NEWSLETTER

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Introduction

Well, we will almost say ‘we told you so.’ Last month we analysed the extraordinary growth of the US share market over the last ten years – and suggested that the main driver of that growth, the technology sector, may be in for a correction. And the correction happened: shares in one company alone (Amazon) fell by 18% across the first 26 days of October, while the (US) market fell 9% overall. Read on to see what this means for the Australian market.

A look at (recent) history… betting on the Melbourne Cup

This coming weekend is Melbourne Cup weekend. The Melbourne Cup is an institution – a race that stops the nation (or at least gets people in metropolitan Melbourne a day off).

But what is the economic effect of the Cup carnival? Racing Victoria, who manages the carnival, reported that in 2016 the total amount bet across the four days exceeded $650 million. Racing Victoria, which gets a cut of money placed as bets, thought this was great news. We were not so sure: the way that odds are set in horse racing means that the ‘house’ (that is, the bookie or – increasingly – the online betting agency) will pay out less than they take in. Basically, the odds are stacked so that punters lose overall.

So, without wanting to spoil the fun, think about that before you place your bets this weekend. It might be better to buys shares in the bookmaker, instead.

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The Share Market

Perhaps we can say 'we told you so.' Or that 'we predicted this.' Although that might be stretching the truth a little - we always try to avoid making short-term share market predictions.

In our last newsletter, we commented on the extraordinary performance of the American stock exchange, as measured by the S&P 500 index, over the 10 years since the commencement of the global financial crisis. You might recall this graph (thanks, Google, for all the graphs) showing the performance of the index over that period:

The American market had gone up almost 4 times since its nadir on March 13, 2009.

Between the start of the month and the 26th of October, however, the US market *fell* by just over 9%. Here is how the month of October looked on US markets:

As you can see, the green has turned to red - never a good sign when it comes to investing.

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Unsurprisingly, the Australian market has followed suit. Between the start of October and Friday the 26th, our market (as measured by the ASX 200 index) fell by 8.2%:

In some ways, Australian investors might be justified in feeling frustrated. The fall in the US market was almost all precipitated by substantial reductions in the value of some of America's largest companies - most of which are tech companies. To give one example, here is the performance of Amazon share price over the first 26 days of October:

Amazon shares fell by 18% in just 26 days. Of course, as we previously reported, this fall followed extraordinary run-up in the value of Amazon shares, especially over the last three years or so:

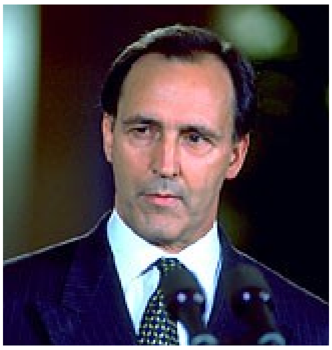
The early October peak of US$2,000 per share at the start of October 2018 represented a 300% increase in the share price since February 2016.

While it is easy to be clever in hindsight, growth like that tends always to need a correction. That is why we wrote the following, admittedly tentatively, in our last newsletter. The italics have been added:

> "Over the very long-term, markets in countries such as Australia and the US have tended to do about as well as each other. Therefore, as a long-term prospect we would expect some correction to this period of disparate performance. Given how much the run-up in tech prices has driven the US experience, *the correction could come in the form of a fall in the performance of one or more of these tech giants* – another reason to not invest all of today's money in yesterday's super-performer."

The lessons and consequences for Australian investors

Australian investors may feel aggrieved because our sharemarket is not dominated at all by tech stocks. Maybe it's unfair that a correction in that sector has had a flow on effect on the Australian market.



While still the Prime Minister, Paul Keating once famously described Australia as the 'arts end of the world.' Except that, many people who heard the comment, didn't quite catch the 't' in arts. While it may have been unwise for a politician to admit it, in world terms Australia is a relatively small player. According to the Australian Securities and Investments Commission (ASIC) in January 2018 the Australian sharemarket constituted just 1.7% of global share markets. This fits pretty much exactly with Australia's share of global GDP as measured by Austrade. Australia has its place and our market knows that place.

What that means is that the Australian sharemarket is vulnerable to swings and corrections on global markets. This is the case despite the fact that the Australian market did not enjoy the outstanding performance of the US market over the 10 years following the global financial crisis. That outstanding performance was not really a swing or a correction; it was more of a gradual increase. And it was focused on a particular sector (technology) which features very little in the Australian market.

The October falls were definitely not gradual. They were a very sudden correction. That should mean that the corresponding correction in the Australian market is an overreach. While world markets remain very volatile, Australian shareholders will remain more inclined to sell than buy, which will keep share prices low. However, as the US market comes out of its current state of heightened volatility, and trading levels return back to normal, we would expect the Australian market to recover during that period of relative quiet. It is likely that the Australian market has overcorrected, given that the fundamentals of the Australian economy and the Australian market have not really changed.

Until then, the substantial recent fall in share prices will at least give investors an increased dividend yield (dividend yield is the percentage figure that shows the dividend income received for shares as a percentage of the current share price). In January 2018, the ABC reported an average 4.5% yield on the Australian market. Everything else being equal, an 8% reduction in share price should increase this average yield to almost 4.9%. Given that the 8% fall in our shares was not associated with falling dividends being reported by Australian companies, an increased dividend yield is a legitimate thing to expect.

So, the simple lesson is that October's volatility in Australia was really a function of market perceptions more so than economic fundamentals. Australian investors - especially the institutions - have observed substantial falls in the value of shares on the US market and been moved to sell accordingly. There is little evidence that the profits of Australian companies are falling. Once this period of volatility is over, buying shares in Australian companies will once again become an intelligent long-term option for growth-based investors. This is especially the case if those investors are intelligent enough to manage volatility risk by buying (and indeed selling) a diversified portfolio over a drawn-out period of time.

Residential property

It's been a few months since we last discussed residential property. The good news is that residential property prices appear to be falling in most Australian markets, and especially the larger ones.

Why do we say good news? Let us explain.

If you own your own home, then general changes to the prices of housing do not really affect you. That is because all housing has changed in the same direction. If housing becomes more expensive, this does not really change your wealth, unless you are one of those relatively few people who is prepared to downsize economically (that is, sell your house and move into a cheaper property). The reality is, when most people 'downsize,' they do so in terms of size of the house, rather than its value. In value terms, people either swap houses of relatively equal value, or even trade 'up' to a more expensive property.

Think about that for a second. If the value of the house you own and live in goes up, nothing really changes. Indeed, you may find yourself paying increased council rates and other holding costs such as building insurance. But because the increase in your wealth has not occurred in cash form, your spending power is not really increased - unless you want to do that very risky thing of borrowing against the equity in your property to finance lifestyle. Yes, if you sell your house you will receive more cash. But if you then need to buy another house, that second house has also become more expensive.

That is why many individual homeowners do not really benefit from increased house prices: if everything gets more expensive, having more wealth is neutralised.

That said, there are some groups of people who do well when house prices rise:

1. **People who own more than one property.** Because they own multiple properties, investors benefit from rising prices because they can access the increased wealth without necessarily having to sell their own home and move into something less expensive;
2. **People with a mortgage**. Yes, this is most people, at least initially when they become homeowners. An increase in house prices does mean that the amount borrowed as a percentage of the value of the asset must fall.
3. **People who can sell their existing home without needing to buy another one of equal or greater value.** This might include deceased estates or people who are prepared to downsize economically as well as physically.

Notice who is <u>not</u> on that list. The most conspicuous absentee is, of course, people who do not yet own a home. For those people, rising house prices make owning their own home more difficult. This has definitely been the Australian experience over the last 20 years, where the increase in residential property prices has far outstripped any increase in real wages. Housing affordability has declined substantially, and many first-time homebuyers (who tend to be young) have simply been unable to enter the market.

Things were becoming a little bit ridiculous. Indeed, if you look back at our newsletter from May 2018, you will see that we calculated the number of years that a person with a median full-time income would need to work in order to be able to buy median property. Such a person would have to dedicate every dollar they earned (including the money they pay as tax, which would of course be illegal!) for 12 years to buy a property at the median property price in Sydney.

Housing affordability had fallen to such an extent that housing had become largely unaffordable to people who did not already have wealth - overwhelmingly, younger people who were yet to buy their first home. Which is why, when we see property prices falling in general across the country, we actually see it as a market economy doing what a market economy *should* do. Logic tells us that market prices cannot remain unaffordable for very long. The market will correct them.

So, what do the falls in residential property prices look like? Market researcher Corelogic reports the following changes in property prices for the 12 months to the end of September 2018 for each of Australia's capital cities:

City	Price Change Overall	Price Change Houses	Price Change Units
Sydney	-6.09%	-7.60%	-2.58%
Melbourne	-3.37%	-4.53%	0.3%
Brisbane	0.73%	0.76%	0.71%
Perth	-2.77%	-1.98%	-6.15%
Adelaide	0.71%	0.64%	1.17%
Hobart	9.3%	9.36%	8.95%
Canberra	2.02%	3.12%	-1.35%
Darwin	-3.71%	2.34%	-14.9%

As always, the relatively large Sydney market skews the national averages, with the also very large Melbourne market having a similar effect.

The most recent inflation figures are for the 12 months to 30 June 2018. During this period, average prices for household items rose by 2.1% (source: ABS). So, any rate of growth in property prices that is less than 2.1% arguably represents a reduction in the real value of that property. Given that, we can see that Canberra, Adelaide and Brisbane can be added to Darwin, Melbourne, Sydney and Perth as cities in which properties effectively fell. Only Hobart, which has a relatively small market that has been playing 'catch up' over the last 18 months, rose in real terms.

To put these figures into perspective, the 6% fall in Sydney prices (7.6% for houses) means it will take almost a year less for a person on an average income to buy their house. Economically, you could even argue that the fall in prices has added a year to a life of every first home buyer. That's another reason why the fall in prices is probably good news rather than bad.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances.All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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