

Martin Bros

MONITOR

Creating Long Term Financial Success For Our Clients



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

In this edition of the Martin Bros Monitor:

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- [September Seasonality](#)

A Tulip, a Tulip, \$500,000 for your Tulip

No, we haven't gone mad. Tulips are arguably the first recorded speculative bubble in economic history. In the early 1600's, Tulip mania as it is commonly referred to, took over during what is known as the Dutch Golden Age. Contract prices for bulbs of the recently introduced tulip reached staggering levels before they suffered the same fate as every subsequent economic bubble since.

At the height of the tulip boom, some single bulbs apparently sold for more than 10 times the annual income of a skilled craftsman. In today's terms, that would likely be well over \$500,000 per tulip bulb! This was in March 1637, right before the crash.

The term "tulip mania", is now often used as a metaphor to describe any large economic bubble when asset prices deviate from their intrinsic value (fundamental value). We would refer to the current Bond market as a modern day example of "tulip mania". Not quite the same extreme, but far larger in terms of size and potential for global impact once the "great unwind" occurs.

Until recently, a Bond was an exchange (loan) from the investor to the issuer (government or company), in return for an annual interest payment (coupon) and the promise of the return of capital at the end of the bond term. As we wrote about in our June edition of MBM, trillions of dollars of bonds around the world were in a negative yield position based on current pricing. This means that an investor is lending money to an issuer, effectively paying them money each year for the privilege of using their money(!) and receiving their capital back at the end of the term.

We say until recently, because up until a year or two ago, this concept was thought impossible (negative yields). In fact, we recently listened to a 42 year veteran Professor of Economics from the US who stated that for 40 of his 42 years he told his students that there was no such thing as negative yield – it doesn't make sense. Of course, in the last year or two, he's had to come up with a different answer!

So why would one buy a bond that cost them money each year to hold? The answer is that someone else will come along and pay a higher price (lower negative yield) than what they paid. Therefore, it is simply capital speculation, much in the same way that people bought tulips on the assumption that someone else would pay a higher price than they did. It almost sounds like a Ponzi scheme.

Bonds have historically always been a defensive asset. Investors received a coupon (interest) payment and their capital back at the end of the term. In a negative yield scenario, it is entirely capital price speculation. Pension funds around the world and large public superannuation funds in Australia typically have mandated asset allocations they have to adhere to. Defensive assets often make up a large part of this asset allocation. Defensive assets are typically cash.....and bonds. With negative yields, or even very very low positive yields, it raises the question about whether investment into these assets by these funds is in fact in keeping with their mandate. Trustees have a fiduciary capacity to protect and invest the members assets in accordance with their mandates. Is it prudent to be investing a funds defensive asset allocation into price speculative investments? Most likely not, but as the current interest rate environment was thought impossible only a couple of years ago, how do you allow for this change in mandates? **Luckily we, or our clients, do not have to worry about this.**

Until now, we have not seen any negative yields outside of government bonds. Last week however, two European companies issued medium term bonds with a negative yield. Large French pharmaceutical company, Sanofi, sold 1 billion euros worth of 3.5 year bonds with a yield to maturity of -0.05%. German consumer goods company Henkel sold 500 million euros

worth of 2 year bonds with the same yield. Investors are paying these companies 0.05% per annum to have their money! We don't know if this trend will continue or if this non government issuance will mark the beginning of the end.

Some initial signs in the past week have merged though that the tide could be turning. If it does, the bond sell off could be long and significant. The real risk lies in it becoming a Tsunami, as investors rush for the exit, such that occurs when bubbles burst. The initial signs we are referring to, are admissions by the European Central Bank (ECB) and Bank of Japan that monetary easing (quantitative easing by buying bonds to push down yields) may not provide the necessary stimulus required to grow these countries / regions out of economic stagnation. In fact, it is estimated that both central banks will run out of available bonds to buy in the next 12-18 months.

In our last MBM we included a table of bond yields from quarter to quarter. We will keep this going for a few more quarters to see the direction global bonds are taking, and see if this initial sell off continues and / or accelerates.

Bond	Yield 31st March 2016	Yield 30th June 2016	Yield 14th Sept 2016
Japan 5 year bonds	0.04%	-0.32%	-0.19%
Japan 10 year bonds	0.04%	-0.24%	-0.02%
German 5 year bonds	-0.33%	-0.57%	-0.46%
German 10 year bonds	0.15%	-0.13%	0.07%
France 5 year bonds	-0.21%	-0.35%	-0.34%
France 10 year bonds	0.48%	-0.19%	0.28%
UK 5 year bonds	0.84%	0.35%	0.36%
UK 10 year bonds	1.41%	0.87%	0.81%
US 5 year bonds	1.20%	0.99%	1.24%
US 10 year bonds	1.77%	1.45%	1.73%
Australia 5 year bonds	2.05%	1.63%	1.75%
Australia 10 year bonds	2.49%	1.97%	2.13%

September Seasonality

Since the start of September, the market has seen a sharp negative price movement - but this is nothing new as far as the month of September is concerned.

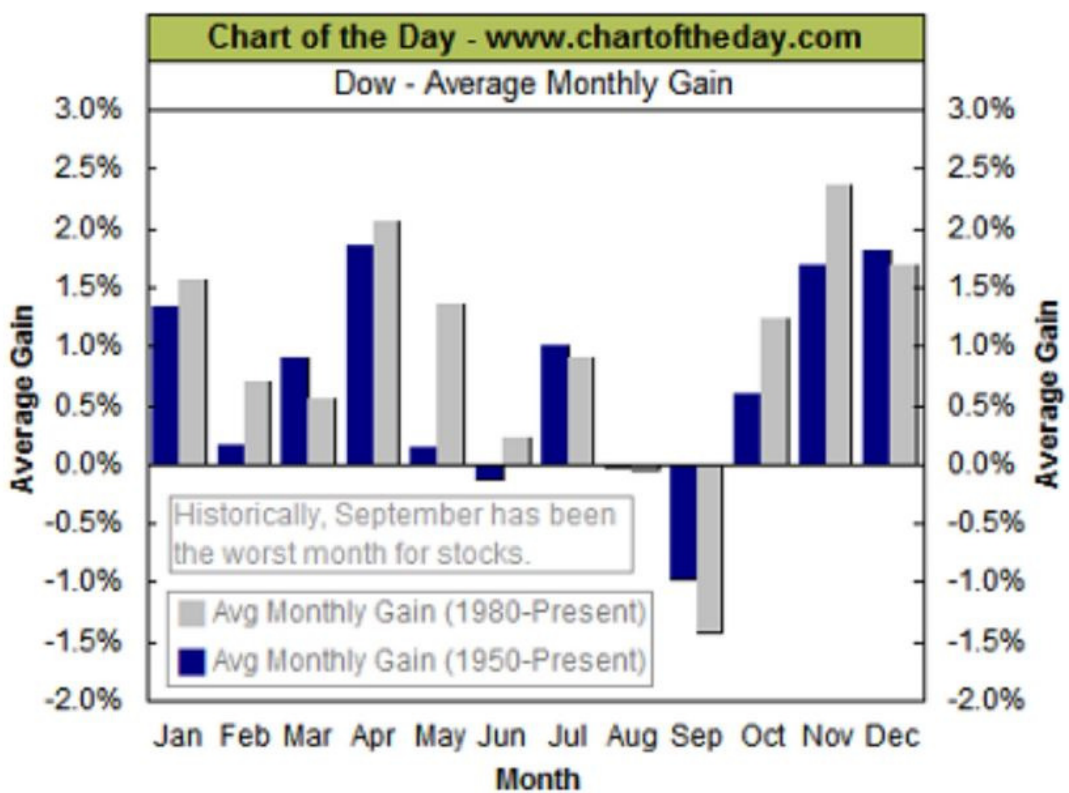
The below chart plots the median price return (left hand side) and the percentage of positive returns of the United States S&P 500 index for each calendar month back to 1928.



Source: BofAML US Equity & Quant Strategy, S&P, Bloomberg
 Note: Based on S&P 500 price returns since 1928

As the above chart demonstrates, historically September is the only month to have a positive return less than 50% of the time and also the only month to have a negative median return.

Whilst the above chart goes back to 1928, the below chart looks at some shorter timeframes for monthly returns on the Dow Jones index - 1950 to present & 1980 to present:



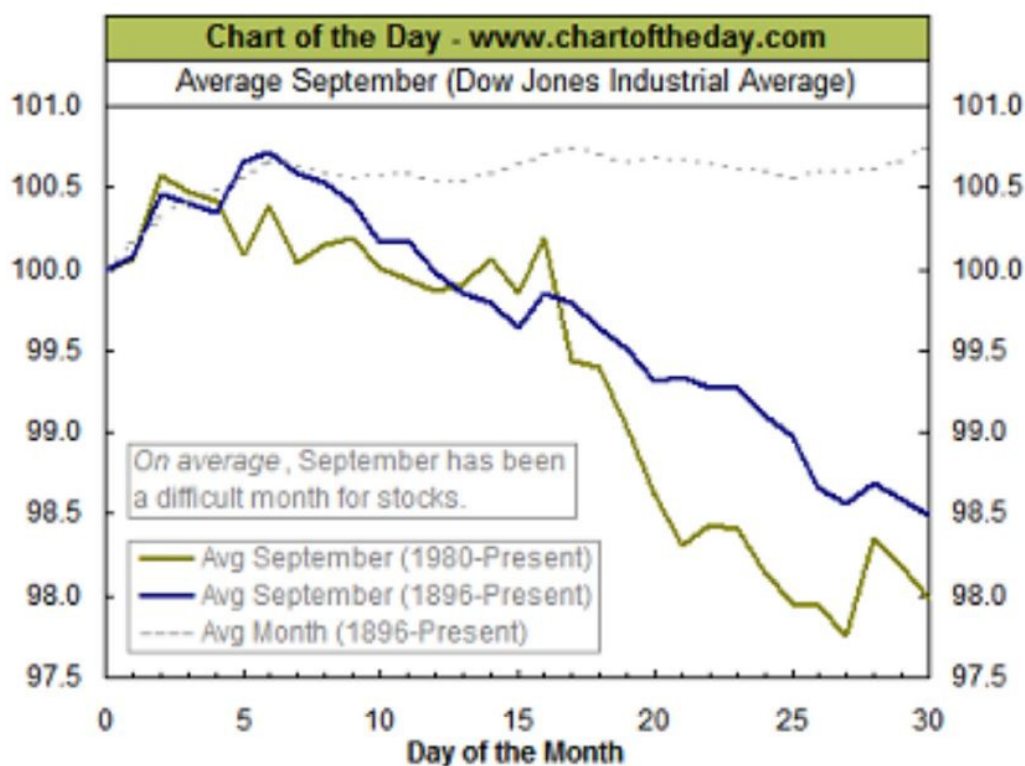
As we have moved from the 20th to the 21st century, September returns have on average deteriorated further.

These charts also show that once we get past September, we usually have a good run into the end of calendar year - otherwise known as the Santa Claus rally - which we have spoken about in many past editions of the MBM.

Many seasoned investors and economists have tried to come up with a reason for this historical September weakness, with some of the most common possible explanations below:

- US holiday season ends in early September and investors stop investing to pay down credit card bills;
- Investment managers return from holidays and corporate action activity picks up, sucking money out of the market to invest in new floats and placements;
- Parents selling stocks to pay for the new year school or college fees;
- Many US mutual funds have October year ends and begin their tax-loss selling in September; and
- Finally, a weak September becomes a self-fulfilling prophecy.

The other thing to note about September weakness is that it is usually concentrated to the second half of the month - see below chart of the historical daily moves of the Dow Jones index:



Whilst the above charts relate to the US markets, it is worthwhile to remember that the Australian markets generally follow the lead of the American markets each day.

(Sources: Bank of America, S&P, Bloomberg, www.chartoftheday.com, The Coppo Report)

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