

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we review the major financial events of the past year and look ahead to the prospects for 2021.



EXECUTIVE SUMMARY

- **The pandemic-induced recession forced government and central banks to take extraordinary actions, which have negatively impacted self-funded retirees**
- **A side effect of changes in interest rates is the requirement for investors to adopt greater risks to earn the same returns**
- **While the stock market has recovered most of the gains lost in the COVID-19 crash, in some instances there is evidence of a bubble forming, accompanied by irrational investor behaviour**





A year to forget

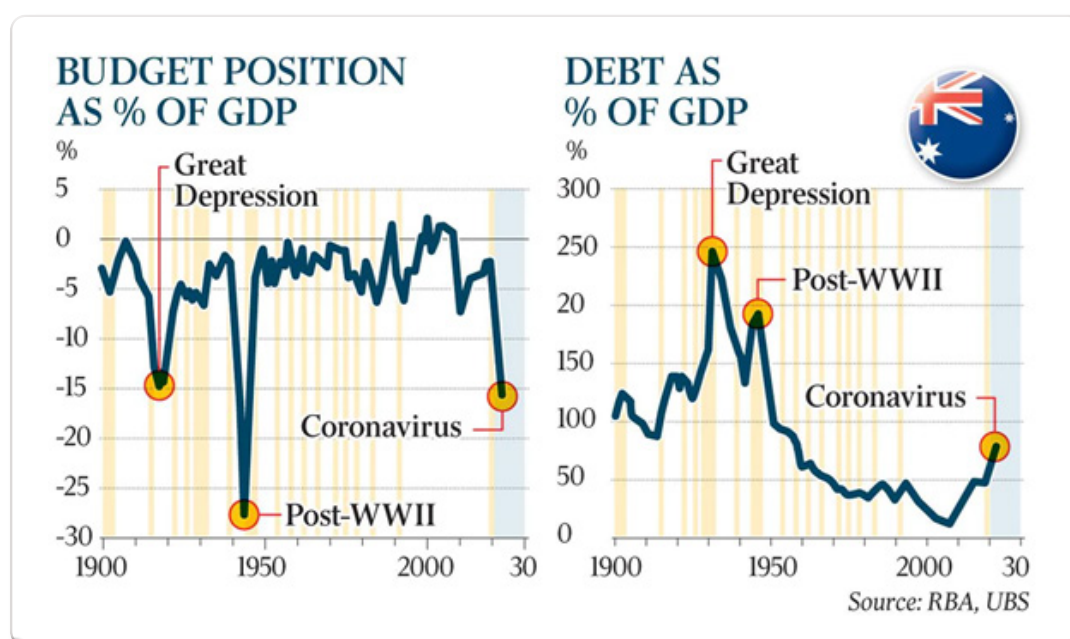
At the start of a new year, it is our usual custom to look back and review the major economic and financial events of the preceding year. For the past year however, this is a process which many would no doubt rather forego, happy to see the back of 2020 and move on readily to 2021. Nonetheless, it is still helpful to review the financial implications of events during 2020, as they set the stage for the year ahead.

From a financial perspective, the most significant event of 2020 (and setting aside the very serious and severe medical consequences of the pandemic) was the crushing economic cost of dealing with the pandemic. While it would not be accurate or appropriate to state that this was truly a case where the cure was worse than the disease, given the rising number of global deaths due to COVID-19, the economic costs of shutting down a significant proportion of global activity has been immense.

The economic health of a country relies on activity: individuals and families going out shopping, getting a haircut, going on holiday, catching a taxi or train, going to the movies...any one of a myriad of activities which may be individually inconsequential, but taken as a whole comprise around two thirds of Australia's entire economic activity. Likewise, but slightly less significant, is business and government activity: the everyday details of buying stock, selling products, purchasing equipment, leasing premises and all the other many millions of daily business transactions.

Unfortunately, regardless of the apparent advances in medicine over the past century, the primary strategy for slowing (if not stopping) the spread of a pandemic is largely unchanged since the 1917 Spanish flu – encouraging or ordering people to stay at home. Such an approach has the unwanted side affect of ceasing all of the many little micro-transactions listed above, effectively placing the economy in the deep freeze. This is the situation which confronted both policymakers and investors in early 2020.

To minimise the economic fallout from the shutdown, two measures were taken. From government (including both state and federal) came an enormous level of fiscal assistance, which is a complicated way of saying that governments injected billions of dollars directly and indirectly into the economy. By now the various methods of achieving this have become household names: JobKeeper, JobSeeker, and the less well-known Small Business COVID Cashflow Boost. Total government spending to offset the economic impact of the measures put in place to halt the pandemic is expected to amount to around \$507 billion – and this is the federal government alone and does not include spending and financial assistance provided by state and territory governments. To put this into perspective, the last time federal government spending was so vast, relative to the size of the economy, was in the immediate years following World War 2.



The majority of this spending is financed using borrowed money, however there is no shortage of willing lenders, given Australia is one of only ten countries in the world that are rated as AAA (i.e., the highest level) by all ratings agencies. At the moment this source of funding is relatively cheap, with the federal government able to borrow for 10 years at around a 1.00% interest rate. While a 1.00% return does not look very attractive from a lender's perspective, this compares to the 0.25% return a lender earns from lending to the UK government, a discount which hardly seems appropriate given the UK's struggle with COVID-19 and the unknown impact of Brexit. While on the topic of government debt, there is a well-presented argument that the current cost of federal borrowing (just 1.00%, as described above) presents an opportunity for the federal government to borrow an even greater amount of money, to be invested in an array of productivity-enhancing projects. For example, Infrastructure Australia estimates that at least \$600 billion will need to be spent on infrastructure projects around the country over the next 15 years. While it hardly seems appropriate to be considering extra debt at a time of near-record government debt levels, this comes at the risk of ignoring what is potentially a once-in-a-generation opportunity to fund infrastructure projects at almost negligible cost.

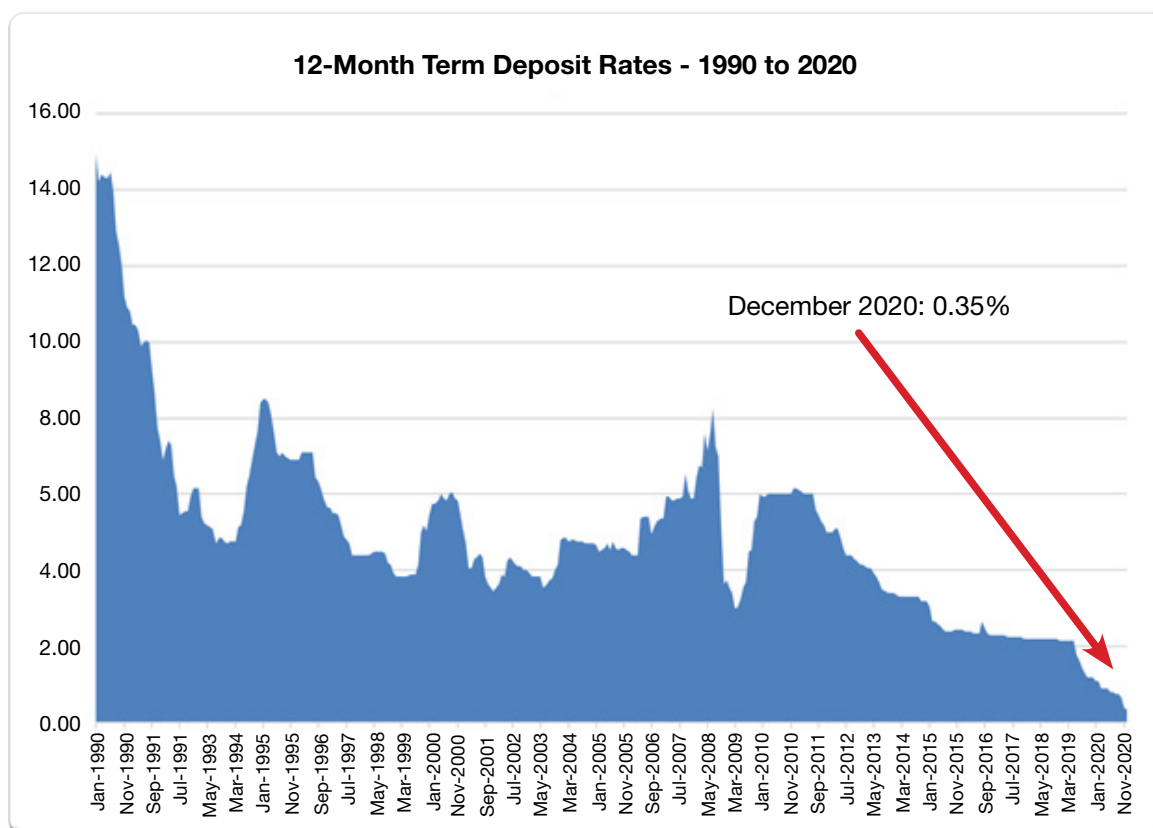
The second approach to minimise the economic impact of the pandemic-related shutdown, was action taken by the Reserve Bank to lower interest rates and ensure an appropriate level of liquidity in the financial system. Aside from the lowering of interest rates, this was primarily achieved through the implementation of quantitative easing (QE), an approach long considered to be a no-go area as far as the RBA was concerned.

It was only mid-2019, as shown below, when RBA governor Philip Lowe was confidently predicting that quantitative easing was ‘...quite unlikely.’ Then again, in mid-2019 the only virus you really had to worry about was the flu.



For many years the RBA had remained steadfast in its view that quantitative easing was best avoided, however events associated with COVID-19 finally left the central bank with no choice. As a reminder, quantitative easing are actions taken by a central bank to try and stimulate economic growth primarily through lowering the cost of government borrowing. In Australia's case, the RBA committed to buying \$80 billion of federal government bonds and \$20 billion of state government bonds. In effect, instead of the government selling bonds to overseas investors, the RBA steps in and buys the bonds direct from the government. The government is then required to pay interest on the bond and eventually repay the entire bond (loan) back to the RBA. If one views the RBA as an extension of the government (which it isn't really, but this suffices for this discussion), it effectively allows Australia to lend money to Australia at a very low cost. The money the RBA uses to buy the bonds from the government is essentially created out of thin air, which is why many people erroneously equate the process to 'printing money' (which it is not).

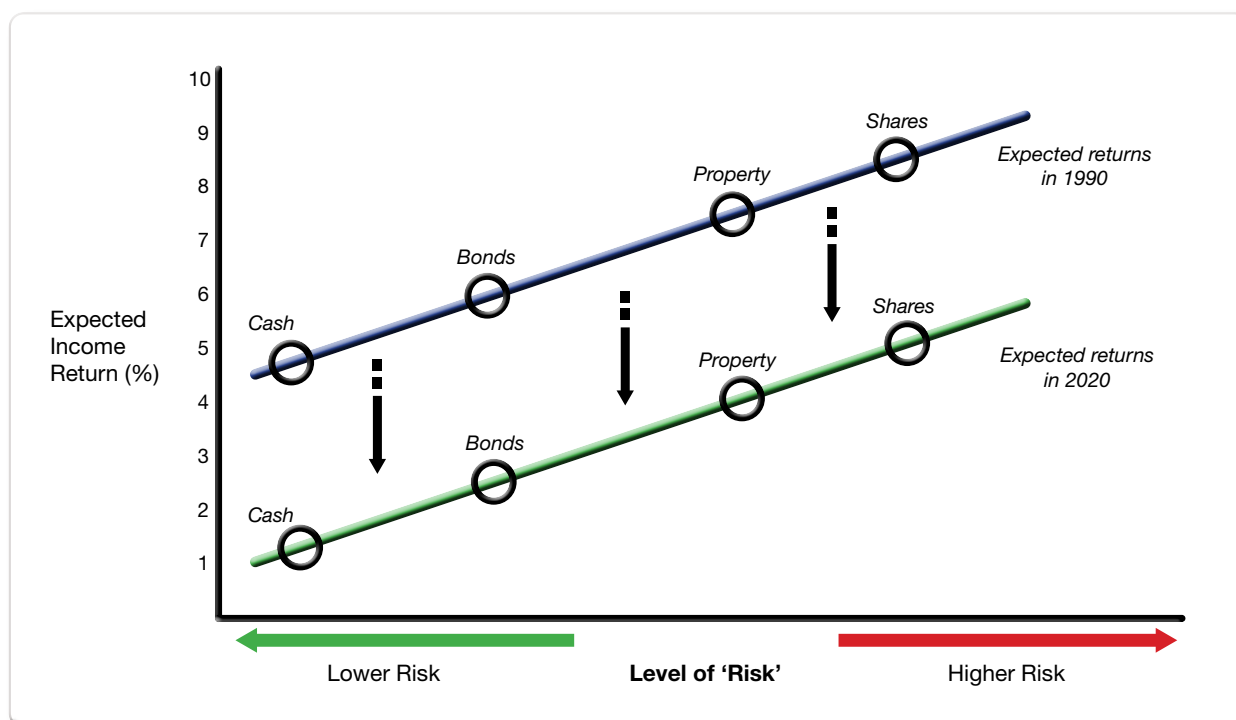
The primary purpose of the RBA actions at the onset of the pandemic were to lower the cost of funding (i.e., interest rates) for all entities in Australia – governments, corporations and households. Theoretically, forcing interest rates as low as they can leaves more money in the hands of households and corporations, potentially providing material assistance in surviving the pandemic induced recession/economic slowdown. Unfortunately, as with most decisions, there are winners and losers. Winners are governments (both federal and state), most businesses (who usually have some form of finance agreement in place) and households or investors with a mortgage. The losers, as many will no doubt have found out when inquiring about term deposit rates at their local bank, are primarily self-funded retirees and anyone with a healthy level of savings. As shown on the next page, the interest rate offered by banks for a 12-month term deposit has fallen from just over 14% in 1990, to only 0.35% by the end of 2020.



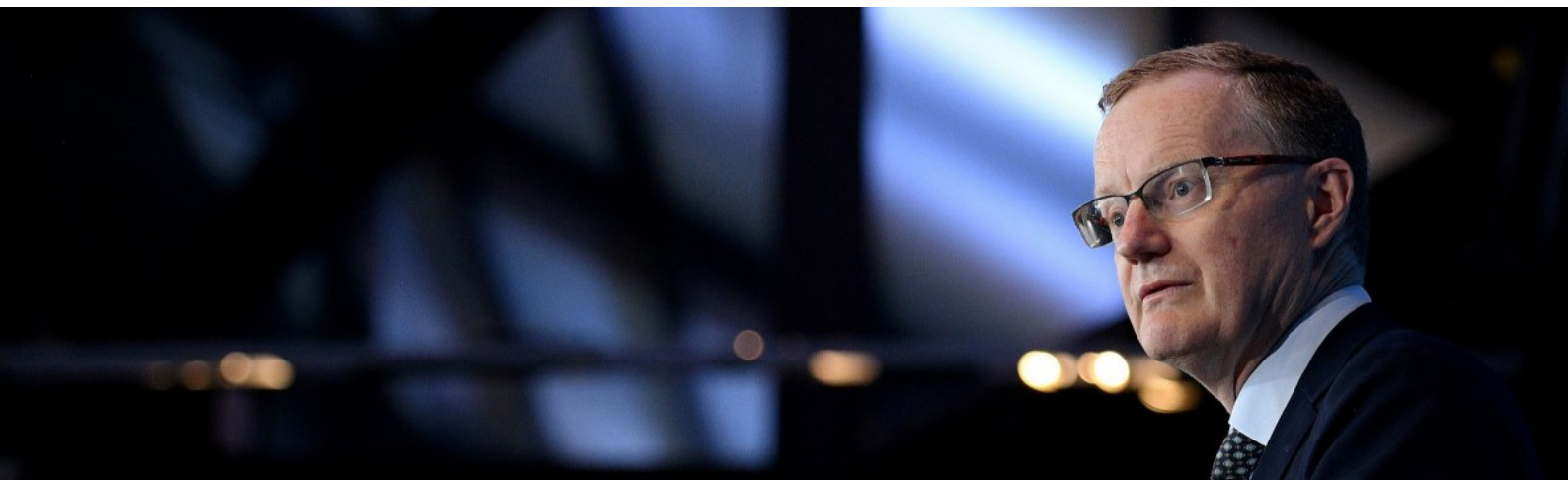
Simple maths demonstrates that someone who is able to invest \$1 million into a 12-month term deposit can expect to earn only \$3,500 in interest over the 12-month period. For the vast majority of retirees, such an approach would be wholly insufficient to fund their retirement income needs, necessitating a significant draw down of their capital to support their lifestyle. Furthermore, it is not just risk-averse retirees seeking the safety of term deposits that are affected – low interest rates impact ALL interest earning investments, such as bonds, mortgage loans and other credit securities. For example, a common inclusion in most client portfolios would be exposure to corporate bonds. In the past this would have included bonds issued by the major banks such as CBA and ANZ. Where these investments once offered what seemed to be an attractive return, the compression of interest rates to almost 0% has reduced the offered return commensurately, to the point where a similar investment today offers only around 1.00%. While this is certainly higher than a 12-month term deposit rate of just 0.35%, consider that the term deposit has no risk, its security being guaranteed by the federal government. A corporate bond, however, carries with it the risk of complete loss of capital, even if that risk may be somewhat remote in the instance of a bond issued by one of the big four banks.

The most worrying side effect of the collapse in interest rates is that it pushes investors higher up the risk curve, as they are forced to seek out riskier and riskier investments in order to maintain the level of income generated by their investments. For example, while some years ago a bond issued by Commonwealth Bank would have offered around 5%, a similar return today can only be achieved by investing in bonds issued by MyState. MyState is a former credit union based in Tasmania, which changed into a bank some years ago and expanded into Central Queensland. It has 400 employees and made a net profit of around \$30 million last financial year. This compares to the CBA, which has around 43,000 employees and last financial year made a profit of around \$9.6 billion. So, in order to earn the same return today, as you could have earned have a few years ago, you need to be willing to lend money to a very small bank based in Tasmania, whereas the same return was once able to be earned by lending to CBA. This illustrates the risks that some investors are taking on as they attempt to maintain their desired level of income.

This relationship between falling interest rates and the subsequent impact on expected returns (and thus investor behaviour), can be illustrated in the graphic below. Put simply, lower interest rates have effectively shifted the entire curve of expected income returns downwards, such that investors who wish to maintain the same income return are forced higher up the slope towards riskier investments.



While the onset of the pandemic in early 2020 was a significant event, from a portfolio management perspective the impact of the Reserve Bank's quantitative easing program and the bank's overall intent to keep interest rates as low as possible is of even greater significance. The challenge confronting any investment manager is how to generate the desired returns without an inappropriate increase in the level of risk. Unfortunately, given the very parlous current state of the world, this is not a situation which we expect to normalise soon. Governor of the Reserve Bank, Philip Lowe, has indicated that the bank intends to keep interest rates where they are for at least the foreseeable future, which suggests we should not expect any increase in interest rates for at least three years or more.



The stock market during 2020

Regardless of the length of one's investment experience, there can be few investors or portfolio managers who have lived through a year like 2020. Following an impressive return of over 20% during calendar 2019, the market continued to perform strongly in the first few weeks of 2020. In mid-February the benchmark ASX All Ordinaries Index reached a record intra-day high of 7,289 points. At the same time, global news media were reporting on the gradual spread of the coronavirus around the world, despite assurances from US President Donald Trump a few weeks earlier that *"It's one person coming in from China. We have it under control. It's going to be just fine"*.

Unfortunately, as we all now know, it wasn't 'fine' and neither was it under control. Within weeks stock markets around the world had experienced their quickest crash in history. The ASX All Ordinaries Index eventually stopped falling just over four weeks later on the 23rd of March, hitting an intra-day low of 4,564. This equates to a fall of 2,725 points over the period, a drop of -37.39%. At this stage investors may have been forgiven for ringing up their adviser and demanding to cash in all their investments. After all, the pandemic had really only just begun: there was little information on the mortality rates associated with the virus; no mention of potential vaccines; across the world borders, schools and workplaces were shut; global trade had frozen; supermarket shelves were bare and streets were deserted. And looking at the stock market up to that point, it may have seemed like only worse was to come. In just a few weeks, the stock market had given up all its gains since 2012.



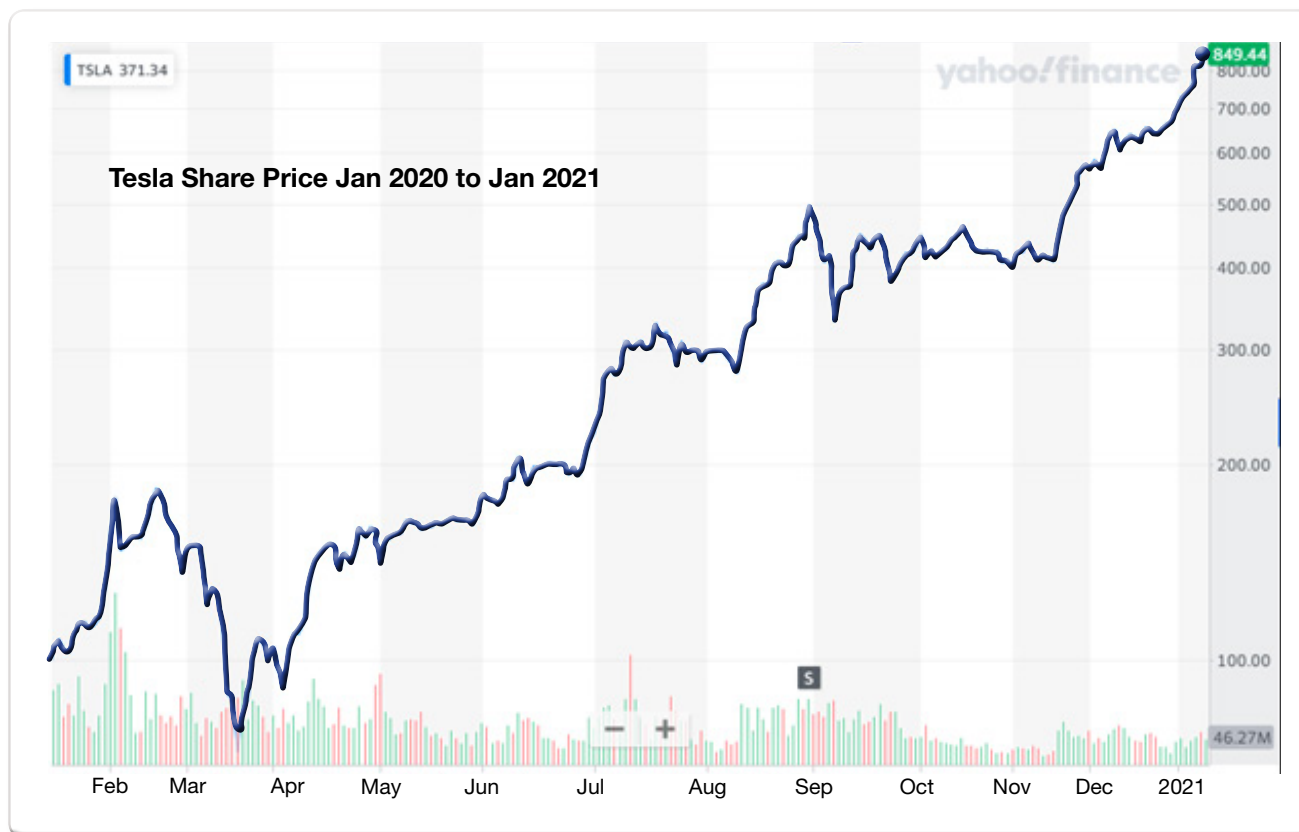
Unfortunately, there were possibly some investors who either didn't listen to their adviser to stay the course, or perhaps they simply didn't have one and chose to sell their investments, fearing even further losses. For those investors it would prove to be a costly decision, for the next nine months would prove to be almost as astonishing, as the market rallied 2,286 points, ending the year at 6,850, just 439 points or 6% below the all-time high set in mid-February.



In our view, the market crash experienced in early 2020 was likely due to misplaced extreme pessimism and fear. Likewise, it may be the case that the rally since the March low is due to misplaced optimism and a tinge of greed. Certainly, there is an expectation that the ongoing distribution of COVID-19 vaccines worldwide will eventually lead to a recovery in global economic growth, however we do not view this as being the primary reason behind the market recovery since March 2020. We believe that a proportion of the market recovery is being driven by record low interest rates, which has had the unintended (but expected) effect of driving money into the stock market. This is not a new phenomenon of course, as the ongoing reduction in interest rates since the 1980's has been responsible for reducing the attractiveness of fixed interest investments for many years now, however the compression of rates this year to effectively 0% appears to have all but eliminated investor's appetites for cash, term deposits, corporate bonds and almost any interest-bearing investment.

In a world which is awash with monetary liquidity, and few palatable alternatives to the stock market, in certain instances stock prices have begun to diverge from reality, reminiscent of the dot.com bubble in the late 1990's. The poster child of this irrational exuberance must surely be electric vehicle manufacturer Tesla.





While not passing judgement on the quality of their cars, Tesla's share price has increased by over 800% over the past year, despite falling over 50% during the COVID-19 crash. Judged by market capitalisation, Tesla is worth more than the nine largest car companies in the world combined, a group which includes Volkswagen, Toyota, Nissan and Mazda. To put this into perspective, Tesla sells around 500,000 cars per year, compared to annual sales of around 65 million for the nine largest car manufacturers. Based on its current earnings, it would take Tesla almost 1,600 years to repay an investment in the company – for most companies, a similar ratio of just 15 is considered an indication of excessive valuation.

This is not to say that Tesla may not one day justify its extreme valuation, merely that extreme valuations such as Tesla's (and others) are often a warning sign to investors that market valuations may have moved too far from reality. The acronym coined to describe the flood of money into the stock market (facilitated by gaming-like mobile stockbrokers such as the infamous 'Robinhood' app) is 'TINA', which stands for 'There Is No Alternative'. In this instance, TINA implies that when it comes to making money, there is no alternative to the stock market. However, for those who believe that shares like Tesla can only go up and that defensive assets such as bonds and fixed interest securities have no place in an investment portfolio, may we suggest spending some time studying history. The most expensive words ever said in the context of investing are "This time it's different".

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Looking ahead to 2021

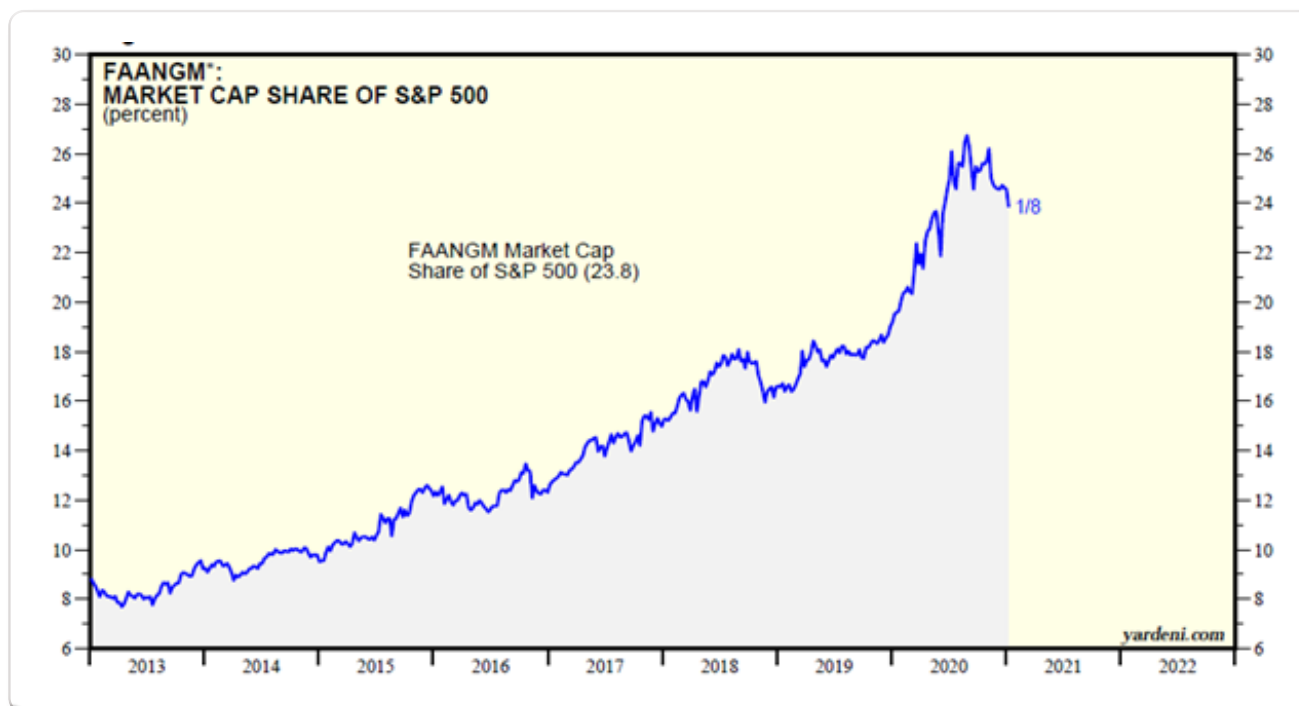
After the unforeseen events of last year, we might be forgiven for simply skipping this section entirely and moving on to the end of the newsletter. After all, what good are any forecasts when they can be simply swept aside by events such as that which occurred in early 2020?

Nevertheless, our role is not necessarily to make accurate forecasts about the exact sequence of events during the next twelve months, but rather, to consider the current environment and assess how this impacts our investment decision-making. This task is made unusually difficult at the moment, given the extreme uncertainty associated with the COVID-19 pandemic. A reasonable assumption for 2021 might be that the world manages to get to grips with the virus, insofar as possible, through the rollout of an extensive global vaccination program. As we write this, around 23 million people have been vaccinated around the world – a large number true, but only around 0.2% of the potential target market. Clearly there is a long way to go in this regard.

Rather than focus on the medical implications of the ongoing pandemic and efforts to treat it, an area where we profess no special capability, it is more instructive to consider the economic environment as we enter 2021. Generally, we expect governments and central banks around the world to continue to provide fiscal and monetary support, an environment which is usually viewed as favourable for stock markets. That said, we are reaching the limits of this support, with governments being constrained by existing excessive levels of debt, and central banks already flirting with the fringe element of monetary policy. To go further down this path risks crushing governments with unsustainable debts and for central banks, having to openly embrace radical (and discredited) policies such as Modern Monetary Theory (which posits that one should simply create money out of thin air in order to provide governments with an unlimited budget).

The other factor is the possibility of a correction in asset prices, specifically share prices, in certain sectors and countries. As discussed earlier in this newsletter, there appears little doubt that government and central bank actions, while helping to ameliorate the economic impact of the pandemic, may also be leading to an over-heated stock market. This may not be as relevant in Australia, where our market remains slightly below its pre-COVID peak, but is certainly an issue in the United States, where the S&P 500 Index is at a record high, around 13% above the pre-COVID peak. In this however, there are certain sectors, such as technology, which have been the driving force behind the outsize market gains. The chart on the next page shows how just six companies – Facebook, Apple, Amazon, Netflix, Google and Microsoft – now make up around 24% of the entire S&P 500 Index.





From the evidence available, it would appear that certain sectors of the stock market are over-inflated and in bubble territory. This does not necessarily presage a major stock market crash during the next twelve months; however, it should be viewed as a warning sign to investors. It is clear that in certain instances, investor behaviour has exceeded the bounds of rationality. As an example, consider would-be electronic truck maker Nikola, listed in the US. Piggybacking on the euphoria and mania associated with car maker Tesla, Nikola's share price increased to the point where the company was valued at US\$30 billion during 2020. This is despite it never having earned a cent in revenue: it had never sold a truck; it had never even produced a vehicle and in fact the company had not even built the factory which was meant to build the trucks. In essence, Nikola is simply an idea which exists only on paper, yet investors felt that a US\$30 billion valuation was not inappropriate.

As we enter the New Year, we remain focused on ensuring client portfolios are appropriately positioned, with a measured level of risk and exposed to those investments we view as best suited to the current environment. We cannot predict the future; however, we believe our tested investment strategy provides the best chance of navigating the uncertain days ahead.





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We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us. We trust that you and your families remain safe and healthy in these uncertain times.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	0.7% (Sep)	-1.5%
Australian unemployment rate	7.00% (Oct)	+0.01%
RBA Cash rate	0.10% (Nov meeting)	-0.15%
ASX 200 Index	6,587	+772 points
Australian \$ vs. US \$	\$0.7702	+5.14c
Australian \$ vs. UK £	\$0.5657	+1.03c
Australian \$ vs. Euro €	\$0.6269	+1.51c

This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.



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