Welcome to the March 2016 Edition of the Martin Bros Monitor.

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“When my information changes, I change my conclusions”

John Keynes

In our Xmas 2015 edition of MBM we concluded with:

“The themes we have been talking about for some time now are not over in our view. That is, falling commodity prices, falling $A and low global cash rates (not necessarily long bond yields) – although the US are expected to begin raising cash rates, they are off a very low, effectively zero, level. Yield and growth will still be sought after. We continue to be positioned for this.”

Whilst this remains true, there seems to have been a fundamental shift in the psychology of equity market participants. About a year ago we warned volatility was likely to increase and the benign (positive) environment of the last couple of years was coming to an end. It did, and now it seems this volatility has ratcheted up a notch – many notches in fact.

The well flagged “lift off” of the US interest rate normalisation process i.e. raising the cash rate, occurred in December. Post the seasonal Santa Claus rally which we have written about several times in the past, equity markets globally began the 2016 calendar year in a tail spin and have been on a roller coaster ride ever since. This increase in volatility was arguably started by the first US interest rate rise however well flagged. Quickly following this, the EU and Japan have embarked on unprecedented increases in their Quantitative Easing (QE) programs. We are now in a world of NIRP (Negative Interest Rate Policy) when we thought ZIRP (Zero Interest Rate Policy) was the ultimate in free market stimulation. The new world of NIRP has contributed to the volatility in equity markets.

As NIRP is an untried and untested monetary stimulus measure, it seems the uncertainty of this, and more importantly the unknown consequences of this, has contributed to equity market volatility as global money managers reduce their “risk on” bets.

Let’s explore NIRP a bit further to understand how it’s different to anything we have seen before. As the name implies, NIRP actually targets negative interest rates. Negative interest rates mean the purchaser must pay someone to hold their money for them. We saw this during the height of the GFC in the US for overnight deposit rates. This meant, banks were paying the government (in the US) to hold their money overnight as they did not trust any other counter party (i.e. Banks). This was only on overnight deposits.

NIRP targets medium to longer term interest rates of say 2-10 years. The idea is that by forcing these bond rates into negative territory it will encourage money to flow into other (risk) assets, preferably capital investment to stimulate economic activity and job creation. It does this because rather than Bond holders being paid interest when they buy and hold a Bond, it will cost them money, thereby creating a dis-incentive to own these types of assets. Of course, if the bond yields continue to worsen and the negative yields get bigger, then the value of the Bond goes up. So in a bizarre twist, someone buying a negative rate bond could actually make money. I’m not sure I’d like to bet on that though!

As we write, here are some of the negative bond yields in government securities around the world:

- Japanese 2yr yield -0.23%
- Japanese 5yr yield -0.23%
- Japanese 10 yr yield -0.09%
- German 2 yr yield -0.50%
- German 5yr yield -0.35%

Other countries with negative yields include Denmark, Sweden and Switzerland.

Negative yields are of course a new extreme on the Quantitative Easing programs of Central Governments. QE is undertaken to fight off deflation (negative inflation) and sluggish growth (GDP). Both of these are not good for economies or their sharemarkets. Sharemarkets globally have been supported by these QE programs for the last few years which was instigated by the US Federal Reserve. It has been referred to over the past few years as the Yellen Put (after Janet Yellen, head of the US Federal Reserve). Which means if things aren’t going well, the US (and now EU) will just pump more money supply into the system to boost risk asset prices and hope growth follows.

The problem now seems to be QE fatigue. More and more market participants are questioning how does this all end? What is the exit strategy for unwinding this massive stimulus and what are the side effects of negative interest rates. No one truly knows, but one effect is an increase in the nicknamed “currency wars” between governments globally. The idea being the lower you can get your currency versus a basket of international peers the more export driven growth you will have and international competiveness for services e.g. tourism and education in Australia.

There is fear that the longer central banks persist with NIRP, the larger the risk becomes to the real economy. At present, it is estimated there are currently $6 trillion dollars of negative yield bond holders globally. IF they panic and decide to sell, yields could jump dramatically, back into positive territory yes, but the ramifications of a dramatic bond sell off would be – more volatility.

On top of the unknowns created by NIRP, domestically our market is being impacted by the ongoing resources rout and now a sell off in financials (banks) caused by concern over a bottoming in the bad debt cycle (meaning bad debts for banks will increase). We can thank ANZ for kicking this off last week when four weeks after their result they increased their bad debt provision by $100m. The market doesn't like surprises, especially just four weeks after a comprehensive result presentation.

Throw into the mix the uncertainty a domestic Federal election creates and the potential for a very divisive man (Trump) to become President in the USA later this year, and the markets are rightly skittish at present. However, certain companies (equities) and sectors continue to perform well, but overall, a more conservative stance is warranted until some of the uncertainty is clarified. This may take some time.

Stock Review - Seven Group Preference Shares (SVWPA)

Seven Group (SVW) is a diversified investment house with ownership and interests in several different businesses. Included in its stable of investments is the exclusive licensing rights to sell Caterpillar equipment (including mining, agricultural, infrastructure etc) in NSW, Western Australia and North Eastern China. SVW also hold approx. 35% of Seven West Media listed shares, a 41% interest in Coates Hire and approx. $1b in other listed/liquid investments.

Seven Group is therefore very well capitalised with a large amount of liquid assets. It's earnings have declined over the past couple of years by approximately 10% per annum as a result of the impact on the CAT franchise from the slowdown in resource activity.

The SVWPA's are a preference share issued by Seven Group in 2005 and which became a perpetual security in April 2010, at which time the distribution margin was stepped up and now pays an annual gross (incl franking credits) floating rate distribution of 4.75% plus the 180 day bank bill swap rate, based on a face value of $100 per security. As the security is currently trading at $59.00, the current gross floating annual distribution rate is circa 11.85%.

This income yield is still very healthy, particularly in a market where term deposit rates continue to be sub 3%. Given the diversified earnings of the parent company, SVW, and its strong liquidity position, we are very confident of the company's ability to continue to meet the distributions on an ongoing basis (which is the real risk to these types of securities). Beyond the ability of the parent company to pay the distributions, the only other notable risk with securities such as these is the interest rate margin. This is different to official interest rates and is the interest rate demanded by the market (through supply and demand) for securities such as this that fall into the income securities / hybrid asset class.

Interest rate margin risk is affected by general market sentiment and in an ordinary market or global environment is relatively stable. In a GFC type of event then the interest rate margin demanded by the market will increase. Since these securities pay a fixed rate margin above the 180 day (or 90 day) BBSW, then if the interest margin demanded by the market increases, then the security price of existing securities will fall so that the yield matches the increased interest margin demanded by the market.

In the GFC we saw the interest rate margins expand on heightened fear for all income securities including the big four banks. The security prices did fall, not by nearly as much as the equity market, however, when common sense prevailed and the fear had subsided, most securities recovered to where they were trading prior to the GFC. Except those that were issued by underlying companies that did not recover (these were few).

In a new world order of NIRP (Negative Interest Rate Policy), we believe the risk being priced into these securities is excessive versus the underlying companies ability to continue making a profit and paying distributions. There is also a dividend stopper which means SVW would need to cease dividend payments on the ordinary shares before they are allowed to cease distributions on the SVWPAs. This seems unlikely in our view as SVW has maintained a 20 cent per share dividend each half year for the last 4 years running. The last being February just gone. In addition, SVWPA security holders rank ahead of ordinary shareholders in the event of a wind up. This means Kerry Stokes would have to lose the majority of his wealth before note holders do. He owns approximately 65% of the ordinary shares in Seven Group.

SVWPA's are currently yielding 11.85% gross and the distributions are supported by a well funded, diversified and liquid parent company. We are very comfortable holding these as within a diversified income securities allocation (of a portfolio).

ANZAC Day - Monday 25th of April - Office Closed

Our office will be closed on Monday 25th of April for ANZAC Day and will re-open on Tuesday 26th of April.

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