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Editorial

The art of buying stocks at 52-week lows

Stock markets are highly efficient in the long run yet share prices can fluctuate wildly near term. The art of investing is buying quality stocks when they're temporarily down, and a current blue-chip may fit that profile.

All the academic literature suggests that stock markets are efficient in the long term. That is, market prices will accurately reflect business values over time. Yet, markets aren't as efficient in the short term, and stock prices can deviate from business values, sometimes significantly.

Take the top 10 companies in the ASX. These companies range in market capitalization from $60 billion to $242 billion. They're enormous. And look how much their share prices have moved around in the past year.

Company	Code	Mkt Cap (billion)	Current price	52-week high	52-week low
BHP Group	BHP	242	47.77	50.21	41.66
Commonwealth Bank	CBA	174	103.65	111.43	93.05
CSL	CSL	125	258.18	314.28	228.65
National Australia Bank	NAB	87	27.86	32.15	25.10
Fortescue Metals Group	FMG	78	25.47	25.81	18.77
Westpac Banking Corp	WBC	75	21.24	24.14	20.03
ANZ Group	ANZ	72	24.15	26.08	22.39
Macquarie Group	MQG	65	168.39	195.74	155.30
Woodside Energy	WDS	61	32.01	39.23	30.91
Wesfarmers	WES	60	52.92	54.28	45.13

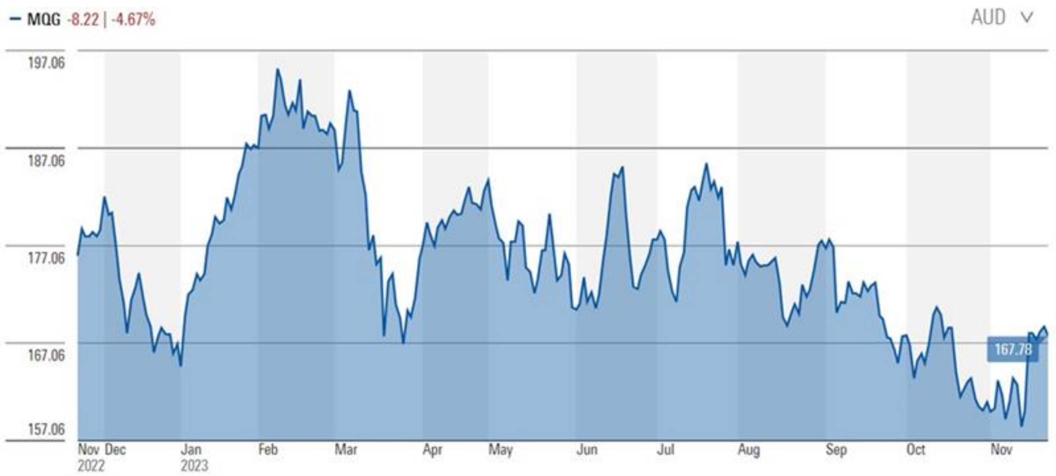
Source: Morningstar

Macquarie Bank

Let's use Macquarie Bank (ASX:MQG) as an example. It's almost regarded as Australia's 5th bank and a home-grown success story. Macquarie's share price is down 5% over the past year, and it's been flat year-to-date. Fairly boring, you might say.

Those figures disguise the size of the moves throughout. From $176 last November, the stock went down to under $165 at the start of this January, before catapulting to a 52-week high of $195.74 just five weeks later. It went down to $167 in March, before rising again to $185 in July. And Macquarie got wiped out after recent results to reach of low of $155 before climbing again to its current price of $168.

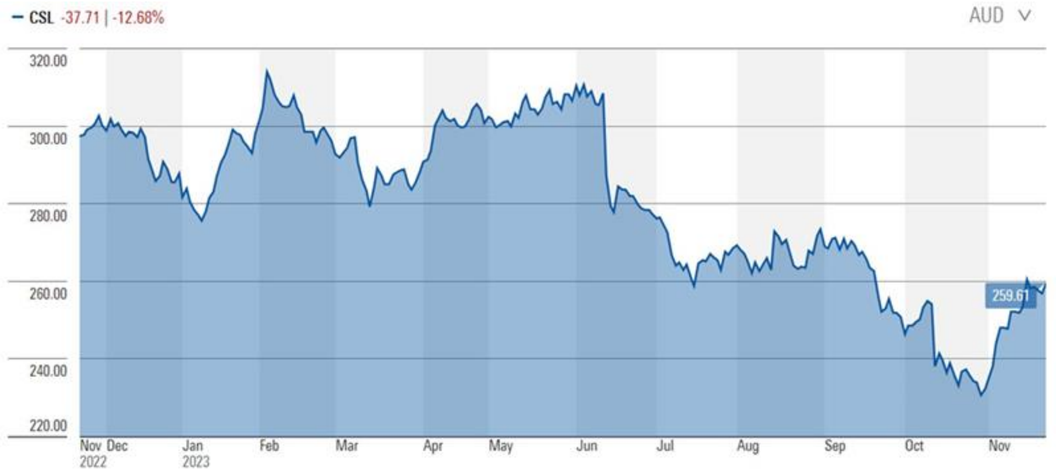
What a ride.



Source: Morningstar

CSL

CSL (ASX:CSL) is another example. It's a blue-chip healthcare stock that's been a market darling for a long time, having delivered stellar returns for shareholders since IPO'ing. Though in the past year, its price has fluctuated wildly. It peaked near $314 in February this year, before diving to under $229 at the end of October, before bouncing back to today's $258. Put another way, the stock went down 37% over nine months to October, and in the past three weeks, it's gone up by 13%.



Source: Morningstar

To make this starker, CSL's market cap reached $151 billion at its peak in February and bottomed at $110 billion at the end of October – its market value decreased by $41 billion at one stage. And CSL's market value has increased by $15 billion since bottoming around 22 days ago.

They are crazy moves. Yes, issues have emerged with the business including continued doubts about the merits of an overseas acquisition, uncertainty around the impact of obesity drugs on its business, insider selling, and valuations which looked frothy back in February.

However, have these issues warranted a $41 billion move in nine months? Is the business worth $15 billion more than it was just three weeks ago?

Both Macquarie Bank and CSL demonstrate that market prices can move around much more than underlying business values. But is it just a matter of buying quality stocks when they reach 52-week lows? If only it were that simple - that's where the art of investing comes in.

ResMed

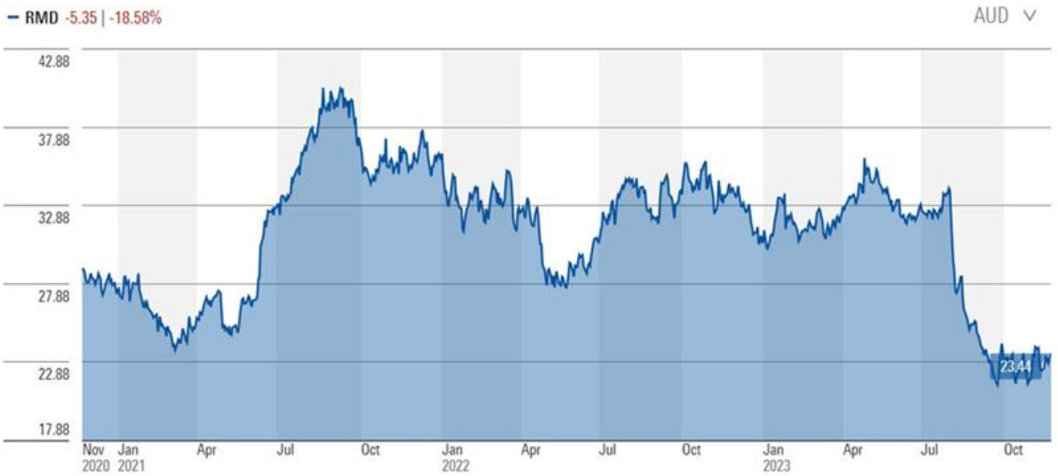
Let's look at a topical example in ResMed (ASX: RMD). Started in 1989, the company has been another home-grown success story. It's become the global leader in sleep and respiratory care. The company specializes in positive airway pressure devices for the treatment of obstructive sleep apnoea (OSA).

OSA is a chronic illness characterized by repeated obstruction to the airway at the back of the throat during sleep. After a person with OSA falls asleep, their airway intermittently narrows and collapses causing fragmented sleep and contributing to severe health issues if left untreated.

That's where ResMed comes into play. It makes Continuous Positive Airway Pressure (CPAP) devices that deliver a stream of pressurised air through a mask to prevent the collapse of the upper airway during sleep. ResMed and its main competitor, Philips have an estimated 80% market share in CPAP devices.

ResMed has been an amazing performer. Ove the past 15 years, it's returned 16.4% p.a. Over 10 years, it's been a similar story, with ResMed returning 16.3%. That's been driven by double-digit growth in both revenue and earnings.

Yet the once market darling has turned pariah over the past year. The stock reached an all-time high above $40 in August last year. It subsequently fell almost 50% to a low of $21.14 in September this year, before bouncing marginally to today's price of $23.44.



Source: Morningstar

With ResMed still hovering close to 52-week lows, the question is whether stock is now a buy or a value trap.

To answer that, it's helpful to know why the stock has dropped so far, so fast. And it's because of the rise of GLP-1 or obesity drugs (Ozempic, Wegovy, and Mounjaro). These drugs were initially designed to target type 2 diabetes by stimulating greater insulin production, but they've evolved to being helpful with weight reduction and cardiovascular indications. Given obesity is a key risk factor for OSA, there are worries that these new drugs will reduce the need for the CPAP devices of ResMed.

At one time, the market priced ResMed assuming that it was a global leader in a huge market with a long runway of growth ahead. The obesity drugs have dimmed the narrative with considerable uncertainty about future demand for CPAP devices.

Whether ResMed's a buy or sell depends on how much these drugs could dent future demand, what impact that may have on earnings, and to what extent that's factored into the share price. My assessment is that it's impossible to say exactly how much CPAP demand will be impacted, and that could weigh on the stock for several years.

Yet it is possible to take a reasonable guess on future demand, and that's what several fund managers who've bought into the stock have done. One of these managers, Matt Williams, Head of Australian Equities at Airlie Asset Management, told me as much on a recent episode of the *Wealth of Experience* podcast.

What struck me about this interview with Matt though wasn't so much his thesis for buying ResMed, but that he'd probably seen this movie before and that may have helped with his investment decision. What I mean by that is that he has more than 30 years' experience in funds management, and he's seen it all: market manias and crashes, companies come and go, hundreds of competent and incompetent managers. And specific to ResMed, he's probably seen the rise of drugs that don't have as broader impact on adjacent markets as first assumed.

From the interview, I realised that an underappreciated edge in investing is experience. I can't help but wonder that the average performance of active managers would be markedly better if all of them had +30 years' experience in the market.

For the average investor, the lesson is that becoming good at investing takes time. If you don't have the time, it may be best to outsource the job to others, perhaps to a fund manager with a successful track record over a long period of time.

Full disclosure: Airlie Funds Management is owned by Magellan, a Firstlinks sponsor.

James Gruber

In this week's edition...

One of the most common questions that investors have been asking of late is: with cash and term deposits yielding +5%, is it really worth venturing into other assets for steady income? **James Gruber** looks at the pros and cons of different assets - such as stocks, bonds, and hybrids - in providing yield and how they stack up against cash.

Another bank reporting season is done and dusted, and it's a mixed picture. The big negative is reduced margins due to increased deposit competition. Yet this is somewhat offset by low bad debts and healthy capital positions. **Hugh Dive** gives a full breakdown of the results, as well as the winners and losers.

Recently in Firstlinks, **Roger Montgomery** highlighted the ASX 200 is around the same price that it was 16 years ago. He blamed the poor performance mostly on our taxation system, which encourages companies to pay out most of their earnings as dividends. **Ashley Owen** gives a counterpoint to Roger's arguments. It's a more optimistic take on why the ASX remains a good place to invest.

It's great to have **Rachel Lane** back. She and **Noel Whittaker** have just released a second edition of their popular book, *Downsizing Made Simple*. We have an extract from the book that runs through the key things to research to make an informed downsizing decision.

Two weeks ago, **Graham Hand** broke the news of his brain tumour diagnosis. Today, he gives a diarised update of his journey since, and he pays tribute to the kind messages that he's received from hundreds of readers.

Firstlinks interviewed famous Australian-raised investor **Sir Michael Hintze** when his credit-focused hedge fund CQS was at the height of its powers in 2018. Since then, he's changed the firm's investment strategy and found a buyer in Canadian giant, Manulife.

The team at **First Sentier Investors** are calling the recent period, The Great Reset, meaning the pivot from an ultra low interest rate regime to a more normalised one. They go through what signals they're looking at to indicate that this reset is done. In the meantime, they say bonds are offering the prospect of favourable risk-adjusted returns.

In this week's whitepaper from **Neuberger Berman**, investigates the 'higher-for-longer' rates outlook in the US and Europe, and the potential for slowing growth in 2024.

Curated by James Gruber and Leisa Bell

The best income-generating assets for your portfolio

James Gruber

The return of cash as an income yielding asset has transformed the investment landscape. For so long the ugly duckling, cash now provides serious competition for every other asset. Stocks, bonds, hybrids, and other assets all need to justify why investors should pay a premium for them versus the safety of cash. That's especially the case for investors searching for steady income.

Let's look at the pros and cons of different assets for those seeking regular income, from the lowest yielding to those offering better yields.

Bank savings/money market funds

Bank savings accounts don't yield much, especially at the major banks. Outside of that, it gets better but often with lots of strings attached.

An alternative is 'cash' ETFs. These ETFs can get you a higher yield and good liquidity. The main choices are as follows:

ASX code	Base fee	Buy/sell spread	Current rate
AAA (BetaShares)	0.18%	0.02%	4.44%
BILL (iShares)	0.07%	0.03%	4.46%
ISEC (iShares)	0.12%	0.03%	4.61%

Sources: Issuer websites as at 21 November 2023

AAA is the market leader and offers the best liquidity and tightest spreads. It's become a popular place to leave cash with better rates than bank saving deposits. However, it's also the most expensive on fees, making the others more attractive if money can be left in cash for a while. ISEC carries more risk than the others as it can hold up to 20% in floating rate notes.

Term deposits

Investors have been pouring money into term deposits and for good reason. They're an attractive option for many investors seeking income. The good news is that banks have improved their offers to attract more depositors. Even the major banks have upped their game after badly lagging for the past 18 months:

- Commonwealth Bank has a 'special offer' term deposit of 5.05% per annum (p.a.) for personal and SMSF customers for 12-23 months.
- ANZ offers a 5.05% p.a. term deposit for 12-24 months.
- Westpac has done a little better, now offering 5.10% p.a. over 12-23 months.
- NAB is at 5% p.a. for a 12-month term deposit.

As is often the case, there are better deals outside the major banks. Macquarie had been aggressive in attracting term deposits though that seems to have recently changed. It now offers a 5.05% p.a. term deposit, largely in line with the big banks.

ING has one of the highest term deposit rates at 5.3% p.a. for 12 months. Judo Bank isn't far behind at 5.25% p.a. over the same period.

A curious development is that many of the banks which were the most aggressive with their term deposit rates had previously attached many conditions to their offers. I'm thinking especially of ING and Macquarie. However, most of those conditions now seem to have been dropped.

It pays to know the particulars of the banks' term deposit offers. Here are a few suggestions:

- There are different rates for term deposits paid at maturity and those paid monthly. Know the difference and what suits your needs best.
- Know the penalties for withdrawing money from a term deposit early - they vary significantly.
- Always read the terms and conditions carefully. There may be other 'nasties' in there. I read in ING's terms that it can change the terms and conditions whenever it likes. That's not nasty, and it might be standard practice, though it's good to know who's holding the whip hand in the relationship from the start!

In my own case, I bank with two of the majors though recently chose to open several Judo Bank term deposits, from 3 to 12 months. I found the process both quick and easy.

The big positive for investing in term deposits is that you lock in an attractive yield. The downside is that every term deposit still trails the current inflation rate of 5.4%. So, you're losing money in real terms.

That may not remain the case if inflation continues to fall yet it remains a risk. And that's where potential alternatives for getting better yield come into play.

Bonds

Bonds have had a miserable three years, though don't let that put you off (it's probably bullish).

10-year government bonds are regarded as 'risk-free' as the government will always pay you back. In Australia, these risk-free bonds are yielding 4.48%. That's reasonable, though down from the peak of 4.98% at the end of October. Many bond funds with a mix of federal and state government bonds offer yields of more than 5%.

Investment-grade corporate bonds have even more appealing yields, anywhere between 5.75% and 6.5%. Note that corporate bonds are riskier than government bonds given their exposure to corporate balance sheets.

ETFs with high quality government and corporate bonds can be a good option. Two of the most popular are Vanguard's Australian Fixed Interest Index ETF (ASX:VAF) and iShares Core Composite Bond ETF (ASX:IAF). They're yielding 4.95% and 5.91% respectively.

There are different types of bonds that offer even better yields. For instance, Australian commercial mortgage and private debt have yields of 10-12%. These are potentially compelling as they offer the prospect for equity-like returns with less risk.

Even further up the risk spectrum, there are insurance-linked bonds with yields of up to 15%. These bonds are based on insurance payouts from weather events, and therefore are highly risky and suit sophisticated investors.

With bonds and all assets, the higher the potential rewards, the greater the risks. And vice versa. The trick as an investor is to find the reward versus risk that meets your return expectations and risk profile.

A key benefit of owning government-related bonds is that if an economic slowdown happens in future, bond yields are likely to fall and prices to rise. That way, an investor can get both income and capital appreciation from owning bonds. That's something that you can't get with cash.

The greatest risk from owning bonds is inflation. High inflation means rising rates, and bond prices move inversely to rates. It's noteworthy that 10-year government bond yields are well below inflation at present, which means these bonds are losing money in real terms.

Stocks

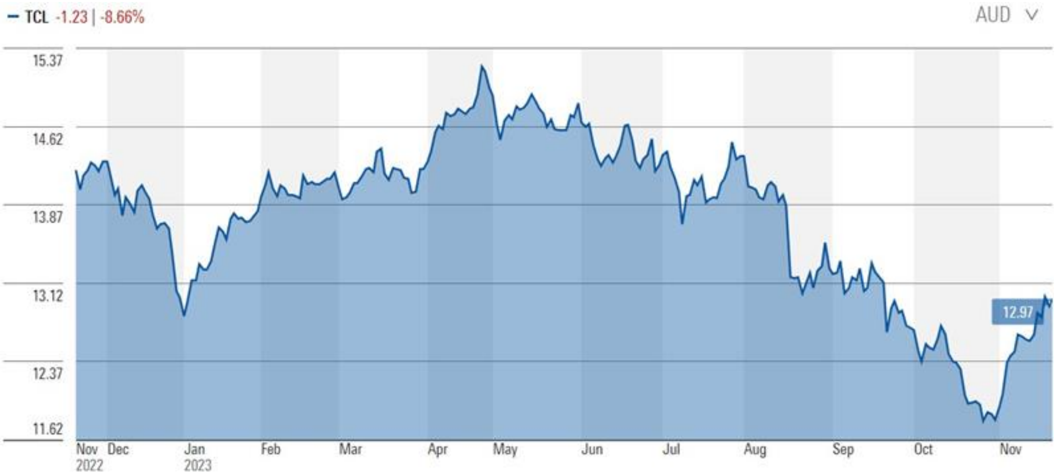
For a pick-up in yield, stocks are an obvious option. The ASX 200 is trading at more than 17x trailing price -to-earnings or an earnings yield of 5.81%. On the face of it, that's not great value compared to the yields of risk-free bonds or term deposits. You're not being paid enough to compensate for the risks of holding stocks.

The dividend yield on the ASX 200 is 4.44% or a grossed up 6.34%. That's reasonable, without being outstanding.

As for individual stocks, the banks are a place to start for yield. Yes, they aren't growing much and may struggle to grow in future. Yet, they are a quasi-oligopoly that should generate adequate returns on capital. Dividend yields on the major banks range from 4.35% at CBA (ASX:CBA) to 6.4% at ANZ (ASX:ANZ) with NAB (ASX:NAB) and Westpac (ASX:WBC) falling in between. These are net yields, and on a gross basis, they look very good.

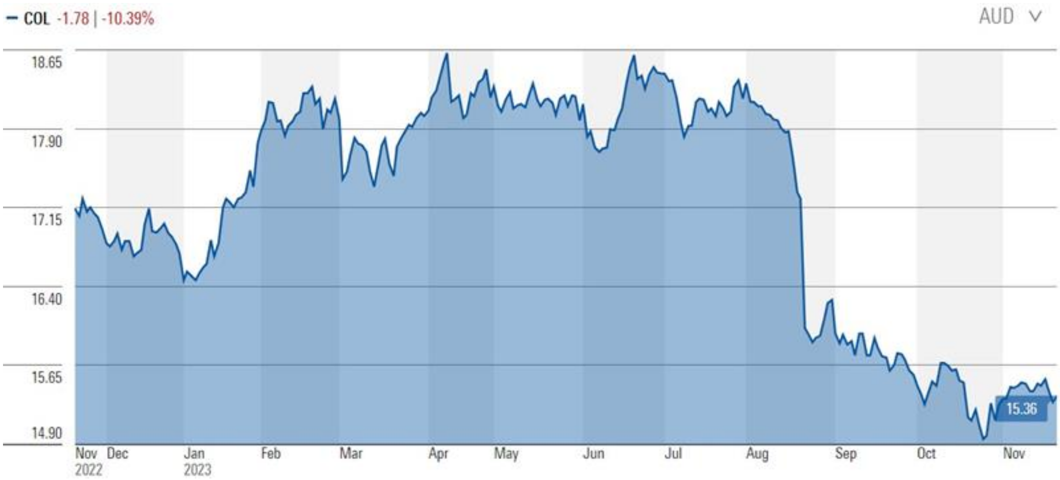
Outside of the banks among large caps, commodity stocks offer nice dividends though their sustainability and consistency are always the question mark.

Of the top 25 stocks, Transurban (ASX:TCL) looks interesting, with a dividend yield of 4.47%. The stock is far from cheap, though the yield is attractive.



Source: Morningstar

Coles (ASX:COL) is another one that seems reasonable from an income viewpoint. The stock sports a dividend yield of 4.32%. Coles has some headwinds, especially with its inability to execute as well as Woolworth. Though in my experience, ascendancy among the supermarket duopoly tends to ebb and flow over time. The critical point is that the duopoly needs to stay intact and if that happens, then returns and dividends should be ok.



Source: Morningstar

Dividend ETFs

Of course, the other option is to buy a dividend ETF instead of individual stocks. Here are the main dividend ETFs listed on the ASX:

Name	Code	Fees (Indirect cost ratio)	Dividend yield	Performance 1yr	Performance 5yr
Vanguard Australian Share High Yield ETF	VHY	0.25%	5.40%	5.55%	8.75%
iShares S&P/ASX Dividend Opportunities ESG Screened ETF	IHD	0.30%	4.88%	9.67%	5.61%
Russell High Dividend Australian Shares ETF	RDV	0.34%	5.74%	0.73%	5.09%
SPDR MSCI Australia Select High Dividend Yield Fund	SYI	0.20%	5.73%	8.59%	7.04%
Global X S&P/ASX 300 High Yield Plus ETF	ZYAU	0.35%	8.04%	na	na
Van Eck Morningstar Australian Moat Income ETF	DVDY	0.35%	4.10%	-4.12%	na

Source: Company websites

Vanguard's VHY is by far the most popular dividend ETF, followed by State Street's SYI.

It’s important to note that each of these ETFs use a different methodology to come up with their underlying holdings.

One potential drawback of these ETFs is that none of them offer fully franked dividends. The level of the franking depends on the franking offered by their underlying portfolio companies.

More broadly, it’s worth mentioning that dividends rely on earnings, and in an ideal world, you want a growing stream of earnings that can pay a growing stream of dividends. It’s not only about the starting dividend yield of an ETF or stock, but what that yield may look like in future.

Also, one potential issue for investors is that stocks and dividend ETFs are unlikely to deliver regular, consistent dividends. The reason is that when there’s a sharp fall in earnings, there’s normally a corresponding fall in dividends.

That said, grossed up yields of 7-9% for solid, growing stocks are worth investigating given their superiority to the yields offered from government bonds and cash.

Listed investment companies

Listed investment companies (LICs) are a popular alternative for ASX dividends. One advantage that LICs can build up cash reserves to pay consistent dividends through an economic cycle. For instance, several of the blue-chip LICs were able to continue to pay steady dividends through the pandemic despite falls to their net asset values (NAVs).

A disadvantage of LICs is that the prices of many seem stuck at perpetual discounts to NAVs. Investors have soured on the structures and fees of LICs, and NAV discounts have proven difficult to remove.

That said, there are a handful of solid, long-lasting LICs that offer the prospect of steady, growing dividends. Australian Foundation Investment Company (ASX:AFI) and Argo Investments (ASX:ARG) are standouts in this regard. Whitefield Investments (ASX: WHF) is smaller yet has a good track record.

Washington H. Soul Pattinson (ASX:SOL) is sometimes referred to as an LIC but it isn’t. It’s a family-run investment company with a long history of outperforming the ASX and delivering strong dividends.

Hybrids

Bank hybrid notes – combining features of both equity and debt - have been hugely popular among investors in recent years. With major banks offering 6-8% yields, and smaller banks more, it’s little wonder they’ve been well received.

I have been, and remain, more cautious on hybrids for a few reasons. The first is the APRA review into hybrids. This might change the ballgame. It’s likely that APRA will change the product terms to make it clear to banks and investors that in times of financial distress, distributions may be missed and AT1 will be converted into equity, or even written off. In other words, APRA will probably want to make it clear that distributions aren’t safe at all costs.

The second reason is that bank hybrids are relatively new products in Australia, and they haven’t been tested across an economic cycle, especially during a serious economic downturn.

Other assets and issues

For the sake of brevity, I’ve only covered the major assets in this article. I also haven’t addressed tax issues with the different assets, or the specific income needs of SMSFs and retirees. That’s for another article.

James Gruber is an assistant editor at Firstlinks and Morningstar.com.au

Bank reporting season: which ones get the gold stars?

Hugh Dive

The last four 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 an emergency capital raising from NAB (some of which was used to pay the dividend) and Westpac missing their 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.

In 2022 and 2023, the concerns have switched to the impact of a 4.25% rise in the cash rate on bad debts and the looming fixed interest rate cliff that would see retail sales and house prices plummet.

In this piece, we will look at the themes in approximately 900 pages of financial results released over November, including Commonwealth Banks 2023 full-year results from August and the regional banks, awarding gold stars based on performance over the past six months.

Lower net interest margins

Net interest margins are always a major topic during the November banks reporting season, with most investors going straight to the slide on margin movements in the immense Investor Discussion Pack. Banks earn a net interest margin [(Interest Received – Interest Paid) divided by Average Invested Assets) by lending out funds at a higher interest rate than by borrowing these funds from depositors or wholesale money markets.

During the peak COVID-19 period, when the cash rate was at 0.1%, interest margin pressure was on the lending side of the book, with banks trying to write as many loans as possible. The banks were willing to cut margins to gain market share by offering competitive interest rates and cash-back offers, with some exceeding $10,000! Today, this pressure has moved to the deposit side of the book, with consumers benefiting from higher interest rates on bank deposits and term deposits. Banks are now being forced to offer competitive deposit rates as consumers look to move their money to those who are most willing to offer better rates.

The November reporting season saw net interest margins decrease 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. Commonwealth Bank posted the highest net interest margin in June, with 2.07%. However, due to CBA closing their books on 30th June, we may see this number compress with the more recent deposit competition.

Reporting season scorecard November 2023

Company	Share Price	Market Cap $B	Cash earnings per share growth (pcp)	Increase in Dividends	Net interest margin	Credit Impairment charge as % of loans	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	Grossed Up Yield	2023 total return
Westpac	$21.25	$ 76.3	26.4% ★	13.6%	1.95%	0.09%	12.4%	10.1%	11.5X	6.4%	9.1%	-3.1%
ANZ	$24.30	$ 71.6	14.4%	19.9% ★	1.70%	0.01% ★	13.2% ★	10.9%	10.9X	6.9%	9.8%	10.0%
NAB	$27.94	$ 85.1	8.8%	10.6%	1.74%	0.12%	12.2%	12.9%	13.1X	6.0%	8.6%	-1.4%
Commonwealth (FY23 Results and 1Q24)	$103.76	$ 163.8	5.9%	16.8%	2.07% ★	0.09%	12.2%	14.0% ★	17.1X	4.2%	5.9%	5.4%
Macquarie Half Year	$169.16	$ 67.1	10.0%	-15.0%	1.92%	0.01% ★	13.2% ★	11.0%	16.9X	3.0%	3.6%	5.7%

Source: Company reports, IRESS, Atlas Funds Management

Low bad debts

From May 2022, Australia's official cash rate climbed from 0.10% to 4.35% across 13 different rate hikes. Every time we had a cash rate increase, investors were worried and questioned *how it would impact consumers? Are bad debts going to rise sharply? Do house prices colla*pse? What we have seen over the last year is that employment in Australia has remained remarkably robust in a tight labour marketplace. This has seen consumers being able to reallocate funds from discretionary or non-necessity spending to being able to fund their home loans.

Bad debts have remained low in 2023, with all banks reporting negligible loan losses; ANZ and Macquarie reported the lowest level, with loan losses of 0.01%. To put this in context, since the implosion in 1991, banks grappled with interest rates of 18% and considerable losses to colourful entrepreneurs such as Bond, Skase, et al. Since then, loan losses have averaged around 0.3% of outstanding loans, and the banks price loans assuming losses of this magnitude.

The level of loan losses is important for investors as high loan losses reduce profits and, thus, dividends and erode a bank's capital base. Conversely, the very low losses in 2023 have translated into record dividends and billion-dollar share buybacks.

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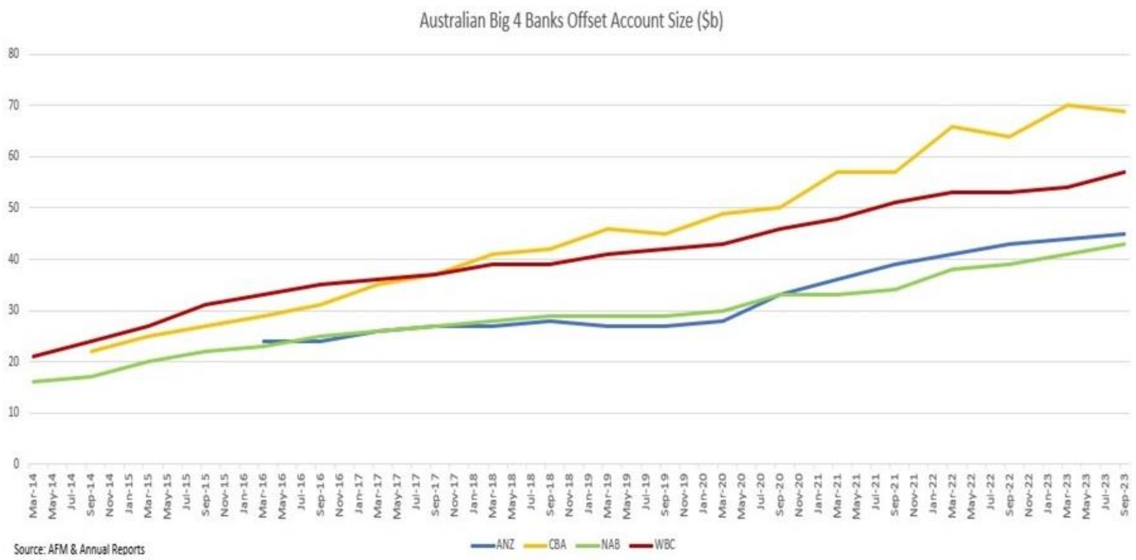
Building offset account balances

Something that we have seen over the past few years is consumers allocate more towards their home loans through offset accounts. As you can see in the chart below, balances in offset accounts have ballooned, meaning banks are forgoing some interest income in exchange for more secure clients and lower bad debts. We were surprised to see that despite rising interest rates, offset account balances have risen rather than fallen, with $5 billion added since March 2023, with a total of $214 billion currently sitting in the offset accounts of the big four banks.



Show me the money

While the big Australian banks are sometimes viewed as boring compared with the biotech or IT themes du jour, what is exciting is their ability to deliver profits in a range of market conditions. In 2023, the banks generated $32.7 billion in net profits after tax. This saw the big four banks' dividends per share increase by an average of 15% per share, with all banks except for NAB now paying out higher dividends than they did pre-Covid 19. The star among the banks was ANZ, which raised dividends per share by 20%.

Well capitalised

Capital ratio is the minimum capital requirement that financial institutions in Australia must maintain to weather the potential loan losses. The bank regulator, the Australian Prudential Regulation Authority (APRA), has mandated that banks hold a minimum of 10.5% of capital against their loans, significantly higher than the 5% requirement pre-GFC. Requiring banks to hold high levels of capital is not done to protect bank investors but rather to avoid the spectre of taxpayers having to bail out banks. In 2008, US taxpayers were forced to support

Citigroup, Goldman Sachs and Bank of America, and British taxpayers dipping into their pockets to stop RBS, Northern Rock and Lloyds Bank going under. The Australian banks were better placed in 2008 and did not require explicit injections of government funds; the optics of bankers in three-thousand-dollar Armani suits asking for taxpayer assistance is not good.

In 2023, the Australian banks are all well capitalised and have seen their capital build. This allows the banks to return capital to shareholders through on-market buybacks. During the bank reporting season, Macquarie announced a $2 billion dollar on-market buyback, Westpac announced a $1.5 billion share buyback, CBA announced a $1 billion share buyback, and NAB announced they had a remaining $1.2 billion share buyback. For investors, this not only supports the share price in coming months but reduces the amount of shares outstanding to divide next year's profits by.

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, other banks swiftly match moves to gain a higher market share and increase profits by discounting loans. However, banks can grow profits by reducing their expense base, which expands yearly.

Containing expense growth 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 the Anti-Money Laundering and Counter-Terrorism Financing Act 2006.

Wage growth was the major contributor for all the banks this year, accounting for more than half of the growth in expenses. Due to the persistent higher-than-normal levels of inflation experienced over the last year, banks were forced to increase wages for staff after increasing headcount from last year. Atlas still believes that rationalising the branch network will be the easiest way for the banks to grow earnings over the next few years.

An important measure when looking at a bank result is how the jaw ratio changed, which is the difference between the growth of operating income and operating expenses. This is a very important measure for banks due to the large size of their loan books. A small move in the jaws can move hundreds of millions of dollars in profits. Westpac wins the gold star for expense control, cutting costs by 1% whilst growing operating income by 8%.

The Vampire Kangaroo - Macquarie

After two sensational years driven by high volatility in energy and oil prices due to supply shocks from weather and geopolitical events, Macquarie's first-half profit was down 39%, cycling off a strong first half last year. The first half of last year was a great time for renewable companies following lots of hype around the transition to renewable energy, allowing Macquarie to get top dollar and even above book prices for these assets. This year, though, has seen a very different environment, with the market sceptical of risky IPOs in a risk-off environment, which has created a $831 million deficit on last year's earnings. Instead, MQG is moving some of these assets into a specific Green Energy Fund, creating lower short-term earnings but longer-term profits.

Outside of the market-facing business, the banking and financial services business has been outperforming, with the home loan portfolio growing by 6% to $114 billion and deposits growing to $131 billion. This is a great outcome for the bank, taking market share away from the big four banks while maintaining a strong net interest margin.

The regional banks

There are 4,236 commercial banks in the United States, with many small regional banks, a very different structure to Australia. This is a relic of historic US banking laws that prohibited interstate banking and limited the ability of banks to operate branches outside their state. While many of these regulations were repealed in the 1990s, they favoured the existence of many small local banks and in 2023, left the big 4 (JP Morgan, Bank of America, Citibank, and Wells Fargo) with a combined market share as measured by total assets of only 23%. Conversely, in Australia, there are 95 banks, with the big four banks having a market share in 2023 of 73%. The two listed regional banks, Bank of Queensland and Bendigo Bank, have a market share of around 2% each.

As we can see in the bank matrix at the top, the Australian regional banks did not win a single star across the board. This is due to having a higher capital cost than the big banks, as wholesale funders require higher coupons on their bonds to offset their higher risks. Additionally, the regional banks have limited access to the large pools of corporate transaction account balances that have historically paid minimal interest rates. To be competitive against the lending products from the major banks, the regional banks need to accept a lower net interest margin across their loan book, leading to lower returns on equity.

Our take

Overall, we are happy with the financial results in November from the banks owned by the Concentrated Australian Equity Portfolio. The three main overweight positions, Commonwealth Bank, ANZ, and Westpac, all increased their dividends, which is a crucial signal indicating improving prospects and board confidence in the outlook. All banks showed solid net interest margins, low bad debts, and good cost control. Profit growth is likely to be tough to find on the ASX over the next few years, with earnings for resources and consumer discretionary likely to retreat; however, Australia's major banks are in a good position in current turbulent markets.

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 ASX's 16-year drought: a rebuttal

Ashley Owen

The All-Ordinaries index hit a peak of 6,853 on 1 November 2007, but it is barely above that 16 years later. Why?

Is the local share market in terminal decline? Has it lost its mojo? Is it ever going to get back to growth? Is it time to give up on the local share market and look elsewhere?

Growth everywhere, but not in share prices

How can share prices remain flat for the past 16 years when, over the same period:

- The Australian population has ***grown by 26%***
- The overall Australian economic pie (GDP) has ***more than doubled*** in size.
- The aggregate value of ASX listed companies has ***increased by 51%*** (that's mainly because a lot of shareholder-diluting capital has been raised over the period)
- Aggregate profits for ASX listed companies have ***risen by 23%***
- Aggregate dividends have ***risen by 83%***

Despite all of this growth over the past 16 years, why have share prices in aggregate gone nowhere?

Of course, amongst individual stocks, there have been wide variations over the 16 years:

- there have been some winners (eg. CSL, FMG, Transurban, CBA, Macquarie, Wisetech, JB),
- some losers (eg. Telstra, WBC, NAB, ANZ, ASX, QBE, all property trusts including Goodman),
- and many that have gone nowhere (eg. Wesfarmers, Woolworths, Qantas, BHP, AGL).

However, here we are talking about the share market has a whole. Anyone can buy this with a low-cost passive index fund – which would have beaten many 'professional' fund managers and individual investors.

(NB – this story relates to price changes – so you need to add dividends of course, including franking credits where applicable.)

Timing is everything!

That headline about 16 years of nil growth is true – but it is only a *fraction* of the truth. By carefully selecting specific start and end points, you can come with pretty much any story you like!

Those headlines selected 1 November 2007 as the start date because that just happened to be the very top of the pre-GFC credit / China boom, immediately before the GFC crash.

Subsequent returns are always going to be very poor if measured from the tops of wild booms. Big market crashes generally take many years to recover, and the recovery from the GFC crash has been similar to past major crashes.

Pick a different start date, and you get a different story!

Instead of picking the start date at the top of the pre-GFC boom, if we start at the ***bottom of the GFC crash*** (6 March 2009 in Australia), then we see that the All-Ordinaries index actually has risen +133% in the 14.7 years up to now.

This is an ***above-average*** price gain of 6% per year.

The lesson is simple: if you buy in a wild speculative boom (they are easy to spot at the time), even if you buy a diversified index fund covering hundreds of stocks across all industries, then you will probably have to wait many years to get back to square one.

'Buy high - sell low' – history repeats in every cycle

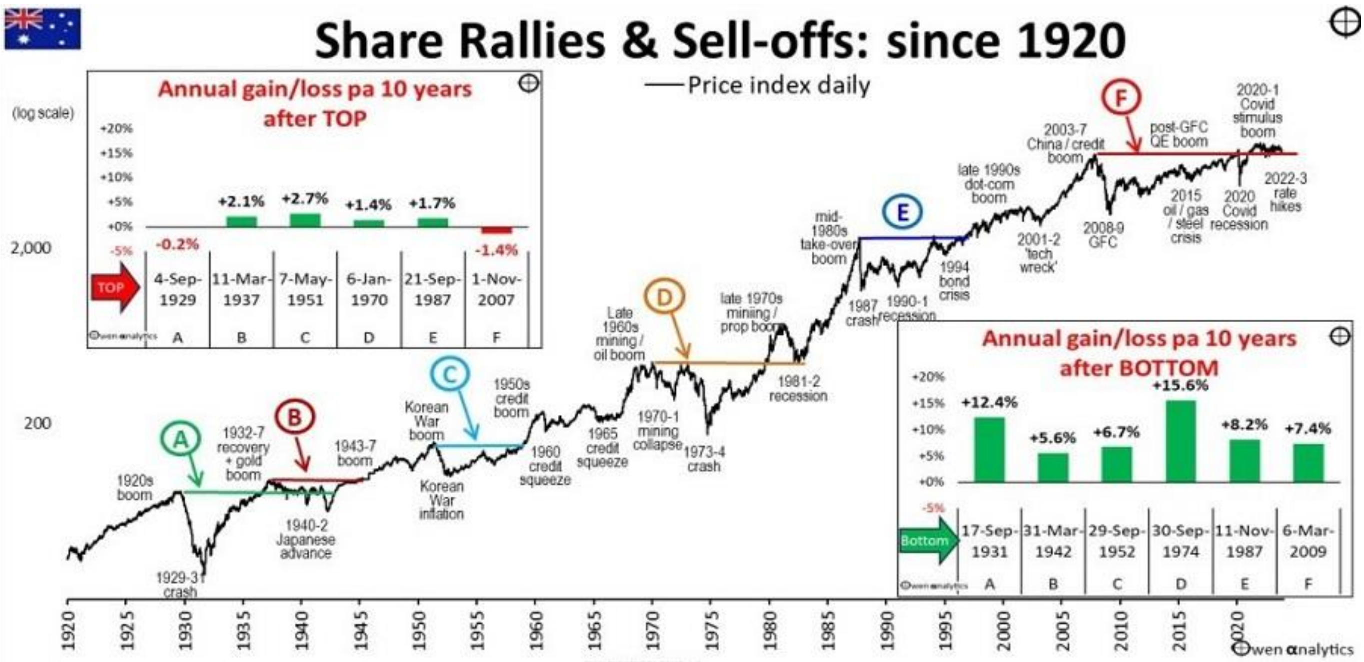
The sad fact is that the tops of wild speculative booms are when hordes of new investors finally pluck up the courage to enter the market. They have been cautiously watching prices rise for several years, and they finally succumb to 'FOMO' – the 'Fear Of Missing Out', after seeing their friends and family make 'easy money'.

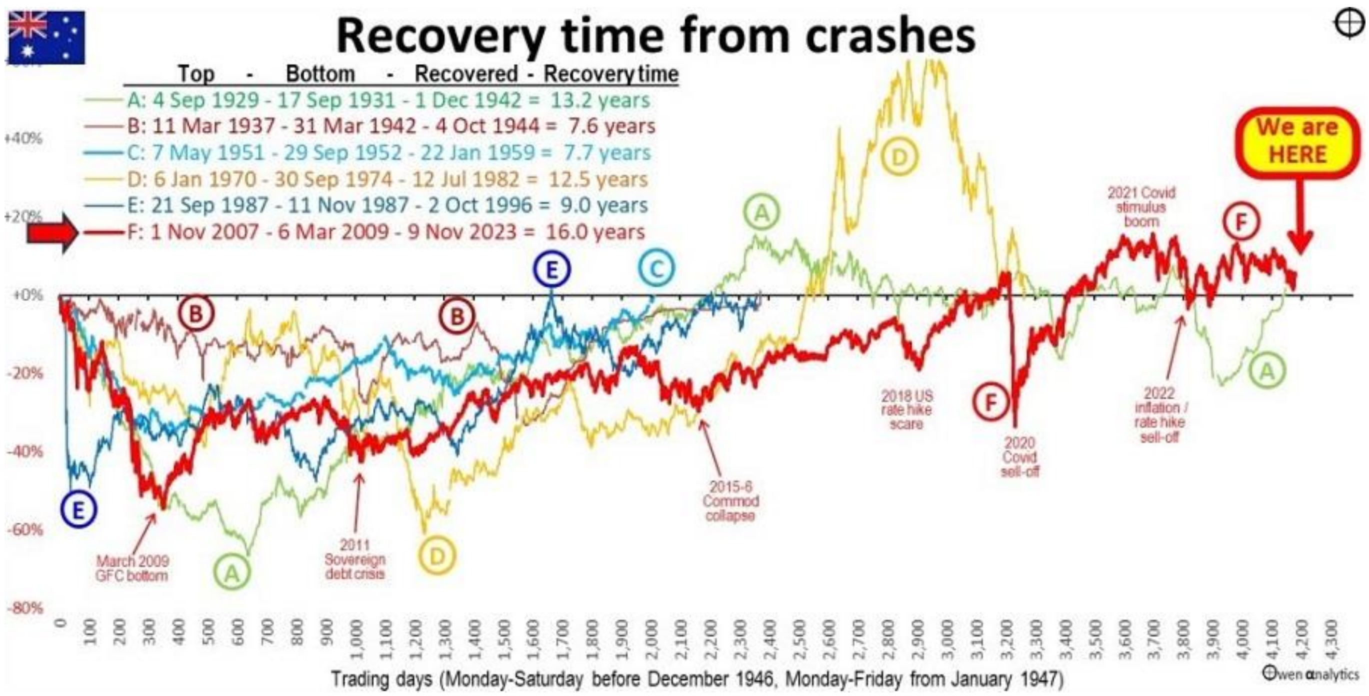
Equally, after the inevitable crash, in the depths of despair at the bottom of busts, most investors are shell-shocked and can't bring themselves to buy the very same assets at a fraction of their boom-time prices.

It is hard enough getting people to not to completely sell out at the bottom, which turns temporary price falls into permanent losses of capital.

The charts

The main chart in the first image shows the daily price index since 1920 (All Ordinaries and predecessors). Also in this image are two smaller charts we will cover below.





The price index has risen by an average of ***5% per year over the past century***, but there are no straight lines – ever. There have been a few booms and busts along the way – about once per decade.

I have highlighted six major busts from which it took many years to recover back to square. From the tops of the booms, it is not unusual to have to wait a decade or more for the market to recover back to the boom-time top.

Each of the cycles is shown from a common start point in the second chart above. In Cycles B, C and E – it took 8 to 9 years to recover boom-time peak prices. In Cycles A, D, and F – prices took more than 10 years to recover (including cycle F, which we are still struggling to recover for good, and put behind us).

Cycle A – the 1929-1931 crash

The 1929-1931 crash at the start of the Great Depression was our deepest market fall, but it was shallower than the US market. Our market started recovering a year earlier than the US market (we were quicker to devalue our currency, we had no banking crisis, and our boom market was less speculative and less over-priced).

The local market recovered its September 1929 high by late 1936 (seven years), but it fell back from early 1937 through to March 1942, in the early stages of WW2. It finally recovered its September 1929 high by the start of December 1942.

Cycle B – the 1937-1942 lead into WW2

The market fell from March 1937 in the lead-up to WW2 but started to rise in April 1942 when the US started to look like defeating Japan in the South Pacific. Prices finally recovered the 1937 high in October 1944, during the WW2 boom. The recovery would have been quicker, but wartime price controls limited share price rises.

Cycle C – 1951-2 Korean War inflation spike

This was a sharp share market fall as the government aggressively tightened fiscal and monetary policy to fight 25% inflation caused by the Korean War and lifting of WW2 price controls.

Cycle D – 1970-1 mining crash + 1973-4 property/finance crash

The double crash was nearly as deep as the 1929-31 crash and took nearly as long to recover 12.5 years), during the stagflation 1970s. Prices had recovered their January 1970 high by September 1979, soared in the 1980-1 mining/property boom but then fell in late 1981 and first half of 1982 in the early stages of the 1981-3 recession. Finally put the January 1970 high behind it in July 1982.

Cycle E – October 1987 crash

This was our sharpest and third deepest crash, and only recovered the September 1987 high nine years later in October 1996.

Cycle F – 2008-9 GFC

This is the one we are still struggling to recover. It included not only the 2008-9 GFC crash, but also some recent selloffs during the recovery:

- 2011 sovereign debt crisis
- 2015 China slowdown/commodities collapse
- Late 2018 US rate hike scare
- Feb-March 2020 Covid lockdown sell-off
- and now the 2022-3 inflation/rate hike sell-off

The index actually did recover the November 2007 high a few times in late 2019, but then fell back below square in the Feb-March 2020 Covid lockdown sell-off. It recovered again in December 2020 and rose in the 2021 Covid stimulus boom but fell back below par during the 2022 inflation/rate hike sell-off.

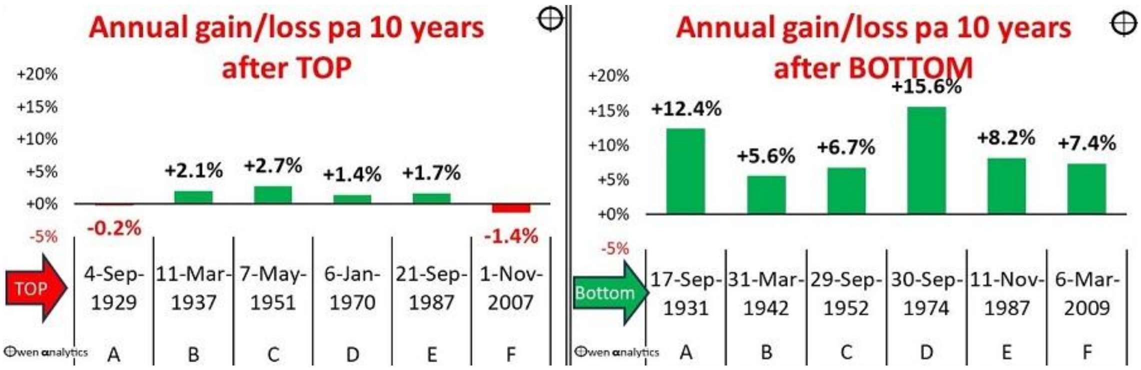
The index has been staying a little above the 1 November 2007 high of 6,853 since 13 October 2022, and almost fell back to it on 31 October 2023.

If we can put finally move ahead and not retreat to 6,853 again, we will finally rule a line under it and call the cycle over as at 13 October 2022, a fraction under 15 years from the November 2007 top.

Ten-year returns from different points in time

Below are the two smaller charts that are imbedded in the main chart above. These show the actual price gains/losses over 10-year periods starting from the tops of booms (left chart), and from the bottoms of busts (right).

As expected, the left chart shows virtually nil returns in the 10 years starting from the tops of booms.



This shows that the current cycle (F) has had very poor 10 year returns from the top, on a par with all the similar prior cycles.

On the other hand, the right chart shows above average returns in the 10 years starting from the bottoms of every one of the busts. When you buy cheap, you get above average returns.

Where are we now?

The current cycle (F) has been a little longer than prior similar cycles, probably because both fiscal policy (government spending/tax policies) and monetary policy (interest rates and QE) were far too loose for far too long – in Australia as well as in the US and elsewhere. This just prolonged and worsened problems and crises.

However, monetary policy is finally being restored to 'normal', inflation rates are retreating from their 2021 highs. However, fiscal policy is still loose and inflationary, and global trade and military tensions are rising, so there are a few challenges yet.

Pricing very different now

The big difference is pricing of the local share market.

The fact that the overall price index has remained flat for 16 years despite aggregate profits for ASX listed companies ***rising*** by 23%, and aggregate dividends rising by 83% over the period, tell us that we get 23% more profits, and 83% more dividends per dollar of shares we buy now, compared to what it bought at the top of the pre-GFC boom.

The market was substantially over-priced in 2007, but it is much cheaper now. We are not in a market crash or correction at the moment, so prices are not super-cheap as they were in early 2009 at the bottom of the GFC crash, or in March 2020 at the bottom of the Covid lockdown crash.

However, the market is certainly much better value than it was at the top of the market in 2007, and at the top of the 2021 Covid stimulus boom.

The local share market is not 'broken'

We have lagged the US market because we don't have a big tech/online sector. That has taken the US market much higher than ours, but the US will be hit much harder when the boom ends, as they always do.

You could look at the past decade and a half in two ways:

- ***no growth*** for 16 years if you start from the top of the pre-GFC boom
- ***above average*** growth for 15 years if you start from the bottom of the GFC bust

The first makes for a great headline to scare people. The second is equally true, but good news rarely makes the headline.

Ashley Owen, CFA is Founder and Principal of OwenAnalytics. Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual. OwenAnalytics Newsletter is currently published on LinkedIn. Original article here: 'Australian share market has gone nowhere for 16 years? Is it 'broken'? Has it lost its mojo? Will it ever get back to growth? Time to look elsewhere?

Navigating downsizing

Noel Whittaker, Rachel Lane

You may have spent years (and a significant amount of money) making your current home your "forever home" so thinking about downsizing can be hard. It helps to offset any sadness about leaving with excitement about your new home and the happy times to come. Like any big decision getting your downsizing decision right is going to take some research.

Know your why?

Understanding why you want to downsize is a crucial first step. Knowing what you want to leave behind, what you want to keep and those things you want to change helps you understand the driving force behind your decision. You may want a different lifestyle and seek a "sea change" or "tree change" or you may simply want a low maintenance home in your current community. There can be financial reasons too: paying off debt, freeing up equity and reducing property related costs with the combined outcome being more time and money to spend doing the things you love.

Determine what you can afford

Moving costs money. While that may seem obvious, many people simply compare the price they are getting for their existing home with the price of their new one, but this is a recipe for disaster – because the cost of moving can easily run to tens of thousands. You need to break it down into selling, moving, and buying costs, this will make sure you are not left short when it comes to how much you will have available to spend or invest.

Work out where

Where you live affects how you live and it's something you can't change without moving again. So, think about the people and places you want to be close to (or far away from). Whether it is family, friends, the beach or a favourite club identifying the people and places that you want to be close to can help you narrow down your Where.

Consider the accommodation itself, taking into account the spaces you'll need – a second bedroom if one person snores, a room for visitors, an outdoor space to enjoy your morning coffee – think about how you will live in the space.

And while you may be fighting fit now, it's wise to contemplate your future needs, especially if your plan is to stay in your new home long term. Ask yourself "What happens if I need care?". Modern homes, including granny flats and those within retirement communities, are often designed with future care in mind. Look at your new home for potential access challenges, such as narrow halls and doorways and cramped bathrooms.

Few people plan to spend their days watching television, but if you don't plan anything else that's what you can find yourself doing. So when you're thinking about where to downsize to ask yourself "How will I spend my time?". If you are thinking about moving into a retirement community there is normally an events calendar, grab a copy and circle the activities that interest you.

Understand what you are signing

No matter what form your new home takes – whether it's a freehold, strata title, leasehold, licence, or a granny flat arrangement – you will need to sign a contract. Your contract spells out your rights, responsibilities, and costs. Your job is to ensure that you understand it and that it has a fair balance of these three elements.

Of all the downsizing options granny flat arrangements can be particularly complex as they involve family, are not necessarily on commercial terms and if it goes wrong the whole family can be affected.

Crunch the numbers

While the purchase price of your new home may be obvious there's much more to consider.

In freehold or strata properties, you may need to factor in stamp duty, owners' corporation fees, and the potential for special levies. While granny flat arrangements are typically with family that doesn't mean they are free. In retirement communities, there is the weekly or monthly fee that you pay to live in the village and often there can be an exit fee. Your exit fee will typically include a Deferred Management Fee (DMF) as a percentage of either your purchase price or future sale price and there can be shared capital gains or losses with the village operator, along with renovation costs, marketing and selling fees.

There is a simple exercise called the Ingoing, ongoing and outgoing that you can use to work out how much you will pay upfront, while you live there and when you leave.

Armed with the knowledge of what your new home is going to cost you can get a clearer view of the bigger financial picture. How much money will you have to invest or spend, how much Age pension (and other benefits) you can receive, your cash flow, and in the longer term your financial position should the need for aged care arise.

The Where and Why of your downsizing decisions are just as important as the contract you sign and its associated costs. Ultimately, getting good "bang for your buck" from your downsizing decision often comes down to how you invest your time and who you spend it with.

This is an edited extract from Downsizing Made Simple (2nd Edition) by Rachel Lane and Noel Whittaker. Downsizing Made Simple is available from www.downsizingmadesimple.com.au and all good bookshops. The website also has lots of useful exercises, checklists and calculators to help you on your downsizing journey.

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

Firstlinks readers are invited to celebrate the launch of the second edition of Downsizing Made Simple with authors Rachel Lane and Noel Whittaker. Places are limited, so book early. In various major cities from November 28 to December 7.

From our 2018 interview with Sir Michael Hintze, what's happened since?

Graham Hand, James Gruber

Sir Michael Hintze is an Australian success story (well, we'll claim him, anyway). Born in China, he emigrated to Australia as a young boy. He earned degrees in Physics and Engineering in Sydney before joining the Australian Army, and then finding work in bond trading.

Hintze moved to Britain in the 1980s and set up his own credit-focused hedge fund, CQS, in 1999. It was wildly successful and Hintze, like a number of hedge fund managers, became an investment rock star in the lead-up to 2008.

The rock star status faded in the 2010s as serene markets made outperformance tougher. Still, Hintze grew his business until stumbles during the pandemic saw funds under management fall 25% to A$20 billion.

It was during this recent period that Hintze pivoted away from his hedge fund roots, growing his long-only business with lower fees.

Since 2022, as market volatility has returned, hedge funds have found favour with investors again. And that's perhaps proved the tipping point for Hintze to step away from his firm, announcing the sale of CQS to Canadian giant, Manulife, for an undisclosed sum. A well-time sale, though you'd expect nothing less.

In 2018, Firstlinks' Graham Hand interviewed Sir Michael about his firm and what gave it an investing edge.

GH: You've made the point that to have an investment edge, knowledge is not enough, you need imagination. How important is it when you hire staff that they have backgrounds and interests outside of finance?

MH: Over the years, I've hired staff with broad backgrounds, but let me say, they do need to be numerate as well, good with numbers. I've hired people who are historians or work in English literature, for example, many different backgrounds.

Knowledge has become a commodity, and true alpha lies in insight and imagination. You construct an investment, trade it and then risk manage it. You get paid for the imagination.

GH: When you interview someone, how do you find out if they have imagination?

MH: It's difficult, that's why you need to have a conversation. We have a process to see whether they can absorb some facts and how they think about them in a creative way. We might ask if they've seen something in the news today, what they think of it and have a conversation around it. It's hard but you can pick up if someone is not aware.

GH: You also write about the need for context and deep analysis in investing. Do you find you need to encourage staff to switch off their first reaction to something (what Daniel Kahneman calls 'System 1 thinking') and delve deeper into a problem?

MH: That's why you have processes. You want analysts who pull apart a problem, you want them to understand the fundamental issues around it with issues viewed through the lens of our models.

GH: Is that what you mean when you write, "Models are a great way to begin but a terrible place to end."?

MH: We have models which simulate various scenarios, but the really interesting thing for me is thinking about the problem and using imagination and judgement. We like to look at what can go wrong. For example, looking at the sub-prime market meltdown, you need imagination to say whether it will matter or not, to try to think about the fatter tails, the opportunities.

GH: In 2008, despite delivering excellent performance in the previous few years, your funds under management fell corresponding with a negative performance. And then 2009 and 2010 performance was again good. The same in 2015, there was a negative followed by a really strong year in 2016, but funds flowed out in 2015. Is that frustrating for you, that some investors take such a short-term perspective and exit at the wrong time?

MH: Operationally, we're always watching liquidity, we're watching what's happening, and perhaps that makes us an ATM. Many of our investors who were getting cash calls in 2008 needed to take money out.

GH: I can understand why you felt like an ATM around the GFC, but what about 2015?

MH: I think what happened in 2015 was a general view that the credit cycle was going to turn and the strategies I manage had substantial exposure to that. It's structured credit, and to some extent, still is. But we need to make sure our messages are put together in a more effective way.

GH: Your long-term track record is outstanding with only three small negative years since 2005. Do you look back on those years and ask what did we do then that was different?

MH: We always study where we make and lose our money, we pull it apart, I make sure we have liquidity and excess margin, we manage operational risk, and we take a longer-term view. The types of investments we make where the market falls often allows the next year to be much better.

In 2015 for example, there were a number of dislocations such as the end of QE, the end of the year concerns over China growth and systemic risk, a sharply-declining oil price, and that affected the high-yield bond market. That dislocation provided an opportunity to set up for a good 2016.

GH: It does look like many investors are exiting at the wrong time.

MH: I think they might but that's the nature of the business. I'm just managing strategies for long-term opportunities and not worrying about if it falls a bit.

GH: You've had an office in Sydney since 2010, and CQS funds are not available to retail investors although they are available to sophisticated investors through some private advisers. We have a shortage of the types of funds you manage for retail investors. Are there better opportunities to open access to retail investors in Australia, perhaps with a listed vehicle?

MH: We're uncomfortable with the potential volatility not only from the assets, but in a listed entity, the discount or premium relative to net asset value. It doubles up on the NAV volatility.

GH: In some of your presentations, the amount of detail on geopolitical issues is mind-boggling. How do you stay on top of it and lead to an investment decision?

MH: Again, we have a process, we have staff who do it and it's been my passion in my thinking, it's always been there. The market will also give a view, provided we've already done the background work. You start with noise, such as prices, news and events. You have to structure that noise into data sets to be able to create information and do more work on it to create knowledge. The problem is that because of education and data services, many can get to that knowledge, and there are lots of financial qualifications such as CFAs, CAIAs and MBAs.

Plus we're very well plugged in, we access think tanks. The key is to understand the transmission mechanism, not every interesting event will have a market impact. If you're in the Department of Defence or the Home Office or Foreign Affairs or wherever, you'll have a different take on it. Consider, say, the ebola virus versus SARS. Different cost and effect on GDP.

GH: Can you elaborate on your comments that social media undermines the battle for ideas?

MH: If somebody says something that is mildly controversial, the trolling can get quite aggressive. It doesn't even need to be controversial if you put your head above the parapet. It's not just the individual, it's their family. An example is my view on the environment. I care deeply about our planet and our environment is complex and fragile. For the record, I do think there is anthropogenic climate change and the whole global warming issue is important, but the almost-exclusive focus on CO2 is too simplistic. When I write that, I've had most horrific hate mail. The point I make is it's all very well to get the Government to focus on CO2, but what about deforestation, use of antibiotics, what about plastic pollution and poisoning the oceans, biodiversity, what about all those critical issues. Some people think all we should legislate about is CO2 and we'll be fine. We need a holistic view and strong global leadership to tackle the environmental challenges our planet faces. It's like the sugar debate … people should know not to eat too much and exercise more, why should the government legislate against sugar?

GH: Do you mean it's a personal responsibility, not the government's?

MH: Any market needs to have rules and guidelines but governments cannot simply legislate things away. We are living through a time of unprecedented challenge and change and the old world order is under threat. The institutions and governments and economic models we've grown up with are struggling and less effective. Politically-inspired regulation can be stifling. But given proper rules, markets, which are a voting system, can solve problems.

GH: Last question, it's important to mention your charity work, worsening income inequality, the plight of refugees, you say it's our job to protect the most fragile in society.

MH: Society cannot rely solely on the public purse. Prior to the 20th Century, it seldom did. I believe private philanthropy is better placed to motivate and partner with charities. We must take individual responsibility to look after others, it's our obligation to give back.

I often quote from the bible. It says, 'To those to whom much has been given, much is expected.' Charity is important. There are three principles that shape my philanthropy and career. The first is protection for the most fragile in society; the second is fostering aspiration; and the third is respect for institutions.

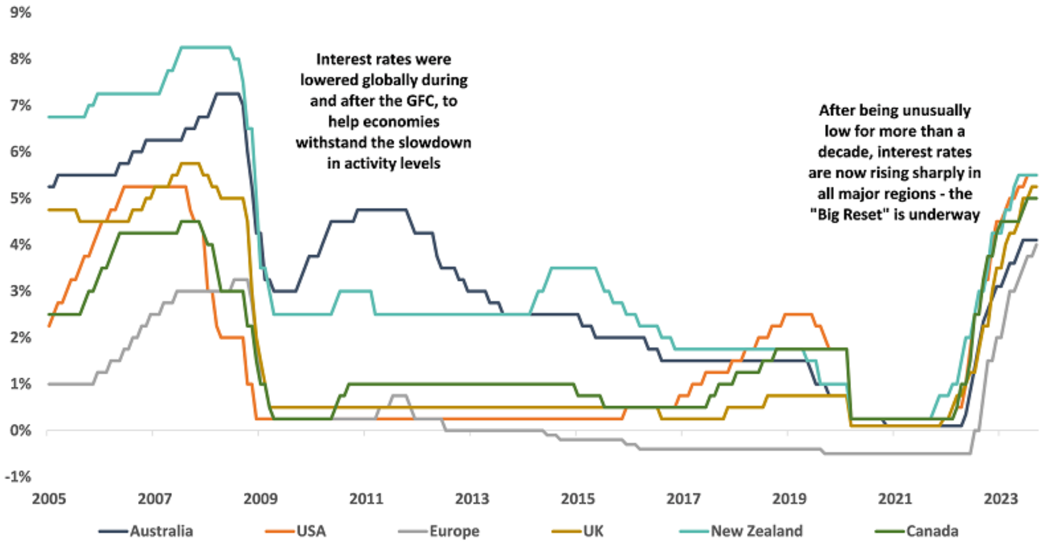
Graham Hand is Editor At Large at Firstlinks and this exclusive interview with Sir Michael Hintze, AM took place on 8 March 2018.

The time for bonds has come

Adrian Janschek, John Barrasso

Markets worldwide spent much of 2008-2021 adjusting to unprecedented central bank support. This period began with policymakers' response to the Global Financial Crisis (GFC) and finished at the end of the COVID pandemic. Much of this period saw cash rates in key regions at, or below, zero. Central bank balance sheets became bloated mostly with government bonds as authorities bought assets to support financial markets.

Figure 1: Developed market overnight rates



Source: Bloomberg. Data shown 1 January 2005 to 30 September 2023

In 2021, two major changes marked an inflection point for the 'Big Reset' to begin.

1 – Inflation exploded globally

- COVID lockdowns significantly disrupted manufacturing and supply chains across the globe, increasing both product prices and delivery costs. Commodity prices also began to skyrocket as the conflict in Ukraine unfolded.
- The scale of the global pandemic support delivered by governments and central banks was unprecedented and, in hindsight, arguably excessive. Consumers looked to deploy excess savings once the pandemic eased, resulting in an increase in global demand.
- These factors have seen inflation soar and the Consumer Price Index is now meaningfully above central bank targets in all key regions. Policymakers have responded by raising cash rates, hoping to dampen discretionary spending and bring inflation under control.

2 – The 'elephants' left the room

- With the global economy in full recovery and cash rates moving higher, central banks began to unwind their balance sheets, selling securities they had acquired in the preceding years. Central banks, previously the largest buyers of government bonds, became sellers.
- Government finances around the world were required to fund huge deficits from higher spending during the COVID pandemic. Markets have been flooded with higher bond issuance as governments look to repair their financial positions.

Historically, transitions away from aggressive central bank policies created volatility in financial markets, owing to uncertainty around the pivot from one interest rate regime to another. We believe that a soft landing is the most likely outcome over the next six to nine months whereby policymakers are able to engineer a slowdown in economic growth and inflation, without tipping economies into recession, and further changes in central bank policy will be gradual following a recent pause in the tightening cycle.

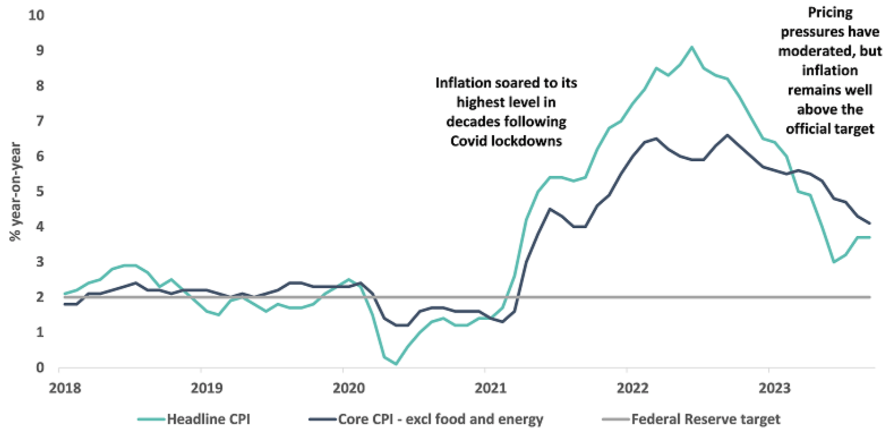
Where to from here? We share our thoughts on inflation, the pending actions of central banks regarding cash rates and, in turn, the possible implications for long-term bond yields.

Inflation

With some of the large increases in prices in late 2022 and early 2023 rolling off the calculations, referred to as the 'base effect', we believe annual inflation will continue to moderate well into 2024. The most recent data, including 3-month and 6-month annualised run rates, are converging back towards central bank target rates. In some cases, most notably in the United States (US), readings such as the Multivariate Core Trend[1] and the Underlying Inflation Gauge[2] have nearly recovered to pre-COVID levels.

We are mindful of stickier elements of inflation, which might be harder to dislodge from the official data. These include rent or shelter costs and the prices of other services that have lagged the rise in goods prices globally, and which may remain elevated due to surprisingly robust economic growth rates, low unemployment levels, and strong wage growth. Central banks are not forecasting a return to target inflation rates until 2025 or 2026, suggesting they could continue to warn about the possibility of further interest rate hikes, and guide investors away from the possibility of premature policy easing.

Figure 2: US inflation



Source: Bloomberg. Data shown 1 January 2018 to 30 September 2023

Cash rates

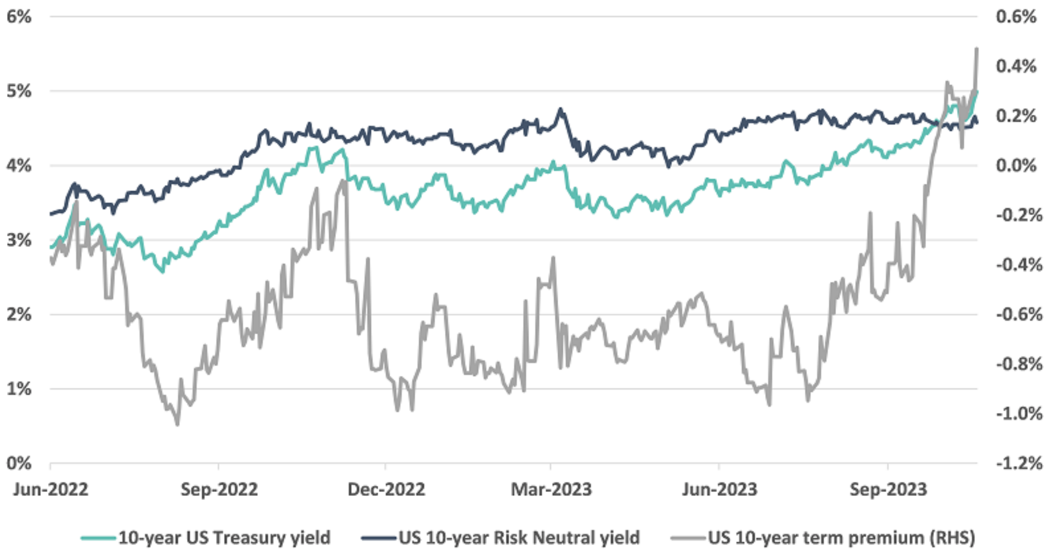
Following the sharp rises over the past 18-24 months, overnight cash rates in many parts of the world are at or near their cycle highs, in our view. Most major central banks now regard the risks to economies as more balanced, and given our inflation view, we believe policymakers' 'higher for longer' stance will be maintained. Some countries might be required to raise cash rates by another 0.25-0.50% in the next 12 months if delays in inflation returning to target exhaust central banks' patience. At the very least, we feel policymakers will likely seek to guide markets forcefully away from expecting rate cuts until inflation is much closer to target levels or growth begins to falter.

Although this is our base case, our inflation and interest rate views are fluid. We are mindful of a potential re-acceleration of the global economy by mid-2024 driven by US economic strength, which in turn could require another round of rate hikes to counter this.

Long-term bond yields

Yields on longer-dated fixed income securities consist of two elements: expectations regarding the future path of cash rates and the term premium. Term premium, defined as the compensation that investors demand for interest rate risk in bonds, plays a critical role in understanding yield movements. The impacts from central banks unwinding their balance sheets, increased government bond issuance, geopolitical events and uncertainty around future inflation all suggest we could see further upward pressure on long-term yields i.e. the term premium and yield curve moving higher. The grey line in Figure 3 shows how much of an effect the recent increase in term premium has had on bond yields, over and above the market's expectations of higher interest rates.

Figure 3: US 10-year term premium



Source: Bloomberg. Data shown 1 June 2022 to 19 October 2023

What signs are we looking for to suggest the "Big Reset" could be complete?

- First, we expect the Bank of Japan to strongly support and defend its recently announced 1.00% target for 10-year Japanese Government Bond (JGB) yields. The Bank of Japan changed its Yield Curve Control policy in July, doubling the cap on 10-year yields from 0.50% to 1.00%. This is a strong and underappreciated driver of global rates, given the Japanese yen has long been regarded as a funding currency, and since JGBs have anchored global rates. Japanese bonds have not participated in the global sell-off to the same extent as other sovereign bond markets due to stable Japanese monetary policy, which has seen official cash rates remain unchanged in Japan for more than seven years. While this yield adjustment is ongoing, we believe upward pressure on global yields could persist.
- Base effects continuing to slow inflation to a pace that may be slightly higher than central bank forecasts, but without any big upside (greater than +0.50% from target) surprises.

- Asset selection starts to favour US Treasury yields over equity earnings yields by greater than 0.50%. Currently, 2-year US Treasury yields are close to 5.20%[3], compared to an earnings yield of around 4.75%[4] on the S&P 500 Index.
- With the Effective Federal Funds rate[5] currently above 5.30%, we are looking for yields on 10-year Treasuries to approach that level and largely remove the negative carry still embedded in yields before we consider the market to have reached a more stable equilibrium.
- The risk/reward balance favours our forecast for a further increase in term premium and the possibility of further increases in cash rates.

If bond markets travel as expected and the "Big Reset" is close to completion, fixed income should appeal to investors. Specifically, an allocation to bonds currently offers a good opportunity to access attractive, credit risk-free income streams.

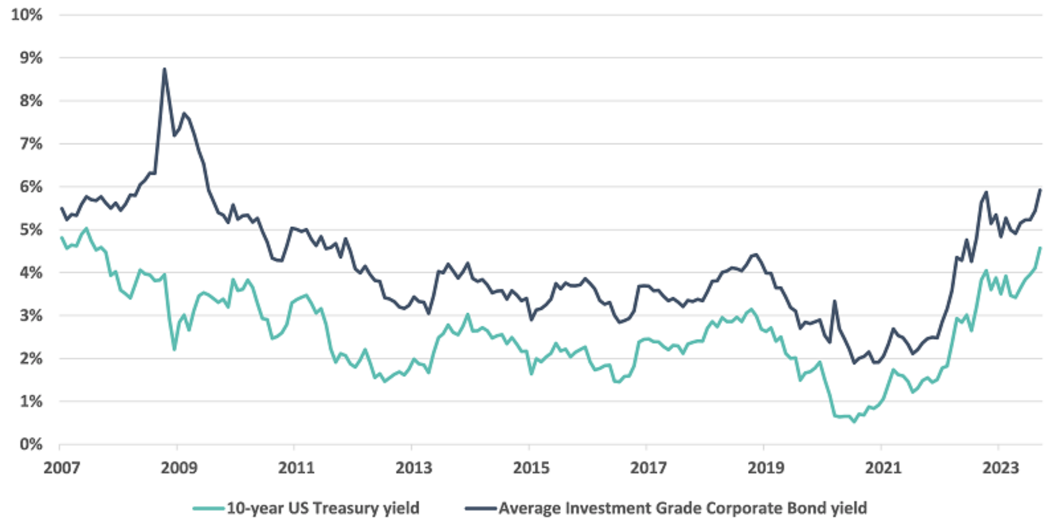
For local investors, for example, a 0.50% increase in the 10-year Australian Commonwealth Government Bond yield from today's 4.73% would still generate a total return of 0.9% over a one-year holding period. Conversely, the yield falling 0.50% would result in an 8.6% return.

The skew is now much more in favour of investors than it was during the extended period of near-zero interest rates following the GFC, because higher rates mean higher income streams, cushioning any potential capital depreciation of bonds. In order to have a negative return over a one-year holding period, 10-year Australian Commonwealth Government Bond yields would need to rise 0.60%, on top of the 3.70% they have already risen over the past two years or so as the Reserve Bank of Australia has increased the official cash rate from 0.10% to the current 4.10%. Regardless of the future interest rate path and the potential for some variability in returns along the way, long-term investors will capture an annualised, risk-free return of nearly 5% over ten years if purchased bonds are held to maturity.

As a reminder, fixed income offers two main attributes to investors:

- **Income** – Low-risk 10-year government bonds in the US, Australia and New Zealand are typically offering yields between 4.50% and 5.50%. Highly rated corporate bonds are providing even more appealing income streams, typically between 5.75% and 6.50%. These are the most enticing levels for more than a decade. First Sentier Investors' flagship Australian Fixed Income Fund, which consists primarily of State and Government bonds, is currently yielding around 5.20%[6].

Figure 4: Prospective yields from US Treasuries and Investment Grade Corporate Bonds



Source: Bloomberg. Data shown 1 January 2007 to 30 September 2023.
Investment Grade Corporate Bonds are represented by the Bloomberg Global Aggregate Corporate Index.

- **Diversifier to equities** – Post the cyclical "Big Reset" that appears to be nearly complete, we believe the correlation between fixed income and equities will reassert itself. We saw this during the banking crisis of March 2023, when bond prices increased (as yields fell by around 0.50%) and the S&P 500 Index fell around 5% during that two-week period. An allocation to fixed income should therefore provide useful diversification from risk assets, helping investors generate smoother, more stable overall returns from their investment portfolios over time.

With these considerations in mind, we consider the current risk/reward trade-off for holding bonds to be particularly favourable and could present investors with a good opportunity to increase exposure to fixed income assets.

[1] A model that measures inflation's persistence across the core sectors of personal consumption expenditures price index (PCE).
[2] This captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data.
[3] Source: Bloomberg. Data as at 19 October 2023.
[4] Source: Bloomberg. Data as at 19 October 2023.
[5] A daily effective interest rate, calculated using the volume-weighted mean of overnight rates on trades arranged by major brokers. Data as at 19 October 2023.
[6] Source: First Sentier Investors. Data as at 19 October 2023.

John Barrasso and Adrian Janschek are Portfolio Managers in the Australian Fixed Income team at First Sentier Investors, a sponsor of Firstlinks. This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs.

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What can brain cancer really be like?

Graham Hand

On 26 October 2023, less than a month ago, I was playing soccer in the same way I do each week, in an over 60s competitive kickaround with the lads. My right leg felt strange, like a numbness, which had started a couple of days earlier.

How did I go from this relative health to full-on brain cancer treatment in a few weeks?

I write this not as a medical record or an analysis of brain cancer. There are better places for such research. It's more about how quickly events can change, none of us knows what might happen and everyone will be different.

Thursday, 26 October

Advised by local GP to go immediately to North Shore Hospital by ambulance to check leg numbness. Did not take any overnight clothes, expected to be out in a couple of hours. Scans showed shadows or marks deep in the thalamus where information from the body's senses is processed. Held overnight before transferring to ward.

Saturday, 28 October

Finally completed full MRI and met with neurosurgeon. Greater detail from MRI showed brain tumour cannot be removed as extremely sensitive part of brain, too dangerous to operate. Only possible action is biopsy to determine type of tumour and small brain samples for analysis. Met with another neurosurgeon who specialises in such surgery and will operate as soon as possible.

Wednesday, 1 November

Given operation priority, checked into hospital for more MRIs, interviewed by anaesthetist ready for earlier start tomorrow.

Thursday, 2 November

Four-hour operation, passed the first hurdle that a small percentage of patients don't survive. Stayed overnight in ICU, feeling fine but groggy. Surgeon said operation went well, stay in hospital for a couple of days.

Friday 3 November

Transfer to ward next day. Tried walking but was shocked how unsteady on my feet. Physio said normal after brain surgery so walked around ward to gain confidence. Right leg numbness not improved, tingle in hands. Surgeon visited to review expectations for first week. Taking anti-epilepsy and steroids to control brain swelling each day.

They plan to include me in new global drug trial, the first Australian patient, by the end of November after recovering from surgery. Good candidate as live near hospital and never in a clinical trial before. Treatment will run in parallel with normal techniques. Met with three doctors from Singapore excited to be starting in Australia.

Sunday, 5 November

Went home but slept a lot. Not worried or distressed, quite comfortable. Able to see a few friends over coming days but only for an hour until needing to sleep again. Walk a couple of times a day, fine at night. Surgeon suggested gradual reduction in doses of drugs, especially steroids which they prefer to avoid.

Friday, 10 November

Met with neurosurgeon again who will stay close to my case but pass me more to specialists in oncology, radiation and chemo. Calm and confident advice from professionals, impressive treatment, no false promises. Confirmed as Stage 4 glioma, any theories about Stage 2 or 3 not relevant. Met with main oncologist who will handle chemo, who prefers me to stay on steroids and anti-seizure tablets until we know reaction.

Sunday, 12 November

Bad day, probably came off steroids too quickly last week. No energy, leg painful. Walking worse and brain confused, struggling with details.

Tuesday, 14 November

Appointment with radiation oncologist who will lead my case now. Clear explanation of what will happen. He expects to start chemo and radiation towards end of November, prefer to wait at least three weeks after operation, then initial six weeks of treatment.

Wednesday, 15 November

Vague, sleepy. Eat little. Tried to attend an event but could not coordinate after getting ready. Based on new MRI, oncologist decided far more brain swelling than expected around thalamus although no tumour growth. He decided to cancel including me in the global trial, suddenly treatment urgent and will commence in a week. Placed onto extra steroids to cover tiredness.

Friday, 17 November

Oncologist rang again late Friday and wants to start treatment immediately, no benefit in waiting and clearly worried about energy levels and my brain swelling. Fitted for Kevlar mask which locks head tightly into position for radiation (actually, x-rays) of tumours in brain. More than one area to target. Doubled the drugs on the weekend to avoid sleepiness. Felt fine with higher doses.

Monday, 20 November

Full radiation treatment starts. Head must be held perfectly still. For the next six weeks, need to attend hospital every day except weekends, plus chemo every day to support the radiation. Monitor steroid use closely as they can erode strength and muscles, so a fine balance.

Tuesday, 21 November

Good walk, feeling fine, met again with radiation oncologist. Happy with results from first two days of radiotherapy. Impressive knowledge and approach, I'm happy I'm in the best care. Radiation is carefully designed to target exactly the right area of the brain, leaving healthy parts while focussing on the tumour. Oncologist is far happier with the decision to push ahead quickly as scans last week were not good but I have improved from the brain swelling.

So that's where I am. Better than a week or two ago but taking nothing for granted. Multiple medications every day, blood tests every week, regular meetings on progress.

Thanks for the hundreds of kind messages, apologies for inability to respond, trying to stay well and active, sleeping where needed. Amazing wife and family, great friends, still feeling good and optimistic but nobody knows.

Graham Hand is being treated at North Shore Hospital in Sydney but the names of experts involved have been withheld for their privacy. Graham announced his initial diagnosis here.