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Contents

Editorial

First up, two pieces featuring **Julie Bishop**, Australia's first female foreign minister. Her speech at a CFA conference last week to celebrate International Women's Day (IWD) has not been widely reported. She spoke about leadership skills and her time in government. Then we add her interview with **Leigh Sales** on Monday's night's 7.30 on **ABC TV** which was equally revealing with her views on the Prime Minister not being told about major events in Canberra and neither **Christian Porter** nor **Scott Morrison** reading the allegations.

A reminder we published additional articles for IWD in the Weekend Edition, including how women invest, the 'Witch' of Wall Street, and business culture.

On the markets and the bull v bear arguments ...

NASDAQ roared back 4.5% on Tuesday night, just when people were calling a major correction in tech prices. While markets always have differences of opinion, fund managers are further apart than I can ever recall at the moment. At one end is the 'bounce back' theory of strong consumer spending. At the other is the overvaluations during a pandemic with mutant virus threats.

Even the optimists must acknowledge that if there is a severe correction, it's will not come with someone waving a red flag a week before. Waiting for it to happen risks being on the wrong side of it. While the best strategy is to stay invested and not sell after a heavy fall, many people panic and turn to cash at the worst moment.

I'm reminded of a couple of famous lines in **Ernest Hemingway**'s first major novel, *The Sun Also Rises*.
"How did you go bankrupt?" Bill asked.
"Two ways," Mike said. "Gradually, then suddenly."

Seth Godin developed this idea in a 2014 note on his blog. He said,

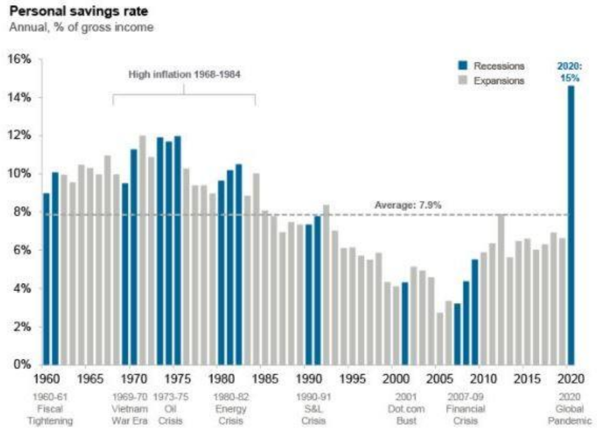
"This is how companies die, how brands wither and, more cheerfully in the other direction, how careers are made. Gradually, because every day opportunities are missed, little bits of value are lost, customers become unentranced. We don't notice so much, because hey, there's a profit. Profit covers many sins. Of course, one day, once the foundation is rotted and the support is gone, so is the profit. Suddenly, apparently quite suddenly, it all falls apart. It didn't happen suddenly, you just noticed it suddenly."

It's also what happens in markets, and we currently have many signs of excess, of overvaluation, of hubris, of overconfidence. We know there's something weird when Bitcoin hits US$50,000, Tesla is worth more than all the other large car makers in the world combined, and governments borrow and spend unlimited amounts (US Government stimulus packages are now worth over US$7 trillion ... that's US$7,000,000,000,000). But we shrug our shoulders and go along with it, until a crisis comes gradually, then suddenly.

The strongest argument of the bulls is the rebound trade. Here's a new phrase you can use whenever anyone asks you to justify the current high valuations: '**revenge spending**'. Some fund managers believe that when Americans and Europeans emerge from the pandemic and lockdowns, the burst of buying activity (or revenge spending) will lead to a massive economic rebound.

And maybe they're right. **Jeff Schulze**, Director at **ClearBridge Investments** made a strong pitch at the **Portfolio Construction Forum** last week. He has also written that growth conditions will be the best in 40 years in late 2021:

*"There is going to be a powerful force that's going to be unleashed on the US economy, which is consumer balance sheets and the excess savings that have been accumulated over the last year ... So, our core view has and continues to be that you're going to have this **deferred gratification** or **revenge spending** in the middle part of the year."*



And here it is, in the middle of a pandemic and a rapid rise in unemployment, record personal savings in the US.

This week, **The Economist** leads with the same point, saying:

"The economic controls implemented during the second world war make today's restrictions on restaurants and football stadiums look lax. In America the government rationed everything from coffee to shoes and forbade the production of fridges and bicycles. In 1943 its entire automobile industry sold only 139 cars. Two years later the war ended, and a consumer-led boom ensued. Americans put to use the personal savings they had accumulated in wartime. By 1950 carmakers were producing more than 8 million vehicles a year. The big question is whether or not the rich world can repeat the post-war trick, with pent-up savings powering a rapid bounce-back."

What about Australia? The latest ABS savings numbers released last week show a decline in the household saving ratio for December 2020 to 12.0% from 18.7% in September 2020 and 22% in June 2020. These are historically very high, suggesting Australia could also see revenge spending.

Source: ABS National Accounts

We focus on this big question today.

While **Andrew Mitchell** does not believe the market as a whole is expensive, he identifies four bubble areas which show investors need to watch risk closely.

This week's White Paper is an article and video by **Hamish Douglass**, where he gives a detailed review of vaccine developments, with a sobering outlook for mutations. Hamish says he reads a couple of scientific papers a day, and he is at the cautious end of fund managers. He says risks are foreseeable and investors could have their "shirts ripped off" if something goes wrong, and he sees "clear speculative frenzies" in some assets.

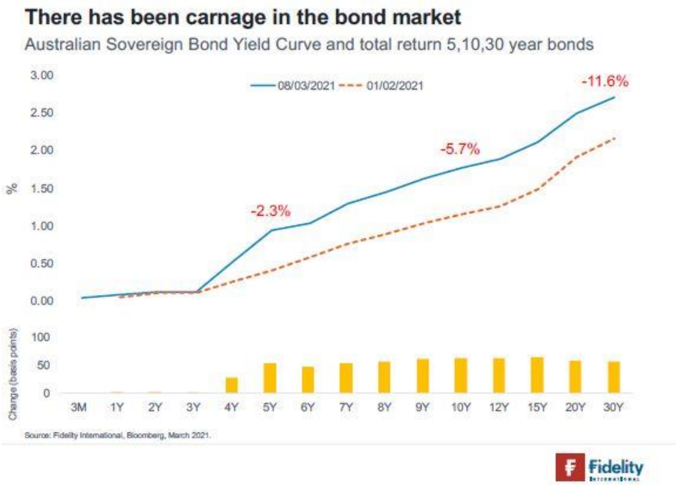
"There is no margin for error in markets at the moment … At one point you want to have risk on because of the stimulus and the economic recovery holding up, but there are other warning signs that you could have your shirts ripped off if something goes against you ... If it is the new inflation coming, the Federal Reserve at some point is going to have to change course and start lifting interest rates. That is a disaster for financial markets. The very long-term – is all this printing of money going to lead to a new paradigm and monetary induced inflation in the world? That is a great question that I do not know the answer to … it is very foggy out there."

What about simple indexing to take advantage of the overall market rise? **Shane Wodenthorp** looks inside passive investing benchmarks to see how concentrated they have become, leaving even the index with heavy sector bets.

Then **Harry Chemay** examines whether all these attempts at forecasting have much merit. Ultimately, despite the expertise, they are educated guesses, leaving investors to decide for themselves.

And we draw on the ultimate investor, Warren Buffett, who has not been beyond criticism himself recently. **Susan Dziubinski** reviews his latest shareholder letter for three main features and the long-term consistency of how to make money.

So where to invest? One possibility is to take on more risk in non-government bonds, and **Adam Grotzinger** describes the parts of the market where he sees value, especially when inflation threatens. To emphasise the point, see the chart below of capital losses on Australian Government bonds in six weeks between 1 February and 8 March 2021: a loss of 5.7% in the 10-year and 11.6% in the 30-year as rates rose at the long end. Such volatility is equity-like, leaving doubts about bond capital protection.



This rise in bond rates and uncertainty about inflation stems from government spending, debt, money printing and QE. It may not sound exciting but it's important and **Tony Dillon** gives as simple an explanation as possible on what is happening. Grab a coffee and concentrate (your mind, not your portfolio!).

Julie Bishop on leaders, life, Liberals and libertines

Graham Hand

Julie Bishop was Australia's first female foreign minister and was also Deputy Leader of the Liberal Party. Among her many achievements after a career in law, she led the international response to the downing of Malaysian Airlines Flight MH17. Today, she manages her own advisory firm and is the first female chancellor of the Australia National University.

She spoke at the International Women's Day annual event for CFA Societies Australia on 5 March 2021.

She also appeared on ABC TV's 7.30 on 8 March 2021 and shared her views on recent events in Canberra. The video and extracts are added at the end of this article.

The CFA presentation was Julie Bishop's first trip to Sydney for over a year, and for someone who spent much of her career travelling the world, being grounded in Western Australia was a big change. She sees reasons for a bright future after the pandemic, especially for Australia, but warns that shocks will continue for some time. The World Bank is predicting that the number of people around the world living in extreme poverty (under $2 a day) will increase from 700 million people to 800 million due to the pandemic.

There will be long-term fundamental changes from developments in technology, which will disrupt our lives in unimaginable ways. Workers will need reskilling and retraining as businesses adopt technology to their advantage. There will be new jobs and new workplaces, offering opportunities for a bright future.

"Another mega trend that will impact on all our lives is a great power competition between the United States and China. As the Secretary General of the United Nations, António Guterres, put it: it's like a great fracture. The world's splitting into two. The two largest economies are creating separate and competing worlds, each

with their own dominant currency, their own AI and internet capacities, each with their own zero sum geopolitical and military strategies.

In the past, Australia has always said, 'We don't have to choose.' But increasingly, China and the US are forcing a choice. And for the first time in our history, our major trading partner is not also our major defense and strategic ally. And for the first time in our history, our major trading partner, China, is in direct economic conflict with our major strategic and intelligence ally in the United States."

Bishop identified a third global megatrend as a pushback against globalism, as more people feel they are missing out on increasing wealth. The gap between the haves and the have nots leads to a feeling of unfairness and inequality. It has also led to the rise of populism, with seemingly attractive short-term policies adopted to solve an immediate problem but with long-term poor consequences, such as trade wars and restricting migration.

Bishop reflected on the many world leaders she has met ("Boy, should I write a book!"), but she identifies the major characteristic of strong and resilient leaders:

"I think those who best served their community were those who could understand the consequences of their decisions by putting themselves in the shoes of the person they were dealing with. They could appreciate the impact of what they were doing on individuals."

She characterised her life as a series of 'sliding door' moments, where a seemingly inconsequential decision led to significant changes in her career or life. She had always been fascinated by foreign affairs and to eventually become Foreign Minister was her dream role. She had been raised to believe that entering public office was the highest calling. She persevered and after 15 years in Parliament and 11 years as Deputy Leader of the Liberal Party, she was able to choose her preferred portfolio.

While not wanting to generalise, she saw different characteristics of male and female leaders. Women are more transformational, and they tend to focus on the needs of the individual. They build a team from the ground up and they focus on professional development with empathy for individuals in the team. Men are more transactional. They set goals, and then build a team and hold the individuals to account. They are less focused on the individual and more on the big picture.

She believes there are lessons for business. Both styles have strengths and weaknesses, and boards are far more effective if there is a diversity of views and styles around the table. Greater diversity is not only the right thing to do, it's the smart thing. Every business must embrace the talents and abilities and energies of 50% of the population.

She also made a surprising comparison between Barack Obama and Donald Trump to show the need to be decisive and understand the consequences of decisions.

"Let me give you two examples. Complete contrast within the one country. President Obama was an extraordinary man, very elegant, very cool kind of leader. And he consulted widely. He would listen to experts, he would seek out advice. He would gather all the evidence and information before making a decision. That is great. But he then didn't make the decision. His serious critics called him the 'Ditherer in Chief'.

Then look at the style of President Trump, his successor. He didn't get briefed, didn't want to know about expert opinions. He went on his infamous gut instinct and would shoot from the hip or shoot from Twitter. But he would just go with his gut instinct.

Now history will judge who is a better president. Sure, get the evidence, but sometimes you do have to trust your gut instinct."

She then described a leadership structure she admired, developed by Thomas Sowell, a Stanford philosopher and economist. She used this approach when faced with difficult decisions. Sowell asks three questions:

1. What are the alternatives? What else could you do?
2. At what cost? Is this the best allocation of scarce resources?
3. What's the hard evidence? If there is no evidence, then it may be taking a risk.

And she added her own fourth: What could possibly go wrong?

Then during question time with Sandi Orleow, she faced the inevitable focus on recent events in Canberra that have dominated media for weeks. She was asked for some strategies to deal with these cultural problems.

She said she feels a sadness and emptiness hearing the stories. She is frustrated that such events are occurring in this day and age. She said Parliament House is where lawmakers gather to make laws on workplace relations and what workplaces should look like across Australia. Parliament House should be the model workplace, the gold standard of workplace behavior. It's not, and the reasons go back to the cultural attitudes and environment that have evolved over time when there were no women in Parliament.

She said they don't have an induction programme for new people coming into the House. There's nothing about how to behave, there is no moral code. People need a reminder of the rights and responsibilities. It needs ongoing training with feedback and an independent counselling service. She said:

"Political parties are absolutely focused on preserving their party's prospects and they will do anything to manage risk, to manage a crisis, and not necessarily in a textbook way because the political party's prospects are at stake. The only authority with the competency and the capability to investigate is the police. And yet, people don't inform the police of allegations of serious illegal conduct in the workplaces. Now, when I was a managing partner of a law firm, I understood it was my duty to inform the police. And if the complainant didn't want to press charges or wanted confidentiality or privacy, they would have to work it out with the police and the lawyers. But as the employer, it's not up to me to cover up an allegation. I had a duty not to the person but to the entire workforce to tell the police."

On a lighter note, she was asked about her advice to someone starting their career now.

"I would start by urging them to not let others define who they are, or define what you can achieve and what you can do, set your own standards, set your own benchmarks and then work hard to achieve them. You need to be true to yourself. What do you feel passionate about and what is going to keep getting you up every morning and getting out in the world?"

Julie Bishop is an example of what can be achieved when you believe in yourself and tread your own path.

"My mother, who was a huge influence in my life, had this saying, 'You go this way but once.' And I took that to mean, do everything you can. If you've got one opportunity, sure you'll make mistakes and you learn a lot, but just try it. Get out there and live every day, and I do. I get up in the morning, I go for a run, and I do a bit of yoga. I just feel excited by the opportunities that are out there and the things I can do and the people I can meet, and I just love life. I don't have any difficulty being driven."

Graham Hand is Managing Editor of Firstlinks and attended the CFA Institute event as a guest of MFS International, a sponsor of Firstlinks.

Video: *Julie Bishop also appeared with Leigh Sales on [ABC's 7.30 Report on 8 March 2021]. Selected parts of the interview are reproduced below to avoid repeating points already made above.*

LS: Can I ask you broadly for your assessment of the workplace environment for women in Canberra in Parliament House?

JB: There's a powerful culture within all political parties to ensure that no individual does anything that would damage the party's prospects, the party's image or its reputation, particularly at election time. There's so much at stake. One party forms government, ministerial careers are in the balance, marginal seat holders could lose their seat, hundreds of staff jobs are on the line if you lose the election.

So this culture has developed where there's a very low tolerance for mistakes, that people are encouraged not to do anything or say anything that is out of line with the party's prospects.

And so that puts enormous pressure on staff, on members of Parliament, in fact, on everyone, to toe the line, don't rock the boat, don't do anything that would damage the party's prospects.

LS: So for women then who are mistreated or harassed or things of that nature, what effect does that environment have on them and also what message does it send to men in power in Canberra?

JB: Paradoxically, it can mean that a culture develops whereby those who are prone to inappropriate or unprofessional or even illegal behaviour get a sense of protection. They know that people aren't going to complain because that would damage the party, it would damage the party's prospects, and this is across Parliament.

It makes it a very unusual workplace in that regard but also, we don't have the structures in place to counter that. For example, staff are employed by the taxpayer and answer to the Department of Finance. The Department of Finance answers to the Minister for Finance and the Finance Minister is a political figure.

So people are concerned that if they raise a complaint, if they raise an issue, then it may well become politicised, it will become public, it will be the subject of an FOI application. They won't have their complaint dealt with.

LS: When you heard about the Brittany Higgins case, and the aftermath of it and the way it was handled, did it surprise you, or did it strike you as entirely consistent with what you see going on in Parliament?

JB: In my experience, an allegation of that nature, a serious indictable offence, would be brought to the attention of the Prime Minister immediately and that it would have been handled by Prime Minister and Cabinet, the public service side of it.

I'm surprised that no-one thought to inform the Prime Minister. It's the kind of information that prime ministers, in my experience, want to know about and I know there's an inquiry into what the Prime Minister's office knew and why they handled it the way they did. So I guess we'll know why it was that this information was withheld from the Prime Minister.

LS: Do you have any theories as to why that kind of information wouldn't go there?

JB: I think the inquiry will have to give us those answers. But also as someone who has employed many people over many, many years, if someone had come to me with an allegation that a rape occurred, as it turned out, in my office, but in a workplace for which I'm responsible, I would have felt a duty, not only to that person, but to others in the workplace to inform the police.

Now if the person making the complaint wanted privacy, didn't want to press charges, wanted to maintain utmost confidentiality, then that was a matter that person should raise with the police or their lawyers.

And I would have felt that I had an obligation to inform the person who is telling me that I must put it in the hands of the authority.

Nobody else in Australia has the competency or the capacity or the legal authority to investigate such serious complaints and allegations and be able to bring people to justice, both the alleged victim and the alleged perpetrator.

LS: That is a particularly serious allegation. More broadly, though, how widespread do you think the issue is of sexual harassment and discrimination in Parliament House?

JB: A culture has developed over many years, I think it is embedded in Parliament, because the environment, the conventions, the protocols, were all established at a time when there were no women in Parliament or very few women in Parliament and it's taken a very long time for there to be a change.

Getting more women into the Parliament is not the immediate answer, but it will help. When you have a critical mass of women who put forward their views and state what is acceptable or not acceptable behaviour, then you may well see change and I, for one, would continue to encourage women to consider politics as a career. It can be the most rewarding and satisfying career, but behaviour that is unacceptable, unprofessional, it's not accepted in workplaces across Australia and what concerns me is that Parliament House is where the laws are made. We, in Parliament, we, I was in Parliament, are the legislators.

We make the laws that we impose on workplaces around the country. Parliament House should be the exemplar, the gold standard, the place where people can see how best practice in workplaces should be carried out.

LS: Your former colleague, the former Liberal minister, Sharman Stone, said that when you were in politics a group of male politicians who called themselves the 'swinging dicks' sought to block your career aspirations. Were you aware of this at the time, does it strike you as credible, what did you make of it?

JB: Well, actually, I believe 'big swinging dicks' so there was obviously an overexcited imagination on the part of some I would suggest. Look nobody self-identified to me, thank goodness for that, but if they were seeking to block my aspirations, well they didn't succeed because my ambition was to be the foreign minister of Australia, and I am very proud to say that I served in that role for five years and likewise I was deputy leader of the party for 11 years.

LS: In the matter of Christian Porter, do you believe that he can continue in his role as Attorney-General without further investigation?

JB: This is such a difficult area and I feel so unspeakably sad for everyone involved and there are families and friends who are still suffering and there will be trauma for some time.

The challenge, of course, is that the allegations are historic, that the woman who made the allegations took her own life, and now a serving Cabinet Minister has been informed that the police investigation is at an end.

So, there are no answers. I do know, however, that the South Australian coroner is considering an inquest and to me that is the next logical step. It's within the criminal justice system. There are checks and balances and there are statutory powers. It has legal standing and so, that is the next step and I understand from media reporting that that's what the family would welcome.

JB: I knew him, in fact, when he was a young lawyer in Perth and he was a highly intelligent young man. He had a bright future ahead of him. People often spoke of Christian Porter as someone who would go on to greater things and of course, he did become state treasurer, state attorney-general and then he came into federal politics.

I didn't work closely with him and no-one made complaints to me. The first I heard about these particular allegations was about six months ago from an informal source.

So, people hadn't raised these issues with me. Obviously, as a senior female in the Liberal Party and as a deputy leader, had serious allegations been brought to my attention, I would have reported them to the Prime Minister, to the police, and continued down that path.

LS: What about the Prime Minister and Mr Porter both saying they have not read the letter that was sent?

JB: I have not seen the material. I have not seen any of the documentation and I haven't read media articles about it, but I wonder why they haven't. I think in order to deny allegations you would need to know the substance of the allegations or at least the detail of the allegations.

LS: Do you think that we are at a moment in politics of genuine change or do you think it will be business as usual in Canberra when this current storm passes?

JB: If the events of the last few weeks haven't led political parties to embrace change, I don't know what has to happen.

They are very serious allegations, and they seem to be continuing, and there are changes that can be made. I talked about the structural changes that we could make to ensure that Parliament House is a model workplace.

There are things that can be done but also there has to be education at every level. I'm aware that schoolchildren, schoolgirls and schoolboys, are talking about this issue and that the schools are taking positive steps to have conversations with young people about issues of consent and healthy sexual relations and respect and I think this is, well I know as Chancellor of the Australian National University, these are conversations we have at universities in the higher education sector, where young men and women are together.

So, Parliament House must also have this conversation.

And, you know, Leigh, it's always been a mystery to me why political parties don't appreciate that over 50% of the voting public is female and that a party that embraces and supports and respects women will be a very popular party indeed.

LS: Julie Bishop, thank you.

Four bubbly market pockets show heightened risk for investors

Andrew Mitchell

The ongoing surge in stock prices, including the NASDAQ, up almost 100% from its March 2020 low despite the recent pullback, has many investors fretting that stock markets are in bubble territory and at risk of a crash. Indeed, according to one survey, the majority of investors now believe the US market is in a bubble.

It has become increasingly clear over the last few weeks that, whilst we don't believe the markets we invest in (Australian and global small and mid-caps), are in a bubble, some parts of investment markets are frothy with stretched investor sentiment.

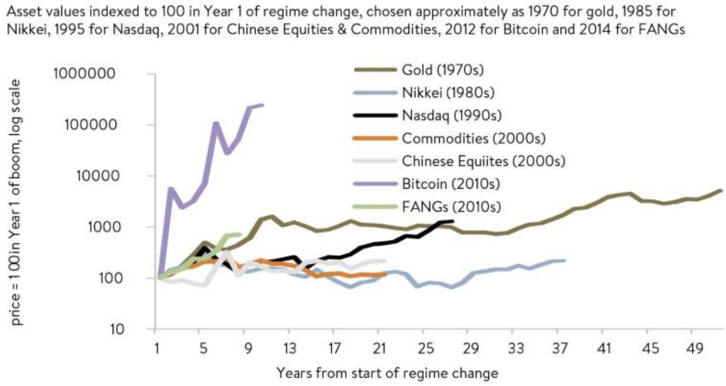
The four pockets of exuberance described here may not be the 'four horsemen of the apocalypse' portending a major bear market, they are indicators that investors need to be managing risk. Ophir remains focused on investing in quality companies at reasonable valuations, but also stress testing those companies' likely performance during a savage sell off.

Exuberance Exhibit 1: Bitcoin

The first bubbly pocket is Bitcoin. There is so much noise surrounding the digital currency and we are constantly asked about its valuation. Even Uber drivers ask for our thoughts, and advertisements for Bitcoin trading courses and transacting platforms are becoming ubiquitous.

This is not unexpected given the rise in price of Bitcoin over the last few years, putting other financial market bubbles in the shade, as shown below.

The Bitcoin ascent



Source: J.P. Morgan

Bitcoin is somewhere between a collectible and a currency, nd not a particularly good one yet. In our view, it doesn't qualify as an asset because it doesn't generate cash flows from which to value it. This makes it ripe for speculation and a good barometer for when financial market sentiment is high.

Exuberance Exhibit 2: SPAC IPOs

IPO issuance has ramped up in the US, particularly through Special Purpose Acquisition Companies, or SPACs. These vehicles, often called 'blank cheque' companies, have a two-year window to find a private company target which they merge with and list, or else hand back the capital to investors.

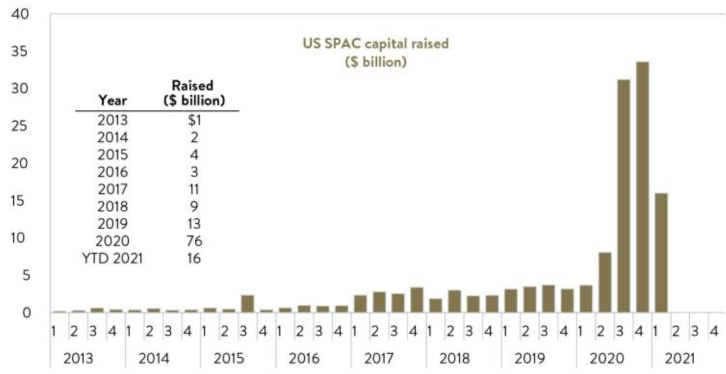
Private office leasing company WeWork is the latest in a long line said to be in talks with a SPAC to go public.

IPO issuance tends to increase when company owners think they can raise capital, or sell out, at heightened valuations, and generally not when it represents good value for buyers. SPACs have been around for a number of years but they raised six times the amount of money in 2020 than they did in 2019.

SPACs have emerged from a relative backwater to become the dominant form of listing for US companies, currently comprising over 50% of IPO activity in the US.

Their boom has come with SPACs bringing early-stage higher-growth businesses, particularly technology businesses, to market. There is huge demand for these stocks from retail traders with more time on their hands and less aversion to volatility.

The 2020 SPAC IPO boom has continued into early 2021 (as of 21 January 2021)



Source: Dealogic, Goldman Sachs Global Investment Research

The demand has been fuelled by interest rates near 0%, which means the opportunity cost for investors of having their cash tied up in a SPAC waiting for an acquisition is low.

Exuberance Exhibit 3: retail call options

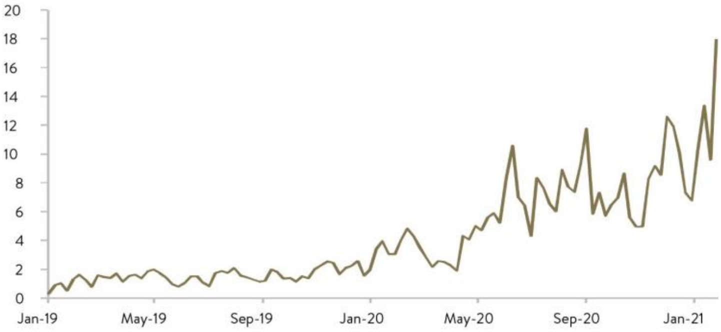
The democratisation of investing has given retail investors cheap access to trading platforms and financial information. When combined with government stimulus cheques and extra time on their hands, small retail traders have been investing heavily in call options on individual listed companies.

These options essentially give the buyer the right to buy a share in a company at a certain price (strike price) and the trader executes the option if the share price rises above the strike price. They are generally bought if the investor is bullish on the company and its price is rising higher, but they are popular with retail traders because options are a cheaper way to get exposure to a price rise.

As can be seen in this chart, call option volumes for small parcels (less than 10 contracts) that retail traders tend to buy, have risen dramatically.

Such betting by often value-agnostic retail traders should give long-term investors concern as this may not be a sustainable source of demand behind price rises of companies.

Call Option Buy Minus Sell at Open for investors with less than 10 contracts for options on individual US equities. (In million contracts. Last observation is for the week ending 29th Jan 2021).



Source: OCC, Bloomberg Finance L.P., J.P. Morgan

Exuberance Exhibit 4: growth stock volume

And, finally, trading volumes in the most expensive growth-orientated companies have exploded recently (as shown).

Whilst not at the dot.com levels from 2000 at present, those companies trading at greater than 20 times Enterprise Value-to-Sales ratios (an historically expensive level) are making up a much bigger part of the market and account for around a quarter of all trading activity.

There are some rational reasons for this, including some large high-growth (and high valuation) technology companies further entrenching their dominant positions during COVID, but it does suggest caution is warranted.

Trading in stocks with extremely high EV/sales ratios has surged (as of 21 January 2021: LTM EV/sales ratios of stocks with LTM revenues > $50 million)

Source: Compustat, Goldman Sachs Global Investment Research

A buying opportunity

In the short term, we would not be surprised to see a 5-10% pull back in the major share markets given the extended level of investor optimism in some corners at present. Timing for any pullbacks is always difficult to judge when it is sentiment based.

We see such a pull back as a buying opportunity in our funds and a healthy occurrence for markets.

We think it less likely that a major bear market is around the bend given the supporting backdrop to corporate earnings as the vaccines bring the virus under control, and central banks' willingness to keep short-term and long-term interest rates lower for even longer in the absence of signs of inflation. This should support the attractiveness of equities relative to bonds for some time yet.

Our risk management plan to deal with bubbly markets

The measures of investor sentiment described above argue for caution in company selection.

Beyond being well diversified by company, sector and geography and not overexposed to any particular investing style, our risk management plan ensures the companies we hold in our funds have a high probability of upgrading earnings at their next results' announcements and are trading on reasonable valuations compared to fundamentals (cash flow and earnings) and peers.

Moreover, we track how the company is likely to fair in an economic and market 'meltdown'. This includes tracking measures related to liquidity, dividend yield, gearing and how opaque the company's business model is. We aggregate these measures at a portfolio level to understand how we are faring across each metric, ensuring the exposures are calibrated appropriately for where we are at in the market cycle.

These measures help provide downside protection in a market sell off. Whilst our funds are fully invested, we are paying particular attention to not overpaying for growth and being conservatively positioned across our risk metrics.

Andrew Mitchell is Director and Senior Portfolio Manager at Ophir Asset Management. This article is general information and does not consider the circumstances of any investor.

Read more articles and papers from Ophir here.

You think you're passive but are you really concentrating?

Shane Woldendorp

As investing rules of thumb go, 'don't put all your eggs in one basket' is widely accepted and uncontroversial. Sure, a lot of academic work has been done on the optimal number of baskets investors should have, what each basket should be made of, even the number of eggs to include in each, but the general principle is considered a sound way of spreading risk. And more baskets are better than fewer.

The problem with rules of thumb is that they can often oversimplify things. In average circumstances, simplification is usually enough, but right now, markets are anything but average.

There's more to diversification than 'more'

In the case of diversification, the difference between the rule of thumb and a more nuanced version lies in the gap between the expression *more = better* and *more + different = better*.

For a portfolio to be diversified it can't just have lots of things in it, it needs to be filled with assets that are going to react in different ways to the same thing.

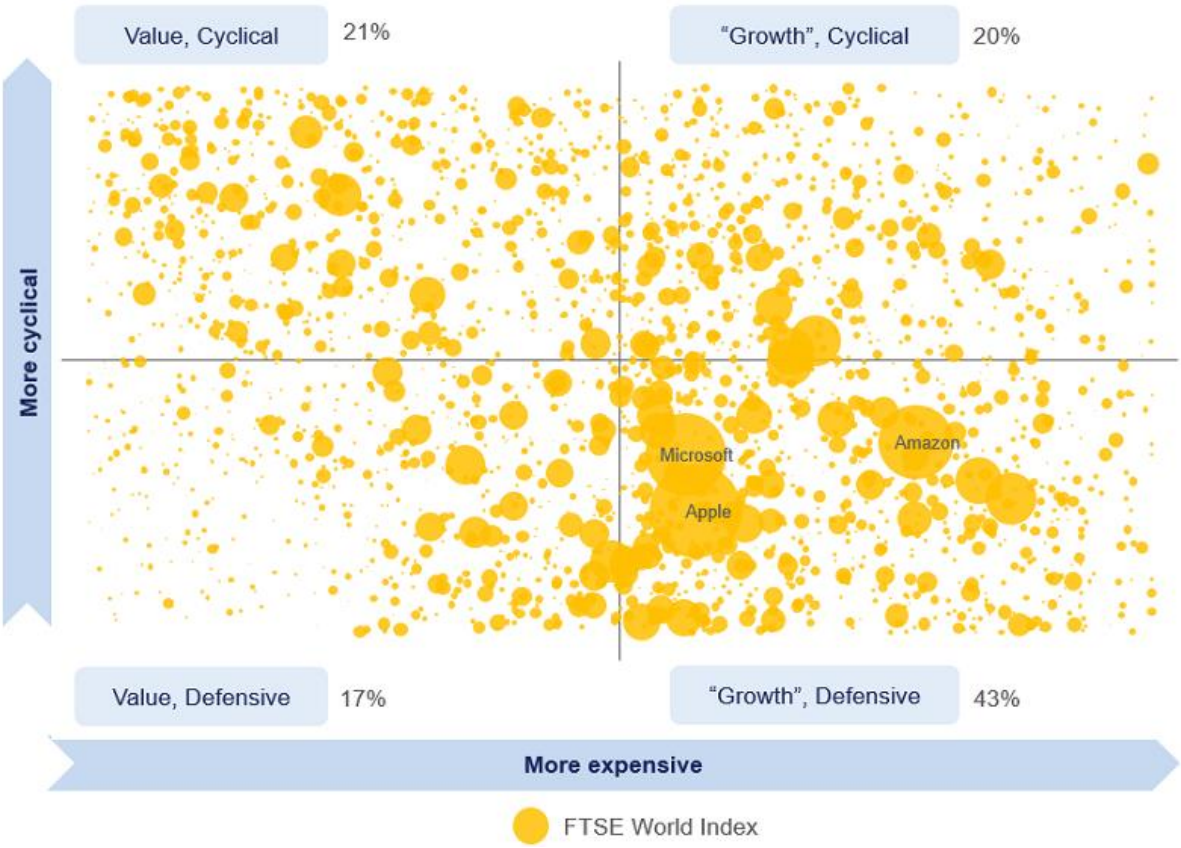
And, by that logic, we believe, the broad market is far less diversified right now than it looks on paper, especially if you are a passive investor.

Take the FTSE World Index, for example. Using the *more = better* version of diversification, an investment into an index that provides exposure to thousands of stocks across the globe should provide a good degree of diversification.

But, as is evident from the chart below, which plots the stocks in the FTSE World Index, with bigger positions shown as bigger yellow circles, the index is currently heavily weighted to defensive growth stocks (see the bottom right hand quadrant).

These include companies like Amazon and Netflix, with business models almost perfectly designed to benefit from the economic climate created by a global pandemic in 2020. Those conditions have propelled these 'lockdown beneficiaries' to rich valuations and to a colossal weight in the index. So much so, that defensive growth companies now account for over 40% of the index.

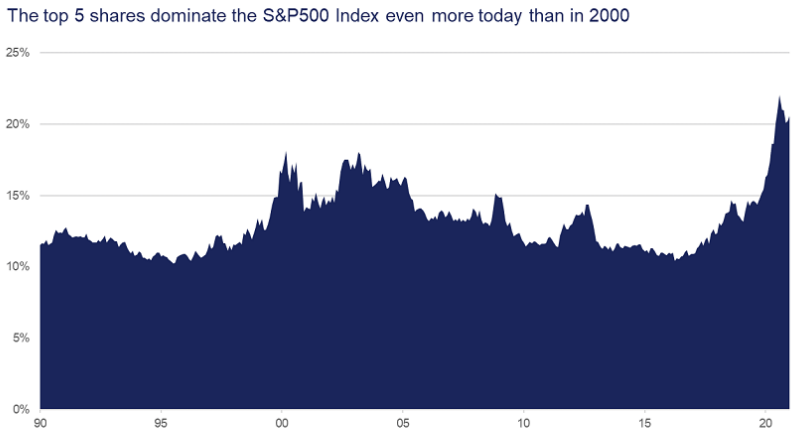
Under the microscope: FTSE World Index



As at 31 Dec 2020. Source: Various industry sources, Company information, Orbis. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Stocks in the FTSE World Index are ranked based on their valuations (dividend yield, earnings yield, free cash flow yield and book to price; all based on trailing 12 month fundamentals) and their beta to a basket of global yields (as a proxy for cyclicality). Figures represent the aggregate weighting of shares within each quadrant for the FTSE World Index. Figures may not sum due to rounding. Bubbles representing the top three stocks in the FTSE World Index have been labelled.

Success creates sector bets

While there is no denying that many of the companies within the bottom right hand quadrant are of high quality, many are in similar sectors and are exposed to similar economic forces, which means they won't necessarily do a good job of diversifying risk should economic circumstances or investor sentiment change.



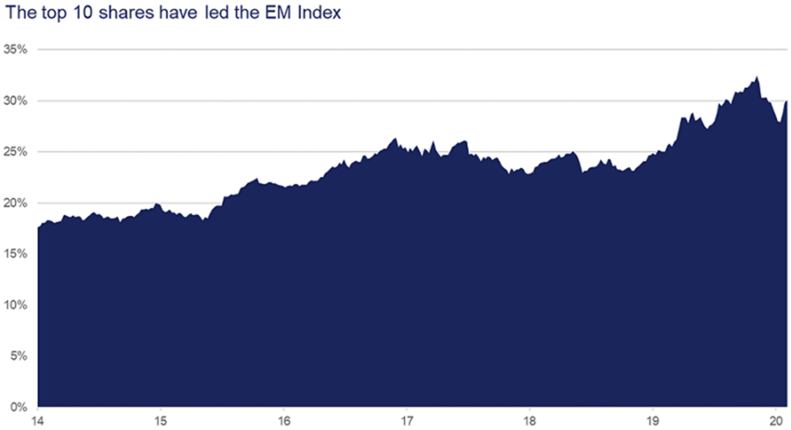
As at 31 Jan 2021. Source: Refinitiv, Orbis.

To put an even finer point on it, in the US market (S&P500 Index), the top five stocks now account for almost a quarter of the total. That is a level of concentration never seen before. At the height of the technology bubble in 2000 the top five accounted for less than 20% of the total.

Again, that is not to say that those five companies are bad, far from it. But rather, it points out that for every dollar invested into the broad S&P500 Index, roughly 25 cents is going into five technology stocks, all of which are in direct competition with each other in one way or another.

And, while the weight of the FANGAM stocks get the headlines, the extreme concentration seen within indices currently is not limited to developed markets. In fact emerging markets are arguably even more concentrated.

Within the MSCI Emerging Markets Index, the top 10 stocks currently account for over 30% of the total, approximately double their weighting five years ago.



As at 31 Jan 2021. Source: Refinitiv, Orbis.

As long-term, active, fundamental investors, we are no strangers to concentrated portfolios, in fact we are a firm believer in their ability to deliver outsized returns over the long run.

But, we build them intentionally from the bottom up. As we look across global markets today, that intent seems to be lacking, replaced by a fear of missing out that is leaving a lot of eggs in one very small basket. A basket predicated on the notion that the future is going to look very similar to the recent past. And, what we have learned over the past 30 years, is that the only thing we can say for certain about the future is that it seldom looks like the past.

Shane Woldendorp, Investment Specialist, 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.

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Bonds, buybacks and Apple: three takeaways from Buffett's annual letter

Susan Dziubinski

Berkshire Hathaway (BRK.A) (BRK.B) Chairman Warren Buffett recently released his annual letter to shareholders, along with the company's 2020 earnings.

Despite negative comments from Berkshire partner Charlie Munger last week about the market mania surrounding GameStop (GME), Bitcoin and SPACs, Buffett didn’t directly mention any of that in his letter. Instead, he extolled the virtues of long-term investing.

Here, we take a look at a few highlights from this year’s missive.

Bond investors' 'bleak future'

When it comes to fixed income investing, Buffett doesn’t pull any punches: "Bonds are not the place to be these days."

He points out that the yield on the 10-year Treasury bond had fallen 94% between September 1981 and year-end 2020, and he reminds readers that around the globe, some investors are earning negative returns on sovereign debt. The solution to investing in a low-yield world isn’t stretching for income with lower-quality fare: the debacle in the savings and loan industry some 30 years ago is proof of that, notes Buffett.

"Fixed income investors worldwide - whether pension funds, insurance companies or retirees - face a bleak future," he concludes.

Buybacks, Apple, and the 'jewels'

Berkshire spent US$24.7 billion last year buying back its own shares, and Buffett notes that the firm has continued to repurchase shares in 2021. Why the buying spree? Because doing so enhances Berkshire’s intrinsic value per share for current shareholders while still leaving the firm with ample cash (to the tune of US$138 billion), he explains.

Further, the buybacks provide current shareholders with greater interest in what Buffett calls the four 'jewels' of the firm: controlling interests in its property and casualty business, railroad BNSF, Berkshire Hathaway Energy, as well as its 5.4% stake in Apple (AAPL). He wrote:

"In no way do we think that Berkshire shares should be repurchased at simply any price. I emphasise that point because American CEOs have an embarrassing record of devoting more company funds to repurchases when prices have risen than when they have tanked. Our approach is exactly the reverse."

Investing for the long term

Buffett breaks down Berkshire's shareholder base into several buckets, including index funds, active institutional investors, active individual investors, and long-term individual investors. Buffett says he appreciates the mix, though he has no interest in attracting shareholders who don't appreciate the firm's "hamburgers and Coke" style. He writes:

"The tens of millions of other investors and speculators in the United States and elsewhere have a wide variety of equity choices to fit their tastes. They will find CEOs and market gurus with enticing ideas. If they want price targets, managed earnings and 'stories,' they will not lack suitors. 'Technicians' will confidently instruct them as to what some wiggles on a chart portend for a stock's next move. The calls for action will never stop."

For more on this topic, see Buffett's 2020 scorecard

Buffett has a special affinity for the Berkshire 'lifers', the long-term investors who treat an investment in Berkshire as a partnership. He notes:

"Productive assets such as farms, real estate and, yes, business ownership produce wealth - lots of it. Most owners of such properties will be rewarded. All that's required is the passage of time, an inner calm, ample diversification and a minimisation of transactions and fees."

Buffett confirmed that Berkshire Hathaway's annual meeting will be held on May 1 and will again be virtual this year. However, the event will be run out of Los Angeles rather than Omaha, and Munger will appear (after being absent last year). So will Vice Chairmen Ajit Jain and Greg Abel.

And if we're lucky, maybe Buffett's ukulele will make an appearance this year, too.

Susan Dziubinski is Director of Content for Morningstar.com. This article does not consider the circumstances of any investor.

Three key themes for global income investing post COVID

Adam Grotzinger

Investors need to manage different type of risks, including inflation risks and ongoing trade and geopolitical tensions. Building a diverse, multisector exposure to corporates, high yield, and other fixed income sectors can play a part in portfolios that maximise yield and return potential while limiting exposure to market volatility and default risk.

Re-emergence of inflation risk

Looking into 2021, we anticipate strong, if uneven, recovery across regions as the pandemic plays out. The expected availability of COVID vaccines, the reopening of economies, continued monetary and fiscal policy support, and pent-up demand in pandemic-sensitive sectors of the economy should provide a significant boost to demand.

Although our outlook is heavily dependent on a successful and timely distribution of safe, efficient and effective vaccines, we believe that recent approvals and distribution suggest that the end of the pandemic is in sight.

We expect the reopening of economic activity to lead to labour sector recovery, with job growth shifting higher and unemployment rates gradually trending lower as labor force participation increases. We also expect stronger consumption due to heavy consumer spending in certain sectors like travel, given that consumer savings have stayed elevated through the crisis.

Focusing solely on the impact of the COVID crisis on end demand and the labour sector could easily reach the conclusion that inflation may prove similar to the post-GFC 'low-flation' regime. But the nature of this crisis is very different from any in recent memory. It's critical to assess the inflation outlook through the prism of demand, supply, central bank policies and structural forces to achieve a more holistic view.

Demand impact and outlook

Overall, the recession led to increased spare capacity and higher unemployment, which are both deflationary forces. However, the shuttering of supply and huge fiscal stimulus helped temper the downward pressure on consumer prices and provided a bridge for lost wages until global economies fully reopen and lost jobs are restored. Therefore, we believe that slack will have a less meaningful effect on inflation than in previous crises.

Supply outlook

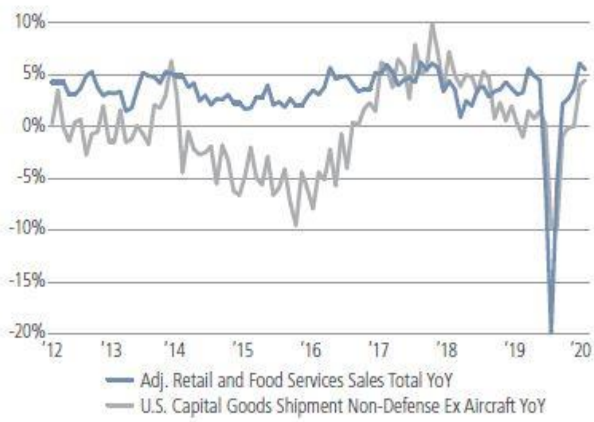
With demand weak, one might assume that goods and commodities prices would remain muted. However, there are signs of an upward shift in consumer goods prices with recent changes in spending patterns. The question is in which sectors these changes could persist, and continue to boost inflation until supply realigns with demand.

Perhaps surprisingly, not only have consumer goods benefited from pent-up demand and rotation to durable goods, but business spending seems to be exhibiting similar trends as well. This is reflected in raw capital expenditure data despite industrial production being below pre-crisis levels, a clear sign that companies are drawing down inventories.

In our view, the reopening of economies post-vaccines should motivate a sharp inventory rebuild by businesses that drives a strong final goods recovery and exerts further strains on the supply of goods in the near to medium term.

The recent pickup in demand for housing further solidifies our thinking that strength in durable goods might be undergoing more of a structural transition than previously thought.

GOODS SPENDING BY HOUSEHOLDS AND BUSINESSES IS NEAR PRE-CRISIS HIGHS



Source: Bloomberg and Neuberger Berman calculations. Data through October 31, 2020.

OPEC IS POSITIONED TO REGAIN MARKET SHARE

Crude Oil Production Market Share

Source: EIA Short-Term Energy Outlook, September 2020.

The crisis has also created a long-awaited opportunity for old and traditional oil players to reclaim market share and regain their stranglehold on the supply outlook. OPEC and its partners have been successful in eliminating smaller U.S. shale producers and many survivors have been forced to consolidate with bigger U.S. producers. This leads us to believe in a firmness in oil prices.

Another variable of importance for inflation rates globally will be exchange rates. We expect the US dollar to weaken modestly as interest rates have converged to around zero globally. This should boost the U.S. inflation rate while the rest of the world experiences a moderating impact.

Overall, we think the probability of a 'cost-push' positive impact on inflation rates is higher than market expectations.

Monetary and fiscal policy transition

The lessons for central bank policymakers, governments and investors from the GFC were relatively straightforward:

First, central bank policies do not generate inflation but rather provide the channels for inflationary pressures to build and lift inflation expectations. Central bank policies, however, can block these channels and shift the inflation trajectory lower in the event of a policy mistake of tightening monetary policy before it is necessary.

Second, monetary policy in isolation has limitations, but can be powerful when combined with fiscal responses.

Policymakers seem to be taking these lessons to heart, as shown by their response to the current crisis, which has been more timely and larger than during earlier crises. With central banks massively increasing their balance sheets, the argument has been rightly made that increasing money supply by itself is not inflationary, but we believe that combined with other factors it could incentivise 'green shoots' of inflation.

Our argument is built on the premise that consumer and bank balance sheets were in good shape coming into this crisis. This has created a low bar to increasing leverage, as we think the unprecedented level of money supply currently in the system could fuel pent-up demand in consumer spending, the creation of small businesses and bank relaxation of loan requirements, all of which are key in generating economic activity and an upward trajectory in inflation.

Clearly, the COVID crisis abruptly tilted the balance of price pressure back toward disinflation. Moreover, the magnitude of current economic slack will continue to create strong headwinds against inflation. While we expect the global recovery to be choppy, with elevated inflation volatility, disinflationary pressures are starting to ease and should gradually reverse in favor of higher inflation, with the potential for a resilient up-tilt in global core consumer price inflation over the next 12 – 36 months.

Three key themes for fixed income positioning

The potential transition to higher inflation represents a significant shift in the economic and market environment.

What could it mean for investors?

We anticipate a calibrated and slow rise in yields in 2021. Overall, we see an investment environment of renewed growth and improving fundamental conditions, combined with increased inflation pressures, but without any significant change in monetary policy as central banks maintain current support in light of ongoing, though potentially fading, pandemic conditions and lockdowns.

As such, we are constructive on inflation-sensitive assets and select credit securities that favour earning carry with minimal duration impact. In our view, this makes COVID-sensitive, non-investment grade loans and emerging market FX attractive.

From a multi-sector perspective, this leads us to three key themes:

1. **Focus on yield without duration**. For investment grade credit, low yields coupled with long durations are creating return risk even with positive credit fundamentals. Portfolios should emphasize high yield, loans and other sectors offering attractive yields with minimal duration risk.
2. **Protect against inflation**. Inflation is likely to increase starting in the second quarter, on the back of pent-up demand and loose monetary conditions. This suggests the potential benefits of global sovereign inflation bonds and non-dollar currencies, particularly in emerging markets.
3. **Sector & security selection rise in importance.** Even with the virus likely to fade, we continue to focus on secular winners, as not all "COVID losers" will benefit from vaccines. Opportunities also should develop in sectors that have strong secular tailwinds, but have perhaps faced headwinds from this COVID period.

Sector outlooks

Investment grade fixed income: improving fundamentals

Although 2020 was a year of historic volatility, spread levels ultimately were little changed, with unprecedented fiscal and monetary actions, including low rates, critical to the recovery of credit conditions. These factors, coupled with improving fundamentals and solid technicals, should prove supportive to credit spreads in the investment grade credit market. In aggregate, metrics around cash flow and leverage will likely improve for companies as vaccines are distributed and the economy begins to emerge from COVID-19.

Non-investment grade credit: inflation isolation

Most significantly, the average duration of non-investment grade corporate credit is well below that of many other fixed income alternatives, which creates a positive backdrop for these sectors as a vehicle to earn attractive income with minimal duration risk.

At the same time, we view security selection as the primary driver of relative returns in the non-investment grade universe. So, in considering the outlook for inflation and interest rates, we focus on what it means for individual issuers, sectors and segments of the high yield and loans markets, as well as the relative valuation between the two asset classes.

Research Challenge: Identify Secular 'Winners' Coming Out of COVID-19

Source: Neuberger Berman

High yield: interest rate impact and equity correlation

High yield bonds have a higher correlation with equities than with interest rates. While interest rates tend to rise in an economic recovery, issuer fundamentals are levered to that growth and benefit from increasing volumes and pricing power. Furthermore, high yield spread compression will tend to offset any negative duration impact from rising interest rates.

Emerging Markets debt: return to growth

Our base case for continued gradual recovery in Emerging Market Debt (EMD) may hit speed bumps along the way as countries grapple with virus flareups and temporary restrictions, but we believe the risks to the EMD asset class are subsiding. Valuations for EM hard currency bonds remain at reasonably attractive levels, especially in the high yield space. Local bond yields have tightened meaningfully, but we continue to see value in high yielders while EM currencies are still cheap. The yield pick-up offered by EM sovereigns and corporate credits could lead to a sustained resumption of inflows and allocations to the asset class.

Adam Grotzinger is a Senior Portfolio Manager at [Neuberger Berman](), a sponsor of Firstlinks. This material is general information and does not constitute investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. You should consult your accountant or tax adviser concerning your own circumstances.

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Investment forecasts: foresight or folly?

Harry Chemay

Forecasting is an integral part of the human experience. Almost every key decision we make in life involves some element of guessing at the future; from the suburb in which we buy a property, the studies we undertake and those we might encourage our children to pursue, the career direction we take and, of course, to the investment decisions we make.

We want our financial futures to be as secure as possible, and so it is only to be expected that anyone claiming investment foresight (real or otherwise) will find a willing ear.

We therefore listen attentively to the forecasts of those only too happy to prognosticate on television, the radio or online. And there is, at present, no shortage of investment sages proffering views on everything from the re-emergence of US inflation to the future of fiat currencies.

But how do we, the investing public, determine if any of these predictions are in any way superior to simple guesses? Well, help is at hand.

The Professor of Prescience

Enter Philip E Tetlock. Tetlock is a Professor at the University of Pennsylvania, with appointments across the Wharton Business School, psychology and political science. In 1984 Professor Tetlock embarked on a multi-year research project to understand the nature of expert judgement, studying some 28,000 forecasts made by hundreds of experts across a variety of fields including politics, the economy and finance. His is among the longest, most detailed academic studies of whether humans can actually predict the future with any statistically significant degree of accuracy.

Tetlock pitted the expert forecasts against a range of algorithmically derived forecasts (so-called 'Clinical' versus 'Actuarial' forecasts). His conclusions at the end of almost 20 years of investigation? *"Surveying these scores across regions, time periods, and outcome variables, we find support for one of the strongest debunking predictions: it is impossible to find any domain in which humans clearly outperformed crude extrapolation algorithms, less still sophisticated statistical ones."*

Forecasts made by the experts were statistically indistinguishable from random guesses. This finding subsequently morphed, somewhat unflatteringly, into a metaphor of the average finance guru being no more accurate than a 'dart-throwing chimp' in guessing future investment outcomes.

Are investment professionals better forecasters?

OK, so geo-political analysts can't predict the location and timing of the next military coup. But surely seasoned investment professionals, with all that financial market data at their disposal, can outperform random guesses? One might be tempted to think so.

Unfortunately, the evidence is to the contrary. In a 2015 study of investment analyst forecasts, researchers Marcus Spiwoks, Zulia Gubaydullina and Oliver Hein found that none of the predictions for share markets, interest rates and exchange rates for four countries were able to beat simple forecasts based on a simple 'random walk' assumption (that the best guess as to the future state is the current state).

Delving specifically into the forecasting of interest rates, they studied 158,022 4- and 13-month rate predictions across 12 countries only to find that over 98% of the forecasts better reflected rates at the time of making the forecast than at the future date. Hence the name of their paper, *"Trapped in the Here and Now – New Insights into Financial Market Analyst Behavior"*. In short, there was no noticeable evidence of investment foresight present.

Separating forecasting skill from luck

So how does one determine if an expert's forecast might suggest a degree of foresight rather than being just a product of luck? You certainly wouldn't want to ask for examples of his or her forecasting track-record. Why? Because if someone makes enough forecasts, some of them are bound to be proved right. These correct 'calls' can then be used as proof of foresight, while the unsuccessful ones go unmentioned in the hope of a quick burial without the possibility of exhumation and further analysis.

Just as a broken clock can still be right twice a day, it can be difficult to know where forecasting skill ends, and luck begins. Without a way of separating the two we'll never know if a forecaster is lucky but without skill or skilful but unlucky.

Thankfully one such way does exist, and it is remarkably low tech. It involves committing a forecast to paper in an investment diary. But, and this is key, the forecaster must provide both the forecast and an explanation as to why it will eventuate. In this way the forecaster commits to providing a prediction of both cause ***and*** effect.

As simple and effective as this technique is, it is roundly ignored by the investment industry. Few investment manager(s) or financial planners are prepared to back their forecasts in such a manner. Fewer clients are prepared to demand they do. That's a pity as keeping an investment diary is one of the most powerful ways to determine if one is right for the wrong reasons (lucky rather than skilful) or wrong but for the right reasons (skilful but without luck).

If it all sounds a little pedestrian and something that an investment manager or adviser would deem to be beneath them, consider this. One of the world's most astute investors, hedge fund billionaire George Soros, recalls a period when he recorded all his investment decisions and the reasons behind them in an investment diary. In his words: *"I kept a diary in which I recorded the thoughts that went into my investment decisions on a real-time basis. …The experiment was a roaring success in financial terms – my fund never did better. It also produced a surprising result: I came out of the experiment with quite different expectations about the future."*

Learning to sit with irreducible uncertainty

Danish physicist and Nobel prize-winner Niels Bohr is reputed to have once said *"Prediction is very difficult, especially if it's about the future."* What holds true in the sub-atomic world of matter holds doubly true in the world of investing, where the unpredictability of human behaviour, unlike the predictable laws of quantum mechanics, have an outsized effect on outcomes.

View the forecasts of investment gurus and talking heads for what they are, guesstimates. Undoubtedly intelligent and well informed, but guesstimates of an essentially ***unknown and unknowable future*** all the same. T'was ever thus.

Post-script: Those interested in delving further may wish to avail themselves of a copy of Philip Tetlock and Dan Gardner's "*Superforecasting: The Art and Science of Prediction*" Crown Publishers (New York), 2015.

Harry Chemay has more than two decades of experience across both wealth management and institutional asset consulting. An active participant within the wealth and superannuation space, Harry is a regular contributor in Australia and overseas, writing on topics across investing, retirement planning and the provision of financial advice.

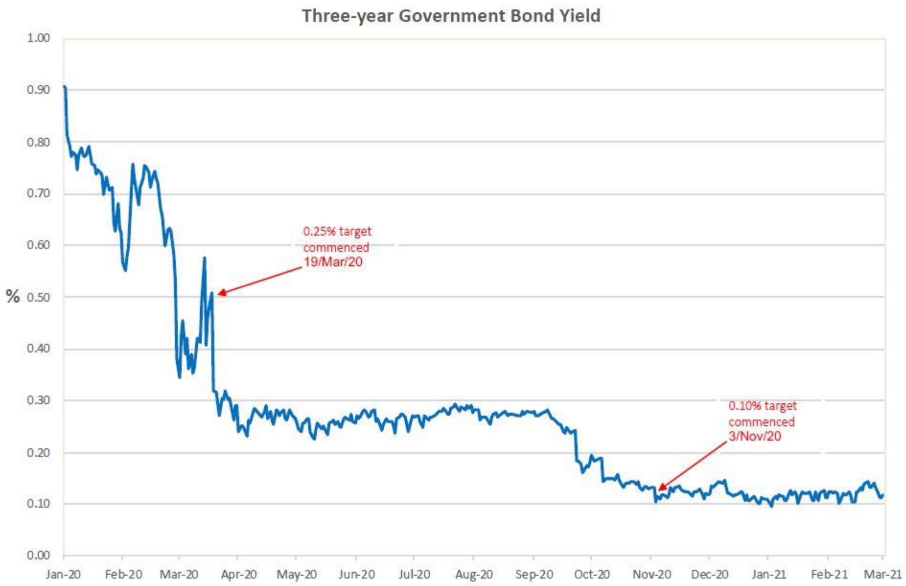
Harry was a co-founder in one of Australia's earliest digital advice services, Clover.com.au, and has more recently been appointed an Australian Ambassador to the Transparency Task Force, a UK-led initiative to bring greater transparency and accountability to financial services.

Understanding QE and its impact on inflation

Tony Dillon

At the February 2021 Reserve Bank (RBA) Board meeting, the RBA announced it would continue its 0.1% target for the three-year Government bond yield, while committing a further $100 billion to purchase those bonds in the secondary market. This comes in addition to the $100 billion programme announced in November targeting bonds with a 5- to 10-year term.

This form of monetary policy is known as Quantitative Easing (QE). Typically, central banks resort to this when short-term interest rate targets are at or near zero, rendering conventional monetary policy no longer effective. QE may then be introduced with the aim of lowering interest rates further out on the yield curve, to encourage borrowing and spending to boost the economy.



Why do central banks target inflation of 2-3%?

When QE was put on the table by the RBA, a lot of discussion was generated, and misconceptions emerged. In particular, many think that it is just a money printing exercise that will lead to high inflation.

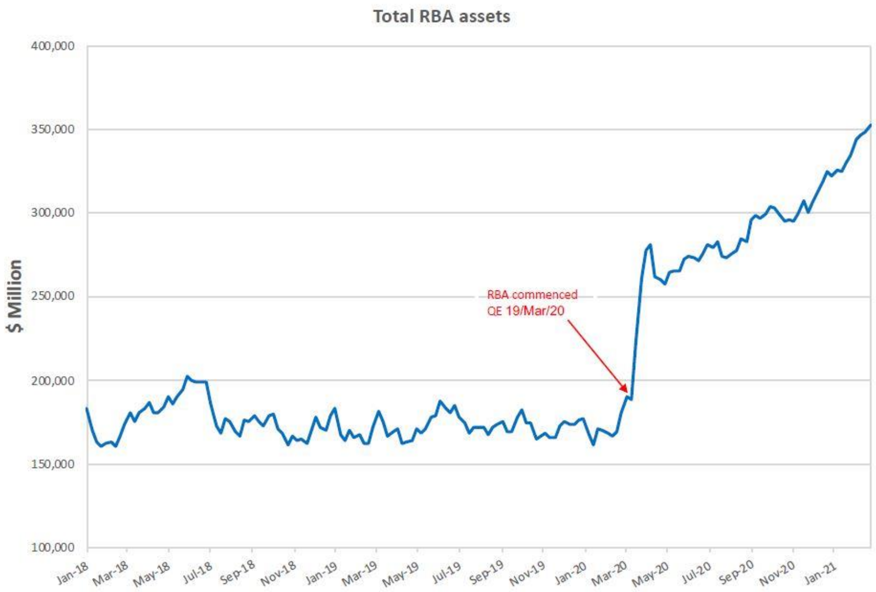
So it's worth exploring how such unconventional monetary policy is implemented, and what might be the effect on inflation.

We have been in a low inflation environment for some time now, well below the RBA's preferred target range of 2-3%, a range considered the sweet spot by many central banks around the world. But why 2-3%?

If inflation was any less, then the urgency for spending would dissipate. Why spend today when it could be cheaper tomorrow? Any discretionary spending can be put on hold, which acts as a deadweight on economic growth. But any higher than the target range and consumers' purchasing power erodes and they cut back on spending, causing businesses to reduce spending and investing, resulting in higher unemployment, even less spending, and on it goes.

QE is not money printing, but what is it?

QE involves the RBA purchasing government securities in the secondary market, which may consist of both private investors and commercial banks. Any securities purchased by the RBA are recorded as assets in its balance sheet, offset by increasing exchange settlement account (ESA) balances held at the RBA by the commercial banks, by an amount in total equal to the cost of the securities.



An ESA balance is an RBA liability and a commercial bank asset. This is called 'expanding the balance sheet'. Since the start of 2020, the RBA's balance sheet had increased by about $160 billion by the end of January 2021.

The ESAs are accounts that facilitate payment transactions between the commercial banks, the RBA, and the Australian Government, all within a closed system. It is not possible to transact with, or lend money directly to, non-banks via these accounts. As the RBA cannot trade directly with non-banks, the commercial banks act as intermediaries when the RBA purchases securities from private investors, because they can transact with investors outside the closed system.

In effect, bank ESAs (that is, the liability side of the RBA's bond purchase) are credited with the stroke of the RBA’s keyboard. At that point, base money in the system has increased, being the RBA’s money-like liabilities, including holdings of banknotes. Importantly, this does not mean free money for banks, and far less a case of money printing.

Rather, QE is more an exercise in creating reserves, seeking to increase the quantity of broad money in the system or private sector deposits.

How does this happen, and who 'creates money'?

Suppose the RBA purchases government bonds from a bank. The bank’s ESA balance increases, while its liabilities in the form of private sector bank deposits remains the same, therefore private sector money has not increased. The bank's capital adequacy has strengthened though, giving it confidence to create more private sector loans and hence customer deposits than it otherwise would have.

Or the incentive might be to rebalance its portfolio by expanding its loan portfolio, as ESA balances currently earn 0%. Either way, increased lending increases the quantity of broad money, noting banks are not compelled by the RBA to lend. The bank could also purchase new government bonds.

Suppose also that the RBA purchases government securities from a non-bank investor. The investor’s bank facilitates the sale. That bank's ESA balance is also credited by the RBA, but this time its liabilities increase by the same amount, representing an increase in its deposits held by its investor as a result of exchanging its government bonds for bank deposits. Broad money has increased, and the investor now has available funds to spend or invest.

In both instances, the process aims to lower the yield on the bonds targeted for purchase by the RBA, thereby lowering the cost of finance to stimulate borrowing and hence, the economy. Again, such activity will depend on the risk appetite of both banks and investors.

So while the RBA may increase the quantity of broad money when undertaking QE, it is not necessarily a precursor to further money creation by commercial banks, and any inflationary effects will also be indirect.

Money creation in the private sector is the preserve of commercial banks and not the RBA. Loans to the private sector are created by the banking system when they simultaneously create bank deposits for their clients. This happens independently of the RBA and will only occur when banks are motivated to lend to willing clients.

Back to the impact on inflation

QE is indeed an inflationary tool, but increasing the monetary base does not guarantee inflation. For example, money creation in the form of lending may not occur if banks want to shore up increased ESA balances in times of uncertainty such as recession or in a pandemic.

Or the private sector wants to stockpile cash or indeed even pay down loans, which has the opposite effect to lending in that it actually destroys money. It may be then overall, that the increase in base money by the RBA is saved and not spent.

Money is not necessarily circulating and therefore has little, if any, effect on inflation.

The other variable in the inflation equation is production. Ordinarily, increasing the money supply in an economy at or close to full capacity, would likely cause inflation. That is because there is no room to absorb excess money. Goods and services cannot outpace the growth in money, therefore prices must rise. If however, there is spare capacity in the economy, there is scope to increase production and soak up new money to stymie inflation.

In fact, increasing the money supply is not even necessary for inflation, because if there is a contraction in economic activity, less goods and services could drive price increases. Again, a case of too much money. And we are seeing output contract now with the pandemic, which may push prices up, money supply aside. When the pandemic subsides, utilising the spare capacity in the economy would have a deflationary effect.

Ultimately, the effect of QE in Australia coupled with a restricted economy due to the pandemic, may see temporary inflation, because increasing the money supply and curtailing output are both inflationary actions. Then as vaccines are rolled out and the threat of the pandemic subsides, output should trend back to more normal levels and use up any excess money. Also, we are coming off a sustained low base of inflation.

If however, policy did happen to overshoot, QE can be unwound by the RBA selling bonds back to the secondary market. The ability to unwind sets QE apart from true money printing, whereby central banks credit Treasury accounts electronically for the government to spend as it sees fit without needing to repay. An example is so-called 'helicopter money', where governments drop money into peoples' accounts to stimulate economies. Central banks end up with no assets, and the effect is both irreversible and inflationary.

Importantly, QE also has a currency effect. With QE lowering interest rates, it can weaken a currency. And QE has been going on in Europe, the US, and Japan for quite some time now, causing lower exchange rates than otherwise would be the case. With the RBA now getting in on the act too, it should help our currency's competitiveness.

Finally, there has been a focus recently on the rise in bond yields globally, particularly in the US. Investors could be dumping bonds in the expectation of inflation finally taking off, perhaps due to the early unveiling of vaccines, and the thinking that central banks may have overstepped the mark with pandemic stimulus measures. Note, that it is expected inflation and not actual that influences bond yields.

The RBA says it expects to keep interest rates at low levels at least until 2024, and would buy even more government debt "if necessary". It also says there are few signs of an inflation rise in Australia that would require higher interest rates. Perhaps for now.

Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.