

POINTS OF INTEREST

Autumn 2021

Issue 34

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss some of the current economic and market issues, including the seemingly never-ending rise of Bitcoin.



EXECUTIVE SUMMARY

- Events of the past year have had a significant impact on investor behaviour, evidenced by the rise in valuations of 'assets' such as Bitcoin
- Government handouts, FOMO and inflationary concerns appear to be the primary drivers behind this behaviour
- While concerning, we do not see this as evidence of an impending crash of the broader market
- The Australian stock market enjoyed another positive quarter, rising by 3.10% over the three months



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INVESTMENT PORTFOLIO MANAGERS



A busy start to 2021

If you think back to this time last year, we were in the midst of a parallel health and economic crisis, unsure as to what the future held in terms of a vaccine, the likelihood of a recession, and whether a return to “normal” was possible, let alone when this might even occur. While the first three months of 2020 were dramatic and eventful like none before it, 2021 has proven itself to be almost just as dramatic.

In no particular order, throughout the first three months of 2021 we saw the following:

- An armed insurrection in Washington DC, and the transition of the US presidency from the Republican Donald Trump to Democrat Joe Biden.
- Gamestop shares soared 2000% on the back of a mobilised group of Reddit forum users, unsteady global markets in the process.
- The Reserve Bank of Australia declared no interest rate rises will occur until at least 2024.
- Sydney, Melbourne, Perth and Brisbane experience snap lockdowns.
- Iron ore reached an almost 10-year high price of AU\$178 per tonne.
- Bitcoin reached a record price of US\$60,415 per unit.
- Facebook blocked all news on its Australian platform, before reversing the ban as an agreement was reached with the Federal government.
- The rollout of COVID-19 vaccines began in Australia, along with production of the Astra-Zeneca vaccine on home soil.
- The Ever Given container ship became stuck, blocking the Suez Canal for days, creating an immediate impact across global shipping and distribution channels, with extended impacts likely to follow.
- US President Joe Biden passed a US\$2.5 trillion stimulus package.

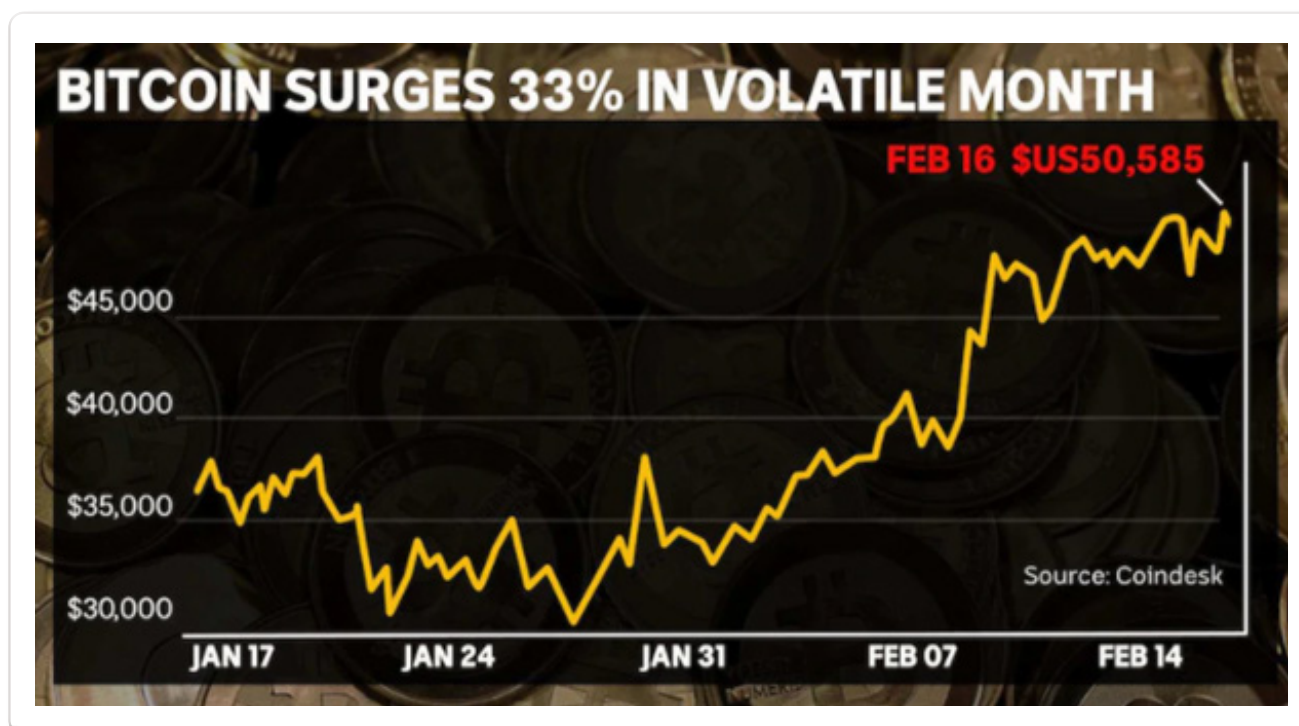
Despite uncertainty and volatility associated with these events, the ASX 200 managed to rise by 3.1% in the March 2021 quarter (and the US S&P 500 rose by 7%), which suggests that perhaps investors have become largely immune, if not desensitized, to the impact of dramatic world events. After all, if a global pandemic, the first seen in a century, isn't enough to frighten investors, what is?

This is perhaps explained by another change seen across markets throughout the year, a remarkable shift in investor attitudes from fear to greed. Twelve months ago, boardroom executives were preparing their companies for navigation through a potential economic depression. Today, we see a heightened sense of confidence and appetite for risk not seen in years. This is best demonstrated by the behaviour of investors seeking returns in assets with uncertain futures – GameStop and Bitcoin for example. Investors, desperate for huge payoffs, are pouring into investments without any real understanding of the risks. These risky behaviours, and the remarkable performance figures seen around the world (particularly in the US but also here in Australia), have led to many debates about whether the market has entered a new bull period, whether the last bear period ever really finished, or are we now verging on bubble territory?

Here we take a closer look at two of the current causes for concern driving the bubble territory debate:

Bitcoin – Bubble bubble, toil and trouble?

Bitcoin, the most well-known part of the cryptocurrency market, experienced an extraordinary surge in value in the first quarter of 2021, commencing a rollercoaster ride for investors from a price of below US\$20,000 in December 2020 to a high point of over US\$60,000 in March 2021. During that period, it took only six days for the value of Bitcoin to increase from US\$30,000 to US\$40,000, which bears all the hallmarks of past manias such as the Dutch Tulip frenzy of 1637 and the South Sea bubble of 1711.



While cryptocurrency remains a mystery to many, there appears to be three factors driving the current mania: speculation, “FOMO”, and crypto’s inflation hedging qualities.

Firstly, investors were speculating that the US Government would inject more cash into its COVID-afflicted economy. This speculation proved to be correct, with a US\$2 trillion package announced by President Biden in January, with the price of Bitcoin rising sharply in response. It appears that many Americans have elected to ‘invest’ their stimulus cheques in Bitcoin, an outcome which was definitely not intentional.

Secondly, “FOMO” - the psychological sensation of a ‘fear of missing out’ – was responsible for a large push from investors towards the digital currency. Equally, a number of large corporations weren’t able to overcome their FOMO, with Tesla, PayPal, Square and Mastercard all joining the Bitcoin bandwagon. These businesses explain that while they see the risks, they also view digital currencies as a way to expand their businesses, and such endorsements saw the market value of the collective cryptocurrency market extend beyond \$US1.5 trillion.

Finally, a fall in the value of the US Dollar, slashing of interest rates to near zero by central banks around the world, and the cash injections implemented by the US government, have been interpreted as a precursor to rampant inflation (think Germany in the 1920’s or Zimbabwe in 2007). There is a view that in an inflationary environment, cryptocurrency, as an asset with limited supply, should either maintain or increase in value whilst other assets, such as cash, will fall in value. The perceived protection that Bitcoin provides against rising inflation was another factor driving the price of Bitcoin to record levels.

Bitcoin’s rapid increase in value has led many to question whether a bubble exists and if the recent excessive increases in value will be reversed. Usually, for a bubble to exist, an asset has to be trading at a significant premium to its underlying value. Given that it is difficult to determine Bitcoin’s true intrinsic value, this is a challenging question to answer. Instead, we can look to history and draw our own conclusions.



Special Purpose Acquisition Companies – a SPACtacular opportunity?

Special Purpose Acquisition Companies (SPACs), or ‘blank cheque companies’, have been in circulation in the US since the early 1990s, though they are currently enjoying a resurgence of popularity in the US, with US\$76 billion raised in 2020 and almost US\$26 billion raised in January this year alone.



Fortunately banned in Australia, a SPAC is a company created solely to merge or acquire another business and take it public. At the time of its initial public offering, SPACs have no existing business operations or even identified targets for acquisition. Investors in the SPAC will essentially write ‘blank cheques’, with the funds raised from this exercise used by the SPAC’s directors and management team to identify and purchase a target business. If an acquisition is not made within two years, the SPAC must liquidate, and all funds must be returned to investors. Recent high profile international companies that have gone public via SPACs include electric vehicle maker, and Tesla competitor, Nikola Motor Co. and Virgin Galactic Holdings (Richard Branson’s space-flight company).



SPACs have enjoyed a surge in popularity in recent times. This is firstly due to companies finding it simpler to go public via acquisition from an already listed company than to go through the regulatory listing process itself. Last year, 248 SPACs listed in the US, as opposed to 209 traditional initial public offerings. The second reason for the heightened popularity is increased appetite coming from investors wanting to get in on the next 'big thing' at the earliest possible opportunity, a perk which was previously reserved only for the ultra-wealthy. The relatively cheap price payable for SPAC shares (typically around \$US10 a share) is also assisting in driving this trend.

While some SPAC investments prove successful, such as Virgin Galactic Holdings which appreciated 146% between going public and October 2019, not every investment has the same outcome. Numerous studies have shown that SPACs have a tendency to underperform benchmarks in the 3, 6 and 12 months after acquisition. A SPAC investment is essentially just an investment in the ability of its leaders to identify and successfully acquire a private business with good future potential. In other words, it's a case of betting on the jockey (the SPAC founders) rather than the horse (target company). Of the 248 SPACs listed in the US last year, it is unlikely that all performed well, and it is virtually impossible to pick the one 'winner' from the long list of candidates. The picture below shows the performance of various SPACs (as at 8 March 2021). As you will notice, the number of green listings is far outnumbered by those in grey (indicating neutral performance) and red (negative performance).



The very nature of SPACs bears an uncanny resemblance to the South Sea Bubble in 1711, where some cunning promoters were able to convince investors to purchase shares in a company whose main line of business was "For carrying-on an undertaking of great advantage but no-one to know what it is".

Bitcoin and SPACs seem to exemplify the current investment environment. Illogical behaviour appears widespread, with some areas prone to outright hysteria. But what does this mean for rational investors like us, focused on business fundamentals and long-term investment? In the medium to long-term, the answer is this: very little. The current fascination with Bitcoin and SPACs or any other speculative 'asset' is not the first time some investors have collectively lost their sense of reason, and nor will it be the last.

Rising Bond Yields

A more rational area of concern for investors is the phenomenon of rising bond yields in most advanced economies. The bond yield is effectively a reflection of the cost of borrowing money. Central banks will try to push down bond yields in times of economic stress, while a booming economy and rising inflation are typically associated with higher bond yields. After an extended period of record low yields (designed to kick-start economic growth coming out of the COVID pandemic) bond yields have recently begun increasing. The Australia 10-year bond rate (essentially the interest rate the Australian government pays investors to borrow money over a ten-year period) is currently sitting at 1.705%, after beginning 2021 at a level below 0.97%. While these numbers may seem low, this represents an almost doubling of the cost of borrowing money in just three months. To put this into perspective, imagine if the interest rate on your house mortgage doubled in three months.



The rise in bond yields, both here in Australia and abroad, is on the back of expectations that the rollout of the COVID vaccine and generous government spending packages will stimulate the global economy, increasing economic growth much faster than expected (and leading to a rise in inflation). Any increase in inflation will likely lead to central banks, such as the Reserve Bank of Australia, lifting interest rates to ensure that inflation remains within its own band of tolerance (which for Australia is currently 2% - 3%).

Rising bond yields will be welcome news to fixed-interest investors, who can expect an increase in their income as interest rates on such investments increase in line with bond yields. The news for equity investors is not so good, however, given that rising bond yields usually cause equity valuations to fall. Fast growing sectors of the

stock market are typically more sensitive to bond yields and have performed relatively worse as bond yields have started rising. An example is ATEC, an exchange traded fund which tracks the performance of the S&P/ASX All Technology Index, and includes companies such as AfterPay, Xero, Seek and REA Group. As shown below, the decrease in the fund's value coincides with the rise in bond yields. At the time that bond yields started rising, in February 2021, the share price of ATEC contracted by around 22%.

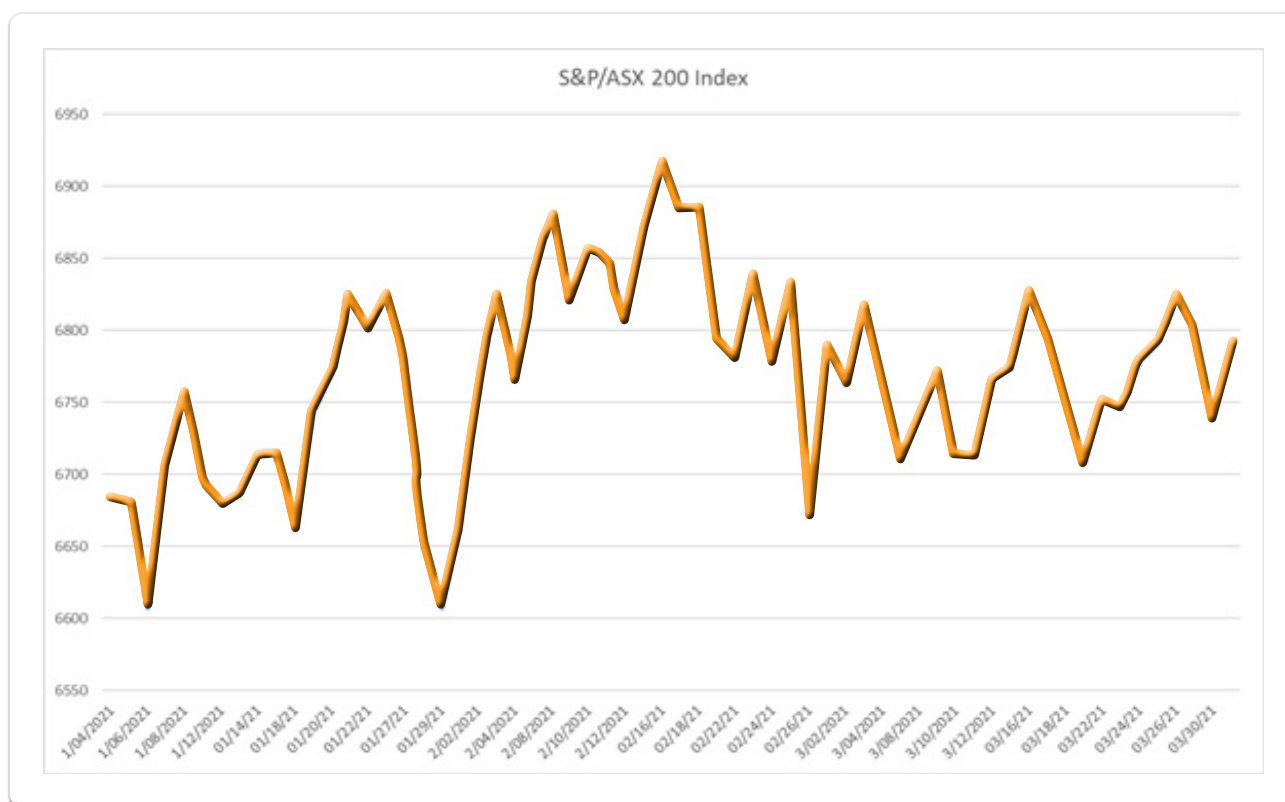


The key issue is whether or not the bond market's view of the world is correct – are we heading for a period of booming global economic growth and ultimately a surge in global inflation? We're not so sure. Yes, there is a significant amount of 'pent up' economic activity waiting to be unleashed as restrictions on movement and association are dropped in key areas such as the US and Europe. However, we expect this surge of activity to be temporary, with global economic growth rates experiencing an initial jump, followed by a return to lower levels over time. In our view, a diversified investment approach, with a balance between growth, value and income, is the most appropriate manner in which to navigate the uncertainty of the years ahead.



The stock market during the March quarter

The local stock market recorded a positive return for the past quarter, with the benchmark S&P/ASX 200 Index increasing by 3.10%. This performance reflects the continuing recovery from the economic impact of the COVID pandemic, with the stock market now just 409 points below the record high reached in February 2020.



As is often the case however, the movement of the broad average can mask significant changes in the background. Over the past year, for example, well-known companies such as CSL Limited have underperformed, while the large banks, very much 'on the nose' with investors over the past few years, recovered very strongly. As an example, Westpac Bank's share price increased by 65% over the past twelve months, while CSL's share price fell by 15%. The prospect of an improved global economy has driven investors to favour 'value' over 'growth', with the previously unloved banks falling into the former category.

As already discussed in the newsletter, we are conscious of evidence of irrational behaviour in certain markets and for certain assets. In terms of portfolio construction, our approach to managing the uncertainty is to remain invested while still holding an above average level of cash (if possible). We recognise that cash offers almost no return in the current environment, however it does offer optionality. That is, without cash one cannot take advantage of any opportunities which may present themselves during periods of uncertainty.



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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)	0.9% (Dec)	+0.2%
Australian unemployment rate	5.80% (Feb)	-1.20%
RBA Cash rate	0.10% (Feb meeting)	-
ASX 200 Index	6,790	+197 points
Australian \$ vs. US \$	\$0.7602	-0.01c
Australian \$ vs. UK £	\$0.5538	-0.0119c
Australian \$ vs. Euro €	\$0.6493	+0.224c

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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