prices of alternatives to risk-free assets, economic activity will not be turned on a dime. It will take several quarters before we see a meaningful lift in activity and then it may be short-lived. In the meantime, markets are priced for perfection and the delivery of such is almost impossible.

With almost all macro pointers in decline, corporate earnings growth will be a victim. Expanded price earnings multiples, many in nose-bleed territory, will be exposed and the reality of expensive purchases will come home to roost. With markets at elevated levels and earnings per share growth generally not keeping pace, implied one-year forward market multiples are comfortably above long-term averages. Currently the average price-to-fair value of our Australian and New Zealand coverage is 1.1. More importantly, the market capitalisation weighted ratio is 1.2, a 20% premium. Given we want to buy stocks at a discount to fair value to provide an adequate margin of safety, the current premium is over 30%. (Exhibit 2)

In my opinion, the odds are in favour of a repeat of the December half of 2018. A meaningful market correction.

Global data points to contraction

Global economic activity continued to slow in the June quarter. Hot off the press, the global manufacturing PMI for June was 49.4, from 49.8 in May and confirms continuing weakness from the March quarter. May and June are the first consecutive below 50 readings since November 2012. The June reading was taken before the truce in Osaka and may have reflected earlier pessimism. But the index is a measure of manufacturing output not business confidence and so has credibility.

The deterioration in June was not just US/China-facing nor had a developed versus emerging economy bias. It showed an all-round weakness, with the fall in exports more symptomatic of subdued demand than trade war inflicted. (Exhibit 3)

Australia—Availability of credit and households hold the key

The Australian economy remains closely tied to the health of the Chinese economy. While a truce in the US/China trade war has been called, few imagine the calm will last. Most believe history will repeat itself, reliving the upheaval after the Buenos Aires short-term calm. Any further Chinese stimulus prolongs the solid demand for our resources, and we want the party to continue. The 83% increase in the iron ore price over the past year, and a further 6.5% jump since 28 June, resonates loudly.

But domestic issues will remain the underlying driver of economic activity and GDP growth. Holding a crowded centre stage will be the housing market and the wealth effect, the availability of credit and household consumption. While monetary policy will have some influence by reducing interest expense, it is unlikely cuts in official rates will be passed on in full, given only two of the four major banks did so with the 25-point June cut. Interest savings will likely go toward reducing debt, rather than lifting consumption. The price of money in isolation will do little. It is the velocity of its circulation that is the key to generating economic activity, which reflects changes in demand and ultimately drives the direction of GDP growth.

Fiscal policy will likely lift consumption. Tax cuts and rebates are focused on low income earners and most likely will be spent. It will have little or no effect if the additional income is absorbed by higher household expenses including gas and electricity, insurance and education or debt reduction.

Australia joins the ultra-low rate club

The Reserve Bank of Australia's (RBA) decision on 2 July to cut the official cash rate from 1.25% to 1.00% smacks of a panic move. It is the first time since 2012 two consecutive monthly cuts have been made. The board knows full well the 25-point reduction will not be passed on in full to borrowers. After the cut on 4 June, governor Philip Lowe said "we are not cutting because the economy is getting worse, rather we are cutting rates because we want the economy to get better." This suggests cutting rates is a means to an end, but central bank actions over the past nine years, cutting rates and swamping the financial system with liquidity have not improved global economies a great deal. The end, so coveted by the governor, could still be a little way off while he admits, "it is unrealistic to expect that lowering interest rates by 1/4 of a percentage point will materially shift the path we look to be on." The path has many potholes and there may be more spare capacity in the economy than he and others anticipate.

The premise the decision "will support employment growth and provide greater confidence that inflation will be consistent with the medium-term target" is likely flawed, just as the Phillips Curve disciples exhibit furrowed brows. The statement "the outlook for the global economy looks reasonable" is at odds with the incoming tide of disturbing data. While trade and technology disputes mean "the risks to the global economy are tilted to the downside", the resultant easing of monetary policy urges investors to consider taking on greater risk.

"Global financial conditions remain accommodative." What is the next word after accommodative that explains the US$13 trillion of negative-yielding global debt?

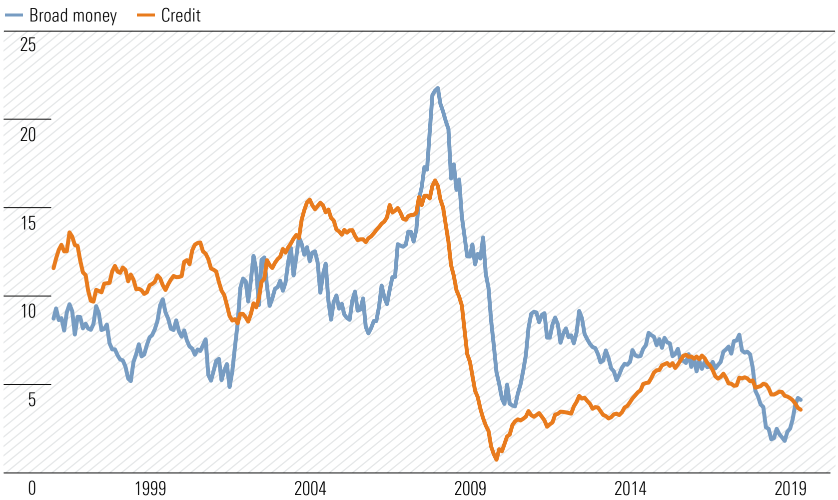
"Over the year to the March quarter, the Australian economy grew at a below-trend 1.8 per cent. Consumption growth has been subdued, weighed down by a protracted period of low income growth and declining housing prices. Increased investment in infrastructure is providing an offset and a pick-up in activity in the resources sector is expected, partly in response to an increase in the prices of Australia's exports. The central scenario for the Australian economy remains reasonable, with growth around trend expected. The main domestic uncertainty continues to be the outlook for consumption, although a pick-up in growth in household disposable income is expected to support spending."

While the combination of strong resources-driven export growth has lifted the contribution of net exports to GDP growth, and elevated public demand or infrastructure spending has similarly provided a welcome offset to a subdued household consumption contribution, there are question marks over the sustainability of the infrastructure spend.

In the March quarter public demand added 0.2% to a below-trend 1.8% growth in GDP. Volumes rose 0.7% on top of a 1.8% surge in the December quarter and posted year-on-year (y/y) growth of 5.6%. More of the same is expected going forward. But the Australian Bureau of Statistics engineering construction report reveals public work done in the March quarter fell 13% y/y. While construction spending is near record levels as are completions, the pipeline is not being replenished at the same rate, indicating the rate of growth in public spending will slow. Completions exceed commencements. State governments have probably reached their peak so it's now over to the federal government to do some heavy lifting. Perhaps a dam or four and a couple of clean coal-fired power stations for starters would help. But don't hold your breath. So maybe the public demand component of GDP could disappoint in the back end of 2019.

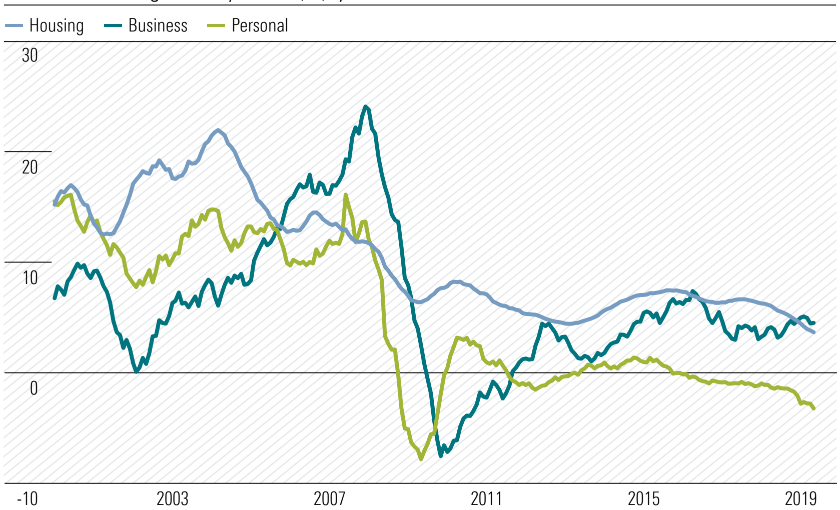
RBA governor Philip Lowe rightly pleads "we can't do it on our own" as he leaves the door open for a further cut to sub-1.00% territory. Co-operation and co-ordination of monetary and fiscal policy is paramount. The US mess is a stark example of a lack of co-ordination. As economic activity contracts, both monetary and fiscal policy should be moving in unison. In line with easing monetary policy, the federal government should be running deficits not trying to deliver a surplus, as is currently the case. Added government support, via increased spending on public works/infrastructure or by

Exhibit 4: Credit and broad money growth (%), year ended



Source: ABS, APRA, RBA

Exhibit 5: Credit growth by sector (%), year ended



Source: ABS, APRA, RBA

meaningful tax cuts, is designed to either support failing household consumption and business investment or lift disposable income to trigger an increase in household demand.

While lower mortgage rates will support affordability, the availability of credit is of greater importance. But should it put a floor under housing prices, it will help ease the drag the negative wealth effect of the past two years has had on household consumption. Lower interest rates will not necessarily trigger a sharp rebound in business investment or hiring intentions.

The pool of liquidity created by quantitative easing is stagnant and lifeless. Life, vibrancy and growth depend on movement or velocity, and until authorities understand this and focus on increasing total demand, lower interest rates are destined to become hostage to the law of diminishing returns.

Credit growth is still in decline as the tables below reveal.

Exhibit 6a: Financial Aggregates

Percentage change	Monthly		Year-ended	
	Nov 2018	Dec 2018	Dec 2017	Dec 2018
Total Credit	0.3	0.2	4.8	4.3
- Housing	0.3	0.3	6.3	4.7
- Personal	- 0.3	-0.4	-1.1	-2.0
- Business	0.5	0.3	3.1	4.8

Source: Reserve Bank of Australia

Exhibit 6b: Financial Aggregates

Percentage change	Monthly		Year-ended	
	Apr 2019	May 2019	May 2018	May 2019
Total Credit	0.2	0.2	4.8	3.6
- Housing	0.3	0.2	5.8	3.7
- Personal	-0.3	-0.6	-1.4	-3.2
- Business	0.0	0.1	3.9	4.5

Source: Reserve Bank of Australia

Year-on-year (y/y) total credit growth has slowed from 4.3% at December to 3.6% in May. That is not a slowing of 0.7%, but 16% in five months. From May 2018 the fall is from 4.8% or a 25% y/y decline. Housing credit growth, the engine room of total credit growth, is down from 4.7% y/y December to 3.7% or 21% in five months. From May 2018 the fall is from 5.8% or a 36% y/y decline. Is it any wonder GDP growth is struggling? Credit growth and its availability is the life blood of the economy.

While the availability of credit to the critical housing sector has been impacted by the findings of the Hayne royal commission and the subsequent resurrection of the regulators previously AWOL, the business sector is much more favoured as the financial aggregates reveal.

Until the rate of total credit growth stops falling, which requires housing credit growth to also stop falling, will Australia's GDP growth stabilise? Net exports are likely to remain positive through 2019 and into 2020. Public demand (government spending/infrastructure) may disappoint. Dwelling investment will be a drag, and business investment is likely to be inconsistent. As always household consumption will be the main event and disposable income growth the key. (Exhibit 4 & 5)

United States — Now five Ts: Tariffs, Trade, Trump, Tweets and Tantrums

A year ago, in Forecast 2018–19, I wrote, "The financial landscape of the US, dare I say the world, is in the hands of the unpredictable, Twitter fanatic president Donald Trump. His bully-boy, my-way-or-

Exhibit 7: What usually happens after the Fed tightens rates?

Tightening cycle began in:	US Manufacturing PMI fell below 50	EPS recession	GDP recession
1954	Yes	Yes	Yes
1958	Yes	Yes	Yes
1961	Yes	Yes	No
1967	Yes	Yes	Yes
1972	Yes	Yes	Yes
1977	Yes	Yes	Yes
1980	Yes	Yes	Yes
1983	Yes	Yes	No
1988	Yes	Yes	Yes
1994	Yes	No	No
1999	Yes	Yes	Yes
2004	Yes	Yes	Yes
Hit rates	**100%**	**92%**	**75%**

Source: Cornerstone Macro, U.S. Global Investors

the-highway negotiating tactics could have profound implications for global trade. Winners will be hard to find."

"Meanwhile, the Fed upped the ante at its June meeting, raising the Fed funds rate as expected but signalled two more rises in 2018, up from indicating one at the May meeting. Rising US inflation influenced the thinking and behaviour of the Federal Open Market Committee (FOMC)."

The first paragraph is still relevant. The second, 180 degrees from the current situation. After an unprecedented backflip in late December 2018, the Fed is on the verge of unwinding the interest rate increases of 2018, as the implications of the trade war with China and skirmishes elsewhere take centre stage. Despite the latest truce, peace seems a long way off. Surrender does not appear to be on the cards. But fear-driven financial markets could be a means to an end as Trump wants lower interest rates come hell or high water. It may be financial markets go to hell and investors drown.

The big questions for 2019–2020 are: Will an intimidated Fed ensure Trump gets re-elected? And could the US economy blow up before November 2020?

Many a time over the past year financial markets have been blindsided when the chief resident of 1600 Pennsylvania Avenue, Washington DC, has a bout of insomnia. The most recent was the threat of tariffs on Mexican imports unless Mexico did more to stop the flow of illegal immigrants into the US. Paul Whitfield of Investor's Business Daily summed up the market slide thus: "Stocks learned a lesson Friday, namely that they are not operating in a bull market or a bear market but in a Trump market, which in some ways is the worst scenario for Wall Street." The Trump 2020 re-election campaign has just started. Markets should be ready for tweet bombardments over the next 16 months. Hold on tight, it is likely to be a bumpy ride.

Historically, a Fed tightening cycle results in a fall in the US Manufacturing PMI below 50%. An index reading above 50 signals the industry is expanding. Below 50 warns manufacturing activity is contracting. There is a high correlation between a sub-50 PMI reading and a trailing recession in both corporate earnings per share and GDP. (Exhibit 7)

The US Manufacturing PMI currently stands at 50.6, marginally above contraction and at its lowest level in 116 months or almost a decade. This, as the Fed is about to start cutting rates to stop a further decline into contraction. On the other hand, unemployment is near a 50-year low thanks to a more buoyant services sector. Manufacturing payrolls have slumped since October 2018 when US and China tariffs started to bite. But overwhelmingly, most jobs created in the US since 2010 have been outside the manufacturing sector. The "Make America Great Again" campaign has not created the manufacturing jobs promised.

While most manufacturing PMIs are at or below 50, the non-manufacturing or services PMIs are above 50, although they are also trending downward. If they were sub-50, it is likely the world would be on the verge of, if not, already in recession.

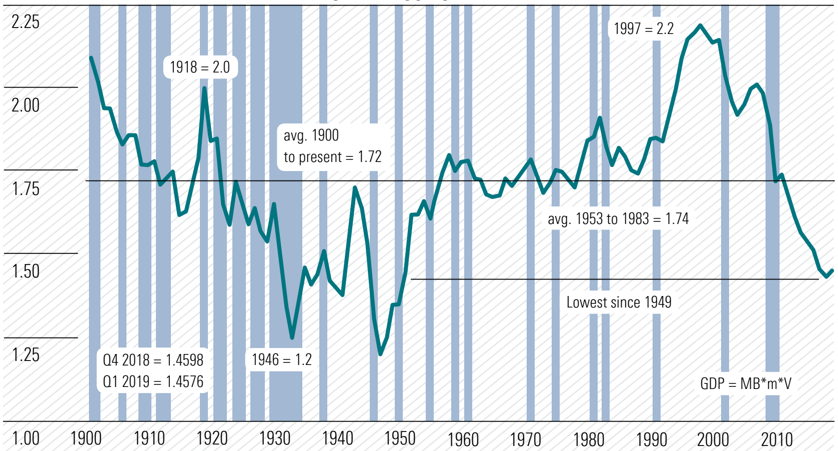
Velocity of circulation and freight shipments

What do the velocity of money (circulation) and freight shipments have in common? Both reflect the level of economic activity in the most basic sense.

In short, economic growth is the product of money supply and its velocity, or the number of times it changes hands. Past major economic contractions are characterised by falling velocity and in expansion or better times velocity is either flat or rising. The velocity of money has been falling since 1997 and currently is at its lowest point in 70 years. As Lacy Hunt of Texas-based Hoisington Investment Management Co. puts it, "if money lubricates the economy, it needs to be as slippery as possible—but it is growing less and less so." If money supply increases, but most of it stays in a bank account, it will have no impact on economic growth and productivity will suffer. This is one of the problems

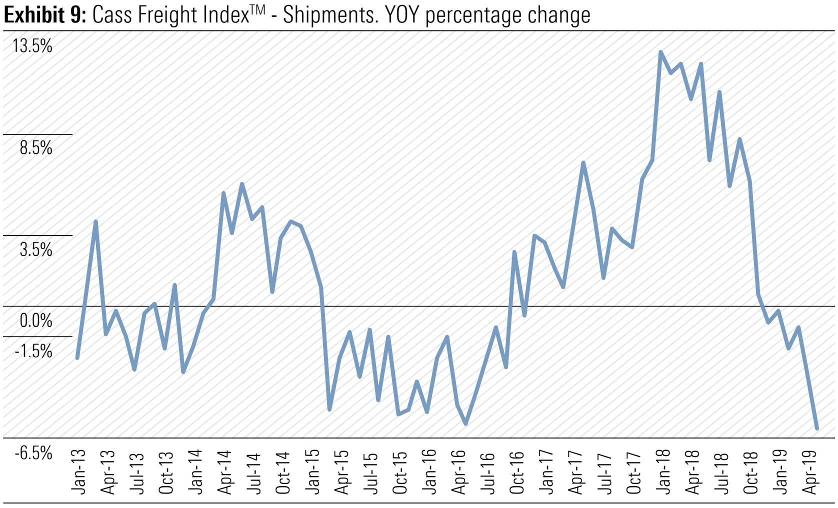
Exhibit 8: Velocity of Money 1900-2018. Equation of Exchange: M*V = GDP

V = Y/M, if Y = coincident, M = leading, V = lagging



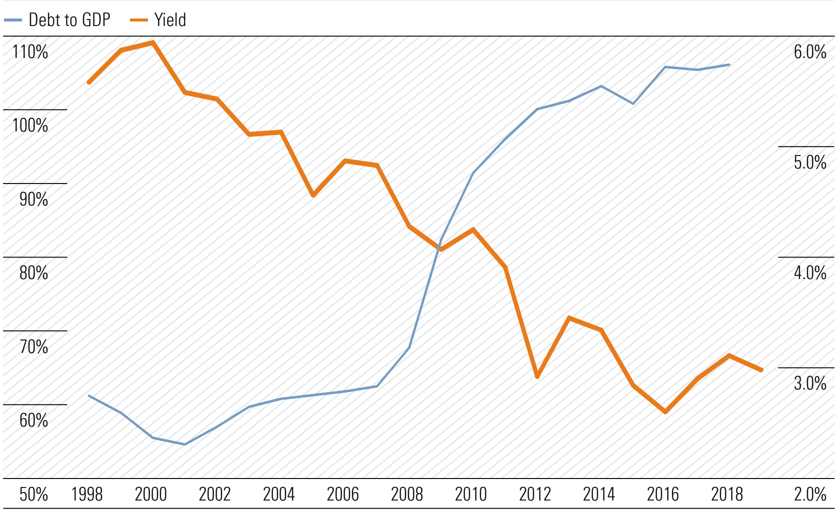
Source: Federal Reserve Board, Bureau of Economic Analysis, Bureau of the Census, The American Business Cycle, Gordon, Balke and Romer. Through Q4 2018. Q4 2018; V = GDP/M, GDP = 20.9 tril, M2 = 14.3 tril, V = 1.453

Exhibit 9: Cass Freight Index™ - Shipments. YOY percentage change



Source: Cass Information Systems, Inc.

Exhibit 10: United States: Debt as a % of GDP and 30 year Government Bond Yield - Annual



Source: Federal Reserve, O.E.C.D, Haver Analytics. Through 2018. Yield through March 2019.

facing all central bankers, as they have no way to boost velocity, and probably one reason their policies have been increasingly less effective. (Exhibit 8)

Freight shipments reflect the velocity of goods moving throughout the economy with the velocity of money most probably being the driving force. Both are demand driven. If the velocity of money slows then so will the velocity of goods. Cass Information Systems, Inc describes “the volume and velocity of tangible goods as the heartbeat of the economy.” The highly regarded and closely tracked freight index was one of the first flow indicators to turn positive in October 2016 and a pointer to a recovery in the US economy later that year. Cass does not believe the index is the only guide but “tracking the volume and velocity of those goods has proven to be one of the most reliable methods of predicting change because of the adequate amount of forewarning that exists.” (Exhibit 9)

But overall freight volumes are one of the best predictors of overall economic health and the Cass Shipments Index is one of the most dependable measurements of overall freight volumes in the US.

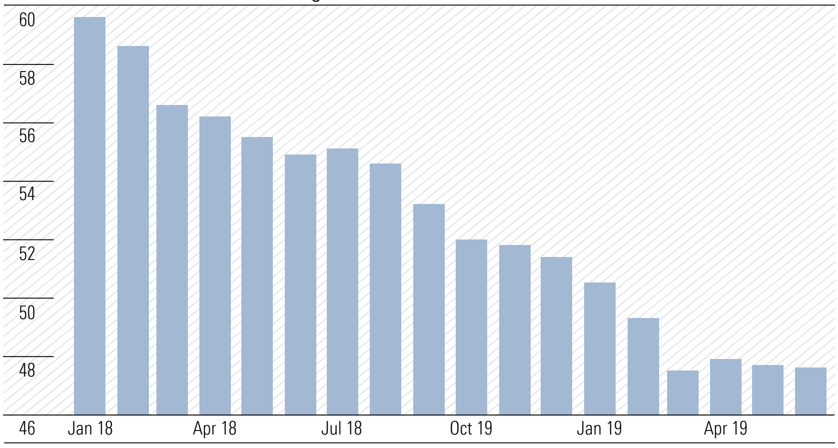
The accelerating decline in the index from mid-2018 into negative territory reflects the opening salvos in the US/China trade war. International air freight volumes have slumped, and US railroad volumes continue to weaken. Spot pricing for transport services, particularly for trucking is consistent with falling volumes. European, Asia Pacific and Chinese inbound air freight volumes are all sliding. There is mounting evidence from incoming US data that an economic contraction is brewing, and it is vital a resolution is reached between the US and China in the near term.

US government debt continues to rise under the fiscal expansion of the Trump administration. Lacy Hunt’s research shows this will keep interest rates lower for longer. (Exhibit 10)

The 30-year bond yield is currently 2.50%

Trump’s rant slamming the Fed “despite a Federal Reserve that doesn’t know what it is doing” is not helpful. The Fed balance sheet has reduced by 6% since the “auto pilot” was switched off in December. At 26 December total assets were US$4.076 trillion with US Treasuries of US$2.24 trillion and mortgage-backed securities US$1.64 trillion. At 26 June total assets were US$3.83 trillion, down US$246bn, with Treasuries down US$131bn and mortgage-backed securities US$97bn.

Exhibit 11: Euro Area Manufacturing PMI



Source: tradingeconomics.com

The Eurozone—Brexit and Italy

A year ago, I wrote, "While political tensions in Italy have abated, it is still possible the coalition of the Five Star Movement (M5S) and the League (Lega) could disintegrate, triggering new elections by year's end. Should this scenario unfold, the elections are likely to be a vote on whether Italy remains a member of the European Union and the euro."

All roads lead to Rome. The Italian situation has taken on a Grecian tinge, the difference being the Italian economy is much larger than that of Greece. The implications from any fallout will be more pronounced.

The German economy holds the key to the eurozone. The export-sensitive economy has been buffeted in the US/China backwash. But the general export bias of the zone has also attracted the attention of the US president and tariff threats have been issued. The president has not restricted his criticism of central banks to the Fed. He blasted the European Central Bank's president Mario Draghi on his comments that further monetary policy changes may be required to arrest the slide in economic activity in the eurozone. The resultant dip in the euro against the US$ prompted an immediate tweet. The cause of global weakness is the US/China trade war, which was started by the president, but he seems to be in denial.

However, the fact remains most countries affected will ease monetary policy which will impact currencies. Whether that provides an advantage by making exports more competitive is a moot point, but widespread monetary policy easing has had limited success so far despite its scope.

The Euro Area manufacturing sector is in contraction with the Purchasing Managers Index (PMI) in June at 47.8. This is the fifth consecutive month of a reading below 50 which signals a contraction in activity. (Exhibit 11)

The Euro Area PMI tracks that of its major contributor, the German economy. In June, the German PMI was 45.4, with new orders falling for the 10th consecutive month, although the decline in June was the slowest since January. Output and employment remain in decline. Manufacturers are now less pessimistic than earlier in the year, with neutral output growth expectations. Clearly Osaka holds the key to the near to medium-term outlook.

October also looms as a probable disruption to an already troubled economy as the United Kingdom exits the European Union. The June UK manufacturing PMI slumped to is lowest level since April 2009, falling from 48.6 in May to 43.1 and 53.1 in June 2018.

German bund yields suggest a sombre outlook—2-year minus 0.78%; 10-year minus 0.37%, and 30-year 0.24%. Another 25-point decline would see the entire German bond market of US$850bn with a negative yield—the last flickering positive yield close to being snuffed out. The 2-year Spanish and Italian yields of minus 0.45% and just 0.03% are scary. Does this signal the "Japanification" of Europe? This is not an exciting prospect.

China—How much more stimulus can be provided?

GDP growth is likely to slow in the December half. Caixin and Official Manufacturing PMIs for June declined from May and both are below 50, signalling business in contracting. The official non-manufacturing PMI also slipped marginally from 54.3 in May to 54.2, to a six-month low. While construction edged higher, it meanders near a 16-month low despite several infrastructure-biased stimulus programs. The services sector was the dampener.

In the absence of the Osaka truce, further stimulus was likely and still may eventuate given the slowdown in global demand and the implications it would have on Chinese export volumes. Disconcertingly, new orders continue to trend lower. Manufacturers have reduced their demand for labour as industrial output has slowed, which restricts household income and may affect household consumption. Weak investment from both the private and public sector is an unwelcome intruder and needs to rebound to provide support to growth over the short and medium term.

Year-on-year GDP growth for the June quarter is likely to come in near 6%, slowing from 6.2% in the March quarter and toward the bottom end of the target growth range for 2019.

Energy Commentary

Low LNG spot prices not indicative of the medium-term potential

Mark Taylor
Senior Equity Analyst
Energy and
Mining Services

Australia's three largest listed hydrocarbon exploration and production companies, Woodside Petroleum (WPL), Santos (STO) and Oil Search (OSH), are all materially exposed to LNG pricing following completion of major LNG export infrastructure chiefly within the last decade. With respect to our fair value estimates, LNG projects, existing and planned, comprise 78% for WPL, 53% for STO and 67% for OSH. But LNG pricing is more important still, given its influence on domestic gas pricing via export parity price pull, particularly important for STO, and also as up-front capital expenditure for planned LNG expansions weighs on balance sheets; LNG production represents an even greater share of the pie, particularly into the future.

Of more than passing interest then is recent deterioration in spot LNG pricing into Asia. While the US$5.30 per million British thermal units (mmBtu) May Japan price is simply near sub-US$5.00 lows plumbed approximately three years ago, the angst is far higher given the greater margin to the contract price. Most Australian company LNG exports are sold under long-term contracts referenced with a three-month lag to the Japan Customs-Cleared (JCC) oil price approximating Brent crude.

Contracts in recent years have typically been struck at a 14% slope to the lagged JCC price. This yields a US$8.40/mmBtu LNG price when crude is at US$60 per barrel. Spot prices are more volatile than contract, but on average have traded at an approximate 5% discount to contract. Allowing for the three-month reference lag, the spot LNG lows plumbed in mid-2016 were at this approximate 5% discount to contract. But current spot lows are abnormally at a near 40% discount to a rising US$9 oil-linked contract price (Exhibit 12). Near-term excess supply, including from new US projects, and weak demand conspire against spot pricing; although we still think the LNG market will need new supply from 2022.

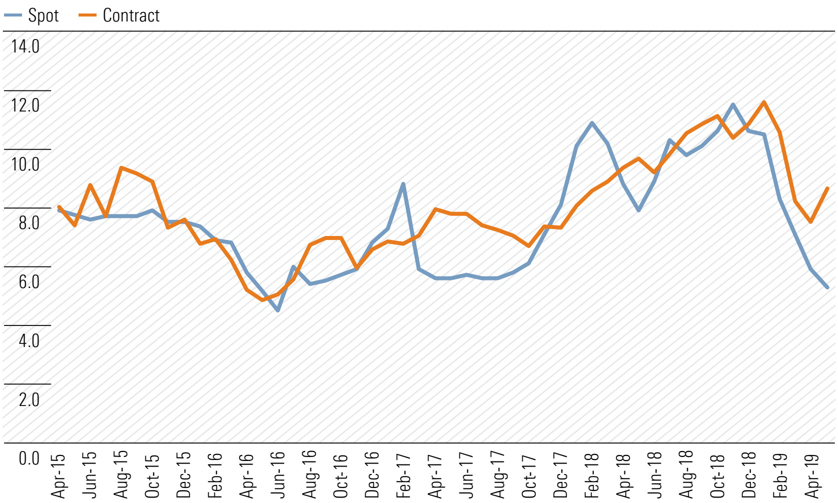
The worry around the near-term weakness is greater than might have been in the past due to the willingness of companies like WPL to allow a growing proportion of mid- and short-term and spot sales, for more customers to request mid- and short-term contracts, and due to the potential for the slope in new LNG contracts required for sanction of expansion projects to flatten. As existing contracts with customers are renegotiated or expire, failure to renegotiate terms as favourable as existing contracts or to find replacement purchasers of LNG would hurt earnings.

This is of limited near-term consequence to Australian LNG companies. OSH's PNG LNG project has 7.9Mtpa or 90% of existing production under long and mid-term agreements, including 6.6Mtpa or 75% under 20-year contracts. STO's Gladstone LNG has 7.0Mtpa or more than 90% of capacity sold under long-term contracts. WPL has the least at approximately 75% of production under long-term contracts. At Pluto it has 3.75Mtpa or 90% of capacity sold under long-term, Wheatstone has approximately 80% of LNG volumes sold under long-term contract, but the older North West Shelf has far less. About two-thirds of all the long-term contracts—around 11Mtpa from the WPL-operated North West Shelf (NWS) and Pluto LNG export plants in Western Australia are due to expire by 2025. However, WPL's equity exposure to this is considerably less given its just one-sixth share of NWS from where the majority three-quarters of output (100% basis) derives.

The main risk then is to LNG expansion projects, where a final investment decision requires enough volumes to be contracted at satisfactory prices, for comfort on the large capital commitment. We don't think current spot prices are in any way indicative of the long-term potential for LNG markets. We think the price required to incentivise enough new capacity to balance the market is ~US$8.50/mmBtu, in line with our mid-cycle price outlook at US$60 per barrel Brent. But were expansion projects to be killed off due to insufficient demand/pricing, it would detract to the tune of $15.30 or 33% from our base case $46.50 WPL fair value estimate, $1.00 or 12% from STO's $8.15, and $1.05 or 15% from $7.00 of OSH, all else being equal. This includes killing off Browse and Pluto Train 2 for WPL, PNG LNG expansion and Barossa to Darwin LNG for STO, and the PNG expansion and Papua LNG projects for OSH.

But our mid-cycle LNG price forecast is unchanged at US$8.40 per mmBtu, effectively a 14% slope to US$60 Brent price, or a 20% discount to Brent in energy equivalence. We think US shale growth is likely to see Brent revert to our mid-cycle forecast,

Exhibit 12: Asia Spot LNG versus Contract price (US$/mmBtu)



Source: METI, Morningstar

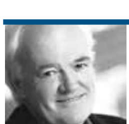
where production is incentivised to meet oil demand but not to the point of over-production likely at higher prices. We remain cognisant of the growing importance of US gas prices on export LNG markets. But even were the long-standing Brent-LNG pricing mechanism to erode faster than anticipated, we still think strong Asia-Pacific demand growth will support US$8.40 LNG prices on a cost basis. US LNG is cheaply made but is considerably more expensive to ship to Asia. Australian and PNG shipping costs into Asia at ~US$0.64/mmBtu are 60–70% below Gulf Coast costs of ~US$1.77 via the Panama Canal, or even more via the longer Cape of Good Hope route. This equates to a netback of US$7.76/mmBtu for Australian/PNG projects versus just US$6.63 or less for US Gulf Coast, at our mid-cycle US$8.40 LNG price forecast.

With US LNG exporters only needing to cover variable costs in the short term, volumes will keep flowing even at prices as low as US$6/mmBtu in Asia. However, we see this excess supply eventually being soaked up by a return of European demand, emergence of Middle East demand, and rapid consumption growth in Asia, bringing the market back into balance by 2022. Then new capacity will need to come on-line in order to meet the predicted supply gap into 2025. The tighter market and the need to cover long-run marginal costs and generate acceptable returns on new investment in US projects should push prices to US$8.50/mmBtu globally to earn adequate returns.

Australian company expansion plans seem well timed to both meet expected supply shortfall, but also to take advantage of lower capital costs following the now completed inflationary Australian LNG construction boom. Market conditions point to a 40% increase in Chinese LNG demand by 2021, with growth driven by clean air policies and urbanisation, while European growth is anticipated to be driven by rising carbon prices and declining domestic supply. In 2018, China's total natural gas imports climbed by nearly 32% to 90Mtpa making it the world's biggest importer. Gazprom has a 30-year contract for annual supply of 1.3Tcf (28Mtpa) of gas via a new 3,000km pipeline to China from Irkutsk and Yakutia commissioning by end 2019. But this still leaves plenty of room for LNG growth. WPL notes 230 Mtpa of additional LNG supply will be required by 2030, in broad step with our own views.

Ian Huntley's comments

Bubbles and Caution plus psych test for all!



Ian Huntley

There's an old saying for the tail end of a bull market—when pygmies cast long shadows. Exhibits 13a and 13b showing revenue to market capitalisation of our leading emerging tech stocks appears to show exactly that.

Our leading ASX listed emerging tech stocks are known as the WAAAX and I have added the big daddy of them all, Nasdaq-listed Atlassian, whose figures are in US$, but tell the same story. A revenue multiple 30 times, approximately. Very few established companies show a market cap more than double revenue and need a very high return on equity to justify it.

Profit is it always a good indication for a growing tech stock as the history of Amazon has shown. Essentially, most of these stocks are similar to a media stock where the number of eyeballs is critical, and then the ability to monetise them. So as profits emerge, they are constantly re-invested into the business, often largely in marketing and development, all of which is written off, thus no stated profit.

Exhibit 13a: WAAAX Stocks - Revenue growth ($m)

Company	FY14	FY15	FY16	FY17	FY18	FY 03/19
Wisetech (WTC)	56.7	70.0	102.8	153.8	221.6	--
Afterpay (APT)	--	--	--	22.9	113.9	--
Appen (APX)	--	82.6	110.9	166.6	364.2	--
Altium (ALU)	75.0	104.5	125.9	144.1	188.0	--
Xero (XRO)	65.8	121.5	186.5	269.8	381.9	530.5
Atlassian (TEAM)	215.0	320.0	457.0	620.0	874.0	1,110

Source: Company reports

Exhibit 13b: WAAAX Stocks

Company	Market Cap ($bn)	Revenue ($m)	Profit ($m)	PER	Rev Multiple
Wisetech (WTC)	6.7	221	40	209	39x
Afterpay (APT)	5.4	113	-9	Negative	55x
Appen (APX)	2.8	364	41	74	9x
Altium (ALU)	4.2	187	50	86	23x
Xero (XRO)	7.2	381	-26	Negative	22x
Atlassian (TEAM)	31.8	1,110	-27.6	Negative	30x

Source: Company reports

I have no argument a number of these and other similar companies on the ASX and Nasdaq have very interesting business concepts, and many are kicking early goals.

What we are seeing is very similar to the boom time valuation of exploration companies with their first few successful drill holes. The market extrapolates initial promise into a major discovery and the market capitalisation rapidly equates with optimistic assessment of a real mine, not just the promise. And, as with every early-stage emergent company, there is many a slip between the cup and the lip, especially when the market is drunk with excessive optimism.

With the tech stocks, the analyst attempts to calculate the addressable market, when this goal can be reached, and thus uses these ingredients for a valuation. In the early days of Microsoft and Apple Messrs Gates and Jobs spoke of the computer having the potential to rival the auto industry in size, and they succeeded. Many other start-ups fell by the wayside, but buying Microsoft, Apple or Google in the early days on price earnings multiples of 100 proved correct! Unfortunately, many more launch at the starting gate, but crash well before the rosy goals.

How do we attempt to justify revenue multiples like these? These companies expense tremendous amounts in marketing and R & D to drive growth, growth the object not stated profit. Thus forget PER. Exhibit 13a shows individual company revenue growth in recent years. If they can continue to grow revenues – the business – at 30 to 50% per annum they are in with a chance to reach something that may justify current market caps – and if the growth continues. WOW! Stocks such as Amazon, Microsoft, Apple did all this! But many a slip between the cup and the lip!

When the next bear market does occur, I am sure some real value well may emerge, so getting an understanding of these companies may well be worthwhile!

Caution recommended

The bull market at 10 years of age reflects the longest business cycle since they have been recorded in modern history, and curiously one where many believed—not expecting such low velocity of circulation—would be very short because of the usual result of huge monetary stimulation.

However, bond markets here and in the US are signalling recession ahead with an inverted US yield curve. In Australia, the major issue is the extremely high levels of household debt, the result to my mind of excess RBA stimulation in recent years. Now the game is to cut interest rates further to reduce the burden, similarly tax cuts. But as the chasm becomes clearer, we are left to wonder when the usual end of decade bear market will emerge. Is this time different? I doubt it! I do believe US and Australian options for reflation are limited, though very low long-term interest rates present many an opportunity to finance major infrastructure programs.

Personally, I have trimmed my portfolio of weaker or nil dividend paying stocks, and have cut family debt, some of which was used early in the cycle to buy dividend-paying stocks with yields nicely in excess of interest paid. I retain a quite highly invested position of quality dividend-paying stocks but have sharply reduced my bank exposure over the last 18 months. Most have been held for many years, indeed a number of decades. (I am 77.)

I let the cash build up for the next rainy day!

Those psychologists!

I must compliment ASIC chief James Shipton, on his plan to foster the presence of psychologists in the corporate boardroom. As a self-confessed expert on corporate culture, I am sure he will adopt code 1 of management and lead by example. A psychologist in the ASIC committee room. Why not in cabinets—state and Federal. And the RBA too! Gosh, the field is immense. Just fill in this space… Blue Sky Mines? And more!