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Contents

Editorial

It's a year since the World Health Organisation declared COVID-19 a global pandemic, and we've all experienced daily lives in a way none of us expected. The 12-month range for the S&P/ASX200 is 4,402 to 6,938, a rise since February 2020 of 58%. We also know from the changes in our spending habits - less travel, more on cars and homes - that the fortunes of individual companies have varied significantly.

Let's take a quick look at three examples: **Flight Centre, JB Hi-Fi and CBA**. Note the time scales in the Morningstar charts are different to illustrate the main points.

Anyone who invested in Flight Centre at below $10 in March 2020 has done well as investors look through to a travel recovery. But the three-year chart below tells another story, a stock above $60 in 2018 and now below $19, with some analysts saying there's a lot more in its recovery yet.

Contrast this with a winner like JB Hi-Fi, as Australians spend money on electronics and improving equipment in our homes. Falling initially to below $25 in March 2020, it has recovered to be above its 2019 high and is now around $50.

And finally a stock most people have exposure to, directly or indirectly, this time charted over a decade. CBA has also had an impressive recovery from below $60 in March 2020 to about $87 now, but still below its all-time high above $96. Bank share prices are flat over six years but dividends are a lot better than term deposits.

Where do we stand one year on in the pandemic? Now the talk is of recovery, rising rates and inflation, so we turn to **Howard Marks** for his latest views in a webinar delivered this week. His major criticism is the market saying there is 'no price too high' for some stocks, but check his comments on public and private markets.

An Australian example of price exuberance is the remarkable recent fund raising for **Afterpay**, where investors lapped up $1.5 billion of 5-year zero-coupon convertible bonds. The only upside is in bettering the exercise price, a healthy $194.82, by 12 March 2026, yet the offer was six times over-subscribed. The share price at the time of the issue was about $135 and it is now about $110. The Afterpay founders did not participate and sold shares worth $60 million each. Hard to believe their bankers could have found $10 billion of demand for a security paying no interest for five years. The announcement that CBA will offer a BNPL service to four million existing debit and credit cardholders will not help Afterpay or the note holders.

It's interesting to hear from **Gemma Dale** how [seasoned investors and traders] using **nabtrade** have reacted recently to market conditions, seizing opportunities they would not have considered a year ago.

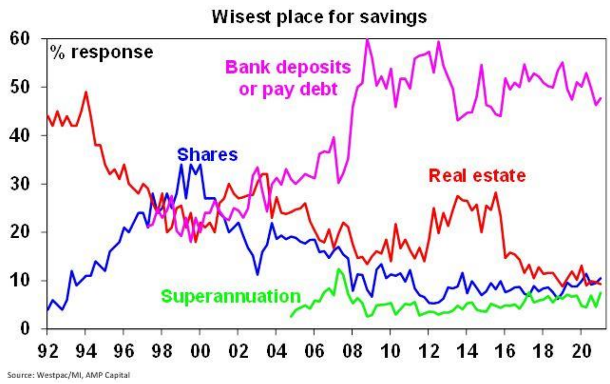
Brokers have seen a big increase in new clients in the last year, with **Investment Trends** reporting:

"At the end of 2020, the population of active retail online investors in Australia reached a new high of 1.25 million. Over the last 12 months alone, 435,000 Australians began trading listed investments for the very first time amidst the pandemic-induced lockdown. COVID-induced market volatility and a low interest rate environment were important prompts for first-time investors entering the market, but even more prominent was the desire to learn a new skill, highlighting how many Australians chose to spend their free time during the lockdowns. The record growth in investor numbers is also driven by strong interest for international stocks, with the number of active international share traders in Australia doubling from 54,000 to 109,000 in the 12 months to December 2020."

Sinclair Currie looks at how social media and inexpensive or free share platforms have changed the market, with a surprising argument that easy money has [actually increased market risk], especially on the upside for anyone shorting stocks.

Looking to the future, six portfolio managers from **Capital Group** imagine life in 2030 and [check the sectors and themes] they like. It's an optimistic outlook that augers well for some companies.

Notwithstanding these opportunities and low interest rates, the Westpac-Melbourne Institute Index of the wisest place for savings still favours bank deposits or paying off debt, while real estate intentions belie the current price rise frenzy at auctions. Shares have received an uptick recently but nowhere near levels of 20 years ago, before the GFC taught a generation that prices fall as well as rise.



This relatively low ranking for shares is despite the fact that most investors are aware that over the long run, equities will outperform investment alternatives. Take a guess when this was written:

"Students of financial history can point to historic levels of valuation to suggest that we are in a bubble. But students of psychology may be needed to complete the picture. For one thing, the financial markets have been so strong for so long that fear of market risk has mostly evaporated. People who used to hold bank certificates of deposit now maintain a portfolio of growth stocks. It is not really within human nature to comprehend that you may not know everything you think you know, and, further, that what you believe in could change on a dime.... With more and more of the market value of U.S. equities represented by lofty (in some cases infinite) multiples of current results, a change in sentiment could wipe out a large percentage of investor net worth. Sentiment, existing only in the minds of investors, is subject to change quickly and without notice."

It reads as if it were written this week, but **Seth Klarman** wrote it 22 years ago in [June 1999 (pages 32-36 on this link).] Most patterns in markets are repeating and there's not much new.

Regardless of how shiny your crystal ball, one thing's is for sure, that China will have a profound impact on Australia for all our lifetimes. We depend on China for economic prosperity, but with dark sides to our relationship on military confrontation, human rights and trade sanctions. So it's good to keep our eyes on what is happening with our largest trading partner, and **Qian Wang** explains some of the [challenges China is facing] as it emerges quickly from the pandemic.

In a lighter but constructive mood, **Nicholas Stotz** marks another anniversary, a year since the death of **Kenny Rogers**, with a quirky look at what we can [learn from *The Gambler*.] Investing is not about winning the first few hands, as there'll be time enough for counting when the dealings done.

Finally, an important and controversial note from **David Knox**. There is a widely used chart which David cites which shows how wealthy people receive the most support in retirement due to generous superannuation benefits. But the chart critically assumes a high discount rate for future benefits, which reduces the value of the lifetime age pension. What happens with a more realistic assumption recasts the popular claim.

Still on super, in a strange move and another early access scheme, the media is reporting a plan to allow domestic violence victims to access up to $10,000 of their super. As the CEO of **Women's Safety NSW, Hayley Foster,** told *Crikey*:

"It does send the message that you've got yourself into this business, you need to be responsible for getting yourself out of it. We as a society should be making sure that we're putting in place the measures to assist people to get out of those unsafe situations."

With culture and gender a hot topic, and notwithstanding some readers commenting that Firstlinks should avoid such topics, the White Paper from MFS International discusses responsibility for diversity and inclusion by businesses, individuals and, dare I say ... politicians.

And watch for a **Special 400th Edition** next week with unique features.

Howard Marks on four riskiest words: No Price Too High

Graham Hand

On 16 March 2021, Howard Marks spoke at an Australian Israel Chamber of Commerce webinar. Marks is well known to regular Firstlinks readers as the Co-Chairman of Oaktree Capital Management, which he co-founded in 1995 and is the world's largest distressed debt investor.

The moderator, Alicia Gregory from Australia's Future Fund, started by asking Marks about the potential for inflation. He discussed the consequences of the steps taken by the US Federal Reserve and Treasury to rescue the economy in the face of COVID.

Defining a bubble

"That was very strong action and it worked. It turned the economy and the markets around but lowering interest rates has a lot of strong impacts. It raises the value of assets, it reduces the competition that bonds pose for stocks, and lets the stock market rise. The low rate of interest on cash forces people to go out and buy assets, and also the low returns on safe investments force people to become more risk tolerant and move out to riskier investments to get a decent return.

The impact on the price/earnings (P/E) ratio applied to stocks is particularly strong, and the lower interest rates go, the higher stock P/Es and stock prices that can go. That's the mechanical linkage. Now, today, after the stock market has risen roughly 80% from the March low, are we in a bubble?

First you have to say, what is a bubble?

It's not just any bull market, it's not just any rise. A bubble, to me, starts with a grain of truth. It might be that the internet will change the world or the tulips are beautiful back in 17th century Holland. It's usually about something new because when it's something new, the limitations have not been found and there's no past to hold it back. So, if this a grain of truth is taken to an extreme, the assumption is that every company in that field will be successful.

And finally, we have irrational optimism, and the four words that seal the deal: ***no price too high.*** *And back in 1999 for example, they were saying the internet's going to change the world so there's no price too high for an e-commerce company. The internet did change the world, of course, but most of those e-commerce companies closed worthless."*

Marks then switched to today's market, justifying high valuations due to historically low rates:

"Are we in a bubble? I say compared to that definition, asset prices and particularly stock prices, and especially probably technology, are high, but not irrational. I think that as I described the mechanism through which

lower interest rates produce higher stock prices, on that basis, today's stock prices are justified and justifiable, albeit high.

Now that's very important, because that means they are dependent for their current level on interest rates staying low for longer."

Can the Fed keep interest rates low forever?

Despite the actions of the Fed and Treasury pumping up the economy, Marks sees few signs of inflation, but he uses a fascinating analogy, with a warning:

"I think of the Fed actions as a kind of like a waterspout coming out of the sea and there's a ball on top. As long as the spout is coming out, the ball can stand suspended above the level of the water. As soon as the waterspout stops, the ball falls to earth because its former level was an artificial one. That's what I think about interest rates. The Fed can try to keep interest rates low for a long time, as it has direct control over short interest rates. But it does not have the same degree of control over the longer parts of the bond market, and from a low of 0.6% yield on the 10-year Treasury during the height of a COVID, we're already at 1.6%.

But if you ask me, can you pump trillions of new money into the economy, year after year with interest rates staying low for long? I'm not convinced. I'm not firm enough in my views about the future to say what will happen, but we have to give room in our portfolios for the occurrence of inflation and higher rates."

Private market premiums

Alicia Gregory then asked about his views on the existence of an illiquidity premium as an incentive (and reward) for investing in private markets.

"People always talk about the illiquidity premium illiquidity or any risk premiums. Risk premiums are not naturally occurring. They're not part of nature, they only happen if people are risk averse. If people say, I don't want to tie up my money, and in order to do so, I have to be induced, then there'll be an illiquidity premium.

But if people say I'm eager to tie up my money, and they're all crowded into the illiquid markets, then you won't have a risk premium. Risk premiums exists to bribe people to do things that they don't want to do.

So I think it's very important to realise that. A lot of universities emulated Yale into the private markets and then when we had the global financial crisis, they were in a big jam because they had taken on more liquidity than they could live with.

No investor needs 100% liquidity for all their portfolio. I think of it as like geological layers. As you dig down, you get to more and more illiquid assets, but you can have a layer of illiquid assets and partially liquid and semi liquid and meet your needs that way. But you have to accurately assess your ability to live with illiquidity, and I've seen people skip that."

Private markets are alpha, public markets are beta

Marks makes an interesting distinction between the skill needed to generate excess returns in private versus public market, with what sounds like a criticism of active managers in listed securities.

"In the private markets of private debt or infrastructure or real estate, you become dependent on the managers. These are what we call alpha markets, where alpha is personal skill. And in these markets, you need personal skill.

And if you go into the stock market, in the long run, it doesn't make much of a difference who you hire because these are not alpha marks. These are what we call beta markets where most of the return comes from the performance of the market. So, which manager you choose is much less critical.

But if you go into a locked up, private illiquid investment fund, with a manager you're relying on for a skill, who turns out to have what we call negative alpha, which is the ability to hurt a portfolio, then you have manager risk. If you turn to the private markets you may get a higher return, some of them will be reward for illiquidity, some of it will be hopefully from picking a manager with skill."

Special Purpose Acquisition Companies (SPACs)

Marks is tolerant of SPACs, but as in private markets, he sees manager skill ultimately determining who will be successful:

"SPACs are a form of financial innovation and financial innovation can only take place when markets are optimistic. When markets are downcast and skeptical and depressed, you can't bring out something new. So the fact that SPACs have been so popular is an indicator, but that doesn't mean they are fallacious.

They serve a purpose as a way to get companies public without the torturous process of going public through an IPO. And over time, just like with private equity, they'll sort out. And after there's been 1,000 SPACs, they'll say XYZ is somebody who has brought out SPACs that consistently have done well and ABC is somebody who was a fly-by-night and was unsuccessful. Right now, when there's a SPAC frenzy (as I said about bubbles), they are being treated as if everybody is likely to be successful."

Howard Marks released his latest memo to clients this week and it can be read here.

Howard Marks spoke at an Australian Israel Chamber of Commerce webinar in partnership with Spire Capital. This article is general information and does not consider the circumstances of any investor.

The equity of government support for retirement income

David Knox

For many years there has been considerable media debate about the fairness (or otherwise) of the superannuation tax concessions and the apparent advantage they provide to high income earners.

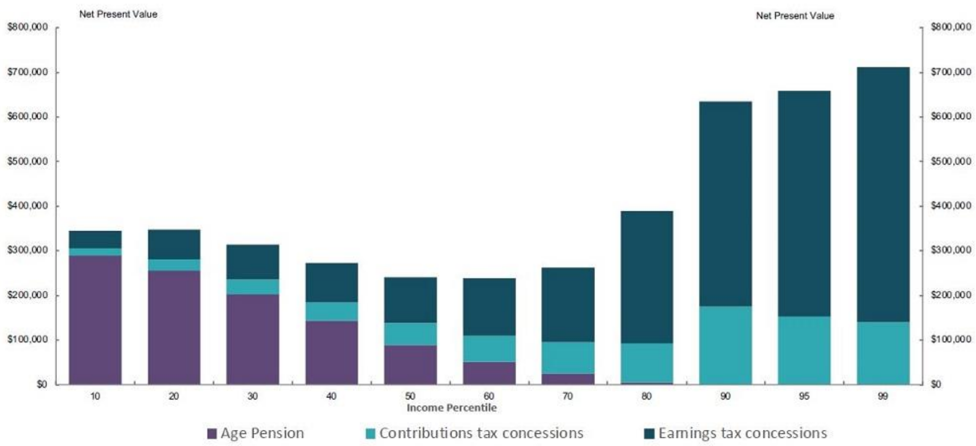
However, government support for retirement income comes from two main sources:

- the direct age pension payments made by the government to many older Australians who have experienced low-moderate lifetime earnings, and
- the superannuation tax concessions, in respect of concessional contributions (received during one's working years) and investment earnings (received both before and after retirement).

This is illustrated in the following graph taken from the Treasury consultation paper prepared for the Retirement Income Review which shows the level of lifetime government support at various income levels.

As expected, the value of the expected age pension payments reduce as incomes rise whereas the reverse applies in respect of the super tax concessions. This is chart is commonly used to demonstrate the inequity of superannuation concessions.

Government support for retirement incomes



Discounting to a present value requires assumptions

Of course, both the age pension payments and tax concessions are spread over several decades into the future. Therefore, to obtain a present value of the level of lifetime support in today's dollars, it is necessary to discount these future payments and concessions.

The Treasury calculations discount these future levels of support at the assumed nominal GDP growth rate, or about 5% per annum. While this rate may be reasonable from the government's perspective, as it allows for productivity gains and population growth, it is totally inappropriate when comparing the level of government support between individuals.

A lower rate relevant to individuals is needed.

The Retirement Income Review used the assumed wages growth of 4% pa until retirement and then the assumed inflation rate of 2.5% pa during the retirement years. So, to keep it simple, let's use 3.5% pa. The results are shown below.

As expected, the present value of all these future payments increases when a lower discount rate is used. However, given that the age pension payments are further into the future than the superannuation tax concessions, the level of retirement income support received at lower incomes increases by a higher percentage than at higher incomes.

(For an analogy, growth stocks that are estimated to earn profits far into the future become more valuable when rates are lower, as the discount rate on the earnings is less. So important is this assumption that it has driven the value of growth stocks ever higher as rates have fallen over recent years).

A highly different result

Indeed, the lowest three income deciles now receive more government support than the 80th income percentile. This is a very different result from the Treasury numbers.

It is also apparent that middle income earners receive less support than both high and low income earners. That is, there is a 'U-shape' in the level of government support.

One way of providing a fairer outcome is to reduce the assets test taper from $3 per fortnight (equivalent to 7.8%) to $1.50 per fortnight (or 3.9%). The next graph shows the effects of applying the lower deeming rates that applied in 2020 and halving the assets test taper.

While the reduced deeming rates provide some improvement, the halving of the assets test taper provides a significant boost to the level of government support to middle income earners as more age pension payments will be received by these individuals.

In fact, this is a similar result to that shown in the Final Report of the Retirement Income Review through their somewhat unrealistic assumption that retirees could spend their assets down more quickly than normal and so receive increased age pension payments.

One final comment

Even with the halving of the assets test taper, the highest income decile receives the highest level of government support due to their high levels of superannuation and the resulting tax concessions.

However, the approach adopted by Treasury in valuing these concessions is misleading as it assumes that these individuals would pay the highest marginal tax rate on their investment earnings ***if there was no superannuation***. This is unrealistic as I'm sure they would find other legal means to reduce their tax.

In summary, the level of government support for retirement income across different income levels is not as unequal as often claimed. Indeed, if the assets test taper were halved, the level of support would be remarkably level across all incomes.

Dr David Knox is a Senior Partner at Mercer. See www.mercer.com.au. This article is general information and not investment advice.

Five strategies popular with active share traders

Gemma Dale

While the sharemarket continues to attract record numbers of new investors, seasoned traders are looking to specific strategies to grow or protect their portfolios in volatile times. This article looks at some of the strategies they are using at the moment.

1. Buying financials especially banks

Banks have been a significant drag on Australian stockmarket returns over the last five years, with the value of the XFJ (S&P ASX200 Financials Index) flat while the broader S&P/ASX200 is up 35% over the same period. Retail investors have been largely willing to wear the share price decline in exchange for strong fully franked dividends, and therefore suffered twice during COVID as bank share prices collapsed and dividends were cut or postponed. As a result, financials have fallen from approximately 35% of the average nabtrade portfolio to under 28%.

While many high net worth investors took the opportunity to top up their bank holdings during COVID, recent economic strength and the prospect of a return to higher dividends has resulted in strong buying across the banks in early 2021. While all of the big four are finding favour, Westpac has attracted strong attention, with some feeling that it had fallen further than its peers and has a greater chance of returning to favour during reporting season.

2. Resources for dividends

Traditionally viewed as cyclical and capital intensive, with little potential for yield, the resources sector is attracting investors seeking income. The big miners have rewarded investors over recent years with both strong share price growth and high dividends.

Fortescue (FMG) remains hugely popular with a small but wealthy proportion of the nabtrade investor base. FMG topped trading numbers four weeks in a row despite an elevated share price, lifted by record iron ore prices. Many investors continued to pick up the stock in advance of reporting season, anticipating a strong result and an attractive dividend.

3. Positive gearing in a low rate environment

With interest rates at record lows, housing finance has recently surged to exceed pre COVID levels, and data suggests borrowing is also increasing in other sectors.

For many investors with substantial assets, the attraction of borrowing is to generate a positive yield after interest payments. This involves modest loan-to-valuation ratios and investing in assets that generate average or above average yields. Investors with existing borrowings who may have been motivated to pay down their borrowings are now more likely to maintain them at existing levels.

4. Purchasing portfolio protection

One of the more surprising products that surged in popularity during the sharemarket turmoil of 2020 was BBOZ, an ETF that allows investors to profit in a falling market. Many large investors bought or traded BBOZ as a way to minimise volatility in their overall portfolio value, or to take a position on where they expected the market to trend.

The popularity of BBOZ waned over recent months as volatility has fallen and economic news improved. But signs of market weakness or a return of volatility typified by the wild swings in GameStop sees activity resurface.

5. The 'silver squeeze'

It was impossible to ignore the dramatic tug-of-war between hedge funds and Reddit-inspired retail investors over GameStop and AMC in the US. Many speculated that silver was the next big 'squeeze', resulting in an 8% rally in the silver price overnight, and a spike in buying across silver miners, ETFs, futures and more.

Nabtrade saw elevated buying of the ETF Securities Physical Silver ETF, of which a substantial proportion was from high net worth investors. Far from new to the silver trade, or trying to execute a squeeze, many have been accumulating silver over recent months.

Two of the fundamental theories behind this trade are the rising demand for silver as a component in solar technology, supported by a wave of 'green legislation' under a Biden presidency, and a growing discrepancy between the gold and silver price. Gold has traditionally sold at around 50x the silver price, but with levels recently reaching more than 70x, some investors concluded that a reversion to the long run average was likely.

These strategies are used by experienced investors for their own circumstances or views. As with all investment strategies, it's important to determine whether it is appropriate for your personal goals and circumstances.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs.

For more articles and papers from nabtrade, please click here.

The world in 2030: Six investing tips for the next decade

Capital Group

Featuring: Martin Romo, Jody Jonsson and more

The world in 2030 may seem a long way off, but for long-term investors, it's an appropriate timeframe. Capital Group's Vice Chairman Rob Lovelace says:

"Imagining life in 2030 is not a hypothetical for me. In the portfolios that I manage, my average holding period is about eight years, so I'm living that approach to investing."

Capital Group asked its investment team to look in their crystal balls to envision how life may change by the end of the decade. Here are six portfolio managers' perspectives on the world in 2030, and how these shifting trends influence their investment decisions.

1. COVID could be this generation's Pearl Harbor - Martin Romo

Ten years from now I think we will look back on COVID as our generation's 'Pearl Harbor moment' - a period when extreme adversity spurs innovation and behavioral changes to help address some of the era's biggest problems. When Pearl Harbor happened, the U.S. artillery was 75% horse drawn. Yet by the end of the war they had entered the atomic age. That incredible transformation sparked a period of innovation and growth in the U.S. economy that lasted for decades.

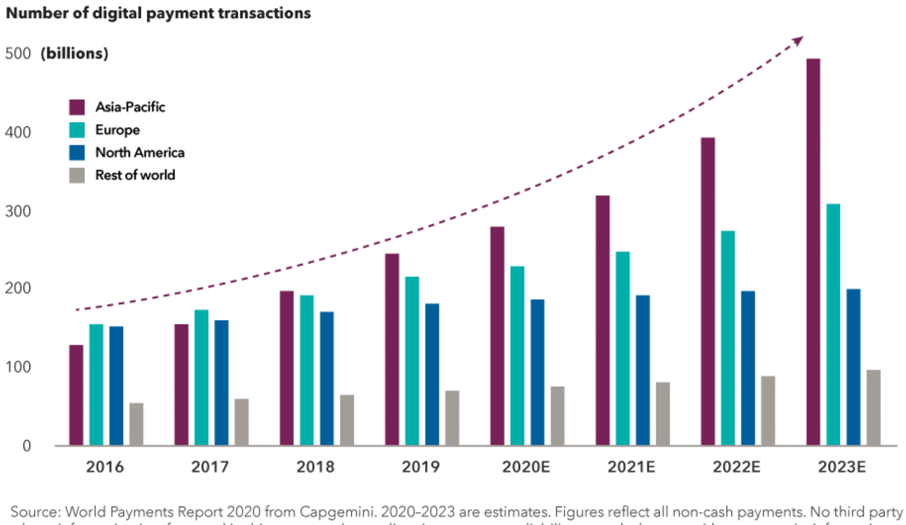
COVID could be the trigger that spurs us to tackle critical issues in the US over the next decade, such as the cost of health care, education and housing. We've already seen an almost magically rapid development of COVID vaccines at a speed few thought possible. And we're doing things in our daily lives we never imagined would happen this quickly.

In 2030 we may be living, working, studying and playing in a radically new world. Our lives could be better, richer, healthier, cheaper and profoundly more digital, virtual and data centric. Many of the technologies already exist, but I believe there's still so much untapped potential for innovative companies to think bigger and use them in ways that solve societal problems.

2. Cash is an endangered species - Jody Jonsson

A decade from now I think digital payments will be the norm, and people will give you odd looks if you try to pay with cash.

We've seen this trend for several years in developing countries - where many consumers had no bank accounts but did have mobile phones and adopted mobile payment technology quickly. The pandemic accelerated use of digital payments around the world, including places where it hadn't previously been ingrained in daily life. Once this crisis is over, I think a lot more people will be comfortable making digital payments, and they probably won't feel the need to use cash as much as they did before.



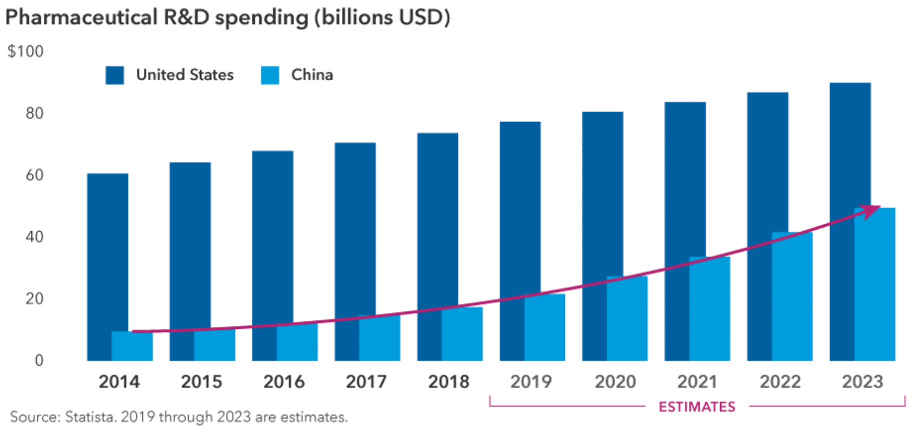
Source: World Payments Report 2020 from Capgemini. 2020-2023 are estimates. Figures reflect all non-cash payments. No third party whose information is referenced in this report under credit to it, assumes any liability towards the user with respect to its information.

As consumers become increasingly comfortable with the technology, companies with large global footprints could be poised to benefit. We've also seen strong growth in smaller companies based in countries such as Brazil that offer mobile payment platforms for merchants.

3. A cure for cancer may be around the corner - Cheryl Frank

A cure for cancer may be closer than you think. In fact, I believe some cancers will be functionally cured with cell therapy between now and 2030. New, reliable tests should enable very early detection of cancer formation and location. Beyond that, cancer could largely be eradicated as a major cause of death through early diagnosis.

Vastly reduced costs and scientific developments have contributed to phenomenal growth in medical research. We're in a renaissance period for R&D, and companies are investing aggressively to find unique ways to battle cancer and other illnesses. Genomics research and therapies derived from genetic testing have the potential to extend lives and generate billions of dollars in revenue for companies that develop them.

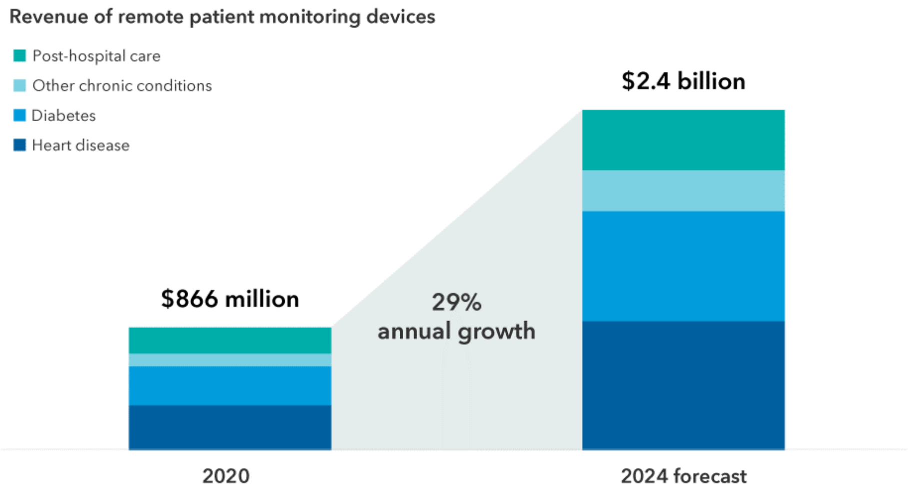


Source: Statista. 2019 through 2023 are estimates.

I wouldn't be surprised to see increasing amounts of pharmaceutical innovation come from outside the U.S, which has historically been considered a leader in this field. In fact, I expect to see many blockbuster drugs from China by 2030. The country has the biggest population of cancer patients in the world, and it's significantly easier to enroll those patients in clinical trials. I expect they will begin to produce novel drugs within five to 10 years and sell them at one-tenth the cost in the U.S.

4. Health care innovation will reach warp speed - Rich Wolf

Star Trek, the classic sci-fi TV series, depicted a far-off future where space explorers traveled the galaxies equipped with cutting edge technology such as the tricorder, a hand-held medical device that scanned a person's vital signs, issued a diagnosis and prescribed treatment in minutes. While I don't think there is going to be a single tricorder that does everything, I suspect that by 2030 many of us will have devices like it that will analyze blood, do cardiology monitoring and even remotely check our breathing while we sleep, some of which are available today.



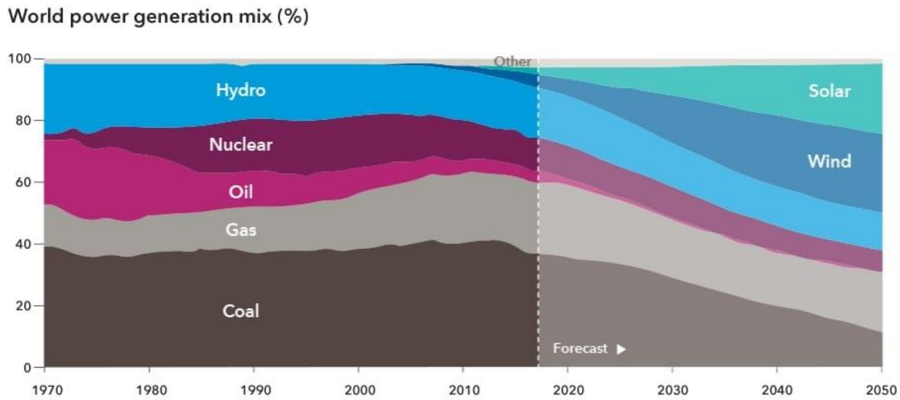
Sources: Industry & government data, Kagan estimates, Standard & Poor's. Data compiled June 2020. Values in USD.

We are already experiencing a massive wave of innovation and disruption across the health care sector that has the potential to drive new opportunity for companies, reduce overall costs and, most importantly, improve outcomes for patients. Breakthroughs in diagnostics will help lead to earlier detection of illnesses, which can help make drugs more effective — or in some cases treat disease before it progresses. One of the most exciting things today is something known as liquid biopsy, whereby a sample of your blood can identify a tumor at its earliest stages.

A broad range of traditional technology and medical technology companies have been working to develop home diagnostics for some time, and patients are now benefitting from their innovation. These are cost-effective devices that can collect all kinds of health-related metrics that not only help coach us to improve our own health but can be immediately sent to our doctor for further consultation. We're still in the early stages of development, but by 2030 it should be a routine part of our daily lives.

5. Renewable energy could power the world - Noriko Chen

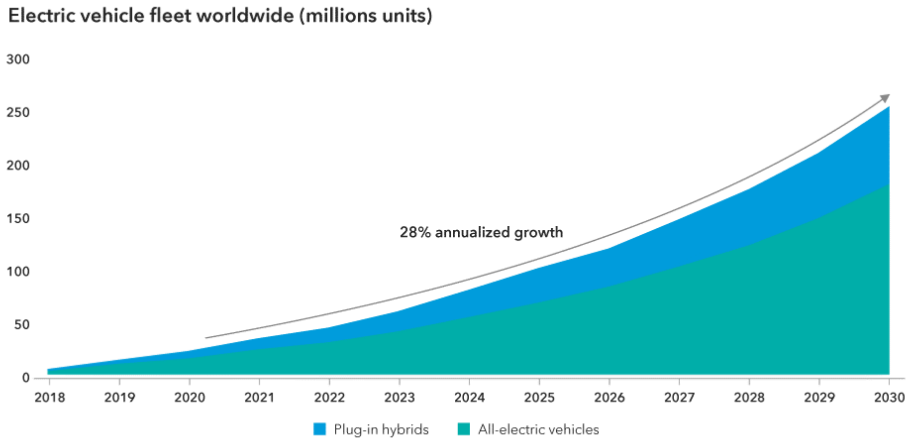
I believe we'll see a dramatic shift towards renewable energy over the next decade. We are in the early stages of the transition to an electrification of the grid and green energy, and there are strong tailwinds that could drive growth through 2030 and beyond. Automation and artificial intelligence are setting the stage for a golden age in renewables, pushing costs down while boosting productivity and efficiency.



Source: Bloomberg, New Energy Outlook 2019, a detailed study on global energy demand and supply conducted by 65 analysts for Bloomberg New Energy Finance. "Other" includes geothermal, biomass, etc.

Renewable energy has historically been perceived as expensive, impractical and unprofitable but all that is quickly changing. Some traditional utilities are already generating more than 30% of their business from renewables and are reaching an inflection point where they are being recognised more as growth companies rather than just staid, old-economy power generators and grid operators. The move towards renewables is most pronounced in European utilities, where their governments have set high decarbonisation targets. For example, the Renewable Energy Directive stipulates that a minimum of 32% of energy in the European Union should come from renewable resources by 2030.

6. Electric and autonomous vehicles hit the fast lane — Chris Buchbinder



Source: IEA, Electric vehicle stock in the EV30@30 scenario, 2018–2030, IEA, Paris. Data for 2020–2030 are forecasts, provided by IEA.

I think in 2030 we will have widely deployed fleets of autonomous electric vehicles operating in most major and many secondary cities around the world. Ownership of a personal vehicle will go from being a necessity to a luxury. Many people will still have vehicles, just like people ride horses or bicycles for fun. But personal vehicles will no longer be necessary as the primary form of transportation for most people in major cities.

This is an area that I believe the market hasn't fully appreciated yet. Right now, the market leaders are embedded in other companies - such as Alphabet's Waymo, Amazon's Zoox or the Cruise division of GM - so investors can't buy a pure-play autonomous driving company. But as these fleets roll out more publicly, the market should start to reevaluate these companies and realize this is a real business, not a science project.

I also think 2030 is when we're likely to see hybrid electric engines and hydrogen engines introduced into commercial aircrafts, with widespread deployment over the following 5–10 years. The impact on global emissions could be significant if we transition to a world where we've got huge fleets of autonomous electric vehicles on the road and aircraft transportation shifting from oil-based fuel to a mixture of oil, electricity and hydrogen.

Martin Romo, Jody Jonsson, Cheryl Frank, Rich Wolf, Noriko Chen and Chris Buchbinder are Portfolio Managers at Capital Group, a sponsor of Firstlinks. This article is neither an offer nor a solicitation to buy or sell any securities or to provide any investment service. The information is of a general nature and does not take into account your objectives, financial situation or needs. Before acting on any of the information you should consider its appropriateness, having regard to your own objectives, financial situation and needs.

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Now playing: China's policy normalisation challenge

Qian Wang

with contributions from Vanguard economist Beatrice Yeo

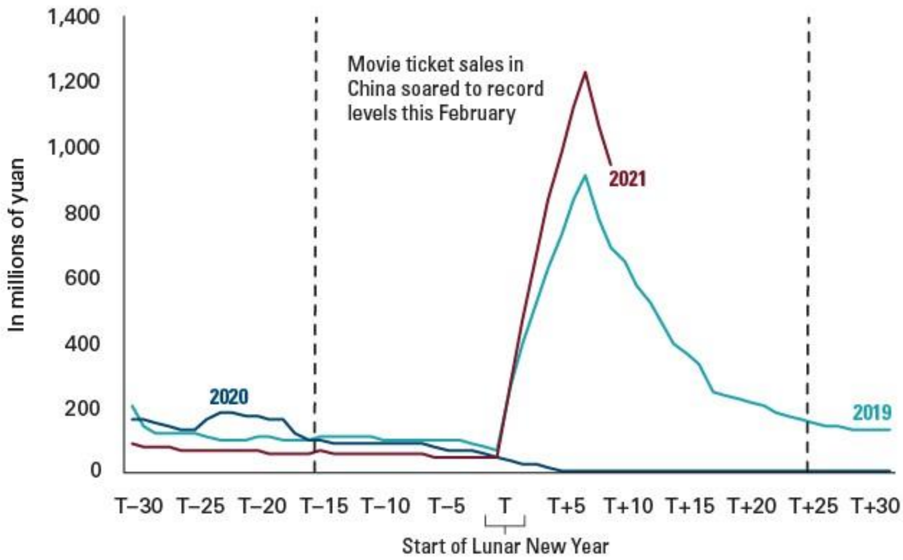
People in China went back to the movies this Lunar New Year, in a big way. Compared with 2019, box office revenues were up by a third at their 2021 holiday peak. These record sales came despite a 75% capacity limit imposed to counter a recent resurgence of COVID-19.

Daily life has largely returned to normal in China, the first country affected by the coronavirus. Because it contained the virus and its fallout better than most large economies, China could limit its fiscal and monetary support for the economy relative to others.

Signs of recovery

Still, policymakers, who even before the pandemic were tasked with balancing the nation's growth and its financial stability, face a challenge in readjusting policy for more normal times. With China being the first major economy to emerge from the pandemic, and its growth having returned to its pre-pandemic trajectory in the fourth quarter of 2020, its policymakers' moves will be assured a global audience.

Box office revenues provide anecdotal evidence of pent-up demand



Notes: *The illustration shows the seven-day rolling average of box office revenues in China. T represents the Lunar New Year, which this year was on February 12. Associated numbers represent the number of days before and after Lunar New Year. Data as of February 20, 2021.* ***Source:*** *Wind Economic Database. Data accessed February 23, 2021.*

Other high-frequency indicators, such as those measuring container ship volumes and local traffic congestion, similarly suggest an economy that has largely returned to normal. China's fourth-quarter 2020 GDP growth of 6.5% was greater than economists as a group had expected.

Although COVID-19 lockdowns interrupted China's most important holiday period for a second year in a row, the economic effect this year was largely benign compared with 2020s. Whereas last year's lockdown was nationwide, the lockdown that extended from late December 2020 through February 22, 2021, affected regions representing only 4% of China's GDP.

The timing of last year's lockdown left migrant workers stranded in their home villages, delaying restarts of factories after the holiday period. This year, lockdowns occurred before the holiday travel season, keeping workers in place and allowing for earlier factory restarts than usual. The resulting higher capacity utilisation in the industrial and construction sectors offsets some of the weakness in consumption and the service sector.

Vanguard recently published commentary on how monetary and fiscal policy remains a tailwind in most developed economies, where policymakers aim to sustain economic recovery and keep inflation expectations anchored.

In China, however, post-pandemic policy normalisation is a headwind.

Doubts about balance of growth and financial stability

For 2021, we expect slower credit growth, less government bond issuance, and a reduction in the fiscal deficit. The question is no longer whether and when the People's Bank of China will normalise monetary policy - it's the pace and magnitude of normalisation.

We expect tightening to be gradual and dependent on the economy's performance. The recently released Jan-Feb 2021 economic data confirmed our expectations of accelerated production and exports offsetting the modest drop in consumption and investment, and reaffirms our forecast of sequentially slower but still positive Q1 growth forecast.

As both an emerging market and a global economic powerhouse, China faces a continuing challenge in balancing growth stability and financial stability. Rising leverage and housing market bubbles are among the concerns. I wrote recently about how China's attempt to find such a balance may help explain a remarkable consistency in China's official GDP numbers. A recent Vanguard research paper discusses an approach that we believe presents a truer picture of China's growth.

But China also must find a balance between near-term and medium-term financial stability - a challenge shared by policymakers in developed markets. Policy normalisation that is too aggressive or not communicated well could trigger immediate stress in the financial system. We saw this play out in China with an interbank liquidity squeeze this January and credit-market stress in the second half of 2020.

In managing recovery from the unprecedented economic disruption brought on by COVID-19, policymakers in China and elsewhere will need to make sense of ever-changing data that at times will send mixed signals. To avoid undue market volatility that in turn could hamper economic growth, policymakers will need to communicate with markets effectively and stick to a well-prepared script.

Qian Wang is Chief Economist, Asia-Pacific and Beatrice Yeo is Economist, Australia in the Vanguard Investment Strategy Group. Vanguard Australia is a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any individual.

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Social media's impact is changing markets

Sinclair Currie

What made the GameStop squeeze remarkable was its velocity and magnitude. Stock promoters used social media to communicate their message to spectacular effect. The evidence suggests most GameStop buyers acted on a conviction that they would profit by selling to a forced buyer after the crowd drove up the stock price.

There was limited evidence that these investors evaluated the fundamentals of the business. Boosted by social media and lubricated with fiscal and monetary stimulus, the collective power of the positive narrative overwhelmed the fundamental-based reasoning of the established short interest of hedge funds.

Social media spectacularly demonstrated a unique capacity to influence traders and violently move markets. The power of sentiment, unconstrained by fundamentals was amplified, and volatility reigned.

Why is this new source of volatility a big deal?

It is not difficult to imagine that easy money combined with social media's power to promote a narrative will result in more situations like GameStop. Markets have become accustomed to central banks acting to limit downside volatility. It seems strange to consider that volatility on the **upside** might also upset markets, yet we just saw that happen.

Beyond the stories of sole traders making millions, the notable outcomes of the GameStop spike reported were:

1) heavy losses at respected hedge funds, resulting in portfolio rebalancing, liquidation and recapitalisation, and

2) online broker Robinhood's expedited $3 billion equity raising to meet adjusted capital buffers and margin calls.

These outcomes are indicative of the broad and meaningful implications for markets should there be a re-evaluation of volatility, even if it is skewed to the upside. GameStop's share price spike resulted in liquidations and margin calls. These are signals of stress we usually associate with bear markets, not rising markets.

Not simply a zero-sum game

The upside-skewed volatility burst also impacted long-short strategies. These strategies commonly access leverage by reinvesting the dollar proceeds of their short sales to add investments in their long exposures. Securities lending is essentially leverage.

If markets become more wary about unpredictable upside spikes in stocks, long-short strategies are likely to become more selective with their short positions thus generating less leverage to invest in their long positions. This deleveraging is likely to reduce market liquidity. To the extent that many of these strategies crowd the same themes and factors, it may also narrow the dispersion of valuations.

Greater volatility will also affect the activity of market makers and options traders. Options traders use volatility to determine premiums (prices). Generally, higher volatility makes options premiums more expensive. Underestimating volatility is dangerous for traders selling uncovered options. Uncovered means that the trader doesn't own the underlying stock and is therefore exposed as a forced buyer in the event of a spike in the share price. A short option position has limited upside and unlimited downside. With this sort of payoff, you do not want to sell too cheap.

Options are generally sold by market makers with large, finely-tuned portfolios which are often leveraged and highly sensitive to sudden and violent changes. Market makers are an important contributor to market liquidity and provide valuable risk management tools. Dislocations for market makers can have broad market consequences, particularly for the counterparties who use markets for the purpose of insurance rather than speculation.

Effective markets need secure counterparties

The margin calls faced by Robinhood highlight the importance of the trading hubs upon which the integrity of financial markets depend. Much of the counterparty risk in financial markets is managed or intermediated through an exchange or a clearing house. For example, the owner of a call option relies on a clearing house to deliver on an 'in the money' (profitable) contract when that option is exercised. If the seller of that call option does not post sufficient margin to settle the trade, the clearing house wears the loss.

Volatile price movements can result in extraordinary margin calls (such as those demanded of Robinhood). If additional funding cannot be secured, margin calls will result in forced liquidation and can create market dislocations and elevated counterparty risks. Layers of leverage and opacity associated with stock lending and derivatives tangles the web of counterparties.

In a worst-case scenario, a sudden breakout in volatility could erode confidence in the market hubs and thus the integrity of markets.

We have grown to accept the central bank put

For decades, investors have become accustomed to central banks providing a backstop to markets to dampen volatility. The perception is that central banks have unlimited capacity to provide adequate liquidity to overcome any market dislocation. When a systemic risk to markets emerges, we no longer hope for a central bank bailout, *we expect it.*

A contemporary view is that central banks should have an asymmetrical impact on markets. That is, they should support failing markets but do not need to act against speculative bubbles. An interpretation of this might be that central banks truncate downside tail risks and thus reduce overall volatility.

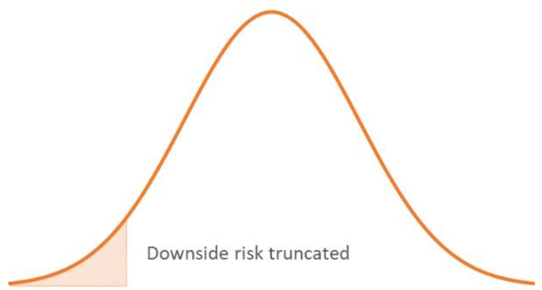
Graphically, this might look like the top chart.

The GameStop saga could justify an alternative interpretation. Introducing asymmetry may skew the distribution of returns (to the upside) but not actually reduce volatility. If the impact of the 'Fed Put' is to skew returns as displayed in the bottom graph, volatility is not reduced, merely altered.

GameStop demonstrates a paradox. Did this happen because easy money *actually contributed* to a breakout in volatility?

If that is the case, further central bank actions might only exacerbate volatility and have the converse effect of reducing liquidity and risk appetite.

Does the 'Fed Put' cut tail risks and limit volatility?



...Or does it just create more skew, with no reduction in volatility

The implication for Australian small companies

This has implications for small companies in Australia.

The most direct and obvious is that it elevates the risks for short interest. A share price spike created by a social media-led buying frenzy may be short lived; however, margin calls and leverage mean even brief spikes can lead to forced liquidation and significant losses. Contemporary hedging strategies for example, those used to reduce exposure to market risk or 'beta', might need fine tuning.

A debate about the appropriate estimate of volatility may also impact the valuation gap between market favourites and less sought-after names. A feature of Australian small companies in recent years has been the increased dispersion of valuations between companies. Market realities and themes such as lower interest rates and growth scarcity explain most of this; however, it has also been exacerbated by long-short strategies. An unwinding of these positions may reduce this dispersion.

If volatility has been underestimated, it is indicative of a mispricing of risk across the market. Perhaps central bank bailouts have not reduced volatility by simply truncating the downside. Maybe they skew the distribution into a fatter tail on the upside, with less reduction in volatility than previously thought.

The best performing stocks are generally companies which are sustainably building valuable businesses. However, if volatility has been mispriced as described, the best opportunities are likely to arise from contrarian viewpoints rather than pursuit of expensive momentum.

Sinclair Currie is a Principal and Co-Portfolio Manager at NovaPort Capital, a boutique Australian equities investment manager specialising in small and microcap ASX-listed companies. This article is for general information only and does not consider the circumstances of any individual.

What Kenny Rogers can teach you about investing

Nicholas Stotz

Saturday marks a year since the legendary country singer Kenny Rogers passed away. Although the world has changed dramatically since Ken passed away, there are still plenty of pearls of wisdom (or Aces to Keep) from his most popular song, The Gambler.

You've got to know when to hold 'em

Former NBA General Manager Sam Hinkie once wrote that when running his basketball team he wanted to have "*the longest view in the room*". Other teams would often be so desperate to be successful immediately that they would overpay for current assets (players in their prime now) and sell future assets (players who are still developing) on the cheap. Hinkie would be happy to trade away one player who is good today if he could get back two players who would be good in three years' time.

Having the longest view in the room also helps investors when markets are choppy. Whether it's rising bond yields, trade wars, inverted yield curves, etc, there will always be new developments to worry about when investing in shares. If you don't think these developments are relevant to your long-term view of your investments (e.g. what impact does Brexit have on BHP's earnings?) then you probably should ignore them.

Know when to fold 'em

It is common for investors to get caught in value traps. They buy a poorly performing stock because they think it's become cheap, and then the stock continues to perform poorly (think AMP, Telstra, etc).

Being a contrarian investor only works if you hold a convergent view AND you are proven to be right. When your investment thesis is flawed, it's usually best to cut your losses rather than double down and hope for the best.

Know when to walk away

Your brother-in-law has a hot tip about a penny stock miner?

Know when to run

Somebody on the internet reckons they've got a proprietary FX trading system that'll help you quit the 9 to 5?

You never count your money when you're sittin' at the table

It's common to hear someone say that they've made money in shares, property, etc, but paper gains can't pay for your next trip to Woolies. If you're sitting at the table your winnings are at risk, and investors should keep that in mind when evaluating their profits and losses.

There'll be time enough for countin' when the dealin's done

Australia is a nation of punters and it's all too common to see investors punt with money that's supposed to fund their retirement or pay for a home deposit.

In his classic *Where are the Customers' Yachts?*, American stockbroker Fred Schwed opined that the difference between speculators and investors is that speculators try to turn a little into a lot, while investors try to prevent a lot turning into a little.

You can be a speculator with money you're ok with never seeing again but be an investor with money that you need to last for decades.

Nicholas Stotz is a Dealing Associate at prime brokerage firm, [Lazarus Capital Partners](). This article is general information.