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Weekly Review

WEALTH

– Issue – 16 Dec. 2016

There are some good tools for predicting long-run share market returns, but year-to-year forecasting is more problematic.

BY SCOTT FRANCIS • EUREKA REPORT • 16 DECEMBER 2016

Will shares boom in 2017?

As we look ahead to 2017, it is interesting to think a little about the type of share market returns that we could see over the coming year.

Key Point

- ***The average annual return since 1987 has been 10.5 per cent. Will 2017 be a magnificent year for shares? In reality, there are very few years of 'normal' returns – share market returns fall into a wide range, and volatility over 12-month periods is significant.***

If the core of owning a share is being a part-owner of a business (or portfolio of businesses), then a starting look at the earnings of businesses might provide some insight into what we might expect.

What does the average PE ratio say?

Wharton Business School professor Jeremy Siegel, author of the book *The Future for Investors*, has done research into long-run historical share market returns. For example, from January 1802 to December 2015, he calculated the average 'real' (after inflation) annual return from US stocks to be 6.7 per cent per year.

An interesting element of Siegel's work is the link he has made between PE (price-to-earnings) ratios and future share market returns. He describes PE ratios as good long-term predictors of real (after inflation) long-term returns. The PE ratio can be used to find an 'earnings yield' of a share, or group of shares.

Putting one over the PE (1/PE) ratio gives you the earning yield. For example, for a PE ratio of 15 the earnings yield is 1/15 = 6.7 per cent. These particular numbers are important in Siegel's argument, as the long-run average market PE ratio is 15, and the long-run return from shares is 6.7 per cent above inflation.

So where does that put us for the Australian market? The current forward PE ratio is estimated to be 16.4. This is slightly higher than the 15 long-run average, suggesting a slightly lower return.

However, Siegel has made the point that given the current low interest rate environment, it is not unreasonable for the share market to have a higher than usual PE ratio. The current Australia PE ratio of 16.4 implies an earning yield (1/16.4), or 6.1 per cent. This would correlate to a long-run return of 6.1 per cent per year above inflation. The current inflation rate in Australia, according to the Reserve Bank, is 1.3 per cent, suggesting a total return from shares of 7.4 per cent.

It should be noted that a number of things need to happen for this to work out: the market needs to keep shares priced on a 16.4 PE ratio; the company/s have to increase earnings and costs in line with inflation, and given the adjustment in thinking for PE ratios and low interest rates, this needs to stay the same.

Importantly, Siegel repeatedly made the point that PE ratios are a predictor of long-run after-inflation returns. So using them to predict the total return from shares next year is not in line with his thinking.

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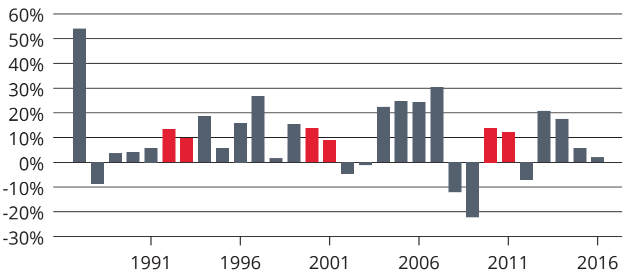
That said, in a recent interview, he used his methodology to make a forecast suggesting that "reaching 2300 points for the S&P is definitely a possibility by the end of 2016". It is interesting to note that the US S&P 500 index is currently around 2260 points.

What about 12-month returns for the past year?

The following graph shows the 12-month returns for each of the past 30 financial years (this is the most recent data that we have, seeing as we don't have the final calendar year return for 2016 yet).

Chart 1: Australian financial year sharemarket total returns, 30 yrs to end-June '16 ('normal' years in red)



Source: Vanguard

Over this period the average annual return has been 10.5 per cent per annum. The chart also shows a number of interesting things.

Firstly, the best three years of returns have come from years that end in a 'seven'. That has to be an optimistic sign heading into 2017; although in reality it surely shows more about how financial data can misconstrue coincidence.

Clearly the fact that years ending in seven provide the highest return are nothing but coincidence, but let's assume that these three years of highest returns were not the years ending in a seven, but the years following the biggest market downturns – a more powerful investment story.

Now, we might be very inclined to think that a great time to invest will be a year following a downturn, without considering the possibility that three strong years of returns following a downturn might just be a coincidence, just as the three highest years ending in a seven are in this case.

The other thing is that the average annual return has been 10.5 per cent. I have highlighted the years that fall within an 8 per cent band around 10.5 per cent, those years with returns from 6.5–14.5 per cent. I have chosen this range as an indicator of what are 'normal' returns; returns between an average cash rate up to returns above which you think that you have had a pretty good year. Six out of 30 years fall within this range of 'normal' returns, which highlights for me two interesting things:

- **Investing in shares is challenging**. There are very few years of 'normal' returns – share market returns fall into a very wide range, and volatility over 12-month periods is really significant. Over the 30 years the average return (10.5 per cent) would have turned $100,000 into $1,999,255. This is an impressive creation of wealth over a period that included the 1987 share market crash and the Global Financial Crisis. A US-based research firm, Dalbar, researches the actual returns that investors receive and finds that it is significantly less than the average share market return, because the volatility of the market sees people buy and sell at the wrong time.
- **Forecasting in the short term is challenging**. The tendencies for one-year returns to fall outside a 'normal' range of returns suggests that short-term factors must be significant over these periods. While Siegel emphasises that PE ratios are useful predictors of long-term returns, forecasting short-term returns implies the far greater ability to foresee the factors, both good and bad, that change the PE ratio that investors will be prepared to buy and sell shares at. There is a significant body of research that says short-term forecasting is extremely hard, and I would suggest that this is the key reason why.

Of course, next year ends in a seven...

Scott Francis is a personal finance commentator, and previously worked as an independent financial advisor.

While demand is high nationally, conditions are highly variable across the country.

BY NERIDA CONISBEE • EUREKA REPORT • 16 DECEMBER 2016

10 property predictions for 2017

Too many apartments, low levels of affordability and variable performance across capital cities defined the Australian residential property market in 2016. Can we expect more of the same in 2017? Here are my predictions, and also watch my latest **Property Point video** interview with Eureka Report's editor, Tony Kaye.

Key Point

- ***Unprecedented levels of apartment development in Melbourne and Brisbane CBDs will make these the markets most likely to see price declines***

1. Global political uncertainty to impact Aust. economic growth

Brexit and Trump were two surprises in 2016 and the ramifications will continue to be felt across the global economy into 2017. While the impact of Brexit has been largely self-contained, the same cannot be said for the US election result, and how the US economy performs next remains uncertain. We'll see this impact upon the Australian economy and, ultimately, the direction of our interest rates.

If the US economy continues its strong growth, it will put further pressure on the US Federal Reserve to increase interest rates. For Australia this means better economic growth and less pressure on the RBA to cut rates.

Conversely, if economic growth in the US economy slows dramatically and global trade is adversely impacted by policy decisions made in that country, it will have a strong negative impact on the Australian economy. Fortunately, in that situation the RBA still has capacity to cut rates. However, due to the ongoing impact of interest rate decisions on housing demand, this will continue to fuel the already strong housing markets in Sydney and Melbourne.

2. Syd, Melb to continue to see strong housing demand

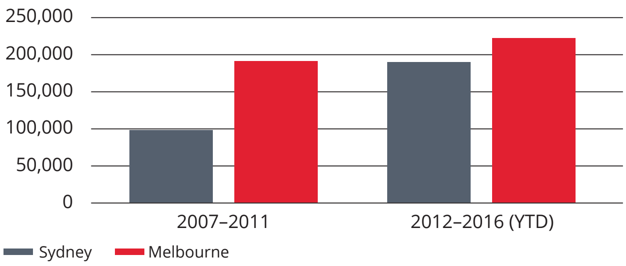
In 2016 the REA Group Property Demand Index reached the highest level recorded. While this was partly due to a drop in the number of properties for sale, a surge in the number of people looking at properties on the site was the key driver. As we look forward, there is nothing that suggests we'll see demand decrease significantly. Factors that could change this include a rise in unemployment, a rise in interest rates or changes to negative gearing.

While demand is high nationally, conditions are highly variable across the country. New South Wales and Tasmania are both incredibly in-demand markets, while Western Australia and Northern Territory are seeing much lower levels of demand according to the index.

3. Perth to remain challenged, opportunities will present

The Western Australian economy is still growing, but growth is far lower than what the state is accustomed to. Next year, the WA Government forecasts growth of 1.25 per cent, far lower than the long-term average of 5 per cent. This, combined with a slowing in population growth and continued high levels of new housing development, are challenges for the residential sector.

Chart 1: Housing approvals, 2007–2016



Source: REA Group

House prices and rental rates have fallen and, given the poor demand conditions the state is experiencing, it is unlikely that this will reverse quickly. However in any market, even low growth ones, there are always opportunities and Perth is no exception. While overall prices are down, suburbs like Peppermint Grove and Swanbourne saw substantial price increases in excess of 14 per cent in 2016 as buyers saw an opportunity to upgrade in an otherwise slow market.

4. Overdevelopment to still challenge some apartment markets

It should be made clear that not all apartment markets are challenged. However, unprecedented levels of development in Melbourne and Brisbane CBDs will make these the markets the most likely to see price declines. While good for affordability, the potential for price decreases isn't great news for investors in these markets or, for that matter, the banks. Other CBD markets are seeing less development, however slow conditions in Perth are also causing concern.

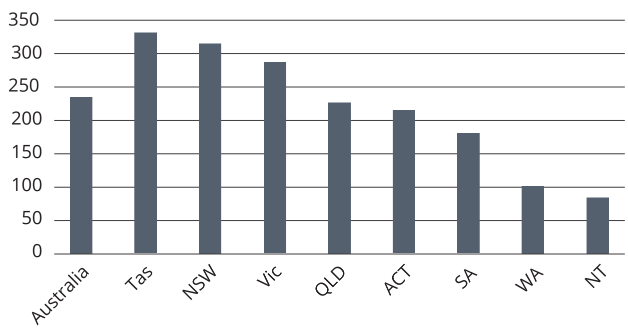
> **"While demand is high nationally, conditions are highly variable across the country ... Western Australia and Northern Territory are seeing much lower levels of demand.**

In Sydney, apartment development needs to continue at its current rate to ease affordability issues and ensure adequate housing for population growth forecasts. Sydney is finally catching up to Melbourne in terms of development, however the city is coming off an extended period where very little new housing was being built.

5. Affordability to be a focus

Tasmania is currently the only state or territory in Australia where a single person on an average income can still afford to buy a house at the median. This is perhaps one of the key drivers in the increased popularity of Tasmania in 2016. This state has risen rapidly in popularity since mid-2015 on the REA Group Property Demand Index and is now seeing the highest levels of demand of all states and territories for all dwellings.

Chart 2: REA Group Property Demand Index – all dwellings, November 2016



Source: REA Group

With median prices continuing to rise across all capital cities, with the exception of Perth and Darwin, the drive for affordable housing is changing behaviour. In NSW, Central Coast suburbs are increasing in popularity, driven primarily by homebuyers from Sydney looking for larger, more affordable homes. In Melbourne, the outer east is also seeing increasing interest from home buyers, again driven by relative affordability and larger homes on larger blocks.

6. Negative gearing: still hot topic

Negative gearing was introduced to increase the supply of rental housing and stop it from being a government supplied service. It worked well, with government provided rental housing declining from 25 per cent of the total, to less than 12 per cent today.

The original intent of negative gearing has largely been forgotten and it's more often now seen as a tax break for wealthy people, which contributes to decreasing affordability for homebuyers.

The negative gearing debate will continue in 2017 and although the Federal Government continues to publicly support it, recent comments by the NSW Planning Minister, Rob Stokes, show that the issue is far from resolved.

7. Unique properties to sell well

Unique dwellings are the properties that attract the most interest on realestate.com.au. Uniqueness comes in many different forms – perhaps the house is beautifully designed, architecturally interesting or of historic note – but the fact is strong interest usually attracts more buyers and higher prices. Of course, a property can also be too unique and too different to attract buyers so finding balance is key.

Despite discussion and concern surrounding oversupply of apartments in some suburbs, not all properties can be painted with the same brush. A recent analysis of art deco apartments in Melbourne showed that they attracted a premium when compared to other styles. While location remains important and a significant driver of price, there is no doubt that scarcity can also play a role.

8. Gold Coast, Melb Inner and Syd Inner West to still be the top markets for renters, sharers

Analysis of where renters on realestate.com.au and sharers on flatmates.com.au are looking show the Gold Coast, Melbourne Inner and Sydney Inner West as the most popular locations. In these areas the number of people looking to rent or share far outstrips the number of listings on the respective sites. For both renters and sharers, the main driver of location popularity continues to be the amenities in the area. Good restaurants, bars, retailing and access to public transport are all high on the agenda.

9. China's major influence on Aust. residential property will remain

Property seekers from the US are the dominant offshore group viewing residential property on realestate.com.au, however it's China that has seen the strongest increase in interest over the past three years. Chinese developers and subsequently Chinese buyers are increasingly intrinsically linked to the level of new apartment development in our capital cities.

> **"Central Coast suburbs are increasing in popularity, driven primarily by homebuyers from Sydney looking for larger, more affordable homes.**

Table 1: Top 10 suburbs for sharers (May 2016 to November 2016)

RANK	STATE	SUBURB
1	NSW	Sydney
2	Vic	Fitzroy
3	NSW	Surry Hills
4	NSW	Newtown
5	NSW	Bondi Junction
6	Qld	Broadbeach
7	NSW	Bondi Beach
8	Vic	Collingwood
9	NSW	Darlinghurst
10	NSW	North Sydney

Source: Flatmates.com.au

In 2016, there was a slight drop off in Chinese interest in Australian property on realestate.com.au driven by new taxes on foreign buyers, difficulties in accessing finance in Australia and capital controls in China. The cities most impacted were Melbourne and Sydney, which saw an overall decrease.

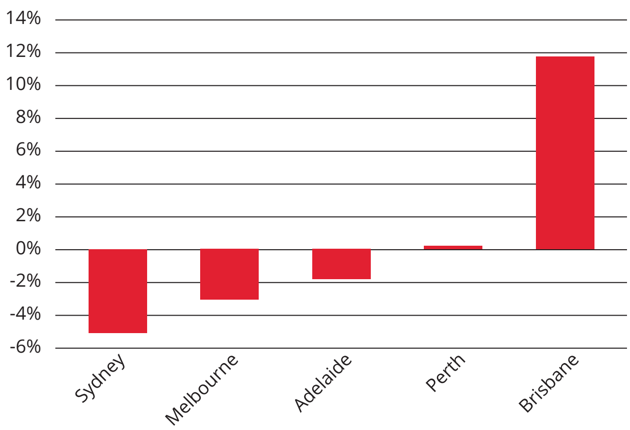
Table 2: Top 10 suburbs for renters (May 2016 to November 2016)

RANK	STATE	SUBURB
1	Vic	Richmond
2	Vic	St Kilda East
3	Vic	South Melbourne
4	Qld	Surfers Paradise
5	Vic	Northcote
6	NSW	Surry Hills
7	Vic	Brunswick
8	Vic	Prahran
9	Vic	Port Melbourne
10	Vic	Elwood

Source: Flatmates.com.au

As Chinese buyers become more educated about the Australian market, and the restrictions as to what they can buy, it will continue to impact our market. Changes in 2016 included a growing interest in Brisbane as well as house and land developments. The most popular price points for Chinese buyers also changed, as many looked to more affordable markets.

Chart 3: Views by China-based property seekers (% change, 20 Nov 2015 – 20 Nov 2016)



Source: REA Group

Chinese buyers also drove price growth in favoured locations. Melbourne's Glen Waverley, which is often the top location searched by Chinese property seekers, has seen some of the strongest price growth over the past five years and a very high number of sales over $1 million. In Sydney, Chatswood has seen a similar dynamic.

10. Digital disruption to continue to change property markets

As 'fintech' becomes increasingly overcrowded, 2016 saw a significant growth in 'proptech'. To keep pace with changes in digital advertising, at REA Group we announced the appointment of a chief inventor, Nigel Dalton, to focus on proptech initiatives such as virtual reality, augmented reality, drones and robotics.

BrickX launched the first fractional ownership model in Australia, allowing people to invest in prime property for less than $100, while Purplebricks, a success in the UK, launched in the Australian market, offering a fixed price for people wanting to sell their homes. In 2017 we can expect to see more digital initiatives targeting the property sector as companies look for a competitive edge.

Nerida Conisbee is chief economist of REA Group.

Regular portfolio reviews are prudent to ensure your overall investment strategies remain focussed and your asset allocations are well balanced.

BY TONY KAYE • EUREKA REPORT • 14 DECEMBER 2016

Time to get into some super rebalancing

Whether you're a do-it-yourself superannuation investor, or have your super in a managed super scheme, you owe it to yourself to do a full review of your super portfolio now to ensure you are best positioned for growth.

Key Point

- ***After a tumultuous year on financial markets, there's a high likelihood the balance of your superannuation portfolio has changed. It's wise to conduct a strategic review now. For SMSF trustees, that may involve buying and selling assets. For others in managed super funds, it may involve adjusting your investment options.***

Although monitoring your super portfolio and making adjustments along the way should be a continuous process through the year, the end of the year should at least be a trigger point if you're a less active DIY fund manager.

Now is the time to review your holdings in shares, bonds, cash and other assets including property, ultimately to see what scope there is for improving your overall portfolio growth returns, or to hedge against risk if your agenda is to be more defensive.

Data from SuperRatings to October 31, 2016, shows typical balanced funds have produced an average annual return of just over 8.80 per cent for the past five years, slightly underperforming the Australian share market's 9.04 per cent. Those in high growth options have achieved average returns of 10.09 per cent over five years.

Cash returns over the same period have averaged just 2.60 per cent, reflecting record low interest rates in Australia and across the world.

As always, diversification is a key investment strategy and, as a first objective, super investors should be aiming to preserve their base capital as much as possible, which needs to involve a strategic investment plan that actually beats inflation.

Starting the process

If you haven't reviewed your portfolio for a while, a good first step is to review your general asset allocations. It's good to make this into a regular habit.

Click to InvestSMART's free portfolio manager tool here to enter your asset details and view your current asset allocation ratio, based on your specific investment goals.

According to data from the SMSF Association, most self-managed funds have 30 per cent of their fu nds in Australian equities, followed by cash and term deposits (26 per cent), and listed and unlisted trusts and other managed investments (19 per cent). Overseas investments accounted for just 1 per cent.

This data suggests that a high percentage of Australian self-managed investors have poor asset allocations, with too much exposure to low-returning assets such as fixed interest and cash, and too little to international equities. Keep in mind that the Australian share market represents only around 2 per cent of the global market.

Equities

In terms of equities, as well as having exposure to the blue chips, investors should really be building stakes in a mix of stocks that, on current trading levels, are undervalued.

Holding a portfolio of blue chip stocks alone has not really delivered brilliant returns, even when you just stick to the top 20 listed companies by market capitalisation, with a number just barely ahead of where they were a year ago.

Picking the undervalued stocks is not always easy, but a good starting point would be to look at major stocks with sound businesses that may have suffered as a result of current economic or market conditions.

Also look at the good dividend payers, to ensure there is a steady flow of funds into your account, ideally where the dividends are fully franked so the tax has been paid.

> **As a first objective, super investors should be aiming to preserve their base capital as much as possible.**

A good equities portfolio also needs to have a sprinkling of well-positioned smaller capitalised stocks, each with positive growth stories, and even some fixed-interest securities (bonds, at-call cash or term deposits) to lock in a capital protected income stream.

Fixed interest

As a DIY super investor, working out how much you allocate to cash and bonds should be based on the minimum capital you need to protect your overall financial goals.

Over time, fixed interest and cash have delivered lower returns, so over-exposure in these asset classes is not recommended for those seeking capital growth. They are primarily used as defensive assets that deliver regular income.

Those drawing a pension should ensure they have sufficient cash in their account to cover their minimum age-based drawdown requirements, as stipulated by the Federal Government.

Time to act

Changes to superannuation legislation in the latest budget mean now is a good time for many to push more money into their super before July 1, when new lower contribution limits take effect and when higher taxes will be payable for those earning more than $250,000 per annum.

From an asset allocation perspective, now is also a good time to look at doing some rebalancing with a well-researched strategy that, as best as possible, takes a big picture view of the known investment universe.

Some restrictions could be put on SMSFs borrowing to purchase properties. That's a good thing.

BY BRUCE BRAMMALL • EUREKA REPORT • 14 DECEMBER 2016

In defence of SMSF borrowing restrictions

With the slightest hint of increased regulation in most sectors, teeth start gnashing and mouths start frothing. Reminds me a little of Stephen King's *Cujo*. Certainly one of the most terrifying movies of my upbringing.

Key Point

- ***The single biggest threat to a newbie SMSF trustee – or even a trustee in waiting – is a property developer.***

In recent weeks, gnashing and frothing has occurred over the possibility that there could be some restrictions put on self-managed super funds (SMSFs) borrowing to purchase properties.

Some industry players are concerned that the Australian Prudential Regulatory Authority, or the Australian Tax Office, could start pushing, or enforcing, that SMSFs must be of a certain size before a lender is allowed to lend money to them to purchase under a limited recourse borrowing arrangement (LRBA).

The figure generally floated is $200,000.

The concern is that the powers-that-be (probably the Australian Prudential Regulatory Authority, who regulates the banks) might impose on lenders a restriction in regards to the minimum size a SMSF must be before being able to qualify for a loan.

(APRA has taken a heavy regulatory approach in recent years, in trying to restrict the amount of lending to investors.)

Some heavyweights of the SMSF industry – and some others who can cloak themselves in nought but self-interest – are claiming that APRA has no right to force banks to restrict lending to SMSFs, based on a borrower's (SMSF's) size.

The arguments go that SMSF trustees are grown ups who need to be free to make their own investment decisions and take their own risks. And that, given they are in charge of their own money (just not their own money, yet) and no-one else's, they should be able to make investment decisions with little interference or restrictions.

'Protection at some point'

At heart, I lean towards being a libertarian. People should be able to make their own decisions, make their own mistakes, benefit when they get a call right and suffer when they get a call wrong.

But all libertarians, in my experience, have boundaries. Protection, or the law, needs to kick in at some point.

With SMSFs, there needs to be rules to protect the inexperienced, the gullible and the stupid. Therefore, if APRA, backed by the Australian Tax Office, step in to "protect" some newbie SMSF trustees from the voracious appetites of property developers and spruikers ... then they have my support.

Case study

I spoke with a newbie SMSF trustee this week. He was calling, asking about borrowing for an SMSF property investment; specifically, requesting that he be the lender in the transaction. He wanted to be the lender, charging no interest to his SMSF.

- Concern number one: The ATO closed that door in 2014. **See this column**.
- Concern number two: How did he set up the SMSF? At his accountant's recommendation. See next.
- Concern number three: How much did he have in his SMSF? $40,000. Plus some other investments in precious metals, which he didn't go further into, and weren't liquid in any case.
- Concern number four: He wanted to gear into property. With $40,000. Seriously?
- Concern number five: He wanted to use a property developer recommended by his accountant. (Oh my goodness. If I could tell you how many financial advice stories have gone wrong this way.) "But, Bruce, this is different. He has recommended his own daughter invest with this developer." No less dangerous.

Moral: This SMSF newby needs to be protected from a whole army of people close to him. And if APRA introduced a rule

> **Legislation is, largely, if done properly, about protecting the multitudes. It often comes with a cost of impeding on the rights of a few.**

about having a minimum of $200,000 for investment in property, it would save this guy from being fleeced, for a start.

SMSF newbies' single biggest threat

As I've written a number of times, **including a year ago here**, the single biggest threat to a newbie SMSF trustee – or even a trustee in waiting – is a property developer.

They are slick. They know how to sell (their largely inferior, even negative, investment products). And in my experience of the industry, do not have anything but their own profit motives at the forefront of their sales tactics.

Once the new property is sold to the brand new SMSF trustees, they could not care less about the financial well-being of the purchaser. (And that applies whether they are SMSFs or any other purchaser of their wares.)

Many Australians who are desperate to try to get on the property investment wagon have no hope of doing so in their personal name because they don't have the requisite income and/or assets to satisfy a bank's credit assessment procedures.

However many of those same Australians, particularly when combined as couples, have a bigger ability to purchase a property through a SMSF if they are allowed to combine their super funds together for the purchase.

These 'unborn' SMSF trustees are targeted by property developers. Very, very specifically. Get a couple into a seminar and explain how, while they might not be able to buy an investment property in their own right, they can if they combine their super balances into a shiny new SMSF.

It's these people who need to be protected. From property developers. From the sector of the real estate sales industry that deals with these properties. From the promoters, marketers and seminar organisers **who spruik investments**.

Legislation is, largely, if done properly, about protecting the multitudes. It often comes with a cost of impeding on the rights of a few.

But is instituting a $200,000 minimum (or whatever dollar figure) by APRA and/or the ATO a sound idea. Yes.

Why? It will protect countless thousands of unwitting, usually unborn, SMSF trustees every year from having close to their entire retirement savings vacuumed into the pockets of a property developer.

Don't listen to the moaning from property developers, mortgage brokers, or libertarian SMSF industry advocates.

Tell your sons, your daughters. Save them.

Even the lenders agree

And all of the experts' hyperventilation ignores the fact that many lenders had moved to introduce lending restrictions to SMSFs on their own. Well before the ATO started jawboning and fears started that APRA might start listening.

In 2015, AMP withdrew completely from lending to SMSFs. They returned in late 2015, but banned lending against properties that were less than six months old. Yes, specifically they were banning lending by SMSFs to purchase form property developers.

Macquarie Bank, a significant lender in the SMSF space, introduced their own minimum SMSF size of $200,000 in mid-2016. They had already made the decision that $200,000 should be a minimum.

Some lenders are making their own (sensible) decisions on LRBA restrictions. For what reason, I don't know. But it probably has something to do with potential brand damage – being the lender in a trail of destruction is not good for business, or for your reputation.

Note: For proper disclosure, I should point out that I run a SMSF and one of the assets of this fund is a property purchased under an LRBA. I waited until I had well more than $200,000 in my SMSF, but that was largely because, even back then, lenders for LRBAs wanted that much in a SMSF, to prove liquidity for those early years of negative gearing.

*Bruce Brammall is a licensed financial advisor, a mortgage broker and an expert on self-managed super funds. He is a regular contributor to Eureka Report. To contact Bruce, please **click here**.*

Higher interest rates and the expectation of further rate hikes makes the US a more attractive destination for global capital flows.

BY CALLAM PICKERING • EUREKA REPORT • 14 DECEMBER 2016

The threats to Australia from US growth

The Federal Reserve will raise interest rates by 25 basis points when they meet this week (outcome announced on Thursday morning).

Key Point

- ***Capital outflows from emerging economies, including China, are likely to reduce demand for Australia's major commodities.***

Nevertheless, the policy outlook beyond this year is fraught with both economic and political uncertainty that complicates matters not just for the Fed but also the global economy.

Policy normalisation

Policy normalisation in the United States began 12 months ago when the Federal Open Market Committee (FOMC) – the group within the Fed that makes decisions on the federal funds rate – increased interest rates for the first time since 2006.

The path towards the second rate hike has been anything but smooth. The US economy struggled over the first half of the year and has only recently started to show the type of momentum that would warrant tighter policy.

Growth in non-farm payrolls remained solid throughout the year but economic growth eased to 1.3 per cent by mid-year. A stronger September quarter and expectations of above trend growth to end the year has squashed concerns on that front.

Inflation remains below the Fed's annual target of 2 per cent, but bank officials remain adamant that it will get there eventually. Nevertheless, pockets of weakness remain, which ensures that any further tightening will be undertaken in a slow and steady manner.

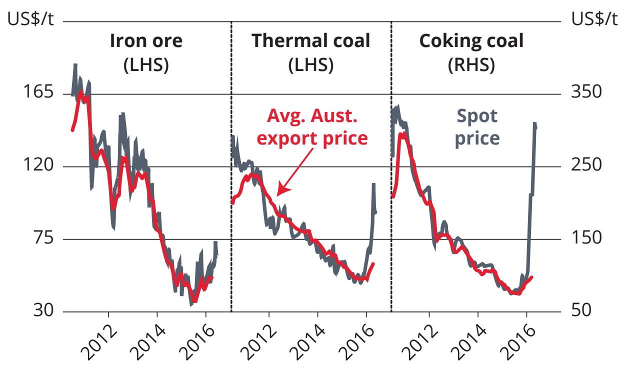
With a rate hike widely anticipated, by both analysts and financial markets, we should expect a relatively muted response on Thursday morning. But it does reinforce recent sentiment: that the US economy is travelling better than other developed economies – in particular the Eurozone and the United Kingdom, but more recently Australia as well.

Macroeconomic impact

Higher interest rates and, more importantly, the expectation of further rate hikes makes the US a more attractive destination for global capital flows. Investors and companies are already redirecting capital from emerging economies towards US financial markets.

The result has been stronger US equities – the Dow Jones index has notched up a record close on 15 occasions since the presidential election in November – as well as a stronger US dollar.

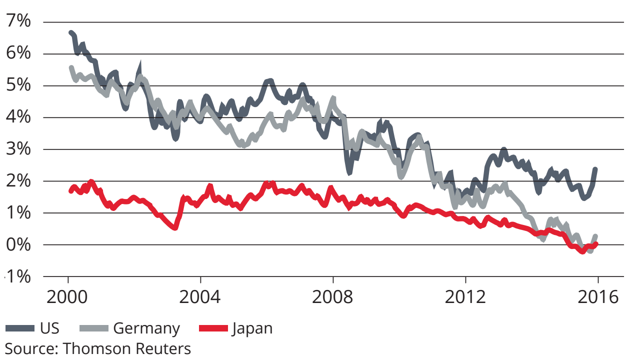
Chart 1: Bulk commodity prices (free-on-board basis)



Source: ABS, Bloomberg, IHS, RBA

A stronger US economy is normally regarded as a positive for the global economy. The US is a net importer, and a high US dollar supports demand for low-cost consumer goods from emerging economies.

Chart 2: 10-year Government bond yields



Source: Thomson Reuters

It's not ideal for commodity exporters though. All else being equal, a stronger US dollar makes commodities more

> **A stronger US economy is normally regarded as a positive for the global economy ... It's not ideal for commodity exporters though.**

expensive. It's one of the reasons why periods where the US dollar rises in value is often associated with a decline in commodity prices in US dollars.

Meanwhile, capital outflows from emerging economies, including China, are likely to reduce demand for Australia's major commodities. Capital outflows mean weaker-than-anticipated investment, which ultimately is undesirable for Australia's mining sector. Both coking and thermal coal prices have fallen significantly from their recent highs and are likely to fall further in the near term. Iron ore has escaped that fallout so far.

There is a very real chance that Australia's major coal producers will see few benefits from the recent rise in coal prices. The graph below, sourced from the Reserve Bank of Australia, compares spot prices in the iron ore and coal markets against the average Australian export price.

Australian producers in the coking coal market are hoping they can negotiate contracts in excess of US$300/tonne, but recent price action makes that unlikely. This sets up a fascinating round of negotiations between buyers and producers early next year. The outcome of those negotiations will be pivotal to Australia's economic performance in the first half of the year.

The impact of Donald Trump

It would be remiss of me to discuss the issue of policy normalisation and the Fed without touching upon the upcoming presidency of Donald Trump. The recent rise in US government bonds and associated expectations of tighter monetary policy hasn't occurred due to improving economic data, but expectations of big tax cuts and public spending by the Trump administration.

To say that markets have reacted positively to Trump's victory would be an understatement. But such euphoria is perhaps unwarranted, as I explained in the immediate aftermath of the election (***Prepare for a stumble on Trumponomics***; 16 November).

As I noted back then, the Trump administration is likely to find support for its tax cuts in the Republican-controlled Congress, although they may baulk at the size of those cuts. The infrastructure program will struggle to gain widespread support among Republicans, who have rallied against stimulus in the past, but may find some support among Democrats.

Senate Majority Leader Mitch McConnell poured cold water on Trump's economic policies, highlighting the type of resistance Trump will face within his own party.

"I think this level of national debt is dangerous and unacceptable," McConnell said. "My preference on tax reform is that it be revenue neutral."

House speaker Paul Ryan has also indicated that he wants tax changes to be deficit-neutral.

This doesn't necessarily mean that Trump's stimulus is a non-starter, but it does suggest that it won't be as large as markets anticipates. Negotiation and compromise will be key, particularly with regards to the infrastructure program.

My position is largely unchanged from last month. Bonds have been oversold and markets are currently overestimating the speed at which the Fed will raise rates. In Australia, markets are currently underestimating the likelihood that the RBA cuts rates further.

It strikes me as unusual that markets have reacted so strongly to Trump's victory without giving due consideration to the underlying politics that will shape his economic plan. The US president doesn't operate in a vacuum and the real power, at least with regards to domestic policy, sits firmly in the hands of Congress and the likes of McConnell and Ryan who stand in opposition to Trump's economic plan.

The Fed will surely understand this or at the very least be somewhat reluctant to take recent market moves at face value. As it stands, I doubt that Trump's victory has had a material effect on thinking within the Fed and that won't change until it becomes clear that his policies can find their way through Congress.

The world's biggest zinc producer has put another rocket under the metal and its stablemate, lead.

BY TIM TREADGOLD • EUREKA REPORT • 9 DECEMBER 2016

Making hay while zinc shines

There was a time when a mine opening excited investors. Today, it's mine closures or, in the case of zinc and lead, a promise to not restart mothballed mines.

Key Point

- ***Zinc and lead continue to rise as demand outstrips supply -- but doubts persist about the boom's longevity.***

That has put a spark in the price of two metals which were once an Australian specialty.

Ivan Glasenberg, chief executive of the international mining and commodities trading group Glencore, said last week that he would not move quickly to replace an estimated 500,000 tonnes of zinc removed from the market over the past 12 months because of low prices.

Because Glencore is the world's biggest producer of zinc, Glasenberg's comment on future production plans added a few cents to the price of the metal, largely used to galvanise steel, which was already at an eight-year high.

It also boosted the price of lead, which is often produced in association with zinc, to a five-year high.

For Australian investors the surging price of zinc and lead is proving to be somewhat frustrating.

While both metals were once found at the heart of the two biggest miners, BHP Billiton and Rio Tinto, exposure now is primarily through South32 which operates the Cannington mine in Queensland (best known for its silver output).

Most other Australian stock exchange-listed companies exposed to zinc and lead are in the exploration stage of their lives, which means they are not yet benefiting from the higher metal prices and face the hurdles of funding while hoping that the current prices are not another short-term spike that could fade as quickly as it has appeared.

Despite that risk there are signs of interest growing in some of the explorers, especially those with the potential to be involved in the development of a substantial mine of the sort that might attract a big producer as a partner with financial clout and operational expertise.

The last time *Eureka Report* took a close look at the zinc market was in early June (***Zinc is back on the radar***, June 8) when conditions in the market were starting to heat up.

Back then the zinc price had risen to US90c a pound, up by 36 per cent from US66c/lb at the start of 2016.

On Thursday, zinc was trading at $US1.24, up by another 38 per cent. Glencore's share price, meanwhile, has risen to £2.96 on the London Stock Exchange, 310 per cent higher than its opening trades in 2016 (and 105 per cent higher than our June 8 story).

Zinc is not the only metal driving Glencore which, like South32, has a broad range of mining assets under its control, including coal and copper.

Among the small zinc and lead exposed stocks that were mentioned in June the one that has risen furthest is Ironbark Zinc, which was trading at 5.9c but has recently cracked the 10c ceiling – up 69 per cent in six months and 230 per cent on its 3c low point reached in January.

Ironbark's plum asset is the Citronen zinc project in Greenland, a potential world-class mine which has attracted the close attention of Glencore and one of the world's biggest zinc refiners, Nyrstar.

Red River Resources, which is redeveloping the Thalanga zinc mine in Queensland, is up another 4.5c (28 per cent) from its early June price to trade at 20.5c, but did get as high as 28c in August and last week announced completion of a $30 million capital raising to fund Thalanga's development.

Other stocks mentioned in June have not done as well. Heron Resources, which is redeveloping the Woodlawn mine near Goulburn in NSW, has slipped 2c lower from its June price of 15.5c but at 13.5c it remains 5.5c higher than its low point for the year while Energia Minerals, which is redeveloping zinc mines in the north of Italy, has lost 1.9c to 3.8c.

On the metal market there is no sign of prices retreating as the effect of production cuts squeezes supply just as demand appears to be accelerating, thanks to the latest round of economic stimulus in China and the promise of faster growth in the US.

> **“While lead and zinc were once found at the heart of the two biggest miners, BHP Billiton and Rio Tinto, exposure now is primarily through South32.**

The net result of falling supply and rising demand is that both zinc and lead are enjoying their best trading conditions since 2007.

Can it continue?

As always with commodities, that's a question which goes directly to supply, demand and project development.

With zinc the supply/demand situation is quite promising with the International Lead and Zinc Study Group, an industry research body, reporting last month that metal consumption has started to outstrip production after several years of surplus.

In September, the ILZSG said zinc metal usage totalled 1.2 million tonnes while metal production totalled 1.18 million tonnes – with the deficit trend expected to continue.

That drift into deficit is thanks to strengthening demand but also because of Glasenberg's promise that Glencore will not be rushing to bring capacity back online.

“We will not being tonnes into a market where we will be the ones to cause a negative effect on prices,” Glasenberg said last week.

Significantly, he also noted that restarting a mine back into production was not a short-term exercise.

“Each mine takes nine to 15 months to bring back, and you won't bring it all back at once.”

Lead, which has a variety of industrial uses, has been late to the party and remains in slight surplus, according to the ILZSG.

Despite having a market closer to being balanced the price of lead has recently moved back above $US1/lb, trading on Wednesday at $US1.04, up 40 per cent since May.

Of the two metals zinc is very much the leader given its bigger market and important use in protecting steel from corrosion.

If China and the US achieve their growth targets, and if Glencore and other big producers of zinc maintain their production discipline, 2017 could be a very good year for the metal, with the final words belonging to Glasenberg:

“If you believe 2 per cent demand growth next year, you've got to wonder where the supply will come from. We see tightness starting to flow through the whole supply chain, it's a scarce commodity.”

As with every edition of Minefield, this article is not providing investment advice. For all of Eureka Report's stock recommendations, click here.

BY TIM TREADGOLD • EUREKA REPORT • 13 DECEMBER 2016

Minefield: Zinc prospects lead explorers

Mineral exploration is not a part of the resources sector that can be financially modelled. But exploration is where success can generate value, with the starting point being metals in short supply. And today that means zinc, a topic explored here last week (***Making hay while zinc shines***, December 9).

A gap between zinc supply and demand has been widening for several years as old zinc mines close and replacements are not developed. The result is that stockpiles from surplus years have effectively disappeared, which is why the price of zinc has doubled since January.

Declining supply and steady demand growth for a metal mainly used to galvanise steel will not be fixed quickly because new mines take years to develop and restarting mothballed mines can also take more than a year.

The challenge for investors with an appetite for the risk (which comes with grass roots exploration) is to find explorers with the potential to succeed. And that means starting with companies in the right location, a common thread connecting the first two stocks in this edition of *Minefield*.

Energia Minerals (EMX)

Location, history and a major shareholder with a proven track record of creating value from an asset that others have ignored is a combination that makes zinc-project developer Energia Minerals worth a look.

The Gorno project in far north Italy is the major asset in Energia, and while it has a production history which can traced back to Roman times there is just as much interest in Alexander Burns, the major shareholder with a 23 per cent stake.

Not a prominent figure in Australian mining, Burns was the man behind Sphere Minerals, which explored the Askaf iron ore deposit in the African country of Mauritania before it was acquired by Xstrata in 2010 in a $514 million takeover. That was a handsome return for a company once valued at $1m.

The sale of Sphere was a classic boom-time deal, struck when iron ore prices were high. But Glencore, the eventual owner (after it acquired Xstrata), mothballed Askaf after the iron ore price collapsed.

Lightning does not necessarily strike twice but in Energia there are the hallmarks of a Sphere-type deal emerging. If not value-creation through a corporate deal, then there's value from restarting zinc production in the heart of Europe (a major market for the metal).

A modest resource of zinc and lead has already been established at Gorno with the potential of more to come as exploration continues.

Complementing the fieldwork is a definitive feasibility study into mine redevelopment, due for completion in the next few months.

Potentially, Energia will be in a position to push ahead with mine development and start production as the zinc price is squeezed higher by what are expected to be big supply deficits over – at least – the next two years.

Unlike rival projects in remote locations there is a ready market for Gorno's zinc in Europe's steel industry, just as there is likely to be a willing buyer for the project (or the company) like Sphere six years ago.

Pushing ahead with exploration and the feasibility study means that Energia is working itself into a win-win situation; either it starts mining and sells zinc, or it sells itself.

Zinc of Ireland (ZMI)

Like Energia in Italy, the theory behind Zinc of Ireland is that a combination of the right location and the right commodity is a money maker. And while many Australian investors might not think of Ireland as a mining country, it is a one of the world's major sources of zinc.

The Tara zinc mine of Sweden's Boliden in Navan County is the biggest in Europe and the ninth-biggest in the world. And the Lisheen mine, owned by India's Vedanta, was one of the world's biggest until making its final shipment 11 months ago.

The closure of Lisheen, and the earlier closure of the Century mine in Australia, removed around 700,000 tonnes of zinc from the world market, close to 5 per cent of annual global consumption.

> **“If you want to make a commercial discovery, start by exploring in a location known to contain commercially viable mineralisation.**

Zinc of Ireland is a minnow applying one of the basic rules of exploration; if you want to make a commercial discovery, start by exploring in a location known to contain commercially viable mineralisation.

That process started with the acquisition of tenements in seven locations across Ireland, all close to proven zinc reserves – a first step also known as ‘address pegging’.

The next stage, exploration drilling, has just started at the Kildare project where reasonable zinc intersections have been reported over the past month, including 21.05 metres assaying 7.35 per cent zinc, and 1.72 per cent lead from a depth of 405m.

The depth is a challenge, though shallower intersections – such as 36.5m at 4.05 per cent zinc just 4.5m from the surface – are a pointer to the potential for an easier start to mining, if the project gets that far.

The point about Zinc of Ireland is that it is exploring in a region known for its rich zinc mineralisation, at a time when zinc demand is strong and the price looks likely to stay high for some time.

Lefroy Exploration (LEX)

If gold is your target even after the recent price decline, then there’s no better place to look than in the goldfields near Kalgoorlie in WA, which is what a newcomer in Lefroy Exploration is doing.

In terms of location, Lefroy is well positioned with its foot on 540 square kilometres of ground in its major asset, the Lefroy project. Lefroy has established goldmines to the east and west, including the big St Ives development of South African-controlled Gold Fields Ltd.

It is very early days for the Lefroy project, which has been created by consolidating tenements held by a number of other companies close to and including parts of Lake Lefroy -- a salt pan extending south from the nickel-mining centre of Kambalda.

Ignored by early prospectors, the lake itself has become a primary target thanks to modern exploration tools such as measuring changes in gravity and magnetics to help identify drilling targets.

One of those lake targets, Zanex, was drilled in 1996 and returned an encouraging 6m assaying 2.87 grams of gold a tonne. That result was not followed up, partly because the gold price in 1996 was a depressed $380 an ounce.

Lefroy, subject to finalising government approvals, plans to return to Zanex in the first three months of the new year. That will come after its inaugural drilling program at the Lucky Strike prospect close to the Randalls gold processing plant of Silver Lake Resources.

As a potential investment, Lefroy is high risk given the grass roots nature of its exploration. But in terms of being in the right location, it is one of the better early-stage explorers.

Commodity price volatility due to currency swings will have a tremendous impact on companies that source their goods globally.

BY JOHN PIATEK • EUREKA REPORT • 15 DECEMBER 2016

The investment fallout from currency wars

The currency wars have already started – and commodity based businesses are in the thick of it, despite iron ore and coal enjoying an uptick since mid-2016.

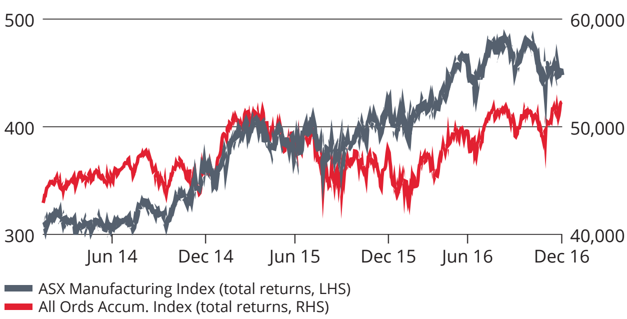
Key Point

- ***Australian activist investors should be demanding businesses mobilise now to upgrade their corporate governance around commodity risk management.***

And the currency wars may prove challenging for individual investors. One could argue that it will be difficult to fairly value businesses exposed to these currency swings. Aggressive investors should consider searching for the emerging leaders – businesses that are proactively shaping their responses and that are making public statements. All investors though should expect wilder and more variable shareholder returns and valuations.

The last two years have crushed the markets' belief in the predictability and stability of currency values.

Chart 1: Australian manufacturing has outperformed since commodity prices started their decline in 2014.



Source: Bloomberg, Eureka Report

In fact, Australia may be enjoying the calm before the next currency conflict breaks out.

Declining commodity prices have made many manufacturing businesses look good and led economists and analysts to debate whether we are at the end of a commodity super cycle that will propel prices even lower.

For example, as China tries for a 'soft landing' of decelerated economic growth, commodity prices could fall further as demand slows. If so, those lower prices may be giving business leaders a false sense of peace.

Globally, the decline in commodity prices is already adding political pressure on commodity exporters such as Australia and Saudi Arabia to do something, and is sparking political unrest in countries around the world such as Russia and Venezuela.

It leads one to expect that currency wars have started when we consider the following:

- '**Francogeddon**'. In January last year, Switzerland abandoned its peg to the euro and threw financial markets into chaos, with the value of the Swiss franc spiking to more than 20 per cent above its prior valuation relative to the US dollar.
- '**Brexit**'. Mainstream media missed the anti-EU sentiment building in the UK, causing many to be startled when voters there supported the Brexit effort to leave the European Union in June this year. The economic impact was immediate and by mid-October the UK pound had fallen 18 per cent against the US dollar.
- Struggles of '**Abenomics**'. After some success, Shinzo Abe's economic policies of fiscal stimulus and monetary easing for Japan are struggling to contain the value of the yen, which has risen 14 per cent since the beginning of 2016.
- **Chinese moves**. In August 2015, China changed the structure of how exchange rates are fixed, enabling more market input on its valuation. This sent the currency on a steady downward slope. The yuan is now down 8 per cent in US dollar terms as compared to January 2015.

What this means is that investors today are operating in a world where both commodity and currency values are changing rapidly – and in unpredictable ways.

> **“Australia may be enjoying the calm before the next currency conflict breaks out. Declining commodity prices have made many manufacturing businesses look good.**

Rising commodity-price volatility

As investors in Australia adapt to this new reality, currency volatility is likely to trigger commodity price volatility.

This will have a tremendous impact on companies that source their goods globally – and will especially impact local businesses, which are so reliant on commodity exports.

That is because the structure of commodity production is not set up to withstand these swings in currency prices. Domestic production cannot be started quickly enough to replace supply disrupted by the increased costs of imports. Increased costs often have to be absorbed by the consumer.

The current unstable economic outlook should compel company directors to take action now before it’s too late. Yet given what we have experienced in commodity prices over the past few years, many organisations overlook how important commodity volatility is to their overall enterprise risk. For that reason, any uptick in commodity volatility would catch many companies off guard – and the impact for investors could be significant.

Investors should demand that action become a “C-suite” (chief executive officer, chief operating officer and chief information officer) priority. While many organisations are not ready to manage commodities in a comprehensive, end-to-end manner, there are actions a company can take now in preparation for higher prices.

Things investors should be calling on the C-Suite to do

1. Define and publish a **commodity risk management strategy** (CRM) throughout the business. Many organisations have different perspectives on what the risk strategy should be. Should the company try to outperform the market? Can market intelligence be used to gain an advantage? Would it be better to pay a premium for stability? How far in advance should the company plan in these uncertain times?
2. Agree how CRM will be **measured**. What are the objectives of the risk management program? How will performance be measured against these objectives? What metrics are needed to track this?
3. Arm the business with a **full arsenal of CRM weapons**. Effective CRM is not simply derivatives and other financial hedging strategies. Leaders should consider a full spectrum of solutions, including partnering with suppliers to manage risk, integrating CRM into pricing actions and, where possible, changing the long and short physical stock holding positions.
4. Execute CRM as a standard **business-as-usual process**, not as an exception driven by market disruption. Strong CRM systems have a tiered governance structure to balance executive involvement, decision-making and escalation protocols for extreme market disruption. The process is well structured and not reactive, and is transparent to stakeholders with roles and responsibilities defined. The process is supported by a set of standard tools that reside in a central repository.
5. Upgrade **internal tracking of currency and commodity markets** and develop a single voice on the market data. The different functions of the business (marketing, supply management, supply chain, finance) need the same feed of information to make decisions. While opinions will vary on the future, the business should be fully informed and aligned on the past and present.

Activist investors should be demanding businesses mobilise now to upgrade their corporate governance around commodity risk management and commodity buying strategies. This may be the end of the calm before the next commodity storm begins.

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