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## Editorial

Hi all, Harry here, sitting in Graham's editor chair (albeit virtually) for a couple of weeks while he enjoys a long-overdue break. I hope you backed a winner at the Melbourne Cup. Mine's still running, suggesting that I'm better off sticking to investments over horseracing.

Having been a contributor to Firstlinks over the years, it's very humbling to see the work of so many talented contributors from an editor's perspective, rather than a writer. I hope you enjoy the thought-provoking pieces on offer in this edition.

Graham left me one tip; "If you want to avoid too much work, try not to transcribe interviews into Firstlinks pieces". Yet when a podcast conversation between **Magellan** CIO and Chair **Hamish Douglass** and legendary businessman and philanthropist **Sir Frank Lowy AC** was made known, I jumped at the chance.

Graham was right, it was hard yakka editing down this fascinating conversation between two individuals who clearly have a high regard for each other, but I hope you'll find it as informative, and inspirational, as I did.

The latest CPI data, released on 27 October, revealed the trimmed mean CPI rate rising from 1.6% to 2.1% for the year to September, and would have had many a market strategist nervously revisiting their mid-term forecasts for inflation. The rate now sits within the RBA's target 2-3% inflation band, but the concern isn't just for rising prices; it's for prices rising in the absence of a commensurate rise in economic activity.

Lethargic economic growth combining with rising prices is something no economist wants to see become entrenched. This week **David Lubin** takes a look at inflation's much-reviled cousin, stagflation.

**Don Stammer** adds his formidable voice to the issue, while also looking at how the faster-than-expected vaccine rollout in developed economies is shaping the investment outlook for 2022 and beyond.

Perhaps it wasn't a central bank capitulation in the manner of the Bank of England's infamous 1992 defeat defending the British Pound against George Soros, but last week's about face by the Reserve Bank was, in its own way, no less significant.

Having placed a 0.10% p.a. yield target for the April 2024 Bond back in July, the RBA had communicated its willingness to spend up to $4 billion each week in order to keep shorter-term rates constrained as part of a 'yield control' strategy.

All seemed to be going to plan until late last week, when bond market disquiet over that inflation pick-up brought shorter dated securities under heavy selling pressure. The RBA blinked, the bond markets reacted and the yield on the two-year bond spiked precipitously, jumping from around the target level mid-week to over 0.60% by week's end. A big week in the normally sanguine bond markets!

**2-year Australian Government Bond Yield**


*Source: [MarketWatch.com](MarketWatch.com)*

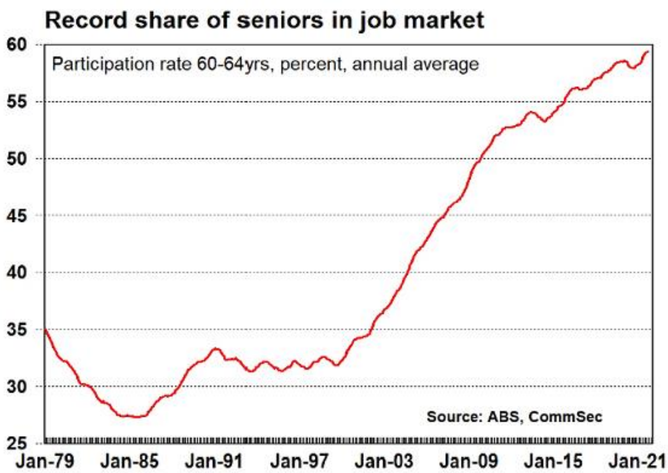
Former RBA economist turned academic **Isaac Gross** picks up the story following the RBA's Melbourne Cup day decision to abandon its strategy, what this might infer for near-term bank funding costs, and thus by extension mortgage interest rates.

The venerable '60/40' portfolio has, in some ways, become the workhorse of modern-day investment management. A product of the golden age of Modern Portfolio Theory, its longevity has been a testament to the power of investment diversification. As rules-of-thumb go, 60% in 'growth' assets and 40% in 'defensive' assets has certainly stood the test of time. But what might happen to the 'defensive 40' if interest rates were to continue to percolate ever upward? **Andrew Yap** brings some ideas to bear on the issue.

New protocols for how SMSF trustees should communicate rollovers came into effect on 1 October. **Julie Steed** takes a look at the new SuperStream system and what it will now mean for you and your SMSF prior to accepting a member rollover from another fund.

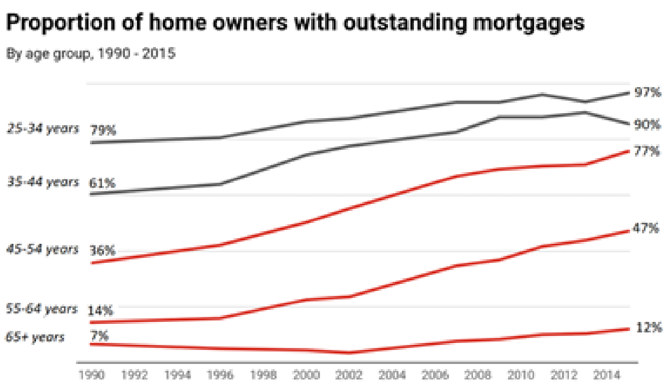
And to round out the week's contributions, **Craig James** looks at "The Great Resignation" a phenomenon currently sweeping America, where 'COVID epiphanies' are resulting in a spike in resignations as people re-assess their career and lifestyle goals. Might the same thing happen here?

Craig turns his attention in particular to older Australians, and looks at the historic workforce participation of those 60 and beyond. I found this chart from his piece particularly interesting.




It's always difficult to gauge individual intent and preferences, but I do wonder to what extent the high participation by Australians 60 and over reflects the positive social engagement benefits that come with being in the workforce, and how much of it is driven by economic necessity, particularly in reducing mortgage debt prior to retirement.

At a recent University of Melbourne talk, I presented this next chart on the rise in later life mortgage burdens, and it did warrant a pause for thought.




Source: Ong, R & Wood, G *"More people are retiring with higher mortgage debts. The implications are huge"* The Conversation, 12 June 2019

It's certainly an issue set to become increasingly relevant, as Australians delay household formation and carry higher levels of mortgage debt into later life.

This week's Comment of the Week comes from **David Hellstrom** in response to the article 'Hey boomers, first home buyers and all the fuss'. It is a poignant reminder both of the escalation of

Australian property prices over these past few decades, and of the fact that those who have benefitted aren't blind to their good fortune and the travails of fellow Australians at the other end of the journey.

*"I belong to the "silent generation as I am 87. My first house was built on a block of land at the northern beaches for £1,400 ($2800) and the little two bed house cost another $8,000 to build. Borrowing rates were around 6%.*

*After two years I moved to the North Shore and bought a nice block for £2,000 ($4,000) [and] built a little three bed double brick house for a further £6,000 ($12,000). Many years later in 2007 (having done major improvements on the house) I sold for $1.1 million and bought a three bed unit at the station for around the same.*

*Just recently I sold that [unit for] $2.8 million and bought into an old folks home which left me with a sizable pot to place into my retirement savings (which have since shown a 10% cap gain plus dividends). I have certainly lived through the lucky years."*

This week's white paper is available to you courtesy of **Martin Currie**, who take a look at how progressive fund managers can strive to deliver something beyond 'Alpha' (risk-adjusted investment outperformance), in focussing also on outcomes such as environmental, social (including diversity) and governance improvements. Very topical in the wake of the COP26 summit in Glasgow.

**Harry Chemay, Guest Editor**

## "Trust your instinct" Hamish Douglass in conversation with Sir Frank Lowy AC

### Hamish Douglass

*Sir Frank Lowy AC is the former long-time Chairman of Westfield Corporation, founder of the Lowy Institute, and chairman of the Institute for National Securities Studies, relating to Israel's national security and Middle East affairs. This is an extract of Sir Frank's recent chat with Magellan's Hamish Douglass.*

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**Hamish Douglass (HD):** Frank, firstly, to start, would you be able to provide our listeners with a brief background on your childhood and education and ultimately your journey to Australia?

**Sir Frank Lowy AC (FL):** Well, Hamish, the beginning of my life was very turbulent. I was born in Czechoslovakia in 1930. Eight years later, it became Hungary, so I was a Hungarian. Antisemitism was very difficult for us to cope with. In the town where I was born, there were about 5,000 inhabitants and 150 Jews. Business was difficult. The anti-Semitic laws prohibited us from owning businesses. So my father in 1942 decided to move to Budapest where we were able to mingle with the world without it being known that we were Jewish.

Life was quite good in spite of the war already raging. It all came to a sudden stop on the 19th of March 1944. The German army occupied Hungary and life turned terribly worse. I lost my father the next day because they caught him in the street, and I haven't heard from him since.

I was left with my mother, sister and brother. I went into hiding and I stayed with my mother. It's a very long story, it was a very difficult time. But by the end of 1944-45, the war was over for us and we went back to Czechoslovakia, which then became Slovakia. So you can imagine how many nationalities I had to cope with.

Only 35 Jews came back [to my small town]. So it was a very sad place and it was mainly males, and I had no company there. I didn't really want to go back to school. I decided to emigrate to Palestine at the end of 1946. I joined the Israeli army in 1947, fought in the Arab-Israeli war, and afterwards I got a reasonably good job. I learnt accountancy at night, got a job in the bank and I enjoyed myself very much. But I was very much longing to be with my mother and sister and brother who survived the war, and they, meanwhile, [had] emigrated to Australia. So being in Israel, then for about six years, I decided to join them, they sent me the air tickets and I arrived in Australia in early 1952.

**HD:** Frank, I don't think many listeners unless they are probably over 70 or 80 have any appreciation of that background. Many of us complain about issues that are going on in the world, but we have lived our lives in very peaceful times. You grew up in a horrendous period of antisemitism, and loss your father at a young age.

Family is so important at the end of the day. What are the lessons you learnt from your parents that you're trying to pass on to your three sons and your grandchildren?

**FL:** Both my parents, together and individually taught me to be charitable, to share. And I do remember it well, but once we discussed it and my mother said: "If you have a little, give a little, if you have a lot, give a lot".

That became my ethos in life. Of course, the difficulties during the war also taught me to be vigilant, to be paranoid. And it taught me a lesson about if you want to succeed or survive, you need to be curious to see what's going on. Where are the opportunities for various activities of your life? And I think it did give me some grounding to my life later on.

**HD:** And maybe that's a good segue from family into business. In 1955 you and your business partner John Saunders started out as partners in a delicatessen in Sydney. And how did the partnership in a small delicatessen lead to the establishment of Westfield Building Corporation? That seems quite a leap.

**FL:** Yes, it is something I wonder myself, but looking back is a lot easier than looking forward. Most of the decisions that we took were strategic business decisions. We could have opened the delicatessen in Bondi junction or in the city, but we had two opportunities: one in Bondi Junction and one in Blacktown. John lived in North Sydney and I lived in Dover Heights, and we chose Blacktown not because it was close and convenient, but because the opportunity in Blacktown seemed to be a lot better than in Bondi junction.

Immigrants were pouring into Sydney, and most of them went to the western suburbs. So we decided to go there and didn't mind the travel of an hour each way.

We left about 7:00am from Sydney, opened the shop at 9:00am and then came home 7:00pm or 8:00pm at night. But as I said, looking back, it was a strategic decision to go to Blacktown and why? The shop we rented was opposite the railway station. One day it was quite afternoon and I walked in the street to look around, and I see about three shops are being built next door to our delicatessen. I told John “listen we could do that”. So we decided to try it.

But beforehand, we also opened a coffee shop next to our delicatessen, and it was the first or second espresso machine in Sydney. There were a lot of Italians living in the area, and the coffee shop was opened on Sunday. So we were working seven days a week. Shirley and I used to get up Sunday morning, take [my eldest] David to my mother, then go together to the shop.

So we built those few shops next to us. I think it was four shops, and it was very successful. We rented them and [finally] sold them. So that was our first real estate venture. On top of that, the landlord of ours in Blacktown had four or five acres behind the shops next to the post office.

We thought, well why can't we try to buy it and build some more shops? We’d already heard about shopping centres in the United States, so we bought some architectural magazines, and we learnt a little bit about how to. We bought that piece of land, hired an architect, and created a small shopping centre of 12 shops, a small department store and parking for 30 cars. It was an unbelievable success. Meanwhile, we sold the delicatessen and the coffee shop, which gave us the capital to carry on business. We opened that shopping centre on the 9th of August 1959.

**HD:** It's incredible that you chose Blacktown because of immigration there. And then when you were in a delicatessen, you expanded into real estate and you just saw an opportunity. So it wasn't like you went to Blacktown to build a shopping centre. The plans developed as you could see things as they were happening.

**FL:** Practically my whole business career was instinctive; I have an instinct and then I do the research about my instinct. And that's the way I made decisions.

I'm very curious and, as you know, I'm paranoid. But at the same time, I'm an optimist because you cannot be a real estate developer without being an optimist. The paranoia must follow you, and that's how I think I can attribute my success; to those feelings and then the people I choose to be with.

When we sold out of Westfield there were people who used to work for me, started as young people and 30 years later there were still there. Of course, I was very lucky to have three sons like David, Peter and Steven, who are smart, hard workers, and also I think there is an optimism in the four of us and also the paranoia. I can't quite describe it to you, but the mixture of those does wonders.

**HD:** Frank, you once said to me, "always play the ball and not the man". But how do you avoid playing the man when you're playing tough to get outcomes in business?

**FL:** I think what I used to do is decide by myself where I want to be in those negotiations. And I just didn't give in. I kept my point. Occasionally in business, you have to give in, to give the other guys some victory also. But I decided where I wanted to be at the end of the negotiation, and once I got there, there was nowhere to go.

The opponent must have realised this, because you need the buyer and the seller all the time. Somebody has to be definite. I was definite because I believed that's the way to go. I don't like these negotiations that drag on for a long time. I lose patience and I know where I want to be. So why play around? Just state your position and stick to it.

**HD:** Frank, I'm going to move on from Westfield a little bit, and I haven't asked you this question before, so I'm incredibly interested in the answer. You have had a great privilege of meeting so many people around the world in your life, who has impressed you the most and why?

**FL:** You'll be embarrassed by my answer. One of the men is you, because I felt when I talked to you like I was talking to myself. And of course, it's enjoyable to meet a smart person. And every time we were together, we learnt from each other. Life is about learning. Not standing still, and I learnt a lot from you, and I'm very pleased to hear from you, from time to time, how much you enjoy the interaction between you and I.

There are also a lot of other people that influenced me. I [also] enjoyed working with my sons. We get on well, it is not a honeymoon that we agree all the time with each other. We respect each other. So when we debate, at the end there is a consensus. There is no better way to make decisions.

**HD:** We have fascinating conversations, Frank, and I'm always amazed. You've just turned 91, so how do you retain so much energy and such a positive outlook? You're still moving with a lot of energy. You still move around the world. COVID probably slowed you down a little bit, but how do you retain a positive outlook and energy in life?

**FL:** Well, I think I am very interested in what I do, which I probably inherited from my mother and father. I am very curious. I don't want to stop because I'm 91. I'll stop when I have to. I enjoy what I do. I enjoy my activities in the Lowy Institute and the [Institute for National Securities Studies] that I chair here in Israel for the Middle East.

Life is very interesting if you are interested, and I don't spare myself energy. What I inherited, and the energy I have, is a combination of luck, interest, and curiosity. I get up in the morning around 6:00, and I go to the gym. I spend a couple of hours there before I start [the day]. You know, it's a lesson that you get energy in the gym. I might do some swimming and come up for breakfast.

**HD:** And Frank, one very last question to end here. Every time we get together, I must admit, I come back more optimistic and more energised than I was before we get together. A lot of people are very pessimistic about the world at the moment. What are you most optimistic about?

**FL:** I think that life rolls. It doesn't stop. I failed to bring the 2022 [Soccer] World Cup to Australia. I was miserable. Of course, I was cheated out of the position, but I came back from Zurich, and I had to face the music. The journalists were waiting for me, and I accepted the great responsibility and I said, "You know what, fellows? The Sun will rise tomorrow", and I finished my interview that way.

The Sun did rise. So what am I optimistic about? The same thing. It's a bit of a cliché, but of course, the Sun will rise tomorrow.

**HD:** Well, Frank, I couldn't think of a better note to end on. I hope to see you back at home in Australia and I know Tel Aviv and New York is also home. But Australia is a very important part of your life. You've got a lot of friends here, you're also an incredible businessman, but most importantly, a friend and a mentor and somebody who I admire and I'm very lucky to call a friend. So thank you very much, Frank.

**FL:** Okay, thank you very much, Hamish, and I hope to see you soon.

**HD:** Likewise.

*Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of [Magellan Asset Management](), a sponsor of Firstlinks. You can listen to the full interview [here]().*

*For more articles and papers from Magellan, please [click here]().*

## What's the truth about stagflation?

David Lubin

Stagflation occurs when growth stalls, inflation surges and unemployment stays stubbornly high. It's unsettling when the term starts getting global attention, as it is now, but are we really facing the first resurgence of stagflation in 40 years?

If 'stagflation' talk is referring back to the oil shocks of the 1970s – when the US fell into recession as inflation rose sharply – we're only there metaphorically. In other words, the US, and the global economy more broadly, currently seem far from recession.

In the 1970s the US suffered five quarters of negative real gross domestic product (GDP) growth in 1974 and 1975, and while 'supply shocks' are hitting us now as they did then, the comparison only goes so far.

First, while the global economy is suffering simultaneous downward pressure on activity and upward pressure on prices, economic activity in advanced economies remains well-supported, even if growth forecasts are vulnerable to the downside.

Second, to the extent the 1970s contains some lessons, it is possible that that decade reinforces the 'transitory' effect of supply shocks on inflation, since inflation did fall meaningfully in the US after the first oil shock in 1973-74.

Finally, while the US has a bigger 'flation' problem than a 'stag' problem, we continue to underline the risks to global activity coming from China, where 'stag' seems to be the dominant risk now, holding out the possibility that China is in for a deeper and longer slowdown than the market is currently braced for.

**Trade growth looks particularly vulnerable**

Breaks in global transport network supply chains are increasingly apparent, and power shortages in China may put downward pressure on trade growth as a result of the widespread hit to Chinese manufacturing that's currently occurring.

Simultaneous upward pressure on prices and downward pressure on activity are especially clear now in Europe and the US.

Growth remains strong, but 'stagflation' headwinds to the Eurozone economy are blowing ever stronger, and in the US where job growth has proved disappointing. In the Eurozone, supply shortages which had already triggered a decoupling of production from orders are now aggravated by a huge spike in energy prices.

While energy accounts for only 3% of firms' production cost on average across the EU, some sectors such as land and air transport or power generation will suffer significantly, and rationing could affect others.

This increases risk of business closures and insolvencies, with knock-on effects to the wider economy. Households spend 5% of the consumption basket on energy, and although we expect government intervention to cushion some of the impact of rising energy prices, we still expect 10% to 20% price increases, cutting disposable incomes by 0.5-1%.

Falling energy prices later in 2022 will then drive the reverse effect but shift growth from 2022 to 2023. Yet with GDP growth next year expected to be close to 4% both in the Eurozone and in the US, we remain far from 'stag' risks in economies whose potential growth is below 2%.

**'Stagflation' in a metaphorical sense has been evident for months**

As markets are forward looking, the potential for inflation and economic surprises has already been priced into market indices, reducing the risk of shock and policy intervention.

'Stagflation' also implies recession, and as we have noted, we see this as a remote risk on current data.

While there is no formal definition of stagflation, the term entered public consciousness in the 1970s against a background of a genuine collapse in economic activity as inflationary pressures simultaneously surged.

What makes the 1970s especially interesting as a historical parallel is that, as today, the proximate cause was a negative supply shock, in the form of a sharp increase in food prices and, especially, in energy prices following

OPEC's announcement in October 1973 that the posted price of oil would rise from US$3.01 per barrel to US$5.11.

This was followed by a decision a few days later to cut off oil shipments to the US, causing a further surge in the price. In the US at least, the inflation problem was accentuated by the end of the wage-price controls that the Nixon administration had introduced after suspending the dollar's convertibility into gold in the summer of 1971.

The result of these actions caused chaos in the global economy, as world GDP growth fell from 6.3% in 1973 to 1.2% in 1975, and the US itself suffered five consecutive quarters of negative year-on-year GDP growth starting in Q2 1974.

**What are the parallels to the 1970s?**

The real price of energy has risen sharply recently, but its impact is less significant than it was 50 years ago. It is clear that while real oil prices are still quite low compared to historical pressure points, the real price of gas is indeed a concern on the face of it, reaching historically high levels.

Yet the macro impact of elevated energy prices isn't what it used to be; diversified supply, alternative energy supplies, country fuel stockpiles and lessons learnt from previous shocks has led to the decline of energy's impact on GDP over the past 50 years.

It would take a near-unimaginable rise in energy prices to induce a global recession, unless high energy prices shock financial markets.

To illustrate how far we are from recession, it is worth referring to an exercise based on simulations in the Oxford Economics Model. In order to get that model to predict near-zero global growth next year, a US$500 a barrel oil price is needed to shock the current baseline scenario.

In our view, while energy has the potential to create shocks the larger risk to lower growth lies with China, particularly as Chinese authorities seem determined to change the nation's growth model and wean the economy off its dependence on real estate.

*David Lubin is Head of Emerging Markets Economics for Citi, a sponsor of Firstlinks. Information contained in this article is general in nature and does not take into account your personal situation.*

*For other articles by Citi, see here.*

## RBA signals the end of ultra-cheap money. Here's what it will mean

### Isaac Gross

The Reserve Bank of Australia had a Cup Day surprise in store for the country, announcing it was abandoning its policy of "yield curve control", meaning it was no longer going to defend any particular interest rate for borrowing over any particular duration.

Until today it had a formal target for the three-year bond yield of 0.10%, enabling banks to provide three-year fixed mortgages very cheaply, and indicating the cash rate wouldn't climb above 0.10% until the most recent three-year bond expires in April 2024.

But it has now abandoned the target, a full two years early.

**Why control the yield curve in the first place?**

When COVID hit last year, the bank announced it would buy enough government bonds to keep the yield on the three-year bond at 0.25%, as good as guaranteeing money would be cheap for years to come.

Later, it cut the target for three-year bond yields (and the target for its cash rate) to a near-zero 0.10%, further lowering the cost of borrowing.

Responding to an improving economy, the bank decided at its July 2021 meeting not to extend the program bond target beyond April 2024.

The decision created a reasonable expectation the cash rate would remain close to zero until 2024.

**What did yield curve control achieve?**

Yield curve control achieved a lot. It took the bank just 11 days and A$27 billion dollars of bond purchases to achieve its first target, establishing ultra-low interest rates for years into the future.

After that, it didn't need to spend much. The new three-year rate became the new norm. Markets believed it would do whatever was needed to defend it.

Over the next 18 months it intervened in the market only occasionally, and only in small amounts. That all changed last week.

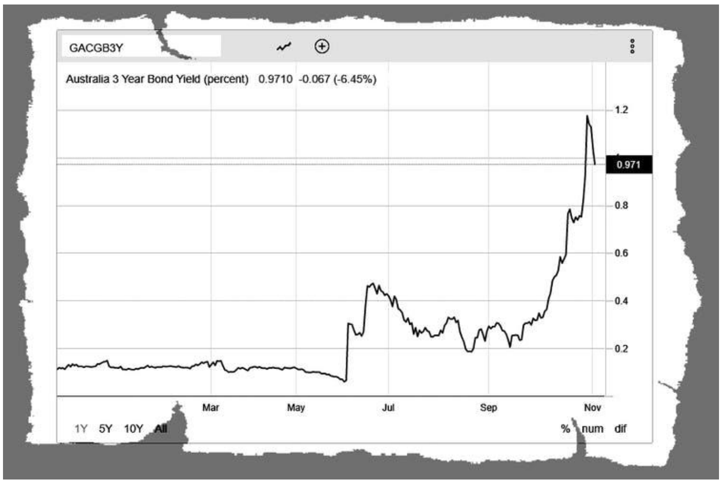
On October 15, the three-year bond rate started to climb above the bank's target of 0.10%. It initially bought enough bonds to defend the rate and then, without warning, capitulated last Thursday, as good as withdrawing from the market and allowing the rate to climb to a high of 0.70%.

By Monday the rate had climbed to more than 1.00%, more than ten times the Reserve Bank's target.

Today's announcement merely made formal what was apparent on Thursday: the bank is no longer going to spend public funds defending a line that might eventually be crossed.

Bond traders thought the improving economic outlook meant the bank would have to lift its record low cash rate sooner that it had said it would. It lost the will to disagree.

In a 4pm press conference Governor Philip Lowe said that to maintain the target would have been untenable. Eventually the bank would have owned all the three-year bonds on offer.




*Trading Economics*

**What will this do to the housing market?**

Today's decision is a sure sign interest rates are going to start to rise. Not today, or even for the rest of this year, but sooner was previously expected.

For what it is worth, Lowe said the latest data and forecasts did "not warrant an increase in interest rates in 2022".

For now, sub-2% fixed-rate mortgages are a thing of the past. The last were withdrawn this week.

The decision means the booming housing market will start to crest. Low interest rates sparked the boom as renters flocked to become first-homebuyers and investors jumped in to catch rising prices.

The prospect of higher mortgage payments is going to dent this enthusiasm, perhaps quickly. Prices are set to stabilise, before edging, or sliding down .

We don't yet know how quickly variable interest rates will start to rise, but given the Reserve Bank has walked away from a battle to defend yield curve control, we do know it'll be a long time before it even considers doing it again.

*Isaac Gross, Lecturer in Economics, Monash University*

# Rising bond yields complicate the COVID recovery

Don Stammer

COVID-19 will soon have been with us for two full years. Since the pandemic started, the course of investment returns has differed greatly from what was initially expected in investment markets.

What now lies ahead for investment markets? Here are some thoughts for investors contemplating how to allocate across the main asset categories. But first a brief review of what's happened, and why.

**A brief retrospective**

When the pandemic broke out, share markets plummeted, for around five weeks. Since then, most equity markets have made substantial gains, and at the time of writing were trading at or close to record levels.

Bond yields initially rose for a week or so before falling to record lows. They've now moved modestly higher (with quite a lift in recent weeks, particularly at the 2 year tenor); however yield curves remain upward sloping and spreads continue to be skinny.

Commercial property initially slumped but has since risen unevenly, producing some spectacular gains in particular sectors (notably warehouses) while average residential housing has shot up in price.

Exchange rates haven't varied as much as was expected in the pandemic's early days. Commodity prices have been volatile – especially prices of energy, iron ore and inputs into renewable energy production – but for the most part the super-cycle in commodities has continued. With strong terms of trade and weak capital spending, Australia is running huge surpluses on trade and current accounts.

The strong recovery in the prices of most assets since early April 2020 reflects three main influences:

- The massive - and sustained - easing in fiscal and monetary policies around the world (noting that accommodative monetary policies also mean investors must live with cash rates at near-zero levels).
- The speed with which efficacious vaccines were developed (mainly benefitting wealthy countries and China).
- Exaggerated fears, initially, that the global economy would suffer a depression or structural stagnation. (Recall the scorn directed at early suggestions that the slumps in economic conditions and shares would be V-shaped. As it turned out, both the economy and share market have not only exhibited V-shaped recoveries, but the deepest and narrowest V-shapes in history).

**The investment outlook**

Looking ahead, here are some thoughts on key influences on prospective investment returns.

**The shape of the pandemic:** Population-wide mass vaccination has been critical in containing COVID, particularly in developed economies and China (but not as yet in most developing economies). With this uneven access to vaccinations, with the risks of further mutations, and with all governments now having swung from eliminating the virus to "living with COVID", prospects for case numbers, hospitalisations and deaths remains highly uncertain.

**The global economy:** Provided infection numbers stay reasonably contained in the major economies, and governments and central banks do not move too quickly to tighten policy settings, the big economies - North America, Europe, China and Japan - seem unlikely to tip into recession in the near future. That's a bold forecast. It reflects these inputs: fiscal and monetary policies are currently stimulatory, yield curves are upward sloping, liquidity is abundant, and gains in asset prices have added to household wealth (albeit unevenly).

China's economy is likely to be soft for another quarter or two because of problems in property markets led by Evergrande, but GDP is unlikely to fall, even for a quarter. These supportive economic conditions should bring about modest growth in aggregate earnings to labour and capital.

**Valuations:** All major asset classes are highly valued – especially when assessed by way of price-earnings ratios and price-to-book. However, share market valuations look more comfortable to investors who expect some continuing growth in profits (most importantly in the US, where Q3 earnings remain encouraging) and who expect real interest rates to remain 'low' relative to past trends.

But investors need to allow that momentum has driven valuations higher – and not only for 'quality' stocks but also for many start-ups, 'meme stocks' and cryptocurrencies.

**Macro policies:** Budget and monetary policies are extremely stimulatory in most countries. Expansionary fiscal policies provide a strong boost to economic activity when inflation is non-existent and savings are high (conditions seen in the 1930s when Keynes penned his 'General Theory').

Expansionary macro-policies don't, however, do much to raise GDP and jobs when inflationary expectations are high and savings are low (as Gough Whitlam and Jim Cairns learnt in the 1970s). Winding back budget deficits to sustainable levels will be a hard slog for many governments.

Monetary policy's traditional instruments (cash rates and open market operations) and its unconventional measures (quantitative easing (QE), yield curve control, forward guidance, special funding of banks) remain highly accommodative.

Central banks will face immense challenges in raising interest rates, in tapering QE and in reversing other recent moves. In financial markets, expectations of monetary policy shifts will likely increase, and over-reactions may become more frequent.

**Inflation:** In recent years inflation has been stubbornly low in most major economies. Lately however, market expectations for this continuing have been surprised on the high side. The prevailing view of central banks and bond investors has been that the recent increases in inflation were mainly transitory. That view, increasingly, looks to be wrong.

Supply side issues and disruptions - including from higher energy prices, the enormous jump in shipping costs, breakdown in international supply chains, and now wage increases likely to result from labour shortages - are building up.

Announcements made at the recent COP26 Summit are also likely to be more inflationary than the majority of participants will admit. Demand-side influences will also likely sustain inflation in the US, Europe and Australia in 2022 and beyond.

In my view, inflation will be an increasing concern over the medium and longer terms in most major economies. It is possible that Australia could see inflation ranging between 3% to 5% in 2023, and potentially even moving a notch higher in 2024.

**Stagflation:** Stagflation, whereupon low economic growth couples with high inflation, was a horror for many countries in the 1960s and 1970s. In my view, the prospect of a re-emergence of stagflation is real, though on a lesser scale.

There are some similarities with the conditions that produced earlier bouts of stagflation. They include: heavy spending in the US on social security and defence accompanied by big budget deficits; disruptive supply shocks; signs of an acceleration in wages; high commodity prices; and the widespread view that inflation is only temporary.

The main difference, this time around, is inflationary expectations have so far remained subdued – and more-so in wage negotiations than in bond markets.

**COP26:** Many people claim committing to renewable energy rapidly and at scale will serve three purposes: arresting the trend in higher global median temperatures, providing cheaper energy and creating lots of 'green' jobs.

In my view, the reality is much harsher: yes, global warming is real – but the likely costs of effective policies to contain it are much, much higher than will be recorded by the majority of people participating in the Glasgow discussion on climate change.

**The implications for shares, bonds and property**

In my view, shares still offer positive, but modest, returns on a twelve-month outlook. That's because risks of an early global recession are limited, real interest rates are historically low, and the initial rebound of inflation is usually a positive for share prices.

But we are in the stage of the investment cycle for shares when investors need to focus on companies with high or sector-leading return on equity, low balance sheet gearing, high spending on R&D and new technologies, high and sustainable growth in earnings per share, and some pricing power.

On bonds, it seems prudent to be a little underweight; to prefer shorter-dated or floating rate bonds and inflation-linked bonds; to be careful of sub-investment grade bonds; and to hold some bank-issued hybrids while banks have strong balance sheets.

Quality property offering warehousing and inventory management appeals. The boom in house prices is likely to cool.

*Don Stammer has been involved in investing for many decades as an academic, a senior official of the Reserve Bank, an investment banker, a fund manager and the chairman of nine companies listed on the ASX. He is currently an adviser to Stanford Brown Private Wealth. This article is general information and does not consider the circumstances of any investor.*

## The 60/40 Portfolio – saying bye to old friends and welcoming new ones

### Andrew Yap

The 60/40 portfolio (i.e., 60% growth / 40% defensive assets) has become emblematic of an industry-wide challenge; how to build diversified portfolios in an environment of anchored cash rates and negative real bond yields. With the likelihood of more subdued returns from defensive asset classes over the medium term, the ability of managers to implement active management strategies that achieve the dual purpose of enhancing returns and controlling volatility has been a key focus across this year's review cycle.

The following is an exploration of the effectiveness of the 60/40 portfolio to deliver CPI plus objectives under a scenario where asset class valuations are expensive and defensive asset classes are offering less in terms of income and portfolio diversification.

**The 60/40 portfolio – a historical perspective**

Investors have been treated to a period of strong returns, largely by virtue of a massive structural decline in inflation and interest rates, set against the backdrop of reasonable economic growth, a global savings glut and supportive policy settings. There have been setbacks along the way, including the sharp downturns in the early 2000s, 2008-09 and 2020, but each was met with increasingly aggressive monetary policy easing.

The traditional 60/40 portfolio (represented by the Median Manager in the Zenith Multi-Asset – Balanced Universe) has performed strongly amidst this market backdrop, generating returns of 6.5% p.a. and 5.3%, over the past 10 and 20 years respectively. With inflation averaging just 2% over the past 10 years and 2.4% over the 20 years, the traditional 60/40 portfolio has easily achieved its return objective with relatively low volatility. The following table summarises the performance of the Median Manager for the 10-year period ending 31 August 2021.

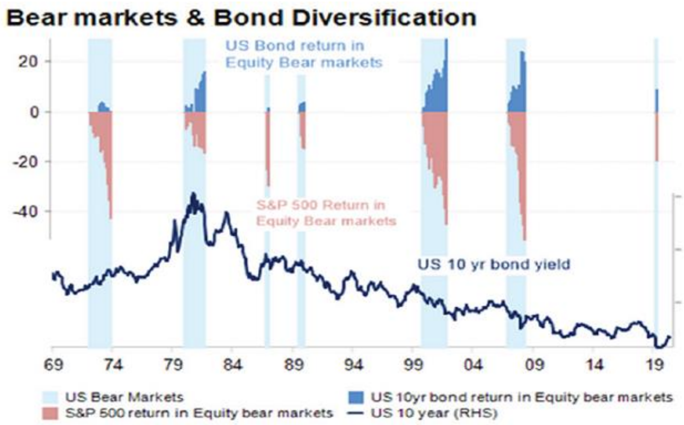
**Table 1 Zenith Multi-Asset Universe – Balanced – Median Manager Performance as at 31 August 2021**

| | Median Manager – Multi-Asset – Balanced Peer Group | |
|---|---|---|
| | 10-Year Period to 31 August 2021 | 20-Year Period to 31 August 2021 |
| Annualised Return % | 6.48% | 5.31% |
| Australian CPI – Average % | 1.86% | 2.37% |
| Real Return - % p.a. | 4.62% | 2.94% |
| Annualised Volatility | 4.99% | 5.18% |
| Median Worst Drawdown | -10.00% | -21.19% |
| Correlation to Australian Equities | 0.93 | 0.93 |
| Correlation to Global Equities (Hedged) | 0.82 | 0.85 |

*Source: Fund Managers*

Within the 60/40 construct, when equity market drawdowns have occurred, bonds have generally provided the diversification expected offsetting equity market declines through a combination of yield and capital growth associated with declining yields on long duration securities. Even in the COVID equity market downturn, bonds provided some gains to help cover initial equity losses.

The following chart depicts that an allocation to bonds has generally worked, certainly in the last 20 years, although that was not the case in the 20 preceding years, particularly in real terms.



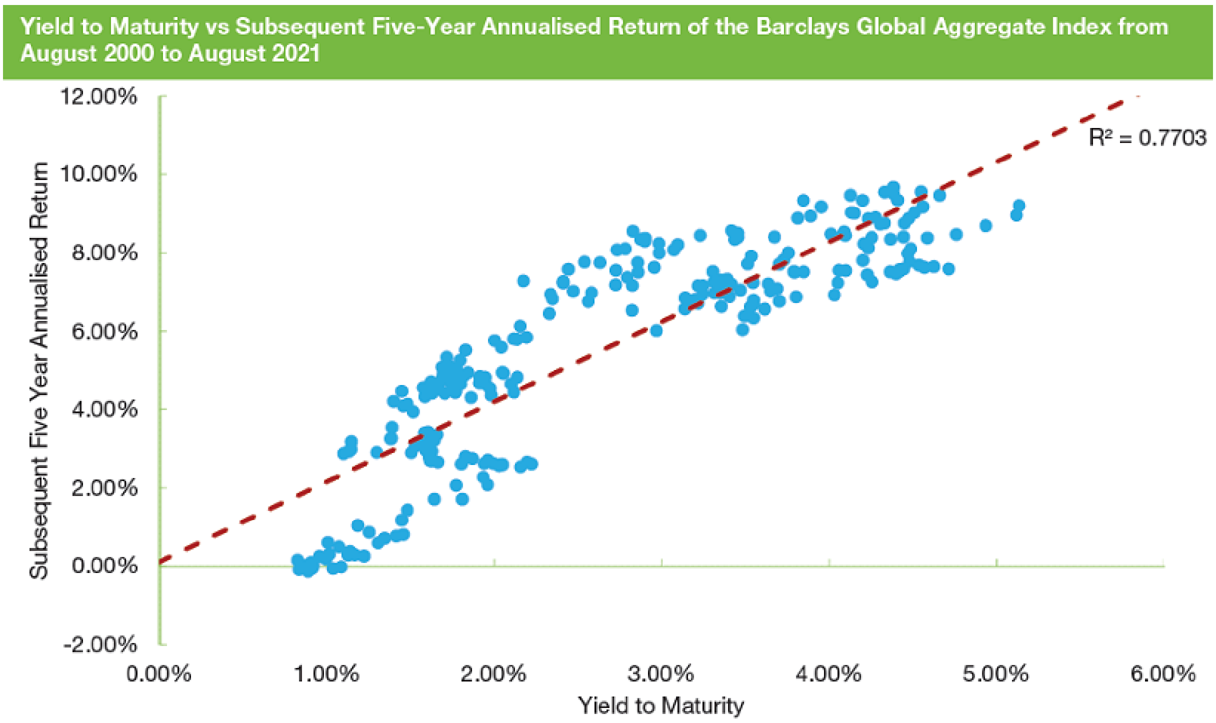

*Source: St Louis Fed, IRESS, Heuristics*

**The 60/40 portfolio in a low yield environment**

The ability of the 60/40 portfolio to deliver CPI plus 3% p.a. (representing the most common return objective in Zenith's Diversified – Balanced sub-category), under a scenario where asset class valuations are stretched and the '40' component (or defensive sleeve) is offering less in terms of real returns and portfolio diversification, was a key theme across this year's review cycle.

The role of the '40' component is to produce consistent income (or carry), exhibit low volatility and diversify equity risk, with the income or carry component closely linked to the level of cash rates and bond yields. Based on our research, the yield-to-maturity (YTM) of the major domestic and global bond benchmarks provides a reasonable proxy for future return expectations over the medium-term.

To illustrate this, the following chart compares the YTM of the Bloomberg Barclays Global Aggregate Index with the return realised over the following five years.

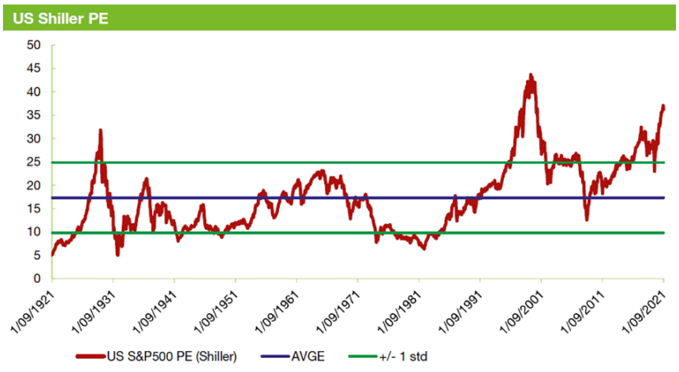



*Source: Zenith Investment Partners*

Based on the chart above, the Coefficient of Determination ($R^2$) over the analysis period is 0.77, representing high explanatory power. With the YTM of the Bloomberg Global Aggregate Index (Hedged) and Bloomberg AusBond Composite Index (0+ maturities) being 0.95% p.a. and 0.85% p.a. (as at 31 August 2021), the ability of fixed income to generate meaningful real returns is questionable and such returns are likely to be well below the CPI objectives of a typical Balanced fund.

With the '40' component likely to undershoot most CPI-linked objectives, the growth allocation is expected to become more important with respect to meeting real return objectives. Across the peer group, the view on equities was broadly constructive as corporate profits continued to rebound, supported by accommodative fiscal and monetary policy settings.

From a valuation perspective, equities are supported by their relative attractiveness to fixed income, most notably, higher yields and tax efficient income streams. However, the relative relationship is highly sensitive to inflation and government bond yields remaining at their current levels. At an absolute level, the following chart plots US and Australian Shiller P/E's which is a ratio measuring the current index level divided by trailing 10-year earnings adjusted for inflation.





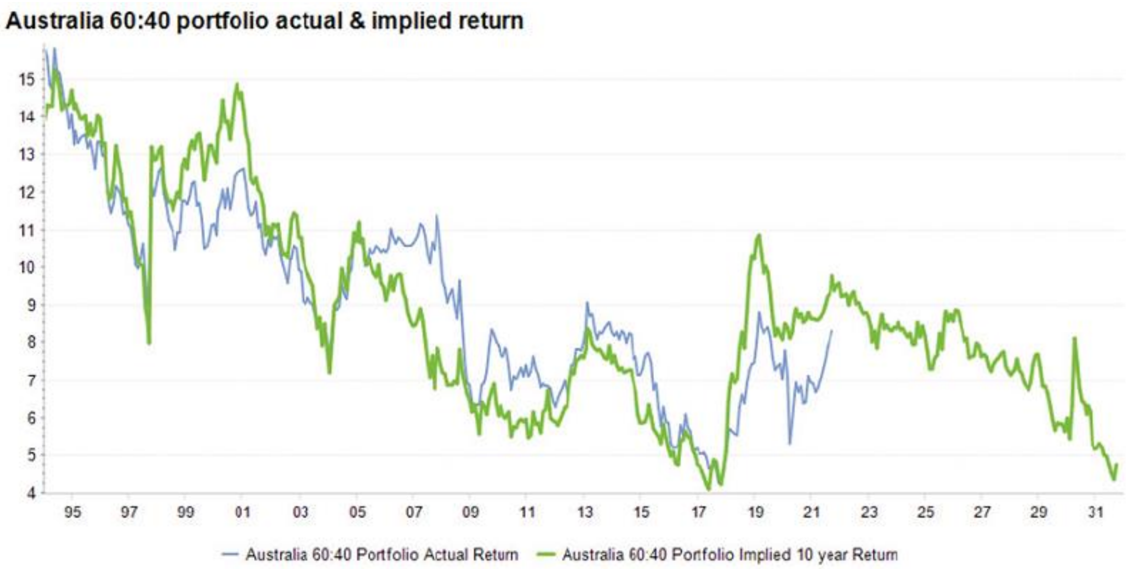
*Source: Heuristics*

The US and Australian Shiller PEs are trading at approximately 36 and 21 respectively, representing a significant premium to the historical averages (purple and green line). If these valuations were to revert to long-term averages over the next decade, this would have significant implications for the ability of the 60/40 portfolio to meet objectives.

**The outlook for the 60/40 portfolio**

Using the Zenith Heuristics asset allocation framework, we have modelled the potential impact of bond yields remaining at current levels and equity market Shiller P/E's mean reverting to longer term averages over a 10-year horizon. The Heuristics model assumes earnings per share (EPS) growth of 6% p.a. and a dividend yield of 4% p.a. and the portfolio is rebalanced on a monthly basis.

The following chart plots the hypothetical performance of the portfolio over the next 10 years.




*Source: ABS, RBA, Refinitiv, IRESS, using proxy updates*

Under the mean-reversion scenario, the forecast return for the 60/40 portfolio is approximately 4.4% p.a., well below the prior returns experience. Further, Heuristics long-term projection for domestic CPI is 2.25% p.a., meaning Balanced investors are facing a potential return shortfall over the next decade. While the forecast is subject to input sensitivity, it highlights that a 60/40 portfolio can no longer rely on structural tailwinds from declining bond yields and rising equity market valuations to meet return objectives.

### Conclusion

The 60/40 portfolio has become a metaphor of the challenges associated with constructing diversified strategies in an environment where bonds offer unattractive real yields and the '40' component is offering less in terms of diversifying equity risk and controlling drawdowns.

While the typical Balanced Fund can no longer rely on structural tailwinds from declining bond yields and rising equity market valuations to meet return objectives, Zenith remains highly supportive of the level of process innovation across the Multi-Asset – Diversified peer group.

*Andrew Yap is Head of Multi-Asset and Australian Fixed Income at Zenith Investment Partners. This article provides general information only and does not take into account the objectives, financial situation or needs of any specific person who may read it.*

## Is your SMSF ready for SuperStream?

### Julie Steed

From 1 October 2021 rollovers to and from SMSFs can only be processed via SuperStream.

SuperStream is the electronic system used to transfer money and data to super funds and is used to process employer contributions to APRA-regulated funds and for rollovers between super funds. It can also be used for certain ATO release authorities.

The move to include SMSFs in SuperStream rollovers has been welcomed by many SMSF fund members who have experienced delays in receiving rollovers to SMSFs. The SuperStream protocols require paying funds to process the rollover of a member's benefit electronically and within three days of receiving a valid request.

Many SMSFs have mature members who are not anticipating receiving any further rollovers so they have paid little attention to the SuperStream requirements. However, if members decide to wind up their SMSF and rollover to a retail fund, they will generally need to register for SuperStream before the SMSF can process the rollover. SuperStream, however, can be activated at any time and can be expected to be established within days.

In-specie rollovers are not covered by SuperStream and may continue to experience delays. Members may also initiate a rollover via their MyGov account or by requesting the rollover from the paying fund.

ASIC's requirement for an SMSF's investment strategy to consider an exit strategy may require SMSF trustees to consider SuperStream as part of their next regular investment strategy review.

**What is required for an SMSF to be SuperStream ready?**

Most professional administrators are SuperStream ready, and many have been using SuperStream to process rollovers for some time. Where an SMSF doesn't use professional administration services they will need the following:

- An electronic service address (ESA) which is provided by most SMSF software platforms, administrators, tax agents and some third-party suppliers. The ATO provide a list of ESA suppliers on their website - ATO ESA providers
- A unique bank account recorded with the ATO
- A Unique Superannuation Identifier (USI) which is the fund's Australian Business Number (ABN)

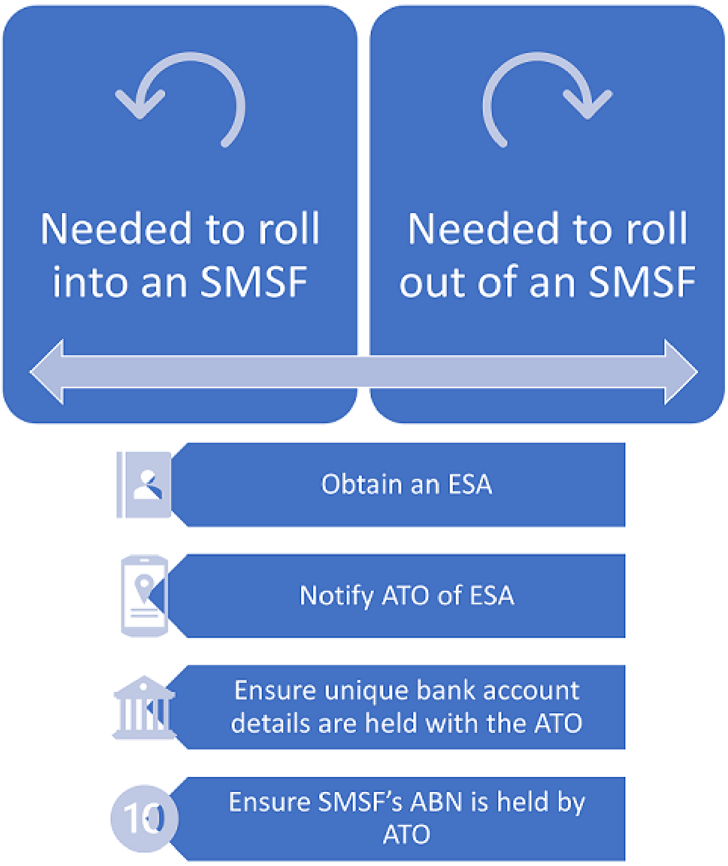
**Verifying member details**

The fund that is paying a rollover is also required to use the ATO's electronic services to verify the SMSF and member details. Details include that:

- the SMSF status is complying or regulated
- the TFN of the member requesting the rollover is associated with the SMSF
- the SMSF bank details are held by the ATO
- the SMSF's ESA is held by the ATO

The process should reduce delays in verifying the bone fides of the receiving SMSF - if the ATO is happy, the paying fund should be happy!

The ATO has been active in identifying SMSFs where the fund is not recorded as holding a unique bank account. If an SMSF changes bank account details, the fund will need to advise the ATO of the updated account details.




**Processing a rollover**

The paying fund has three days from receiving an actionable rollover request to process the payment. If the rollover request has incomplete information, the trustee of the paying fund must request the required information within three days. Additional time may be allowed if the paying fund needs to sell down assets.

Whilst the prompt receipt of rollovers into SMSFs is welcomed, there may be many practical reasons why an SMSF is not able to action a request to rollover to another fund within the three-day timeframe. In the absence of professional administration, it is not always possible to accurately calculate a member's entitlement within three days. In addition, the sale of assets to make the cash payment may take longer than the time allowed.

Where one member is leaving because of a dispute with another member, further difficulties in meeting the required timeframes may occur.

Another requirement of the SuperStream system is that the trustee of the receiving fund must allocate the rollover to the member's account within three days of receipt of the funds. For SMSFs without professional administration, a minute regarding the allocation may be required.

**Conclusion**

SMSFs expecting to receive member benefits rolled over from another fund will need to ensure they are registered for SuperStream prior to the member requesting the rollover. Likewise, registration will be required before an SMSF trustee can rollover a member benefit to another fund.

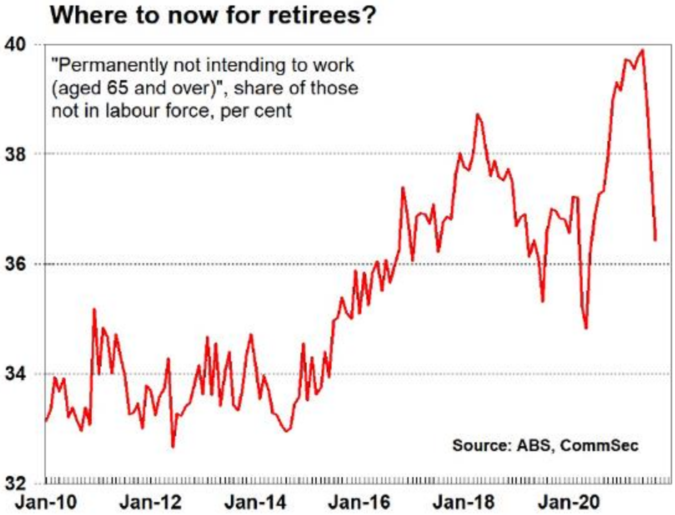
*Julie Steed is Senior Technical Services Manager a [Australian Executor Trustees](). This article is in the nature of general information and does not consider the circumstances of any individual.*

## Are older Australians re-assessing the job market?

### Craig James

Before Covid-19, a major reason that Aussies weren't employed or looking for jobs was because they had retired. That is, they were out of the job market. In fact, in April 2018, 38.7% of people said that they were "Permanently not intending to work (aged 65 and over)", up from 33% just four years prior (September 2014). Then there was a reassessment. The proportion of those not in the workforce because they were retired fell from 38.7% to a 3-year low of 35.3% in July 2019.

**Record numbers, but are they accurate?**



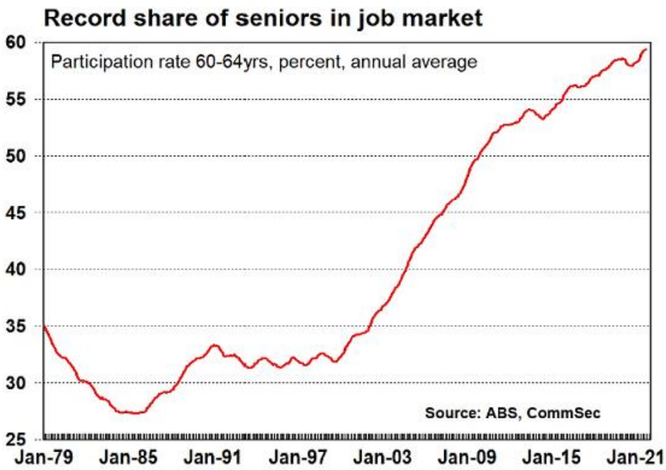

And in the period since, due to Covid, it is not possible to determine firmly whether the trend has changed because more people exited the job market over the lockdown period. They weren't employed as such – they didn't work for one hour or more in the past week - but neither were they looking for work because they were likely to return to their employer after the lockdown.

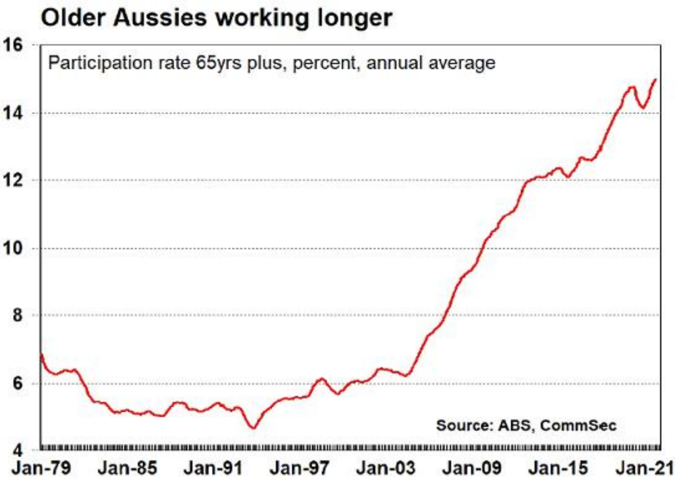
The lockdowns have effectively scrambled the data. The proportion of those not in the workforce because they were retired hit a record 39.9% of the total in June 2021 and this has since fallen to a low of 36.4% per cent in September 2021.

So let's check two other data points at different ages.

**First**, a record proportion of people aged 60 to 64 years are in work.

**Second,** the 65 years plus age group participation rate shows more Aussies are working longer.




**Impact on overall job market**

Working out why people are not in the job market will be important in coming months. If more people are electing to retire then there are fewer potential workers to fill positions. That may mean the job market tightens more than generally expected, putting upward pressure on wages and prices. And that is especially the case if foreign borders stay closed.

In other words, The Great Retirement could lead to a tighter job market. Older Aussies may see greater health risks in being in the job market in the Covid era. And still others may elect to live large given the experience of the past 18 months.


At this stage data still shows that older Aussies are active in the job market with record participation levels. However peak levels may not be far away.

In other countries, notably the US, there are similar concerns about the future state of job markets with more businesses saying they can't find the workers to fill positions.

The great reopening has led to supply-chain breakdowns and higher prices for goods. The great reopening may lead to similar worker-job breakdowns, with labour shortages driving up wages. With thousands of Aussies reaching retirement age every week, their decisions about work could have broader, long-term inflationary implications.

*Craig James is Chief Economist at Commonwealth Securities Limited (CommSec). This article provides general market-related commentary only and has been prepared without taking into account your objectives, financial situation or needs.*