Firstlinks
a Morningstar company

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Editorial

At the **Morningstar Investment Conference** yesterday, Founder of **GMO, Jeremy Grantham**, lamented the consequences of high prices of everything for younger people looking to build wealth. A longer extract from his interview covers his views on markets, technology, commodities and venture capital, but he also said:

"Having high priced assets is great for retirees and old folks like me, for selling off my assets, but for everybody else, it means you compound your wealth more slowly. And if you don't have any wealth, you pay twice what your parents paid for a house, you pay twice for a portfolio in the sense that you get half the yield. It's a fairly miserable world so I welcome lower asset prices which I'm confident will come from these very high prices."

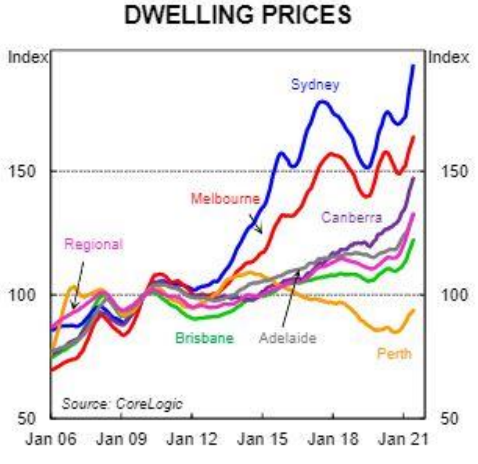
I was reminded of **Powderfinger's *These Days***, and I'm sure it's how many people feel about the struggle to buy a home or invest. At the moment, each month goes by (*the slowly creeping hand of time*) with further price rises (*shadow in my face*) leaving the market out of reach (*it's slipping right through my hands*).

It's coming round again
Slowly creeping hand
Of time and its command
Soon enough it comes
And settles in its place
Its shadow in my face
Puts pressure in my day

This life well it's slipping right through my hands
These days turned out nothing like I had planned

If there's comfort for those feeling they have missed out, Grantham strongly believes a major correction is coming. Then one day, interest rates will rise and higher loan repayments should put downward pressure on home prices. Maybe it will turn out as planned.

But for now, the latest **CoreLogic** data gives no respite, but it does show how prices fell in 2018 around the time of the **Hayne Royal Commission** and tighter lending rules, and then again at the start of COVID.



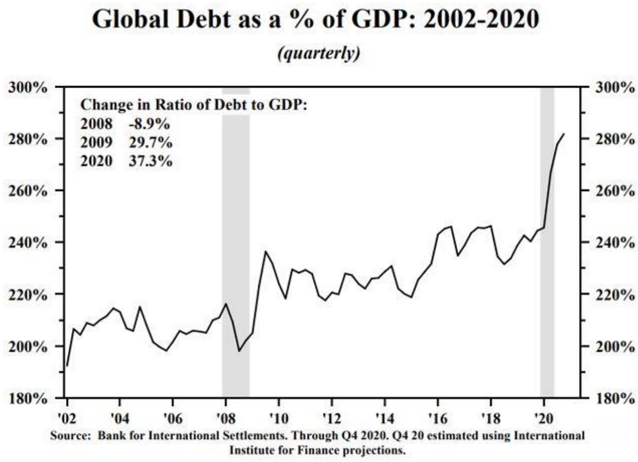
CBA Economics reported on the latest results:

- Dwelling prices rose by 2.3% in May across the 8 capital cities combined, with Hobart and Sydney rising strongly.
- Over the year dwelling prices have risen by 9.4%, but the rises range from 5.0% in Melbourne to 20.3% in Darwin
- We are starting to see trends in the market shift; capital cities are now outperforming the regions and the top end of the market is outperforming the more affordable end of the market.
- The leading indicators of the housing market remain strong and point to continued growth in prices.

"Looking ahead we expect dwelling prices to continue to rise. We have a 14% lift in dwelling prices in 2021 and 2022 with a stronger increase for houses relative to apartments. Auction clearance rates have softened a little but remain very high. Very low interest rates and the recovery in the labour market are supporting dwelling prices."

The possible resurgence of inflation is dividing economists, with prominent minds on both sides. **Dr Lacy Hunt of Hoisington Management** (as quoted by **John Mauldin**) has a strong multi-decade record on inflation (there will be little or none), interest rates (flat or down) and Treasury bonds (bullish). Says Mauldin:

"In Lacy's view, today's core problem is that excess debt suppresses economic growth, without which demand can't rise enough to generate inflation or push up interest rates over the medium term. This is a structural problem, which at this point we really can't fix."



Source: Hoisington Management

The other, more practical side of the argument is that inflation is evident across many sectors. In the US, there is excess consumer demand from the stimulus cheques and a huge backlog of orders. Spending and travel are rising, and resources such as copper and lumber are in short supply. Wages for unskilled workers are rising and businesses cannot find people to hire. The argument is that these are temporary factors with Federal Reserve **Chairman Jerome Powell** describing the recent rise in inflation as "transitory". But will he be forced into action within a year if inflation takes hold?

Professor Tim Congdon, Chairman of the **Institute of International Monetary Research**, wrote in his newsletter this week on US inflation:

"The average monthly increase in the CPI so far this year has been just above 0.6%, while business surveys indicate price-raising pressures are at their most intense for over a decade. Evidently, there is a possibility that the annual rate of consumer inflation will soon go above 5%."

Transitory or not, that's well above the range wanted by major central banks.

In addition to the interview with **Jeremy Grantham**, two prominent Australian fund managers lead this edition. **Marcus Padley** provides evidence that analysts are largely wasting their time studying the merits of mining companies such as BHP versus Rio. Overwhelmingly, the fortunes of miners depend on the main commodity they produce, and know that and the share price follows.

Then back on the inflation issue, **Roger Montgomery** answers a reader question on how the value of a company might fall as rates rise and fund managers discount future earnings at a higher rate. Roger explains how rising rates look fine at first until they start to slow activity.

Robert Almeida holds similar concerns as higher real yields feed into lower risk asset valuations, forcing the fundamentals of companies to come to the fore again.

In case all this talk of inflation is a bit confusing, **Richard Montgomery** gives a basic explainer on the impact of inflation on financial assets and what sectors to consider as a defence.

Then **Michael Buckland** has checked the numbers when members withdrew their superannuation under the Early Access Scheme, showing their losses are even worse than reported, and offering a better alternative.

Looking longer term and more strategically, **Geoff Warren reviews** the main drivers of wealth and gives a framework for focussing away from volatility to achieving long-term goals.

A reminder that the Government has announced that the temporary reduction in pension drawdown rates by 50% will be extended another year to 30 June 2022. This will make it three years with the lower minimums. These are minimums, not recommended levels, and higher amount can be drawn if needed for your lifestyle.

And if you have been working from home, you may be eligible for extra tax deductions. There is a shortcut method of a deduction of 80 cents for each hour WFH over FY2021, or a fixed-rate method. You may be able to claim for the work-related proportions of household costs.

This week's White Paper is from Epoch Investment Partners (an affiliate of our sponsor, GSFM) and it looks at the famous Moore's Law and implications for technology and computing and the growth in semiconductor revenues.

And finally, Comment of the Week comes from publisher and journalist, **Greg Bright**, having a good snoop around our dogfooding article.

"Interested to see both the Prime Minister and Treasurer have accounts with AustralianSuper. Who'd have thought? Great story Graham. Lots of rewards for readers along the way to the bottom of the page. Interested to know how you came upon that internal Apple memo from 40 years ago?"

Grantham interview on the coming day of reckoning

Morningstar

Jeremy Grantham co-founded GMO in 1997 and is a member of its Asset Allocation team, serving as the long-term investment strategist. He was interviewed by Kunal Kapoor, CEO of Morningstar, at the Morningstar Investor Conference Australia on 2 June 2021. We previously featured Grantham's pessimistic outlook on the market in 'Waiting for the Last Dance'.

JG: Having high-priced assets is great for retirees and old folks like me, for selling off my assets, but for everybody else, it means you compound your wealth more slowly. And if you don't have any wealth, you pay twice what your parents paid for a house, you pay twice for a portfolio in the sense that you get half the yield. It's a fairly miserable world so I welcome lower asset prices which I'm confident will come from these very high prices, even a modest retracement back towards the last 100-year average. If it went back halfway, there's a major bear market.

And the other thing we have to watch is, if you're going to have a bubbling market, make sure you only do it in one major asset class. Don't pull a Japan. Japan had the biggest bubble in history in land and real estate, bigger than the South Sea Bubble in my opinion. It also had the biggest equity bubble of any advanced country. Pulling two at the same time means 32 years later, their land is not back to where it was in 1989, and the stock market is not back in nominal dollars to where it was in 1980.

And that's a perfect example as the higher you go, the longer and greater the fall. Japan had never sold at over 25 times earnings before and at the time, it was 65 times. That's a pretty hefty new high, from 25 to 65.

And the same in 2000. We had never sold over 21 times earnings and then the tech bubble took us to 35 and 10 years later, we were selling at a lower price. And that's how it works. You can't get blood out of a stone. You can have a high-priced asset or a high-yielding asset, but you can't have both at the same time.

KK: What do you think some of the triggers might be that could lead to this reassessment of the valuation of different asset classes?

JG: Well, they're still arguing about what caused the 1929 crash. We have not been good at identifying causes and it may be because there is no traditional pin to pop the bubble. The market hits its all-time high when optimism is at an absolute peak. And the following day, is the second-most optimistic day in history, but it's a shade less optimistic than it was yesterday, and the price begins to fall a little bit.

It won't take bad news, it won't take a thoroughly bad economy. It will take a perfectly good economy and perfectly optimistic outlook, but a little less than it used to be a week ago, a month ago. And in 2000, we saw the really optimistic crazies, the pet.coms, peel off in March of 2000. The rest of the market shrugged them off as crazies and the market kept rising, and then they peel through the growth stocks and finally they shot Cisco which for eight seconds was the biggest company in the world by market cap.

By September, the 30% of the market that had been growth was down 50% but the S&P was unchanged. The rest of the market had continued to rise by 15%, and then the termites, the optimism termites or the pessimism termites, would be a better description, finally got to the balance of the market and the whole 70% rolled over and dropped 50% in two years.

What do we see this time? The super crazies are anything to do with electrification, EV for sure. Tesla is the king of that route, and the SPACs (Special Purpose Acquisition Companies) and the intersection whether EVs or batteries and so on. It was perhaps the most outstanding degree of enthusiasm and the SPAC index is down 30%.

KK: So amidst that big picture where we're in a unique time with unique asset prices, interest rates low, debt high, debates around whether inflation is going to be real or not, are there any pockets that you think are interesting from an asset class perspective? Where you think people can earn a decent return, or do you feel you're going to have to just be defensive for a long time?

JG: It's closer to that. 2000 was brilliant, though. Bonds were incredibly cheap, TIPS (inflation-linked bonds) yielded 4%, real estate sold below replacement costs. You don't want to pull a Japan, and we tried to in 2008. We had a genuine housing bubble in America, a three sigma, one-in-100-year event, and it sucked the equity market with it. The housing market went all the way back to trend line and it took the S&P down 50% with it.

And those two combined packed a much bigger punch to the economy than had the tech bubble in 2000. And 2008 also had oil and commodities spiking in 2007 so they inflicted quite a lot of pain on consumer income and that made the recession even worse. This time, real estate is suddenly pretty bubbly in almost every interesting market in the world. I have to say, notably including Sydney, but also Vancouver, London, Paris, New York, San Francisco all over, and our housing market is up 15% in the last year. You can't have an asset class like housing, where the house doesn't change and you're just marking it up in real terms, year after year. Eventually, there'll be a day of reckoning.

And remember, the higher the multiple of family income, the longer and the bigger the pain is likely to be based on Japan and on the US. So real estate almost everywhere on the planet has doubled in price and halved in yield. The bond market, as Jim Grant would say, is the highest in the history of man. We have records going back to the Babylonians, and there's never been these kinds of negative real rates. And then it comes to equities, where it isn't so much global as the US.

The developed world is merely overpriced, no big deal on its own, but the US is heroically overpriced and emerging markets is actually fairly cheap. Then within the structure of equities, value managers have had a brutal 11 years. It was the worst 10 years in history for value versus growth, and then last year was by far the worst single year. Value is certainly as cheap as it has ever been against growth, and there are signs over the last few months that it has shifted.

If you look at the intersection of these two ideas, emerging markets and value, I have complete confidence that if you bought the intersection - cheap emerging market stocks - then you would get a perfectly handsome 10- or 20-year return. And I am pretty darn confident that you will not get a handsome 10-year return from say the S&P 500 or NASDAQ. NASDAQ peaked two months ago, and is now up 5% versus the S&P’s 12%.

Remember, it has a higher beta. When high beta stocks start to underperform, you want to watch out. In 1929, the flaky, junky high beta stocks underperformed the whole year so badly that they were down year-to-date the day before the crash. They did the same in the Nifty50 era of 1972. The S&P was up 17% while the average big board stock was minus 17, nice symmetry. And then in 2000, as I said, all the growth stocks went down, and the rest of the market went up for eight months. And this time, my guess is the super SPACs peaked in January, the NASDAQ peaked in February, and maybe in a few months, the termites will get into the rest of the market.

KK: I want to ask you a simple question around the surge in commodity prices where any significant commodity is at multi-year highs. What's your view and what's going on and is it sustainable? Obviously for investors in Australia, it's a very important topic.

JG: I think there was a paradigm shift. We had gone from 100 years of irregularly falling prices, yes, they go up in World War One and World War Two and the oil crisis, but in between they kept coming down. So over 100 years, they lost 70% of their real value. Then from 2000 to 2008 and then in 2011, prices bounced up without anyone getting too excited, mainly due to China. That created a new era where we've kind of entered the end game, where instead of prices routinely falling in the long term, some will rise, some will fall, some will be flat, and you just have to get used to the fact that it’s not a tailwind (for the economy) any longer.

There is no way copper will not rise hugely from here because of the electrification of everything. And that goes for cobalt, that goes for lithium, and all of the metals except iron and aluminium are really scarce. We’ve done a pretty good job over 200 years of mining out the really high-grade ores everywhere. There's a lot of aluminium, there's a lot of iron ore, you may have squeezes like we have today from time to time but in the end, there's plenty, but everything else is really, really scarce.

You have to be reconciled in the long run for a different world of commodity prices, but what that means for the next two years, I leave to other people.

KK: A lot of what you've been laying out (in the past about climate change) obviously makes sense if you're overseeing a large pool of money and you're allocating assets and you have access to all kinds of information and data that allows you to make some of these decisions. What do you think an effective decision making and implementation framework might be for a financial adviser or an individual investor who's starting to think about these issues? If they want to make a shift in their portfolios to reflect valuations and climate change and some of its effects. How can folks individually start to make a difference?

JG: They can make a difference by buying climate change funds. I'm happy to say GMO has a pretty good one. ESG funds, where many reputable firms have them, that would make a difference. It would be good if we had a better rating on all the funds voting records to see how green they are.

Let me just say a word about the Grantham Foundation because we have a completely different investment approach. We decided that American capitalism seems to be past its prime, a little fat and happy, not aggressive enough. There's only half the number of people working for firms one- and two-years-old as there were in 1975. So we're losing some of our dynamism, but there is one thing where the US is still exceptional and that is venture capital. Venture capital is really attracting the best people these days, they don't go to Goldman Sachs to write algorithms, they go into venture capital or to start a new firm.

Venture capital is not like private equity. It's not institutional investing. In the end, we have to admit we're playing a cosmic poker game. We (GMO) are trying to beat the other players, and it's fun, but we're not really creating value. Venture capital is, we're causing firms to exist that otherwise would not exist. We're raising money for them, and in some cases, some of us are giving good advice to them. But America does that very well and we decided in our Foundation to go for broke. We are aiming to put 70% of everything we have into early-stage VC, of which half is in green early-stage VC, and we have our own team doing that. Thoroughly exciting Boston is a great place to do that, we started more new ventures last year than San Francisco.

It's just amazing what new technologies are out there. Microbes that will sequester nitrogen in the ground. Batteries that will last twice as long and weigh half as much and won't burst into flames. The list is completely endless. And the challenge is endless, so this is going to be where all the opportunities are.

The FANG-type companies are what separates the US stock market from the rest of the world, and not so much the P/E as the earnings. Most of the outperformance of the US market in the last 10 years has come from extra earnings, and over 80% of those extra earnings have come from this handful of FANGs. They have sprung out of the venture capital industry. They are a classic demonstration of that pool of venture capital 20 to 50 years ago, these are some of the winners that have become global giants, bone crushing in their competence and competitive spirit. And I think that that will continue, and it will be a true advantage for the American system.

This is an edited transcript by Graham Hand, Managing Editor of Firstlinks. A full transcript and video of the interview will be added as soon as it is available. This article is general information and does not consider the circumstances of any investor.

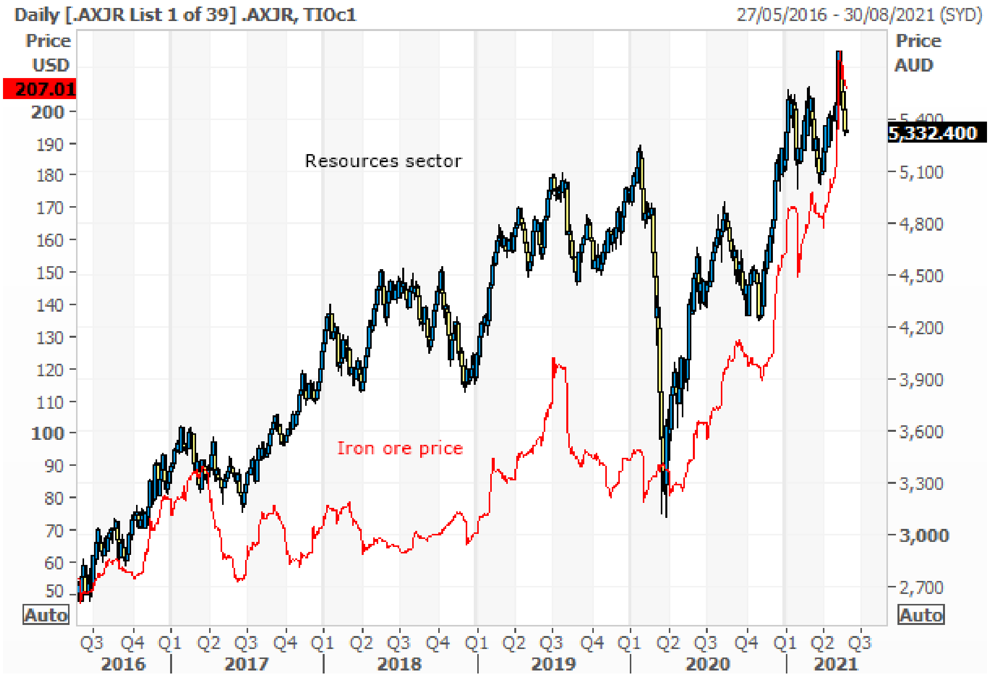
BHP v Rio v Fortescue: it's all about the iron ore price

Marcus Padley

When you look at charts comparing commodity prices and the share prices of mining companies, you begin to realise that it really doesn't matter what the broker analysts say, what the earnings forecasts are, what the return on equity of the Brazilian subsidiary of BHP (ASX:BHP) is or what anyone thinks.

When you are trying to decide whether to be in the resources sector or not, it is all about guessing what the underlying commodity prices are going to do next.

The chart below shows the very close correlation between the iron ore price and the ASX 200 resources sector (ASX:AXJR). *(All charts are created in May 2021 and sourced from Refinitiv).*



Commodity prices are all that matters

BHP, Rio Tinto (ASX:RIO) and Fortescue Metals (ASX:FMG) can look cheap or expensive, but it really doesn't matter. Their share prices are inextricably tied to commodity prices and in particular, the iron ore price.

That makes them great long duration trading stocks, great proxy trades for the less volatile commodity prices which sometimes offer significant and accelerated gains in short periods of time compared to the industrial stocks.

But don't for a moment bother looking at an earnings forecast, or a PE, or a DCF valuation or a broker target price, because they are only as good as the commodity price assumptions they are based on.

And that's a guess, and that guess changes every day that the company wakes up and finds the commodity price has changed. It means those accelerated gains are not based on fundamental analysis. They are based on whether you can time the sector and that means one thing – timing commodity prices.

The game at the moment, with the iron ore price up from US$80 to around US$200, is to decide whether the iron ore price rise is sustainable or overbought. It is the multi-million-dollar question. Capital Economics guesses the iron ore price will drop to US$100 per tonne by the end of 2021. Morgan Stanley research guesses the iron ore price, under a bull case scenario, could hit US$215 by the end of this year. It has already reached that. And a UK broker recently put out some now misdirected research saying *"We expect continued weakness in the iron ore price with the market increasingly oversupplied as the year progresses."*

Everybody's guessing. They always are. When it comes to resources, even the people who know more than anyone else about the stocks and about commodities, can't agree.

Watch the chart trends not the fundamentals

Your best bet is not in depth fundamental analysis, but charts, charts of the stocks, charts of the commodity prices, and an assumption that they trend. Applying technical analysis is something everyone can attempt, it is a 'commodity art' available to all.

So what do we do with BHP and Rio and the other Australian resources stocks geared to commodity prices?

For now, with BHP on a PE of 11.4x and a yield of 9.9% (including franking), with Rio on a PE of 7.0x with a yield of 14.1%, and with FMG on 5.6x with a yield of 15.4%, there is no fundamental reason to sell and as yet no technical reason to sell either.

But here's the rub. Those fundamental numbers should give you no comfort. As soon as the iron ore price falls over, so will the share prices, no matter the yield, no matter the PE. When the iron pore price falls, the earnings numbers and the dividend forecasts will be downgraded on a daily basis.

To make a few points clear:

- Forget fundamentals when analysing resources stocks.
- Commodity prices drive share prices.
- Respect the trend in commodity prices, it is the 'wind beneath the wings'.
- Australian resources stocks are great long duration trading stocks.
- Australian resources stocks offer great leveraged exposures to commodity prices.
- Get the commodity prices right and you'll get the share prices right.
- Never stand like King Canute saying stocks are cheap when commodity prices drop.

Checking some more charts, commodity and share prices

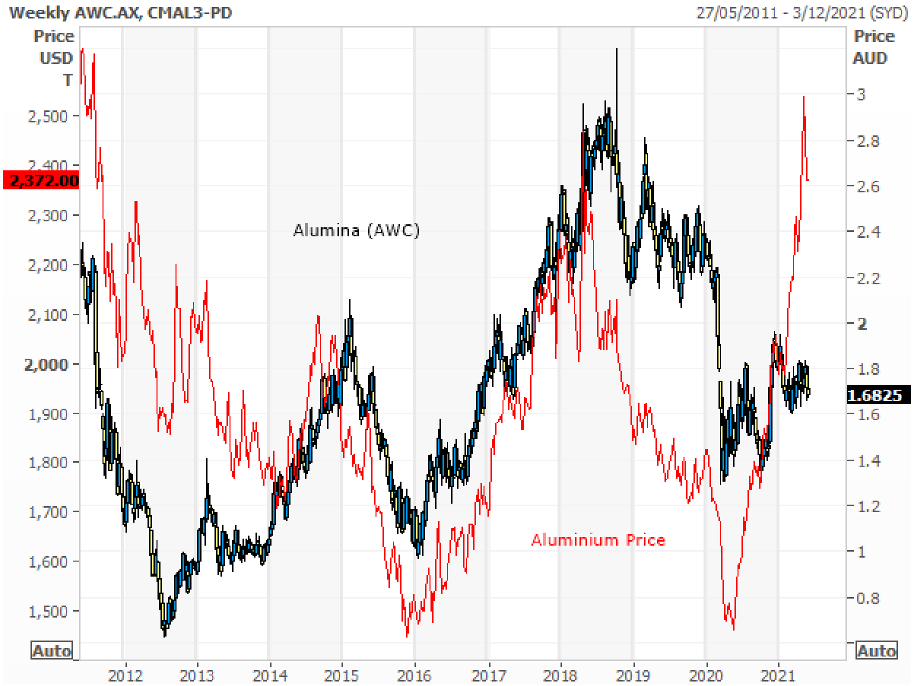
Here are a few more charts which make it clear that this commodity price correlation phenomenon is not confined to BHP, Rio and iron ore.

This is the Energy sector and the oil price:

This is the gold sector and the gold price:

This is Oz Minerals (ASX:OZL) and the copper price:

This is Alumina (ASX:AWC) and the aluminium price:



I could go on. It's a wonder why any analyst bothers visiting the big resources companies. All their analysis, all their insight, all their experience, counts for nothing is their commodity price assumptions are wrong.

Do you have a special insight into commodity prices?

Unless you have an insight into the future of the relevant commodity price, you have nothing to offer because your fundamental analysis of the individual resources stocks is futile.

The good news is that commodity prices trend. They have big trends, some that last for years, and these provide solid 'tides' for the stocks involved. If you can catch or spot or predict the big pivot points in the major commodity prices, investment becomes easy in Australia.

And if you don’t have such an insight, you still have a chance if you resort to technical analysis. Where there is a trend and the occasional trend changes, you have a chance of exploiting the resources sector for the accelerated gains on offer in the stocks rather than the commodity.

Bottom line, as an individual investor, you could do a lot worse than focus on one or two commodity prices, find out everything about them, what drives them, the seasonal moves, the daily chatter, and take a view.

Marcus Padley is the author of the daily stock market newsletter [Marcus Today](#) and the Co-Manager of the Marcus Today Separately Managed Accounts. This article is general information and does not consider the circumstances of any investor.

How much will rising inflation hit company valuations?

Roger Montgomery

We received a question from a reader, Steve, asking:

"There is plenty of talk about inflation as a risk in somewhat qualitative terms (that risk exists, but generally not quantified). The question is how big is the risk. The classic response to inflation is raising interest rates to cool the economy. This also feeds into discount rates impacting the valuation of shares etc. How much would a rise impact the discount rate for share valuation (the risk free rate is only a small part of the overall value used is it not?). If one could estimate the impact of a range of interest rate increases on overall economic activity as well as the impact on this discount rate we could get an idea of the risk to market valuations, going from a qualitative risk to a more quantitative risk."

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“If you invest in stocks, you should keep an eye on the bond market. If you invest in real estate, you should keep an eye on the bond market. If you invest in bonds or bond ETFs, you definitely should keep an eye on the bond market.” Investopedia

Bond interest rates have an impact on the price of all long-duration assets. The greatest beneficiaries of declining bond interest rates were businesses with earnings way out on the horizon, especially those companies that are profitless today but are forecast to earn a lot in the future.

Of course, the reverse is also true

Consider Table 1 on the impact on the present value of future earnings of a rise in the 10 year bond rate from 0.4% in April 2020 to 1.58% in May 2021.

Table 1: Valuation decline from rise in US bond rates

US 10yr impact on PV of $1	Rate	1 year	5 year	15 year	30 year
8/04/2020	0.50%	$1.00	$0.98	$0.93	$0.86
25/05/2021	1.58%	$0.98	$0.92	$0.79	$0.62
Valuation decline		1.06%	5.20%	14.81%	27.43%

When rates start to rise, intrinsic values start to fall. The rise in bond rates from 0.5% to 1.58%, when applied as a discount rate, results in a decline of 27.4% of the present value of a dollar earned in 30 years.

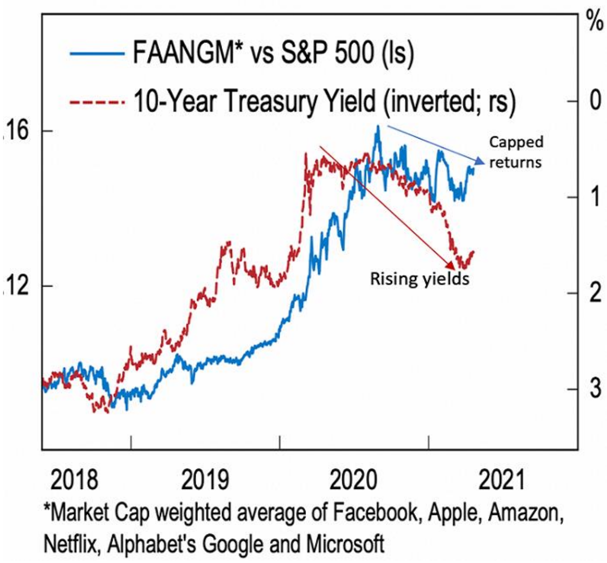
The current (as at 25 May 2021) US 10-year Treasury bond yield of 1.58% is more than triple the 0.51% Treasury bonds traded at a year ago. Consequently, stocks are under pressure and those hit hardest were the same stocks that benefited most when rates were declining, as shown in Figure 1.

The rise in bond yields to date primarily reflects a shift in inflationary expectations as well as a rise in real bond yields.

Figure 2 plots the difference between inflation-linked bond yields and nominal bond yields for both Australia and the US markets, providing an indication of the market's implied inflation expectations over the subsequent 10 years. As Figure 2 illustrates, inflation expectations today exceed the expectations prior to the pandemic in both Australia and the US.

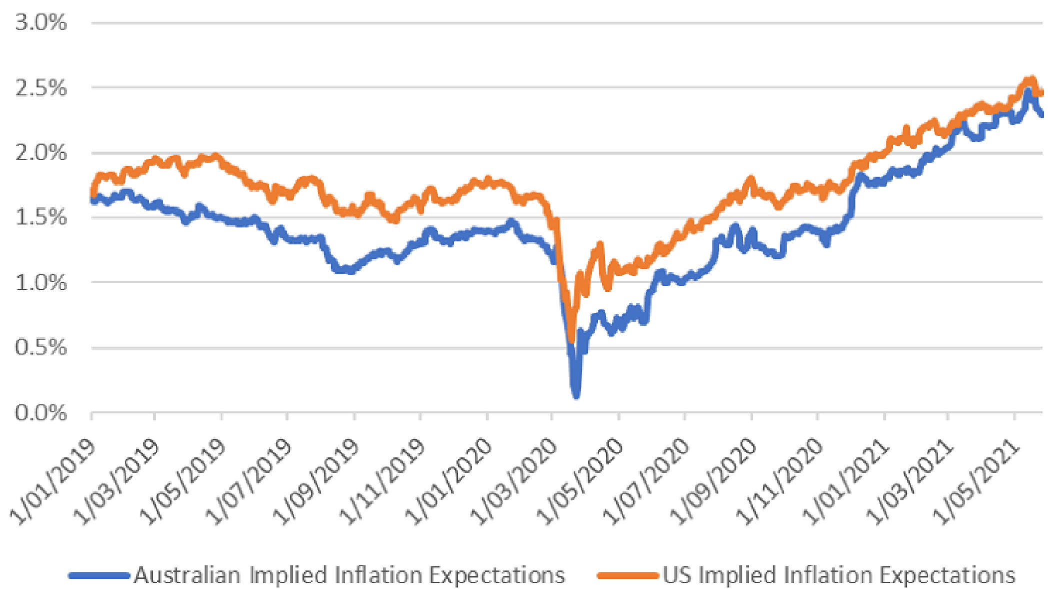
While increasing inflation expectations appear to be driving the overall increase in bond yields, a rise in real yields is also occurring.

Figure 1: The real world: Rising bond yields impact long duration growth stocks



Source: Alpine Macro

Figure 2: Implied Australian & US Inflation Expectations: 10-year bond yields - inflation indexed bond yields



Source: Montgomery, Bloomberg

The positive is the economy is growing

There's a potential positive to this combination of factors driving bond rates higher. Rising real yields are common coming out of a recession. This is because inflation is still low and rising bond rates reflect confidence in the economic recovery. Consequently, the gap between the bond rate and inflation (real yields) widens. Inflation typically lags economic growth and so the early phase of rising bond yields, coming out of a recession, means the economy is growing, which is usually positive for revenues and an optimistic signpost for markets.

Concerns over inflation however are also a component of the latest spike in bond yields with investors beginning to worry US President Biden's multi-trillion fiscal packages will spur runaway inflation. Should inflation rise, the impact on long duration stocks – companies not earning anything now, and the impact on companies unable to pass on the price increases - will be negative.

It's a complicated picture. On one hand, rising real yields is a positive, on the other, expectations of inflation, a negative. As vaccines roll out globally, economies will return to normal so shifting expectations towards reflation makes perfect sense. Whether it is associated with inflation however is a bet that markets are making.

But markets don't always get it right. The yield curve is an aggregate market forecast of where interest rates will be in the future, but just because markets anticipate inflation, doesn't mean inflation will emerge.

Rising rates start as a positive, then bring trouble

History provides a reasonable guide as to what to expect for equities after a recession and amid rising bond yields. Typically, the early stage of rising bond yields reflects optimism about accelerating economic growth and improving business conditions. This is a positive for equity markets generally. During the initial period of recovery both bond yields and equity markets can rise in tandem.

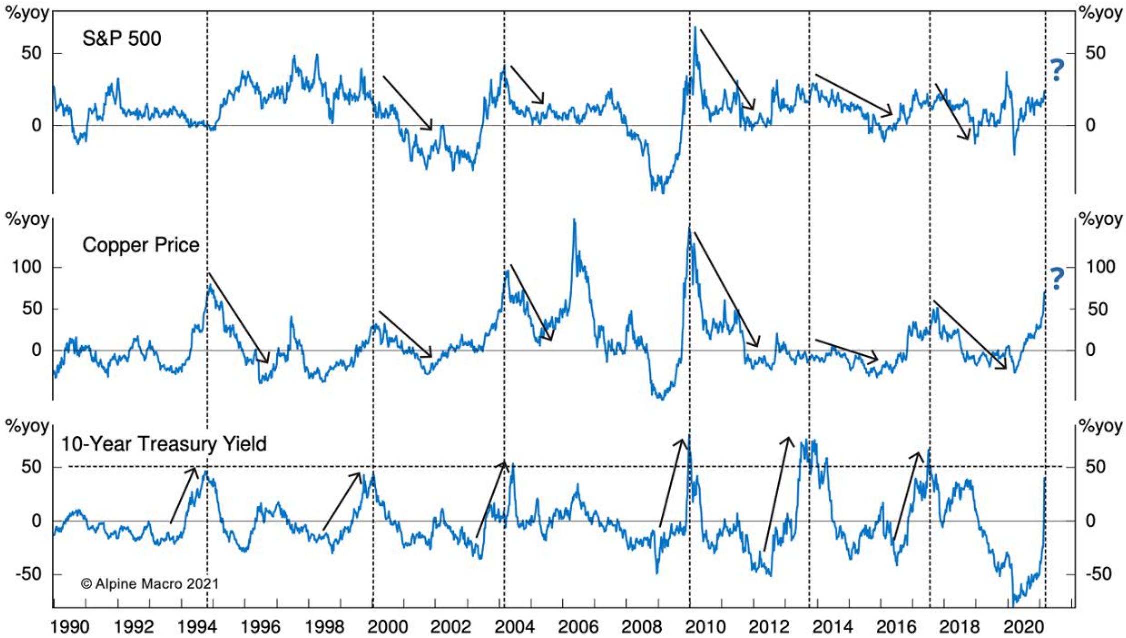
As the recovery from recession matures, continued increases in bond rates prove counter-productive, kerbing economic growth. The yield curve begins to flatten spelling trouble for equities, and presumably long-duration growth assets and cyclical assets such as commodity related assets and commodities themselves.

Unfortunately, history offers no set period of time at which the impact of rising bonds switches from being supportive to being deconstructive. A more useful guide may be to watch the slope of the yield curve. A flattening yield curve has been a useful warnings signal.

Today however, waiting for a flattening of the curve could be problematic because central banks promising to keep short rates at zero renders a flattening of the yield curve doubtful.

One interesting concept proposed by the team at Alpine Macro looks back at history by examining the pace of bond rate rises.

Figure 3: Bond yields, stock prices and copper prices



As Figure 3 reveals, whenever 10-year Treasury yields rose by 50% or more within one year, the move was often, but not always, succeeded by deteriorating equity market performance. Using this historical observation as a guide, the recent near tripling of bond yields might trigger an equity correction.

The relationship however cannot be counted as reliable as there aren't enough observations and there are periods where a spike in bond yields, such as into 1994, was not followed by poor stock market performance.

Alpine Macro goes a step further, plotting the copper price against bond yields. A 50% plus jump in bond yields tends to push down copper prices. Copper prices are an oft-used gauge of economic growth and historically, falling copper prices amid rising bond yields, may suggest the higher borrowing cost are adversely impacting economic growth.

Today however, copper prices are not retreating, which suggests the higher bond yields are not overly restrictive.

Are company growth assumptions reasonable?

Rising bond yields, hyper-extended Cape Shiller PEs and waves of speculative fervour are enough to scare Jeremey Grantham sufficiently to predict a crash is coming soon. He might be right.

Investors should look at each company in their portfolio and ask whether those companies are reasonably expected to generate strong growth in the next five years. That growth will depend on economic and monetary conditions. Investors should also ask how much of that growth is already factored into prices. Also keep in mind the impact on present values from rising bond rates. This is inescapable. Nothing can replace a rational and continuous assessment of the fundamentals.

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

Rising real yields likely to undermine equity values

Robert M. Almeida

In the United States, the economy has recouped nearly all the ground lost during the pandemic, and corporate earnings aren't far behind. As I wrote in Firstlinks in April, 'A year like few others but what's next?', risk assets have discounted this V-shape recovery but as economic and earnings data evolves from forecast into fact, markets are looking ahead to see what's next.

I believe what's next will be a day of reckoning as investors grapple with higher yields. Here's why.

Every investment opportunity is ultimately weighed against competing possibilities for use of funds. The decision to allocate capital happens only if the investment will clear its hurdle rate. While the height of every investment hurdle is determined by its idiosyncratic risk, real, inflation-adjusted interest rates are the first input into that calculus.

Anchors aweigh

During the 2020 recession, central bankers were determined not to allow lockdowns to morph into a credit crisis. In order to buoy animal spirits, policymakers drove real US Treasury yields deeply into negative territory, as illustrated in Exhibit 1 below.

Exhibit 1: Central bankers have crushed real yields

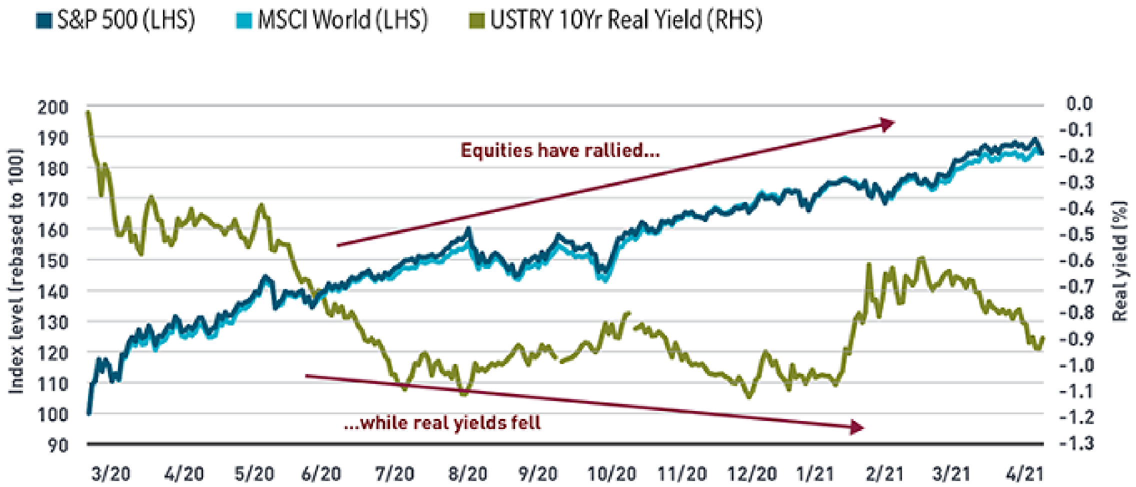
Source: Bloomberg, as of 5/12/21. Real yield is the nominal yield of a bond minus the rate of inflation.

In the years leading up to the pandemic, the real yield on the 10-year US Treasury Note lived in a meagre range below 1%, but at least it was positive and provided investors with some sort of measuring stick.

However, financial theory holds that asset prices can't go negative. Since capitalism requires a hurdle rate, business school courses don't teach students how to value a company or a project with negative nominal or real interest rates.

Without an anchor, it's apparent why risk assets have risen as they have. Exhibit 2 overlays the advances made by the S&P 500 and MSCI World indices from their pandemic lows against the path of U.S. 10-year Treasury real yields into negative territory.

Exhibit 2: Strong equity rally amid negative real yields



Source: Bloomberg, as of 5/10/21.

(The **Standard & Poor's 500 Stock Index** measures the broad US stock market. The **MSCI World Index** measures stock markets in the developed world).

While there's much sell-side research contending that risk assets can absorb inflation and higher rates, there's an observable inverse correlation in the chart above that I think is causal and not coincidental. Since rates are the first hurdle in the valuation of any asset, higher rates, whether real or nominal, lower the value of that asset.

Negative real yields are unsustainable

As economies continue to reopen and excess savings are spent, inflationary pressures will continue to mount. We're seeing it in goods such as lumber, semiconductors and automobiles; in services such as airfares, rental cars and vacation rentals; and in hard assets such as commodities and real estate.

Ultimately, we believe these pressures will prove transitory as the secular disinflationary forces of the past decade-plus — elevated debt levels, aging demographics and continued digitalisation, to name three — reassert themselves.

However, we're confident that negative real rates are unsustainable and will eventually normalise. What we're less confident about is the timing or the rate at which real yields will rise.

Regime shifts are always clear in hindsight but rarely at the point of inflection, yet markets have a way of sniffing them out. And when they do, we suspect that the relationship displayed in Exhibit 2 will reverse as rising real yields undermine equity valuations. As we go from forecast to fact, we believe market performance and leadership will look materially different than they have in the past several quarters.

Robert M. Almeida is a Global Investment Strategist and Portfolio Manager at [MFS Investment Management](). This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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Which stocks and sectors are hit by inflation?

Which stocks and sectors are hit by inflation?

Richard Montgomery

In recent years, economies and investors around the world have been operating in a low inflation environment. In recent months, however, rising inflation has emerged as a threat.

Inflation concerns came to a head in April 2021, with a far higher than expected lift in U.S. consumer prices. The markets had been expecting an increase in the core U.S. CPI of around 0.3% for the month and were shocked when the figure came in at 0.9%. That jump, in combination with low price increases during the shutdowns this time last year, meant the annual core CPI rate lifted to 3%, the highest since the mid-1990s.

In this article, we look at why, and how, rising inflation can affect investment markets.

What is inflation?

Inflation is a sustained rise in the price of goods and services in an economy.

There are two widely used indicators of inflation:

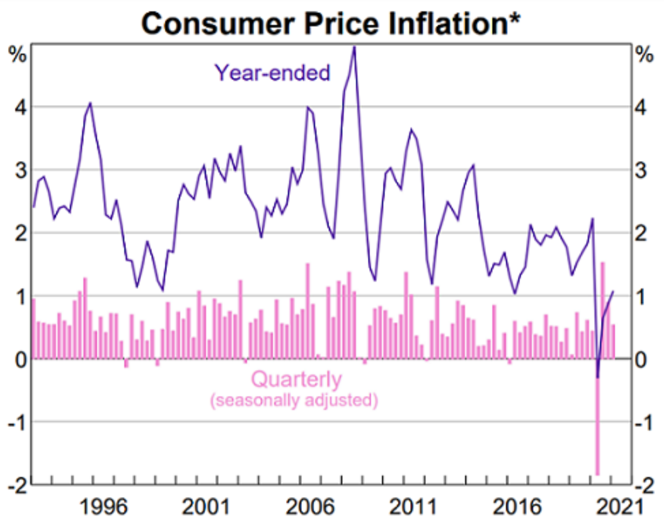
- the consumer price index (CPI)
- the producer price index (PPI).

The CPI is a measure of the price of a basket of goods and services typically purchased by households. Changes in the CPI reflect the price inflation faced by consumer households.

The PPI measures the change in the price of goods sold by manufacturers, and so is a measure of prices from the perspective of producers, rather than consumers.

Changes in these indicators are referred to as inflation. So, for example, if from the first quarter of one year to the first quarter of the next year the CPI increases by 2.5%, we say annual inflation is running at 2.5%.

This chart shows Australian consumer price inflation over the three decades to the end of the March quarter 2021.



* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Why does inflation matter?

Inflation means increased input costs for businesses.

For example, higher commodity prices mean manufacturers have to pay more for the materials they use to produce their goods, which means they either have to increase the prices they charge for the goods they produce, or they suffer from tighter profit margins.

Rising energy prices are bad for companies, as they have to pay more for the power they use, and the cost of transporting goods increases. These increases typically flow through to the prices manufacturers charge.

Inflation means increases in the cost of living for consumers. Consumers can purchase fewer goods, and they have to pay more for those goods. Unless wages keep up with inflation, this results in a lower standard of living.

The twin dangers – rising inflation, rising interest rates

Higher rates of inflation have an influence in their own right, but just as important, they tend to be accompanied by, or result in, increasing interest rates, which also can have a significant impact.

Governments typically use higher interest rates as a measure to combat rising inflation. High inflation is seen as a sign of an overheating economy, and in response, governments (or central banks) will often tighten monetary policy (increase interest rates) in an attempt to dampen economic activity.

It should be noted that some inflation is generally regarded as a good thing. A moderate level of inflation is seen as a sign of a growing economy. In Australia, the RBA Governor and the Treasurer have agreed that the appropriate target for monetary policy in Australia is to achieve an inflation rate of 2–3%, on average, over time.

How does inflation affect investors?

Inflation eats up the value of money for everyone – not just investors.

Returns can be thought of in 'nominal' or 'real' terms. The nominal return is the actual rate of return in percentage terms. The real rate of return is the nominal return less the inflation rate.

For example, if you invest in a term deposit paying 4% p.a., and inflation is 2% p.a., your real return is 2% p.a.

A higher inflation rate means you have to earn a higher rate of return simply to break even in real terms.

How are share investors affected?

While modestly rising inflation generally is seen as a positive for the broad sharemarket, as it is consistent with an economy growing at a sustainable pace, inflation above a certain level, or unexpected jumps in inflation, can be a negative – although the effect may vary for different sectors, and for different investing styles.

This is partly because of the effects of inflation itself, and partly because rising inflation often is accompanied by rising interest rates, which also can have a negative impact.

Higher inflation is usually seen as a negative for stocks because it typically results in:

- increased borrowing costs
- higher costs of materials and labour
- reduced expectations of earnings growth.

Taken together, these variables generally put downward pressure on stock prices.

Are all stocks affected the same?

The answer to this question is - 'No'. There are some sectors that have the potential to outperform in inflationary environments.

Gold is widely regarded as a 'safe haven' in inflationary environments, given that it is seen as a 'store of value', so an exposure to gold bullion or gold producers may have the potential to outperform.

People need to eat, regardless of whether inflation is rising or falling. Investors can consider exposures to agricultural commodities and food producers in an inflationary environment.

If rising inflation is accompanied by increases in the prices of commodities such as iron ore, this will have a negative impact on the purchasers of those commodities – but is likely to benefit commodity producers such as iron ore miners. Similarly, if there is an associated increase in the price of oil, an exposure to **energy** producers may provide defensive benefits.

Value versus growth stocks

Inflation has generally tended to affect growth stocks more than value stocks.

A common method used to value stocks is the discounted cash flow (DCF) method. Essentially, DCF values an investment based on its future cash flows. It involves calculating the present value of expected future cash flows, by applying a 'discount rate' to those future cash flows, to arrive at a valuation. The discount rate is dependent on interest rates – the higher the rate, the lower the present value of future cash flows, and therefore the lower the valuation attributed to the investment.

The other relevant point is that the further into the future a cashflow occurs, the lower the present value of that cash flow will be.

Many growth stocks have relatively low cash flows now but are expected to generate significant flows in the future, while many value stocks have strong cash flows now, but are expected to grow at a slower pace, or even decline.

Increases in inflation and interest rates are therefore likely to have a higher impact on growth stocks than on value stocks, as the cashflows their valuations are based on will be discounted more.

Fixed income investors

Rising yields (interest rates) are bad for fixed income investments that pay a ***fixed*** rate of interest, such as bonds, for two reasons.

Firstly, there is an inverse relationship between a bond's price and its yield - as interest rates increase, bonds fall in value, so bond holders can face capital losses.

Secondly, the income stream from fixed rate bonds remains the same until maturity. As inflation rises, the purchasing power of the interest payments declines.

Investments that pay a ***floating*** rate of return are likely to be better off in an inflationary environment, as the interest rate they pay is adjusted periodically to reflect market rates. If interest rates rise, the interest paid by the investment should also increase at the next reset date. This applies to investments such as hybrid securities, as well as funds (including exchange traded products available on the ASX) that provide exposure to such hybrids.

Inflation is generally regarded as damaging to holders of cash and cash equivalents, since the value of cash will not keep up with the increased price of goods and services.

Richard Montgomery is the Marketing Communications Manager at BetaShares, a sponsor of Firstlinks. This article is for general information purposes only and does not address the needs of any individual. Past performance is not indicative of future performance. Investment value can go down as well as up.

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Buy high, sell low: early super access and foregone returns

Michael Buckland

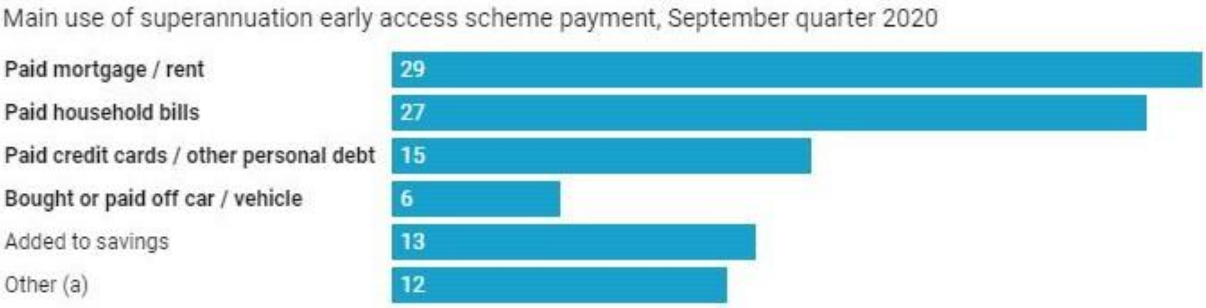
with Connor Wherrett and Edward Cavanough

In response to the COVID-19 pandemic, the Government allowed individuals affected to access up to a total of $20,000 from their superannuation. During the course of 2020, over three million Australians withdrew a total of $36.4 billion out of their super accounts. In March, the Institute published 9 reasons why accessing super early is a risky idea. A key reason why was our concern that the policy drives people to sell at the bottom of the market. Unfortunately, that appears to have been the case.

Why some Australians withdrew their super

During the course of the scheme, there was concern that the early access to super was used on gambling, as well as other purposes that the scheme wasn't intended for. According to ABS data published April 2021, early access of superannuation was utilised by Australians for paying their mortgage, rent, bills, or paying down person debt obligations.

Figure 1: People withdrew their superannuation for payments they should have been able to defer



Source: ABS Household financial resources Get the data Created with Datawrapper

The ABS and the Government greeted this statistic with celebration as a demonstration of the necessity of the scheme. However, these statistics are problematic. Australians shouldn't have to withdraw from their super to meet these financial obligations. If Australians were struggling with mortgages, bills or credit cards during a pandemic, there should have been economic stimulus and a secure social safety net to provide for them.

Super funds have made a massive recovery since their bottom in April

Australian super funds, like the Australian economy generally, have made a healthy recovery from the lows of the pandemic. Compared to January 1, 2020– most leading super funds have now recovered up to 20% higher than that position, recovering from a temporary decline of 10-15% during the COVID-19 pandemic.

Figure 2: Super funds indexes have now exceeded their pre-pandemic levels

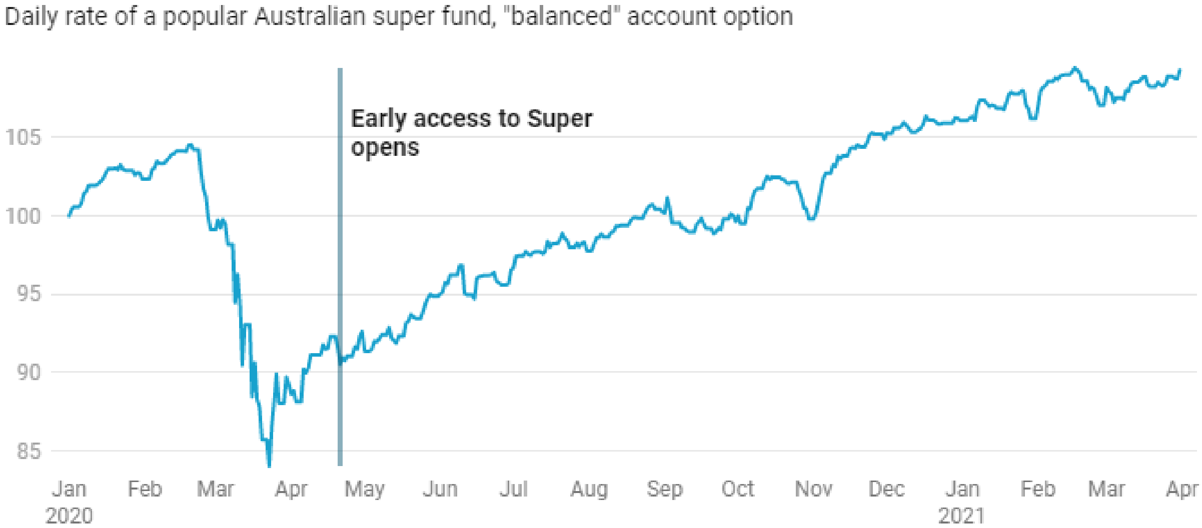


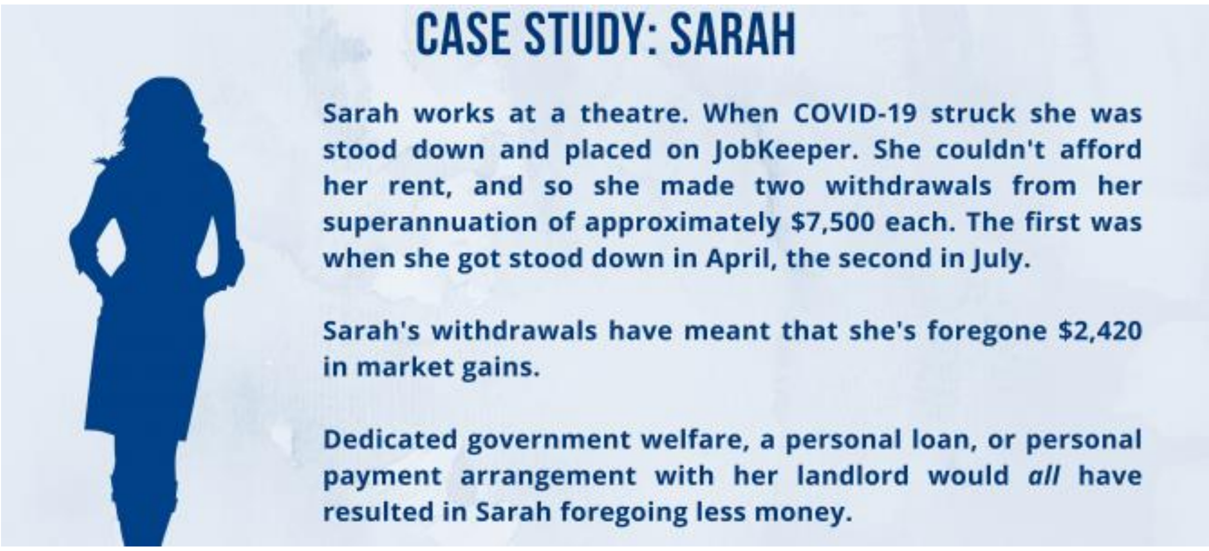
Chart: Connor Wherrett Source: Get the data Created with Datawrapper

The investment performance in this chart represents an average of three of Australia's most popular super funds. As shown, the early access to superannuation scheme was open for withdrawals in late April 2020, during the few months at the bottom of the market.

Australians who made super withdrawals have foregone this market gain

Any Australian who took part in the early access scheme has foregone this market recovery on the amount that they withdrew.

According to ABS figures, the average withdrawals were $7,728 and $7,536. McKell Institute estimates calculate that if an individual withdrew these figures at their first opportunity, they have foregone $2,420 in returns from market growth.



Similarly, an individual who withdrew the maximum allowable of $20,000 has already foregone $3,164 of additional savings. Another way of conceptualising these early withdrawals is that these individuals have taken credit with ~15% interest. In order to restore this money to their superannuation accounts in 2021, they will have to make a voluntary contribution that is 15.8% higher than the amount that they withdrew at.

In total, from the $36.4 billion that was withdrawn from superannuation early, a total of $4.7 billion of market gain has already been lost.

What the Government should have done instead

The first thing that the Government should have done is offer more targeted Government assistance programs to those in need, rather than giving them the option of paying off their super. Even if this would have required a higher amount of Government debt, the Government currently has the ability to borrow money for effectively little to no interest. As such, it would be far more equitable for the government to have withdrawn.

Alternatively, to do this, the Government should have enforced with banks, landlords, lenders, financial services and utility companies to offer deferred payment schemes to all customers. The banks themselves offered mortgage holidays, and State governments implemented moratoriums with regards to residential tenancy. However, more should have been done to avoid the necessity of Australians withdrawing from their super. Even if Australians were able to take out a loan in 2020 with an (astronomical) interest rate of 10%, this would have resulted in less foregone personal wealth than the early access to super scheme.

For instance, in Sarah's case, if the Government offered $15,000 in direct payments to her, it would pay little interest back and Sarah's super would be unaffected. Alternatively, it could intervene in tenancies and enforce a rent deferral scheme. Further, even if Sarah took a personal loan, she'd still be better off in a better financial position.

The losses will compound

It's well known that superannuation invested early will multiply by retirement age. Therefore, $2,000 in lost interest today could well become $5,000 by retirement age, according to modelling by Super Consumers Australia. The lost investment growth calculated in this article is only the beginning of resulting losses from the early access to scheme. This is a particularly pronounced as young workers were the most likely to embrace the early access scheme. As such, almost any option for providing welfare to Australians would have been better than this.

Connor Wherrett is a Policy Officer, Edward Cavanough is Director of Policy, and Michael Buckland is the CEO at The McKell Institute. This article is general information and does not consider the circumstances of any investor.

Four key wealth drivers affecting long-term investment goals

Geoff Warren

Investment risk is often viewed as the possibility of incurring a negative return over the short-medium term, as reflected in measures like volatility or drawdown. Such measures are useful for investors with shorter horizons.

But they become increasingly less effective as the horizon lengthens, especially when investing over multiple periods where cash comes into or out of the portfolio. The classic example is investing for retirement: return volatility says little about the risks of failing to generate an adequate income stream over future decades.

This article draws out the main themes from a recent paper where I discuss risk from the perspective of long-term investors, e.g. those investing for a decade or more.

Risk and long-term objectives

Risk may be defined as the failure to attain an objective. The objectives of long-term investors fall into three groups:

- building wealth (real return targets, bequests, some sovereign wealth funds and family offices)
- generating an income stream (retirement income; endowments and foundations), and
- funding long-term liabilities (defined benefit pensions; life insurance).

Two questions arise. **First**, what could lead to failure to achieve the objective? **Second**, how might the risk of falling short of objectives be measured?

Sustained losses matter more to long-term investors

Measures based around return volatility describe the possibility of suffering shorter-term loss. What matters to long-term investors is incurring a loss that is *sustained* over their investment horizon.

Volatility-based measures do not distinguish between losses arising from forces that can result in sustained loss, from transient effects with no consequence for ultimately achieving objectives.

Further, volatility can be as much a source of opportunity as a risk for long-term investors, as market fluctuations can provide opportunities to buy assets at attractive prices for the long run (or exit and redeploy the capital).

An alternative framework is needed.

Nature of risk for long-term investors

Viewing wealth accumulation as associated with four drivers – initial expected return, cash flow risk, discount rate risk and reinvestment risk – can help identify the factors that long-term investors should worry about. This decomposition derives from asset prices as the present value of future cash flows. Initial expected return equates to the discount rates on which assets are priced.

Deviations from the initial expected return stem from subsequent changes in the cash flows being discounted, and the discount rate applied. Wealth accumulation also depends on the rate at which cash flows released by assets are reinvested.

1. Initial expected return

For assets that offer relatively high expected returns in excess of that required, the probability of achieving an objective will not only be higher but also increases with investment horizon. The reverse holds for assets offering sub-par expected returns. The rub is that higher-returning assets tend to be more variable, raising the possibility of even worse outcomes in the 'lower tail'.

The upshot is that equities may appear more attractive (in terms of shortfall risk) to a long-term investor on the balance of probabilities, but they need to be willing to bear some chance that things might turn out even worse than investing in (say) fixed income.

Meanwhile, fixed income may offer more reliable outcomes, but could be almost certain to fall short of a long-term objective.

2. Cash flow risk

Sustained losses occur when the cash flows generated decline versus what was originally reflected in the price. For example, equities will suffer a permanent downward adjustment upon a sustained reduction in the future cash flow stream due to an earnings revision. For bonds, rising inflation can generate sustained losses by eroding the real value of their promised cash flows. Investing in assets that do not deliver on their promise for (real) cash flows is a key risk faced by long-term investors.

3. Discount rate risk

Asset prices also fall when discount rates rise. However, the fall leaves the asset priced to deliver higher returns thereafter, meaning that the wealth losses are gradually clawed back.

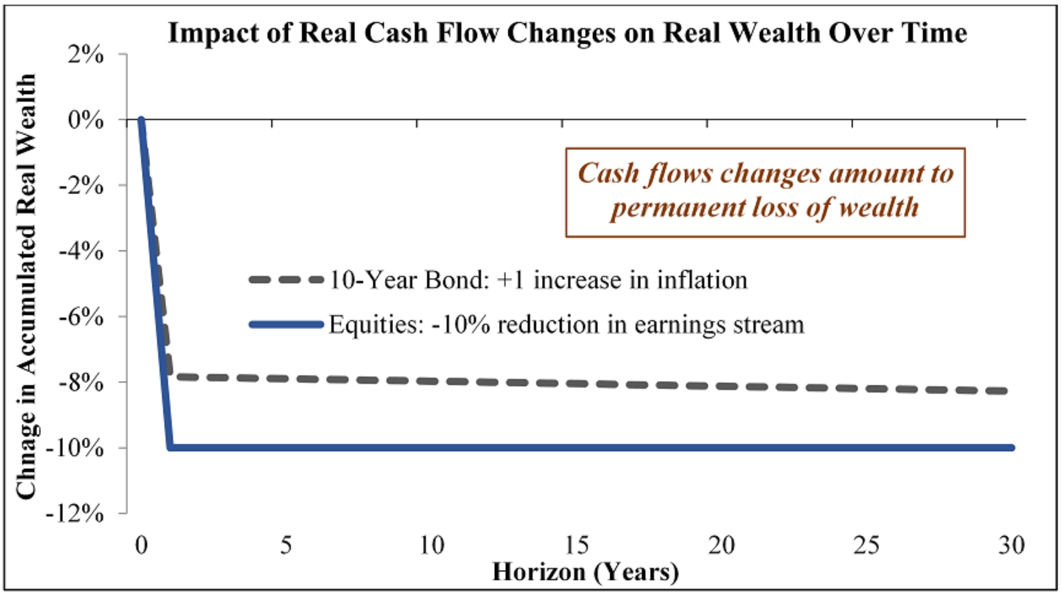
Consider how bonds respond to rising yields: there is an immediate capital loss, but the bond resets to a higher yield. If the bond is held to maturity, the investor gets the return they expected initially. The relation between asset duration (i.e. term of the cash flows) and investment horizon establishes a pivot point.

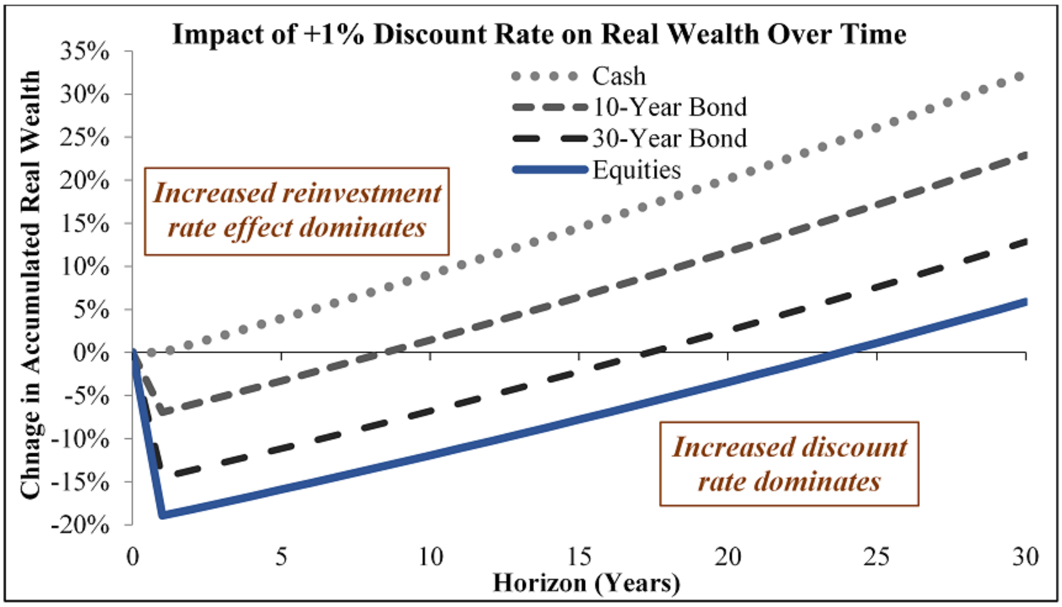
An investor faces discount rate risk when duration is longer than the investment horizon; but no discount rate risk when the two equate. If duration is shorter than horizon, then reinvestment risk comes into play.

4. Reinvestment risk

Most assets release cash flows to be reinvested, creating exposure to uncertainty over reinvestment rates. For equities, this uncertainty relates to reinvestment of dividends and retained earnings. For bonds, both coupons and principal at maturity need to be reinvested.

Reinvestment risk increases as asset duration shortens relative to investment horizon, and as horizon lengthens given that most assets continue releasing cash over time. The concern when exposed to reinvestment risk is that rates will fall; while the concern with discount rate exposure is that rates rise.





This decomposition changes how a long-term investor might perceive the risks associated with various assets.

Equities emerge as less likely to fall short of long-term objectives by virtue of their higher expected return. But they carry exposure to cash flow (i.e. earnings) risk, and reinvestment risk related to companies reinvesting at value-destroying rates. Equities may also bring exposure to discount rate risk, unless the investor has a very long horizon.

The main concern with fixed income is the likelihood of falling short of objectives due to insufficient expected returns; although mismatches between duration and horizon and whether inflation might erode the real value of cash flows should also be considered.

Path dependence

Path dependence emerges where the sequence of returns may result in shorter-term losses being crystalized, thus generating sustained losses. Two situations are notable. First is where poor initial returns disrupt the ability to follow-through on well-founded long-term investment plans. For instance, a fund might be forced to sell assets cheaply after a bout of poor performance if their investors withdraw, or support is lost from within the organization. Second is sequencing effects arising from the interaction between returns and cash flows. For instance, a retirement account will be exhausted more quickly if a fixed amount is drawn and poor returns are incurred early in retirement.

Measuring long-term investment risk

I will briefly overview the key elements involved in measuring long-term risk and leave it to interested readers to access my paper for guidance and examples.

Long-term risk analysis involves scoping out potential future 'paths', and then identifying paths where objectives are not attained. It will likely entail some form of simulation or scenario analysis.

As real spending power is typically the concern over the long run, it will usually be appropriate to model in real terms. Although analyzing real long-term returns may sometimes suffice, in many situations real wealth accumulation should be modelled to account for cash inflows and outflows and reinvestment at rates other than available in the market, e.g. company reinvestment. Risk metrics should convey the *likelihood and magnitude of shortfall* versus objectives. This involves estimating both the probability of failing to meet the objective, and the size of any shortfall that might occur.

Finally, it is important to allow for initial market conditions, especially with regard to baseline expected returns. Currently, returns on offer appear well below what has occurred historically, with fixed income priced for zero-to-negative real yields and equities and other risk assets highly priced. The risk of falling short of long-term objectives would be misrepresented significantly if the analysis drew on historical data, rather than calibrating to the current market return structure. Further, acknowledging that market discount rates have more upside than downside from current low levels will have implications for discount rate versus reinvestment risk, and hence the relative attractiveness of assets with differing exposure to these two drivers.

Standard Risk Measure (SRM)

The SRM as reported by Australian superannuation funds reports the expected number of negative return years out of twenty. It essentially reflects the volatility of yearly returns. An ideal measure would focus on the risk of failing to generate adequate income in retirement; but this needs to be implemented at the member rather than fund level. At the very least, the SRM should be replaced or supplemented with a measure conveying the probability of a fund failing to achieve its stated real return objective over a horizon like 10-years, perhaps coupled with some indication of downside risk such as the probability of delivering a zero or some negative real return.

The key question

Evaluating long-term investment risk requires shifting the mindset away from a focus on shorter-term losses towards failure to achieve a long-term objective. A key question to ask is: what developments might result in losses that are sustained over the investment horizon?

Answering this question will help distinguish exposures that need to be managed from those of little consequence. When it comes to measuring risk, analysis should be directed towards generating the range of potential future paths and estimating both the likelihood and magnitude of any shortfall versus objectives.

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