NEWSLETTER

December 2019

WATTLE
FINANCIAL PLANNING

Introduction

This is our final newsletter for 2019 - we hope you have enjoyed reading our newsletters as much as we have enjoyed putting them together for you. The emphasis of our monthly newsletter is typically an in-depth analysis at Australia's residential property and share markets. In this edition, we look at the performance of these markets over the 2019 year - and see that both markets have performed extremely strongly.

Famous People in (Australian) Finance – George Turner

George Turner was Australia's first Federal treasurer, holding the office from the first day of federation (January 1, 1901) to 29 April 1904. He then took a short break before regaining the role in August 1904 and holding it until July 1905 – the recent turmoil in Australia Prime Ministerships has nothing on the situation in the first years of Federation. Prior to Federation, Turner had the first state Premier of Victoria to have been born in that state – although he was the 18th Victoria Premier overall.

Chris Watts

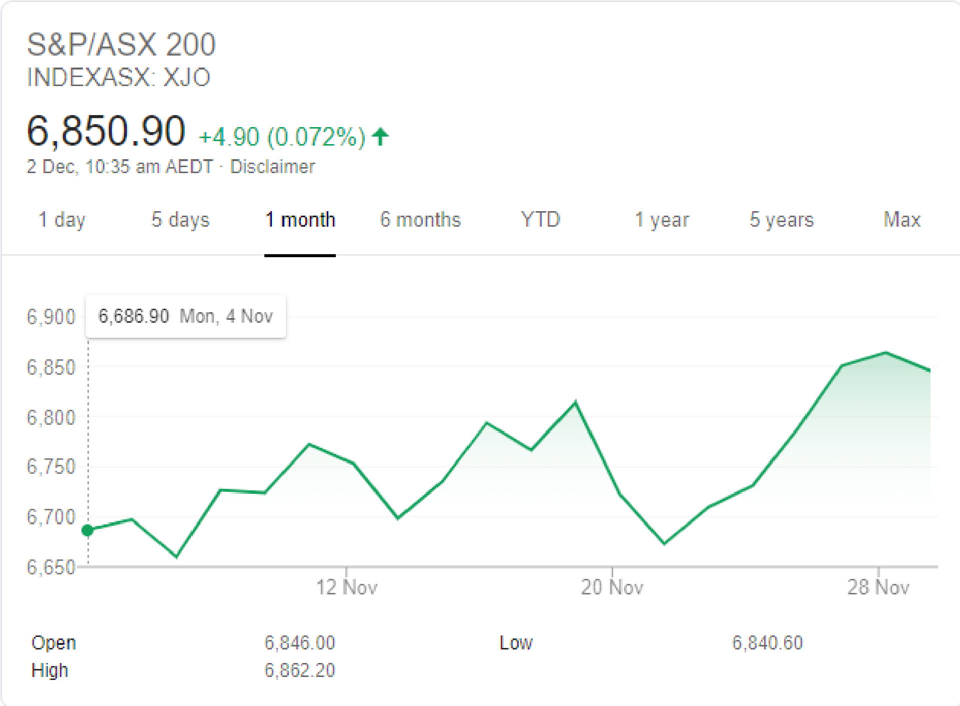
04 2319 2887

Chris@WattleFP.com.au

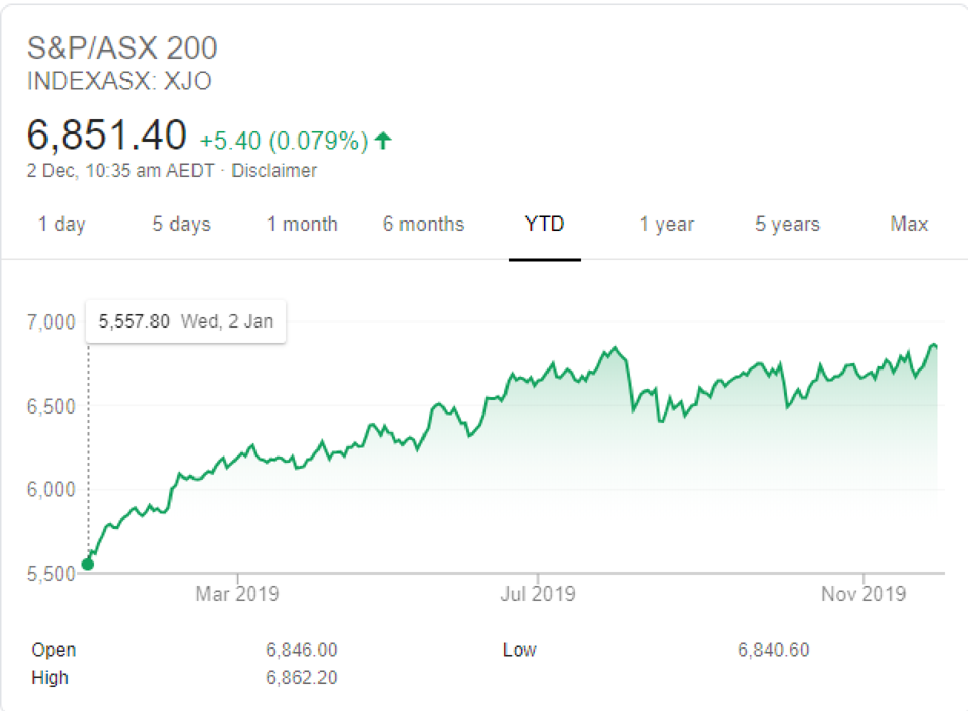
www.wattlefp.com.au

The Share Market

The month of November was another good one for Australian shareholders – the market rising by 2.65%. Here is how it looked graphically, with thanks to Google and the ASX:



2.65% is a great return over a single month. For the whole calendar year to date, however, the story was even better. Once again, here is how it looks on Google, with thanks to the ASX:

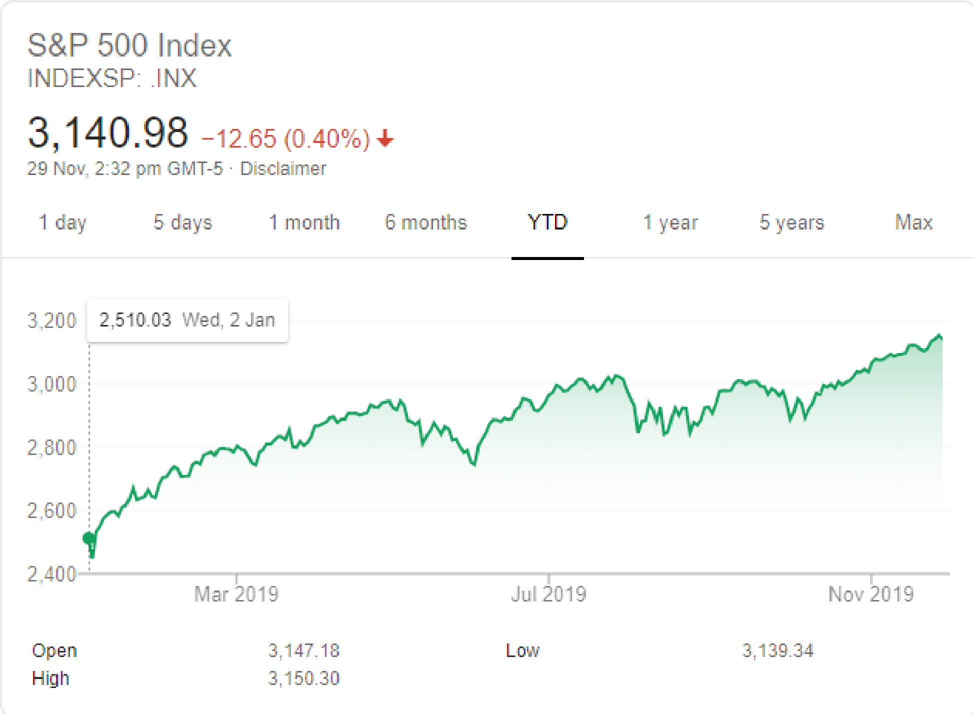


As you can see, the market has risen by more than 23% in the eleven months since January the 2nd – the first trading day of 2019. Add to this an average dividend yield in the market of 4%, and the total share market return for 2019 so far is more than 27%.

WATTLE FINANCIAL PLANNING

If prices hold throughout December, then 2019 will be one of the 'best' calendar years ever for the ASX. What's more, in July 2019, the market rose to it's highest ever level - finally surpassing its previous high that was set before the global financial crisis of 2007/2008.

Australia cannot take all the credit for the performance of its share market, however. Our performance was actually slightly less good than that of the lead market index for the American economy: the S&P 500 index. Here is how it looked for the 11 months to the end of November:



The growth in prices on the US market was slightly more than 25%. The US market has a slightly lower dividend yield, however, so the overall return for the two markets was eerily similar. This is a consistent observation of the Australian market – we often follow the moves on the dominant world markets – and the US market is the most dominant of them all.

The average Australian sharemarket return over the past 119 years is 13.1% per year (source: marketindex.com.au). So, the performance over the last 11 months is unusually positive - almost twice as good as the average.

Economic theory tells us that the main driver of share market prices is the earnings of the companies whose sharemarket is being tracked. Over time, market analysts have developed a neat ratio to compare the market price of shares in a particular company with the earnings that the company is enjoying. Unimaginatively, this ratio is known as the price-earnings ratio (or P/E ratio, for short).

Over the past 40 years, the average P/E ratio for shares in Australia's All Ordinaries index (an index that is very similar to the ASX 200 that we typically use as an indicator of the entire market) has been 15. This means that the average share price is typically 15 times the per-share earnings of the underlying company. What this means is that if a company is earning one dollar per share, we would expect shares in the company to trade for $15.

$$\text{P/E Ratio} = \frac{\text{Price per Share}}{\text{Earnings per Share}}$$

A higher P/E ratio means a lower dividend yield. This is a basic aspect of mathematics, because the dividend yield is the dividend per share divided by the market price of the share. Dividends are paid out of company earnings. So, the higher a company's earnings, the higher we would expect the dividends to be (the relationship is not exact because a company may choose not to pay its profits out as dividends).

Of course, high dividends typically attract buyers of shares in that particular company. So, if earnings rise, we expect that prices will also rise - meaning that the P/E ratio should remain about the same. (In reality, there can be a period of adjustment, after which the P/E ratio returns to its ‘stable’ level).

We say *should* because markets do not always act as the theory would predict. And that is what we are seeing now. According to Bloomberg.com, the current PE ratio for the ASX 200 (as at the end of November 2019) is 20.23. This suggests that a company earning one dollar per share will have shares trading for more than $20 each. This is significantly higher than the long-term average of 15. That tells us the prices have risen to a greater extent than the underlying earnings in the companies that comprise the ASX 200.

When prices rise at a rate faster than earnings, then some combination of two things tends to happen. Either a company’s earnings will rise or it’s share price will fall. Either of these things, or both of them in concert, will have the effect of reducing the P/E ratio. Economic theory would predict that the P/E ratio will tend always to revert back to its long-term average, which is currently 15.

Generally, when prices are driven higher by the market - as has obviously been happening so far in 2019 - the market is anticipating an increase in future earnings. The market is anticipating that earnings will rise so that the P/E ratio falls back towards its long-term average. Whether the market is anticipating correctly remains to be seen. But what we can say is that the outstanding performance of the Australian sharemarket so far in 2019 has seen prices rise proportionately faster than company earnings. That does mean that the Australian sharemarket is now riskier investment than it was at the start of 2019.

We live in interesting times.

The Property Market

In our last newsletter, we brought you an analysis of the residential property markets in each of Australia's capital cities. As that analysis shows, in terms of prices residential property looks set to return to the record levels being seen in 2017, before Australia's major property markets began to 'falter.'

Intriguingly, the simple rebound in prices has not been seen as good news by many people who work in the real estate industry. This is because the rebound in prices has largely been driven by a reduction in supply. In November, Property media company domain.com reported a 14% reduction in listings across Australia over the previous 12 months. In Melbourne, Australia's second largest market, there had been an 18% reduction in the number of properties available for auction. The reduction in auction listings in Sydney, Australia's largest residential property market, was 10%.

Fewer listings means fewer sales and unhappier selling and buying agents – even while prices themselves rise. These agents might be getting higher commissions – but they are getting fewer of them.

State revenue offices are also unhappy – fewer sales means less stamp duty, and stamp duty has become a very significant source of revenue for most state and territory governments. In May 2019, for example, the Victorian state government announced a 75% reduction – more than $5 billion - in the amount of stamp duty it expected to collect in the coming 12 months.

Residential property prices fell by more than 10% (on average) during 2017 and 2018. One of the great fears when property prices fall is that borrowers will find mortgage loans difficult to service - especially if the value of their property falls towards or below the level of their debt. This can lead to financial distress, causing people to sell property simply to repay debt. This can increase supply of property on the market - which would have a further negative affect on prices. A vicious spiral can eventuate: lower prices cause more people to sell their homes, which leads to lower prices, etc.

It looks like Australia has avoided such a spiral. Undoubtedly, the reduction in official interest rates over the course of 2019 has meant that servicing loans has become easier. (Please read back over our previous newsletters to learn more about these reductions and how interest rates are set in general). Falling prices must mean lower equity for homeowners. However, because interest rates have also fallen, this lower equity has not led to significant increases in mortgage arrears. Lenders have not needed to take action against borrowers whose properties have fallen in value because those borrowers have been able to continue to meet their loan repayments. Now that property prices have rebounded many of Australia's markets, there is even less incentive for lenders to take such actions. Equity is being restored.

It has been more than 30 years since Australia took steps to ensure that its interest rate management was performed by an independent board (the RBA) completely separate from government. In terms of the residential property market and keeping people in their homes, the RBA board have done a very good job. The quality of economists in charge of adjusting the levers of the Australian economy is one of the unsung strengths of Australia in 2019.

So, as 2019 comes to a close, our advice to people who hold debt in this period of very low interest rates remains the same: make hay while the sun shines. Use this period of lower interest rates to increase the amount of principal debt that you repay each fortnight or month. This will create even further equity and put you in a much stronger position if and when interest rates rise again.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

Contact Details

Address	829a Sydney Rd BRUNSWICK VIC 3056
Phone	04 2319 2887
Website	www.wattlefp.com.au
Email	Contact@wattlefp.com.au

Licencing Details

Wattle Financial Planning Pty Ltd ABN 46 609 920 274 is a corporate authorised representative (no. 1239513) of The CJ Partnership Pty Ltd ABN 66 666 987 391 (Australian Financial Service Licence no. 548394).