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Editorial

Every Federal Budget is a balance of politics and economics. On Tuesday, Treasurer **Josh Frydenberg** handed out some short-term goodies in the form of a reduction in fuel excise, a temporary tax cut of $420 for 10 million workers and a payment of $250 to 6 million welfare recipients. The sting in the tail is that the excise is scheduled to return in six months and the entire $1,500 Low and Middle Income Tax Offset (LMITO) will end next financial year, and any new government is facing these two potential grenades.

Both problems are the other side of the election, so it can be sorted out later. There was little in the Budget on superannuation, which seems to have lost its proclivity as a fiscal punching bag. Apparently, deficits don't matter as much as they used to and the retiree vote is too powerful. Here's the Budget Paper comment on the main item relating to super.

> The Government has extended the 50 per cent reduction of the superannuation minimum drawdown requirements for account-based pensions and similar products for a further year to 30 June 2023.
>
> The minimum drawdown requirements determine the minimum amount of a pension that a retiree has to draw from their superannuation in order to qualify for tax concessions. Given ongoing volatility, this change will allow retirees to avoid selling assets in order to satisfy the minimum drawdown requirements.
>
> This measure is estimated to decrease receipts by $50.0 million and increase payments by $2.8 million over the forward estimates period.

The SMSF and super industry loved it because it gives flexibility and retains funds in accounts. **SMSF Association CEO John Maroney** said:

"The temporary reduction in the minimum drawdown rates will help retirees manage the impact of volatility in financial markets. The reduction is designed to reduce instances where retirees may have to sell some superannuation investments in a volatile or depressed investment market simply to satisfy the Government's minimum pension drawdown requirements, so, in the current geopolitical and Covid climates, extending the cut in drawdown rates is an important initiative that will help many retirees."

Even the Treasurer now loves retirees, somewhat ironic given it was **Scott Morrison** as Treasurer who introduced the caps on the amount allowed in super pensions. Said Frydenberg:

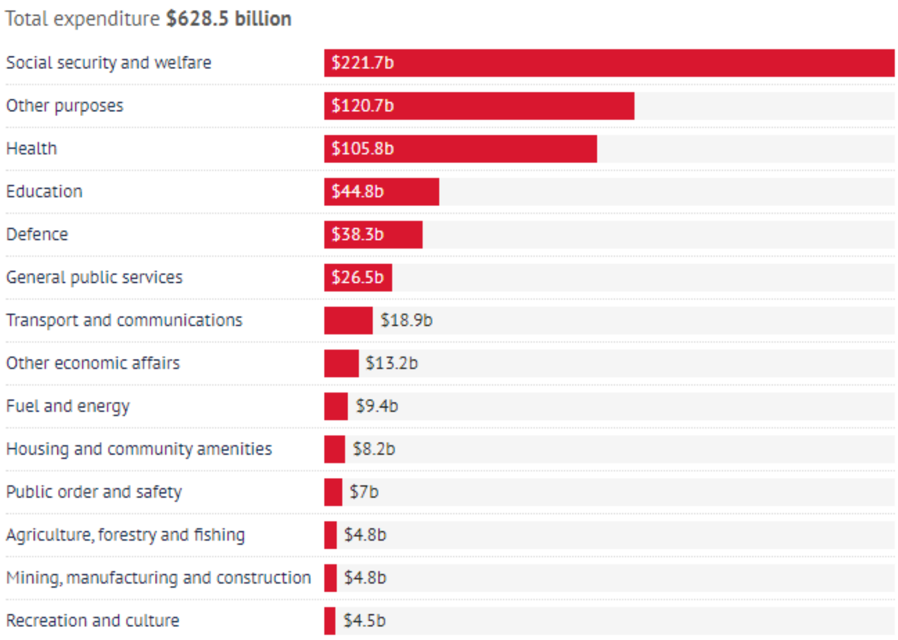
"We recognise the valuable contribution self-funded retirees make to the Australian economy and the sacrifices they made to provide for their retirement. This will provide retirees with greater flexibility and certainty over their savings."

Let's remember these words if Frydenberg becomes Prime Minister and looks again to target overly-generous retirement benefits.

In reality, the 50% drawdown reduction is no less an election ploy than the other handouts. It allows people to retain more money in tax-advantaged super when policy directs it should be drawn out. Markets have recovered strongly from the pandemic and most retirees are far wealthier than when this measure was introduced for a year in 2020, especially with the skyrocketing value of their homes. Anyone managing a superannuation pension who does not have the minimum legislated amount available in cash is not planning retirement properly. Nobody should need to '*sell in depressed markets*' - and markets are not depressed anyway. It's another election sop with the Treasurer knowing around 1.8 million accounts are subject to the minimum drawdowns.

Looking longer term beyond the next election, the government's dilemma is to move to some semblance of fiscal responsibility while meeting expanding costs of health, education, NDIS and other welfare. A potential saviour is higher commodity prices, which are delivering a massive bonus and making Treasury's predictions of only a few months ago look conservative. Treasury also overestimated the damage caused by the pandemic on health and the economy, with low unemployment and a reduction in welfare costs kicking in.

Here's a snapshot of where all the money goes (the second item, 'Other purposes', is mainly payments to states and territories).

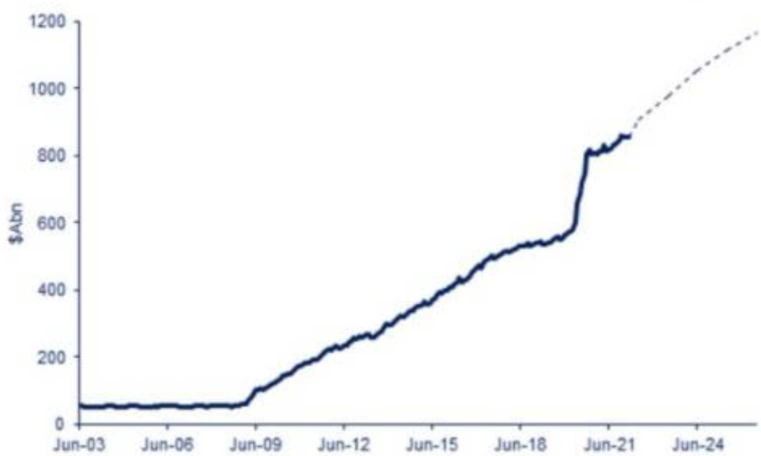


Source: TREASURY PAPERS

Financing a trillion dollars of debt becomes more expensive with higher interest rates, especially as the Reserve Bank scrapped its $350 billion bond buying program in February. This means real investors need to be found at higher yields. Hard to believe we were worried about having no bonds on issue only a decade ago.

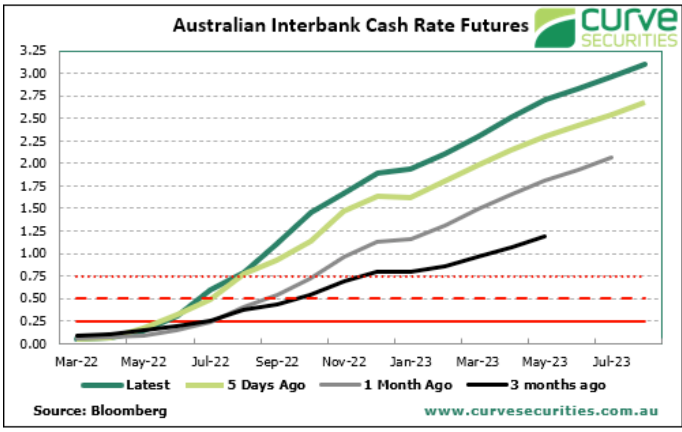
Bonds are seeing the type of volatility usually expected in equity markets, with the Bloomberg Aggregate Bond Index (US investment-grade bonds) falling in price over 6% this year, the worst quarter since 1980. Losses on global bonds are even higher.

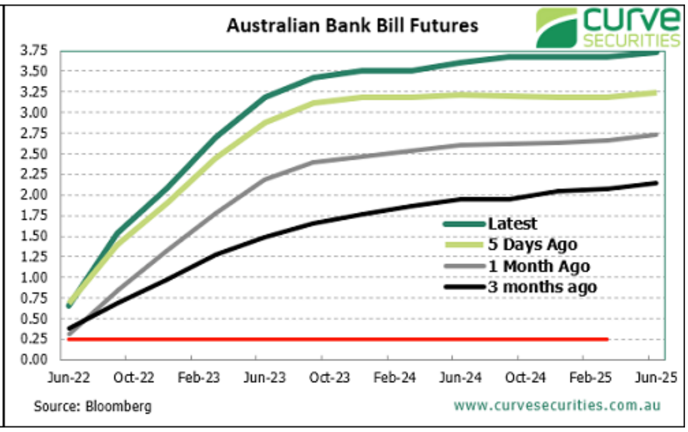
Chart 6: Australian Commonwealth Government Bonds on Issue (dotted line is Treasury forecast)



Source: Commonwealth Treasury and JBWere. Past performance is not a reliable indicator of future performance.

This week, we look at [inflation and interest rates] with a few fresh perspectives and consider what the Reserve Bank will do over 2022 and 2023, knowing the central bank is itself guessing. Let's hope they guess right because if the futures markets are correct, as shown below, many borrowers will be handing over the keys and losing their dream. A bank bill rate of 3.5% would see variable mortgage rates near 6%. Surely not.





Graham Hand

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Also in this week's edition ...

Remember how in 2020, Treasurer Josh Frydenberg banned conflicted remuneration called stamping fees, particularly targetting Listed Investment Companies and Listed Investment Trusts (LICs and LITs). Treasury had found many advisers and stockbrokers were not acting in the best interests of their clients. Now, with a rapid expansion of investors qualifying as 'wholesale', LICs and LITs are back and the issuers are lining up again.

Shane Oliver and **Diana Mousina** give their highlights of the 2022 Budget, noting that 'fiscal repair' in the medium term is in the form of restrained spending rather than austerity. Pre-election, the Budget aims to create far more winners than losers but with some stings in the tail.

The conventional logic is that bigger is better when it comes to population and innovation. More people means more researchers and innovators and more consumers to buy products services. However, **Emma Davidson** sees many benefits in the inevitable decline in global population.

Cameron McCormack explores how investors can navigate changing economic conditions by incorporating factors into their investing approach. He explores how quality, momentum, growth and enhanced value perform throughout the economic cycle.

The Covid-19 pandemic, and the range of policies aimed at mitigating its impact, has triggered a return to levels of inflation unseen for 40 years. **Ashok Bhatia** believes that there is a strong case for thinking about inflation in the asset allocation process, but also how it fits into the broader objective of portfolio diversification and income generation.

And finally, supply chain pressures highlight the important role and economic value created by companies working to make our infrastructure more efficient. **Francyne Mu** reviews two logistics companies that are well positioned to perform.

Conflicted selling fees are back, and it’s game on

Graham Hand

In 2020, in a high-profile change, Treasurer Josh Frydenberg extended the ban on fund managers paying selling commissions to financial advisers and stockbrokers. We have covered the subject extensively. The ban on certain issues was good policy because the fees tempted advisers and stockbrokers to act in their own interests to earn a 'stamping fee', rather than offering the best investment for their clients.

So what’s this in the offer document for a new Listed Investment Trust (LIT)?

*“The Manager proposes to pay a **stamping fee** to the Joint Lead Arrangers and Joint Lead Managers in respect of all Applicants who are certified to be **Wholesale Clients**.”* **(my bolding)**

The definitions of 'wholesale' and 'retail' clients, and the ease of qualifying as wholesale, are driving a reversion in the way new issues and other products are sold and a return to the bad old days of potential conflicts of interest.

The wholesale push is widespread but includes some surprising developments. The Commonwealth Bank endured years of agony sorting out the mess in financial advice due to conflicted remuneration, yet anyone who registers as a wholesale investor with its stockbroking arm, CommSec, must sign a document which says:

"I acknowledge and accept I will lose the retail protections which are available under the Corporations Act 2001 (Cth) which include but are not limited to … (CommSec) acting in my best interests; and access to CommSec's internal and external dispute resolution services."

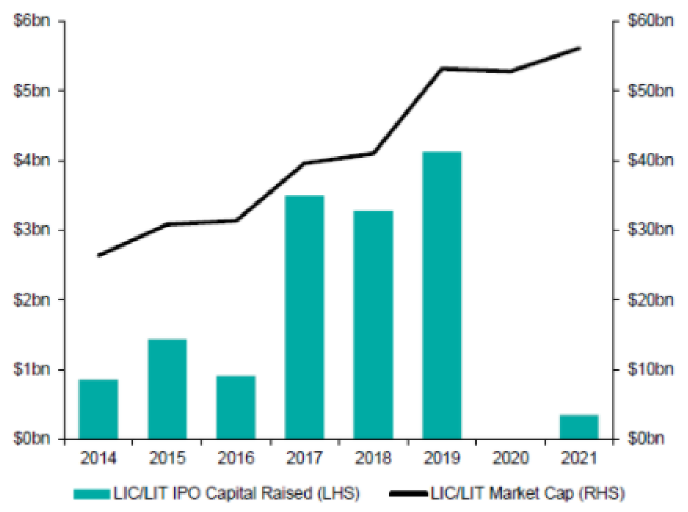
The Bank spent a billion dollars employing an army of consultants and compensating people for poor advice while divesting itself of financial services businesses, and now its stockbroker is absolving itself of the need to act in the client's best interests and even refusing access to dispute resolution.

What's going on?

Not a good look for financial advisers and stockbrokers

It was incriminating for many (but far from all) financial advisers and stockbrokers when the banning of stamping fees closed the Listed Investment Company (LIC) and LIT new issue market in 2020. As the chart below shows, a record amount of over $4 billion was invested in new LICs and LITs during 2019, up from $3.3 billion the previous year. In a golden period for issuers and arrangers, over $10 billion was placed with investors in only three years. Assuming a 1% stamping fee, that was $100 million to share around. And then it stopped.

LIC and LIT new issues, 2014 to 2021



Source: Bell Potter

Why? The main reason was that in January 2020, Treasury began a review of stamping fees paid for placing LICs and LITs with retail investors, leading to a ban a few months later. Treasurer Josh Frydenberg said at the time:

"The Government's changes will ensure that listed investment companies are treated no differently to any other managed fund that invests in the same assets. These changes will provide the sector with certainty and address the risk of mis-selling."

Issuing had become so dependent on conflicted fees that when the fee was no longer paid by the issuer, the market closed. Another reason was the poor investor experience from some large LICs and LITs issued in 2019 which sunk to significant discounts to NTA, suggesting the placements had not been well targetted with firm end investors.

We wrote at the time in this article:

"Can anyone deny that many brokers and advisers are motivated by the selling fee? Some of the advisers rebate the fee but what about the rest? Was a LIT offered in a particular month the best fixed interest fund available, and so much so, it deserved a billion dollars? That's a stretch."

Since 2020, despite record inflows to the competitor vehicle, Exchange Traded Funds (ETFs), the only new LICs have been driven by existing clients of Wilson Asset Management and Salter Brothers.

Amid major reviews of the financial advice industry, including new education standards and guidelines, stamping fees are a legacy incentive putting advisers and brokers in conflict with their clients. When many people celebrated the banning of stamping fees, they overlooked one thing.

The ban applies only to retail clients.

Jumping through a loophole

The floodgates are opening. In the two years since Treasury's so-called ban, a threshold has been reached where enough product distributors (financial advisers and stockbrokers) are either running their businesses by accepting only 'sophisticated' or wholesale clients, or they have identified the qualifying clients in their overall business.

Legislation such as the [Financial Planners and Advisers Code of Ethics] applies to protect retail clients only, such as this definition:

***"client**, in relation to a relevant provider, includes a retail client of the principal of the relevant provider."*

When Standard 7 of the Code of Ethics says the following, it applies only to retail:

"You may not receive any benefits, in connection with acting for a client, that derive from a third party other than your principal."

Without the same protections afforded to retail clients, it is far easier to offer new issues. The CommSec website includes this section headed: "*The Risks of Being a Wholesale Client"*:

- *You'll need to make your own evaluation of investment opportunities without being provided disclosure documents such as a Prospectus or Product Disclosure Statement (PDS).*
- *You'll make investment decisions without the same protections as Retail clients where the risk is entirely borne by you.*
- *We'll contact you (either by email and/or phone) to let you know when a wholesale or other investment offer occurs.*

None of those tiresome Statements of Advice. No need to jump through hoops deciding whether an issue is suitable for a client. Clients are sophisticated so it is their problem.

I'm not saying CommSec will act against the best interests of its clients but why ask customers to sign a document accepting that CommSec has the right not to act in the client's best interests?

It's game on for LICs and LITs and other products such as property syndicates, private placements and hybrids directed at potentially millions of clients who qualify as sophisticated.

DDO obligations have encouraged the move

Ironically, advisers and brokers have been assisted by compliance with the new Design and Distribution Obligations (DDO) meant to protect investors. Under DDO, issuers have decided that hybrids, for example, can only be distributed to sophisticated investors.

For the recent issues by ANZ and CBA, brokers registered qualified clients as sophisticated and now they have a large database that can be sold to outside retail protections.

This is what potential applicants for ANZ's recent hybrid issue were advised, even those who simply wanted to rollover their previous holding:

"If you want to apply for ANZ Capital Notes 7, you must be a client of a syndicate broker ... and either a wholesale investor, or a retail client within the Notes Target Market who has received personal advice from a licensed professional adviser."

Out of the blocks and running

Entering this back-to-the-future world is the first of many expected new LICs and LITs, the PIMCO Global Income Opportunities Trust (proposed code on ASX:PMX), currently in the market seeking $500 million with potential for oversubscriptions of another $200 million.

(This article makes no attempt to analyse the merits of the transaction. We are drawing attention to the distribution processes and changes in advice businesses).

Page 69 of the Product Disclosure Statement says:

(i) Remuneration of financial advisers

The Manager will pay the fees (some of which are based on the volume of funds raised, as explained below) payable to the Joint Lead Arrangers and Joint Lead Managers (see Section 11.2), some of which may also act as financial advisers.

The Manager proposes to pay a stamping fee to the Joint Lead Arrangers and Joint Lead Managers in respect of all Applicants who are certified to be Wholesale Clients. However, no stamping fee will be paid in respect of an Applicant who is not certified to be a Wholesale Client.

In addition to fixed payments for respective roles, the fees are outlined in clause 11.2 on page 76:

* 0.55% for the first $40 million of allocations made to Wholesale Clients
* 0.75% of the next $20 million of allocations made to Wholesale Clients
* 0.90% of any further allocations made to Wholesale Clients raised in excess of $60 million; and
* a broker fee of 0.75% of the total dollar amount of all allocations made by that Joint Lead Manager to Wholesale Clients.

Brokers share the fees with financial advisers. It's the first big LIC or LIT since 2019, proving that there are now enough identifiable wholesale investors to drive a large offer.

Is it difficult to qualify as sophisticated?

Becoming a wholesale investor is significant as clients agree to lose the retail protections under the Corporations Act. Not only have such protections been argued about and developed for years, but billions of dollars have been spent on fines and costs of non-compliance. Some may argue that retail investors never read Statements of Advice or Financial Services Guides, but that's another story. Obviously, governments and regulators think they are necessary.

Given the lack of protection when accessing this wonderland of new issues, surely it's difficult to qualify. No, it's relatively easy and millions of Australians are eligible. To qualify, a 'sophisticated investor form' must be completed, certified by an accountant, confirming the investor has:

- Net assets of at least $2.5 million, or
- Gross income of at least $250,000 per year for the last two financial years.

There is no requirement that the client demonstrate any standard of knowledge about investing or products. The $2.5 million threshold is not indexed and has not changed since its introduction in 2002 and the amount **includes** the net value of the family home. It is not investible assets, it is all assets.

CommSec is far from alone and the common retail protections lost include:

- Financial Services Guide which explains services and fees charged.
- Disclosures and warnings about conflicting interests in financial advice.
- Fee disclosures or consequences of replacing one product with another.
- Access to internal complaints handling procedures for retail clients.

Modelling by Australian National University Associate Professor Ben Phillips, commissioned by Coolabah Investments, and reported by *The Australian Financial Review*, suggests the wholesale investor test is met by 16% of Australians, or over one million households and 3.25 million consumers. It was only 100,000 in 2002.

Let's face it, these are the people that advisers want anyway, not only to reduce compliance, but because they have the money. It further excludes retail clients from the financial advice process as businesses switch their entire operating model to cater only to wholesale. Given the rise in home prices in the last year, these eligibility estimates are probably conservative.

A person who knows little about investing and whose house has risen in value to $2.5 million, or who inherits a valuable estate, or otherwise has wealth without financial expertise, is considered sophisticated and can be targeted. It's reinstating the reason why stamping fees were banned two years ago.

ASIC surveillance of fund marketing

In a strange juxtaposition, at a time when such consumer protection is watered down, the Australian Securities & Investments Commission (ASIC) announced last week:

"a surveillance into the marketing of managed funds, to identify the use of misleading performance and risk representations in promotional material. ASIC is scrutinising traditional and digital media marketing of funds,

including search engine advertising, targeting retail investors and potentially unsophisticated wholesale investors, such as some retirees."

So now we have a new term, '*unsophisticated wholesale investors*'. Wait a minute. Anyone who has net assets over $2.5 million is defined as sophisticated. There is no requirement to identify the unsophisticated people among them.

ASIC is especially focussed on its Regulatory Guide 234 *Advertising financial products and services (including credit): Good practice guidance* (RG 234) which states:

- Marketing must give balanced messages about returns, features, benefits and significant risks.
- Risk disclosure needs to be clear and prominent.
- The safety, reliability or security of an investment should not be overstated.
- Comparisons with other products or benchmarks must be appropriate and reasonable.

When a new issue is in the market, do advisers need to explain why it is better than the thousands of other products already on offer, and reveal the fees being earned? For example, on the PIMCO transaction, the management fee is 1.24%, plus indirect costs of 0.18%, plus transaction costs of 0.02%. Will 'unsophisticated wholesale investors' be told that a fixed interest fund will charge 1.44% per annum?

Not all advisers are the same

Many financial advisers charge their clients a flat fee for service and reimburse commissions received. For example, in response to a Firstlinks article on this subject in January 2020, Richard Brannelly from CommonCents Financial Planning in Toowoomba commented:

"As a professional financial planner with almost 20 years experience in helping clients I cannot think of a single valid justification an adviser could use to accept the "stamping" fee. I believe a very large percentage of my colleagues would feel the same, but I would like to know how many licensees and advisers are accepting such fees. A true profession will call out such behaviour in the interests of consumers. The time for such conduct has well and truly past and if individual advisers cannot do the professional and ethical thing then legislation to remove the exemption is the only recourse."

The legislation subsequently introduced had the desired impact for a couple of years, but with business models changing and many clients now registered as sophisticated, it's game on.

Graham Hand is Editor-At-Large at Firstlinks. This article is general information and based on an understanding of current legislation.

Investing throughout economic cycles

Cameron McCormack

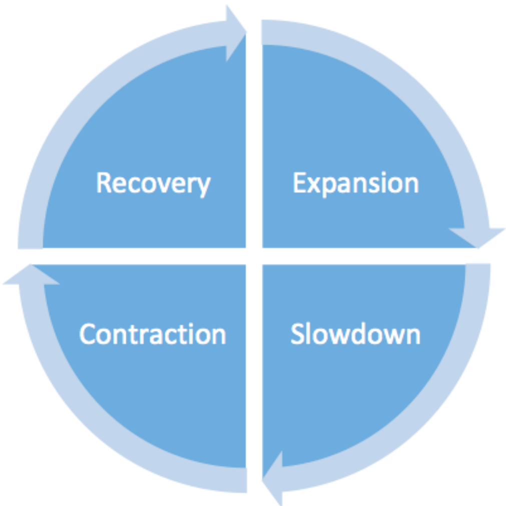
Four identifiable stages make up the economic cycle. They are: expansion, slowdown, contraction and recovery.

The direction and the pace of economic activity identify these cycles.

- An expansionary environment is when growth is expanding and an a faster rate;
- A slowdown occurs when economic activity is slowing down after an expansion;
- A contraction occurs when economic growth is negative and it is still falling; and
- A recovery is when economic growth, after the trough of a contraction, starts to head toward growth.

The Purchasing Managers' Index (PMI) is an index used to measure the prevailing direction of economic trends in the manufacturing and service sectors. It measures the change in

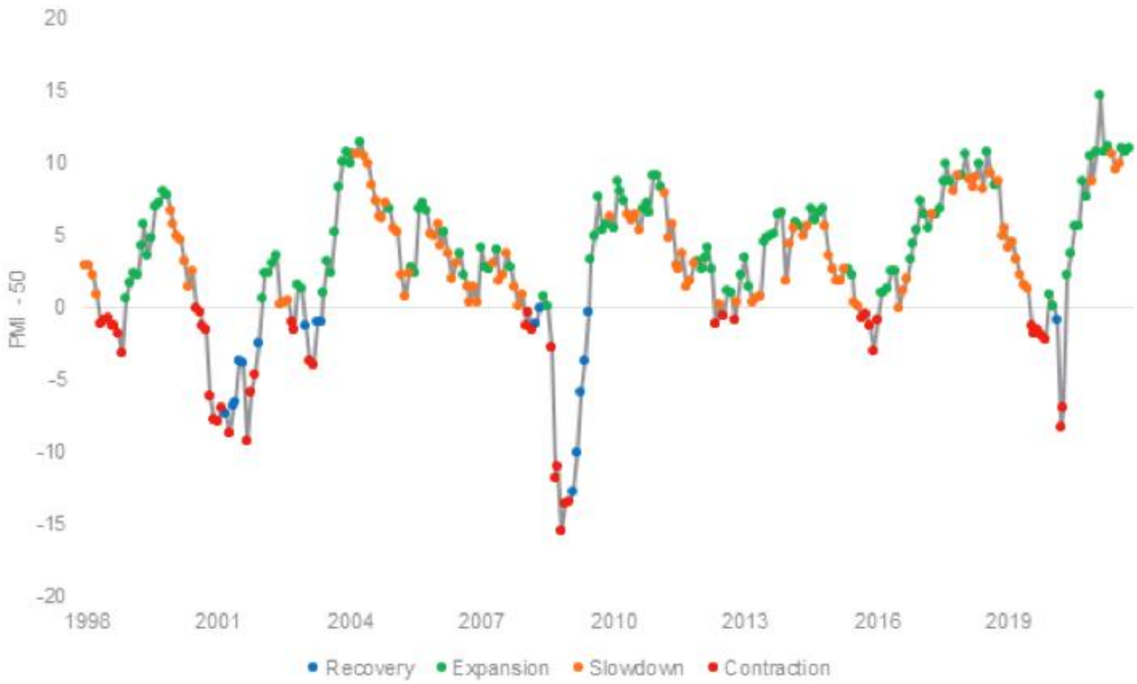
Chart 1: The economic cycle



Source: VanEck

production levels across the economy from month-to-month so is considered a key indicator of the state of the economy. The chart below shows the three-month rolling PMI changes since 1997, highlighting the stage of the economic cycle at that time.

Chart 2: ISM Manufacturing PMI Index



Source: VanEck, Bloomberg. November 1998 to January 2021.

Over that same period, the international share market, as represented by the MSCI World ex Australia Index, has risen despite the falls experienced in the dot.com bust, the GFC and the COVID crisis.

Chart 3: Growth of 10,000: MSCI World ex Australia Index

Source: Morningstar Direct, as at 31 January 2022. Past performance is not a reliable indicator of future performance. You cannot invest in an index. Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude fees and costs associated with investing

The MSCI World ex Australia Index above is a market capitalisation index. For Australian investors this is the 'market' for international equities. While it has risen over the past 25 years, according to MSCI, "Over time, individual factors have delivered outperformance relative to the market."1 That is factors have risen more.

These individual 'factors' are any characteristic that helps explain the long-term risk and return performance of an asset. According to MSCI "Factors are well documented in academic research and have been used extensively in portfolio risk models and in quantitative investment strategies. Active fund managers use these characteristics in their security selection and portfolio construction process."

MSCI's factor indices, which aim to capture the risk and return of factors, perform differently during different economic regimes. We analysed the performance of MSCI's equity style factors of enhanced value, momentum, quality and growth since 1998 during the different economic regimes outlined above, in Chart 2. The performance of each factor broken up by each economic 'season' is presented below.

Table 1: Total performance (% per annum) during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value	Benchmark
Recovery	9.16%	5.07%	4.35%	13.72%	2.89%
Expansion	13.89%	20.58%	16.93%	18.31%	15.23%
Slowdown	5.72%	6.81%	2.54%	1.65%	2.07%
Contraction	5.07%	-7.30%	-2.80%	-3.15%	-2.36%
Since Inception	9.26%	9.88%	7.69%	8.38%	6.83%

Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance.

You can see that the quality factor is either the top performing factor or the second best in three out of the four economic regimes. It is second overall. During the one season of the economic cycle, quality came fourth, expansionary environments, enhanced value and momentum outperformed.

Another way to consider the performance above is relative to the benchmark. This is shown in the table below. You can see that quality's relative underperformance during expansion is dwarfed by its strong relative outperformance during recoveries and contractions. Enhanced value meanwhile has the highest outperformance figure in the table below, during a recovery, while also offering strong performance during the subsequent expansions. The lowest figures in the tables 1 and 2 are under momentum, which falls the most, during contractions.

Table 2: Performance differential (% per annum) compared to MSCI World ex Australia benchmark during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value
Recovery	6.26%	2.17%	1.46%	10.82%
Expansion	-1.34%	5.35%	1.70%	3.08%
Slowdown	3.65%	4.74%	0.47%	-0.42%
Contraction	7.43%	-4.94%	-0.44%	-0.79%
Total	2.43%	3.05%	0.86%	1.56%

Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance. Performance differential is calculated by subtracting the total return from the return of the benchmark.

Naturally, investors are concerned about negative returns and volatility. These are risks. The information ratio combines the return differential with the volatility of those returns. Traditionally it has been used by investors is to evaluate the skill of a portfolio manager at generating returns in excess of the benchmark. The higher the information ratio, the better.

Table 3: Information ratio during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value
Recovery	0.20	0.02	0.05	0.41
Expansion	-0.08	0.20	0.13	0.13
Slowdown	0.24	0.18	0.02	0.03
Contraction	0.39	-0.15	0.00	-0.01
Over analysed time period	0.14	0.10	0.06	0.08

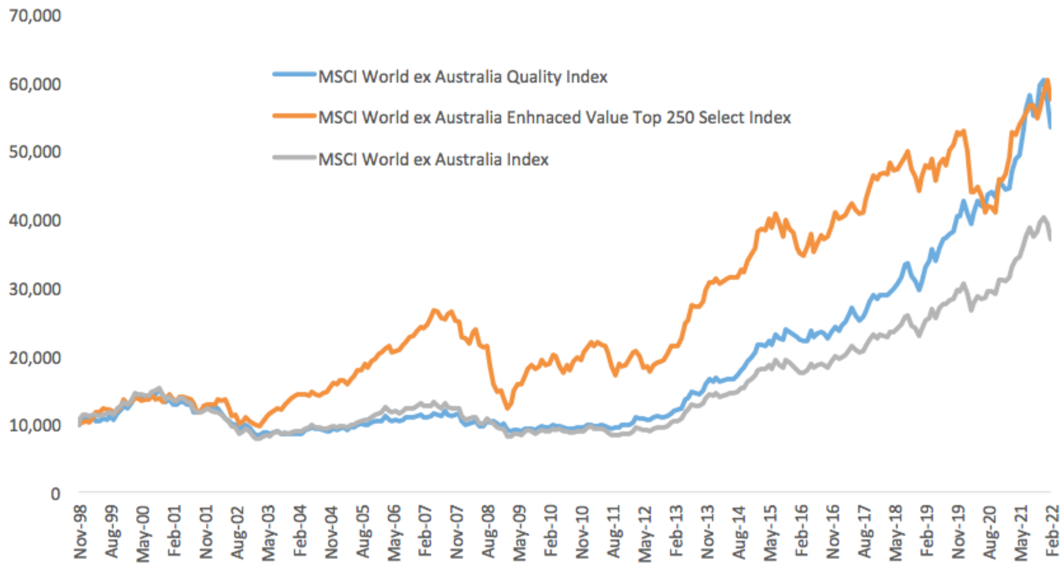
Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance.

You can see from the above that quality has the highest information ratio in slowdowns and contractions and is second to enhanced value during recoveries. Quality has the highest information ratio over the time period analysed, indicating it has the best risk adjusted relative returns over the period.

You can see from the above, while quality does have periods of underperformance, its potential to outperform through the cycle means it could potentially be used as the factor for all seasons. During those periods of recovery into expansion, the enhanced value factor could be also be considered, especially in consideration of its strong risk and performance during recoveries.

The chart below is the same as chart 3 above, updated to include MSCI's quality and enhanced value indices. You can see, consistent with MSCI's findings, these factors have delivered outperformance relative to the market over time. Prior to the GFC as economies were recovering and expanding (more green and blue dots in chart 2) enhanced value outperformed. During the contraction and sluggish growth (slowdown) following the GFC and the COVID-19 lockdowns, quality came to the fore.

Chart 4: Growth of 10,000: MSCI World ex Australia Index, MSCI World ex Australia Quality Index and MSCI World ex Australia Enhanced Value Top 250 Select Index



Source: Morningstar Direct, as at 31 January 2022. Past performance is not a reliable indicator of future performance. The above graph is a comparison of performance of MSCI World ex Australia Quality Index, MSCI World ex Australia Enhanced Value Top 250 Select Index and the parent index, based to 10,000 from 30 November 1998. Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude fees and costs associated with investing in VLUE or QUAL. You cannot invest in an index. QUAL's Index base date is calculated at 30 November 1994. QUAL Index performance prior to its launch on 15 October 2014 is simulated. VLUE's Index base date is calculated at 30 November 1998. VLUE Index performance prior to its launch on 15 February 2021 is simulated. The MSCI World ex Australia Index ("MSCI World ex Aus") is shown for comparison purposes as it is the widely recognised benchmark used to measure the performance of developed market large- and mid-cap companies, weighted by market capitalisation. QUAL and VLUE's index have fewer companies and different country and industry allocations than MSCI World ex Aus.

It is challenging for investors to navigate economic conditions and prevailing markets. ETFs that capture the factors outlined are being used by savvy investors as tools, to either hold through the cycle, or blend, to help mitigate the troughs of the cycle.

Cameron McCormack is a Portfolio Manager at [VanEck Investments Limited](), a sponsor of Firstlinks. This is general information only and does not take into account any person's financial objectives, situation or needs. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act.

VanEck recently launched two microsites to help investors understand the quality and value factors:

- You can learn about quality here – click here
- You can learn about value here – click here

The pages include videos and flyers. They also highlight other investment approaches that capture the quality and value factors. As always we recommend you speak to an investment professional to determine which investment is right for you.

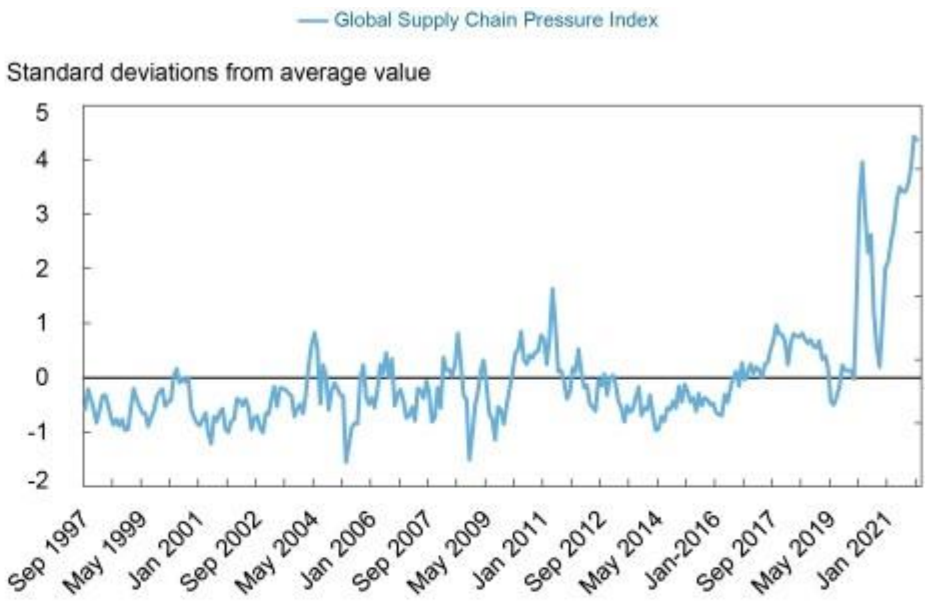
[1]– Introducing MSCI Factor Indexes

Two companies well-positioned amid supply chain disruption

Francyne Mu

As we review the daily headlines chronicling the tug-of-war between inflation and interest rates, we are reminded what a difficult job macroeconomic investors have and how grateful we are to be fundamental investors.

As challenging as it was to predict Covid-19, it would have required truly profound foresight to conceive that a supply chain crisis would rank amongst the most impactful financial consequences of the world's first pandemic in modern history. And yet, as of this writing, the supply chain situation and its resulting inflationary implications have captured investors' and policymakers' attention to the degree that the New York Federal Reserve has recently created a new Global Supply Chain Pressure Index (GSCPI) to help track the health the global system.



Sources: New York Federal Reserve Bank, Bureau of Labor Statistics; Harper Petersen Holding GmbH; Baltic Exchange; IHS Markit; Institute for Supply Management; Haver Analytics; Bloomberg L.P.; authors' calculations. Note: Index scaled by its standard deviation.

While the underlying cause of this newfound supply chain focus is unfortunate, we believe the increased attention will be positive in the long run for both the companies innovating within the supply chain space and consumers globally.

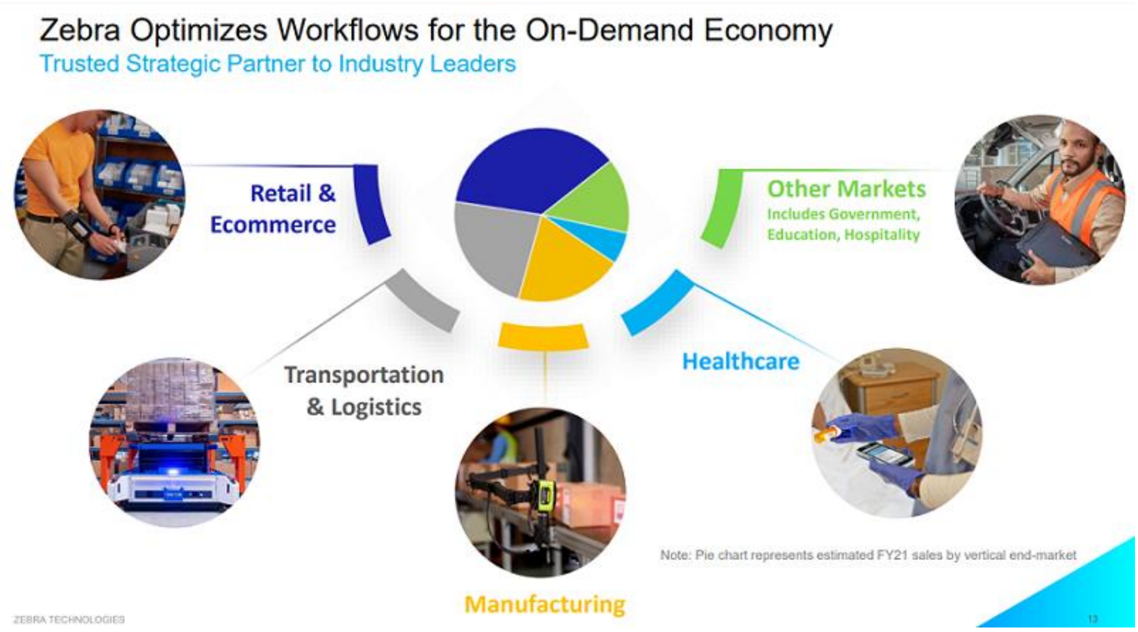
Since before the outbreak of Covid-19, our Global Growth team has been analysing and investing in companies working to increase supply chain efficiencies. In this article, we take the opportunity to review two companies that we see as well-positioned to support a more efficient and robust global supply chain to the benefit of all stakeholders.

Note: The information provided should not be considered a recommendation to purchase or sell any particular security.

Zebra Technologies Corp – Omnichannel automation and integration for retailers

Zebra Technologies Corp (Zebra) designs, manufactures and sells automatic identification and data capture products. Its barcode printers and scanners help companies manage their inventories and assets investment more accurately and efficiently.

Zebra's products and solutions facilitate the digitisation of a company's physical workflows so that they can be more effectively implemented, tracked, and analysed in real-time. For example, Zebra's RFID solutions enhance warehouse managers' capacity to audit and record incoming and outgoing freight, by enabling significantly faster throughput and reduced error rates. Pairing these RFID capabilities with Zebra's barcode scanning technology allows for real-time, point-to-point freight tracking throughout the world, which enhances resource planning and customer response. These scanners and data analysis capabilities allow retailers to accept returns and reintegrate merchandise back into existing inventory.



The company is one of the leaders in its market. Its research spending is nearly twice that of its nearest competitor, helping to maintain its market position. Zebra has reduced its debt and now has the capacity to pursue acquisitions and or share repurchases. Profitability metrics have also improved in recent years.

Zebra is experiencing robust growth, due to both recent acquisitions and several underlying secular trends. Companies are increasingly investing in scanners and other equipment to compete with Amazon's fulfillment speed and customer service. Retailers are also investing more in omnichannel sales, and Zebra's products help keep track of inventory and route sales to customers through the most convenient location. Other areas such as health care are underpenetrated but growing markets for data capture and analysis technologies.

Increased expectations of on-demand fulfillment and rising costs of logistics and inventory storage, places the company in a compelling position to help its clients and their consumers reduce waste and increase service reliability through more effective inventory management systems technology.

DSV Freight Forwarding – Creating scale-based economies for all stakeholders

DSV is a global transportation and logistics company. Acting as a facilitator and coordinator, DSV serves companies looking to ship goods across the globe across a variety of transport methods including, land, sea and air. The company acts as the metaphorical grease in the wheels of a complex global supply chain. In 2021, the company shipped over 4 million tons of air and sea cargo, with each shipment having its own unique requirements that DSV had to coordinate.

2021 was a very challenging year for DSV due to Covid-19's disruption of global supply chains. However, the scale and capabilities that DSV possess placed it in a compelling competitive position to serve its customers.

For example, with a large portion of transcontinental passenger aircraft grounded - planes that usually carry 40-50% of all airfreight - a severe shortage of airfreight capacity developed nearly overnight, often stranding freight in various regions. DSV's large-scale and established agreements with dedicated freight aircraft owners enabled it to secure air cargo space for its customers to keep their freight moving.

Air Freight Inbound Price Index (2006-2022)

Additionally, with airfreight capacity materially reduced, rates to ship freight via air increased substantially. Here too, DSV's scale and existing rate agreements enabled them to provide superior relative cost to their customers.

DSV is one of the largest and fastest-growing freight forwarders in what has historically been a highly fragmented industry. We see significant room for continued market share gains and consolidation in the large, highly fragmented freight and logistics markets. DSV's recent acquisition of Switzerland-based Panalpina Welttransport Holding AG has the potential to create significant value for both stakeholders and shareholders, similar to what the company achieved with its successful UTI acquisition.

DSV's culture and people are at the core of its competitive advantage. Logistics is a complex and rapidly evolving business, and it requires both rigorous processes and employee focus to achieve excellent customer service while preserving margins.

We believe the combination of greater scale, focused culture and strong global trade trends over the longer term places the company in a compelling position to expand its market-share whilst achieving attractive margins.

Better supply for a better-coordinated future

Economists have long remarked upon the power of trade to bring people together, but it took the Covid-19 pandemic to show the degree to which we are all adversely impacted when our supply chain infrastructure breaks down.

It is our expectation that the renewed focus on the infrastructure underpinning our economies from stakeholders spanning individuals to corporations, NGOs and governments will highlight the value that companies such as Zebra and DSV provide by investing in innovation to deliver more reliable and efficient supply systems.

Francyne Mu is a Portfolio Manager of the Franklin Global Growth Fund. Franklin Templeton is a sponsor of Firstlinks. This article is for information purposes only and does not constitute investment or financial product advice. It does not consider the individual circumstances, objectives, financial situation, or needs of any individual.

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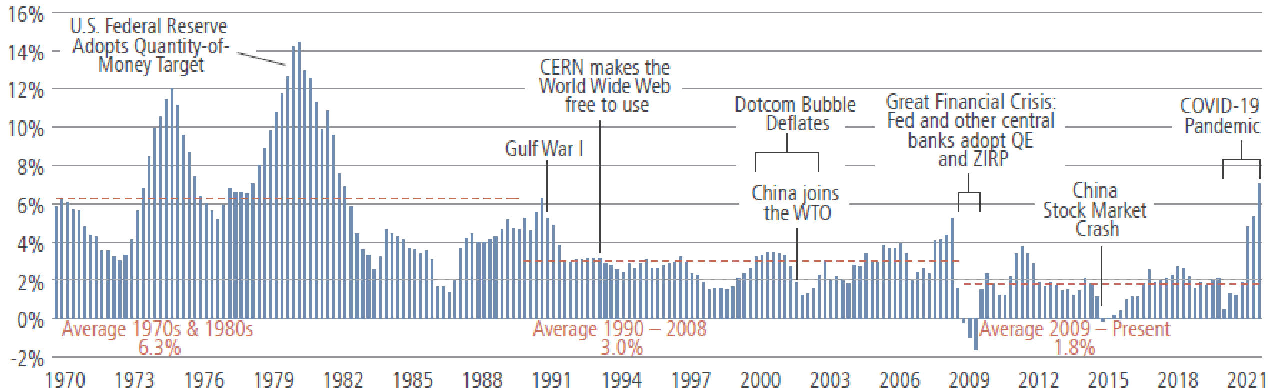
The inflation inflection: Adjusting to the new paradigm

Ashok Bhatia

The Covid-19 pandemic, and the range of policies aimed at mitigating its impact, has triggered a return to levels of inflation unseen for 40 years. While inflation is likely to moderate from these very high levels during 2022, we believe it will settle and persist at a rate higher than we have become used to over recent cycles.

We believe that makes a strong case for thinking about inflation in the asset allocation process, but also about the broader objective of portfolio diversification and income generation. Many investors could be lacking sufficient inflation exposure after experiencing such a long period of stable prices. Moreover, such a major economic inflection, combined with such fragile markets, is likely to be characterized by the kind of heightened market volatility we have already seen this year.

THE COVID-19 PANDEMIC HAS TRIGGERED A RETURN TO LEVELS OF INFLATION UNSEEN FOR 40 YEARS...
U.S. Consumer Price Index, year-on-year change, as of December 2021



Source: FactSet. For illustrative purposes only.

… AND WITH LITTLE SIGN YET OF HIGHER STRUCTURAL INFLATION IN LONG-DATED TREASURIES, MARKETS MAY HAVE A VOLATILE ADJUSTMENT AHEAD…

U.S. 5y5y forward breakeven inflation expectation, as of February 3, 2022

Source: Federal Reserve Bank of St Louis (FRED). For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

30 years fighting inflation, 10 years fighting disinflation

Monetary authorities brought the high inflation of the 1970s under control by aggressively raising policy rates. This set off 40 years of disinflation, pushed lower by the technological advances of the internet age and the absorption of the labor forces of China and other emerging nations into the global trading community. When inflation tipped into negative territory during the Great Financial Crisis of 2008 – 09, fiscal and monetary authorities intervened in the opposite direction, with large economic rescue packages, zero and even negative policy rates, and quantitative easing. They were preparing to withdraw these measures when the coronavirus pandemic compelled them to return to them more aggressively than ever. The 2020 lockdowns were initially disinflationary. Consumers saved at unprecedented rates. The impetus quickly turned inflationary, however, as governments supported exposed businesses and workers. Reassured consumers began to spend before many factory workers, farm workers, ship crews, lorry drivers and shop assistants had returned to their jobs. Even in the aftermath of war, it is rare for such fragmented and under-resourced supply chains to be met with such a wave of pent-up demand. Across Europe and the U.S., inflation hit levels unseen since the 1980s. The Bank of England (BoE) has already started raising interest rates, the U.S. Federal Reserve (Fed) has adopted a much more hawkish tone, and as eurozone unemployment and inflation hit their lowest and highest levels, respectively, in the era of the single currency, the European Central Bank (ECB) has followed suit.

Transition to structurally higher inflation could heighten volatility

Much of the supply-chain disruption associated with the pandemic is likely to subside. The current, extreme inflation is unlikely to last. But we see four major reasons why this could prove to be a lasting inflection point, leaving us with inflation that is structurally higher than we have become used to over the past 20 years.

De-globalization

- Supply-chain disruptions may not last forever, but they have been painful enough for companies to begin localizing and diversifying—leavening the "just-in-time" arrangements of the past 40 years with more "just-in-case" redundancy
- Governments are also encouraging re-shoring for security of supply, particularly in strategic goods such as semiconductors

China

- China's population is aging, barely growing and as urbanized as it is ever likely to be; as a result, its government now prioritizes equality, good health, the environment, and the automation of the economy over jobs-generating growth
- Decades of China exporting disinflation as the workshop of the world are over

Fiscal and monetary policy

- We perceive an implicit and explicit expansion of central bank mandates, which deprioritizes price stability relative to social goals such as the financing of sustainable infrastructure, full employment, greater equality and fiscal liberality
- Responding to the ongoing impacts of both the Great Financial Crisis and the pandemic, fiscal authorities around the world also appear to be adopting more populist economic policies that could tip the balance in favor of labor over capital, which we consider to be inflationary

De-carbonization

- The transition to renewable energy and an electrified economy is necessary but costly: cutting investment in carbon-intensive energy, while demand continues to grow and the supply of renewables is still being built, is likely to generate "Greenflation"—in energy commodities and the metals that are likely to play an important role in the net-zero economy

What might this mean for fixed income portfolios?

Fixed income portfolios are arguably most at risk from an inflationary environment. Inflation and higher rates tend to lower the present real value of a fixed income stream. The longer-dated those income streams are, the more sensitive their present value is to changes in rates—they exhibit longer duration. Should a long-term real yield of 1% or even zero be required to make inflation settle between, for example, 2.5% and 3.0%, nominal yields will be substantially higher than they are today.

We think the priority is to MITIGATE the impact of inflation.

- Short duration: Minimizes the negative impact of rising rates: with the Fed, the ECB and the BoE turning more hawkish on inflation, we favor this positioning in both U.S. and European markets
- Non-investment grade credit: To maintain yield with shorter duration, we favor adding credit risk with U.S. and European high yield bonds, dedicated short-duration high yield strategies, tradable bank loans and securitized debt
- U.S. municipal bonds: Short-duration, with somewhat lower credit risk, in many cases underpinned by a strong housing market
- Currency hedging: As cyclical uncertainty and higher inflation raises the potential of higher currency market volatility, hedging can help isolate and manage risks

Although inflation is generally challenging for bond portfolios, there are ways to TAKE ADVANTAGE.

- Treasury Inflation Protected Securities (TIPS) and other index-linked bonds: Short-dated U.S. TIPS were one of the few bond markets where total returns matched the 7% U.S. inflation rate in 2021, but they are now expensive—we think it is prudent to watch real yields for a more attractive entry point
- Floating rate securities: Tradable bank loans, private credit, securitized credit tranches and municipal variable rate demand obligations have already been outperforming due to their short duration—rising floating-rate coupons may add to their total return once central banks embark on their projected rate hikes
- Subordinated financial securities: Strong credit quality and attractive yields combine with the potential for financial sector issuers to benefit from rising interest rates

Bond markets offer ample ways to DIVERSIFY risk: via duration, credit risk, currency risk, regional risk, fixed or floating rates, senior or subordinated positions in capital structures.

Flexible strategies: The high level of cyclical uncertainty makes the case for "go anywhere" strategies that are able to shift with economic data and investor sentiment.

Finally, we expect company and sector exposures to become more differentiated. For example, sectors that should see stronger revenue growth, such as travel and leisure, likely have better tailwinds for performance than sectors that could see pressure from rising interest rates, such as housing. Likewise, rising labor costs are not impacting all companies or sectors equally: we observe more pressure in consumer products areas, for example. Therefore, we believe security selection would be important in to identifying sectors and companies that are relatively insulated against, or even potentially beneficiaries of, this inflationary environment.

These ideas are discussed in more detail in The inflation inflection: Adjusting to the new paradigm white paper.

Ashok Bhatia is Deputy Chief Investment Officer for Fixed Income at Neuberger Berman, a sponsor of Firstlinks. This material is provided for general informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. You should consult your accountant, tax adviser and/or attorney for advice concerning your own circumstances.

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Embracing the bright side of population decline

Emma Davidson

A growing body of research is showing that global population growth is slowing down and will likely drop into negative territory within the next few decades.

One study predicted that the global population would peak at 9.7 billion people in 2064 – up from around 7.9 billion currently – before falling to 8.8 billion by the end of this century. If this is true, it'll be the first sustained period of world population decline since the Black Death.

But what's worrying some experts today is that many countries are *already* seeing natural population growth come to a standstill. Here in Australia, the lack of immigration contributed to population growth of practically zero in the year to March 2021 . Similar stories are playing out in the UK, the US, and many other developed countries.

Shrinking populations and financial markets

What economic impact will these demographics shifts have? After all, we can't ignore the human aspect of our economies. Financial markets are complex, interconnected ecosystems, and our attitudes and behaviour are key to how they perform.

Well, when it comes to population decline, many analysts are bearish.

They say lower birth rates create ageing nations, with fewer people available to look after the elderly. These stretched workforces limit innovation and productivity. Growing economies need growing populations, it is claimed.

However, I believe this is an overly pessimistic view. I'm far more bullish about the impact of declining populations. There are many possible benefits to having fewer people in the world. And I suspect even the negatives aren't quite as bad as people suggest, given humans have an incredible knack for adapting to change.

Wage growth

It's widely thought that a smaller working-age population could lift wages. Fewer workers give the labour market greater bargaining power, leading to better working conditions.

There would also likely be more opportunities for women and ethnic minorities, increasing workforce diversity. Research shows that diverse organisations tend to financially outperform their less inclusive competitors. They are also six times more likely to be innovative and agile.

Economic growth might slow, but it is my hope that the above changes would lead to healthier, happier, and more engaged workers – and a more even wealth distribution.

The late Swedish statistician Hans Rosling argued convincingly for bringing the world's final 1 billion people out of extreme poverty to limit population growth and provide better opportunities for millions of families who are struggling.

I'm confident that humans can adjust to a 'new normal' where economic growth is still a goal, but not the only goal. Instead, perhaps we can focus more on creating a world where living standards and wealth distribution are our barometers of success.

Then, freed from poverty, some people will inevitably go on to become the scientists, entrepreneurs and leaders of tomorrow that we'll need when populations decline.

Innovation and productivity

The conventional logic is that bigger is better when it comes to population and innovation. More people means more researchers and innovators (as well as more consumers to sell to). And yet, only three of Bloomberg's top 10 most innovative economies have populations exceeding 10 million people (South Korea, Germany and Sweden).

So, it's clearly not just a numbers game.

Investing in education and encouraging more people to work in research and development also facilitates the flow of new ideas. Furthermore, automation can accelerate innovation and productivity by performing all of the tedious, time-consuming tasks that would usually fall to humans, freeing them up for more value-oriented work.

Initial predictions for automation were bleak. The 'rise of the robots' would mean job losses, economists said, as employers replaced workers en-masse with machines that never get sick or tired.

More recent research is challenging that theory. One study found that each robot per 1,000 employees boosts employment at a firm by 2.2%. Essentially, automation makes companies more competitive and profitable, helping them to grow the business and swell their ranks.

Sustainability matters

It's common to hear industry commentators make statements like "ignoring the environmental benefits for a moment" or "sustainability aside" when talking about population decline. But we can't simply forget about the environment. It's too important. Ever-growing populations continue to put a strain on the world and its resources.

Declining populations can help.

Researchers recently calculated that having one child fewer saves approximately 59 tonnes of CO_2 emissions per year. *"Having one less child saves each parent more than 20 times (of CO_2 emissions) as living without a car, or about 70 times as much as eliminating meat from the diet"* Sustainable Population Australia says.

To be clear, I'm not advocating that people should stop having children. I have written previously about the potential repercussions of a 'baby bust' if rising infertility rates are ignored. In addition, and as things stand right now, the global human population begins to decline at the end of this century and is likely to continue along the decline trajectory.

What I am wanting to highlight is the environmental benefits that are associated with population decline.

Finding the right balance

Of course, there are some roles that robots simply can't fill. Ageing populations will place more pressure on our healthcare and elderly care systems, for example. And it's hard to imagine artificial intelligence ever having as good a bedside manner as a real doctor or nurse.

Australia's healthcare and superannuation systems are excellent, which should relieve some of this burden. But we must also find ways to make certain roles, such as elderly care, more rewarding.

Automation is therefore just one piece of the puzzle. We must also recognise there are complex services that only humans can provide.

There are undoubtedly challenges we face with declining populations, and I don't pretend to have the answers.

But do our narratives have to be so gloomy? There is far more room for optimism based on the human capacity to adapt.

Emma Davidson is Head of Corporate Affairs at London-based Staude Capital, manager of the Global Value Fund (ASX:GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.

Yikes! Three critical factors acting on inflation and rates

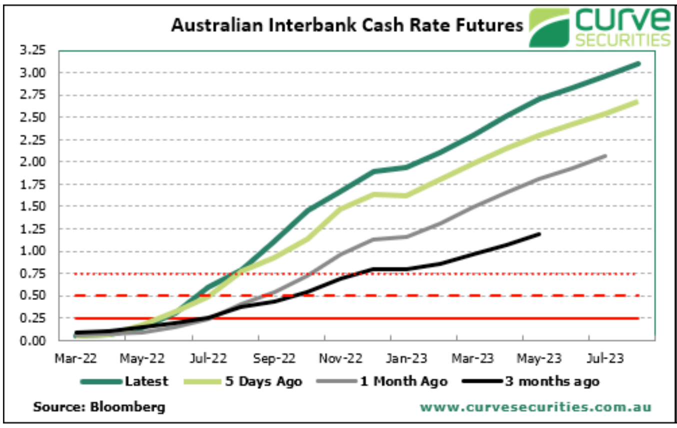
Graham Hand

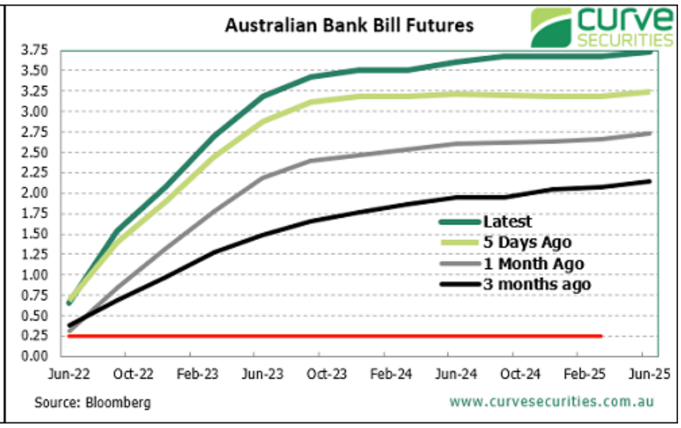
The 2022 Budget contains a healthy dose of sugar pills, but amid all the statistics, one number is most critical for thousands of Australian borrowers. Treasury is accepting that inflation will rise to 4.25% this financial year, and no doubt the Reserve Bank will need to respond with higher cash rates. But here's the potential lifesaver - the inflation forecast for next financial year is 3%. Transitory is back! And Treasury is expecting wages to rise 3.25% next year, making it a rise in real wages for the first time in years.

Treasury has a long history of inaccurate forecasts, and the latest Budget shows the Department was wildly pessimistic on the size of the deficit as recently as MYEFO only a few months ago. But the inflation rate is one number borrowers hope is close to accurate.

Futures market predicting a meltdown

The interest rate and inflation story continues to evolve almost by the day, and the outlook is becoming more acute. The chart below shows the upward revision in expectations as recent months have rolled by, with the market now forecasting the cash rate will rise from the current 0.1% to over 3% by July 2023. That's an amazing 12 0.25% increases. If the Reserve Bank announces a new rate rise almost every time it meets for the next year, followed by a rise in mortgage repayments, borrowers will become increasingly worried and stop spending. If variable rate housing rates head to 6%, thousands will default and property prices will fall.





Source: Curve Securities and Bloomberg, as at 29 March 2022

The rate expectations are driven by the need to control inflation, and widespread expectation that 'transitory' is an illusion. The Reserve Bank is trying to be patient, especially watching wages growth, and Governor Philip Lowe wants to wait until inflationary expectations are firmly entrenched. If Treasury is correct, inflation at 3% will not worry him, but companies are already passing on price increases to each other, and their clients.

Let's consider three influential factors.

1. Price increases passed through the value chain

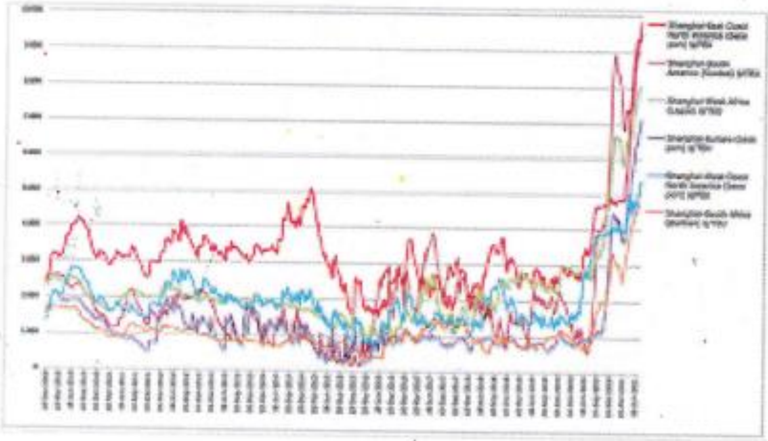
In an 11 March speech, Philip Lowe recognised the important of expectations:

"One issue that we're paying close attention to here is the inflation psychology. For many years, firms were reluctant to put up their prices and because they didn't want to put up their prices, they didn't want to put up wages. It's quite possible that a period of protracted headline inflation will see this psychology shift and firms will decide that they have to put up their prices, and if their prices are rising, then they can afford to pay higher wages. So we're watching very carefully for any shift in the inflation psychology. If that shift were to occur, inflation would be higher and it would be more persistent and we would need to respond to that in time."

Companies have reached the stage where it has become acceptable to pass on price increases at both the wholesale and retail levels, and this is likely to feed into wage demands.

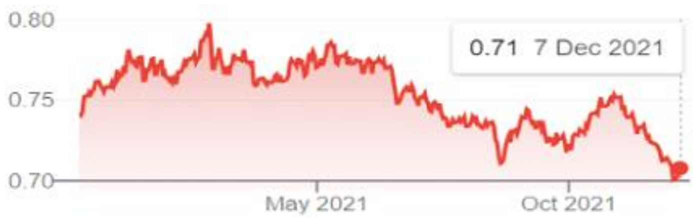
Here are extracts from a couple of letters received recently by a small family company that was holding off passing on increased prices to its retail customers, but finally gave in.

Due to Covid 19m impact around the world, we are experiencing real issues in supply delays. Further to this, we are seeing a dramatic increases in shipping container rates of 500%. We are now paying AUD$16,500 per 40 FT container from AUD $3000 we used to pay.
This equates to an increase of $0.80 per kilo increase across the board on incoming goods.
Please note below graph, indicating the container shipping rates.



We will try to limit price increase where possible, but we need to recover the extra container shipping charges where possible

As we wind up the year, to say it has been challenging, would be an understatement. Like a perfect storm, with a falling currency, rocketing ocean freight costs, shipping delays, pallet shortages and trouble at the ports, Australian businesses have been copping it from all angles.



AUD V USD

Shipping

The shipping delays and complete lack of visibility of stock, transiting through Singapore, continue to cause a great deal of frustration. Most shipping legs are experiencing delays of 6-8 weeks.

The largest impost on business, has been the rapid increase in shipping costs. We have been trying to manage and absorb as much cost as possible, engaging all suppliers to squeeze margins to minimise the impact of these increased shipping costs.

It is doubtful that this company will now reference the AUD rising to US$0.74 as a reason to give some price discount.

2. Philip Lowe's interpretation of the numbers

Followers of interest rates hang on every word from the RBA Governor, but it's clear that he does not have any great insight into what inflation is likely to do for the rest of the year. In fact, he wants to downplay what the market expects of him. This is from his [Press Club Q&A session] on 2 February 2022:

"I didn't expect us to be in this situation. We don't have a crystal ball, there's a lot of uncertainty. But what we have done is respond to the changed circumstances we find ourselves in, and I understand that in some people's eyes that damages our credibility. We don't have a crystal ball. Things happen that we don't expect. But what I hope you expect of us is that we respond to that and try and explain why. The result of that might be damaged credibility for the central bank, but I hope people can see the fact that the economy evolves in an unexpected way, and we respond to it."

While we have all moved on from his expectation of no rate rises until 2024, he still believes the market is wrong. At the Press Club talk:

"So the market is pricing in the same increase in interest rates in Australia and United States by the end of this calendar year. Yet our inflation rate is half that in the US, and labour cost growth is half that in the US. So, that's a thing that I'm kind of still surprised about. We keep looking at the markets and trying to understand what they're telling us, but I still struggle with how the same interest rate reaction is priced in for Australia and the US."

Here are a few points the market is underplaying in reading Lowe's intentions and why rates are unlikely to rise as much as currently priced in.

a) He expects inflationary forces to ease

Again, at the Press Club:

"Cast forward six months, what's likely to happen? I suspect we won't be buying as many electronics, we'll be going to cafes and travelling and the supply side problems in the chip market are now being resolved and the price of chips are coming down. I suspect on that category we'll go back to more normal rates of increase. The same with cars."

b) He sees a moment in history to deliver full employment

"I think we have a unique opportunity here to get people into jobs and get their incomes growing more quickly and we can do that without running an unacceptable risk of inflation. The Board has made the judgement that's an appropriate trade off – managing the risk of inflation being too high, we've got to be conscious of that – but there's great benefit in getting unemployment down and we can do that I think safely."

Even repeating the point later in the same presentation:

"And we're also on the cusp of this historic milestone of getting unemployment down, and I think we can test how far we can get the unemployment rate down without having an inflation problem in the country, and that's worth doing."

c) He believes households are resilient

More than any other country, Australian borrowers are vulnerable to rate rises. Lowe knows a rate rise will have a material impact on borrowers, but he also talks about the high level of household savings:

"The resilience is also evident in household balance sheets. Households have built up a lot of extra savings during the pandemic. Most of us couldn't spend as we used to spend, and the government gave people money to compensate for their loss of income. So people had their income maintained and they couldn't spend, savings went up. So there's almost $250 billion of additional savings over the past couple of years. That's a huge amount of money. The median borrower now is two years ahead of

their mortgage payments. Four or five years ago, the median borrower was one year ahead of their mortgage payments."

Household debt is around 170% of disposable household income versus around 60% in 1990. What does that mean? If a two-income household has income of $200,000, its average debt is $340,000 now versus $120,000 30 years ago. That makes the impact of a rate increase at least three times more powerful.

3. Commodity prices surge

Russia invading Ukraine has made Lowe's 'historic opportunity' even more difficult to achieve. These two countries were major exporters of energy and food. Wheat and oil prices have surged and Europe is struggling to find alternative suppliers. Food costs generally will rise as transport cost is a major input factor, and the dynamics of global trading across a wide range of commodities have fundamentally changed. If it continues for long, questions will arise on how countries will feed their people and keep them warm.

In fact, with US inflation hitting 7.9% in February 2022, mainly due to rising costs of fuel, food and housing, inflation was well-established long before Russia invaded Ukraine. This increases the fear of inflationary expectations as it has been building for longer than the war.

Where does that leave us?

Philip Lowe admits he is adjusting his view day-by-day. If he doesn't know, the rest of us are also guessing.

But if mortgage rates go towards 6% on the back of cash rates at 3%, whatever legacy Lowe hoped to leave will be hit as households struggle. The economy faces recession as central banks attempt to control inflation, and while Lowe will be 'patient' and hold back, global factors may force his hand.

My expectation is that rates will rise significantly less than current market expectations, and the RBA is happy to lag. CBA's Gareth Aird expects increases to 1.25% by early 2023 before the RBA pauses, and this seems more likely. For the sake of the borrowers who stretched to buy a home, the market better not be right.

Graham Hand is Editorial Director at Morningstar. This article is general information and does not consider the circumstances of any person.

Federal Budget 2022: A "magic election pudding"

Diana Mousina, Shane Oliver

The 2022-23 Budget provides a "magic election pudding" of more spending but lower deficits. The additional spending relates mainly to this calendar year and given the strong economy is more motivated by politics than economics. "Fiscal repair" kicks in for the medium-term but this takes the form of restrained spending growth in contrast to the last two budgets rather than austerity.

Despite this, the Government is able to announce lower budget deficit projections thanks to a budget windfall from faster growth and higher commodity prices which is resulting in faster tax collections and lower welfare spending.

This is very much a pre-election Budget with few direct losers (eg, tax avoiders) and lots of winners – including low- and middle-income taxpayers, welfare recipients, motorists, first home buyers, parents with young children, older super members, apprentices, builders, small business owners, defence industries, transport users, tourism operators, Koalas, etc.

The Budget has a bunch of things to commend it:

- medium-term structural spending is no longer being ramped up faster than the economy;
- most of the budget windfall from stronger growth and higher commodity prices is being put to deficit reduction and hence long-term debt stabilisation (unlike last year when it was mostly spent);
- and the annual addition to infrastructure spending along with measures like the Apprenticeship Incentive Scheme will provide some boost to productive potential.

However, at a micro level the Budget may be criticised on the grounds that:

- The temporary fuel excise reduction is bad economic policy in that: it may be very hard to reverse if oil prices keep rising or stay high; it will make no sense if oil prices fall back on say a Ukraine peace deal; and it sets a bad precedent.
- Many welfare recipients are arguably getting compensated for "cost of living" pressures twice – via the one of payment and via the indexation of payments to inflation.
- The housing measures continue to focus more on demand than supply which will result in higher than otherwise home prices (even though they are unlikely to prevent the cyclical downturn in prices now starting) & will boost debt levels.

At a macro level there are two big risks flowing from the Budget.

- First, the pre-election cash splash (which is about 1% of GDP in terms of new stimulus in the Budget for this calendar year, but is actually a bit more if spending of the $16bn in "decisions taken but not yet announced" in MYEFO are allowed for) risks overstimulating the economy at a time when it is already strong, further adding to inflationary pressures and adding to the amount by which the RBA will have to hike interest rates.
- Second, the reliance on growing the economy to reduce the budget deficit and debt is unlikely to reduce debt quickly enough and is dependent on interest rates remaining low relative to economic growth. 10-year bond yields have already gone up more than four-fold since their 2020 low warning of a sharp increase in debt interest payments beyond the medium term. And economic growth is unlikely to be anywhere near strong enough to reduce the debt burden like it did in the post-WW2 period unless there is another immigration boom or 1980s style focus on boosting productivity - both of which look unlikely. In the meantime, the strategy would be highly vulnerable if anything came along to curtail the commodity boom. So at some point tough decisions are likely to be required either to reduce spending as a share of GDP or raise taxes.

Implications for the RBA

We expect the first rate hike in June and the cash rate to reach 0.75% by year end and 1.5% next year. The extra stimulus in the Budget increases the chance that the first rate hike is 0.4% rather than 0.15% (taking the cash rate to 0.5%), with the cash rate reaching 1% by year-end.

Implications for Australian assets

Cash and term deposits – cash returns are poor but they will start to rise as the RBA starts hiking from mid-year.

Bonds – ongoing budget deficits add to upwards pressure on bond yields. The rising trend in yields resulting in capital loss mean that medium-term bond returns are likely to be low.

Shares – more fiscal stimulus, strong growth and still low rates all remain supportive of Australian shares but rising bond yields & RBA hikes will result in a more constrained & volatile ride.

Property – more home buyer incentives are unlikely to offset the negative impact of poor affordability and rising mortgage rates in driving a cyclical downturn in home prices.

The $A – strong commodity prices point to more upside.

Economic assumptions

The Government revised up its growth forecasts for this financial year (from 3.75% to 4.25%) and kept 2022-23 GDP growth unchanged at 3.5%.

Unemployment is expected to fall to 3.75% by June 2023 (down from 4.25%). Inflation and wages forecasts have also been revised up significantly. We are a bit more optimistic on near-term growth but also see higher inflation and wages growth.

The Federal Government sees net immigration (estimated to be +41,000 this year rising to +235,000 by 2025-26) becoming more of a growth support.

The Government pushed out its $US55/tonne iron ore price assumption to September quarter 2022. With the iron ore now around $US135/tonne, it remains a source of revenue upside.

Economic assumptions

		2021-22	2022-23	2023-24	2024-25
Real GDP	**Govt**	**4.25**	**3.5**	**2.5**	**2.5**
% year	AMP	5.0	3.0	2.5	2.5
Inflation	**Govt**	**4.25**	**3.0**	**2.75**	**2.75**
% to June	AMP	5.0	3.0	3.0	2.5
Wages,	**Govt**	**2.75**	**3.25**	**3.25**	**3.5**
% to June	AMP	2.8	3.5	3.25	3.25
Unemp Rate	**Govt**	**4.0**	**3.75**	**3.75**	**3.75**
% June	AMP	3.5	3.5	3.8	4.0

Source: Australian Treasury, AMP

Source: Australian Treasury, AMP

Budget deficit projections

The Government's revised budget projections are shown in the next table. A budget windfall resulting in a boost to revenue and savings in spending from faster than expected economic growth and inflation, alongside higher commodity prices, is estimated to have reduced the budget deficit since the December Mid-Year Economic and Fiscal Outlook by $28.3bn for this financial year and by a total $142.9bn out to 2025-26 (see the line called "parameter changes"). This is being partly offset by extra stimulus (labelled "new stimulus") of $8.9bn this financial year, $17.2bn next financial year and a total $39.3bn to 2025-26. But as a result of the budget windfall exceeding the new stimulus the budget deficit is projected to be substantially smaller in the years ahead than seen in December.

The unwinding of temporary pandemic support measures and the stronger than expected recovery is seeing the budget deficit fall sharply from the record $134bn recorded in 2020-21 (which itself is well down from the $214bn first projected in the 2020-21 Budget).

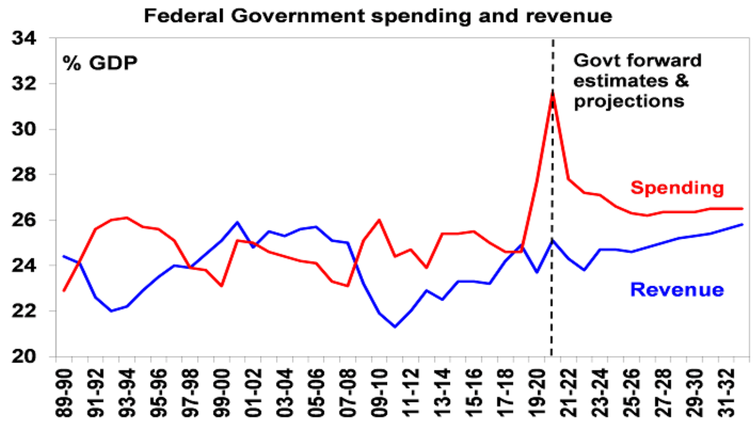
Underlying cash budget balance projections

	2021-22	2022-23	2023-24	2024-25	2025-26
2021-22 Budget, $bn	-106.6	-99.3	-79.5	-57.0	
2021-22 MYEFO, $bn	-99.2	-98.9	-84.5	-57.5	-68.1
Parameter chgs, $bn	+28.3	+38.1	+32.1	+15.6	+28.9
New stimulus, $bn	-8.9	-17.2	-4.1	-5.2	-3.9
Projected budget,$bn	**-79.8**	**-78.0**	**-56.5**	**-47.1**	**-43.1**
% GDP	**-3.5**	**-3.4**	**-2.4**	**-1.9**	**-1.6**

Source: Australian Treasury, AMP

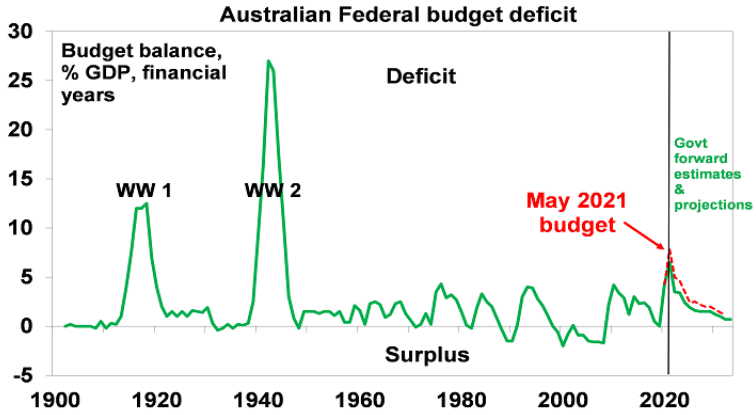
Source: Australian Treasury, AMP

Out to 2025 the deficit is projected to fall rapidly as covid programs phase down. However, spending is still expected to settle about a high 26.4% of GDP. This is well above the pre-covid average of 24.8% and reflects higher health/NDIS and defence spending. Rising revenue with a growing economy is assumed to do all the deficit reduction heavy lifting from 2026.



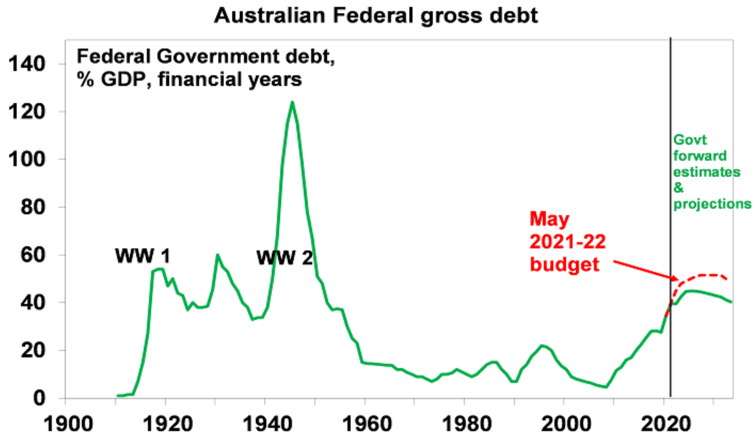
Source: Australian Treasury, AMP

The Government still doesn't see a surplus in the next decade.



Source: RBA, Australian Treasury, AMP

Because of stronger nominal growth, gross public debt as a share of GDP – which is at its highest since the early 1950s - is now expected to peak at around 45% of GDP in 2025, which is lower and earlier than previously expected. Gross public debt is expected to reach $1tn in 2023-24. Net public debt is projected to peak as a share of GDP by the middle of the decade.



Source: RBA, Australian Treasury, AMP

Dr Shane Oliver is Head of Investment Strategy and Chief Economist, and Diana Mousina is Senior Economist at [AMP Capital](). This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice.

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