Firstlinks
a Morningstar company

Edition 456, 6 May 2022

## Contents



## Editorial

An hour into the media conference following Tuesday's increase in the cash rate to 0.35%, the **Reserve Bank Governor Philip Lowe** delivered a mea culpa. He said there would be an internal review later in the year of how the Reserve Bank provides forward guidance, that is, its predictions about the future course of interest rates. Lowe had earlier admitted he was embarrassed by the repeated guidance that cash interest rates would not rise until at least 2024. His confidence lulled many borrowers into a false sense of security that they did not need to fix loan interest rates.

To use Lowe's own words, he "*should have done better*". Why did he even attempt to make a prediction about rates two to three years ahead when circumstances were changing quickly? It's amazing to recall that only three months ago, at his Press Club Q&A session on 2 February 2022, he said:

*"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."*

He was expecting inflation to moderate by the middle of the 2022. Now the forecast for 2022 headline inflation is 6% and underlying inflation of around 4.75% versus the Reserve Bank range of 2% to 3%. He went further, again criticising market traders for pricing in substantial rate rises when he said:

*"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."*

In November 2021, he had been even stronger:

*"I find it difficult to understand why rate rises are being priced in next year or in early 2023."*

Yet on Tuesday, he said, *"I don't want to offer comments on the plausibility of market rates"*, which he has done for months. He said, *"I'm not going to be drawn on fiscal policy"* when he had encouraged governments to spend, for example, in October 2021:

*"The fiscal responses by the Australian Government and the state and territory governments have also been providing welcome assistance in supporting household and business balance sheets."*

In turning from dovish to hawkish within a few months, the Governor should indeed feel "*embarrassed*" and the review of the Reserve Bank which both sides of politics have promised after the election now has an even stronger reason to proceed. The review should look at all aspects of the massive support to the economy which has added fuel to inflation, including lending almost $200 billion to commercial banks at 0.1% for three years which contributed to the property price surge of 2021.

It was no surprise that leading cash rate forecaster, **CBA's Gareth Aird**, was unimpressed, as he was not expecting this week's increase. He said:

*"Today's decision means the RBA walked away from their April guidance that data over coming months (emphasis on plural) would inform their decision on the cash rate. Rather than wait for official data on the evolution of labour costs ... the Governor has instead today cited the RBA's "business liaison" and "business surveys" to make the case that wages growth is moving sufficiently higher.*

*The business surveys had for some time indicated that wages growth was moving higher, so it was a surprise that the Board only today decided to put weight on "unofficial" wages data.*

*Reading between the lines, the RBA has simply been caught off guard by the strength of the Q1 22 CPI data ... We are disappointed in some aspects of the RBA's communication today."*

Amid the fear and inevitability of rising rates, another number has been overlooked. The economic growth for Australia for 2023 is forecast at only 2%, and Lowe also said on Tuesday:

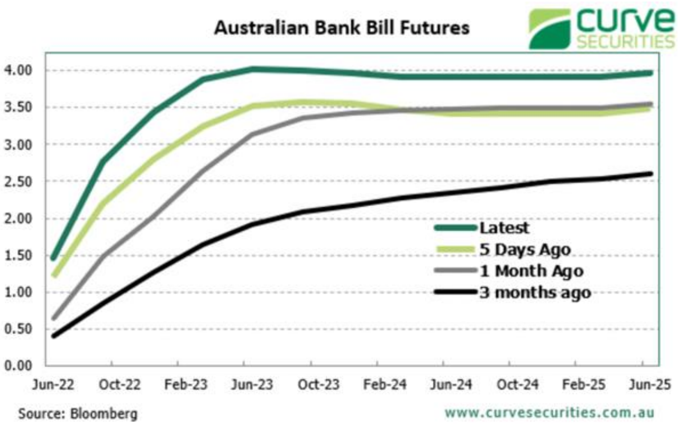
*"By mid-2024, headline and underlying inflation are forecast to have moderated to around 3%."*

The main lesson from all this, as Philip Lowe admits, is not to hang on his every word each month. He does not know what the future will bring, he looks at fresh numbers regularly, and the thousands of pages of tea leaf analysis whenever he says a word like 'patience' or 'sustainable' have not helped anyone.

In fact, there is a decent chance that central banks will be forced to reduce interest rates within a year or two to stimulate the slowing economy. There is now considerable speculation about the so called 'neutral' cash rate, the point which neither stimulates nor contracts the economy. **KPMG** said:

*"Some economists are now suggesting, that given the level of debt being carried across households, this neutral rate is now somewhere around mid-1%. KPMG considers it is most likely to be lower than historical levels, and probably closer to 2% to 2.5%."*

Which is well under current market rate expectations. Here is the latest trading in bank bill futures, at 4% by early 2023. Surely this can't happen, or we will see mortgage rate rises of 3.75% to around 6%, which would kill the residential property market and lift mortgage defaults. The Reserve Bank will not go there, but the market just keeps pushing higher.

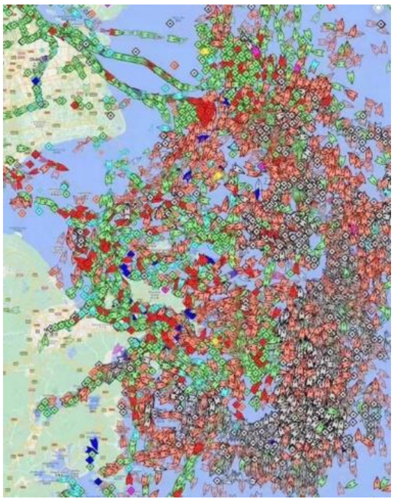


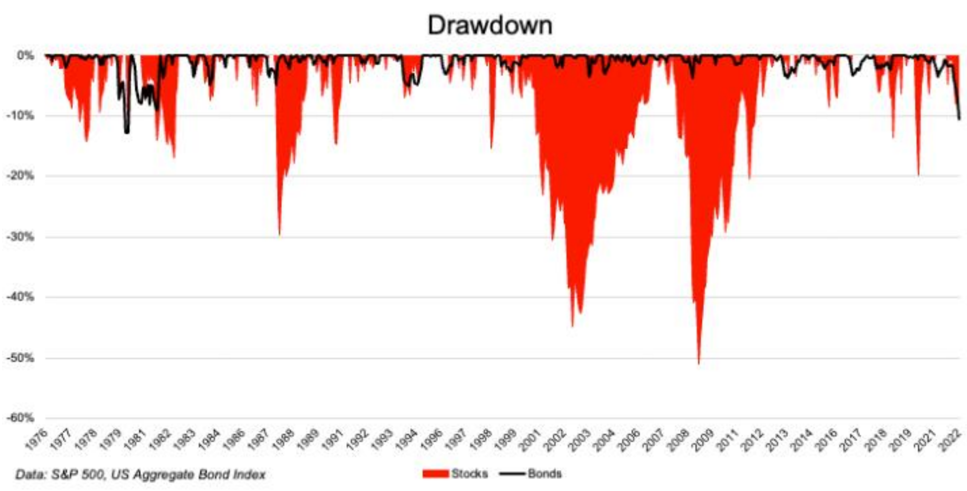

One good side of rising rates is that savers will finally receive some reward, albeit not in real terms until inflation is under control. The rise in interest rates brings back into play that wonder of investing, compounding. As **Charlie Munger** (yes, him again) said, think long term because, *"The first rule of compounding is to never interrupt it unnecessarily."*

A couple of charts stood out this week that summarise world markets.

The first shows why supplies of many goods from China are held up, with ships stuck around Shanghai. Scarcity of products feeds inflation as manufacturers and businesses face supply shortages.

And second, the argument for a diversified portfolio where falling stockmarket returns are compensated by rising bond prices is not working at the moment as both US stocks and bonds have both fallen over 10% for only the second time in at least 50 years.






## Stephen Hayes on how global real estate is changing

### Graham Hand

*Stephen Hayes is the Global Head of Real Estate Securities at First Sentier Investors.*

**GH**: A few years ago, you wrote an article called 'The Evolution of Our Cities'. Has COVID changed what you expected then?

**SH**: There's an extra theme arising out of the pandemic and still evolving around decentralisation. CBD-based tenants and many service-based tenants are adopting flexible work practices as standard HR policies and that's given employees much greater control over where they live. It values more of a lifestyle decision, whereas previously, the workplace location played heavily into where people chose to live.

There are many ramifications. From a commerce perspective, there's no overall change in total but it's moved from centralised, densely-populated areas out to suburban locations. Over time, we expect to see more leisure and service activities appearing in town centres within each major suburb. From a real estate and infrastructure perspective, that means a lot. Land values have risen in suburban locations, not only across Australia but almost all major cities globally. The theme is the same and inflation has been rampant. It will take pressure off toll roads with less commuting, which is very inefficient, and there are lifestyle benefits as well. Employees can manage their time better.

**GH**: If a business moves to a hybrid work environment, do they still need the same amount of office space? And it looks like coffee shops and restaurants in the city are still quieter.

**SH**: It's part of this decentralisation theme, and yes, retail in the CBD is disrupted. On the office tenancy question, it's yet to be properly tested because in Australia, the average larger corporate lease is around seven years so there are gradual maturities coming up. Accommodation requirements are assessed towards lease expiry so any changes will be progressive. But yes, absolutely, they will require less office space.

There are a couple of themes within the office market. One, there is a flight to quality, especially towards carbon-efficient and energy-efficient buildings. Things like touchless entry and a wide range of new technologies with that go with new buildings, but they're expensive as well, so tenants have to be able to pay for them. I don't think that theme will be strong enough to prevent the overall disruption of CBD office space for an extended period of time. It's not the death of the office building but there will be less natural demand. Vacancy rates will rise, rents will fall over time, including the retail services at the bottom of the towers as well. The building's use may change, for example, towards education instead of corporate.

**GH**: You manage global portfolios, do you see any global trends which are not yet playing out fully in Australia?

**SH**: In many other countries, younger generations are adopting rental over home ownership. Historically, we have valued the Great Australian Dream, young people with a pattern of settling down in employment and entering into an extraordinarily large loan for up to 30 years. We are generally indebted to an institution for that time and at the end of a working life, the home is the largest asset.

Younger generations don't trust banks, they're quite financially savvy and it doesn't make sense to have all their wealth tied up in a single asset like that. And now, the build-to-rent product from institutionally-owned and managed apartment buildings built purely for rent is absolutely compelling. That's not only from an affordability perspective, but for lifestyle, a typical house or rented apartment cannot compete with these buildings.

**GH**: Why's that? What makes them different?

**SH**: You enter the building using your phone, you enter your apartment using your phone, you arrange the lease on your phone, you pay your rent on your phone, if you want to. You contact maintenance to fix your leaky tap on your phone, if you want to move apartments, you use your phone, if you want to book the yoga room, or some office space, or the media room, or a car from the carpool or a bike … you get the picture. Younger people are growing up with these conveniences and technologies and it's an easy decision for them to enter this sort of product offering.

And here's what Australians don't yet appreciate. Firstly, it is in the interest of the institutional owner to maintain the occupancy. A renter leaving is very bad because then there's downtime that hits the operating margin. So they offer a holistic product that encourages renters to stay, and that includes affordability. There is a symbiotic relationship between the owner and the customer. The other thing is – and this applies in Australia such as the Mirvac development of 215 apartments at Homebush called Indigo – the tenants can enter a lease for as long as they like. Indigo is let to 98% occupancy and most have adopted a 12-month lease, but tenants always have the option to stay. It gives the certainty and security, like home ownership, without the big upfront payment and an enormous loan for a long time. Australia has been really slow to adopt this.

**GH**: Other than the Great Australian Dream, any other reasons for that?

**SH**: State land taxes don't favour it. If you think about an SMSF that owns an apartment – and that product will be heavily disrupted – if there are 100 apartments in the building, one apartment might incur 1/100th of the land tax liability. But each owner has access to the land tax threshold (currently $822,000 in NSW) so probably pays no land tax. Whereas if you own the whole building, you incur 100% of the land tax. The states are onboard in building more of this product with a 50% land tax exemption until 2040.

**GH**: Australia is part of the global ecommerce and industrial warehouse boom, which has benefitted the likes of Goodman and Charter Hall. Has this still got room to grow?

**SH**: This is early days. The first iPhone was launched in 2007 and we're only 15 years into it. This will run for decades and decades. Cities are messy, disheveled places, they're not well organised, they were never expected to have such large populations with all the conveniences we have today. It will take decades to modernise supply chains. Procurement centres or logistical warehousing are nothing like they were 20 or 30 years ago, when they were glorified tin sheds. Now, these buildings are modern and full of technology. Some of the fitouts cost upwards of $500 million and they are integral to the future of society and cities.

Whenever we click on our phones, a lot happens behind the scenes, and much of it is inefficient. The tenant demand for modern logistical warehousing is the highest I've seen in my entire career. If companies don't want to compete only on price, they must get it out of the door the fastest.

**GH**: You divide your portfolios into categories such as retail, office, industrial and specialised. How has the mix changed and what do you expect over the next three years?

**SH**: There's a misconception that real estate portfolios contain a lot of 'old world' traditional-type assets such as tall office buildings and shopping malls. From a global perspective, those assets make up only a fraction of the real estate types by market capitalisation. The majority of real estate is in the new world, the modern economy where capital is going to not from. Residential is a large component, especially the apartment side. We have the widespread adoption of technology, logistical warehouses, technology hubs, data centres are an integral part of the whole internet usage and streaming services, self storage. Health care is massive with everything from acute care private hospitals to outpatient facilities, specialised rehabilitation facilities, seniors housing, skilled nursing facilities. The amount of capital going in is immense. Science and research and demand for laboratory space is off the charts, driven by the pandemic. There are a lot of opportunities.

**GH**: You recently launched a new fund with a carbon reduction focus, how will that work?

**SH**: Responsible investing has been fully ingrained into our investment process for a decade, so this isn't new for us. We've been able to collect data properly now to benchmark the real estate sector, including the carbon associated with developments. It's around 40% of man-made greenhouse gases, so it is a massive emitter. We're invested in some of the largest landlords in the world and they're sophisticated and we've been engaging with them on the carbon side. The reporting coming out of the publicly-traded markets for real estate only tells part of the picture on carbon. We want a full picture so every stock within our portfolio includes a complete carbon analysis. We take it to the landlords and say this is where you're behind.

**GH**: We know about solar and recycling, but do you have a couple of quick examples of how buildings are reducing the use of carbon?

**SH**: One that doesn't get a lot of air time and can't really be retrofitted is geothermal, using the earth's core temperature to maintain the ambient temperature. In most building, temperature control is a major use of carbon, the heating, ventilation and air conditioning (HVAC) systems.

**GH**: How does that work, do they drill hundreds of metres into the earth's core?

**SH**: Not that far down. It's a range of tiny pipes sitting underground pumping air from the building into the core and it either warms or heats and takes workload off the HVAC systems. We have a mixed-use (office and retail) investment in Toronto where they are excavating deep into the ground and building massive wells that will contain water from the lake to circulate through the building to maintain the ambient temperature. It's so large they will be able to cater to a range of nearby city blocks.

**GH**: Do you own something now that you expect you still own 10 years from now?

**SH**: Most of our portfolio. The only component we probably won't own is around 5% of the portfolio in hotels and resorts. They are more cyclical and starting to return to normal so we're looking for valuations that appeal. Everything else we invest in as a long-term owner based on strong fundamentals and thematics.

**GH**: You have global opportunities, but do you like any Australian stocks in particular?

**SH**: We spoke about logistics and the Goodman group is a global leader in the development of modern warehousing for long-term ownership. They also have a partnership model where they joint venture and a lot of superannuation funds and sovereign wealth funds invest with them. The high quality of their portfolio with targeted cities, high barriers to entry, land is scarce, they are experts at building. In Hong Kong, they have multi-level warehousing, five or six levels, and they're in Japan, London, Paris, California, New Jersey. And their portfolio is 98% occupied, dividends have grown 6% compound over the last 10 years, earnings growth that we're forecasting for 2022 is over 20%, with earnings up since the start of a pandemic by over 40%.

**GH**: How do you manage a global portfolio from Australia and gain the local knowledge of conditions in other countries?

**SH**: Yes, real estate's very localised in nature, they are fixed assets, you can't pick them up and put them in another market. Each asset is different based on local fundamentals. So we've got a team of 10 located in Sydney, London and New York, in the different time zones. We've been together a long time and our track record speaks for itself.

**GH**: I must finish by asking you about sensitivity of real estate to inflation and rising rates.

**SH**: Central banks have been very accommodating with ultra-loose monetary policy, and as we all know, that's changing. But even with some rate rises, from an historical perspective, rates are still very low. There is a long way to go before money supply is constrained but central banks must act to control inflation. So in real estate and financial markets generally, the required returns will rise over time. If you're invested where the real return is not high enough, you will get impacted. But if you're in the new economy, a beneficiary of these societal change, with low unemployment rates and healthy household finances, many will benefit and that's where we believe we're invested.

*Graham Hand is Editor-At-Large of Firstlinks. Stephen Hayes is Head of Real Estate Securities at [First Sentier Investors]() (Australia), previously Colonial First State Global Asset Management and a sponsor of Firstlinks. This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs. For more articles and papers from First Sentier Investors, please [click here]().*

## 2022 election survey results: disillusion and disappointment

Firstlinks

*Reader comment: "At no point in the last 9 years have I seen a politician from either major party provide a meaningful - or indeed even coherent - discussion of an actual policy. The decade before that occasionally showed bursts of actual policy-making, but most were quickly abandoned as soon as they proved controversial. Without a willingness to endure appropriate risk for a good governance outcome, there cannot be high quality government. Without high quality government, there cannot be a high quality political debate, because all sides are arguing over trivia, rather than substance."*

We received thousands of comments in our Election 2022 Reader Survey, and with a few exceptions, they are reproduced here. If there is a common theme, it is frustration with the quality of debate and policies from all sides of politics. It seems a forlorn hope that Australian politicians will deliver substance to engaged voters who can then make an informed decision.

With almost 1,000 responses, it's a great sample of our readers, thanks for participating. While the overall results are illuminating, it is in the comments where the intensity of emotions and frustrations come out.

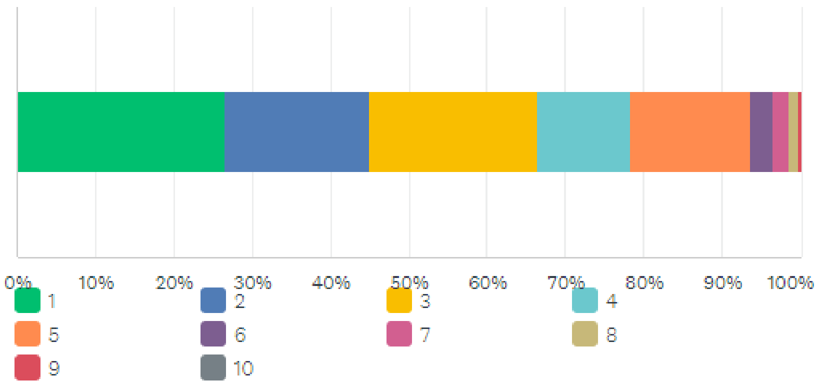
**Dire quality of political debate**

We'll return to question 1 at the end. Let's start with how you feel about our democratic process at work. Yes, we should all be grateful to live in a society where we pick our leaders, but when parts of the media can influence the outcome, and much of the debate is shallow and misleading, you are clearly disappointed and disillusioned.

On a scale of 1 to 10 where 1 is terrible, two-thirds of our readers rate the quality of political debate at 3 or less, and few believe it is better than the mid point of 5.

**Q2. How do you feel about the quality of political debate? (on a scale of 1-10, where 1 is terrible and 10 is excellent)**

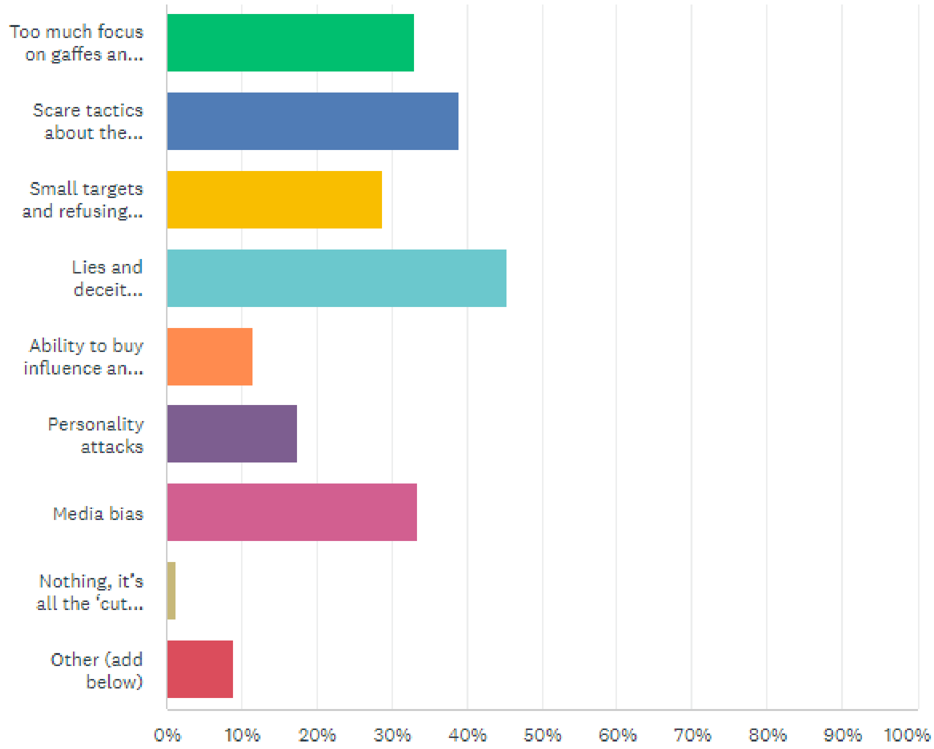
It's a sign of a disillusioned electorate. Why do people bother to enter politics if it is not to make some meaningful change, rather than descending into the spin and trivia that most people dislike?




**Q3. Which aspect of campaigning and elections do you most dislike? (Choose up to two)**

The highest score at 46% was 'Lies and deceit' followed by 'Scare tactics about policies of other parties' at 39%. 'Media bias' and 'Too much focus on gaffes' also polled strongly at one-third of responses each. Only 1% accepted nothing is wrong and "It’s all the ‘cut and thrust’ of a democracy".

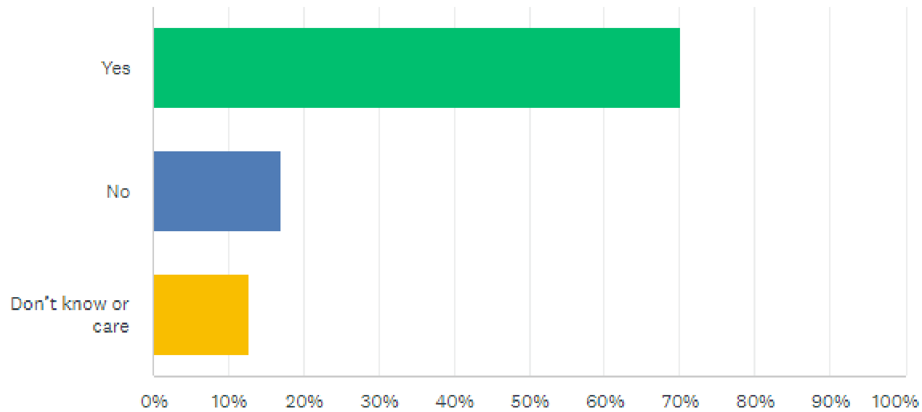
With such a focus on lies and deceit, it's no surprise that there was strong support for a Federal Integrity Commission with 70% saying 'yes'.




**Q4. Do we need a Federal Integrity Commission?**

Now we come to the all-important voting intentions. We know from previous surveys that our readership is generally older (75% over the age of 55) and wealthier than the general population, which would suggest conservative and Coalition tendencies. And indeed, 37% intend to vote for the current Government and only 17% for Labor.

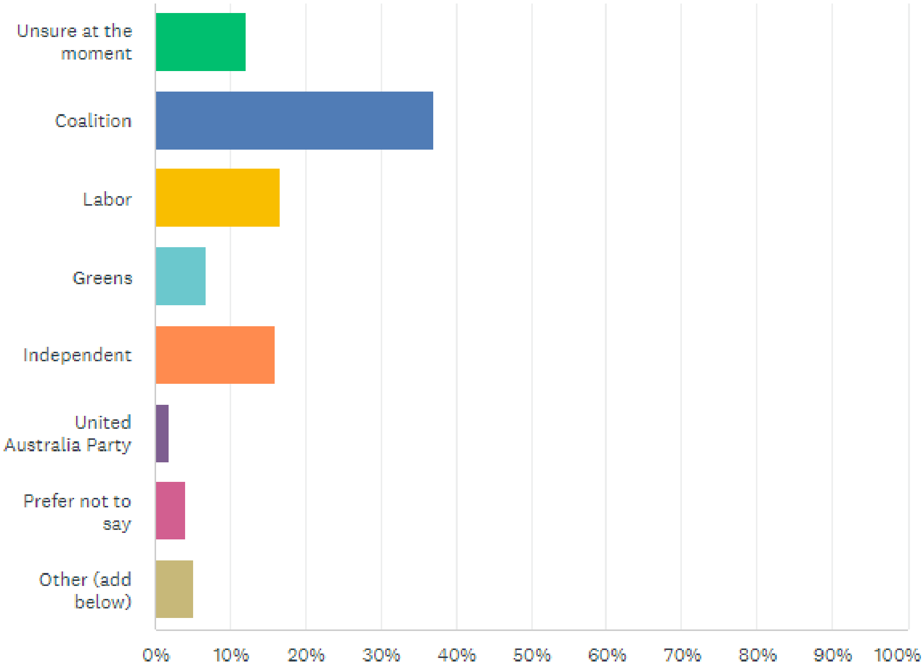
We have no data on our readers from previous elections but it's likely that the vote for independents at 16% is far higher than usual. It's a guess but our readers are probably over-represented in the so-called 'teal' seats of high-profile independents taking on Trent Zimmerman, Josh Frydenberg and Dave Sharma, plus support for sitting member Zali Steggal. On the Greens at 7%, Adam Bandt's 'Google it, mate' reply to an attempted 'gotcha' question no doubt won him plenty of friends.




**Q5. How do you intend to vote in the Lower House?**

The public polls strongly favour Labor, but our survey with 12% undecided suggests preferences will determine the outcome. Even with our more conservative readers, the combination of Labor+Independents+Greens is higher than for the Coalition.

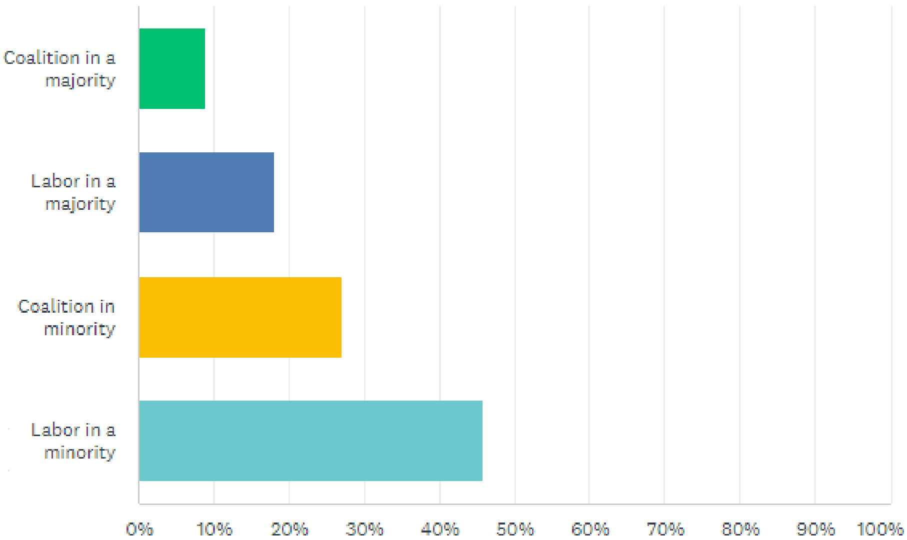
So who do you think will win? This diverges strongly from voting intentions.




**Q6. Who do you think will form Government?**

Matching the support in Q5 for minor parties, there is stronger expectation for Labor in a minority (46%) than majority (18%) but that's a combined 64% expecting Labor versus 36% for the Coalition.

And returning to Q1, these are the issues you would like to address. A clear winner at 42% is 'Climate change and the environment', followed by 'Defence', 'Government spending and budgets' and 'Establish a Federal Integrity Commission'.



**Q1. What should be the most important issues in the election? (Choose up to three)**

A complete set of comments is attached here, with these few examples.

| ANSWER CHOICES | RESPONSES |
|---|---|
| Climate change and the environment | 42.15% |
| Defence | 35.89% |
| Government spending and deficits | 30.34% |
| Establish a Federal Integrity Commission | 27.74% |
| Housing supply and affordability | 21.37% |
| Health | 20.78% |
| Aged care | 20.31% |
| Taxation | 19.83% |
| Employment and jobs | 18.30% |
| Cost of living | 15.23% |
| Misinformation and integrity | 14.05% |
| Education | 13.11% |
| Other (add below) | 11.81% |
| Wages growth | 10.74% |
| Immigration | 8.38% |
| Social security | 2.72% |
| Mental health | 2.01% |
| Domestic violence | 1.89% |
| First Nations rights | 1.42% |
| Disability services | 1.30% |

*"Most of the issues above are important to our future. However I dont see any party capable of dealing with them effectively other than sound bites and royal commission that then goes nowhere. We are no longer a united nation but groups of special interests, be they political, states, gender, green or conservative and religious to mention a few."*

*"The bias in reporting across mainstream media, and even the ABC, favouring the LNP, is beyond incredible and frankly disturbing. Murdoch media is making no attempt to even appear balanced, much less actually report facts."*

*"I am sick of the negativity and criticism of other political parties/individuals. Tell us your policies and how you will pay for them."*

*"The quality is not helped by journalists constantly asking politicians to "guarantee" they will never do "x" or "y", which takes nuance out of debate and boils everything down to talking points with no boldness in policy development."*

*"Politicians are able to throw taxpayer funds around for political purposes with no restraint and wealthy individuals & corporations are far too easily able to manipulate government decisions in exchange for party donations."*

*"I suspect that the rorts, misappropriations and unacceptable practices and conduct that make the headlines are the tip of the iceberg. The absence of integrity in government encourages the same lack of integrity in business and the community."*

*"As a Project Manager in the construction industry & 90% of our work is for Government, I see way too much waste of tax payers money. This is by very poor scope of works, budgets and blow outs."*

*"Both parties really disappoint me. The Liberal Party had plenty of time to do good things but often dropped the ball or bungled the management. Both have been asleep at the wheel on China. The Liberals over did Job Keeper with so much money and no oversight for businesses that did not need it. Both parties fail to prosecute a pragmatic climate change plan that moves the country forward without destroying the country doing it."*

Footnote. We have done some minor editing but overwhelmingly, we have allowed our readers to offer their frank opinions, even the unkind comments about some politicians. Overall, readers have contributed constructively but there is clear frustration and we did not want to sanitise these views. Thanks again for participating.

## Betting markets as election predictors

Tony Dillon

When Scott Morrison called the election for May 21, betting agencies had the Labor Party at $1.33 to form government, with the Coalition at $3.25. That converts to a 75% probability of Labor winning. And even after a diabolical first week of the election campaign for Anthony Albanese, odds eased Labor only slightly out to $1.45, with the Coalition $2.70 at the half-way mark of the campaign.

Now the current odds may be short for Labor, but they were even shorter in 2019, and we all know what happened then.

It was often touted in the media in the lead up to the 2019 election, that Labor was a good thing to form government because they were so short with the bookies. But how good a predictor of election results are betting markets?

Believe it or not, betting agencies are in the business of making money, not predicting outcomes. Their win quotes will be weighted by dollars held for various outcomes. That Labor ended up such a short-priced favourite just days before the election, would have reflected the greater holding in the win pool for a Labor victory. Sportsbet for example, reported that 70% of total money wagered with them, was held for a Labor win.

Now a quote of $1.15 to win reflects an 87% implied probability of winning. And before placing a bet, the punter should weigh up whether that reflects value or not. If he believed the true probability of a Labor win was greater than 87%, he would gladly accept the $1.15 on offer. If not, he should have walked away.

So was Labor's true probability of winning anywhere near 87% in 2019? When the TAB opened betting on the election in February 2018, they installed Labor favourite at $1.50, an implied winning probability of 67%, with the Coalition at $2.50.

Labor probably opened favourite for a number of reasons. That the 2016 election result was so unexpectedly close with Labor almost snatching victory. That there was perceived instability within the Coalition with Tony Abbott lurking in the background of a Turnbull government. And that Labor finally had a stable team with a fistful of policies to take to the 2019 election.

Then from that point, things began to get even worse for the Coalition. There was the Barnaby Joyce resignation over a relationship with a former staffer. Then the leadership debacle that saw Malcolm Turnbull ousted and Scott Morrison installed as new PM. Followed by the Wentworth by-election loss, and then the announced exodus of senior Liberal figures, not seeking re-election. Things unravelled fast, and many deemed the Coalition unelectable. Meanwhile, Labor sat back quietly observing the self-destruction.

Consequently, the big bets began to roll in for a Labor win, and its odds tightened with the bookies. Such a trend can often become self-fulfilling, as the prospect of a Labor win attracted more punters chasing seemingly easy money but requiring bigger wagers at short odds for a half decent payout. Meanwhile on the other side of the ledger, the Coalition's price was blowing out further, becoming attractive only to small time punters prepared to have a nibble, not needing to mortgage the family home for a reasonable reward.

But as the dollar quotes became steadily more lopsided, did the true probabilities shift in tandem? Probably not a lot. Because with the Coalition already at a low base, the probability of them winning surely could not have become much worse, and therefore Labor not much better. In fact to the contrary, things began to slowly turn.

As they steadily unpicked Labor's high taxing and high spending agenda, the true probability of a Coalition win began to edge upwards. And Morrison began to display his campaigning skills that had largely been unseen by the electorate. He and his party effectively began to make inroads, slowly willing themselves back into the contest. The polls revealed an improved Coalition two party preferred measure, moving from as far out as 56:44 in Labor's favour, to just 51:49 days before the election. Which was within the margin of error.

So the true probability of a Coalition win had more than likely increased, and that of Labor's decreased. But the sheer weight of money for a Labor win could not move its short quote. In fact, it tightened even further in the last weeks of the campaign to that skinny price of $1.15, with the report of one punter waging $1 million on Labor to win. Meanwhile the Coalition's price drifted out as far as $5.50, equating to just an 18% implied probability of winning.

In the end, there simply was not enough money to correct the bias in the win pool. Noting also that punters were unlikely to be representative of the electorate, ensuring persistent bias. Momentum however, continued to swing the Coalition's way, and the rest as they say, is history.

The thing is in politics, true probabilities can move with sentiment fast, but the betting markets may not have the scope to adjust. Probabilities can be indicative when markets open, but as we have seen, events can quickly cause a disconnect between true and implied probabilities.

Interestingly, we saw similar results with Donald Trump winning at long odds in the US in 2016. And the Leave vote triumphing over the Remain vote in the Brexit referendum also at long odds in 2016, with about 75% of £40 million bet on the outcome, wagered on Remain. Even though it was revealed later that there were far more individual bets on Leave than Remain, which proved prophetic in hindsight. After all, it makes sense intuitively that numbers of bets as opposed to dollars bet, should be a better predictor of what the electorate is thinking.

So when we accuse bookies of failing to read the political landscape, we should realise that that is not their charter.

*Tony Dillon is a freelance writer and former actuary. This article is general information and does not consider the circumstances of any investor.*

## Australia's economic outlook robust, but risks are rising

### Panos Mamolis

Australia is one of the world's most expensive places to live, but perhaps that's not surprising as its population is amongst the world's wealthiest. We are not a nation like the United States or China, where a massive population can generate sufficient demand to drive the local economy. We need to trade with the world to generate the wealth we need to grow, and when you look about the globe today, it contains many risks.

The conflict in Eastern Europe is driving fuel prices higher and fueling inflation, which was already on the rise from a severe disruption to global supply chains, stemming from two years of pandemic-induced lockdowns and changes in people's spending patterns.

While much of the world is putting the pandemic behind it, China is ratcheting up its lockdowns to try and maintain a zero Covid-19 policy. The slowdown in economic growth this is causing is impacting key commodity markets important to Australia, adding a growing source of risk over the past couple of months as major Chinese capitals go into lockdown.

Domestically, the rising cost of living and the threat of a rapid series of interest rate hikes to stem inflation is creating daily headlines about tougher times ahead. While that may be true, the Australian economy remains resilient with record low unemployment, muted inflation pressure compared to many leading western nations, and strong terms-of-trade, the latter giving the government revenue to explore cost of living abatement measures.

However, we need the global economy to stay on track for growth to ensure there remains strong demand for the products Australia sells to the world.

The International Monetary Fund in its most recent report titled *"War sets back the global economy"* is projecting global growth to slow from an estimated 6.1% in 2021 to 3.6% in 2022. This is 0.8% lower from what it projected in January this year and is mainly attributed to the Russia/Ukraine's war's direct global spillovers.

That projected growth remains under pressure for further downgrades. If we look at major regions of importance, the European Union is between a rock and a hard place due its high dependence on Russian energy and the cost to rapidly try and expand alternative supply options. Meanwhile, inflation in the United States accelerated to 8.5% in March, including a 32% jump in fuel process and an 8.8% hike in food prices, the largest rise since 1981, according to economic data analytics group Trading Economics.

Australia's own outlook took a bit of a battering in late April when it was revealed the inflation rate for March at 2.1% pushed the annual inflation rate to 5.1%. This is the highest annual level since the introduction of the goods and services tax in June 2001.

While the cost of living and inflation will continue to dominate headlines throughout the remainder of the year, there remains many reasons for optimism about the economic outlook.

**Commodities**

Prices for key commodities like iron ore have skyrocketed following the outbreak of war in Eastern Europe. Australia is a major energy and food exporter with very limited direct trade to Russia or the Ukraine. While the hostilities are fueling inflation, our exports have increased which have direct benefits to the economy.

The increase in key export commodities boosts Australia's income and growth. GDP is expected to grow by 4.25% in 2021-22 and by 3.5% in 2022-23 in real terms (inflation-adjusted), according to ABS data.

**Inflation**

The cost of living has recently picked up sharply in Australia, reaching 5.1%. However, this level is low compared the most recent US record reading of 8.5% and UK's inflation rate of 7%. This offers an advantage to Australia in terms of how much and how quickly the central bank needs to move to keep prices under control. Additionally, after 2022, as oil prices are expected to gradually start falling and supply chain pressures will ease, inflation is also expected to moderate.

**Labor market**

The unemployment rate has dropped to 4% and it is expected to drop further to 3.75% by the end of the year, according to government data. Wages are also growing at an annual rate of 2.75% so far this year, which is a trend that is expected to continue. This compares to an average of 3.1% between 1998 to 2021, according to Trading Economics.

In addition, labor force participation is at high levels, which means a larger percentage of the working-age population are now either working or looking for work. On the other hand, the recent Queensland and New South Wales floods caused major disruption and had a direct impact to total number of hours worked. People simply worked fewer hours due to extreme weather conditions.

**Business and consumer confidence**

Collected data from several industry sources indicate that surveyed firms see the glass half-full. The focus has been more on positive news as mobility and economic conditions improve, rather than negative news from offshore. Australia's tourism sector is one of the main areas for an improvement in business conditions, which have been stronger than pre-Covid-19 levels.

On the other hand, consumers are not as confident as businesses. Consumer sentiment has recently declined which is mainly attributed to expectations for higher interest rates and deteriorating financial conditions. Apart from expected interest rate increases, consumers also worry more than businesses about the implications of domestic natural disasters and the effect of the Russian-Ukrainian war to the local economy and daily life.

**Interest rates**

Set by Reserve Bank of Australia (RBA), the official interest rate sat at a historical low of 0.1%. That changed on May 3 when the RBA increased the rate by 0.25% to 0.35%. It is the first of what is expected to be a series of rate hikes this year. Other central banks had already started hiking policy rates. The Bank of England has increased rates three times since December last year to 0.75% and in March the US Federal Reserve announced the first of multiple rate hikes expected this year.

There is no doubt that the interest rate expectations have shifted to the upside, and this is reflected in the current prices of the bond and futures markets. In other words, while the RBA's policy rate remains low, market participants have already adjusted their expectations and are pricing Australian bonds and futures as if several rate hikes have already happened – as traded markets are forward looking. Remarkably, the market implied rate for end of 2022 is at 2.8%, which may turn out to be excessive.

**Debt and deficit**

The Government has increased spending and accumulated additional debt in order to deal effectively with the pandemic. Increased interest rates also contribute to higher public sector debt payments over the medium term. However, according to a report by The Secretary to the Treasury and The Secretary to the Department of Finance, the budget deficit is expected to narrow down from 3.5% of GDP today to 1.6% in 2025-26 and 0.7% in 2032-33.

In conclusion, the Australian economy remains resilient and has performed well compared to most other developed countries. Idiosyncratic characteristics such as being a major commodities exporter helped Australia minimize the effect of the Russian-Ukrainian war to the local economy. At the same time, strong labor market and less extreme levels of inflation have put Australia in a good position from a monetary policy point of view. The full re-opening of the economy and international borders could be a positive catalyst for Australia, as migrant inflows could accelerate working-age population growth and increase domestic demand.

*Panos Mamolis is an Investment Specialist for Citi, a sponsor of Firstlinks. Any advice is general advice only. It was prepared without taking into account your objectives, financial situation, or needs. You should also obtain and consider the relevant Product Disclosure Statement and terms and conditions before you make a decision about any financial product. Investors are advised to obtain independent legal, financial, and taxation advice prior to investing. Past performance is not an indicator of future performance.*

## Where to find the opportunities of the future

### Nick Griffin

Global markets have entered a difficult period as fundamentals turn and the spectre of inflation remains on the horizon. As global economies faced myriad difficulties over the past couple of years, governments responded by supporting their economies through various crises with large amounts of debt. That, in turn, has meant the equilibrium level of interest rates has continued to get lower and lower.

But while higher inflation is now driving interest rates back up, it is unlikely they are headed back to where they were previously and ultimately, we are still living in a low-rate world.

Highly indebted governments (and consumers) can not afford rates to reach levels much above 3%. If they do get too high, the risk is that economies will be pushed into recession again.

All of this means it is a tough time for growth managers, and growth equities have been under pressure for some time. In fact, many of the problems in global equity markets were apparent as early as March of last year.

Investors need to remember that in any market environment, earnings growth drives stock prices. It's not an equity market. It's a market of stocks. So those companies producing great earnings growth can continue to do so through any cycle. It may not happen in a straight line, but it will happen.

Identifying big technological and structural changes in society are a key component in recognising opportunities. One of these areas that we are focused on is High Performance Computing. But more about that later.

**Market outlook**

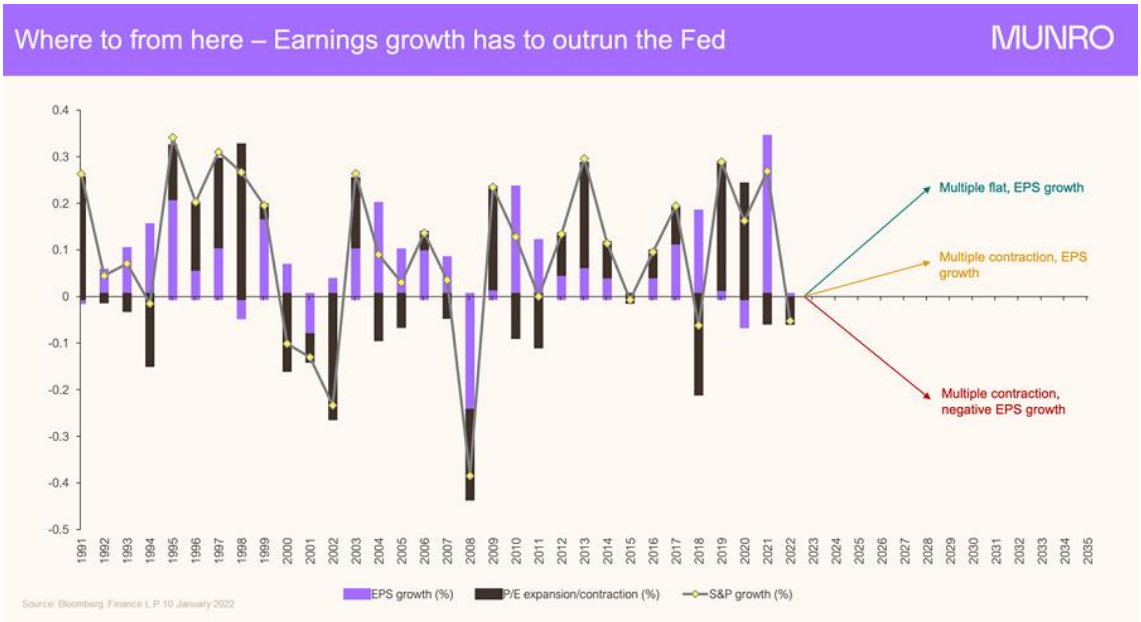
First let’s assess the current market outlook. As outlined above, we still believe the big picture is a low-rate world continuing to underpin high asset prices in the medium to long term.

In the short term, inflation is causing interest rates to go up. And expectations around interest rates have changed rapidly in the last 12 months alone. In March 2021, the US Federal Reserve was forecasting no rate hikes for the next three years. By December, estimates had increased to three rate hikes, rising to seven by March, with latest estimates at close to 10.

A simple way to think about markets is that if you take the earnings yield of the S&P 500 and subtract the US 10-year bond yield, you need to get a carry, or positive return, for taking the risk of owning equities, in the same way you expect a carry for the risk of owning a house or for owning high yield credit.

That carry has remained roughly the same at 3% for a long period. Markets might have gone up a lot, but interest rates have gone down a lot too, which means the market has not gotten more expensive for a number of decades.

We're now seeing that equity risk premium move below 300 basis points for the first time in a long while and that is creating volatility in equity markets. Fortunately, as long as you assume that interest rates won't get much above 3% in the long term, that equation will work itself out over time.




The above chart shows the different movements in S&P 500 earnings per share (EPS) growth, price-to-earnings (P/E) multiples and index growth over the past three decades. There are varying periods of P/E multiple expansion/contraction, EPS positive or negative growth and market movements.

We believe the most likely scenario for the year ahead is P/E multiple contraction and EPS growth. That is slower EPS growth this year and P/E contraction, and potentially reduced growth next year with more P/E contraction.

However, the worst-case scenario outcome – of P/E contraction and negative EPS growth – would require a large proportion of big US companies to simultaneously experience earnings contraction, something that is highly unlikely.

**Area of interest – the fourth era of computing**

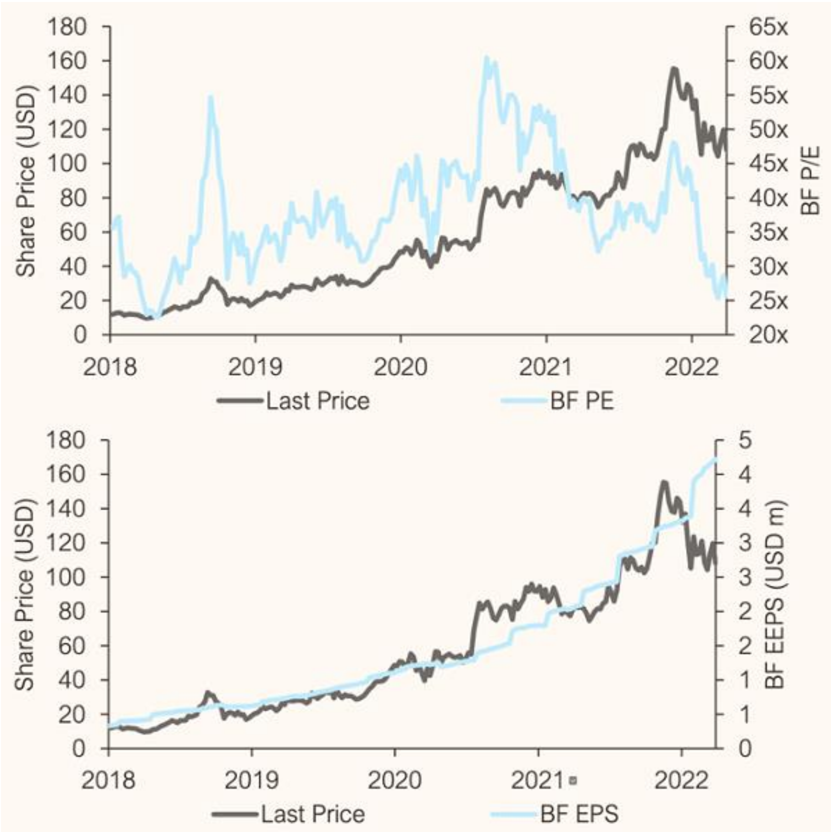
Investors invest in equities – not economies – and equities are driven by structural earnings growth, and this is why we like to identify key areas of Interest and structural change.

Semiconductors are one such area. Semiconductors have gone from a zero per cent market, or zero per cent business, nearly four decades ago, to half a trillion US dollars today. Semiconductors now are on their way to becoming a $US1 trillion business as we head into the fourth era of computing, or the artificial intelligence (AI) era of computing.

As every single device in the world becomes connected to the internet - your fridge, your garage, your security system, your airport parking, etc – a multitude of data is going to go up into the cloud. Once there, it needs to be processed at incredibly fast speeds with AI in order to create predictive outcomes. This is already happening to some extent with, for example, streaming service recommendations.

But all this high-speed data processing is going to require more GPUs or graphic processing units to create accelerated computing. We are forecasting that the server market has the potential to grow from roughly $US25 billion per annum today to nearly $US250 billion, or by a multiple of 10, by 2035.

There are only three or four companies worldwide that are in this highly focussed world of high-performance computer architecture and one of our favourites is semiconductor company AMD (Advanced Micro Devices). As a growth stock, it's obviously not currently popular, but it's going to get very exciting very soon.




*Source: Bloomberg Finance L.P 1 April 2022*

As indicated in the above chart, AMD's earnings growth has grown structurally over time and will continue to grow as more and more companies invest in this product. Not so long ago you had to pay 30 times earnings for AMD, but you can now buy it at 18 times earnings, even though it's growing its earnings at 35% this year. We forecast it will grow its earnings at 30% next year as well as it really is one of the great growth opportunities of the future.

**Final word**

There is no doubt it's a tough time to be investing in growth stocks but by continuing to identify the structural areas of interest, such as accelerated computing outlined above, growth fund managers and investors can take advantage of lower prices and be well positioned when the market and interest rates do return to some level of normality.

*Nick Griffin is Chief Investment Officer at Munro Partners. Munro is a specialist investment manager partner of GSFM Funds Management, a sponsor of Firstlinks. The information included in this article is provided for informational purposes only. Munro Partners do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our judgment at this date, are subject to change and should not be relied upon as the basis of your investment decisions.*

*For more articles and papers from GSFM and partners, click here.*

## Is this the real life or is this just fantasy?

### Marcus Burns

From time-to-time equity markets are enveloped by short-term irrationality and aspirational future cash flows. While some investors embrace this fantasy world, others choose to keep their feet on the ground.

I've likened this situation to The Matrix, the film in which people were offered the choice between taking a blue pill or a red pill.

The blue pill effectively plugged them into this sort of fantasy machine-led world. The red pill would reveal the truth and what's occurring in the real world.

Today we have blue pill investors and red pill investors. The question is which investor do you want managing your money?

**Blue pill investors**

These investors at the forefront of market irrationality have been driven by various forces, including:

- Historically low rates – you can't get yield on bonds; you can't get yield on cash in the bank.
- A belief that central banks will remain all powerful and they'd keep buying bonds forever and keep interest rates incredibly low.
- The rise of passive machine-led investing, which sees capital blindly flow into the biggest stocks in an index, regardless of fundamentals and valuations.

In this context, market disruption, trends and stories become even more of a drawcard. Growth stocks are all the rage. Especially small and microcaps. Afterall, there are few other options.

In this environment, the market went, what I call upside-down – it inverted. With rates being extraordinarily low, blue pill investors chased hyperbolic returns.

Case in point - the graph below. It summarises the ASX small and microcap universe of stocks between $50 million and $3 billion in market cap. It shows what would've happened if you bought a portfolio equally weighted of stocks that had negative operating cash flow from September of 2019.


*Source: Bloomberg, as at 28th February 2022. Australian listed stocks between $50m and $3bn market cap divided into positive op cash flow and negative op cash flow as at 1/1/2019. Average returns measured across basket of stocks.*

You can see that perversely, negative operating cash flow companies (blue line) materially outperformed positive operating cashflow companies on average over that period of time.

This is the blue pill fantasy world that we've experienced in recent years.

But as history tells us, it won't last forever. The stock market can be irrational short term, but in the long run, we have found that the laws of economics, a little like gravity are hard to escape. We think the market is actually very rational in allocating capital over time.

**Red pill investors**

Also in the above chart, you can see the curve does come down towards the end of the period. We are starting to see negative cash flow operating companies pulling back as rates tick up and people wake up to the fact that inflation is likely here to stay.

A rising interest rate environment also sees the cost of capital rise and a "risk off" environment emerge. This is what happens in the real world.

While blue pill investors have dominated markets in recent years, red pill investors realised that for a long period of time, capital has been very cheap and the way capital has been allocated (by both companies themselves and investors) has perhaps been a little loose. They stuck to fundamentals and never forgot that valuations matter. All the while, as blue pill investors dominated markets, red pill investors were presented with an abundance of opportunity.

Now a critical juncture is emerging. Rising interest rates have a flow on effect that means cash burning companies are actually becoming more costly to hold. With interest rates on the rise this does tend to lead people back to the notion that cash is actually worth more today than tomorrow.

Disciplined red pill investors always focus on sustainable free cashflow and look at numbers through the cycle.

Long term investors would have seen all types of stocks go through cycles. We like the idea of trying to smooth out aggressively over-earning companies and not punishing companies that are temporarily under-performing on a short-term basis. This is the reason we look at 'through the cycle' cash flows and earnings.

Furthermore, we like to buy stocks that have low debt levels. Why? With rates rising, the cost of debt is increasing, and this puts pressure on the earnings of these companies with massive amounts of debt on the balance sheet. Additionally, we are trying to buy stocks at a discounted valuation. We try to value the stock on a mid-cycle basis and pick these stocks up at a decent discount.

And the final point is that we do keep an open mind for inflection points and changes in a company's strategy or management teams.

**A red pill stock idea**

Michael Hill (ASX:MHJ) is one of our key portfolio holdings and one we think is a great illustration of long-term red-pill thinking.

It is a specialty jewelry retailer with operations in Australia, New Zealand and Canada, with a 40-year-plus track record. It is also a company that has been completely ignored in recent years by blue pill thinkers who favoured hot tech companies and concept stocks.

However, the graph below demonstrates some of the reason why we think it is a compelling opportunity for red pill investors.


*Source: Morningstar, IRESS, Spheria*

By looking at cash flow conversion (left graph) you can see how much of the earnings reported on an accounting basis that transfers into cashflow.

Additionally, we look at return on capital metrics (right graph). If earnings are growing on a fixed cost base and fixed capital base, there's little doubt that earnings and returns will improve over time.

Current CEO, Daniel Bracken was hired several years ago. Since joining Michael Hill, Daniel has invested in technology, changed the pricing strategy, introduced a loyalty program and driven increased online sales. These changes have diversified the revenue stream and have led to dramatically improved results.

So much so that even the first half numbers just reported showed strong returns and earnings growth, despite approximately 20% of trading days being lost due to COVID lockdowns in Australia.

**Investing for the long term**

We believe that a focus on fundamentals and valuations will lead to long term outperformance for investors who are patient. For those caught up in irrational exuberance, they could very well find themselves caught in a capital landslide.

Ultimately, we live in the real world. And investors can't continue to escape reality.

*Marcus Burns is Co-founder and Portfolio Manager at Spheria Asset Management, an affiliate manager of Pinnacle Investment Management. Pinnacle is a sponsor of Firstlinks. This article is for general information purposes only and does not consider any person's objectives, financial situation or needs, and because of that, reliance should not be placed on this information as the basis for making an investment, financial or other decision.*

*For more articles and papers from Pinnacle Investment Management and affiliate managers, click here.*

## Arms stocks don't belong in our ESG funds

### Victoria Maclean

Excluding defence companies has long been common practice for responsible investors. At a minimum, most negatively screened 'ethical' funds exclude the controversial weapons banned under international law for example chemical weapons and cluster bombs. However, most funds take it a step further and exclude all companies (typically screened on a revenue basis) involved in weapons manufacture due to the preferences of many underlying investors.

The invasion of Ukraine has shocked the world and spurred many countries to increase their spending on defence. Germany has announced a €100bn spending package and a commitment to reach 2% of GDP spent on defence. Poland will raise its defence spending to 3% of GDP starting next year, and Lithuania, Romania, Sweden and Denmark have all announced dramatic spending increases. Even in Australia, Scott Morrison announced a plan to increase the size of the Australian Defence Force by 30% over the next 18 years.

Whilst the reaction of these countries is not unexpected, it has been fascinating to follow the conversations from within the investment industry about whether armaments could or should now be considered appropriate environmental, social, and governance (ESG), or even impact investments. We have seen calls for the EU to recognise the defence industry as a positive contribution to 'Social Sustainability' under the EU Taxonomy which has been convened by the European Union to define the ESG investment rules.

According to the UN Global Compact, social sustainability is about identifying and managing business impacts, both positive and negative, on people. Within social sustainability, human rights are the main component that would be relevant to questions of defence. Protecting and promoting human rights would be seen as a positive contribution to social sustainability.

A recent report from Citi seems to indicate that they see no challenge in applying this definition: "Defence is likely to be increasingly seen as a necessity that facilitates ESG as an enterprise as well as maintaining peace stability and other social goods." Similar conclusions have been reached in the financial press: if something is obviously vital to maintaining peace how can it also cause social harm?

We find this approach astonishing. The defence function of governments is an important one, and they do rely on private actors for components and equipment. But the social sustainability of their use will be entirely dependent on how a government manages its defence function.  We don't need to look too far into history to find examples of actions taken in the name of defence which has resulted in significant social harm.

Taking the view that weapons contribute to positive impacts that outweigh the harm is a challenging conclusion to reach in our view. Not only does it require analysis of the customer base, but it also requires normative judgements of who are the good and bad actors, and which conflicts are justified. We prefer to consider the issue from the perspective of risk of negative impact, rather than taking a normative view. With this lens, it is very difficult to reach a conclusion about the net positive impact of these activities given the inherently high risk of human harm, particularly given that the companies can't influence their product's end-use.

Investors have two main ways of creating positive impact: influencing the cost of capital and engagement. These have evidence of success in areas such as climate and diversity. In the defence industry, they risk being significantly less effective. Defence is a government function. Defence expenditure and budgets are set by governments and those spending decisions are likely to outweigh any impact on the cost of capital from investor decisions. Secondly, private enterprise doesn't influence defence strategy, it merely acts as part of the governmental supply chain. It is difficult to see how investors could have any influence over the use of these products to ensure they only achieve social good. More importantly, it's questionable whether we would want either capital markets or the companies themselves to have influence over defence decisions.

The debate has made clear that there is still a lack of clarity on the difference between impact and ESG investing. The latter is about risk mitigation and the sustainability of internal operations. Investors who choose to invest in the defence sector should certainly consider material ESG risks in their decision-making and engage on those matters. Impact is about furthering social sustainability, and this is where it is hard to make the case for the defence sector.

Finally, there is a question about why now? This conflict is different. Its potential scale and the nuclear threat are unlike anything that we have seen in recent years. Who it's affecting and our ability to identify with the victims of this crisis may also have played a role in the sudden emergence of the "defence is ESG" claim. But the need for defence is not new. Larger budgets may improve the growth opportunity and for some that will make defence a more attractive investment. However, it doesn't change the underlying principles of ESG and impact investing, and it doesn't justify the conclusion that defence contributes to social good more so now than it did before this conflict.

*Victoria Maclean is Associate Fund Manager, Pengana WHEB Sustainable Impact Fund*

*Disclaimer*

*This message is from Morningstar Australasia Pty Ltd, ABN 95 090 665 544, AFSL 240892, Level 3, International Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000, Australia.*

*Any general advice or 'regulated financial advice' under New Zealand law has been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. For more information refer to our Financial Services Guide (AU) and Financial Advice Provider Disclosure Statement (NZ) at www.morningstar.com.au/s/fsg.pdf and www.morningstar.com.au/s/fapds.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement before making any decision to invest. Past performance does not necessarily indicate a financial product's future performance.*

*For complete details of this Disclaimer, see www.firstlinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.*