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Editorial

One of the downsides of being a financial newsletter and media junkie is reading the same material over and over again. Each month, fund manager updates describe what central bank chiefs **Philip Lowe** and **Jerome Powell** said a few weeks earlier as if we have not heard it a hundred times before. Then the updates take a guess at what the central bankers might do next month suggesting some unique inside knowledge. Do they all subscribe to the same machine learning or AI programme for their reports? C'mon, fundies, you're supposed to be Masters of the Universe and the Smartest People in the Room. Mix it up a bit. Don't let us think your Intelligence (I) is Artificial (A).

These are the same fund managers who implore investors to think long term and ignore short-term performance (especially when the numbers are not so flash). Yet their communications include pages of comments on the very short term like nobody else has covered the cash rate, inflation or daily index moves. Leave that stuff to economists such as **Bill Evans**, **Shane Oliver** and **Gareth Aird** and tell us something original. The **Reserve Bank** does not even have a track record worth following, with the Governor himself calling their guidance "*embarrassing*".

For anyone writing a programme using AI for fund managers, here's a template for the opening paragraph:

> *"Last month, the [Australian index]/[global index] [increased]/[decreased] by [x%] due to the the US Fed making [dovish]/[hawkish] comments on the [better]/[worse] [inflation]/[interest rate] outlook. The [name of fund] [gained]/[lost] by [y%] in [month name], [outperforming]/[underperforming] the index by [z%]. The portfolio benefitted from its exposure to [sector x], especially [company x name], but the position in [sector y] through [company y name] detracted. The outlook for next month is [strong]/[weak] based on expectations of [growth]/[recession] with GDP forecast to [increase]/[decrease] by [a%]. We expect cash rates to [rise]/[fall] by [0.25%][0.5%][0.75%][1%] at the next [Reserve Bank][Federal Reserve] meeting. As we invest through-the-cycle in quality companies, we expect them to perform well over time."*

And on it goes. No choices in the last sentence, as every fund manager thinks their investments are the best. Add some charts, update the performance table, send it off, rinse and repeat, across thousands of fund managers all over the world.

In the current climate, many pontifications are out-of-date before the analysts hit the send button. The US Fed's Powell may announce a 0.5% change while newsletters are still asking whether he will go to 0.75%. He upended the market recently at Jackson Hole in a speech that lasted only eight minutes. *The Wall Street Journal* claimed that prior to the speech, Fed officials were concerned that investors were pushing stocks higher and misreading Fed intentions to control inflation by rising rates aggressively. So Powell changed his original

speech to be far more blunt and direct, with the punchline that *"the Fed would accept a recession as the price of fighting inflation."* The stockmarket in the US dropped 4% immediately, and the optimism of a few hours earlier was completely reversed and updates rewritten.

As they say about sausages, nobody should see how they are made. You don't want to know how quickly an analyst can change their opinion based on one number or one sentence from a government official.

There are exceptions where research provided is genuinely unique. One of my favourites is the **Global Fund Manager Survey** (FMS) from the **BofA Data Analytics** team in **BofA Securities**. The monthly report records the views of about 300 institutional fund managers around the world. Here is a sample of charts showing the current investment activity of global market professionals, and what is especially notable is how many of these indicators are at record levels. The signs are nearly all negative for the market outlook.

First, asset allocations to equities (dark blue line) are at an all-time low.

Chart 1: FMS Asset Allocation to Global Stocks at All-Time Low
Net % of FMS investors that are overweight/underweight equities vs YoY change in S&P500 returns

Second, a record number of investors expect a weaker economy.

Chart 2: Close to a record share of FMS investors expect a weaker economy in next 12m...
FMS net % expecting stronger economy

Third, 79% of FMS investors expect slower global inflation in next 12 months than today, suggesting that inflation may have peaked last month when inflation rate was 9.3%.

Chart 7: Has inflation peaked? FMS investors think so as a fewer share expect stronger global CPI growth in next 12 months in September than last month
Net % expecting higher global CPI vs world inflation

Source: BofA Global Fund Manager Survey, Haver. YoY change in global CPI. GDP-weighted CPI. Large sample of 60 economies.
BofA GLOBAL RESEARCH

Fourth, a record low share of FMS investors (net -60%) taking higher risk than normal.

Chart 9: ...and cut risk
Net % taking higher than normal risk levels

(Of course, neither BofA nor Firstlinks takes any responsibility for how these charts may be interpreted and this is only general information).

And while many media outlets have reported on the **Deputy Governor, Michelle Bullock**, speaking at a **Bloomberg** event yesterday, describing the $40 billion mark-to-market loss on its bond holdings and inability to pay a dividend to the Government for many years, I took away an important sentence during question time. *"The outlook for the world's economy is on a knife's edge."*

Overnight (Thursday morning AEST), the Fed increased its target rate by another 0.75% and more to come, with projections reaching 4.40%. Jerome Powell is warning that the 'soft landing' is becoming less likely. The US market finished weakly with the S&P500 down 1.7% and NASDAQ off 1.8% on the day.

In this week's edition ...

With well over 800 responses to last week's **Reader Survey**, we have a strong sample of your opinions on a wide range of policy issues facing the Government as it frames the upcoming Federal Budget. Check the full results with an attached PDF quoting thousands of your comments. Thanks for the exceptional result. We will leave the Survey open for a few more days and publish highlight comments in another article next week.

A few articles this week focus on the impact of inflation in investing. **Don Hamson of Plato Investment Management** shows how much purchasing power a conservative investor is losing in term deposits, and warns that many more people may end up on an age pension if their assets do not grow. He sees a positive outlook for dividends. And **Ashley Owen of Stanford Brown** includes two of his fantastic charts to show the dramatic impact of inflation on asset values over time.

Then the analysts at **Natixis** led by **Dave Goodsell** dive into the impact of inflation and demographics on the retirement wellbeing of Australians and investors globally, and report on Australia's progress in the Global Retirement Index (GRI). Of the many factors contributing to a good or bad retirement, see how we rate on a global scale.

Will Low of Nikko Asset Management suggests there is a regime change hitting investors and they need new techniques to navigate along a different and bumpier road. Then **Robert M. Almeida of MFS Investment Management** argues that many analysts do not actually invest money, and that's where the rubber hits the road. He describes changes he has made in his portfolio in the last month, believing we have not yet 'hit the bottom' as there is not enough pain.

And **Stephen Dover of Franklin Templeton** says the focus on inflation and high employment is missing a major threat, that of stagflation, where low growth is accompanied by low inflation and low interest rates.

Finally, remember all the talk a year or two ago about meme stocks on Reddit and first-time traders making a killing on the RobinHood trading app in the US? We don't hear much about it these days, but the beauty of social media like Reddit (extract here) is people can post their results anonymously. In the meme mania, some people leveraged into options without knowing what they were doing, and that's how US$700,000 was turned into US$122,000. We don't hear enough about these losses and risks as 'diamond hands' only talk about their wins. (Example courtesy of MyMoneyBlog).

Readers back mining tax and gas reserve but not Stage 3

Graham Hand

To date, over 800 readers have responded to our survey. This article is a summary of the overall results, but as ever, the most-revealing parts of the survey are the thousands of comments. These are too long to include in an article and are loaded into this PDF document.

We are leaving the survey open for a few more days to allow further comments, and we will publish a highlight selection next week. Many thanks for your participation.

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> *"Many difficult choices will need to be made."*

In the past, Reserve Bank Governor Philip Lowe was unwilling to venture outside his responsibilities for monetary policy, refusing to answer questions on government spending and fiscal policy generally. Last week, appearing before a Federal Parliamentary Committee, he changed his tune. He said governments must either reduce services or increase taxes, or find other ways to reform the economy. He said:

> *"Each of those are very difficult. Taxes, cutting back and structural reform. We have to do one of those three things, maybe all three of them ... You can raise more taxes to pay for the things the community wants. You can cut back in other areas. Or we can get the economy to grow more strongly, so the pie is bigger ... We can't pay for these things on the national credit card … I would hope during this term of parliament that you could start addressing probably each of these three things."*

Then quoted in *The Australian Financial Review,* EY Chief Economist Cherelle Murphy said high government spending needs to fall from emergency levels in recognition of an economic bounce back. She said:

> *"Arguably in an economy running as hot as Australia's is, this level of spending is inappropriate as it uses up resources that the private sector may otherwise need for expansion ... in 2022, with the economy bouncing back and lockdowns over, government spending has remained high. This is for a number of reasons, including ongoing health system spending and flood-related recovery. There are structural reasons spending is high too, such as the NDIS needs."*

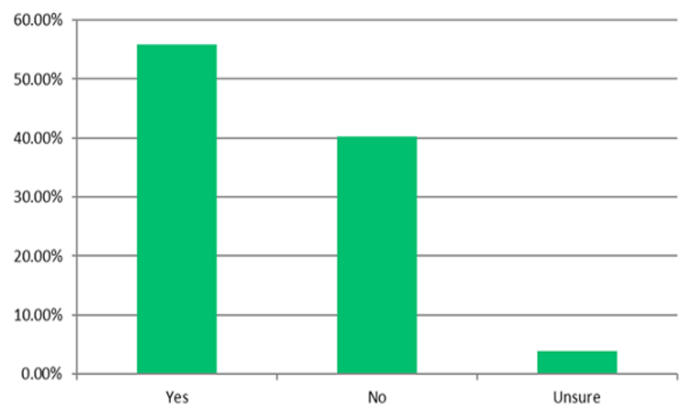
Our Reader Survey is therefore timely, especially with a Federal Budget on 25 October 2022, and many thanks to the over 800 people who responded. See last week's article for an introduction to the issues.

Q1: Should the Stage 3 tax cuts be cancelled?

With 55% in favour of cancelling the cuts and 41% wanting to leave them (4% undecided), there's a clear winner but plenty of views on both sides. Typical comments were about the need for financial incentives and an obligation to meet election promises versus the changed economic outlook.

"The top marginal rate remains too high which restricts our ability to compete for talent."

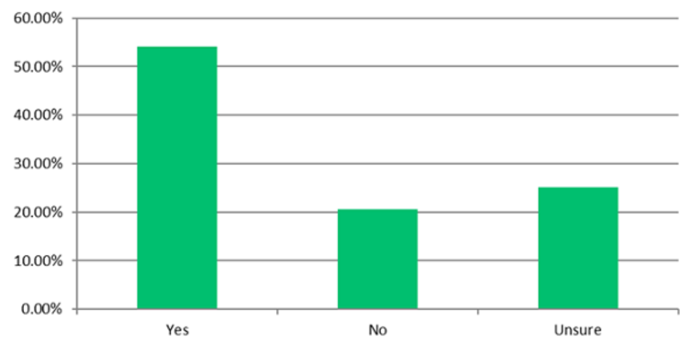
"It was enacted in different economic times with an expectation that the budget would be in surplus. Great pity the previous government didn't put some caveat's around what the budget status needed to be for the tax cut's to proceed."



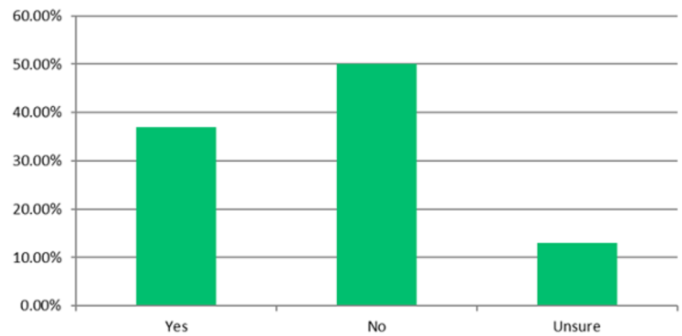
Q2: Are prices increasing due to embedded inflationary expectations?

The Reserve Bank Governor has expressed dismay at the prospect of inflation becoming embedded in corporate and consumer decisions, and based on the survey results, his concern is justified. A healthy majority at 54% believe inflation is embedded with 21% unconvinced but a high 25% unsure. Typical of the 'yes' case was:

"The bulk of cost increases have genuine cause but I think it has been much easier to implement cost increases and also get away with a bit of extra thrown in to take advantage of the situation."



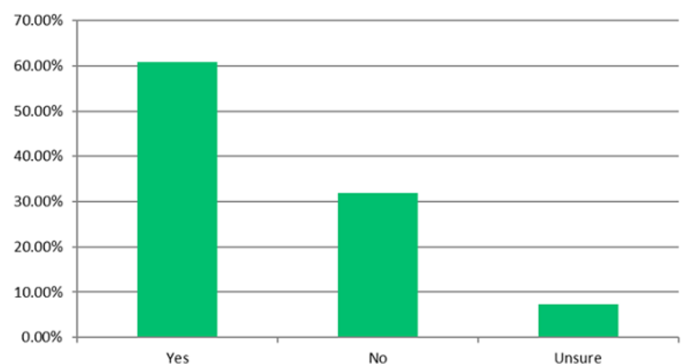
Q3: Should the childcare subsidies be brought forward to 1 January 2023?



Half of respondents supported the view of Treasurer Chalmers that the new childcare subsidies should be delayed, while only 37% were in favour of moving the date to 1 January 2023 despite claims of productivity and economic improvements. There were many strongly-worded comments about family priorities and the best way to look after children but also this type on encouraging workforce participation.

"Australia needs to better mobilise its available human resource and better childcare to those who cannot fund the present scenario and who could add a meaningful measure to our human capital in the workforce skills and intellectual fields."

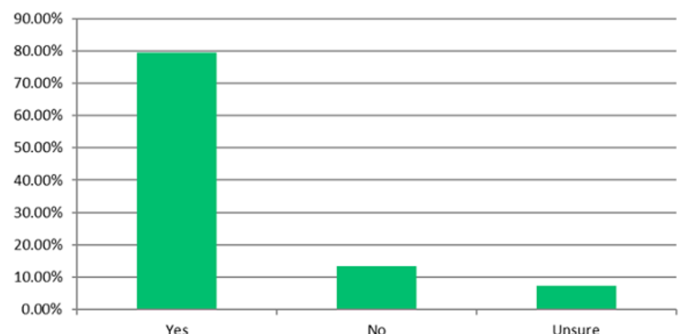
Q4: Should a mining super profits tax be introduced?



Strong support for a super profits tax at 60% with only 32% against. A range of comments included the opaqueness of who is benefitting, whether the mining companies misled governments about the extent of reserves and the sovereign risk to investments if taxes are introduced retrospectively. This is a balance of both sides of the argument:

"I think this is reasonable but of course the question is also about the definition of a "super profit". I've always worked in the mining industry and all mining companies pay royalties based on mineral revenue. It is difficult to move the goal posts just because previous State governments applied too low a royalty measure at the approval stage of a project. But it would not be unreasonable to seek a fairer distribution in times like we are currently seeing and where those circumstances have resulted in somewhat artificial opportunities for mining companies to make more profit through no extra effort of there own personnel. So perhaps when selling prices were outside the bounds of say 2 sigma of the real past 10 years then tax on revenue could be imposed. Cost to produce could be a key issue and so perhaps the revenues might need to be indexed to allow for cost increases. But in my view if the state and it's people want to grab some of the upside then they should be expect to chip in and support the companies when mineral prices are extraordinarily low. I can't see governments or the average Australian being prepared to do that. But fair is fair."

Q5: Should gas supplies be reserved for the East Coast domestic market?

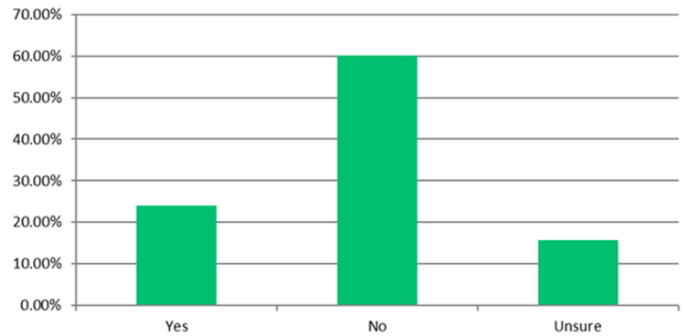


The strongest view in the survey results with almost 80% in favour of a gas reserve and only 13% against. There is a lot of anger and criticism of past governments for poor negotiation skills and failing to recognise the need for energy security.

"It is a farce that the eastern state governments were so shortsighted that they did not insist on some energy supplies that arguably belong to the people of Australia, were not set aside for domestic use."

Q6: Should the October 25 Budget include additional cost-of-living concessions?

Many readers accept the need to tighten their belts, with only 24% in favour of additional cost-of-living relief and 60% against. Many comments on a focus on needs not wants or helping only low-income earners.



"We must learn to live within our means. Having low government debt allowed us to withstand several crashes now, and the more debt the government carries, the less robust we are to shocks. I don't want Australia in the same position as our major allies who are now in a hopeless situation with respect to government debt. We still have the opportunity to get on top of the debt."

A final question asked about other policy issues and received hundreds of responses, as reproduced in [our full report](#).

Thanks again for the excellent comments and response rate.

Dividends strong as some things change, some stay the same

Don Hamson

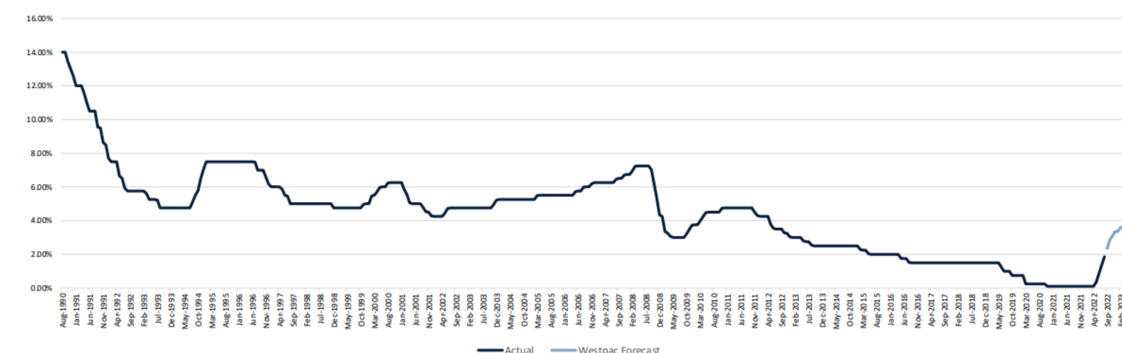
While some things are changing, many are remaining the same, and to some extent, the things that are changing are going back to what's happened before. It's the last 10 or 12 years that were unique. At the start of this year, I thought interest rates would remain low until at least next year, as the Reserve Bank and Governor Philip Lowe were saying. So things have changed but they've changed back to what we've always had, which are investment and economic cycles.

Rising rates and inflation are not new

We now have interest rates going up which we haven't seen for a decade. If you've joined the investment industry in the last 11 years, this is the first time you've seen interest rates rising. But this is not unusual for those of us with a few grey hairs (or all grey hairs in my case).

In fact, we haven't really seen interest rates rise much at all in 2022. If interest rates reach the high 3s as Bill Evans from Westpac's is forecasting at 3.6%, it will be the most aggressive tightening by the RBA ever. The following chart is the history of the RBA cash rate. The central banks only started affecting the overnight rate in 1990 and the tightening this time around may be larger than in 1994. And I think the current environment is similar to 1994 when global interest rates went up and inflation was rising, and we had negative returns on bonds and equities.

What happened to 0.1% until 2024? The cycle is back



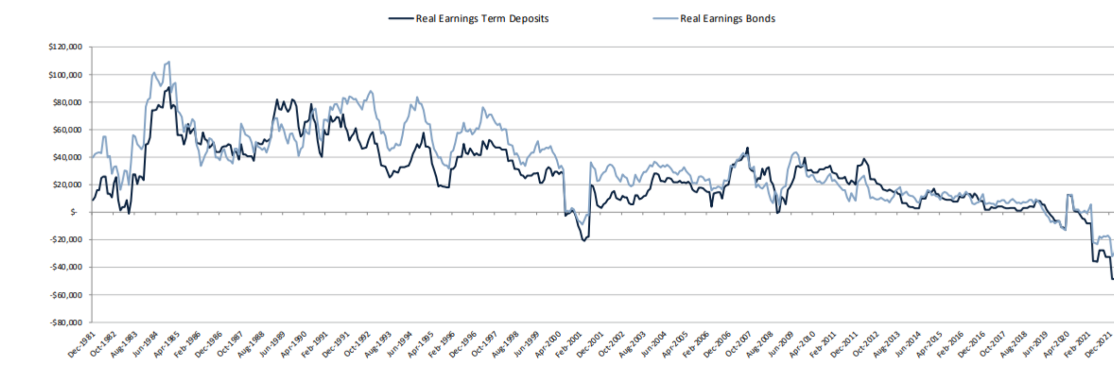
But in 1994, inflation reached only about 5% so we have already cracked through that in Australia at 6%, and it's 10% in the UK, it's 8% in the US. While we're seeing 30-plus year highs in inflation, we've been there before. This is not new, it's called economic history.

Significant adverse changes for conservative investors

Income investors who are conservative with money in normal term deposits at a big four bank are going backwards. The numbers in the following chart are from the RBA, and with one-year term deposits at 1% or 2% with inflation at 6%, some investors are going back 4% to 5%. On $1 million, they are losing in real terms after inflation $40,000 to $50,000 a year and we've never seen that before. Back in the 1980s, interest rates were double digit and, yes, inflation was double digit, but actually interest rates were higher and so bank deposits gave a positive real return. My parents had fantastic returns off cash in the 1980s.

Safe assets now losing money big time

REAL AFTER INFLATION EARNINGS ON $1M

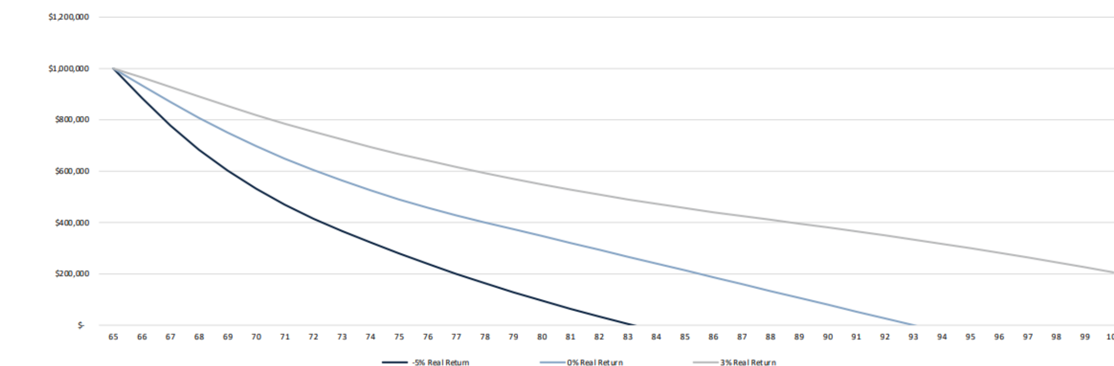


Source : Plato, RBA updated to 30/6/2021

These numbers are based on real assumptions. Many couples with $1 million to invest on top of owning their home will retire at 65. They want a comfortable lifestyle and if they're investing at minus 5% real on that safe asset, the black line in the chart below is the balance of their retirement money in real terms. And it's going down and it only lasts until they are 83. But reality is that one of the people in a couple will probably live well into their 90s and or longer.

Negative real returns are a killer for retirement balances

-5% REAL RETURN MEANS YOU'LL BE ON THE FULL PENSION AT 72



Source: ASFA, Plato, Services Australia

Assumptions: Homeowner couple, $1m starting assets, ASFA comfortable lifestyle, eligible for pension subject to assets test.

The couple will start drawing an age pension. If they achieve a minus 5% real rate of return, they'd be receiving the full pension at age 72. I can't imagine too many retirees retiring with $1 million expect to be on the full pension at age 72. Within seven years, they will draw on that pension and live off it. It's challenging that safe assets are losing value. However, if they achieve just a zero real return, they reach 78 before drawing on the full pension, and earning 3% real return is looking pretty good. So, I believe this couple needs more growth assets, such as money in a balanced fund, not only in those safe assets.

The best of times, the worst of times

There is obviously a lot of uncertainty at the moment, but apart from the disaster in Ukraine, the doom and gloom seems overstated. On the negative side we have:

- Rapidly-rising inflation, the highest in 30 years (ex GST introduction)
- Rapidly-rising interest rates
- War and energy crisis in Europe
- Supply chain issues due to COVID
- House prices falling
- Bonds and equities selling off together, the worst since 1994

That is the glass half empty, but the other side of things is more positive:

- Australian economy is at full employment
- Official overnight cash rate is still close to 'normal' lows
- Corporate balance sheets are strong and debt levels low
- Some Australian companies well placed to benefit from war in Ukraine
- House prices still well above pre-COVID levels
- Many borrowers are well ahead on repayments, offset accounts at record levels.

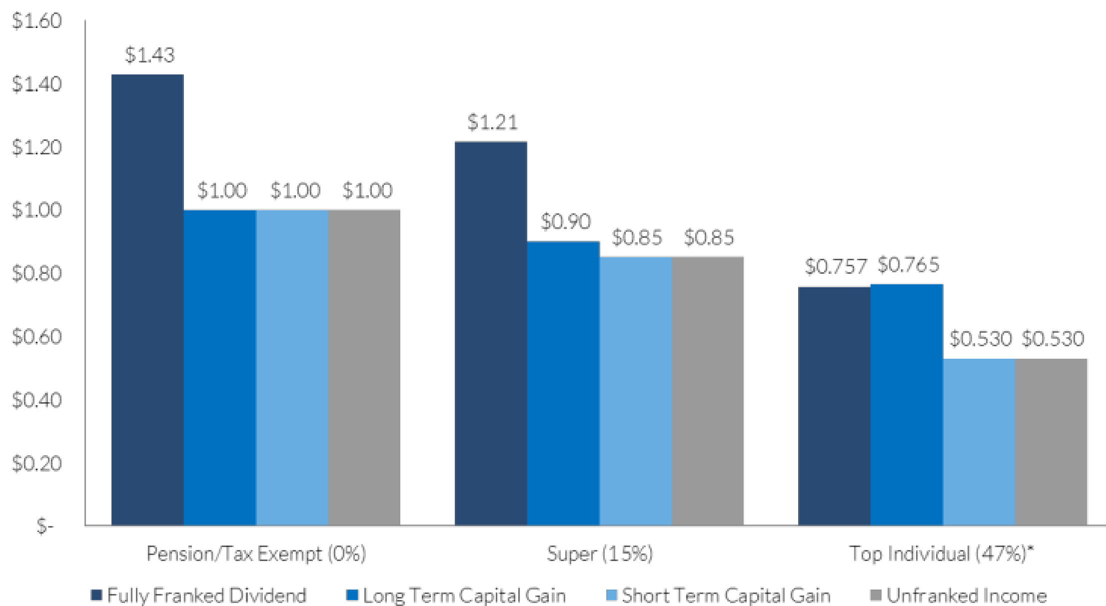
Yes, as unpalatable as it may sound, the reality is some Australian companies are making a mint out of the war, such as gas and LNG exporters. Coal stocks are doing well and GrainCorp's making a lot of money from record year grain prices.

And although we've just had the third-worst year for financial assets and for superannuation returns, that followed the second-best-ever year. So, on average, it's about normal. The media like to beat all this stuff up.

What remains the same?

Franking credits have not changed, nor are they likely to. Franking credits are valuable for retirees, as for every dollar of fully franked dividend, investors receive $0.43 worth of franking credits. The chart below uses the ATO 1 July 2022 tax rates including the Medicare levy to show the after-tax value of a fully franked $1 of pre-tax dividend at various tax rates. The tax effectiveness depends on the investor's marginal tax rate.

Franking credits remain valuable



We had a record year for buybacks last year which allowed a fund like the Plato Australian Shares Income Fund to make large distributions. The Westpac buyback was worth 12% for a tax-exempt investor, such as a retiree with less than $1.7 million in their pension phase of super. There were six other significant buybacks for the year. Plato's process is very active, moving to where the dividends are. At the moment, coal and energy stocks such as Woodside are delivering strong dividends.

Another thing that hasn't changed adversely is the income generated from shares over time. While there was a big dip in the pandemic year when many companies cut their dividends, there was a major bounce back last year and it will be even bigger this year. It continues a long-term trend.

Finally, the outlook for dividends looks good with a below average probability of stocks cutting their dividends. Despite all the uncertainty, it is nowhere near the likes of the GFC or during the pandemic. Based on our statistical model which is a bottom-up look at all the dividend payers in Australia, dividends should still underpin Australian equity income.

Dr Don Hamson is Managing Director at [Plato Investment Management](). Plato is affiliated with [Pinnacle Investment Management](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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For a video presentation version of this content, [click here]().

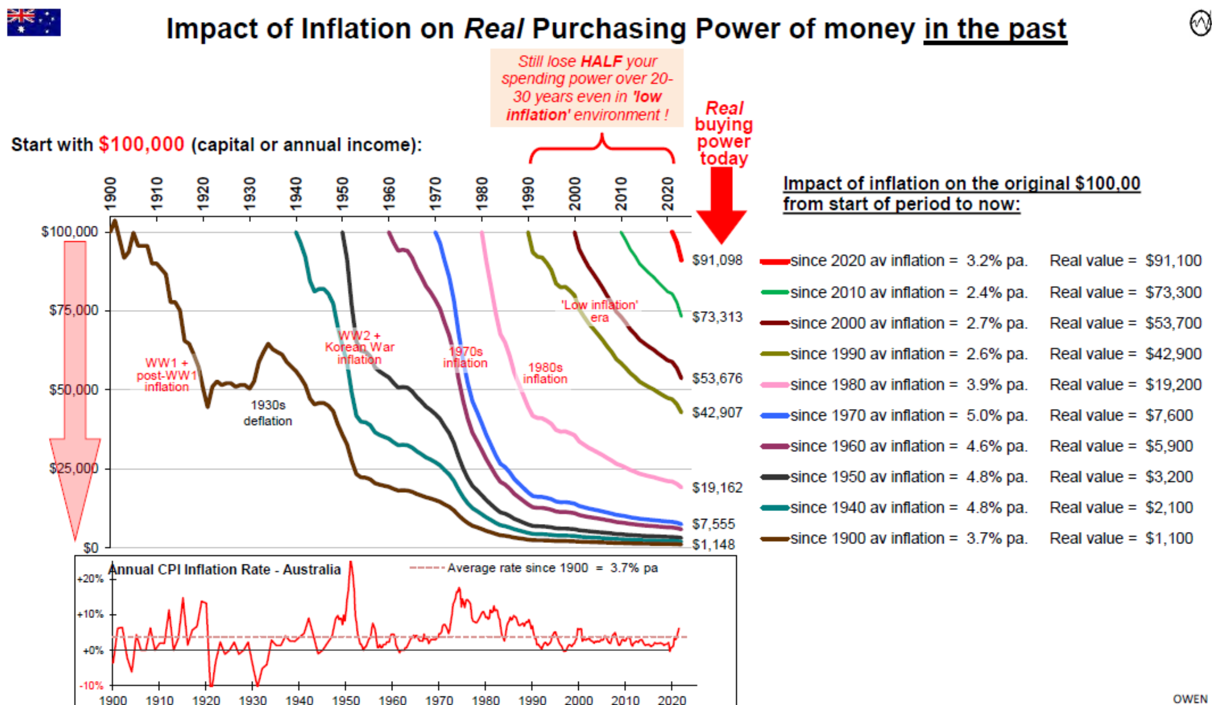
The wealth-destroying impact of inflation never went away

Ashley Owen

The recent return of inflation has spurred a sudden surge in interest in the implications for investors. In reality, inflation has always been a destroyer of the spending power of money, and therefore of critical importance for investors, even in the so-called 'low inflation' years.

Don't underestimate the impact of inflation

The chart below shows the impact of inflation on $100,000 in assets or income over time in Australia, from different starting points. For example, $100,000 of assets or income in 1980 was a lot of money at that time (the median Sydney house price was just $69,000 in 1980) but $100,000 in 1980 dollars would have been whittled down to just $19,000 in today's dollars if you didn't protect it against inflation.



Another way of looking at it is if you had $100,000 in cash in 1980 and locked it in a safe then opened the safe today, you still have that same $100,000 but it would only buy $19,000 worth of today's goods and services. (Or if you invested in term deposits in 1980 and you lived off the interest). Inflation over the years has eaten away 81% of its purchasing power.

The 1980 'real' (i.e., after inflation) value line is the pink line starting from 1980 near the middle of the chart. We can see that the real purchasing power of $100,000 in 1980 decayed very quickly in the high inflation 1980s, but then the rate of value decay eased off (a less steep downward value decay curve) in recent decades. The section at the bottom of the chart shows the annual CPI inflation rate in Australia since 1990. Inflation was very high in the 1970s, then declined in the 1980s, and has been relatively 'low' in the 2000s and 2010s decades.

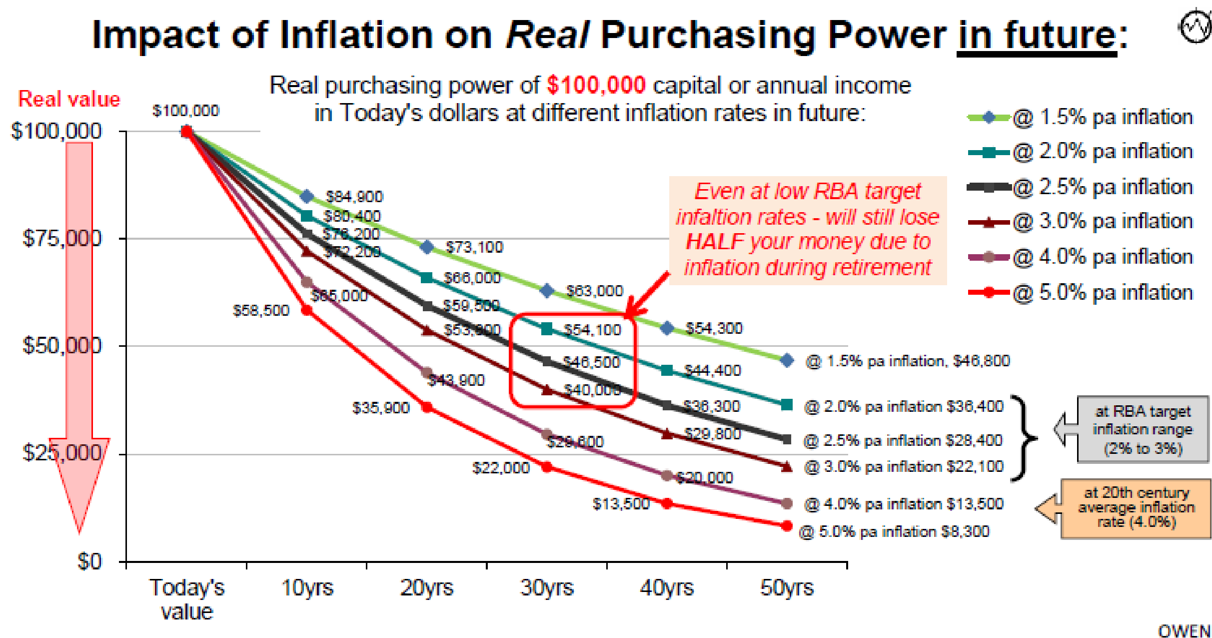
The problem is that, even in these so-called 'low inflation' years, inflation still had a serious detrimental impact on wealth and incomes. For example:

- $100,000 starting in 1990 has been eaten away to a purchasing power of just $43,000 today.
- $100,000 starting in 2000 has been eaten away to a purchasing power of just $54,000 today.
- Even in the ultra-low inflation post-GFC years, $100,000 in 2010 has been eaten away to a purchasing power of just $73,000 today.
- In the past two years alone, $100,000 at the start of 2020 has already lost 9% of its purchasing power to $91,000 today (the steep red value decay curve to the right of the chart).

The wealth-destroying effects of inflation never went away. Remember how central bankers dreamed about reviving inflation in the post-GFC years, and especially in 2020-21. We are all paying for that now!

Planning for future inflation

The next chart shows the impact of inflation on the purchasing power of money over time, at different rates of inflation. Obviously the higher the rate of inflation, the greater the destruction of the real purchasing power of money.



However, what is not as obvious is the fact that even 'low' inflation rates still have serious destructive effects on the purchasing power of money over time, and this was highlighted in the previous section. Even if inflation can be contained within the RBA's target range of 2-3% per year, money still loses half of its purchasing power over 30 years (highlighted in the red box) if we don't invest in assets that at least keep pace with inflation. Even if inflation were contained at a very low 1.5% per annum, you will still lose 37% of purchasing power over 30 years.

The second key lesson from this chart is that the longer we need the money to last, the more of it is eaten away by inflation, and therefore the more important it is to invest in 'growth' assets that offer some inflation protection.

In previous generations, time in retirement was relatively short. Most people had working lives of 40 years or more (from their late teens to retirement in their 60s). Retirement was usually only for half a dozen years or so, if that. Inflation, and even high inflation, did not have much time to work its destructive damage on their savings, and most people lived off the age pension, which was indexed to wage inflation.

Now, a large proportion of the population live well into their 90s, or even past 100, and life expectancy is increasing further with advances in medicine and nutrition. Retirement funds need to last several decades, and so the capital values and incomes need to be invested in growth assets to keep pace with inflation for several decades.

The need for growth assets over time

There are many types of assets used in long-term investment portfolios, but they fall into two main groups – 'growth' and 'defensive' assets.

The main types of growth assets are equity (ownership) interests in businesses (e.g., in the form of shares in listed or unlisted companies), and real estate (residential, commercial offices, retail shops, etc.). Companies (especially of diversified mix) can often offer good inflation hedges, with rising revenues, profits, dividends and capital values. In the case of property, well located and managed properties (especially a diversified mix) can also see their rents and capital values rise with inflation, depending on their location, supply and demand for tenants, etc. The main downside with 'growth' assets is that the income (dividends, rent), and also their capital values, can suffer big falls in business/credit cycles, especially in broad economic recessions.

On the other hand, defensive assets are mainly debt funds lent to governments (in the form of treasury bonds, notes and bills), debt funds lent to businesses (corporate bonds, notes), debt funds lent to banks (bank deposits, bills, notes and hybrids), and debt funds lent to property owners and developers (mortgages, debentures).

In essence, with 'defensive assets' you are a **lender**, but with 'growth assets' you are a part-**owner**.

The defensive (debt) assets are usually favourites with retirees because they offer advantages of regular, relatively reliable income, and usually relatively stable capital values. The downside of their relatively stable capital values and income is that capital values (and future income) do not provide any protection against inflation. They suffer the inflation decay illustrated in the above charts. People investing for periods of more than a few years (which includes almost all retirees) still need high quality, diversified 'growth' assets in their portfolios.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.

The most-challenging year to retire in recent history

Dave Goodsell and colleagues

Retirement security globally is under increasing pressure, as inflation, a volatile market environment and low interest rates impact retirement balances. The recently-released 10th annual Natixis Global Retirement Index (GRI) reveals 2022 could be the most-challenging year to retire in recent history. The GRI examines the factors that drive retirement security, combining key indicators essential for people to enjoy a healthy and secure retirement.

This article is a summary of the full GRI Report which can be downloaded from this link.

Australia's ranking

Retiree risk in 2022 arises not only in taking retirement income from an already depleted pool of assets, but accepting greater risks in portfolios to make up the ground already lost.

The GRI includes 18 performance indices, grouped into four thematic indices. Australia ranks as follows in 2022:

- 4th for Finances in Retirement (4th in 2021 and 8th in 2012)
- 9th for Health (compared to 10th in 2021, and 20th in 2012)
- 15th for Quality of Life (15th in 2021; 21st in 2012)
- 19th for Material Wellbeing (compared to 23rd in 2021 and 4th in 2012)

These four indices use the following factors:

1. Health – life expectancy, health expenditure per capita, non-insured health expenditure
2. Finances in Retirement – old-age dependency, bank non-performing loans, inflation, interest rates, tax pressure, governance, government indebtedness
3. Quality of Life – happiness, air quality, water and sanitation, biodiversity and habitat, environmental factors
4. Material Wellbeing – income equality, income per capita, unemployment

Here are the recent movements in Australia's scores.

AUSTRALIA

RANKING			SCORE		
2022	2021	2012	2022	2021	2012
5	7	8	75%	76%	79%

SUB-INDEX AND INDICATOR SCORES	SCORES 2022	CHANGE	2021	CHANGE	2012
HEALTH	88%	▲	87%	▲	82%
QUALITY OF LIFE	77%	–	77%	▲	75%
MATERIAL WELLBEING	66%	▼	67%	▼	85%
FINANCES IN RETIREMENT	72%	▼	74%	▲	73%
Old-Age Dependency	43%	▼	44%	▼	57%
Bank Non-Performing Loans	63%	▼	67%	▼	78%
Inflation	100%	–	100%	▲	86%
Interest Rates	73%	▼	78%	▲	71%
Tax Pressure	25%	▼	30%	▲	10%
Government Indebtedness	53%	▲	50%	▼	94%
Governance	90%	▼	91%	▼	94%

The impact of inflation

For most of the past decade, inflation has been exceptionally low. Between 2012 and 2020 inflation for the 38 OECD member countries averaged just 1.76%. However, in the first half of this year, inflation rose for those 38 countries, reaching 9.6% in May 2022.

In Australia, inflation is expected to peak at an annual rate of 7.75% by the December quarter of this year and to fall gradually, however the current level of 6.1% is the highest rate recorded since 1990.

The speed at which costs have increased around the world gives reason to rethink fundamentals in retirement planning. Significant price rises for oil, food, and housing are reducing the purchasing power of retirees and presenting a core economic lesson to those planning for retirement.

Further, financial professionals around the world say underestimating the impact of inflation is the number one mistake investors make in their retirement planning. The OECD projects the over-65 population will increase from 17% of the total in 2019 to 27% by 2050, increasing the strain on retirement security, and putting additional pressures on healthcare and long-term care systems.

10 years of the Global Retirement Index

When we introduced the Natixis Global Retirement Index in 2012, the world had just emerged from the global financial crisis and memories of market turmoil were still fresh. Inflation was low, but so was growth. Central banks had slashed interest rates to all-time lows. Balance sheets had ballooned from asset repurchase programs. And public debt had swelled to record highs around the globe.

On top of it all, the first wave of the Baby Boom generation had just reached retirement age, indicating that pay-as-you-go retirement systems around the world would soon face a stress test like no other. It all raised the question of whether the models for those systems would be sustainable in the long term.

In 2022, the world finds itself recovering from another global crisis. Inflation is running at levels not seen since the 1980s. Balance sheets and debt levels have soared even higher. Central bankers again are turning to interest rates as a stopgap, only this time they're raising rates. After a decade-long bull run, the markets are more volatile, with indexes and investors around the world experiencing losses. The Boomer retirement wave is at its crest, and the Millennial generation is making its presence known in the workforce.

Interest rates and income: long-term gains, short-term pain

Low interest rates have been the bane of retirement security for well over a decade but there are a lot of advantages to living in a low-interest-rate world. Low rates helped propel global growth from $75 trillion to $104 trillion over the past decade. They've helped drive equity markets to record highs, helped business grow, and helped individuals attain homeownership.

Those investing for retirement most certainly benefited, but low rates have not helped retirees in equal measure. In fact, low rates have presented retirees with some difficult choices.

In the simplest terms, low rates have made it hard for retirees to generate income off their savings. With rates in low to negative territory, many were not able to follow the golden rule of 'Never touch the principal'. Instead of waiting for bonds to throw off a sustainable income, retirees were forced to dip into the principal of their nest egg when they might normally seek to preserve their capital.

This puts them in the difficult position of lowering their expected income, accepting that their assets may run out too early, or taking on more investment risk to make up the difference. Each decision takes on heavier consequences in 2022’s volatile markets.

Risks at every turn for retirees

With inflation running at a 40-year high, those on a fixed income will already find it difficult to keep pace with rising costs, let alone find room to cut their income. Longevity adds to the challenge. People may be living longer, but nobody knows how long they will live. As a result, there’s a crucial piece missing to the equation that tells you how much income you can take from your savings while ensuring it will last the rest of your life.

In the long run, retirees may gain some hope for higher income in the future, but not without some pain along the way as markets weather the change. Unfortunately, few investors may understand what rising rates hold in store for them. In 2019, the Natixis Center for Investor Insight conducted a quiz with 9,000 investors in 27 countries. We asked them what two things happen when rates go up. They weren’t sure.

Professionals may recognise that with rising rates there’s a greater chance for higher income in the future, but that the present value of the bonds you currently own goes down. Only 3% of investors worldwide understood both sides of the equation. One-third didn’t understand either.

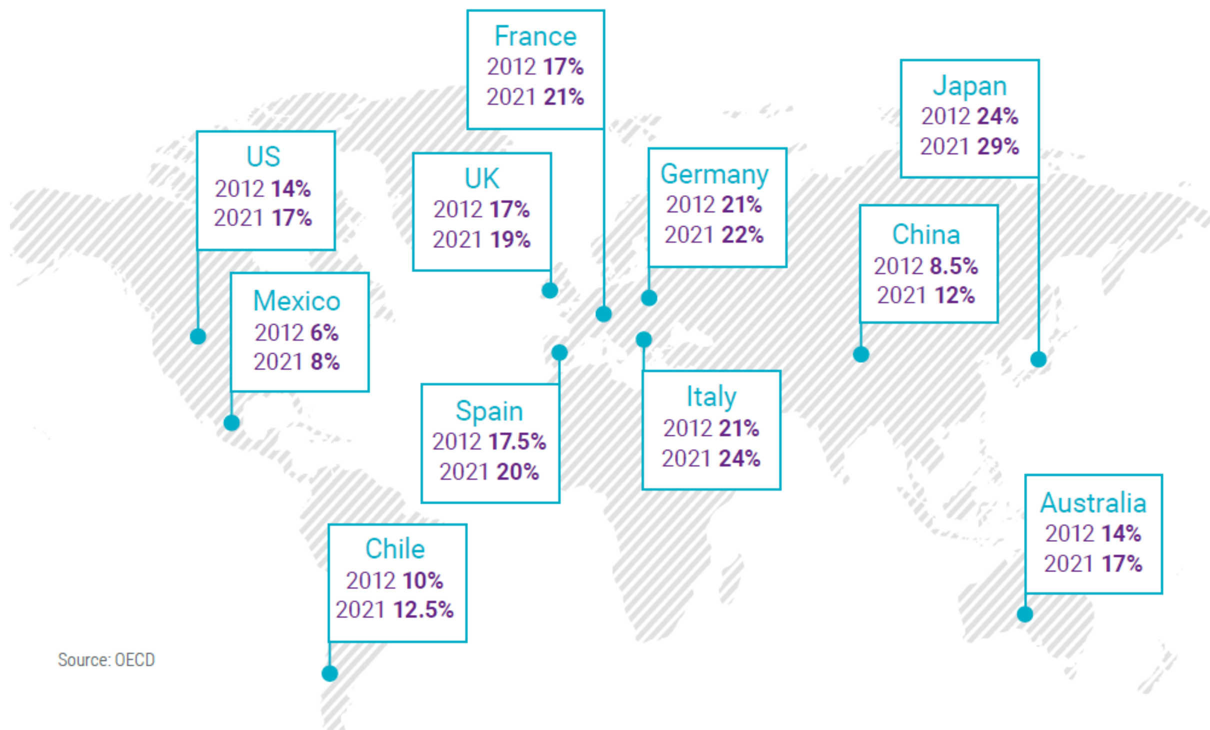
Individuals and institutions will find the hope for higher income and improved funding ratios in the long run, but the ancillary effects of rate increases can result in a lot of pain in the here and now.

Demographics: the good and bad of living longer

It’s no secret that the population in Japan, Europe and the US is aging. The drumbeat of concern has been loud and clear since statisticians first realised that the massive post-World War II Baby Boom generation would eventually enter their 60s and that wave would put a strain on retirement systems.

In 2012, the earliest wave of the Baby Boom generation was just reaching retirement age as the 2.1 million individuals born in the US in 1946 inched closer to age 66. Since then, the number of people age 65+ in the US has grown to 16% of a population of 331 million. In Europe, that population represents an even bigger piece of the pie at 20.8% of the 750 million EU residents. The number is bigger still in Italy (23.5%), Finland (22.7%), Greece (22.5%), and Portugal (22.4%).

Even regions with young populations could soon face similar challenges as improved nutrition, healthcare and environmental factors contribute to longevity and low birth rates help push the overall population ever older. This is the case in both China and Latin America in 2022.



Older for longer

Adding to the sheer volume of individuals who would be entering retirement is how long they will live after they retire. OECD reports that the average life expectancy past age 65 in G20 countries reached 21.3 years for women and 18.1 years for men between 2015 and 2020. And while the gains in lifespans past 65 have slowed slightly since 2010, the average for women past 65 in these countries will reach 25.2 between 2060 and 2065, while it will increase to 22.5 for men.

As a result of increased life expectancy and slowing fertility rates, OECD projects the over-65 population to increase from 2019's 17.3% to 26.7% by 2050. The percentage will be even higher in older countries. OECD estimates that this share of population will surpass 30% by 2050 in Greece, Italy, Japan, Korea, and Portugal.

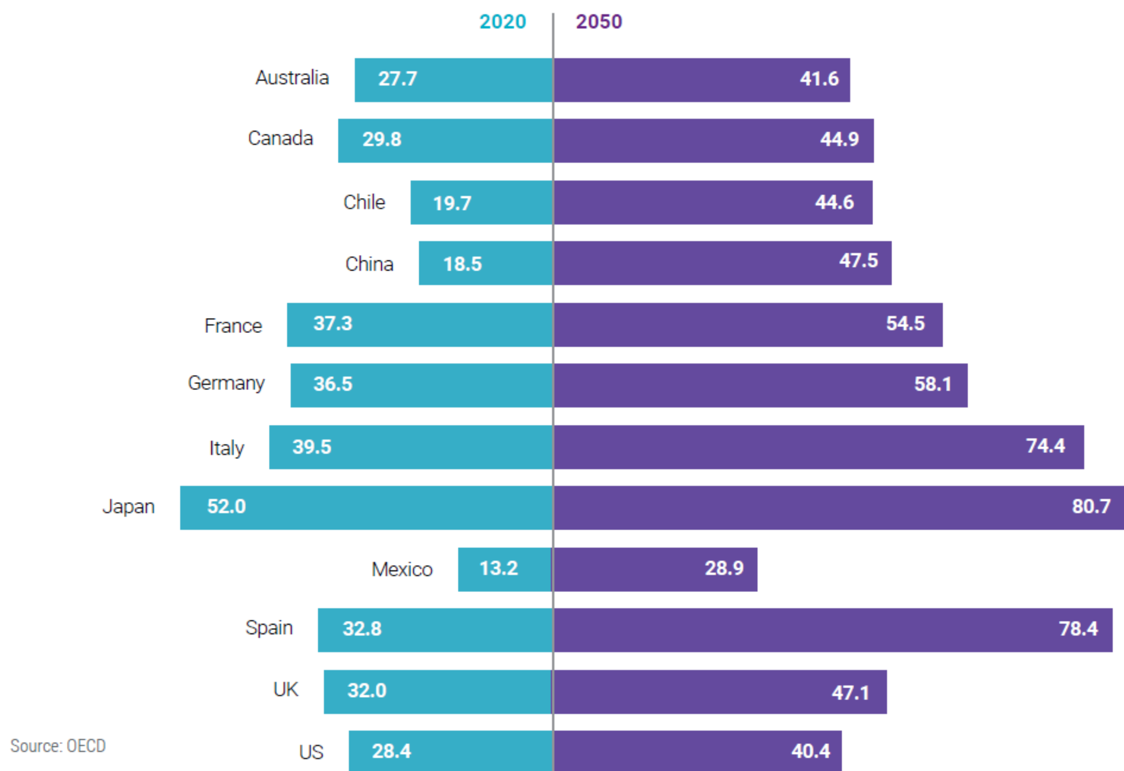
Population growth doesn't add up to retirement security

This is where maths becomes most concerning for policy makers. A larger population that will live longer breaks the formula behind most pay-as-you-go retirement systems. Many of these systems, like social security in the US, use payroll taxes to fund government retirement benefits. What makes them work is the balance between the number of working age people and the number of retirees – and others – drawing benefits.

The problem is best illustrated by old-age dependency ratio, which provides a simple statement on the number of retired people out of every 100 people within a population. For most of the developed world, that number has been climbing steadily higher for the past century.

In 1950, just 15 years after its social security system was created, the US had an old-age dependency ratio of just 14.2%. Seventy years later it reached 28.4%. By 2050 the over-65 population in the US will reach 40.4%.

A similar trend shows up in the perennial top three countries in the Natixis Global Retirement Index. Iceland will see its old-age dependency increase from 26.6% to 46.2%, Switzerland's will go from 31.3% to 54.4%, and Norway's will rise from 29.6% to 43.4.%.



Limited options for policy makers

Aging populations present limited choices for policy makers – choices that will be difficult as retirement benefits compete with a growing public debt burden. The debt to GDP ratio for OECD countries reached a record high of 95% in 2020, a figure that's 73% greater than it was in 2007, before the Global Financial Crisis.

Down the road, policy makers could be forced into one of three tough decisions, none of which are real vote-getters. To make up for funding shortfalls they may need to:

1. **Raise payroll taxes:** Hiking taxes is never popular and will be even less so should inflation continue to reduce consumer purchasing power as it's done in 2021 and 2022.
2. **Raise the retirement age:** Telling people they have to work longer than planned is an unenviable position. In 2020, French workers took to the streets to protest a proposed retirement age increase from 62 to 64. And in 2021, Swiss workers marched in Bern to protest retirement reforms including a proposed hike in the retirement age for women from 64 to 65.
3. **Reduce benefits:** Maybe the least popular option, reducing benefits is not only a political loser, it's also an economic nightmare for retirees, especially during inflationary periods when their dollars don't go as far to begin with.

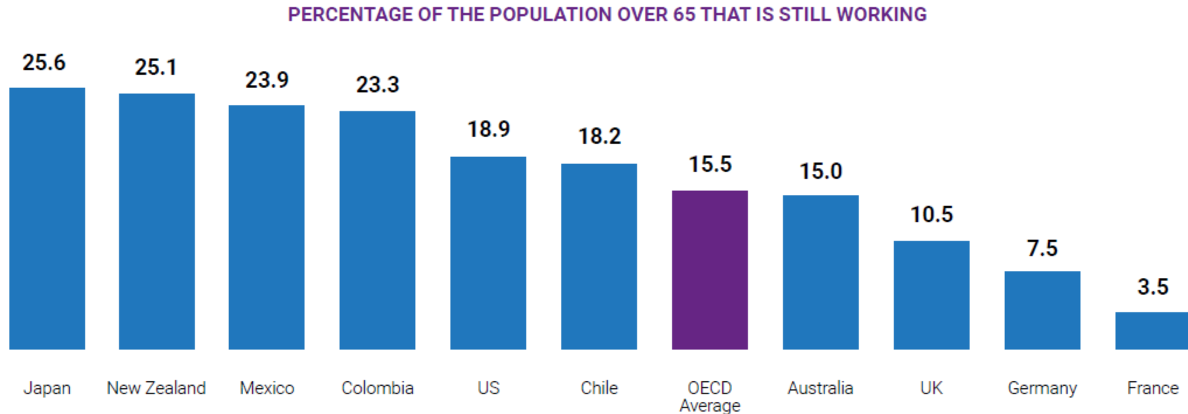
Aging also presents a critical healthcare challenge for both policy makers and retirees themselves. For example, in the US, where health expenditures already account for nearly 19% of GDP, those age 55 and older accounted for 56% of healthcare spending in 2019. Those 65 and older accounted for 35% on their own.

Rising costs are not limited to the US. The World Health Organisation reports that global healthcare spending topped $8.5 trillion in 2019, or twice the $4.2 spent globally in 2000. An older population can also translate into a slower economy. With large numbers of individuals leaving the workforce, OECD suggests that there could be significant economic consequences. Growth could be impeded as:

"there will be less working-age people in the population, older workers tend to be employed less, and may be less productive and entrepreneurial."

Retire or keep working?

For many individuals globally, the traditional view of retirement is fading. Many continue to work well beyond retirement age. In fact, results from the 2021 Natixis Global Survey of Individual Investors show that even as they plan to retire at age 62 on average, six in 10 believe they will have to work longer than they anticipated. This from a group of more than 8,500 individuals who already has at least $100,000 in investable assets.



To view and download a full copy of the report, visit link.

The Natixis Center for Investor Insight is a global research initiative focused on the critical issues shaping today's investment landscape. The Center examines sentiment and behavior, market outlooks and trends, and risk perceptions of institutional investors, financial professionals and individuals around the world.

The team includes Dave Goodsell, Executive Director; Stephanie Giardina, Program Manager; Erin Curtis, Assistant Program Manager and Jessie Cross, AVP, Content.

This article is a summary of the full report which should be referenced for more details and source references. The views and opinions expressed may change based on market and other conditions. This material is provided for informational purposes only and should not be construed as investment advice. There can be no assurance that developments will transpire as forecasted.

Three steps for navigating the tougher road ahead

Will Low

The experience of investing in risk assets over the last six months has been a miserable affair for most involved, particularly in some corners of the market where we have seen a collapse in share prices. We question, however, why this might be a surprise for investors.

Many investors became conditioned by the environment that had prevailed for over a decade, with a smooth and clear road to higher prices for equities and most financial assets. The world's key central banks had a specific goal of lower yields (higher prices) on financial assets since the great experiment of quantitative easing commenced. We have been in an era that has been less about investing capital efficiently and more about deploying capital to the beneficiaries of the great inflation in financial assets.

This era even had its own language: SPAC, FAANG, meme, NFT, crypto, FOMO, etc. Whether the current outcome is surprising or not, all investors are now faced with a new and ongoing challenge. In our view, policymakers no longer have our back and inflation – rather than the price of risk assets – is their number one priority. The road ahead will not be so easy.

Techniques to navigate gloomy markets

It is easy to become gloomy after the losses of the last few months, but there are reasons to be more optimistic about the prospects for compounding capital from today's levels.

1. Recognise we have shifted to a rougher and more variable road

As investors in individual companies, we are constantly asked to differentiate between volatility that is either short-term angst versus a signal of change. We suggest always being open-minded to new information that could undermine a thesis.

The thesis is that we are seeing a regime change.

First, in the shorter term, inflationary trends are likely to ease as the pending rate-induced recession commences and supply chain pressures improve. On balance, however, structural energy undersupply, labour market constraints and military expenditures will all contribute to sticky inflation at rates likely to be above the 2-3% ideal for central banks. Risk-free rates will therefore remain at higher levels.

Second, geopolitics will likely remain problematic as the battles for technology dominance between China and the US, and the struggle for military supremacy in Ukraine, are likely to be prolonged. The free flow of capital across borders should no longer be assumed, the cost of borrowing in the world's reserve currency will likely stay high and we need to be prepared for an increasing shift from certain actors, such as China, moving away from the US dollar as the currency of external trade in the years ahead.

In short, we believe that growth in the broader economy will be less certain and more cyclical, and as a result, the cost of capital will not return to the low levels of 2020–2021.

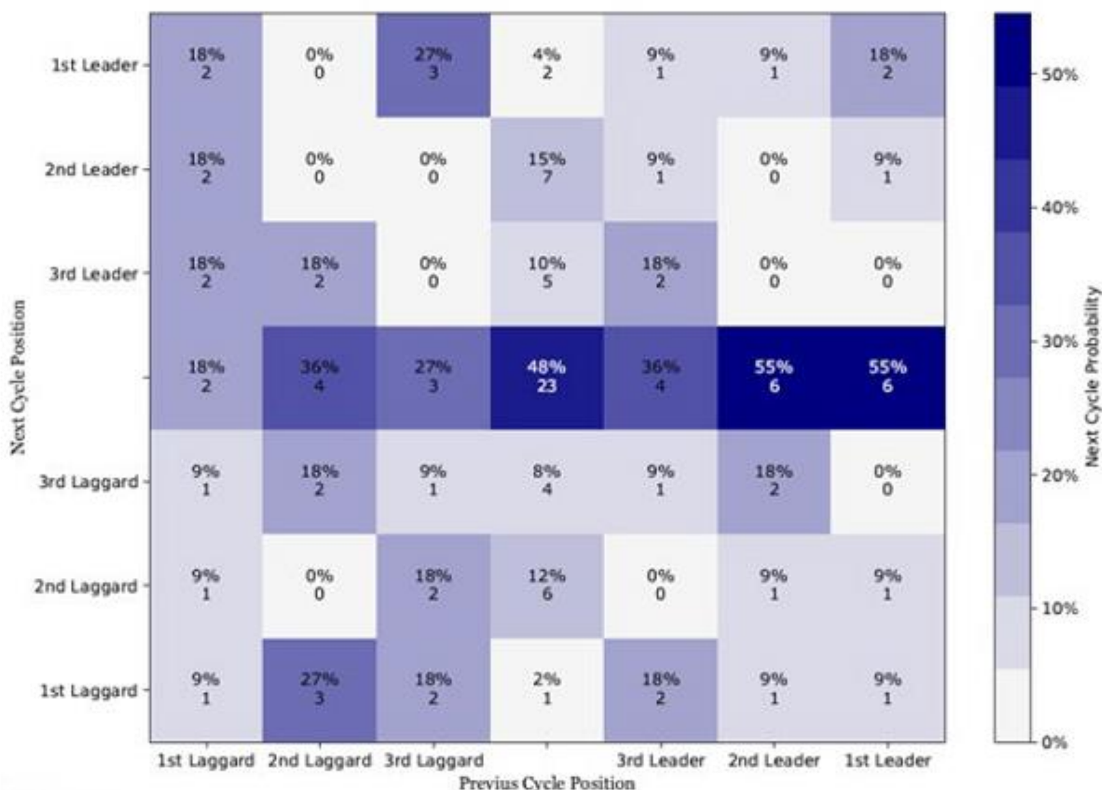
2. Realise that this new road may be best travelled in different vehicles

The good, albeit challenging, news for investors is that when there is a regime change, there is a high probability that there will be new leaders in the race ahead. The leaders over the last cycle were information technology, consumer discretionary and energy. Assuming they will automatically return as market leaders is a brave call based on this work.

New leadership is likely to emerge given the scale of surplus capital previously allocated to the winners.

This following table looks at the probability of a sector in the equity market leading in the next market cycle having led in the previous one. After a 20% drawdown in markets, such as recently experienced, what are the chances that the prior leader can repeat the performance in the next market advance?

Probability of maintaining leadership after-market drawdown over 20% (1957-2022)



Source: RENMAC

This study ranks sectors back to 1957 for the US market. It counts the bull cycle as the point of the price low after a 20% bear market to the subsequent price high before the next 20% drawdown. There were 11 such cycles in the last 65 years.

The probability of tech leading the market over the next five years or so is answered in the top right of the table with only a 27% chance of tech remaining in the top two sectors for forward returns. In fact, the top left shows that there is a somewhat higher probability that the next cycle may be led by those that have lagged the most. It underlines the need for investors to keep an open mind as to where market leadership will emerge.

3. Stick to a few enduring principles

There are often some common traits in quality companies, and we highlight the following:

A) Invest in price makers versus price takers

It is not just the price for assets that has had favourable tail winds over the last decade, but also profitability. In the decade prior to 2021, about half of the improvement in profit margins for US manufacturers was down due to lower interest costs and taxes. Whilst lengthening of debt duration may dilute the impact of rising rates, there is now a clear headwind for interest costs and taxes similarly are heading upwards in many economies.

Gross margins are similarly challenged by rising labour inflation (and availability), a shift to more local and higher cost supply chains, rising raw material input prices and (particularly for those sectors previously benefitting from COVID-related revenue boosts) negative operating leverage as sales decline. On average, times are getting tougher for businesses, and franchise strength is being tested more fully. Where products and business models are unique, dominant or gaining share, the scope for passing on costs to customers and sustaining volume growth is greater.

B) Ensure capital funding is sustainable

The cost of debt is going up and the availability of debt could become more irregular. The degree of change in debt costs in US dollars is much greater than in other currencies, and given its reserve currency status, it raises the global cost of capital for many businesses. Self-funding growth (high free cash flow) and balance sheets with appropriate and long-duration debt, in our view, will be better placed to keep investing through the pending down cycle. Cash-burning, profitless business models likely won't pass the test.

C) Focus on justifiable valuations

The penalty for investing at inflated prices and a lack of future cashflows can be quite onerous. Compounding capital from levels that can be politely described as 'frothy' is difficult. When the music stops, falls of 80-90% are common for the frothy crowd, and more often than not they stay down as profitability remains a dream rather than reality.

D) Find the future quality winners

Companies on a unique journey of improvement that can sustain high returns on invested capital over the next five years or more have always been the best starting point.

Energy transition

We retain our optimism that an enduring cycle of rising investment is now upon us as societies need to address the challenge of sustaining the still-necessary fossil fuel production, increasing supply from more trusted regimes, improving energy efficiencies, reducing emissions, and further developing alternative energy sources. The latter is key from a climate perspective, but also energy intensive in its own right, creating a circular requirement for the other drivers.

This quarter we have added **Worley**, an Australian-based provider of engineering consultancy and design services, and **Linde,** a leading global industrial gas provider. Both are expected to be price makers in their respective markets.

Enduring growth

We are increasingly cautious about the growth outlook for many consumer-facing companies. We believe that falling propensity to consume (due to greater spending on mortgage and utility costs) and prior COVID-led pulling forward of demand will be difficult and enduring problems to overcome.

Sustainable growth that is less impacted by consumer cyclicality. Our long-standing overweight in the healthcare sector highlights the fact that we see the demand backdrop for better and more cost-effective solutions across ageing societies as being very much enduring in nature.

In other sectors, we have also added new holdings with similar attributes, such as **O'Reilly Automotive** and beverage maker **Diageo**. The need to repair autos given the significant ageing of the fleet in the US will remain strong, and premium spirits will remain an affordable luxury with long-life inventory less impacted by the current rise in input costs.

Other recent additions include leading franchises in areas such as travel, where prior consumption has been constrained significantly by COVID and as a result, we added **Amadeus IT**, the world's largest provider of travel booking systems, to our portfolios.

In summary, the benevolent investment conditions of most of the decade until 2021 are now gone and investors need to stick to stronger long-term principles that have succeeded in the past.

William Low is Head of Global Equities at Nikko Asset Management, part of the Yarra Capital Management Group. This article is of a general nature and does not constitute personal advice, nor does it constitute an offer of any financial product. This is not a recommendation in relation to any named securities or sectors and no warranty or guarantee is provided.

In portfolio construction, actions speak louder than words

Robert M. Almeida

There's an important distinction between the views most strategists espouse and how money is actually managed. The budgeting of portfolio risk sheds more light on their market views than interviews or written content.

After inflation, the most common questions I receive are about the performance prospects of various asset classes. Since actions speak louder than words, the portfolios I manage should show you how I feel about relative opportunities and risks.

However, I appreciate the questions since most of the strategists I know don't manage assets. I'm sure there are some who have portfolio management responsibilities but I just don't know of many. It's easy to have a view when capital isn't at risk. To me, it's far more valuable to see how portfolio risk is being budgeted.

Portfolio construction

Broadly speaking, there are three critical factors when deciding how to weight any asset in a portfolio:

1. **Expected return**. Given that cash flows drive investment return, what are the long-term cash flow prospects or the investment base case?
2. **Expected distribution of return and volatility.** What might the distribution of cash flows look like? How wide are the ranges of potential outcomes? How volatile might the returns be? What does the left tail look like? In other words, what could go terribly wrong? What is the asymmetry of return potential versus risk?
3. **Expected correlation.** How differentiated are the sources of potential cash flows? How might the return streams interact with the other assets in the portfolio? Will this asset diversify or concentrate existing portfolio risk?

Since the future is uncertain, we can only make assumptions when answering these questions.

Our assumptions in early 2022 were that interest rates were too low and that risk was overpriced. As 2022 progressed, yield curves shifted up and risk sold off.

What now as much of the repricing is behind us?

Notwithstanding our view that monetary policy will continue to be tightened to dampen aggregate demand, and ultimately inflation, flattening and inverting yield curves are reflecting weak medium- and long-term economic growth prospects.

While long-term rates may rise as central bank balance sheets are unwound and increased supply pushes up the risk premium for owning sovereign bonds, we feel a lot of the repricing is already behind us, which makes high-quality, long-duration bonds attractive compared with other financial assets.

As a result, beginning several months ago, we started adding significantly to the AAA US Treasury, Agency and mortgage-backed security sleeves in the multisector income portfolios that I manage. The active weight of AAA securities is the highest it has been during my time managing the strategy.

At the same time, with nominal yields higher and spreads having nearly doubled from the tights reached a year ago, we closed our underweight to US investment-grade credit. While spreads could widen amid rising recession risks, in my opinion there is strategic or long-term value in these bonds given their low default risk. Relative to other risky assets, the potential return per unit of risk in US credit has become markedly more attractive as the ranges of outcomes have narrowed. The active position is a slight overweight, and I'll look at adding more as our credit investors pinpoint opportunities.

Average spreads but greater risks

While credit spreads are wider than a year ago, and close to their historical average, we don't believe we're in a period that looks remotely average. A considerable percentage of the companies in the publicly traded high-yield universe have an interest coverage ratio below 1x. Thus the entire revenue stream of nearly one out of six high-yield issuers is needed to meet their bond obligations, leaving no breathing room for lower revenues or higher costs.

Over the past dozen years, easy access to capital has suppressed the number of defaults and bankruptcies in the broad economy — particularly within its most leveraged asset class: high yield. With economic growth slowing and corporate revenue poised to follow, not to mention higher labor and debt refinancing costs, investors aren't being appropriately compensated in this universe. In my view, there isn't enough expected return, considering what could go wrong. The range of potential outcomes remains too wide and is why I have maintained an underweight.

Are we there yet?

Market rallies are an event, while market bottoms are a process. A bottom requires a level of capitulation we've not yet seen.

When the S&P 500 Index bounced more than 12% from mid-June until the end of July, investors started asking whether the market had bottomed. While that's impossible to answer without hindsight, here are a couple of historical observations:

- A market rally is an event, almost like a party. Once the momentum gets going, everyone wants to be there. Late arrivals don't know what they're celebrating, they just know that it's the place to be and consequences are an afterthought.
- Market bottoms are more of a process than an event, and like hangovers, they take time to recover from and are often tinged with regret. A bottoming process weeds out the overleveraged and those who have stayed at the party too long. The aftermath of the bursting of the dot-com bubble from 2000 to 2002 and the fallout from the global financial crisis in 2008 and 2009 are good examples.

While holdings data suggest institutions (mutual funds, hedge funds, pension plans, etc.) materially de-risked their books in 2021 and have done the same in 2022, equities held by US households remain near all-time highs, according to the US Federal Reserve.

Historically, bottoming processes are cleansing mechanisms. During the cleansing process, everyone feels the pain, but I wonder whether we've felt enough yet.

Too imbalanced

Economic cycles tend to end when imbalances become too big and are then sharply corrected. In the late 1990s, the excesses were in technology hardware. We built too many personal computers and routers, laid too many fiber optic cables and so on, fueling the Internet boom. At the turn of the century, that overbuild was painfully corrected in the broad economy, in general, and in technology and Internet stocks, in particular. A few years later, a new bubble emerged in the form of too much credit being extended to US consumers, particularly mortgage borrowers, which of course led to gross excesses in residential real estate and banking, the correction of which spawned the global financial crisis.

Historically, there has been a consistent pattern of recurring economic and market imbalances. But sometimes they aren't easily detected by the lay observer because they aren't centered around a particular industry, such as technology or housing.

From the end of the GFC until the outbreak of the pandemic in early 2020, too much credit (both public and private) was supplied to nonbank corporations. However, that capital was not used to increase the production of goods or services, as evidenced by the anemic growth of the 2010s, the weakest decade of growth in 150 years. Rather than using capital to enhance organic revenue and profit growth, businesses financed higher dividend payouts, share repurchases and acquisitions to generate inorganic growth across all sectors, excluding financials. This explains why the 2010s produced outsized profits but saw a feeble economic expansion and a historic gap in wealth between the owners of capital and labor. The excess of this last business cycle was corporate leverage and profits.

In February 2020, credit availability evaporated. Companies were undercapitalized. An economic and market rebalancing began, only to be short-circuited by policymakers. As a result, more corporate debt was created and profits reaccelerated at the fastest pace on record.

Is a bottoming process underway?

Until the excesses of too much financial leverage, underinvestment in production and overheated profits described above are corrected, I'm skeptical about whether a durable recovery can take hold. I'm not an economist, but it doesn't take one to know that pandemic-era stimulus didn't replenish depleted capital stock or lead to investment in productive assets, which would have set the stage for sustainable economic growth. Instead of investing in plant and equipment or research and development, the government issued previously unimaginable quantities of debt so that consumers could buy more goods than the economy could produce. The result? Inflation running at 9%.

In my view, as growth continues to fade, so too will corporate revenues. Companies have fixed costs that need to be covered by revenues, and those costs are now structurally higher than before thanks to the rising cost of labor, interest on debt and environmental, social and governance (ESG) compliance, leading to what we think will be lower profit margins and an adjustment in asset prices to reflect this long overdue reality.

When will we know?

Historically, markets have tended to bottom when investors give up (stop caring, vow never to invest again and no longer ask, "Is this the bottom?"). I've lived through that twice and I don't think we're there yet. But when investors stop asking whether we are, we will be.

Robert M. Almeida is a Global Investment Strategist and Portfolio Manager at MFS Investment Management. This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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Stagflation is underrated in the shifting economic narrative

Stephen Dover

With surging inflation amid record-low unemployment over the past 18 months, discussions about 'secular stagnation' have receded into the background. Today's high inflation stems from severe supply-side shocks (war, sanctions) and interruptions to supply chains (due to the pandemic), coupled with large but temporary increases in spending (fiscal stimulus, pent-up demand as pandemic lockdowns ended). Given these factors, the focus on inflation, while justified given its acceleration and breadth, may nevertheless distract attention from longer-term drivers of growth, inflation, and interest rates.

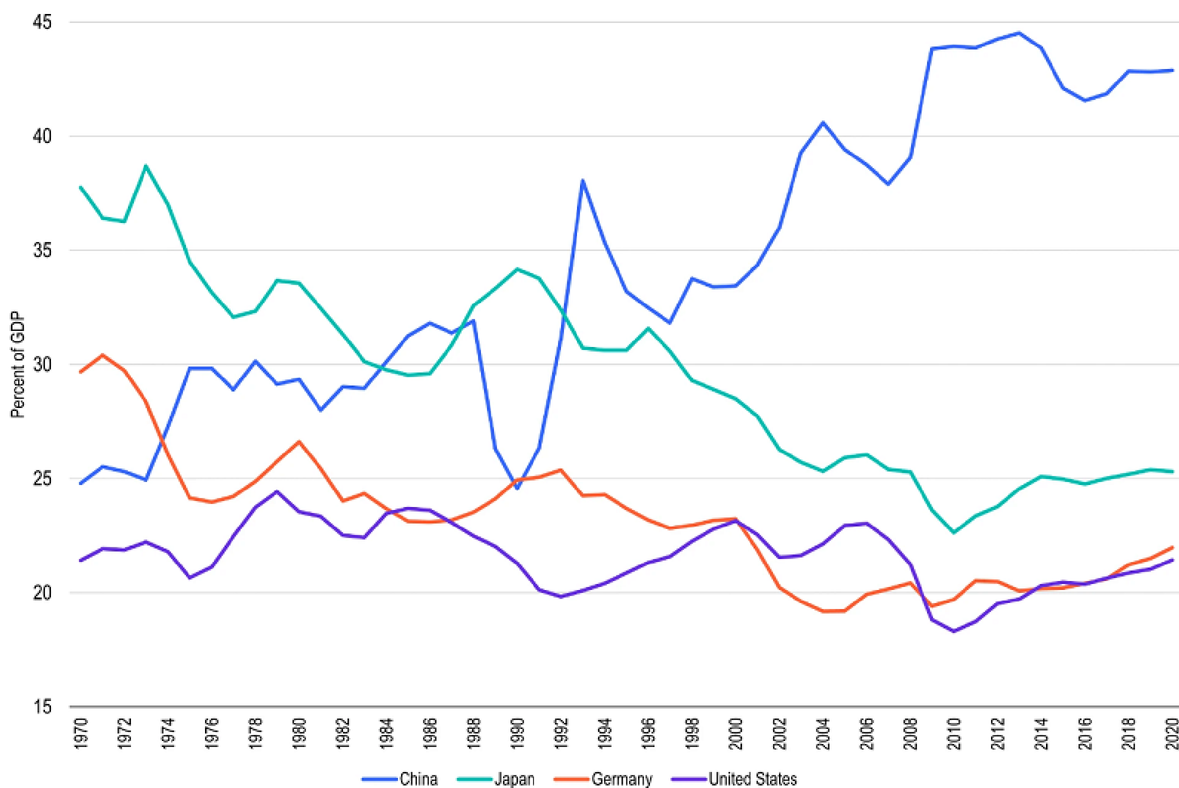
In short, secular stagnation may still be the driving force impacting long-run outcomes for asset values.

What is secular stagnation?

Secular stagnation is a prolonged period of chronic underinvestment in productive enterprises (investment in plant, equipment, and new technologies) relative to the amount of savings in the economy. Secular stagnation leads to both a lower trend rate of growth as the 'supply side' grows more slowly and to a deficiency of demand as excess savings imply a shortfall of spending in the economy. As a result, the economy tends to produce underemployment, low inflation, and low real and nominal interest rates.

If we look closely, we can see troublesome signs that secular stagnation remains a credible description of broad economic trends. In Chart 1, gross fixed capital formation as a percentage of gross domestic product (GDP) — a measure of total investment spending in the economy — has been declining in advanced economies (such as the United States, Germany, and Japan) since the 1970s and, despite some recovery over the past decade, remains below average investment rates seen in the 1980s, 1990s or early 2000s.

Chart 1: Weaker worldwide investment spending



Source: Franklin Templeton Institute, FAO, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

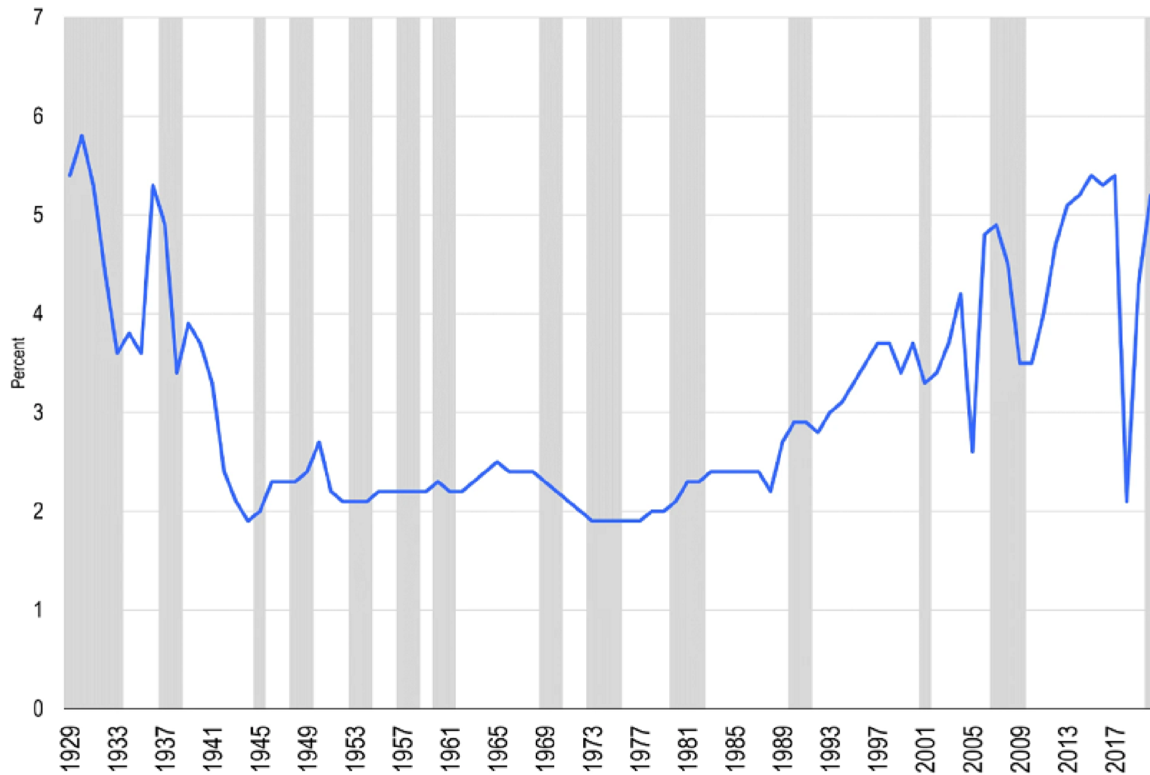
Even in China, the world champion of capital expenditures over the past quarter century, rates of investment peaked nearly a decade ago and have been gradually receding ever since. Large swathes of the global economy are seeing evidence of weak capital formation, a story that may also be unfolding in China.

Why is investment spending relatively weak?

More tepid capital expenditures strike many as an oddity. After all, we live in a world of breathtaking invention and innovation. Moreover, in many advanced economies (above all in the United States), corporate profitability in the 21st century has attained levels (such as profit share in GDP) never previously sustained in the post-WWII period. Surely, innovation and profits should spur capital spending?

Chart 2: The share of corporate profits in US GDP

United States: Shares of Gross Domestic Income, Corporate Profits with Inventory Valuation and Capital Consumption Adjustments, Net Dividends



Source: Franklin Templeton Institute, U.S. Bureau of Economic Analysis, Macrobond, as at 2020. Notes: The US recessions are marked in grey and are as defined by NBER. Important data provider notices and terms available at www.franklintempletondatasources.com.

Perhaps not. Much of the innovation that dazzles us today is either directed at consumption (think video streaming services, social media, gaming, or smartphone applications), speculative purposes (eg cryptocurrencies) or is not fundamentally improving the efficiency of our daily activities (alternative energy, battery-powered cars). Those inventions may give us pleasure, occupy our minds, race our hearts or make us feel better about the planet, but they are not enabling the masses to produce more with less, which is the essence of productive investment.

Moreover, high profits may partly reflect increased industry concentration, not more valuable goods and services. Technology, among other things, allows firms in information technology, consumer discretionary and other key sectors to create monopolies or oligopolies defended by high barriers to entry. Rather than spur new investment, the presence of market power deters it.

As Alvin Hansen, who coined the term secular stagnation in the late 1930s noted, low rates of business investment spending relative to savings can be driven by demographics (stagnating or declining population growth, peaking labor force participation), income inequality (leading to high savings by the very wealthy and constrained demand by those living at the margins), and high levels of indebtedness (which constrain the ability and willingness to borrow and spend).

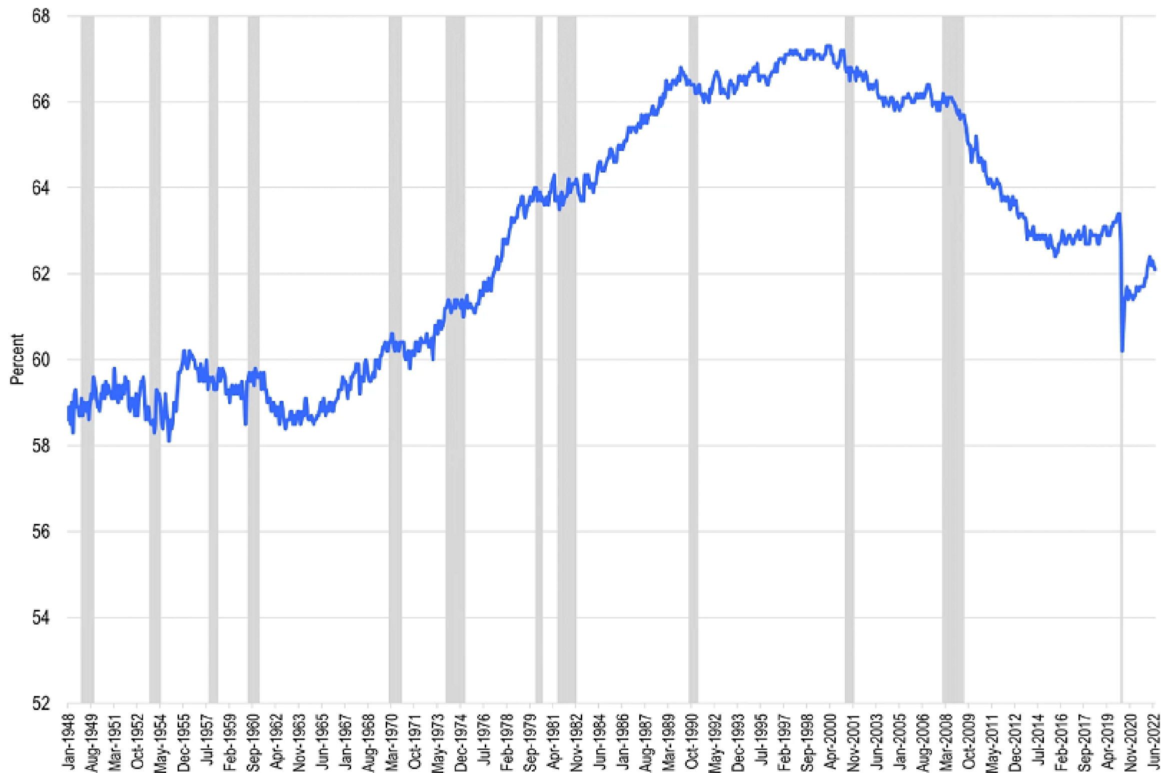
Secular stagnation could also return for another reason: the need to rein in and ultimately reduce mountains of public debt created during the pandemic, which implies higher taxes and fewer government services in the coming decade. This ultimately leads to a further drag on total spending in the economy.

What are the implications for growth?

If secular stagnation remains the key long-term narrative for the world economy, global growth will slow to a weaker trend rate of growth. As we have noted, the key inputs to trend growth—labor force growth, the rate of business investment, the pace of technological change—all appear challenged. In the United States, for

example, labour force growth has been decelerating over the past few decades as big jumps in female participation and boomer generation cohorts stagnate or reverse. Capital expenditures and innovation, as noted above, are not taking up the slack.

Chart 3: A smaller percentage of Americans are working (labour force participation rate)



Source: Franklin Templeton Institute, Bureau of Labor Statistics, Macrobond. As at July 2022. Notes: The US recessions are marked in grey and are as defined by NBER. Important data provider notices and terms available at www.franklintempletondatasources.com.

In addition, the slowing pace and possible reversal of globalisation are likely to harm business investment spending and growth. Despite commentary to the contrary, globalisation in the post-war era made economies more efficient and more productive. Trade is positive sum. Now, as supply chains are trimmed and, in some cases, brought back onshore, the impact on global economic activity is negative. The same is true for immigration. As borders are sealed and worker mobility is constrained, economic activity is damaged over time.

What are the implications for monetary policy?

Secular stagnation implies a very low, perhaps even negative, equilibrium real interest rate. That is because to generate full employment, borrowing costs must be sufficiently low to induce business investment that might not otherwise take place because of weak demographics, spluttering innovation or general perceptions of a diminished future.

Although the Federal Reserve and other central banks today are now hiking interest rates to lower current high rates of inflation, they cannot completely ignore the implications of very low long-run equilibrium interest rates. Slowing demand and curbing spiking inflation today are necessary, but overdoing things could be very damaging. The interest rate required to slow growth and lower inflation could be much lower than a federal funds rate of 3.5%-4.0%, which is increasingly the consensus view. Hiking rates to those levels could be overkill, in my view.

What are the implications for capital markets?

Secular stagnation, if it persists, presents investors with significant challenges, many of them already familiar from the past decade. After their recent jump, interest rates on risk-free assets, such as developed market government bonds, will likely revert to much lower levels. That will recreate challenges for income-oriented investors.

Weak GDP growth implies that profits growth will also be pedestrian. Moreover, if profit share in GDP remains elevated political pressures stemming from income and wealth inequality will only increase.

Growth styles which favour the relatively few companies that can sustain high earnings over time (including via monopoly or oligopoly power) appear likely once again to outperform value and cyclical styles that are offer fewer profit opportunities in a world of secular stagnation.

Finally, low interest rates may again spur unproductive speculation in the customary places, including property markets or cryptocurrencies, or in new ones devised to capture the allure of high returns.

This conclusion that secular stagnation may lead to a focus on longer-duration assets may be surprising to some but highlights the constant push and pull between economic forces and capital markets.

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Alvin Hansen source: The American Economic Review, "Economic Progress and Declining Population Growth," March, 1939. Information Administration (EIA), December 2020.

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