Firstlinks

a Morningstar company

Edition 377, 1 October 2020

Contents

The elusive 12%: is superannuation at a turning point? *Graham Hand*

My lessons from five decades of investing *Claudia Huntington*

The impact of our marriage breakdown on our SMSF *Alex Denham*

The future is always clearest once it is in the past *Roger Montgomery*

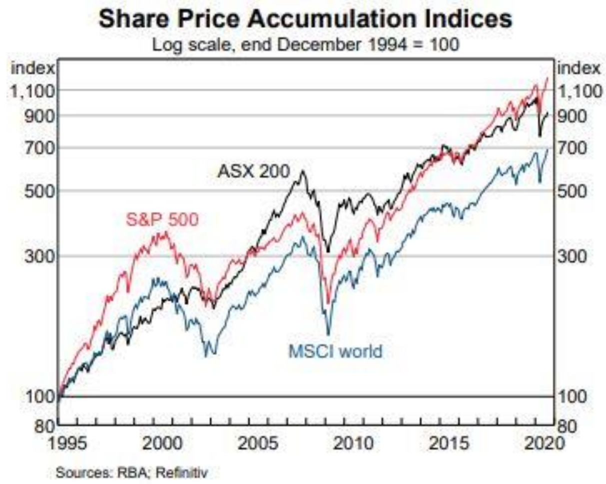
Emerging markets: Should I stay or should I go? *Shane Woldendorp*

20k now or 50k later? What's driving decisions to withdraw super? *Susan Thorp*

The surprising resilience of residential housing and retail *Chris Bedingfield*

Editorial

The most significant change in asset allocation by Australian investors in recent years has been the move into global equities. It's been a canny trade for those who focussed on the US, especially great companies such as Apple, Microsoft, Amazon and Google. International equities, for example, experienced net inflows into Exchange Traded Funds (ETFs) of $722 million in August 2020 versus only $181 million for Australian equities. International is now by far the largest asset segment in the $70 billion ETF industry.



For two decades between 1995 and 2015, Australian shares (ASX200 top right) held their own against the US (S&P500 top right), which with the added benefit of franking credits, encouraged a home country bias. But since 2015, the decline of our banks and previous stalwarts such as Telstra and AMP left the heavy lifting to CSL and the miners. Showing it is a US story rather than the rest of the world, Australia remains well ahead of laggards in Europe and Emerging Markets (in MSCI World top right).

Focussing on Australia shares (bottom right), the headwind from financials is apparent since 2015, and resources was a disaster until early 2016. So in the investing world, the big winners are those who made a call to take a US focus and rotate out of banks a few years ago. Will this continue as a successful move for the next five years?

The US market's strength is in the wake of the uncertainties of the US election. Watching the debate yesterday was painful as the Leader of the Free World shouted down **Biden** and the moderator. Imagine a President saying he will not accept the result in a democracy like the US. **Donald Trump** has so usurped the rule of law that he can say he will not accept the result and most people shrug it off as one of his crazy eccentricities. This has much potential for anarchy and social unrest playing out badly between the election on 3 November and inauguration on 20 January. Here's what Trump said a few days ago:

> **NBC News** @NBCNews · 3h
>
> Reporter: "Win, lose or draw in this election, will you commit here today for a peaceful transferal of power after the election?"
>
> President Trump: "We're going to have to see what happens."
>
> President Trump: "Get rid of the ballots and we'll have a very peaceful — there won't be a transfer, frankly. There will be a continuation."

During the debate, when asked to condemn white supremacists, he argued violence was a left-wing problem, and far-right boys should "stand back and stand by". It's only 21 working days until the election.

Many topical issues to cover ...

After nearly 50 years as a portfolio manager, **Claudia Huntington** is calling it a day, and she summarises the major lessons revealed along her journey. Good investing is about people, leaders and cultures as much as numbers.

The union movement and Labor are rallying to preserve both the existing super structure and the legislated Super Guarantee increases. After former PMs **Keating** and **Rudd** weighed in recently, **Bill Kelty** hit the campaign trail this week. Read what one of the fathers of super says about our social commitment. With super balances falling, future returns under pressure and a loss of support for SG increases, is super at a critical turning point?

Still on super, **Susan Thorp** and her colleagues at various universities have done a deep dive into a survey by industry fund, **Cbus**, of thousands of its members, to answer a wide range of questions on why they accessed their super early. A lesson for governments next time.

In one of the most personal articles ever written for Firstlinks, **Alex Denham** uses the example of her marriage breakdown to show the ramifications for SMSF trustees. Since one-third of Australian marriages end in divorce, including a surprising number of long relationships, Alex is probably helping more people than she realises.

As most people talk about the disconnect between the stock market and the economy, **Roger Montgomery** explains why we are in one of those times where a strong case can be made for both the market rising and the market falling.

And what about residential property prices? **Chris Bedingfield** reports on the surprising resilience in the face of the pandemic. While the reduction in JobKeeper will bring out more sellers, the relaxation of bank lending rules will provide a counter. Can the market hang on until a vaccine?

Amid all these doubts, is there any part of global stock markets which still offers value? **Shane Woldendorp** makes the case for selected Emerging Markets stocks on both a relative and absolute basis versus Developed Markets. Like value investing, one day its time will come.

This week's White Paper from **Realindex** (manager of $27 billion within **First Sentier**) examines 'zombie' companies. These companies would normally go bankrupt but they are kept alive by favourable policies and low rates, kicking the default can down the road.

The elusive 12%: is superannuation at a turning point?

Graham Hand

On Sunday 27 September 2020, sections of the media received an invitation to a 'summit' the next day, as if a crisis needed immediate attention. Indeed, the Australian Council of Trade Unions (ACTU) arranged an 'Emergency Superannuation Summit' because "*We are at a major crossroads on the future of superannuation in Australia.*" The focus was "*on highlighting the economic benefits of superannuation and the impact that scrapping the increase will have on the Australian people, now and into the future.*"

The esteemed panel included Bill Kelty (former ACTU Secretary and with Paul Keating considered the fathers of the super system), John Hewson (former Liberal Leader), Heather Ridout (former Chair of Australian Super), Emma Dawson (Executive Director, Per Capita), Sheree Clarke (aged care nurse) and Michele O'Neil (ACTU President).

This extract focusses on the introduction by Michele O'Neil, and the comments by Bill Kelty as an insight into where our superannuation system came from. The full recording of the Summit is linked here.

There was nobody representing the 'other side' with arguments to delay the increase in the Superannuation Guarantee (SG), such as The Grattan Institute or the Productivity Commission. Validation for those pushing Scott Morrison to abandon his election commitment to honour the SG increase recently came from Reserve Bank Governor, Philip Lowe, who told a Parliamentary Hearing:

"The evidence is that increases of this form do get offset by lower wage growth over time. If this increase goes ahead, I would expect wage growth to be even lower than it otherwise would be. There will be less current income and if there is less income, there may be less spending, and if there is less spending, there may be less jobs."

Every person on the panel at the ACTU Summit rejected this claim.

What's happening with superannuation?

Despite the system being widely regarded as one of the best retirement policies in the world, super comes under continuous attack. Paul Keating even argues that the Coalition wants to end compulsory super:

"Not take a chink out of it, but to actually destroy it. They intend to do this in two ways. That is, they want to drain money out of the bottom of the system, and stop money coming into the top of the system ... This malarky they talk of, 'if they take it in super, they won't get it in wages', there's been no wages growth for eight years and there's not going to be."

Superannuation statistics as at 30 June 2020 (Source, APRA)

	June 2019	June 2020	Change
Total superannuation assets	$2,880.7 billion	$2,864.1 billion	-0.6%
Total APRA-regulated assets	$1,925.4 billion	$1,921.8 billion	-0.2%
Of which: total assets in MySuper products	$756.5 billion	$731.3 billion	-3.3%
Total self-managed super fund assets	$749.1 billion	$733.1 billion	-2.1%

Some of its current headwinds include:

- Early withdrawals of $34 billion from 3.2 million applications under COVID-19 relief, and while much of the money was urgently needed, billions were also spent on wants rather than needs. Across the entire super system, total benefit payments (ie withdrawals) to 30 June 2020 totaled $100 billion versus only $76 billion the year before, a rise of 31%. This meant that net contributions fell from $38 billion to $23 billion.
- Markets struggling to deliver the numbers assumed in most superannuation modelling, with bond rates below 1% and future returns from equity markets hit by recessions and expensive valuations. There is a strong case that performance will not be as good as in the past, as explained here. As shown in the table below, superannuation assets fell in the year to 30 June 2020 despite the mandated flows.
- Doubts whether the Government will allow the legislated move from 9.5% to 10% on 1 July 2021 and then on to 12%. The Assistant Minister for Superannuation, Financial Services and Financial Technology, Jane Hume, recently told ABC Radio that she was 'ambivalent' to it.
- The major banks have significantly exited not only financial advice but also wealth management, which were once considered jewels in the crown for the future growth of finance. There is now a shortage of business voices defending the super system.

- Continuing criticism that the major benefits from superannuation go to the highest-paid workers, who are able to take advantage of tax benefits.

O'Neil and Kelty on the social covenant of super

Here are some key statements made by Michele O'Neil and Bill Kelty at the Summit aimed at protecting superannuation and ensuring the 0.5% increase proceeds on the way to 12%. The discussion should be read in the context of the union movement's close relationship with industry funds and the increasingly political battleground between Liberal opponents and Labor supporters of super, but also a genuine desire by unions to protect workers' rights.

Michele O'Neil (ACTU President)

"When it comes to the retirement prospects of Australian workers, there is no more important issue than protecting the retirement saving system from attack. At a time of great uncertainty, the Morrison Government and sections of big business have thrown back into question the legislated increase to the superannuation guarantee, and the fundamentals of the system itself. This does nothing but generate further concern and anxiety for working people …

Today, the average Australian will run out of retirement savings 10 years before they die. Over 70% of women have estimated balances under $150,000, and over a quarter of women have balances of less than $50,000. This has them retiring with half as much superannuation as men, which is one of the reasons why older women are the fastest growing group amongst homeless Australians.

The cost of delaying the legislated increase to the superannuation guarantee will be enormous. A typical nurse will be more than $120,000 worse off at their retirement, and a typical early educator would be more than $80,000 worse off on retirement. This shortfall only gets covered by people working longer into their retirement or having to rely on an inadequate pension to survive in old age. For many Australians the notion of working into their 70s is a frightening reality.

In 2014, Tony Abbott convinced the Parliament to delay the increase in superannuation from 9.5% to 12%. Like today, the delay was justified on the basis of promised wage increases. There was no mechanism set up by the Government to deliver that, no requirement on business to pay people more. The Government simply said it would happen, as if by magic. The problem is that higher wage growth did not eventuate … Even before the pandemic hit, our wage growth was anaemic with no growth in real terms since the super freeze started … super increases were delayed in 2014 and almost immediately we saw wages dive and profits soar."

Bill Kelty (former ACTU Secretary)

"When we devised the system, we didn't have a minor objective. We wanted to develop the best retirement system in the world, or at least one of those, because the nation was aging, the pension system was inadequate, and too many people were falling off the edge as they got to retirement … The three premises were superannuation, the pension system and individual contributions, reflecting a social base, a pluralist structure and individual choice.

An Australian way of doing things.

How was it to be paid for was essentially out of the increasing productivity and economic capacity of the nation and wealth, and part of that wealth would be distributed into the retirement system. This was part of a widespread safety net system of high minimum wages, retirement systems, Medicare, and the right to education - four fundamental safety nets underpinning a market-based system. That's what set us apart.

We said then that if it comes out of the productive capacity of the nation, then you can make some judgments about what will happen. ***First*** *of all, less people will be reliant upon the pension therefore we will be able to increase the pension in real terms.* ***Secondly****, because it's essentially capital for a long period, it will improve the capital base of the country, and therefore will reduce or remove the premium which existed in terms of equity for Australian shares.* ***Thirdly,*** *it will change the balance of payments in respect of its current deficit. We will move out of that dependency and move to a surplus.*

Unheard of things, yet all of those things have occurred. That's the test. But most importantly, of course, the superannuation balances have increased and we have a decent retirement system with high levels of dignity. Now that means workers have choices when they retire, to buy a car or go take an overseas trip or to support the family. Increased dignity and capacity when they needed it most.

And in doing so, superannuation helped create new industries, in the finance industry, in infrastructure across Australia, the leisure and retirement industries that are part of the economic capacity for the nation. So that's how it's funded and that's why it occurred … When we introduced the SGC, in the first eight years, wages increased by an average of 3.5% and superannuation increased from 3% to 9%. In the last eight years, the SGC has increased by half a percent and wages have only changed 2%. So there's simply no basis for it.

In conclusion, the last point is why the 12%? Well, the 12% was a commitment. People frame their expectations and their obligations around the 12%. Companies went out and negotiated in advance of that, increasing superannuation from 9% to 12% on the basis that there was an expectation and a covenant with the Australian people that superannuation would be increased to 12. To my knowledge, not one candidate in this country said that they opposed superannuation going to 12%. Not one, and certainly the government did not. So it's a covenant.

But most importantly, it is the extra dignity that is required in the generations ahead. It's the extra two or three years of retirement. The extra two or three years of security for people that is at stake here. It is the inequality that is removed for those people dependent on the SGC. The higher paid people are fine. They'll take it up to $25,000, they'll take their tax break, but those dependent upon the SGC are the vulnerable people who need it now and they will need it then. They are the vulnerable people. If you don't increase it, then they're at risk. It is their two or three years of extra dignity.

The best system was the system we were going to put in place. So you go to 15% and you allocate 3% of that for the extra aging, the people over 75 to 80, that was the best system … so we've got to increase the pension and increase super to 12%. I think that progressively over the next decade or more, as people realise they are living into the 80s and 90s, people will regret not going to 15%. People are already starting to regret not having the best health care system in terms of the recent crisis. That's what the best system looks like as part of a safety net, in which wages are adjusted regularly, superannuation is available and the Medicare system works. You have on display right now in the United States, the worst of a developed country. No decent national health care system, no retirement systems and an inadequate social security system.

We should aim for the best."

(Editor's note: Britannica defines a **Covenant** as 'a binding promise of far-reaching importance in the relations between individuals, groups, and nations'.)

Michele O'Neil summarised the Summit as follows, making it clear the battle lines have been drawn:

"I want you to know from the Australian trade union movement. This is a fight that we are not giving up. We understand that this is a critical issue we are not going to allow the government to remove those increases that are scheduled and legislated and in fact promised. We will be campaigning to ensure that we finish the job of building an adequate, fair, equitable retirement saving system for every Australian. So join with us in that, we'll be continuing this campaign."

The Retirement Income Review final report of over 600 pages was delivered to Treasurer Josh Frydenberg on 24 July 2020. He has yet to release it publicly, but look for the Review's a stance on whether increasing SG comes with a wages tradeoff.

Graham Hand is Managing Editor of Firstlinks. Parts of this transcript are slightly paraphrased without changing the meaning.

My lessons from five decades of investing

Claudia Huntington

Claudia Huntington is an Equity Portfolio Manager at Capital Group with 47 years of funds management experience. She began her investing career in 1973 — a period of rapidly rising inflation and volatile markets — and has decided to retire in 2020. She recently sat down to share insights and lessons learned over nearly half a century as a professional investor.

Our best investment decisions are made when we are on the same wavelength as the CEO. We gain a deeper understanding of their talents and the likelihood that they can successfully navigate risks and execute their strategy. Quarterly results are important, but taking a longer view can lead to a rich dialogue with company leaders.

What are the most important lessons you've learned?

I've learned that this business is more art than science. Early in my career I thought it was primarily about math and perfecting my model. Sure, you need math, but the more you invest, the more you realise it's about making judgments — about people and about the future. There are no facts about the future, so you have to try to look around corners.

Perhaps the most important lesson I've learned is that a company's management is essential to its ultimate success or failure. If you have a great company run by a poor CEO, the odds of that company turning into a good investment are low. On the other hand, if you have a mediocre company in a mediocre industry with a superb CEO, then it is much more likely that company will turn out to be a good investment. So, being able to calibrate CEOs and management teams is an important skill to develop.

Who are examples of CEOs you've encountered who were difference makers?

A recent example is Satya Nadella, Microsoft's Chief Executive. He was not an obvious choice to run the company when he succeeded Steve Ballmer in 2014, but he has excelled for a number of reasons. One thing Satya does at the end of every meeting, regardless of whom he is meeting with, is ask, "What do you think?" The fact that he wants to encourage participation, to hear other voices, is such a demonstrable, cultural advantage.

One of the most effective CEOs I've ever encountered was Mark Donegan of Precision Castparts, a maker of specialty metals for the aerospace and defense industries. Donegan is a detail-oriented leader with a laser focus on productivity and a great allocator of capital. But what is most special about Donegan is the culture he has fostered at his company. He created a real sense among his employees of working together to do the right thing.

I often ask executives to describe the culture of their company. Some have great answers; others look at you like you came from the moon. The best companies are often the ones with a very strong culture.

Identifying a strong CEO is no guarantee of long-term investment success. Years ago, I invested in a company called Silicon Graphics largely because I believed the CEO was first-rate, and I had faith in his strategy for the company — a maker of specialized computer systems for graphic applications. We identified the opportunity early, and the company experienced strong growth. The investment was a good one — until it wasn't.

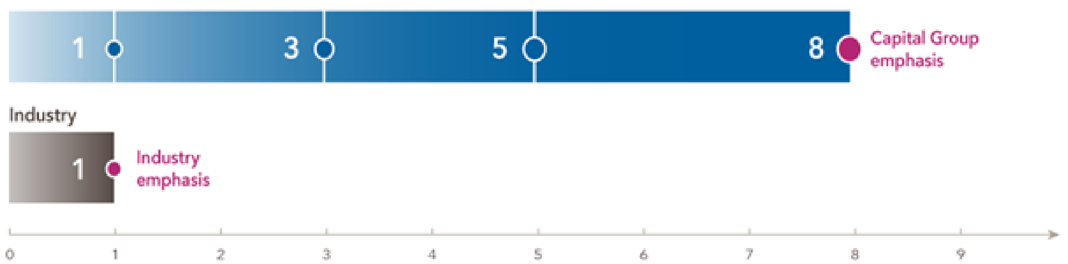
The CEO eventually got interested in politics and essentially assigned running the company to a subordinate who made a series of bad decisions. I had established such trust and faith in the CEO that I didn't look more closely when changes were made. That was an important lesson for me.

How has culture shaped you as a portfolio manager?

At Capital, we are encouraged to focus on long-term results. In fact, under The Capital System℠, compensation paid to our investment professionals is heavily influenced by results over one-, three-, five- and eight-year periods. Increasing weight is placed on each successive measurement period to encourage a long-term investment approach. Our culture is also designed to encourage what I call the lonely idea. By definition, good investments are not something everyone knows about. It takes a great deal of courage to identify an opportunity early on that has the potential to be a great investment.

Long-term focus is built into The Capital System℠

Portfolio manager compensation basis (years)



Source: Capital Group. Compensation paid to our investment professionals is heavily influenced by results over one-, three-, five- and eight-year periods. Increasing weight is placed on each successive measurement period to encourage a long-term investment approach.

Precision Castparts, the company I mentioned earlier, is an example of a 'lonely idea'. On paper this company was not that interesting. It was in the industrials space, with a concentrated number of clients and limited supply sources, so there were risks. When I travelled to Portland to meet with CEO Mark Donegan, I found the headquarters on the third floor of a small unmarked industrial building next to a gravel parking lot down a dirt road. Clearly this was a cost-conscious company. I found it to be to be well-managed and operationally focused.

When I presented this unlikely investment idea to our investment group, I was challenged by my colleagues. They were polite and respectful, but skeptical. "Why would you want to invest in a specialty metals company in this stage of the cycle?" But the beauty of The Capital System, is that I could act on my conviction to invest, and by doing so I convinced some colleagues to invest with me. Our system allows that bright spark of the lonely idea to shine through rather than being dimmed by consensus.

You have seen your share of downturns. What advice do you give younger colleagues?

I started my investing career near the beginning of one of the worst bear markets since World War II. My first job was at another asset manager that had three rounds of layoffs in my first six months. Capital ended up acquiring the firm's assets, which is how I came here. This early experience taught me that this is a very volatile business but that down markets are opportunities.

We try to reassure associates during periods of uncertainty and encourage them to focus on long-term opportunities that may arise. With the COVID-19 pandemic leading to a recession and bouts of volatility earlier this year, I shared with younger colleagues a list of 10 tips for weathering market downturns to provide some perspective from my own experiences. Among them are "don't dwell on what the market did yesterday," "pay attention to balance sheets," and "keep talking to companies." The easiest thing to do in a downturn is to just freeze, so many of my suggestions try to help colleagues manage emotions and take action.

10 tips for weathering market downturns

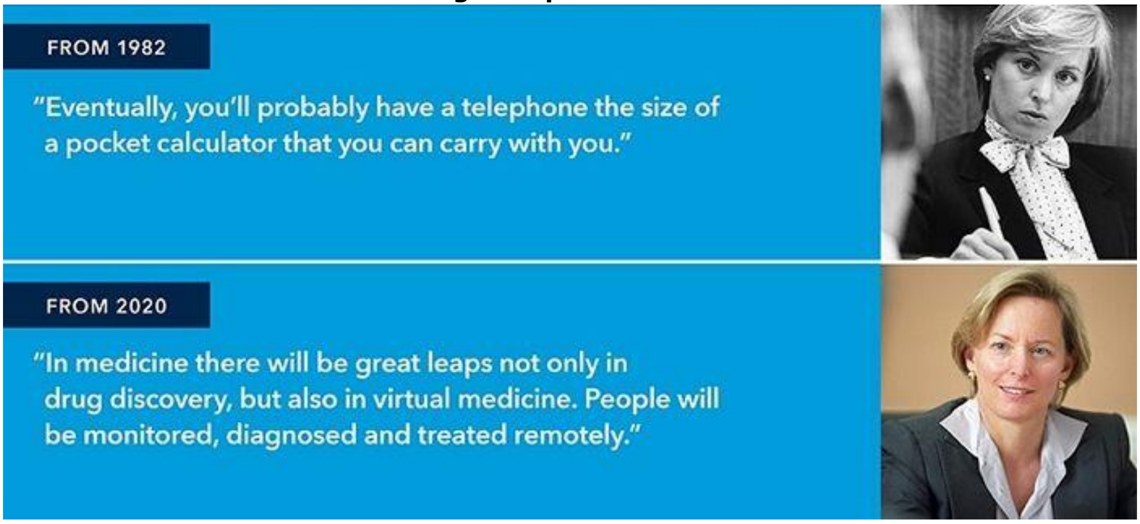
- Do scenario analysis
- Pay attention to balance sheets
- Keep talking to companies, but understand they don't know more than we do
- Don't dwell on what the market did yesterday
- Try really hard to see around corners
- Keep Will and Ariel Durant's "The Lessons of History" handy
- Remember buying opportunities may exist when fear is at its worst
- Keep a current wish/worry list and update it daily
- Humor helps, so talk to one another
- When things are bleakest, think about what "green shoots" could make the future "less bad"

For a primarily U.S.-focused investor, you have spent much of your time traveling abroad. Why is that important?

First and foremost, traveling gives me fresh perspective on the companies that I follow. So many companies today have global operations and customer bases. I can travel to India, for example, and visit a pharmaceutical business. That's going to give me perspective on all pharmaceuticals, wherever they are.

I travel to get some notion of the competitive environment, but also a sense of where challenges could come from or new opportunities. To truly understand a company — or a market or an industry, for that matter — you really have to go see it with your own eyes. You can't do this job from a Bloomberg terminal.

Claudia Huntington's predictions for the future



As an investment analyst in 1982, you predicted the coming of the mobile phone. How do you think the world will be different in 10 years?

I have witnessed remarkable change in my career, not only in terms of investing opportunities but also global opportunities.

When I started, there were no cell phones, no internet, not even desktop computers. I am certain there will be comparably huge leaps in the coming years. Many will be in technology, but there will be leaps in other areas. With respect to energy, I expect there will be some fabulous storage technology and better battery technology. That's going to have a tremendous impact on the kind of transportation people use. There will be major changes in agriculture, in the way farms operate.

I think one of the most exciting areas is medicine, where I believe there will be great leaps not only in drug discovery, but also in virtual medicine. People will be monitored, diagnosed and treated remotely.

What drew you to a career in investing?

I would describe myself as someone who has always been interested in learning about the way things work. That's what drew me to study economics in college and then to a career in investing.

Capital has a culture that encourages lifelong learning, which really has been a perfect fit for me. I am working on a project to quantify the role that management plays in a company's stock returns. I'll be working on it until my last day in the office!

Claudia Huntington is an Equity Portfolio Manager at Capital Group, a sponsor of Firstlinks. Claudia has 47 years of investment experience. She holds an MBA from Harvard and an Economics degree from Stanford.

For more articles and papers from Capital Group, click here.

The impact of our marriage breakdown on our SMSF

Alex Denham

My husband and I separated last year after being together for 11 years and married for 6 (it's ok though, we are keeping it nice – we just weren't meant to be). My reason for this overshare is not to garner sympathy, but to talk about managing relationship breakdowns in an SMSF and what better case study to use than myself.

As I said, we are keeping it nice, and are in the throes of finalising our property settlement DIY style without lawyers if we can help it. Together we have an SMSF which of course also needs to be dealt with. Managing the impact of a relationship breakdown on an SMSF needs special consideration and is often mishandled, so I thought I would highlight some of the issues.

These days superannuation is one of many assets that are considered 'property' and can therefore be formally divided (or 'split' as it's referred to in the legislation) as part of a divorce. The same applies to the breakdown of a de facto relationship in all states except (currently) Western Australia (this wasn't always so).

Splitting super balances in an SMSF

The way superannuation can be divided is set out in the Family Law Act, and the superannuation law (the SIS Act and Regulations) contains specific rules that allow funds to re-assign some or all of a person's superannuation to their soon-to-be-ex spouse or partner. Whilst these rules are valuable, they are not always well understood, and in some cases don't operate so well.

1. Better get a lawyer

Firstly, superannuation interests can't be 'split' on a handshake or under the separating couple's own arrangements, the law simply does not allow that. Deciding, amicably, that "Bob can have the SMSF" isn't enough.

To split superannuation interests, the law requires that the parties either make a 'Superannuation Agreement' (which has a range of legal requirements including that each party must obtain legal advice) or by Court Order (and it's usually recommended – but not compulsory – that legal advice is obtained for that too).

In our case, we have agreed to keep our own superannuation balances, we are not splitting anything, so it appears that we don't have to worry about getting lawyers. But not so fast – one of us needs to roll out of the fund eventually. We may be friendly, but still both keen to unravel our entwined financial matters.

Without a Superannuation Agreement or Court Order, rolling out may mean missing out on some special rules around …:

2. Capital gains tax

When superannuation in an SMSF is split under the relationship breakdown laws, generally one of the spouses will then transfer their balance out of the SMSF to another fund – be that another SMSF or a retail fund.

In normal circumstances, a transfer out of assets in specie or the sell down of assets to cash to affect a transfer will trigger a sale event for capital gains tax (CGT) purposes within the fund. However, special rules apply such that where a spouse transfers out assets (for example listed shares or units in managed funds) under these laws, CGT is not triggered in the transferring SMSF. The cost base of the asset is transferred from the SMSF to the receiving fund and the receiving fund will realise a capital gain or loss when the asset is ultimately sold by that fund.

Remember my ex and I are not splitting our super, our own balances remain our own. Most of the investments in our SMSF are listed shares and overall (due to my – cough, cough - brilliant investment management skills) they have increased in value.

If I simply transfer my balance out to a new SMSF (or Wrap account) by transferring shares in specie, those special CGT rules won't apply without a Superannuation Agreement or Court Order. The transfer of the shares will trigger a capital gain in the original fund and my ex will cop the CGT that results whilst I will enjoy reset cost bases in mine (second thoughts, that doesn't sound too bad).

Planning for the CGT impact requires specialist knowledge and skills, and unfortunately many divorce lawyers are not really across those issues. This is where an accountant and/or financial adviser needs to step in.

3. Don't die until it's done

Another issue we (or more accurately, I) have come up against is estate planning. Until the property settlement is complete and one or both of us is extracted from the SMSF, what happens if one of us dies?

We've taken a long time to get to the property settlement as we agreed it was easier to sell our property (a farm), pay out our combined debts and split the cash before we bothered. The farm was on the market for quite some time before it has finally sold.

In hindsight that decision has put me in a position of considerable risk. As we had a substantial mortgage, we both hold death and TPD insurance policies in the fund. Of course, the idea behind that was that if something happens to either of us, the survivor can pay out the debt with the proceeds and not lose our home.

The risk is my ex is in a de facto relationship so until we divorce, technically he has two spouses. If he pops his clogs, she has a claim on his super benefits – including his life insurance proceeds - as his superannuation dependant.

After we are debt free and everything is officially split and settled, good luck to her, but in the meantime, without a legal agreement in place, I'm running the gauntlet hoping he doesn't die. Yes, there are binding nominations for that, but there's nothing stopping him from changing it or changing his will to include her and lock me out.

And vice versa – what's to stop me from making a binding nomination to my estate and a will gifting everything in trust to our daughter leaving him with the debt and no insurance proceeds to pay for it if I die? Nothing.

The moral of the story is, no matter how friendly, the property settlement really should have been taken care of soon after separation to prevent those problems arising. I'll remember that next time….

Alex Denham is a Senior SMSF Specialist at [Heffron SMSF Advisers](). This article is general information and does not consider the circumstances of any individual.

The future is always clearest once it is in the past

Roger Montgomery

For stock market transactions to occur, there must be a buyer and a seller. Consequently, there must always be divergent, and even polar opposite, views despite generally similar information being available to both sides.

You decide which side of the fence you are on

But ask the question about whether the market is expensive or cheap and you stir up a hornet's nest of opinion. And reaching a conclusion on the affordability of the market is often interpreted as a prediction about its future direction. Argue the market is expensive and one is forecasting a crash. Conclude the market is cheap and you must foresee a rampaging bull run.

Of course, it is entirely possible that the market remains cheap or expensive for a long time. Therefore, a comment on whether it is cheap or expensive is not a prediction about anything. Today, I intend to demonstrate why the market could be cheap and why it might be expensive. I will leave you to decide on which side of the fence you sit and to draw your own conclusions about what happens next.

How big tech prices can be justified

Many of those who point to an overvalued market cite the extreme valuations for some technology companies. Apple, Facebook, Amazon, Microsoft and Google – commonly referred to as the FAAMGs – collectively represent 25% of the entire S&P500's market value, and the market value of US tech stocks is greater than the capitalisation of all European exchanges. Meanwhile, Apple's market capitalisation alone is now on par with the market capitalisation of the entire US small cap index, the Russell 2000.

Much of the market's 2020 rally has been driven by a stampede of investment into these five giant technology companies. In the absence of these five, the S&P500 would be about flat so far this calendar year.

In terms of measuring their popularity, over the last six years, while the famous five's profits have increased by US$80 billion, their market value has increased by more than US$5 trillion – a multiple of over 62 times. Investors have simply been willing to pay a lot more for each dollar of earnings that these companies generate.

Perhaps this is because while every economic contraction produces challenges for many businesses, there are others that win. And the FAAMGs are indeed winning.

I looked at the returns on equity for each of the FAAMGs for the last five years and discovered something universal. As these companies grew, they became more profitable. In 2016, Microsoft was earning US$20 billion on US$76 billion of equity, or a return on equity of 27%. In 2020, Microsoft's equity was a little more than 50% higher at US$110 billion but the company earned more than double its 2016 profits at US$44 billion. It therefore recorded a return on equity of 40%. Improvements in profitability, as measured by return on equity, similarly improved for the remaining four of the FAAMGs.

If I gave you a choice of purchasing a bank account with $10 million earning 27% interest or a $15 million account earning 40%, which would you prefer? You will always take the bank account with more money earning a higher return. It is no different with companies and when it comes to equity and returns on equity, too much of a good thing is wonderful (with apologies to Mae West).

As the profit and return on equity has risen these companies have become more valuable. And its unsurprising during a period of low growth and ultra-low interest rates that more valuable companies should also become more popular. Such assets are scarce, and history shows scarce assets always become more popular when growth and interest rates are low.

Of course, investors need to be mindful that popularity can be fickle.

The booming stock market therefore is at least partly due to the popularity of five very large but very profitable companies. While some value investors who predict an immediate crash and an emerging crisis could be right, they must also understand the same conditions also explain the concentration of money into those companies and business models that are actually winning.

IPOs come out of the woodwork

Booming stock markets tend to attract IPOs because the right time to list a company on the stock exchange, and sell out or sell down, is when investors are applauding their listing. Indeed, the appearance of today's conga line of IPO's is cited by many as a sign that temperatures are rising and therefore so should investor nervousness.

I have some sympathy with this idea. Experience tells me that we should be tempering enthusiasm when the most popular and oversubscribed IPOs are for companies with no profit and in some cases no revenue.

But the IPO wave has been rolling on for some years. Indeed, there was a bumper crop of IPO's in 2019 and investors will recall the IPOs of Lyft, Uber, Peleton, Pinterest and Zoom. This year's crop of listings which includes Snowflake, Unity and Palantir are different however in that they have much shorter histories and less time has passed between private equity capital raisings and an IPO. Snowflake has also seen its value more than triple in six months between the last private equity funding round and its price on the market today.

In Australia there may be a similar level of enthusiasm for the unprofitable. Sixty-three companies in the All Ordinaries index gained 20% or more this reporting season compared with only two companies that were down as much. But what some analysts point out is that out of the top 10 performing stocks in the All Ordinaries index, none made any free cash flow for the period. And of the 20 best performing stocks, only four made any free cash flow at all.

Such unbridled enthusiasm for loss making companies always gives me cause for concern based on the three similar scenarios in history I lived and invested through.

The overall market level is not a bubble

When I instead look at various models for estimating the fair value of the aggregate market, I reach a more sanguine conclusion. Australia, like the US, has experienced a similar expansion of price to earnings (P/E) multiples as a function of ultra-low interest rates and the migration out of cash and into growth assets.

Ultra-low interest rates helped the Australian Treasury sell 31-year Government bonds at around 1.9%. If we add on the equity market risk premium (ERP) of, say, 3%, we arrive at an earnings yield of about 5%. The inverse of the earnings yield is the PE ratio and if we then divide 100 by five, we arrive at a PE of 20 times earnings. At the time of writing, the forward PE for the ASX200 is currently 19.8 times, suggesting it is about fair value, even without factoring in growth. If long term growth is 2.5% (and yes, that may yet prove ambitious) the fair multiple of earnings could be materially higher than 20 times.

So perhaps the market isn't expensive at all.

The US Federal Reserve has also articulated and demonstrated a desire to do 'whatever it takes'. Indeed, central banks are aggressively buying an unprecedented range and quantum of listed and unlisted assets and securities. The consequence is the frustration of the traditional price signals that tell investors which businesses are weak and should fail.

What about the zombies?

And that brings me to the final point - the wave of zombie companies that some analysts are citing as a justifiable source for unease.

A zombie company is one that is unable to pay its interest expenses from its EBIT (earnings before interest and tax). The number of zombie companies listed around the world has been rising as a proportion of all listed companies in most western democracies and it has many investors worried.

Among the Russell 2000 – the US small caps index – the proportion of companies unable to meet interest on debts from profits for at least the last three years has risen from 10% in 2017 to 15% today. During the GFC, the proportion of such companies in the Russell 2000 was 16%, so today's number is almost on par with the experience during the GFC. A similar jump in the walking dead is evident elsewhere almost everywhere. The share of US listed firms more than 10-years-old with an interest coverage ratio of less than one for three years in a row is 19%, in Germany 15%, in the UK 8.5% and in France it is 17%. But while the numbers have been rising steadily it should be noted Japan's proportion of walking dead is almost double the US at 36%.

Time will tell

There are solid arguments suggesting the market is not expensive and equally solid arguments suggesting it isn't cheap. The future is always clearest once it is in the past.

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is for general information only and does not consider the circumstances of any individual.

Emerging markets: Should I stay or should I go?

Shane Woldendorp

"Should I stay or should I go?" sings Mick Jones in The Clash's popular 1980s rock song. It is perhaps a question many investors find themselves asking today, when thinking about emerging market (EM) equities. Many EM investors have answered this question already and headed for the exits!

But how should you as an investor attempt to answer this question? Ironically, the very fear that pushes valuations and prices down can also help to reduce the biggest risk that long-term investors face - the possibility of permanent loss of capital. This is most pronounced when an investor pays more for an asset than it is worth.

When investors all head in one direction, it can often be safer to go the other way. Of course, this is highly uncomfortable but as contrarians we believe that discomfort is the reason so few do it and those who do may be highly rewarded.

For long-term investors, the price you pay is almost the only thing that matters

Consider the cyclically-adjusted price-to-earnings (CAPE) ratio (also known as the Shiller P/E), a well-established barometer of how expensive a market is. It is not only helpful in telling us if a market is expensive or not, but has also shown to be a helpful tool to forecast long-term equity returns.

A 2012 study by Klement, titled *Does the Shiller-PE work in emerging markets,* found that the CAPE ratio was a reliable long-term valuation indicator to predict future real returns not only in developed markets (DMs) but also in EMs. The same study found that the correlation between the CAPE ratio and future real returns is low over shorter investment horizons, but is much higher (averages around 0.7) over longer investment horizons of five years and more, in both DMs and EMs.

Similar to the CAPE ratio, a 2017 study by Keppler and Encinosa, called *'How Attractive Are Emerging Markets Equities? The Importance of Price/Book-Value Ratios for Future Returns*' showed that there was a negative relationship between the price-to-book (P/B) ratio of the MSCI EM Index and the subsequent returns in US dollars over the next four years, over the period January 1989 to October 2016.

In other words, the lower the starting P/B ratio is, generally the higher the subsequent returns over the next four years and vice versa. The same authors also found the same relationship in the United States over the period 1970 to October 2016.

EMs appear to be cheap on an absolute and relative basis

As shown in Figure 1, EMs in aggregate traded at a CAPE ratio of around 12 at the end of June 2020, which is low versus its history and at a similar level reached during the GFC. In contrast, the US market traded at a ratio of close to 30, much higher than its long-term average of around 17. In short, EMs trade at low levels when looking at the CAPE ratio, both on an absolute and relative basis.

Figure 1: EMs trade at low valuations relative to history

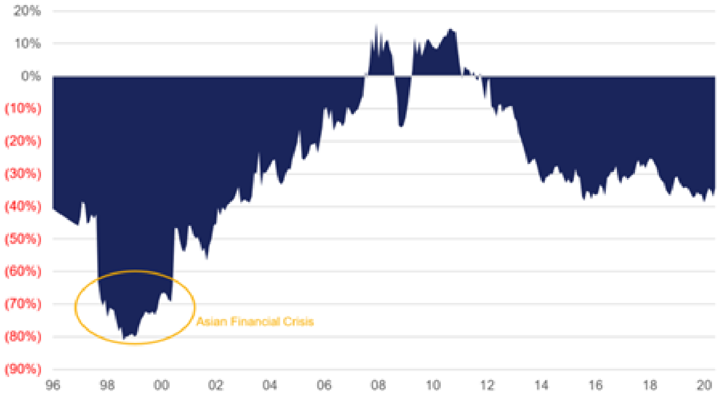
The CAPE ratio for the US and EMs, June 2020

*Source: Minack Advisors, MSCI, National Bureau for Economic Research. Data as at 30 June 2020. CAPE ratio is based on trailing operational earnings. *US$ price index, with index and cyclically-adjusted earnings deflated by US Consumer Price Index.*

Like many valuation metrics, the CAPE ratio has limitations and investors should never rely on a single metric. The good news here is that EMs are also attractive when evaluated using other metrics, such as the P/B ratio. Figure 2 shows that EMs trade at around a 35% discount to DMs on a P/B basis as at 30 June 2020. This is lower than the long-term average discount of around 28% (since the end of 1996). Admittedly, this is not as low as the discount levels reached during the Asian Financial Crisis in the late 1990s, arguably a once in a lifetime buying opportunity for Asian equities.

Figure 2: EMs also appear cheaper than DM's

The P/B discount or premium of MSCI EM Index relative to MSCI World Index, 1996 to June 2020



Source: Bloomberg, Orbis. Data as at 30 June 2020.

From starting valuations like these, investors in EMs may be handsomely rewarded

Keppler and Encinosa also found that when the P/B ratio fell between 1.22 and 2.76 (the range we find ourselves in today, with the MSCI EM Index trading at around 1.6 times at the end of June 2020), the average total annual return in the four years that followed was 9.4%. Although, the study also found that there was a wide range of potential outcomes.

Furthermore, the subsequent 10-year return in US dollars is also clear, that at the current P/B valuation level, the outlook for EM investors looks promising over the long-term.

The cheapness in EMs isn't justified by its fundamentals

Of course, low valuations alone are not necessarily enough to make an investment case. If fundamentals are diminished, then investors would simply be paying less for lower quality companies.

As shown in Figure 4, EMs trade in aggregate at more attractive and favourable multiples than most other regions globally. For example, the median stock in EMs trades at a lower multiple of earnings (the normalised price-to-earnings (P/E) ratio for EMs is around 21 times versus 27 times for the FTSE World Index) at the end of June 2020, despite being fundamentally better businesses – as demonstrated by having grown revenues at a faster average rate over the past 10 years, despite lower levels of debt.

Figure 4: EM's in aggregate trade at attractive fundamentals versus other regions

	Trailing net profit margin as % of 10-year median†	Price/ earnings (normalised)*†	Average revenue growth, last 10 years†	Net debt/ equity†
FTSE World Index	106%	27x	7%	29%
North America^	113%	28x	10%	25%
Europe^	102%	24x	4%	51%
Japan	103%	24x	5%	5%
Emerging Markets*	92%	21x	11%	-6%

*As at 30 June 2020. Source: Worldscope, Orbis. In each case, calculated first at the stock level and then aggregated using a weighted median. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. *Earnings are normalised by multiplying each company's trailing revenue-to-price multiple by its median 10-year net profit margin. †For non-financial companies. ^Excludes emerging markets.*

EMs appear cheap on both and absolute and relative basis when looking at both the CAPE and P/B ratio. Both metrics have historically proven to be good predictors of long-term returns. Furthermore, it does not appear that the average company found within EMs is of lower quality, with EMs trading in aggregate at more attractive fundamentals versus other regions.

Of course, investors should be wary of piling into the market blindly. In our view, there are plenty of exciting opportunities within the EM universe but in *selected* parts of the market.

NetEase: a quality business with long-term growth potential

A small number of companies exposed to the Chinese internet sector look attractive and trade at a significant discount to our assessment of intrinsic value. A good example is NetEase, a provider of online games, education, and entertainment. Founded in 1997, today its key businesses are all delivered online and therefore almost custom-made for a world in lockdown.

In our view, a combination of secular tailwinds and its proven game development capability should drive the growth of its core online gaming business over time. In addition, it also has some exciting new ventures that are currently loss-making, but which we believe offer substantial long-term upside potential.

After adjusting for cash, NetEase traded at around 19 times our estimate of 2020 earnings of its core games business (at the end of June 2020). We believe this is an undemanding valuation for a resilient business with long-term growth potential, and a rock-solid balance sheet with net cash equivalent to about 20% of its market value. The US-China tensions have been a concern of late for investors, but we think that the fundamentals of NetEase are generally less exposed, given the company provides most of its services domestically.

Please stay, don't go!

We think EM offers investors with a better chance of generating meaningful returns over the long-term starting at today's levels. There is no doubt that EM equities do come with additional risks often related to economic or political instability. But the risk that really matters to investors is not the short-term uncertainty, but the possibility of permanent loss of capital, which occurs when you pay more for an asset than it is worth.

Fortunately for investors today, after a prolonged period of relative underperformance versus DMs, the risk of overpaying now appears to be well below-average. While most investors have chosen 'to go', we think that the facts support the opposite conclusion: investors should instead choose 'to stay'.

Shane Woldendorp, Investment Counsellor Group, [Orbis Investments](), a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person. For more articles and papers from Orbis, please [click here]().

20k now or 50k later? What's driving decisions to withdraw super?

Susan Thorp

Written with Hazel Bateman, Robbie Campo, David Constable, Isabella Dobrescu, Ailsa Goodwin, Junhao Liu, and Ben R Newell.

The COVID-19 Superannuation Early Release Scheme was one of the first pandemic-related policy changes made by the Australian Government. In April 2020, the Government announced that superannuation fund members experiencing loss of employment or financial hardship during COVID-19 could apply to the Australian Taxation Office (ATO) to withdraw up to $20,000 of their superannuation savings by 24 September, without giving formal proof of eligibility at application. On 23 July 2020, the Treasurer extended the Scheme to 31 December 2020.

The Scheme modifies otherwise very tight controls over superannuation withdrawals. The [prevailing rules]() prevent most members from accessing their savings before reaching a minimum 'preservation' age (55-60, depending on birthdate) and retiring (or transitioning to retirement), with some limited exceptions in cases of extreme personal or financial hardship. The Scheme thus changes a fundamental element of the retirement savings system in Australia.

The pattern of withdrawals of funds by superannuation fund members since the start of the Scheme shows that the usual preservation rules play a critical role in preventing members from spending their mandatory savings before retirement. The ATO has received more than 3 million applications to withdraw early under the Scheme, and funds have paid out $34 billion. The number and size of withdrawals indicates that the scheme is likely to have extensive short- and long-term effects on individual and aggregate retirement savings in Australia.

Survey of super members

Many important questions about the operation and effect of the COVID-19 early release scheme remain unanswered. To better understand these issues, we analysed survey responses of early withdrawers from a large industry superannuation fund, Cbus. Cbus is a profit-for-members fund that primarily serves the construction sector. It has almost 760,000 members and manages around $56 billion in savings. By 9 August 2020, Cbus had made more than 229,000 early release payments with an average withdrawal of $8,408. Between early May 2020 and early July 2020, Cbus surveyed 3,047 members who had withdrawn superannuation savings under the Scheme.

Respondent characteristics

The median survey respondent was 39 years-of-age, male, and withdrew the full $10,000 (the Scheme allowed two tranches up to $10,000 each) from their account. Table 1 shows characteristics of the average and median survey respondent.

Table 1: Survey sample: Summary Statistics

	Average	Median
Age (years)	40.4	39.0
Female	15%	0%
Tenure (years)	9.47	8.00
Balance before Early Release	$62,639	$37,396
Early Release Amount	$8,444	$10,000
Balance after Early Release	$54,195	$28,010
% withdrawn	40.1%	25.1%

Amounts withdrawn

More than 20% of respondents virtually emptied their accounts; however, 43% reported they had withdrawn less than 20% of their entire balance as shown in Figure 1.

Most respondents withdrew either the $10,000 upper limit, or an amount very close to their account balance, if their balance was less than the upper limit. Those who left small residual amounts could have been preserving insurance cover or may have been working from slightly dated balance information when making their application. Figure 2 shows residual balances after withdrawals compared with the $10,000 limit. The fact that only 9% of respondents withdrew less than the limit while still preserving more than $1,000 in their account, demonstrates that respondents were strongly guided, and effectively constrained, by the $10,000 limit.

Figure 1: Distribution of respondents by percentage of account balance taken as Early Release

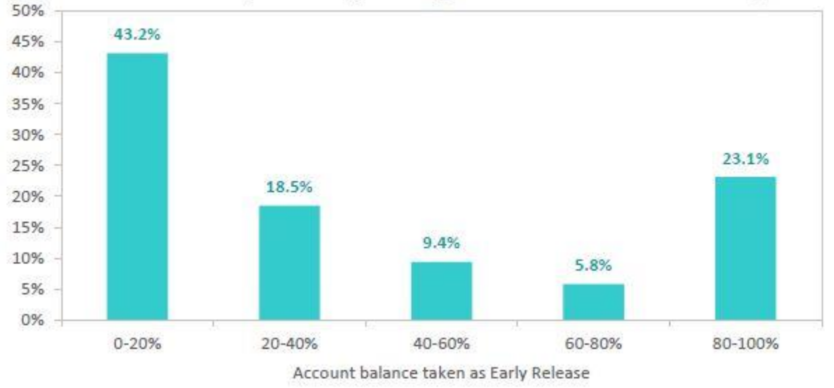


Figure 2: Withdrawals relative to $10,000 limit and remaining balances

Reasons for withdrawal

The Government intended the COVID-19 Scheme would help people who were unemployed, made redundant or who were experiencing reduced work hours, to meet expenses during the COVID-19 restrictions.

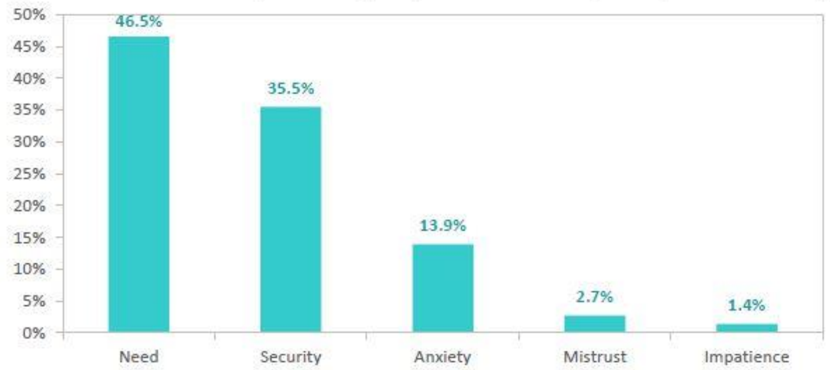
We find that more than half of respondents reported that they withdrew funds to meet immediate expenses or to cover lost income. Notably, results in Table 2 also show that around one quarter were thinking of future financial pressures. In other words, one in four respondents appear to be taking precautions. Then again, few respondents cited concerns about falling asset values or simple impatience as reasons for accessing their savings.

Table 2: Reasons for withdrawal

Main reason for withdrawal		
Immediate concerns	Lost income	16.6%
	Job loss of others in HH	4.0%
	Pay expenses	38.1%
Future concerns	Extra savings	6.1%
	Future bills	20.5%
Savings protection	Protect savings	1.7%
	Falling market	2.2%
Money today	Don't have to wait	1.4%
	Unimportant	0.7%
Others	Others	8.8%
Total		100.%

The focus on needing savings for expenses now or in the near future aligns closely with results in Figure 3, that shows that a sense of need motivated around 47% of early-withdrawers while a desire for security motivated around 35%.

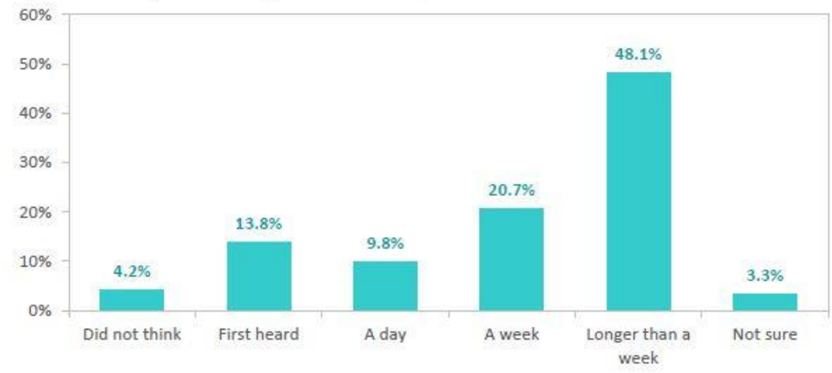
Figure 3: Motivation for early release request ("What word best captures your motivation?")



Understanding the decision to withdraw

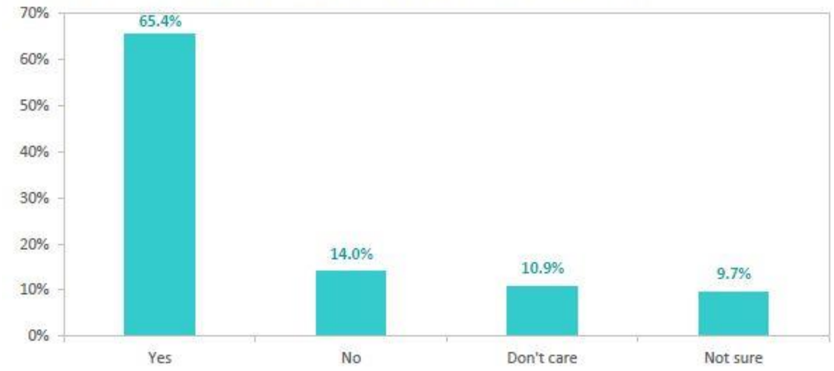
Around half the respondents report spending a week or less thinking before they decided if they would apply for early release, and 28% either made their minds up immediately or within a day of hearing about the scheme. Figure 4 reports the distribution of respondents' deliberation times.

Figure 4: Time spent thinking before deciding to withdraw



Surveyed members expressed a high degree of uncertainty or unconcern about the long-term implications of the withdrawal. Around one-third of respondents said that they were unsure about the impact of their withdrawal on their retirement balances or had not thought about that or did not care. Figure 5 shows how surveyed members answered questions related to retirement impact. These findings demonstrate that many withdrawers either could not, or did not, evaluate the impact of their decision.

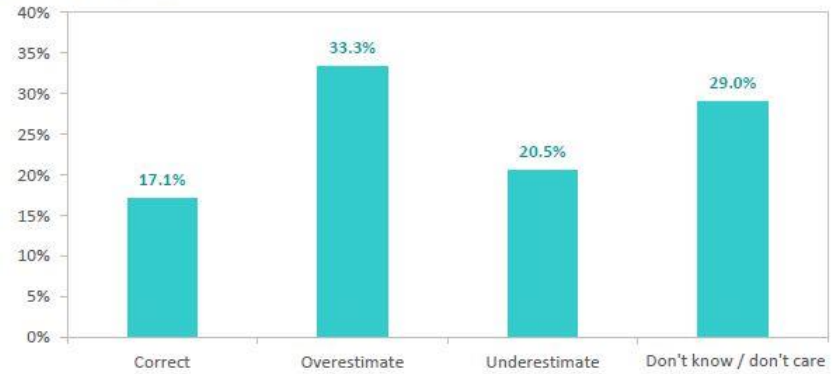
Figure 5: Responses related to retirement impact ("Did you think about the consequences of withdrawing your super in terms of the impact on your retirement?")



We also compared respondents' estimates of the impact of their withdrawal with a projection of that impact based on assumptions made in a Cbus guidance on the early release scheme for members.

Figure 6 shows that 50% of respondents either underestimated the impact of the withdrawal on their superannuation accumulation at retirement or did not make an attempt to estimate the impact (categorised as 'Others' in Figure 6). The pattern of responses to the question on estimated impact, where each possible answer is chosen at approximately the same rate by respondents, is consistent with random selection of answers, and thus with general uncertainty among withdrawing members about long-term impact.

Figure 6: Respondent estimates of impact of Early Release; comparison with Cbus projection amount



Employment status and the Early Release Scheme

To be eligible to make a withdrawal under the Scheme, members must be unemployed, receiving JobSeeker, Youth Allowance for job seekers, Parenting Payment, Special Benefit or Farm household Allowance, have been made redundant on or after 1 January 2020, or experiencing a 20% or more reduction in work hours or turnover for sole traders.

Of surveyed members, 28% had lost their jobs due to the crisis, and 51% had reduced working hours since the crisis (Table 3). Within the group of members who were employed, about 45% were not sure or did not think they would continue to be employed.

Table 3: Employment status of surveyed members

	% of sample
Unemployed before COVID	16.0%
Unemployed due to COVID	28.4%
Employed - Hours reduced	50.7%
Employed - Hours same or increased	4.9%
Total	100%

Members who were employed withdrew a smaller percentage of their account balances, on average (Table 4). (We note that those who were employed were likely to have had higher balances than unemployed members before withdrawing that may partly explain the lower average percentage.)

Table 4: Percentage of account balance taken as Early Release by employment status

	Average percentage of account balance withdrawn
Unemployed before COVID	45.9%
Unemployed due to COVID	43.1%
Employed - Hours reduced	37.0%
Employed - Hours same or increased	36.9%
Total	40.1%

Those who are employed and maintaining their working hours are less likely to withdraw for immediate concerns and expenses, and more likely to anticipate future needs or the protection of their savings (Table 5). Those who are employed but experiencing reduced hours spent more time thinking about withdrawing their superannuation savings before they acted (Table 6).

Table 5: Main reason for withdrawal by employment status

	Unemployed before COVID	Unemployed due to COVID	Employed - Hours reduced	Employed - Hours same or increased
Immediate concerns	58.8%	62.9%	58.0%	40.5%
Future concerns	21.9%	25.2%	28.6%	29.1%
Savings protection	3.3%	3.6%	3.9%	7.4%
Money today	3.5%	2.3%	1.2%	4.7%
Other	12.5%	6.0%	8.3%	18.2%
Total	100%	100%	100%	100%
% of sample	16.0%	28.4%	50.7%	4.9%

Table 6: Time spent thinking before deciding to withdraw by employment status

	Unemployed before COVID	Unemployed due to COVID	Employed - Hours reduced	Employed - Hours same or increased
A day or less	33.6%	31.6%	23.4%	32.4%
A week or more	63.5%	64.8%	73.3%	63.5%
Not sure	2.9%	3.6%	3.2%	4.1%
Total	100%	100%	100%	100%
% of sample	16.0%	28.4%	50.7%	4.9%

Future survey work will examine whether these trends continue in the second phase of the early release scheme, which allows an additional $10,000 to be withdrawn from superannuation accounts in the period 1 July to 31 December 2020.

The full version of this report can be found here.

Hazel Bateman, School of Risk & Actuarial Studies, UNSW Sydney & CEPAR. Robbie Campo, David Constable, and Ailsa Goodwin, Cbus. Isabella Dobrescu, School of Economics, UNSW Sydney. Junhao Liu, Finance Discipline, The University of Sydney Business School, The University of Sydney. Ben R Newell, School of Psychology, UNSW Sydney. Susan Thorp, Finance Discipline, The University of Sydney Business School, The University of Sydney.

Thanks to Cbus, particularly Robbie Campo and David Constable for access to data from a survey of Cbus members. This article is general information.

The surprising resilience of residential housing and retail

Chris Bedingfield

We are in the midst of a one-in-100-year pandemic and unemployment has reached levels not seen since the Great Depression. And while market observers continue to either marvel or scratch their heads at the surge in global equity prices, some truly unexpected real estate metrics continue to emerge.

First, it was widely expected by many economists and observers that the local residential market was poised to crash by up to 30%. However, to date, the data is not playing out as expected.

A pandemic and one million people unemployed, so house prices are … going up?

While it's early days, some of the best real-time data we have – in this instance, preliminary auction clearance rates – suggest house prices are not (yet) falling in a meaningful way. In fact, despite the naysayers, a strong case can be made that by the time we reach the fourth quarter this year, residential prices in some of our main cities will in fact be rising.

Source: Domain, CoreLogic, ANZ Research, Quay Global Investors

Of course, auction clearance rates are not a perfect measure. But nevertheless, over the long term there is a steady relationship between clearance rates and residential price movements. For instance, since the end of the lockdown in Sydney, clearance rates have generally oscillated around 60%, a situation suggesting a flat-to-rising market. CoreLogic reports that in the four weeks to 20 September across all capital cities, new listings increased and auction clearance rates were rising.

It appears to be happening elsewhere too

Australia is not alone in these unexpected metrics. The incredible resilience of our domestic residential real estate market is consistent with observations from other parts of the world too. In the UK, for instance, house prices are accelerating at their fastest pace since BREXIT.

Source: Bloomberg, Quay Global Investors

And in the US, despite the sharp rise in mortgage delinquency rates, prospective home buyer activity (as measured by foot traffic) is at its highest level since 1994, matching the recent surge that has been seen in existing home sales.

Source: US Bureau of Economics, Quay Global Investors

Retail also doing well

Residential property metrics are not an outlier. Another economic indicator that appears to defy the current economic narrative has been retail sales.

In Australia, ABS retail sales for July showed retail sales were up a significant 12% year-on-year. This bounce is more than just a catch-up from the April slump. On a rolling 12-month basis, we estimate Australian retail sales are now up 3.7% compared to the previous corresponding period.

Source: ABS, Quay Global Investors

In fact, Australians have spent an additional $12 billion in the 12 months to July 2020 compared to the 12 months to July 2019.

While much has been made of the strength of the online shopping business models during this period, this retail activity is not all online either. During the recent Scentre group earnings call, it was noted that portfolio in-store retail sales during July were actually above those of July 2019, including Victoria (which went into lockdown on 9 July).

Overseas retail experience

We can observe similar data trends in retail sales in the US. While it is not quite as strong as Australia, total retail sales are nevertheless higher on a rolling 12-month basis.

Source: US Census Bureau, Quay Global Investors

The US is not alone. In Germany, for instance, retail sales for the six months to June are 0.8% higher than the previous six months.

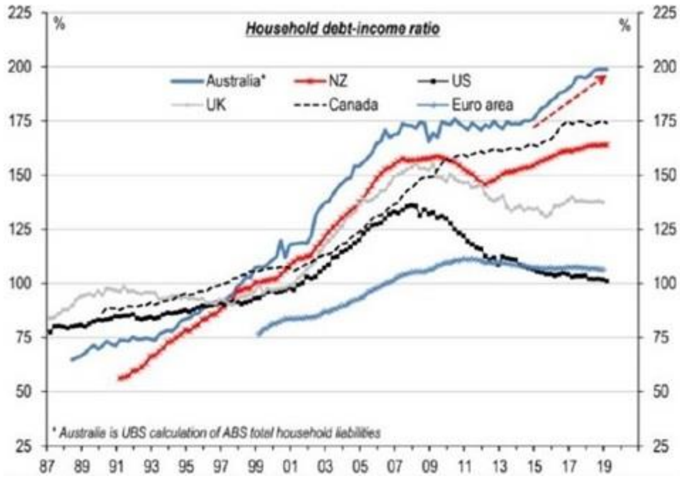
So, what's happening to explain the rise of residential and retail?

Explaining the data via sectoral balances

It would be easy to suggest the observed data in residential and retail is a result of a 'sugar high' from fiscal stimulus – and indeed, that could be part of the story. As well, many consumers have been denied certain spending 'avenues' in 2020, most obviously air travel, entertainment and eating out. It may well be that the additional dollars are simply being spent elsewhere.

But we think there is more to it than that.

For the best part of 10 years, the common narrative has been that the Aussie consumer is 'dead'. Weak wage growth coupled with very high levels of household debt has constrained the consumer. And the data certainly supported this argument.



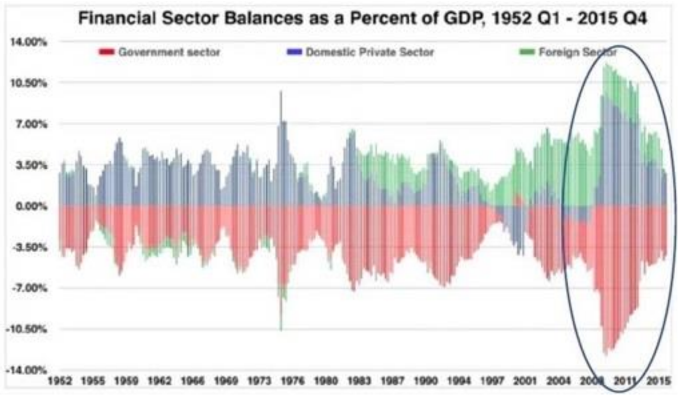
Source: ABS, Bloomberg, UBS

But the massive fiscal response to the lockdown from most governments will go a long way to repairing household balance sheets, freeing up the way forward for increased consumer spending.

Regular readers of our articles will know from the sectoral balances' framework, that government financial deficits equal non-government financial surpluses. (The non-government sector includes businesses, households and the foreign account – aka the current account deficit.)

The US GFC experience

Below is a chart of the sectoral balances in the US in response to the financial crisis in 2008-09, clearly showing the significant increase in net financial assets (cash and bonds) accruing to the domestic private sector as a result of the Obama-driven American Recovery Act. This was a major reason why the US avoided repeating a second Depression.



Source: Tipping Point North South

What is interesting about this chart (and Australia is similar) is the American Recovery Act deficit measured $831 billion. The current CARES act is closer to four times the size, at $3.5 trillion.

Similarly, in 2009 the Australian government stimulus to the financial crisis was $45 billion, or 4.5% of GDP. Today's response is closer to $150 billion.

Even after allowing for 10 years of inflation, the sheer scale of government spending now is multiple times that undertaken during the GFC.

The bottom line is that household balance sheets (and corporate profits) are receiving a significant boost from net government spending. And until governments reverse course and start generating surpluses (which we do not envisage any time soon), these net financial assets will continue to reside in the private sector, permanently repairing balance sheets and setting up households for the next cycle, as the household savings ratio from the national accounts confirms.

Source: ABS, Quay Global Investors

Conclusion: the power of public spending

This has been a very unpredictable economic cycle. Despite a one-in-100-year pandemic and near-depression levels of unemployment, residential property prices and retail sales are not following the widely expected doomsday script. While the recent data could of course be temporary, we think it is also helpful to view the recovery and other leading indicators from a sectoral balances' framework.

Much in the same way that many financial commentators overestimated the power of central banks during the last decade (see our Investment Perspectives article which suggests the Federal Reserve does not influence long-term stock market returns), we believe there is an equal risk they will underestimate the power of the public purse now.

Chris Bedingfield is Principal and Portfolio Manager at Quay Global Investors. This article is general information and does not consider the circumstances of any investor.