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Editorial

For most investors, 2021 will deliver good performance, with the benchmark All Ords Index rising from about 7,000 at the start of the year to 7,700 at the time of writing. Given the virus, the threat of rising rates and inflation, and heady valuations of leading stocks, it's better than many expected. The best superannuation funds are likely to deliver returns of about 12%, the 10th positive year in a row. Good times for investors, indeed, and that's before we include house prices.

If 2022 is worse, that is part of the deal all equity investors must accept. Some years are losers and nobody can pick the timing. Knowing how you are likely to react in advance will determine your long-term outcome.

The US stockmarket has again outperformed Australia, with the S&P500 up nearly 1,000 points to 4,696, or 27%. More surprising over the last decade is that underlying performance of companies based on fundamentals (profits, sales, etc) has been flat, but the gains have come from valuation expansion, as shown below. That is, investors are paying more for the same earnings. It's all part of the unusual investing landscape that 2021 continued.

EXHIBIT 2: U.S. FUNDAMENTAL PERFORMANCE HAS NOT BEEN EXCEPTIONAL

Changes in multiples can be the difference between exceptional and lost decades

Source: MSCI U.S. index, GMO analysis
Fundamentals are an average of sales, gross profits, smoothed earnings, and GMO's Economic Book Value.

But what was weird, crazy and different about 2021 was not in traditional equities and bonds, but the new 'investments' delivering massive gains and losses unrelated to any underlying fundamentals. Some were new technologies which may become good businesses, but others will crash and burn. **Charlie Munger** said at the 2021 AGM of **Berkshire Hathaway:**

"If you are not a little confused by what's going on, you don't understand it."

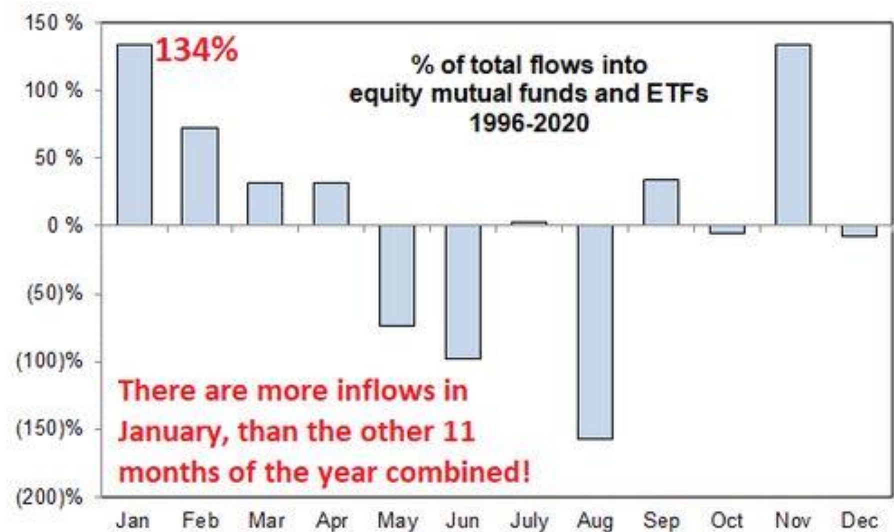
So we could not let 2021 pass without looking at the worlds of crypto, Bitcoin, memes, NFTs and finfluencers ... and new businesses devoted to BNPL, esports and gaming to see if there's more to the mania and mayhem.

I turned 64 yesterday, and if (like me) some of these opportunities have passed you by, you might be feeling your portfolio is a bit traditional and old style. But ask yourself this. In 10 years from now, will such a traditional portfolio be in better shape than a mix of the new ideas? I know which side I'm on.

In the second part of the interview with **Hamish Douglass**, he too admits, *"It doesn't seem like we're in a normal world."*

But there's a more serious side. He explains the conditions needed to cause a recession, the likelihood that some assets will become worthless, and the impact of inflation on most portfolios. Little wonder he invests cautiously.

There's always another side, with **Goldman Sachs** putting out a report this week arguing the negative sentiments may reverse in January, for two simple reasons: the flows into equities remain strong and January is the month of 134% of annual inflows versus -34% the rest of the year since 1996.



In our final edition for 2021, our usual mix of investing insights and policy opportunities ...

Beatrice Yeo warns that making predictions is fraught, especially timing the turning points when it looks like markets are expensive. The common advice to hold a diversified global portfolio might sound traditional but it holds as true now as ever.

If there is one part of portfolio management that investors need to be wary of, it is holding money in long-dated fixed rate bonds as interest rates rise. **Elsa Ouattara** finds fixed income investments that minimise this risk, including bank hybrids and some OTC bonds available to sophisticated investors.

Many people who assume they are not eligible for the Commonwealth Seniors Health Card might be in for a pleasant surprise, as **Jon Kalkman** explains how it works and what it's worth. For example, a couple with financial assets of $4 million could be eligible due to the way deeming works.

Real Estate Investment Trusts (REITs) have characteristics of equities and bonds, but underlying sectors will be affected by inflation in different ways. **Matthew Doherty and Robert Almeida** suggest the subsectors with the most potential.

Andrew Mitchell and Steven Ng look at the impact of rising interest rates, inflation and Omicron on some leading companies in their portfolio, such as NextDC, EBOS, Elders, Pinterest, Robinhood and DocuSign. They analyse whether the small cap pullback in prices is justified.

This week's White Paper is **Vanguard**'s 2022 Economic and Market Outlook, where they believe macroeconomic policy will be more crucial for returns than the pandemic.

When I'm 64: the year traditional investing looked old

Graham Hand

If you are not a little confused by what's going on, you don't understand it."
Charlie Munger, Vice Chairman of Berkshire Hathaway, at the 2021 Annual General Meeting.

I turned 64 yesterday. A few years ago, at an amazing Paul McCartney concert in Sydney, the then 76-year-old explained that he was 19 when he wrote the lyrics to 'When I'm 64', and the age seemed very old at the time. Now, if he were writing the song again, he'd go for 'When I'm 84'. McCartney looked spritely enough to live well beyond 84 in his three hours on stage without a break.

Here's the 2009 remastered version from Sgt. Pepper's Lonely Hearts Club Band.

When I get older losing my hair
Many years from now
Will you still be sending me a Valentine
Birthday greetings bottle of wine

If I'd been out till quarter to three
Would you lock the door
Will you still need me, will you still feed me
When I'm sixty-four

A new era when fungible became non-fungible

In my 40+ years of investing, I have never experienced a year like 2021 with so many aspects of 'investing' that I cannot fathom. It feels like many of the techniques of traditional investing, such as discounting the expected future earnings to a present value, have become old, and younger generations are inventing new ways to build wealth.

NFTs, crypto, Bitcoin, memes, BNPL, eSports and don't start me on social media stonks and finfluencers.

I could be handy, mending a fuse
When your lights have gone

In my younger years, I had strong claims to working at the leading edge of financial markets innovation. They were pioneering days in Australian dollar Eurobonds, and it was great fun arranging the first zero coupon bond, the first bond with warrants attached, the first subordinated bond for an Australian borrower, and in the ultimate irony, the first fungible issue.

Yes, in a new world where 'non-fungible' tokens are the hottest properties in art, our Eurobonds were deliberately 'fungible' (interchangeable) with previous issues to build liquidity in a sector notorious for its lack of liquidity. It was a great success, bringing more investors to Australian dollar Eurobonds, but non-fungible is now the way to riches.

I even developed a term deposit product at the Commonwealth Bank, called Excel-A-Rate, where the rate increased the longer the investor left the money in the bank. Incredible to recall it was offered in a thousand bank branches on the back of a proposal written by a young kid.

I split the investments that puzzle me into two camps:

First, those I generally understand, such as the hysteria and FOMO of a Rivian IPO that makes it the second-most valuable car maker in the world when it's barely made a car. There are enough punters willing to believe the dream or hope there's a higher buyer. This type of mania has come and gone for hundreds of years.

But **second**, new technologies are creating investments where I have neither the time nor patience to fully appreciate the opportunity, such as NFTs and cryptocurrencies, which sell for crazy numbers. They are either scams or opportunities, with plenty of people in both camps.

History is full of tulip manias but what is different this time around is an interconnected world of billions of people, and technology can deliver leverage and long-term success in a way we have never seen before.

Doing the garden, digging the weeds
Who could ask for more

1. Bitcoin and cryptocurrencies

There's a difference between the potential of blockchain as an emerging technology and an investment in a cryptocurrency like Bitcoin and thousands of other coins. Satoshi Nakamoto wrote his original paper:

"A purely peer-to-peer version of electronic cash would allow online payments to be sent directly from one party to another without going through a financial institution ... We propose a solution to the double-spending problem using a peer-to-peer network. The network timestamps transactions by hashing them into an ongoing chain of hash-based proof-of-work, forming a record that cannot be changed without redoing the proof-of-work."

Fair enough. A new payments system will develop.

But there are now over 6,000 cryptocurrencies available, and while they can be used for speculation and trading, there is nothing fundamental to their value as a long-term investment. Coin prices can move rapidly based on no more than a Tweet from Elon Musk. When he announced recently that "*Tesla will make some merch buyable with Doge & see how it goes",* Dogecoin's price jumped 20%. Most commerce cannot be based on such volatility.

Yet cryptocurrencies are already valued at about $3 trillion, with Bitcoin at $1.2 trillion and Ethereum at $700 billion. That's serious coin. As shown below, a single Bitcoin, worth less than US$4,000 a couple of years ago, has a high of US$68,789, although it has dropped to about US$48,000 now.

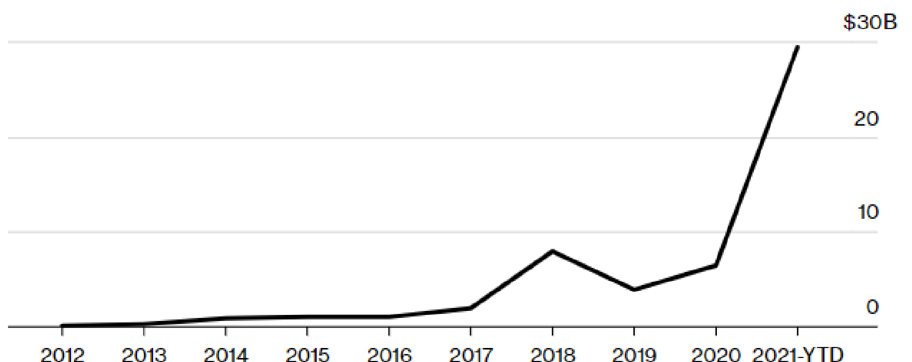
Hamish Douglass wrote [this article in Firstlinks]() where he gave a detailed analysis and concluded:

"In our opinion, it is virtually certain that, in time, cryptocurrencies that are not backed by assets or by a central bank will become worthless."

The chart below shows Venture Capital funds have invested about US$30 billion into crypto in 2021, according to PitchBook Data, more than in all previous years combined (the technology is about 10 years old).

How can this be justified? Spencer Bogart of Blockchain Capital, one of the largest investors in the crypto industry, explained:

"We've moved beyond just digital gold. We've got financial services, art, gaming as a subcategory of NFTs, Web 3.0, decentralised social media, play-to-earn ... all of that made investors think, `We don't have enough exposure.'"

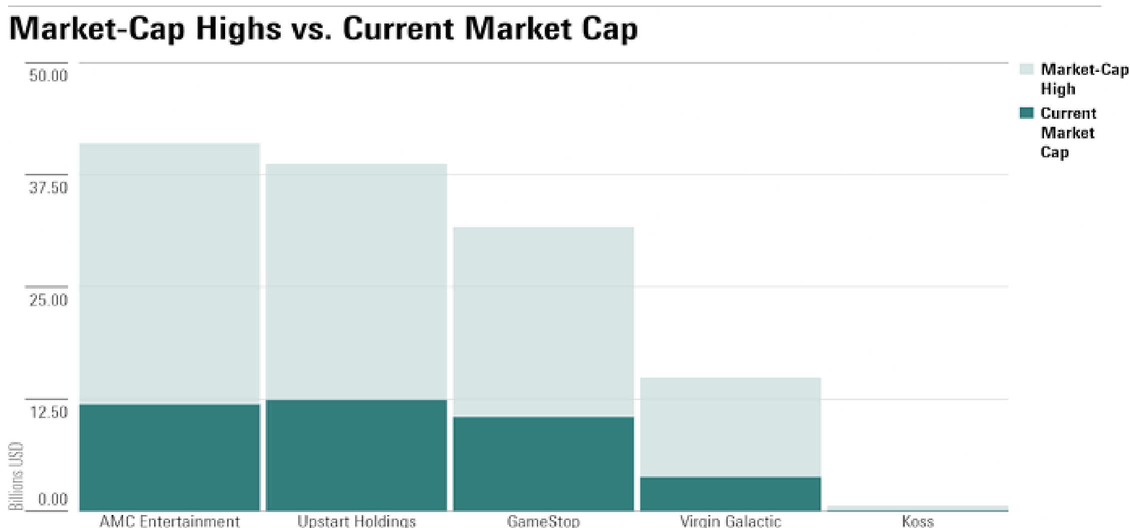


2. Meme stocks

Remember all the fuss a few months ago about the impact of Robinhood? Recall how the media

was full of stories about GameStop? In the US in particular, although we had minor versions in Australia, meme stocks backed by social media trading on sites such as Reddit and TikTok delivered massive returns and losses with little based on the merits of the underlying businesses.

Here is a chart showing four leading US meme stocks and their current value versus their highs.



3. Buy Now Pay Later (BNPL) copycats

Afterpay hit on a great idea and redefined the way millions of people pay for goods. Their execution of a strategy was almost flawless, reinvesting capital in the business and not caring about profit while expanding globally. The business was sold at the peak for the sector in another piece of exemplary business. I wrote about my modest profits but I've been out of it since the Square offer.

What was harder to understand was the expectation that all the companies that jumped on the BNPL bandwagon would find enough market share and margins to make viable businesses. Investors bought into each new offer like crazy and have paid a severe price in most cases. The chart below shows the market highs and lows for Australia's BNPL companies, in some cases down 90%. This week, Afterpay hit a 52-week low.

Name	Ticker	Market Cap (A$ million)	Price (A$) 52 Wk High	Low	Difference %
Afterpay Ltd	APT	24,351	160.05	81.30	-49%
Zip Co Ltd	Z1P	2,432	14.53	4.05	-72%
Latitude Group Holdings Ltd	LFS	1,963	2.00	1.88	-6%
Sezzle Inc	SZL	577	11.99	2.90	-76%
Humm Group Ltd	HUM	451	1.36	0.71	-48%
Splitit Payments Ltd	SPT	108	1.54	0.22	-86%
Openpay Group Ltd	OPY	101	3.57	0.76	-79%
IOUpay Ltd	IOU	88	0.85	0.12	-86%
Laybuy Group Holdings Ltd	LBY	57	1.50	0.15	-90%

(as at 21 December 2021)

4. Non-Fungible Tokens (NFTs)

This one is an absolute cracker. At the start of 2021, the global NFT value was about $400 million, and it is forecast to reach $15 billion by the end of 2021. An NFT is an electronic image that exists in a digital form.

The craze really started in March 2021 when an NFT called *Everydays: The First 5000 Days* sold for US$69 million at Christie's. Much of the NFT universe is linked to popular culture and US sport, and there are now hundreds of millions of dollars of NFT sales each week via public marketplaces.

It's a new asset class, and the reason I do not fully appreciate the possibilities is that they are opening markets and businesses that I simply don't recognise or use.

Here’s a rough explanation of why it works. Previously, the owner of a digital image had no clear property rights. NFT owners now have a way to prove ownership rights. The NFT is stored in a public domain on a blockchain, and because they are programmable, they can function in innovative ways. They might become tickets to events, memberships, merchandise, cards, or give access to discounts or special games. A community can be created around a popular image. NFTs create potential for royalty payments, as the owners of songs have received for decades (Bruce Springsteen just sold the rights to his catalogue for US$550 million).

But for the ultimate putdown of NFTs, check this fantastic South Park tweet, already viewed over two million times.

How far can this go? *The Australian Financial Review* reported this week that an Australian has earned almost $100,000 in six months operating a car repair shop online in a virtual city. The shop sits on:

"a multi-blockchain metaverse gaming platform that launched this year. Players can buy non-fungible tokens that represent virtual taxis, petrol stations, billboards and even motorcycles."

5. eSports and gaming

Yes, we played board games a lot in my family, and Monopoly, Cluedo, Scrabble, Trivia Pursuit and dozens more now sound so cute and innocent. More recently with my kids, a wide range of new games continued the family fun (I love Codenames).

But younger generations are big time into online gaming and stadium events. Online gaming is any video game using internet interaction with other players, who could be anywhere in the world. The eSports ecosystem will exceed US$1 billion in revenue in 2021 and it is expected to double next year.

This is a massive business that makes serious profits with genuine future earnings potential (and sales of baseball caps). Frank Gibeau, the CEO of Zynga, a global leader in interactive entertainment, claimed recently:

"Now it's (the gaming industry) bigger than movies and music combined. It's the largest entertainment form in the world. It's growing and proliferating across the world, across so many different devices and new markets."

So while it's a parallel universe for me, Australian ETF providers are in on the game. For example, VanEck has launched its Video Gaming and Esports ETF (ASX:ESPO) based on:

"The MVIS Global Video Gaming and eSports Index is designed to track the overall performance of companies involved in video game development, eSports and related hardware and software globally."

6. Finfluencers

The influencer economy is worth an estimated US$22 billion a year, although a small part of it relates to investing and advice. But it's the same principle. Someone builds an audience and they are paid to influence their audience.

I’m too old and grumpy to listen to a twenty-something talk about how to invest my first $1,000, and most readers of Firstlinks are not in the target audience for #finfuencers having a giggle about investing while admitting they don’t know much. Some of them have more followers than Firstlinks, as we don't play the clickbait game or 'prime our pump'.

Some financial advice comes from beautiful people on Instagram with beginner guides to investing, YouTube videos on asset management, Facebook groups discussing company share prices or TikTok on anything with dances, makeup and, yes … let’s throw in investing.

They bring in the advertising dollars, which is the main game, and a social media endorsement from one of these bright young things might cost thousands of dollars, depending on the audience. Why a fund manager wants to reach someone with $1,000 and a credit card debt is a mystery. And yes, they reach clients that qualified financial advisers are not interested in, so where are young people supposed to turn? I blame the educational system for not making financial literacy as important as other subjects.

The Australian Securities and Investments Commission (ASIC) is watching social media influencers who are offering financial advice without a licence. The ASIC Chairman, Joe Longo, calls it an 'area of big concern'. ASIC reports on its website that it is:

- *We are engaging with social media platforms, forum moderators and financial influencers or 'finfluencers' to consider market practices, the application of financial services laws and drive behavioural change.*
- *We are embedding tools and undertaking reviews of social media to detect unlicensed advice to retail investors.*
- *We are enhancing our social media monitoring and network analytics capability to identify more connections, as well as coordinated activity that may harm market integrity or contribute to market manipulation.*

If you can't beat 'em, join 'em. Peter Warnes and I will be back in 2022 with more seasons of the 'Wealth of Experience' podcast.

We shall scrimp and save
Grandchildren on your knee

A Day in the Life and signs of the times

There are many more examples. Companies with little potential to justify their IPO prices are listed on exchanges and soon crash (Robinhood is 74% down on its IPO price, Didi is down 63%, Rivian is off 35%). A lot of wealth has been destroyed in 2021 jumping on these bandwagons.

'When I'm 64' was the first song written for Sgt. Pepper's Lonely Hearts Club Band. The album's final track is the classic 'A Day in the Life' which includes the phrase "*I'd love to turn you on*". The BBC banned the song because this line could "*encourage a permissive attitude toward drug-taking*".

Can you imagine that happening today? Society, popular culture and entertainment have moved on. So, too, it seems, has investing, although over the long term, I expect traditional techniques will win.

BTW, what's a postcard?

Send me a postcard, drop me a line
Stating point of view
Indicate precisely what you mean to say
Yours sincerely, wasting away

Give me your answer, fill in a form
Mine for evermore
Will you still need me, will you still feed me
When I'm sixty-four

Graham Hand is Managing Editor of Firstlinks, and his 64-year-old right knee is telling him to stop playing football.

Part 2: Hamish Douglass on not swinging for the fences

Graham Hand

On 14 December 2021, amid a backdrop of intense media coverage of Magellan's recent performance and the resignation of CEO Brett Cairns, Hamish Douglass presented online to clients of advice group Stanford Brown. He was interviewed by Stanford Brown Director and Private Wealth Adviser, Hamish Harvey. This is Part 2 of an edited transcript. Part 1 is here.

Note also that in this video update released on 22 December, Hamish Douglass addresses the challenges the business has faced in recent weeks, including commenting on his personal circumstances which have received so much attention. He says:

"People have tried to create an image that my wife and I [are in] some nasty divorce – nothing could be further from the truth. My wife and I remain incredibly close. Actually, we spend a lot of time sharing a house together. We're spending the whole Christmas holidays together." He also clarified that neither party will sell Magellan stock and "We've never sold a single share in Magellan."

HH: We talk frequently to clients about the concept of sequencing risk. They need to ensure they have dry powder, money set aside for pension payments and the fixed expenses in life. We don't know what's around the corner.

HD: And don't have a fear of missing out in this environment. For example, everybody has a crazy story about housing at the moment. We thought it was crazy a few years ago but now we have extreme anecdotes about a house that sold for double what it was worth 12 months. It doesn't seem like we're in a normal world.

HH: Some of the numbers we're seeing are phenomenal. What do you expect from quantitative easing and interest rates in 2022?

If inflation is sustained, the result is recession

HD: I think Powell is under enormous political pressure because the Democrats are taking a big hit. I think (the Fed) will go very slowly easing out of QE and with a few rate rises on the table. They're going to try not to disturb asset markets. If we don't get real inflation, we will get out of this without a huge effect on markets. The rate rises are in the market's expectation, but that's not a tightening. It's a modest change to a very expansionary policy although they are well behind the curve of where they really should be at this stage. The problem will be where inflation is in April, May, June next year.

I had lunch with Glenn Stevens, maybe four months or so ago, we were debating this issue, he put a 25% probability on the inflation scenario. He's probably higher today, but I haven't spoken to him. And I said, 'What is the answer, if we truly get inflation?" And he just looked at me and he said, 'Hamish, there's only one answer. It's a global recession.' He said we will be forced to move monetary policy to stop it, and that will stop economic activity.

So the party comes to an end if we have inflation, and you have people going, 'I should own commodities and banks in an inflationary environment.' It shows we've been a long time without inflation because they happen to be the most stupid things in history to own if you're worried about inflation. They perform well in the cyclical recovery story. You can't have your cake and eat it too.

HH: Which leads to the next part, portfolio construction. In an environment of higher inflation and interest rates rising, where would you want to be sitting?

HD: We own businesses that are capital-light with very high returns on capital, the vast majority have pricing power and royalty structures. Something like Yum Brands, it's a royalty company. If there's inflation, prices go up and they collect effectively about a 5% royalty on the revenue line. So their actual profitability is indexed to inflation and that's what you want. Netflix, Starbucks, PepsiCo have pricing power and other businesses are capital-light like Visa and MasterCard. They're leveraged to reopenings and payments, they're a bit sensitive to the economic scenario but people traveling will happen in maybe 12 to 18 months, or only six months without Omnicom having an effect.

Assets are going to be affected but as a sign of how finely things are balanced, consider DocuSign which is an incredibly good business. It gave out some revenue guidance for the next quarter that was marginally below the street estimates and the stock price plummeted 40% in a single day. It is a risk that it is foreseeable if the world changes its view that Tesla could drop 50% in a few days. We have so many of these large companies that are unanchored in terms of valuations that are almost a popularity contest at the moment. Everybody could rush for a door at the same and hit an air pocket and fall through it. We don't have those air pockets in our portfolio if the market plummets 30%. I don't want to mislead people, inflation is an ugly place to be.

Home ownership and affordability

HH: I have a question here on the housing market in Australia. Home loan rates can still be fixed around 2.3% to 2.5% but rates are creeping up a little bit. Do you have a view on Australian housing?

HD: I'm no expert in housing but I do believe it's correlated to two things: interest rates and the stockmarket. We've had a 12-year bull stock market and we've had falling interest rates for 30 years and both have been supportive of housing. If it's an inflationary environment, and rates are going up, while people can fix for five years, you own a house for 30 years. So you're not fixed for the duration of the ownership. Ultimately, the house price will reflect affordability through its life.

If interest rates go materially higher and we have a wealth effect with the stockmarket falling, I think it's almost inconceivable that we couldn't get a major change to house prices. It becomes self-reinforcing to a downside scenario. In the GFC, we didn't see a collapse in housing because China and central banks came to the rescue.

Books will be written on all this stuff such as Bitcoin. Charlie Munger said he wishes he would live for another 30 years just to be a spectator to see how this all ends. It's one of the most extreme and fascinating periods in history. We're cautious and we're fiduciaries of all our clients' money, we're not going to swing for the fences. I can take a dent to my ego and all the press coverage and everything that's coming but I would feel really bad if I started using other people's money to make up my ego by swinging for the fences trying to catch up some short-term performance. **It's not my damn money**. I'm not going to take risks that I think are imprudent, even if it causes my ego to underperform in the short term.

A mass delusion of modern history

HH: What's your thinking on cryptocurrencies and Bitcoin?

HD: It will go down as one of the mass delusions in modern history. At the end of the day, there's nothing there. There's no value of anything sitting there. Yes, we are going to have digital currencies based on the blockchain and there's a fundamental change in the world. We'll have stable coins. We'll have centrally-banked coins.

But infinite value from a thing that is nothing more than thin air! I'm highly skeptical whether Bitcoins are worth $1 or $50,000, there's no reference point. Of course, we've got mass crowd-buying of a limited supply of something that they can get any price you want. But ultimately, the regulators will probably end up killing it as it undermines monetary policy. There's nothing stopping people just launching look-alikes, and I can't tell you whether it's two years or it's 10 years from now, but I think it's fairly predictable that these things will go to zero. Who will be left holding the can? It's a great study in human psychology. If you think it's a core part of investing and putting a huge amount of money in it, well, people can do it if they want but do it with your eyes open as you may lose all your money as well. I don't win a popularity contest giving that answer. There's a lot of very passionate people who tell you I'm the greatest idiot on the planet and a dinosaur.

Future returns

HH: That's alright, we can handle that. My kids probably say that about me sometimes. Markets have done so well recently, and we aim for CPI plus 4% to 5% over the long term. Do you think we should have lower expectations of returns over the next five to 10 years?

HD: If you look at peak cycle to peak cycle over the long term, returns are around 8% per annum. The world economic machine has delivered about 6% nominal growth plus dividends. So economic growth is on average 2% real, plus 2% inflation is 4% growth. That's what profits have been growing at. There are then additional returns due to either buybacks or gearing to get you to about 6%. Equities have delivered 200 basis points more for 30 years due to falling interest rates and a real leveraging of corporate profitability.

Over time, I think both those games are up. There isn't much left in leveraging up and interest rates are now at zero or 1%. And if I look out beyond the next 18 months, I am struggling to see how economic growth is suddenly going to be about 4% per annum. China will be less of the contributor just because it's becoming a bigger part and a slower and lower number. And rising interest rates are headwind to equity returns.

If people have been used to 8%, in terms of your wealth accumulation, there is a huge difference over an extended period of time between 6% and 8%. It's about double the difference of the amount of money you would have after 20 years. We're aiming at 9% per annum but we've benefited in the last 15 years from falling interest rates and the job's got harder.

People need a reality check that they don't get delusional as the world's a lot tougher for asset owners as we go back into a low growth, low inflation world. I don't know what's gonna happen in the next two years. I'm talking about that 10- to-15-year sort of expectations moving forward.

Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information only and does not consider the circumstances of any investor. This is Part 2 of an edited transcript of a client event hosted by Stanford Brown.

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

Chairman Powell and Omicron: the Grinches who stole Christmas?

Andrew Mitchell, Steven Ng

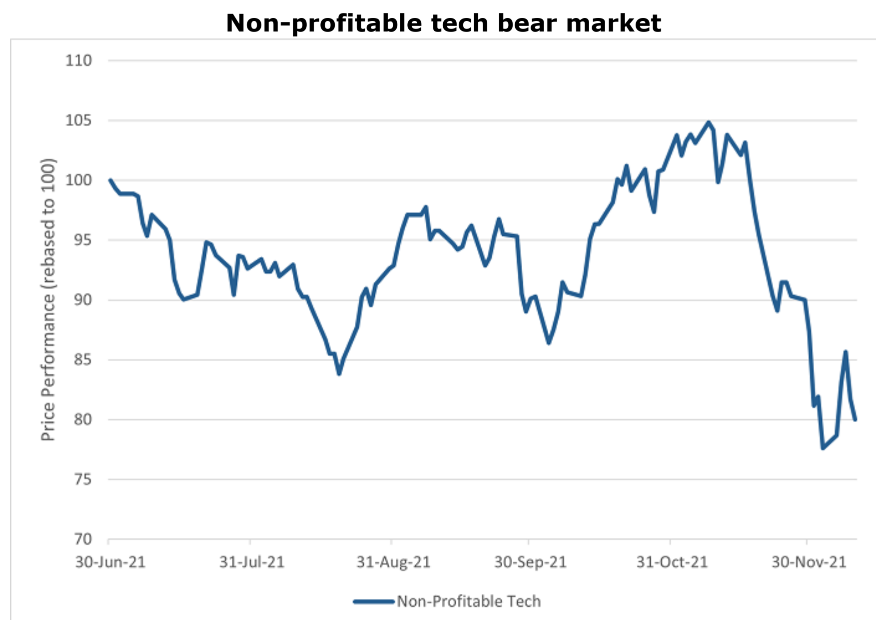
Equity markets were generally chugging along quite nicely until November when news broke that a new Covid-19 variant, Omicron, had started spreading outside South Africa, grabbing global headlines and sparking fears of a new round of economy- and company-damaging restrictions.

Then on the last day of the month, US Federal Reserve Chair Powell threatened to become the 'grinch who stole Christmas'. He abruptly changed his tune on inflation. Powell announced he would retire the word 'transitory' – the word he'd been using to quash concerns about a possible sustained surge in inflation. Powell's about-face was a hawkish signal that the monetary punchbowl that has turbocharged markets might be drained faster than expected. As a result, most equity indices fell between 0% to 4% over November.

Non-profit techs fare worst

One section of the market, 'non-profitable' tech companies, has been particularly severely affected. These companies entered a veritable bloodbath, slumping -13.4% for the month and taking falls from their November highs to a bear-market sized -25%.

We explore the impact of Omicron, although by early December, investors were becoming more sanguine about the variant's impact and reecouping some losses.



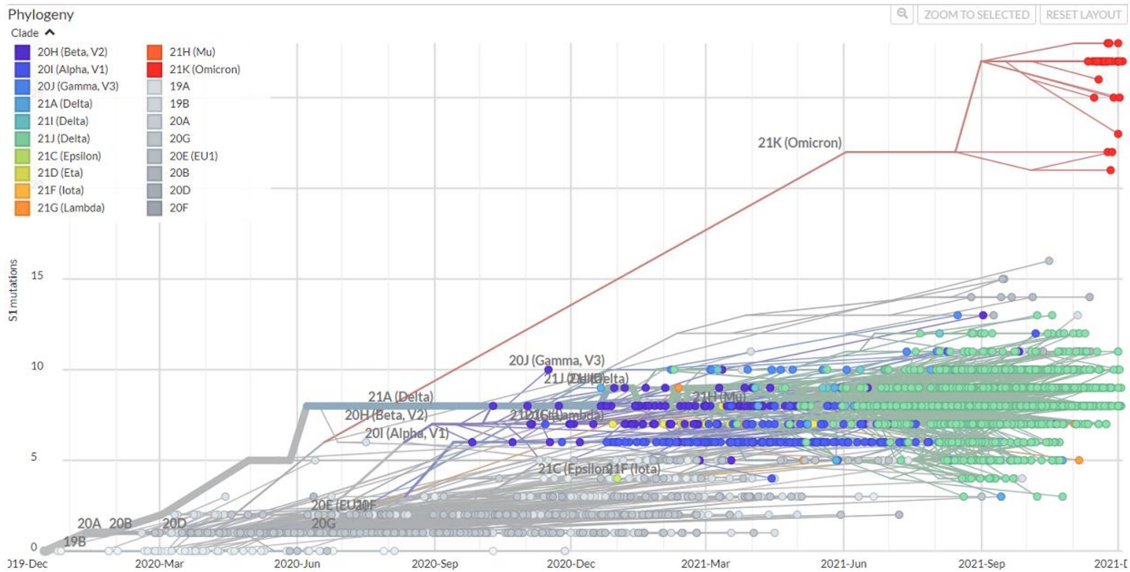
Source: Bloomberg, Goldman Sachs Non-Profitable Tech Index

Omicron – different, different, but same?

Late November and December usually have little stock-specific news. The last quarterly or six-monthly results are out of the way and investors are waiting for the next earnings results in late January and February the following year. Late in the calendar year markets are often driven by macro factors like inflation, unemployment, GDP growth and geopolitics.

Omicron is the 'X-factor' driving markets late this year, and experts are worried this new strain could send the COVID fight back to square one.

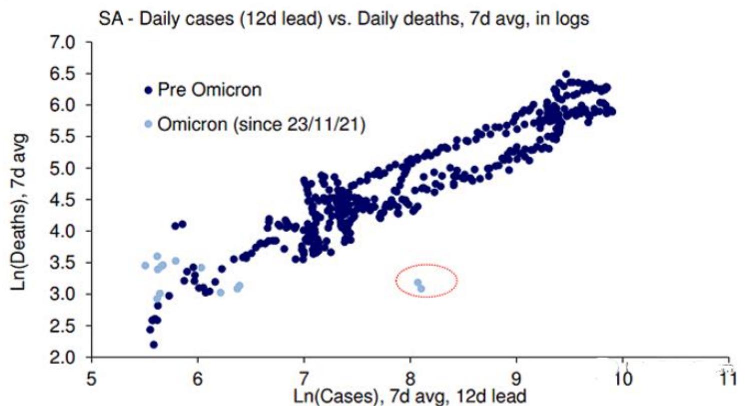
The excellent chart below from Nextstrain.org shows just how different Omicron is to previous variants, including Delta. It details the number of mutations to the spike protein (S1) that different variants have undergone. Omicron is in red and the most recent Delta variant in green. Different indeed!



Source: Nextstrain.org

But the growing consensus is that while Omicron may potentially be more transmissible than Delta, it may not be as severe. Early evidence also suggests that whilst existing vaccines may provide less protection against Omicron, they still guard against severe disease and booster shots may help re-establish previous protection levels.

As you can see in this chart, the recent rise in cases in South Africa has not been accompanied by a rise in deaths as was seen in previous waves.



It is too early to be definitive, though. Omicron cases in South Africa have been disproportionately in the young and in a population with higher vaccines levels than in the past, which makes historical comparisons tricky.

Markets hate uncertainty and news on this new variant will dominate markets moves until there is greater clarity across three key areas:

- Its transmissibility
- Its virulence
- The effectiveness of current and future vaccines

For equity investors, the impact of the virus on company valuations is often most directly felt through the effect of mobility restrictions on demand for companies' goods and services. Governments will be loath to reintroduce more restrictions given what countries have already been through. However, if Omicron threatens to overwhelm health care systems investors need to be prepared for fresh measures. Some countries have already slapped restrictions on travel.

We manage the Ophir funds so that companies in our portfolio are impacted as little as possible by virus outcomes. Examples of these businesses for our Australian equity funds includes:

- Elders – the rural services business involved in the sale of wool, grain, seed, fertilizer and animal health products.
- EBOS – the medical consumables and equipment company that supplies goods to hospital and pharmacies.
- NextDC – Australia's leading independant data centre operator that benefits as businesses move to the cloud.

Given our lack of PhD's in virology, we are unlikely to get an 'edge' on the market by pricing Omicron outcomes. We remain content to maintain our edge from the bottom-up work we do in meeting with company management and others (customers, suppliers, competitors, etc) in the eco-system in which they operate.

Inflation (and rate rises) – a Scrooge-like shadow

The other main risk garnering attention for equity markets in 2021 is inflation, which is casting a Scrooge-like shadow over Christmas.

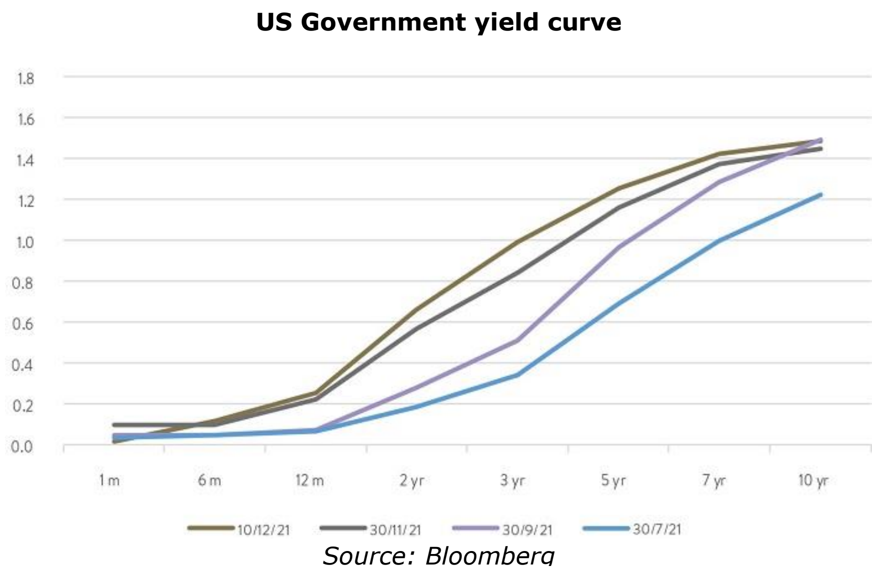
COVID and inflation are linked at the hip, with the former in large part causing the latter. Today's current multi-decade-high consumer price inflation levels in some major developed economies has been caused by two main influences:

First, huge fiscal stimulus by governments in response to COVID. When combined with mobility restrictions, this pent-up demand has been disproportionately spent on goods, while supply chains simply haven't had the capacity to keep up with that demand.

Second, labour supply has taken a knock because COVID has forced some workers permanently out of the workforce and others are unwilling to come back to work yet due to virus-related health concerns.

Inflation has persisted longer than most economists predicted, including central bankers whose job it is to tame it, so many now expect the removal of rock-bottom emergency-level interest rates to be brought forward.

Earlier this year, most expected US interest rates to begin increasing only at the start of 2024. Now the consensus is steadily moving towards rates lifting off in 2022. Below we show the US government debt 'yield curve', or the rate of interest for lending money to the US Government for different time periods from 1 month up to 10 years. These rates have been consistently moving higher recently, particularly for short periods like the next 2-3 years.



Source: Bloomberg

Bear market bloodbath and the 'expensive small growth' implosion

This has created headwinds for domestically-orientated small-cap growth businesses in the US, especially 'non-profitable tech' companies. These up-and-coming technology-based businesses are not making profits yet or are deliberately suppressing profits to reinvest for future growth.

Some examples of more well-known names to be hit hard include, with their share price falls from their 52 weeks highs in brackets: Draft Kings (-61.2%), Pinterest (-59.9%), Lyft (-43.7%), Robinhood (-76.8%), and Docusign (-55.6%).

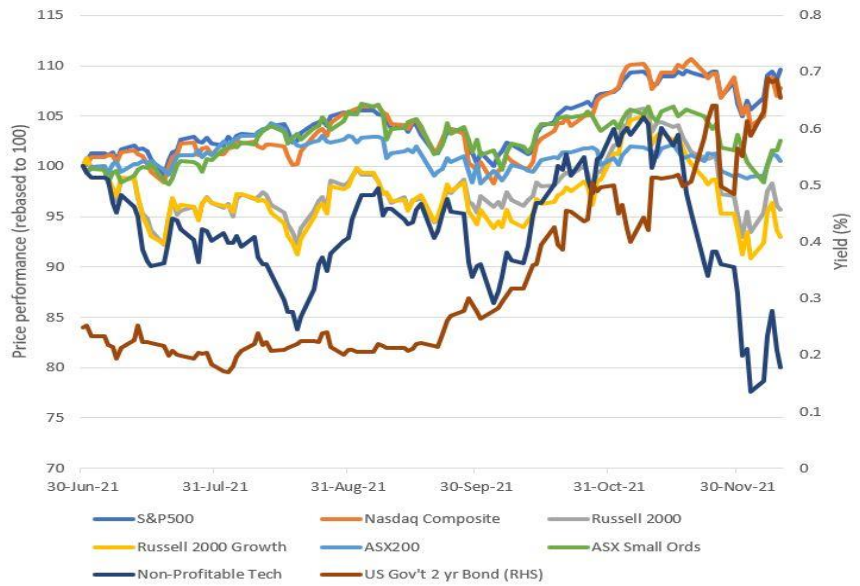
In the chart (next page) of US small-cap growth (as proxied by the Russell 2000 Growth index in the yellow line), and non-profitable tech businesses (blue line), you can see steep falls over the last month or so as bond yields (red line) have continued to move higher.

Higher interest rates disproportionately negatively impact the valuation of businesses with the most profit growth out further into the future, and this tends to be the smaller and less profitable businesses.

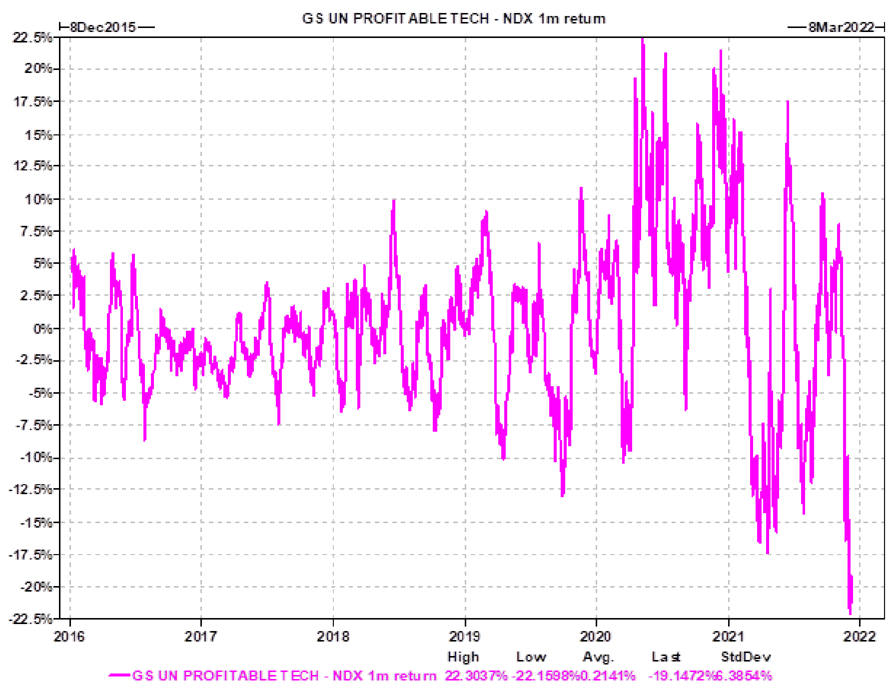
The median valuation of non-profitable tech stocks has almost halved (!) from a peak this cycle of 10x Enterprise Value/Sales in March this year, to 5.6x today.

Some of our most growth-orientated and high valuation companies in our Global Opportunities Fund have had their valuations de-rate substantially – hurting performance – whilst underlying company fundamentals such as revenue growth, in general, continues to be strong and beat consensus.

The key question for us is whether there is much further to go in the valuation pull-back for the 'growthiest' parts of the global market, particularly the US small-cap market? The good news is that the underperformance of non-profitable tech versus Big Tech (Nasdaq) has been historically extreme recently, with the biggest gap seen in years (lower chart).



Source: Bloomberg



Valuations in our global pond still looking ok

The reality is there is no one 'market', just a collection of individual companies in which we can invest. That said, the two most 'expensive' parts of the markets are the two pools we don't invest in – US large caps and US Big Tech.

In the chart, you can see that the long-term average (cyclically adjusted) price-earnings ratios of the S&P500 and the Nasdaq are well above their pre-COVID levels. Global small-mid caps (MSCI World SMID Cap), US small caps (Russell 2000) and the Australian share market (ASX200) valuations don't look anywhere near as worrisome.

Difficulty anticipating corrections

The uncertainty of Omicron and more recent heightened volatility can no doubt create some unease for investors. For those perpetually worried about market falls and trying to time them, the wise words of famed investor Peter Lynch often come to our minds:

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

Andrew Mitchell and Steven Ng are co-founders and Senior Portfolio Managers at [Ophir Asset Management], a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Far more people are eligible for the Commonwealth Seniors Health Card

Jon Kalkman

Everyone is aware that age pensioners receive a Pensioner Concession Card with its considerable range of health benefits and discounts. Part pensioners also receive the card, even if they receive only a few dollars in pension per fortnight.

This is just one more incentive for retirees to arrange their affairs to be eligible for even a small part age pension.

What about the CSHC?

Many independent retirees often incorrectly assume that, because they do not receive the age pension, they are not entitled to a health card. They may be unaware of the Commonwealth Seniors Health Card (CSHC).

The CSHC provides a range of concessions due to a lower Medicare safety net and similar savings via the Pharmaceutical Benefits Scheme (PBS). It also offers bulk-billed doctor visits at the doctor's discretion and the card allows retirees access to some state and territory concessions.

To qualify for the CSHC you must:

- have reached the pension age, but **not** be receiving an age pension or any payment from Veterans Affairs
- be an Australian resident living in Australia
- meet an income test (there is no assets test).

For independent retirees, the important consideration is that Centrelink only uses an **income test** to determine eligibility for the card.

The income test will consider both:

- adjusted taxable income
- **deemed income** from all financial assets including super account-based income streams.

What's the income test?

To meet the income test, the assessable income must be below the following thresholds:

- $57,761 for singles
- $92,416 for couples
- $115,522 for couples separated by illness, respite care or prison

Deeming is a departmental process which ignores the actual income received and 'deems' all financial assets as earning income at the same rate. Deeming is used in most Centrelink calculations of income in determining a range of benefits. It makes their calculations easier and discourages pensioners hiding assets in zero-interest bank accounts in order to maximise their pension.

The deeming rate was lowered again from 1 May 2020 in response to the COVID-19 pandemic. The present deeming rate is 0.25% up to a threshold of $53,600 for singles and $89,000 for couples. Anything above these thresholds is deemed to earn 2.25%. The deeming rate is subject to periodic change by ministerial directive.

For independent retirees (not receiving the age pension), deeming works in their favour because anything they can earn above the deeming rate from their financial assets is ignored in Centrelink's calculations.

Assets of $4 million get a card

With deeming rates so low, it means that retirees can have substantial financial assets and still be eligible for the CSHC. A single retiree with financial assets of up to $2.5 million may be eligible for the card. Similarly, a couple with financial assets of $4 million could also be eligible. Of course, if the deeming rate goes up again, those effective asset limits will be reduced.

Financial assets include anything that produces an income:

- The market value of your super account-based pension
- The market value of any other investments such as term deposits, investment properties, shares and managed funds, outside super

Financial assets do not include the family home or the market value of your super accumulation account because they do not produce an income stream.

Be aware that there are different thresholds for couples and singles. In the event of death, the surviving spouse will have a lower income threshold for card eligibility. Without careful planning, the survivor could lose their spouse and the benefits of this health card at the same time.

According to the Retirement Income Review Report, 71% of retirees over the pension age receive the age pension, either in full or in part. They would be eligible for the pension concession card automatically because the card is linked to the pension.

Of the remaining 29% of people of retirement age who are independent, their eligibility for the CSHC will depend on the size of their super account-based pension as well as their investments outside super such as investment properties, but not the value of their accumulation fund.

An unintended consequence of the Transfer Balance Cap which forced many people to limit their account-based pension to $1.6 million and forced the excess into an accumulation fund, is that this policy change may have made many more people eligible for the CSHC than might have been otherwise.

Spending in retirement

The Retirement Income Review Report noted that retirees could have a much more comfortable lifestyle if they were prepared to spend some of their capital in retirement, not just the income from that capital.

I argued in Firstlinks Edition 386 that independent retirees need to manage many risks in retirement that age pensioners do not. These risks include market risk, inflation risk and longevity risk. For independent retirees, the prudent response to managing risk is to hoard capital against an uncertain future rather than to spend it. As the Covid-19 pandemic has demonstrated, where there is great uncertainty about the future, the rational response is to save rather than spend.

Age pensioners face minimal costs for health and age care. For independent retirees, arguably the most difficult risk to manage in retirement, is the financial cost of ill health because the timing, severity and financial impact of negative health events are so unpredictable and indiscriminate.

It suggests that, if we were serious about encouraging independent retirees to spend more of their capital, the government could take the risk of high medical expenses off the table by making the CSHC available to all retirees above a certain age, say age 75. That would give all retirees the confidence in knowing that, no matter what, their future health care costs would be contained.

The additional budgetary cost of this proposal would be small because such a high proportion of retirees, including self-funded retirees, is already eligible for a health card, but the benefit to retirees and their future planning would be the certain knowledge that it was one less risk for them to manage.

Jon Kalkman is a former director of the Australian Investors Association. This article is for general information purposes only and does not consider the circumstances of any investor.

Fixed income solutions in a rising rate environment

Elsa Ouattara

The world economy is entering a post-COVID phase but many investors have been caught out by the rise of inflation and the impact on interest rate expectations. In such an environment, it’s vital to have the right fixed income strategy to manage your returns.

The good news is there is a strategy to achieve your income needs no matter what markets are doing, but to get it right we first have to understand the macro environment.

The economic backdrop

We are in for a surge of economic growth as countries exit the more severe impacts of COVID-19 on population mobility. We are watching countries such as the United Kingdom closely as the litmus for how the Omicron

strain may impact the recovery. At this stage, it's a case of 'living with the pandemic' even as some restrictions return.

Meanwhile, the surge in economic growth is putting pressure on global supply chains, which were impacted by reduced shipping, manufacturing and uncertain supply and demand expectations. This has combined with an energy shortage in the Northern Hemisphere as it navigates winter.

Markets are concerned inflation will rise higher and stay higher but we see two strong factors at play that should prevent this scenario.

First, supply chain disruptions will be resolved, so supply will grow. Second, demand has been turbo-charged by both higher savings during the pandemic and government stimulus. As the stimulus is withdrawn, people spend and the savings rate drops so demand should also moderate over time.

If we take the global economic barometer as a test case, we see inflation spiking this year at 4.5% in the US but dropping to 3% next year.

How will this impact interest rates?

In Australia, the interest rate mantra of the Reserve Bank of Australia since the pandemic began has been 'lower for longer'. As we progressed through 2021 the term was dropped from the RBA lexicon.

That slogan is adapting to the changing environment, and the RBA has accepted that the 'transitory' inflation from supply chain disruptions is more entrenched than previously expected. The first rate hike will likely occur sometime in 2023 instead of the previous guidance of 2024.

In the US we expect rates to move higher more rapidly. We expect the Federal Reserve to trigger its first rate rise in June 2022 and increase by 0.75% by year end. The Fed will ween the economy off artificially-induced monetary and fiscal stimulus.

The disparity between Australian and US interest rates will likely be created will make US-denominated fixed income an attractive alternative to local offerings, although our diversification model for portfolio construction prefers a mix of local and international offerings.

With rates re-pricing, the attractiveness of corporate bonds is improving, but of course, as interest rates rise, fixed rate bond prices fall. This creates more of an issue for the duration of fixed income instruments held, as the underlying reason to invest in fixed income to generate regular and stable cash flow remains the same.

Strategies to pursue

We expect the interest rate outlook could push US 10-year Treasuries out to 1.5-2% in 2022, and cash remains unattractive even in a rising rate environment. Longer duration fixed income instruments could also face issue price deterioration, but not all bonds are created equal and there are high-value alternatives.

We have turned our attention to suitably-positioned hybrids, which offer attractive yields, portfolio protection against rising rates and significantly less volatility than shares.

Hybrids are fixed income structures that contain characteristics of both debt and equity. Some can be traded on the ASX but we prefer the deeper liquidity found in the OTC (over-the-counter) market.

They do, however, have terms and conditions that can be specific for each issue, and carry risks different to both bonds and equities.

How can hybrids help reduce a portfolio's sensitivity to interest rates?

Hybrids often have a call option whereby the company will effectively buyback the issue to take advantage of another opportunity to manage the debt side of its balance sheet. That opportunity may be another hybrid issue on terms the company expects will include benefits for it. These call options have created a perception that hybrids are a short- to medium-term investment with low sensitivity to interest rates.

A floating rate may have more emphasis for those seeking USD hybrids as the Federal Reserve is expected to have a more aggressive path for interest rate rises, whereas the RBA is expected to move more slowly, giving greater weight to fixed coupons (usually confined to the OTC market).

For variable coupons, if the bond is not called at the call date, the coupon may be reset to a benchmark rate. This reset may allow investors to take advantage of higher rates.

All these variations and differences in terms and conditions can make hybrids seem complex, but it's more about determining the macro factors you expect going forward and choosing the instrument that best meets those outcomes.

What are the advantages of hybrids in a portfolio?

For income seeking investors:

- Potential for predictable and regular income stream (fixed or floating).
- Potential to receive interest payments over long periods of time.
- Interest payments on hybrids are generally higher than for senior debt (corporate bonds).
- Issuers may also have a step up in coupons paid over the lifetime of the bond.
- Hybrids can enhance returns to core bonds with additional risks or reduce volatility of stock portfolios.
- Hybrid issuers often have high-quality financial profiles and are generally rated Investment Grade.
- Hybrids also enable investors to diversify their portfolios across regions, industries, and sectors.
- Global over the counter (OTC) hybrids are a larger and more liquid market than ASX-listed hybrid offerings. Investors with access a range of international hybrids, included those issued by well-recognised global European banks or leading US blue chip companies.

What we like in the current settings

We currently like hybrids issued from leading global banks. Unlike in the GFC that saw a seizure of liquidity and credit markets, high quality banks are in better position today than they were 12 years ago.

There is continued improvement in the US and European financial system stability as banks benefit from lower regulatory and borrowing costs. Opportunities exist in high quality European banks hybrids that offer yield pick-up to US Financials and are showing ratings resilience due to generally strong capital and liquidity positions, as well as extraordinary support measures in place from government and regulators.

Banks continue to exhibit strong earnings for 2021, bolstered by super charged investment banking revenues and lower provisions for bad debt, the latter providing greater confidence to view a wider variety of opportunities on the risk spectrum.

We are finding more comfort in extending both duration risk and moving down the capital structure for these bonds.

Examples of our top picks (as at December 2021):

- USD: Macquarie Bank London 6.125% perpetual is paying a 4.6% yield and with the first callable date in 2027.
- USD: Vodafone 3.25% 2081 with a first call date in 2026. Low minimum denomination of US$50,000.
- AUD: A perpetual issue by Societe Generale with a first call date in 2024. If the call option is taken, it is an investment under 3 years with a coupon of 4.875% a year and relatively low sensitivity to interest rates.
- Investors can also invest in the property market through fixed income products. Scentre Group hybrid pays a coupon of 5.125% maturing in 2080. Hybrids can be bought and sold every day, investors are not locked in for long periods, they can benefit from the high income and sell the bond any time before maturity.

These four hybrids also have variable coupons - if they are not called by the issuer at the next callable date, the coupons will be reset on a benchmark rate plus a spread. Investors who expect rates to go higher can therefore benefit from higher coupon rates.

Elsa Ouattara is the Fixed Income Investment Lead for Citi, a sponsor of Firstlinks. Information contained in this article is general in nature and does not take into account your personal situation. Please note that some of the investments mentioned in this article are only available to 'sophisticated' investors and are not listed on the ASX or Chi-X in Australia.

For other articles by Citi, see here.

Investment forecasts unreliable in unpredictable times

Beatrice Yeo

Investment forecasts, just like weather forecasts are just that – projections of what might happen on the future, based on past patterns calculated alongside all possible factors that might help provide an estimation of what might occur in the short term. If you've ever relied on a weather forecast to plan an event, you know that the best weather apps are rarely 100% accurate and sometimes just get it downright wrong.

Which is why most of us, already used to the psychological perception that weather forecasts are mostly inaccurate, simply use them to help inform but not entirely drive our decision making. The same should be said for investment outlooks. And yet, it is not always so. As humans it is inevitable for our brains to crave certainty, and when it comes to money and our investment portfolios, the last thing we want is to not know what might happen.

But as the last two years have demonstrated in spades, uncertainty is here to stay. And with that in mind, as we wind down the year that was, and look hopefully towards 2022, now is probably a good time to re-evaluate your investment portfolio and figure out if your risk profile and investment objectives have changed. And if they have, to assess if your asset allocation and investment strategy are still applicable, in your investment time frame.

Against a backdrop of heightened uncertainty, and in recognition of how quickly forecasts can change, Vanguard's annual economic and market outlook sets out our baseline scenario for the year ahead. The analysis also lays out potential risk scenarios – both upside and downside that investors should be mindful of, and the signposts to watch out for in each of these scenarios. Our main message for investors who do not have a strong conviction of how the future will pan out, is that a globally diversified balanced portfolio will serve you best in unpredictable times.

Global economic outlook

In our baseline reflation scenario, the global economy is expected to continue its recovery in 2022, albeit at a slower place, regardless of supply-chain dynamics. In the US and Euro region, growth is expected to normalise to 4%, while in the UK, growth is anticipated at about 5.5%. In China, growth is projected to fall to about 5%. By contrast, in Australia, a slightly more positive picture off the back of a lacklustre 2021 is expected, with stronger growth of 4.5% expected for 2022, thanks to an accelerated vaccination roll-out.

That said, the outlook – just as with weather forecasting – has risks embedded, and our report highlights the potential risk factors that could shift the dial to the other side. In addition to ongoing health risks coming from potential virus mutations like Omicron, we highlight risks coming from persistent labour shortages, elevated inflation and potential policy missteps. In particular, the outlook for policy will be especially crucial in 2022 as support and stimulus packages enacted to combat the pandemic driven downturn are gradually removed. The timing, pace and magnitude of stimulus removal could pose a new challenge for policymakers and a new risk to financial markets.

Unwinding of monetary policy

Inflation continues to be a media buzzword this year, worrying not just economists and policymakers. Persistently elevated inflation may force policymakers to tighten faster, earlier and much more than expected. In the US, we expect the Federal Reserve to raise rates to at least 2.5% by the end of the cycle, higher than what most in the market are pricing in. Meanwhile in Australia, a surge in inflation expectations could lead the RBA to hike interest rates earlier than expected, despite our expectation that rates will remain on hold for 2022 given sticky wage dynamics.

Importantly, while the prospect of modestly higher inflation and rates may lead some to question the benefit of bonds in an investment portfolio, our research nonetheless finds that the diversification benefits delivered by this asset class are still relevant.

Overvalued equities

Vanguard's Capital Markets Model® has for several years now, cautioned that US equities have never been more overvalued since the dot-com bubble era, and are approaching 'stretched' territory, driven by valuation expansion, not increased profit. Thus the overall outlook for 2022 remains in guarded territory and investors, particularly those in the US, should brace for a lower-return decade. Australian equities are similarly stretched,

though to a lesser extent, hence our 10 year annualised returns for the local market are expected to be around 2% lower than our outlook last year, in the range of 3.5-5.5%.

Diversify to benefit

Despite the outlook for Australia looking relatively moderate, it does spell opportunities for Australian investors who allocate a portion of their portfolios to global assets. It also underscores the value of building a broadly diversified investment portfolio. Gains from one investment market could help balance out another investment market's losses, resulting in a portfolio that is less vulnerable to the impact of significant swings in performance.

The last 24 months have rewarded those who remained invested in the financial markets despite the challenging environment and troubling headlines. It would only seem prudent to continue holding on to this discipline and long-term focus for the years ahead.

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

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REIT sectors are different, faced with fundamentals and inflation

Matthew Doherty, Robert M. Almeida

Commercial real estate is an asset class in which the range of outcomes varies by subcategory, and outcomes can tighten or widen depending on the inflation outlook. Fundamental research and ongoing engagement with management is a critical input in the investment decision-making process.

The hybrid features of REITs

To place them in their proper context, Real Estate Investment Trusts (REITs) are a hybrid of asset class that resides somewhere between equities and bonds. They're viewed by investors as equities due to their potential for real capital growth, but also as bonds because of their income streams and focus on consistent capital return through dividend income.

Inflation matters in this asset class, though REIT performance during inflationary periods has been mixed.

The illustration below compares the performance of REITs in the US market (with more data points, liquidity and history than A-REITs) with that of equities during periods when core inflation is rising. While the type and level of inflation matters to the performance of REIT securities broadly, we think the fundamentals — the heterogeneity of the subcategories within the sector and the quality of the management teams and the assets they manage — are more important.

Source: FactSet, FactSet SPAR. Monthly data from 31 January 1970 to 31 September 2021. Core Inflation = Core Consumer Price Index (Consumer Price Index excluding Food and Energy). Cumulative performance calculated for each asset class based on the time frame determined as rising core inflation. Rising core inflation is defined as the period where core CPI YoY% goes from trough (lowest year-over-year change from prior high before rising again) to peak (the highest year-over-year change from prior low before declining again). US REITs = FTSE Nareit All REITs, US Large Cap Equity = S&P 500, DM Equity = MSCI World. Returns are in USD, and gross for US benchmarks and net for non-US benchmarks.

Inflation and different types of REITs

The simplest way to think about REITs is that they are landlords. Because they're owners and operators of properties for rent, building-specific details such as location, regional supply and demand dynamics and the

tenant mix matter. Things like lease structures, including duration of contracts, inflation indexation and replacement costs are also important.

As a general rule, REITs with shorter leases offer greater inflation protection than those with longer ones. Hotel and accommodation REITS, for example, have the shortest leases because hotel room rates fluctuate daily. While they can adjust prices to absorb higher costs, pricing power is a function of supply and demand. Currently, lodging fundamentals are mixed, with leisure demand on the rise but business travel impaired.

While lodging may not be mission critical, having a place to live is, and housing and apartment REITs have become a large part of the public REIT equity universe in the US. It is expected to grow in Australia.

As with lodging, labour and materials inflation are risk factors. At the same time, if replacement costs for comparable assets are rising, which often occurs during inflationary bursts, the intrinsic value of housing or apartment REIT portfolios is likely to appreciate too. Furthermore, if rents rise because of increased tenant demand amid tight housing supply, given relatively short lease durations (typically one year), apartment REITS should be able to pass that asset inflation on via higher prices, as they've been doing over the past 12 months.

Short lease lengths are a feature of self-storage REITs too. This industry has been a beneficiary of the pandemic as the work-from-home dynamic has caused many to declutter. The combination of increased demand and short leases equals price hikes and the potential to better absorb higher costs.

Conversely, long-lease subcategories such as grocery, freestanding retail and office landlords are more at risk. While grocery and retail have benefited from a stimulated consumer, office property fundamentals remain challenged. Vacancies are rising, with more tenants cutting back their space requirements as companies allow their employees to work from home. However, there are nuances, and office fundamentals vary by region and country.

While REITs have underperformed equities since the outbreak of the pandemic, strengthening fundamentals have pushed capitalisation rates down and valuations up, making REITs the market darlings of 2021.

However, we believe their continued recovery will be mixed and uneven. Tenant demands were changing before the pandemic and have only accelerated since. Occupancy costs matter more than ever, and efficient tenants will seek out space with the best value proposition. Against that backdrop, we favour landlords in mission-critical industries such as hospitals, medical offices, labs, residential, storage, data centres, industrial and fulfillment centres, among others.

'Just in case' replaces 'just in time'

What we're hearing from companies is that 'just in time' supply-chain management is being replaced by a 'just in case' approach as many trade efficiency and margin for dependability and market share. The shift is inflationary. After years of labour cost suppression leaving workers feeling left behind, the demand for labour is now outstripping supply. Labour is taking more control from capital, workers are demanding higher compensation and getting it. That, too, is inflationary.

We believe there will be a tug-of-war between secular disinflationary forces such as technology and excessive debt that plagued the last business cycle and the aforementioned sources of the current cyclical upward price pressures. Regardless of where investor' views fall on this continuum, everyone is thinking about inflation, and particularly how much of it there will be. Too much would have different implications than too little, but the implications of either eventuality would be negative for markets and society.

Like any other asset class, REITs are impacted by inflation, but the impacts vary depending upon the type of inflation and the REIT subcategory. To us, fundamentals and security selection, regardless of the economic and inflationary environment, matter most.

Robert Almeida is a Portfolio Manager and Global Investment Strategist, and Matthew Doherty is a Research Analyst at MFS Investment Management. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice. 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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