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Editorial

Three years ago in February 2020, my wife and I were cruising around Antarctica, a long way from the pandemic hitting the rest of the world. Although the coronavirus was first detected in Wuhan, China, in December 2019, it was initially considered more like the earlier SARS and MERS, and cautionary checks before boarding the ship at King George Island in the South Shetlands were cursory. Throughout the trip, nobody wore masks or routinely disinfected their hands, even as we waited for the shared buffet three times a day, and we mingled with the 100 other passengers like we were old friends. There was no COVID-19 onboard or in Antarctica at this time and we were welcomed into scientific bases without any checks. We played with the polar bears (we took them with us to prove they existed in Antarctica) which were a hit with other passengers who queued to take photographs.

As we toured islands and historic sites, news drifted in that this virus was more serious. We joked that we might be the last surviving people on earth, isolated from humanity in our floating prison, unable to land anywhere and gradually running out of power and food. Back in Chile for the flight home to Australia, we escaped their border closure by only two days, and walked through Australian customs as normal, unaware of what was about to hit. Within a few weeks, tourists on the same ship were denied disembarkation in The Falklands and Argentina before pushing up the East Coast of South America and becoming stranded outside Montevideo in Uruguay. Passengers even thought they would die as they were locked in their cabins on a ship staffed by ailing crew members for a month.

"An Australian cruise company is working to disembark a stricken Antarctic cruise ship on which about 60% of the passengers and crew have been infected with coronavirus. The Greg Mortimer has been anchored 20 kilometres (12 miles) off the coast of Uruguay since 27 March, but authorities in the South American country had until now refused to allow passengers off."

Within weeks in Australia, lockdowns and strict rules about going to work, gatherings and leaving home would change some of our habits forever. Stockmarkets fell heavily as investors fretted about the impact on

businesses and global trade, with the ASX200 losing 30% between 20 February and 16 March 2020. And then the cavalry rode in, with Australia's **Reserve Bank** announcing a wide range of measures to support the market, including buying bonds from banks, reducing the cash rate to 0.1% and offering a Term Funding Facility (TFF) to banks at 0.1% for three years. Of course, bankers love residential property, and instead of lending to businesses as the Reserve Bank hoped, the banks (with CBA leading the charge) turned $188 billion of term debt into fixed rate mortgage loans at 2% or less, and 2020 and 2021 saw a boom in residential prices rarely seen in Australia.

Three years is the crucial elapsed time, not only since our Antarctic adventure, but since enthusiastic borrowers started funding loans at 1.88% fixed for three years and bid up house prices to 'whatever it takes'. No doubt they figured their loan rate might rise by 1% to 2% a few years later, but nobody - least of all Reserve Bank Governor, **Philip Lowe** - expected the rate would become 6% to 7%. On $1 million, that's around $40,000 in after-tax dollars.

I rate the TFF as the most egregious and unnecessary policy, especially on top of everything else. Major banks were not facing funding problems but the $188 billion fuelled an auction bidding frenzy in 2021 that placed home ownership further out of reach of many young people. The Reserve Bank facilitated an 'up 30% down 10%' in residential property prices when a steadier market would have benefitted everyone.

S&P Global Ratings expects mortgage arrears to "*meaningfully increase*" due to this fixed to variable switch.

"The largest concentration of outstanding fixed-rate loans is set to roll over to variable rates in H2 2023. Many borrowers have split loans, with both variable and fixed rate components."

In a more encouraging conclusion, S&P forecasts interest rates will start to decline in 2024.

Retail sales remained robust throughout 2022, but they will hit a wall of reality as these borrowers desperately hang on to their homes. In a sign of the belt tightening to come, Australians cancelled 1.3 million streaming services in the December 2022 quarter. There is no '*hand back the keys and walk away*' in Australia as there is in the US, and if a property is sold for less than the value of the debt, the banks will come looking for the shortfall. Everybody, including the banks, wants to avoid that.

By the time we publish the next edition on 9 February, we will know the first interest rate decision by the Reserve Bank for 2023. I expect they will increase cash to 3.35% to show their resolve to halt inflation, together with firm words in their statement, but then take a break to see what nine consecutive increases will achieve. Pushing up towards a terminal 4% will inflict even more pain on borrowers during 2023. The central bank should let economic activity ease without pushing for a recession and 10 consecutive rate increases would be overkill.

Overnight, the US Fed increased its benchmark rate by 0.25%, moving the target to 4.5% and 4.75%, and although this was less that previous increases, Chairman Powell indicated a policy firmness to control inflation. The market took it well with equities rising and bond rates falling, the key 10-year US Treasury rate down 0.1% to 3.4%.

It was not only banks and borrowers who reacted to the central bank largesse over 2020/2021. Fund managers were forced to decide which companies would benefit from changing behaviours, and global companies such as **Peloton** with its sophisticated home bike systems, **Zoom** for videoconferences, **DocuSign** for online signing and **Spotify** and **Netflix** for entertainment at home rose dramatically. Many investors benefitted before valuations came crashing down in 2022 (the USD amount below shows value of

Company	Current value of 10'000$ invested	Performance since peak
CARVANA	103 USD	-99%
PELOTON	503 USD	-95%
BEYOND MEAT	519 USD	-95%
coinbase	798 USD	-92%
TELADOC.	765 USD	-92%
Lemonade	743 USD	-93%
robinhood	931 USD	-91%
Snap Inc.	1'030 USD	-90%
zoom	1'108 USD	-89%
DocuSign	1'686 USD	-83%
Spotify	1'956 USD	-80%
TESLA	2'776 USD	-72%
NETFLIX	4'147 USD	-59%

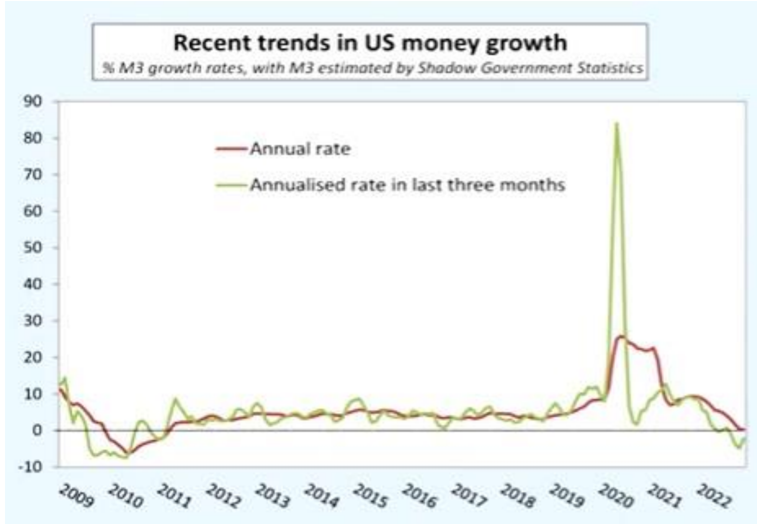
December 27th 2022 update - Chart by Vincent Galan

USD10,000 invested in the IPO, and companies such as **Tesla** and **Netflix** have still rewarded early funders despite the recent falls).

In Australia, it is unlikely that any other fund manager studied the science and shared their knowledge with investors as much as **Hamish Douglass of Magellan**. He told his large online audience that he was reading a couple of scientific papers a day, and his justified concern led him to adopt a defensive portfolio in 2020. As markets recovered strongly, especially the major tech stocks, Hamish underestimated a vital force working against Covid-19: Don't Fight the Fed. There was so much cheap money sloshing around and low interest rates meant valuations of companies with earnings far into the future were suddenly off the charts. The consequences of this miscalculation for Magellan and Hamish became more painful as the rally continued, but it was not for lack of understanding the nature of the pandemic.

Amid all the talk of transitory inflation in 2020 and 2021, Firstlinks published warnings by **Professor Tim Congdon** of the **Institute of International Monetary Research** not to ignore the money supply. Congdon argued we had forgotten some basic economic principles, and he wrote here as early as April 2020:

"The Federal Reserve's preparedness to finance the coronavirus-related spending may prove suicidal to its long-term reputation as an inflation fighter ... If too much money is manufactured on banks' balance sheets, a big rise in inflation should be expected."



Markets ignored him as did global central banks. Tim's updated chart of US money growth (right) illustrates the Federal Reserve actions in 2020 led to extraordinary money supply changes which have since delivered on Congdon's predictions. He says *"I must protest"* in his critical assessment of central bankers, leading economists and people with far-fetched ideas on what is causing inflation with no mention of the money supply, and he makes forecasts for 2023.

The increase in inflation forced interest rates higher and equity markets lower, and this **Bank of America** table shows how most investors suffered as the traditional protection of bonds failed to materialise. How could prices rise even further when bond rates were already zero or negative? What were we blindly hoping for?

Performance of stocks vs bonds in bear markets

Bear market	Dates	Performance	
		S&P 500	UST 10Y*
Stagflation	1973-1974	-48.2%	3.8%
Volker's Bear	1980-1982	-27.1%	26.7%
Black Monday	1987	-33.5%	4.2%
Dotcom	2000-2002	-49.1%	31.7%
GFC	2007-2009	-56.8%	21.6%
Inflation	2021-2022	-25.4%	-17.2%

Source: BofA Global Investment Strategy, Global Financial Data, Bloomberg

BofA GLOBAL RESEARCH

Congdon wasn't alone in predicting inflation in 2020. **Russell Napier**, a go-to strategist for many of the world's largest hedge funds and institutional funds, and author of the renowned book, *Anatomy of the Bear*, had similar warnings. Unlike Congdon, though, Napier thinks inflation will prove structural and investors will need to adjust to a world where economies aren't guided by free markets anymore, but governments.

The euphoria in stockmarkets in January 2023 flies in the face of messages the central banks are giving to halt inflation. Writing in the Weekend FT on 28 January, **Katie Martin** reports on her visit to the **World Economic Forum** in Davos. Among the largest investors in the world, she says it was hard to find anyone buying into the optimism.

"Nicolai Tengen, head of Norway's enormous $1.3 trillion oil fund, is among the party poopers. With a dash of Nordic straight talking, he told me the fizzing market conditions that stemmed from the global injection of monetary stimulus after the outbreak of Covid had pulled a lot of 'crap' in to stock exchanges ... investors

should accept that the Fed may very well restart rate rises and that a very long, slow grind of low returns lies ahead."

In my other article this week, the flows from Australian investors over the last couple of years are shown in a series of charts. Money surged into equities in 2021 and bond funds did well for inflows at the worst time for investors hoping for capital protection.

Last week was lively for comments, with about 120 on three articles. Thanks for the debate with plenty of different opinions. Doug Drysdale's experience as an executor was a warning not to overlook the complexity of superannuation and its relationship with an estate. A few critical points:

- There are limits to the people who can be defined as beneficiaries of super, including your spouse or partner, your children, financial dependants or your executor. It does not normally include grandchildren, other family members or friends.
- Your super does not automatically comprise part of your estate, and your super is held by the trustee of your super fund on your behalf, so the decisions of the trustee are crucial.
- This is why nominating a beneficiary to receive your super is important, as it may go to someone you do not want it to if left to the trustee's discretion.

Graham Hand

Also in this week's edition ...

Kaye Fallick looks at recent media articles mocking a couple with $1 million in assets who asked whether they would qualify for the Age Pension. She says the articles failed to address a key issue: whether the Age Pension system is still fit for purpose after being largely untouched since its inception at the beginning of last century.

Meanwhile, the retirement plans of Australians have changed following Covid, according to a new global survey by **State Street Advisors**. Australia stands out globally with 34% of respondents indicating a changed retirement outlook compared to 25% in the US, UK and Ireland.

And **Michael McAlary** believes that Covid has irrevocably changed other things in the investment world too. He thinks the 60/40 portfolio has reached its endpoint, the 'Fed Put' is gone for good, and moves away from US dollar transactions from countries outside the US will continue.

Growth stocks were obliterated last year, and **Francyne Mu** has been rummaging through these companies to find those that have strong competitive advantages and are now reasonably priced. She thinks she's unearthed three future gems in the US.

Lastly in this week's White Paper, **Franklin Equity Group** explores five recent innovations, including renewables accessing deeper waters and artificial intelligence in the digital realm.

Curated by James Gruber and Leisa Bell

Tim Congdon warned us and we ignored him on inflation

Graham Hand on Tim Congdon

Introduction

My economics degree at UNSW spanned four years of the 1970s, a time when monetary policy - the cost and availability of money in the economy - was an influential theory. Leading monetarist Milton Friedman was awarded the Nobel Prize in Economic Sciences in 1976 and The Economist called him *"the most influential economist of the second half of the 20th century ... possibly of all of it".*

When I started working in investment markets in 1979, the release of money supply data such as M2 was a major economic indicator watched by financial markets. But as the years went by, focus switched to other data points such as unemployment, inflation, GDP growth and trade accounts and most people ignored money supply.

When March 2020 and Covid-19 arrived, and central banks around the world adopted unlimited measures to stimulate economies with low interest rates, liquidity by the trillion and free loans, nobody was watching the elephant in the room. I had been schooled in monetary policy implications and it always nagged me that the theories and policies that guided governments for decades now seemed irrelevant.

Not for Professor Tim Congdon, Chair of the Institute of International Monetary Research. Firstlinks issued his warnings about inflationary consequences of loose money as early as April 2020. This is not looking back with hindsight, here are two of Congdon's articles with a couple of extracts:

Magic money printing and the reality of inflation, Tim Congdon, **15 April 2020**

"What is wrong with the supposed 'magic money tree'? The trouble is this. When new money is fabricated 'out of thin air' by money printing or the electronic addition of balance sheet entries, the value of that money is not necessarily given for all time. The laws of economics are just as unforgiving as the laws of physics. If too much money is created, the real value of a unit of money goes down ... The Federal Reserve's preparedness to finance the coronavirus-related spending may prove suicidal to its long-term reputation as an inflation fighter ... If too much money is manufactured on banks' balance sheets, a big rise in inflation should be expected."

How long will the bad inflation news last?, Tim Congdon, **9 June 2021**

"Further, [Jay Powell's] research staff have evidently failed to explain to him that a monetary explanation of national income and the price level – in which inflation is determined mostly by the excess of money growth over the increase in real output – has a long and distinguished pedigree in macroeconomics."

Central banks, including our own Reserve Bank, thought inflation would be minor and transitory, and Governor Philip Lowe's relaxed statements about no rises in cash rates until 2024 are now part of financial markets folklore.

Congdon has recorded a new video, and below is an edited transcript with my bolded emphasis. Showing how the world again ignores his pleas, this video has been viewed only 1,500 times on YouTube. Influencers receive more than that for boiling an egg or fitting a door. In case readers do not make it to the final sentence, here is Congdon's scathing conclusion.

"I want just simply to warn you that this so-called profession of economics is a disgrace. What's happened in the last two or three years is shocking. The increase in inflation is the result of excessive money growth that was due to the things done by governments and central banks in spring and summer of 2020 above all. All these other theories about corporate greed, and profiteering, and the need for immigration are a lot of rubbish."

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Tim Congdon: It's the start of 2023 and people are interested in forecasts for the year. So, what I want to do is to explain some of the implications of developments in money growth and banking systems for the macroeconomic prospect. I'll also say a few things about the analytical basis of the whole exercise. I'll finish by pointing out four incorrect approaches to inflation, also say one or two things about Paul Krugman's commentary on the world.

Share of world output, %

Figures are for 2021 and are sourced from World Bank	On basis of current prices & exchange rates	On basis of purchasing power parity
USA	24.2	15.7
China	18.4	18.6
Eurozone	15.1	11.9
Japan	5.1	3.7
India	3.3	6.9
UK	3.2	2.3

So, we're talking about where the world economy is going in 2023. Let's look at the relative importance of the main economies.

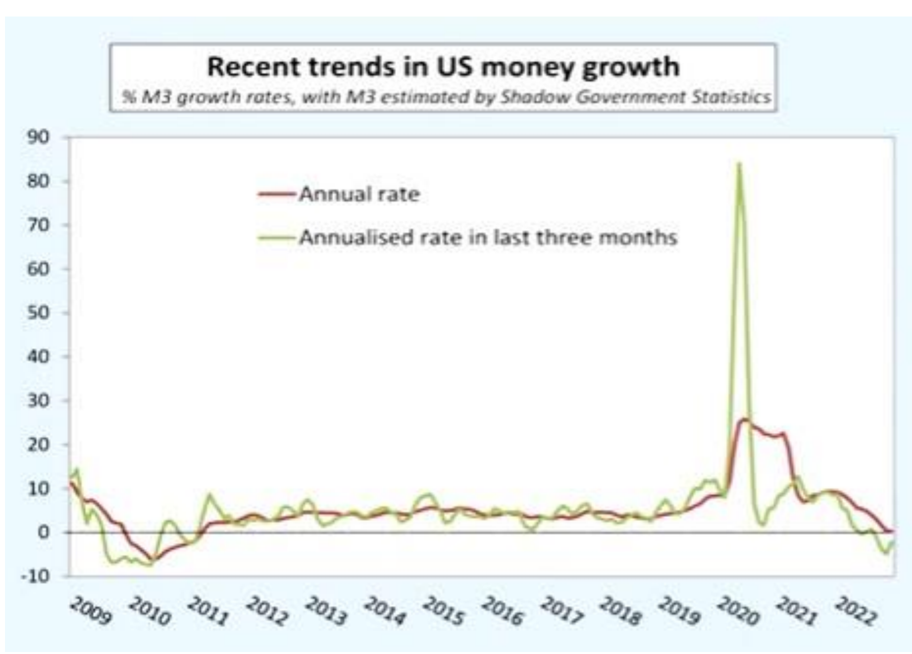
You can see that the United States and China have the world's two largest economies. The relative importance depends on the way in which we assess the size of the economy. And you can see that both of these economies are very important to the world outlook. The Eurozone by itself is quite a bit less important than either China or the USA. Japan comes next, and then I've also included India and the U.K. The U.K. is now relatively

unimportant compared with the rest of the world, of course. India has overtaken the U.K. in terms of GDP in current prices and exchange rates and in terms of purchasing power parity is really quite important.

What does the Institute add to the various pieces of commentary that you see around? **We add the monetary perspective.** We've argued over the years that money is basic to the inflation prospect. The key lines of analyses in all this are, first of all, that over the medium term, **the growth rates of money and nominal GDP are similar**. By money, I always mean a broadly-defined measure of money which is dominated by bank deposits, so behavior of the banking system is crucial. The increase in nominal GDP in turn is split between the increase in real output and the increase in prices. So, **the behavior of money gives us insight into the future behavior of inflation.** That's the key analytical framework that I use.

Money growth in major countries

We'll start off with the United States.



You can see here the extraordinary rapid growth of money in 2020. The Institute warned straight away in spring 2020 that this would lead to inflation. We have been correct about that. The analytical framework in that sense has been vindicated. Now, what's happening at the moment is quite the opposite of that. In fact, towards the end of last year, the quantity of money actually fell in the USA, and with inflation at much higher rates than the rate of money growth, real money balances, money balances adjusted for inflation actually went down very sharply, which is a **classic leading indicator of recession**.

Now we have had weak asset prices in the USA, but we haven't really had any real sign of beneath trend growth of demand and output as yet except, say, in the housing market. All the same, I would insist that the prospect in the USA in the middle and towards the end of 2023 is for **beneath trend growth**.

China is not like the other countries in this discussion. The rate of growth of money was rising through 2022, maybe just coming off the boil in the latest month, but that's just a wobble as yet. The rate of money growth in China was rising through 2022. I've just shown that China has got the world's largest economy, roughly speaking, with the USA. It's a very big importer, larger exporter than the USA. And this therefore has got quite important implications to world economy.

There have also been astonishing announcements about future policy from China in the last few weeks, which almost amount to a complete reversal of what was going on for most of Xi Jinping's period as the leader of China. We're just speculating about what they really mean, but they seem to indicate a move back towards opening up the economy towards more friendship with the West. But I think a fair verdict is that **China will actually have above-trend growth in 2023**. Trend growth may have fallen sharply down to, say, 3% or 4% a year, not like the old 10% plus we had in the hyper-growth period for China. But Chinese developments will be positive for world economy in 2023, unlike what's going on in the main Western economies, which are struggling with inflation.

The story for the Eurozone and the U.K. is that they too had these bursts of rapid money growth in 2020, policy response to COVID. And then, there's been this fall away, but it's less marked in the Eurozone and the U.K. than in the United States. I think the message is that the Eurozone and the U.K. will both have recessions in 2023, and probably they will make less progress on inflation in 2024.

(in the video, Congdon also discusses Japan and India at about the 9 minute mark but for this audience, we will remove the text).

So, let's just try and bring that together. I think we're talking about falling output, of weak demand in most of the big Western economies – USA, Eurozone and Japan, and the U.K. By contrast, in the big Asian economies, and indeed much of the rest of Asia, the continent that really matters to the world economy, the prospect is actually for resilient and possibly even above-trend growth in demand and output.

So, for the world as a whole, **I would expect output to carry on growing in 2023 despite the weaknesses in the western economies**, inflation coming down generally. And in 2024, it's quite conceivable, **given the severity of the current monetary contraction in the USA, that there will be inflation back towards the 2% figure**. I think the message is a little bit more cautious on that front in the Eurozone and the UK.

Well, this is all inside a framework in which money drives nominal GDP. And because real output in the end is driven by other things such as technology, demographics and so on, the excess of money growth over output determines inflation. It's all within the context of the monetary theory of inflation. **In my view, the evidence for that theory is overwhelming**, both in the recent past and over many decades of experience when we have the good data to establish these facts.

Other theories on the cause of inflation

However, in commentary on the last two or three years of this rather shocking inflation episode, there have been a number of other theories going around.

The **first** one is that inflation is caused by social conflict. It's the idea that trade unions demand higher wages that pushes up costs and that pushes up inflation. And so, social conflict is the source of the trouble. Some statement on these lines has been made in the last few weeks by Olivier Blanchard who used to be chief economist at International Monetary Fund.

"Inflation is fundamentally that the outcome of the distributional conflict between firms, workers and taxpayers. It stops only when the various players are forced to accept the outcome."

No reference to money there. And in fact, you might think that inflation is really a matter for sociologists, not economists. But there we are.

Second, there's a similar point of view, just a little bit different, which argues that corporate greed is the cause of inflation. In other words, companies push up prices to widen their profit margins, and this then leads to wider process of inflation. This sort of view has been stated in the last year or two in the United States of America by, for example, a chap called Robert Reich who used to be the US Labor Secretary, and he said that the inflation is caused by this profiteering, price gouging, and indeed, that it should be really countered by prices and incomes policies. There's even been a bit of a debate between President Biden and Jeff Bezos. So, there's those theories that need to be looked at – social conflict, corporate greed.

There's then a **third** point of view that rising wages are the trouble. It reflects what's happening in the labor market, there's shortages of workers. So, the answer is more immigration. And this proposal has been made in a recent article in the Foreign Affairs Journal by two authors called Gordon Hanson and Matthew Slaughter.

And then, the **last** theory I want to review is this idea that the reason that the world had low inflation in the 1990s and then again in the 2010s was because of so-called China effect, that globalization meant that cheap imports were coming in from China, in particular, other countries as well, and this is holding down the price level and leading to low inflation. More generally, that globalization was the key to the explanation of low inflation and decolonization will cause rising inflation.

So, those are the theories that I want to review in future videos. **I regard all of them as wrong, all of them as dangerous. The correct theory is the monetary theory.**

Clear warnings were ignored

Let me finish by saying that it's really been quite a battle with these ideas for the last two or three years, I'd say, for a longer period, and I really must protest about the kind of thing that's being said about monetary analysis.

At the start of this process of the current inflation episode back in March-April 2020, **I gave very clear warnings that rapid money growth would lead to inflation.** There were many other economists at the time who said nothing of the sort, and one of them was Olivier Blanchard, the former Chief Economist at the International Monetary Fund. And let me just quote to you what he said in in April 2020 (sourced in the video).

"This column argues that it's hard to see strong demand leading to inflation. The challenge for monetary and fiscal policy is thus likely to be to sustain demand and to avoid deflation rather than the reverse."

He was utterly wrong. Now, to give Blanchard and people like Larry Summers and so on their due, they were then indeed a year or 18 months later saying that there was going to be an inflation problem, but not because of rapid monetary growth, by the way.

But they were battling with a chap called Paul Krugman, the world's most influential economist, a writer on the New York Times, who led something called Team Transitory, that inflation is going to be transitory. This kind of thing that was also spouted by most of the main central banks. In one sense, although they were 18 months late, Blanchard and Summers were right, but let's just be clear that they had been totally wrong at the start of 2020.

We then get Krugman in a column just a few weeks ago saying that Blanchard had basically been right. He hadn't been. Here's Krugman on Blanchard, this is a column of The Football Game Theory of Inflation, January 3rd (The New York Times):

"Several prominent economists carried on a thoughtful, earnest online debate about inflation over the past weekend. The discussion was kicked off by Olivier Blanchard, the former chief economist of the International Monetary Fund (a towering figure in the profession, who happens to be one of the economists who has gotten recent inflation more or less right)."

I've just shown you, he was completely wrong. In May 2021, people were rethinking this matter, not really because of money growth and money trends and the kind of thing I was saying, but just simply because of what was happening to commodity prices, wages and the economy.

And this is how Paul Krugman characterised me and other people. He said we were cockroaches (NYT 13 May 2021). He said:

"And lately I've been noticing an infestation of monetary cockroaches. In particular, I'm hearing a lot of buzz around how the Fed's wanton abuse of its power to create money will soon lead to runaway inflation."

Look, even by then, it was clear money growth was slowing down a bit, there wouldn't be runaway inflation, but there would be a serious inflation episode and I said so.

Anyway, I'll finish there. I want to warn you that this so-called profession of economist is a disgrace. What's happened in the last two or three years is shocking. The increase in inflation is the result of excessive money growth that was due to the things done by governments and central banks in spring and summer of 2020 above all. All these other theories about corporate greed, and profiteering, and the need for immigration are a lot of rubbish.

This is an edited transcript of the video: IIMR January 2023 video: 'Money trends and the global macro outlook at the start of 2023'. T Congdon.

Professor Tim Congdon, CBE, is Chairman of the Institute of International Monetary Research at the University of Buckingham, England. Professor Congdon is often regarded as the UK's leading exponent of the quantity theory of money (or 'monetarism'). He served as an adviser to the Conservative Government between 1992 and 1997 as a member of the Treasury Panel of Independent Forecasters. He has also authored many books and academic articles on monetarism.

This article is general infomration and does not consider the circumstances of any investor.

Six charts on how Australians invested in 2022 and why

Graham Hand

Investment analysts follow the flow of funds into different assets or structures as a guide to investor behaviour, and a potential signal on the direction of markets. Strong inflows into equity funds might show buying confidence and optimism that prices will rise further. The inflows may generate additional investments. The same arguments are made in reverse for outflows.

However, flows do not always lead markets in the same direction, such as when strong and rising markets are perceived as overvalued, or when funds are forced to rebalance out of the strongest sector if its rise has pushed an allocation above a threshold level. Investors may be required to sell the winners.

Four recent Australian reports provide insights into different aspects of investor behaviour.

1. Calastone on managed funds flows
2. Plan for Life on platform and wrap flows
3. Morningstar on ETF flows, returns and balances
4. Investment Trends client flows reported by advisers

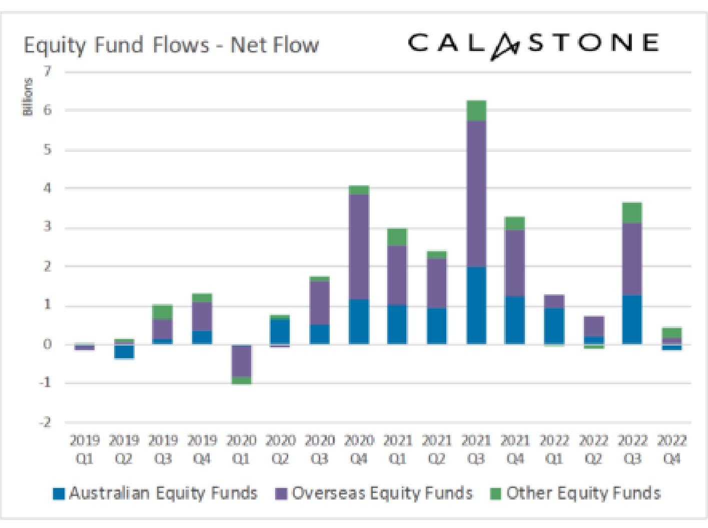
1. Calastone on Australian managed funds

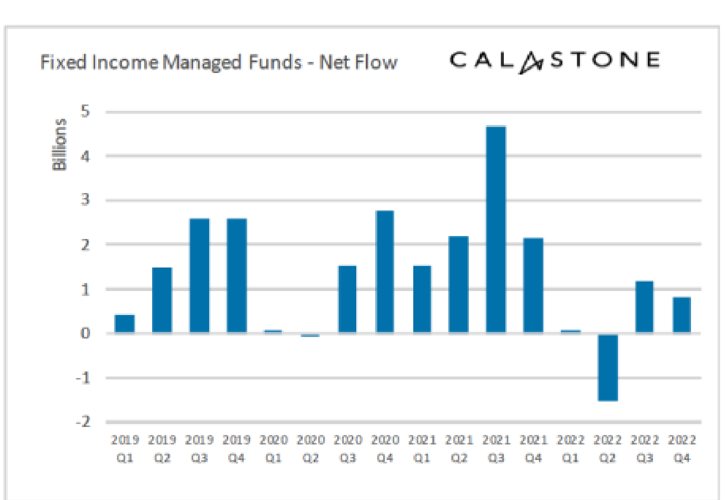
The headlines for Australia are that uncertainty caused by inflation and higher interest rates reduced inflows into all asset classes in 2022 versus prior years. Fixed income fund inflows shrank 95% and equity fund inflows fell by about 60% in 2022 versus 2021. Active equity fund inflows fell an even higher 74%, and Q4 saw the first outflows from domestic equity funds since the onset of pandemic. Calastone, which sees over 95% of Australian managed fund flows across its network, reports:

"2022 saw investors add far less cash to their managed equity funds – down 62% to A$5.74bn, though this decline was from the exceptionally high level seen in 2021. The drop in the net inflow was driven much more by a dearth of buyers (orders fell by 15%) than an increase in selling (orders rose only 7%) ... the large decline in the net inflow indicates much greater uncertainty in 2022 among investors over the likely direction of equity markets.

The third quarter accounted for almost two thirds of the year's net inflow as Australians bought heavily into the bear market rally in July … they became much more negative and net inflows fell to just A$296m in Q4 in consequence … In October and December investors were net sellers of equities."

Net fund flows across selected equity categories, all AU domiciled





Investors allocated heavily into fixed income funds until the end of 2021 when interest rates were low, then redeemed in Q2 2022 on the back of capital losses. This was not good timing as rates rose over the first half of 2022. By October 2022, sentiment had improved again, and investors added $824m to their bond holdings in the fourth quarter. Over the full year, net inflows to fixed income funds were down from $10.5 billion in 2021 to only $562 million in 2022.

Calastone concluded for the end of 2022:

"Indeed, the much greater loss of confidence in equity funds in the fourth quarter compared to fixed income suggests investors are looking at bond funds as a relative safe haven. Q4 was the first time since Q1 2020 that fixed income funds have attracted more cash than equities."

2. Plan for Life on platforms in Australia

Plan for Life collects data on funds held in wraps, platforms and master trusts based on balances rather than flows. As the Calastone data showed, 2022 was a more difficult year compared with 2021 with wraps down 3.6% to $518 billion but platforms and master trusts both fell more.

Notably, Plan for Life data is not itemised by asset class but by the name of the provider, and at the top is Insignia, the new brand for IOOF which bought the MLC business to catapult it to the pinnacle. Familiar names such as BT, AMP, Commonwealth and Macquarie follow, but the big gainers over recent years are the newer wraps, netwealth, HUB24 and Praemium. While the other businesses have seen declining FUM, these 'managed account' platforms are grabbing market share.

With the strong media and investor focus on Exchange Traded Funds (ETFs) and Listed Investment Companies (LICs), it is easy to think that these platform products are less relevant. However, with $920 billion in balances, they dwarf ETFs at about $135 billion and LICs around $48 billion as at 31 December 2022.

Funds Under Management – Total Masterfunds Administrator View

$millions	Sep 22		Sep 21		Sep 20		Annual Growth
Insignia Financial	189,750	20.6%	208,752	21.0%	72,581	8.7%	-9.1%
BT Financial Group	156,866	17.0%	178,169	17.9%	151,321	18.1%	-12.0%
AMP Group	130,777	14.2%	145,745	14.6%	132,902	15.9%	-10.3%
Commonwealth / Colonial Group	129,662	14.1%	144,251	14.5%	126,011	15.1%	-10.1%
Macquarie Group	110,185	12.0%	115,005	11.6%	87,988	10.5%	-4.2%
netwealth	58,103	6.3%	51,959	5.2%	34,023	4.1%	11.8%
HUB24	52,444	5.7%	45,364	4.6%	19,015	2.3%	15.6%
Mercer	27,140	2.9%	29,296	2.9%	24,520	2.9%	-7.4%
Praemium	19,981	2.2%	19,927	2.0%	15,005	1.8%	0.3%
Others	46,724	5.0%	56,941	5.7%	171,062	20.5%	-17.9%
Totals	**921,634**	**100.0%**	**995,408**	**100.0%**	**834,428**	**100.0%**	**-7.4%**

Analysis By Market

Wrap	518,648	56.3%	538,101	54.1%	417,605	50.0%	-3.6%
Platform	327,937	35.6%	361,714	36.3%	333,096	39.9%	-9.3%
Master Trust	75,049	8.1%	95,594	9.6%	83,727	10.0%	-21.5%
Totals	**921,634**	**100.0%**	**995,408**	**100.0%**	**834,428**	**100.0%**	**-7.4%**

Source: Plan for Life

3. Morningstar Australian ETF Report

Morningstar recently started producing a comprehensive ETF report showing:

- Exhibit 1 (Page 2) consists of static information - inception date, the ASX code, a strategic beta flag, and fees. It includes net assets (funds under management as of 31 December 2022, where available), net flows (sum of net monthly flows over 12 and 36 months, where available), and the live Morningstar Analyst Rating at quarter end.
- Exhibit 2 (Page 9) consists of the performance as measured by trailing returns over varying time periods, the average monthly premium/discount over the past quarter, and portfolio statistics (where available) like total number of holdings and % exposure of the fund in the top 10 holdings.

This quarterly report will be published in the Firstlinks' Education Centre as it is updated. It is an excellent resource to see not only performance, but funds flows and total balances.

The broad category Australian-domiciled ETF flows for 2022 were:

Broad Category	Inflows ($m) – Dec 2022
Fixed Income	596.9
Cash	334.5
International Equities	139.5
Listed Property	31.4
Multi-Asset	24.2

Broad Category	Outflows ($m) – Dec 2022
Short	27.9
Commodities	24.5
Currency	3.7
Australian Equities	2.3

Some highlights in the December 2022 Report:

- The vast range of fees. Passive or index ETFs are relatively cheap and, in some cases, almost free, but active ETFs are usually no cheaper than their managed fund equivalents. Investors should not think that ETFs equal low management fees.

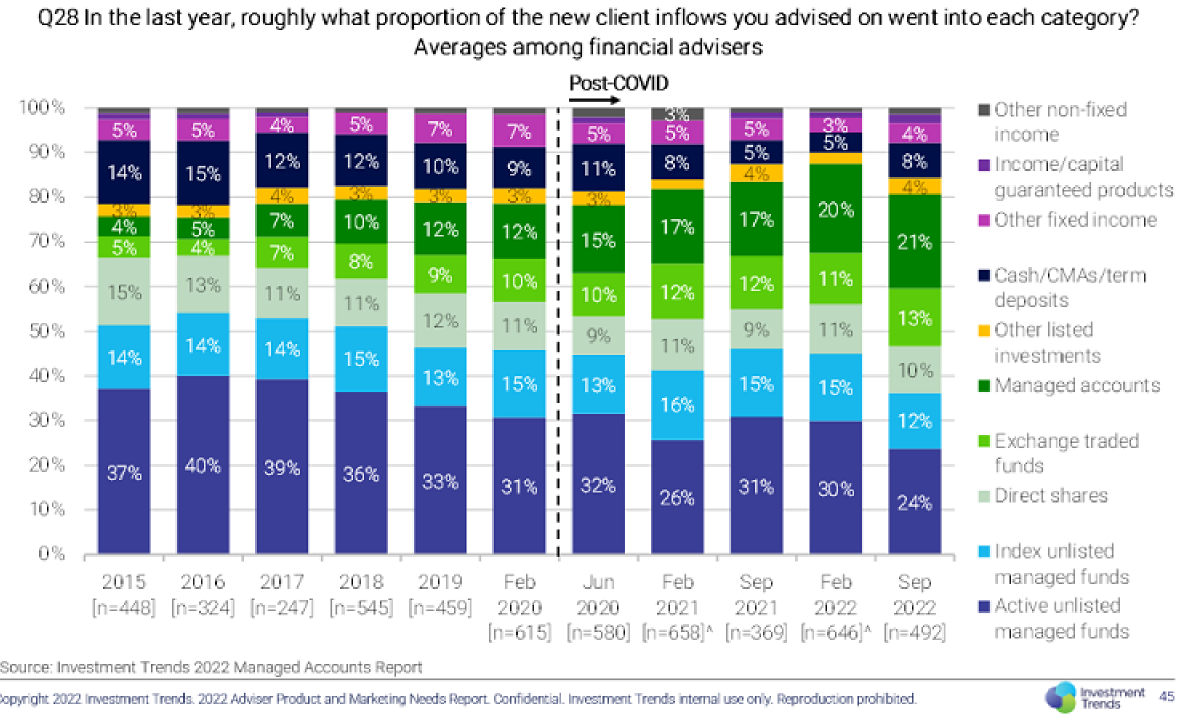
- The largest ETFs in Australia as at 31 December 2022 were:

ASX Code	ETF name	Market value ($bn)	1-year return (%)	1-year flow ($m)
VAS	Vanguard Australian Shares Index ETF	11.8	-1.78	2,086.8
MGOC	Magellan Global Fund (Open Class) (Mgd Fund)	7.5	-15.75	-4,133.7
VGS	Vanguard MSCI Index International Shares ETF	5.0	-12.47	938.6
IVV	iShares S&P 500 ETF	4.8	-12.45	-60.5
STW	SPDR S&P/ASX 200	4.6	-1.16	-10.6
IOZ	iShares Core S&P/ASX 200 ETF	3.6	-1.07	-1,190.7
QUAL	VanEck Vectors MSCI World Ex-Aust Quality ETF	3.0	-17.10	642.8
VTS	Vanguard US Total Market Shares Index ETF	2.9	-13.87	154.2
AAA	Betashares Australian High Interest Cash ETF	2.7	1.40	50.1
VHY	Vanguard Australian Shares High Yield ETF	2.6	8.60	452.0

- Reflecting a year of extremes, there is a remarkable range of 1-year performance across the 319 ETFs offered on the ASX and Cboe exchanges. Highs include Global X Ultra Short Nasdaq 100 Hedge Fund (ASX:SNAS) at +79.5%, Betashares US Equities Strong Bear Hedged (ASX:BBUS) +45% and Betashares Global Energy Companies (ASX:FUEL) +40.2%. The lows include Betashares Crypto (ASX:CRYP) -81.2%, Global X Ultra Long Nasdaq (ASX:LNAS) -69.9%, Montaka Global (ASX:MKAX) -48.2% and Betashares Geared US Equities (ASX:GGUS) -47%. There was even a bond fund, the Betashares Global Gov Bond 20+ year (ASX:GGOV) that lost 31.3%. If buying last year's losers and selling previous winners is a strategy, there is plenty of choice.

4. Investment Trends on client inflows

Investment Trends regularly surveys financial advisers on their client flows, and the chart below shows advisers are major supporters of unlisted managed funds, although significantly less in 2022 (36%) than prior years (51% in 2015 and 45% in 2021). Categories which are gaining are managed accounts and ETFs.



Next week, we will focus specifically on changes in SMSFs.

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

Yes, 'millionaires' can qualify for the Age Pension

Kaye Fallick

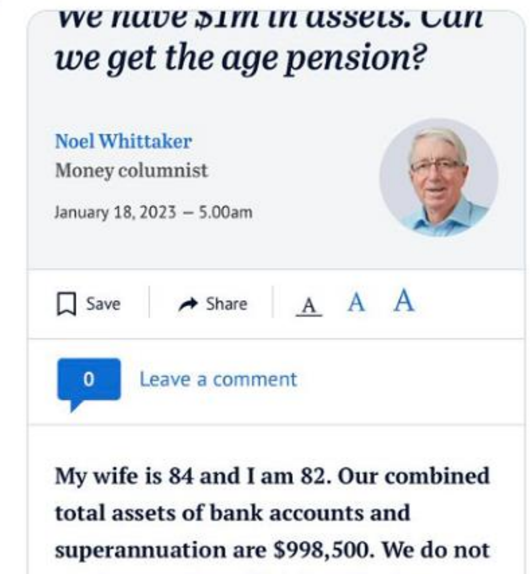
It must have been a slow news day on Thursday 19 January 2023. Or yet another case of our major news outlets taking a pot-shot at each other. Here's what happened.

One major publisher (*Nine*) ran a Q&A with *Money* commentator Noel Whittaker answering a question from a couple (homeowners) with $998,500 in assets. The 82-year-old male wanted to know if he would receive an Age Pension.

The question was answered in a matter-of-fact way; the assets could be reduced but any part pension would hardly be worth the effort.

News Corp journalist, Samantha Maiden then picked up and retweeted the exchange.

An article was then created by Alexis Carey on News.com, mainly consisting of cutting and pasting Twitter responses, with the headline, ['Entitled': 82-year-old millionaire's outrageous pension request mocked by furious Australians]().



Anyone who understands the rules of the Age Pension would be bemused, if not disheartened, by the angle of the News.com article as well as the polarising language attached to this discussion of entitlement.

Let's allow some facts to get in the way of this good story.

The assets threshold for a homeowning couple is $935,000, so this couple is close to the threshold for Age Pension eligibility. If they did not own their home, they would come in well under the non-homeowner couples' threshold of $1,159,500. As things stand, they are likely to qualify for the recently expanded Commonwealth Seniors Health Card, regardless of homeownership or not.

Age Pension thresholds have been in place for many, many years. They increase marginally when indexation is applied, to keep them relevant to prices in the wider world. To put it plainly, this is not news. This information is in the public domain. People with nearly one million dollars can qualify for an Age Pension because that's how our system works.

So why draw attention to this silly exchange? Why not just let it sink without trace? Because equity in retirement matters.

A nuanced debate is overdue

And in amongst all this hot air and indignation, there is a much more nuanced debate begging to be heard. At the core of the debate is the question of whether our Age Pension is still fit for purpose.

We may be under the impression that pension rules are undergoing continuous review and improvement, largely due to widely reported twice yearly indexation and various scheduled July 1 changes. But the vast bulk of the changes associated with the Age Pension are those of degree, not design; tweaks to rates and thresholds to keep the pension in touch with the real world. Whilst many changes are occurring in superannuation, substantial changes to the Age Pension have been rare since it was first introduced at the beginning of the last century.

So it is high time we had another look at this major pillar of retirement income for nearly four million older Australians.

Questions need to be asked:

- What do we expect from our Age Pension?
- What is it designed to achieve?
- How much does it cost (particularly in relation to super concessions)?
- Has the growth of the superannuation industry supplanted some of its core purpose or key features?
- What of its delivery via Centrelink? Is this functioning reasonably or poorly?
- What of systemic complexity, particularly the mix of rules linking the Age Pension and superannuation?

There have been significant changes in Australian society since it was first introduced, not the least of which is enhanced longevity, with most Australians expected to live into their late 80s and some beyond.

But suggesting revisions to the income of most older voters presents a political minefield. Just ask Bill Shorten! Everyone has a view, ranging from:
I've paid taxes all my life so an Age Pension is my entitlement, regardless of how many assets I have.
to:
I have no savings, so it's my lifeline.

Somewhere in the middle of these two extremes could be some more reasonable iterations of our current pension system. But where? And how will we ever uncover them if we don't question this fundamental source of income for so many?

Starting points for change

Already we can find some common ground – increasingly industry leaders and policy experts are calling for a $5 million cap on superannuation balances. And whilst politically contentious, the blanket family home exemption could also be worth a reset.

With significantly improved household equity access products, including the government's own scheme, it's also reasonable to review exactly how we might view the family home, associated debt and ways this equity could better complement Age Pension entitlements.

Not another enquiry, I hear you sigh. Well, not necessarily. The *Retirement Income Review* report in June 2020 has already assessed some aspects of the Age Pension pillar of retirement income, in particular equity, access and sustainability. It's an important start and this work could easily provide a foundation for a more forensic investigation of what we hope our Age Pension will deliver and to whom.

So, thanks Samantha Maiden for tweeting the opposition newspaper's content. The subsequent article may have been superficial, but the issue is very real.

Kaye Fallick is Founder of STAYINGconnected website and SuperConnected enews. She has been a commentator on retirement income and ageing demographics since 1999. This article is general information and does not consider the circumstances of any person.

Covid has changed our retirement plans

Jonathan Shead

Since 2018, State Street Global Advisors has compiled the Global Retirement Reality Report, which includes results for Australia.

The global context for the 2022 report is familiar territory. The last two years has seen the return of three of humanity's great scourges; war, disease and, yes, inflation. Much of what we observe in the Australian results reflect this environment. However, Australia has experienced significant changes in its retirement system which have also influenced the survey outcomes. Notable among these are the Your Future Your Super (YFYS) reforms, aggressive superannuation fund consolidation, the launch of the Retirement Income Covenant and upheaval in the financial advice sector.

Finding #1: Income and age are more important than the passage of time for retirement confidence

The interaction of the Age Pension, Superannuation and Healthcare makes the Australian system particularly complex. Yet 59% of Australian respondents, when asked who had primary responsibility for making sure they had an adequate income in retirement, answered with a simple "Me".

Against this backdrop around 40% of Australian respondents have little confidence in preparedness for, or timing of, their retirement. The proportion has changed little from 2018 to 2022 despite system changes. Dig a little deeper into the 2022 results, and this lack of confidence is particularly evident among those on lower incomes and those closest to retirement. There is clearly still work to be done by both industry and government in simplifying, explaining and confidence building for our national retirement system. Australia is not alone here of course, with a lack of optimism particularly prevalent in the UK.

Figure 1: Not Optimistic About...

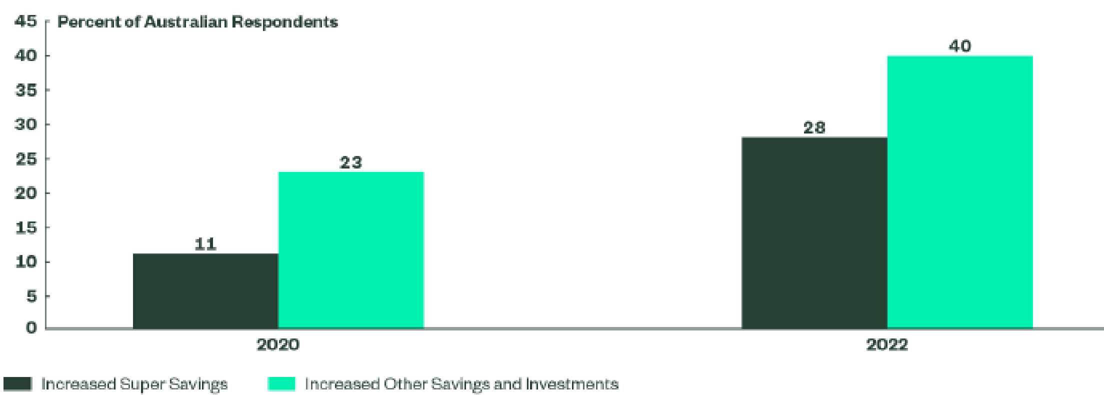
Source: State Street Global Advisors. GR3 surveys of Australian savers (n=800 between 8 February 2018 and 3 April 2018; n=504 between 4 May 2020 and 20 May 2020, and n=618 between 20 July 2022 and 22 August 2022).

Finding #2: The last two years of turmoil have changed financial plans in Australia

With turnover in the workforce and changing patterns of work in several industries, we asked respondents whether they have changed their thinking on when, and how, they might retire. Australia stands out in our

global comparison with 34% of respondents indicating a changed outlook compared to 25% in the sample from US, UK and Ireland. At the same time, more Australians reported a short-term increase in savings both within superannuation and in other savings and investments, than others surveyed. In 2020 we saw a muted, but still noticeable savings response to COVID, however in 2022 the increased rate of short-term saving was more pronounced.

Figure 2: Australians Increased Their Savings



Source: State Street Global Advisors. GR3 surveys of Australian savers (n=504 between 4 May 2020 and 20 May 2020, and n=618 between 20 July 2022 and 22 August 2022).

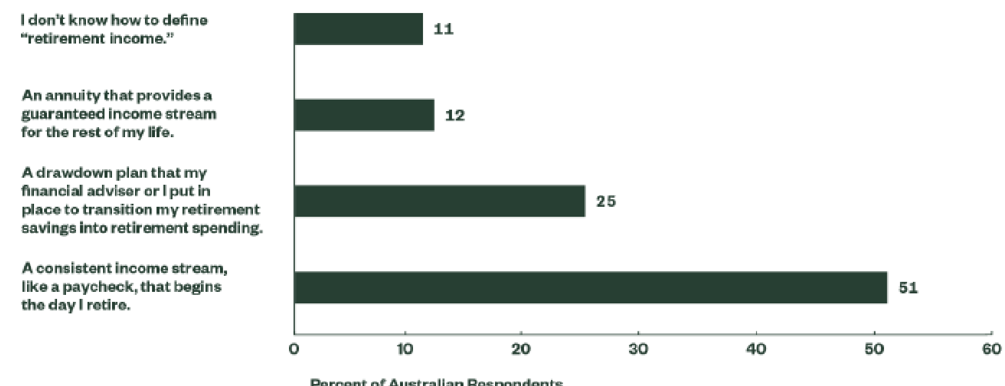
The last two years has brought one particular concern to the forefront for our respondents. Inflation topped the list of factors that most negatively affected retirement confidence in the survey, both for Australia (65% included it in their top 3) and the rest of the world (70%). With an emerging economic slowdown and rising interest rates, respondents were also concerned about mortgage or rent costs (35% in Australia), and about being able to continue to find spare funds for retirement (29%).

Finding #3: Retirement income is messy, but Australia is at least starting in the right place

How to make the shift from "accumulation" to "decumulation" is one of the more vexing problems facing policy makers and the superannuation industry. The industry is still grappling with exactly what the new Retirement Income Covenant does, and doesn't, require. However, the three principles encapsulated in the Covenant are broadly supported by the survey findings: maximising expected retirement income, managing expected risks to the sustainability and stability of retirement income, and having flexible access to funds.

Interestingly, while many in the industry think of "retirement income" primarily as a drawdown of superannuation assets, only 25% of Australian respondents selected this definition. Rather, 51% of the Australian survey respondents preferred a simpler and more direct definition, "a consistent income stream, like a paycheck, that begins the day I retire". The definition suggests a need for stability and certainty, and for both superannuation and the Age Pension to be captured.

Figure 3: Australians Understanding of "Retirement Income"



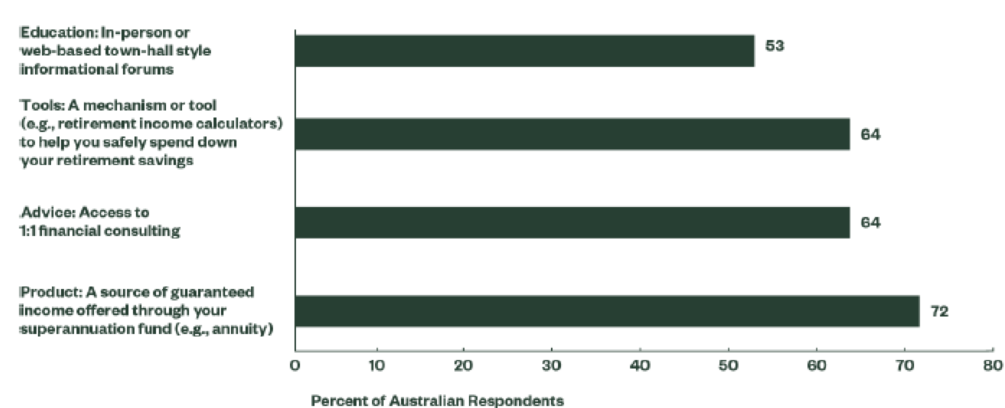
Source: State Street Global Advisors. GR3 2022 survey of 618 Australian savers between 20 July 2022, and 22 August 2022.

Yet, in the mind of our respondents, stability and certainty should not be at the expense of flexibility. Given stylised retirement product choices, the winner was a retirement product that provided flexible access to savings in the early years followed by stable income in later years.

Of relevance to nascent superannuation Retirement Income strategies, is the early retirement years where budgeting is of most concern to respondents. Only 21% of Australian respondents were more concerned about budgeting for later years. This could reflect the backstop of the Age Pension as well as a behavioural "present bias". However, it could equally reflect an expectation that successful management of finances in the early retirement years is a prerequisite to financial soundness in later years. When we asked Australian respondents for their biggest concern when planning their retirement finances, 31% selected "outliving savings". As a side note, only 8% identified "Not leaving a bequest" as their biggest financial planning concern, which may be a welcome finding for policy makers.

A final note on the survey responses and Retirement Income strategies. Consistent with the legislation, many published strategies include a mix of products, tools and calculators, educational information, and advice. When we asked Australian respondents what they would like to see from their fund, several things were noteworthy. Firstly, every choice was selected by at least half our Australian respondents – a general sense of "more is better". Secondly, education was the least popular, which should give pause to those who believe education is a panacea. Advice outranked education. Finally, and perhaps most intriguing of all, the top selection was a good product, described in our survey as have guaranteed income and even using the word "annuity". Granted, 56% of Australian respondents said they weren't exactly sure what an annuity is or how it works, but intriguing nonetheless.

Figure 4: What Would You Like From Your Superannuation Fund?



Source: State Street Global Advisors. GR3 2022 survey of 618 Australian savers between 20 July 2022, and 22 August 2022.

Finding #4: Most Australians would prefer to stay where they are

55% of the Australian respondents would prefer to get their retirement income solution from the superannuation fund that they are already using. This was appreciably higher than the 43% recorded among respondents in other countries and likely reflects at least three features of the Australian industry. Firstly, many funds have been successful building positive brand with their members. Secondly, the industry has continued to invest in retirement solutions – even if the focus to date has tended to be on advice, education, and communication rather than product. And finally, unlike other markets, superannuation funds in Australia are largely independent of the employer, and so retirement is not a natural trigger for leaving a fund.

Finding #5: Sustainability matters to retirees

Think what you may about sustainability, but it certainly matters to respondents in our survey, and Australians recorded even stronger responses than their global peers. While 52% of respondents outside Australia expected sustainability to "happen as standard on my behalf", the survey showed a 65% response rate for Australians. There were four exclusion categories that each attracted more than 50% of Australian respondents: tobacco, controversial weapons, gambling, and violators of international norms (human rights etc).

Finding #6: Fee pressure is not going to abate any time soon

Debate continues to rage within the industry over passive versus active management, including the role and impact of fees on investor outcomes. The YFYS performance test may have made the debate more visible and consequential, but it certainly didn't create it.

Maximising returns is the dominant priority among global as well as Australian respondents, while risk management (expressed as short-term loss) is a lower priority across the globe. However, minimising costs appeared as a stronger priority in Australia than the rest of survey, where it was a clear second to maximising returns. Over 20% of Australian respondents had it as their top priority.

Figure 5: Top Priorities for Australian Respondents

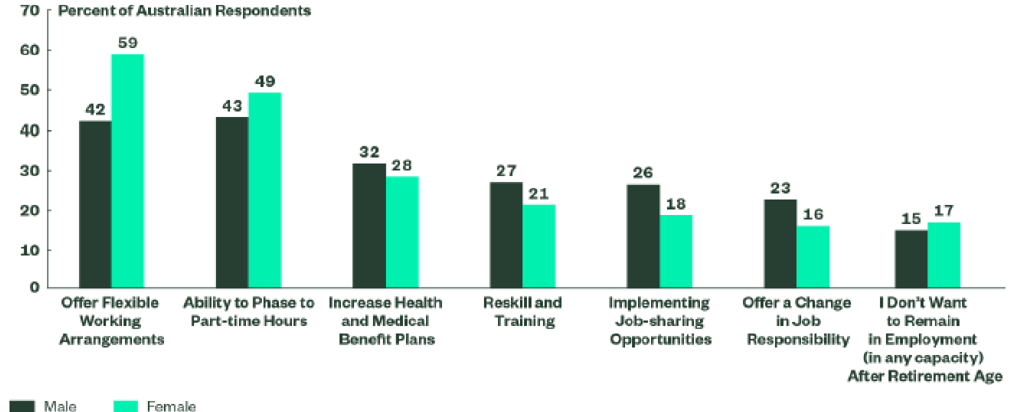
Priority	Percent of Australian Respondents
Sustainable investing (also known as environmental, social and governance or ESG investing)	26
Risk management, i.e., limiting short term losses	26
Having an investment strategy that is managed by experts so that I don't need to do anything	39
Minimising cost and/or low fees charged	49
Maximising returns	60

Source: State Street Global Advisors. GR3 2022 survey of 618 Australian savers between 20 July 2022, and 22 August 2022.

Finding #7: Gender matters in superannuation

Along with others, the Australian Human Rights Commission has called out the gender gap in superannuation savings, largely because superannuation is linked to paid work and women are more likely to move in and out of the workforce to care for family members. Consistent with this, the Australian survey results suggest that flexible working arrangements are much more important for women than men as retirement approaches.

Figure 6: What Support Would Enable You to Remain Longer in the Workplace?



Source: State Street Global Advisors. GR3 2022 survey of 618 Australian savers between 20 July 2022, and 22 August 2022.

Women are far less optimistic they will be financially prepared for retirement (18% vs. 38% for men) and are less confident that they will be able to retire when they want to (17% for women vs. 38% for men).

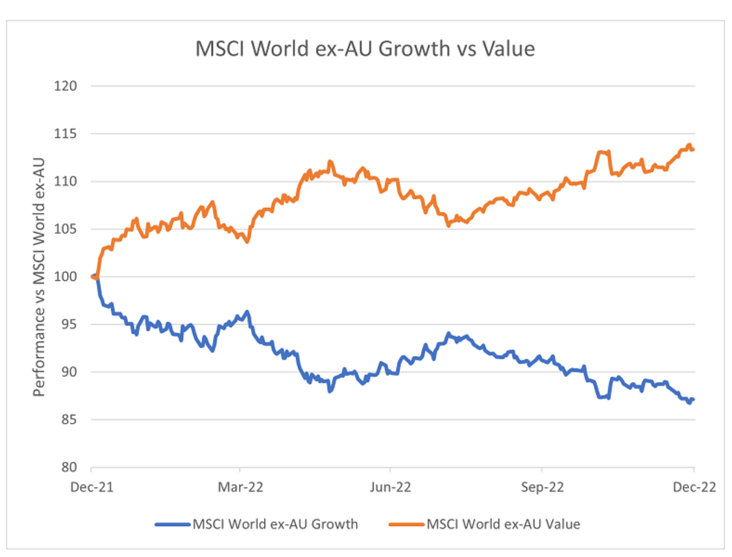
Jonathan Shead is Head of Investments, Australia at State Street Global Advisors. The views expressed in this article are the views of the author as of 30 December 2022 and are subject to change based on market and other conditions. The information provided does not constitute investment advice and it should not be relied on as such. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon.

3 fortress growth stocks for volatile times

Francyne Mu

The economist and speculator John Maynard Keynes once famously quipped that "markets can stay irrational longer than you can stay solvent". This same principle can hold true for companies just as it does for speculators. Today, inflation and its resulting capital market dynamics have created a less forgiving funding environment and one result has been a violent sell-off of growth stocks.

Yet not all growth stocks require access to capital, and we believe that the market has erred by shunning growth companies indiscriminately. There are growing businesses that enjoy strong free cash flow and robust balance sheets, including three US-listed large-cap companies outlined below.



Source: Franklin Templeton, FactSet Data

Tyler Technologies [NYSE:TYL] – Municipal service supports healthy recurring cash flow

Tyler Technologies, (Tyler) is an American company that provides software and technology solutions to the public sector, including local governments, schools, and courts. The company offers a range of products and services spanning financial management, property appraisal, tax assessment, court management, and school administration software.

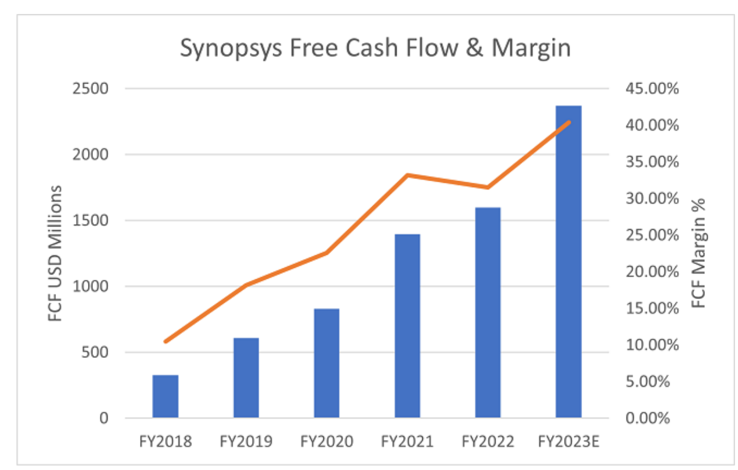
Because its software offerings provide mission critical services, the company has earned a sticky customer base with a high degree of customer lock-in. This allows for strong revenue visibility, with recurring revenues at ~80%, up from ~55% in 2010. The switch from a perpetual license to the much more profitable cloud-based SaaS delivery model has primarily driven this trend.

In addition to strong customer relationships, the company generates strong free cash flow while continuing to innovate within its market. Historical cash flow margins have averaged over 20%. The company has generated cumulative free cash flow of US$1.2 billion over the last 5 years, relative to ~$200 million in capex spend for growth. A debt-light balance sheet further insulates the company from the need to access the capital markets.

We believe Tyler will be able to maintain and even grow its competitive position by leveraging its strong relationships within the public sector channel to take additional share in what is a US$12-15 billion-dollar addressable market. Further stock market turbulence may also create attractive acquisition opportunities.

Synopsys Inc. [NASDAQ:SNPS] – Integrated into the future of computing

Synopsys Inc. provides technology solutions for the design, verification, and manufacturing of electronic systems and components. The company's products and services are used by companies in the semiconductor, computer, and electronic systems industries to design and test their products.



Source: Franklin Templeton, company filings

Decades of accumulated expertise in the development of cutting-edge semiconductor design, and electronic design automation technologies means the company's businesses have both high barriers to entry and high customer switching costs.

The company's strong business model results in robust operating cash flow. Full-year 2022 free-cash-flow margin was over 30% at ~US$1.6 billion. In addition, Synopsys commands a fortress balance sheet with $1.4 billion of cash against only US$600 million of long-term liabilities.

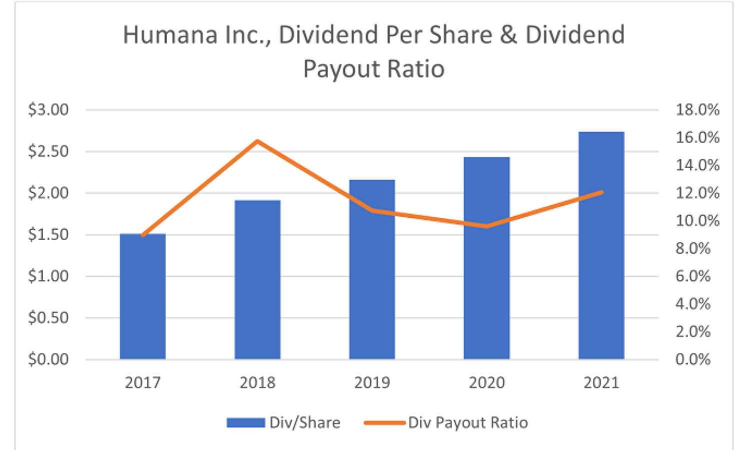
We see the company as positioned to benefit from the increasing growth for connected devices, the internet of things (IOT). And Synopsys can help the semiconductor industry deliver scalable solutions to the rapidly expanding enterprise and consumer demand for Artificial Intelligence (AI) – think ChatGPT – through custom chip designs.

Humana Inc. [NYSE:HUM] – Scaled healthcare delivery

Humana Inc. (Humana) is an American for-profit health insurance company based in Louisville, Kentucky. It is one of the largest health insurance companies in the United States and has operations in all 50 states. The company offers a range of health insurance plans, including Medicare Advantage and Medicaid plans, as well as individual and group health insurance plans. The company also operates health care centres and clinics and has a growing presence in the telehealth market.

We believe Humana has a sustainable competitive advantage in the fast-growing Medicare Advantage market, which caters for an older population cohort. Humana is the second largest Medicare Advantage plan provider, serving over 5 million beneficiaries. It has been growing this business at over 10% since 2017, well ahead of the overall market which itself is poised for continued growth as Medicare eligibility increases.

The company's strong business position has underwritten attractive returns of capital to investors over recent years through a combination of share buybacks and dividends.



Source: Franklin Templeton, company filings

Our analysis indicates that the company's Medicare business will continue to support robust free cash-flow over the medium term. This in combination with its balance sheet which boasts strong cash coverage ratios should hold the company in good stead to weather any future economic turbulence.

Free cash flow and growth can go hand in hand

With high-flying corporate failures dominating the headlines, it can be easy to forget that growth and healthy cash-flows are not mutually exclusive. Our experience as investors has demonstrated that strong business models can and do align with secular growth trends to create profitable businesses which can grow independent of the vicissitudes of capital markets and, to a degree, the economy.

Francyne Mu is a Portfolio Manager, Franklin Equity Group. Franklin Templeton is 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. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

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Why central banks are becoming impotent

Mark Dittli, Russell Napier

This is an edited interview between Russell Napier, a market strategist and historian, and Mark Dittli of themarket.ch

Mark Dittli: In summer of 2020, you predicted that inflation was coming back and that we were looking at a prolonged period of financial repression. What's your assessment today?

Russell Napier: My forecast is unchanged: This is structural in nature, not cyclical. We are experiencing a fundamental shift in the inner workings of most Western economies. In the past four decades, we have become used to the idea that our economies are guided by free markets. But we are in the process of moving to a system where a large part of the allocation of resources is not left to markets anymore.

MD: Why is this shift happening?

RN: The main reason is that our debt levels have simply grown too high. Total private and public sector debt in the US is at 290% of GDP. It's at a whopping 371% in France and above 250% in many other Western economies, including Japan. The Great Recession of 2008 has already made clear to us that this level of debt was way too high.

MD: How so?

RN: Back in 2008, the world economy came to the brink of a deflationary debt liquidation, where the entire system was at risk crashing down. We've known that for years. We can't stand normal, necessary recessions anymore without fearing a collapse of the system. So the level of debt – private and public – to GDP has to come down, and the easiest way to do that is by increasing the growth rate of nominal GDP. That was the way it was done in the decades after World War II.

MD: What has triggered this process now?

RN: My structural argument is that the power to control the creation of money has moved from central banks to governments. By issuing state guarantees on bank credit during the Covid crisis, governments have effectively taken over the levers to control the creation of money. Of course, the pushback to my prediction was that this was only a temporary emergency measure to combat the effects of the pandemic. But now we have another emergency, with the war in Ukraine and the energy crisis that comes with it.

MD: You mean there is always going to be another emergency?

RN: Exactly, which means governments won't retreat from these policies. Just to give you some statistics on bank loans to corporates within the European Union since February 2020: Out of all the new loans in Germany, 40% are guaranteed by the government. In France, it's 70% of all new loans, and in Italy it's over 100%, because they migrate old maturing credit to new, government-guaranteed schemes. Just recently, Germany has come up with a huge new guarantee scheme to cover the effects of the energy crisis.

This is the new normal. For the government, credit guarantees are like the magic money tree: the closest thing to free money. They don't have to issue more government debt, they don't need to raise taxes, they just issue credit guarantees to the commercial banks.

MD: And by controlling the growth of credit, governments gain an easy way to control and steer the economy?

RN: It's easy for them in the way that credit guarantees are only a contingent liability on the balance sheet of the state. By telling banks how and where to grant guaranteed loans, governments can direct investment where they want it to, be it energy, projects aimed at reducing inequality, or general investments to combat climate change. By guiding the growth of credit and therefore the growth of money, they can control the nominal growth of the economy.

MD: And given that nominal growth consists of real growth plus inflation, the easiest way to do this is through higher inflation?

RN: Yes. Engineering a higher nominal GDP growth through a higher structural level of inflation is a proven way to get rid of high levels of debt.

MD: What level of inflation would do the trick?

RN: I think we'll see consumer price inflation settling into a range between 4 and 6%. Without the energy shock, we would probably be there now. Why 4 to 6%? Because it has to be a level that the government can get away with. Financial repression means stealing money from savers and old people slowly. The slow part is

important in order for the pain not to become too apparent. We're already seeing respected economists and central bankers arguing that inflation should indeed be allowed at a higher level than the 2% target they set in the past. Our frame of reference is already shifting up.

MD: Yet at the same time, central banks have turned very hawkish in their fight against inflation. How does that square?

RN: We today have a disconnect between the hawkish rhetoric of central banks and the actions of governments. Monetary policy is trying to hit the brakes hard, while fiscal policy tries to mitigate the effects of rising prices through vast payouts. An example: When the German government introduced a €200 billion scheme to protect households and industry from rising energy prices, they're creating a fiscal stimulus at the same time as the ECB is trying to rein in their monetary policy.

MD: Who wins?

RN: The government. Did Berlin ask the ECB whether they can create a rescue package? Did any other government ask? No. This is considered emergency finance. No government is asking for permission from the central bank to introduce loan guarantees. They just do it.

MD: You're saying that central banks are powerless?

RN: They're impotent. This is a shift of power that cannot be underestimated. Our whole economic system of the past 40 years was built on the assumption that the growth of credit and therefore broad money in the economy was controlled through the level of interest rates – and that central banks-controlled interest rates. But now, when governments take control of private credit creation through the banking system by guaranteeing loans, central banks are pushed out of their role.

MD: Would that apply to all Western central banks?

RN: Certainly to the ECB and definitely to the Bank of England and the Bank of Japan. These countries are already well on their path to financial repression. It will happen in the US, too, but we have a lag there. But there will come a point where it will be too much for the US as well. Watch the level of bond yields. There is a level of bond yields that is just unacceptable for the US, because it would hurt the economy too much.

MD: Walk us through how this will play out.

RN: First, governments directly interfere in the banking sector. By issuing credit guarantees, they effectively take control of the creation of broad money and steer investment where they want it to. Then, the government would aim for a consistently high growth rate of money, but not too high. Again, history shows us the pattern: The UK had five big banks after World War II, and at the beginning of each year the government would tell them by what percentage rate their balance sheet should grow that year. By doing this, you can set the growth rate of broad money and nominal GDP. And if you know that your economy is capable of, say, 2% real growth, you know the rest would be filled by inflation. As a third prerequisite you need a domestic investor base that is captured by the regulatory framework and has to buy your government bonds, regardless of their yield. This way, you prevent bond yields from rising above the rate of inflation. All this is in place today, as many insurance companies and pension funds have no choice but to buy government bonds.

MD: Won't there come a point where the famed bond market vigilantes would step in and demand significantly higher yields on government bonds?

RN: I doubt it. First, we already have a captured investor base that just has to buy government bonds. And if push comes to shove, the central bank would step in and prevent yields from rising higher, with the ultimate policy being overt or covert yield curve control.

MD: What if central banks don't want to play along and try to regain control over the creation of money?

RN: They could, but in order to do that, they would really have to go to war with their own government. This will be very hard, because the politicians in government will say they are elected to pursue these policies. They are elected to keep energy prices down, elected to fight climate change, elected to invest in defence and to reduce inequality. Arthur Burns, who was the Fed chairman during the Seventies, explained in a speech in 1979 why he lost control of inflation. There was an elected government, he said, elected to fight a war in Vietnam, elected to reduce inequality through Lyndon B. Johnson's Great Society programs. Burns said it wasn't his job to stop the war or the Great Society programs. These were political choices.

MD: And you say it’s similar today?

RN: Yes. People are screaming for energy relief, they want defence from Putin, they want to do something against climate change. People want that, and elected governments claim to follow the will of the people. No central banker will oppose that. After all, many of the things that are associated with financial repression will be quite popular.

MD: How do you mean that?

RN: Remember I said that financial repression means engineering an inflation rate in the area of 4 to 6% and thereby achieving a nominal GDP growth rate of, say, 6 to 8%, while interest rates are kept at a lower level. Savers won’t like it, but debtors and young people will. People’s wages will rise. Financial repression moves wealth from savers to debtors, and from old to young people. It will allow a lot of investment directed into things that people care about. Just imagine what will happen when we decide to break free from our one-sided addiction of having pretty much everything we consume produced in China. This will mean a huge homeshoring or friendshoring boom, capital investment on a massive scale into the reindustrialisation of our own economies. Well, maybe not so much in Switzerland, but a lot of production could move back to Europe, to Mexico, to the US, even to the UK. We have not had a capex boom since 1994, when China devalued its currency.

MD: So we’re only at the start of this process?

RN: Absolutely. I think we’ll need at least 15 years of government-directed investment and financial repression. Average total debt to GDP is at 300% today. You’ll want to see it down to 200% or less.

MD: What’s the endgame of this process, then?

RN: We saw the endgame before, and that was the stagflation of the 1970s, when we had high inflation in combination with high unemployment.

MD: What will this new world mean for investors?

RN: First of all: avoid government bonds. Investors in government debt are the ones who will be robbed slowly. Within equities, there are sectors that will do very well. The great problems we have – energy, climate change, defence, inequality, our dependence on production from China – will all be solved by massive investment. This capex boom could last for a long time. Companies that are geared to this renaissance of capital spending will do well. Gold will do well once people realise that inflation won’t come down to pre-2020 levels but will settle between 4 and 6%. The disappointing performance of gold this year is somewhat clouded by the strong dollar. In yen, euro or sterling, gold has done pretty well already.

Russell Napier is author of the Solid Ground Investment Report and co-founder of the investment research portal ERIC. He is also founder and director of the Practical History of Financial Markets course at Edinburgh Business School and initiator of the Library of Mistakes, a library of financial markets history in Edinburgh.

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9 ways that global markets are changing

Michael McAlary

There are many changes happening in the macro-economic world. Here are the key points that will impact investment portfolios this year and beyond.

No going back to pre-Covid times

The world continues to adjust to the macro-economic and geo-political shift that has occurred since Covid. For 30 years interest rates fell with asset prices responding to cheap money and increasing in value. This correction is well underway as increasing interest rates are causing asset prices to fall and are reducing demand. Interest rates will soon reach a point of 'equilibrium', i.e., terminal value high enough to bring the Consumer Price Index (CPI) down.

US M2 (money supply) best demonstrates this new paradigm, having fallen recently for the first time since 1960. A reduction in money supply means that the US Federal Reserve via banks is withdrawing US dollars

from the global financial system in its fight against inflation while at the same time there is an increase in demand for US dollars (see below Triffen's dilemma), as international borrowers of US dollars require more US dollars to meet their increasing debt servicing costs.

To his credit, the Chairman of the US Federal Reserve, Jerome Powell, is doing what he said he would do. He is increasing the Fed Funds Rate to kill off inflation even if the main yield curves are inverted which indicate that rates should fall, and this is why the market is talking of the Fed pivot and is now rallying. Inflation hurts everyone while unemployment impacts few.

Australia is well placed

The positives for Australia are that unemployment remains low and folks have been spending during the Christmas and New Year holiday period. Yet this will slow down as the increases in interest rates flow through to mortgage rates and reduce household disposable incomes. Consumers will re-assess their budgets after the school holidays and find they need to reduce their discretionary spending, e.g., eat out once per week rather than three times, or cancel their Netflix subscription, etc.

Even with higher interest rates Australia is well placed to ride through the global slow down because it has a surplus of energy (food and resources), many mortgage holders are in front on their loans or they fixed their rate in 2021 when rates were low. Importantly, Australia's Debt to Gross Domestic Product (GDP) ratio is low unlike the US, Japan and the Eurozone which are all well over 100%.

Federal Reserve Put

The 'Fed Put' is the financial market belief that the US Federal Reserve will step in to rescue the markets if equity prices fall too much. Over the last 20 years this can be seen by comparing S&P 500 index which moved in lock step with increases and decreases in the US Fed's balance sheet. Powell wants to end this belief, even though he has not explicitly stated this as a goal. The Fed does not want to be captive of the financial markets, nor should it be.

US economy

Some key points:

1. Unlike in Australia, US fiscal policy is not aligned with US monetary policy. The US Fed is increasing interest rates while Congress continues to pass major stimulus packages, the most recent being US$1.7 trillion.

2. The US Fed (and all central banks) can only influence the short end (i.e., cash and bill rates) of the yield curve, whereas the 2-year to 30-year interest rates are determined by the market.

3. The US Fed will put the needs of the US domestic economy first (see Triffen's dilemma below) over the needs of the international community.

4. US has been in a mild recession for 9 months (as a real GDP growth has been negative for three quarters) and key indicators such as the Purchasing Managers Index (PMI) and CPI are now falling, as well as key interest rate yield curves, e.g., US 10-year treasury, remain inverted.

5. The US is a debtor nation compared to 30 years ago when it was a creditor nation. It has the so called 'twin deficits'. There is a budget deficit of around US$3.5 trillion per year and a current account deficit. National debt of US$33 trillion, plus unfunded liabilities for defined benefit pension funds, student loans, etc. The US economy would be much worse if the US dollar wasn't the world's reserve currency.

6. The US debt ceiling has been reached again. We expect an increase as this has been treated historically by both Democrats and Republicans as a political event rather than as checkpoint to take action to address the structural problems with the US budget.

7. US savings rate is 2.5%, as most Americans live pay cheque to pay cheque. Whereas China's saving rate is about 45% which is the highest globally except for Singapore. This high savings rate provides China with the capital to invest, including buying US treasuries to fund US debt.

8. US credit card interest rates on average are now 19.6% which is very high when considered in the context of many Americans living pay cheque to pay cheque.

9. US technology companies in 2022 have been downsizing having laid off 70,000 employees. Amazon (18,000), Alphabet (12,000) Microsoft (10,000) and Salesforce (7,000) and more likely to come in 2023,

particularly in the crypto currency space. It is reported that Twitter has laid off 6,000 staff, or 80% of its full-time staff.

Triffen's dilemma: world reserve currency v domestic economic requirements

The US Fed is facing Triffen's dilemma. This happens only where an individual country's currency is used as the world's reserve currency, as is the case with USD. There comes a point when there is a conflict between the world's needs of the reserve currency with the needs of the domestic economy of that currency. When this situation arises, domestic politics and needs of the domestic economy trump those of the world.

Source: Trading Economics

We are currently seeing Triffen's dilemma played out as the US Fed is restricting money supply through higher US interest rates, whereas the rest of the world needs more US dollars because the higher interest rates are increasing their debt servicing costs. In 2022, the US dollar appreciated significantly against all major currencies, although in the last few months of 2022 it fell back some.

Currency versus government bond market

When forced to choose between supporting their currency or supporting the bond market, central banks always choose the bond market. If the government bond market collapses, a government cannot raise any more money and it can lead to a banking crisis. The UK recently witnessed this scenario as the Bank of England was forced to step in to support the gilt (bond) market and prevent its collapse, while allowing the UK Pound to devalue.

Source: Trading Economics

The world normally associates a currency and bond market crisis with third world economies, but not first world countries like the UK.

De-dollarisation

Sanctions imposed on Russia because of the invasion of Ukraine include the US and its allies freezing US$300 billion of Russia's reserves. For many years US governments have weaponised the US dollar. This has led to autocratic countries such as China and Russia increasing their pace of de-dollarisation -quickly moving to transact in their local currencies, i.e., non-US dollars and possibly tied to gold in some manner.

Countries that have historically aligned themselves with the US, such as Brazil, India, and Saudi Arabia, are taking preliminary steps to be part of this movement as they do not wish to find themselves sanctioned and their foreign reserves frozen because the US does not 'approve' of an action they may have taken.

This does not mean the imminent end of the US dollar as the world reserve currency as there is no obvious replacement. Rather, there will be less reliance on it in bi-lateral trade between countries outside the US. A good example is that Argentina and Brazil are exploring having a single currency, so bi-lateral trade will not have to be transacted (converted) through US dollars. Such a step does not come without risk as those countries that joined the Euro can attest.

Energy is life

The energy market continues to see shortages because of the Ukraine war and an increase in demand because of the end of Covid lock downs. These energy shortages have caused major price increases and disruptions to businesses in several countries, where governments have been forced to take fast and extreme action. For example, over the 6 months to December 2022, the German Government spent US$500 billion on bringing old coal burning fire generators back online and in buying coal, gas and oil, as well as compensating businesses and consumers for the higher energy costs via subsidies and rebates. The German Government must be congratulated on the speed taken to address the shortage problem; however, it does reveal Germany's reliance on fossil fuels.

End of the traditional 60/40 balanced investment portfolio

Another example of the world not going back to pre-Covid days is the traditional balanced investment portfolio model of 60/40 equities/bonds failed to provide positive returns where normally they compensate each other. In 2022, both bond and equity prices fell for the first time in 30 years with the S&P 500 index down by 19.2% and the US bond market (long-term US Treasuries) down by 29.3%. This investment model may not work in the new macro-economic paradigm.

The world is not going back to pre-Covid and pre-Ukraine war days and investors must come to grips with many changes.

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