Firstlinks
a Morningstar company

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Editorial

While every difficult market throws up some winners, such as those who short a falling market, the vast majority of investors have lost money in 2022. Most personal wealth in Australia is held in the $9.5 trillion residential property market (market size according to **CoreLogic**, which compares with $3.3 trillion in superannuation and $2.7 trillion in ASX-listed assets). The most surprising losses in 2022 have been in supposedly conservative allocations to bonds, which have pushed far more people into negative returns than ever before.

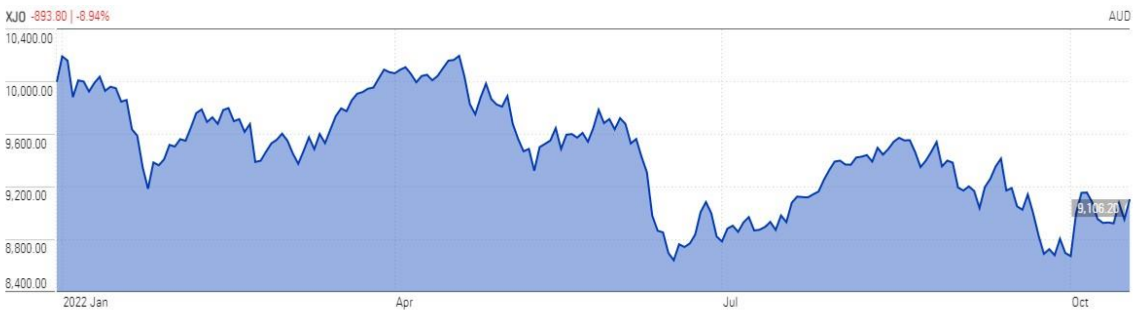
Looking first at US equities, the chart (right) is the **Morningstar** US Price Return Index which is a broad market index covering 97% of the US market. US stocks comprise almost 60% of the global index and what happens in the US affects all other markets. For the year-to-date (YTD), it is all red, with this index off almost 23%. The darling of 2021, the Nasdaq, has lost 31%.

% Change

Index	Value	1-Day	1-Mo	3-Mo	1-Yr	YTD
Morningstar	9,153	+1.19	-3.99	-2.60	-19.33	-22.91
SPDR S&P 500 ETF	371	+1.17	-3.74	-2.43	-15.75	-20.96
Dow Jones	30,524	+1.12	-0.97	-1.77	-13.43	-16.00
Nasdaq	10,772	+0.90	-5.90	-5.17	-28.29	-31.14

Source: Morningstar Direct

For Australian equities, the results are better, with the S&P/ASX200 Price Return index down 9% in 2022, helped by a recent recovery.



Source: Morningstar Direct

And back to residential property, according to CoreLogic, the pain is kicking in during the September quarter, with average prices down 4.1% across the country and Sydney losing the most at 6.1% (and Darwin and Adelaide still rising).

Checking some specific ETFs listed on the ASX reveals the pain of bond investing as rates rise across all terms. Nobody expects one-year losses of 17% on a government bond portfolio.

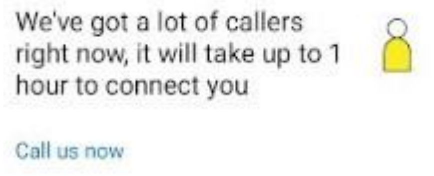
Category & Name	Ticker	Returns (%)[1] 3 Month	6 Month	1 Year	3 Year	5 Year	10 Year
Bonds–Australia							
BetaShares Australian Composite Bond ETF	OZBD	-0.79	-5.90	-	-	-	-
BetaShares Australian Government Bd ETF	AGVT	-1.10	-7.25	-16.74	-5.57	-	-
BetaShares Western Asset Aus Bd ETF	BNDS	-0.60	-5.05	-12.27	-3.67	-	-
iShares Core Composite Bond ETF	IAF	-0.69	-4.51	-11.42	-3.55	0.61	2.15
iShares Core Corporate Bond ETF	ICOR	-0.13	-3.51	-9.68	-	-	-
iShares Treasury ETF	IGB	-0.75	-4.54	-11.89	-4.13	0.26	-0.14
Janus Henderson Tactical Income Actv ETF	TACT	0.97	-4.70	-6.61	-	-	-
Russell Inv Australian Government Bd ETF	RGB	-0.86	-5.76	-14.78	-4.77	0.31	1.71
Russell Inv Australian Semi-Govt Bd ETF	RSM	-0.42	-3.36	-9.68	-2.21	0.59	2.05
SPDR® S&P/ASX Australian Bond ETF	BOND	-0.85	-5.26	-12.91	-4.19	0.34	2.01
SPDR® S&P/ASX Australian Govt Bd ETF	GOVT	-0.98	-5.70	-13.64	-4.60	0.23	1.86
Vanguard Australian Fixed Interest ETF	VAF	-0.67	-4.48	-11.49	-3.59	0.58	-
Vanguard Australian Government Bond ETF	VGB	-0.77	-4.76	-12.06	-3.94	0.54	2.02

Source: Morningstar Direct

So if you are feeling bad about the performance of your portfolio this year, join the long queue of both retail and professional investors. The funds of some of our most-respected managers are down 30%.

Who are the winners in the last year? Again drawing on the Morningstar database of ETFs, the one-year positives are 'bear' ETFs (obviously), cash, oil, physical gold, precious metals, some hybrids, resources, energy, some infrastructure and US dollar funds. There were places to hide but something of a needle in a haystack.

My own quest to transfer cash from my SMSF transaction account into a term deposit led to a weekend of paperwork, with two small banks wanting certified copies of everything to do with my identity and trust deed and physical application forms, not online. I tried to move the money within **CBA** which required no new ID work, and its Term Deposit Selector on NetBank is supposed to make transferring funds easy. Well, I have tried a dozen times without success, each time being told to come back later. In frustration at the failed online process, I sent emails which remain unanswered days later. When I attempted to speak to an actual person, I was advised I needed to wait an hour because "*We've got a lot of callers right now*". Which seemed to be all the time. How about directing some of the billions of profit into more call centre staff and fixing a basic application process?



In this week's edition ...

Now that frustration is off my chest (but my cash still sits earning not much!), a change of tack to take a look at art collecting. My knowledge begins and ends with **Cressida Campbell**, whose exhibition is now on at the **National Gallery of Australia**. In collecting her work for over 25 years, I've come to understand a few things about the strange world of art.

Meg Heffron then provides a fascinating piece on when to close an SMSF, which coming from someone who runs an SMSF administration business, may seem unusual. But Meg sees plenty of clients who reach the stage where an SMSF is no longer suitable, and provides her unique explanations.

As part of our continuing series looking at retirement planning, **Ben Hillier of AMP** reports on new research comparing attitudes to retirement versus responses in 2020 and the issue of FORO, or the Fear of Running Out. Ben suggest steps to mitigate the stress.

Last week's article on the Government's potential franking credit change drew plenty of attention, but it seems a simple explanation of franking is required. **Stuart Cartledge of Cromwell Property** shows the value of looking at after-tax returns at different tax rates.

Investing in small companies is not for the faint-hearted, as **Andrew Mitchell of Ophir** explains. These companies are covered by fewer analysts than the big blue chips, and they tend to fall quicker and further when the market hits a speed bump, but then they recover quickly as conditions improve.

It's always difficult to look far enough ahead to better markets, but a **Warren Buffett** quote helps at times when "*people are scared away*".

"The idea that you try to time purchases based on what you think business is going to do in the next year or two, I think that's the greatest mistake investors make because it's always uncertain. People say it's a time of uncertainty. It was uncertain on September 10th, 2001, people just didn't know it. It's uncertain every single day. So take uncertainty as part of being involved in investment at all. But uncertainty can be your friend. I mean, when people are scared they pay less for things. We try to price. We don't try to time at all."

Amid all this pessimism, analysts at **Bank of America** Global Research, based on their latest Fund Manager Survey (FMS), say there are signs of "*macro capitulation, investor capitulation, start of policy capitulation, cash levels 6.3% = highest since April 2001, investors underweight equities - tasty morsels for another bear rally*" and with maximum bearishness on the economic outlook.

Close to a record share of investors expecting a weaker economy in next 12 months

Although Firstlinks does not focus on picking market tops and bottoms, two leading fund managers are also looking through the current pessimism of rising rates and recession talk. **Tom Stevenson of Fidelity** explains why he thinks it's better to be too early investing into stockmarkets than too late, while **Chris Siniakov of Franklin Templeton** sees value in bonds after the misery of the last year.

Finally, I listened to the latest update from the **CIO of Unisuper, John Pearce**, who I rate as one of Australia's leading investors and asset allocators, and John is also looking to deploy capital. While I'm not ready to move cash to equities yet, John is seeing opportunities in the medium term. Here is an extract.

"Things aren't feeling particularly good at the moment, but we're actually getting back to a sense of normality. I believe that the Fed is actually closer to the end of this tightening cycle than the start. I know there's a feeling that all the Fed officials are walking around with the proverbial hammer in their hand and every problem looks like a nail. I know that some commentators are saying that the Fed is not going to stop until they really break something.

I don't subscribe to that view. Yes, the Fed does have a price stability mandate, but the Fed doesn't have a mandate to put millions of people out of work and I'd suggest that they would start losing their political support if indeed they got to that position. My view is that we're not far from the time when the Fed will have to pause just to see the impact, that the rate rises are working their way through the system. And finally, stock markets are now trading at levels that historically have proven to be pretty good entry points for long term investors ...

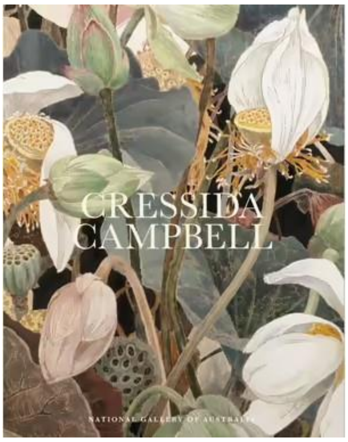
We're not stating that we've seen the lows because we'll never pick the lows. We just believe that the risk reward equation favours taking some risk at the moment. In the event that markets fall even further, we see opportunities across the whole curve ... I'm personally not that concerned with the recession. If you look at the history of economic cycles, recessions are very common. But after every recession is a recovery in the economy or a recovery in the stock market. The cycle never dies."

Graham Hand

10 lessons Cressida Campbell taught me about art

Graham Hand

I don't know much about art generally, but I know a lot about Cressida Campbell, whose career and work I have followed closely for at least 25 years. It is a coming-of-age event when an artist is chosen for a long exhibition at the pinnacle of Australian art, the National Gallery of Australia (NGA) in Canberra. Campbell recently started a remarkable five-month run from 24 September 2022 to 19 February 2023, and 140 of her works show her evolution to a master of her technique over the last 40 years. I can barely contain my excitement about attending. Here is the cover of the NGA book produced for the exhibition.



I bought my first Campbell piece on eBay for $120, an early, unique screen print, but it was only when she released a beautiful, large format book of her collected woodblocks in 2008 that I became enthralled. The print run of the first edition of *The Woodblock Paintings of Cressida Campbell* was only 1,000 copies, and it quickly sold out. I grabbed the last copy from Dymocks for $100, then bought another privately online for $120. The book has subsequently been reprinted in small runs but when the first edition comes up at auction, it sells for $2,000-plus.

My fascination was complete after a small exhibition in February 2009 at the S.H. Ervin Gallery in Sydney. We had to queue to enter, which was a guide to her popularity. My knowledge of art was limited to politely accompanying my wife to galleries, mainly wondering how long we needed to spend there before doing something interesting. But Campbell's work was different and resonated strongly, and I now own about 18 prints and woodblocks, mainly the cheaper, early pieces. I say 'about' because some are in storage.

Her major woodblocks sell at auction for over half a million dollars. In March 2022, an early Campbell woodblock painting from 1987 called *The Verandah* sold for $515,455 (including buyer's premium) at a Menzies auction in Sydney, as the headline below from The Australian Financial Review shows. It sold originally for

$2,500 and had never come up for auction before. There are 99 prints available at more accessible prices of about $15,000 to $20,000 each when one appears at auction.

Why artist Cressida Campbell repainted a $500k work for free

Before a 35-year-old woodblock painting went to auction, she fixed it up and ensured a windfall for its owner.

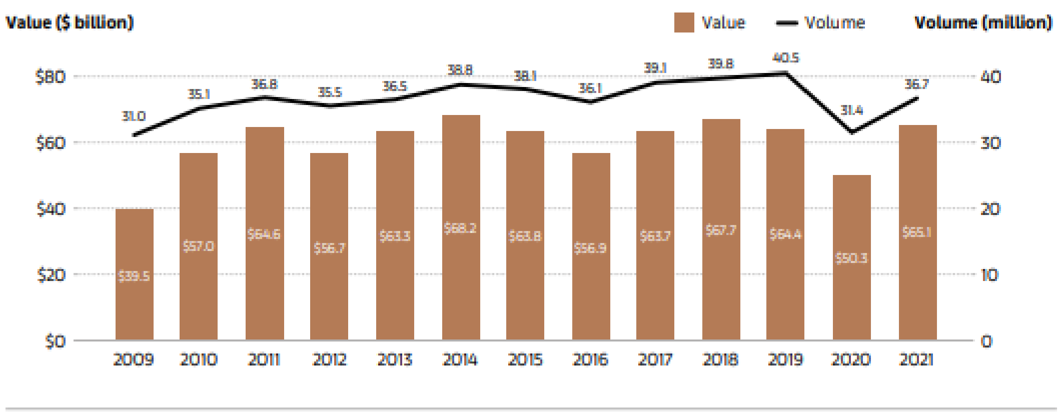
Art is big business, for investment and pleasure

UBS produces an annual Art Market Report, and the 2022 edition reports that following a COVID slump in 2020, the global art market recovered strongly in 2021. Although it's not an easy market to track, UBS places the aggregate sales of art and antiques by dealers and auction houses in 2021 at an estimated $65.1 billion, up 29% from 2020, and above pre-pandemic levels. Far more of the auction action now takes place online.

Art is increasingly seen as an investment as well as for its visual appeal. In a 2021 report on *Art as an Asset Class*, Deloittes said:

"there is a growing recognition of art as an investment class by investors. People become more sophisticated in their financial and estate planning, and they begin to view art as an investment."

Figure 1.1 | Sales in the Global Art Market 2009–2021



© Arts Economics (2022)

Although I love Campbell's work, my background means I cannot avoid thinking about her art in investment terms as well as aesthetic value. One reason I expect her work to continue to increase in price is that her output is modest while her profile skyrockets. There are simply not enough pieces available to satisfy demand at anywhere close to past prices.

According to the NGA exhibition book, her meticulous process allows only five or six new works a year, and they are snapped up before they appear in public. A recent exhibition at Philip Bacon Galleries in Brisbane, his first with her for five years, sold out to his clients three weeks before opening, with 300 people on the waiting list. As Bacon told The Australian Financial Review, in the time between his two exhibitions, the market for her work has "*seismically shifted*".

Campbell's process is time-consuming and meticulous. Briefly, she draws her subject from life onto a piece of plywood with great precision, then using an engraving drill, she carves into the image along the drawing lines. She applies watercolours to the work within the carved sections, preventing the colours from running. From the final painted woodblock, she produces a unique print by dampening the painting and using rollers on the back of the paper to lift the image from the woodblock.

For the last three decades, she has produced single prints only, and she sells the woodblock and the print. A few earlier works were reproduced in print runs of up to 99, making them more affordable, but her recent work sells at dealers for over $300,000 for both the painted woodblock and the unique print.

Here are some brief lessons from my decades of watching Cressida Campbell's works sell at galleries and auctions, but of course, these may not apply equally to all artists. Maybe I was lucky.

Lessons from collecting Cressida Campbell

Most advisers on collecting art will start with the motivation or intentions, and say people should buy what they love then they can't go wrong. I take more of a value approach. There's little reward in paying $10,000 for an artist whose work normally sells for $1,000 even if a collector loves it. But unless a piece is bought for storage and resale, it is certainly true that art should bring joy and a buyer usually has to live with it on their wall.

1. You don't need to know much about art to become a collector

Can a specialist work in heart surgery without knowing how the entire body works? Does any fund manager select stocks in isolation from the economic and market environment? Probably no to both, but art is different. Some people may think they need to have a good overall art knowledge before buying a particular artist, but I know little about art generally. I paid around $500 for early Campbell pieces many years ago because I liked them, but I was also confident that she would develop a big following based on the reaction to her book and exhibition. Now I attend auctions to watch the market for her work and I know more about other artists that come up, although I have no intention of widening my interests.

2. You should like the work

While it's possible to invest in art purely based on price, supply and demand, the market is not assured and interest in artists can come and go. Prices are not immune from economic impact. There's little downside in buying art you love to decorate a room or brighten a space or because it speaks to you at a deeper level, and if owning and living with a piece is enjoyable, the price is less relevant.

3. Auction guides are often wildly inaccurate

In the early days, I missed out on some pieces as I read the upper level of the auction price guide as my budget. A painting would be promoted as $3,000 to $5,000 and sell for $8,000. I gradually realised that at least for Campbell, the auctioneers and dealers were behind the public. As her work rose in price, the professionals seemed to be at the previous auction. Even when I knew the upper range would be left far behind and set myself a bigger budget, more enthusiastic bidders would sometimes pay whatever it needed. Now, the upper estimate might be $200,000 and it sells for $250,000.

4. Don't worry if an artist is labelled 'popular' or 'commercial'

The prices of some artists do not rise quickly because they are labelled 'popular'. This seems to apply to the work of Campbell's great friend, the late Margaret Olley. The Art Gallery of NSW owns many Campbell works but I have never seen them displayed. When I have asked the Gallery where the works are, they explain that their entire collection is many times larger than what can be exhibited, and Campbell's pieces are in storage.

There is a revealing paragraph in the new NGA book which also shows how experts lagged the public:

"Campbell has made her way, almost be stealth, to the first rank of contemporary Australian artists. This is despite museums and public institutions having been slow to recognise her achievements, and comparatively little has been written about her work. Her popularity with private collectors has possibly worked against her in this regard, leading to the lazy assumption that she is a 'decorative' or 'commercial' artist. This may be partly because she came to maturity as an artist at a time when Australian museums and media were preoccupied with the local outgrowths of postmodernism - with art theory, appropriation, and a wide range of self-conscious avant-garde activities."

Sometimes, the less you know, the better. Campbell and her fans have no such pretensions.

5. Watch all sources and auctions

With negligible new supply publicly available from Campbell, there are three potential sources:

a. Private sale on sites such as eBay and Gumtree. It's possible to find Campbell pieces here but they often appear expensive. A quick search when writing this article showed *Resting Butterfly* for $67,500 and *Bush Objects* for $27,500. Even with my enthusiasm, these look pricey to me, but critically, I don't love either piece.

b. Auctions regularly feature Campbell art. The major houses such as Smith & Singer and Deutscher & Hackett are normally top-end and buyers should expect to pay high prices and often above the upper estimate. Recent sales of around $200,000 for unique prints and woodblocks are common. But where a piece such as *Music in the Kitchen*, shown here, is from an early print run of 75, it's still possible to pick one up closer to $10,000 from a smaller auction house.

39: CRESSIDA CAMPBELL born 1960, Music in the Kitchen 1994
Est: AUD8,000 - AUD12,000
View sold prices

Oct. 12, 2022
Menzies
KENSINGTON, NSW, AU
CRESSIDA CAMPBELL born 1960 Music in the Kitchen 1994 colourscreenprint 46.0 x 57.0 cm (image) edition: 68/75 signed lower right:Cressida Campbell numbered lower left: 68/75 titled lower centre

c. Art dealers handle occasionally new or resale works but tend to reward their best clients first, and the general public can join long waiting lists but never hear from a dealer.

6. Stay ahead of price rises

Yes, research the value and know the market, but Campbell is so rare that overpaying may be required for a beautiful piece. It seems strange to make a case for paying too much, but it may be the price of entering this game. If a collector becomes familiar with Campbell's work, they may need to trust their instincts to beat the opposition.

7. Focus less on buyer premiums and commissions

For anyone with an investment background, 4% entry fees for managed funds are now consigned to the history pages, and ETFs with fees of 0.05% make active managers at 1% look expensive. These fees are nothing compared with the art world. The buyer's premium at auction is usually around 22% to 25%, it can be a shock and needs to be factored in, but it's a fact of life if a desirable piece appears. Still, bidding $40,000 and knowing the end price will be over $50,000 takes a bit of getting used to.

8. Learn what is available

Unique works like new woodblocks and prints are one-off and expensive, and as *The Verandah* auction showed, even her older works now attract big money. Beginners may prefer to target the early works produced in larger print runs. However, what is not widely understood is that an artist like Campbell did not necessarily print the full quantity suggested by the reported records. Printing on high quality paper with watercolours is expensive and highly time-consuming for a struggling artist.

While the print run may be recorded as 20, such that the bottom right of a print may say 1/20, Campbell may have printed only 10 copies for sale. In the early days, if they were difficult to sell, they may go into a cupboard as she moved on to another work. A leading dealer told me her early works are not as common as widely believed. Nevertheless, limited edition prints are a great way to begin an art collection.

9. Buy the best you can afford

Do you intend to buy one original, valuable artwork a year, or many lower-priced pieces? My main mistake in collecting Campbell (and yes, I am saying this with hindsight knowing her work has appreciated) is that I tended towards the cheaper pieces rather than hitting whatever the auction price required. I have a particular regret about *Through the Windscreen*, shown below, which I had the chance to buy in the early days and now is worth multiple times more. It is supposed to be printed in a run of 20 so there should be plenty out there. If you have one, give me a call.

I'm intrigued by the mistake she made. Can you spot it? The woodblock is the mirror image of the print. This print shows a scene in Australia so the steering wheel should be on the right-hand side, especially as the numbers on the dial are not reversed.

***Through the windscreen*, the one that got away**

10. Art has a valid role in a portfolio but is often not for sale

I hesitate to quote returns from collecting art as there is so much variation, and although there may be vested interests, there are many results arguing that good art outperforms other major asset classes. Here are the claims for contemporary art (such as the well-known Banksy) price performance for 1995 to 2001. Make sure you like the work first and then invest in it. But you may never sell a great piece, as it becomes part of your life and home. I can't see a circumstance where many of my Campbells will see the market.

Contemporary Art 13.8%	S&P 500 10.2%	Real Estate 8.9%	Gold 7.2%

Art is subjective and so are you

Collecting art is a subjective experience but hanging a painting or another object on your walls says something about you. Whenever I walk into someone's house, I now pay far more attention to the art than I used to. Most people want to tell the story of where the art came from and why they chose it, so don't ignore it.

And get along to Canberra to see Cressida Campbell and learn what all the fuss is about. You might not know much about art, but you'll know what you like.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information and does not consider the circumstances of any person. Images of works are copyright Cressida Campbell.

Meg on SMSFs: when should I get rid of my SMSF?

Meg Heffron

In a monthly column to assist trustees, specialist Meg Heffron explores major issues relating to managing your SMSF.

In last month's article, I explained why I started my SMSF at a relatively young age and why I am glad I did. But a reader raised a good point that can be translated as:

- How will I know when it's time to wind up my SMSF?
- Then what will I do?
- Will it be difficult?

How will I know when it's time to wind up my SMSF?

The flippant answer is "when I don't want to do it anymore" but in fact, that's not a bad place to start. These days, I'm the only member of my fund and the sole director of my trustee company, so it's up to me. Right now, I'm happy to have my SMSF. But perhaps when I retire, I will have zero interest in SMSFs including my own? Not wanting to do the work anymore would be a completely valid reason to wind up my fund.

At some point, my ability to look after my fund might start to fade (dementia, other health problems). At that point, I'll talk to my sons before assuming it's time to wind up my SMSF. If one or both of them are willing and able to take over running it for me, I'll leave it intact and just hand over the reins to them.

Neither of them know much about super or SMSFs in particular so, if a handover looks likely, I'll need to involve them sooner rather than later so I can help in the early days. I could even invite them to become members and we could be trustees together for a time.

At this stage, I still see that as a long way off and will only do it if it's necessary. In the normal course of events, I'm not keen on having multiple generations in the same SMSF. Even if they did join my SMSF, I'd suggest they left most of their super in their own fund, as one day, they will have families of their own and want to manage their finances with their spouse, not with me.

And that may never happen. Plenty of my clients continue their SMSFs into their 90s. The nature of the help they buy in (or receive informally from the next generation) changes over time but they are still actively engaged in their own super planning and value the flexibility their SMSF provides well into old age. They are my inspiration.

But as passionate as I am about my SMSF, I would wind it up if I wasn't able to look after it and my sons didn't want to. I believe an SMSF's main attraction is that it opens up opportunities. If my sons don't want to run it, they probably won't make the most of those opportunities anyway, so why ask them to take on the responsibility?

Death of a member may be a catalyst

For some people, the death of a member is often a driver to wind up and there are probably two reasons for this.

The **first** is that with two people in an SMSF together, there is almost always one person more engaged than the other. If that person dies, it's common for the survivor to wind up, often depending on age. Someone who loses the 'active' spouse in their 50s probably won't wind up the SMSF – they will learn how to do it and probably surprise themselves with their own capability. But someone in their 90s might make a different decision. Both are completely reasonable.

The **second** reason death is a trigger is that it's frequently a moment when the fund has to pay large amounts out of super so the fund inevitably gets smaller.

Deceasing assets and tax on inheritance

Decreasing assets is a trigger for winding up an SMSF as at some point, it can stop being cost effective. In fact, it's worth identifying early – based on the particular features of the SMSF – how low the asset value would need to be to encourage winding up.

These are not decisions to be taken lightly but there will be a threshold where that makes sense for everyone. And remember the transition point is different when your balance is on the way up versus when it's declining. A young person with a growing super balance may be happy to take on higher costs in the short term for longer-term gain. That won't make sense for someone with a declining balance so if cost is a key driver for change, getting out of an SMSF might make sense at a higher balance than you expect.

Another wind-up driver might be tax. Once my sons are financially independent (said with firmly crossed fingers) any super they inherit from me will be subject to tax – mostly at 15%. While that sounds like an innocuously low rate, it adds up when you remember it will be applied to my superannuation **capital**. It might be a big dollar number.

So in the ideal world, I would proactively remove most or even all my money from super (which might mean winding up my SMSF) before I die. Just not too early because it's very tax effective for me during my lifetime. That's another reason why 90-year-olds who've just lost the active member of their SMSF often choose to wind up. They are reaching the point where they want to protect the next generation from tax. They don't just exit their SMSF, they exit superannuation entirely.

And of course there are host of other triggers to wind up that might apply in other cases. Relationship breakdown (sometimes an SMSF makes sense when there are two people but not if there's only one), the sale of an asset that was the primary driver for the SMSF in the first place or even serious breaches of the law that mean the fund and its trustees have attracted the ire of the ATO.

Once I decide to wind up, what will happen?

Winding up will mean removing all the assets from my fund. It doesn't matter whether I sell them all or just move them 'in specie' to their new home (another super fund, my own name outside super, etc), either way the change triggers a capital gain. There are smart ways to manage that capital gain that ***can*** mean it's sensible to manage the wind up over a few years. That's a decision to make at the time. The key is to think about it carefully to get the best possible result.

If the money is going to another fund, I (or my sons) will need to choose one and probably make decisions about investment options in that fund. All decisions don't suddenly disappear just because there's no longer an SMSF involved. My fund's accountant will need to do some paperwork.

For example, I have pensions in my SMSF so my accountant would need to tell the ATO that they've stopped. Ideally, we want to do that before my new fund tells the ATO that they've started some new ones for me in their fund. Otherwise, the ATO will think I've got both and will assume I've gone over the limit known as my 'transfer balance cap'.

There is also data to be provided to the new fund in a specific format – again something my accountant will handle. And I might need their help when transferring the money from my SMSF to my new fund if my SMSF's bank restricts the amount I can transfer.

Of course, the money might not be going to another fund. Someone whose superannuation is no longer 'preserved' (say they are over 65) can generally just take the money out of super entirely and invest it in their own name. This requires slightly different paperwork.

There's a final annual return and audit but in reality, they are just like the returns done every other year. Often one of the reasons SMSF wind ups feel like they go on forever is that the fund's bank account is often left open to receive the final tax refund and this won't happen until that last return is done.

There are factors that can make wind ups much harder, for example, if the fund has very old-style pensions (often called legacy pensions), reserves, assets that can't be sold etc. But these can usually be solved with some perseverance and the right advice.

So, my SMSF will definitely end one day, and possibly before I die. When the time comes, I will treat it as a process that happens over a few financial years, not because it has to take that long but because that's probably how I'll get the best outcome.

Meg Heffron is the Managing Director of [Heffron SMSF Solutions](), a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

To view Heffron's latest SMSF Trustee webinar, 'Super contributions unpacked', click here (requires name and email address to view). For more articles and papers from Heffron, please click here.

Bigger fall, bigger bounce: small caps into and out of recessions

Andrew Mitchell

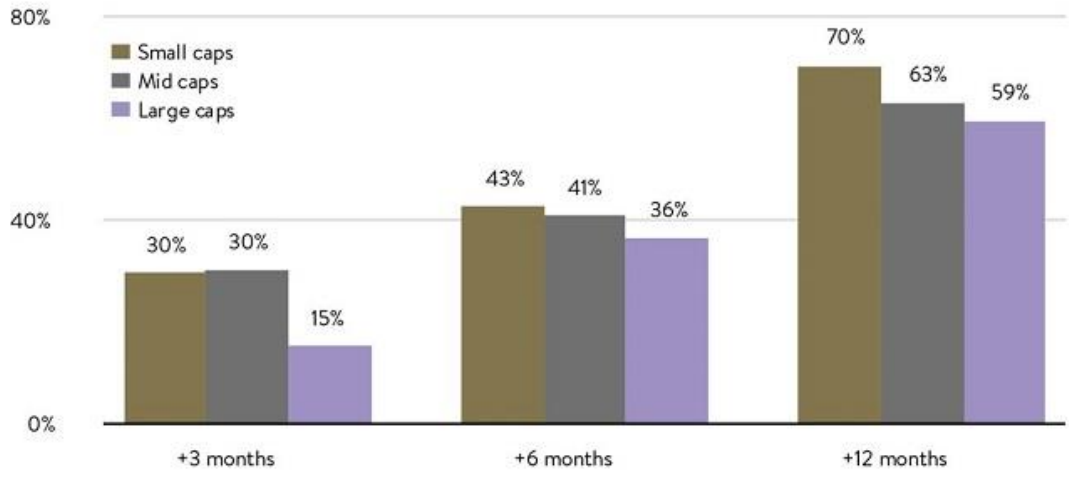
All types of investing require nerve and courage, but perhaps none more so than small-cap stocks. When an economic downturn hits, small caps tend to fall first and farthest.

That has been the case in the current down market and US small caps have slumped 30% from November 2021 highs. Outside of the COVID drawdown, that's the worst fall for US small caps in a 10-month or less period in the last 70 years.

But while small caps fall the hardest, they also recover the fastest.

Historically, in the 12 months after the US small-cap index has bottomed around a recession, they have returned an incredible 70% on average, or 11% higher than large caps (see chart below). The small-cap rebound is also quick: most of the additional return benefit versus large caps has happened in the first three months.

Small caps have the edge over mid and large after trough



Source: BofA ETF research, Ibbotson, Global Financial Data.

If investors can understand the dynamics behind small-cap volatility, they will less likely be whipsawed out of small-cap stocks, but also be more confident in positioning their portfolios for a strong rally.

Why smalls tend to fall more

There are many reasons why the small-cap sector falls hard. They are generally not traded as heavily, so when institutional investors become nervous, they will often sell at the smaller end of the market because they fear they will become trapped in these less liquid positions.

When these big institutions turn bearish, the impact on small caps can be significant, creating something of a vicious cycle: small-cap managers begin to believe that they, too, must preserve cash. They then also stop buying, pushing prices down further and faster on even lower levels of liquidity. And while small-cap managers might see even cheaper stocks, many are unwilling to enter the market so prices in small-cap stocks keep falling at a faster rate

Small-cap companies also tend to be more sensitive to changes in the economy. They are less able to diversify their operations and are less likely to have the large cash reserves needed to withstand difficult trading conditions. That means that there is a higher chance of them going bankrupt.

Depths of despair

But just when things look hopeless for small caps, the point of recovery comes like a tsunami, often bringing with it stellar returns.

As any good surfer knows, it's important to be positioned early – in this case for when the big institutions once again look for investments in small caps that produce returns above the market average.

No one knows the timing of all this. But one sign is that, when everyone thinks investors are crazy for going into small caps, that is the very time when it is a great idea to invest in them. It means it is not just necessary to have nerve, investors must be willing to follow their own judgement, even if it means going against the herd or 'expert' opinion.

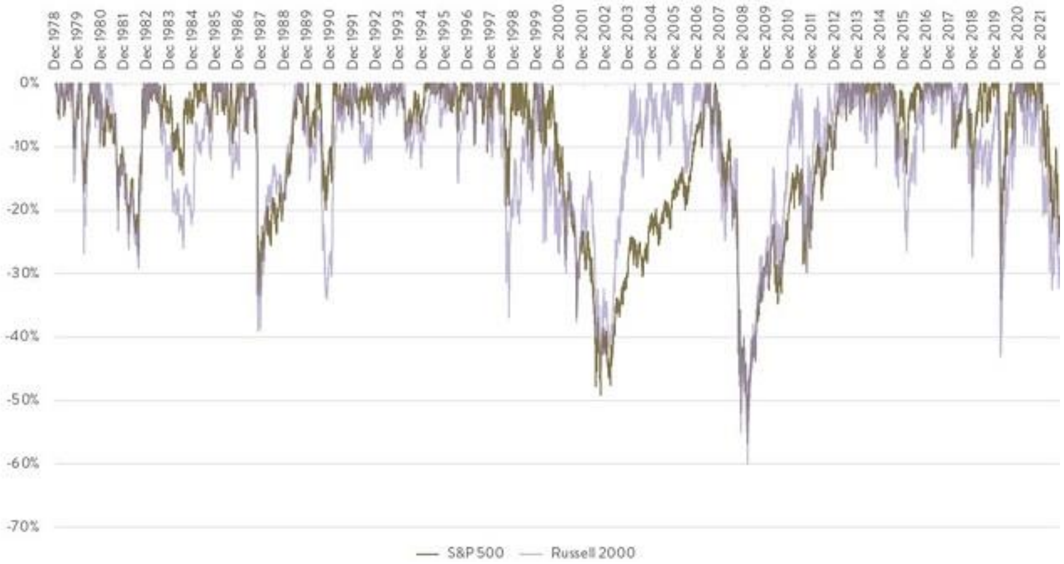
Positioning to surf the recovery wave

So where are we in this cycle? We make three observations:

1. Poor news is priced into small caps

Firstly, there seems to be a lot of bad news already factored into small caps. The Russell 2000's recent 30% drop from highs (versus a 36% drop on average around recessions since 1950) suggests that small-cap equities may be pricing in more recession risk than large caps, which have fallen a more modest 23% (S&P 500).

US Equities Drawdown



Source: Factset

2. Large caps may not be more resilient this time around

Large caps may not retain their resilience over small caps during this downturn. In previous downturns, large-cap stocks were seen by the market as being more resilient because they were more likely to have globalised operations and consumer bases. (In 2008 the strength of China's economy helped global companies survive the extreme stresses.)

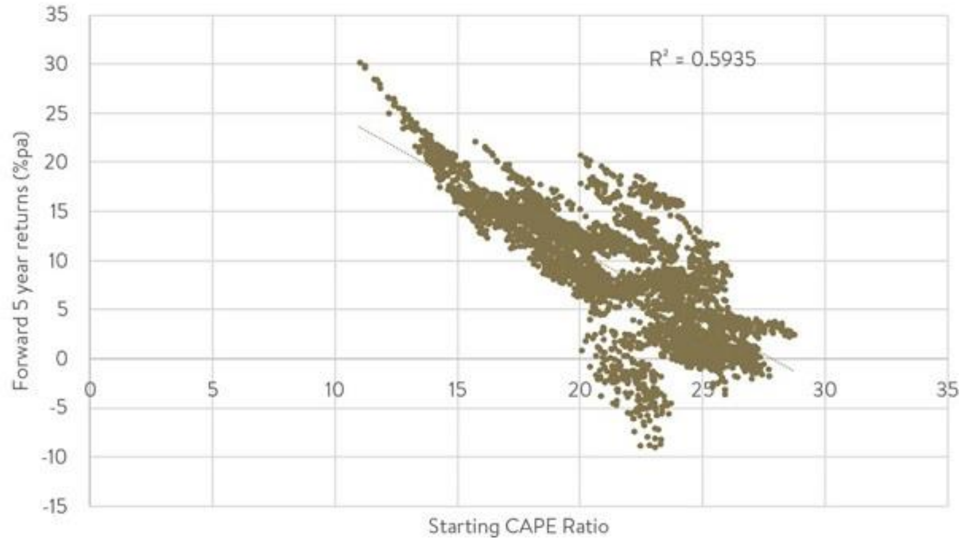
That is less likely to happen this time around. The economic downturn is global, sparked by higher inflation, and in the wake of the pandemic there has been significant fragmentation of international supply chains. The ability to disaggregate production across different geographical regions, which has been a distinct advantage many large caps enjoyed over smaller companies, may prove to be more of a disadvantage this time.

3. Small caps are cheap

And, thirdly, US small caps look cheap. The Russell 2000 is currently trading at a 17.3x long-term price-earnings (PE) ratio. When the Russell 2000 has been at that value historically investors have benefited from double-digit average annualised returns over the next 5 years. The Russell 2000's valuation is also over 30% cheaper than the 25.5x long-term PE ratio for the S&P 500, which has historically resulted in average annualised returns over the next five years in the low single digits.

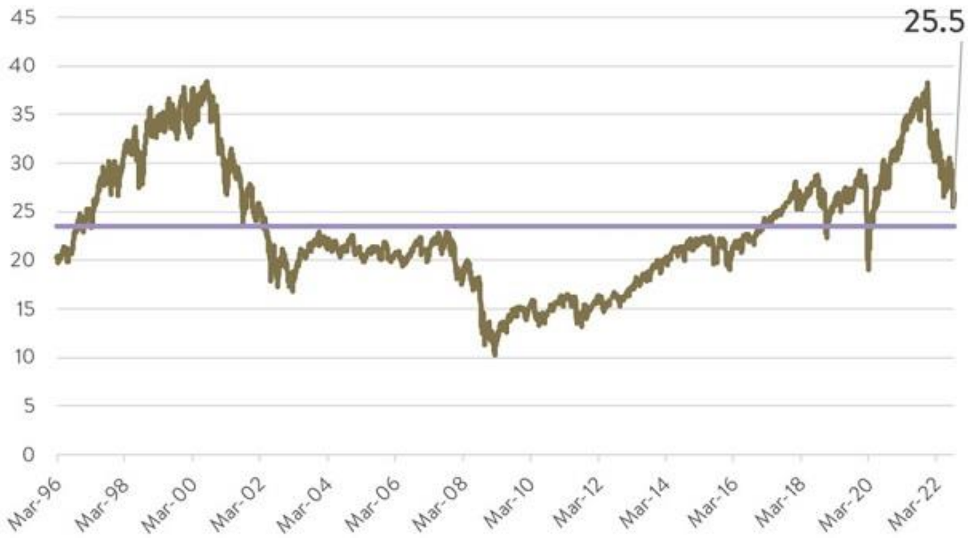
Russell 2000 CAPE Ratio

Starting Russell 2000 CAPE Ratio and subsequent 5 Year Returns

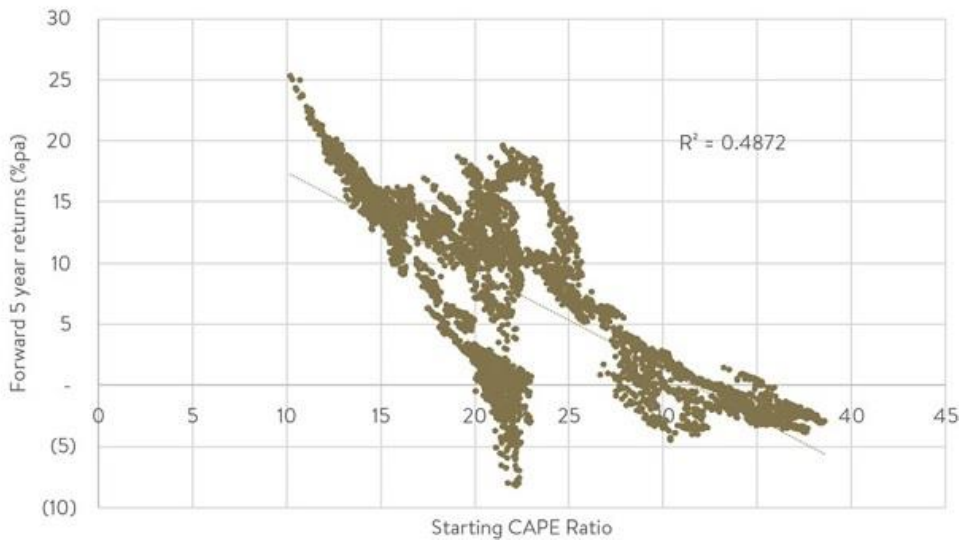


Source: Factset.

S&P 500 CAPE Ratio



Starting S&P 500 CAPE Ratio and subsequent 5 Year Returns



Source: Factset.

Strong returns potential

We may not yet have the catalyst for a sustained rebound in share markets given the source of its falls – high inflation – has not been fully dealt with yet. But we see more limited downside for small caps given what has already been priced in. Indeed, we see strong absolute returns ahead over the next few years once the recovery takes hold, given starting valuations and likely attractive relative returns to more expensive large caps.

There may be further declines to come, but the risk of weakness in the small-cap sector is outweighed by the risk of missing out on the eventual strong recovery that history suggests is likely to occur.

We remain acutely aware of this coming opportunity and have a game plan in place to ensure we can take advantage of it. We encourage other investors to do the same.

Andrew Mitchell is Director and Senior Portfolio Manager at Ophir Asset Management, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

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Five steps to ease retirement stress and FORO

Ben Hillier

A mix of health concerns, market volatility and employment disruption felt over the past two years and recent cost-of-living stresses have increased concerns about their retirement. This slippage is evident in key comparisons with our 2020 research:

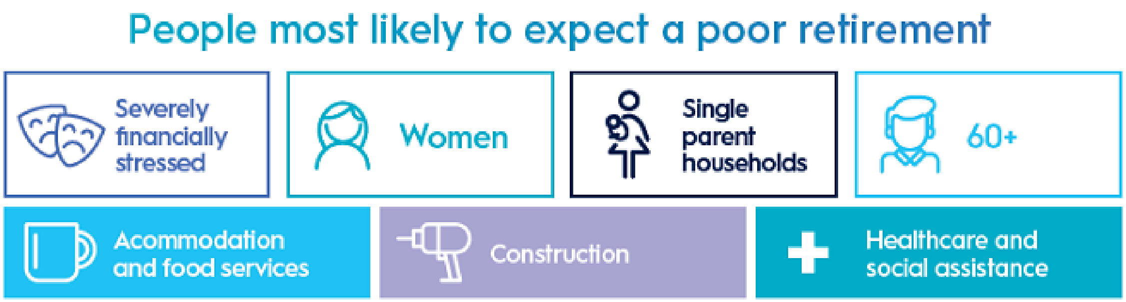
- Employees today expect to retire half a year later than they did in 2020.
- They expect to retire with $100,000 less in retirement savings – their total expected retirement saving has fallen from $500,000 to $400,000.
- The number who expect a comfortable retirement has fallen nearly 10%.

The cost crunch

Over one third (35%) of workers have changed their retirement goals due to the impact of the pandemic and the policy responses to it (lockdowns, JobKeeper etc). But it's striking that the more recent economic trends of higher costs and rising inflation are now dominating worries about retirement, especially those who may not have had the opportunity to build their savings over a long period.

About 45% of women are particularly concerned about how higher costs will affect their retirement lifestyle, a significant increase on 2020. Similarly, it is women, single parents and pre-retirees who are more concerned about the damage inflation could do to their life after work.

Nearly 50% of 50–59-year-olds cite this concern, reflecting the perceived damage inflation can do to those who are close to retirement but who feel they haven't saved enough to cope with rising costs. On an industry basis, it is workers in areas like Accommodation and Food Services and Health Care and Social Assistance that are most worried about retirement. This is no surprise as these fields are where women are over-represented and part-time work is common.



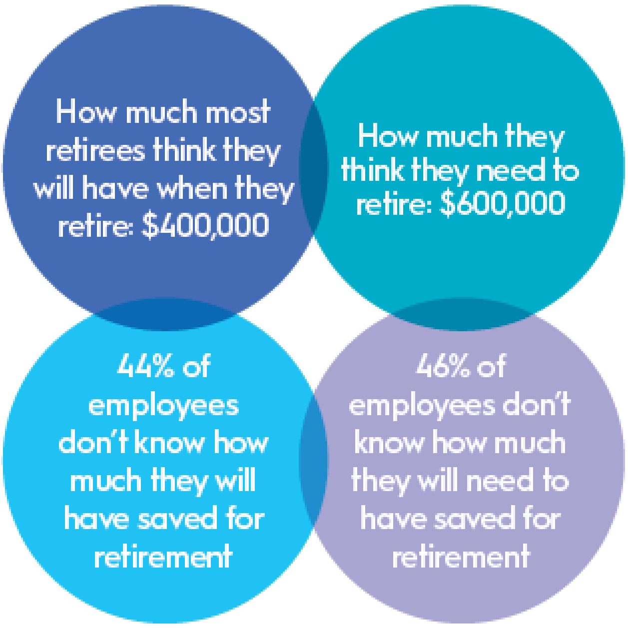
Fear of Running Out (FORO)

There's a clear gap between how much people expect to retire with ($400,000) and what they think they need ($600,000). That $200,000 perceived gap is also a potent source of financial stress.

Whilst FORO is real and understandable, authoritative sources like Treasury's Retirement Income Review (RIR) suggest that many retirees comfortably outlive their savings.

So this stress may be overdone and unnecessary. There are implications for employers and the financial services sector here.

Retirement needs are highly personal. So while industry benchmarks are helpful, we shouldn't be placing too much focus on a single retirement number. Employers, advisers and the financial services industry can promote positive actions – yet reduce financial stress – if they help educate employees to better understand their individual retirement financing needs and how to meet them.



The good news is that the financial services sector is already turning to the task of reducing FORO.

Engaging in the future

Most Australians are not prepared to compromise the lifestyle they've dreamed of in retirement. Many have reduced their current spending, while more than 60% say they would work for longer to avoid a lifestyle downgrade once they finish work. Only a third (34%) would be happy to re-adjust their lifestyle expectations.

This flexibility means employees give themselves more time to plan for retirement and craft new working and saving arrangements that help them reach their long-held retirement dreams, even if it's a few years later.

The past two years have increased people's fears that retirement won't live up to their expectations and that their non-work lives will be crimped by financial concerns.

However, the fact that Australians are engaging more actively with their super planning and are prepared to be flexible about reaching their goals is a highly positive development. To take advantage of these trends, the financial services industry, employers, financial advisers and policymakers need to:

- Invest in retirement income education that looks beyond generic 'needed to retire numbers' to give people a more realistic and less stressful view of their retirement prospects.
- Educate people about the broader range of tools that can help them fund their retirement, such as the age pension, government benefits such as discount cards, low-cost healthcare through Medicare, property ownership and part-time work.
- Encourage retirees to look beyond the return on their assets as the only source of retirement income. For many retirees it makes sense to draw down on their retirement capital to support their lifestyle, as long as it's done in a disciplined fashion.
- Similarly, help people to 'right-size' their retirement goals, to take into account their income, health, family circumstances, work patterns and lifestyle expectations in ways that encourage positive action rather than worry and anxiety.
- Highlight how effective good financial planning can be in helping individuals ride out the effect of market volatility or short-term economic dislocations.

Five ways to ease the pressure on yourself

Here are five practical approaches to managing financial stress, but the main message is not to overanalyse the feelings of financial stress. Identify ways to control those fears, assuage those stresses and move on.

1. Find your bearings, clarify your situation, build your budget

Without a clear sense of where you are, you can't take any steps to change your position. Start by clarifying and writing down exactly where you are financially. That means knowing the balances in your banks, super funds and credit card providers to get a clear picture of your personal balance sheet.

Take a look at both your spending and income. Many bank accounts today have budget or tracking apps that provide a clear view of your spending patterns. The first step here is to put aside some cash for emergencies (3-6 months' income is often recommended).

With all this information at your fingertips, a real sense of your financial position helps to stop worrying and start managing.

2. Put yourself first and set your financial goals

Taking control of your money is not just managing the components of a good financial life (budgets, a savings plan, regular super contributions etc). It's having something to aim for. So while good financial management will reduce financial stress, it should also be focused on your goals and your dreams – whether that's a travel-filled retirement, helping your children or simply not having to worry about money every day.

Popular financial goals

Ages 18-29 – Purchasing a house
Ages 30 to 39 – Providing security for children
Ages 40 to 44 – Paying off mortgage
Pre-retirees – Saving for retirement

3. Get help from the experts

There's plenty of research showing that people who draw on expert advice from financial planners, accountants, super funds and more are less financially stressed and make better decisions.

All the providers we mentioned above, plus government sources like the ATO website and Moneysmart.org, have free educational material that can help you budget more carefully, invest more prudently, protect your family via insurance and save for retirement. They contain practical tools – checklists, calculators, tips and online learning, designed by experts - to give you greater control over your money.

Some super funds and investment firms offer access to comprehensive financial advice, but there are more limited advice options available that will help you address specific financial issues that are causing you stress. Take advantage of those options.

Top 5 reasons employees seek financial advice

1.	Help me with a savings plan	38%
2.	Help me to plan my retirement	36%
3.	To help me manage my investments	30%
4.	To help me make investments	30%
5.	To help me with general financial management	29%

1 in 2 employees say their likely to seek professional financial advice in the next 12 months

4. Make work, work

Workers who are financially stressed find it harder to focus on work, so it makes sense for your employer to care about your financial position. The more secure you are, the better for you, the better for them.

Talk to HR, your line manager and your super fund. All of them will have avenues you can explore together to build financial security. They could range from financial and psychological helplines, access to cheaper insurances, discounts on goods and services and financial education. Or it could be sophisticated solutions like salary sacrifice options and access to comprehensive financial and insurance advice. These are work-related benefits that can boost your financial wellness and make you better at your job.

5. Prepare for retirement

As with any journey towards better financial wellness, the path to a more comfortable retirement starts with knowing where you start. Whether by yourself, with an accountant, financial adviser or help from your super fund, you need to get a clear picture of your pre-retirement financial position: the money you have in super, savings and investments, any debt, your insurance needs and likely spending patterns in retirement.

It’s also important you understand the support you can access from government benefits, not just the age pension but the pension card and associated discounts.

You also need to understand the intersection of the super and retirement income systems as you transition to retirement. That means the tax and social security implications of withdrawing super, making contributions and earning income from work or other investments.

Ben Hillier is General Manager Retirement Solutions, [AMP Capital Investors Limited](#).

Extracted from [AMP's 2022 Financial Wellness research](#) with permission. Data from more than 2,000 respondents was collected between mid and late June 2022 and post-weighted based on ABS statistics: gender, age, location, working status, and industry. This article is general information only and as such, does not consider your personal goals, financial situation or needs. AMP recently announced its new retirement income product which we will examine in a subsequent edition.

After-tax returns and the value of franking credits

Stuart Cartledge

After-tax returns are the real measure that matters to investors. However, the funds management industry is configured to present investment returns on a pre-tax basis and this can lead to the underpricing of franking credits. For example, over the six tax years to June 2022, the Cromwell Phoenix Property Securities Fund (Fund) has delivered franking credits that have ‘topped up’ investors income by an average of 0.51% per annum but that extra is not normally quoted in performance numbers.

This article takes a closer look at franking credits and how they can help to maximise your after-tax returns.

Table 1: Franking and the benefits to investors

			Super			
Investor category			Retirement	Accumulation	Company	High Net Worth
Net profit before tax	a		$100	$100	$100	$100
Company tax rate	b		30%	30%	30%	30%
Company tax	c	=a*b	$30	$30	$30	$30
Net profit after tax	d	=a-c	$70	$70	$70	$70
Franking Credit	e	=c	$30	$30	$30	$30
Payout ratio	f		100%	100%	100%	100%
Cash dividend	g	=e*f	$70	**$70**	$70	$70
Taxable income to investor	h	=g+e	$100	$100	$100	$100
Investor’s tax rate	i		0%	15%	30%	47%
Investor’s after tax proceeds	j	=h*(1-i)	$100	**$85**	$70	$53

The theory

Some of the stocks held in the portfolio are traditional corporates, subject to Australian tax, and are therefore likely to generate franking credits under the Australian dividend imputation scheme. These are valuable to investors and should influence how the portfolio is managed.

The table set out above shows the impact, with each column representing a different investor category. For example, the second column, labelled 'Accumulation' shows how a super fund investor in accumulation phase receives $85 of after-tax value from a $70 fully franked dividend. The performance figures for a fund only capture the $70 of cash dividend. The uplift goes unreported but is clearly valuable.

In practice: Goodman Group versus Charter Hall Group

Goodman Group (ASX:GMG) (Goodman) and Charter Hall Group (ASX:CHC) (Charter Hall) are both Australian listed property securities that derive earnings from a combination of rental income, development and funds management activities. Goodman is focused on industrial property and is diversified geographically with operations in the US, Europe and Asia in addition to Australia and New Zealand. Charter Hall is diversified across multiple property sub-sectors, but the business is focused geographically on Australia.

There are of course many other differences between these two companies, but Charter Hall's domestic focus results in its corporate earnings being subject to Australian tax. Charter Hall is a stapled security that includes both a trust and a company but only the company pays a franked dividend, so the overall franking level is less than 100%. The last dividend paid by Charter Hall Group in August 2022 was 45% franked.

Goodman's global business, on the other hand, will likely pay at least some tax in foreign jurisdictions, and these tax payments will not carry franking credits. For instance, Goodman's last dividend was 0% franked.

All else equal, an Australian investor should prefer the domestic business, because their after-tax returns will be higher.

Sometimes it gets even better

The Cromwell Phoenix Property Securities Fund holds a position in property development company Sunland Group (ASX:SDG) (Sunland). Sunland has been a profitable business for many years and has retained some of its profits to grow the business and it has built up a significant franking credit balance.

Following a strategic review, Sunland has elected to wind up its business and return all capital to shareholders. Phoenix likes the business and management team and we believe the company has been an excellent steward of shareholders' capital.

A wind-up of the business may seem like a drastic step, but the sharemarket has never really valued Sunland appropriately. The stock price has traded at a material discount to the book value of the company's assets for most of its listed life, thereby ascribing negative value to the goodwill of the business. Furthermore, a sizeable franking credit balance has also been ignored by investors. For a tax-aware investor like Phoenix, we find this appealing.

At the risk of over-simplifying the transaction, as Sunland goes through the process of completing projects and selling inventory, it will pay out all cash proceeds as a combination of fully franked dividends and a return of capital.

Table 2 shows some key metrics immediately prior to the announcement of the Sunland Group Strategic Plan, and the share price reaction to the announcement on 20 October 2020. This is now about two years ago but it shows the opportunities when the franking credits are undervalued by the market, as well as misunderstanding the company's value.

Despite the strong share price reaction to the announcement, we lifted exposure to the stock

Table 2: Key metrics

SDG, per share	19 October 2020	20 October 2020
Book value	$2.56	$2.56
Franking credits	$0.59	$0.59
Book + Franking	$3.15	$3.15
Share price	$1.33	$1.95
Discount	58%	38%

given the increased certainty of the recognition of value.

Over the subsequent period, Sunland has made significant progress towards its strategic goal and has recognised further profits from the sale or completion of several development projects, such that the eventual outcome is likely to be even better than the original estimates.

For Australian taxpayers on low tax rates, such as super funds or foundations, the value of such a transaction is 'super-charged'. Pun intended.

Portfolio construction needs to consider a myriad of factors and most of them require estimates of the future. At least with tax and franking credits, the framework for analysis is reasonably steady, and a tax-aware strategy can deliver more certainty in an uncertain world.

Stuart Cartledge is Managing Director of Phoenix Portfolios, a boutique investment manager partly owned by staff and partly owned by ASX-listed Cromwell Property Group. Cromwell Funds Management is a sponsor of Firstlinks. This article is not intended to provide investment or financial advice or to act as any sort of offer or disclosure document. It has been prepared without taking into account any investor's objectives, financial situation or needs. Any potential investor should make their own independent enquiries, and talk to their professional advisers, before making investment decisions.

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Why it's better to be too early than too late

Tom Stevenson

Given the near impossibility of timing the market's highs and lows to perfection, investors have to expect that, even if they get the general direction of travel right, their trades will be either too early or too late. Which is better?

Usually late to the party

I believe it's better to be early even though human nature ensures that most of us have a tendency to come late to the party. The fear of losing money in the short term, which is the destiny of the early investor, is a powerful disincentive to pre-empt the market. Far easier to wait for confirmatory signals from the market and/or the economy before we take the plunge. Easier but costly.

If you wait until it is clear the low point has been passed, the temptation to keep waiting for a pull-back to a more favourable price is irresistible. Many investors sit on the sidelines while others enjoy the recovery. If you had taken the pain of an initial loss, you would have been in at the bottom and sitting comfortably as the rally gathered pace.

I think we are precisely at this 'shall-I-shan't-I' moment in the market cycle for the two main asset classes, shares and bonds. I accept that my optimism may be a early on both counts but I'm prepared to live with that. I think by the end of next year, we may well look back on a period of positive returns for both investments.

It's not easy to commit on the back of losses

That may look eccentric nine months into what will probably turn out to be the worst year for shares since the financial crisis and the worst for balanced funds, holding both assets, perhaps since the 1960s. The idea that the two act as diversifiers for each other has been tested to destruction this year. Persistent inflation and rising interest rates have damaged for bonds, while shares have tumbled in anticipation of recession and falling earnings.

The case for investing in bonds looks counter-intuitive in the week that the Bank of England has confirmed that its sticking plaster measures to prop up the UK's fixed income markets will draw to a close. Forced sales by pension funds to plug holes in too-clever-by-half risk management strategies have driven bond yields higher than inflation.

That's bad news for anyone holding those bonds but for anyone looking for an entry point, it's a gift. Bonds are looking more interesting than they have done for many years. Even where the rise in yields has not received this liability-driven boost, the adjustment to a world of higher inflation and interest rates has largely happened now. And the additional yield premium on corporate bonds has widened too. I believe, for the first time in a while, investors are being rewarded for the greater risk of lending to a company rather than a government.

Bonds finally offering investible yields

So, investors can now lock in a decent yield. Even better, as we head towards recession on both sides of the Atlantic, they can also look forward to a potential capital gain in due course if the Fed and other central banks take their foot off the monetary gas and pivot to lower interest rates to support a slowing economy. We are not there yet. The peak in the interest rate cycle probably won't come for another six months or so but before that point actually arrives bond yields will fall in anticipation and their prices will rise.

If identifying the low point for bonds looks a bit hasty, it looks even more so for stock markets as we approach what by all accounts is going to be a tricky earnings season. We should expect plenty of gloomy commentary about falling demand and unhelpful currencies (there'll be a lot of talk about the negative impact on US companies of the strong dollar, for example).

But just as we expect the bond market to pre-empt the peak in the interest rate cycle, so too will the stock market move ahead of the trough in corporate earnings. The market and the earnings cycle are not the same. They march to a different beat and the gap between the two can be as much as six months or so. Prices move first and waiting for the data to confirm the market move can be expensive.

Not quite there yet

So far in 2022, the fall in stock markets has been caused by lower valuation multiples. At the beginning of the year, investors were paying 23 times expected earnings but that multiple is now about 15. But a few weeks of disappointing results announcements could easily see that fall to 13 or so. That would imply an S&P500 of closer to 3,000 than today's 3,600. Here's the YTD movement of the S&P500, showing it has given up 23.3% since 1 January 2022.

Source: [Google Finance]

If you think you are smart enough to time your re-entry back into the market, then by all means sit on your hands for a bit longer. However, the early weeks of the pandemic showed how quickly markets can regain lost ground when they get a sniff of recovery and interest rates start to fall again. You won't care too much if you got in at 3,300 or 3,500 if the US benchmark is back above 4,000 again.

You will care if you are still waiting in vain for a better entry point.

Some of the wisest advice for investors is not to get more bearish as the market falls. The time to get interested is when everyone else is focused on the grim economic and corporate outlook. And if you are lucky enough to get double helpings in both the bond and stock market so much the better. Time to grit your teeth and start to prepare for the upturn. Even if it hurts in the short term.

Tom Stevenson is an Investment Director at Fidelity International, a sponsor of Firstlinks. The views are his own. 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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Why we believe bonds are now beautiful

Chris Siniakov

The Reserve Bank of Australia (RBA) announced a surprise adjustment to its policy path when it reduced the pace of tightening to 0.25% after months of 0.5% increases. We applaud the RBA for moderating its pace as it should minimise the chance of over-tightening and a potential accident. Lags between policy changes and impact are approximately three months on average and the RBA increasingly acknowledges that most borrowers have still only experienced the first handful of rate hikes.

Monetary policy has reached a critical point

This new pace of rate increases represents an important stage in the tightening cycle. The RBA estimates the neutral policy setting for the Australian economy is circa 2.50%. Hence, any additional increase in the cash rate above 2.50% represents an ever-greater level of intensity applied to the economic brakes. It appears Australia is now entering the late stages of the tightening cycle.

The forward-looking market impact from October's RBA policy announcement was immediate. Prior to the RBA meeting, market pricing had the terminal cash rate in Australia circa 4.35%. This quickly came down 0.50% to 3.85%, validating our view that market expectations for policy in Australia have been too aggressive. At 3.85%, we believe market pricing remains aggressive relative to where the RBA is likely to pause.

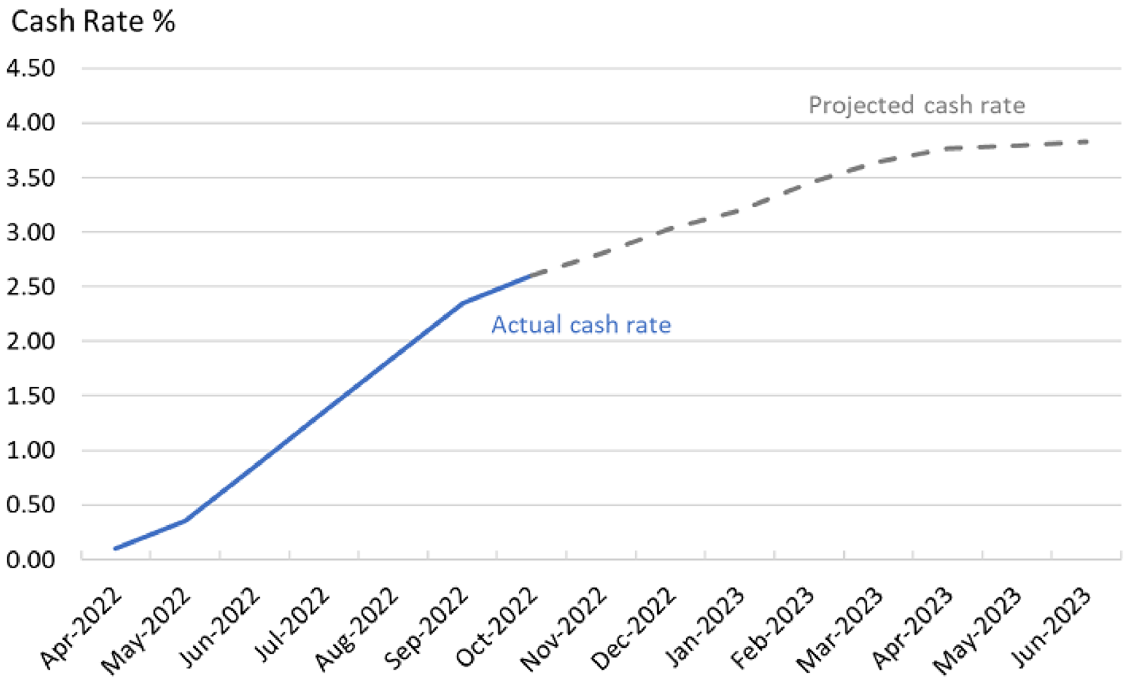
Where to from here?

At the risk of over-simplifying, in fixed income, there are three broad scenarios:

1. Yields rise
2. Yields stay the same (track sideways in a range)
3. Yields fall

What is less widely-understood is the consequences of the market already building these scenarios into existing interest rates.

Scenario 1 (yields rise) has been the experience for much of the last 12 months as markets adjusted to higher interest rates, driving negative bond returns. The chart below shows the path of the actual cash rate from 0.1% in May 2022 to the current 2.60% in October. The chart also shows that the market has already priced (projected) the cash rate will rise to 3.85% next year.



Source: Franklin Templeton, Reserve Bank of Australia,

Both components – i.e. the change in actual cash rate and the market projected cash rate – are already 'in the price'. So, for scenario 1 to have a meaningful return impact over the next 6-12 months, the market will need to be concerned that the actual cash rate will rise above market projections, above 4.0%. The tone and actions of the RBA in this past week suggest this is now a low probability scenario.

Scenario 2 (yields stay the same, track sideways in a range), suggests that with time the market projections in the above chart will be broadly met and no material adjustment in yields (higher or lower) is likely. Under this scenario, the portfolio effectively earns its yield over the next 12 months.

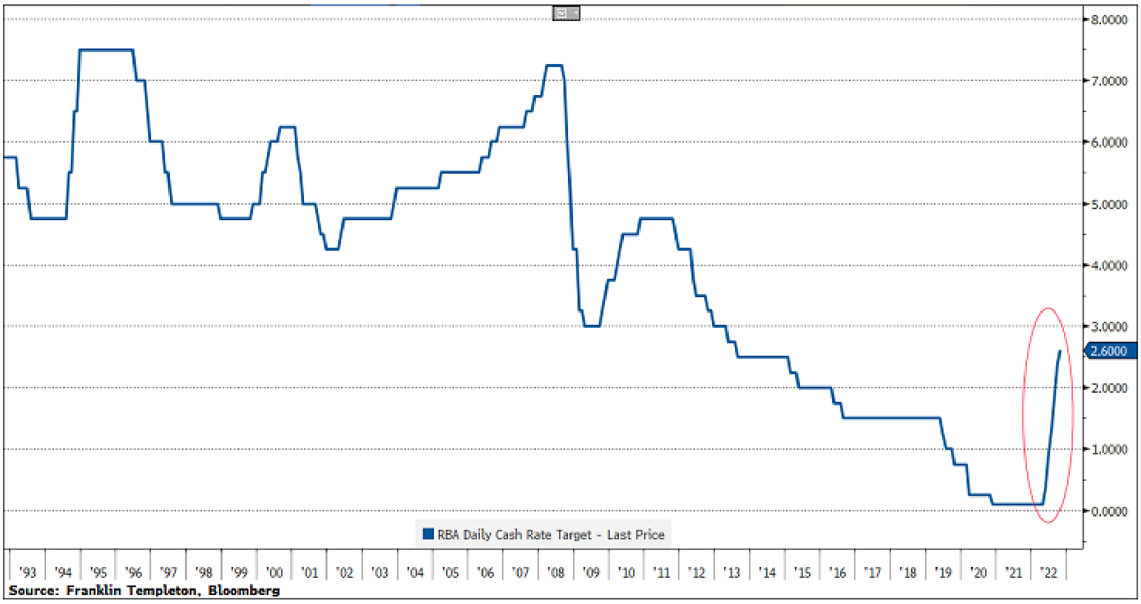
Our core view is that current market pricing for the terminal cash rate remains too high. We believe the actual cash cate will settle at 3.10% and **scenario 3 (yields fall)** is most likely over the next 6-12 months.

Scenario 1 Yields rise	Scenario 2 Yields stay the same	Scenario 3 Yields fall
RBA cash rate rises materially higher than market pricing. Terminal cash rate above 4.50 % Potential drivers: Geopolitical/energy crisis events 2nd round wage/inflation pressures	RBA eventually delivers on current market pricing. Terminal cash rate 3.85% Potential drivers: RBA sticks the landing. Gentle moderation in domestic activity, small rise in unemployment.	Market unwinds excessive market pricing for rate hikes. Terminal cash rate 3.10% Potential drivers: Tightening works. Policy settings already too tight. Economic demand declines with lags, driving softer than expected 2023.

Tightening works

Monetary policy works with a lag and the strident leaps the RBA has taken in recent months won't show up in behaviour and key data until the few remaining months of this year. But show up they will and that is before any further tightening that will ensure 2023 will be truly a challenging year.

The chart below shows policy settings over the last 30 years and illustrates how sharp the current adjustment has been. The full impact of tightening has not yet been felt in the economy. It's a bit like having six shots of vodka and suddenly you realise that you've drunk too much!



Some indications the worst is in the past

Our economic indicators show that momentum has turned down significantly across several indicators: namely, consumer confidence, housing (cash flows, prices, construction approvals, work done and construction materials prices), financial conditions, and trading partner growth.

Global pressures behind high inflation this year also appear to be through the worst. Global supply chains are flowing more freely with shipping costs retracing significantly lower. Commodity prices are down, and inflation expectations are contained across consumers and financial markets.

On the strong side, business sentiment remains elevated, and the labour market is tight with jobs for anyone who wants one. In fact, this is arguably the tightest labour market we have seen in 50+ years. This has translated into wages growth from the Covid lows up 2.6% so far. Looking forward, partial indicators suggest further wage increases up to the 3.50-3.75% area next year.

But, by 2H2023, labour supply will have improved substantially through an accelerated net migration program. Preliminary signs of a slowdown in job vacancies, albeit from elevated levels, are also emerging. This coincides with the lags in central bank policy, ultimately driving diminishing domestic demand from the RBA's tightening this year, including what's still to come.

Modelling our core view suggests that the term yields will adjust materially lower. Initially, we estimate bonds to rally in the order of 0.5%-0.75% as the excessive tightening priced in the market is unwound. The market will then take several months to assess the underlying economy after which we expect a second rally as the market begins to price for subsequent policy easing by late 2023, early 2024.

In sum, what makes bonds beautiful is the favourable skew in return outcomes under various scenarios. We believe fixed income investment is supported by either scenario 2 (yields stay the same), or scenario 3 (yields fall). Today, we believe probabilities are skewed to these scenarios.

Chris Siniakov is Managing Director, Fixed Income at [Franklin Templeton](), a sponsor of Firstlinks. This article is for information purposes only and does not constitute investment or financial product advice. It does not consider the individual circumstances, objectives, financial situation, or needs of any individual.

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