THE VIEW | TAILWINDS STILL SUPPORT GROWTH ASSETS

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TAILWINDS STILL SUPPORT GROWTH ASSETS

In my recent "Letter to Investors", I noted that new headwinds are confronting an equity market that still benefits from the tailwinds of aggressively expansive monetary policy.

These headwinds wax and wane as time passes, and this weekly communication (both written and video) attempts to address these issues in a timely matter.

This week's heightened issue (headwind) is the emergence of elevated energy prices (notably across Europe), with power shortages and supply disruptions. This will lead to higher readings for inflation and place increased pressure on households with low incomes. Whilst this is not a welcome development, it will most likely subside post the northern winter - but the next period will require further government (and therefore supportive monetary policy) responses.

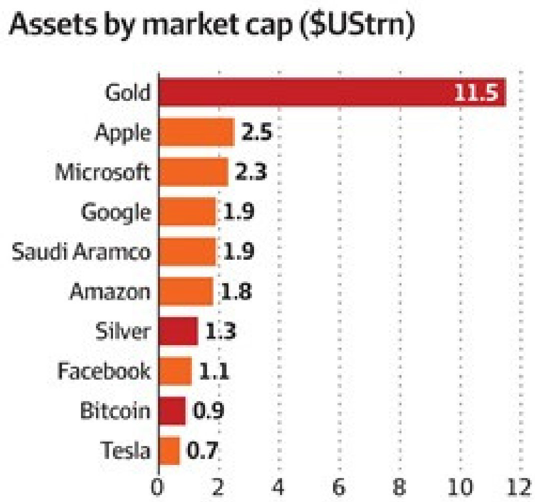
The global push for a non-carbon world continues and is causing both supply and pricing issues in energy markets. UK and European natural gas prices shot higher early this week to trade at close to 10 times their level from the beginning of the year. Record natural gas prices are one symptom of a global battle to secure fuel supplies after demand rebounded rapidly from the depths of the pandemic. The price of thermal coal, which is used to generate electricity and for heating, has also surpassed its all-time peak set in 2008.

One beneficiary of this is the Australian trade account, where iron ore price declines are being offset by energy exports prices (notably both LNG and thermal coal). To this point, Australia has posted a record September Quarter trade surplus, with a run rate in excess of $150 billion per annum.

One predictable policy response of energy price rises across Europe will be that Governments can be expected to subsidise households to hold down the effective cost of energy. That means more government expenditure funded by further QE support. That is the cycle we are in, and QE will remain as a government funding policy until it is shown not to work.

Before moving to the main agenda of this note, it would be remiss not to make mention of the revelations concerning the Pandora Papers that exposed the significant hiding of wealth by some extremely wealthy people.

In a world that is full of massive speculation, supported by negative interest rates and currency printing, it is interesting to note the emergence of bitcoin with near US$1 trillion of market value. That begs the obvious question: How much wealth is now being hidden from tax authorities in bitcoin? Indeed, is that an underlying reason why bitcoin has been so well sought?



Source: Bank of America

Back to the headwinds/tailwinds for Australia

After that slight deviation, let's return to the longer term. Indeed, it is our view that many current headwinds will fade, and the growth engines that have aided the Australian economy for many decades will return. As the COVID-19 shutdowns are traversed and economies reopen and activity returns, the equity market will reassess the outlook for 2022 and beyond. From my vantage point, the medium term outlook remains positive and more so with a determined desire by the developed world to live with COVID-19.

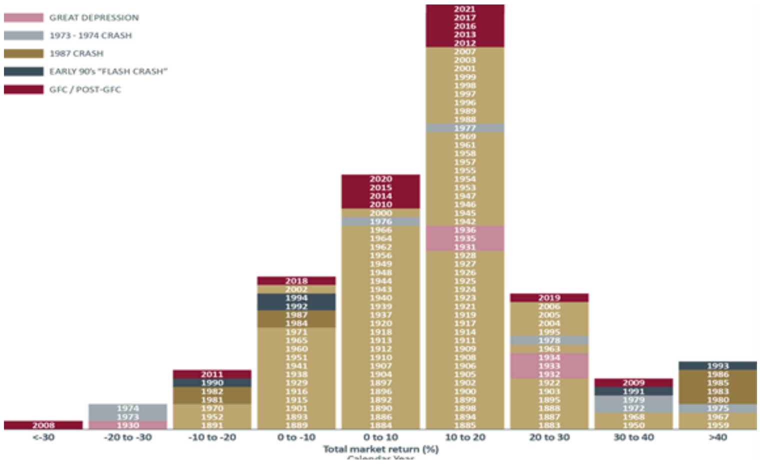
In this note, I will scan financial history to show that investors need to hold their nerve and maintain exposure to growth or risk markets. Whilst the current cycle is unique, with extraordinary monetary settings, it is still the case that a balanced asset allocation should remain tilted to growth assets because of two key reasons:

1. Growth assets (particularly equities) generate returns that are superior to other assets over the long term, and therefore generate the core of the required return for a balanced portfolio; and

2. Bond or low risk yield assets have yields that are currently well below inflation and therefore are guaranteed to generate poor returns and provide little to the required return of a balanced portfolio.

To support these contentions, I have opened with some charts that I believe will help you (as an investor) focus or maybe re-focus on the longer term. Always remember that the management of pension assets to meet pension liabilities is a long term endeavour. In securing long term returns, we must maintain a level of investment in growth assets (equities and properties), for these continue to outperform passive yield investments and they have done so for decades.

The first chart (updated for calendar 2021 year to date) shows that the equity market has produced positive returns in 80% of years. When positive returns are generated, about 50% of those years generate returns greater than 10%.



Source: Bloomberg

Reviewing the above chart, we can see that equity returns in 2018 were below average, returns in 2019 were above average, whilst both 2020 and 2021 produced average returns. Thus, despite the volatility and the pandemic crisis, the returns from the equity market over the last 4 years have not been extraordinary. Indeed, given the negative interest rate environment and the economic growth flowing from China, returns are hardly suggestive of a bubble that will soon burst.

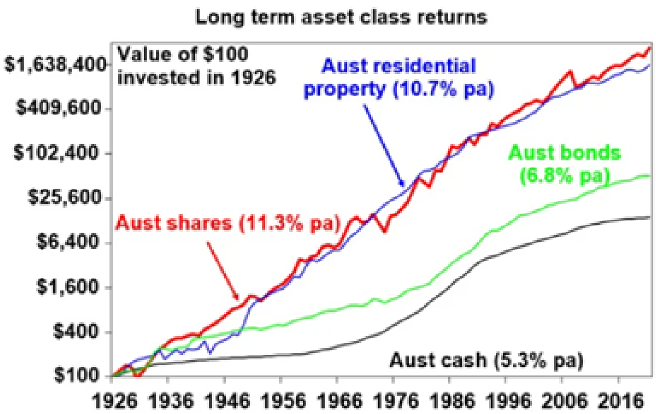
As I have often stated (and again in my recent Letter), bubbles do exist in parts of the equity market but not all across it. However the most obvious bubble is present in the bond market, with its large negative real yields.

The next table covers returns from equity markets over both 125 years and the last 42 years. The table makes obvious the observation above that the equity market achieves a positive return in the overwhelming majority of years. Further, the average return of positive years is twice that of the negative return in poor years. The average return of poor years is increased by severe crashes (negative 30% years) which have occurred sporadically. The most recent crash in 2008 was the worst recorded and it is etched in many investors' memories.

SINCE 1875	NEGATIVE RETURNS	POSITIVE RETURNS	TOTAL
# of Years	29	117	146
% of Years	19.9%	80.1%	100.0%
Average Return	-10.4%	16.1%	**10.8%**
SINCE 1979			
# of Years	11	31	42
% of Years	26.2%	73.8%	100.0%
Average Return	-11.8%	21.8%	**13.0%**

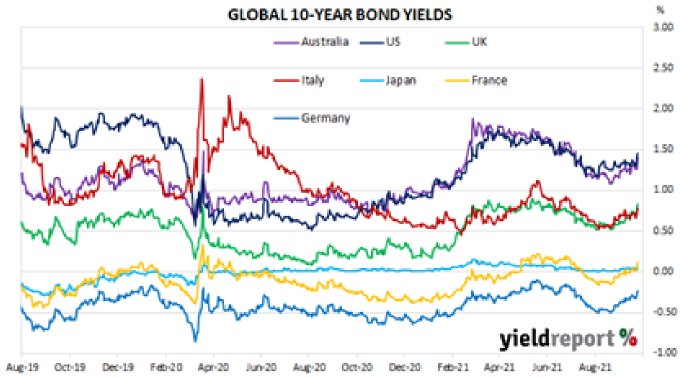
Source: Naos Funds

Whilst the table above speaks for itself, it is the following chart that shows the long term compounding returns from asset classes. This chart also gives us a potential glimpse into the medium term outlook for returns, given that cash rates are set at historically low levels and bond yields are well below inflation.



Source: AMP

It is clear that bond returns over the next five years are likely to be well below the long term average of 6.8% pa. Current 10 year bond yields across the developed world range from negative -0.25% to positive +1.5%.



Source: YieldReport

It is also obvious that cash rates (and term deposits), currently at 0.25% (average) are at least 5% below their long term compound returns.

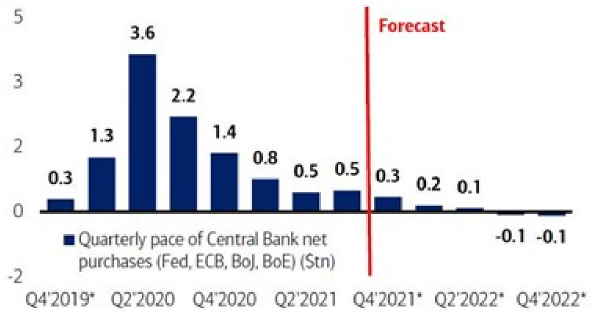
The fundamental issue to consider for the outlook for both equities and property is their likely performance against the headwind of slowly rising interest rates. The creation of market prices will be determined by the interplay of growth (economic growth leading to corporate earnings growth) against PER (price to earnings ratio) compression (as interest rates rise).

The extent to which interest rates rise and the time frame over which that occurs will be determined by speed and rate of inflation. However, and unlike in the past, we are being told that Central Banks are determined to live with a level of inflation slightly above 2% per annum. The Central Banks will slow interest rate rises, stimulate economies by supporting Government expenditure (QE), and thereby maintain the tailwind support for growth assets – equities and property.

Those tailwind policies are the subject of much speculation. How long will interest rates stay low? And for how long will QE be maintained across the developed world?

The next chart from Bank of America suggests that QE across the world will end and be reversed in mid-June 2022. Whilst that may happen (we think it unlikely), it will only occur if the "unaided or un-manipulated" bond markets support bond yields at below inflation rates. That won't happen because a bond manager's job is to generate returns above inflation. Therefore, without Central Bank guidance and support, we expect bond yields would lift by between 1% and 2% across the world and cause a "bond crash". QE will not end if that is the likely and predictable scenario.

Chart 13: Central Bank purchases set to decline
Quarterly pace of Central Bank net purchases (Fed, ECB, BoJ, BoE, $tn)



Source: BofA Global Investment Strategy, Haver
BofA GLOBAL RESEARCH

Clearly, Central Banks are not conducting their policies consistent with their past practices; we truly are in uncharted waters. That is creating the confusion in economic and market commentary. Whilst forecasting remains inherently difficult, we do have an unprecedented level of forward guidance by Central Bankers. That guidance (assuming it is followed by action) allows an investor to allocate to investments supported by the policy guidance. The trick is to discount forecasts that ignore Central Bank guidance; it is the old adage "Don't Fight the Fed".

Fundamentally, we must manage portfolios based on the proven assumption that Central Banks will pivot to support both their bond markets and their Governments. Further, we must acknowledge that Governments will do whatever is needed to support economic growth and to be re-elected. Fortunately, this means a likelihood of benign conditions being maintained for equity and property markets for a few years yet.

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