New York Securities Pty Ltd

Monthly Newsletter – October 2014

BEARISH RISING WEDGE BREAKS DOWN

The XJO S&P/ASX200 index halted its three year uptrend during the month, swiftly breaking through the bearish rising wedge pattern with increased volume. The decline has been lead by Bank and Commodity stocks, as institutions restructure portfolios and the fall in iron ore prices, amongst other commodities, continues to dampen confidence among the miners.

Historically October is a bad month for Stock Markets, as this is the month where three of the biggest stock market crashes have occurred, 1929, 1987 and 2008. The “lower range” index level we calculate below could come into play this month, a correction we welcome to alleviate the market dysfunction we have become accustomed to.

EXPECTED CHANGES IN INDEX LEVEL FOR OCTOBER

In the July newsletter we calculated the expected change in the XJO index over a one month period using the volatility level at the time. Using the same methodology, with a current volatility level of 15.32% and converting it to a one month period, we calculated a standard deviation for the month of 4.42%. Given the index level currently stands at 5313, the market expects the XJO index to range between:

Upper Range – XJO of 5548 index points (+4.42%)
Median Range – XJO of 5313 index points
Lower Range – XJO of 5078 index points (-4.42%)

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PREPARE YOURSELF AND TAKE ADVANTAGE OF THE PULL BACK

We have long discussed the divergence between price and value, the premium investors are placing to obtain higher yield, but the gap is now closing. If you have been holding off entering the Stock Market we believe October is likely to be the month to pull the trigger on that buy. In our August newsletter we issued a list of financial formulas that help in selecting a good investment, they were:

- EPS
- Return on Equity
- Return on Assets
- Payout Ratio
- Free Cash Flow
- Debt

Debt is always a silent killer and if you agree with our view that rates are set to rise from 2015, then it's important to avoid companies with too much debt on their books. A company with a debt level greater than 40% is generally worth avoiding, in our view. Also, be wary of companies playing down their debt position. FMG is a prime example; their debt to equity ratio stands above our preferred level of 67% and their net gearing level (current debt+ non-current debt – cash/shareholder equity) remains high, at 99%. We believe they are overly optimistic on the China story and consequently, the Iron Ore price. **Companies like this should be avoided**.

AUSTRALIAN HOUSEHOLD DEBT – ARE WE HEADED FOR A CONSUMER LEAD DEBT RECESSION?

Australia has a growing fondness towards debt and our deep rooted attraction to property is leading us toward a dangerous wave of financial hardship where, if certain trends continue, consumer spending will be materially impacted.

The Australian Bureau of Statistics released a report in May 2014 on the trends of household debt for the past 25 years and the trends are concerning. Property is a substantial contributing factor to the uptrend in household debt levels. As the median price of housing rises people take on larger mortgages, eroding a greater portion of disposable income. In theory, to ensure we live within our means, private consumption should fall but for the majority, personal lending products and credit cards maintain the lifestyle we believe we are entitled to. As a result we find ourselves entrenched in a life revolved around reducing the debt, reliant on **income** and **rising asset prices** **which are always at risk of disruption**.

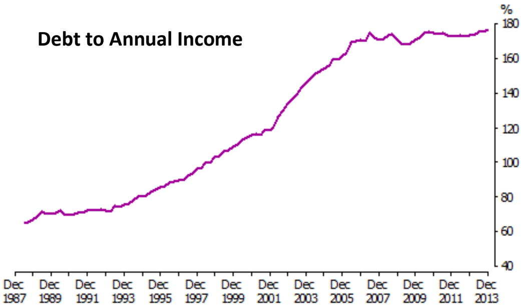
Cause for concern

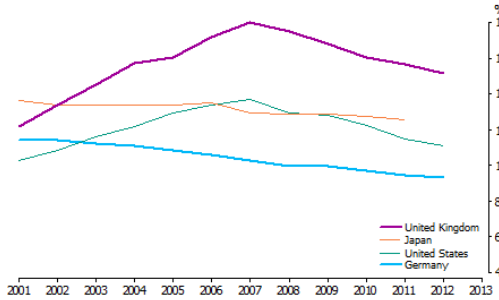
Our concern stems from three factors that are working against a household's ability to service that debt:

- **Debt to Income**
- **Cost of Living Vs Wage Growth**
- **Interest Rates**

Debt to Income

As at December 2013, household Debt-to-Income ratio reached 180% of disposable income (1.8 times income), the highest level this country has seen in 25 years. Growth in household debt between 2001 and mid 2007 increased at an average rate of 10%, year on year until the onset of the GFC. Since 2007 to 2013 the rate of growth has reduced to a modest 2%. It currently stands at $79,000 for every person living in Australia.



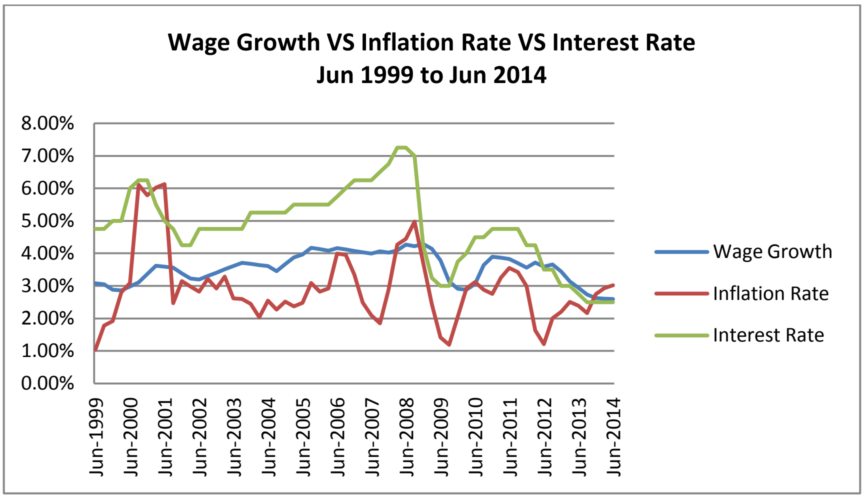


For comparison purposes (above) Debt to Income in the UK is 150%, 130% in Japan, 110% in US and 100% in Germany.

The concern we have with high debt to income ratios is simple; the more households borrow, the more sensitive they are to rising interest rates and the more reliant they are on their sole/joint incomes to service debt. Given we are seeing a moderation in the growth of debt to income, we believe it's an indication households are close to the upper limits of their borrowing capacity and with interest rates destined to rise as early as next year, a greater proportion of income will be required to service debt, leaving households with a lower disposable income to spend on everyday necessities.

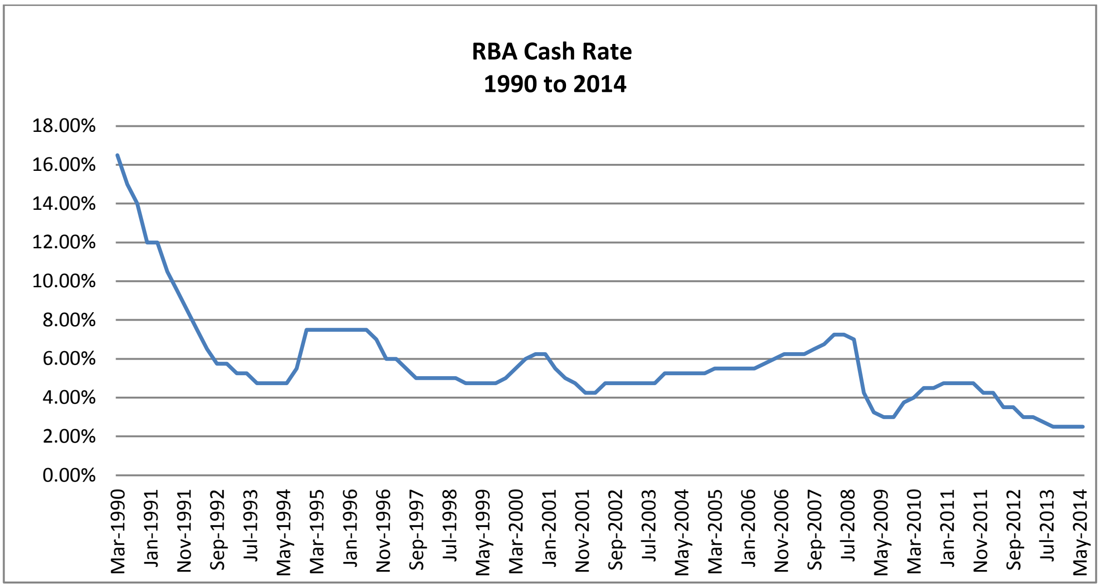
Cost of Living Vs Wage Growth

It's fair to say many Australian households do not prepare for disruptions in their household income. Common disruptions that can affect households include: loss of employment and sickness & death, but it's the macroeconomic factors that generally are not given much consideration. Australia's wage growth has, in most years outpaced the cost of living but this trend could be ending. As many companies reign in their spending and clean up their balance sheets, the pace of wage growth will likely continue to moderate. Growth in wages for the year to June 2014 recorded its lowest level in 16 years at 2.6% and with the inflation rate for the same period of 3%, we are now experiencing negative wage growth. The jury is out if this is the beginning of a new trend, time will tell, but as wages fail to keep up with the cost of living it will place additional pressure on households. Dun & Bradstreet, a credit information supplier, reported the second highest level of financial stress amongst Australian households in four and a half years and it's expected to rise, very concerning given we are at the lower end of the interest rate cycle.



Interest Rates

The RBA uses the cash rate in an attempt to adhere with its mandate of currency stability, targeted inflation rate (2-3%), full employment and sustainable growth in Australia. As threats to its mandate presented themselves post GFC in 2009, the RBA dropped the cash rate to an “emergency level” of 3%, the lowest level since 1961.



Today, the rate is no higher. As the RBA attempts to balance an economy of subdued GDP growth, subdued wage growth, an inflation rate sitting at 3% (the top of their target range) and a high Australian dollar, the rate remains below the “emergency level” at 2.5%. The concern we have is simple, these rates aren’t normal. We are clearly **at the bottom of the interest rate cycle** and it’s only a matter of time, most analysts agree by early 2015, before rates make their way towards normalized levels of around 5.75 % (prior 24 year average), placing additional pressure of what seems to be a highly indebted, rate sensitive consumer.

Australian households are experiencing a unique set of circumstances where the inflation rate now exceeds the cash rate and wage growth (as per the WGvsIRvsIR chart above). If rates do indeed rise at a good pace towards normalized levels, we can expect an increase in financial stress among householders and considering final household consumption expenditure (which excludes purchase of dwellings) contributes generally over 50% to Australia’s GDP, there is a strong case building that Australia is at risk of a **consumer lead debt recession**.

Performance of Key Indices

Equities	***Close***	***Change (M)***	***Change % (M)***
All Ordinaries	**5316.6**	**-308**	**-5.5%**
S&P/ASX200	**5625.9**	**-313.40**	**-5.6%**
Dow Jones (US)	**17113.15**	**+14.7**	**+0.1%**
NASDAQ	**4512.19**	**-68.1**	**-1.5%**
S&P500	**1982.85**	**-20.5**	**-1.0%**
FTSE 100 Index	**6649.39**	**-170.4**	**-2.5%**
Nikkei 225 (Japan)	**16229.86**	**+805.3**	**+5.2%**
10-year bond rate (US)	**2.5288%**	**+0.0018**	**+7.9%**

Upcoming RBA Events

Reserve Bank Board Meeting – 7th October
Minutes of the RBA meeting – 21st October

ABS releases March

Retail Trade (August) – 1st October
International Trade in Goods and Services (August) – 2nd October
Labour Force (September) – 9th October

Housing Finance (August) – 10th October
Lending Finance (August) – 13th October
Sales of New Motor Vehicles (September) -15th October
Consumer Price Index (September) – 22nd October

Upcoming US Economic Releases

ISM Manufacturing Index – 1st October
International Trade (August) – 3rd October
US Employment Situation (September) – 3rd October
FOMC Minutes (September) – 8th October
Retail Sales (September) – 15th October
Producer Price Index (September) – 15th October
Existing Home Sales (September) – 21st October
New Home Sales (September) – 24th October
Durable Goods Orders (September) – 28th October
GDP – 30th October
Jobless Claims – Weekly Basis