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Editorial

As industry heavyweights go, there aren't much larger than **Rob Arnott**, who chairs the US-based Research Affiliates, a US$132bn asset management behemoth. His views are widely respected and widely read.

Today, Arnott and colleague **Omid Shakernia** look at the history of inflation. The conclusions are sobering for those who believe inflation growth rates will fall quickly from here. History suggests once inflation peaks above 8%, as the US and much of Europe did this year, it takes between 6 and 20 years - with a median 10 years - to get the rate back to a politically acceptable 3%.

On the other side of the fence sits **Peter Zeihan**, a noted strategist. He's more in the deflationary camp. Zeihan thinks the Federal Reserve rate hikes will crunch demand from businesses and consumers in the US. But their greatest impact will be on other countries that will be starved of capital when they most need it. He's particularly concerned for Germany.

One factor that will influence future inflation is demographics. This week, the world reached a milestone with the global population officially hitting 8 billion. Australia has played its small part. New figures from the Australian Bureau of Statistics (ABS) show life expectancy in Australia actually increased during the COVID-19 pandemic. From 2019-2021, life expectancy for both men and women lifted by 0.1 years to 81.3 and 85.4 years respectively, compared to the 2018-2020 period.

Australian life expectancy increases during pandemic

Australian Bureau of Statistics

Top 10 countries for life expectancy

Country	Life expectancy
Monaco	86.5
Japan	84.7
Australia	84.3
Republic of Korea	83.6
Malta	83.4
Norway	83.2
Switzerland	83.1
Singapore	82.9
Liechtenstein	82.8
New Zealand	82.7

Note: Based on life expectancy at birth for persons
Source: United Nations, Department of Economic and Social Affairs, Population Division (2022) World Population Prospects 2022, Online Edition

Australia was one of the few countries that showed increases in life expectancy during the pandemic and has the third highest life expectancy in the world, according to United Nations' estimates.

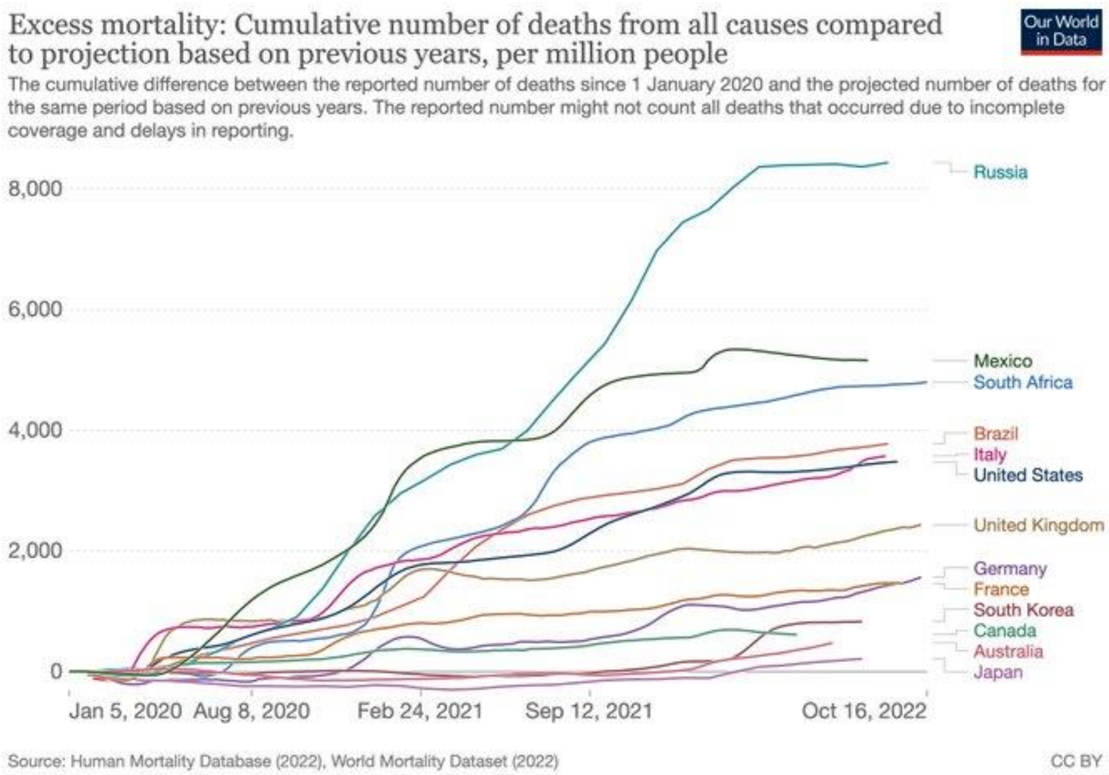
Life expectancy in Australia is almost 12 years longer for men, and 11 years longer for women, compared to the world average.

Broken down by state, the ACT has the highest life expectancy, while the Northern Territory has the lowest. Victoria was the only state where life expectancy decreased during the pandemic.

It might not be the whole story

The ABS figures raise some questions: how did the life expectancy go up? Was it because of the lockdowns? What about vaccines? Did Australia's distance from the rest of the world play a part? Were masks helpful? Did the closure of schools have an impact? The ABS doesn't answer these questions, as it's not really its expertise.

Another question: why isn't 2022 included? After all, Covid is still with us this year, even if less virulent. Figures on excess mortality - the cumulative number of deaths compared to previous years - suggest Australia has had an uptick in 2022. This might result in marginally lower life expectancy figures when the ABS reports next.



Whichever figures are used, and there are all kinds of methodologies used to measure the pandemic's impact on human life, Australia looks to have come out the worst of COVID-19 in decent shape compared to other nations. We've been the lucky country once again.

Fear and loathing

I was in two minds about presenting the figures above given the virus is a lightning rod for many people. I'm not sure about you, but I find talking about the pandemic with almost anyone a difficult exercise these days. It's almost as if there's a collective silence in Australia about what we went through. It's understandable: people went through a lot.

Fear and uncertainty were pervasive during the pandemic. Interestingly enough, both of those things form the basis for many types of anxiety and depression. Perhaps the heightened anxiety from that period hasn't full dissipated, which explains some of the collective silence around the issue today.

Isn't now though the time to look back and see what Australia got right during the pandemic, what it got wrong and what it can learn for the next crisis, pandemic or otherwise?

What can we learn for next time?

I get that most people want to forget about the pandemic. What I don't get is why governments and others in authority aren't rigorously analysing Australia's response to COVID-19. Largely, there's been radio silence from our politicians and the public service (perhaps reports from the latter may not have seen the light of day). We had a royal commission into the banking industry, why not one into our COVID-19 response?

One of the few reports into the issue that I've seen came from an independent panel, funded by philanthropic foundations, and led by former senior public servant, Peter Shergold. The report found government missteps and was especially critical of the closure of schools, arguing the costs of that move outweighed the benefits.

In contrast to Australia, the UK is up to its third investigation into the pandemic. Recently, it announced an inquiry into the impact of the pandemic on healthcare in the country.

Inquiry Chair, Baroness Heather Hallett, said:

"The pandemic had an unprecedented impact on health systems across the UK. The Inquiry will investigate and analyse the healthcare decisions made during the pandemic, the reasons for them and their impact, so that lessons can be learned and recommendations made for the future."

Here's to hoping that the ABS statistics, and others like it, can be used one day as part of a broad-ranging investigation into how Australia can best prepare for the next crisis that comes our way. It's time to put politics aside and have a sensible discussion on the issue.

Also in this week's edition ...

We review a book called *What to do when I get stupid*, which suggests our financial abilities peak at the age of 53. Given this, it's wise for us to take financial decision-making out of our hands while we still have the mental capacity to do so. Planning is critical to guarantee we'll have enough income coming in each month for the rest of our lives.

High Dive gives us his bank reporting season scorecard. With Covid largely behind us, low unemployment and minimal bad debts, bank results were mostly positive. He argues for a benign loan loss cycle in coming years and for bank share prices to be re-rated higher.

Shane Woldendorp of Orbis Investments has the audacity to suggest that investors don't forecast well (c'mon, Shane). Rather than that being bad news though, he believes it can create opportunities for those investors that are prepared to think differently.

As markets whipsaw, the risk that volatility might undermine investors' ability to achieve their return objectives looms large. **Roy Maslen** asks, what can investors do to mitigate that risk and avoid falling short of their goals?

For international investors, it's not just market volatility that needs to be considered, but currency volatility too. **Alice Shen** runs the numbers of how much currency movements impact the performance of international portfolios and finds that they make minimal difference in the long-term. The short-term is a different story, however.

This week's White Paper comes from **Capital Group** which recently surveyed over 1,100 global professionals - including advisors, consultants and intermediaries - to get their latest views on ESG.

James Gruber

History lessons: How 'transitory' is inflation?

Rob Arnott, Omid Shakernia

Key points

- The US Federal Reserve Bank's expectations for the speed of reverting to 2% inflation levels remains dangerously optimistic.
- An inflation jump to 4% is often temporary, but when inflation crosses 8%, it proceeds to higher levels over 70% of the time.
- If inflation is cresting, inflation levels of 4 or 6% revert by half in about a year. If inflation is accelerating, 6% inflation reverts to 3% in a median of about seven years, threatening an extended period of high inflation.
- Reverting to 3% inflation, which we view as the upper bound for benign sustained inflation, is easy from 4%, hard from 6%, and very hard from 8% or more. Above 8%, reverting to 3% usually takes 6 to 20 years, with a median of over 10 years.

"Those who cannot remember the past are condemned to repeat it." – George Santayana

Bad news: History tells us that once the inflation genie is out of the bottle, it can take far longer to return to normal levels than most people realize. Indeed, when Federal Reserve Chair Paul Volker took office in 1979, he pushed the fed funds rate to an unprecedented 20%, 5% above the previous peak inflation rate, the equivalent of today's Fed embracing double-digit rates. Even so, it took two more years for this extreme policy intervention to cut inflation to half its peak level (to 7%), and over six years to bring inflation to 2%.

In a meta-analysis of 67 published studies on global inflation and monetary policy, Havranek and Ruskan (2013) found that across 198 instances of policy rate hikes of 1% or more, in developed economies the average lag until a 1% decrease in inflation was achieved was between roughly two and four years.

Those who expect inflation to fall rapidly in the coming year may well be correct. But, history suggests that's a "best quintile" outcome. Few acknowledge the "worst quintile" possibility, in which inflation remains elevated for a decade. Our work suggests that both tails are equally likely, at about 20% odds for each.

When will the inflation genie go back in its bottle?

To answer this question, we studied all cases where inflation surges above 4% in 14 OECD developed-economy countries from January 1970 through September 2022.[1] After a country's inflation rate first exceeds 4%, we observe inflation's behavior thereafter. As Neville, et.al. (2021) point out, an inflationary surge is not always a bad sign – for example, an increase from -2% to 1% may foreshadow a healthy upturn in the economy.

Here, we test inflationary surges at thresholds of 4% and above, so as to exclude those cases where the economy is recovering from a bout of deflation. For each episode, we measure the time from the first crossing of the thresholds we study (4% to 20%, at intervals of 2%) until the next time inflation retreated to one of two specific targets: in the first test, halfway back to zero or, in the second test, to below 3%. We found 52 instances when inflation rose above 4% for the 14 OECD economies in our sample, of which 6 instances proceed to exceed 20%.[2]

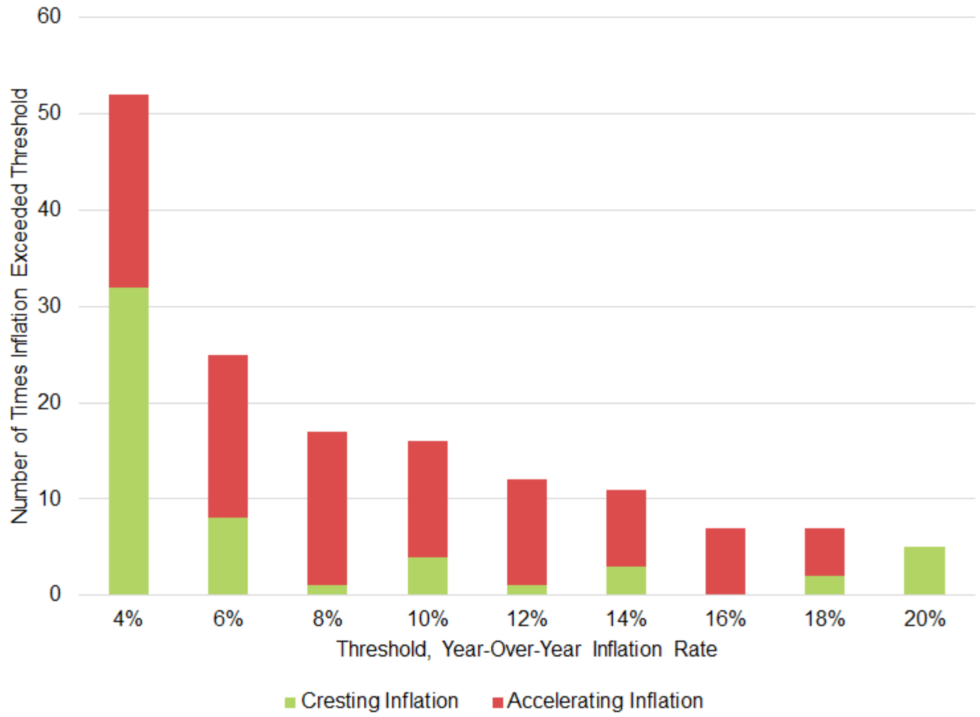
We observe a useful pattern. When inflation first crosses the 4% threshold, often caused by a temporary exogenous shock, it usually reverses course; in 32 out of 52 cases; over 60% of the time inflation never reaches the next threshold of 6%. We call any case where inflation fails to reach the next threshold *cresting inflation*. That is the good news.

The bad news is at 6% and higher inflation, cresting inflation is the exception, not the rule: inflation usually marches to the next threshold. When inflation subsequently rises to the next threshold, we call these cases *accelerating inflation*. Indeed, once the 8% threshold is surpassed, as happened this year in the United States and much of Europe, inflation marched to the next threshold, and often well beyond, over 70% of the time.[3] The lesson we should take from this is not that inflation is destined to move to new highs in the months ahead (after all, nearly 30% of the time, it is, in fact, cresting!), but that we dismiss that possibility at our peril.

Note that we are not posing the question, how fast *can* inflation subside? We know that a singular focus on price stability can rein in inflation almost overnight, as was the case with German hyperinflation in the 1920s, Hungarian hyperinflation in the 1940s, and Zimbabwean hyperinflation in the 2000s. In each instance, central bank control of the printing press was rescinded, and the failed currency was ditched in favor of a broadly trusted medium of exchange, typically gold or the then-prevailing reserve currency.

An inflation jump to 4% is often temporary, but when inflation crosses 8%, it proceeds to higher levels over 70% of the time.

Number of Times Inflation Rose above Threshold Levels, January 1970–September 2022



Note: Showing the number of times first rose above a given inflation threshold, before either shrinking by half, or accelerating to the next threshold. Instances when inflation increased to the next threshold are labeled "accelerating inflation," while instances when inflation shrunk by half are labeled "cresting inflation."
Source: Research Affiliates, LLC, based on data from Bloomberg.

Money is very simple. It is a medium of exchange to buy or sell labor, goods and services, either contemporaneously or intertemporally (the latter being money's use as a *store of value*). Money cannot serve multiple masters. Nevertheless, central bankers seem eager to promote an array of goals they hope to achieve through monetary policy: price stability, full employment, low servicing costs of government debt, bear market disruption, and so forth. When money is asked to serve multiple masters, how long, on average, will a burst of inflation linger?[4]

How long before inflation falls by half?

In our first test, we estimate the half-life of high inflation: the amount of time it takes for inflation to fall by half, from 4% to 2%, from 6% to 3%, and so forth. For some of the cases of 4% (or higher) inflation, inflation arrives and then recedes; for others, it accelerates further—in some instances, a lot further—before receding.[5]

The following graph shows the median number of years for inflation to be reduced by half, from the first time it hits one of the inflation thresholds we study. The shaded band representing the middle three quintiles (leaving out the top and bottom 20% of outcomes). The distribution includes cases when inflation reaches the next threshold (accelerating inflation), or does not reach the next threshold before receding (cresting inflation).

We find that once inflation has reached the 4% threshold, at the low end of the grey band, at one year, tells us that 20% of the time it takes a year or less to revert to = 2% inflation (half of the 4% threshold). *At the other extreme (at the top of the grey band), 20% of the time, it takes 10 years or more to fall back to 2%!*

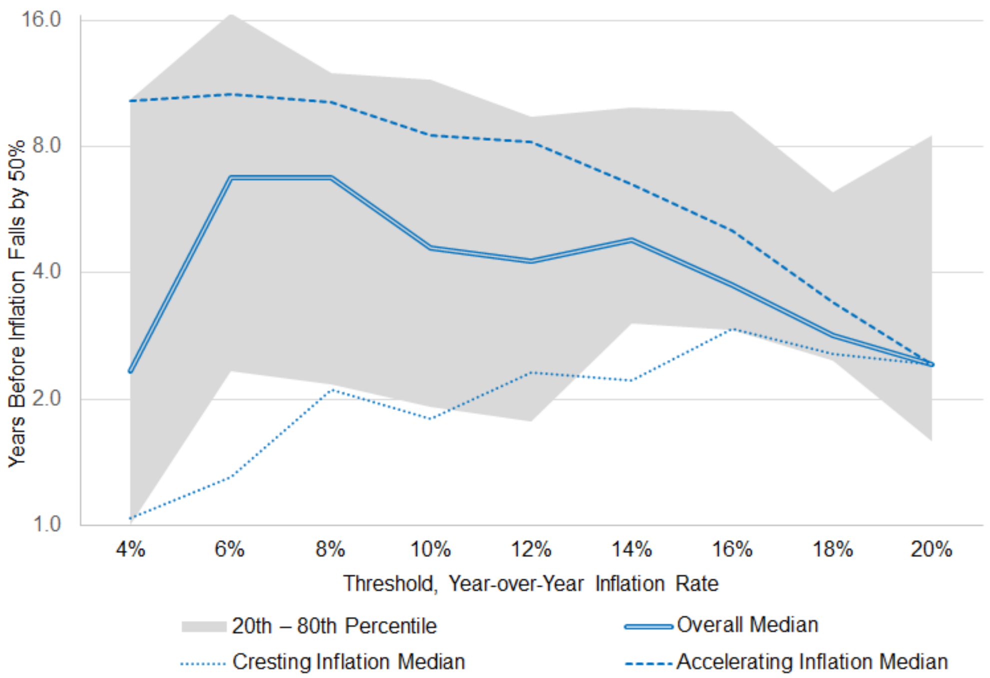
The median result is a 2½-year wait before a modestly elevated 4% inflation falls below 2%. All of which invites the question: When inflation was already crossing 4% in April 2021 (2% of which was in the prior three months, which was an 8% annualized rate!), what were Powell and Yellen thinking in declaring the inflation transitory? Should we consider a median expectation of 2½ years to revert to a 2% inflation rate as transitory?

The medians for cresting inflation and for accelerating inflation are very different. Cases of cresting inflation dominate the lower reaches of the distribution, while cases of accelerating inflation dominate the top of the distribution. If 4% inflation never makes it to the next threshold of 6%, then this cresting inflation recedes quickly, with a median time of just 1 year to revert to = 2%.

But if inflation is accelerating *and proceeds to the next threshold of 6%, and perhaps higher* trouble likely awaits. In this situation, with a median of 10 years until the inflation level returns to 2%, the economy could face a protracted period of high inflation. At a 6% threshold, if inflation crests and recedes, the median is 15 months for inflation to fall by half (i.e., to revert to 3%). If instead inflation proceeds to 8% or more, the median time to revert to 3% is nearly 11 years.

If inflation is cresting, 4% and 6% inflation revert by half (to 2% and 3%) in about a year. If inflation is accelerating, 6% inflation reverts to 3% in a median of about seven years, threatening an extended period of high inflation.

Number of Years for Inflation to Fall by 50%, since January 1970



Note: For 7 of the 52 cases when inflation rose above 4%, inflation did not revert to 2% before sweeping past 4%. Therefore, this graph is based on 45, not 52, cases. The gray band represents the middle three quintiles (excluding the top and bottom 20% of outcomes), which measure the passage of time until inflation is cut in half. Because of a limited number of cases, when we bifurcate between accelerating and cresting inflation, we smooth these two lines by consolidating the data for 4%, 6%, and 8% inflation for the 6% plot point, and do the same for all but the endpoints (4% and 20% inflation) of the graph.
Source: Research Affiliates, LLC, based on data from Bloomberg.

When US inflation crossed 4% in April 2021 for the first time since 2008, our study of history might have supported a declaration that the inflation should be transitory. *That would only be true, however, if we had been certain that inflation was cresting and would not accelerate to 6% or more.* But if inflation moved higher, the median wait to return to 2% inflation would increase tenfold. Then, once inflation crossed 6% in October 2021, if our crystal ball had shown that was the peak, the median expectation would have been to revert to 3% inflation in about 15 months. Otherwise, if inflation rose further (as it did), the median wait for = 3% inflation would be another decade.

Once inflation crossed 8% in March 2022, *had we been sure it would not exceed 10%*, we could reasonably have expected a return to 4% in about two years. Of course, 4% would still be twice the Fed's target of 2% and likely would not be reached until March 2024. If the next move from here is to new highs, we would be looking at an average decade-long wait to recede to 4%, which could be extremely painful.

At higher levels of inflation—from crossing the threshold of 6% to crossing 20%—we observe a slight hump-shape in the median half-life peaks at about 7 years when inflation is 6% to 8% (today's level of inflation!), falling to about 2½ years at an inflation rate of 20%.[6] The worst-quintile outcomes, across all levels of inflation, require a wait of anywhere from 8 to 16 years to lower the inflation rate by half from the first time it crosses on of our inflation thresholds.

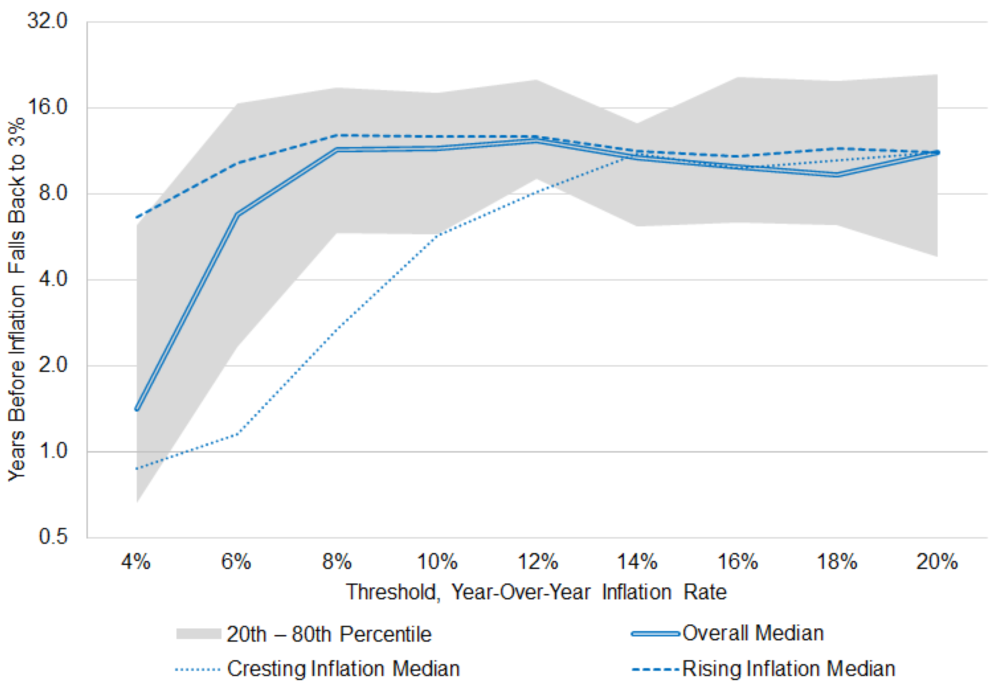
How long for inflation to revert below 3%?

Few would consider it an applause-worthy win to bring 20% inflation down to 10%. Accordingly, let's consider another test in which, after inflation first crosses the various thresholds in our analysis (4% to 20%), we declare victory as soon as inflation falls below 3%, an inflation rate most of the citizenry would find tolerable.

It should come as no surprise that the median time to bring 4% inflation down—ever so modestly—to 3% is brief, about 18 months (still perhaps longer than many might expect). But after inflation hits a less-benign 6%, the median number of years to cut inflation to below 3% soars to 7.5 years. From inflation levels of 8% to 20%, the median span required to bring inflation below 3% is surprisingly flat, from 9 to 12 years. This lengthy period may actually be understated because of the handful of cases missing from our dataset in which inflation has failed to return to 3%, to this day.

Reverting to 3% inflation, which we view as the upper bound for benign sustained inflation, is easy from 4%, hard from 6%, and very hard from 8% or more. Above 8%, reverting to 3% usually takes 6 to 20 years, with a median of over 10 years.

Number of Years Until Inflation Reverts Below 3%, since January 1970



Source: Research Affiliates, LLC, based on data from Bloomberg.

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Given the recent US inflation rate, which has been above 6% for the last 12 months and above 8% for the last 7 months, history tells us that the median number of years to reduce inflation below 3% is 10 years, with a 20th to 80th percentile range of 6 to 19 years. How many economists—let alone pundits and policy 'experts'—have suggested we may have elevated inflation for six years, much less the longer outliers?

Rob Arnott is a Partner and Chair, and Omid Shakernia, PhD is a Partner, Multi-Asset Strategies at [Research Affiliates, LLC](). This article is general information and does not consider the circumstances of any person. Republished with permission. For footnotes and references, see the full article here.

Why our financial abilities peak at age 53

James Gruber

I happened upon an interesting book about how our financial abilities start to decline quite early in age and what we should do about it. The book is called *What to do when I get stupid* and it's by a US economist, Lewis Mandell. Here is an overview of Mandell's findings with my thoughts interspersed.

Mandell cites a plethora of scientific studies which suggest our capacity to make financial decisions peaks around the age of 53.

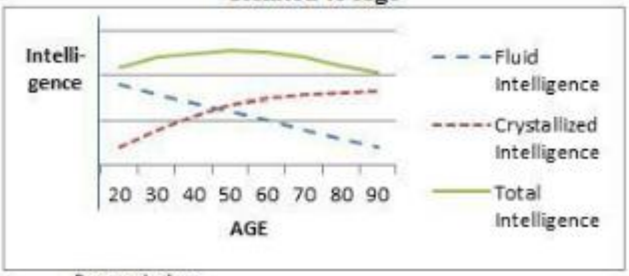
He first distinguishes between 'fluid intelligence' and 'crystallised intelligence'.

Fluid intelligence is the ability to think abstractly and deal with complex information. Psychologists have long known that fluid intelligence peaks about age 20 and declines by 1% each year thereafter. It's why great mathematical discoveries tend to be made by younger scholars, for instance.

As we age, however, we also gain experience to help us make better decisions. This is called crystallised intelligence. Thus, while fluid intelligence decreases with age, crystallised intelligence increases:

"Since fluid intelligence declines at a slow but steady rate, overall intelligence will tend to increase at first, boosted by the relatively quick increase in crystallised intelligence, but then begins to slow down in middle age. The constant loss of fluid intelligence begins to match the smaller and smaller increases in crystallised intelligence, until the increases and decreases are equal, at which point our overall intelligence peaks."

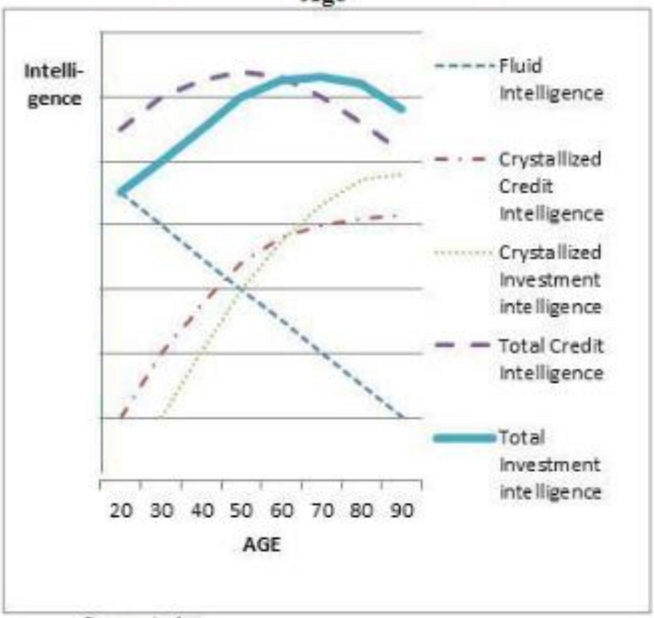
Hypothetical Illustration of Fluid Intelligence, Crystallized Intelligence and Overall Intelligence Related to Age



Source: Author

When you combine the two types of intelligences and apply them to financial decisions, research indicates that we peak around age 53 and decline thereafter at a rapid rate. The age for peak performance varies according to different financial products, from a low of 45.8 years old to a high of 61.8 years.

Hypothetical Illustration of Fluid Intelligence, Crystallized Credit and Investment Intelligence and Overall Credit and Investment Intelligence Related to Age



Source: Author

Decisions related to borrowing and debt peak at around age 53 while investment skills peak around age 70. The difference is likely due to the varying ages at which we get experience in borrowing and investment. When we're young, we don't have much money and therefore will rely on debt to fund a house, for example. When older, and perhaps thinking about retirement, we're more likely to have accumulated assets and are more open to learning about investment.

Get prepared now

Only a small number of us will reach 80 years of age without some kind of mental impairment that will cloud our financial decision-making. But our self confidence in our financial decision-making *increases* with age. Older investors are more prone to use new investment information from television and newspapers, yet they're less skillful in using the information and are more likely to increase the risk profile of their investments as a consequence.

Mandell believes it's wise for us to take financial decision-making out of our hands while we still have the mental capacity to do so. He thinks planning is critical to guarantee we'll have enough income coming in each month for the rest of our lives to maintain our desired standard of living.

He advocates a guaranteed income that should be regular, virtually impossible to lose and should increase as our expenses increase with inflation. And it should last no matter how long we live.

Threats to this planning include low interest rates, stock market volatility, rising inflation and ourselves if we rely on our own decision-making as our faculties age.

The best strategy

The goal is to have enough money coming in each year to cover our core retirement expenses. Beyond that, any additional income is discretionary. They are surplus assets which can be used to increase our standard of living.

If the income coming in each year isn't enough to cover retirement expenses, there are two choices: 1) reduce our standard of living, or 2) gamble on risky assets to make up the shortfall. Many people opt for 2).

Mandell goes into how to calculate core retirement expenses, including identifying which ones will increase with inflation.

Much of his solutions to the problem are US-centric. Broadly though, he suggests a mix of fixed annuities and Treasury Inflation-Protected Securities (TIPS).

First, he likes fixed annuities where you pay in a sum of money and get a fixed monthly payment for life. By doing this you: 1) eliminate market risk 2) since these annuities pay for the rest of our lives, they eliminate longevity risk and 3) since they can't be cashed in, they eliminate judgment risk.

He thinks TIPs are a useful hedge against inflation. An additional strategy to reduce the impact of inflation is to try to retire debt and rent free. And owning a low-cost maintenance home and car are also important.

The book examines ways to protect assets against irrational judgments that you might make. This includes such things at joint accounts, splitting assets etc.

If you manage your own investments, there is little legal protection against irrational decisions that one might make in future.

Conclusion

The statistics on declining financial abilities may have surprised you as they did me. Of course, in Australia, we have a generous pension and superannuation system, which both help in funding our retirements. Nonetheless, it's useful to at least consider Mandell's point of automating much of our financial decision making before our cognitive abilities start to wane.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

Bank reporting season scorecard

Hugh Dive

The last three years have been eventful for bank shareholders, with each year bringing a new set of worries predicted to bring the banks to their knees. 2020 saw capital raisings from NAB and Westpac missing its first dividend since the banking crisis of 1893, as experts forecasted 30% declines in house prices and 12% unemployment! Then 2021 saw the banks grappling with zero interest rates and APRA warning management teams about the systems issues they may face from zero or negative market interest rates expected to come in 2022. This year, the concerns have switched to the impact of sharply rising interest rates on loan growth and bad debts.

In this piece, we will look at the themes in the approximately 900 pages of financial results released over the past two weeks, including Commonwealth Banks 2022 results, awarding gold stars based on performance over the past six months.

Reporting Season Scorecard - Nov 2022

Company	Share Price	Market Cap $B	Cash earnings per share growth	Increase in Dividends	Net interest margin	Credit Impairment charge/(writeback)	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	2022 total return
Westpac	$ 24.08	$ 84.3	12.0%	6.6%	1.90%	0.13%	11.3%	9.3%	13.2	5.4%	14.0%
ANZ	$ 24.64	$ 73.7	9.0%	3.0%	1.71%	-0.08%	12.3%	10.4%	9.9	7.1%	-6.0%
NAB	$ 31.35	$ 98.9	6.0%	16.4%	1.67%	0.04%	11.5%	11.7%	13.6	5.5%	10.4%
Commonwealth (August 2022)	$ 105.81	$ 179.3	11.0%	5.0%	1.87%	-0.04%	11.5%	12.7%	17.8	4.1%	7.1%
Macquarie (First Half 2023)	$ 179.30	$ 69.3	7.0%	10.0%	n/a	0.12%	12.8%	15.6%	15.8	3.8%	-9.6%

Source: Company reports, IRESS, Atlas Funds Management

Rising net interest margins

Net interest margins were a major topic during the November banks reporting season, with most investors going straight to the slide on margins in the voluminous Investor Discussion Pack (in the case of Westpac, it was page 22 of the 139 pack). Banks earn a net interest margin [(Interest Received - Interest Paid) divided by Average Invested Assets] by lending out funds at a higher rate than by borrowing these funds from depositors or wholesale money markets.

When the prevailing cash rate is 3%, it is much easier for a bank to maintain a profit margin of 2% than when the cash rate is 0.1%. Rising interest rates increase the benefits banks get from the billions of dollars held in zero or near-zero-interest transaction accounts that can be lent profitably. Net interest margins can expand faster if the bank is quick to raise loan rates, slow to increase rates paid on term deposits and incurs minimal loan losses. In its result, Westpac revealed that as of September 2022, the bank held $252 billion in transaction accounts earning minimal to no interest.

The November 2022 reporting season saw net interest margins increase for all banks. The banks more heavily exposed to mortgages (CBA and Westpac) traditionally have higher margins than the business banks (NAB and ANZ) which face competition from international banks when lending to large corporates.

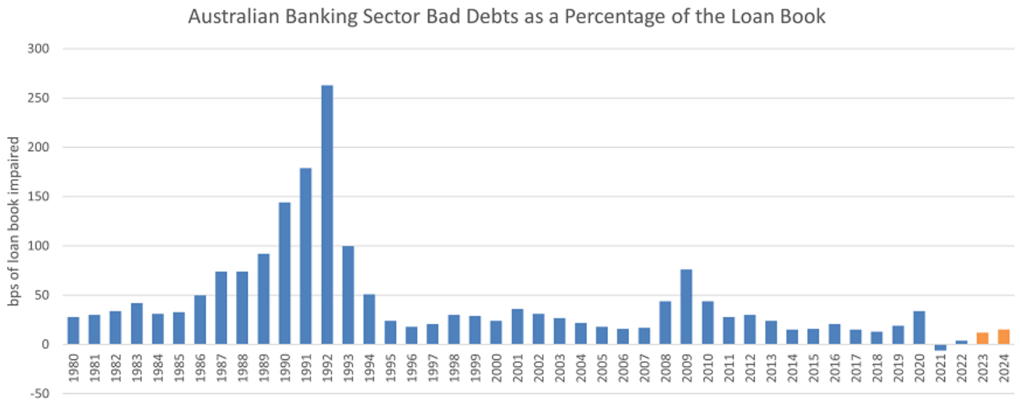
Westpac posted the highest net interest margin in November, with 1.90%. However, Commonwealth Bank may report a higher margin in February 2023 because their books closed on 30th June, and CBA's financial statements did not capture much of the rate increases seen in 2022. Over the last six months, Westpac increased its net interest margin by 0.05%; while this sounds like a minuscule amount, this small increase equated to $564 million in additional profit when multiplied across the bank's $740 billion loan book!

Bad debts

After net interest margins, the second most important number in every bank's financial reports in 2022 was bad debts, with investors looking to see if rising interest rates have caused losses on loans made. One of the biggest drivers of earnings growth over the last few years has been the ongoing decline in bad debts at a time when they were expected to spike sharply on rising unemployment and crashing house prices. Low bad debts boost bank profitability, as loans are priced assuming that a certain percentage of borrowers will be unable to repay and that the bank will incur a loss on the loan. From the below chart, since the 1991 recession, the normalised long-term level of bad debts has been around 0.3% of total loans for Australia's banks.

Bad debts remained low in 2022, with all banks reporting negligible loan losses; ANZ reported the lowest level with a positive 0.08%. This positive number occurred as new loan losses were offset by write-backs and recoveries from previously taken provisions.

Gold Star - ANZ



Dividends

As can be seen in the first table, all banks increased their dividends in the most recently completed reporting season. However, for all banks, there was an element of catching up for reduced payments to shareholders in 2020 after APRA placed a cap limiting dividends to 50% of earnings and the ongoing uncertainty in 2021 from Covid-19 and associated lockdowns. NAB won the gold star by increasing their dividend by 16% to 78 cents per share in November, though this remains below the 83 cents paid pre-pandemic. Macquarie Bank increased its dividend by 10% to be the only bank paying a higher dividend in 2022 than in 2019. As a global investment bank, Macquarie Bank has enjoyed a good pandemic, growing earnings over the past three years and profiting from market volatility.

Gold Star - NAB

Expenses

Australia's banks operate in a competitive oligopoly, largely selling an undifferentiated product (loans) where their competitors have a similar cost of production (capital from depositors and wholesale capital markets). Consequently, moves to gain a higher market share and increase profits by discounting loans are swiftly matched by the other banks. However, banks can grow profits by reducing their expense base, which seemingly expands each year.

Containing growth in expenses has proved challenging for the banks, with low unemployment contributing to wage growth and the need to hire more compliance staff after the 2018 Banking Royal Commission. Additionally, compliance teams have grown in response to the Commonwealth Bank and Westpac getting hit with hefty penalties from AUSTRAC for not complying with Anti-Money Laundering and Counter-Terrorism Financing Act 2006.

While there was minimal discussion around cutting expenses by closing branches, Atlas sees that rationalising the branch network will be the easiest way for banks to grow earnings. On average, the significant banks have around 800 branches across Australia. Over the past decade, there has been a big decline in customer visits to these branches, as most bank transactions are now conducted online or via smartphones. Indeed, last week Westpac announced that over the past 12 months, the bank had processed 22 million physical transactions in a branch but 690 million digital transactions. Westpac wins the gold star for expense control, cutting their cost base by $766 million as a result of reducing headcount by close to 5,000 employees and closing 119 branches and 200 ATMs.

Gold Star - WBC

Our take

Investing in Australian banks is one of the major questions facing institutional and retail investors alike, with the banks comprising 25% of the ASX 200. We expect the banks to deliver over 10% earnings growth over the coming year benefitting from higher net interest margins and low bad debts from historically low unemployment levels. Though earnings do face headwinds from lower credit growth, normalising bad debts and reduced earnings support from provision write-backs. However, if investors examine the broader Australian market, the banks look relatively cheap and are well-capitalised.

The banks are in a much stronger position in 2022 than they were in 2008, going into the last rate tightening cycle. In 2008, the major banks held very skinny Tier 1 Capital Ratios of around 5% of risk weights assets (~11.5% in 2022), and the unemployment rate was over 5%, much higher than today. As ANZ's CEO said in his presentation, it is not falling house prices that cause loan losses but falling house prices combined with job losses.

Additionally, the banks' loan books are cleaner in 2022 than they were 14 years ago, with a greater focus on domestic lending to housing and small enterprises. In 2022 there have been no major corporate collapses and no large companies with obvious issues, such as ABC Learning, Allco, Babcock and Brown or Centro.

Furthermore, the foreign adventures in the UK and Asia that caused problems in 2008 have mostly been either sold or demerged. Over the past decade, Australia's banks have retreated to their home market and are now less impacted by a recession in Europe or the USA. All of this augurs for a more benign loan loss cycle in the coming years, and in this situation, bank share prices will be re-rated higher.

Hugh Dive is Chief Investment Officer of Atlas Funds Management. This article is for general information only and does not consider the circumstances of any investor.

The world's about to hit a brick wall

Peter Zeihan

This is an edited transcript of a video talk given by geopolitical strategist, Peter Zeihan, on the intended and unintended consequences of recent Federal Reserve rate hikes.

I thought it would be a good idea to give you an idea of why the Fed is doing what it's doing and what that means for all of us.

Normally, interest rates are a tool that are used to regulate demand – the idea being that when demand falls, you want to lower interest rates so you can get them back up and get some normal economic activity moving again.

And in the case of the United States, most of the demand is coming from the millennial class, people who are aged in their 20s and their 30s - which is normal. This is the age group that's usually buying homes and raising kids and buying cars. And in that, this is no atypical period.

But when the Federal Reserve looks around the world, they're discovering that the millennials in the United States don't have a lot of peers around the world. There aren't really many German or Chinese or Japanese or Korean millennials at all.

So, it's not that the Fed is overly concerned about the current economic conditions with inflation – well, although they are – but they're really thinking to what happens the next time. Because we have a number of countries who cannot increase interest rates enough to regulate demand, because they don't have demand. If they raise them too high, too fast, or really moderately at all, it will be their last economic expansion.

And even before you consider the economic impacts of things like the Ukraine war, this was always going to be the end of the road for a lot of East Asia and Europe, it's just down to the numbers. When the Federal Reserve is looking at this, they know this tool will work for us, but it won't work anywhere else. That means the next time American demand falters, the next time the United States falls into recession, it better make sure it has as many monetary tools as possible.

The Fed is not going to stop when rates get to 4%. They're probably not going to stop when rates get to 6%. 6% is kind of like their minimum for what they need in the mid-term to deal with the next economic crisis.

There's going to be a lot of whinging

So, you shouldn't expect the Fed to stop because there's a lot of whinging. Now on the topic of whinging, there's going to be a great deal, and I would say that it comes from two places. Number one are those industries that have boiled up over the last 15 years in an environment of basically having free capital. We had interest rates at zero for a decade, and in many cases, interest rates went negative either because of central banks doing it directly like they did in Europe, or indirectly like the United States did with its quantitative easing programs. But regardless, when money is free, all kinds of weird things happen.

Past periods of low interest rates gave us the Chinese boom. Well, that's over. Past periods gave us the Japanese boom. That's over. Past periods gave us subprime. That's over. In the current boom, we're getting crypto currency. And this is no different from any other technological marvel that we've had in previous economic expansions.

The tech sector in Silicon Valley writ large is more aware of this. They've been around a little bit longer. But it's no surprise to anyone in San Jose that they're facing massive crunches, because ultimately tech requires a lot of young people and a lot of capital. The capital is necessary to pay the young people to do all the big think work, to operationalize the technologies, to prototype it and then to get them out there and keep them updated. That's all very expensive.

If the cost of capital doubles, quadruples, or more, that becomes harder. Whether it's a perspective technological marvel or something that's a little bit more bread and butter, like say, Twitter or Facebook or Tesla, you should expect a lot of whinging as they're dealing with a capital environment that their business plans were not designed for.

Millennials will be crunched

Second – the millennials. The millennials, the oldest ones, were born in 1980, which means that they have not had any experience with high interest rates and high capital costs their entire adult lives. And yes, we have all heard about how life for the millennials has been so hard. But now it's going to be hard with 9% interest rates.

I'll give you an idea what that feels like. At the fourth quarter of last year, it was still possible to get a mortgage in the US at a 3% rate. By the end of the first quarter of next year, it's going to be impossible to get one with less than a 9% rate, and that 6-point increase from 3% to 9%, that increases the monthly payout or the monthly payment requirements for your mortgage by 50%.

And look at your mortgage. Could you afford one that is 50% higher? Now, apply that across the entire millennial cadre for people who are in their first or maybe second home and think about what that does to their life choices, think about what that does to their political decision-making. We're about to experience that on mass. The annual payments that the federal government has to make on interest will go up by at least 0.5 trillion. That's just kind of baked into the pie right now.

Germany is a big worry

What does this mean on the broader scale? Well, it's actually worse than it sounds, because while interest rates are going up rapidly in the United States, remember they can't go up as rapidly everywhere else. If you've got a bunch of money in a foreign country and you want to invest it somewhere, you want to put it in a rock-solid asset, preferably one guaranteed by the government, you want to put into a place that preferably has an appreciating currency, and you want to put into a place where the underlying economic growth is stable to positive. Well, at the same time as rates are going up, we're also going to be seeing the United States hoovering up capital from the world over.

And the country that I am most worried about is Germany. Germany has run a very tight ship from a fiscal point of view for decades. However, the financial crisis that the Europe is brewing up because of what's going on with interest rates here [the US] and the capital transfers and the capital flight combined with the Ukraine war, which is crashing energy supplies to the German system and sending prices through the roof is damaging the entire economic model of the country.

Also, Germany doesn't have a lot of young people anyway, so they depend upon exports. And anything that slows down the world writ large is devastating for them. And now, this is all hitting at the same time.

But finances in Germany are relatively liberalized, so that people can get their money out to safer places. Germany is likely to be the first of the European countries to enact broad scale capital controls because very soon they won't have a choice.

Whether it is crypto, or millennials, Germans, get ready for a lot of complaining. This is going to get a lot worse before it gets better.

Peter Zeihan, founder of [Zeihan on Geopolitics](), is a geopolitical strategist, speaker and author. This article is general information and does not consider the circumstances of any investor. This article is an edited transcript of Peter's video, [Implications of Rising Interest Rates](), posted on 3 November 2022.

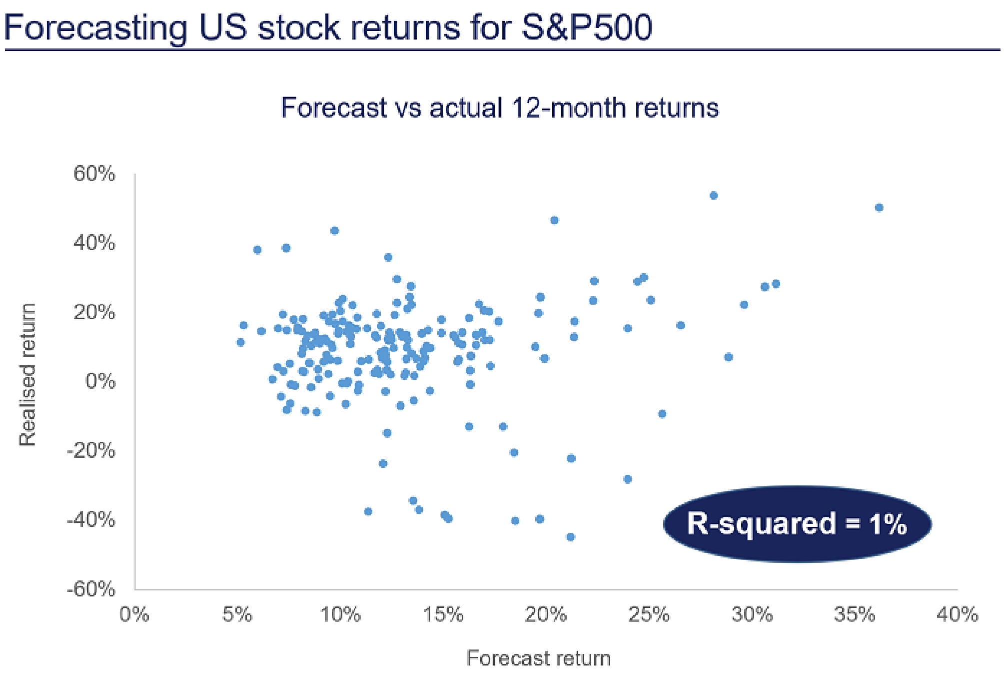
Investors don't forecast well, and that's good news

Shane Woldendorp

Generally speaking, investors aren't good at forecasting market returns. If they were, then stock prices would likely be much less volatile than they are and would generally be priced to give a reasonable real return every year, as everyone would know what to expect.

But in real life, forecasters' predictions of stock returns and bond yields are all over the place compared to the reality.

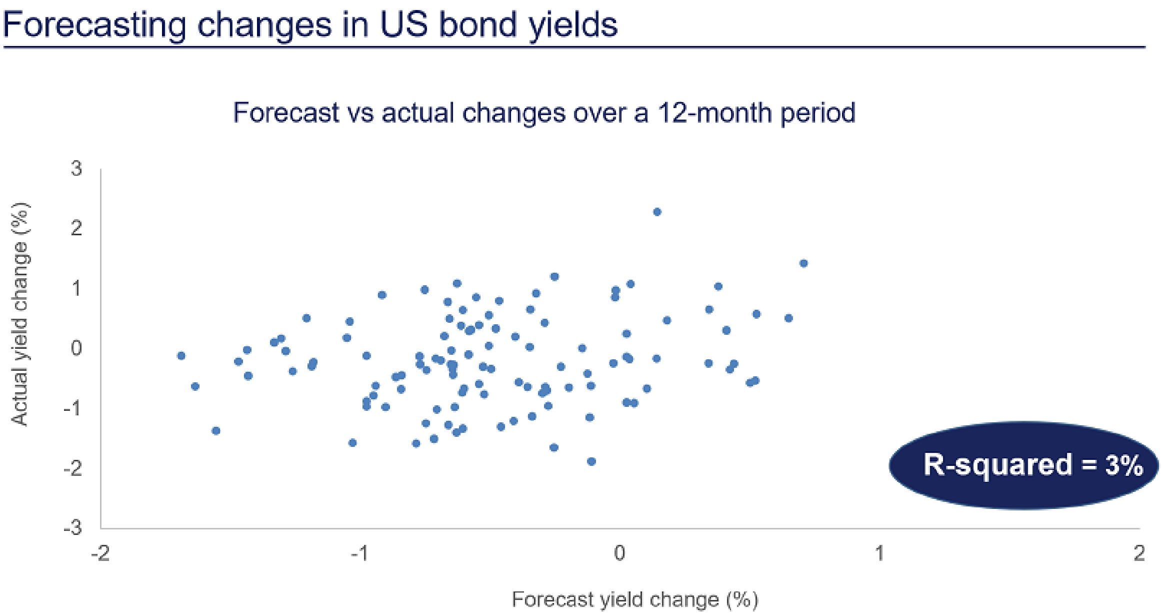
For example, if you use the Bloomberg best consensus forecasts for the S&P500 and plot the predicted one-year return against the actual return over a period of more than 15 years to 2021, you get a random scatter of points. Using a statistical measure known as R-squared, which measures the relationship between two variables, the relationship between forecasts and actual 12-month returns is just 1% out of 100%. Suggesting there is effectively no relationship between the two.



Source: Bloomberg best consensus S&P 500 12-month target price, Bloomberg, 2004 to 2021.

Just in case you think this is just an equity problem, a similar effect is evident if we look at bond returns.

Theoretically, to accurately price bonds, investors only need to predict inflation and interest rates. But if you take a decade's worth of data provided by the Philadelphia Fed Survey of Professional Forecasters and plot 1-year forecast changes in bond yields against the 1-year actual changes, you again get a random scatter of points, With a similarly low R-squared relationship measure of just 3%.



Source: Philadelphia Fed Survey of Professional Forecasters 1-year forecast for 10-year Treasury Yield, Federal Reserve Bank, Philadelphia, 1992-2001.

Meanwhile, large macro events such as recessions are arguably even harder to predict. Research by the International Monetary Fund (IMF) in 2018 showed that while economic forecasters are generally aware that recession years – where real annual GDP growth falls - will be different from other years, they tend to misjudge the scale of the recession. Forecasts are then not revised fast enough to avoid large errors, which means forecasts and reality don't match up until the recession year is almost over.

Exploiting overconfidence

The good news is that you don't have to be able to predict the future to find good investment opportunities. As contrarian investors, we have found some of our best opportunities on the opposite side of the most confident predictions.

When investors are overconfident with their forecasts, this tends to push the prices of these stocks up higher than they should, while the stocks they are ignoring or are less confident on could see their prices fall.

And it is in the areas where forecasts are the most bearish that we are currently finding some of the best contrarian opportunities. For example, stocks where Covid has temporarily disrupted their markets, or in so-called 'ESG Orphan' stocks that are discarded by investors who are more focused on things such as high emissions and coal production rather than the price.

Covid disruption

As the name suggests Global Payments is a payments company operating in 100 countries and processing about 50 billion transactions per year.

The payments space has attractive economics. It has high barriers to entry because you need huge scale to make any money and because trust is an important factor in winning business. The global payments sector grew at roughly 7% a year between 2014 and 2019, according to the latest Global Payments Report by McKinsey, yet despite a decline in revenues during Covid, the sector is expected to return to a long-term growth trajectory of 6-7% a year.

However, Global Payments itself has grown faster than this for two reasons. Firstly, they are big in the credit card space and card payments, where volumes have been growing faster than cash and cheques. Secondly, the firm itself has been winning market share from their competitors.

So, fast growth, high barriers to entry, inflation proof – what's not to like? The market should love this kind of company and indeed that has been the case up until now. Historically, Global Payments has traded at a 30% premium to the price/earnings (P/E) of the S&P500 Index, but currently it is trading at around a 30% discount to the market on a P/E of only 15x. That is a good price for a great business, so what's the catch?

There are four reasons why the market is concerned right now:

1. The company's payments volumes are heavily skewed toward small businesses that have not recovered as quickly post-Covid as larger companies.
2. Credit cards have lost market share relative to debit cards.
3. During Covid there were fewer transactions but in larger amounts, and margins on big payments are lower than for small payments.
4. A number of new listings in the payments space created the impression that competition was increasing.

We believe all of these will fix themselves as the major economic impacts of Covid disappear into the rearview mirror.

Small businesses will recover, credit volumes will go back to normal just as they have done after previous recessions, payment patterns will do the same, and the market will come to realise that the newly listed companies are not true competitors for Global Payments.

This means currently you could pay 15x times earnings for a great business that is growing rapidly. We think that is good value in any market, but particularly good value in the current environment.

ESG orphans

Another unloved part of the market is what could be called the 'ESG orphans'. There has been a tendency for institutional investors to divest from companies with high emissions, particularly companies with high emissions that come from coal.

They might be doing this for ethical reasons or because they're forecasting that coal has no future, but to some extent it doesn't really matter. The result of this indiscriminate selling is that the prices of companies that generate power using coal have fallen dramatically.

Now, while some of the selling is deserved, not all of it is. That's because for some of these companies there is no place for coal in their future.

One such company is AES (NYSE:AES).

AES is a US power company that is attractively priced because it still has 22% of its power coming from coal generation, so it doesn't look very green and would be excluded by many ESG-orientated funds.

You can see how their coal exposure has impacted their valuation by comparing AES to Next Era Energy (NYSE:NEE) – a power generator that lacks coal exposure. On the fundamentals AES looks to be more attractive: it has a higher dividend yield, slightly faster growth and a higher proportion of its power coming from renewables. However, you can see that AES has a much higher exposure to coal and that this is reflected in a much lower P/E multiple.

AES compared to Next Era Energy

	aes	NEXTera ENERGY
Dividend yield	3.0%	2.1%
Growth rate	7% - 9%	6% - 8%
Power from renewables	44%	37%
Power from Coal	22%	2%
PE ratio*	13x	28x

*Source: Company reports. Refinitiv. * consensus earnings for Dec 22.*

However, if you look a little deeper, AES is perhaps 'greener' than it seems. AES owns a collection of renewable energy businesses including a joint venture called Fluence that is a top-2 installer of grid scale battery storage in competition with Tesla. In addition, it owns a large solar developer that it's using to reduce its own (as well as other customers') reliance on carbon energy, and as a result the company's emissions are falling.

From 2018 to today AES has reduced its coal exposure from 50% down to 22% of the power it generates. Importantly the company is on track to eliminate its coal exposure by 2025.

So, in this example you could get a collection of green businesses growing at an attractive rate, but you only pay 13x earnings for them and you have the prospect that the P/E multiple could double once the coal exposure has gone.

Forecasting distractions

Clearly the evidence shows that investors can't forecast well. On the surface, that seems like bad news, but if you dig a little deeper, it quickly becomes evident that it can create opportunities for those investors that are prepared to think differently.

Shane Woldendorp, Investment Specialist, Orbis Investments, a sponsor of Firstlinks. This report contains general information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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How 'less pain, some gain' can smooth your volatile ride

Roy Maslen

As equity markets in Australia and elsewhere whipsaw, the risk that volatility might undermine investors' ability to achieve their medium-to-long-term return objectives looms large. What can investors do to mitigate that risk, and so limit the potential for falling short of their goals?

Several strategies exist for reducing volatility in investment portfolios. Some make use of derivatives to hedge against falling markets. But derivatives can be expensive, and reliance on them may unintentionally lead to other risks.

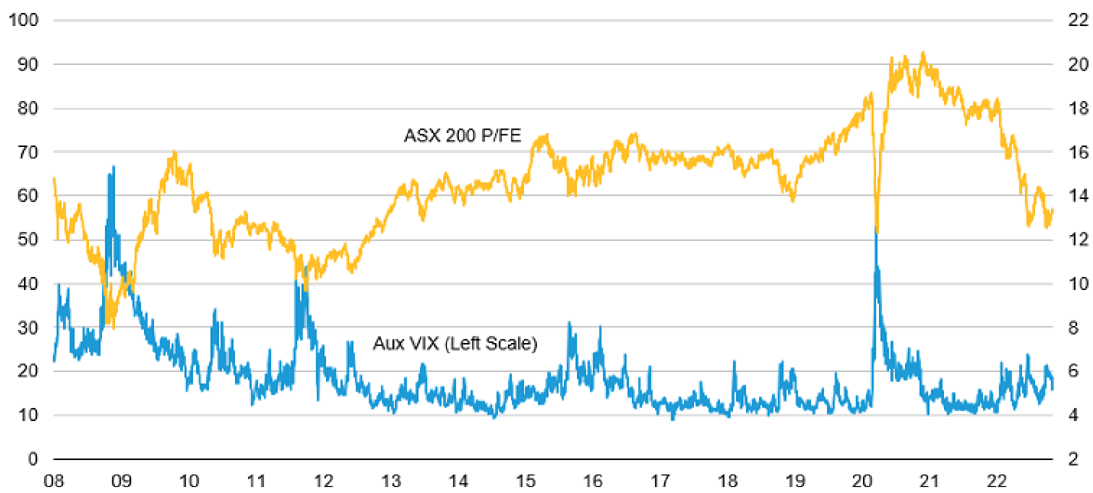
For example, using derivatives as a buffer may lull investment managers into paying less attention to a key source of volatility within the portfolio itself—stock selection. Failure to evaluate stocks carefully for low-volatility characteristics could offset some of the benefits of using derivatives.

Appropriate stock selection, in our view, is one of the keys to managing volatility risk. We know from experience that it can help to produce portfolio performance that's 25% less volatile than the market over five years.

But investors need to think about risk-adjusted returns as well as volatility. That's especially true in today's markets where share prices have already fallen steeply, and volatility appears likely to continue and perhaps increase.

Share Prices Are Down and Volatility May Increase

VIX vs. S&P/ASX 200 P/FE Index

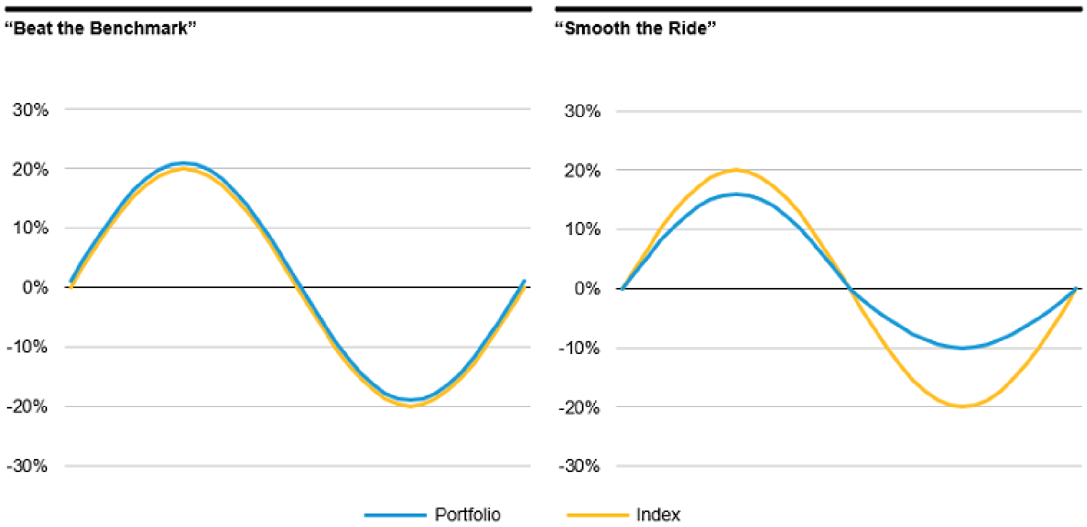


Historical analysis does not guarantee future results.
Through October 31, 2022
Source: FactSet

Our research and experience have shown that the right stock selection can result in lower losses when the market falls and positive (though not market-beating) returns when the market rises.

Over time, this trade-off—sacrificing a little upside gain in return for lower downside risk, or 'less pain, some gain'—can give investors a smoother ride relative to the market as a whole, while still resulting in attractive returns.

Smoothing the Ride by Reducing the Downside



For illustrative purposes only
Source: AB

The question is, how to select the right stocks and manage the portfolio appropriately?

Ignore the benchmark

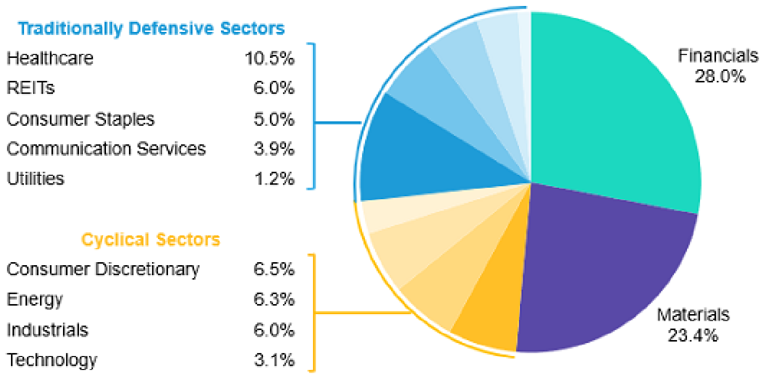
The first step is to build a portfolio that consists entirely of low-volatility stocks. This means ignoring market benchmarks as a guide to which stocks should be in the portfolio, and in what proportions—an approach known as benchmark-agnostic investing.

While the idea of designing portfolios to meet specific investment objectives has become more widespread over the last few years, most active investment strategies—and, of course, index funds—continue to use market benchmarks as templates for portfolio construction.

For investors seeking a low-volatility strategy in the Australian equities market, being benchmark-independent is particularly important because the local indices are dominated by volatile industry sectors such as banks and resources.

A benchmark-agnostic approach frees investors to focus on less volatile sectors, such as consumer staples, healthcare, utilities and communications services. These defensive sectors have outperformed on an earnings-per-share (EPS) basis during past slowdowns.

Avoiding the Benchmark Means Avoiding Volatile Sectors

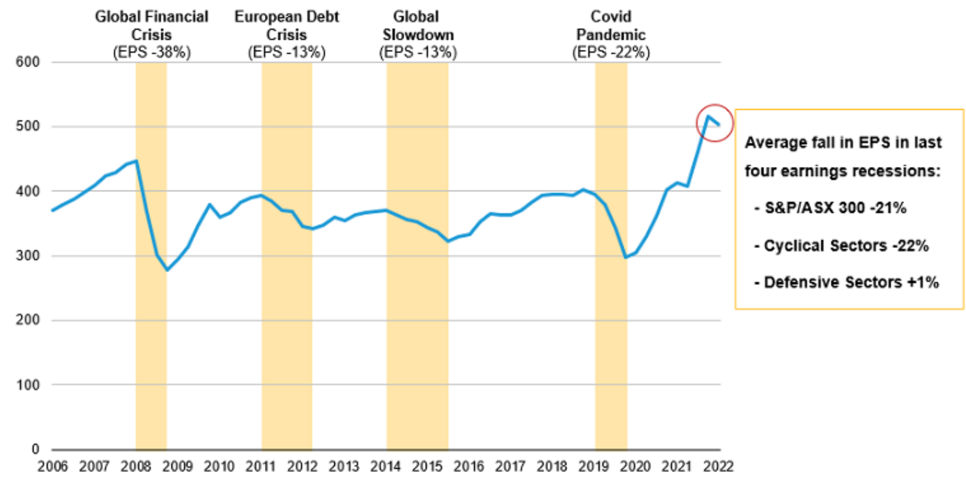


Based on the S&P/ASX 300 Index. Numbers may not sum due to rounding.
As of September 30, 2022
Source: S&P Dow Jones and AB

Narrowing the investment universe in this way helps to lay the groundwork for less volatile investment performance. But investors are interested in risk-adjusted returns, too—hence the importance of picking the right stocks within the low-volatility universe.

In past slower growth led to 'Earnings Recessions' but Defensive Resilience

S&P/ASX 300 Consensus One Year Forward Earnings



Historical analysis is not indicative of future results.
Earnings recession are when consensus EPS falls greater than 10%. Defensives sectors Consumer Staples, Healthcare, Utilities and Communications Services all other sectors are Cyclicals. As of September 30, 2022. Source: Bloomberg and AB

Look for stability, quality, and reasonable valuation

In our view, the best stocks will be attractive on three key measures—stability, quality, and valuation.

Low volatility stocks, by definition, tend to be more stable than the overall market. The degree of relative stability is likely to differ for each stock and may change over time. For investors seeking low-volatility performance over the medium or long term, this is an important point to consider.

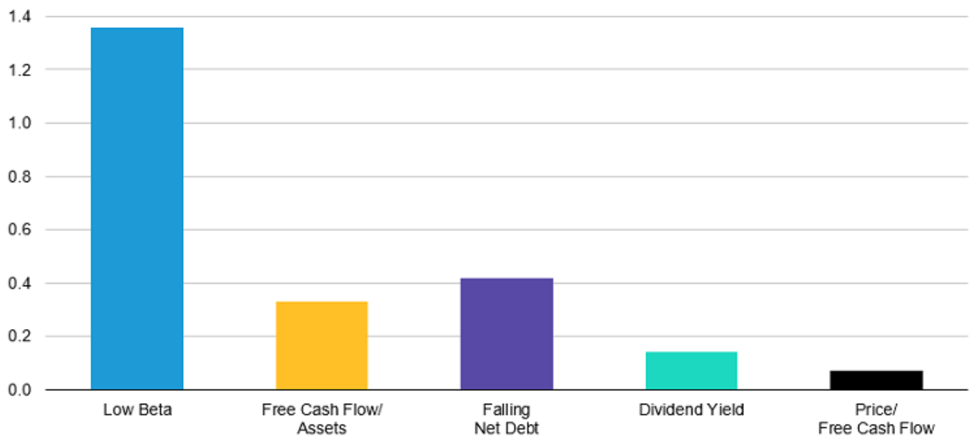
It means that attention should be given to each stock's price behaviour over different time periods—say, five years and 12 months—to see whether there's been any change in the pattern of stability. The next step is to understand the factors that lie behind that pattern.

These are the stock's quality attributes such as balance-sheet strength (for example, low net debt and high free cash flow to assets), high and stable profitability, and shareholder-friendly management of capital (which may include low asset growth or declining shares on issue).

Stocks with these attributes and attractive valuations (low price-to-free-cash-flow ratio) have outperformed in down markets, as seen from the returns for the most attractive 20% of stocks for each factor during months when the S&P/ASX 200 was down.

Invest in Stability and Quality with Reasonable Valuation

Relative Monthly Returns for Factors in months When Index* is Down (%)



Past performance is no guarantee of future results.
Returns of the most attractive 20% of stocks for each factor
*Subset of S&P/ASX 200 consisting of large-cap stocks as defined by AB for the period from January 1, 1990, to September 30, 2022
As of September 30, 2022
Source: FactSet, MSCI, S&P Dow Jones, Thomson Reuters I/B/E/S, Worldscope and AB: see Disclosures and Important Information.

Attractive valuation is particularly important from a return perspective because a stock that's fairly valued relative to its fundamentals is less vulnerable than an overpriced stock to a sharp price decline when the market falls.

Consequently, when the market recovers, a fair-valued stock has less ground to make up in price terms than a stock that was overvalued. This gives it a reasonable prospect of participating in the market upside. It's important to note, however, that it's unlikely to outperform a rising market.

The obvious reason for this is that it's a low-volatility stock. With this approach to investment, it's important to think differently from the usual 'beat-the-index' mentality. Overall returns come less from participating in the upside and more from lowering the downside risk.

A sensible objective, in our view, is to aim to capture 80% of market upturns over five years or longer, while limiting participation in market downturns to 50%. Over time, this should result in delivering attractive returns for investors with much lower volatility than the market.

Stock selection is not one-and-done, however. This approach to low-volatility investing is an active one, and portfolios need to be managed accordingly.

Avoid volatility traps

Active portfolio management involves continuously monitoring the portfolio, the economy and the equity market for risks and opportunities and adjusting the portfolio to take account of them.

Some risks, such as 'volatility traps', are particularly relevant for low-volatility portfolios. Even stocks that score highly on each of the factors discussed above can fall prey to unexpected developments that undermine their prices.

For example, a utility company in a sector that is undergoing a large-scale regulatory review may appear to be stable. But the stability won't necessarily be permanent if the outcome of the regulatory review could hurt the utility.

Volatility traps usually result from stock-specific causes. Our research shows that cyclical downturns account for 50% of volatility traps, followed by balance-sheet stress and event risk.

Cyclical risk can manifest itself through a broad economic or business downturn, or changes in a company's key markets. An indicator of balance-sheet risk may be the willingness of lenders to provide credit to a business, and the price they would charge for doing so.

Event risk can include a change in government or regulatory policy, the restatement of company earnings, an acquisition that falls short of expectations or a regulatory or legal ruling that could hurt the stock price.

The way to manage these risks is through fundamental, bottom-up stock research.

Concentration risk—the possibility that a portfolio will become overloaded with similar stocks, or stocks from sectors that are positively correlated—is another potential pitfall, especially for a specialised portfolio drawing on the relatively small universe of Australian stocks.

This can be mitigated by allocating part of the portfolio to carefully chosen international stocks.

Macro risks are important, too. A stock chosen for its stability, quality and price may be undermined by external factors such as adverse foreign-currency fluctuations, supply chain disruptions and geopolitical tensions. These risks should be taken into account when building the portfolio.

Roy Maslen is Chief Investment Officer of Australian Equities for AllianceBernstein Australia Limited. Its listed fund is AB Managed Volatility Equities Fund (Managed Fund) – MVE Class (AMVE). This article is general information and does not consider the circumstances of any investor.

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To hedge or not to hedge?

Alice Shen

The decision whether to hedge your international equity portfolio can impact your investment over the short and medium term, but an analysis of the data shows that currency impact over the long term is negligible.

Currency hedging international exposures

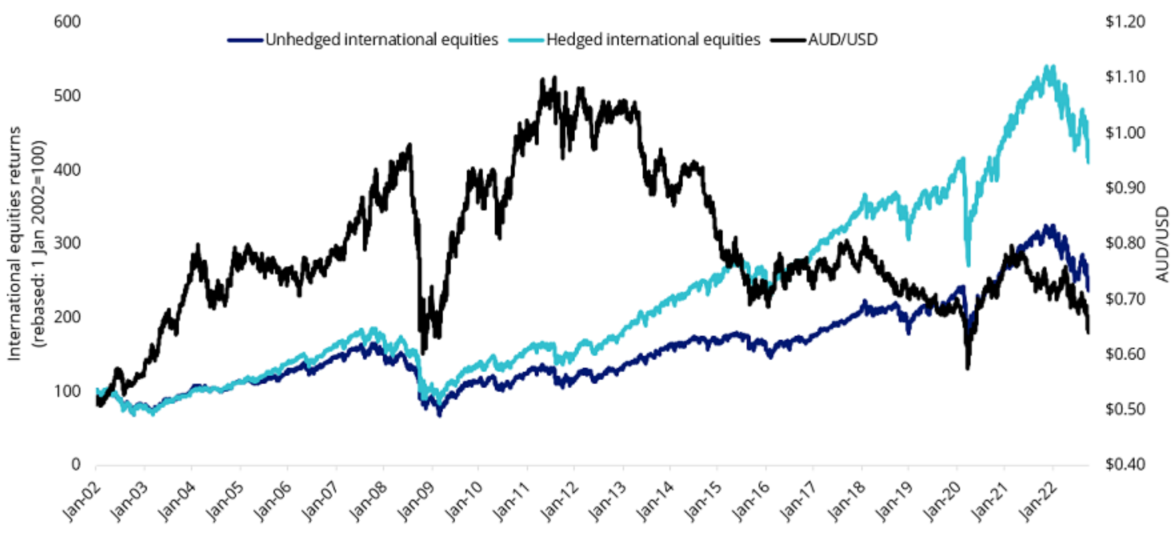
The decision to hedge your currency exposure is an important one as movements in the Australian dollar can either erode or add value to your international investment. Any drop in the Australian dollar helps unhedged investors as it magnifies gains when assets are converted back into Australian dollars. So if, for example, the Australian dollar fell by 10%, all other things being equal, the value of your offshore investments would rise by 11%.

However, the converse is true and any rise in the Australian dollar diminishes returns when foreign investments are converted back into Australian dollars. This is where hedging an international portfolio may be advantageous, as it will benefit from rises in the value of the Australian dollar.

The chart below shows the impact of movements in the AUD vs USD on the value of international equities over the past 15 years. As the Australian dollar appreciated into 2008-09, hedged international equities outperformed. When the AUD fell sharply from April to August 2013, unhedged equities benefitted significantly while hedged equities gained only from underlying stock performance.

As the AUD depreciated further in 2014-15 hedged international equities continued to gain due to underlying stock performance while unhedged equities gained more. Finally in March this year, you can see that the value of hedged international equities fell much more sharply and in line with the broader market crash, versus the unhedged equities which were cushioned with the simultaneous collapse of the Australian dollar.

Chart 1: Australian dollar and hedged and unhedged international equities returns



Source: Bloomberg, 1 January 2002 to 30 September 2022. Unhedged International equities is MSCI World ex Australia Index. Hedged International equities is MSCI World Ex Australia 100% Hedged to AUD Index. You cannot invest in an index. Past performance is not a reliable indicator of future performance.

AUD/USD fell below 50 cents back in 2001

When the Australian dollar tested lows before, in 2001, 2008, and the Covid crisis it was different from the current rate environment. At US$0.67, it currently is a long way from those depths.

Back in 2001, times were different. Monetary policy was orthodox, and the RBA cash rate was high. In 2008, Australia went into the GFC with among the highest cash rates in the developed world and avoided the need for unorthodox policy.

Now there is a range of different factors to consider including the fallout of the unorthodox monetary policy that was implemented in the wake of the Covid crisis, the global recovery and associated supply shocks from COVID-19, the deleveraging of government balance sheets, the Fed's rapid rate rises in the face of 30-year high inflation and Australia's lower cash rate relative to other crises. During the current RBA rate rising cycle, the Australian dollar is not appreciating as it has during past hikes (2002 to 2008, and 2009 to 2010).

Chart 2: Australian dollar and the RBA cash rate

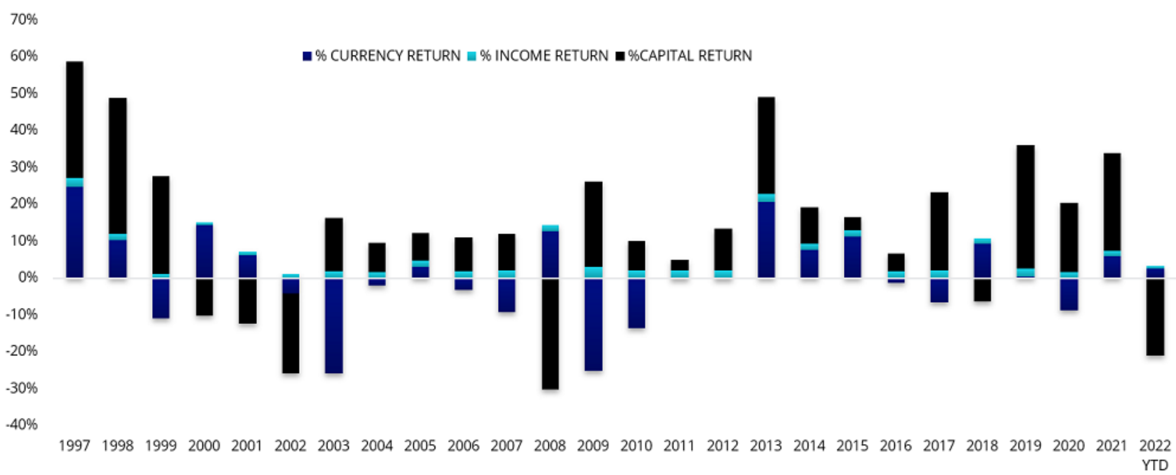
Source: Bloomberg, 1 January 2000 to 30 September 2022.

To hedge or not to hedge a Quality international equity exposure

This year's fall in the Australian dollar has led investors to ponder: should they be investing in hedged or unhedged international investments, or a bit of both?

It's important to remember over the long run, currency risks even out – what goes up, must come down – and currency volatility is smoothed out. Chart 3 below shows the long-term returns for the unhedged index tracked by QUAL.

Chart 3 Calendar year breakdown of MSCI World ex Australia Quality Index's returns



Source: MSCI. Annual returns to end of each calendar year data. 2022 is to 30 September 2022. Past performance is not indicative of future results.

The total return from currency for the calendar years from 1997 to 2022 is -0.03% p.a. Over that same time the index has returned 10.34% p.a. In other words, over a long-term period of nearly 26 years the decision to hedge or not hedge your international equities investment would have had a negligible impact on your overall portfolio performance. For short to medium term investors, the decision becomes more important as can be seen in blue in the chart above in which there are fluctuations from year-to-year.

It's impossible to predict markets and the same could be said of currencies. As always, we recommend talking to a financial professional to determine which currency strategy is right for you.

Alice Shen is a Senior Associate, Investments & Capital Markets at VanEck, a sponsor of Firstlinks. Any views expressed are opinions of the author at the time of writing and is not a recommendation to act. This is general information only and does not take into account any person's financial objectives, situation or needs. Investors should do their research and talk to a financial adviser about which products best suit their individual needs and investment objectives.

Key risks
An investment in QUAL carries risks associated with: ASX trading time differences, financial markets generally, individual company management, industry sectors, foreign currency, country or sector concentration, political, regulatory and tax risks, fund operations and tracking an index. See the PDS for details.

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