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Editorial

"Glory days, yeah they'll pass you by
Glory days, in the wink of a young girl's eye
Glory days, glory days

Think I'm going down to the well tonight
And I'm going to drink 'til I get my fill
And I hope when I get old I don't sit around thinking about it
But I probably will
Yeah, just sitting back trying to recapture
A little of the glory of, well time slips away
And leaves you with nothing mister but
Boring stories of glory days"

*Excerpt from Glory Days, by **Bruce Springsteen***

Fund manager reports for last financial year are drifting into client mailboxes, and the glory days have passed by many of the portfolios. With markets taking a major downward turn in 2022, the managers who missed the change are delivering disappointing results, often worse than expected. Bond investors will be shocked to see supposedly defensive funds down 10%, while global equity index funds have lost 20% in calendar 2022. In a sector such as US small company growth funds, some losses range from 40% to as high as 70%.

Investor reaction will vary and depend on the entry point and understanding of the manager. A common feature of funds with the worst 2022 was a strong 2021. Despite believing that many of their stocks were in bubble territory, often wildly overvalued, some managers held on to their winners too long. They thought they should let their growth stocks run due to a fear of missing the last drinks at the bar, but they should have left the party earlier.

Even in passive land, the results are sobering. For example, here is the performance of two global index ETFs from Vanguard, the MSCI International (ASX:VGS) and the MSCI International Small Companies (ASX:VISM). One is down 15% and the other 20%. Some active fund managers are down 20% or more than these indexes in the latest reporting period.

Source: Morningstar

What are the explanations? Here is one of the more honest and open from **Steve Johnson of Forager.** In FY21, Forager's two funds returned an exceptional 79% (global) and 87% (Australian). Then in FY22, losses were 38% and 28% respectively. Over two years, most clients are probably happy, but not if success encouraged investment in June 2021. Johnson is upfront:

"In our International Fund, we took baby steps when giant steps were required ... We were aware of and vocal about a bubble in growth stocks. I wrote a CIO letter in our December 2020 Quarterly Report warning about the risks of higher inflation. We sold half our position in some stocks that were beneficiaries, three-quarters of our stakes in others ... But the returns have still been terrible. The remaining investments in the winners of 2021 tumbled, some more than 70% ... Paraphrasing Warren Buffett, predicting rain doesn't count if you don't build arks as well. Our portfolio changes were meaningful but they needed to be dramatic. Patience is usually a virtue but there are times when urgency is called for. The 2022 financial year was one of them."

Such actions explain many of the results. **Scott Berg** of **T Rowe Price** told a Sydney audience this week that he knew the market was in a bubble, driven by free money in 2020 and well into 2021. He made some portfolio adjustments, but in late 2021, just as conditions looked better, two events hit. One was the new Omicron variants, especially in China, and the second was the Ukraine war and its impact on commodities. And so his portfolio in 2022 gave back much of the gains made in the two prior years.

Tony Lewis of **EGP Partners** explained the late 2021 change this way:

"In October 2021, the fund for a period of a few days was handsomely outperforming our index for the financial year. Our largest holdings were all executing well on their strategies and the market was awarding them pricing that (especially in hindsight) placed a high valuation on these prospects. Since that point in October, despite generally continuing good fundamental performance from most of our major holdings, there has been a massive reversal in the valuation the market ascribes to their prospects."

The most dramatic turnaround is probably in the **Frazis** fund, up 93% in FY21 and down 71% in FY22. **Michael Frazis** was interviewed by *The Australian Financial Review* in January 2021 after his success in 2020. The AFR said:

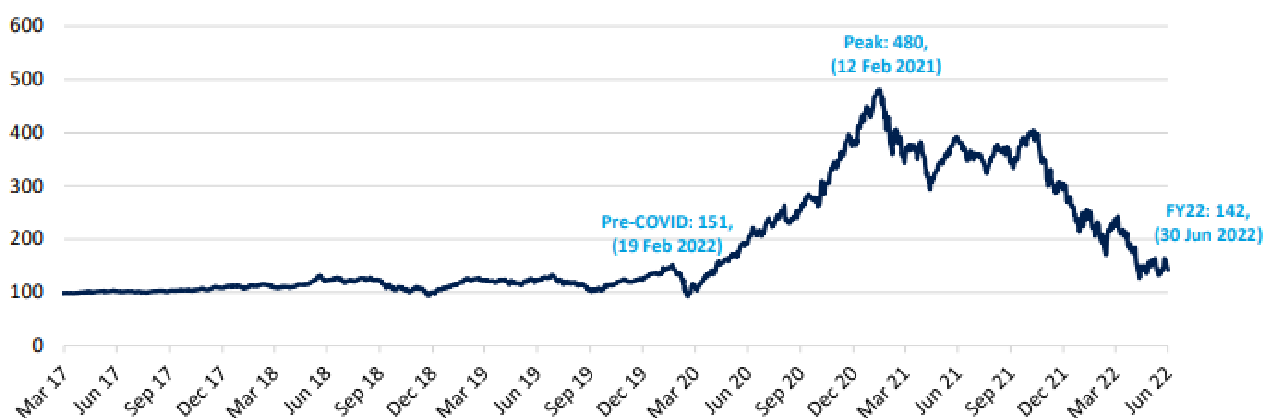
"He barely pays attention to traditional valuation metrics such as price-to-earnings ratios, in part because the companies he likes to buy normally don't have any earnings."

Then Frazis is quoted directly:

"We'll tend to be gone by the time the profits come through. We want our companies spending and growing – hiring staff, opening new locations, putting money back into the community, spending on R&D. That's the perfect profile for me. As the companies mature, that's when they become profitable and the growth slows down, that's when we exit. We want companies investing heavily in doing really great things. That's how I look at profitability, which is different, right? It's different to most people."

The timing of the interview must have seemed ideal in January 2021 on top of the stellar results. The **Goldman Sachs'** 'Non-Profitable Tech Index' peaked on 12 February 2021 at 480 and was down to 142 by 30 June 2022, off 70% in 18 months.

Figure 4: Non-Profitable Technology Index (indexed to 100)



Source: Goldman Sachs as at 30 June 2022.

For anyone thinking this is all hindsight, the following was also written in January 2021, the same month as the Frazis interview, by **Anthony Aboud of Perpetual**, who admitted it "vents some of our frustrations" at missing the party:

"Right now, market participants are basing their investment decisions on how articulate a CEO is, whether or not a company fits the narrative of the day, the long term total addressable market (TAM) and how many times a CEO says the words AI or network effect on their conference call. At some point, the market environment will change, and focus will swing back to companies making sustainable cashflow. When that happens, we will see a lot of these hyped-up tech names fall 90+%."

And 18 months later, that has played out. For what it's worth, on [9 December 2021](), I went against my usual preference to not predict stockmarkets by saying I was reducing my personal exposure in anticipation of a decent fall.

Those who invested at the end of 2021 based on promotional material that boasted of 'protecting capital' and 'deep research' have a right to feel disheartened. Some manager reports are blaming the 'market' for misunderstanding the amazing growth opportunities, but there was too much hubris over 2021 as markets recovered from the pandemic. Was there a belief that inflation and interest rates were low forever, that central banks would come to the rescue and it did not matter if company profits were too far into the future? Risks were building at the end of 2021 and into 2022 yet too many stayed invested in companies while their circumstances changed.

Jeff Ptak, Chief Ratings Officer for **Morningstar** examined the performance of domestic US equity funds to the end of May 2022 and concluded:

"I would say active managers are prone to exaggerating about their prowess during down markets. It's usually not as good as they say, not as persistent as they say, and not as important to their long-term success as they would lead you to believe."

Amid the pessimism, we are experiencing a strong 'bear market rally' at the moment. The recent **Bank of America** fund manager survey showed a 'dire level of investor pessimism'. When the market capitulates, that is a signal to many that we are near the bottom. Cash allocations are at their highest for a decade, showing plenty of dry powder. Many professionals are asking if we are at the start of a new period of Glory Days.

Once again, **Charlie Munger**, Vice Chairman of **Berkshire Hathaway**, was on the money at the 2021 Annual General Meeting.

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

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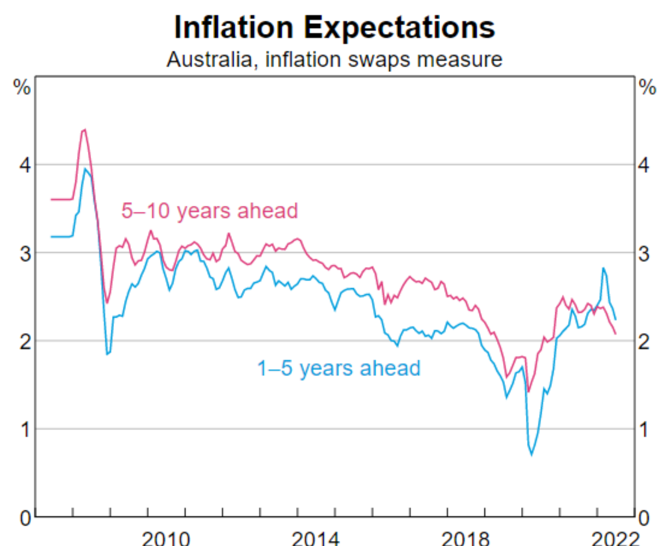
Has there ever been more general public interest in inflation? It's even reached the unusual point where the **Prime Minister, Anthony Albanese**, has warned the Reserve Bank against "overreach". The Reserve Bank's change of tune over a few months is extreme, as the minutes of the June meeting showed this week:

"The level of interest rates was still very low for an economy with a tight labour market and facing a period of higher inflation. Members viewed it as important that inflation expectations remained well anchored and that the period of higher inflation be temporary. Members agreed that further steps would need to be taken to normalise monetary conditions in Australia over the months ahead."



This week, we look at the for-and-against arguments [whether inflation has peaked](). This was among the many subjects addressed by the **Reserve Bank Governor, Philip Lowe**, [in another speech]() on Wednesday that reiterated his recent views. He showed this chart as a measure that inflation expectations are tempering.

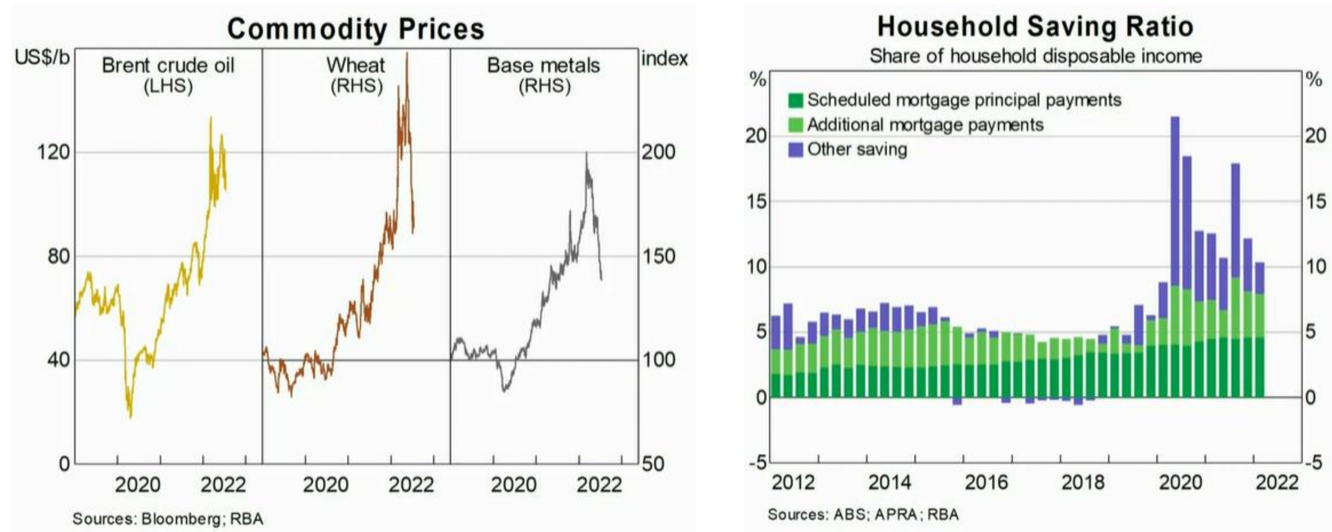
Lowe also seemed to go a step closer to accepting more responsibility for rising prices.

"I recognise though that while this approach meant we avoided some damaging long-term scarring, it has contributed to the inflationary pressures we are now experiencing."

And he took some pressure off the expectation of immediate tightening, such as **ANZ Bank**'s new forecasts of 0.5% in each of the next four months. He said of his firm intention to keep inflation in the 2-3% band:

"We don't need to return inflation to target immediately, as we have long had, for good reasons, a flexible medium-term inflation target."

He showed this Commodity Prices chart (below, left) as evidence of lower commodity prices offering hope. A major investment implication is the effect on the mortgage books of our banks. Lowe also used this Household Saving Ratio slide (below, right) to show how well positioned households are to withstand rate rises.



Australians rightly feel secure with their banks, not only supported by the Reserve Bank whenever they are in trouble, but with strong capital positions and assets heavily weighted to mortgages. But the banks time some of their capital management moves poorly. **ANZ** is looking to buy **Suncorp** by issuing $3.5 billion of new shares at $18.90, but only a few months ago, it bought $1.5 billion of ANZ shares at $27.70. As we have reported before, **NAB** issued $4.25 billion of new shares at $14.15 in June 2020 and is buying back over $3 billion worth at $28.63 per share. Shareholders don't seem to complain.

On the subject of banks and risk management, **Tim Fuller** compares the Australian and American approach to mortgages. Is there anything to learn from the land of 30-year fixed rate mortgages and its impact on borrowers and monetary policy?

Our interview this week is with **Adam Grotzinger** of **Neuberger Berman**. If there is a beneficiary of the interest rate rises, it may be new investors into bond funds who have avoided a painful adjustment phase. Adam explains how diversified global bond funds available to Australian investors are delivering around 7%. Is it time to lock some of this away, or will prices fall further?

As consumers around the world were locked up in 2020 and 2021, they turned to online stores and everything servicing that market soared. Now, even the **Zooms, Amazons, Metas, Pelotons and Kogans** of the world have fallen to earth, replaced by services and experiences. **Aneta Wynimko** looks at the 'opening trades' which are helping travel, hotels and other industries.

At turbulent times like this, it pays to check some basic principles, **Shane Oliver** reminds us of nine quick investing tips which stand the test of time.

Then two articles on personal tax and aged care management. **Rachel Lane** explores the impact on residents of aged care homes of the largest rate change in the Aged Care Interest Rate since the GFC. As tax season kicks off, **Michael Brown** looks at the tax advantages of ETF over managed funds.

Has inflation peaked? The yes and no arguments

Graham Hand

There is no more important market statistic at the moment than inflation. It determines consumer spending, company margins, central bank policy and of particular interest to millions of Australians, mortgage and deposit rates. High inflation and high rates will push down property prices, affecting the asset in which most Australian wealth is held, the $10 trillion of residential property.

While there is growing optimism that inflation will peak in 2022, the coming European winter threatens to maintain high food costs. We are now realising what a terrible strategic mistake France and Germany made with their dependence on Russia for gas, giving Vladimir Putin not only the money to finance the war, but the ability to turn off a pipeline and hold Europe to ransom. As The Economist wrote on 15 July 2022:

"In Europe we look ahead to the bitter energy shock that is in prospect. You may be sizzling on a Mediterranean beach or slow-roasting on the streets of Berlin, but winter is coming, and it promises to be brutal and divisive. As Vladimir Putin strangles supplies of Russian gas to Europe, the warning signs are flashing red. Prices for delivery of gas this winter, at €182/mwh ($184/mwh), are almost as high as in early March, after Russia invaded Ukraine, and seven times their long-run level. Governments are preparing to rescue crippled utilities in France and Germany, and some investors are betting on which industrial firms will go bust later this year as rationing takes hold. Several calamities in the past decade have come close to ripping Europe apart, including the euro crisis in the early 2010s and the migrant crisis in 2015. The winter energy shock of 2022 could yet join them. Once again, the continent's unity and resolve are to be tested."

From easy to ignore to impossible to avoid

For many years, inflation has not mattered much. In fact, the main worry for the Reserve Bank was deflation, and trying to push inflation into its 2-3% target band.

This chart shows the low US inflation and interest rates for the last decade, and it drove a rapid escalation in asset prices, and with it, massive speculation using free money that is now undergoing a painful unwinding. The US represents almost 60% of global stockmarkets, and where the US goes, Australia follows.

This article on where inflation is headed draws on other authors who take different views on our inflationary outlook.

1. US inflation hit another record in June but this is the peak

This is edited highlights from an article by Lauren Solberg of Morningstar.

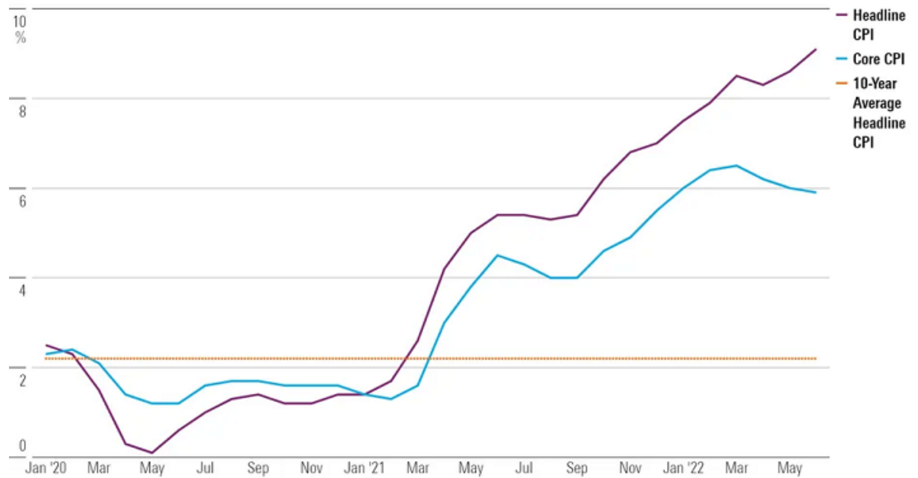
American consumers haven't seen any relief from rising prices according to the latest US inflation report. In fact, they've been getting worse. And that could mean even more aggressive interest rate increases from the Federal Reserve, further raising the risk that the US economy might be forced into recession in order to cool off rising prices.

Morningstar's Chief US Economist, Preston Caldwell, says:

"The June report will almost certainly mark the peak in inflation, as food and energy prices are set to fall sharply in next month's report. The uptick in inflation was driven heavily by food and energy prices, but indicators of food and energy prices have plummeted in July, which will show up in the next CPI report.

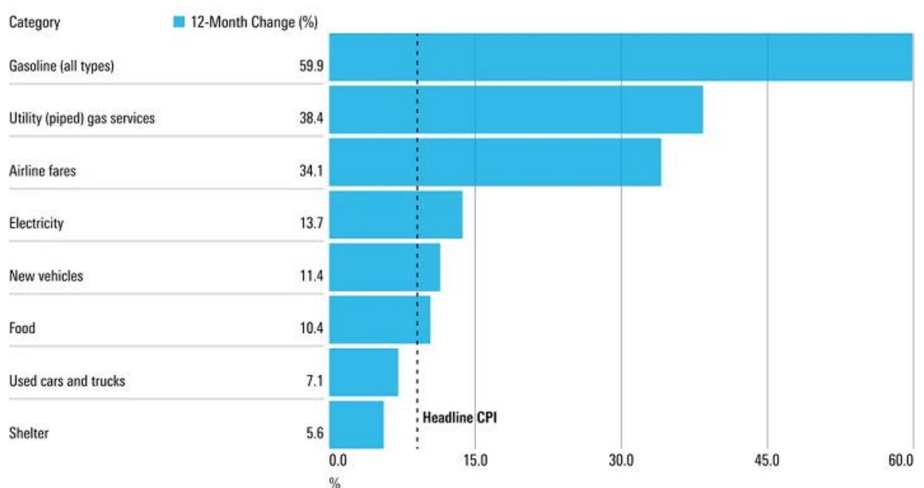
"It's still the case that the bulk of the inflation problem since the start of the pandemic has been driven by supply disruptions in autos, energy, and food. We expect these issues to be resolved, contributing to an unwinding of the inflationary surge."

For June, the Bureau of Labor Statistics reported that the Consumer Price Index rose a larger-than-expected 1.3% in June. Year over year, inflation was up 9.1% in June, the biggest increase since November 1981.



Caldwell says:

"The June report did show signs of a broadening in inflationary pressures, as have the last several months. This probably reflects a catch-up of pricing for businesses and industries which have lagged behind the overall inflation trend. However, the Fed has the opportunity to nip in the bud this broadening of inflation. Wage growth is running at moderate rates, so if the Fed continues with its course of tightening, we don't expect inflation in the broader economy to remain high."



While the jump in US inflation was widespread, the cost-of-living increases were concentrated right where it hurts consumers most: food, fuel, and shelter. Excluding food and energy, the CPI rose 0.7% in June, and 5.9% over the last 12 months.

Futures markets are suggesting the Fed could raise rates by a full percentage point in July. The Fed has not raised rates by that amount since it began using the fed funds rate as a target under Alan Greenspan in the late 1980s.

Caldwell thinks that given the drop in commodity prices, a 1% tightening is unlikely. He believes further rate increases will bring the fed funds rate up to 3% by the end of 2022. He expects news on inflation to improve through to the end of the year, although the Fed will continue tightening until it feels victory over inflation is assured.

2. Why inflation might have peaked in June

This is edited highlights from Samuel Smith, author of High Yield Investor.

In this article, we will share five reasons why we think inflation may have peaked in June and why we think inflation will still remain at an elevated level for the foreseeable future.

Reason 1: Falling commodity prices

The biggest green shoot for a peaking of year-over-year CPI increases is the fact that commodity prices have been falling in recent weeks, and the market seems to be pricing in substantial further declines given how it is

pricing businesses in those industries. For example, energy giant Exxon Mobil, agricultural giant Nutrien, and mining giant Rio Tinto have all seen their prices plummet in recent weeks.

In fact, the pullback in these key commodity sectors has prompted Barclays to reduce its year-end CPI forecast by 600 basis points to 5.7%, which is a far cry from the robust high single digit first half numbers we have been seeing so far in 2022.

Reason 2: Supply chain backlogs clearing

Shipping costs are falling and product delivery times are improving according to Pantheon Macroeconomics. This is the result of gradual efforts to combat backlogs finally taking effect, continued reductions in COVID-19 related headwinds, and demand destruction resulting from higher prices.

Reason 3: Reduced inflation expectations in bond markets

The performance of the iShares TIPS Bond ETF (TIP) year-to-date says a lot about expectations for inflation. Despite inflation rates soaring this year, TIP has had a rough performance year-to-date. That is because bond market investors are not expecting inflation levels to stick around and TIP's performance is dependent on long-term inflation levels, not necessarily just the short-term performance.

(Editor's note: In Australia, this is equivalent to inflation-linked bonds, where there have been similar price movements, such as on the Vanguard Inflation-Linked Bond Index ETF).

Data by YCharts

While bond market investors are not always right, where they put their money often sends a powerful signal of where things may be headed.

Reason 4: Decelerating wage growth

While wages continue to grow at a strong pace relative to history, June's 5.1% year-over-year increase was a deceleration from earlier in the year and lags 400 basis points behind the inflation rate. This implies that the current inflation rate is not only unsustainable given that it significantly exceeds the growth in workers' income levels, but it also means that cost pressure growth on businesses is beginning to subside, which is also a deflationary signal.

Reason 5: Inventory growth

Last, but not least, as was already mentioned the supply chain is finally catching up with the post-COVID demand explosion, leaving retailers with demand surpluses. On top of that, rapidly rising interest rates are making it more difficult for buyers to finance products that have typically been purchased on credit. A big example of this is the housing sector, where home builders are having to slash prices in order to move inventory. Similar things are being predicted for the used car market.

Investor takeaway

Inflation remains at the forefront of most consumers' and business' concerns and for good reason. CPI remains at four-decade highs and has accelerated thus far this year. However, there are several clear evidences that its momentum is declining and in fact CPI might have actually peaked in June.

As long as the economy suffers no more major supply shocks and can continue to iron out its imbalances, inflation should settle at a more reasonable level in the near future and remain there until deflationary technological innovations can bring it down still further.

3. Inflation? We ain't seen nothin' yet

The third piece is an edited transcript of a video by Peter Zeihan. He is one of my favourite commentators on geopolitics, with vast knowledge of world events, including the war in Ukraine.

Well, the new data that came out of the United States government is not great, suggests that the inflation rate within the American system is about 9.1% which is easily a 40-year-high. And if you look at most of the things that are going on with the markets and with jobs and with energy and with food, it's going to be going up. So let me knock down all of those real quick so you see where we're coming from.

Ongoing food shortages

We're looking at fertiliser limitations on a global scale. The Chinese have restricted the export of phosphate because they need it for rice, the Russians are discovering it's hard to get their potash out because of the shutdown of a rail or partial shutdown of a rail line that goes through Belarus and into Lithuania on the way to the port of Kaliningrad. And because natural gas prices are so high, a lot of companies, particularly in Europe, have stopped making nitrogen-type fertilisers at all. So we've got price pressures in all three.

In addition, the world's number one wheat exporter, Russia, has invaded the world's number four wheat exporter, Ukraine and is systematically destroying all civilian infrastructure it comes across with a double emphasis on agricultural infrastructure. So we have already lost one of the world's great agricultural powers. And probably before the end of the year, Ukraine will devolve into a net importer for at least several years.

Demographic changes

On top of that, the Baby Boomers are moving into retirement and the replacement generation that is taking their jobs is known as the Zoomers. While the Baby Boomers are the largest generation we've ever had, the Zoomers are the smallest in calendar year 2022. There is already a shortage of 400,000 workers and that number will increase each year until at least 2034 where it will probably peak at around 900,000 shortage.

This is not gonna get better anytime soon. And as frustrating as that is, it is so much worse everywhere else. Now the United States may have a slightly damaged demography the whole Boomer versus Zoomer problem, but America's Baby Boomers did something that most of their equivalent cohort around the world did not do. They had kids. Millennials are spending now, and that gives the United States a ballast demographically and economically that most countries in the world don't have.

The US consumer has about $2 trillion of spare cash still saved up from the aftermath of COVID. And so we're not seeing meaningful reductions in retail sales or general consumption. In fact, with the US now mid-summer, people are traveling as much as they possibly can which is putting more pressure on everything.

Why does this matter for inflation?

The US Federal Reserve still has a consumption profile that it can regulate with interest rates. So the Fed is likely to do another sharp rate increase very soon and at least one or two more before the end of the year. Because the American system has consumption, we have a tool that is still appropriate to the situation. Europeans don't.

The Europeans don't have much a Millennial generation. If they were to raise interest rates, it really wouldn't have any impact on consumption. So if they raise rates at all, they're gonna be going more slowly and in lower increments, and that is widening the differential between rates in the United States versus rates in Europe, which is pushing the Euro through the floor.

On the same day that the inflation data came out, the Euro officially dropped below parity, something that it hasn't done in 20 years. And while there's always all kinds of fun and crazy stuff that happens with currency trades, on the whole, we shouldn't expect the Euro to recover. There's no consumption. Interest rates are not an appropriate tool.

That makes inflation in Europe even worse, because oil is dollar-denominated, natural gas is dollar-denominated, food is for the most part dollar-denominated and so are fertilisers, so is iron ore, so is bauxite, so are most of the commodities and most of the finished metals. And now the Europeans are not simply dealing with less consumption and less economic activity and more exposure to Russia. They're also dealing with an environment of currency weakness. Everything that they need to make modern society work has to be imported in someone else's currency and that currency is going through the roof.

So yes, inflation in North America is bad. It's probably gonna get worse. But nothing compared to what the Europeans are wrestling with.

Peter is the founder of [Zeihan on Geopolitics](), is a geopolitical strategist, speaker and author. This article is general information and does not consider the circumstances of any investor. His recently released book is [The End of the World is Just the Beginning]().

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Where does that leave us? To summarise a few points:

1. The market expects a spike in inflation for the next year, due to supply constraints and strong spending, but then inflation will slow.
2. If we look back to pre-Covid, the reason central banks feared deflation was the growth of cheap Asian goods, especially from China, and it's likely trade globalisation will eventually unlock again.
3. Again longer term, the ageing of the population, especially in Europe and Asia, will be deflationary as older folk tend to spend less than younger people setting up houses and brining up families.
4. Europe realises it has become too dependent on Russia for energy, and while the adjustment to other sources, including renewables, will be slow and painful, at some point the change in energy mix will take pressure of the oil price, especially as European growth slows. It was not that long ago when oil was trading close to zero.
5. And finally, what was the major factor reducing company costs and driving down prices in recent years? Technological change and disruption bringing new competition to most industries. This will not stop.

Many of these factors are more likely to act on inflation over the medium to long term, leaving the next year or two exposed to more pain.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any person.

How diversified bond portfolios yield 7%

Graham Hand with Adam Grotzinger

Adam Grotzinger is a Senior Portfolio Manager for Neuberger Berman's Strategic Income Fund, widely available on Australian platforms. Neuberger Berman manages about US$440 billion across all asset classes in 35 offices worldwide, including Sydney.

GH: It's been a difficult time for investors with global stockmarkets down 20% and major bond indexes off 10%, even US Treasuries. Is it a 'nowhere to hide' period for investors?

AG: Yes, in the wake of the so-called 'interest rate normalisation' from very low government rates and the supply-demand imbalance after Covid, there's a stark recalibration in yields and spreads that have hit both bonds and risk asset globally.

GH: You manage the Strategic Income Fund. How has the macro environment affected the way you've positioned the fund?

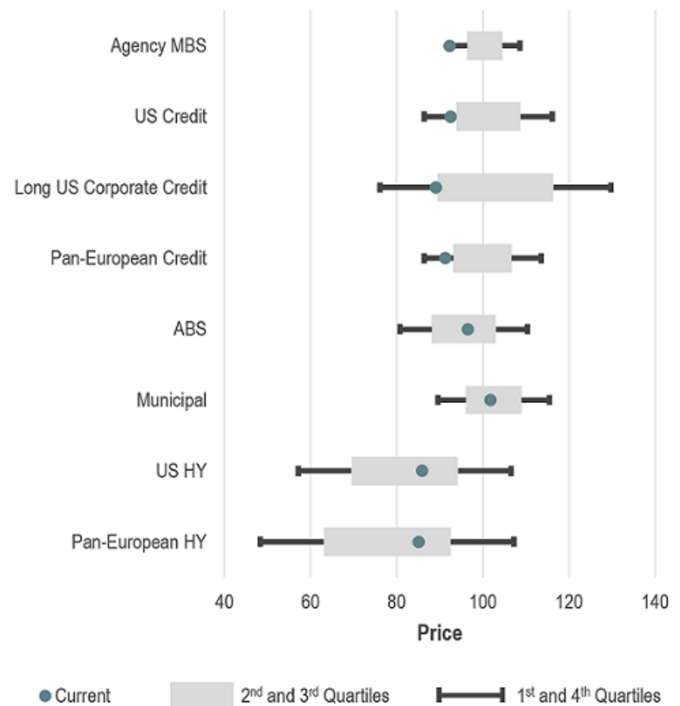
AG: When we were winding down 2021, we had a view that 2022 would bring a lot of macro, central bank-induced volatility due to the lift off from the zero boundary of interest rates. It then happened in quick order and sizable magnitude. So in Strategic Income, we brought down the risk budget of the fund in Q3 and Q4 of 2021, we reduced the high yield exposure and the market value of exposure, and we increased to about 20% cash and cash equivalents as ballast. We were largely invested but feeling good about on a line-by-line basis on the credits we owned coming into choppy waters.

But we've also evolved from concern about interest rates and macro trends to increasingly economic and growth worries, so we've been gradually redeploying capital back into the bond market where we think there's good value. It's mainly in investment grade assets largely in the US. As a result of the adjustment factors, they yield attractive margins and we see value at these levels. We have good quality corporate debt at 150 basis

points (1.5%) over Treasuries, triple-A agency mortgages with coupons of 5%. It gives us a portfolio yielding around 7% for an average credit quality of A-minus. Cash is down to 7% so we still have some dry powder.

GH: This availability of 5% to 7% yields is something investors haven't seen for many years. Do you think credit markets are closer to pricing in a recession than equity markets?

AG: Well, right now, we see better relative value on a multi asset basis increasingly in fixed income. The adjustment has occurred in short and swift order and the risk/return looks attractive, even if we have a technical recession in the US. For instance, the US high yield market spreads have offered 500 to 600 basis points (5% to 6% above Treasuries) and that level of compensation is out of kilter. It is pricing in a much worse environment for defaults than we are modelling from a bottom up, issuer-by-issuer analysis. So we have a different takeaway there from the market and that's leading us to see better value. It started in favour of investment grade but it's seeping into the lower quality credit end.

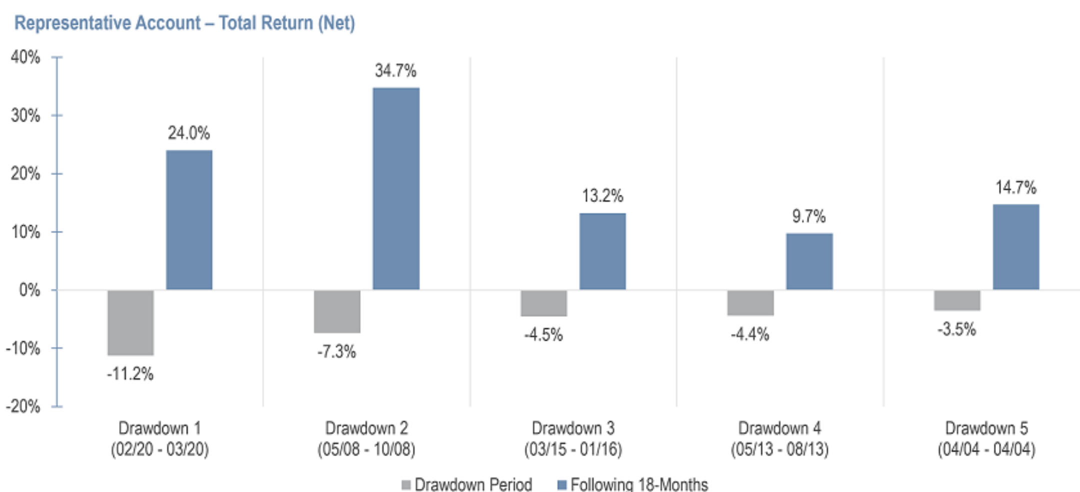


Source: Bloomberg. Ranges represents 20-Year High/Low. As of June 2022.

GH: Even when you expect higher yields and wider spreads, you essentially need to stay invested to generate income despite some price deterioration. Do you need to communicate to clients that this year is more of an income story than a capital gains story?

AG: Yes, setting expectations is spot on for the environment we're in and the objectives for a multi sector bond fund. We embrace market volatility, but the distinction is that we don't want to embrace impairment risk by poorly underwriting credits. So there's some short-term volatility in the fund but the medium-term objective is to make the opportunities work for our clients. Expectations need to be set.

Since before the GFC, after the top five drawdowns (falls in price) in the Fund, the following 18 months more than recovered those losses. We need prudent amounts of risk so we're not forced liquidators of credits and with ample liquidity to buy assets on the cheap. It has enabled us to recover more than the temporary marks down.



Source: Neuberger Berman, as of 31 March 2022

GH: Do you own any Australian securities?

AG: Not today in the Strategic Income Fund but it has been a market we've used in the past. In looking for compelling relative value on a global basis, the portfolio is anchored on the US market given the macro environment and the greater growth opportunities versus say Europe, for example.

GH: Does the massive strength of the US dollar, now at parity with the Euro, influence your positioning?

AG: No, currency is not a big part of how we reach our objectives. It's more about bond returns and relative value opportunities

GH: Looking at aggregate fund flows in fixed interest, we've seen outflows globally in the June 2022 quarter. What was your experience, and do you find it a little frustrating that when there is finally some value in fixed income, investors leave the sector?

AG: Well, I let the market determine where capital goes, but it is frustrating when we think there's good value after a painful readjustment process. We recognise the path to that value has been painful for some clients. We've been fine on flows, we have a long history of managing daily traded vehicles and we respect the needs of clients to adjust their asset allocations.

GH: Many active manages talk about downside protection. What are the key steps in 2022 and 2023?

AG: We're entering a period of below-trend growth, a coin toss on recession, with policy volatility. We need to get the fundamentals right and credit selection and managing risk budgets and liquidity are big parts. When the yield is close to 7% on A-minus quality, that is accruing strong income which will be a major component of returns.

GH: Can I understand better where this 7% comes from? It's higher than my top-of-mind understanding of where yields are. What are the securities included?

AG: Let's start with the US aggregate bond index, leaving aside global for a simple reference. It includes only investment grade securities and that's yielding (on a so-called 'yield to worst') today 3.7%. Treasuries are at 3.1%, securitised products like mortgages are 4.5% to 5%. Investment grade corporate debt is yielding upper 4%, close to 5%. Then depending on where you go in corporates, different levels of maturity and quality stack, into diversified, non-investment grade offering today a yield around 8.5%, a spread over government bonds of 5.5%.

A lot of the return is coming from the massive correction in Treasury yields. It's not hard to construct a quality portfolio earning 5.5% in investment grade assets, and 7% in a broader portfolio.

For more detail, see Neuberger Berman's Q3 fixed income outlook.

Graham Hand is Editor-At-Large for Firstlinks. Adam Grotzinger is a Senior Portfolio Manager for Neuberger Berman's Strategic Income Fund.

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Consumer habits normalising is critical for stock selection

Aneta Wynimko

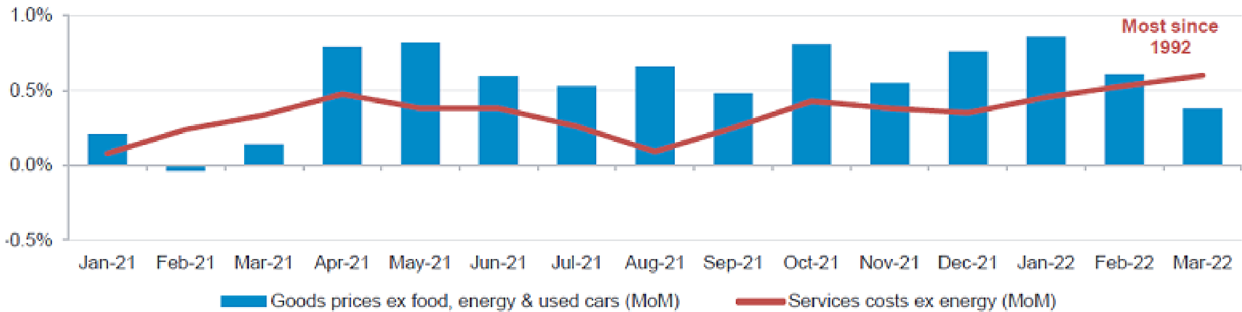
Given the current macroeconomic backdrop of rising inflation and interest rates that is putting pressure on consumers, it is no surprise that household finances are central to debates on global growth. It's an important input for the manager of a global demographics fund.

Consumer demand moves between goods and services

Inflation shifts from goods to services as consumer habits normalise. As we enter the second half of the year, global inflation readings remain well above target and stubbornly high (except for China). The drivers of inflation are also broadening and, while goods inflation shows some signs of easing, non-core inflation and services inflation rising (Figure 1).

This is not surprising. As mobility restrictions in response to the Covid-19 pandemic are eased, consumers are shifting their purchasing to areas that were most depressed during the lockdowns, for example travel and leisure.

Figure 1: Inflation transition - Core goods prices in the US show signs of cooling, while costs of services pick up



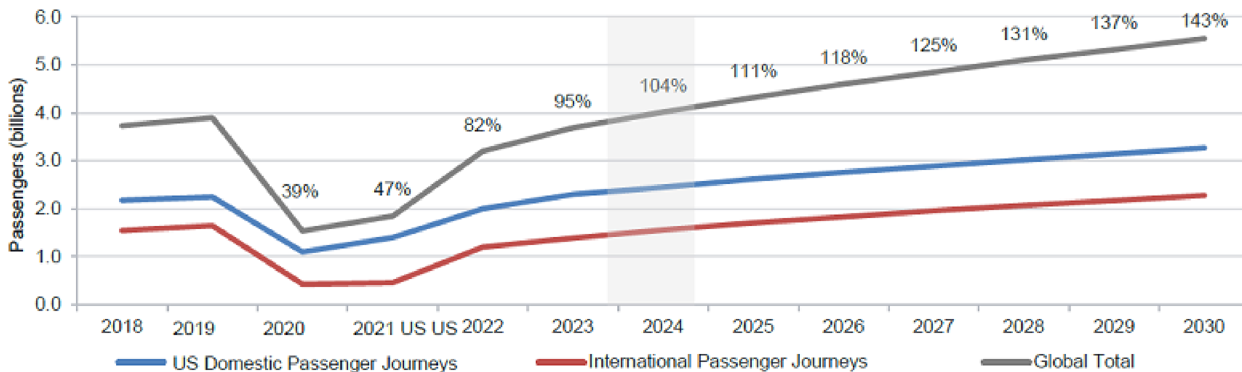
Source: Bureau of Labor Statistics, May 2022

A growing appetite for travel and leisure

After two years of enforced constraints, the desire to resume normal life benefits the leisure and travel industries. This is reflecting in, for example, the rebound in air traffic and hotel occupancy rates (Figures 2 and 3). Bookings for both cross-border and air travel have started to recover and are now at 66% and 72% of 2019 levels in the US respectively.

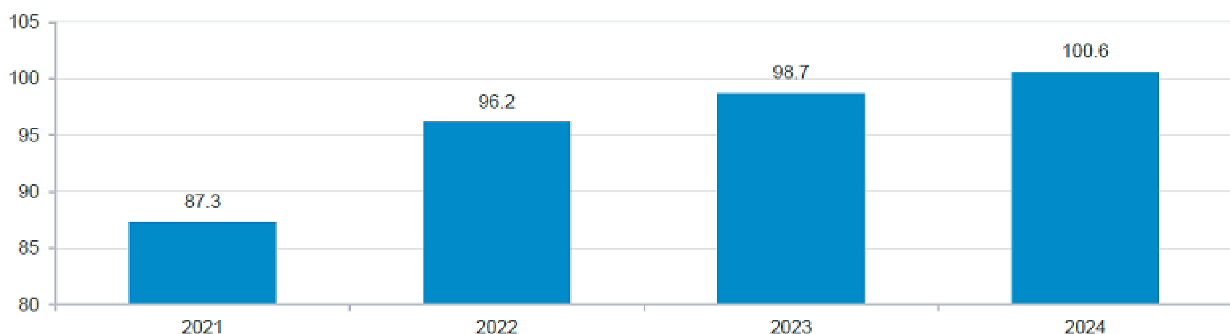
While domestic air traffic recovered faster as mobility restrictions were aimed primarily at international travel, the gap between international and domestic bookings is narrowing. However, we observe some disparities across regions with Asia-Pacific lagging behind significantly due to lingering restrictions, particularly in China.

Figure 2: Long term US passenger forecast (billion passengers and % of 2019 level)



Source: IATA Economics/Tourism Economics - 20-year Passenger Forecast - May 2022

Figure 3: Hotel occupancy index (global indexed to 2019)



Source: Tourism Economics, May 2022

Across the portfolio, we hold several stocks that are well positioned to benefit from the uptick in consumer demand for 'experiences'. Airbnb and Booking Holdings - the leading vacation rental business and largest online travel agent respectively - are geared towards the rebound in demand. We also hold Ryanair, Europe's largest low-cost carrier.

Consumers will make trade-offs across sub-sectors

The effect of normalisation will not be consistent across industries. Given the elevated and pervasive nature of inflation at this time, consumers may have to make trade-offs, particularly in their discretionary spending. Potential impacts vary and depend on sub-sectors as well as the consumer groups these companies appeal to.

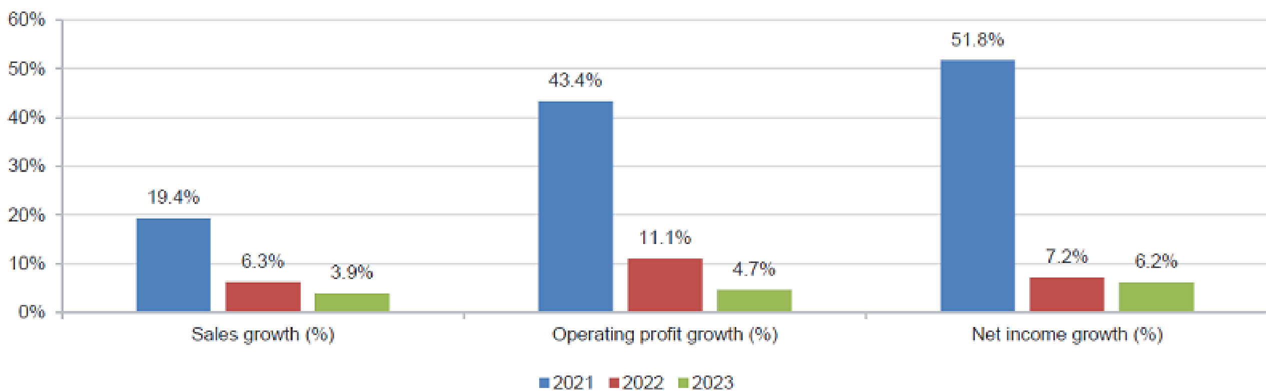
For instance, thanks to their higher disposable incomes, luxury consumers may not feel the pinch from inflation as much as other groups, although they are not completely immune. Luxury group LVMH is a key holding across the portfolio and in the beauty space, we hold L'Oréal and Estee Lauder, which, given their higher exposure to luxury cosmetics compared to peers, should prove resilient. The broader consumer trend to buy higher quality goods that last may accelerate amid the current inflationary conditions, and this offers a further tailwind to these names.

Careful consideration of the broader structural growth drivers is important when assessing consumer behaviour. For example, the increasing focus on health and wellness spurred by the pandemic provides the sporting goods segment with some resilience to navigate through lower consumer budgets. However, selectivity should be key. We continue to prefer the highest quality players such as Nike, which has a demonstrated a track record of resilience in even tougher economic backdrops, for example in 2009 and 2010 when it posted flat revenue growth while many economies were still in contraction.

Company pricing power

More generally, cost control and pricing power are potentially key in the current conditions. We expect consumer companies that can leverage their strong brands to maintain pricing power to emerge as winners. As costs rise with inflation, corporate profit margins are under threat and, as a result, investor returns could fall (Figure 4). Sustainable pricing power can protect margins by passing on higher costs to customers.

Figure 4: Fidelity Analyst Survey points to end in margin expansion



Source: Fidelity International, May 2022

Sustainability to remain in focus

Sustainability has become dramatically more influential in consumer decisions. This has led to companies guiding their brands to invest in and develop their identities through clever and dynamic sustainability strategies. This trend could persist despite the tougher market conditions. Recent survey data shows that most consumers will continue to consider sustainability in their purchasing decisions despite the rising cost of living1.

We maintain an explicit focus on sustainability credentials for the portfolio when assessing businesses, as reflected in the relatively high proportion of holdings rated BBB and above by MSCI ESG (85% for Fidelity Global Demographics Fund as of 31 May 2022).

High quality names could protect investors

The health of the consumer will remain in focus as we progress into the second half of the year. For investors, it is crucial to identify high quality names with business model resilience, balance sheet strength, and brand

power. These are important factors that can translate into a superior ability to exert pricing power and protect investor returns in this high inflation, high-rate environment.

Aneta Wynimko is Co-Portfolio Manager, Fidelity Global Demographics Fund at Fidelity International, a sponsor of Firstlinks. This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.

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A tonic for turbulent times: my nine tips for investing

Shane Oliver

Dr Shane Oliver, AMP's long-standing Chief Economist and member of the *AMP Investments* team, has witnessed numerous economic cycles and market events in his more than 35 years as a leading economist. His *Nine Tips* for investing are particularly relevant amid the current market turbulence.

1. Compounding

Compound interest is magical! The value of $1 invested in 1900, allowing for the reinvestment of dividends and interest along the way, would now be worth $243 if invested in cash, $901 if invested in bonds and $757,136 if invested in shares. If you want to grow your wealth, you should have exposure to growth assets like shares and property.

2. Diversify

The best performing asset class each year can vary dramatically – last year's top performer is no guide to the year ahead. Have a combination of asset classes in your portfolio. This particularly applies to assets that have low correlation, i.e., that don't just move in lock step with each other. A well-diversified portfolio is less volatile.

3. Understand risk and return

Put simply: the higher the risk of an asset, the higher the return you should expect to achieve over the long-term, and vice versa. There is no free lunch, and you should always allow for the risk and return characteristics of each asset in which you invest. If you don't mind short-term risk, you can take advantage of the higher-returns growth assets offer over long periods.

4. Time-in, not timing

In times of uncertainty its temping to try to time the market. But without a proven asset allocation or stock picking process, it's next to impossible. Market timing is great if you can get it right, but without a process, the risk of getting it wrong is very high and can destroy your longer-term returns. Selling after big share market falls can feel comfortable given all the noise is negative but it locks in a loss and makes it much harder to recover from.

5. Time is on your side

Since 1900 there are no negative returns over rolling 20-year periods for Australian shares. Short-term share returns can sometimes see violent swings, but the longer the time horizon the greater the chance your investments will meet their goals. In investing, time is on your side, so invest for the long-term.

6. Remove the emotion

Emotion plays a huge roll in amplifying the investment cycle, both up and down. Avoid assets where the crowd is euphoric and convinced it's a sure thing. Favour assets where the crowd is depressed, and the asset is under-loved. Don't get sucked into the emotional roller coaster.

7. The wall of worry

It seems there's plenty for investors to worry about at the moment. While this is real and creates uncertainty, in a long-term context its mostly noise. The global and Australian economies have had plenty of worries over the past century, but they got over them. Australian shares have returned 11.8 per cent per annum since 1900. Turn down the noise around the short-term movements in investment markets.

8. Look less

Day by day it's pretty much 50/50 if share markets end up or down. On a monthly basis, they finish up two thirds of the time. On a calendar year basis, using data back to 1900, this increases to 80 per cent. The less you look at your investments, the less you will be disappointed, and the less likely you'll sell at the wrong time.

9. It's cyclical

The higher returns shares generate over time relative to cash and bonds is compensation for periodic short-term setbacks. Recognise that these setbacks are part of the cycle. Don't get thrown off the higher returns that shares and other growth assets provide over the longer-term. Cycles are a fact of life and, while they don't repeat precisely, they rhyme.

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP and AMP Capital. This article has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

Two index ETF gifts at tax time

Michael Brown

The last few years have provided an enthralling comparison in the many facets of life between Australia and the USA. From a pandemic perspective, the Australian mortality statistics speak for themselves in our appropriate handling versus the fractured attempts by our strategic allies.

Australia's sensitivity to interest rates

From an economic standpoint, however, the resumption of 'normal' monetary policy may be an area where 'the land of the free' has a structural advantage to emerge victorious.

One of the many issues that confront central bankers worldwide is that in the face of surging inflation, low unemployment, and the strength of their currency (for those that care), they have at their disposal one lever to exert force on their respective economies.

Raising rates to help cool the economy makes sense. It increases the cost of borrowed capital for all and sundry, quelling frothy asset speculation both at a household and industry level. It can help to dampen government spending and is helpful to cast a pallor over excitable and speculative projects that need reconsidered using a rising risk-free return.

What's more, when viewed at a distance, this primary mechanism offers simplistic answers to the economic problems of the day. It is hard not to like it.

As past Governor of the Reserve Bank of Australia (RBA), Glenn Stevens remarked in 2008, the cash rate has been described as a 'blunt instrument' to exert influence over the economy.

So does it have the resolution to steer the next century's fast-moving and highly levered economies? Well, that can depend on how these economies are geared.

Similar and yet so very different

Australia and the US (like most developed countries) share similar traits concerning homeownership, as shown below:

Household Ownership	USA	Australia*
Homeowners (with a mortgage)	27%	37%
Homeowners (without a mortgage)	37%	30%
Non-homeowners (renters/public housing)	36%	29%

*Sources: policyadvice.net and abs.gov.au. *Data provided does not equal 100%.*

Where the similarities end, however, is with the predominance of the US fixed long-term (usually 30, sometimes 15 years) home loan versus Australia's obsession with either short-term fixed or variable rate mortgages:

Mortgage Originations 2021-22	USA	Australia
Long term fixed rate (>10 years)	89%	0%
Medium term fixed rate (3-10 years)	10%	0%*
Short term fixed rate (<3 years)	1%	38%*
Variable (floating) rate	0%	62%

*Sources: bankrate.com and abs.gov.au. *Data provided does not indicate fixed rate term length, however 2 years is predominant.*

The US is the only country in the world in which the 30-year fixed rate residential mortgage is the dominant home mortgage product. The ability for Americans to easily access relatively cheap long-term money at a fixed rate serves several purposes.

From a borrower's standpoint, a fixed rate mortgage (FRM) allows a reliable and standard repayment, fixed for the considerable life of the loan. This may account for the higher percentage of 'free and clear' owners in America over Australia, as it could well be the only mortgage they ever need. A notable feature is if the borrowers situation changes after a few years and the home needs to be sold, there is no prepayment penalty for closing the loan.

From a lender's standpoint, the situation is a little less rosy. Just the thought of locking in a market acceptable rate for 30 years would be enough to give an Australian banker heartburn. Enter government intervention. The one critical defining difference is the ability of banks to shift this risk onto a willing buyer, in this case, the US government-backed Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). With the interest risk removed, these products suddenly become commercially viable to the distributing banking sector.

In Australia, it's a different story. For those banks willing to offer 'extended' fixed terms, usually only up to 10 years, the internal interest risk mitigation usually means unenticing rates to the market. On top of that, borrowers are faced with severe penalties if they need to move house and 'break' the term if interest rates have fallen. Without the backstop of a federally-supported entity to remove this risk, it isn't easy to see the extended fixed-rate market maturing properly here.

So, what would motivate the Australian government to bother with such an initiative?

Structuring for a sharper instrument

The quantum of the impact that central bank rate rises have on the general population can differ materially depending on the predominant mortgage structure.

As we see today, central banks globally have moved to restore cash rates from their pandemic lows, with notable and often significant upward movements. Leaving aside the great lifts on a percentage basis owing to the low base effect, these changes are flowing rapidly and by design to households with mortgages.

In the US, this means a real impact on new mortgages at the margins but leaves the remaining loan book largely unharmed. A benefit of this outcome is especially relevant when you consider the younger loans where recent first home buyers are borrowers are often the primary risk case for severe property price downturns.

In Australia, due to the prevalence of variable loans, be it first home buyers or not, the effect of rising rates is felt immediately by most with a mortgage. The ability for the RBA to create ‘mortgage stress’ comes at a much lower level when compared to the US, especially given the enormous growth in personal debt levels over the last two decades.

Their unique mortgage structure allows the US Federal Reserve a lot more 'headroom' for raising rates to meaningful levels when looking to address the many other components of their financial system. By reducing the direct impact on the real estate coalface, there is now an opportunity to hone cash rate pressure to areas such as commercial and government demand without the risk of destabilising the whole economy in the process.

In Australia, however, the omnipresent risk of suffocating demand on a household level while trying to reach meaningful cash rate levels for other areas of the economy is genuine. If the RBA wants a sharper stick, it may need to consider funding an Australian 'Fannie Mae' (feel free to offer another name in the comments).

The future indicates that increasing debt loads are almost a certainty, and it brings the need for a reflection on whether the present structure in Australia offers the best fit for the main instrument available to our central bank. As we emerge from a decade of expansionary monetary policy into a tightening one, the time is nigh to consider extended fixed-rate mortgage alternatives.

Tim Fuller is Head of Wealth at Strata Guardian. This article is for general information only and does not consider the circumstances of any individual.

Is it time for an Australian 30-year fixed rate mortgage?

Tim Fuller

Here's a reminder about two gifts for investors just in time for tax reviews and Christmas in July. Index Exchange-Traded Funds (ETFs) are managed funds bought and sold on a listed exchanges such as the ASX and they have tax benefits compared with unlisted and actively-managed funds.

Gift 1: Streaming of capital gains

The 2021/22 financial year ended with negative returns for many asset classes. In periods of such volatility, many investors have exited the funds they were in, waiting for calmer days. Such a strategy comes with the perils of market timing, but in unlisted managed funds, the tax liability for an investor who stays in the fund goes up as other investors leave. ETFs have a mechanism to mitigate this risk.

In unlisted managed funds, if an investor redeems from the fund, they leave behind their share of the tax liabilities on any capital gains that are realised. In an unlisted managed fund these tax liabilities will be attributed to the remaining investors.

This does not happen in an ETF. Investors sell their units on the exchange to other investors, or the market maker. A market maker is someone whose job is to ensure there are units available for investors to buy or sell. In an ETF this doesn't happen because the withdrawal mechanism is different.

An investor who wants to withdraw from an ETF simply sells their units on ASX where they are purchased by other investors or an 'Authorised Participant'. Only Authorised Participants may withdraw (redeem) from the ETF. If they do, the capital gains created by the withdrawal can (and will) be passed to the Authorised Participant rather than being left behind for remaining investors. The ETF therefore protects investors from the impact of redemptions by other investors.

Those who have had a bad tax experience with an unlisted managed fund will understand. An ETF won't hit you with a large taxable distribution the way an unlisted actively managed fund can do due to client redemptions.

This tax efficiency is often an overlooked benefit of investing ETFs.

Gift 2 – Passive management and less trading

Passive ETFs hold a portfolio of shares or other assets that track an index. As a passive ETF's portfolio is automatically determined by the rules of the index, its portfolio only changes when the index changes. The contrast to this is actively managed funds where the fund manager picks the shares that they think are going to perform the best.

The tax problem with the active management process is that it causes a lot of shares to be sold each year, whereas the index fund process generally does not. The more shares that are sold by the active fund manager in a year, the higher the investor's capital gains tax liability for that year. This brings forward capital gains.

To summarise:

1. ETFs are generally a tax efficient investment vehicle because they minimise exposure to capital gains tax when other investors redeem.
2. As passive funds, ETFs typically have low turnover and therefore generate lower levels of capital gains tax compared to actively managed funds.

AMIT and TOFA

For more tax details on AMIT (Attributed Managed Investment Trust) and TOFA (Taxation of financial arrangements), see Avoiding tax time dinosaurs.

While AMIT can be used to smooth income payments, the TOFA hedging rules smooth the tax liabilities for investors in a fund that hedges its currency exposure. Without it, currency hedging can lead to tax shocks.

Michael Brown is Finance Director at VanEck, a sponsor of Firstlinks. This is general information only and does not take into account any person's financial objectives, situation or needs.

For more articles and papers from VanEck, click here.

We outline tax advantages in The Tax Advantages of ETFs which can be found on the ETF education page.

Biggest change in the Aged Care Interest Rate since the GFC

Rachel Lane

Whether you are an investor or borrower you will know that rates are rising. On 1 July 2022, the Aged Care Interest Rate (better known as the Maximum Permissible Interest Rate or MPIR) jumped from 4.07% p.a. to 5% p.a. It's the biggest change in rate since the GFC which saw the rate drop from 11.31% p.a. to 8.76% p.a.

Who is affected by the rate change?

The new rate applies to people who enter aged care from 1 July 2022 and existing residents who move to another home. Existing residents who are paying the market price for their accommodation will also be subject to the new rate if they choose to move rooms in their current aged care home.

The majority of people who live in aged care pay the market price, determined by a means test that uses a combination of your assets and income. Generally, if you have assets (which includes your home unless it's occupied by a 'protected person') worth more than $178,839 then you will pay the market price. Low means residents are typically people who don't own a home, or their home is occupied by a protected person, and their other assets are below $178,839.

A protected person includes;

- Your partner or dependent child.
- Your carer, who has lived in the home with you for the last two years or more, and is eligible for an Australian Income Support Payment (for example Age Pension, Disability Support Pension or Carer Payment).
- Your close relative, who has lived in the home with you for the last five years or more and is eligible for an Australian Income Support Payment.

If you are not sure whether you will be a market price or low means resident, you can use the Government's My Aged Care Fee Estimator to calculate your fees or you can submit a *Calculation of your cost of care form* to Centrelink.

The effect of the change in interest rate will also depend on whether you will pay for your accommodation by a lump sum, daily charge or a combination. The aged care interest rate is used to determine the Daily Payment for market price residents and the lump sum for low means residents.

Most residents choose to pay a Daily Payment or a combination, there are lots of reasons for this including not wanting to sell the family home for sentimental reasons. Financially speaking, keeping the home can also have benefits because it has a capped value of $178,839 for the aged care means test and a 2-year asset test exemption for calculating your Age pension.

Let's say you are a market price resident who has an aged care bed worth $550,000 and you are going to pay by Daily Payment on 30 June it will cost $61.33 per day but if you moved on or after 1 July the same bed will be $75.34 per day, that's a difference of $5,114 per year. If the market price was $1 million the difference would be $9,300 per year and if you choose the most expensive aged care bed the difference could be $27,900 per year.

Market Price Refundable Accommodation Deposit (RAD)	The Equivalent Daily Accommodation Payment on 30 June	The Equivalent Daily Accommodation Payment on 1 July	Difference in $ per year
$550,000	$61.33 per day	$75.34 per day	$5,113.65
$750,000	$83.63 per day	$102.74 per day	$6,975.15
$1,000,000	$111.51 per day	$136.99 per day	$9,300.20
$2,000,000	$223.01 per day	$273.97 per day	$18,600.40
$3,000,000	$334.52 per day	$410.96 per day	$27,900.60

If you are a low means resident, then moving after 1 July would mean the same Daily Payment but a lower lump sum. If your daily payment is $50 the lump sum equivalent on 30 June is $448,403, but if you move on or after 1 July it will be $365,000.

Criteria	If the Daily Accommodation Contribution (DAC) is	The Equivalent lump sum Refundable Accommodation Contribution (RAC) on 30 June	The Equivalent lump sum Refundable Accommodation Contribution (RAC) from 1 July 2022
If the facility is significantly refurbished or newly built			
Based on the maximum accommodation supplement for facilities who have more than 40% low means and supported residents.	$60.74	$544,719	$443,402
Based on the maximum accommodation supplement for facilities who have 40% or fewer low means and supported residents.	$45.56	$408,584	$332,588
If the facility meets building requirements *Aged Care (Transitional Provisions) Principles 2014*			
Based on the maximum accommodation supplement for facilities with more than 40% low means and supported residents.	$39.60	$355,135	$289,080
Based on the maximum accommodation supplement for facilities with 40% or fewer low means and supported residents.	$29.70	$266,351	$216,810

With many economists tipping multiple rate rises over the coming year it seems that these trends – daily payments becoming more expensive for residents paying the market price and lump sums becoming cheaper for low means residents – are likely to continue.

Impact of 2% further rise

If we assume the MPIR reaches 7%, the market price resident above paying $550,000 by daily payment will pay $105.48 per day, an increase of $11,001 per year from today's price. For the low means resident with a daily payment of $50 the lump sum equivalent will be $260,714.28 which is $104,285 less than today.

If you or a loved one are considering moving into aged care, it is worth seeking advice from a Retirement Living and Aged Care specialist.

Rachel Lane is the Principal of Aged Care Gurus where she oversees a national network of adviser dedicated to providing quality advice on retirement living and aged care. She is also the co-author of a number of books with Noel Whittaker including the best-seller 'Aged Care, Who Cares?' and their most recent book 'Downsizing Made Simple'. To find an adviser or buy a book visit www.agedcaregurus.com.au.

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