Quarterly Review of Investment Markets and Portfolio Changes

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StanfordBrown Private Wealth

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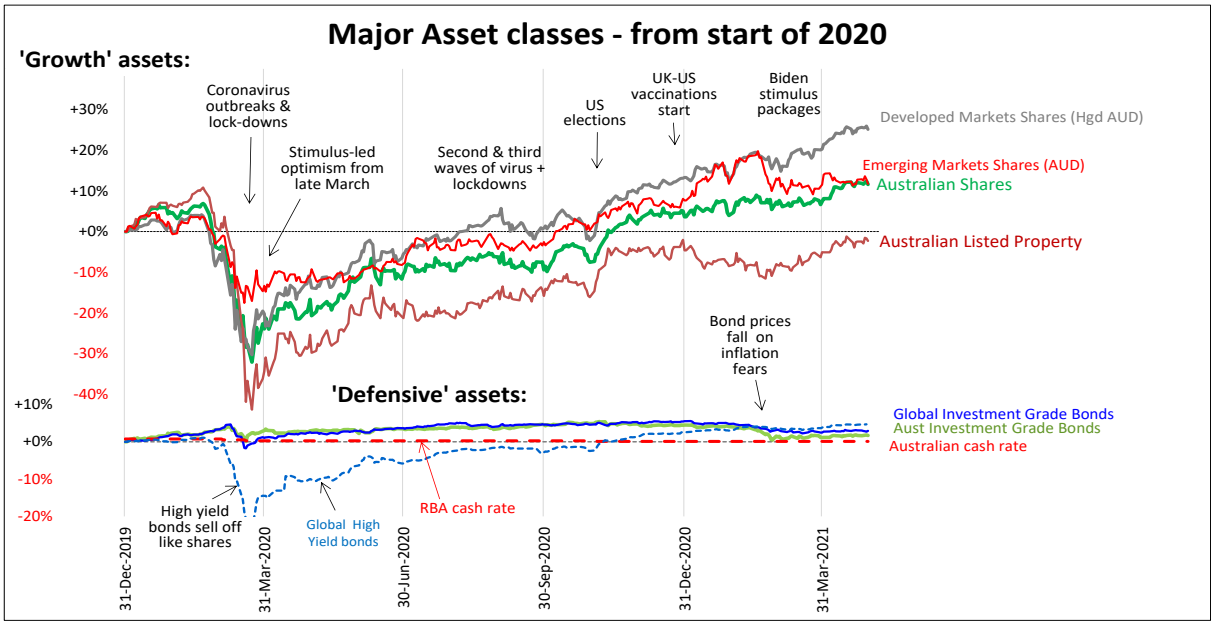
Economic & Investment Market Conditions

This is our regular quarterly report that sets out our portfolio positioning and asset allocation changes following our review of the March quarter 2021, with the changes being made at the end of April.

The first four months of 2021 have been a continuation of the rebound in investment markets that was triggered by unprecedented government support that began in late March 2020 in the very early stages of the coronavirus crisis, lockdowns and economic recession. The main event affecting investments this year have been new US President Biden's $1.9 trillion coronavirus support bill, plus a further $2.3 trillion on infrastructure, clean energy, manufacturing and education. In Australia, support programs are being scaled back, with limited side-effects, and stronger than expected jobs markets and consumer spending. On the monetary side, central banks in the US, Australia and other key markets have renewed their determination to keep interest rates low for years.

Our diversified investment portfolios posted modest positive returns again in April thanks to gains in each of the major asset classes. We are aware that investment markets are priced at very expensive levels, but we remain cautiously optimistic that the enormous fiscal and monetary stimulus can sustain the surge in incomes, spending and company profits for the time being. Fact sheets with portfolio returns can be found at these links: Conservative, Moderate, Balanced, Growth, High Growth.



Virus pandemic – the crisis is far from over. In the 'developed' world, vaccine rollouts are well underway but are being hampered by vaccine side-effects and new strains, necessitating further lockdowns. Infections and death rates are now in a new 'fourth wave'. In much of the 'developing world', in particular India, the crisis is still escalating rapidly.

Economic growth – in 2020, countries everywhere recorded their steepest and deepest economic contractions since the 1930s, but the recoveries continue to exceed expectations in strength and pace. However, there is still a significant risk of further lockdowns causing 'double-dip' recessions or set-backs in recoveries.

Unemployment – jobless rates continue to decline more quickly than expected in most markets, including locked-down Europe. Australia's JobKeeper program ended with little impact as most had been weaned off months ago.

Household savings rates are still at very high levels across the developed world thanks to government hand-outs and restricted spending opportunities. As restrictions are eased, this should unleash a flood of pent-up spending, which should provide a further boost to company revenues and profits.

Share markets – share prices continued to rise as companies posted good rebounds in revenues and profits in the latest reporting season. The US was again the best of the big markets in April, led by its tech, online retailing & social media giants. The best sectors globally in 2021 have been those worst hit in 2020 – banks (with lower bad debts than expected) and oil/gas (with oil prices recovering), although both sectors are still well behind the rest of the market.

Interest rates – Central banks have retained and re-affirmed their commitment to ultra-low rates. Fears of inflation sent bond yields rising in late 2020 and early 2021 due to fears of impending rate hikes, but central banks hit back with renewed bond buying to show their commitment to keeping rates low for years, even if inflation rises above target.

Bond markets – Fixed-rate bond markets in Australia and global markets posted modest positive returns in April as central banks managed to keep global bond yields flat overall despite lingering inflation fears.

Commodities prices – Rising confidence in global recoveries and Chinese production, lifted prices of all industrial commodities. Iron ore prices rose to new record highs, continuing the bonanza for Pilbara miners and Australian tax revenues, despite Chinese restrictions. Rising commodities prices are working their way into higher prices of everything, stoking inflation fears.

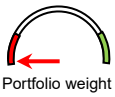
Exchange rates – In April the AUD reversed its slide in March, and rose mainly against the weaker US dollar but the AUD fell against the much stronger Euro. The AUD is now 11% above where it was at the start of 2020 (pre-covid), reflecting very strong commodity export prices and volumes, and strong foreign demand for our sought-after AAA-rated government bonds.

The following table summarises some of the major risks to investment markets – and how they have changed in 2021 –

Risk	2020	2021
Coronavirus	Second & third waves of virus & lockdowns, with sporadic public backlashes and protests	**High risk** of further waves of infections and lockdowns, even though vaccines are being rolled out. Two main risks to investor confidence: 1) the risk of delaying profit recoveries; 2) risk that governments may no longer be willing or able to keep borrowing to finance stimulus programs for longer.
US monetary policy	After cutting rates, increasing QE and cheap loan programs in the March crisis, the US Fed appeared committed to keeping short and long term rates near zero.	The main risk to markets is if the Fed were to start warning of pending plans to raise rates or scale back QE, perhaps on early signs of inflationary pressures. High likelihood of temporary inflationary scares from time to time – but **Moderate risk** of a sustained and significant rise in bond yields. In April, Powel started to outline a process, but not a timetable, for scaling out of QE before starting rate hikes.
US fiscal policy + politics	The turning point for markets in the virus scare was the $2.3trillion 'CARES' Act in March 2020, plus the $480b top-up in April, but that expired end of July. High risk of continued stalled negotiations even after US elections.	Democrat clean sweep of White House, Senate and House substantially reduced the risk of a fiscal freeze. Fiscal stimulus appears locked in with Bidens huge deficit spending plans seemingly locked in, but this creates a **Moderate to High risk** of rising inflationary fears and rising interest rates to counter the resultant inflation
China	China was first into and out of lockdowns, and first into and out of economic recession. Some signs of small second waves were suppressed quickly. Major stimulus spending boost, which benefited Australian miners. Xi emboldened by internal perceptions that the pandemic accelerated the shift in the US-China power balance.	China is likely to continue high levels of stimulus spending programs, which should continue to support prices and export volumes for Australian miners, as long as exports can be shielded from anti-China comments from Canberra. **A moderate** risk that China will further extend import penalties on Australia. In addition, a **Moderate / High** risk of China making a military advance on Taiwan, which is countered by the US – this would escalate risks to Australian exports to China.
Trade Wars	Trump wary of a major escalation in an election year – isolated restrictions by China on some Australian exports as punishment for following US line on China's role in virus	**Lower risk** of trade war escalation risking global trade, production, jobs + Australian exports – however, Biden is still likely to continue the more aggressive stance started by Trump, albeit less volatile.
Europe	ECB increased QE, kept rates negative, waived budget deficit limits, allowed EC to borrow in its own name to hand out money to problem countries, which is a major step toward fiscal union.	**Moderate to High risk** of further waves of virus outbreaks and lockdowns, which would lessen spending and demand for Australian exports, and also risk revenues and profits for global companies. Potential backlash against moves toward fiscal unity. Also, risk of xenophobic backlash against immigration, although global impacts likely to be minimal. **Low risk** of Greek-style debt crises – eg in Italy, Spain, France - that would rattle global markets.
Commodities Prices	Prices of most industrial commodities fell in the virus scare but came back steadily in the rebound. Oil/gas sector posted the biggest losses (like 2015-6 oil/gas bankruptcy crisis)	Much depends on Chinese stimulus spending, which has a high probability of continuing to support global commodities demand and prices – but Australian exporters still face geopolitical and Trade War risks. **Low risk** of commodities collapse
Emerging Markets	Emerging markets shares held up relatively well in 2020 due to the heavyweight of tech/online stocks in China, Korea, Taiwan – but they are not immune from China-US trade war risk.	Most 'emerging markets' (aside from China-Korea-Taiwan) still have serious pandemic crises. **Moderate risk** of foreign debt and currency crises from collapses in export revenues from commodities and tourism. However, emerging markets shares are now dominated by Chinese/Taiwan/Korean tech/online stocks, which should continue to benefit from the lockdowns and are less sensitive to the pace of the global economic recovery.
Middle East	OPEC-Russia price war caused a glut and negative oil price in April 2020 – resulting in massive losses by oil/gas companies everywhere	Our view is that the sight of negative oil prices in 2020 created a lasting resolve in OPEC to never let it happen again. Potential for a price spike due to military tensions, but **Moderate risk** of global inflation from an oil price spike.
Australia	The second wave in Victoria and extended broad-based lockdown ended in 2020. The federal government committed to wartime-like deficits and debts, supported by RBA's conversion to QE bond-buying	**Moderate risk** of further waves of lockdowns delaying recoveries. **Low risk** of government running out of headroom to borrow, even if it loses its AAA credit rating (like NSW and Victoria did in 2020). **Low-Moderate** risk of the RBA starting to talk up the idea of preparing for rate hikes to kill the housing/asset price boom. the housing boom is likely to be contained by lending restrictions rather than rate hikes

Summary of Asset Allocation Positioning & Changes

Following our regular quarterly review after the end of the March quarter, we re-balanced portfolios at the end of April 2021, but we made no major changes to our overall portfolio positioning. The table below sets out the positioning for the main asset classes.

Asset Class	Changes	Current position	Comments & Rationale
Australian Shares	No Change	Neutral	Company profits and dividends were down heavily in the 2020 virus recession, but the flood of free money from governments and almost free money from central banks have boosted incomes and spending, which is flowing through to surging company revenues and profits in most sectors of the economy. The two largest sectors in the local market – banks and miners – were hit hardest last year but are leading the recovery this year. Iron ore miners in particular are enjoying windfall profits from record iron ore prices and volumes from China's infrastructure boom. Our portfolios are biased toward small and mid-sized companies, and these are faring better than the big end of the market during the rebound. The actively managed funds we use in portfolios are selected for their defensive qualities and they added value during the virus sell-off and rebound.
Global Shares	No Change	Over-weight	Although portfolios are 'neutral' in their overall growth/defensive mixes, the extra allocation from being underweight property and infrastructure is being used in global shares instead. Share prices continue to be supported by steady signs of economic rebounds ahead of expectations in most of the major markets, after the deep contractions last year.
Currency hedging on global shares	No Change	Around Neutral	Currency hedging on global shares remains at 50%. The Australian dollar is currently a little above its fundamental 'fair value', but should continue to be supported by rising commodities prices and strong inflows of foreign capital to buy AAA-rated Australian bonds.
Property & Infra-structure	No Change	 Underweight	Last year we removed our property exposures and reduced infrastructure assets. Infrastructure and commercial properties are likely to recover in time, but probably to lower levels than they previously enjoyed with their very high valuations. The lockdowns revealed how vulnerable retail and office properties are to closures by government edict, tenants unilaterally refusing to pay rent, and governments unilaterally removing legal rights to collect rents and outgoings.
Australian Fixed rate Bonds	No Change	Under-weight	Australian bonds are benefiting from strong local and foreign demand, attracted by their relatively high yields, rare AAA credit rating, relatively low debt levels and strong export revenues. Australian bond yields are still relatively high by world standards and have more scope to fall further in a crisis. We favour Australian bonds over global bonds, mainly due to their higher yields, and the potential risk of rising inflationary fears in the US.
Global Fixed rate Bonds	No Change	Underweight	Currently, our bond holdings are biased toward Australia as global bonds are relatively less attractive. Coupon rates and yields on global bonds are lower than in Australia, the traditional return from currency hedging has disappeared, and their upside is limited as there is little scope for bond yields to fall further from current levels. Rising US inflationary fears remain a concern in the medium term. The bond liquidity crisis in March 2020 appears to have been resolved by strong commitments by central banks, backed up by expanded bond-buying programs.
Australian floating rate debt	No Change	Overweight	There is no allocation to floating rate securities in our normal 'neutral' model portfolios, but we have been holding significant allocations to high grade floating rate notes to reduce the portfolio sensitivity to rising bond yields, as rising global/US inflation remains a significant risk to markets.
Australian Cash	No Change	Underweight	In addition to the minimum cash levels across portfolios, we have been holding significant allocations to high grade floating rate notes in order to reduce the portfolio sensitivity to rising bond yields, as rising global/US inflation remains a significant risk to markets.

Background & rationale for asset allocation decisions

Shares, and virtually all other assets globally, are over-priced on a wide range of valuation methods. Pricing is being inflated by unprecedented government deficit spending, ultra-low interest rates, a frenzied global chase for yield (as an intended outcome of those policies), highly leveraged speculation, and bubble-like euphoria in some sectors ('E.V', 'A.I.', 'fin-tech' 'crypto'). On some measures, 'defensive' assets are even more over-priced than 'growth' assets, and this is also an intended policy outcome, in order to encourage more debt and risk-taking in the hope that it creates jobs and incomes.

With share prices at very high levels and heavily reliant on continued fiscal and monetary support, two of the greatest risks to markets are disruptions to one or both of these. Disruptions to fiscal support - Our base case is that governments will continue to be willing and able to keep borrowing and spending to boost incomes and spending, responding relatively quickly to smooth any major setbacks along the way. The Biden stimulus packages should provide a strong foundation for global spending, and households are already sitting on some $5 trillion in additional savings that should be unleashed into spending as lockdowns are eased. This should assist corporate profits in continuing their rebound to pre-covid levels by the end of 2021.

Disruptions to monetary support - Our base case is that central banks will continue to keep short and medium-term interest rates near zero for at least the next few quarters, even if they see signs of rising inflation. On the inflation front – there will continue to be occasional inflation scares that trigger spikes in bond yields (we have had at least one per year in the past decade). They will be short-lived as we are probably some time away from problematic inflation requiring significant hikes in interest rate hikes, given central bankers' reluctance to repeat numerous recent missteps in premature tightening.

Rising interest rates have been a common element in nearly all collapses of asset price bubbles throughout history, and we explore the risk of this below. In addition, there are many other risks that may prick the share boom, including the following:

- Serious world-wide escalation of the covid crisis requiring major lockdowns across the world.
- Trade war escalation that suddenly reduces demand, spending, jobs
- Military strikes (but the current escalating 'cold war' military build-up is positive for commodities and shares)
- Regulatory attacks – especially against US 'big tech' – however this is likely to take several more years
- Global cyber-attacks – especially on banks that cause major losses and or loss of confidence in banks
- Sudden bankruptcy/contagion that creates a systemic crisis in the banking system (much larger than Greensill)

Our current settings in portfolios assume continued support for share prices and also modest rises in inflation. We are: -

- Neutral on Growth/Defensive mix
- Over-weight global shares – biased toward emerging markets, FX hedging at 50% (ie neutral)
- Neutral on Australian shares – biased toward small/mid-caps
- No allocations to commercial property
- Defensive assets – biased to high grade corporate, high grade floating rate notes, no high yield debt.
- In addition, our recommended holdings outside the discretionary model portfolios are biased toward global healthcare stocks, healthcare property funds, diversified private equity.

The dilemma:

Our base case is that global share markets will continue to be supported in the near future even though pricing levels are expensive. With Biden now on a spending spree in the White House, the biggest risk is now on the monetary front. Specifically – how long are central banks likely to be able to keep interest rates at current near-zero levels even if and when evidence of rising inflation appears? This report contains a review of this critical issue: what is motivating central banks, the nature and the size of the challenge they face.

It is important to note that a primary component of our selection process for share funds is their ability to add value (ie generate higher returns than the overall market) in broad market sell-offs. The funds we use in our portfolios have done this during the sell-offs in recent years, including in the covid sell-off, so our portfolios already have a defensive bias.

It is important also to note that our regular quarterly rebalancing of all holdings back to their target weights has the effect of regularly 'taking profits off the table' and re-deploying them, mostly into defensive assets. This is an important discipline that is harnessed by the automatic rebalancing processes in each of our discretionary managed accounts. This ensures that our clients are not surreptitiously increasing their level of risk as prices rise.

We track global corporate profit levels closely, and the $1 trillion drop in profits in 2020 remains on track to be recovered during 2021. Even after the household spending boost in late 2020, households are still sitting on an extra $5 trillion of savings (in developed nations), which is likely to be unleashed on spending as lockdowns are eased, further boosting company revenues and profits.

The decision:

Our decision in the current review is to retain the current positions at present (subject to minor changes outlined), but we are also prepared to take timely defensive action in the event of a material adverse change in conditions.

Monetary & fiscal policy framework in a 180° shift

Share markets are being supported by the central bank promises to keep rates near zero for years, so we need to assess why they are making such promises, and whether they are likely to be kept.

Today's central bankers were brought up being taught that 'inflation is the enemy', and that any sign of higher than the target level of inflation should be countered with interest rate hikes. This orthodoxy was the result of the high inflation 1970s, which was killed off killed off by deep, painful recessions, high levels of bankruptcies, and unemployment rates that took a decade to recover. From the early 1990s, central banks were made notionally 'independent' from the politics of their governments, and given specific inflation targets (and in many cases unemployment targets as well).

In an 'inflation is the enemy' world, the main threat to asset prices is rising inflation – or more specifically, the threat of rate hikes to slow inflation. Share prices (especially when expensive and/or in speculative bubbles) are highly vulnerable to rate hikes to stem inflation, and bond prices are also hurt by rising expectations of inflation and rate hikes. As we are in an economic rebound from the 2020 virus recessions, and with shares now very expensive on nearly every 'fundamental' measure, fuelled mainly by ultra-loose monetary and fiscal policies, the usual position would be to be prepared defensively for impending rate hikes to slow the inevitable inflationary effects of these pro-inflation policies.

However, our base case is that the 'inflation is the enemy' orthodoxy has now changed 180° back to 'inflation is good', and that central banks will most likely be willing and able to stick to their commitments to not hike interest rates for at least the next year or so, or perhaps even longer, even though inflationary signs appear.

Our base case is one of 'financial repression' and negative *real* interest rates (ie interest rate minus CPI inflation) similar to the post-WW2 period, where governments keep interest rates low to keep the cost of their governments' debts down and to encourage household and corporate borrowing to boost spending and jobs. They will try to contain excesses via direct controls on lending and other restrictions, rather than raise interest rates.

Central banks in every major developed market have promised to not raise short term rates, and also to suppress bond yields (via 'QE' bond buying), for at least the next two to three years. The GFC experience was the turning point in the switch on inflation and the role of government. In the post-GFC years we had governments and their central banks experiment with zero and negative interest rates, rate pegging ('targeting') and 'QE' bond buying. They discovered that they could do it without creating inflation, and their tentative experiments have now become accepted practice.

Franklin Roosevelt's Keynesian 1930s depression-era idea of eliminating economic cycles through government spending, cemented in LBJ's 'Great Society' from 1965 – entrenched the ideas of 'big government', heavy regulation, high taxes, protection, nationalism, cold war trading blocs rather than open global markets. The dramatic rise in government spending (social welfare, 'nation-building', military spending on the Vietnam War and Cold War) – fuelled inflation from the mid-1960s. Far from eliminating economic cycles and unemployment, these policies led to high inflation, volatile markets, deep recessions, high unemployment, and economic 'stag-flation' in the 1970s.

To end the crisis, the policy mix was reversed 180° in the next phase – led by Reagan, Volcker and Thatcher from the start of the 1980s – deregulation, tax cuts, lowering of protection, globalisation, free-markets, 'small' (or at least hands-off) government, outsourcing jobs to low wage countries. This post-1980 policy mix led to increased inequality of wealth and incomes, stagnant workers' wages but rising household debts culminating in the GFC, where the high unemployment and decades of flat real wages fuelled a return of populist nationalism, political fragmentation, backlashes against globalisation and wealth inequality.

The GFC and post-GFC stagnation marked this turning point, and it was cemented by the 2020 virus recession. We are back to an era of big (hands-on) government that sees its role as stepping in to solve every problem and smooth every wrinkle. The 2020 virus recession was the sharpest and deepest economic contraction since the 1930s but governments stepped in quickly to support jobs, incomes, businesses, tenants and borrowers, but they threw savers and lenders under the bus. Barely a year later we are back to pre-covid levels of jobs, and aggregate global company profits (even though much of Europe is still in lockdowns), while savers and lenders (bond investors) are punished with zero interest rates.

This is a very different policy mix, and a 180° switch from the 1980-2008 era. How long will this new 'big government' / 'inflation is the goal' era last? Is it just a short term aberration, or will it last for many years like prior phases? This question is critical for asset allocation, and so we need to form a view about the extent to which central banks are committed to this policy, by looking at the scale and severity of the problem they face.

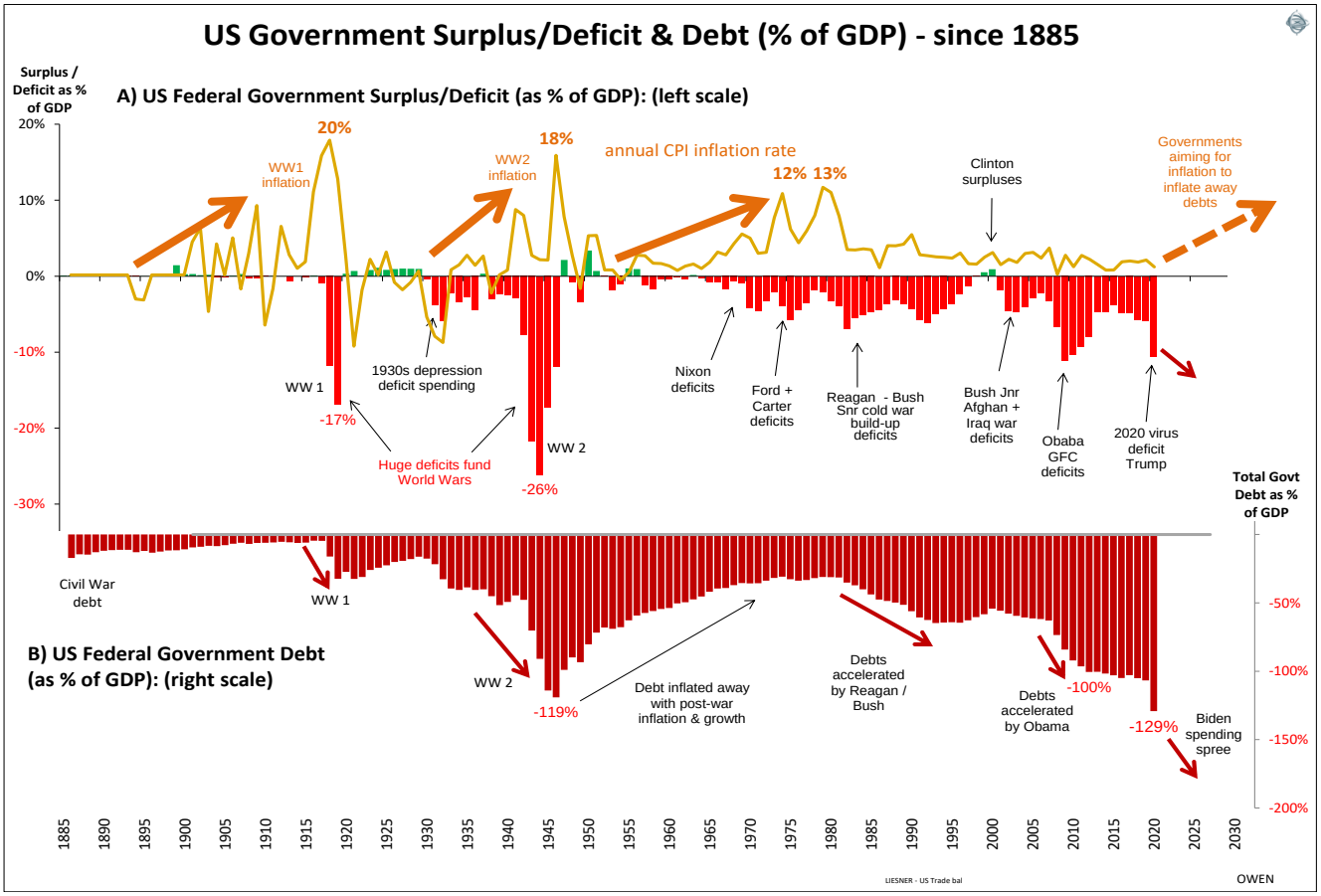
<u>The case for 'financial repression' – no rate hikes for years – no immediate threat to shares (from rate hikes anyway)</u>

The core of the problem is that most 'developed' nations (including the US, UK, Europe, Japan, Australia, etc) are now carrying war-time-like levels of government debt – and are they still running up large deficits that will further increase their debt piles. Some countries (like the US and most of Europe) are still increasing their deficits, while others (Australia) are probably going to reduce deficits sooner than expected, thanks to windfall commodities prices and exports to China (however these could end at any time with the stroke of a pen in Beijing).

The scale of the debt problem

In order to appreciate the size of the problem and possible solutions, we view the current position in context. Here we look at the US and Australia (these are echoed in the UK, Europe and other 'developed' economies, with local variations).

The US position – In the next chart, the upper section shows annual government deficits (red bars) and the occasional surpluses (green), plus the annual inflation rate (yellow line). The lower section shows the level of government debt. Government surpluses/deficits and debts are expressed relative to national output (GPD).



The massive WW2 spending program resulted in peak deficits and debt levels at 119% of GDP in 1946. The path out was through growth and inflation. Debt levels reduced in real terms by inflation building in the 1950s, 1960s – especially from the mid-1960s with tax cuts, nation-building infrastructure and Vietnam War spending. Government debt was finally reduced from 119% of GDP in 1946 down to 31% of GDP in 1980 – but inflation ran from zero in the early 1950s up to 13% in 1980, before the Fed's Paul Volcker had to hike interest rates to 19% to finally kill off inflation in the painful 1980-2 double-dip recessions.

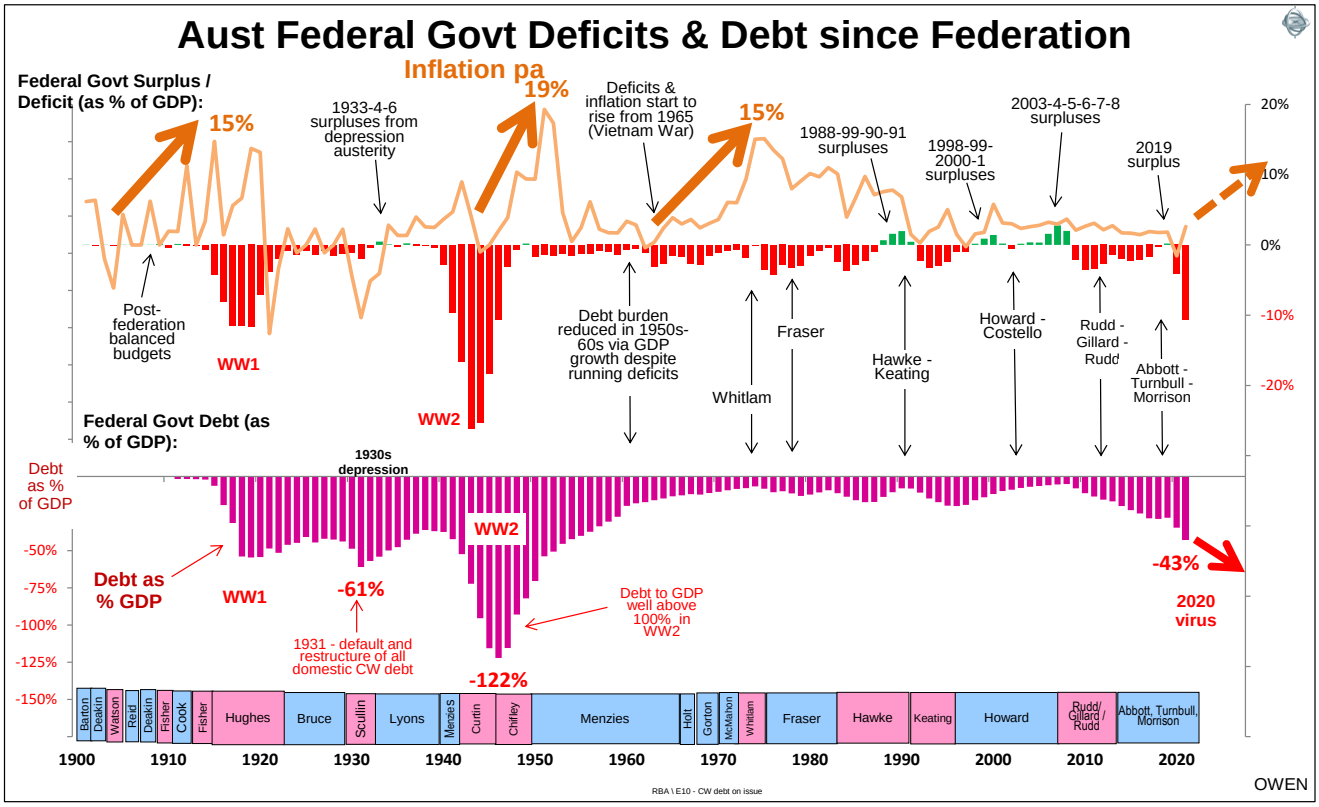
However, the actual dollar amount of debt did not reduce at all – it more than doubled - from $271b in 1946 to $909b in 1980, but the economy grew by more. The government reduced its debt load through growth and inflation.

To the very right of the chart we see the 2020 deficit and increase in debt levels – back above the WW2 peak. This is merely the start. Since 2020 we have had Biden's new $1.9 trillion covid support package (9% of GDP), and very soon the additional $2.25 trillion spending package (another 11% of GDP spread over a few years). On the positive side, tax revenues are steadily increasing as the economy recovers. Biden is also promising to increase tax rates, but this will be a double-edged sword – in theory it should increase tax receipts, but in practice it may slow hiring, spending and tax receipts. When we update this chart next year, the negative red bars on the right will be much deeper in the red.

In the 1946-1980 reduction in debt load - the 'growth' side of the equation was brought about by population growth (post-war baby boom and immigration from war-torn Europe), and the productivity growth came via technology and automation, in particular manufacturing. This time around, population growth and productivity growth rates will probably be lower in future, so it places more pressure on creating inflation to reduce the real size and cost of the debt.

The yellow line shows inflation, highlighting the inflation spikes that helped inflate away debts. To the right is the much-hoped for inflation spike to inflate away the current debt. Whether this dream can or will be achieved, we consider later.

The Australian deficit and debt picture is very similar. Our national debt position was much worse than the US during the 1920-1940s (including the default in 1931), but we have been much better since WW2 (due to Australia's far lower military spending than the US), and also in the 21st century, thanks largely to Australia's mining exports to China.



Australia's debt load peaked at 122% of GDP in 1946, which is similar to today's levels in the US, UK, Canada and Europe, but our debt level today is amongst the lowest in the world (on a par with China but higher than Germany and NZ).

Australia's peak debt of 122% of GDP in 1946 was brought down to just 7% by 1974, but the actual dollar amount of debt rose - from A$3.7b (A£1,835m) in 1946 to A$4.1b by 1974. As in the US and other markets, the debt load relative to national income was reduced by economic growth and inflation. Economic growth was achieved by rapid population growth (post-war baby boom and immigration from Europe) as well as productivity gains, especially in manufacturing behind high tariff walls. Inflation also played a large role in reducing the real size and cost of debt - inflation went from zero in 1945 (war-time price controls) right up to 15% by 1974, including the Korean War inflation spike to 20%.

During the 1950s and 1960s, interest rates were kept artificially low in order to lower the cost of debt, and to encourage households and businesses to borrow. Inflation was controlled not by adjusting the price of money (interest rates) but via direct controls on bank lending (as well as adjusting other levers like tax rates, tariffs) – just like today.

As in the US, inflation did its job by reducing the real size of and cost of government debt, but it soon got out of control from the mid-1960s and well into the 1970s. Finally, interest rates had to be hiked to 9.5%, resulting in a series of recessions and high unemployment from the mid-1970s. Australia took 10 years longer than the US to finally bring down inflation in the 1990-1 recession after interest rates had to be jacked up to 18%.

Four ways to reduce the debt load

There are four ways to reduce the government debt load (note that countries rarely 'pay off' debt, nor do they need to):

- Growth – via population growth and/or productivity growth – resulting in growth in tax revenues that exceed growth in spending. This is a delicate balance, as growth usually requires some spending by governments before revenue growth accelerates.
- Austerity – reducing debts by running surpluses from raising taxes and/or cutting spending. This usually just extends the economic crisis further. German-imposed austerity in Europe after the GFC stifled recoveries for a decade. Premature tax hikes in Japan in 2014 sent the economy immediately back into recession. (It is a reverse 'Laffer Curve' – raising tax rates often reduces the overall tax take. The same thing happened in 1937 when US and Australia raised taxes to try to repay Depression debts, but instead sent their economies back into recession).
- Default - every nation at some point has done this – but it is not a solution in most cases because the terms of debt restructure imposed by lenders usually require debilitating austerity that stifles recovery and stunts growth.
- Inflation – given the sheer scale of debts, this is the new magic bullet – to create inflation to reduce the real cost and size of the debts. It sounds crazy in the 1980-2008 policy mindset – but times have changed.

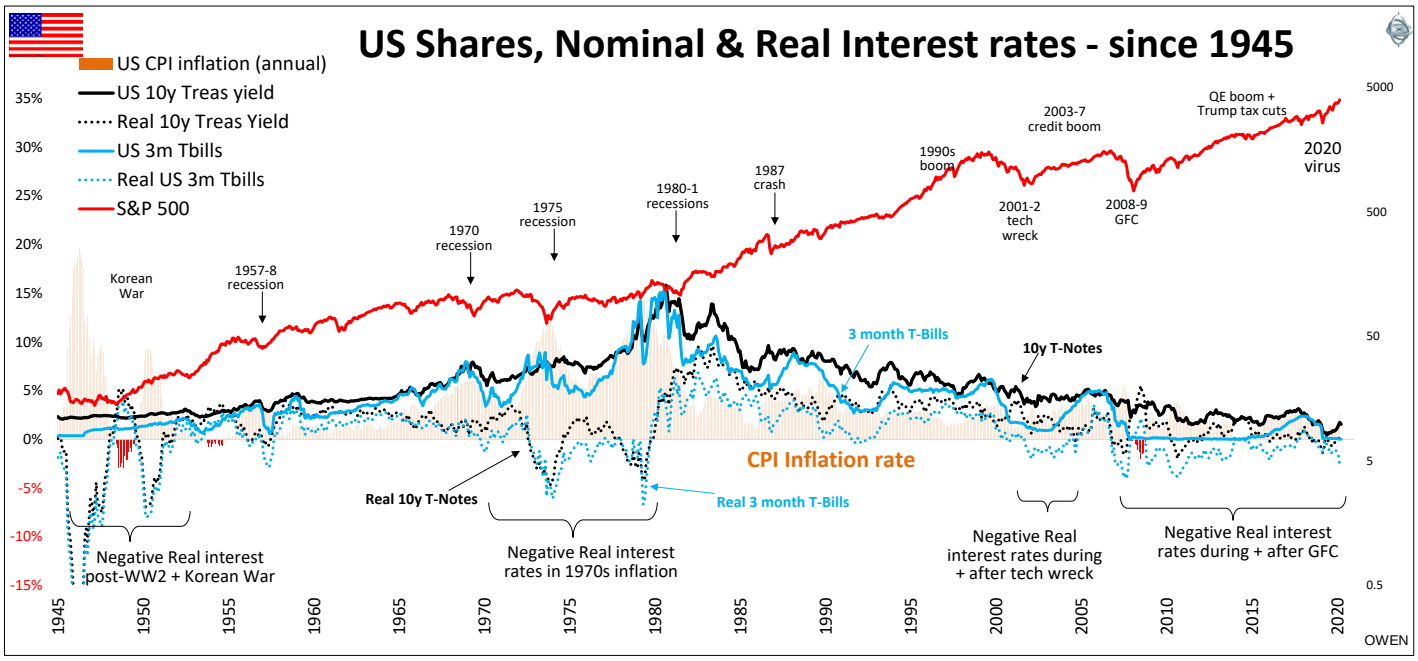
The problem is that Australia and the US are unlikely to see a return of post-war rates of population growth and productivity growth, and this places more pressure to create inflation to reduce the real cost and size of debt.

How governments reduced their World War 2 debt loads – 'financial repression'

Our base case is one of 'financial repression' and negative *real* interest rates (ie interest rate minus CPI inflation) similar to the post-WW2 period, where governments keep interest rates at ultra-low levels to keep the cost of debt down and encourage household and corporate borrowing to boost spending, jobs and economic growth. They will try to contain excesses via direct controls on lending and other restrictions, rather than raise interest rates. Any increase in inflationary expectations (reflected in rising bond yields) will be countered by aggressive bond buying and bond rate pegging to reduce bond losses that would scare investors away from buying bonds to finance the deficits. We saw this new resolve in February and March 2021 - bond yields rose but were hammered back by QE bond buying, even in Australia.

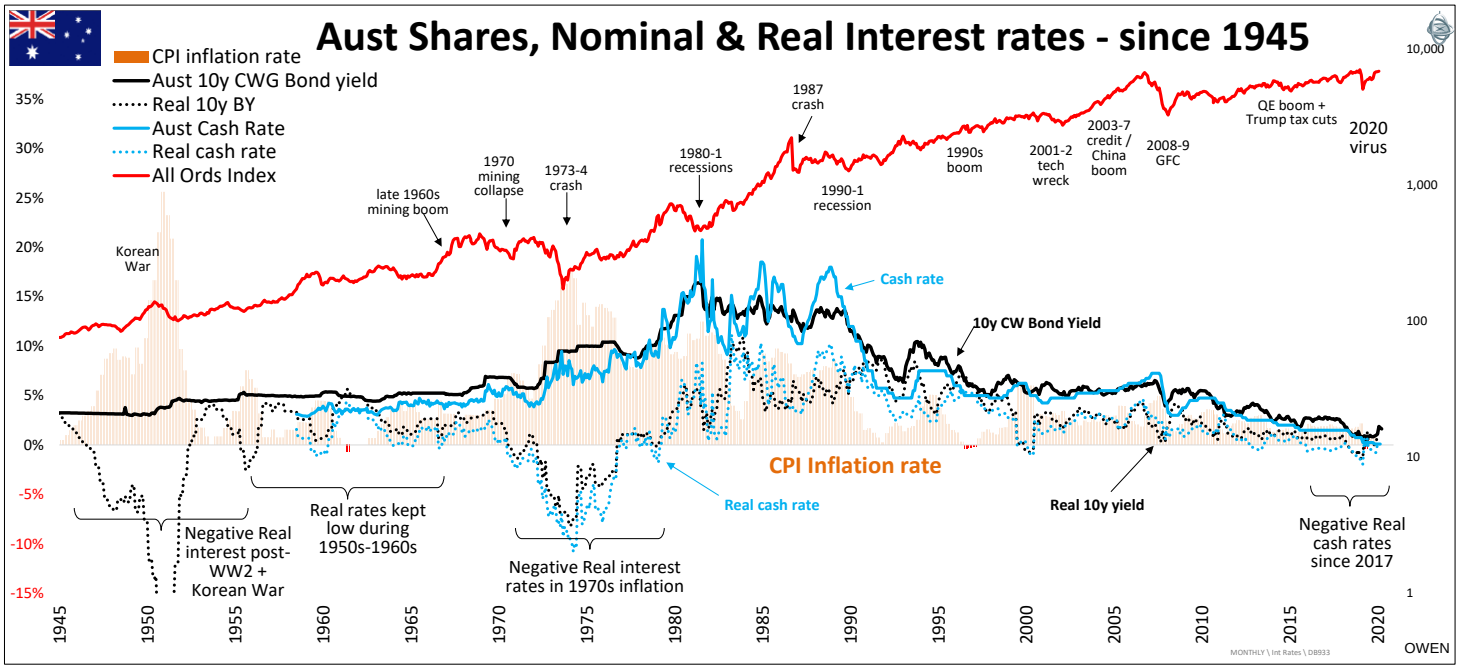
This sounds unusual and unconventional, but it is how governments grew and inflated their way out of their WW2 debts.

Here is the post-war US picture – yields on US 10 year Treasury Notes (black line for nominal yields, black dots for real yields), and three month T-bills (blue line for nominal yields, blue dots for real yields), inflation (orange bars) and share prices.



The US government tried to keep interest rates low through the post-war inflation and Korean war inflation but the pressure became too great, and an 'Accord' was struck in March 1951 under which the Fed was no longer compelled to keeping buying up US debt to prop up bond prices to prevent losses. Real interest rates were negative throughout the 1970s, they have been negative since the government debt explosion began in the 2001-2 'tech wreck', and especially since the 2008-9 GFC debt build-up.

The Australian picture is almost an exact replica, with variations on the same themes -



In Australia, real interest rates were negative or very low for most of the post-war period up to the 1980s. Interest rates were suppressed and economic activity was instead managed through direct lending controls (including the hated 'special account', and 'lending directives') until bank deregulation in the 1980s. The primary monetary policy tool was bond yield pegging until the 1980s, as well as short term interest rates from 1960 when the RBA and the short term money market were established to control non-banks (and bank subsidiaries) that got around the bank lending controls.

We have had negative real cash rates since 2017. Then, in late 2020 in the virus crisis, the RBA returned to old-fashioned bond-buying and bond yield pegging. It has promised to cap rates at 0.10% on cash and bonds up to 3 years maturity.

Financial repression and asset prices

Low interest rates and nil/negative real rates are generally good for asset prices (indeed it is a policy aim) – notably shares and real estate. Prices of shares, housing and other assets are not counted in 'inflation' numbers and therefore are not targeted by central banks. On the contrary, rising asset prices are seen as a positive for the economy as they encourage borrowing and investment, leading to spending and jobs. (Note however that NZ has just become the first central bank to be told to include housing prices in its interest rate decisions. PM Ardern was elected on a platform of affordable housing for all, but has been acutely embarrassed by soaring house prices fuelled by ultra-low interest rates. In 1990 the RBZ led the world in becoming politically 'independent', but it has now joined all other central banks in being hauled back inside the government's political 'tent' since the GFC, and especially since covid).

Australia's Reserve Bank deliberately targets 3-year bonds (unlike Japan and Europe which target 10 years), because most fixed-term loans in Australia are for three years or less. The RBA's cunning plan is to entice people to gear up into three-year fixed-rate loans. They are hoping that this flood of extra cheap debt will inflate house prices by 20% or 30%, so that what starts out as a high-risk 95% 'LVR' ('loan to value ratio') loan today will magically turn into a low-risk 70% or 80% LVR loan in three years. It's a magic pudding of inflation and debt! Everyone suddenly looks and feels richer!

The flaw is that a 70% LVR loan is no safer than a 95% LVR loan if the borrower's income has not increased enough to afford the jump in repayments when the fixed-rate loan converts to a higher cost 'principal and interest' loan at the end of the three years. All they have done is increase the household debt load even more. That's why the RBA is focused on wage inflation. Creating house price inflation is easy – tight supply plus free money and almost-free debt. Creating 1970s-style wage inflation is going to be much more difficult, and may take longer. (We covered this issue in more detail in our last monthly report)

Rising interest rates

Whereas asset prices benefit from low interest rates, they are hurt by rising interest rates when central banks finally decide to act – which is almost always too late and too heavy-handed, usually causing economic recessions. We saw this throughout the 1970s, the early 1980s recessions, early 1990s recessions, the 2001-2 tech-wreck (which Australia largely avoided as our 'dot-com' boom was smaller, but more severe in the US, UK and Europe), and then the 2008-9 GFC.

The impact of rate hikes can be especially damaging for asset prices when they are over-priced/bubble-like and/or highly leveraged. For the US, this was most severe in the late-1990s 'dot-com' boom, where rate hikes triggered the collapse into the prolonged 2001-2 'tech wreck'; in the GFC (highly geared credit and banks), and in the 1929-32 crash (highly leveraged speculative stock bubble).

In Australia, our crashes have mirrored those in the US in almost every instance, but there were differences in severity due to local variations on the same theme in each case. Our 'big ones' have included: the 1893 property/banking crash (highly geared speculative property development combined with commodities collapse), the 1973-4 crash (highly geared commercial property bubble combined with the collapse of the speculative mining bubble); the 1987 crash (highly geared speculative stock bubble); the 1990-1 recession (highly geared speculative property bubble); and the GFC (collapse of the credit boom plus the speculative China/mining boom).

Each of these crashes featured bubble-like over-pricing plus high leverage and/or speculative frenzies, and each collapse was triggered by rate hikes. In almost all cases, central banks tightened too late and too hard. Rate hikes were not the only triggers, they were often the 'last straw' that pricked the asset price bubble.

What is the likelihood of rate hikes?

The important markets for us are the US Fed and the RBA. Our base case is that interest rates will not be raised for some time – even if there are early signs of inflation:

- The Fed and RBA have both promised to not hike rates for at least a couple of years. (Europe and Japan's central banks have made similar promises, but their economies are showing little signs of life and pose less of a threat). Canada's central bank has been the first to blink – they have recently admitted they may have to hike sooner than promised. Australia's situation is probably more similar to Canada than the US on this front.

- Both the Fed and RBA have 'inflation averaging' policies under which they will deliberately allow inflation to run ahead of target for some time before they act.
- They have fresh memories of recent errors in hiking rates too early – premature rate hikes in post-GFC Europe in 2010 and 2011 had to be reversed quickly when they sent Europe back into recession in 2012-3. Premature rate hikes in the US in 2017-8 had to be reversed quickly in 2019 when they caused US and global recession fears and a sharp stock market sell-off in late 2018. They are likely to err on the side of waiting and watching next time.
- The virus crisis is far from over – with the world now into a serious 'fourth wave' of infections, deaths and lockdowns, and problems with vaccination roll-out programs including new side-effects and new strains. There is a significant risk of double-dip recessions, or at least a pause in recoveries if there is a need for further broad lockdowns (although our base case is for steady easing of the crisis).
- Inflation may not be easy to create as central bankers may wish. There is much talk of the fear of rising inflation from all the 'money-printing' and deficit spending around the world. We have covered the inflationary and deflationary forces at work in previous reports. In summary, there are many persistent *deflationary* forces at work that are hampering inflation – including: aging populations, declining fertility rates, slowing immigration, excess human and industrial capacity, 'uber-isation' of work reducing wages, conditions and job security. These are not short term effects and they are not easy to turn around. They are likely to dampen the *inflationary* forces (rising military spending, protection, re-on-shoring of jobs, rising commodities prices, etc).

One consequence of central banks waiting too long before acting is that will probably fall into the time-honoured trap of being caught napping (except this time they are not napping, they are lying awake hoping, wishing and praying for inflation), and then having to hike rates too late and too hard – which inevitably causes an economic contraction. While this is a major risk for share and bond markets when it happens, it is likely to be some way off yet.

Summary of Portfolio Changes

In the portfolio rebalance at the end of April 2021, all portfolio holdings were rebalanced back to their target weights, and the following asset allocation changes were made. Portfolios remain neutrally positioned in their overall growth/defensive mix.

Changes to Dynamic Active portfolios:

Changes made in April 2021

Asset Class	Fund	Dynamic Active Conservative	Dynamic Active Moderate	Dynamic Active Balanced	Dynamic Active Growth	Dynamic Active High Growth
Australian Bonds	iShares 'IAF' - Core Composite Bond Fund ETF	-6.0%	-4.0%	-4.0%	-	-
	VanEck Vectors Australian Corporate Bond Plus ETF	+6.0%	+4.0%	+4.0%	-	-

Changes to Dynamic Index portfolios:

Changes made in April 2021

Asset Class	Fund	Dynamic Active Conservative	Dynamic Active Moderate	Dynamic Active Balanced	Dynamic Active Growth	Dynamic Active High Growth
Australian Bonds	Vanguard Australian Fixed Interest Index ETF	-10.0%	-8.0%	-4.0%	-1.0%	-
	VanEck Vectors Australian Corporate Bond Plus ETF	+10.0%	+8.0%	+4.0%	+1.0%	-

Underlying Fund Returns

12 months to 30th April 2021

Asset Class / Funds	Fund return	Benchmark	Benchmark return	Comments
Australian Shares		All Ords Accumulation Index		
Greencape Capital Broadcap Fund	32.53%	All Ords Accum	33.89%	Factor/Style Neutral
Fidelity Aust Equities Fund	35.67%	All Ords Accum	33.89%	Large-cap broad.
Bennelong ex-20 Aust Equities	52.00%	ASX300 ex-20	30.71%	A mid-cap fund that tends to avoid big banks and miners.
Ironbark Karara Small Co Fund	28.98%	ASX Small Ords	39.78%	Small-cap fund.
Vanguard Aust Shares ETF - VAS	31.85%	All Ords Accum	33.89%	Low-cost passive index fund.
Allan Gray Australia Equity – Class B	32.94%	All Ords Accum	33.89%	High conviction contrarian value fund.
VanEck Australian Equal Weight ETF – MVW	26.56%	All Ords Accum	33.89%	Equal weights the 85 largest ASX stocks, resulting in a mid-cap bias.
Vanguard 'VSO' – small companies ETF	44.48%	ASX Small Ords	39.78%	Low-cost passive ETF of small ASX companies.
Global Shares - AUD Un-Hedged		MSCI ACWI (All Countries World Index) $A Unhedged		Unhedged foreign shares out-perform hedged when the AUD declines.
MFS Global (Un-Hgd)	23.47%	MSCI ACWI UnH	23.41%	A growth-oriented fund that has outperformed in recent sell-offs.
Magellan High Conviction (Un-Hgd)	15.14%	MSCI ACWI UnH	23.41%	Concentrated portfolio with the same philosophy as Magellan Global.
Vanguard International Shares ETF - VGS	20.83%	MSCI ACWI UnH	23.41%	Low cost passive diversified index fund for developed stock markets.
iShares MSCI Emerging Markets ETF – IEM	23.53%	MSCI ACWI UnH	23.41%	Low-cost ETF for Emerging Markets, 30% in China, 40% other Asia.
Global Shares - AUD Hedged		MSCI ACWI (All Countries World Index) $A Hedged		Hedged foreign shares out-perform un-hedged when the AUD rises.
Magellan Infrastructure (Hgd)	10.92%	MSCI ACWI Hgd	40.54%	Listed global infrastructure fund.
Vanguard International Shares (Hgd) ETF - VGAD	38.40%	MSCI ACWI Hgd	40.54%	Low cost passive diversified index fund for developed stock markets.
Real Estate		50%A-REIT TR + 50%G-REIT TR (Hgd AUD)		
VanEck Vectors Australian Property ETF - MVA	29.75%	ASX200 A-REIT	30.90%	Equal weighted Australian listed property ETF that has outperformed the index and most active managers in recent years.
Australian Fixed Rate		Bloomberg Australian Composite Bond Index		Fixed-rate bonds benefit from falling long term interest rates – usually in anticipation of economic slowdowns.
PIMCO WS Aust Bond	1.23%	B'erg AusBond	-1.19%	An active broad investment-grade bond fund
Vanguard Australian Fixed Interest Index VAF	-1.48%	B'erg AusBond	-1.19%	Passive investment grade gov, semi-gov & corporate debt
iShares Composite BOND ETF IAF	-1.42%	B'erg AusBond	-1.19%	Passive investment grade gov, semi-gov & corporate debt
VanEck Corporate Bond ETF PLUS	7.59%	B'erg AusBond	-1.19%	High-grade AUD corporate bonds
Australian Floating Rate		Bloomberg AusBond Credit FRN		Floating rate notes benefit from rising rates (whereas fixed-rate are hurt by rising rates)
Perpetual Wholesale Diversified Income Fund	7.59%	B'Berg Credit FRN	1.78%	Active diversified mostly investment-grade floating-rate notes fund
VanEck Vectors Australian Floating Rate ETF	1.83%	B'Berg Credit FRN	1.78%	Low-cost passive floating rate fund
Global Fixed Rate		Bloomberg Global Aggregate Hgd AUD		A mix of Government, Semi-Gov, Corporate investment-grade fixed-rate bonds across the US, Europe and Asia
Colchester Global Government Bond Fund	0.91%	Global Agg	-0.11%	Active government bond fund that takes positions on bonds & currencies
Vanguard Global Treasury ETF (Hgd) VIF	-2.82%	Global Agg	-0.11%	Low-cost passive fund of global Inv Grade government bonds
Vanguard Global Corp/Semi-Gov ETF (Hgd AUD) VCF	2.89%	Global Agg	-0.11%	Low-cost passive fund of global Inv Grade Semi-gov /corporate bonds

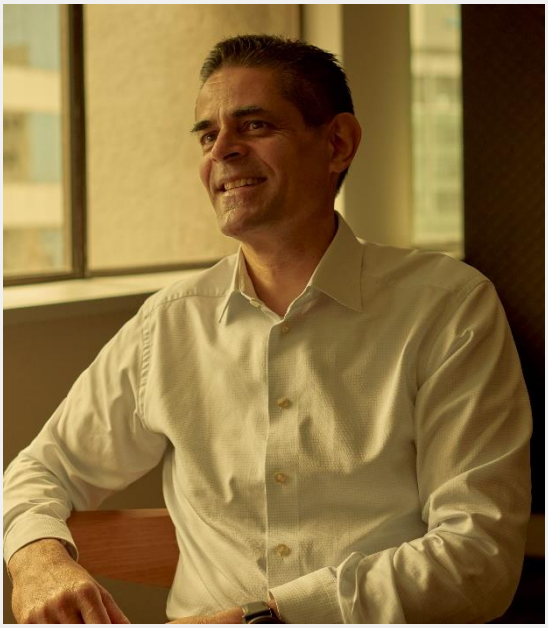
Notes:

- The above table does not include funds that clients may hold outside the Soteria Managed Account portfolios
- The weights of each asset class differ in each of the Model Portfolios. Refer to separate reports for each portfolio.
- Care should be taken when interpreting returns over short periods. Each of the active funds have demonstrated long histories of outperformance over many years and through many types of market conditions, but they will all underperform from time to time.

Ashley Owen

Chief Investment Officer

CFA, LLM, BA, Grad. Dip Applied Finance



Ashley is one of Australia's leading portfolio managers of diversified investment funds for long term investors. His mission is to manage portfolios that provide investors with confidence that their investments will generate the wealth they need to live the life they wish to lead for the rest of their lives – for themselves, their families and as a legacy for future generations.

His primary focus is protecting investors from losses and risks, rather than chasing high returns from the latest hot funds or fads.

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