YOUR PERSONAL WEALTH

WINTER 2022

WELCOME TO THE WINTER EDITION

Labor's recent Australian election victory marks the end of the Coalition's almost decade-long reign. The new Labor government will have a challenge in front of them to govern effectively in a world of higher inflation and interest rates.

Speaking of challenges, in this edition we also take a look at what Shane Warne can teach us about what we can do to reduce risk in our lives.

We also take a look at what we mean by investment style, to give you a better appreciation of the different styles available for use by fund managers.

WHERE TO FROM HERE?

Most global equity markets have been selling off due to rising bond yields which have been reacting to high inflation, not seen for decades, and a very aggressive US Fed. Both the US and Australian 10-year bond yields rose by over 1.5% year-to-date, to trade at around 3.0% and 3.5% respectively. This has resulted in large price falls in common fixed interest benchmarks., including the Australian and Global fixed interest benchmarks down 7.28% and 9.26% respectively in the first 4 months of 2022. Bond yields have since pulled back somewhat from their recent peaks.

The other major event is the Russian invasion of Ukraine. Quite apart from the humanitarian disaster, this has led to elevated oil and commodity prices, adding to inflationary pressure, and resulting in global growth estimates being revised down.

Australian outlook

The RBA, along with many other central banks, underestimated the underlying level of inflation and is now scrambling to bring it under control. Interest rate hikes are well ahead of initial predictions. Only a few months ago the RBA conceded a rate hike was "plausible" this year, but it was prepared to be "patient". On May 3, the RBA joined central banks in the US, UK, NZ, and Canada, which had already lifted rates. The RBA raised the Cash rate by 0.25% to 0.35%, the first increase since November 2010.

HOW COULD A RATE CHANGE AFFECT MY HOME LOAN?

Based on a 30-year principal-and-interest monthly repayment loan with a 3.5% interest rate, increasing by the full May RBA increase.

Loan amount	Interest rate increase	Monthly increase
$500,000	3.5% to 3.75%	$70
$750,000	3.5% to 3.75%	$106
$1,000,000	3.5% to 3.75%	$141

Rising inflation and cost of living

The RBA's forecast for 2022 is for headline inflation to be around 6% and underlying inflation (core) around 4.75%. It also forecast that inflation would fall back to its target range of 2-3% by mid-2024.

4.75%
forecast inflation rate

2.4%
annual wage growth

Headline inflation is currently 5.1% in Australia, but this is still well below 8.3% in the US and around 7% in Europe, the UK, Canada, and NZ. The RBA's assumption is that the cash rates

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6.1% increase in cost of vegetables

32.3% increase in petrol cost

would reach 1.75% by the end of this year and 2.5% by the end of 2023. However, markets are currently pricing in a Cash rate of 2.5% by December 2022 (RBC Capital Markets, AFR), although we believe this is on the high side. While the US Fed is tightening by also reducing the size of its balance sheet, the RBA has indicated it has no plans to sell the $617 billion bonds it currently holds.

Australia is a special case for the moment. The war in Ukraine has boosted the price of many commodities such as oil, nickel, and wheat, and boosted the Australian dollar earlier this year. However, the Australian dollar has pulled back sharply lately, likely due to the COVID lockdowns in China, as we are so dependent on China for our exports. UBS and JP Morgan recently downgraded their GDP growth forecasts for China in 2022 to 3.0% and 3.7% respectively, well below the official target of 5.5%. Our market is seen as a hedge against inflation, so has been one of the best performing markets this year.

US outlook

The main issues right now are how high will interest rates need to go to get inflation under control, and how much will growth slow, and whether that leads to a recession in the US. We believe the Fed would like to rapidly get the cash rate to a neutral level (around 2.4%) before possibly pausing. Market expectations change from day to day, but the cash rate is expected to exceed 3% eventually.

It is an open question whether projected rate hikes will be enough to tame inflation. The Fed is so far behind the curve with CPI inflation over 8% and PPI (wholesale inflation) around 11%. Historically, the Fed has had to raise rates to a level matching wages growth (over 5%) or the level of inflation (over 8%). However, it is very hard to see that happening given the enormous levels of debt post-pandemic.

This is probably the most complex investing environment we can remember. We do not know how far interest rates will rise and this makes it very difficult to value markets. What we can say is that we would expect equity price to earnings (PE) multiples to fall as interest rates rise. This is exactly what has been happening, with the higher PE Nasdaq index in the US pulling back over 30% in the year-to-date, and the broader S&P 500 index down around 19%. Australia is trading a little above the long-term average of 14.7x for the ASX 200, while Europe, Japan, and China are now all trading below their long-term PE averages, something we have not seen for a while.

Outlook

We continue to believe you should hold a mixture of equity styles such as Value/Cyclicals and Growth. Value has done much better than Growth this year, but this could reverse as markets worry about future growth, in China and the US in particular. The case for overweighting Value stocks is more difficult now since the valuations of most growth stocks have come down substantially.

There has been a string of high-profile US companies warning about the strength of the consumer lately. There is no question that growth is slowing in the US. We believe the market will fluctuate between concerns about inflation and slowing growth, and there will be more talk of a possible recession in 2023. We also believe markets have priced in a slowdown in growth resulting from normalised, higher interest rates. However, they would have another leg down if there was a US recession, or if company earnings were to be revised down significantly. The risk is that falling company profits due to increasing costs arising from persistent inflationary pressures have not been fully priced into equities.

We still believe it is too early to start increasing the duration in fixed interest portfolios, as we think there is a risk that central banks may need to raise rates by more than current expectations to tame inflation. However, we would probably not be reducing duration yet as growth concerns will tend to pull bond yields lower. At some stage in a rate hiking cycle, markets will be more concerned about growth outlook rather than inflation.

In our view, it is important to continue to be patient in this market and hold higher cash levels than normal to take advantage of opportunities that will likely arise in a very volatile market.

WHAT CAN SHANE WARNE TEACH US ABOUT RISK?

The recent passing of cricket legend Shane Warne reminds us all too vividly of our own mortality. One positive outcome may be that we become collectively more aware to look for what we can do to reduce the risks and the potential impact of such an event in our lives.

Whilst the average life expectancy in Australia is currently 82.8 years, up from 70.6 years in 1960[1], around 1 in 3 Australians die under the age of 75[2]. Males are more likely than females to experience premature death. In 2019, there were 28,000 potentially avoidable deaths: half (48%) of all deaths for people aged less than 75. Of these deaths, 64% were male and 36% were female[3].

One in three Australians personally know someone who has had a heart attack. In Australia, every nine minutes, someone is hospitalised due to a heart attack[4]. While men are at higher risk of heart attack, women are more likely to die of a repeat heart attack.

Our health risks are wider than that. It's estimated that over 400 Australians are diagnosed with cancer each day[5], with around two in five cases attributable to personal and behavioural risk factors such as smoking or being overweight[6].

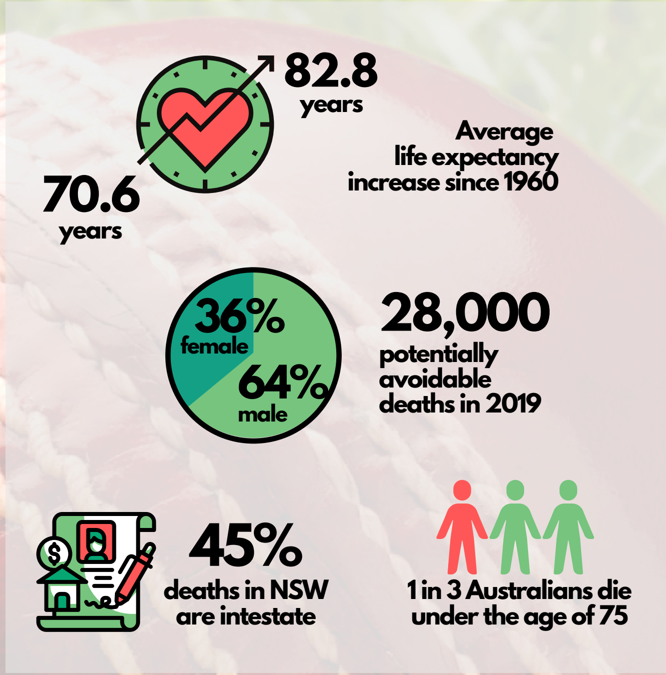
Whilst it's easy to wallow in numbers, we are all aware of risk; after all, we are 100% mortal. Life is full of risks. It's how you chose to act and respond that can make the difference. You can reduce the impact of risk in your life by planning for the worst and living for the best.

Reducing health risks

You can help reduce your heart attack risk by getting on top of your heart health[7] and speaking to your doctor about having an annual heart health check. Making positive lifestyle changes can also decrease your risk factors. Even small changes can have a positive impact. These can include maintaining a healthy weight through a heart-healthy diet and lowering alcohol intake, exercising regularly, quitting smoking, and taking steps to manage blood pressure levels as well as lower cholesterol levels. Speak to your doctor about what changes you can make.

Are you sufficiently insured?

Another important step you can take is to ensure you have sufficient insurance in place, should life take an unexpected turn. This can include things such as health insurance, travel insurance, and most importantly income and life protection insurance. Having these in place will help reduce the potential impact of these life events.



Reducing estate risks

NSW Trustee & Guardian estimated that around 45% of Australians do not have a valid will [8]. This in effect means that the government gets to choose how your assets are distributed. You can ensure this doesn't happen to you by having a valid will and estate plan in place, which is regularly reviewed to keep pace with any significant changes in your life, such as buying a house, getting married, having children or grandchildren, or getting divorced.

No matter what curve balls life may spin us, proactively managing risk in your life can better enable you to live each day to the fullest, with confidence.

[1] https://www.macrotrends.net/
[2] https://www.aihw.gov.au/
[3] https://www.abs.gov.au/
[4] https://www.hri.org.au/
[5] https://www.canceraustralia.gov.au/
[6] https://www.aihw.gov.au
[7] https://www.hri.org.au/
[8]https://www.tag.nsw.gov.au/

WHAT DO WE MEAN BY INVESTMENT STYLE?

In essence, 'investment styles' refer to how fund managers choose the underlying investments of their funds. Investments in a fund may be either actively or passively managed.

Active investing

Actively managed funds require the use of human capital, or 'people power'. A professional money manager or team, makes the investment decisions for the fund, relying on analytical research, personal judgment, and forecasts. Actively managed funds aim to outperform the market, and as such, they are also higher risk. The two traditional ways of choosing stocks that active fund managers use are growth and value. There is also GARP or "Growth at a Reasonable Price" and Style-Neutral.

- **Growth** managers choose shares or companies for which they expect capital gain through improved company earnings. They tend to look at areas of the economy that they anticipate will do better than the market average and companies within those areas with the most growth potential.

- **Value** managers look for stocks with undervalued assets that they believe are trading at less than their intrinsic value. They analyse the company's finances thoroughly to work out a 'fair value' for the stock by looking for low price to earnings (P/E) ratios, low price to book ratios, high dividend yields, and other key indicators of a company's value.

- **GARP** is a mix of the growth and value styles. Here the focus is on stocks that have a stronger growth outlook than the market, but which are cheaper than the average stock bought by a growth manager.

- **Style-Neutral** management uses intensive fundamental analysis of companies to determine their long-term worth. As the name implies, this manager does this without a specific style bias.

Passive investing

Passively managed funds seek to replicate the performance of their benchmarks, rather than outperform them. Two common strategies of passive fund management are index and buy and hold.

- **Buy and Hold** managers operate on the principle that 'time in the market' is more important than 'timing the market'. They buy and hold shares in the belief that the value will increase over the long term despite any short-term volatility.

- **Index** managers aim to reflect a specific index like the ASX 200 in the stocks that the fund holds. Generally, these funds will perform in line with the stock market.

When we refer to asset allocation, we're also considering diversification across the investment management styles as well.

Smart investing is not as easy as it sounds. While we can't be responsible for the investment market returns, we're here to help you understand how the investment strategies we recommend will help you meet your goals and suit your appetite for risk.

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