Baillie Asset Management Ltd

Baillie Capital Stable Monitor

May Day Edition

Repeat of Mandatory Reminder

There is only one mandatory reminder appropriate for any edition of the Baillie Capital Stable Monitor. You need to be reminded that this Monitor is designed as a reliable source of data and provider of insights to capital qualified Wholesale Investors. The Corporation Act definitions establish the boundaries for the Professional, Expert and Sophisticated Investors that qualify.

Orientation

The original title of this Monitor was the "Irregular". It was to be purely event driven and not based on a fixed schedule. Our rationale was to seek to avoid adding to the "communication noise" on economic musings, financial matters and investment commentaries all of us are constantly bombarded with in the Press, on TV, by email etc.

A perfect current example of this has been the massive number of diverse opinions expressed on whether the RBA should cut interest rates prior to the Federal Election.

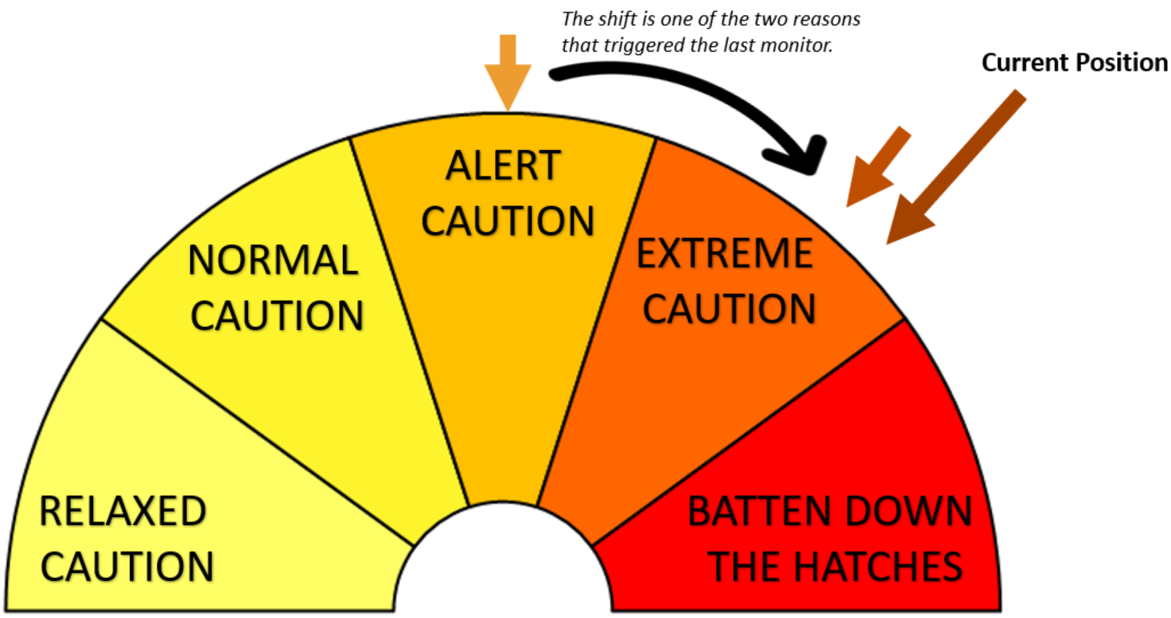
Further we limit our comments to Financial Instruments that do not leave the owners exposed to a permanent loss of capital. In turn this allows us to consider just two of the three analytical guides our group uses, and which we continually urge all targeted readers to adopt.

The two normally used for the Baillie Capital Stable Monitor are:

1. Don't take anything for granted and
2. Review, Re-assess and Recalibrate.

The two events that triggered the last edition was the increase in the US overnight cash range by 0.5% to 2%-2.25% (now 2.25% to 2.5%) in the September 2018 Federal Open Markets Committee (FOMC) and our shifting of our Caution Meter from 50% Alert Caution to 60% Extreme Caution.

Financial Repository Caution Meter



This May Day edition relates to the corollary between workers whose labour is a vital ingredient for economic sustainability to the role of capital stability in achieving same. There is no need to join the naysayers and so the May Day edition is far from a call for help. In this edition, we want to introduce you to the third of our analytical guides which normally is largely related to investments. That analytical guide is "There is no free lunch".

Our Break with Tradition

Traditionally we use 3 questions to help guide the intended readers to deeper and more up to date insights. The perennial questions we use are:

1. What are those you can trust up to?
2. What changes in the United States will impact Australian Interest rates in the short-term?
3. What are those you can't trust been up to?

The 7 events that triggered this issue of the Baillie Capital Stable Monitor are multi-lateral and profound, so we need only rely on the events to provide valuable insights.

The 7 events are so transformational that the insights they provide allow us this luxury.

The Triggering Events

The events that have triggered this May Day edition of the Baillie Capital Stable Monitor are as follows.

Event 1

The table below provides the inflation data of the Australian Bureau of Statistics on a quarter by quarter comparison, year on year comparison to the 31st March 2019 and year on year comparison to the 31st December 2018.

Weighted Average of Eight Capital Cities	Dec Qtr 18 to Mar Qtr 19	Mar Qtr 18 to Mar Qtr 19	Dec Qtr 17 to Dec Qtr 18
	% change	% change	% change
All groups CPI	**0**	**1.3**	**1.8**
Food and non-alcoholic beverages	1.3	2.3	1.5
Alcohol and tobacco	0.3	6.4	6.8
Clothing and footwear	-1.4	-0.1	-0.7
Housing	0	0.8	1.5
Furnishings, household equipment and services	-0.4	-0.8	-0.8
Health	1.9	3.1	3.3
Transport	-1.7	0	2.8
Communication	-0.6	-4.6	-4.3
Recreation and culture	-1.5	0.9	1.7
Education	2.7	2.9	2.7
Insurance and financial services	-0.2	1.1	1.5
CPI analytical series			
All groups CPI, seasonally adjusted	0.1	1.3	1.8
Trimmed mean	0.3	1.6	1.8
Weighted median	0.1	1.2	1.7

Source: ABS

The history of Australian Inflation data over the last 60 years has shown that wage inflation and expectations of inflation are the 2 most influential factors of the recognized variables that contribute to inflation.

It is a commonly held belief that the profligacy of the Labor Government led by Whitlam and the 1973 OPEC oil crisis combined to ignite Australia's 2 decades of high inflation. Our research finds different.

The foundation of inflation for the 2 decades starting 1970 and ending in 1990 was the equalisation of female wages for equal valued work introduced by the Commonwealth Conciliation and Arbitration Commission in 1969.

The consumer price index in the first of those decades was just under 10% followed by 8.5% for the second decade of 1980 to 1990.

In the November quarterly report in 2018, the RBA re-tabled its' concerns about the stubbornly persistent low levels of real wage increases. This is causal to the above data set. The prevalence of the inflation mindsets fashioned from 1970 to 1990 experiences is increasingly declining.

The average inflation rate for the last 25 years has been 2.6% and so less and less people have experienced the economic distortions of mid-to-high inflation.

In turn this should increase the confidence for all readers of this Monitor that the threat of inflation is not what it was, and nor is this likely to change for some years into the future.

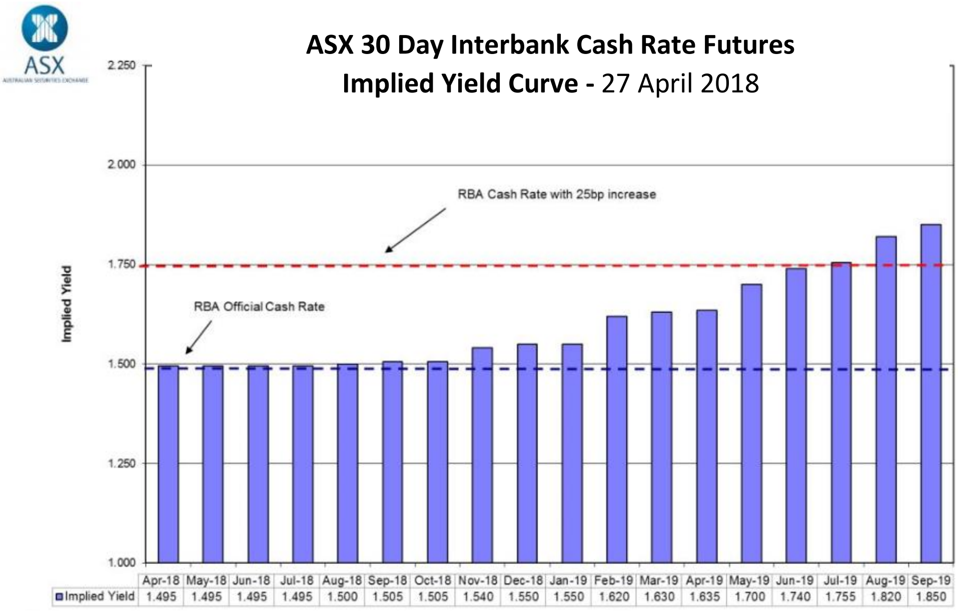
The relevance of Inflation is that it disguises permanent losses of capital where real returns after tax did not protect the purchasing power of investible capital.

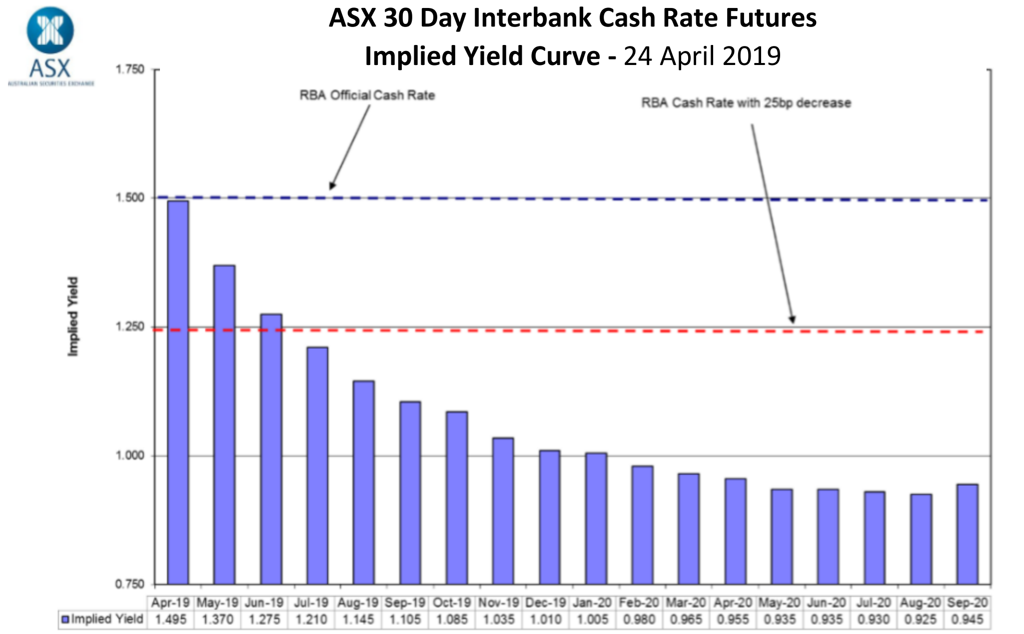
Event 2

As announced on the 7th of May 2019, overnight cash rates have been maintained at 1.5%, the same level that has applied for the last thirty-three months.

Central Bankers from different countries have slightly different briefs that all coalesce around financial stability. Australia has an inflation target range of 2% to 3% and full employment of 4.75% as its Central Bank policy objectives.

The graphs below show the year on year change in the 18-month market pricing for 30-day cash interest rates.





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The change of the direction from a propensity to increase overnight interest rates to a propensity to reduce overnight interest rates illustrates that the level of volatility is significantly more dynamic than historic models and economic beliefs indicate. We now face a market that has said that from September this year to September next year the overnight cash rate will be 1% or less.

Whilst neutral interest rates are optimal for financial stability, Hyman Minsky's 1973 thesis shows that human nature will force Central Banks to either be accommodative or restrictive as appropriately irrefutable evidence becomes available.

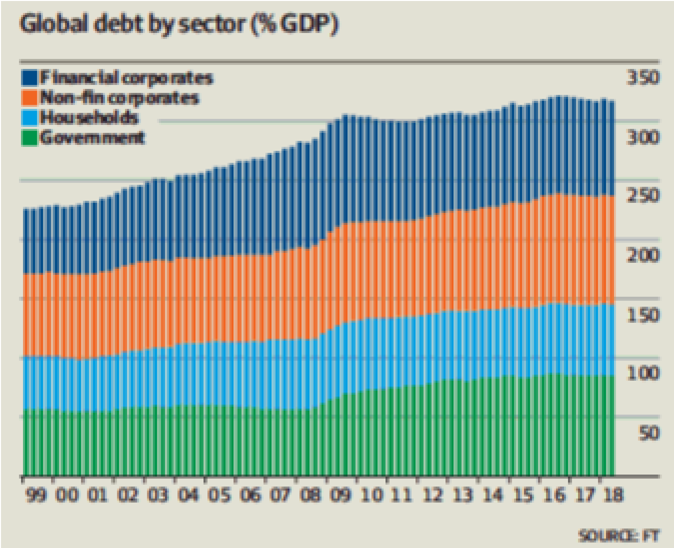
Our RBA wants to provide discipline for monetary policy decision making to provide an appropriate anchor for private sector expectations.

RBA Forecasts – Lens on Economy	May 19	Feb 19	Nov 18	Aug 18
2019 Growth	2.00	2.75	3.25	3.25
2020 Growth	2.75	2.75	3.25	3.00
2019 Underlying Inflation	1.75	2.00	2.00	2.00
2020 Underlying Inflation	2.00	2.25	2.25	2.25
2019 Unemployment	5.00	5.00	5.00	5.25

Source: RBA

Event 3

Global debt as a percentage of GDP has increased by 50% over the last 20 years.



Debt is allocated to the 4 sectors of Government, Households, Non-financial Corporations, Financial Corporations (mainly banks, superannuation funds and insurers).

This raw data has many drawbacks, with two easily identifiable. First, looking at liabilities in isolation to assets produces an incomplete picture. Second, the aggregate debt involves some double-counting. Households have lent money to banks, who have lent money to Corporations and Government.

Despite the drawbacks in data many credible experts question whether the sustainability and robustness in the earnings component of economic growth is compromised by this growth. They have concluded that debt at a certain level is an inhibitor to an economy rather than having neutral impact or being an accelerator.

Is the global economy heading towards a "Minsky Moment"?

We do not profess to know, but we do recognise that the global economy is much more fragile than it was a year ago and that fragility is increasing.

There are no simple mechanisms for reducing the current sources of fragility and based on historic precedent the US Central Bank would need to reduce US interest rates down to minus 2.5% to combat a recession.

Baillie's conclusion is that Event 3 makes Capital Stability much more valuable but increasingly harder to achieve and maintain.

Event 4

Both political parties have declared policies that will lead to a fiscal surplus for the 4 year forward estimate period for Australian Government budgets. The estimate for 2018/2019 fiscal position of minus 0.8 % of GDP may be pessimistic. This puts Australia into a very strong position to continue its 27 Year period of non-recessionary economic experience. However, the per capita position paints a bleaker picture and the RBA's having to adjust its end of year inflation estimate by 0.5% in just over six months shows how cloudy rather than clear, the skies are.

Our fiscal position gives us a get out of Jail card and protects our exchange rate which in turn curbs inflationary pressures.

Event 5

Our February trade surplus was revised upwards to $5.140 billion and the first announcement of the March data shows a $4.949 billion surplus. This is $7.3 billion more than for the same two months a year ago.

This shows we can well afford all our imported trinkets without damaging our exchange rate and in fact we are exporting inflation.

Event 6

ASIC has stipulated to the Federal Court that ASIC has evidence of 261,987 cases of breaching responsible lending laws from 2011 to 2015 by one of the big "four" banks. Both the RBA and APRA are very aware that the current 7.25% default rate used for responsible lending analysis assessments has outlived its applicability and needs to be reduced.

Event 7

On 2 May, the US Federal Open Markets Committee kept the range of overnight rates unchanged at 2.25% to 2.5% despite the U3 unemployment rate shrinking to 3.6% and the U6 unemployment rate staying constant at 7.3%. The personal consumption expenditure measure of inflation in the US moved further down from the 2% target. This has been nominated as the causal element of why Jeremy Powell left interest rates unchanged.

Where to From Here

A 30 per cent decline in Aussie house prices combined with a 10 per cent drop in economic growth – simulating a recession similar to that experienced by the US during the global financial crisis (GFC) – would not be enough to force the banks' capital ratios down to regulatory minimums or convert bank hybrids into equity according to the International Monetary Fund's latest analysis.

It is very comforting that the IMF has re-enforced how strong our banking system is despite our banks sins.

We applaud the perspicacity of Dr Lowe who identified the issues unearthed by the Royal Commission of Banks was the fault of Bank Management not the Regulators.

We have confidence that the same insight will be applied to the $64 question for the Australian economy is: what will be the flow-through impact on consumer spending as a result of the fall in residential property prices? We are certain the Reserve Bank of Australia would love to know accurately what the possibilities or probabilities and plausibility's of this question are.

We assess the balance of probabilities being that inflation will shrink more than it would have done if the house price contraction impact hadn't occurred. The March quarter inflation data, the year to date and the change in the year to date data corroborate this.

We identified the negative of inflation in its capacity to cause a permanent loss of capital. Many self-interested parties believed that a little bit of inflation is healthy because it is a proxy for robustness of economic growth.

We see that the combination of globalisation, technology and demographics will cause continued disinflation and probable deflation leaving the advocates of the healthy view of inflation sorely disappointed.

As advised in Event 3, capital stability is more valuable than ever for the qualified readers of this Monitor. You need to appreciate that you have the choice of investing or not, so any Capital Stable Financial Repository underwrites the rationality of all of your financial decision making.

In turn, you need to identify what Liquid Capital Stable Options are available to you and what Non-Liquid Capital Stable Instruments are available to you.

For those that would like General Advice on the Baillie Sophisticated Savings Fund, the Baillie Incontestable Financing Fund and the Baillie SMSF Lending Fund, please contact our office.

