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Woodhall's Wrap

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The Federal Budget issue

- **Australian trade agreements should not be underestimated**
- **This Federal Budget is critical to our future**
- **Rate rises off our agenda – for now**

The Big Picture

For a change, the big action this month on the economic front was (and is) in our own hands! A massive trade delegation of political and business leaders went to South Korea, Japan and China during April. While there was much talk of 'free trade' in the media it was really just a set of agreements and positions that will *reduce* a number of trade barriers. But the potential impact of these 'take aways' should not be underestimated.

The Hawke-Keating government made big inroads into internationalising our economy in the eighties and they had major long-lasting effects on our economy and our market. Three decades on, this new trade agenda (and other initiatives that may follow starting with the budget) could be the start of something just as big. But it will take a while for the full benefits to be felt.

With the Federal Budget only 12 sleeps away, the political noise is reaching a crescendo. Are we in a crisis? There is no doubt that, if we do nothing, the economy will not die this year – or next. But, by analogy, to me the macro-situation is a bit like a young working couple feeling no need to change their spending patterns even though they are planning a couple of kids in the next few years and mum (with dad's encouragement) is not going back to work (at least full time) until both kids are at school.

They would be silly in the extreme not to take into account the reduced income and increased expenditure NOW – if not when they first got together. Each year they delay saving and tailoring expenditure patterns for the new family, the magnitude of the household economic problem snowballs – and the mortgage repayments are not going away – and interest rates will be much bigger before the mortgage is paid off in twenty or thirty years' time.

Our economy is in good shape – if we all agree not to age – hence we can all carry on working (keeping income up) and not retiring (not needing extra expenditure on pensions and healthcare by the economy from a reduced budget). We frittered away all of the gains from the mining boom rather than saving them for the rainy days that will not go away for decades. Baby boomers – who are causing the main problem – started to reach 65 in 2010 – and it will still be around in 2050 before the vast majority of that class of '45 – '64 passes.

The problem in Australia – and the UK, and the US and ... – was self evident in the sixties and seventies but there was no incentive then for any political party to spoil the party. Thankfully, Hawke-Keating bit a few of the bullets in the eighties. The rest of the bullets in the chamber do not yet bear teeth marks! And please note that these same discussions are the focus in the US over debt ceilings, Obamacare and the rest. We are certainly not alone in needing to face the problems of aging!

So the trade talks are a big part of this second reformation. For example, removing the tax on imported Japanese cars will reduce prices by about 5% for anyone who wants to buy one and that lasts forever! We will have much better prospects of exporting food products. The list goes on and on.

But more is needed in the May budget. Of course, too much enthusiasm for addressing entitlements and debt immediately could throw the economy into reverse. No enthusiasm for change and we will feel the pain over the next few decades. Cans can only be kicked down the road for so long. I think it is almost too late to start. The baby boomers are reaching 65 in increasing numbers (about 300 a day at the moment) – but some of the boomers are still in their early fifties!

When the baby boomers have all passed away, balance between the numbers working and those in retirement will be restored to manageable levels such as we had before.

It is not for me to speculate what should (or will) be in the budget. But a plan needs to be shaped that faces up to the big issues. When I was a teenager, my dad told me all his colleagues tended to die just before or after retiring at 65. So I honestly expected him to pass at around 65. He thankfully made it to 82 in reasonable health.

The pension was originally brought in to help those who lived past their use-by-date – if you can excuse the analogy – or life expectancy. And when I was a kid, many of the oldies in their sixties and seventies were virtually housebound. Now this nomadic tribe of grey-headed (or bald) people are taking cruises on the Danube and beyond. I am grey, partly bald but not yet on the Danube – and I turn 65 in June!

I strongly recommend that we all set aside our political differences on May 13th and face up to our problems and leave our kids – and grandchildren – a future at least as good as that which we enjoyed.

Moving on to the day-to-day management of the economy, the Reserve Bank did not change rates in April and it is extremely unlikely to do so next Tuesday. Some thought there might have been a rate-hike soon because the inflation genie jumped out of the bottle three months ago. The RBA has a target range for inflation of 2% - 3% and last quarter, the number crept above the 3% upper bound. We, and others, thought the 'blip' in inflation was due to the rapidly falling Aussie dollar. But another read above 3% would have put pressure on the RBA to raise rates when the economy couldn't take it.

The Governor does get a million dollars (or four to five times his opposite number in the US Federal Reserve) to consider these problems – but it would have been a tough one. 'Would have been' because the April inflation release came in at 2.6% and well below expectations. The Governor should have had a relaxing long-weekend for Anzac Day.

I think (as before) the next change is up but that may not be before well into 2015. But when the increases start, they may come in rapid fire.

In order to put the focus this month on *our* economy, I am relegating the discussion of the overseas counties and markets this month to the following regular sections.

Asset Classes

Australian Equities

The ASX 200 reached a near six-year high at 5,536 towards the end of April (up +1.7% for the month) but this is well short of the peak that exceeded 6,800 in November 2007. But it would be wrong to think having invested in the stock market was a mistake. If we reinvested the dividends and franking credits back into the ASX 200 since November 2007, this composite index is now about 20% higher than in that November peak!

Indeed, if one were unlucky enough to have invested $100,000 lump sum in the market at the 2007 peak and added $2,000 per month to those savings – those pre-tax savings (or after-tax under certain conditions in a super fund) would have returned nearly 7% pa over the six and a bit years!

So investing in the ASX 200 at the unluckiest time just before the GFC that threw the world economy into disarray would have turned out to be an OK investment under the stated conditions. My point here is that we should take at least a five-year view about investing in the stock market – or keep out of it altogether!

During April, the likes of BHP, RIO and Fortescue reported bumper iron ore shipments. Iron ore prices did slip over the month but are still well above that needed for these miners to make a tidy profit. There is a current lull in prices due to some financing decision in China that should go away soon allowing the price to rise again.

Our end-of-year forecast for the ASX 200 strengthened over the month and we are now back to forecasting 5,750 for December 31st. In short, our start-of-year forecast for 2014 is still on track.

We also measure various statistics that help us monitor market conditions. Indexes representing fear, volatility and mispricing are all indicating that the market is in 'normal' conditions – as before the GFC hit.

Foreign Equities

The S&P 500 again reached new highs in April (1,891) and our end-of-year forecast is for a result near 2,000 with a period well above that level. The Dow finished April on an all-time high.

The US Q1 reporting season came in as largely solid with the traditional 70% or so of companies beating expectations.

For the year-to-date many world markets have been largely flat. But to put this into perspective, The US Federal Reserve has almost halved its bond buy-back purchases (known as tapering) and some thought this action could have sent markets in a spin. While markets are adjusting to the notion of a post-stimulus era, flat is actually not bad.

Bonds

That bond yields did not rise with tapering is a little surprising. Despite the headlines, markets are quite settled.

Fitch probabilities of default for Western Europe have taken the Ukraine situation in their stride. They are barely off recent lows.

Interest Rates

Unsurprisingly, the RBA did not change rates in April and looks unlikely to do so in May. The consensus appears to be that there will be no more cuts in this cycle. Some commentators are expecting hikes this year but the majority are predicting very late 2014 or more likely 2015.

Other Assets

Although there was some volatility in the likes of gold, silver, copper and oil prices, by and large there was no major trend over April. Iron ore prices that are so important to us did fall from $117 / tonne to $105 / tonne this change is of no real concern. Macquarie is still predicting an average price of $120 / tonne for 2014.

China has introduced tighter conditions for borrowing to buy iron ore and a $12 fall in price is not material given the temporary policy change.

Regional Analysis

Australia

Retail sales came in at +0.2% which is very good after a couple of very strong months. On April 10th the unemployment read fell from 6% to 5.8% with +18,000 new jobs being created. As I wrote last year, I thought 6% might have been the peak – even though government forecasts were for an average of 6.25% unemployed for the next few years.

Of course, 5.8% does not mean we are all in 'Happy Land'. The economy is not in difficulty – but it will be if we do not act soon! The so-called two-speed economy is increasingly behaving more like a one-speed economy making it easier to manage.

It is worth noting that miners – big and small – came in with great production and shipment numbers. If the mining boom is over, someone forgot to tell China, BHP, RIO, Fortescue, Atlas Iron and the rest. Does the media really know best? Vale, the massive Brazilian miner stated overnight that it is still exploring for new mines.

But to put writing for the media into perspective – and again on a personal note – I really enjoy writing this note each month. It gives me the chance to express what thoughts I have accumulated over the month. If I had to write something like this (and of this length) every day to keep the TV, newspapers and web pages on fire, I might be tempted to speculate about aliens infiltrating government and statistics bureaux to just to fill space! Just kidding – but the media needs to speculate wildly to keep interest going. It is the job of people like me to filter the real news from the hype.

In short, our economy is fine at the moment but not great. Hockey has the power to destroy the economy or start to liberate it. I am leaning strongly towards the latter.

China

Almost every month, the China bears come out of the woodwork but 'Harry Hindsight' seems relaxed.

There is always talk of China changing some policy or other and gurus and pundits stake their claims. But the data just keeps coming out. A while ago, this was supposed to be the bad time before a second half recovery. China GDP growth yet again surprised lots of people as it came in at 7.4% against a target for an average of 7.5% for 2014. The official PMI result out today was a one notch increase over last month to 50.5 – indicating growth prospects are modestly thought to be improving.

But some China trade data were bad. Last year we all agreed they were gilding the lily – making false invoices to help one cause or another. Let's wait for another month or two before we decide on the fate of China.

USA

The US continues to look good without being great. Overnight US GDP growth came out for the weather stricken Quarter 1 at a miserable +0.1% (against an expectation of +1.0%). This did not stop the Federal Reserve further increasing the tapering programme by $10bn a month because it saw a brighter future – ignoring this past data,

It has also been enough for some to rid themselves of the trendy 'new normal' tag for the US economy in place of the old normal looks fine. The 'old normal' tag doesn't get many headlines!

The US nonfarm payrolls data (job creation) is the big US statistic of the month. In April, 225,000 new jobs were expected but only 192,000 came through. That was enough to appease markets but more is needed. The next number is due out on Friday 2nd May and is well worth watching. Anything above 200,000 new jobs will be very good.

Europe

After all of the problems of the last six years, it was fun to see Greece take a bond deal to the free market rather than just taking another sugar hit from the EU.

With Russia leaning over the border into the Ukraine nobody seems to be happy - nor should they – but there are no signs (yet?) of major disruptions in asset markets. The IMF stepped in overnight with a $17bn aid programmer for Ukraine.

The problem Europe is facing is the same as that for the US and Japan. The spectre is deflation or negative inflation. If people expect prices to fall there is an incentive to delay purchases when possible and that is bad for growth. Europe is considering a stimulus plan (similar to the US and Japan) to rid its economy of this fear.

Rest of the World

New Zealand is racing ahead of the pack with its second successive rate hike in consecutive months.

Japan was out of the blocks with an 11% increase in retail sales for the year to March. But they announced they were putting the sales tax rate up from 5% to 8% on April Fools' Day so wouldn't you jump in early to buy before the price rise? Don't worry, we did it too when the GST came in!

The serious problem is how the Russia-Ukraine situation will play out. The West has placed sanctions on Russia with little impact so far. There is reportedly a 'rogue' mayor in the Crimea who is a self-appointed leader who may not have the wider interests at large.

Given that the situation is two months old, there is some hope that there will be no material spill-over into Western economies and markets.