

## What I lose sleep over!

### & Where the opportunities are.

The extreme & unusual nature of the investment risks we currently face in the West including Australia. By comparison, Asia's time has come. This reality is the Asian century.

By Bruce Baker BSc MBA  
Certified financial planner

*Helping clients navigate through the riskiest period for Aussie investors since 1900.*

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## John Hewson – AFR 2/9/15

- ‘The veteran forecaster admits he has **"never seen it harder than it is today to say what's going to happen."** Most of the world is afflicted "with short-term policies and they are not addressing the longer-term stuff"’
- ‘**quantitative easing hasn't helped much, apart from creating bubbles**, and increasing inequality and debt levels. It sounds a bit like that cliché du jour – kicking the can further down the road. But **reversing that can-kicking process threatens to result in a stock market crash, bond market crash, and currency realignments**, Hewson says.’

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## Susan Gosling, head of MLC Investments

- “Defensive investments such as cash and bonds won't weather a severe storm, which is why Susan Gosling focuses on currencies, derivatives and gold”
- “One of your most conservative strategies contains zero Australian equities. What are your concerns?”
  - Australia sailed through the GFC, partly because of what happened in China, (big stimulus measure towards end of 2008) but if we look at Australia's position today, household debt is extremely high, among the highest in the world and that's gone into housing. It hasn't gone into any productive investment, but if we look at where funding for housing comes from, to an extent banks are dependent on raising capital overseas.
  - You could envisage Australia having its own crisis (BB: She is talking credit crisis) where maybe even the government has to come in and assist the banks. (BB: Brave comment for someone who, in effect, works for NAB.) So we started rethinking, again, for our less traditional funds. Does this exposure actually make sense?
- <http://www.afr.com/personal-finance/think-laterally-in-a-challenging-investment-environment-20150618-zh7tz>
- [http://puzzlefinancialadvice.com.au/Strategy\\_Gosling\\_AS\\_Asian\\_shares\\_150622.pdf](http://puzzlefinancialadvice.com.au/Strategy_Gosling_AS_Asian_shares_150622.pdf)

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## David Murray's Financial System Inquiry

- ‘The FSI (Financial System Inquiry) found that "the major banks have a leverage ratio of around 4.5 per cent ... [and] an overall asset-value shock of the range experienced overseas during the GFC would be sufficient to render Australia's major banks insolvent’
- [http://puzzlefinancialadvice.com.au/151021\\_AFR\\_Joye\\_Malcolm\\_Turnbull\\_paves\\_way\\_for\\_more\\_bank\\_rate\\_increases.pdf](http://puzzlefinancialadvice.com.au/151021_AFR_Joye_Malcolm_Turnbull_paves_way_for_more_bank_rate_increases.pdf)

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## Are the central banks part of the problem?

- Stephen Williamson – St Louis Fed VP, Aug/15
  - QE (money printing) theory is “not well-developed”
  - evidence in support of QE is “mixed at best”
  - “There is no work, to my knowledge, that establishes a link from QE to the ultimate goals of the Fed inflation and real economic activity.”
  - “A Taylor-rule central banker may be convinced that lowering the central bank's nominal interest rate target will increase inflation. This can lead to a situation in which the central banker becomes permanently trapped in ZIRP!”
- GFC showed classical economic theory is broken. What video at this link. <http://ineteconomics.org/about/mission>
- Stephen Roach (former chair Morgan Stanley Asia)
  - Fixated on inflation targeting in a world without inflation, central banks have lost their way. With benchmark interest rates stuck at the dreaded zero bound, monetary policy has been transformed from an agent of price stability into an engine of financial instability. A new approach is desperately needed. <http://www.afr.com/opinion/the-fed-needs-to-start-fighting-the-right-economic-enemy-20151028-gkikiixzz3pzi1n9wK>

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## Some of the Warnings between April 2015 and early July 2015.

- Secretary to Federal Treasury (John Fraser) - Sydney housing 'unequivocally' in a bubble, says Treasury boss.
- ASIC chairman Greg Medcraft.
  - “ASIC's Greg Medcraft 'quite worried' about Sydney, Melbourne house prices:
    - “History shows that people don't know when they are in a bubble until it's over.” Mr Medcraft told The Australian Financial Review.
    - Mr Medcraft's comments come as the Reserve Bank and the Australian Prudential Regulation Authority grow increasingly concerned about the build-up of risks to the financial system arising from a combination of low interest rates, rising house prices and elevated household debt levels.
- David Murray, chairman of Financial Systems Inquiry.
  - AFR 3/5/15 “Soaring house prices threaten the economy, David Murray says”
- Gerard Minack, highly regarded analyst.
  - <http://www.abc.net.au/news/2015-06-05/extended-interview-with-gerard-minack/6526196> 5/6/15.
  - He would be surprised if we avoided recession over the next 2-3 years.
  - Parallels with Japan (post 1990, of course).
  - “Housing is a huge macro risk”. “We have one of the most levered households in the world with clearly one of the most expensive housing stocks.”
- Ken Henry, past head of the Federal Treasury.
  - <http://www.afr.com/news/2015/06/05/ken-henry-on-the-risk-of-a-recession>
  - “Australia's most battle-hardened economist has compared the flight to yield to some of the worst examples of herd-like behaviour” ... have contributed to the most overcrowded trade there is – the rush to yield.”
- Famous Sydney property developer Harry Triguboff 17/4/15 says “The broader country has more risk of oversupply because the councils say that their income comes from approving apartments, so everyone is approving apartments,” he said. <http://www.afr.com/real-estate/whole-country-at-risk-of-housing-oversupply-triguboff-20150417-1mnlly>

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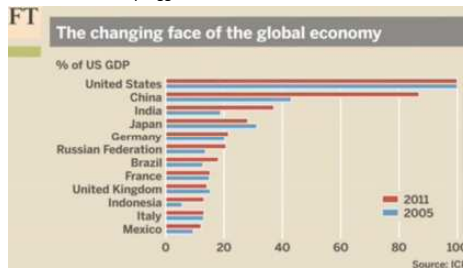
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### The Transformation of Asia

- Globally, we are seeing a very rapid shift in economic power that will reshape the world.
  - On virtually every dimension. Are you ready?
- ANZ - "Caged Tiger: The transformation of the Asian Financial System"
  - <http://www.interest.co.nz/sites/default/files/ANZ%20caged%20tiger%20report.pdf>
- Asian now accounts for 25% Global GDP.
  - By 2030 they expect that to be 35%.
  - By 2050, they expect Asia's share to be 50%.
- US and Europe account for 50% of the world economy today, but this seems likely to drop to 25% by 2050.

### "China poised to pass US as world's leading economic power this year" 30/4/14

- <http://www.ft.com/intl/cms/s/0/d79ff6-cb7-11e3-9b2b-00144feabdc0.html?#edition=nl&maxZoom=230MhayQh8>
- Note: Australia does not even rate on this list compiled by the World Bank.
- Comparison of sizes of economies on a Purchasing Power Parity (PPP) basis.
- Indonesia is already bigger than Australia on PPP basis.



### By 2050, Australia might drop out of G30

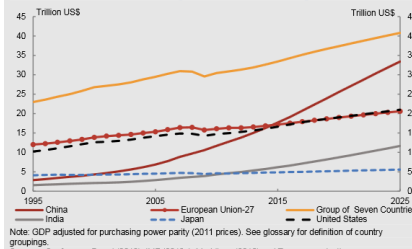
- <http://www.pwc.com.au/media-centre/2015/world-in-2050-feb15.htm>
- <http://www.pwc.com/au/consulting/publications/world-in-2050.htm>
- <http://www.pwc.com/au/en/issues/the-economy/assets/world-in-2050-summary-report-february-2015.pdf>
- Just take a look at which countries are going to over-take Australia over the next decade or two.
- Australia's comparative importance in the world is expected to rapidly shrink.
- Our economic, international relations, military considerations need to take this into account.

Country	2014 GDP (trillion USD)	2025 GDP (trillion USD)	2050 GDP (trillion USD)
USA	16.5	18.5	18.5
China	7.5	15.5	25.5
India	2.5	10.5	20.5
Japan	5.5	4.5	4.5
Germany	3.5	3.5	3.5
Russia	1.5	1.5	1.5
Brazil	1.5	1.5	1.5
France	2.5	2.5	2.5
UK	2.5	2.5	2.5
Italy	2.5	2.5	2.5
Spain	1.5	1.5	1.5
Canada	1.5	1.5	1.5
Australia	1.5	1.5	1.5

### Box 2.1: Asian economies will become bigger than advanced economies

The combined output of China and India will likely exceed that of the whole Group of Seven (G7) by early next decade (Chart 2.4). Asia is set to overtake the combined economic output of Europe and North America within the decade to 2020. India has become the world's third-largest economy and China could overtake the United States as the world's largest economy by 2014 in real purchasing power parity terms.

Chart 2.4: Takeover points of absolute output levels



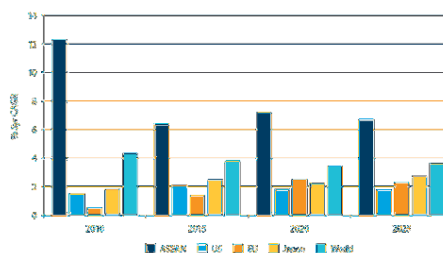
- [http://www.asiaeducation.edu.au/verve/\\_resources/australia-in-the-asian-century-white-paper.pdf](http://www.asiaeducation.edu.au/verve/_resources/australia-in-the-asian-century-white-paper.pdf)

### ANZ – ASEAN to become more important than China to us

- "China is hardly waning but ASEAN is the Next Horizon" ANZ
  - <https://bluenotes.anz.com/posts/2015/04/china-is-hardly-waning-but-asean-is-the-next-horizon/>
  - "There's a giant in Asia, shifting the tectonic plates of manufacturing, trade, services and the global economy. It's not China."
  - "During the next 10 years we expect ASEAN to replace China as the world's manufacturing hub and we expect it to become the fifth largest economy in the world by the end of the decade."
  - "ASEAN's great attractions are favourable demographics, a young population and growing consumer class. Its potential is greater than is commonly understood. Consider iron ore: the infrastructure investment required in the region is double the size of the infrastructure investment to which China committed in the financial crisis. The numbers behind ASEAN's transformation are truly astonishing."
  - ASEAN could replace China as the world's leading manufacturing centre and emerge as a key market for Australian exporters with the potential for the Australia-ASEAN trade and investment corridor to double and exceed US\$210 billion by 2025, rising from US\$90 billion in 2013."
  - "ASEAN: The Next Horizon" ANZ research paper
    - <http://the.corporateor.net/External/Files/News/2015/04/20150424%20ASEAN%20Next%20Horizon%20Research%20Paper.pdf>
  - AFR "ANZ Bank says Southeast Asia will replace China for manufacturing"
    - <http://www.afr.com/news/world/asia/anz-bank-says-southeast-asia-will-replace-china-for-manufacturing-20150424>
  - "The report forecasts that two way trade between Australia and New Zealand and Asean and incoming Asean investment will be worth about US\$230 billion (\$300 billion) by 2025 compared with about US\$100 billion today. Australia's two-way trade with China was \$150 billion in 2014 and approved foreign investment from China in 2013 was \$15 billion."

### More on ASEAN

- Much faster growth in ASEAN
  - <http://www.indepth.anz.com/supporting-data.html>



## Indonesia

- “Why Australia’s relationship with Indonesia is so important.” ANZ
  - <https://bluenotes.anz.com/posts/2015/05/why-australias-relationship-with-indonesia-is-so-important/>
  - “Indonesia has a population 10 times the size of Australia’s and an economy half the size. It won’t stay that way. Much research, including ANZ’s own recent ASEAN study, leaves little doubt Indonesia is destined to become a much larger economic player and a more significant regional power.”
- Other useful links from ANZ
  - <http://www.indepth.anz.com/index.html>
    - “ANZ believes that Southeast Asia will eventually be as important to Australia and New Zealand as China is today.”
  - <https://bluenotes.anz.com/posts/2015/04/mike-smith-asias-importance-has-been-undersold/>
    - “I believe as we shift from a natural resources led relationship with Asia to a deeper, more multi-faceted engagement with the region, that Asia has never been more important to Australia’s future and to ANZ’s future.”

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## Objective of this presentation

- To give you some of reasons to invest in Asia
  - The world is changing very fast.
  - Developing world already 50% global GDP
    - That share to rise quickly
  - Aussie investors have little exposure to Asia
  - Asia is fairly cheap compared with West
- Western world has historic challenges & risks
  - implying weak returns likely in coming years
- Australia has some unique challenges
  - Tough time ahead for Australia
  - A\$ may fall a long way.
  - Offshore investors can make currency gains

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## Context of this presentation

- What is “normal” approach to investing.
- Show why timing matters.
  - And why timing particularly matters now.
  - Particularly in Western developed world

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## “Normal” approach to investing


(simplistic version)

- Investment theory
  - Diversification – Harry Markowitz
  - James Tobin – Separation Theory
  - Risk vs return
  - Fama & French
  - Fama & French extension

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## Professor Harry Markowitz.


Diversification within risky assets



- Nobel Prize 1990
  - for contributions to Portfolio Theory.
- When building an optimal portfolio
  - “Risk means facing the possibility of losing rather than winning.” P43
  - “I was struck with the notion that you should be interested in risk as well as return”. P47
  - “It is necessary to avoid investing in securities with high covariances among themselves.” P50.
  - “The riskiness of a portfolio depends on the covariances of its holdings, not on the average riskiness of the separate investments.” P54
  - Investors should create an efficient frontier of efficient portfolios, then choose an acceptable level of risk. P58

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## James Tobin - Nobel Prize 1981

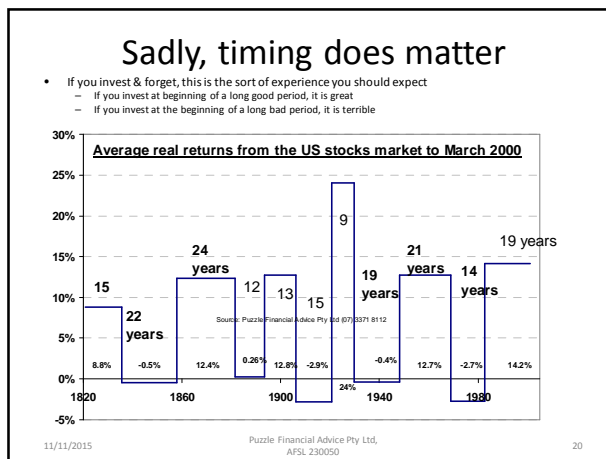
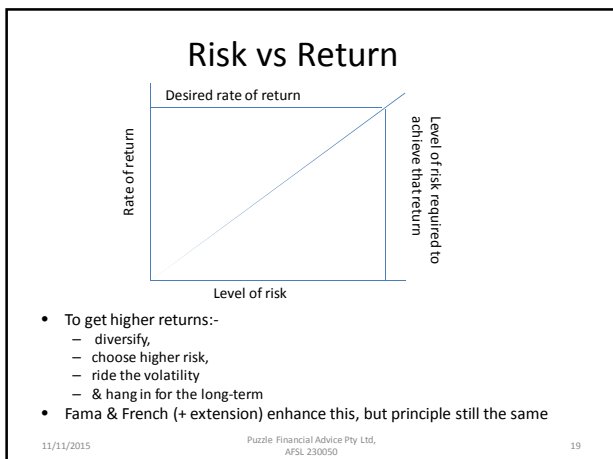


- **The Separation Theorem** “argues that the Markowitz process of selecting securities for the most efficient risky portfolio is completely separate from the decision of how to divide the total portfolio between risky and risk-free assets.” P72.

<b>Cash &amp; “Stable” Investments</b>	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%; border: 1px solid black; padding: 5px;">Property</td> <td style="width: 50%; border: 1px solid black; padding: 5px;">International Shares</td> </tr> <tr> <td colspan="2" style="border: 1px solid black; padding: 5px; text-align: center;">Australian Shares</td> </tr> </table>	Property	International Shares	Australian Shares	
Property	International Shares				
Australian Shares					

Stable vs Shares/property - guidance from Tobin

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### Where are we at in long investment cycles?

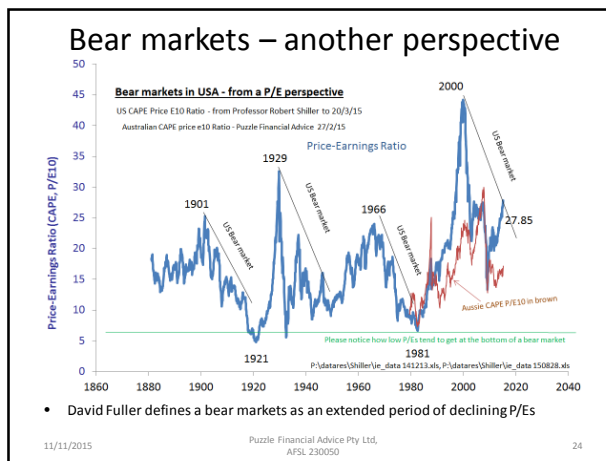
- It appears that:-
  - The US
    - commenced a long "good" period for shares in 1982
    - Ceased their long "good" period in 2000
  - Australia
    - commenced a long "good" period for shares in 1982
    - Probably ceased their long "good" period in 2007
      - The longest bull markets in Australia's history
  - Asia is in a very different cycle
    - See biggest emergence event discussion later

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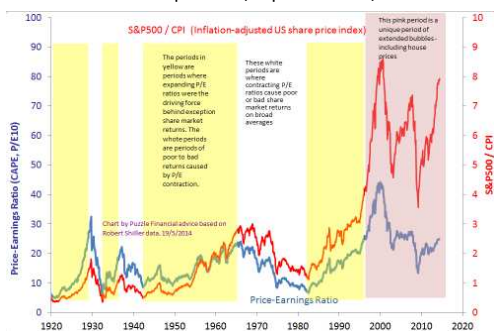
### Western world has historic challenges

- Now. Discuss challenges posed from:-
  - Debt bubbles**
    - risk of deflationary crash
  - Massive money printing**
    - risk of hyperinflation
  - Asset price bubbles**
    - correlated with low/negative returns
  - House price bubble**
    - GFC-style event
  - Largest emergence event in history**
    - China, India + Next-11
    - + technology revolution

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### Why do these long cycles exist? Compression/expansion of P/Es

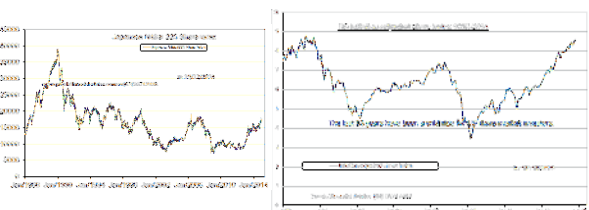


### Implications

- Investors currently face extreme market timing risks.

### Market Timing Matters

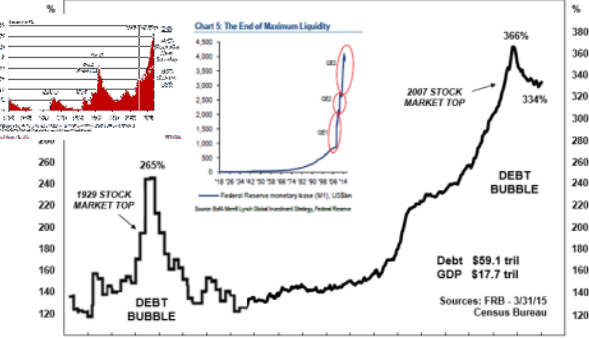
- Some people preach that "It is time in the market, rather than timing", that is the key to getting good investments returns.
- Ask Japanese investors who invested in December 1989 if this is true?
- Ask US investors who invested in January 2000 if this is true?
- The problem with the "Time in the market" dogma, is that if you invest just before the beginning of a secular bear market, you are likely to have a very traumatic experience for a very long time.
- Therefore have no real choice to grapple with the difficult market-timing problem.



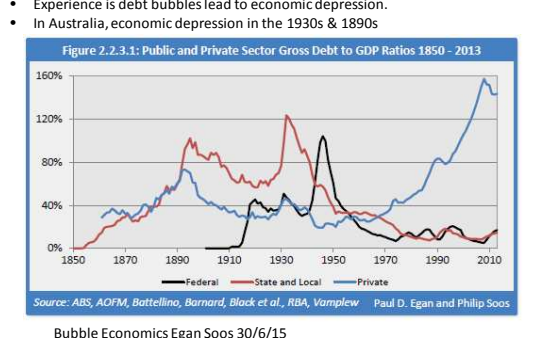
### What are some timing risk factors?

- THE REST OF THIS PRESENTATION
  - Discusses some sources of timing risk
    - Debt bubbles
    - Central bank money printing
    - Asset price valuations
      - Shares
      - House prices
    - Emergence event

### History – on debt bubbles - USA

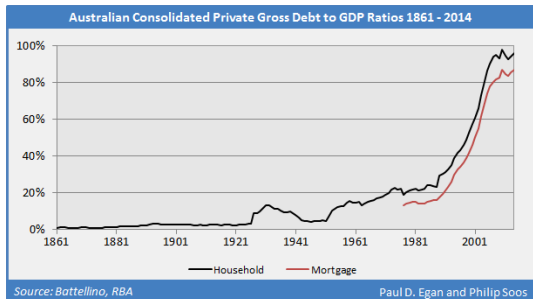


### History – on debt bubbles - Australia



### Australia's current debt bubble dominated by private debt

- Private debt bubbles the most dangerous debt bubbles
- Private debt is mainly household debt
- And the household debt is primarily mortgage debt



Source: Battellino, RBA Paul D. Egan and Philip Soos

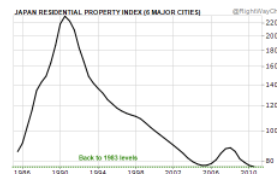
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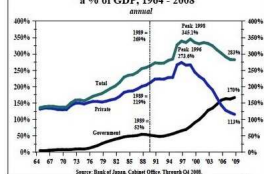
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### History on debt bubbles - Japan

- Japan – no economic depression, but debt bubble now larger than 1990. Maybe Japan has just postponed it.
- Japanese gov debt/GDP now highest among major developed countries
- Nearly 2.5 lost decades, shares & property experienced major crashes
- Shows how long fiscal & monetary measures can delay resolution of debt bubbles



Japan: Total, Government, and Private Debt as a % of GDP, 1964 - 2008



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### Debt bubble summary

- Borrowing too much is very risky for individuals
  - Same for nations
- Debt bubbles
  - A deflationary force
  - tend to lead to bad outcomes
  - Often economic depression (USA, Australia)
  - Japan kept spending
    - avoided economic depression (at least so far ...)
    - But had major asset price crash (asset price deflation)
      - & 2 lost decades
    - Shows how long fiscal & monetary measures can postpone resolution
  - Bank of International Settlements
    - GFC was a "Balance sheet recession" (too much debt)
    - A couple of decades of low growth
      - No recovery from 2008, like from a "normal" recession

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### Western gov/central bank response to Western debt bubbles

- The West (championed by central banks) is pursuing a variation of the Japanese Post-1990 policies:
  - Ultra low interest rates
  - Fiscal stimulus – particularly during the GFC
- However, the West have been far more aggressive with money printing (QE).
- No-one is quite sure where this fiscal/monetary policy will take us.
  - John Hewson AFR 2/9/15:
    - "The veteran forecaster admits he has "never seen it harder than it is today to say what's going to happen." Most of the world is afflicted "with short-term policies and they are not addressing the longer-term stuff!"
    - "Quantitative easing hasn't helped much, apart from creating bubbles, and increasing inequality and debt levels. It sounds a bit like that cliché du jour – kicking the can further down the road. But reversing that can-kicking process threatens to result in a stock market crash, bond market crash, and currency realignments, Hewson says."

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### Debt & Austrian School of Economics

- "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."
  - Ludwig von Mises (Austrian School of Economics).

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### Personal debt bubbles create the risk of Minsky Moments

- A Minsky moment is a sudden major collapse of asset values which is part of the credit cycle or business cycle. Such moments occur because long periods of prosperity and increasing value of investments lead to increasing speculation using borrowed money. The spiraling debt incurred in financing speculative investments leads to cash flow problems for investors. The cash generated by their assets no longer is sufficient to pay off the debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. This is likely to lead to a collapse of asset values. Meanwhile, the over-indebted investors are forced to sell even their less-speculative positions to make good on their loans. However, at this point no counterparty can be found to bid at the high asking prices previously quoted. This starts a major sell-off, leading to a sudden and precipitous collapse in market-clearing asset prices, a sharp drop in market liquidity, and a severe demand for cash.
- [http://en.wikipedia.org/wiki/Minsky\\_moment](http://en.wikipedia.org/wiki/Minsky_moment)
- Australia has its largest personal debt bubble in history
- Making Australia particularly vulnerable to a Minsky moment

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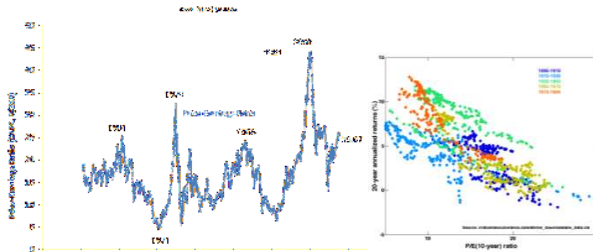
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### Western response to Global Financial Crisis

- GFC brought on by debt
- US Fed recognised risk of economic depression
- US Fed prints massive amounts of money
  - Europe & Japan follow US in money printing
  - Usually leads to hyperinflation historically
    - Eg German Weimar Republic in 1920s
    - Zimbabwe more recently
  - Strong inflationary force battling strong deflationary force
- US govt response to GFC
  - Deficit spending
- In Western developed world
  - More debt now than pre-GFC
  - Problem not resolved

### Massive money printing leads to ...

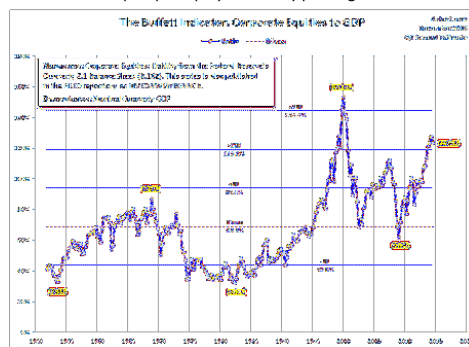
- Asset price inflation
- Asset price bubbles eg US shares
  - Buying assets at high prices tends to lead to low returns over medium-to-long term



### Massive money printing leads to ...

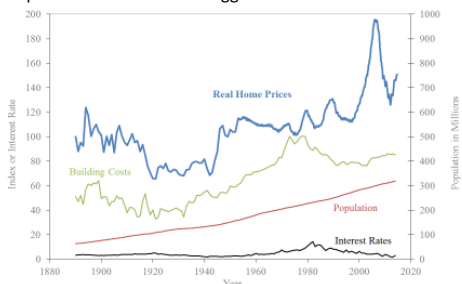
- Alan Greenspan (Ex Chairman US Fed) Oct/14
  - He (Greenspan) went on to say he thought that the lingering effects of quantitative easing could lead to inflation more or less at any moment, and that inflation is now basically out of the Fed's control.
  - "Gold – measurably higher. Interest rates – measurably higher."
  - Political realities, he explained, in the form of entitlement spending and off-balance sheet obligations of the US government, trump the need for sound money every time

### Another view on US share market bubble pumped up by US money printing



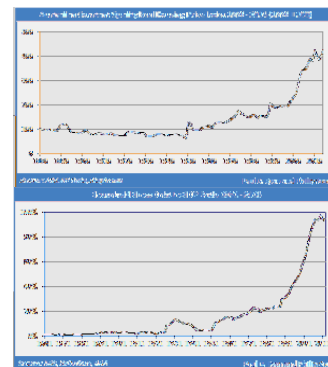
### And house prices .....

- Robert Shiller study on US house prices
  - House prices go sideways in real terms over the longer-term
- House price bubble crash was trigger for GFC



### And house prices ... Australia

- Mortgage bubble
- House price bubble
- These are the same bubble
- Heed Shiller data warning
- Heed warning from Austrian School of Economics



## Biggest emergence event in history

- Emergence
  - China, India, Next-11
- Bigger than US emergence 1840-1910
  - That emergence kept Europe in deflation & recession for much of that 70-years
    - Threatened employment in Europe
- What will this emergence do to the West?
  - Over next 3 decades

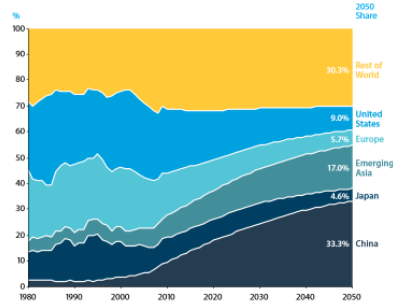
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## Biggest emergence event in history

GLOBAL ECONOMY BY REGION: 1980 TO 2050



Source: CEIC and ANZ Projections.

- Asia's time has come. Asia & related themes look rosier places to invest

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## Rate of technological change

- Robotics
  - Finally delivering
    - Rapidly replacing jobs in East & West
      - Western jobs being replaced by cheap labour in developing world
      - AND technology
- Low-cost sensor-technology
- Low-cost networking
- Low-cost computing power
- High-speed web
- Maturing artificial intelligence
- And much more

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## Summary

- Historically extreme period
  - on many measures
- Investment risks are very high
- Opportunities exist
  - Some markets & sectors very expensive.
  - Some markets & sectors cheaper & better return prospects.
  - Long cycles at different stages
    - In different countries and
    - In different sectors
- Volatility likely to be high
- Discussion

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## Maurice Newman (ex Chair ASX) AFR 29/9/15

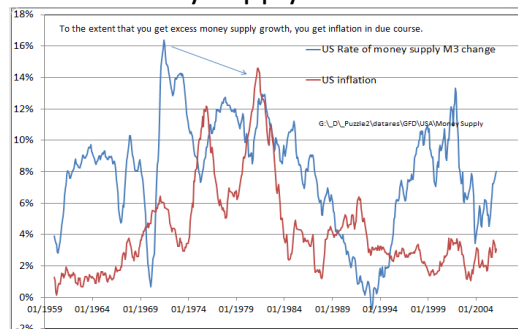
- Newman has similar concerns to mine re Aust:
  - *“Newman has made it clear in various newspaper columns that he thinks Australia is in economic trouble but does not realise how bad it is. He thinks Australians are not cognisant of the decline in the standard of living, the lack of real wages growth and the threat of a downgrade in the country's AAA credit rating from excess debt.*
  - *He is also concerned about developments in the housing market and the excessive amount of residential housing exposure in the balance sheets of the major banks.”*

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## Excess Money supply leads to inflation



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