Welcome to the September 2017 Edition of the Martin Bros Monitor.

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The Trend is Your Friend - Until It's Not

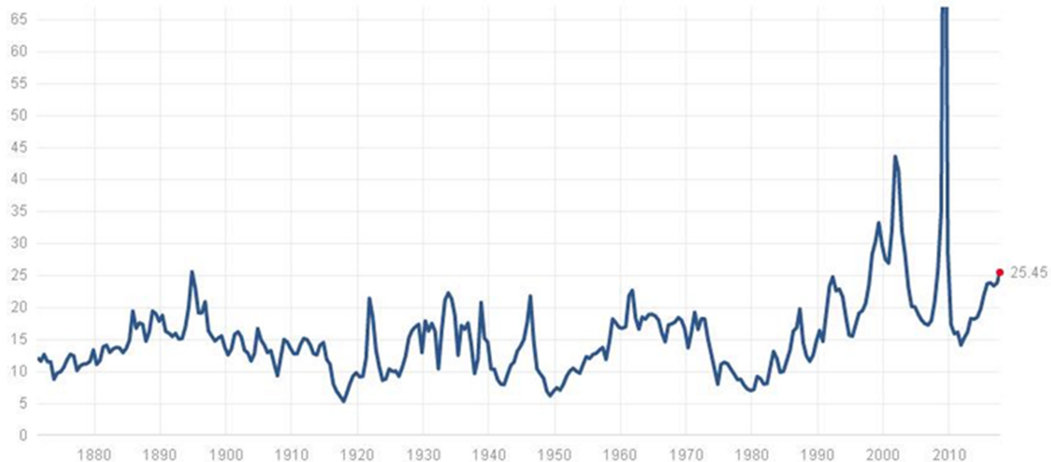
As we write the US market is reaching new all time highs (in $US terms). Events that typically cause market weakness, such as geo-political uncertainty (i.e. North Korea), are currently being brushed aside as markets push ahead and volatility continues to reach multi-decade lows. Helping the equation is US (and global) bond yields that continue to trade at low levels, albeit off their lows seen a year or two ago.

Bond yields are used in equity price valuations by analysts. The lower the bond yield forecast the higher the equity valuation that can be derived. The reason for this is twofold. One, when the forecast cost of (debt) funding is low then profit expectations are higher and; two, the return on equity (profit) has a lower hurdle rate when compared to that which can be earned in the “safe” bond market. Hence the price people will arguably pay for “risk” (equities) is higher. This all translates into higher Price to Earnings ratios (P/E’s) for stock valuations.

Accordingly, with very low bond yields the P/E will expand which is what we have seen to date. In the US, the average P/E of the equity market (S&P 500) is now 25 times. This means that in theory it would take 25 years of net earnings to repay your purchase price if you bought a basket of stocks representing the S&P 500 today. This is historically high (refer to chart below (source www.multpl.com). The two dramatic spikes in the chart were in the late 1990’s at the time of the tech boom when many IT companies were trading at 100’s of multiple P/E’s, as many had virtually no earnings and the other spike was in the GFC when company earnings fell off a cliff, only temporarily as it turned out.

S&P 500 PE Ratio

For the Shiller PE10 Ratio, see Shiller PE.



The US ten year bond yield is currently at 2.35%. It briefly reached a low of 1.36% in mid 2016 after starting that year at 2.27% and finishing the year at 2.44%. The current US cash rate as set by the Federal Reserve is 1.25%. The average expectation of interest rate rises by the Federal Reserve members is an increase to 2.25% by the end of 2018. This is pretty much where the US 10 year bond yield currently sits. This would imply a flat yield curve, meaning cash rates will be the same as 10 year bond rates by the end of 2018. This is not normal and what the bond yields are currently telling the market is that they do not believe interest rates in the US will rise very much.

Also in the mix is the Federal Reserve has stated that it is now unwinding QE (Quantitative Easing) which means that as bonds that they own mature, they will not re-purchase these. This will result in less buyers (demand) and should push the yield on these securities higher. But at the moment it's a standoff between the Federal Reserve and the Bond market.

So with US P/E ratios at historically high levels, for stocks to continue their march higher without any decent (but normal) sell offs of 10-20%, interest rates will need to fall from here (the opposite of what the Fed think) and / or earnings will have to grow at consistent levels in the high single digits to double figure level. For now in the US however, the trend (up) is the markets friend and it is hard to fight it. As they say, the trend is your friend. But at some stage it won't be, history has a way of ensuring we again see "mean reversion" (a return to long term average P/E's at some stage).

In Australia, our market dynamics are a little different. The consumer in Australia has record low mortgage rates and consistent employment, yet confidence continues to wane. This may be due to the world record setting personal debt levels. As much more of household budgets are consumed on servicing debt, growing discretionary spending is hard to forecast. Hence our retailers are doing it tough generally (irrespective of the online Amazon threat which hasn't even arrived).

Global talk is intensifying around Australia and it's concentration in residential property investment. With record high property prices the "wealth affect" this has on consumers should be leading to increased economic activity (spending). If property price growth were to slow, or even turn negative, global observers are concerned about the impact this would have on our economy and in particular our banks, which co-incidentally make up about 40% of our sharemarket.

Kim Jong Un aside, the year ahead is shaping up to be a very interesting one. One, how well does Australia continue to adjust from the mining boom of old and will our property construction boom continue, and two, who is going to be right about where interest rates will be in a year from now.

Investor Education - Fixed Interest Securities

The main characteristics of fixed interest securities:

- Face Value – is the price at which the Security is issued and the amount repayable to the investor at Maturity/Redemption by the Issuer;
- Distribution / Dividend / Coupon – the income stream payable to investors either monthly, quarterly or semi-annually;
- Maturity/Redemption – the date at which holders must be repaid the Face Value of the Security in Cash;
- Call – the date at which the Issuer may (at its option) repay investors the face value of the security; and
- Conversion – the date when a preference share or other convertible security will convert into Ordinary Shares in the Issuer (assuming the required conversion conditions are met or enforced).

General features of ASX Listed Fixed Interest Securities:

- Known return profile with Distributions / Dividends / Coupons being either fixed or floating in nature;
- Returns are more predictable than ordinary share dividends, and in the event that they are not paid on these instruments, companies are generally unable to make payments on lower ranking securities including ordinary shares;
- Franking is often a component of investor returns for Preference Shares and Capital Notes;
- Issuers are generally known and trusted names;
- ASX listing provides transparency and liquidity;
- Price volatility is generally lower the higher ranking the security in the capital structure.

For further information on Fixed Interest Securities, please call us to request a copy of the full Morgans fixed interest education piece

Please contact us should you wish to discuss fixed interest securities or anything else contained within this edition of the Martin Bros Monitor.

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