How to handle market declines

May 16, 2018

By: Capital Ideas Editorial Team

7 Ways to Fight Fear With Facts

You wouldn't be human if you didn't fear loss.

Nobel Prize-winning psychologist Daniel Kahneman demonstrated this with his loss-aversion theory, showing that people feel the pain of losing money more than they enjoy gains. As such, investors' natural instinct is to flee the market when it starts to plummet, just as greed prompts us to jump back in when stocks are skyrocketing. Both can have negative impacts.

But smart investing can overcome the power of emotion by focusing on relevant research, solid data and proven strategies. Here are seven principles that can help fight the urge to make emotional decisions in times of market turmoil.

1. Market declines are part of investing.

Stocks have risen steadily for nearly a decade. But history tells us that stock market declines are an inevitable part of investing. The good news is that corrections (defined as a 10% or more decline), bear markets (an extended 20% or more decline) and other challenging patches haven't lasted forever.

Market Downturns Happen Frequently and They Don't Last Forever
Dow Jones Industrial Average 1900-2017

	-5% or more	-10% or more	-15% or more	-20% or more
Average Frequency[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.75 years
Average Length[2]	46 days	115 days	216 days	338 days

[1] Assumes 50% recovery of lost value
[2] Measures market high to market low
The Dow Jones Industrial Average is an unmanaged, price-weighted average of 30 actively traded industrial and service-oriented blue chip stocks.

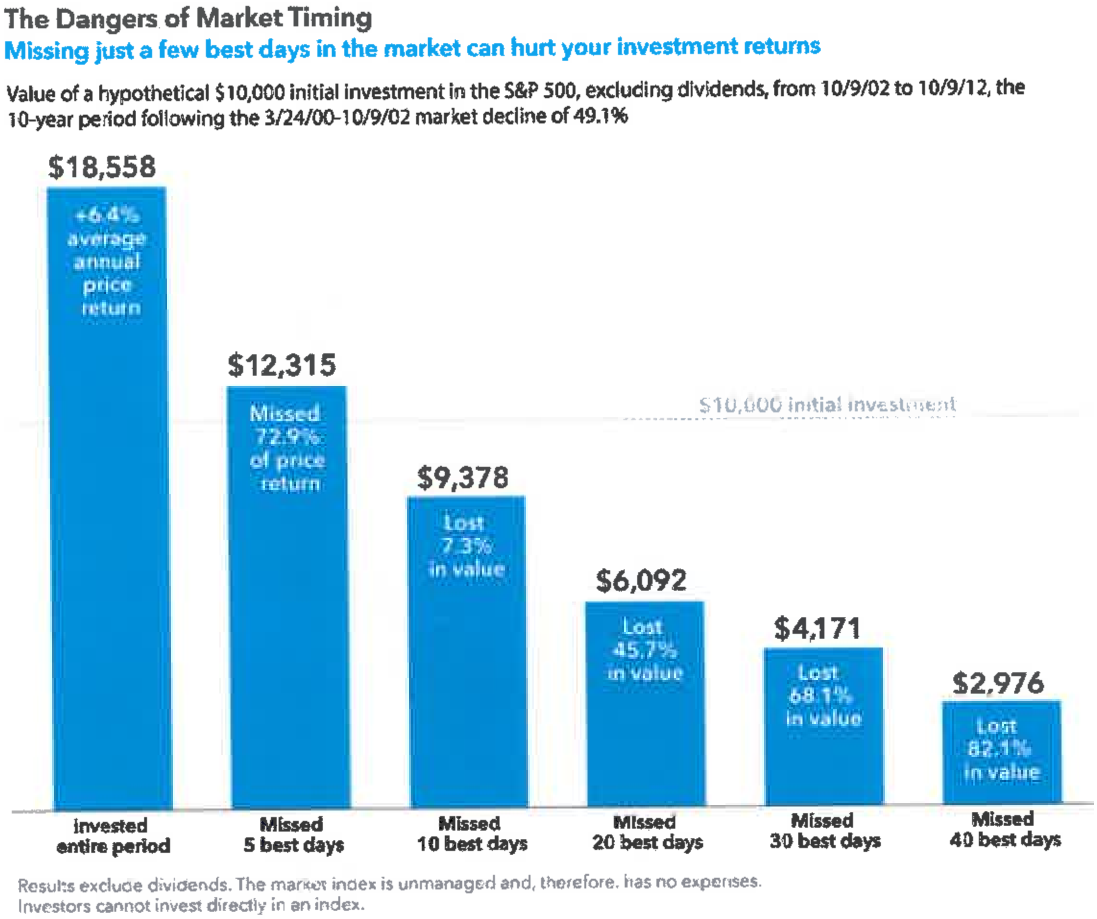
The Dow Jones Industrial Average has typically dipped at least 10% about once a year, and 20% or more about every 3.75 years, according to data from 1900 to 2017. While past results are not predictive of future results, each downturn has been followed by a recovery and a new market high.

2. Time in the market matters, not market timing.

No one can accurately predict short-term market moves, and investors who sit on the sidelines risk losing out on periods of meaningful price appreciation that follow market downturns.

Every Standard & Poor's 500 Index decline of 15% or more, from 1929 through 2017, has been followed by a recovery. The average return in the first year after each of these market declines was nearly 55%.

Even missing out on just a few trading days can take a toll. A hypothetical investment of $10,000 in the S&P 500 made in 2002 – the start of the recovery following the bursting of the technology bubble – would have grown to more than $18,000 by the end of 2012. But if an investor missed the 10 best trading days during that period, he or she would have ended up with just $9,378 – less than the initial investment.



3. Emotional investing can be hazardous.

Daniel Kahneman won his Nobel Prize in 2002 for his work in behavioral economics, a field that investigates how individuals make financial decisions. A key finding of behavioral economists is that people often act irrationally when making such choices.

Emotional reactions to market events are perfectly normal. Investors should expect to feel nervous when markets decline. But it's the actions taken during such periods that can mean the difference between investment success and shortfall.

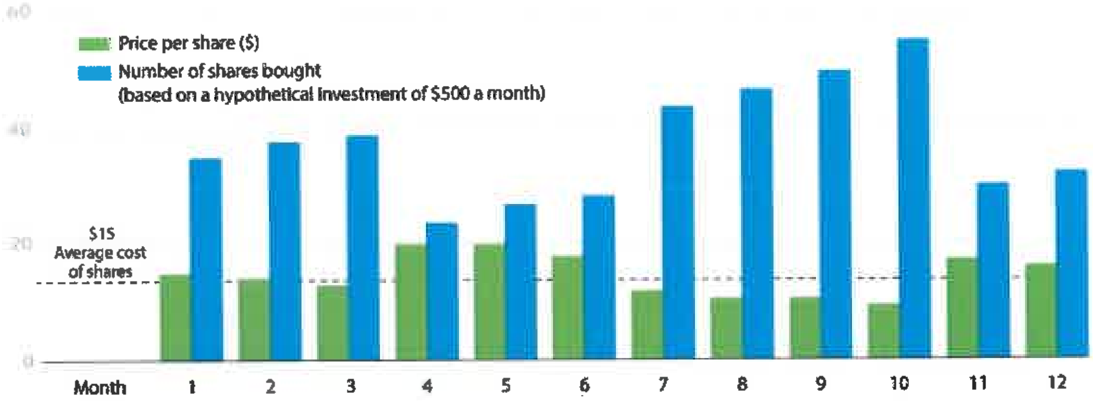
One way to encourage rational investment decision-making is to understand the fundamentals of behavioral economics. Understanding behaviors like anchoring, confirmation bias and availability bias may help investors identify potential mistakes before they make them.

4. Make a plan and stick to it.

Creating and adhering to a thoughtfully constructed investment plan is another way to avoid making short-sighted investment decisions – particularly when markets move lower. The plan should take into account a number of factors, including risk tolerance and short- and long-term goals.

One way to avoid futile attempts to time the market is with dollar cost averaging, where a fixed amount of money is invested at regular intervals, regardless of market ups and downs. This approach creates a strategy in which more shares are purchased at lower prices and fewer shares are purchased at higher prices. Over time investors pay less, on average, per share. Regular investing does not ensure a profit or protect against loss. Investors should consider their willingness to keep investing when share prices are declining.

When Stock Prices Fall, You Can Get More Shares for the Same Amount of Money and Lower Your Average Cost Per Share



Over the 12-month period, the total amount invested was $6,000, and the total number of shares purchased was 439.94. The average price at which the shares traded was $15, and the average cost of the shares was $13.64 ($6,000/439.94). The figures shown are for illustrative purposes only and in no way represent the actual results of a specific investment.

Retirement plans, to which investors make automatic contributions with every paycheck are a prime example of dollar cost averaging.

5. Diversification matters.

A diversified portfolio doesn't guarantee profits or provide assurances that investments won't decline in value, but it does lower risk. By spreading investments across a variety of asset classes, investors lower the probability of volatility in their portfolios. Overall returns won't reach the highest highs of any single investment – but they won't hit the lowest lows either.

For investors who want to avoid some of the stress of down markets, diversification can help lower volatility.

No Asset Class Has Consistently Offered the Best Returns Year In and Year Out

Calendar-year total returns of select asset classes (%)

Best performing assets

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
U.S. bonds 5.24	Emerging markets stocks 78.51	Global small company stocks 26.28	U.S. bonds 7.84	Emerging markets stocks 18.22	U.S. large company stocks 32.39	U.S. large company stocks 13.69	U.S. large company stocks 1.38	U.S. large company stocks 11.96	Emerging markets stocks 37.28
Global (ex U.S.) bonds 4.79	Global small company stocks 50.67	Emerging markets stocks 18.88	Global (ex U.S.) bonds 5.64	Global small company stocks 18.05	Global small company stocks 28.66	U.S. bonds 5.97	U.S. bonds 0.55	Global small company stocks 11.59	Global (ex U.S.) stocks 27.19
Cash 1.60	Global (ex U.S.) stocks 41.45	U.S. large company stocks 15.06	U.S. large company stocks 2.11	Global (ex U.S.) stocks 16.83	Global (ex U.S.) stocks 15.29	Global small company stocks 1.78	Cash 0.02	Emerging markets stocks 11.19	Global small company stocks 23.81
U.S. large company stocks -37.00	U.S. large company stocks 26.46	Global (ex U.S.) stocks 11.15	Cash 0.04	U.S. large company stocks 16.00	Cash 0.02	Global (ex U.S.) bonds 0.59	Global small company stocks -1.04	Global (ex U.S.) stocks 4.50	U.S. large company stocks 21.83
Global small company stocks -43.68	Global (ex U.S.) bonds 6.93	U.S. bonds 6.54	Global small company stocks -11.30	Global (ex U.S.) bonds 4.32	U.S. bonds -2.02	Cash 0.02	Global (ex U.S.) bonds -3.15	U.S. bonds 2.65	Global (ex U.S.) bonds 7.39
Global (ex U.S.) stocks -45.53	U.S. bonds 5.93	Global (ex U.S.) bonds 5.54	Global (ex U.S.) stocks -13.71	U.S. bonds 4.21	Global (ex U.S.) bonds -2.60	Emerging markets stocks -2.19	Global (ex U.S.) stocks -5.66	Global (ex U.S.) bonds 2.09	U.S. bonds 3.54
Emerging markets stocks -53.33	Cash 0.10	Cash 0.12	Emerging markets stocks -18.42	Cash 0.06	Emerging markets stocks -2.60	Global (ex U.S.) stocks -3.87	Emerging markets stocks -14.92	Cash 0.20	Cash 0.80

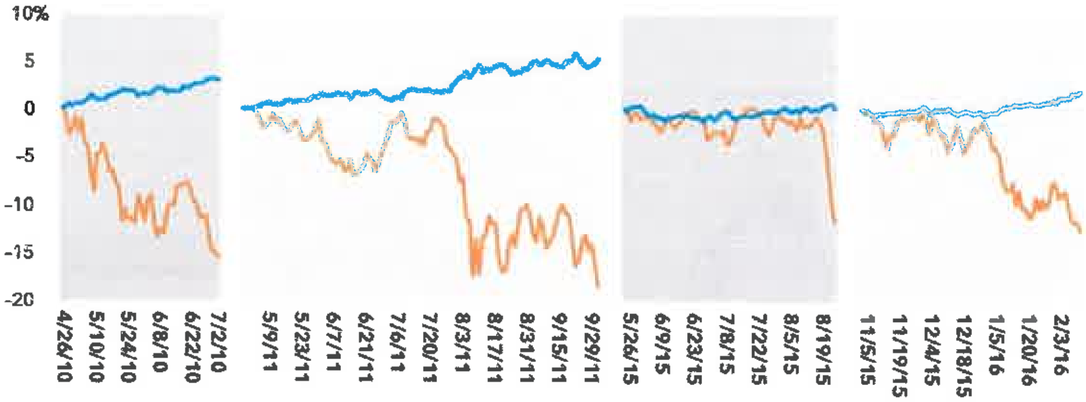
Worst performing assets

Sources: U.S. large-company stocks – Standard & Poor's 500 Composite index; Global small-company stocks – MSCI All Country World Small Cap Index (net dividends); Global (ex U.S.) stocks – MSCI All Country World ex USA Index (net dividends); Emerging market stocks – MSCI Emerging Markets Index (net dividends); U.S. bonds – Bloomberg Barclays U.S. Aggregate Index; Global (ex U.S.) bonds – Bloomberg Barclays Global Aggregate Index; Cash – 30-day U.S. Treasury bills, as calculated by Ibbotson Associates. Unlike fund shares, U.S. Treasury bills are guaranteed. Indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

6. Fixed income can help bring balance.

Stocks are important building blocks of a diversified portfolio, but bonds can provide an essential counterbalance. That's because bonds typically have low correlation to the stock market, meaning that they have tended to zig when the stock market zags.

Cumulative Returns During Recent Market Corrections



	Cumulative Total Return			
	Correction 4/23/10–7/2/10	Correction 4/29/11–10/3/11	Correction 5/21/15–8/25/15	Correction 11/3/15–2/11/16
S&P 500 Composite Index	-15.63%	-18.64%	-11.89%	-12.71%
Bloomberg Barclays U.S. Aggregate Index	3.00%	5.35%	0.04%	1.92%

Sources: Bloomberg Index Services Ltd., RIMES, Standard & Poor's. Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the unmanaged S&P 500 with 50% recovery between corrections.

What's more, bonds with a low equity correlation can offer protection from losses even when the broader market is in turmoil. Funds providing this diversification can help create durable portfolios, and investors should seek bond funds with strong track records of positive returns through a variety of markets.

Though bonds may not be able to match stocks' growth potential, they have often shown resilience in past equity market declines. For example, in four recent equity market corrections, U.S. core bonds were flat or notched gains as the S&P 500 declined.

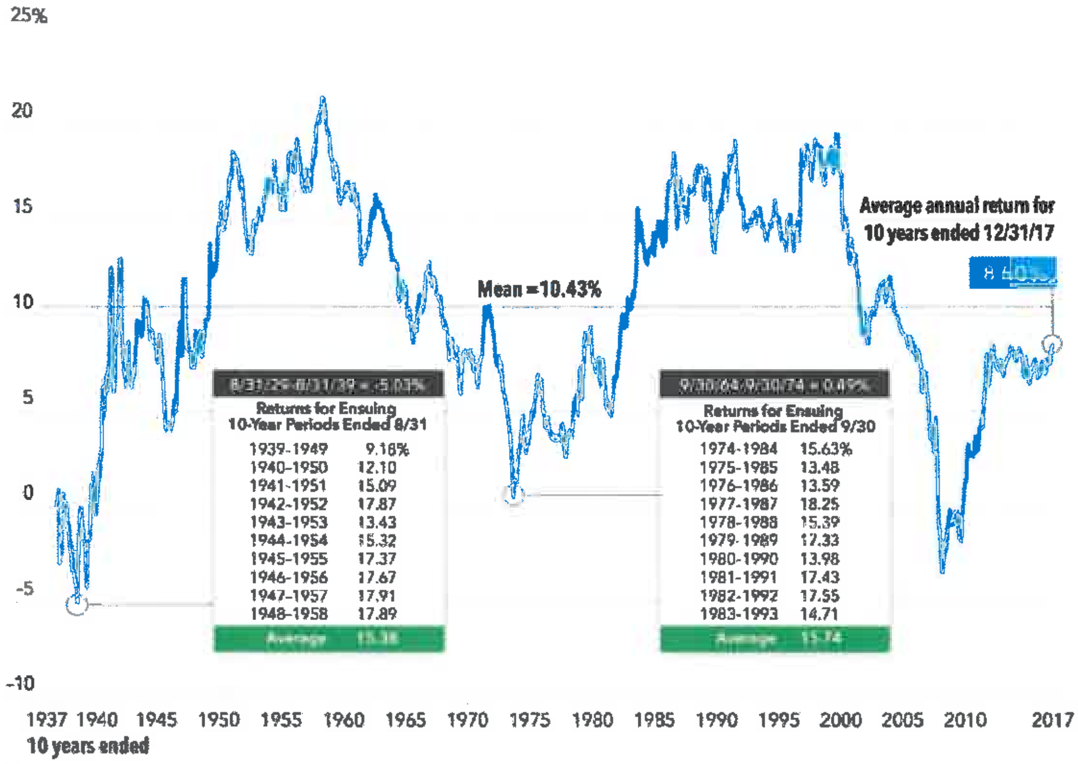
7. The market tends to reward long-term investors.

Is it reasonable to expect 30% returns every year? Of course not. And if stocks have moved lower in recent weeks, you shouldn't expect that to be the start of a long-term trend, either. Behavioral economics tells us recent events carry an outsized influence on our perceptions and decisions.

When stocks are falling, it's important to maintain a long-term perspective. Although stocks rise and fall in the short term, they've tended to reward investors over longer periods of time. Even including downturns, the S&P 500's mean return over all 10-year periods from 1937 to 2014 was 10.43%.

S&P 500 Rolling 10-Year Average Annual Total Returns

December 31, 1937 - December 31, 2017



Source: Capital Group

Results are calculated on a monthly basis. The index is unmanaged and, therefore, has no expenses. Investors cannot invest directly in an index. Past results are not predictive of results in future periods. The Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the results of 500 widely held common stocks. The S&P 500 Composite Index ("Index") is a product of S&P Dow Jones Indices LLC and/or its affi liates and has been licensed for use by Capital Group.

It's natural for emotions to bubble up during periods of market volatility. Those investors who can tune out the news are better positioned to plot out a wise investment strategy.

This article was initially published in the U.S. and refers largely to dollars and U.S. indices, however we believe that the principles apply across global markets

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We believe income is never 'out of style'

INVESTORS MUTUAL LTD

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When investing in shares it is easy to focus on short-term price fluctuations. Then again for long-term investors, the income stream from dividends is an important part of the total return, underpinning portfolio returns even when difficult market conditions are causing volatility in share prices.

Investing can be challenging for those investors seeking income. The traditional safe haven of cash products such as Term Deposits have delivered diminishing income over the past ten years and are now at records lows.

OUR FOCUS ON 'QUALITY' AND 'VALUE'

At IML, we invest for the long-haul, with a disciplined focus on quality and value. Through this, IML aims to deliver:

- a portfolio that is less volatile than the Australian sharemarket
- a sustainable tax effective income stream that grows over time
- and reasonable capital growth over time

...resulting in consistent outcomes for clients for almost 20 years.

CASE STUDY: IML APPROACH IN PRACTISE

A hypothetical investment of $100,000 in the Investors Mutual Australian Share Fund at inception in 1998 would have delivered an income of **$201,050** (pre-tax, and net of fees) over the **19 years**.

Importantly, investors have seen 'real' growth in their income stream whereby the yield has grown from **5.67%** p.a in 1999 to **17.68%** p.a. in 2017 on the initial $100,000 investment.

With the capital of your investment also appreciating to **$310,200** as at **30 June 2017**, this still represents a **yield of 6.07%** p.a on the current capital value.

Further to this, investors may benefit from imputation credits to enhance their final yield. The table below shows the impact of this investment strategy and the income from shares that has been delivered to investors.

Investors should be aware that the level of returns will vary and future returns may differ from past returns.

FY end	Yield (% pa)	Yield from initial investment	Income distribution	Taxable income distributions*	Capital value
30-Jun-98	-	-	-	-	$ 100,000
30-Jun-99	5.67%	5.67%	$ 5,670	$ 6,310	$ 132,020
30-Jun-00	4.51%	5.96%	$ 5,955	$ 7,628	$ 136,410
30-Jun-01	3.26%	4.45%	$ 4,452	$ 6,551	$ 160,160
30-Jun-02	2.61%	4.18%	$ 4,180	$ 5,887	$ 169,010
30-Jun-03	2.38%	4.02%	$ 4,021	$ 5,693	$ 169,140
30-Jun-04	4.52%	7.64%	$ 7,641	$ 9,740	$ 195,510
30-Jun-05	6.95%	13.58%	$ 13,578	$ 16,392	$ 220,910
30-Jun-06	8.61%	19.03%	$ 19,030	$ 22,459	$ 234,550
30-Jun-07	8.34%	19.55%	$ 19,550	$ 23,074	$ 277,360
30-Jun-08	4.36%	12.09%	$ 12,094	$ 15,784	$ 213,320
30-Jun-09	4.88%	10.40%	$ 10,404	$ 14,182	$ 179,840
30-Jun-10	4.46%	8.02%	$ 8,018	$ 11,081	$ 199,980
30-Jun-11	5.38%	10.76%	$ 10,756	$ 14,680	$ 214,260
30-Jun-12	4.71%	10.10%	$ 10,101	$ 14,270	$ 206,800
30-Jun-13	4.94%	10.21%	$ 10,214	$ 14,257	$ 252,610
30-Jun-14	6.59%	16.66%	$ 16,656	$ 20,401	$ 271,160
30-Jun-15	4.31%	11.68%	$ 11,679	$ 15,620	$ 286,470
30-Jun-16	3.27%	9.37%	$ 9,370	$ 12,890	$ 294,900
30-Jun-17	6.07%	17.68%	$ 17,684	$ 21,168	**$ 310,200**
Total			**$ 201,050**	**$258,066**	

"...It doesn't matter what rates are or where the market is, if you can buy a stock with a healthy, sustainable dividend yield, you're virtually more than halfway to achieving a good long-term return from the sharemarket..."

Anton Tagliaferro,
Investment Director
Investors Mutual

Source: IML, RBC, Factset. *Taxable income distribution is the available income to be distributed gross of Australian and foreign franking credits. It is important that investors seek professional taxation advice regarding the tax effectiveness of franking credits in relation to individual circumstances.

Is the US stock market in a bubble?

10 May 2018

By John Rekenthaler

John Rekenthaler is vice president of research for Morningstar, based in the US. He is a columnist for Morningstar.com and a member of Morningstar's investment research department. This is a financial news article to be used for non-commercial purposes and is not intended to provide financial advice of any kind.

No matter what reasonable valuation measure of US stock market valuation that one selects, it will show prices to be high. Major global technology stocks could be overpriced. But bubbles don't immediately pop. Sometimes they linger for several years. Justice does not always come swiftly.

One common valuation measure is forward-looking price/earnings (P/E) ratio. Morningstar calculates that figure by dividing 1) share price by 2) forecast earnings for the current financial year. These results can then be rolled up to give a stock market's aggregate figure.

The S&P 500's figure is currently 17. In spring 2017, it was just below 20. Three years back it was 18, and five years ago it was 14. Rather than describing a bubble, the forward P/E ratio appears to indicate "market as usual".

However, these forward P/E levels are not new. From the 2008 stock-market crash through 2015, forward P/E ratios were consistently lower than today's, but not that much lower, averaging about 14. Surely the difference between 17 and 14 does not constitute a bubble. What's more, the S&P 500's forward P/E ratio was 18 in 2003, and nobody calls that year a bubble, given that stocks were recovering from losses.

Forward P/E ratios are one way to judge stock prices. Other approaches could yield different conclusions. By selecting the measures that support bears' cases – as I did myself when choosing forward P/E ratios – you can raise concerns about current stock prices. But they would be hard-pressed to demonstrate a bubble.

Some tech companies may justify valuations

I don't see a bubble – certainly not with the overall US stock market. At a time when 10-year Treasuries pay 3 per cent and annual inflation hovers around 1 per cent and 3 per cent, stocks are not dear when compared with the alternatives. At some point, of course, the economy will turn; those P/E ratios will spike because earnings collapse; and stocks will get it hard. But the same could have been written in 2012, and 2013, and so forth. Without further evidence, why believe this year is different?

With global technology stocks, the bubble claims may be on firmer ground. It is indeed true that the leading companies must grow their businesses dramatically to justify their stock prices. Sometimes, such minor miracles occur.

For 15 years, sceptics argued that Apple's and Amazon.com's share prices have assumed unrealistically strong business fundamentals. So far, so wrong. Often, though, a glamorous company's business fundamentals don't match the expectations. Perhaps now is that moment for the giant tech leaders.

But the thing is, real bubbles aren't modified by the word "perhaps". In my 30 years at Morningstar, I have encountered only two true bubbles in the stock and bond markets: speculation that led to what I regarded as obviously inflated security prices, accompanied by what appeared to outsiders as a mob mentality among buyers. One was Japanese stocks in the 1980s; the other, US tech firms in the late 1990s. Even at the time, I felt that doom was inevitable.

Not so with today's leading tech companies. They are expensive, certainly. That said, those companies have real, dominant businesses. It is possible, if not necessarily probable, that their business growth will match the sky-high expectations and they will continue to outperform other stocks. Even if that doesn't happen, there is a good chance that their returns will be positive.

Many bubbles are proclaimed, but few arrive. The word is not useful; rather than signal something extraordinary, it has come to mean "securities I don't like because they strike me as being too expensive".

PERSPECTIVE

A wealth of demographic opportunities

The Fidelity Global Demographics Fund has significantly outperformed the benchmark since launch, delivering 19.42% per annum since inception, an active return of 2.51% above benchmark. It has displayed a consistent set of outcomes, including high active money, low beta/relative volatility and low turnover that would be expected from a portfolio that invests for the long term in slow moving but predictable mega trends.

Investing in certainties

At a time of macroeconomic and political uncertainty, demographics – the study of a population based on factors like age, income levels, employment, and education – standout in terms of their predictability. Unlike macroeconomic cycles and investor sentiment, we can predict with a much higher degree of confidence long-term changes in demographics. Demographics have a profound impact on companies. Consider population growth: the global population is over 7.5 billion, and by 2050 we will see another 2.2 billion added – mostly in India and Africa. By the end of the century 89% of the world population will live in what we today perceive as emerging markets.[1] Between 2015 and 2030, the number of people in the world aged 60 or over is projected to grow by 56%, with the number of older persons growing faster than any other age group.[2] The world middle class population stood at 3 billion in 2015, and is projected to rise to 5.4 billion by 2030.[3] The implications for businesses around the world are very significant.

However, while demographics are slow-moving, long in duration and highly predictable, investors for the most part remain short-term orientated, and overly influenced by cyclical factors. As behavioural economics has convincingly shown, humans are hardwired for short-term gains, even at the expense of greater long-term gains. It's the long-term earnings power of companies that are the ultimate drivers of their performance – as opposed to changes in valuation multiples, which tend to drive short-term (say, one month) valuation. Yet sell side analysts are for the most part entirely focused on short-term forecasts (2-3 year projections). Alpha generation is possible by taking a longer-term view of firms, but the market for the most part does not do this.

Performance as at 31 March 2018

	1 mth %	3 mths %	6 mths %	1 yr %	2 yrs % pa	3 yrs % pa	5 yrs % pa	Since inc. (30 Nov 2012)
Fidelity Global Demographics Fund	0.52	4.69	10.67	22.82	15.17	9.07	18.57	19.42
MSCI ACWI Index NR	-0.58	0.99	7.12	14.22	15.11	7.97	16.11	16.91
Active return	1.10	3.70	3.55	8.60	0.06	1.10	2.46	2.51

Source: Fidelity International. Data as at 31 March 2018. Total net returns represent past performance only. Past performance is not a reliable indicator of future performance. Returns of the Fund can be volatile and in some periods may be negative. The return of capital is not guaranteed. Benchmark: MSCI ACWI (All Country World Index) Index NR. NR: NR at the end of the benchmark name indicates the return is calculated including reinvesting net dividends. The dividend is reinvested after deduction of withholding tax, applying the withholding tax rate to non-resident individuals who do not benefit from double taxation treaties.

Fidelity INTERNATIONAL

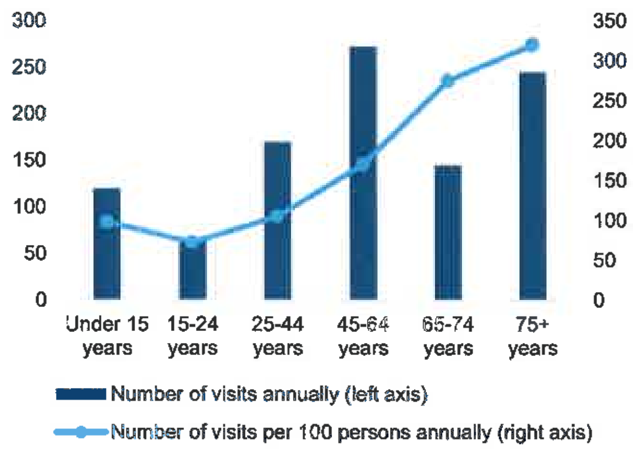
The fund invests in companies whose long-term earnings are driven by demographic factors. The three main factors are ageing populations, growing middle class ones in developing countries, and population growth in general. Within these three are sub-themes like urbanisation and industrial automation (subthemes of population growth). The three main themes are constant, but the sub-themes can change over time. The portfolio managers look for quality companies – as defined by things like superior earnings growth rates to the broader market and higher return on equity – and hold them for the long run; longer than most investors would do, so exploiting the short-termism of the market and the long-duration nature of demographic changes. Over time this emphasis on quality names with sound growth prospects and earnings visibility has delivered outperformance versus the fund's benchmark, as shown in the chart above.

Major theme: Ageing

An older population will have different consumption preferences and needs relative to a younger demographic. In addition, a higher proportion of elderly people are expected to be living on their own, and are therefore likely to require formal care; in the UK, the number of elderly with care needs is expected to rise by 60% in the next 20 years.[4] Ageing societies will have to devote more resources to health care, given an increasing prevalence of chronic diseases. Providers of implements and devices to cope with physical deterioration – hearing aid implant producers like Cochlear for example (a fund holding) – will see increasing business. More retirees will also mean more demand for certain leisure activities (holidays abroad for example).

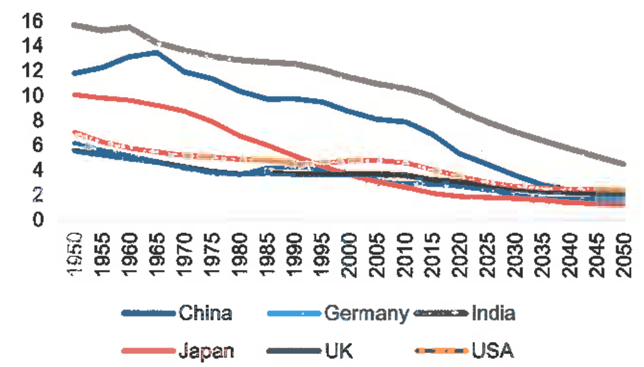
And although we tend to think of developed markets – Japan and Germany in particular – when it comes to examples of ageing societies, certain emerging markets – Russia, eastern Europe and China for example – are also ageing. China is at a demographic turning point; it's working population is shrinking rapidly, compared to the number of elderly/retired (aged 65+). It's demographic echo that of Japan, with a 25-year lag. Robotics and automation are a potential option to mitigate the challenge of this decline in workers.

Trips to the doctor rise rapidly as people age



Source: CDC National Ambulatory Medical Care Survey, 2014

Support ratio for select countries



Source: Berenberg Thematics, September 2017. The potential support ratio is calculated as the number of people age 20–64 per one older person aged 65 or older. This ratio describes the burden placed on the working population (unemployment and children are not considered in this measure) by the non-working elderly population

Managed care providers

An older population is one that will place increasing strain on health and social care services. Particularly in the US, where healthcare costs have been rising in real terms significantly, system costs will need to be controlled. The fund's holding in UnitedHealth Group – a combined managed care and healthcare solutions business – is a play on efforts to decrease utilisation and system costs, specifically via 'value-based pay' models that tie payment from insurers like UnitedHealth to health outcomes and treatment quality. Care providers contract with insurers via alternative payment vehicles that reward providers for improving quality, streamlining care and cutting costs, in contrast with traditional 'fee-for-service' insurance models that too often incentivise wasteful spending.

Alleviating the effects of bodily deterioration

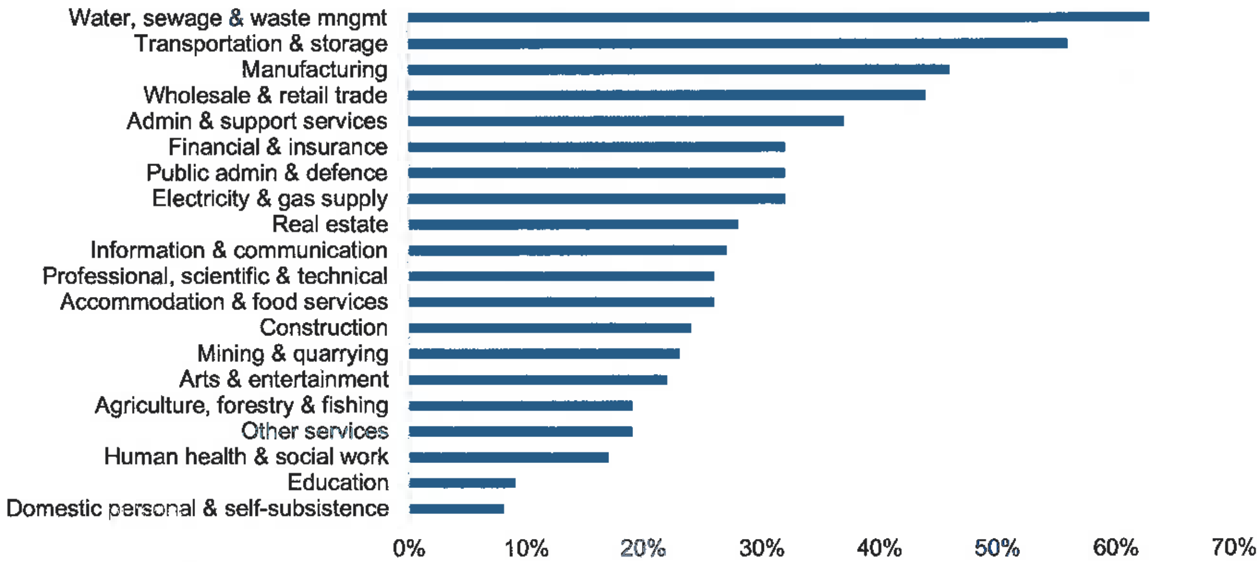
Spending on goods and services to alleviate body deterioration will increase, while therapeutics firms will face increasing demand for their products. The fund holds Boston Scientific and Abbott Laboratories, which have strong positions in cardio and vascular care. Boston Scientific benefits from differentiated new product launches in fast growing MedTech markets, and continued margin progression. Despite manufacturing issues relating to its lotus heart valve product last year, the stock still has significant upside even if the product is not launched. Abbott is a diversified medical products business, with a strong foothold in emerging markets (which account for around 40% of the company's sales). The company remains well positioned in the medium term, with a diversified and well-established set of products in the diagnostics, nutrition, generic medicine and medical devices sectors. In the anti-ageing space, L'Oréal is best-in-class for personal care products, with a strong presence in emerging markets. Its products should be in increasing demand because of ageing populations (think anti-ageing creams, for instance).

Automation

Partly because of necessity (ageing populations), and technological progress (big data and the Internet of Things being two of the most important), factories are becoming increasingly automated. 'Industrial Revolution 4.0' marks the era of connected factories with accelerated use of robots, connected machines, artificial intelligence in maintenance, monitoring and design as well as automated design process. With the growing hunger for new growth drivers, the manufacturing industry is welcoming the wave of automation and robotics with open arms. Technology is at the centre of everything and industrial IoT has the potential to have a meaningful impact on some of the key drivers of the sector, which, in turn, is making it relatively less cyclical in nature.

Dassault Systèmes is the global leader in computer-aided design (CAD), manufacturing (CAM) and product lifecycle management (PLM). It is well placed to benefit from the trend towards factory automation as well as to harness insights from IoT data. The company makes money from selling its software to companies primarily in the aerospace and transportation industries, although it is also entering new areas such as consumer packaged goods and pharmaceuticals. Its core CAD and PLM markets are forecast to grow annually at 5% and 10% respectively,[5] while its key automotive market is forecast to require increasing customisation. Dassault's forays into new industries and high growth countries – with emerging market producers needing to invest heavily in modern production to compete with developed market firms – are all strong drivers of future growth.

Percentage of UK jobs at elevated risk of automation by 2030s by sector



Source: PwC analysis of PIAAC data, March 2017

Japanese firm Keyence is another company that is meeting demand for automation. It sells equipment such as factory automation sensors, and provides direct sales solutions – meaning it builds relations with clients, and help them troubleshoot any post-installation problems. This post-installation trouble shooting makes it standout versus peers. Half of the business consists of new production lines, and the other half replacements. It is likely to continue delivering double-digit sales growth on a constant currency basis, driven by growth in emerging markets and by penetration in new developed market industries.

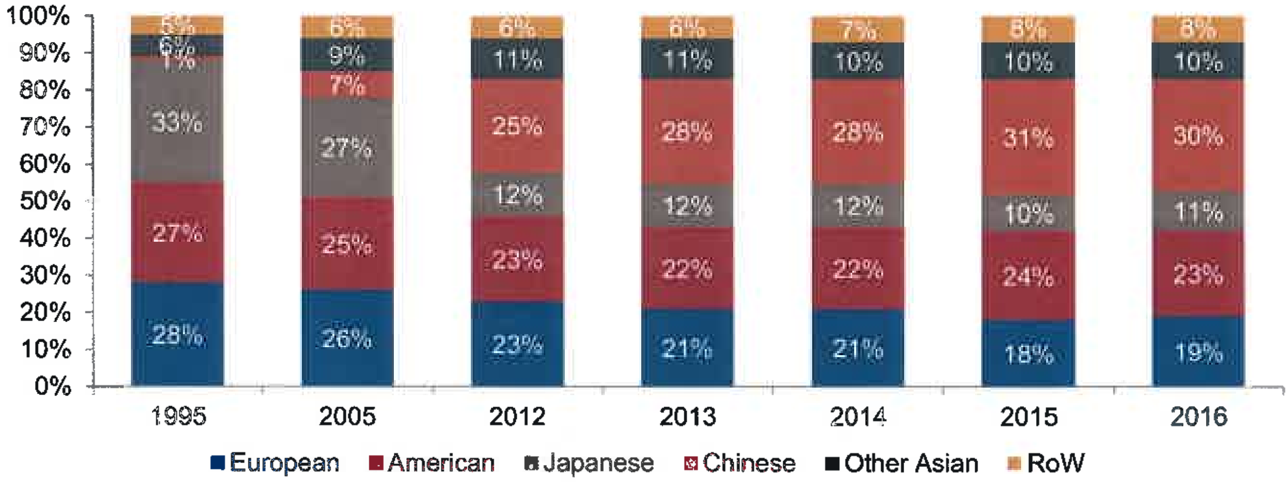
Major theme: Growth of the middle class in emerging markets

While the absolute level of spending in emerging markets continues to grow, the mix is shifting away from staples and towards discretionary items, as the overall wealth of these populations grows and the middle class expands. The growth of the emerging market middle class is expected to have significant economic and demographic effects – such as an increasing demand for discretionary goods in developing countries and entertainment spending, increasing e-commerce, and greater numbers travelling. In addition, we should see greater penetration of financial services into emerging markets, while the increasing prevalence of westernised diets and (sedentary) lifestyles is leading to rising levels of obesity and associated chronic conditions. Wealthier populations will also have more money to spend on health care.

Greater discretionary spending

French luxury goods conglomerate LVMH exemplifies the kind of company that can benefit from increasing discretionary spending in emerging markets. Increasing wealth in developing countries is leading to greater spending on western luxury brands – with European discretionary names significant beneficiaries. LVMH has had success in China, although the government's anti-corruption drive earlier this decade hurt the stock. LVMH has a balanced brand portfolio, with good exposure to relatively defensive categories such as leather goods, spirits and cosmetics, coupled with a strong management team. It is less cyclical than its luxury peers, with a very strong balance sheet and consistently high cash conversion. In the e-commerce space, the fund has a position in Chinese e-commerce company Alibaba, which is very well placed to gain from growth in China's middle class. It is the largest e-commerce and cloud provider in China – with a superior business model to rivals. It is also branching out into many new ventures, such as marketing services and logistics.

Globalisation of consumption patterns: Luxury goods market by nationality



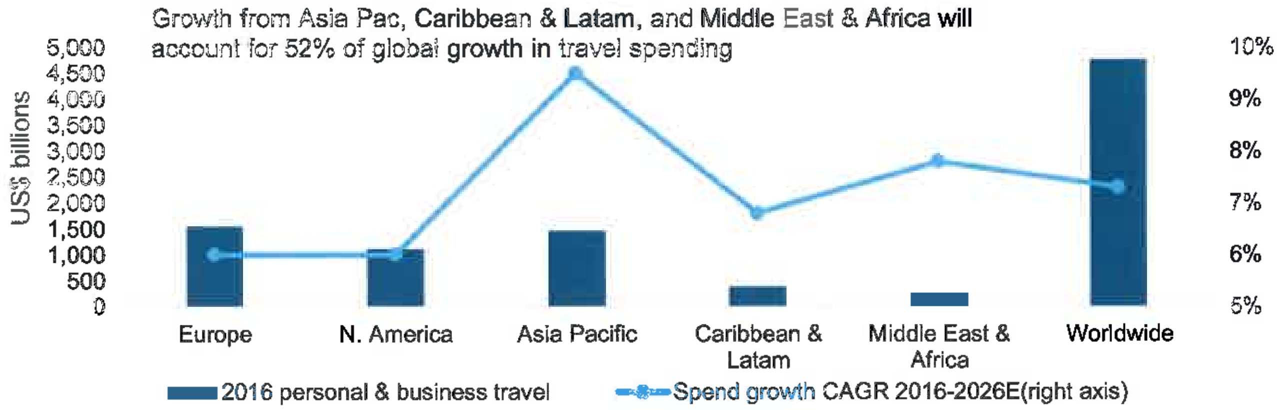
Source: Morgan Stanley, Bain & Co, September 2017

Another company worth mentioning in the context of emerging market discretionary spending is PVR. It is the largest multiplex operator in India, operating more than 550 screens.[6] PVR also has a small movie distribution subsidiary and owns some bowling alleys. The company has a long growth runway – there is huge under-penetration in this market, with five multiplex screens per million of the Indian urban population, rising income levels, strong appetite for movies and lack of other outdoor entertainment options. High entry barriers in the form of supply-side constraints provide a strong advantage to incumbents, making PVR a good long-term earnings compounder. Its strong presence in top cities and prime locations drive higher footfalls and superior metrics versus peers.

Increased levels of travel

Rising levels of wealth will also mean people will have more money to spend on travel, with airlines and airports benefitting – along with associated ventures; greater duty-free spending at airports should be another boost for luxury brands. Chinese retail and tourism is a structural growth market, owing to greater levels of disposable income, and greater availability and propensity to take holidays. The country is seeing secular growth in aeronautical traffic volume, along with government import tax cuts and trade initiatives to benefit duty free stores and luxury importers. Shanghai International Airport is one portfolio example. It could expand capacity to around 80 million passengers a year by 2020, and should see a 20% increase in retail space because of its Terminal 1 renovation.[7] Airbus is a fund holding that offers exposure to global air traffic growth, of which emerging markets are the biggest driver; more than 40% of traffic volumes involve either intra-emerging market flights or developed-to-emerging market flights.[8]

Growing travel spending



Source: Marriott International, October 2017

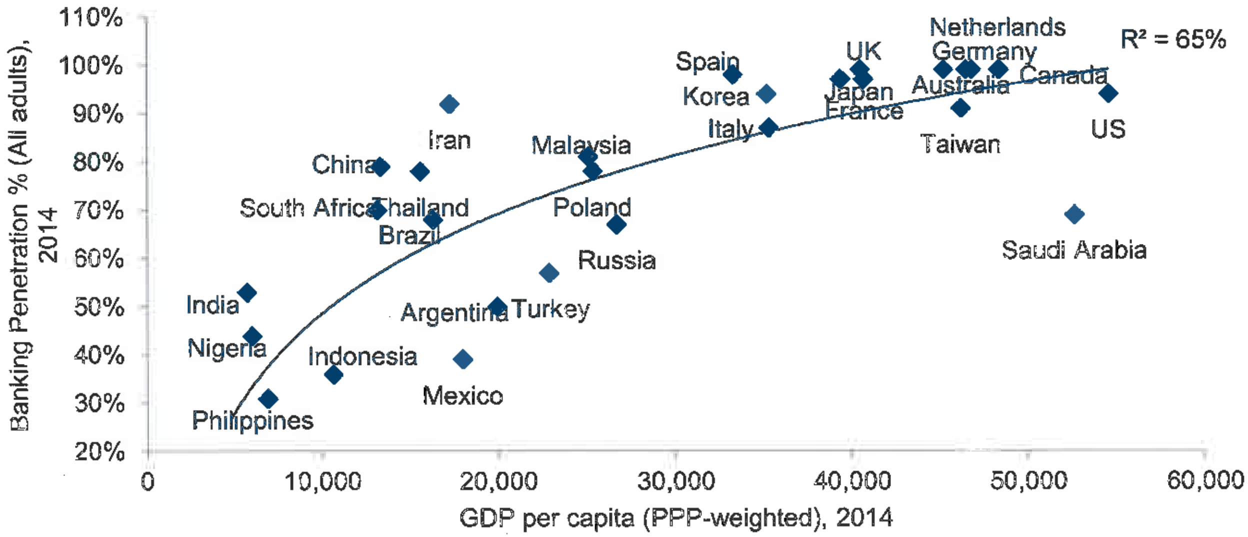
Electric vehicle penetration

Within the travel theme, the fund also has an opportunity to profit from electric vehicle (EV) penetration – particularly in China. Pollution in China's big cities – driven in the main by vehicle exhaust fumes – has encouraged the government to push electric vehicle adoption. Chinese auto manufacturers produced 680,000 all electric cars, buses and trucks last year; more than the rest of the world combined.[9] Mass development of public charging points on top of the significant investment private owners have made in charging points continues. Fund holding Infineon Technologies offers exposure to this structural growth in EV demand, as it is a semiconductor company has a leading position in power semiconductors and radar sensors, which are essential EV components in. EV production also requires significant amounts of copper; fund's holdings Grupo Mexico and First Quantum Minerals are both copper miners that are well placed to benefit from this demand.

Financial penetration

The proportion of the population with bank accounts is low in many developing countries, though varies across market. The USA has 32.9 banks per 100,000 adults; the comparable figures for China and India are just 8.4 and 13.5.[10] There are significant opportunities for good banks to grow in these relatively underserved markets. HDFC Bank in India is one of the fund's top active holdings. It is one of the country's largest banks, and has a very strong growth record and yet consistently maintained asset quality across cycles. Its future growth opportunity is immense, given expected increases in credit penetration in India, twinned with the country's population growth and growing middle class.

Financial services penetration remains low in emerging markets



Source: Fidelity International, Banking penetration data from International Monetary Fund (IMF) - April 2017, GDP data from World Bank – The Global FINDEX Database 2014 published in April 2015

Obesity / lifestyle diseases

Rising levels of obesity and associated medical conditions are a downside to rising global prosperity and the expansion of the middle class in developing nations. Greater wealth and modern technologies are leading to far less physically-demanding lifestyles. In 1969 for example, 40% of schoolchildren in the US rode their bicycles to school, but by 2001 only 13% did so.[11] Obesity is a major driver of lifestyle diseases such as cardiovascular ones and type 2 diabetes; one in 12 adults globally has type 2 diabetes.[12] Novo-Nordisk is a fund holding, and the global leader in diabetes treatment, with best in class GLP-1 drugs franchise and strong positioning in the insulin space. Near term pressure led to some earnings downgrades last year, but the combination of sales of its new second generation GPL-1 drug semaglutide, operational leverage and share buybacks should lead to healthy rates of compounding growth.[13]

Rising health care spending in emerging markets

Aside from the impact of ageing populations around the world, growing wealth in emerging markets will mean more spending in these countries on health care. Spending on speciality pharmaceuticals in emerging markets should reach US$43 billion this year – up from US$23 billion in 2012.[14] Companies which should benefit include US firm Abbott Laboratories – a diversified medical products business, with a strong foothold in emerging markets (which account for around 40%[15] of the company's sales). It is well positioned in the medium term, with a diversified and well-established set of products in the diagnostics, nutrition, generic medicine and medical devices sectors. A combination of new product launches and deal synergies from its acquisition of St Jude should prove supportive going forward.

The buildout of health infrastructure in emerging markets should also encourage greater spending on insurance. Companies like AIA are likely beneficiaries. It is an independent, pan-Asian life insurer, with operations in 17 markets in ASEAN. AIA is a long-term compounder, and beneficiary of the region's favourable demographics and rising life insurance penetration (from a low base), with a strong competitive position. Penetration into mainland China is a key growth driver for the company.

Major theme: Population growth

Global population growth is expected to support a rise in consumption. Resources such as water, arable land and energy will be in high demand where industrialisation and urbanisation take place. Certain countries, notably African ones, are projected to experience continuing dramatic population growth – with the UN predicting that Nigeria's population could surpass that of the US by 2050.[16] This is creating many opportunities – but particularly as relates to agriculture, and urbanisation / industrialisation.

Agricultural challenges

The food supply needs to increase by 70-100% to meet the increase in global population by 2050.[17] This comes at a time of multiple challenges to the food industry, including booming demand for proteins, a reduction in arable land due to urbanisation, increased chemical resistance to pesticides and herbicides due to overuse of agri-chemicals, yield increases plateauing in the main crop producing regions, and restricted availability of fresh water – farming accounts for 70% of withdrawals from rivers, lakes and aquifers.[18]

Related to this, Ecolab is a fund holding that is provides water sanitisation and energy-efficiency optimising products. Approximately 90% of the firm's revenues come from recurring product sales with high gross margins and low capital intensity. Its competitive advantages include scale (it is the largest player in a fragmented market), great management, strong R&D capability (allowing for innovative new products), and unmatched sales force (providing unparalleled customer service). Zoetis is a fund holding that offers exposure to agriculture as theme; it is the world's largest global animal health company, active in medicines and vaccines for livestock and pets. It's production animal health business is a durable one, protected by increasing population growth and increased affluence leading to greater meat consumption.

Urbanisation

Urbanisation continues apace: it is predicted that by 2050, more than 70% of the world will be urbanised, in comparison with 50% today.[19] Lock maker ASSA ABLOY is a business that should benefit from urbanisation. It is a global market leader in security – mechanical locks and security doors – and entrance automation. It is an attractive, low capital intensity, high return and long-term growth business. Although core revenues are geared to cyclical construction trends, it can support this with pricing power, emerging market growth due to increasing security penetration, and the structural shift towards electro-mechanical locks which offer higher ASPs, shorter replacement cycles, greater barriers to entry and attractive service/aftermarket opportunities.

Conclusion

The fund invests in companies whose long-term earnings are driven by demographic factors. These include our three main themes, as well as additional sub-themes. The portfolio managers look for quality companies – as defined by things like superior earnings growth rates to the broader market and higher return on equity – and hold them for the long run; longer than most investors would do, so exploiting the short-termism of the market. The fund has high active money and low turnover. Over time this emphasis on holding quality names with sound underlying growth prospects should deliver superior returns compared with the fund's index, MSCI AC World.

Footnotes

1. UN Department of Social Affairs, Population Division, data accessed, April 2017
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4. https://www.kingsfund.org.uk/time-to-think-differently/trends/demography/ageing-population
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FINANCIAL STANDARD

Economics

Chief economist update: A$ falls to the occasion

BY BENJAMIN ONG | WEDNESDAY, 2 MAY 2018 10:28AM

"My fellow Australians, ask not what your country can do for the Australian dollar, ask what the Australian dollar can do for your country."

That's me bastardising John F. Kennedy's inaugural address as the 35th US President back in 1961 (before I was born if I may add).

For sure and for certain, Australia - the country - can do many a thing to set the A$'s value...but that's if we're living pre-12 December 1983, the days before the Australian currency was allowed to float and left to the whims of market speculations and fluctuations.

"A$ down!" is again making the news as I type. My spreadsheet shows that, in the first four months of 2018, our legal tender is tendering less against all major currencies: down 3.5% against the US$; down 4.1% on the euro; down 6.3% against the yen; down 5.2% versus the pound; down 6% vis-a-vis the renminbi; and, down 4.3% on the trade weighted index.

The Australian dollar's depreciation is broad-based so don't you ever tell me that it's a US-dollar story. It's also not a commodity price story. The S&P GSCI commodity price index is up 7.5% in the first four months of 2018.

According to the *Australian Financial Review* (AFR), Global FX Capital's Greg Gibbs typed in his morning note that the A$ "faces headwinds from protectionist trade policies, tightening Chinese financial sector oversight, a weaker housing market, rising bank funding costs, pressure on its financial sector from a Royal Commission into its misconduct, and political uncertainty."

I couldn't have said it any better myself. For sure and for certain, these "headwinds" can blow stronger and take the A$ down some more. If so, thank you very much!

While the European Central Bank and the Bank of Japan struggle to keep their respective currency's exchange rate low, the market is doing it for Australia sans a single bullet shot - a cut in in interest rates or QE - to get the same result.

Only yesterday, when the Reserve Bank of Australia (RBA) met and decided to keep the official cash rate unchanged at 1.5%, it noted in its statement that: "An appreciating exchange rate would be expected to result in a slower pick-up in economic activity and inflation than currently forecast."

Ipso facto, the opposite is true: A de-preciating exchange rate would be expected to result in a faster pick-up in economic activity and inflation than currently forecast.

A depreciating A$ would make foreign goods and services more expensive - encouraging Australians, all, to buy local instead - and overseas holidays more costly - prompting staycations.

On the flipside, a cheaper A$ makes Australian exports more competitive and overseas company earnings higher when translated back into the local currency.

The floating A$ is again doing what it does best, "falling" to the occasion in times of uncertainty to keep the Australian economy afloat.

The A$/US$ sank from US$0.80 to below US$0.60 during the Asian financial crisis; it fell from around US$0.65 to US$0.49 during the US recession in 2001 and following the September 11 attacks of the same year; and, it dropped from US$0.91 to US$0.62 at the onset of the GFC.

Ben Ong is the Director of Economics and Investments at Rainmaker Group. He previously worked as a fund manager, economist, asset allocation strategist, portfolio analyst and stock market analyst. Check out his economics analysis here.

This page was found at: **http://www.financialstandard.com.au/news/a-falls-to-the-occasion-116104381**

Printed: **Wednesday, 2 May 2018 3:10pm**

Sydney and Melbourne house prices could fall as much as 4 per cent, says SQM

"It should be noted that on a nominal aggregate incomes to dwelling prices measure, the Sydney market is approximately 45 per cent overvalued," SQM said. **Arsineh Houspian**

by Su-Lin Tan

The days of double digit growth in house prices for Sydney and Melbourne are over as the two big cities head for a house price tumble, new forecast from SQM Research confirms.

Property research group SQM Research, led by Louis Christopher who has successfully forecast house prices, has revised its prediction that Sydney prices will fall as much as 4 per cent in 2018. The best case scenario is a flat zero growth in prices for Sydney home owners.

The group's previous prediction for Sydney made in its *Housing Boom and Bust* report last October was a 4 to 8 per cent rise in prices for the full year.

SQM also says Melbourne's house prices are expected to fall as much as 3 per cent for the year, with a 1 per cent growth in prices at best. This was revised from an earlier forecast of a 7 to 12 per cent growth.

Revised dwelling price movements for 2018

	Estimated dwelling price changes Jan1 to Apr30, 2018 (%)	Old forecast, Oct, 2017 (%)	Revised forecast, 2018 (%)	Revised direction
Perth	-0.3	+1 to +4	+1 to +4	Unchanged
Brisbane	+0.1	+3 to +7	0 to +3	Downgrade
Darwin	-3.0	+1 to +4	-5 to 0	Downgrade
Melbourne	-0.5	+7 to +12	-3 to +1	Downgrade
Sydney	-1.8	+4 to +8	-4 to 0	Downgrade
Adelaide	Unchanged	0 to +4	0 to +4	Unchanged
Hobart	+3.0	+8 to +13	+8 to +13	Unchanged
Canberra	+1.0	+5 to +9	+1 to +4	Downgrade
Capital city avg*	-0.7	+4 to +8	-2 to +2	Downgrade

* Weighted

SOURCE: SQM RESEARCH

Brisbane and Canberra also had expectations of prices rises downgraded.

Canberra price movements will land somewhere between 1 and 4 per cent, from previous predictions of 5 to 9 per cent, and Brisbane has been downgraded to 0 to 3 per cent from 3 to 7 per cent.

The culmination of deteriorating auction clearance rates in recent weeks, more listings with falling asking prices and worsening numbers of the days on market for properties trading outside of auctions, suggest Australia's overvalued markets are headed for an "unwinding".

"Leading indicators such as auction clearance rates, total aggreggated property listings and asking prices suggest further deterioration in market conditions in recent weeks," SQM said.

'Markets are 45 per cent overvalued'

"It should be noted that on a nominal aggregate incomes to dwelling prices measure, the Sydney market is approximately 45 per cent overvalued. SQM Research expects this over valuation to wind down somewhat over an extended period of time."

SQM is of the view that APRA's move to lift the brakes on investment lending growth will not rouse up new investor interest, given the softening conditions.

Macroprudential policies to curb house price inflation had worked on the national housing market, but a crash was not imminent, SQM said.

"The evidence now suggests that action to reduce borrowing risks is now affecting the national housing market as a whole," SQM said. "This action, predominantly targeted at property investors, has triggered a decline in demand for residential property.

"However it is stressed that SQM Research does not expect a general housing price crash to occur this year. The conditions required to create such a downturn are not in the housing market at present.

"If there is a more pronounced downturn, SQM Research believes that monetary authorities as well as federal and state governments may intervene to stabilise the market."

Low unemployment and population growth will put a floor on prices "crashing", SQM added.

SQM's forecasts assumes APRA does act further in 2018 and the cash rate remains unchanged.

But the impending fall in prices may not strip the "45 per cent" overvaluation at the same pace as it has risen, other experts say.

Capital Economics' Paul Dales says by late 2021, prices for the combined capital cities will only be about 10 per cent below their peak.

In a note two weeks ago, using a new ratio, "sales to new listings", Mr Dales said house prices were likely to fall in the next 6 months Sydney and Melbourne bearing the brunt of the fall.

"While prices may only edge lower this year and next, higher interest rates will probably mean they fall more sharply in 2020 and 2021. Units look much more vulnerable than single-dwellings, while Melbourne appears to be the most exposed of the eight capital cities," Mr Dales said in his last note two weeks ago," he said.

In 2018, he predicts apartment prices will fall faster than detached houses, as much as 4 per cent in Sydney, 7 per cent in Brisbane and 8 per cent in Melbourne.

The fallout from the banking Royal Commission could also lead to tighter credit conditions and along with impending interest rate rises, put more downward pressure on house prices.

"The risk is that the resulting weakening in demand relative to supply causes prices to fall faster in 2020 and 2021," Mr Dales said.

These forecasts may come as relief to potential home owners but not enough to solve housing affordability quickly.

Ahead of the Federal Budget release on Tuesday, community groups such as "Everybody's Home" are calling for more changes to ease high house prices including winding back capital gains tax and increasing the Commonwealth Rent Assistance to struggling renters.

Fidelity's Paul Taylor is watching for two triggers to spark house price falls

House prices are one of the biggest risks to the Australian economy, Fidelity's Paul Taylor says. **Glenn Hunt**

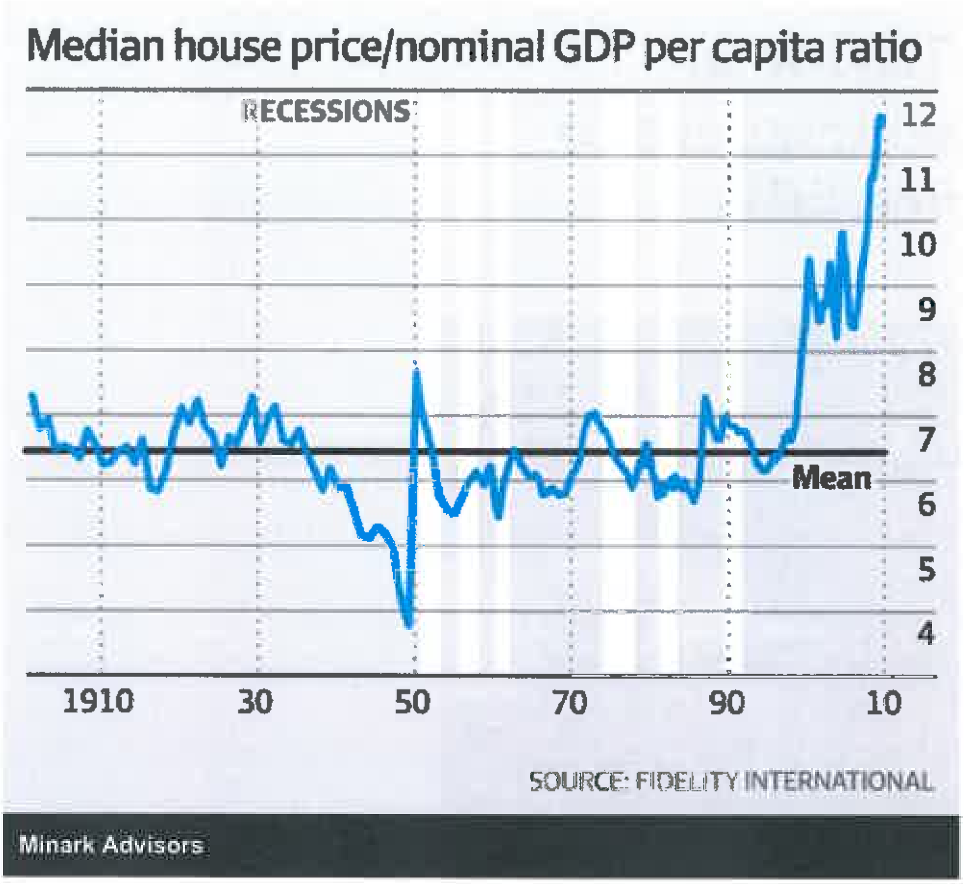
by **Sarah Turner**

Fidelity International says the Australian housing market appears overvalued on three key measures and is a risk for investors, with unemployment and rising interest rates the potential triggers for a correction.

Paul Taylor, the highly rated manager of Fidelity's Australian Equities Fund, said there were two questions investors needed to ask about the housing market – is it fundamentally overvalued and what catalyst would shine a spotlight on that overvaluation and create a market reaction?

He pointed to the global financial crisis in 2007-08 when a liquidity crunch provided the trigger for sharp house price falls in the US and elsewhere. "It was the catalyst," he said.

Mr Taylor evaluated the market on the basis of median house prices compared to gross domestic product per capita – or house prices within a broader economic context.



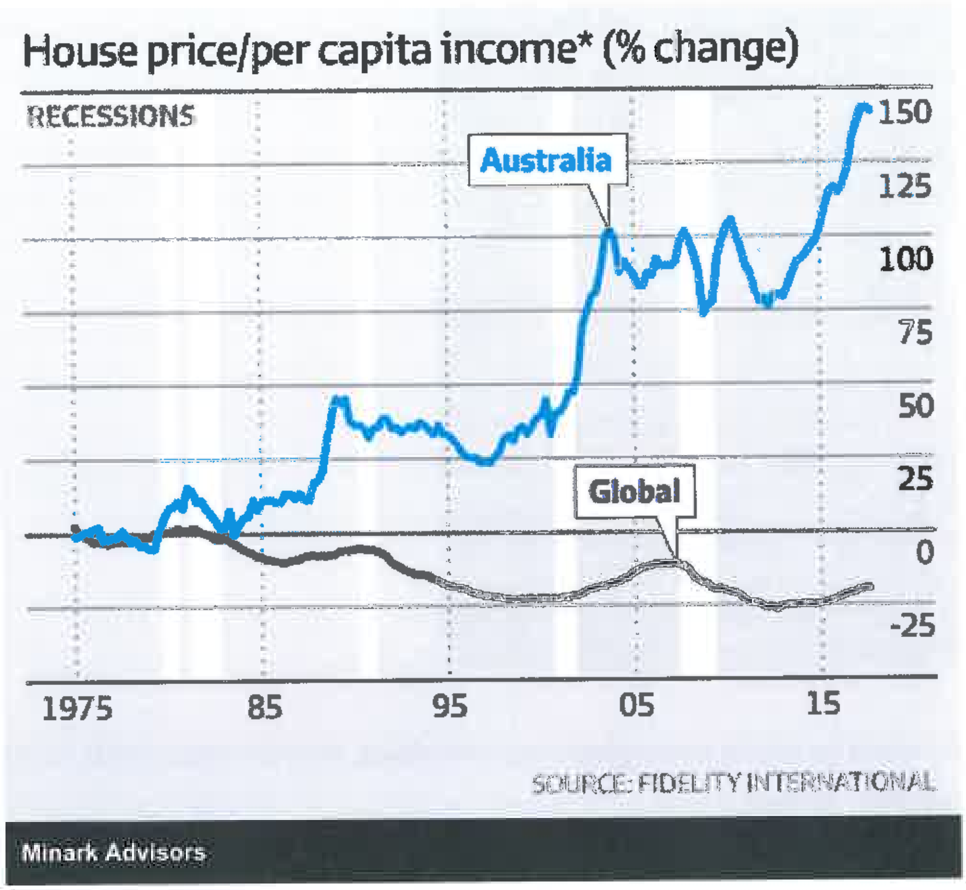
He noted that from 1900 to 2000, the multiplier was broadly stable but it kicked up from 2000. "So just looking at the long-term chart you can say 'well maybe there's a bit of an issue at the absolute level in Australia'," he said.

High prices at every level

Other measures appear just as disturbing.

When Mr Taylor examined house prices divided by per capita income relative to the rest of the world, he found Australian house prices had shot up dramatically while the rest of the world hadn't really changed.

"So not only can you say house prices look high in an absolute sense, in a relative sense against the rest of the world they also look high," he says.



The final chart Mr Taylor used to illustrate his point at a Fidelity conference on risk in Sydney showed small and large towns and cities around the globe, and indicated "even the smaller towns in Australia look very expensive."

Still, while house prices look stretched in terms of valuations, a catalyst to send them lower was not looming, he said.

"While the market does look overvalued, it's hard to see a trigger that's going to cause significant changes. In Australia we typically see prices rises, then the market goes nowhere for 7 years," he said. "That's how we adjust."

Potential catalysts

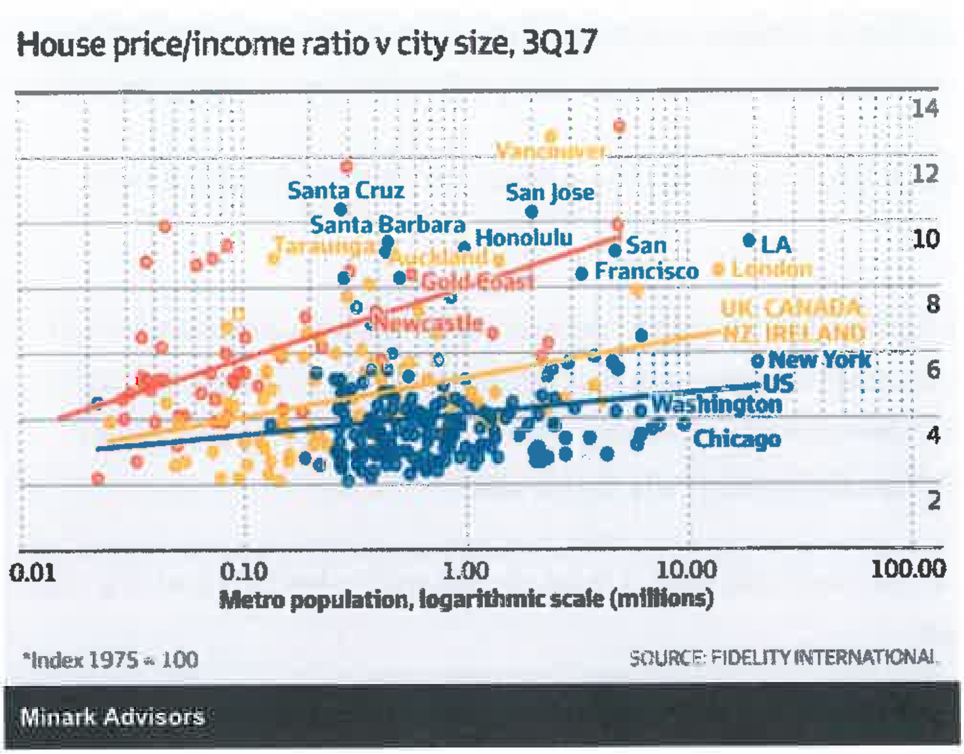
"Not only can you say house prices look high in an absolute sense, in a relative sense against the rest of the world they also look high," Fidelity's Paul Taylor says. **Glenn Hunt**

Two potential catalysts, however, could be rising unemployment and rising interest rates, with rising unemployment the more likely catalyst, he said.

"There's more likely to be something around jobs," he says. "If unemployment rises, we lose our jobs and people have to sell their homes because they are now a forced seller, then that forces fundamental values down," Mr Taylor said.

However, with good jobs growth last year and unemployment still quite low, he said "I don't think unemployment is an issue in the short term."

Another catalyst could be interest rates. "In the short term, maybe that's not going to be a huge issue but in the longer term that could potentially be a trigger," he said.



Mr Taylor made the comments on the housing market and interest rates as part of an evaluation on the key risks facing investors.

He took a look at US government interest rates from 1946 to the present, noting there had been two very different cycles, with interest rates advancing from 1946 to 1981 in the "last great bond bear market".

Low point for interest rates

Since 1981, those interest rates have declined, he said, but there was an argument that the long-term declining interest rate cycle that started in 1981 bottomed in 2016.

He said interest rates had hit a low.

"I'm of the view that we will see a long cycle of interest rate rises but at a much slower increase than we have previously seen," he said. "I think we are in for longer-term higher interest rates but maybe not for the next five to 10 years.

"Maybe it's not really a short-term risk but we think it's one of the key long-term risks."

A 30-year interest rate increase cycle is extremely bad for bonds, he said, but "I think it's a bit more nuanced for equity markets".

"Our own internal research shows that key trigger points are around 5 to 6 per cent interest rates. For the equity market, as interest rates rise to 5-6 per cent, that's still quite a sweet spot," he said.

"Typically as you get rising interest rates, it means that economies are moving ahead and we're getting a little bit of inflation."

Along with interest rates and the housing market, other risks facing investors in Australia include iron-ore prices driving the Australian dollar higher and making the country more unattractive for tourists, government intervention, the removal of franking credits and a drop-off in population growth. Trade war and China risks are also present, Mr Taylor said.

But for portfolio managers, risk is not inherently bad. "I think it's not really about eliminating risk, it's about controlling risk," he said.

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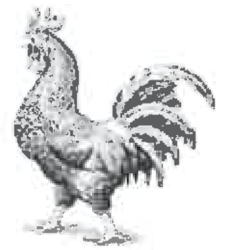
CHANTICLEER
May 29 2018 at 11:00 PM
Updated May 29 2018 at 11:00 PM

Royal commission spreads housing fears



by Chanticleer

As the royal commission ground through another day of worthy but unspectacular revelations about small business lending, the broader impacts of the commission's work are setting off some rather shrill – and perhaps overly pessimistic – alarms in federal politics, the property industry and the consumer sector.

In Canberra, Treasury secretary John Fraser amplified a warning from ratings agency Moody's, which argued that the royal commission could threaten economic growth if tighter lending standards start to hit the availability of credit.

"There is also the risk that there is an unanticipated tightening in financial conditions through reactions to the royal commission into the financial services industry," Mr Fraser told a Senate estimates hearing on Tuesday.

While this is not necessarily a new idea – RBA governor Philip Lowe has delivered similar warnings – the potential flow-on effects were demonstrated on Tuesday with two pieces of research from UBS.

A downgrade to the bank's recommendation on property group Stockland, from "neutral" to "sell", saw the company's shares fall 2.3 per cent on Tuesday. UBS cuts it earnings forecast for Stockland by 3.4 per cent for 2020 and by more than 8 per cent for 2021.

Central to the downgrade was the UBS house view that residential property prices will fall more than 5 per cent in 2019, as stricter lending criteria (mainly through the use of higher living expenses and debt-to-income limits) are introduced following the royal commission. UBS believes this will reduce the borrowing capacity of lenders by 30 per cent to 40 per cent.

Record levels of new home building, poor housing affordability and weaker demand from foreign buyers could further exacerbate house price falls.

The latter point was underlined by new data from the Foreign Investment Review Board, which showed total approved investment into residential property fell by two-thirds to $25.2 million. A sharp pull-back in demand from Chinese investors, who comprised 40 per cent of applications, was blamed for the drop; China has imposed much stricter controls on overseas investment in the past 12 months.

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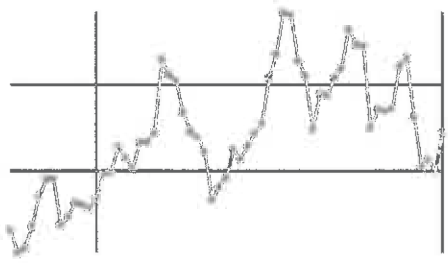

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ASX Announcements

The UBS team's decidedly pessimistic view of the housing market – and the impact of the royal commission on the lending standards that banks will be forced to accept, which has been documented in detail by UBS bank analyst Jonathan Mott – is flowing through to its view of segments of the consumer market.

Also on Tuesday, UBS warned on the outlook for ASX-listed car dealers, arguing that over the past 20 years, every 10 per cent fall in house prices will be followed by a 10 per cent fall in new vehicle sales (and an 8 per cent fall for luxury cars).

The confluence of these events – Fraser's warning, the Stockland downgrade, the car sales warning and the FIRB numbers – may make it appear that the economy will be damaged by a major tightening of lending standards that will dry up both the capacity of mortgagees and the banks' willingness to lend.

Certainly anecdotal evidence suggests the royal commission is adding to existing regulatory pressure on banks to increase the amount and quality of information they seek from borrowers.

But a reduction in borrowers' capacity of the magnitude that UBS has imagined would be dramatic, particularly given the final recommendations of the royal commission are not due until next February, and would then need to be implemented.

But accepting that some sort of tightening of credit supply feels likely, and will put further downwards pressure on house prices that are already drifting lower, investors need to be realistic as they wrestle with how hard these forces hit various sectors.

Take banks, which will be one of the first sectors to consider, given it accounts for 25 per cent of the ASX. While bank stocks had a good day on Tuesday – and veteran broker Richard Coppleson is tipping a rally in the coming months – they are down 7.7 per cent since the first royal commission hearing on March 13.

Investors will need to continue to think carefully about the trade-off between very attractive yields and a growth outlook that will likely not be clear until at least next February, when the royal commission's final report is due.

But even with the banking sector's direct exposure to falling house prices, some historical context is important.

House prices dipped in 2005, in 2009 and again in 2012. While there were no royal commissions running during any of these periods, the point is that the housing sector has slowed from time to time in the past two decades – and the consequences certainly haven't been calamitous.

Indeed, house prices dipped sharply in Western Australian and parts of Queensland earlier this decade in the wake of the mining bust; the lasting economic damage might be rated somewhere between minimal and limited.

Flat to falling house prices look highly likely. But even in an environment of heightened scrutiny from the royal commission, investors should be cautious rather than fearful about suggestions that banks will tighten the screws on borrowers (or be forced to tighten them) in a way that damages the economy.

James Thomson

j.thomson@fairfaxmedia.coma.au

SGP

Conventional wisdom is wrong. Rate rises are good for property trusts

MAY 2018

April was a month of streaks. The Prime Minister's 30th straight loss in the polls dominated headlines, the Reserve Bank's 89th consecutive month without a rate increase less so. But we're now into the beginning of May and the RBA's streak without a change in policy rate has stretched to 90.

This shouldn't be a surprise. The cash rate remains at a record low 1.5% and the last change was down, 21 months ago. But, as RBA governor Philip Lowe has said, the next change is likely to be up.

The market appears to be pricing in the prospect of future rate increases. Year-to-date total returns of the S&P/ASX 200 AREIT index have been -1.2%, wiping out last calendar year's modest gains and confirming what many dividend-focussed investors already suspect - that interest rate rises, or even the prospect of them, are bad news for AREIT investors.

We beg to differ.

It's true that as interest rates rise, all else being equal, the value of an asset's future income stream falls. But it's a little more complicated than that.

Interest rates are more than numbers on an analyst's spreadsheet. When rising, they're usually an indicator of buoyant economic conditions, a mark of low unemployment and inflation and high business and consumer confidence.

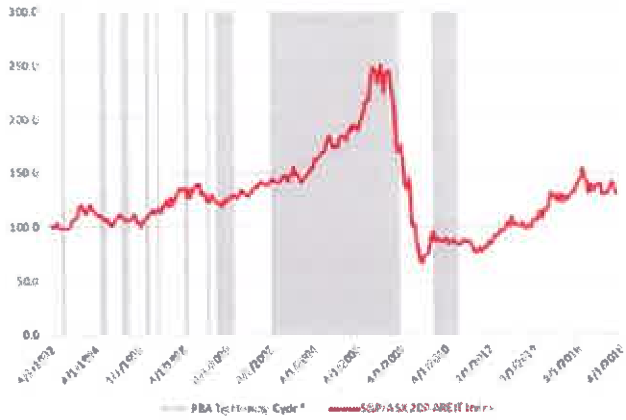
In such environments businesses expand, leading to increasing demand for office and retail space and logistics facilities. Low unemployment also results in improving consumer confidence, pushing up wages growth. This subsequently increases an individual's ability and willingness to spend.

Higher demand for commercial office, industrial and retail space is a by-product of elevated economic activity. Eventually, rental receipts rise – driving long-term value for commercial real estate investors.

It may challenge conventional wisdom but this explains the mechanisms by which rate rises can be good for AREIT returns.

And the data supports the argument. This chart shows AREIT returns since 1992, highlighting periods when the RBA has progressively increased the cash rate:

S&P/ASX 200 AREIT Index Performance vs. RBA Tightening Cycles*



Source: RBA, IRESS, APN FM
*Tightening cycle defined as a period of consecutive rate increases or where multiple rate increases have been punctuated by a period of no change.

In the last five interest rate tightening cycles highlighted above – an aggregate 100 months – the S&P/ASX 200 AREIT Accumulation Index achieved an average annualised total return of 7.5%. Even after excluding the longest RBA tightening cycle from 2002 to 2008 (preceding and including the GFC) the AREIT sector returned 7.0%.

Of course, property trusts use debt to finance the ownership of their assets, thus exposing them to rising interest rates. Whilst higher debt servicing costs can be more than offset by rent increases, it's also important to acknowledge that today's environment is very different to that in the period prior to the Global Financial Crisis (see Lessons from the crash: Property trusts 10 years on).

AREITs generally are now managing debt with more prudence. Gearing levels are lower and a greater percentage of debt is fixed-cost. Gearing across our AREIT coverage universe is now a low 29.6% and over 60% of that is fixed cost debt. If and when rates were to increase, they won't hit a property trust's cost base in the way they did a decade ago.

Moreover, further rate increases still seem a way off. GDP growth remains at below-trend levels, there's little evidence of wages growth and inflation remains below the 2-3% range targeted by the RBA. The concern over an imminent rate rise seems misplaced and overdone.

But even if that changes and the RBA does raise rates there's a strong historical precedent for it being a good thing for property trust investors. Because behind the case for higher rates are economic conditions that deliver increases in commercial property rents.

In our view there is no cloud hanging over the sector. There is however a silver lining, courtesy of those investors unduly worried by the prospect of higher rates. Investors in APN's AREIT Fund can now get a running yield of 6.32%[1], the highest figure in quite some time.

For investors seeking sustainable, low risk income returns, with the prospect of higher rents if and when rates do rise, that seems pretty attractive.

1 As at 2 May 2018. Current running yield is calculated daily by dividing the annualised distribution rate by the latest entry unit price. Distributions may include a capital gains component. Past performance is not an indicator of future returns.

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Established in 1996, APN's listed on the ASX and manages $2.8 billion (as at 31 December 2018) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

Contact us

APN Property Group Limited

Level 30, 101 Collins Street,
Melbourne, Victoria 3000

Investor Services Hotline 1800 996 456
Adviser Services Hotline 1300 027 636

Email apnpg@apngroup.com.au
Website **apngroup.com.au**

Financial Review - afr.com

May 31 2018 at 3:25 AM
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Italy's rattled bond market finds measure of calm

Italy's government bond yields fell from multi-year highs, as a renewed attempt to form a government in Rome and a smooth bond auction brought a degree of calm to a market battered by a political crisis.

The two anti-establishment parties, the 5-Star Movement and the League, abandoned plans to jointly take power at the weekend after the president blocked their proposed cabinet lineup. They are now trying to find a compromise, a source said on Wednesday.

Late on Wednesday, 5-Star called for eurosceptic economist Paola Savona to withdraw his candidacy as economy minister, the stumbling block in the previous effort to form a government, to help in the latest attempt.

Italy's short-dated borrowing costs fell back below 2 per cent, after surging more than 150 basis points at one point on Tuesday on fears that fresh Italian elections could strengthen the hand of anti-establishment parties.

A sale of five and 10-year government bonds also eased concerns about Italy's ability to finance itself.

Italy sold €5.57 billion ($US6.5 billion) in bonds, narrowly missing the top of its targeted issuance range of €3.75 billion to €6.0 billion.

"We are not yet at the point where investors refuse to lend money to Italy," said Roberto Coronado, senior portfolio manager investment grade credit at PineBridge Investments. "If they had tried to borrow yesterday, it might have been harder. Today things were more stable and people were happy to lend."

Italy's two-year government bond tumbled 45 bps at 1.98 per cent, below a five-year high touched in early European trade. A week ago it traded at just 0.20 per cent.

Italian 10-year bond yields fell 7 bps to 3.03 per cent, off four-year highs of 3.38 per cent.

The Italy/Germany 10-year bond yield spread tightened to 269 bps having blown out to more than 300 bps briefly on Tuesday .

A political crisis has increased speculation around Italy's continued membership of the single currency and pushed its borrowing costs up sharply.

Some analysts said that they were sceptical of the possibility of Italy leaving the euro, a fear that contributed to the Italian two-year yield recording its biggest one-day rise since 1992 on Tuesday.

"It's questionable how credible Italy's threat of leaving the EU actually is, if push comes to shove," said Barclays investment strategist Hao Ran Wee, citing blocks in the country's constitution as the main hurdle.

"No investor would lend to the Italian government if they deem it as being unable to pay back its debt," he said.

The European Central Bank is keeping a watchful eye on the market rout and political crisis engulfing Italy, but it sees no reason to intervene at this time, sources close to the matter told Reuters on Wednesday.

As Italy's bond market recovered, yields on safer, high-grade euro zone bonds, rose 4 to 6 bps.

Germany's 10-year bond yields rose 6 bps to 0.34 per cent, above a more than one-year low of 0.19 per cent on Tuesday.

They also faced some upward pressure from inflation numbers.

German consumer prices rose by a higher-than-expected 2.2 per cent year-on-year in May after an increase of 1.4 per cent the month before, overshooting the ECB's inflation target of just below 2 per cent.

Financial Review - afr.com

OPINION
May 30 2018 at 12:49 PM
Updated May 30 2018 at 2:12 PM

Will the ECB really do 'whatever it takes' to prevent Quitaly?

by **Jamie McGeever**

Euro zone markets are gyrating like it's 2012, with political crisis in Italy blowing out peripheral yield spreads and triggering the strongest demand for safe-haven German bonds since the depths of the euro crisis six years ago.

But at the risk of uttering the dreaded words, this time it's different, it's almost impossible to believe that the ECB will stand by and allow domestic political crisis in Italy to descend into an existential crisis for the euro zone.

"Whatever it takes", to quote ECB chief Mario Draghi's famous commitment from 2012, will avert "Quitaly", if push comes to the shove.

Still, the rise in Italian yields and spreads under way now is astonishing. The 10-year Italian/German yield spread rose above 300 basis points on Tuesday, meaning it has more than doubled in just two weeks.

Italy's two-year yield rose above 2 per cent on Tuesday, significantly higher than the two-year Greek yield, and well on track for its biggest one-day rise since 1992.

This is causing serious pain for Italian banks, which are among the biggest holders of these bonds. Their balance sheets and ability to raise financing on money and bond markets are getting hammered, which will be ringing alarm bells at the ECB.

The wave of selling on Tuesday also strongly suggests financial markets are now pricing a euro break-up premium into Italian bonds and bank stocks, and even the euro. This is anathema to the European Central Bank and will prompt it to act.

New measures

The risk of a euro break-up forced the ECB's hand six years ago. The difference today is not that investors doubt the ECB stands ready to help Italy, but that Italy wants that help at all. Italy itself may choose "Quitaly", which is a different proposition for the ECB and euro policymakers entirely.

If the ECB is forced to act it could expand and tweak its current bond-buying programme, provide emergency funding for Italian banks, or dust off and deploy the Outright Monetary Transactions programme if Italy is forced to take financial support from the euro zone bailout fund.

It could employ a mix of all of the above or come up with entirely new measures.

The 2011-12 debt crisis showed that the ECB is flexible, creative and willing to bend or suspend its rules. The list of acronyms for its unconventional policy measures and programmes is lengthy, including: OMT, LTRO, SMP, APP, CSPP and CBPP.

This was a hill on which two high-profile German policymakers at the ECB were willing to sacrifice themselves. Successive Bundesbank chiefs Axel Weber and Jurgen Stark argued in protest at the direction the ECB was headed but ultimately lost those arguments and quit instead.

The euro zone's last existential crisis prompted Draghi to deliver his now famous remarks in London on July 26, 2012, that the ECB would do "whatever it takes to preserve the euro. And believe me, it will be enough."

Back then Italy's 10-year bonds yielded 540 basis points more than German bonds, Spain's more than 600, Portugal's almost 1000 and Greece's almost 3000. Speculation was rife that any one of these countries was about to crash out of the euro, bringing the whole currency union down with it.

Then Draghi stepped in. And whatever else has happened since – in terms of euro zone politics, banks, financial markets, the economy, and monetary and fiscal policy – it's unarguable that the euro was saved.

The ECB went all in with unconventional policy which included negative interest rates, a sovereign bond-buying programme running into the trillions, and cheap loans worth hundreds of billions to the 19-nation bloc's banks. Italian banks were among the main beneficiaries.

Fresh elections

Six years on, the ECB is looking at exiting these crisis-era policies as smoothly as possible with minimum market disruption. It's a process that isn't scheduled to start until later this year at the earliest, and would take years to complete anyway.

But the current standoff in Italy will almost certainly put that on hold, maybe for a very long time. It could also push the ECB to take more, yet to be determined emergency measures.

Italy is set for fresh elections after the President appointed a former IMF official as interim Prime Minister once anti-establishment forces had abandoned their efforts to form a coalition government at the weekend.

These elections are likely to be fought over Italy's role and very place in Europe and the euro zone. Investors are dumping Italian assets and the euro on fears that the third largest euro zone economy and third largest bond market in the world could crash out of the euro.

Visibility on what happens next, in terms of the makeup of Italy's next government, elections and what credit ratings agencies, the ECB and euro zone leaders do, is low. Investors are choosing to dump Italian assets now and ask questions later.

Ultimately, however, it will boil down to whether they believe Italy is bankrupt, will default, leave the euro, or that the ECB will allow the euro project to fall apart. Of course, anything can happen. But the answer to those questions, right now at least, has to be "no".

Reuters

Financial Review - afr.com

OPINION
May 30 2018 at 9:40 AM
Updated May 30 2018 at 1:21 PM

Why investors are so worried about Italy's latest political crisis

by **Karen Maley**

It's the nightmare scenario that has worried financial markets for close to a decade – the prospect of a debt crisis in Italy, the eurozone's third largest economy.

So it's scarcely surprising that financial markets are panicking as Italy sinks deeper into a political and institutional crisis.

Investors were initially cheered when Italian President Sergio Mattarella vetoed the appointment of a eurosceptic minister for finance, Paolo Savona, who had been proposed by the anti-establishment Five Star Movement, and the far-right League.

It appeared as though that by blocking Savona's appointment, the Italian president had averted the risk of an "Italexit" – the risk of an Italian exit from the eurozone.

But the calm was short lived. Investors now worry that the administration of Carlo Cottarelli, the former IMF official who has been named caretaker prime minister, will be short lived, and that Italian voters could be again headed for the polls, possibly as soon as late July.

Even worse, they fear Cottarelli, who epitomises budgetary orthodoxy, could stir up even more euroscepticism among Italian voters, many of whom already blame Berlin, Paris and Brussels for their fate.

The fear is that the next election will further entrench the League and the Five Star Movement, who consistently denounce what they describe as a conspiracy by the elites to stop them taking power.

The market's worst nightmare is that the next election will essentially be a referendum on whether Italy should remain in the euro.

Anxious investors have responded by dumping Italian bonds, which has sent the yield on two-year Italian bonds – which a fortnight ago carried a negative yield – soaring to close to 2.7 per cent.

At the same time, the yield on Italian 10-year bonds has climbed to 3.44 per cent, the highest level in more than four years.(Yields rise as bond prices fall).

Investors have also been selling bonds of other debt-heavy southern eurozone countries, such as Spain and Portugal.

The ~~rise~~ fall in bond prices has sparked a sell-off in European bank stocks, because investors are worried that the banks will suffer hefty losses on their large bond portfolios if bond prices continued to tumble.

The share price of Italy's largest financial institution, UniCredit, fell 5.6 per cent, Spain's Santander was down 5.4 per cent, France's BNP Paribas fell 4.5 per cent lower, and Germany's Commerzbank lost 4 per cent in trading on Tuesday night.

The head of the Bank of Italy, Ignazio Visco, tried to allay investor anxiety on Tuesday by saying there was "no justification" for the market sell off.

But he also warned "we must never forget that we are only ever a few short steps away from the very serious risk of losing the irreplaceable asset of trust".

Despite Visco's reassurances, the selling spread well beyond Europe, as memories of the eurozone debt crisis again roiled financial markets.

The US financial sector lost 4 per cent in trading on Tuesday (even though US banks have little or no exposure to Italian bonds) because of fears that an Italian debt crisis will inevitably dry up liquidity in global markets.

The huge issue for investors is whether the eurozone is heading for a replay of the debt crisis that plagued the region between 2010 and 2012. Back then, yields on Greek, Portuguese and Italian bonds soared on "Grexit" fears.

The turmoil in financial markets was soothed after Mario Draghi, the head of the European Central Bank, pledged to do "whatever it takes to preserve the euro" back in July 2012. The ECB then launched two two bond buying programs to reduce bond yields.

The first, known as Outright Monetary Transactions, was never activated. But the ECB has also spent a massive €2.6 trillion ($4 trillion) under its bond buying program known as quantitative easing (QE) in order to increase liquidity and drive down bond yields across the eurozone.

But the ECB is now winding back its bond purchases, and is expected to end new QE buying by the end of the year. And this has focused investors attention on the inadequate bulwarks European politicians have erected to guard against a fresh debt crisis.

In particular, they fear that the European Stability Mechanism – which has a lending capacity of €700 billion and which is designed to help countries that are struggling to raise funding in financial markets – is far too small to deal with Rome's potential problems.

Italy's debt – 36 per cent of which is held by foreigners – stands at a massive €2.3 trillion, or close to 135 per cent of Italy's GDP. This is the second-highest debt-to-GDP ratio in the eurozone after Greece.

FINANCIAL STANDARD

Economics

Chief economist update: "Quitaly"

BY BENJAMIN ONG | WEDNESDAY, 30 MAY 2018 10:15AM

Move over China and North Korea, you too Iran and Israel, a new old crisis has come back to town...and it could be bigger.

While the financial market world still haven't seen the end game of US President Donald Trump's protectionist trade policies and diplomatic ones (an oxymoron?), along comes Europe adding to the uncertainty that'll beat the optimism out of every true blue investor.

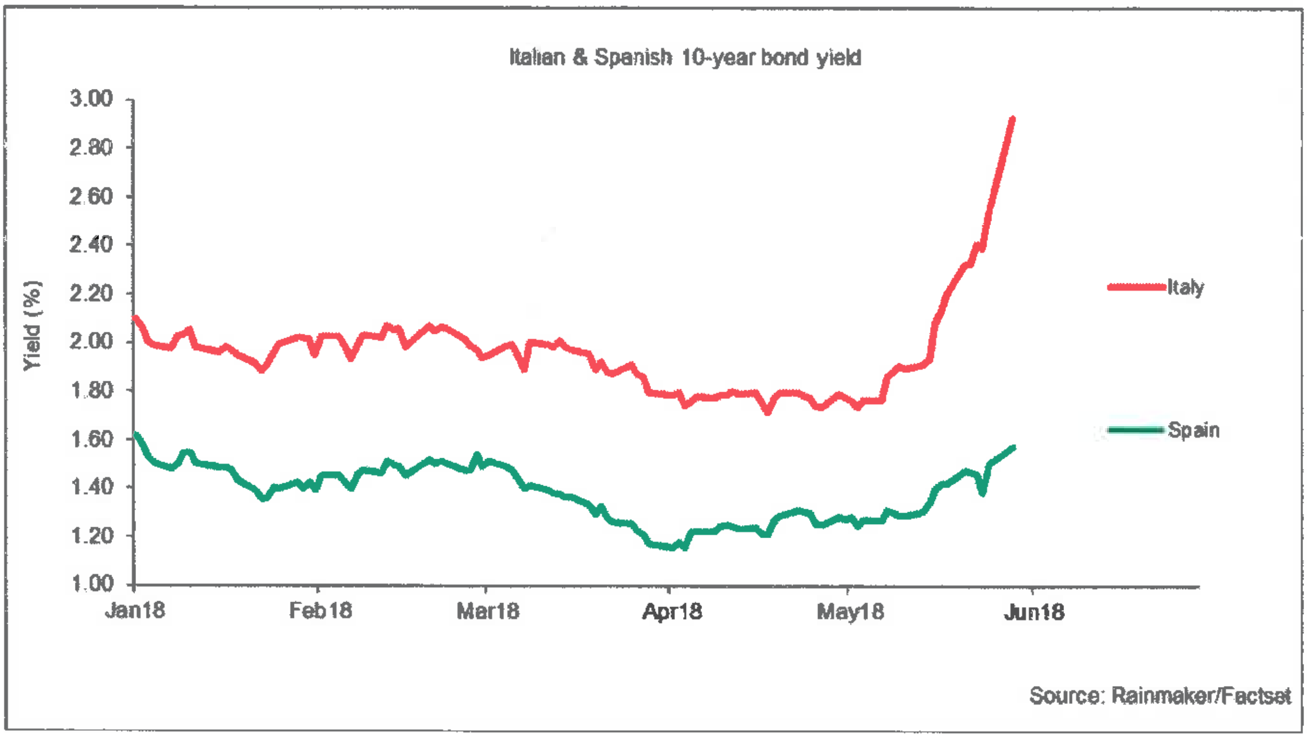
Suddenly the jokes that sprout following Brexit and Grexit is becoming real. This time, it could be "Quitaly". There's also an emerging problem in Spain but, at this point, it's still early to call for a "Madriddance".

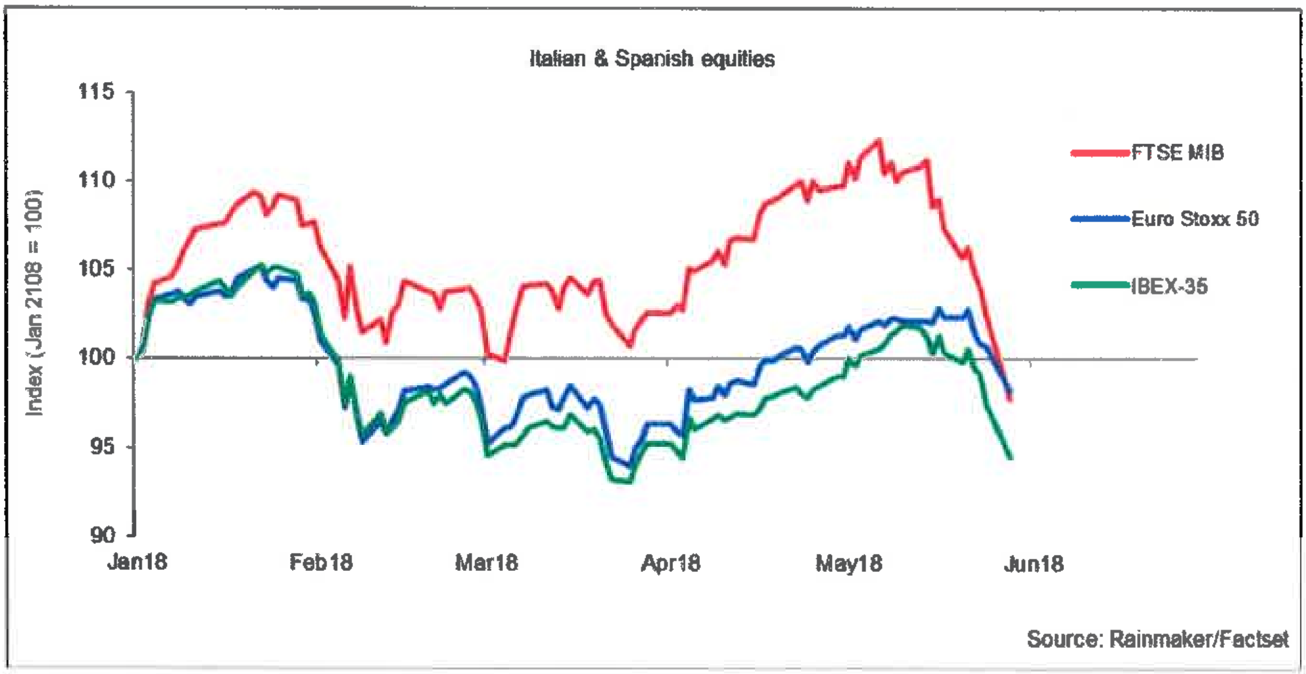
The reason, as Factset put it succinctly: "Italian president Matterella rejected populist finance minister choice and called on former IMF official Cottarelli to lead a technocrat government. However, unlikely to win vote of confidence, setting stage for snap election seen as referendum on the euro. In Spain, prime minister Rajoy to face no-confidence vote on Friday (though likely to survive)."

Recall the financial market mayhem the Greek crisis caused way back when, Italy's would be greater should the anti-establishment Five Star Movement party win the snap elections many expects Italian President Sergio Mattarella to announce today to be held as early as July. The Five Star Movement campaigned on a proposed referendum on Italy's membership in the Eurozone (they were against it).

Eurostat stats show that Greece accounts for only 1.2% of total EU GDP (as at 2016). Italy - the ~~fourth~~ third biggest economy in Europe - accounts for 11.3% and Spain (the fourth biggest), for 7.5%.

The extent of financial market fears over Italy is best captured in the following two charts:





European Central Bank (ECB) president Mario Draghi succeeded in calming nerves over Grexit with his "whatever it takes" policy.

Draghi might have to throw in more than the kitchen sink if current speculations about "Quitaly" become real.

Ben Ong is the Director of Economics and Investments at Rainmaker Group. He previously worked as a fund manager, economist, asset allocation strategist, portfolio analyst and stock market analyst. Check out his economics analysis [here.](#)

Financial Review - afr.com

OPINION
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Updated May 30 2018 at 12:23 PM

Ethiopia is already the 'China of Africa' as growth rate approaches 8.5 per cent

by **Tyler Cowen**

Will Ethiopia become "the China of Africa"? The question often comes up in an economic context: Ethiopia's growth rate is expected to be 8.5 per cent this year, topping China's projected 6.5 percent. Over the past decade, Ethiopia has averaged about 10 per cent growth.

Behind those flashy numbers, however, is an undervalued common feature: Both countries feel secure about their pasts and have a definite vision for their futures. Both countries believe that they are destined to be great.

Consider China first. The nation-state, as we know it today, has existed for several thousand years with some form of basic continuity. Most Chinese identify with the historical kingdoms and dynasties they study in school, and the tomb of Confucius in Qufu is a leading tourist attraction. Visitors go there to pay homage to a founder of the China they know.

This early history meant China was well-positioned to quickly build a modern and effective nation-state, once the introduction of post-Mao reforms boosted gross domestic product. That led to rapid gains in infrastructure and education, and paved the way for China to become one of the world's two biggest economies. Along the way, the Chinese held to a strong vision that it deserved to be a great nation once again.

My visit to Ethiopia keeps reminding me of this basic picture. Ethiopia also had a relatively mature nation-state quite early, with the Aksumite Kingdom dating from the first century AD. Subsequent regimes, through medieval times and beyond, exercised a fair amount of power. Most important, today's Ethiopians see their country as a direct extension of these earlier political units. Some influential Ethiopians will claim to trace their lineage all the way to King Solomon of biblical times.

In other words, the process of organised, national-level governance has been under way for a long time. It was this relative strength of Ethiopian governance that allowed the territory to fend off colonialism, a rare achievement. It is also why, when you travel around the country, a lot of the basic cuisine doesn't change much: Dishes are seen as national and not regional.

It is thus no surprise that once Ethiopia abandoned its 1970s communist ideology and put some basic reforms into place, its government was able to rise to the occasion. The infrastructure is remarkably good by regional standards, and the Ethiopian government is known for conducting a relatively successful industrial policy. The state-owned Ethiopian Airlines is run as a responsible business, it is becoming a major air power, and standards of service are high.

Chinese are helping build the place up

The Ethiopians I have interacted with express a remarkable degree of enthusiasm for their country and culture. Maybe that isn't unusual in a rapidly growing nation, but I've been struck by how historically rooted these sentiments have been. Ethiopians are acutely aware of their past successes, including their role in biblical history. Like many Iranians, they think of themselves as a civilisation and not just a country. They very self-consciously separate themselves from the broader strands of African history and culture. And, as in China, they hold an ideological belief that their country is destined to be great again.

China and Ethiopia intersect in yet another way, with the Chinese helping to build the place up. There are new and modern apartment buildings scattered around Addis Ababa, built by the Chinese, a light rail system in Addis that would look nice in any country, impressive dams for hydroelectric power, and a high-speed rail connection to Djibouti and the coast.

The pride of Ethiopians in their history and freedom from colonialism may help explain why the nation has accepted so much Chinese infrastructure involvement with little evidence of the angst that has plagued some other parts of Africa. The intuitive background assumption in Ethiopia is that foreigners may try to interfere, but the government won't lose control. There are prominent statues in Addis Ababa celebrating how the Ethiopians drove out both the Italians and the British.

Just to be clear, Ethiopia is hardly a finished nation-state. There are festering disputes with Eritrea to the north, a place many Ethiopians strongly feel belongs to them. The southern and more tribal parts of the country are not always well integrated into the major commercial centres ruled by the highlanders, and there are clashes with the Oromia and Somali regions to the east. For those reasons, the national optimisms found in the better developed parts of the country are not found everywhere.

That said, if you are looking for a special place in Africa, Ethiopia may be your best bet. But to understand its recent success, you have to go beyond policy - it is also a matter of their history, their confidence and, above all, their ideas.

Bloomberg