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SE inside views

HD **Global crises hit home**

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MARKETS

Chinese geopolitics and recent events in Ukraine highlight the need for prudence when considering overseas components for your portfolio, writes Christopher Joye.

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Good ideas often begin like a whisper of wind. The strongest can build into furious storms that irreversibly shape our financial destinies – for better or worse. One goal of this column is to act as a radar for the "big ideas" before they hit our shores.

The past month has highlighted two risks and one opportunity for anyone aspiring to retire rich. The risks could wipe out a large chunk of your wealth. The opportunity is more tactical and real-time in nature, but also has consequences for the way you think about constructing diversified portfolios.

Russia's mostly unanticipated decision to invade the Crimean Peninsula, which is an autonomous territory governed by Ukrainian law, illuminated the oft-neglected yet vital nexus between national security and economics. Investors frequently extrapolate out from the last 65 years of relative peace and prosperity and assume the future will be similar. Yet conflict seems to be a historical constant.

I've talked before about the worrying potential for some kind of conflagration between China and its near neighbours – Japan, India and South Korea – enmeshing the US and its close ally Australia with devastating consequences for market sensitive savings. All these nations rank among our top five trading partners.

Putin's opportunistic intervention into the Ukrainian crisis was enough to give financial markets a temporary aneurysm. The lesson for investors is to avoid the mindless diversification into foreign markets recommended by your suburban adviser.China deserves caution

I would, for instance, advise against reflexively investing in seductively high growth areas like China and contiguous countries because the prospective downside losses in this volatile region could be unbearably high for everyone but the most committed Sinophiles. And Australian investors already have huge (derivative) leverage to China, India, Japan and South Korea through our trade ties.

National security is not all bad news. In September 2013, I canvassed the looming Nasdaq listing of FireEye Inc (FEYE). It doubled in price on debut with a $US4 billion market cap. Today that has multiplied to over $US11 billion ($12.2 billion). My view is that the splintering of the internet could be grim for global technology firms like Cisco and Huawei that have clear links to their native governments. But it might be a boon for smaller domestic players that only care about their local market, especially if they possess intelligence and defence credentials. Keep an eye out for future ASX listings.

Another idea I've been nurturing is the notion that Australia's housing market could undergo a wrenching boom-bust cycle when interest rates inevitably normalise. There is no sign that the spectacular price growth since mid-2013, which we forecast, is decelerating. National house prices are now up 12 per cent since their trough in June 2013. On the back of the cheapest borrowing costs in history, prices are continuing to climb at double digit rates.

There are certainly attractive trades to be done if you can lock in record low rates for a long time and snap up discounted properties. But I would encourage caution. The concern is that when borrowing rates increase 50 per cent to get back to long-term benchmarks, the housing market gives back all its recent capital gains. Raw prices are chalking up new peaks every day and, deflated by incomes, are only a few months from breaching their all-time watermark.

Two mitigants are a lower Aussie dollar, which is fuelling offshore demand, and the desire of wealthy **Chinese** to expatriate capital to politically stable destinations such as Australia. It's not clear that putting a big chunk of your super into residential property, or even buying a home, is a terribly good idea right now. When the price of money increases, there will be an inevitable correction. Hybrids with promise

One opportunity I want to alert you to has been consistently profitable. The term "hybrid" is used crudely to denote a wide range of securities listed on the ASX, including senior-ranking **bonds**, subordinated **bonds** and several different "convertible preference shares" (sometimes called capital notes), which sit above ordinary shares but below **bonds** in a **company**'s capital structure. Where you rank is important if the **company** defaults and is wound up. If you own shares, you will be last in a long line to get paid.

To complicate matters, our banking regulator has introduced a new form of risk, known as a "non-viability trigger", which allows it to unilaterally convert, or "bail-in", both bank **bonds** and hybrids into shares in an undetermined crisis. You would be lumped in with the riskiest possible securities at the worst possible time in the name of supporting the bank's solvency.

Until recently sophisticated institutional investors have boycotted any **bonds** with non-viability risks. They basically felt it was an untenable hazard. But this position has changed and it has important ramifications for the ASX hybrids that many readers have in their portfolios.

For the first time we have the big end of town properly pricing non-viability risk premiums every day. Right now they are saying they need an extra 0.25 to 0.35 per cent in interest. Watch how this evolves. If the risk premium compresses you will likely see additional capital gains on ASX hybrids.

Also watch for periodic dislocations in the pricing of ASX hybrids when new issues come to market. Brokers churn clients out of existing hybrids, which soften in price, to earn commissions on new deals. The old assets invariably bounce back.

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