This communication is not for circulation to retail investors.

ASSET MANAGEMENT

# Something's gotta give

*August 2021*

Anthony Golowekno, Portfolio Manager

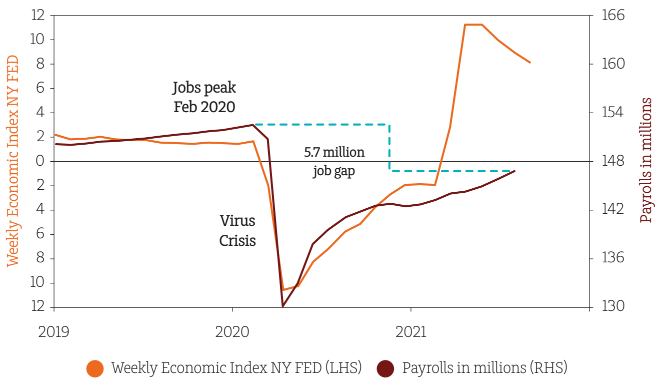
Music lovers may recall Bobby McFerrin's 1988 hit song 'Don't worry, be happy'. If you only looked at one piece of fairly recent data, the roaring US share market with the S&P 500 Index setting new heights through June,[1] you might conclude that investors are generally in a happy place.

Of course, there's more to the story than that. Economically speaking, important parts of the world have come a long way since the dark days of mid-2020.

Though America's unemployment rate is still above pre-pandemic levels, the US job creation machine has sprung back to life and people are getting hired at a healthy clip **(Chart 1)**.

### Chart 1: Jobs are coming back in the United States

US economic activity vs employment




'Weekly Economic Index' on the left hand side of the chart, is "four-quarter GDP growth rate" (essentially, real annual change in Gross Domestic Product).
'Payrolls', on right hand side of chart, shows US Non-Farm Employment in millions (essentially, total US employment).

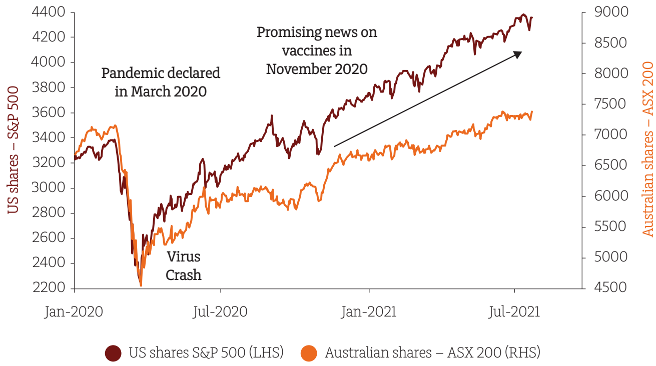
Data is at June 2021 for US Weekly Economic Index and Payrolls.

**Source:** Federal Reserve St Louis.

Australia can boast an even better jobs story with the June 2021 unemployment rate being the lowest since 2010.[2] While the domestic share market hasn't roared as loudly as the US equity market, it too has staged a marked recovery from last year's COVID-related slump **(Chart 2)**.

Mergers and acquisitions activity is another confidence gauge and a recent Goldman Sachs report showed, "$148 billion worth of deals announced across Australia and New Zealand in the first half of calendar 2021, about 2.6 times the five-year average of $58 million for the same period."[3]

### Chart 2: The Australian and US share markets have both recovered




Data is at 16 July 2021 for S&P 500 and ASX 200 Index.

**Source:** Refinitiv (formerly Datastream).

## Massive government and central bank support

You don't have to dig far to uncover the reasons why both share markets and economies have been recovering – massive government spending, and central banks going all-out through extraordinary levels of credit creation and ultra-low official interest rates.

The International Monetary Fund (IMF) estimates that on the basis of "additional spending and foregone revenue",[4] the US government has provided 'support' equating to a stunning 25.5% of America's nominal gross domestic product (GDP), or about US$5.3 trillion in fiscal support.[5]

The level of 'above and beyond' commitments by the Australian government is around 16.1% of GDP or roughly A$311.8 billion in fiscal support.[6]

Governments in other advanced economies have done similar things[7] to cushion communities from the worst impacts of COVID-related disruption.

*"Share markets and economies have been recovering thanks to massive government spending, and central banks support."*

Central banks stepped up with the US Federal Reserve (the Fed) buying US$120 billion of US Government Treasuries and mortgage backed securities each month[8] to suppress long-term interest rates and keep the wheels of credit moving.

Like its US, as well as European and Japanese counterparts, the Reserve Bank of Australia has gone down a related path with a bond purchase program running at A$4 billion a week[9] and a special funding facility of around A$200 billion to provide low cost funding for banks for three years.[10]

These eye-popping levels of government and central bank support have worked their way through business and households and showed up in encouraging data including jobs growth, improved consumer spending, and increased levels of consumer and business confidence.

A feature of the COVID period has been the phenomenon of 'on the couch spending' – spending by households on everything from TVs, to laptops and monitors, as well as home offices and furniture, and "Zoom clothing" as people settled into working from home. It's been a boon for electronics retailers and home officer suppliers, amongst others.

Arguably the biggest difference-maker has been the rollout out of vaccines against COVID, however uneven rates may be across countries. Full vaccinations rates (as a percent of populations) range from 61.9% for Chile, 54.2% for the UK, 49.2% for the US, 46.8% for Germany, to 11.2% for Australia.[11]

## Clouds in the silver lining

Despite these positive markers, we're not in the *Don't worry, be happy* camp, yet. We believe there are good reasons to be cautious and watchful in what we see as an economic environment in delicate balance.

There are a few reasons for this starting with doubts over governments' ability to sustain the rates of spending of the past year.

The White House's Office of Management and Budget estimates the US budget deficit to be around 15% of GDP[12] while Australia's budget deficit is near 10% of GDP.[13]

The US dollar's global reserve currency status endows it with an "exorbitant privilege" – to use the term coined in the 1960s by Valéry Giscard d'Estaing, then the French Minister of Finance – and so American governments can draw on other countries' savings to fund US spending for far longer than can other governments.

Countries without America's "exorbitant privilege", like Australia, can't keep spending at the present rate ad infinitum.

*"There are reasons for doubts over governments' ability to sustain the rates of spending of the past year."*

## Wage growth and spending transition needed

In other words, sustaining positive economic momentum will require the passing of the spending baton from governments to the private sector and households. Private sector investment and household spending, in turn, stem from confidence, and household confidence is significantly influenced by wage growth.

Recent Australian wage growth of just 1.4%, is "the lowest rate on record,"[14] well below the "sustainably above 3%"[15] wage growth required to push the economy forward. To be clear, low wage growth is not a new issue; it's been with us for several years.[16]

*"Recent Australian wage growth is 'the lowest rate on record.'[17] Wage growth is required to push the Australian economy forward."*

Many explanations are given for Australia's low wage growth including employers' emphasis on cost-cutting, technological change, the decline of trade unionism, the globalisation of labour markets, job insecurity, and the rise of the gig economy. Whatever the causes may be, overcoming lacklustre wage growth is perhaps the central issue to ensure a sustained economic recovery.

Changes to spending patterns would also contribute to genuine economic recovery. We think a shift is needed from 'on the couch' spending to 'off the couch' spending on services and experiences like entertainment and dining out. We see this 'on the couch' to 'off the couch' transition being key to more meaningfully turning the flywheel of sustained economic activity, job creation, sustained wages growth and ultimately recovery.

Education services, which are such a massive exporter earner, have been in the doldrums and reviving this growth driver would be another economic tonic. Arguably, greater progress against the pandemic would be needed before this can happen.

*"A shift is needed from 'on the couch' spending to 'off the couch' spending to sustain economic activity."*

## Higher inflation: temporary or structural?

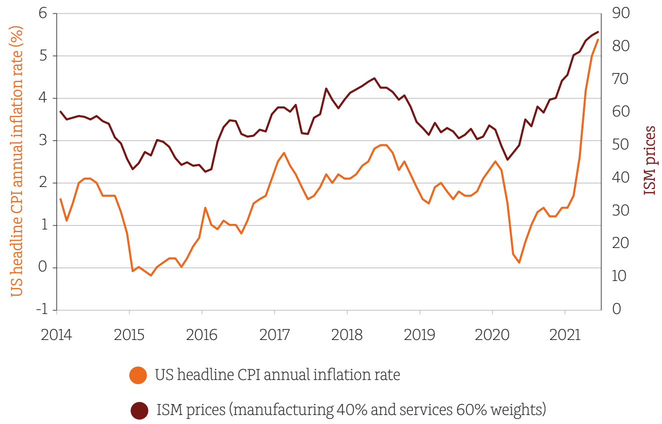
Important as the issues mentioned are, inflation is the subject grabbing most investment professionals' attention.

The recent jump in US inflation **(Chart 3)** sent ripples through financial markets, for a time, before investors, especially bond market participants, settled down as they appeared to conclude that the causes of this inflationary spurt were likely to be temporary.

Big rises in US car prices, for instance, stemmed, in part, from a global shortage of semiconductors and microchips. It's reasonable to assume that supply shortages will be overcome when semiconductor and microchip makers in Taiwan and South Korea gradually return to full production.

**Chart 3: Recent rise in US inflation sent temporary ripples through markets**

The ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of US economic activity based on a survey of private sector companies.




Data is at June 2021 for US CPI Inflation and ISM surveys.

**Source:** Federal Reserve St Louis and ISM Manufacturing and Services Survey.

Recent US inflation readings have also been artificially bloated by comparisons against periods last year when inflation collapsed as economic activity cratered on the back of shutdowns. This 'base effect', because of last year's unusually low inflation numbers, will eventually drop out of future calculations and give a cleaner read on the true inflation situation.

Investors wouldn't be so focused on the inflation issue if this was all there is to it.

They are looking beyond this year to structural factors that may cause inflation to move higher over the longer-term, compared to the low levels of inflation we've become familiar with over the past few decades.

*"Structural factors may cause inflation to move higher over the longer-term."*

China has been exporting deflation to the rest of the world since it re-entered the global economy. The country's massive workforce added to the global labour pool and contributed to lowering costs in many industries from consumer goods to industrial machinery.

There are now reasons to think that China's influence as a deflation exporter may be peaking. For starters, rising living standards mean that China is no longer the ultra-low cost manufacturing country it once was.

*"China's influence as a deflation exporter may be peaking."*

Secondly, its population is aging, a result of the decades-long one-child policy that has brought about a steep decline in births. In a major policy shift, the government announced that it "will allow couples to have up to three children."[18]

The policy change, however, may not be enough to reverse China's demographic trends. If other countries' experience of drops in fertility also proves true for China, the population would continue to age, the working age population would gradually decline (as a proportion of total population), further dampening China's deflationary impact on the world.

There are other forces that could add inflationary pressures too. Economic globalisation, in which China has played such a pivotal role, may be nearing a peak.

COVID-19 has exposed vulnerabilities associated with a reliance on global supply chains for vital personal protective equipment as well as pharmaceuticals, including vaccines against the pandemic. There are growing pressures to "on-shore" industries judged 'essential'.

Even a partial reversal of globalisation and 'off-shoring' would probably not be confined to just a few essential industries as communities may demand more emphasis on 'just in case' domestic production versus 'just in time' global production.

There may be good reasons for doing so, but producing for smaller local demands, without the scale of global markets, would logically be inflationary.

*"Producing for smaller local demands, without the scale of global markets, would logically be inflationary."*

## Stretched valuations and policy risks

As it is, valuations across asset classes are stretched, by historic comparisons, making them delicately poised.

The price-to-earnings ratio (P/E)[19] of the global share market (MSCI All Country World ACWI Index) is, at the time of writing, around 26.6,[20] while the US S&P 500 Index's P/E stands at 29.3,[21] and MSCI Emerging Markets Index P/E is at 16.3.[22]

By contrast, the 30-year average P/E ratio for the US S&P 500 Index is 19.9,[23] while the average P/E ratios, over 26.5 years, for the MSCI All Country World Index and MSCI Emerging Markets Index, are 20.4[24] and 15.6[25] respectively.

Meanwhile, the yield on closely watched US-10 Treasury bonds is 1.3%,[26] well below the 30-year average of 4.1%.[27]

The picture that comes out of all this is of tightly wound strings on a tennis racquet. The ball coming off the racket may sound sweet. Equally, a string under sustained tension might break.

As for the risks that may cause an investment market string to break – we see the primary ones being inflation and policy risks.

Investors and the US Federal Reserve (the Fed) are in a delicate dance. Investors expect the Fed to be alert to inflationary impulses and take action, before cost pressures become meaningfully entrenched.

*"Investors and the US Federal Reserve (the Fed) are in a delicate dance. Investors expect the Fed to be alert to inflationary impulses and take action before cost pressures become meaningfully entrenched."*

A first step towards monetary policy normalisation could potentially involve a winding back of the Fed's US$120 billion a month asset buying program.[28]

But here's a complication: financial markets have become so accustomed to central bank support that there must be some risk of a market fright should the Fed begin to start on monetary normalisation, even if gently done.

Investors may recall the infamous May 2013 'taper tantrum' when the then Fed chief Ben Bernanke triggered a jump in US 10-year bond yields (bond prices fell)[29] when he testified before Congress of the Fed's intention of winding back its asset purchase program.

A similar Fed misstep, could unsettle markets. Share market valuations are high because of extremely low official interest rates, which increase the future value of cash flows measured in current terms.

*"Financial markets have become so accustomed to central bank support that there must be some risk of a market fright should the Fed begin to start on monetary normalisation."*

P/E ratio expansion has surpassed earnings growth in some well-known global equity indices, over the past decade.

For example, the MSCI All Country World index's earnings grew 15.8% over the 10-years to 23 July 2021.[30]

Outsized earnings growth in sectors such as Technology and Healthcare, in the S&P 500 index, resulted in overall earnings growth (for the benchmark) of 73.9% over the same 10-year period.[31]

P/Es, in both instances, rose by more than earnings over the same 10-year period – by 86.0% for the MSCI All Country World Index,[32] and 96.3% for the S&P500 Index.[33]

In other words, strong (valuation) 'multiple expansion' rather than strong earnings gains, especially for the MSCI All Country World Index, have predominantly propelled equity markets higher.

Today's elevated share market valuations could be vulnerable in a rising interest rate environment, even if rate rises were slow and gentle. If persistently higher inflation did materialise, financial assets would be repriced.

*"P/E ratio expansion has surpassed earnings growth in some well-known global equity indices, over the past decade. Today's elevated share market valuations could be vulnerable in a rising interest rate environment."*

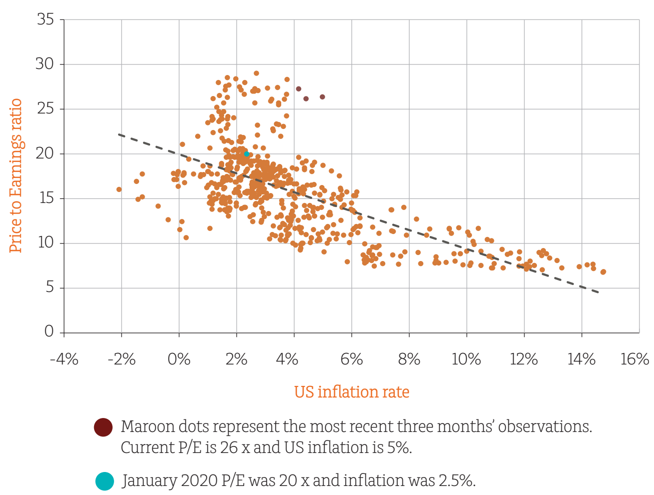
While the negative relationship between bond prices and inflation is well understood, what may be less well understood is the negative relationship between inflation and equity multiples.

**Chart 4** shows a scatterplot of US inflation (x axis) against the corresponding S&P500 P/E ratio (y axis) over the last 50 years. As inflation rises, PE ratios decrease.

The maroon dots represent recent three months' observations, highlighting how equity multiples have not been this high when annual inflation has been above 4%. **The perspective is not suggesting inflation is bad for equities, but that it is bad for equity valuation multiples.**

**Chart 4: Inflation is bad for share market valuations**

Relationship between US inflation vs S&P 500 Index P/E ratio (1970–2021)




**Source:** FactSet and MLC Asset Management Services Limited analysis.

## What we're doing: 'participate and protect'

From our perspective, the takeaway from all this is that now is not the time for 'chin out' investing. Instead, we believe that 'participate and protect' strategies are more appropriate.

As implied, these strategies are designed to enable our clients' portfolios to participate in risk assets' return potential, while simultaneously seeking to protect them should volatility rise and asset prices decline.

*"Now is not the time for 'chin out' investing. Instead, we believe that 'participate and protect' strategies are more appropriate."*

More specifically, we've cut interest rate sensitivity (duration) in our government bond exposures, and hold inflation linked bonds, which would offer some protection should inflation expectations rise.

We also prefer to invest in investment grade credits (corporate bonds) for their higher yields versus government bonds and are seeking out these types of investment opportunities globally. We're also doing this as we prefer to assume greater credit risk, on balance, to interest rate risk.

Emerging markets equities offer better value compared to developed market shares and so, coupled with their diversifying attributes, they occupy a meaningful part of our listed shares exposure.

As a generalisation, our listed shares exposure is biased towards what we judge to be 'quality' companies – those that dominate their industries, that have strong interest coverage and cash flows, as well as resources companies with operations low on the cost of production curve.

**1** S&P 500 books 34th record of 2021 as Dow closes up over 200 points, nears May 7 record high. Mark Decambre, 30 June 2021, https://www.marketwatch.com/story/sp-500-books-34th-record-of-2021-as-dow-closes-up-over-200-points-nears-may-7-record-high-2021-06-30, accessed 21 July 2021.

**2** Unemployment rate falls to 4.9%. Media release, Australian Bureau of Statistics, 15 July 2021, https://www.abs.gov.au/media-centre/media-releases/unemployment-rate-falls-49, accessed 21 July 2021.

**3** Why Goldman Sachs says this M&A boom is different. Australian Financial Review, Chanticleer, 1 July 2021, https://www.afr.com/chanticleer/why-this-m-and-a-boom-is-different-20210630-p585o0, accessed 21 July 2021.

**4** International Monetary Fund Fiscal Monitor - A Fair Shot, April 2021, https://www.imf.org/en/Publications/FM/Issues/2021/03/29/fiscal-monitor-april-2021#Full%20Report, accessed 21 July 2021.

**5, 6, 7** Ibid.

**8** What does the Federal Reserve mean when it talks about tapering? Eric Milstein, Tyler Powell, and David Wessel, 15 July 2021, https://www.brookings.edu/blog/up-front/2021/07/15/what-does-the-federal-reserve-mean-when-it-talks-about-tapering/, accessed 21 July 2021.

**9** Government Bond Purchases. Reserve Bank of Australia, https://www.rba.gov.au/mkt-operations/government-bond-purchases.html, accessed 21 July 2021.

**10** The Term Funding Facility, Other Policy Measures, and Financial Conditions. Speech by Christopher Kent, Assistant Governor (Financial Markets),Reserve Bank of Australia, 9 June 2021, https://www.rba.gov.au/speeches/2021/sp-ag-2021-06-09.html, accessed 21 July 2021.

**11** Vaccinations by location. Our World in Data. 20 July 2021, https://ourworldindata.org/covid-vaccinations?country=OWID_WRL, accessed 21 July 2021.

**12** Federal Surplus or Deficit [-] as Percent of Gross Domestic Product. https://fred.stlouisfed.org/series/FYFSGDA188S, accessed 22 July 2021.

**13** International Monetary Fund Fiscal Monitor - A Fair Shot, April 2021, https://www.imf.org/en/Publications/FM/Issues/2021/03/29/fiscal-monitor-april-2021#Full%20Report accessed 21 July 2021.

**14** The Recovery, Investment and Monetary Policy. Speech by Reserve Bank of Australia Governor Philip Lowe 10 March 2021, https://www.rba.gov.au/speeches/2021/sp-gov-2021-03-10.html, accessed 22 July 2021.

**15** Ibid.

**16** The extent and causes of the wage growth slowdown in Australia. Geoff Gilfillan, Statistics and Mapping Section, Australian Parliamentary Library, 9 April 2019, https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp1819/WageSlowdown, accessed 22 July 2021.

**17** Ibid.

**18** China allows three children in major policy shift. 31 May 2021, https://www.bbc.com/news/world-asia-china-57303592, accessed 22 July 2021.

**19** The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its earnings-per-share (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

**20** Trailing Twelve Months (TTM) P/E ratio as of 23 July 2021. Source: Bloomberg.

**21, 21** Ibid.

**23** Trailing Twelve Months (TTM) P/E ratio as of 23 July 2021 over the period 31 July 1991 to 23 July 2021 (S&P 500 Index). Source: Bloomberg.

**24** Trailing Twelve Months (TTM) P/E ratio as of 23 July 2021 over the period 31 January 1995 to 23 July 2021 (MSCI All Country World ACWI Index). Source: Bloomberg.

**25** Trailing Twelve Months (TTM) P/E ratio as of 23 July 2021 over the period 31 January 1995 to 23 July 2021 (MSCI Emerging Markets Index). Source: Bloomberg.

**26** Yield for the US Generic Government 10 Year Index as at 26 July 2021. Source: Bloomberg.

**27** Yield for the US Generic Government 10 Year Index over the period 26 July 1991 to 26 July 2021. Source: Bloomberg.

**28** What does the Federal Reserve mean when it talks about tapering? Eric Milstein, Tyler Powell, and David Wessel, 15 July 2021, https://www.brookings.edu/blog/up-front/2021/07/15/what-does-the-federal-reserve-mean-when-it-talks-about-tapering/, accessed 21 July 2021.

**29** Yields move in opposite direction to prices. Thus when bond yields rise, it means their prices fall. "U.S. 10-year yields rose from a low of 1.4% in 2012, to 3%" during the taper tantrum. Taper tantrum? Only if somebody wakes the U.S. bond market. William Watts, 7 June 2021, https://www.marketwatch.com/story/taper-tantrum-only-if-somebody-wakes-the-u-s-bond-market-11622842086 accessed 16 July 2021.

**30** Earnings growth for MSCI World ACWI Index over 10 years to 23 July 2021. Source: Bloomberg.

**31** Earnings growth for S&P 500 Index over 10 years to 23 July 2021. Source: Bloomberg.

**32** P/E ratio growth for MSCI World ACWI Index for the period 31 July 2011 to 23 July 2021. Source: Bloomberg.

**33** P/E ratio growth for S&P 500 Index for the period 31 July 2011 to 23 July 2021. Source: Bloomberg.

ASSET MANAGEMENT



M200128-1021