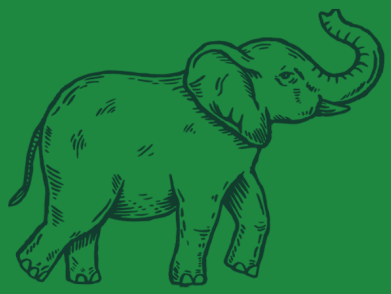
# Investment Markets Report



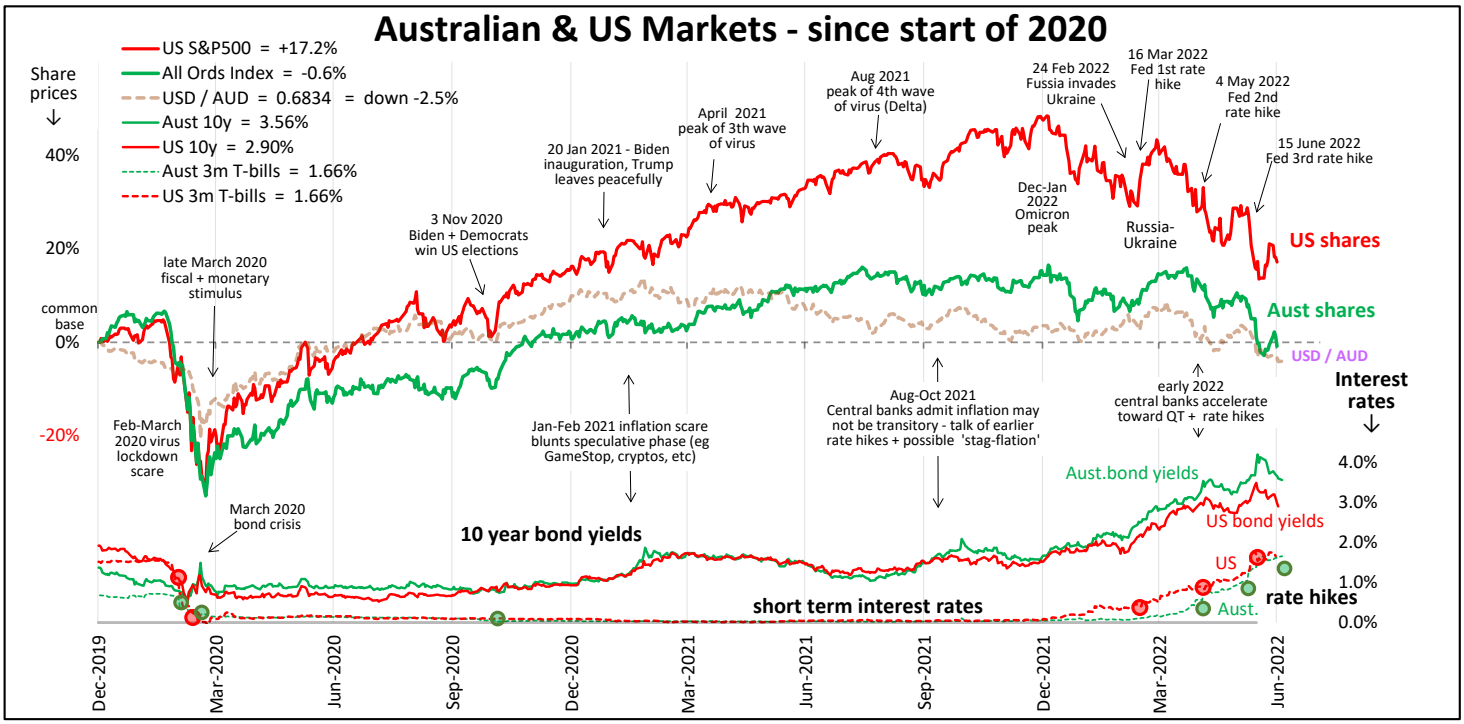
5 July 2022

StanfordBrown Private Wealth

# Global financial markets snapshot

This report refers to the month of June 2022, but we also include today's (5 July) +0.50% RBA rate hike to 1.35%, which is consistent with the theme of accelerating rate hikes driving global sentiment and investment markets.

June 2022, like May, was another month of two halves. In the first half, share prices rose and bond prices fell (ie yields rose) on hopes of continued economic growth, albeit with inflation. In the second half of June, share prices fell and bond prices rose (yields fell) as investors started to worry more that increasingly aggressive rate hikes would trigger economic recessions. The turning point was the US Fed's 3rd rate hike on 15 June, raising US rates by 0.75%, following hikes of 0.25% in March and 0.50% in May. Slowdown fears in the second half of June also brought down prices of oil, gas, coal, industrial metals like copper and iron ore, and also the Australian dollar.




Recent editions of this report have suggested that central banks are unlikely to bring down inflation without triggering recessions, given their patchy record in numerous past cycles. Fears of rising rates and the likelihood of persistent inflation and/or slowdowns resulted in a poor month, quarter and financial year for the main investment asset classes.

For share markets, what is most important is impacts on company profits and dividends. Over the past 12 months, global profits surged by an incredible +56% to $4.1 trillion. These profit gains are no longer just recoveries from the losses suffered in the Covid recession, as global profits are now more than 40% above pre-covid levels. Dividends are also strong, rising +14% over the past year to $1.6 trillion globally, 7% above pre-covid levels. While profits and dividends are backward-looking, share prices are based on investors' future expectations. Share markets are falling this year in anticipation of rising costs and interest rates hitting consumer spending, flowing through to lower profits and dividends in the coming year.

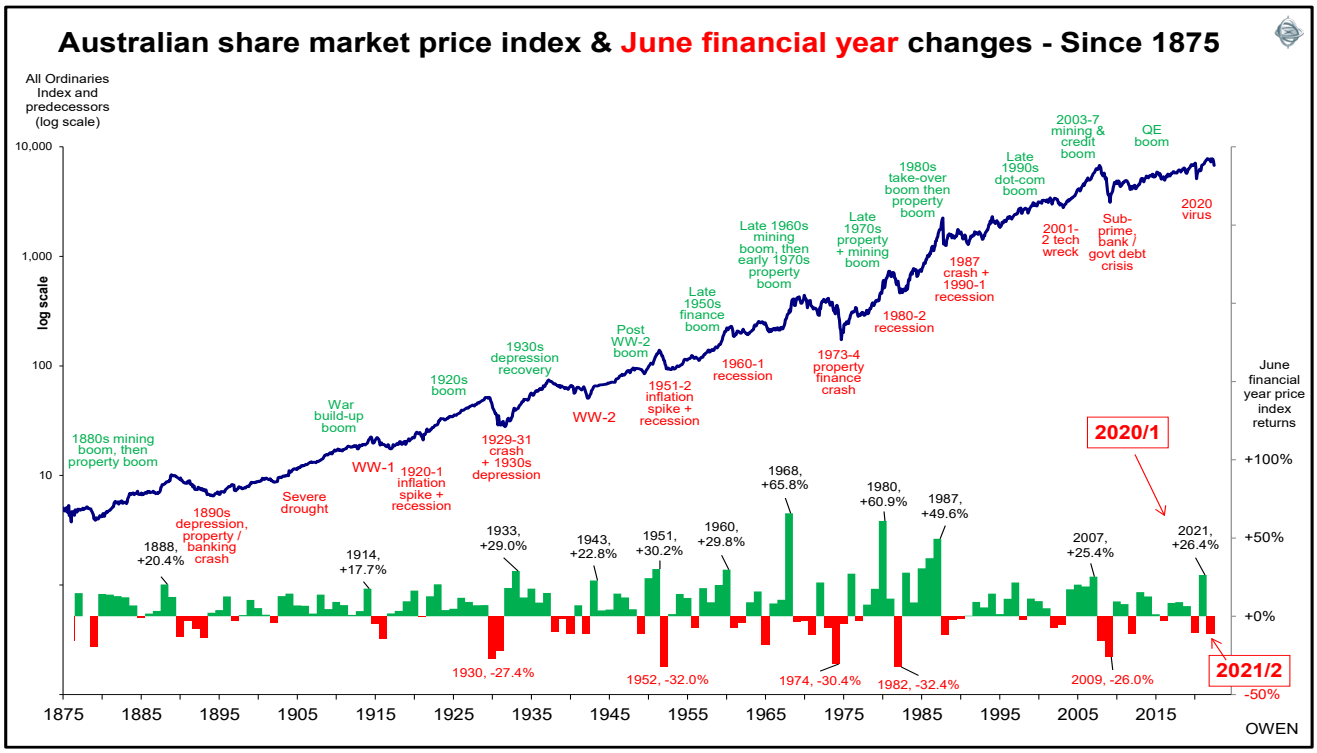
In the current 'pre-recession' phase since the start of 2022, share markets have fallen across the board. The Australian market has held up better than most this year, down by -13%, compared to larger falls in the US market (-21% for the S&P500, and -30% for the NASDAQ), Europe (-20%), and similar declines in most other markets. In Australia and globally, the stocks and sectors hardest hit this year have been those that shone brightest in the stimulus boom – including the tech/online stars. The best sectors for the year were the fossil fuel fiends, profiteering from the global energy crisis and war in Europe. While share markets tend to fall in anticipation of recessions, as they are now, they almost always rebound out of the middle of recessions when they do arrive.

Meanwhile, Australian and global bond markets are also down by around -11% for the twelve months, similar to the broad Australian share market. It was the worst year for Australian bonds since 1931, when the Commonwealth defaulted on its entire stock of domestic bonds. There have been some winners, and we cover these later.

# Memories . . .!

Exactly one year ago, our 5 July 2021 edition of this report ran a rather sombre story. At the time, media outlets were full of optimistic reports celebrating the 26% rise in the broad Australian share market (All Ordinaries index), making it the best June financial year result since the 1980s. This tremendous result was seen as a sign that the Covid recession problems were behind us, and the good times would continue. We were more cautious.

The problem is that high returns tend to breed complacency and over-confidence. Here is the chart from our July 2021 report, now updated to include the June 2022 financial year:




After the unusually high returns in the year to June 2021, our July 2021 report included the following warning:

*"When we look at previous years of great returns on the market, we see a rather disturbing picture:*

- *2007 – at the top of the speculative China/credit boom, before the 2008-9 GFC crash*
- *1987 – at the top of the 1980s speculative take-over boom, before the October 1987 crash*
- *1980 – at the top of the late 1970s property/mining boom, before the 1980-2 recession sell-off*
- *1968 – at the top of the 1960s speculative mining boom, before the mining crash – which continued into the 1973-4 property/finance crash*
- *1960 – at the top of the late-1950s consumer finance boom, before the 1960-1 recession sell-off*
- *1951 – at the top of the post-war boom, before the 1951-2 Korean War inflation spike sell-off*
- *1914 – at the top of the war build-up boom, before the outbreak of WW1*
- *1888 – at the top of the 1880s mining and speculative property booms, before the property/banking collapse that triggered the 1890s depression*

*There were only two 20%+ financial years that were not followed by big sell-offs:*

- *1933 – in the middle of the Great Depression.*
- *1943 – in the middle of the Second World War*

*This, of course, is not 'evidence' or 'proof' that the share market is heading for a big fall in the coming year, but it is a useful reminder to look behind the good years to identify possible risks – either in the level of pricing, in the market environment, especially in speculative behaviour, and the degree of strength and sustainability of the underlying profits and dividends."*

By including the above section from last year's report here, we are not claiming to have predicted the fall over the past year. Share prices are unpredictable, but human emotions and behaviour patterns are entirely predictable, as we explore further later in this report.

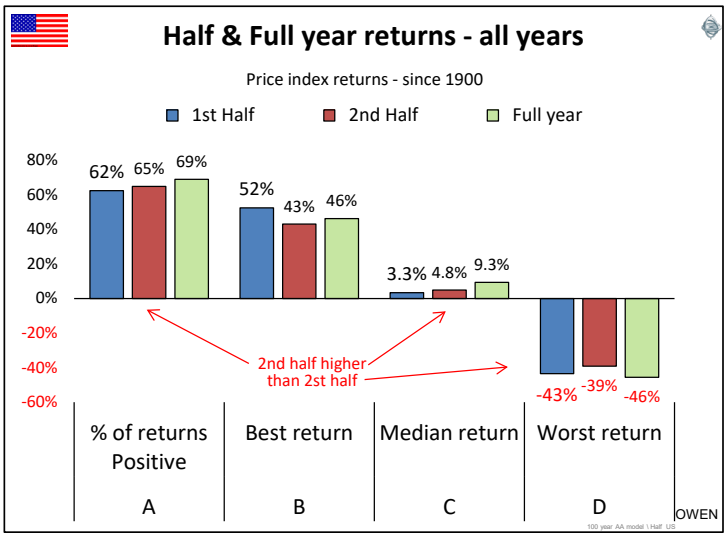
# Shares down in first half – chances of better second half?

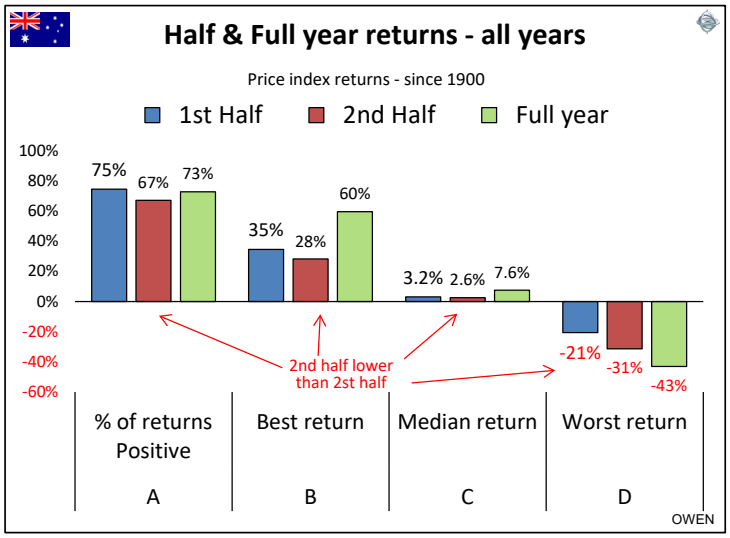
The US share market has had a bad first half in 2022, heading more or less in a straight line down from its peak in first week of January. The S&P500 index fell by -20%, the worst half year for US shares since 1970. (By comparison, in the 2020 Covid recession, the US market index fell -20% in the March quarter but recovered almost all of that in the June quarter, in the middle of the sharpest and deepest economic recession since the 1930s Great Depression, leaving the first half of 2020 almost square). The Australian market also fell -13% in the first half of this year.

Will share markets keep falling or will they bounce back? The answers are: 'probably for a while', and 'definitely yes', respectively. The timing, of course, depends on a host of unknowables, including rate hikes, consumer spending, cost pressures, bankruptcies, fiscal support, etc. Meanwhile, as we have had countless crashes, recessions, inflation spikes, wars, rate hikes, etc before, we can look at what has happened in the past.

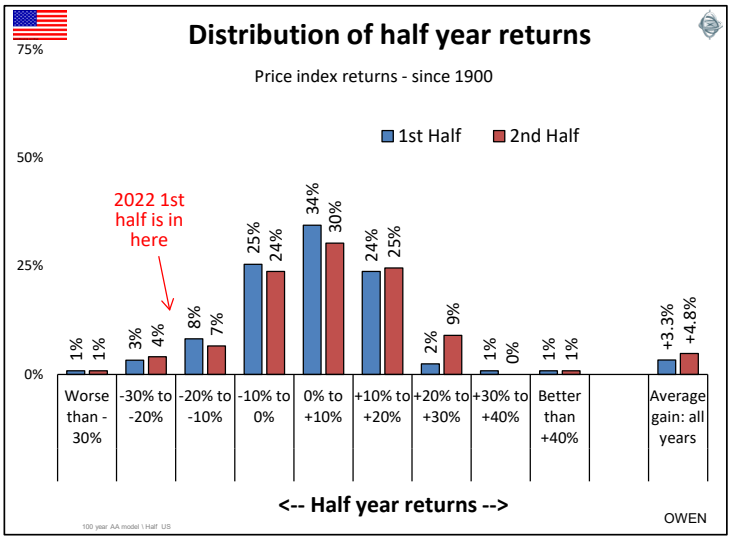
Our first question is:- Has there been any historical differences between returns in the two halves of each year (due to factors like seasonality of industries, weather, holidays, timing of bonuses, tax payments, etc)? In short: No.

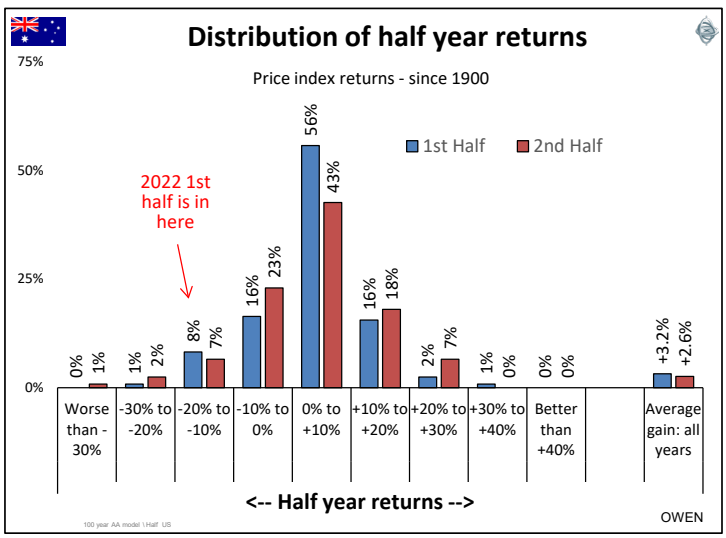
The first pair of charts show returns from the main US and Australian share price indexes since 1900. In the US (left chart), shares have generally done a little better in the second half (maroon bars) than in the first half (blue bars), but the differences are minor. For example, section A shows that 65% of second halves have been positive (maroon), compared to 62% of first halves (blue). In section C, we see the median second half year return in the US has been 4.8%, which is higher than 3.3% for first halves. For Australia (right chart) it is the reverse – second half returns have been a little lower than first half returns. Although Australia has almost always followed the same cycles as the US, some of our larger local crashes have been in the second half, by pure luck (eg 1987, 2008, 1974).




The next pair charts show the distribution of half year returns in the two markets since 1900. Returns in Australia have been much more bunched in the centre. Although our total returns (share price gains plus dividends) have been almost identical to the US, Australian dividends have been higher and share price growth has been lower.



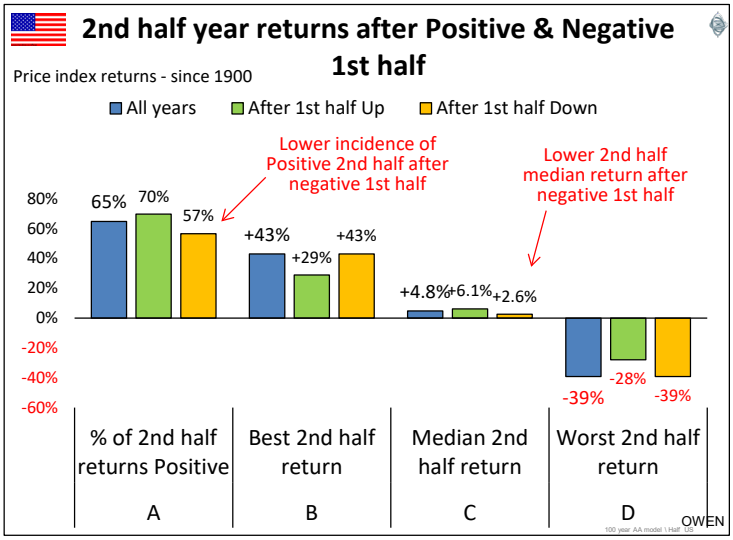
# Are share markets random, or do they have a memory?

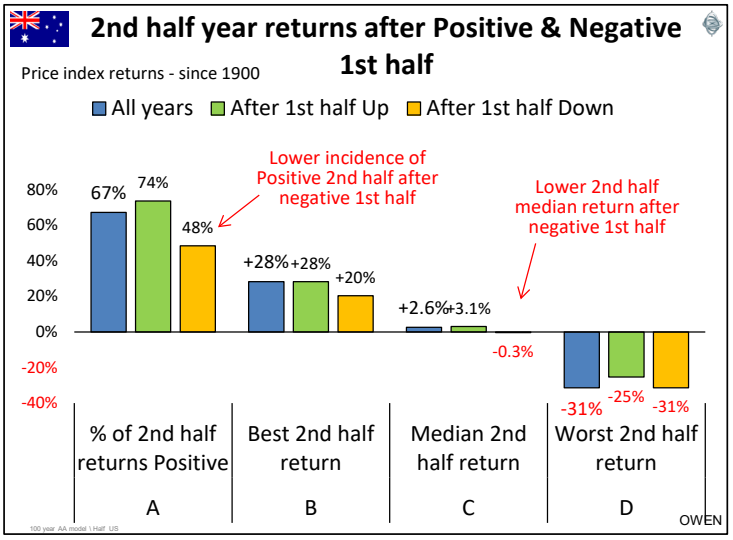
A coin doesn't have a memory. If I toss say 10 tails in a row, or even 100 tails in a row, the probability of getting another tail on the next toss is still 50/50, regardless of what happened in the past. Is it the same for share prices?

The previous story demonstrates that, averaged over a period of 100+ years, there have been no major differences between share market returns in the first half versus the second half. However, that is just the average experience. Having just been through a particularly poor first half, it is natural to ask:- Does what happens in the first half make a difference to returns in the second half? In other words, are share prices random? Or do they 'trend' (continue in the same direction)? Or do they 'revert' (reverse direction, back toward some 'fair' value)?

Share prices are not abstract, they are driven by two forces: (1) information about market conditions (eg. interest rates, spending, profits, dividends, etc); and (2) by investor sentiment (how people feel about the prospects for interest rates, spending, profits, dividends, etc). Therefore, our question becomes:- Are market conditions and investor sentiment random/unpredictable, or do they 'trend' or 'revert'?

The next pair of charts show what happened in the second half years, after positive first halves (green bars), compared to what happened after negative first halves (yellow bars).




In both the US and Australian markets, second half returns were significantly lower (and below average) following negative first half years (yellow), than they were after positive first halves (green) – in terms of both the incidence of positive returns (section A), and median returns (section C). Conversely, second half returns were significantly higher (and above average) following positive first halves, than they were after negative first halves.

This suggests an element of 'trending' in both the US and Australian share markets, where good (or poor) returns in the first half have displayed a consistent habit of 'trending' (ie continuing) in the second halves, before eventually reverting into a collapse (or rebound) at a later time. What causes these patterns?

While market conditions are unpredictable, human emotions and behaviour patterns are entirely predictable. Humans (and investors in particular) are herd animals, emotionally 'hard-wired' to be caught up in sustained bouts of irrational speculative buying frenzies, followed by sustained bouts of equally irrational fear and panic selling. In speculative booms, when fundamental conditions deteriorate, it usually takes some time for the of boom-time over-confidence to finally run out of steam, so prices keep rising purely on the momentum of over-confidence. This was the case in 2021, when inflation spiked well above target levels (well *before* Russia invaded Ukraine).

Likewise, in the depths of pessimism in a market crash, even after underlying conditions improve, it usually takes some time for the fear to subside enough for people to feel confident enough to 'jump back in' again – so prices keep falling purely on the momentum of over-pessimism. We are probably entering this territory in mid-late 2022.

Portfolio impacts: – just because share markets are down heavily in the first half of this year, there is little reason to suddenly panic sell now. Historically, although returns are likely to be below average for the rest of this year, there is still at least an even chance of positive returns in the second half. We can say with confidence that conditions will improve at some point (usually when least expected). We can also say with equal confidence that the general market pessimism will continue for longer than warranted, presenting buying opportunities for rational investors.

# Share market crashes, rebounds and recessions

While poor first half returns have tended to be followed by lower than average returns in the second half (most probably due to human herd mentality described above), when we look at the very worst of the poor first halves in the US share market over the past 100 years or so, they were all followed quickly by remarkably good rebounds.

There have been five first half years since 1900 when the US share market fell by more than -20%, as it did in 2022. In four out of those five episodes, the share market sell-offs quickly turned into strong rebounds. In the fifth case, the strong rebound was delayed by a few months, but otherwise the patterns were the same.

Here are the five worst first halves for US shares, going back through time:

- 1970 – shares were down -21% in the first half of the year, which was early in the mild 1970 recession, while earnings were starting to weaken, and cash rates were being cut despite inflation running at 6%. In the second half of 1970, the market jumped +27% from the middle of the recession, leaving it square for the 1970 calendar year. The market then rose another +11% in 1971, while earnings and dividends were still being cut. Shares even rose through the US dollar crisis when Nixon broke the gold standard.
- 1962 – shares were down -23.5% in first half, with Kennedy's attacks on the steel industry, a year after the 1960-1 recession. Earnings were strong, inflation was at 1%, and cash rates were flat. Kennedy's 26th June tax cuts triggered the rebound, with shares surging +15% in the second half, right through the Cuban Missile Crisis (October), and then up another +19% in 1963, which included Kennedy's assassination.
- 1940 – down -22% in first half, early in World War Two. Shares rose +9% in the second half, but then fell -17% in 1941 mainly in the lead-up to the Japanese bombing of Pearl Harbour. After Pearl Harbour, US shares surged right through to the end of the War. The WW2 share market boom ended with with the end of the War and the start of the post-war inflation spike .
- 1932 – down -44% in the first half (the worst ever half year for the US market), in the late stages of the 1929-32 crash. But shares surged +43% in the second half of 1932, in the middle of the Great Depression, before Roosevelt was elected, and while earnings and dividends were still being cut savagely. The market then rose another +46% in 1933, while the economy was still contracting in the Depression.
- 1907 also had a bad first half – down -20%, then down another -16% in the second half – resulting in -33% for the year. 1907 was the only one of the five worst first halves that the market did not rise in the second half. There were several causes for the 'Panic of 1907'– a speculative bubble in the hot commodity of the day (copper), a frenzied boom in the hot infrastructure sector of the day (electric utilities), regulatory attacks to break up the Standard Oil monopoly, runs on banks and on speculative unit trusts, and corporate bankruptcies. However, the share market bounced back +37% in 1908 while the economy was in recession and while earnings and dividends were being cut. Then up another +14% in 1909.

Portfolio impacts: – Although this sample size of five prior episodes is not enough to draw any conclusions about what might happen in the current cycle, they do echo some well-worn patterns that have occurred in nearly all recessions in all eras, including the 2020 Covid recession, the 2008-9 GFC, the 2001-2 'tech-wreck', the 1990-1 'recession we had to have', the early 1980s Volcker inflation-busting recessions, the 1930s Great Depression, the 1890s depression, and many more. In almost all cases, share prices rebounded out of the middle of recessions, while economies were still contracting, while unemployment was rising, when pessimism was at its greatest, and while profits and dividends were still being cut. This pattern has even held true during World Wars, presidential assassinations, and a host of other crises that tend to spook investors.

We have used the US market as an example here, because it is once again the culprit this year, also because it makes up more than half of the entire world stock market value, and because US markets and monetary policies drive all world markets. It is important to note that the Australian share market, as well as other markets, also follow the same pattern. While the local conditions in each country differ of course, what is the same everywhere is hard-wired human emotions, and that is what causes price volatility and the wild boom-bust cycles.

# House prices & interest rates

Former RBA chief, and current Stanford Brown Investment Committee member, Ian Macfarlane, wisely observed that in the US, easy money ends up inflating bubbles on Wall Street, but in Australia it ends up inflating house prices. This time last year, the Australian Financial Review ran the following story trumpeting double-digit growth in house prices across the country, driven by ultra-low interest rates and the generous Covid stimulus hand-outs.

**Sydney house prices soar 15pc in fiscal 2021**

Nila Sweeney

Sydney's home prices surged 15 per cent in financial 2021, defying pandemic warnings of steep falls, as ultra-low interest rates and government stimulus sparked a buying frenzy.

All capitals ended the fiscal year with double-digit price growth except for Melbourne and Perth, which gained 7.7 per cent and 0.8 per cent, respectively. In May, Perth rose by 1.4 per cent and Darwin by 2.1 per cent.

National home values rose 1.9 per cent in June, higher than the decade average of 0.4 per cent, but 3 basis points lower from May and 9 basis points below the recent peak in March.

The quarterly results also showed a noticeable slowdown, ranging from 20

**Pumped up**

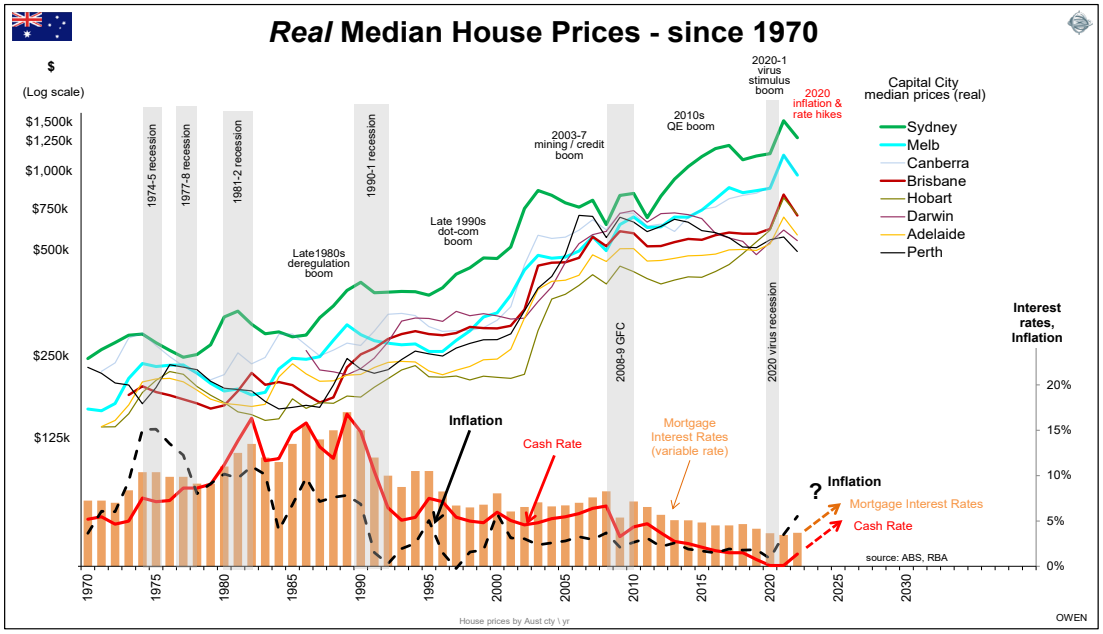
Dwelling values (% change)

| | Past month | Past 3 months | Past 12 months |
|---|---|---|---|
| Darwin | +0.8 | +6.3 | +21.0 |
| Hobart | +3.0 | +7.4 | +19.6 |
| Canberra | +2.3 | +6.1 | +18.1 |
| Sydney | +2.6 | +8.2 | +15.0 |
| Adelaide | +1.6 | +5.6 | +13.9 |
| Brisbane | +1.9 | +5.7 | +13.2 |
| Perth | +0.2 | +2.1 | +9.8 |
| Melbourne | +4.5 | +4.6 | +7.7 |
| **Australia** | +1.9 | +6.1 | +13.5 |

SOURCE: CORELOGIC

One year later, the stimulus party is over, interest rates are rising, and house prices have started to give back some of those windfall gains. How far will interest rates rise, and how will they impact house prices?

Here is an update on our regular chart of house prices, cash rates, mortgage rates and inflation over the past few cycles. Here we use real house prices (ie after CPI inflation), to highlight the inflation protection in housing.




There have been regular price booms once or twice per decade – including during periods of high inflation and interest rates, like the early 1970s, late 1970s and late 1980s. These booms were followed by periods of static or falling prices, usually during economic slowdowns when interest rates were being cut.

We have just enjoyed a tremendous house price boom. In the three years to December 2021, median house prices surged by +43% in Sydney, Brisbane and Canberra, +41% in Melbourne, +62% in Hobart, +35% in Adelaide, but Perth was more subdued with +15% growth. As interest rates are now rising again, prices are falling as there are fewer buyers with less loan money, and more sellers, including recent buyers with big mortgages.

How far prices fall will depend mainly on how high interest rates rise, and for how long. Even if inflation is contained within the RBA's target 2-3% range, cash rates are on their way back up toward 'normal' levels of around 3% or 4%, and mortgage rates around 5-7%, as they were during most of the past two decades. It is unlikely house prices will give up all of their 40% gains from the 2019-2021 boom. However, this might occur if aggressive RBA rate hikes trigger a broad economic slowdown that brings high unemployment and widespread corporate and personal bankruptcies. We have had these before, in the mid-1970s, early 1980s, early 1990s, and the 2008-9 GFC (the GFC was caused mainly by a global systemic banking crisis, but the Fed hiking rates from 1% to 5.25% was certainly a major contributor to the housing collapse that triggered the banking crisis).

Despite these setbacks, housing is a long term investment, and housing markets in Australia's large cities have enjoyed a long upward march driven by population growth (mainly immigration), favourable demographics (progressively smaller numbers of people per household), 'NIMBY' supply constraints, and tax advantages (exemptions from capital gains taxes and means tests). These long term fundamentals are likely to remain strong.

# Winners

The 2021-2 financial year saw negative returns for the main types of assets - including shares, bonds, and listed property. Especially hard hit were speculative categories like crypto's, NFTs, and profitless start-ups. Many types of 'unlisted' assets (ie without the daily volatility of listed share markets) – including commercial property, infrastructure, private equity, venture capital and hedge funds – appear to have held up better because they don't have the volatility of shares. Instead their values are set by slow/opaque valuations cycles, and they are probably yet to bear the brunt of lower valuations due to rising bond yields, higher costs of debt, and less buoyant markets.

However, there are always some winners in every set of conditions.

Undoubtedly, the biggest 'winners' this year are those who avoided the temptation to dive headfirst into the hot fads of the stimulus boom, including crypto's, NFTs and profitless start-ups. Unfortunately, many people geared up in the rush to get rich quick, and now face losing a lot more than the purchase price.

Fossil fuel producers, distributors and burners have been the winners in share markets, profiteering from the current energy crisis. Although they are milking the crisis at the moment, in the longer term the incumbent fossil fuel players face enormous costs in clean-up, remediation, dismantling and disposing of 'stranded' and 'wasted' assets, and also the costs of the high-risk transition to renewables. There will be many more losers than winners.

Gold in US dollars rose a modest 3% for the 12 months (hardly an inflation hedge, as inflation surges around the world), but in Aussie dollar terms it rose a healthy +12% because the AUD fell against the US dollar.

The US dollar has been a 'winner' (as it almost always rises as a 'safe haven, in share market sell-offs), However, a stronger US dollar hurts US exporters, and also reduces returns to US investors on their foreign holdings.

Australian investors with foreign assets gained from the falling Australian dollar, against the US dollar in particular, as the majority of global shares are priced in US dollars. In our diversified portfolios, half of the foreign shares are 'un-hedged', so the decline in the AUD cushioned part of the declines on foreign shares.

Japanese exporters have benefited greatly from the collapsing Yen. As a result, Japanese revenues, profits and share prices have held up better than their global peers.

Farmers are benefiting from rising global food prices, especially oats, wheat, milk, butter, cheese, orange juice, coffee, and many others. Many Australian farmers were able to reap windfall prices, volumes and revenues after the fires, floods and lockdowns over the past couple of years. Farm prices are also rising, due to a flood of global money hoping that agricultural land is the 'next big thing'.

Bank depositors are finally seeing some income on their deposits, especially new term deposits for longer periods. Some of the smaller banks are now offering rates on new TDs above 3.5% for 3 year terms, and above 4% for 5 year terms. So far, these rates are still below the 5% Australian inflation rate, but spare a thought for Swiss savers. In June, the Swiss banks reduced the fees they charge on deposit accounts (ie. negative deposit interest rates) from -0.75% to -0.25% in line with the rate 'hike' by the central bank (Swiss National Bank), so Swiss depositors are still paying the banks for the privilege of keeping their money 'safe', while Swiss inflation is running above 3%.

In the next story we also highlight many of the winners in the Australian share market over the past year.

It is important to point out here that we included this story on winners in order to demonstrate that in all markets there are many winners and losers. The aim is certainly not to entice people to chasing last year's winners, as more often than not, they turn out to be next year's losers. We provide practical examples of this in the next story.

Long term investors would know that 'you only lose when you sell'. The converse is that you also only 'win' when you sell. There are many people who claimed to be 'winners' at the top of the stimulus boom in late 2021. Of course, they now know that they were really only winners if they actually sold out, paid tax on their gains, paid brokerage and transaction costs on the sale, and then banked the net cash from the sale.

The other side of the coin is that, even though prices are down this year, they only become 'losses' if you sell. The main theme in this month's report is that human emotions drive investment market volatility and boom-bust cycles. We have seen many of these emotion-driven sell-offs and rebounds in the past, and we will surely see many more in the future. Managing emotions is, and always has been, the key to investment success.

# Aussie share market: speculator's paradise – or graveyard?

The local share market held up better than most countries in the 2021-2 year, but the overall market indexes (eg the 'All Ordinaries Index') were still down by -11%. However, while the general market indexes were down, there were still 543 ASX-listed companies that posted share price gains for the 2021-2 year, including 276 that rose more than 25%, 90 that more than doubled in value, and even three companies that rose ten-fold or more (more than 1,000%). We look at these in a moment.

The Australian share market is unusually large, with more than 2,400 companies listed on the ASX (plus several hundred more on other, smaller exchanges). Australia has more publicly listed companies per head of population than any other country. (It is probably no coincidence that Australians have long been the world's biggest gamblers per capita). The largest 20 listed companies in Australia (which is mainly the big banks and miners) account for half of the A$2.5 trillion in total stock market value of the 2,400 listed companies. The largest 100 account for more than 75% of total value, and the largest 500 (the 'All Ordinaries index') account for 95% of total value.

That still leaves another 1,900+ listed companies outside of the largest 500, and this is a speculator's paradise, or graveyard. Half of these 1,900+ ASX-listed micro-companies are miners (mostly speculative explorers with no revenues or profits, and little more than a map, a compass and dreams of striking it rich). Another quarter of the total are tiny bio-techs or 'fin-techs', and the rest are scattered across other industries and sectors. Given the recent surge in world commodities prices, it is not surprising that speculative mining explorers dominate the list of winners in the 'micro-cap' sector for the year. Out of the 90 ASX-listed stocks that more than doubled in price for the year, almost all were resources stocks.

The 'ten-baggers' (up more than ten-fold) for the 2021-2 year were:

- Pacific Bauxite (PBX) - bauxite explorer, WA - up 34,000%
- Viagold Rare Earth Resources (VIA) - rare earth processing, China – up 2,340%
- Resource Mining Corp (RMA) - nickel explorer, PNG – up 1,015%

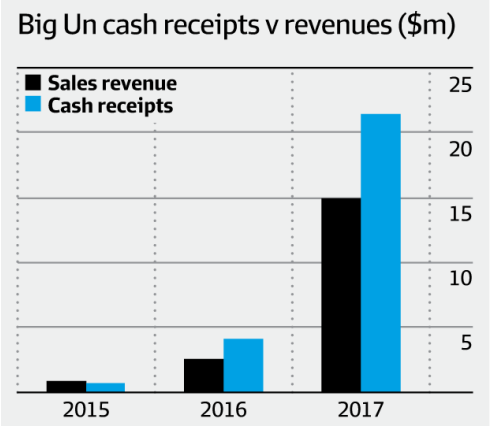
In each case, the current share price is still well below their peaks a decade ago.

This story is certainly not a recommendation to rush out and buy shares in these, or any other tiny, speculative stocks. Because even the worst years produce astonishing stories of fantastic gains from a few dozen tiny micro-stocks, the dream of striking it rich attracts an endless stream of new 'investors' into the field. For most of us, the micro-cap market is little more than a casino, riddled with poor or non-existent information, related party transactions, low trading volumes, and also very often spiced with 'salted' drilling samples, falsified assay reports, insider trading, and dodgy accounts. To make any sort of money in the micro-cap market, it is a tough game that usually requires many years of patient research, including constant field trips to mining & exploration sites in remote, hostile deserts and jungles. My intention here is not to deter hardy souls who are prepared to put in the time and effort to spend many years researching the market and identifying opportunities, but it's a long, hard slog.

In any given year, last year's winners often turn out to be the next year's losers. For example, let's look at the micro-cap winners from the previous year (2020-1), to see how they fared in 2021-2:

- The best stock in 2020-1 was Sparc Technologies (SPN) – up 27,000% in 2020-1, but down -33% in 2021-2.
- Second best was Suvo Strategic Minerals (SUV) – up +7,650% in 2020-1, but down -75% in 2021-2.
- Third best was Proptech Group (PTG) - up +7,100% in 2020-1, but down -72% in 2021-2.

I recall a company called 'Big Un' – it was the best performing stock in 2017, with a 1,478% gain. It was the hot stock of the day, and I received many emails and phone calls from people asking about it. The company boasted 400% revenue growth (according to its audited accounts anyway). To the right is a chart published in the AFR's glowing story on 17 December 2017. Surprise, surprise, it turned out the revenues didn't actually exist. The shares were suspended two months later, and the company collapsed, worthless, just six months after that.




Like any casino, there is big money to be made from shares for those who spend years doing detailed research, but the risk of loss is high.

# What Lies Ahead?

Although Russia is still waging war on Ukraine, and the Covid pandemic is still morphing into new strains, the main game affecting all types of investment markets is monetary policy. Can central banks contain inflation by unwinding their ultra-loose and ultra-expansionary monetary policies that created the inflation in the first place?

Political leaders, governments and central bankers have been quick to shift the blame for inflation to Russia, which is a convenient scape-goat. The problem is that, even before Russia's February 2022 invasion of Ukraine, inflation was already running at 7.5% in the US, 5.2% in the UK, 5.1% in the Eurozone (including 5.3% in Germany), and 3.5% in Australia. In 2021, central banks dismissed this inflation as 'transitory', and then in 2022 they jumped on the opportunity to shift the blame to Russia. The Russian invasion certainly added to supply restrictions (severely affecting poorer countries much more than the west), but the main problem was the trillions of dollars of stimulus money from governments and their central banks, sloshing around the market pushing up prices everywhere.

Blame-shifting is not new. Governments and their central banks have taught the public to believe that the early/mid-1970s inflation was caused by the 1973 Arab oil embargo, and that the late-1970s/early 1980s inflation was caused by the 1979 Iranian revolution. In fact, US inflation was already running at more than 7% before the October 1973 Arab oil embargo, and at more than 8% before the November 1978 Iranian oil workers' strike. These two 'oil shocks' certainly did add supply constraints to the inflation picture, but the real problems in both cases were poor central bank policies, and inflationary government deficit-spending since the mid-1960s.

We are not in the blame game here. We are interested purely in navigating investors through the market conditions as they emerge. Inflation was caused by too much money chasing the supply of goods, services, labour, commodities, housing, shares and other assets. This excess money came from governments (loose fiscal policy) and their central banks (loose monetary policy). On the fiscal side, cutting spending and raising taxes to end the deficits, and even run surpluses to pay off debts, is going to be political suicide for elected governments, especially with fractured politics since the GFC in the US, Europe and even in Australia. This will mean the heavy lifting will have to be done by central banks. Their primary tool is very blunt – increasing interest rates to reduce spending, by reducing peoples' surplus spending money after paying the mortgage, and by taking away their jobs.

There are early signs that some of the temporary supply constraints are easing, and that inflation numbers are starting to ease in the US, but is probably still rising in Japan, UK, Canada, most of Europe, and in Australia.

If central banks can manage to pull off a miracle and bring inflation back to target ranges without triggering economic slowdowns and big reductions in jobs, spending, and corporate profits, then the share prices of most companies are probably already over-sold at current levels. On the other hand, if the rate hikes do result in economic slowdowns that materially hurt profits and dividends, then share prices probably have further to fall.

Since mid-June, three of the main indicators have started to point to increasing risk of economic recession ahead: bond yields are declining (good for government bond markets), commodities prices are falling (good for US shares generally, but bad for Australia's miners), and credit spreads are rising (bad for corporate bond markets).

Whether we have a recession or not, share markets have always managed to rebound out of the middle of recessions and slowdowns, usually more quickly and more strongly than most people expect, while pessimism is at its worst, and while losses and bankruptcies are dominating the news stories of the day.

This edition has been focused on two main themes: how share markets perform through different types of conditions, and how human emotions drive boom-bust cycles in markets. The past 12 months to June 2022 was a poor one for share markets, but this cut-off date is arbitrary. The 12 months to May 2022 was positive, as were the 12 month periods to April and to March, so it is important to not get caught up with arbitrary cut-off periods.

In our portfolios, we tend to err on the side of caution, avoiding the temptation to chase high returns in unsustainable booms, but also being ready for the rebounds. We are undertaking our regular quarterly review toward the end of July, and we will keep you informed of any changes in due course.

Ashley Owen, CFA
Chief Investment Officer

# 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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