



JUNE 2015

Welcome to the June 2015 Update

Here we are again - the end of another financial year! Michael Kodari has provided us with an interesting insight into the markets and the currency, while Alan Hull gives us an interesting take on global inflation. Enjoy!

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Currency or Bonds, What's driving markets?

Michael Kodari

Effectively the recent reaction to the RBA interest rate cut was irrational. In the lead up to the rate decision the AUD sold off in anticipation of an interest rate cut, however once the cut was delivered the AUD rallied strongly counterintuitively. It seems illogical that the 'talk' of interest rate cuts is enough to drive markets one way, while the 'action' itself drives markets the opposite way. But that's the unpredictability of the markets for you. It's worth pointing out that even after the RBA's surprise rate cut in February the currency actually rallied for the three days following the announcement, before eventually falling away.

Upcoming Events



AIA Annual Investors Conference

Brisbane Information Meeting

Level 19/200 Mary St Brisbane
1 July 2015 1.00pm

Geelong Discussion Group

7 July 2015 7.00pm

Perth Information Meeting

7 July 2015 7.30pm

Canberra Discussion Group

13 July 2015 7.30pm

Adelaide Information Meeting

14 July 2015 7.00pm

Frankston South Discussion Group

15 July 2015 1.00pm

Currency or Bonds: What's driving Markets? (Cont'd)

The reality is there are numerous variables driving the currency markets, with the ability to forecast the timing and size of movements in the currency being one of the most difficult tasks in finance. Nevertheless, with significantly declines in commodity prices hindering the terms of trade, slowing growth in China, and record low interest rates, it seems inevitable that the exchange rate will decline in time particularly once that the United States begin to raise their local rates.

When it comes to the currency, bond markets and the stock market correlation and causation is difficult to determine. Clarity as to whether the main driver of the stock market is decreasing bond yields or a declining currency remains ambiguous, somewhat like the old chicken and the egg conundrum. Nevertheless both bond yields and currency fluctuations are likely to have their unique impact in the current environment of depressed interest rates and quantitative easing programs.

For instance equity and fixed income securities compete for investment dollars. The theory is that when interest rates are low, investors prefer investing in the stock market and when interest rates are high, investors prefer fixed income or cash. At present, the cash rate in Australia is at a historic low sitting at 2 percent, while bond yields around the world remain depressed with the 10yr US Treasury note trading on a yield of 2.18 percent.



Given the low yielding environment globally, investing in Australia can be seen as a favourable given the ASX has an average dividend yield of 4 percent. This figure is considerably higher than the rest of the world due to a favourable franking credit system which incentivises corporate management to appease local investors by prioritizing dividends. In addition to a favourable landscape for domestic investors, the wide spread between the ASX dividend yield and government bond yields globally, naturally helps to drive overseas interest the ASX by attracting yield hungry foreign investors despite those investors not being entitled to the franking credits.



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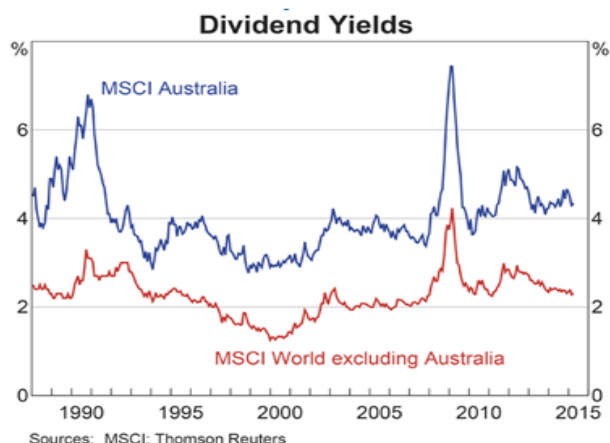
Full details, and bookings on the AIA Website
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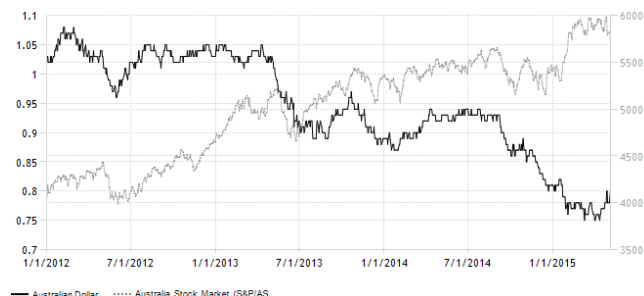
**If you are eligible for a tax deduction
and want to claim your conference
costs in this financial year (2015),
you must book & pay before
5pm Tuesday June 30th.**



Looking at currencies and in a general sense we believe anticipated currency movements should only play a minor role in investment decisions. Nevertheless when the currency is going through a more sustained rerating as we're currently experiencing then this can have a material impact on business earnings and the direction of the index as a whole.

Over the past 12 months the Australian Dollar has depreciated from approximately 0.94 US Cents to 0.79 US Cents for a decline of 15 percent. With that in mind it's worth noting that some of the largest investors in the Australian Market are large international investors such as US and Japanese hedge funds and pension funds. For these investors the ASX is effectively 15 percent cheaper in US dollar terms than it would've been otherwise.

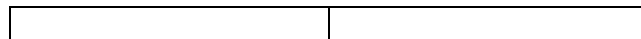
To demonstrate the effect of the currency we can take a look at the ASX over the 12 month up until May 2015. In AUD terms, over that same period the ASX All Ord's has rallied, with the index rising 5.5 percent from approximately 5,400 to approximately 5,700, while on multiple occasions pushing the 6,000 barrier. However, on the other hand, in USD terms, the ASX has actually fallen from 5076 (*ASX 5400 multiplied by 0.94 AUD/USD*) to 4503 (*ASX 5700 multiplied by 0.79 AUD/USD*). That's a decline of 11.30 percent in US dollar terms over the same period due to the decline in the currency.



The chart above illustrates the inverse correlation between the AUD and the ASX. The black line is of the AUD since 2012, while the grey line is the performance of the ASX over the same period. What we can see is that as the currency has declined the stock market has rallied, perhaps highlighting the aforementioned dynamics above at play.

The purpose of the article is to really look through the volatility and identify some of the key drivers of the market. In many ways it appears that the economy has all the hallmarks of being closer to the beginning of the bull market cycle than the end given that economic conditions remain weak and confidence subdued. After all it's for these reasons why we have low rates in the first place. The state of euphoria characterised by strong economic conditions where elevated inflation rates drive profit growth and rampant company valuations appears to be nothing but a pipe dream at present. For that reason while risks such as a potential Greek exit and a premature Federal rate rise remain, the stock markets seems to be some distance away from the peak of the investment cycle.

Michael Kodari is CEO of Kodari Securities,
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Where's the inflation?

Alan Hull

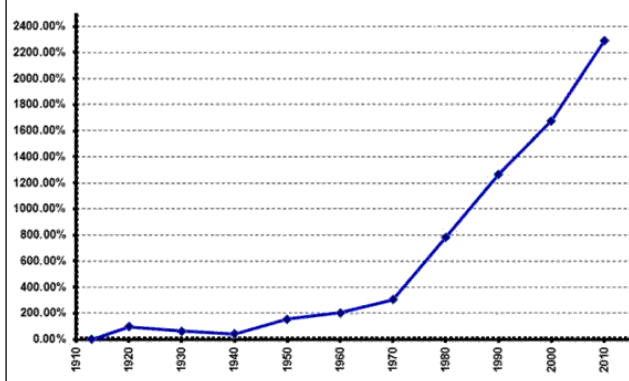
Here's a question – with all the quantitative easing that's been going in recent years, why hasn't it destroyed the value of the US dollar (USD) and driven up inflation? After all, isn't that the problem with printing money?

The answer is to be found in the difference between the absolute and relative value of a currency, and absolute and relative inflation.

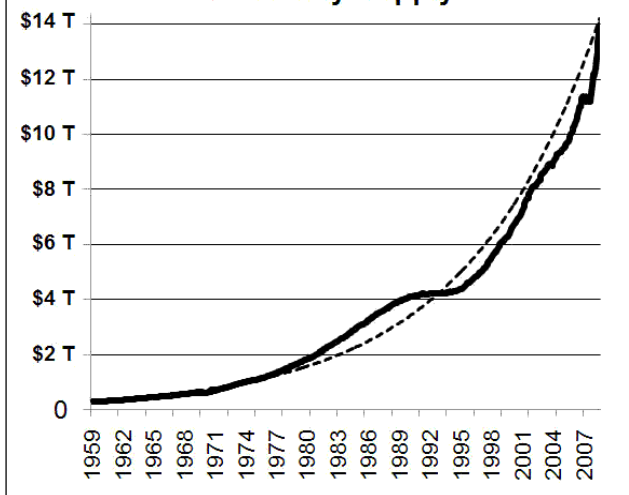
The first thing I need to do is paint you a picture explaining how the USD has been gradually undermined by cumulative inflation and the printing of money ever

since the US moved off the Gold standard in 1971 and onto a debt-backed fiat currency system. The following two charts are of <cumulative> inflation in the US and the (exponentially) rising money supply.

Cumulative inflation - 1913 to 2013



US Money Supply



In 1971 Nixon announced that the US was leaving the Gold standard and therefore the USD would no longer be tangibly backed. Thus the US Federal Reserve was free to print money against debt (shown as an asset) on its balance sheet. From this point the USD was not defined in terms of its absolute value (with reference to gold) and while the above chart of cumulative inflation shows a staggering figure of 2,300%, what exactly does it apply to?



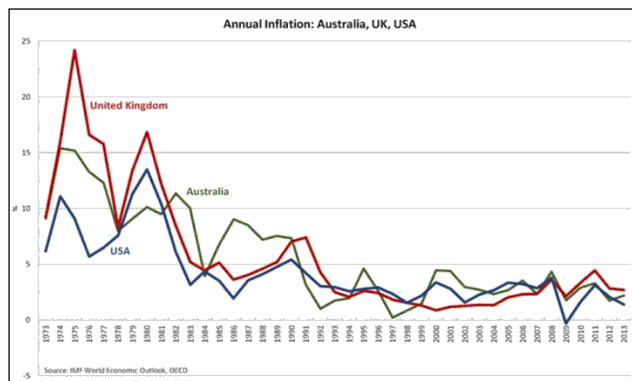
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So why aren't we seeing signs of this in the inflation numbers? The CPI in Australia, the UK and the US is inert in recent times at about 3% or less, as the following chart demonstrates.

There's no point of reference in absolute terms, but in relative terms the comparative value of the US\$ is not so shabby. Thus the US\$ index is defined as a measure of the value of the US dollar relative to a majority of its most significant trading partners. And here is a long-term chart of the US\$ index showing that over the past few years it's clearly not collapsing.



Now three guesses how the US Federal Reserve chooses to view the US\$? You guessed it – in relative terms. So what's the issue with this? Well you're destroying the value of your currency in real or absolute terms if you print money and this will eventually catch up with you by driving up the price of locally sourced goods and services. This includes housing and stocks.



This is a good question and again the answer is to be found in measuring something in absolute versus relative terms. Inflation can be a measurement of locally sourced products and services or imported products and services. This is a critical factor to me because imported goods and services do not reflect the cost of local labour and raw materials. And isn't that the purpose of measuring the CPI for setting national economic policy?

In the above chart, which shows historical inflation for Australia, the UK and the US, you will note that they have all dropped over time to about 2% to 3%. But did you also notice how they have all converged over time? Thus globalisation has led to a convergence of global pricing and therefore a convergence of inflation figures. Are we looking at three different inflation figures or are we now looking at global prices and therefore global inflation?

The real danger here is that the pricing trend is towards the lowest, most competitive price. If we can't manufacture a product in Australia for the same price that it can be manufactured in China then what do we do? We stop manufacturing it and therefore the price of that item is determined by the lowest input costs in terms of labour and raw materials. On a global scale!

To see what some economic experts (e.g. Peter Schiff, Jim Rickards) are calling double-digit inflation you have to look at just goods and services that include only locally sourced material and labour inputs, not imported goods. Locally made products and services would include health care, land and housing (yes, this is a consumable), insurance, energy prices, education etc.

Now look at a sample of some of the goods and products used to calculate a typical CPI and note how these items can be imported and therefore would include inputs

from overseas, e.g. Chinese cost of labour, raw materials from impoverished Third World countries etc.

Food	Fruit	Salted/roasted nuts
Food	Vegetables	Canned sweet corn
Food	Vegetables	Canned sweet corn
Clothing	Garments	Socks
Clothing	Garments	Underwear
Clothing	Garments	Jeans

There are typically about 500 items in the basket of items used to calculate a CPI and by my assessment they are predominantly foreign items. Thus today's national CPI figures from around the world are an average of local inflation and imported deflation, where imported deflation is masking local inflation and blindsiding anyone who relies on these numbers.

Of course this measurement was valid 40 years ago when we considered the price of a 1974 locally made Rank Arena colour TV and not an imported flat-screen TV. The price of the former was a true indication of local factors but not the latter. Globalisation has changed things.



So we are using an out-of-date methodology to calculate what is a pretty critical data point for every central bank

in the world and I think we are all being hoodwinked. Of course if inflation were rising at 2% to 3% per annum then it would be pretty linear and benign in the medium term, but if it's rising at around 10% per annum then it's clearly on an exponentially accelerating path.

Of course I could be more cynical here and suggest that maybe the world's central bankers are seeing what they want to see. Printing money allows governments to buy back their own debt and redistribute wealth. Hence the US Federal Reserve prints money to purchase US Treasury bonds and then pays the interest it earns on these back to the US Treasury. Hmm...

Alan Hull

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