Firstlinks
a Morningstar company

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Editorial

One of the benefits of investing in Exchange Traded Funds (ETFs), besides the low fees for the index options, is the ease of entry and exit. Anyone with a broker account needs no fresh paperwork. Contrast this with the pain of many unlisted funds which still require a time-consuming 20-page application process with certified documents, copies of trust deeds, tax and residency checks, identification procedures ... and the name of your dog and favourite colour. Fill in Section A, B, G through K (if applicable). Who can be bothered in a digital age?

However, while 'friction' in business is normally a negative, there are disadvantages in making selling investments so easy when people overtrade. **BlackRock CEO Larry Fink** tells a story about meeting the manager of one of the world's largest sovereign wealth funds. The fund's objectives, Fink was told, were 'generational'. *"So how do you measure performance?"* Fink asked. *"Quarterly,"* said the manager.

In her book, "*Good Habits, Bad Habits: The Science of Making Positive Changes That Stick*", **Wendy Wood**, a Professor of Psychology and Business at the University of Southern California, writes:

"Your behaviour is much more controlled by what's easy in your environment than most of us think ... One of the really nice things about adding friction to a behaviour is that it encourages you to do something else."

To block bad habits, she says we need to add friction or restraints that turn easy, automatic behaviours into actions that require effort. Some of her tips are to set our phones to light grey to reduce the excitement of checking share prices and overtrading, or removing apps completely. She suggests watching business programmes with the sound off.

Howard Marks says in his latest memo to his clients:

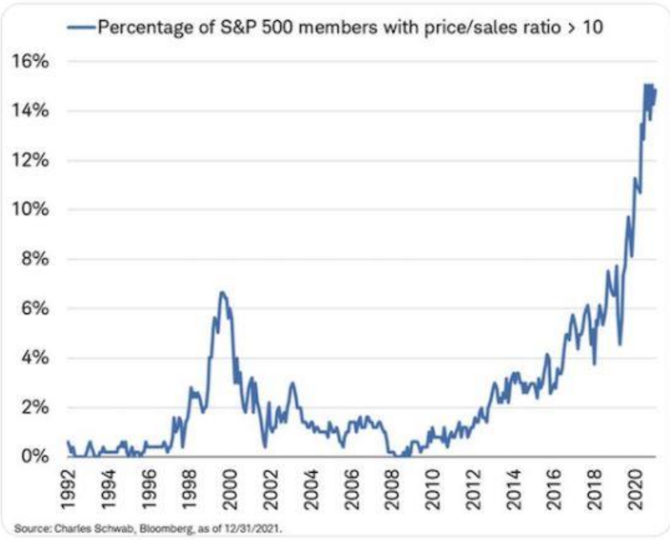
"When you find an investment with the potential to compound over a long period, one of the hardest things is to be patient and maintain your position as long as doing so is warranted based on the prospective return and risk. Investors can easily be moved to sell by news, emotion, the fact that they've made a lot of money to date, or the excitement of a new, seemingly more promising idea. When you look at the chart for something that's gone up and to the right for 20 years, think about all the times a holder would have had to convince himself not to sell."

One way to reduce overtrading is to think about the time and effort involved in investing. It's not only the buy and sell process, but the monitoring, accounting, tax returns and performance measurement. Are you convinced enough about an investment to bother or is it more of a punt? This year, particularly when I'm scaling back exposure to the market, an investment must deserve my attention to warrant the effort. It's counter-intuitive to want more friction but do you spend too much time checking prices and trading for marginal gains?

Although I'm a fan of ETFs for the choice, cost and easy access, there are potential risks in using them that should be considered.

It has been well reported that smaller tech companies without proven revenues are experiencing a sell-off, with 40% of NASDAQ companies off 50% from their yearly highs. At times like this, it is better to focus on resilient balance sheets and companies with pricing power and strong cash flows. While **Roger Montgomery** is generally optimistic about markets in 2022, he identifies the types of companies that will do better if there is a selloff.

Similarly, **Rob Lovelace** sees strength in company earnings in 2022. While he expects some level of correction after 11 years of the bull, it's better to weather the storm by staying invested rather than guessing when to buy and sell.



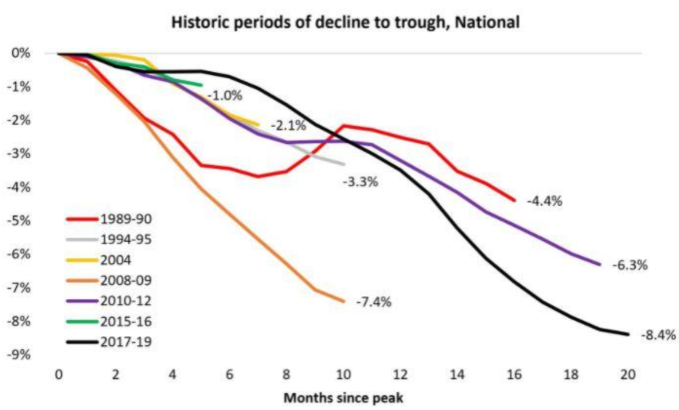
One of the remnants of a rampant bull market and IPOs of companies based on a dream is the move away from judging value based on Price to Earnings (P/E) ratios. It's not possible to calculate a P/E if there's no E, and so promoters of new companies find other metrics, such as Price to Sales (P/S). No longer is an investor deciding whether a P/E of 20 - paying for 20 years of current earnings - is expensive, but a record percentage of companies are trading at a P/S of over 10. No profit so investors are paying for sales.

Still overseas, a friend who writes for the **BRINK** newsletter sent me a global snapshot of what two dozen of their experts think were the surprises of 2021 and the challenges of 2022, and it's good to read a global perspective at a time of major change.

It's not surprising in such a strong market that 2021 was a record year for IPOs and capital raisings in Australia. **James Posnett** shows the highlights of 240 new listings, including nine companies with a market cap over $1 billion at listing. While the original owners no doubt did well, not all the new investors have. For example, the largest IPO of the year, fund manager GQG Partners, listed at $2 and is currently $1.82.

Is it time for gold to shine again after a disappointing 2021? **Jordan Eliseo** looks at gold's potential as inflation and interest rates rise.

And **Michael Collins** asks the question on many minds: what is the limit to how much governments can borrow? There must be some boundaries or we would not need taxes - governments could simply borrow to meet all expenditures, and promise their populations (and voters!) everything they desire.



This chart released by **CoreLogic** during the week brings some perspective to the tearaway national residential price growth seen in 2021. It's tempting to forget that prices do fall. Faced with tight lending conditions imposed by the **Financial Services Royal Commission**, prices struggled for much of 2017 to 2019. So while 2021 was stellar, there was some making up of lost ground from prior years.

This week's White Paper from **Fidelity International** looks at the vital subject of demographics. It defines megatrends shaping global growth, and the trends are long term and predictable for investing outcomes.

And it was good to see the **Australian Shareholders Association** issue a note this week on its top three webinars of 2021.


Australian Shareholders' Association
1,743 followers
19m •

Check out ASA top 3 webinars of the year 2021

ETFs are winning the battle against LICs, but is the war over? – With Graham Hand, Morningstar Investment Management Australia
Is TINA (there is no alternative) pushing portfolios out of cash and into Equities – With Evan Lucas, InvestSMART Group Limited
Using ETFs In Your Portfolio – With Robin Bowerman, Vanguard Australia

Look out below for details of the **2022 Morningstar Investment Conference**. Filled with star guests, I will be interviewing **Hamish Douglass**. Due to the virus, the event will be held online, and registration is only $25.

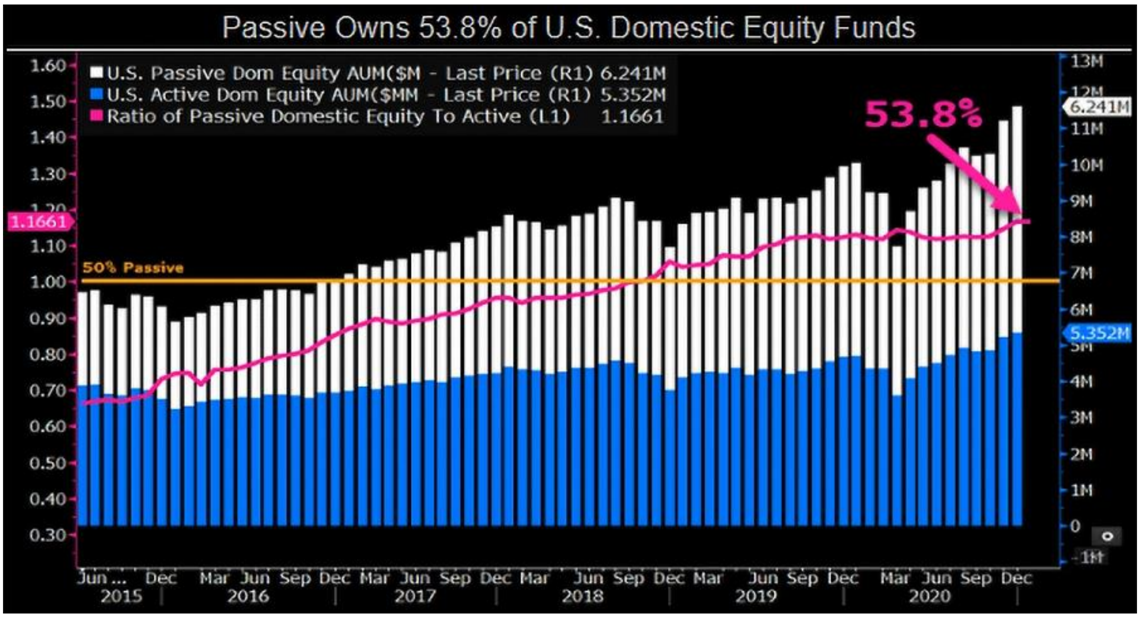
Three ways index investing masks extra risk

Graham Hand

The powerful shift in recent decades toward indexing and other forms of passive investing has taken place for the simple reason that active investment decisions are so often wrong. Of course, many forms of error contribute to this reality. Whatever the reason, however, we have to conclude that, on average, active professional investors held more of the things that did less well and less of the things that outperformed, and/or that they bought too much at elevated prices and sold too much at depressed prices. Passive investing hasn't grown to cover the majority of U.S. equity mutual fund capital because passive results have been so good; I think it's because active management has been so bad.

Howard Marks, memo to clients 'Selling out', January 2022

It's commonly-accepted wisdom that the majority of active equity managers struggle to beat their benchmark after fees. The loss of confidence in the ability of many fund managers to justify their fees is so strong in the world's largest market that, according to Bloomberg in the chart below, passive funds comprise about 54% of the US domestic equity funds.



Source: Bloomberg Intelligence

In the Australian market, the active performance data is not flattering, as shown in the table below. Standard & Poor's Index Versus Active (SPIVA) Australia Scorecard reports on the three main equity fund categories:

Australian Equity General Funds: Over the 5- and 10-year horizons, 76% and 81% of funds **failed** to beat the benchmark, respectively.

Australian Equity Mid- and Small-Cap Funds: Over the 5- and 10-year periods, 65% and 55% of funds underperformed the benchmark, respectively.

International Equity General Funds: Over the 5- and 10-year periods, more than 82% and 91% of funds underperformed the S&P Developed Ex-Australia Large-Mid-Cap, respectively.

The number in the table is the % of funds outperformed by the index. Over long terms such as 15 years, large cap managers do poorly, with 85% to 95% of funds failing to match their index. Smaller- and mid-cap managers hold their own at around 50%.

Report 1a: Percentage of Funds Outperformed by the Index (Based on Absolute Return)

FUND CATEGORY	COMPARISON INDEX	1-YEAR (%)	3-YEAR (%)	5-YEAR (%)	10-YEAR (%)	15-YEAR (%)
Australian Equity General	S&P/ASX 200	44.3	75.9	75.7	80.8	85.8
Australian Equity Mid- and Small-Cap	S&P/ASX Mid-Small	35.0	49.6	65.3	55.1	50.0
International Equity General	S&P Developed Ex-Australia LargeMidCap	54.6	78.1	81.9	90.6	94.8
Australian Bonds	S&P/ASX Australian Fixed Interest 0+ Index	29.9	67.2	70.2	85.5	83.1
Australian Equity A-REIT	S&P/ASX 200 A-REIT	58.5	56.7	56.5	78.8	78.8

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of June 30, 2021. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

There are some active managers who consistently deliver results, but the argument for an allocation to passive management is strong, at least as part of a core/satellite approach. That is, investors may choose to hold index or passive funds for a core position to save costs and participate fully in the market, but select active managers with strong performance who the investor regards highly.

What about the 'outperform in down markets' argument?

Many active managers acknowledge underperformance in strong markets but argue they are protecting capital by not backing the big (and now expensive) winners. An active manager may underperform simply by missing a big mover such as Afterpay in Australia or Tesla in the US, but who can blame them for avoiding such overprices stocks? They say they will more than compensate for lost relative returns when the market goes through a slower or weak period.

It's a narrative which works sometimes but often not. In the US (and soon to come to Australia), Morningstar publishes a semi-annual 'Active/Passive Barometer', and in March 2021, a paper studied the results from the 2020 selloff due to COVID-19. The report concluded:

"The coronavirus sell-off and subsequent rebound tested the narrative that active funds are generally better able to navigate market volatility than their index peers. As we documented in our midyear 2020 report, active funds' performance through the first half of the year showed that there's little merit to this notion. Across all 20 categories we examined, 51% of active funds both survived and outperformed their average index peer during the first half of the year. The full-year result for active funds wasn't much different. In 2020, just 49% of the nearly 3,500 active funds included in our analysis survived and outperformed their average passive counterpart."

It's not encouraging for those investors looking to their active manager to recover performance when the market tanks.

When the case for active management is stronger

The rapid growth of index funds in Australia, most notable in the success of passive Exchange Traded Funds (ETFs), shows Australians have embraced the same investment philosophies as US investors, although far less as a proportion. In Australia, unlisted managed funds are still dominant.

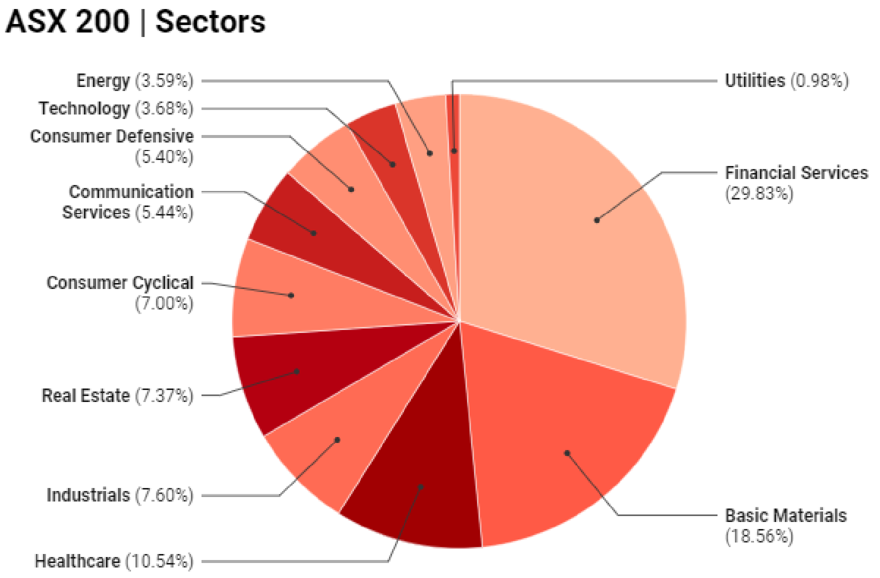
However, there are some circumstances where index investing may carry unacceptable risks.

1. When the index is overweight in certain sectors

The Australian stockmarket comprises 11 main sectors, often based on the Global Industry Classification Standard, or GICS. To add to the confusion, there are also 24 Industry Groups and 68 Industries, so the terminology of 'sectors' and 'industries' in sometimes unclear.

While most investors believe buying an index exposure to, say, the ASX200 gives a diversified investment in 200 companies, it is heavily concentrated in the sectors of Financial Services (30%) and Basic Materials (18.5%). After BHP switches its dual listing to a single Australian listing, these two sectors will be over half the ASX200 exposure. That's a lot riding on highly-leveraged banks and miners exposed to China and iron ore, as shown below. Technology is a modest 3.7%.

This lack of sector diversity shows why the days of home bias in Australian share portfolios should be long gone.



Data as at 13 January 2022
Source: Morningstar • Created with Datawrapper

Sector concentration weighs heavily on the underperformance on the ASX versus other global markets. Financial Services is itself dominated by five banks and the sector has underperformed the broader market. In calendar 2021, the Australian market rose 18.6% but the tech-heavy US S&P500 was up 28.7%.

The rapid growth of ETFs facilitates investment in a wide range of themes and sectors. But investors should watch the composition of some of these ETFs by visiting the websites of the ETF providers and checking the weightings in the funds. Even in the large US market, Apple and Microsoft together comprise one-third of the Morningstar Technology and Communications Index.

There are thousands of indexes around the world, and many of them are not based on 'cap-weighted', or the market value of the company. One way to manage the concentration risk with the cost benefits of an index is to invest in a fund where stock selection is tied to another type of index. Some indexes do not automatically drive up a greater allocation to a company as its share price rises, as happens with a cap-weighted index. Examples include 'equal-weighted' or 'fundamental' indexes, both of which are available on Australian ETFs.

For example, VanEck (a sponsor of Firstlinks) says:

"The VanEck Australian Equal Weight ETF (MVW) equally weights the largest and most liquid stocks on the ASX. It is underweight the mega-cap resources and big banks relative to the S&P/ASX 200 Index. As at 30 November 2021, MVW's portfolio is underweight financials by 12.58%, mega-caps by 18.47% and overweight large-cap (+12.07) and mid-cap (+6.62%) stocks."

2. When the index is overweight in certain stocks

Along a similar path, Australia's index is increasingly dominated by large companies, especially after stocks such as Sydney Airport and AusNet delist when bought by private equity or major funds. As shown below, 10 Australian companies each comprise over 2% of the ASX200, a total weighting of 44%.

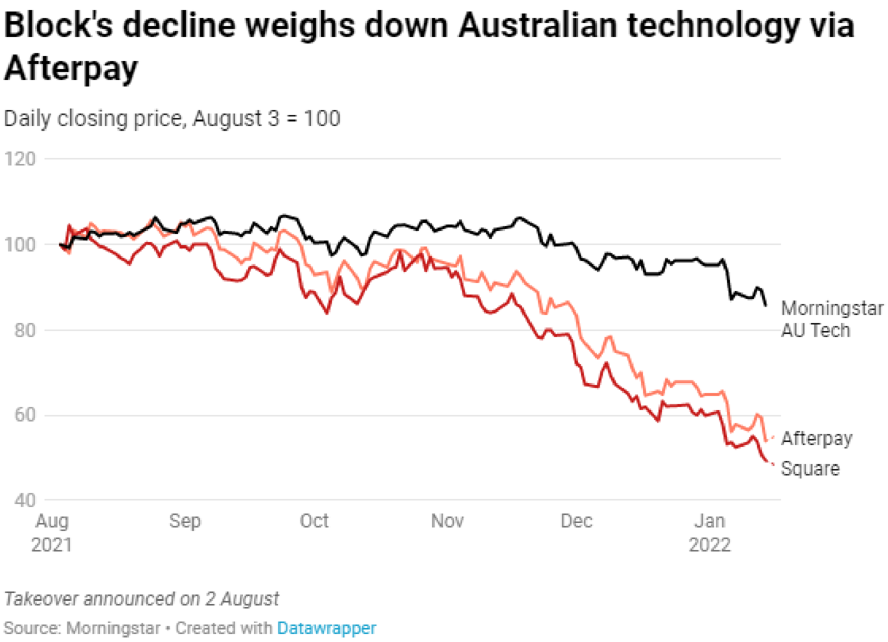
In the next two weeks, BHP will become Australia's largest company as it unifies its corporate structure with a single primary listing on the ASX. Morgan Stanley estimates its weight in the index will rise by about 4% above the level shown in the table below. ETFs tracking the index will become not only more concentrated in resources but one company will command over 10%.

Such index changes result in major buying and selling in Australia to rebalance. Morgan Stanley estimates local index funds will need to acquire $3.6 billion of BHP shares. However, there will be selling in the UK as their index funds no longer need to hold BHP. Other companies in Australia will be sold as their weighting falls, so the net new money into the market will be modest. The target date for completing the BHP change is the end of January.

Index funds are already preparing for BHP's big increase, with some buying in the UK where BHP trades at a discount to the Australian price (mainly due to the value of franking credits in Australia, but also recognising better liquidity). Vanguard has advised investors in the Vanguard Australian Shares High Yield ETF - which tracks the FTSE Australia High Dividend Yield Index - that:

"This index applies a 10% maximum weighting to any one company when the index is rebalanced semi-annually. To maintain these diversification requirements, a 10% cap will be applied to BHP based on the closing price on 21 January 2022. On the effective date, Vanguard fund weightings in BHP may be over 10% due to market movements."

The influence of a single company, Afterpay, has significantly dragged down the Morningstar Australia Technology Index in 2022 year-to-date. APT represents one-third of the tech index and has fallen by about 50% since August 2021, when it was acquired by Block (previously Square), as shown here. The index has also not been helped by a fall from favour of stocks such as Nuix and Appen.



3. When the index holds illiquid assets

A highlight of recent developments with ETFs is the wide range of sectors, asset classes and specific themes now available. Investors can back their judgement on dozens of categories such as commodities, AI, robotics, crypto, EVs, cloud computing, clean energy and video games, all listed in Australia.

There is also better availability of fixed and floating rate funds, bringing income choices previously available only to wholesale and institutional investors. These include government debt, corporate debt, hybrids and floating rate notes.

This variety raises questions about the liquidity in difficult market conditions. On the plus side, an ETF based on Australian or global large companies should deliver good liquidity in all markets because the underlying investments themselves are liquid. An ETF or any index fund is simply a vehicle for holding assets, and if investors want to redeem, the fund manager (or market maker) sells the underlying shares or bonds to pay the withdrawal. Even in tough markets, the trading price spread of large companies usually remains firm.

However, Morningstar research around March 2020 during the peak of the virus showed some fixed interest ETFs faced spread costs of about 3%. With low interest rates, that is equivalent of more than a year of interest payments.

One advantage that Listed Investment Companies (LICs) and Listed Investment Trusts (LITs) hold over ETFs is the commitment of capital. The manager does not sell to meet redemptions, as liquidity is provided by buyers in the market. However, it's a double-edged sword as prices can move to a discount if there are few buyers, but at least the manager is not forced to liquidate. For this reason, some asset classes, such as non-investment grade bonds and private debt, are better in LIC/LIT structures than ETFs.

And that's the way the market has developed. With a few exceptions, the bond and note ETFs in Australia are predominantly government or investment grade, with a couple of hybrid Active ETFs which rely on the liquidity of hybrids.

A comment on the ease of selling and overtrading

Behavioural risk can be costly for investors who cut and run at the first sign of market weakness.

One of the benefits of ETFs is the ease of access. Anyone with a broker account can buy ETFs like any other share. But there are disadvantages in making buying and particularly selling so easy. Many people overtrade and would do better to buy and hold rather than try to time the market by jumping in and out. Ironically, there are benefits in some selling 'friction'.

In her book, "*Good Habits, Bad Habits: The Science of Making Positive Changes That Stick*", **Wendy Wood**, a Professor of Psychology and Business at the University of Southern California, writes:

"Your behaviour is much more controlled by what's easy in your environment than most of us think ... One of the really nice things about adding friction to a behavior is that it encourages you to do something else."

To block bad habits, she says we need to add friction or restraints that turn easy, automatic behaviors into actions that require effort.

Check what's in that index

As the Australian stockmarket becomes more concentrated in a few big names, and as ETF issuers move away from liquid markets into specialised sectors, it is increasingly necessary to check what is in an index. The word 'index' does not refer only to broadly-based market indexes, as there are thousands of them (Morningstar alone has 1,330 indexes). Investors should not simply buy an index fund and assume it is diversified.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Will 2022 be the year for quality companies?

Roger Montgomery

I have previously written 2022 will be a good one for equities. Historically, the performance of equities, especially growth equities, innovative companies, and those with pricing power, during periods when deflation (consecutive years of lower rates inflation) coincides with economic growth has been consistently strong. I believe 2022 will reinforce that historical track record.

Markets have experienced a great run

Since the GFC, we have all been beneficiaries of an 'everything bubble'. And over the last decade-and-a-half, thanks in particular to sharply-declining interest rates and the advent of unconventional monetary policy, that bubble has accelerated.

From technology shares, that in aggregate have advanced more than 10-fold, to the tripling in price of low digit number plates in less than three years, and from digital currencies advancing 16,000% in less than eight years to boring old US Treasuries returning 250% over 15 years, it is easy to fall into the trap of believing one is a genius.

As John F. Kennedy once observed, a rising tide lifts all boats, and for many, the rising tide, not the boat captain, has been responsible for the wins. For this reason alone, investors need to be aware that all bubble's, even 'everything bubbles', eventually pop.

If 2022 proves to be the year the bubble pops, investors, depending on where they've ventured, must consider their response.

Quality falls less and recovers first

You see, the optimistic combination of economic conditions – deflation and economic growth - doesn't remove the ever-present risk of a setback. One should always operate on the assumption the market could pull back 10 or 15% and occasionally much more.

At one end of the spectrum are the investors who have ignored speculation and focused their portfolios in the securities of the highest quality companies – defined by the aforementioned characteristics and to which we can add little or no debt, and sustainable high rates of return on incremental capital. Their response will always be the same; do nothing. Their securities will be dragged down in any sell off; however, they should fear nothing because their securities tend to fall less and recover first.

This has hitherto been the case for the highest quality larger issues. And for investors in these highest quality issues – I might count Reece, ARB, Cochlear, REA Group and CSL among others in this group – and with additional cash flow, the temporary period of price weakness should be used to add more securities to each holding.

As Ben Graham once observed, buy stocks like you buy groceries.

'Profitless prosperity' will be treated harshly

Towards the other end of the spectrum are those investors who have strayed from quality and drifted up the risk curve, purchasing riskier securities such as those I refer to as 'profitless prosperity' stocks. These will be treated more harshly in any rush for the exits and falls of up to 95% should not be surprising.

These investors must consider their weighting in such securities and 2022 is as sensible a year as any to rebalance. Some investors, especially those guided by wise advisers, will have appropriately allocated a relatively small portfolio weighting to riskier issues. The everything bubble of course will have enlarged that weighting and now might be a wise time to bring it bring it back to its original position.

At the extreme end of the spectrum are those who have ventured into asset classes that are purely speculative: today, it might be cryptocurrencies or NFTs (Non-Fungible Tokens) such as those by Bored Ape Yacht Club, CryptoPunks or RTFKT. Younger investors, in particular, have been lured into this realm, driving capital gains, which have subsequently attracted older and wiser investors, even some institutions.

I believe there is merit in the long-term disruptive power of the blockchain. At the extreme, there are legacy technology companies today that are dead men walking. They will cease to exist when blockchain technology reaches its full potential.

But there is also merit in the argument many of the current crop of blockchain beneficiaries are nothing more than speculative junk, playing on hype and celebrity to attract further acolytes to drive prices even higher. Sprouting terms like Web 3.0 - an amorphous mess - to justify their 'investment' and in some cases of hundreds of millions of dollars, many have forgotten their gains are based on nothing but popularity.

The metaverse and decentralised blockchain technology is promoted as taking power away from centralised financial institutions, Facebook and Google and returning that power to the masses. But the reality is that the financial gains from this decentralised phoenix remains firmly in the hands of those who control it and those who issue the tokens. According to Chainalysis and Flipside, 80% of the NFT market is controlled by just 9% of accounts. In cryptocurrencies, 95% of Bitcoin is owned by just 2% of accounts. The more recent Web 3.0 projects are launching with the same concentration of control, voting power and ownership as the technology IPOs of yore.

Popularity is not investing

With Facebook renaming itself Meta, and with companies like Nike and Adidas issuing NFTs of their own, it is easy to succumb to the hype. But popularity is fickle and many investors in this space, amid a deflating bubble, if they aren't nimble, will find themselves holding valueless digital art. With NFTs, one cannot own the physical art but is instead paying huge amounts of money to merely have their name listed as the owner on a digital distributed database. So what?

If 2022 proves to be the year of a setback, any pain will be temporary for some but permanent for others. It might be wise today to review your portfolio and where you sit on the risk spectrum.

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

2022 outlook: buy a raincoat but don't put it on yet

Rob Lovelace

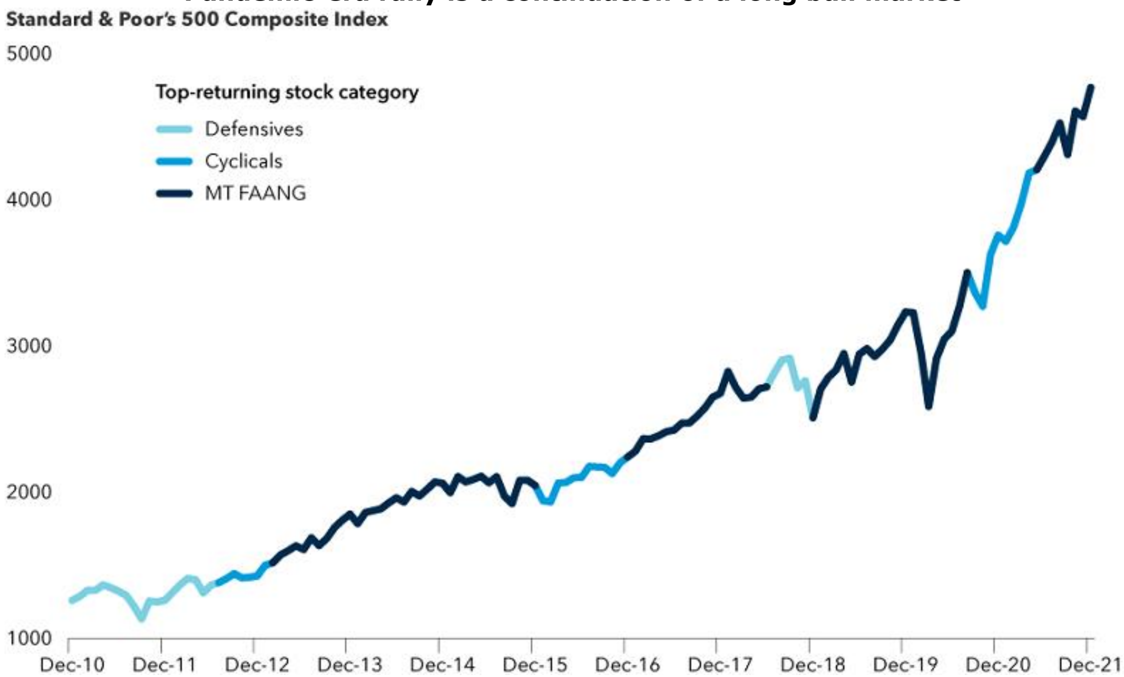
Investing in the pandemic era has raised a whole new set of challenges, but in some ways, the fundamentals haven't changed. Corporate earnings still matter. In fact, they might just matter more than ever. The bull market may be long in the tooth and overdue for a correction, but there's a reason the pandemic shouldn't bring it down.

The outlook for global equity markets in a new year

There's a three-part framework I like to use and that is: pandemic, economy, markets. The pandemic will be with us for a while, but it will have a diminishing impact on the economy over time. And the health of the economy matters a lot to the bond market, but less so to the equity markets. The stock market is driven by the earnings of the companies that are listed, and many companies have done well even during the COVID period. So we should see the pandemic having less impact on the economy, the economy continuing to expand and companies well positioned to thrive.

After the COVID correction in the first quarter of 2020, stocks not only bounced back, they continued the extension of what we now realize is a decade-long bull market. It's been led by the same group of U.S. tech-related stocks that we used to call the FAANGs — Facebook (now Meta), Amazon, Apple, Netflix and Google (now Alphabet). That long-term trend is still in place. COVID interrupted the climb, but it didn't change the fundamental direction of the markets.

Pandemic-era rally is a continuation of a long bull market



Sources: Capital Group, FactSet, MSCI, Standard & Poor's. As of 31/12/21. MT FAANG represents the collective price performance of shares of Microsoft, Tesla, Meta (Facebook), Amazon, Apple, Netflix and Alphabet (Google).

Over this 10-year period, we've definitely seen some excesses building up, and it's usually these excesses that need to be cleaned out by a correction. That doesn't mean it's going to happen right away but, at some point a stabilization in prices, if not a full correction, would probably be a good thing at this point in the cycle. We may be seeing that needed correction starting already this year.

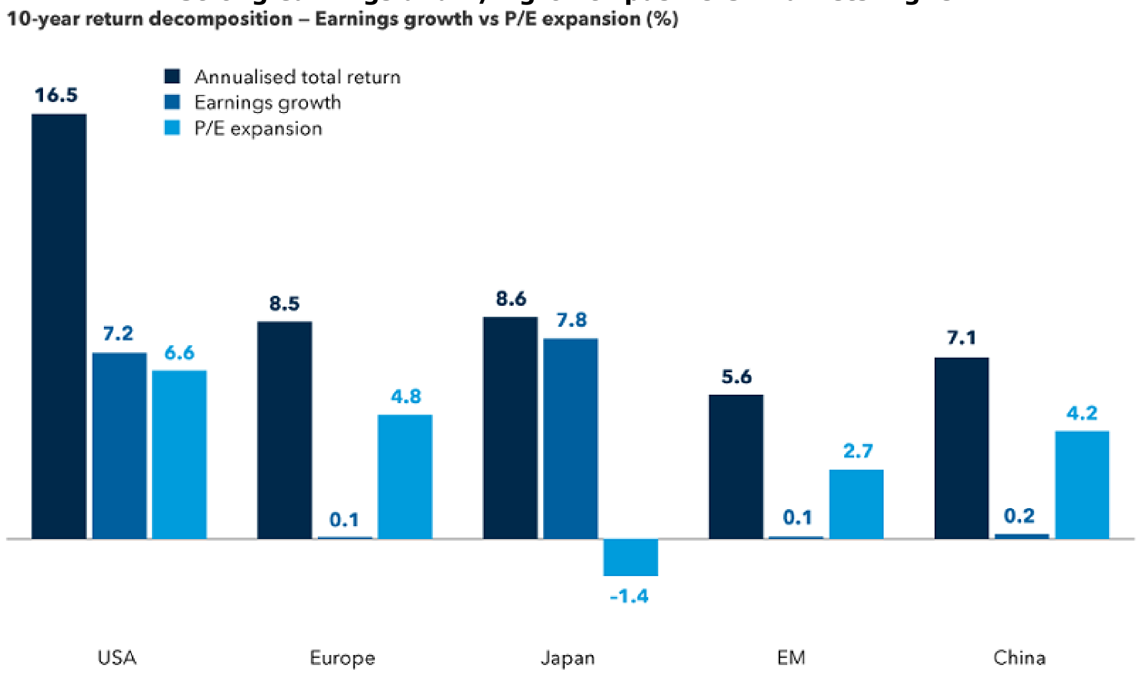
Growth in the world's major economies

I'm expecting solid economic growth in the U.S. and Europe. It may be slower in China, but economies are not necessarily the best indicators of stock market levels. Equity markets will do well depending on the performance of the underlying companies.

Let's take a look at the U.S. stock market, which has been compounding at more than 16% a year over the past 10 years. That's a remarkable number. Many people think it's because of the stimulus that has come into the market, so most of it has been due to multiple expansion. But that's only half the reason. The compound average growth rate of U.S. corporate earnings has been over 7% a year. So that means about half the growth is driven by earnings and the other half is driven by investors valuing those earnings more highly.

This chart (shown below) makes a powerful statement about what's happened over the past decade in the U.S. compared to other major equity markets.

Strong earnings and P/E growth push U.S. markets higher



Sources: FactSet, MSCI. "Earnings growth" represents the annualised 10-year growth in earnings per share. "P/E expansion" represents the annualised 10-year change in trailing price-to-earnings ratios. Returns include dividends and are net of withholding taxes. All figures reflect USD. As of 31/12/21.

Other markets have been growing at only about half the pace of the U.S. Europe had almost no earnings growth at all. Japan hasn't had any valuation expansion, but it's had decent earnings growth. So those two markets have been compounding around 8% a year. Emerging markets are even lower, and a big piece of that is China.

When we look at growth around the world, most of it is finding its way to the bottom line in the U.S., which is why this market has outpaced others over the past decade. While we are seeing some excesses, what's happening in the U.S. is unique and keeps us focused on opportunities in this market.

The risks that could bring this long bull market to an end

In investing, you don't have to figure out what's going to start the fire, you just need to know the brush is dry. When you think about how the markets are currently structured, how far they've gone up and where multiples are, you just have less room for mistakes.

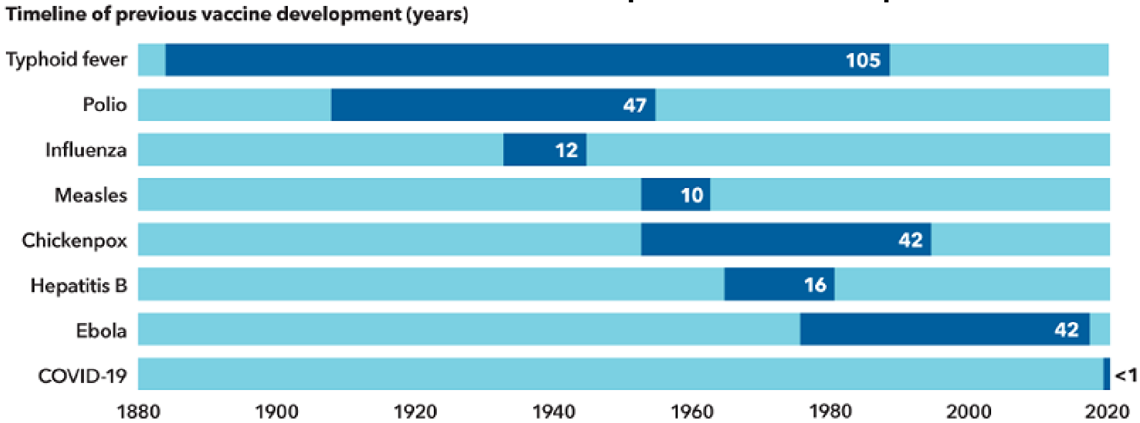
Some of the excesses today aren't necessarily in listed securities, but in the private equity markets and so-called PIPE (private investment in public equity) deals. That's where I'm seeing things that worry me, and that's why I am in no way sending a panic signal about the public equity markets. As we've just demonstrated, U.S. stocks are driven as much by earnings expansion as P/E expansion, and that's healthier than I think most people realize.

The pockets of growth and innovation

We've already discussed the FAANGs and I think Tesla has also joined that group. These are companies which have wide moats. They're making a lot of money and not just in their core business areas. Some have two or three other strong pillars of growth. And while people may argue that valuations are stretched, they are less stretched than they were a few years ago because the underlying earnings are so powerful.

I am also excited about advancements in the health care industry. Most of the COVID vaccines have resulted from the mRNA technology delivery system developed about 20 years ago, and it's finally finding its way into common drugs. This structure will be used to develop multiple new treatments and even cures for deadly diseases. It's going to change our lives, so I'm interested in a number of companies in that space.

COVID-19 vaccines were developed at breakneck speed



Sources: Capital Group, NIAID, Our World in Data. Date ranges represent the approximate time between the year the pathogenic agent was first linked to the disease and the year that its vaccine became licensed in the United States.

Also, don't count out Europe and some of the emerging markets. They've learned from the U.S. and China, and they are creating their own centres of excellence, especially in the technology sector. I see this in Canada as well. There are many companies such as Shopify building their own innovative platforms. They have great products that they are bringing to market in the digital and meta worlds.

Positioning our portfolios for the year ahead

As long-term investors, we have an average holding period of about eight years, so we try to build all-weather portfolios. We have this incredible bull market in the U.S. and I don't want to count it out, so my view is: I'm buying the raincoat, but I'm not putting it on yet. I just want to have that raincoat nearby. And with low interest rates, cash isn't as attractive an asset class to use on the defensive side.

I'm looking more toward durable companies with strong operating positions, often dividend payers. Because of the duration of the bull market and current valuations, I am cautious and shifting where I can to strong cash-flow generating companies. But when our analysts find amazing new companies doing innovative things, I can often be convinced to hold a few in my portfolio. That's why I describe it as all-weather. It's structured with a nice safe core, but I try not to miss some of these opportunities, particularly in the digital space.

ESG is everywhere, and it's only going to get more important. We have made a commitment to fully integrate ESG principles into our investment process. So every security now goes through an ESG filter. We know it's going to be driving prices and outcomes.

We have a role as bottom-up fundamental investors who are out there every day talking to companies. Companies want to do the right thing. They want better governance. They want to treat their workforce better. They want to have minimal climate impact. And they are looking to us for guidance on those issues.

What's your perspective on Environmental, Social and Governance (ESG) issues?

Environmental

- Climate change
- Waste management
- Renewable energy
- Water utilisation
- Resource efficiency
- Pollution externalities

+

Social

- Workforce diversity
- Health and safety
- Training and development
- Human rights
- Community relations
- Supply chain transparency
- Political contributions

+

Corporate governance

- Disclosure and transparency
- Executive compensation
- Corporate board structure
- Ownership and control
- Capital allocation
- Shareholder rights

Source: Capital Group.

ESG concepts are global and cut across all asset classes

In addition, it's important to give asset managers the flexibility to evaluate companies from an ESG perspective, rather than simply banishing some companies from a portfolio. Don't think of ESG as just an exclusion process. Think of it as identifying companies that are doing the right thing and also supporting companies in transition.

I understand there is some trepidation about how ESG concepts will be implemented in our industry. People are worried about new government regulations, additional rules or expanded disclosure requirements. But I would say: Get over it. This is important. There's a lot to learn, but I would go into it with a sense of optimism and enthusiasm.

Parting thoughts

First, remember that even though the pandemic isn't fading, it shouldn't scare you. It will have less impact over time.

Second, we're in the 11th year of an extended bull market and near the end of the cycle. Some type of correction is likely, but it's not time to panic. What's happening underneath is solid, healthy and underpinned by strong earnings growth. For all the worries about rising inflation and broken supply chains, we're seeing lots of opportunities in individual companies and securities throughout the world. We found ourselves in a very tough situation but we got creative and figured out a way to get through it.

Bottom line: Stay invested. Don't try to time the market.

Rob Lovelace is Vice Chairman and President of The Capital Group Companies, Inc., Chief Executive Officer of Capital Research and Management Company, and an Equity Portfolio Manager. Capital Group Australia is a sponsor of Firstlinks. This article contains general information only and does not consider the circumstances of any investor. Please seek financial advice before acting on any investment as market circumstances can change.

Time to give up on gold?

Jordan Eliseo

Gold prices have started the year in a narrow trading range, sitting at US$1,822 per troy ounce (oz) on 14 January 2021. This follows an underwhelming performance in 2021, with the precious metal falling by 3.6% in US$ terms, its first annual fall since 2018.

End of year gold prices and annual returns – 2010 to 2021

Year	USD gold price	AUD gold price	Price change (%) - USD gold price	Price change (%) - AUD gold price
2010	1,405.5	1,371.2		
2011	1,531.0	1,493.4	8.9%	8.9%
2012	1,657.5	1,596.5	8.3%	6.9%
2013	1,204.5	1,346.3	-27.3%	-15.7%
2014	1,206.0	1,473.7	0.1%	9.5%
2015	1,060.0	1,456.9	-12.1%	-1.1%
2016	1,145.9	1,582.5	8.1%	8.6%
2017	1,291.0	1,650.6	12.7%	4.3%
2018	1,279.0	1,816.8	-0.9%	10.1%
2019	1,514.8	2,154.9	18.4%	18.6%
2020	1,887.6	2,446.2	24.6%	13.5%
2021	1,820.1	2,508.4	-3.6%	2.5%

Source: The World Gold Council, The Perth Mint

Despite this pullback, gold has rallied by more than 70% since the low seen in 2015, making it one of the best performing assets during this period.

What went wrong for gold last year?

Several factors contributed to the gold pullback last year, including:

- A strong move higher in the US dollar index, which finished the year up 6%.
- The rollout of vaccines across most of the developed world which reduced fears about the economic damage COVID-19 would cause.
- A major upward revision in actual and forecast GDP growth, with OECD estimates for 2021 rising from 4.2% to 5.7% over the year.
- A strong rally in global equity markets, epitomised by a more than 25% increase in the S&P 500, with global equity strategies also seeing record inflows.
- A boom in digital assets with Bitcoin up 65%, while the value of all cryptocurrencies rose by 205%.

Global gold ETF investors also lightened their exposure, with total holdings falling by 8% from the peak seen in late 2020. Notably, Australia was an outlier in this regard, with investments in gold ETFs holding up far better than their global counterparts last year.

Did anything go right?

Encouraging signs for gold in 2021 included very strong consumer demand for bars, coins and jewellery.

This is highlighted in the table below, which shows demand in the first three quarters of 2021 was 44% higher than 2020. It was also 5% higher than 2019, before anyone had ever even heard of COVID-19.

Gold: Consumer demand (tonnes)

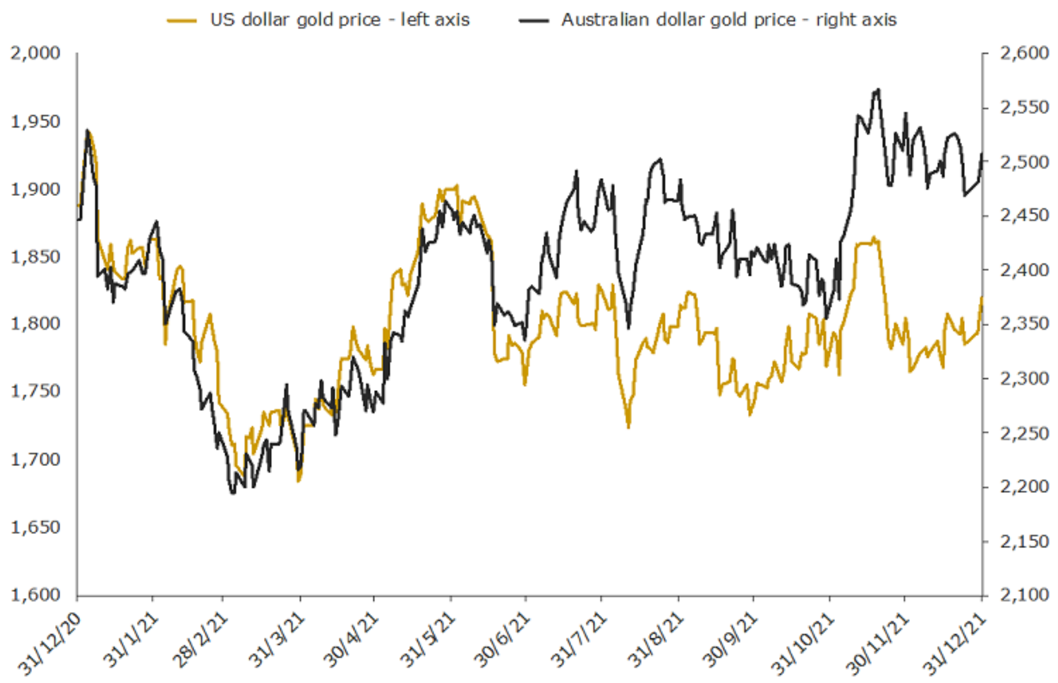
	Q1-Q3 2019	Q1-Q3 2020	Q1-Q3 2021	Change (%) 2021 v 2020	Change (%) 2021 v 2019
India	496t	260t	360t	39%	-27%
China	679t	427t	730t	71%	8%
Middle East	177t	124t	154t	24%	-13%
Americas	136t	155t	224t	45%	65%
Europe	143t	219t	240t	10%	68%
Total	1,630t	1,185t	1,709t	44%	5%

Source: World Gold Council, The Perth Mint

Central bank demand was robust, with net purchases in H1 topping 330 tonnes, almost 40% above the five-year average. Most estimates suggest net purchases by central banks for 2021 will be in the 400-500 tonnes range, with developed markets like Singapore and Ireland joining the list of nations adding to their gold reserves.

Finally, while gold recorded a calendar year loss in 2021, all the pain was seen in Q1 when gold dropped by 10% to the end of March, trading below USD 1,700/oz. From then on, gold trended higher, as the chart below illustrates.

Daily gold prices in 2021



Source: The World Gold Council, The Perth Mint

The outlook

Multiple factors are likely to influence gold during 2022.

Potential headwinds include the fact that US inflation rates may soon decelerate. The expectation that we will see at least three interest rate hikes in the United States this year (with more to come in 2023) could also weigh on the precious metal, as would any further upside in the US dollar.

That said, the fact gold rose during December last year suggests that the accelerated tapering of asset purchases and the more hawkish interest rate projections announced by the US Federal Reserve (Fed) at their most recent FOMC meeting, were largely priced in.

Gold also has a history of delivering positive returns once the Fed begins rate hiking cycles (for example, gold prices rose by 30% between December 2015 and July 2019, a period that saw the effective Federal Funds rise from 0.24% to 2.40%).

Given such history, the Fed tightening monetary policy this year may not be the death-knell for gold that some assume it will be.

Gold may also experience renewed safe haven demand in 2022 given the potential for higher volatility in equity markets. This may prove to be a particularly relevant driver for gold, given:

- the low nominal and negative real yield environment investors face when looking at sovereign debt markets.
- how expensive equity markets (particularly in the United States) are today, with the famous Buffett Indicator showing the market capitalisation of US stocks ended 2021 at 218% of US GDP.

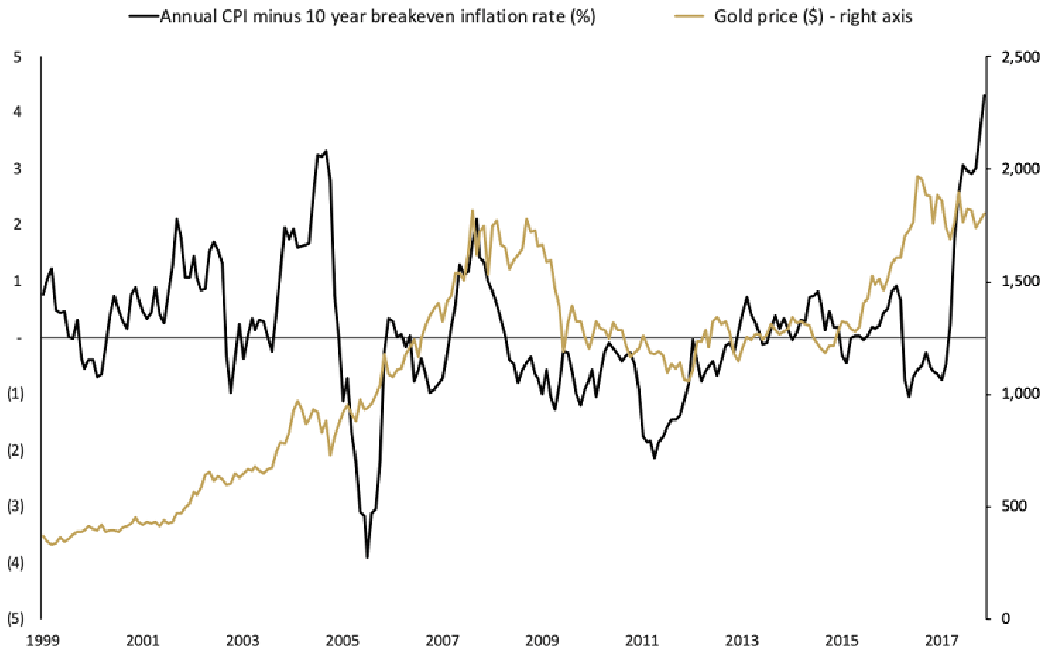
Indeed, with markets beginning to show signs of fragility in the face of the withdrawal of policy support, it would not take much to boost gold. Any further complications caused by the spread of the Omicron variant, and geopolitical flare ups from the Ukraine to Kazakhstan, are also potential tailwinds.

On the inflation front, while surging consumer prices didn't lead gold to deliver a positive return in 2021, it's too early to say the precious metal no longer works as an inflation hedge, as some have claimed.

While the Fed dropped the word 'transitory' late last year to describe inflation, the market has yet to meaningfully price in higher rates of inflation. The US five-year break-even inflation rates ended 2021 at just 2.87%, while 10-year break-even inflation rates were below 2.6%.

This meant the market ended 2021 with the largest gap between current CPI rates (6.8%) and 10-year break-even inflation rates on record, as the chart below highlights.

Inflation dynamics and gold price



Source: The Perth Mint, World Gold Council, St Louis Federal Reserve

Given this set up, there's plenty of room for the CPI to fall a long way from current levels, yet still end up overshooting current market expectations.

Finally, it's worth noting that gold has now worked through a roughly 15-month period that at its worst saw prices correct by almost 20% from peak to trough.

Corrective cycles like this are part and parcel of gold bull markets, and indeed are often healthy developments as they allow the market to rid itself of excess froth and speculation.

Sentiment towards precious metals has also done a 180-degree turn, from near unanimous bullishness in Q3 2020 to a far more subdued outlook today.

This is illustrated through a range of high-profile headlines in recent articles discussing gold. They have ranged from describing the precious metal as 'unloved and uninteresting', to others claiming that gold has 'lost some of its investment allure'. A number of financial institutions have also released bearish gold price forecasts for 2022.

They may, of course, turn out to be correct, but these are typically the signs one sees at, or very close to, the end of a corrective cycle.

At the very least, it might be too early to give up on gold just yet.

Jordan Eliseo is Manager of Listed Products and Investment Research at The Perth Mint, a sponsor of Firstlinks. The information in this article is general information only and should not be taken as constituting professional advice from The Perth Mint. You should consider seeking independent financial advice to check how the information in this article relates to your unique circumstances.

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Global leaders reveal surprises of 2021, challenges for 2022

BRINK

BRINK is a global content platform, supported by Marsh McLennan, that provides insights on critical business issues. In Part 1, BRINK recently asked a cross section of its experts to identify - in a couple of sentences - what they had learned that surprised them the most in their areas of expertise over the last year or so since the pandemic began.

In Part 2 of the survey, they asked their experts to name the challenge or opportunity that they think will rise up the agenda the most in their area of expertise.

Part 1 - surprises from 2021

Jo Owen, Author of *Smart Work: The Ultimate Handbook for Remote and Hybrid Teams*

The speed with which firms and people can change. In March 2020, remote working was transformed from unthinkable to essential in one weekend.

Mona Sloane, Sociologist and Senior Research Scientist, New York University

Literacy around AI systems and their risks and benefits has increased over a very short period of time.

David Dollar, Senior Fellow, Brookings Institution

The difficulty of establishing scientific certainty in real time; policies keep changing.

Ellen Ernst Kossek, Basil S. Turner Distinguished Professor of Management, Purdue University, Krannert School of Management

How much COVID-19 negatively impacted the work-life equality, labor force participation and careers of women; perhaps setting them back at least a generation.

Larissa van der Lugt, Director, Erasmus Center for Urban, Port and Transport Economics

The difficulty of achieving cooperation, while the pandemic urged that even more.

Deborah Gordon, Senior Principal at Rocky Mountain Institute

How easily the work world adapted to virtual interactions and maintained productivity. I'm eager to see how hybrid working (both in-person and virtual) shapes up in the year ahead.

John Asafu-Adjaye, Senior Fellow, the African Center for Economic Transformation

The extent to which the use of ICT has been scaled up over the past two years in most African countries, especially in the areas of banking, finances and education and health. Going forward, there is an opportunity to accelerate the use of ICT for nation-building by addressing the infrastructure challenges.

RM Charan, President of Charan Associates

How little U.S. business leaders were aware of the implications of the evolving U.S. China relations.

Sarah Tong, Senior Research Fellow at the East Asian Institute at the National University of Singapore

That there are social groups who would oppose efforts to contain the spread of the pandemic.

Alicia Garcia Herrero, Senior Research Fellow, Bruegel

Supply chain disruptions.

Richard Wilding, Professor of Supply Chain Strategy, Cranfield University U.K.

That scenario planning in good times is excellent planning for the challenging times.

Ben Hoster, Director, Transformative Technologies, Marsh McLennan Advantage

The pace of technology adoption and related perils. The second and third order effects of increased remote work and related cyber/digital risks. Technology is at once a key enabler and also a threat vector at increasingly large scale.

Bart W. Edes, Distinguished Fellow at the Asia Pacific Foundation of Canada

How quickly our work environment could dramatically change, with long-term impacts now embedded for the post-pandemic era.

John West, Executive Director, Asian Century Institute

I have been surprised at the incompetent management of COVID in most advanced countries and the lack of a serious effort to uncover the origin of COVID. Against that, I have been equally surprised at how rapidly effective vaccines were developed.

Alexander Privitera, Head of European affairs at Commerzbank AG

The resilience of banks.

Blair Chalmers, Director, Marsh McLennan Advantage

The ability of firms to conduct due diligence on acquisitions virtually (in the face of travel restrictions).

Marcus Courage, CEO at Africa Practice

The constraints of labor laws in managing remote and distributed workforces.

Anbumozhi Venkatachalam, Director, Research Strategy and Innovations at the Economic Research Institute for ASEAN and East Asia

The resilience of value chains and digitalization.

Haig Nalbantian, Senior Partner, Mercer

The ease of adaptation to flexible work arrangements in response to COVID and the ability to sustain productivity and engagement under these circumstances is beyond anything I predicted.

Jason Clay, SVP Markets, ED Markets Institute, WWF

The pandemic is getting all the headlines, but climate change will disrupt and kill more lives and economies. It is already here and is having much more profound impacts than expected.

VADM (Ret) John Miller, CEO, The Fozzie Miller Group

I've been impressed by how quickly businesses and populations have adjusted to the "new normal" that the pandemic caused, despite poor performances across the globe by governments, which was slow, oppressive in the establishment of restrictions and regulations, and largely ineffective in easing the burdens caused by the virus.

Kavitha Hariharan, Director, Healthy Societies, Marsh McLennan Advantage

The continued failure to appreciate that in a pandemic, no one is safe until everyone is safe. Lack of vaccine access in poor countries and vaccine hesitancy anywhere result in persistent transmission of SARS-Cov-2, which rolls the dice in favor of the emergence of new variants.

Part 2 - challenges for 2022

In the second half of the survey, we asked our experts to name the challenge or opportunity that they think will rise up the agenda the most in their area of expertise.

Jo Owen, Author of *Smart Work: The Ultimate Handbook for Remote and Hybrid Teams*

Hybrid working will become the new normal.

Mona Sloane, Sociologist and Senior Research Scientist, New York University

We will see more AI regulation kick in in 2022, and businesses will have to adapt rapidly to new transparency, accountability and audit requirements.

David Dollar, Senior Fellow, Brookings Institution

Rising trade disputes and protectionist policies.

Ellen Ernst Kossek, Basil S. Turner Distinguished Professor Of Management, Purdue University, Krannert School of Management

Implementing flexible working in a way that truly balances employee and employer needs and transforms the workplace from a place to a virtual relationship.

Larissa van der Lugt, Director, Erasmus Center for Urban, Port and Transport Economics

Making progress in the energy transition.

Deborah Gordon, Senior Principal at Rocky Mountain Institute

In 2022, we will need to develop a better understanding of the dynamics of market transitions, especially in an effort to rebuild a net-zero emissions economy. It will be essential to maintain market integration as we shift to low-carbon inputs and outputs — this risk is especially concerning in the refining sector.

John Asafu-Adjaye, Senior Fellow, the African Center for Economic Transformation

The main challenge will be how African economies can recover from the effects of the pandemic and speed up economic growth and create good jobs for the large population of young people. Many countries have had to borrow to supplement the COVID-19 response measures — how can they scale back their debt levels without cutting back on social expenditures?

RM Charan, President of Charan Associates

Inflation, U.S.-China relations, and the U.S. economy.

Sarah Tong, Senior Research Fellow at the East Asian Institute at the National University of Singapore

Uncertainty around the global pandemic and U.S.-China tensions are two of the most serious challenges to the world economy.

Alicia Garcia Herrero, Senior Research Fellow, Bruegel

Taiwan becoming the central focus of U.S.-China strategic competition.

Richard Wilding, Professor Of Supply Chain Strategy, Cranfield University U.K.

Increasing agility and planning for onshoring, nearshoring and multi-shoring to increase supply chain resilience.

Ben Hoster, Director, Transformative Technologies, Marsh McLennan Advantage

Technology convergence, "smart" devices and applications, with related cyber threats and digital risks, and some day, the Metaverse.

Bart W. Edes, Distinguished Fellow at the Asia Pacific Foundation of Canada

Containing COVID-19 to enable the launch of a sustainable, inclusive global recovery.

John West, Executive Director, Asian Century Institute

Growing global political instability in light of [President] Biden's weakness and unpopularity at home, [President] Xi's anxiousness to have his term as China's leader extended, [President] Xi's impatience for Taiwan to be unified with mainland China, and strategic drift in Europe with the departure of [former Chancellor] Merkel and the French elections.

Alexander Privitera, Head of European Affairs at Commerzbank AG

Calibrating fiscal and monetary policies.

Blair Chalmers, Director, Marsh McLennan Advantage

The adaptation and resilience of infrastructure assets.

Marcus Courage, CEO at Africa Practice

Regulation/regulatory compliance. A wave of new regulations to address tax compliance, health, digital/data and environment.

Anbumozhi Venkatachalam, Director, Research Strategy and Innovations at the Economic Research Institute for ASEAN and East Asia

Destructive innovation and financing sustainability.

Haig Nalbantian, Senior Partner, Mercer

Developing effective, data-driven DEI strategies which will continue to accelerate and come to dominate the HR agenda.

Jason Clay, SVP Markets, ED Markets Institute, WWF

The need for common metrics, methodologies and boundaries to make meaningful change. Absolute reductions of all climate impacts.

VADM (Ret.) John Miller, CEO, The Fozzie Miller Group

2022 will be a year of continued challenges — especially regarding Chinese and Russian aggression. The most pressing issue will be responding in Ukraine, should Russia decide to invade. We can expect China to further pressurize Taiwan as they continue to move toward an unwanted re-unification.

Kavitha Hariharan, Director, Healthy Societies, Marsh McLennan Advantage

Workforce burnout will exacerbate delivery challenges in health care, in a context of swelling demand caused by new SARS-Cov-2 variants and Long COVID, care that has been deferred during the pandemic, and other health crises such as those caused by increasingly severe extreme weather events.

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2021 was a standout year for stockmarket listings

James Posnett

2021 was a year of records in the Listings business. The global Initial Public Offerings (IPO) market recorded highs in terms of capital raised and number of IPOs, at US$610 billion and 3,097 respectively (Dealogic). This coincided with US and Australian equity indices recording all-time highs, spurred on by fiscal and monetary stimulus.

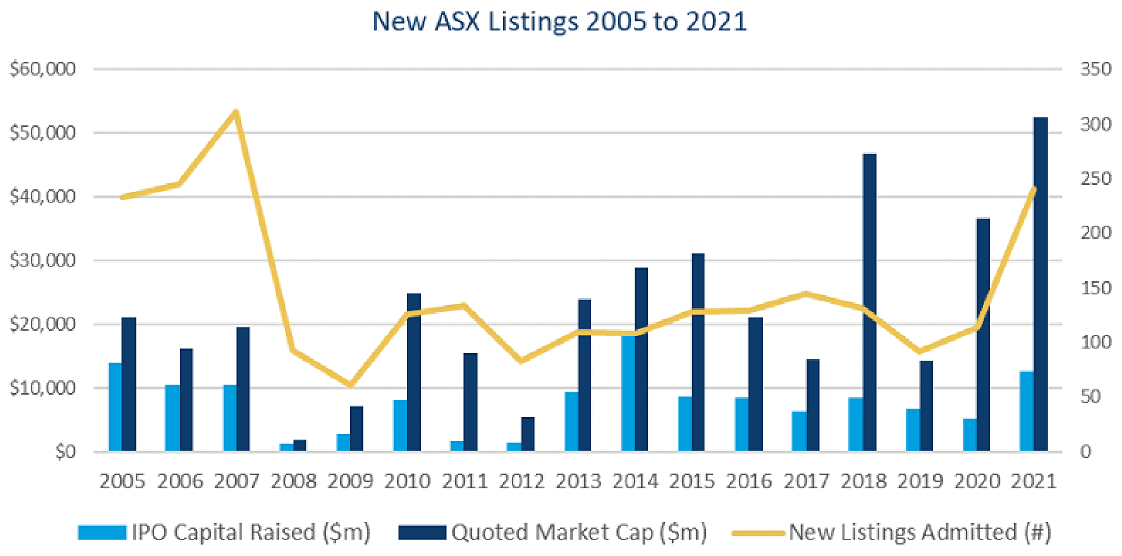
The largest offshore IPO was California-based electric vehicle maker Rivian Automotive Inc, which raised US$13.7 billion. Investors embraced the broader themes of electrification and decarbonisation. The US market also saw a record in Special Purpose Acquisition Company (SPAC) IPOs.

Australian listing records

It was a standout year for ASX with 240 new listings – the biggest year since the height of the mining boom and bull market of 2007 (this includes all admissions to the Official List). By volume of listings, ASX again outperformed nearly all exchanges globally, just behind those in the world's two largest economies, the US and China.

Australian IPOs raised over $13 billion in capital, the highest in seven years. The value of new listings, including IPOs, spin-offs, dual and direct listings, was $52 billion - another record. The average price performance of IPOs was 17%, outperforming the broader S&P/ASX 200 index, which ended 2021 up 13%.

The year saw Australian mergers and acquisitions (M&A) activity at record highs and a significant level of share buybacks and special dividends. Both factors helped increase demand for IPOs as cash was returned to investors and then redeployed.



Source: ASX

Increase in large local IPOs

It was a record year for billion-dollar IPOs with nine in total across a range of sectors, including financials, industrials and technology.

The largest IPO of the year was Florida-based asset manager GQG Partners (GQG), which raised $1.2 billion at just under a $6 billion market capitalisation. GQG Partners chose ASX instead of a US listing largely because of comparatively attractive valuations of asset managers listed on the Australian market.

Of the top 20 IPOs by capital raised, 15 were private equity- or venture capital-backed, compared with 11 in 2020. The largest listing of the year by value was Woolworths' hotels and bottle shops spin-off Endeavour Group (EDV) at an $11.1 billion market capitalisation.

Top 10 IPOs in 2021 by market capitalisation

Ticker	Company	GICS Sector	Deal Value ($m)	Market Cap at Listing ($m)
GQG	GQG PARTNERS	Financials	$1,187	$5,906
APM	APM enabling better lives	Industrials	$982	$3,190
PXA	PEXA	Real Estate	$1,175	$3,038
LFS	Latitude Financial Services	Financials	$200	$2,600
JDO	judobank	Financials	$653	$2,322
VNT	ventia	Industrials	$438	$1,454
SDR	SiteMinder	Information Technology	$627	$1,363
PPM	pepper money	Financials	$501	$1,270
WTN	WINTON	Real Estate	$331	$1,091
29M	29 Metals	Materials	$528	$961

Source: Dealogic, ASX

Despite travel restrictions, there were 23 international listings, with most transaction processes and investor roadshows running in virtual format due to Covid-19 restrictions. The top five countries of origin for ASX listings were New Zealand (6), the United States (5), Canada (5), Israel (2) and the United Kingdom (2).

Mining activity continues apace

Like 2020, the highest volume of listings was in the mining sector, with explorers accounting for around half of all new listings. This reflected continued elevated prices in commodities such as gold, copper, lithium and nickel.

At the opposite end of the market, 29Metals (29M) was ASX's largest copper IPO. NexGen Energy (NXG), a Canadian uranium miner listed on TSX and NYSE, added an ASX listing to facilitate access to Australian investors.

In mining services, drilling business DDH1 Drilling's (DDH) IPO enabled selldowns by founders and US alternative investments firm, Oaktree Capital Management.

Growth opportunities in financials and technology

Fintech companies continue to gain critical mass. The category now has over 60 listings at around $82 billion in total market capitalisation in areas such as lending, payments, capital markets and wealthtech.

Last year, IPOs in the financial sector included challenger bank Judo Capital Holdings (JDO) and non-bank lenders Pepper Money (PPM) and Latitude Group Holdings (LFS), all of which are utilising technology to scale key parts of their businesses.

Judo was the first IPO of a licensed bank on ASX in 25 years (since Macquarie listed in 1996). Judo is focusing on small and medium enterprises underserved by incumbent banks.

Listed Investment Company Touch Ventures (TVL) raised IPO capital to target investments in retail innovation, consumer, finance and data. PNG-listed BSP Financial Group, (BFL) the South Pacific's largest bank, dual-listed onto ASX to help expand its investor base.

Hotel-booking software company SiteMinder (SDR) continued to execute on its growth strategy despite global travel restrictions. Its IPO provided growth funding and a liquidity event for the founders and early investors, including Silicon Valley-based growth equity firm TCV, which had been invested since 2013.

Other tech-enabled IPOs included electronic conveyancing platform PEXA Group (PXA), jobs marketplace Airtasker (ART) and lithium-sulphur battery technology company Li-S Energy (LIS).

Over 2021, the number of constituents in the S&P/ASX All Technology index increased from 69 to 77. The index now includes 28 'listed unicorns' and has a total market capitalisation of around $190 billion.

Healthcare hitting new highs

It was a strong year for the healthcare sector with 16 listings, the majority in biotech and medtech. Highlights included:

- radiopharmaceuticals company Clarity Pharmaceuticals (CU6), which was the largest-biotech IPO
- California-based cardiovascular medical-device company, EBR Systems Inc (EBR)
- analytical science and devices company Trajan Group Holdings (TRJ)
- US-Australian rapid diagnostics company Lumos Diagnostics (LDX)

New Zealand-based NZX-listed cancer diagnostics company Pacific Edge (PEB) dual-listed to access Australian investors and accelerate growth into the US market. Australian Clinical Labs (ACL), Australia's third-largest pathology group, was the largest healthcare IPO of the year.

The year's largest healthcare equity capital markets transaction was CSL's $6.3 billion institutional placement, used to partly fund its acquisition of Switzerland-based Vifor Pharma. It was ASX's largest-ever non-privatisation capital raising and took two days to complete from the date of announcement, highlighting the speed and efficiency of the public capital-raising framework versus private markets.

2022 outlook

The listings pipeline for 2022 remains strong. Mining explorers make up the largest portion by number, with the remaining companies in a broad range of sectors including technology, consumer, financials and healthcare.

The most significant company to list on ASX is US payments giant Block Inc (NYSE: SQ). Block commences trading on ASX this week ahead of the Afterpay acquisition, which will be formally implemented on 1 February 2022. The secondary listing of Block (SQ2) is a strong endorsement of the Australian tech sector globally.

It is also a positive reflection of the Afterpay journey, demonstrating how high-growth companies can use an Australian listing to fund their development from an early stage right through to becoming multi-billion-dollar success stories. Afterpay listed in 2016 with a market capitalisation of $165 million and subsequently raised $3.7 billion in follow-on offerings and convertible debt up to the acquisition announcement in 2021.

Over the coming months, global markets will continue to deal with several key risks, including those relating to inflation, central bank policy and the pandemic. Nevertheless, valuations and market liquidity remain relatively high. Provided market volatility stays at reasonable levels, IPOs will continue to flow.

James Posnett is Senior Manager, Listings at the ASX. This article is for general information only and does not consider the circumstances of any individual. Letters after the company names are the listing codes.

Let 'er rip: how high can debt-to-GDP ratios soar?

Michael Collins

The 'IMF crisis' as South Koreans call the 'Asia crisis' of 1997 is the worst event to have hit South Korea since the civil war of 1950-53. Their focus on the IMF is because South Koreans, perhaps ungratefully, focus on the damage after the International Monetary Fund bailed out a country tormented by a currency-turned-banking crisis.

Even though South Korea's economy rebounded quickly from IMF-imposed austerity, the crisis scarred South Koreans. One legacy was a consensus that Seoul must not let gross government debt exceed 40% of output.

No longer. The government of President Moon Jae-in in August 2021 vowed to use fiscal stimulus to counter the damage of the pandemic and, more broadly, fight poverty and inequality. Public debt is expected to reach 59% of GDP by 2025, from 36% when Moon took office in 2017.

Why not let government borrowing rip?

Does anyone care that government debt-to-GDP ratios (however imperfectly measured) are higher than seemed possible because interest rates are so low? US government debt is now at 103% of GDP. Eurozone public debt is at a near-record 98% of output. While Australia's federal debt is only headed to 50% of GDP by 2025, Japan's public debt stands at 257% of GDP, while for advanced countries the figure is 124% of output. Public debt in emerging markets extends to a record 64% of output. The IMF estimates 'general' government debt now reaches a record 99% of global output, from 83% in 2016.

An overarching question is: At what level might public debt become disruptive? History is replete with examples of when excessive debt triggered a crisis, from an inflationary economic collapse to endless stagnation.

Managing government debts

Governments have three standard options when it comes to tackling debt burdens.

The **first** conventional cure is to raise taxes and reduce spending. The handbrake of austerity is often politically fraught and undermines economies so much that it backfires and debt ratios rise.

A **second**, and the most appealing, option is to ensure economies flourish in a way that erodes real debt burdens over time. This is how the victors reduced their bills after World War II. The formula is to ensure nominal output (GDP unadjusted for inflation) grows at a higher rate than the average interest rate on public debt – a historic norm.

Over the pandemic, these formulas were met because interest rates were around record lows partly due to central bank asset purchases. A repeat of the post-World War II drawdown will be hard because back then pent-up demand, low regulation, favourable demographics and free trade drove economies, advantages lacking now.

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Still, within this option, governments can choose to allow some inflation and suppress interest rates. The benefit of this approach is that rising nominal GDP growth offers governments tax windfalls. But artificially low rates would only encourage companies and consumers to add to their record debt loads that come primed with risks too.

Permitting inflation is tricky. Officials might lose control of prices and interest rates would rise. To counter that, governments might be tempted to pressure central banks not to raise rates. But that would demolish central-bank independence to fight inflation, perhaps the economic policy most responsible for recent prosperity.

The **third** option is to default. While no defaults in advanced countries with their own currencies are imminent, their governments can't boost debt forever. Pressure will mount for authorities to control debt ratios to stop ratings downgrades, perhaps even engage in accounting tricks.

Where are the vulnerabilities?

Eurozone governments with high debt ratios are more vulnerable to default because they lack their own currencies, yet any default could bring down the European Monetary System. More crises from the euro area are likely, especially if bond yields rise after the European Central Bank stops its asset buying.

Emerging countries, which are inherently less stable economically and politically, are most likely to default. The candidates are many – the IMF in December 2021 estimated that 60% of low-income countries are at "high risk or already in debt distress" compared with 30% in 2015. Emerging countries that have borrowed in foreign currency (a diminishing percentage) and ones that have borrowed from foreigners rather than locals are the most at risk.

For indebted advanced and emerging countries, a world of record government debt could soon enough be a realm of hard choices and one of sporadic crises.

As the debt status quo appears unsustainable, any rise in US interest rates will signal trouble ahead.

Debt played a role, but there is a price

To be clear, government debt proved its worth during the pandemic and there's nothing risky with it per se, especially when governments borrow in local currency from locals. As Japan shows, debt-to-GDP ratios can climb far higher than thought possible without any obvious damage to an economy. It's true too that few indebted governments are struggling to sell debt at low rates. But, at some point, rising debt would trigger steeper borrowing costs and puncture the complacency that public debts are manageable because interest rates are low.

History shows that public debt ushers in its nemesis; higher interest rates. That reckoning one indeterminant day likely means a harsher, poorer, perhaps crisis-prone future awaits.

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