POINTS OF **INTEREST**
Winter 2021

Issue 35

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we consider the impact of the pandemic on a number of areas, such as commercial property and migration levels. We also look at the performance of the stock market over the 2020/21 financial year.

EXECUTIVE SUMMARY

- Falling fertility levels and the impact of the the pandemic have combined to constrain Australian population growth
- The shift to ‘work from home’ poses challenges to the office property sector, although we consider the impact to be largely transitory
- The end of June 2021 marked a twelve-month period where the stock market recorded one of its best performances for many years, as markets recovered their losses from the pandemic-induced falls in early 2020

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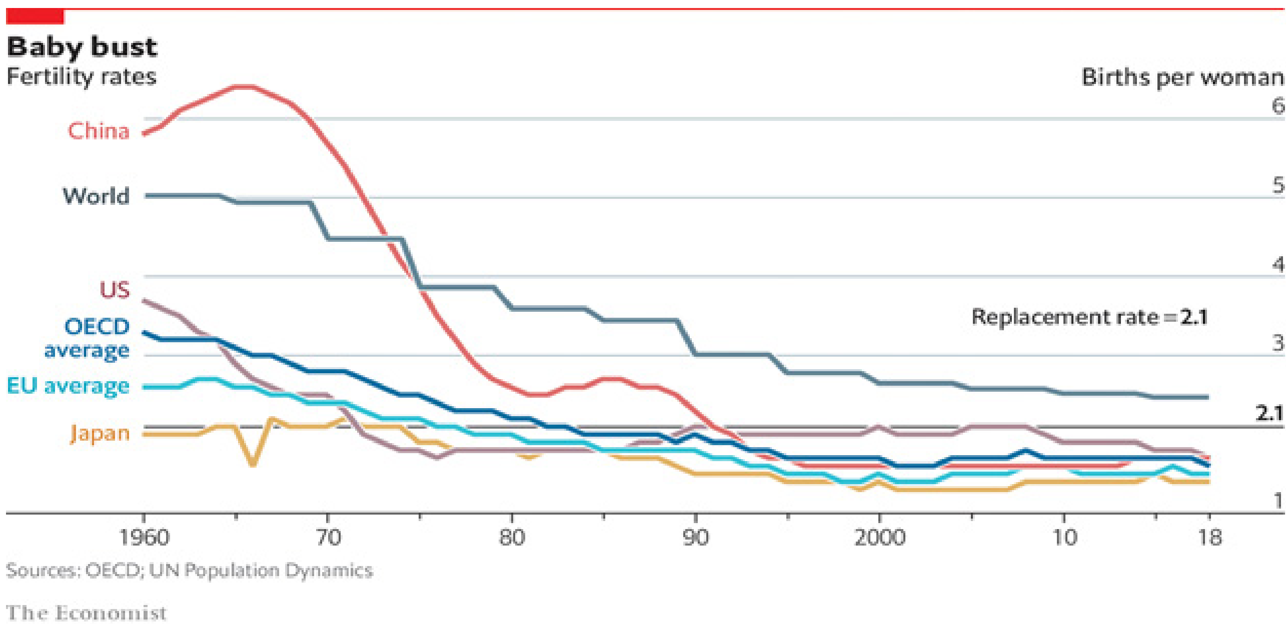
GLOBAL FERTILITY RATES

There are many factors which influence the economy and the stock market and in this section we consider fertility rates. While changes in global fertility rates are unlikely to have an immediate impact on an investment portfolio, over the longer term it is secular changes in factors such as fertility rates which can have a considerable impact on investment returns.

Global fertility rates have long been in decline, with the birth rate more than halving from an average of five children per woman in the 1960s to around two children per woman in 2019. Several major societal shifts are responsible for this, including changing religious values, higher education levels and increasing participation rates of women in the workforce, and in cases such as China and India, government efforts to rein in rapidly expanding populations. While the world's population grew between 1% and 2% every year from 1950 to 2019, by 2100 the growth rate is expected to be less than 0.10% - an effective growth rate of zero. For a country to naturally replace its population, the birth-rate needs to be at least 2.1 children per woman. For much of the developed world, the average birth rate is below this figure, including Australia which measured an average rate of 1.74 in 2018.

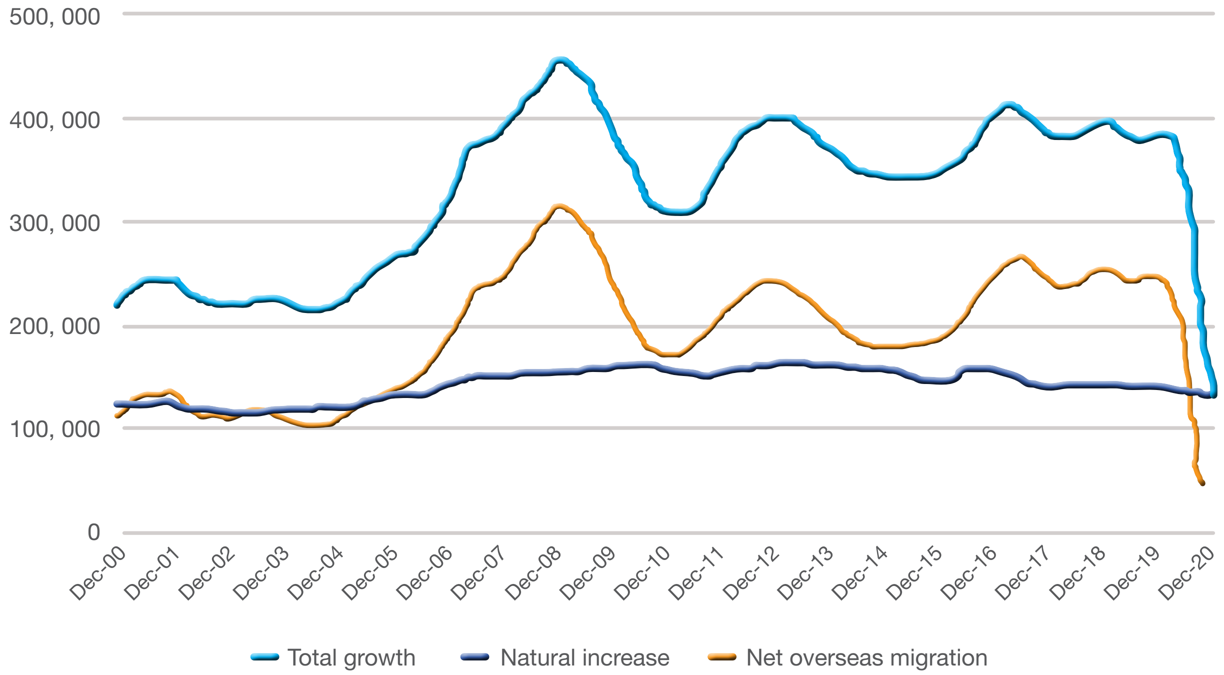


While the prospect of a smaller world population may be welcome news from an environmental perspective, from an economic perspective, a declining population has significant long-term implications. Interestingly, before things get worse, a declining population does in fact temporarily lift the population's standard of living. This is because men and women are able to gain an education before starting a family, which has the effect of creating a more skilled and specialized labour force.

This leads to higher disposable income levels, increased spending, increased demand which stimulates jobs growth, higher income tax revenue and so on. Once the initial favourable impacts wash through however, an imbalance in the ratio of elderly dependents to working-age people starts to appear, otherwise known as an ageing population. The costs associated with ageing (increased healthcare, welfare etc.) must then be borne by a smaller working population, who struggle to produce the income tax revenue to support these high and ongoing costs. Over time, this imbalance causes spending power to decrease, job growth to slow, and a stagnating economy.

In Australia's case, the response to the problem of declining population growth has long been migration, with the current migration policy allowing for 160,000 people the right to relocate to Australia (for the 2020-21 year). The focus of Australia's migration policy has been on skilled labour, the aim being to increase the likelihood that new migrants will be able to gain employment and achieve economic independence. However, with COVID-19 all but halting migration, the migration level is forecast to fall by around 72,000 people, representing the first time a net migration decrease has been experienced since 1946.

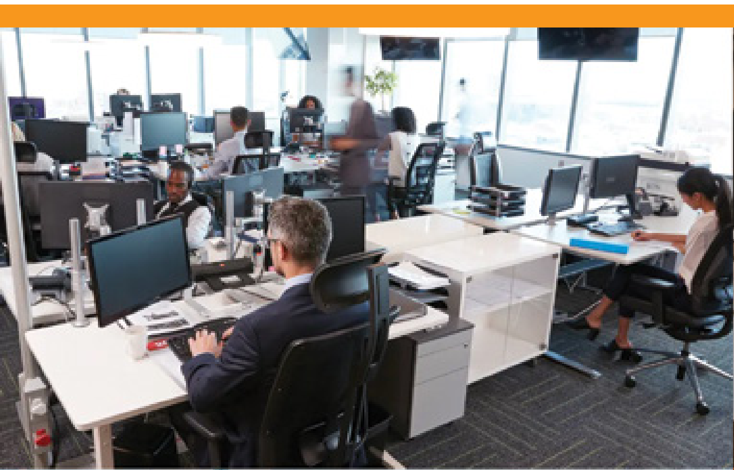
Components of annual population change(a)



While migration growth is expected to revert to usual levels in 2023 and beyond, the impacts of reduced migration growth are expected to be one of the most enduring effects of the pandemic. Slowing population growth is largely responsible for the downgrading of economic growth forecasts from the 3 per cent average annual rate of the past 40 years to 2.6 per cent over the next four decades. To ensure the future economic viability of Australia, in the absence of a naturally increasing population, government attentions are likely to turn to increases in the cap limit on current migration levels and potentially a greater emphasis on the financial situation of potential migrants.

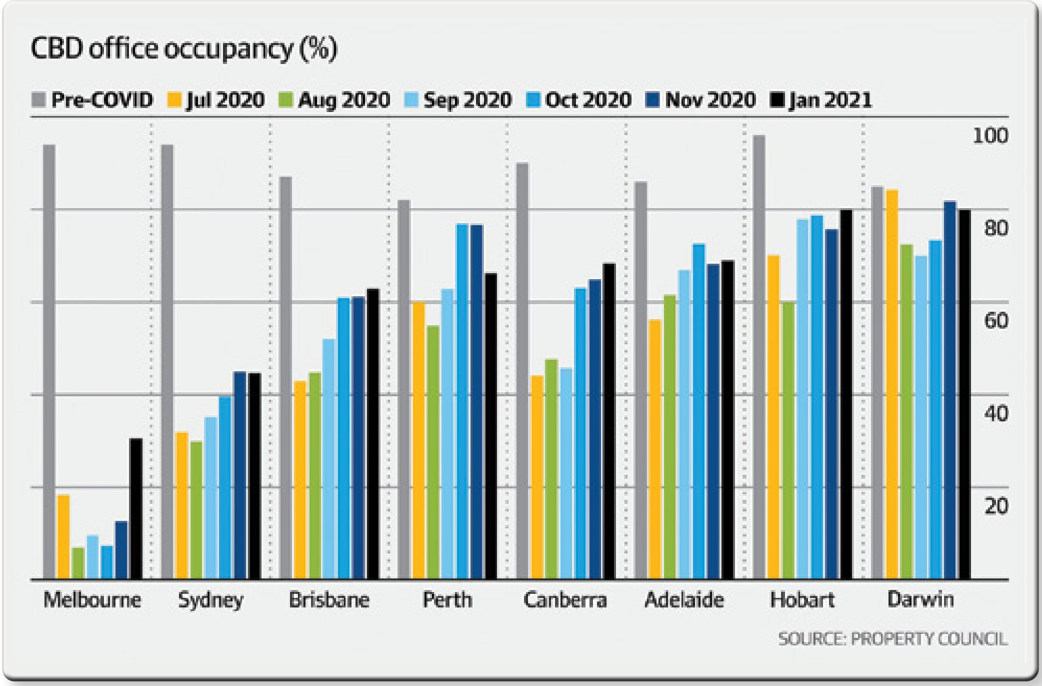
The future of the office?

COVID-19 has been responsible for many shifts in our usual ways of life. Elbow bumps, face masks in public, electronic check-ins everywhere we go and so on. For many, one of the most significant changes in behaviour has been the shift in working from a permanent office base to working from a remote location, most usually at home. With this change came the loss of the commute to and from work, the kitchen table transforming into a permanent workspace, and the introduction of new technologies that enabled remote working in an efficient manner, such as Zoom and Slack.



Working from home was a change imposed on many employees in the interests of safety and protection from the spread of the virus. Much has been made of the benefits and drawbacks of working from home, with little firm conclusion made on which is the best approach and why. Some employees cite higher productivity as a result of fewer office disruptions, while others find themselves too easily distracted whilst in the home. While many thought the working from home revolution brought on the death of the office place, evidence suggests that many employees are opting to return to the office in a reduced capacity. That is, two to three days are worked remotely with the remainder of the working week spent in the office

Since the onset of the global pandemic, a steady return to the office has been experienced across the majority of the major capital cities (notwithstanding the occasional lockdown in various cities upon a cluster outbreak):

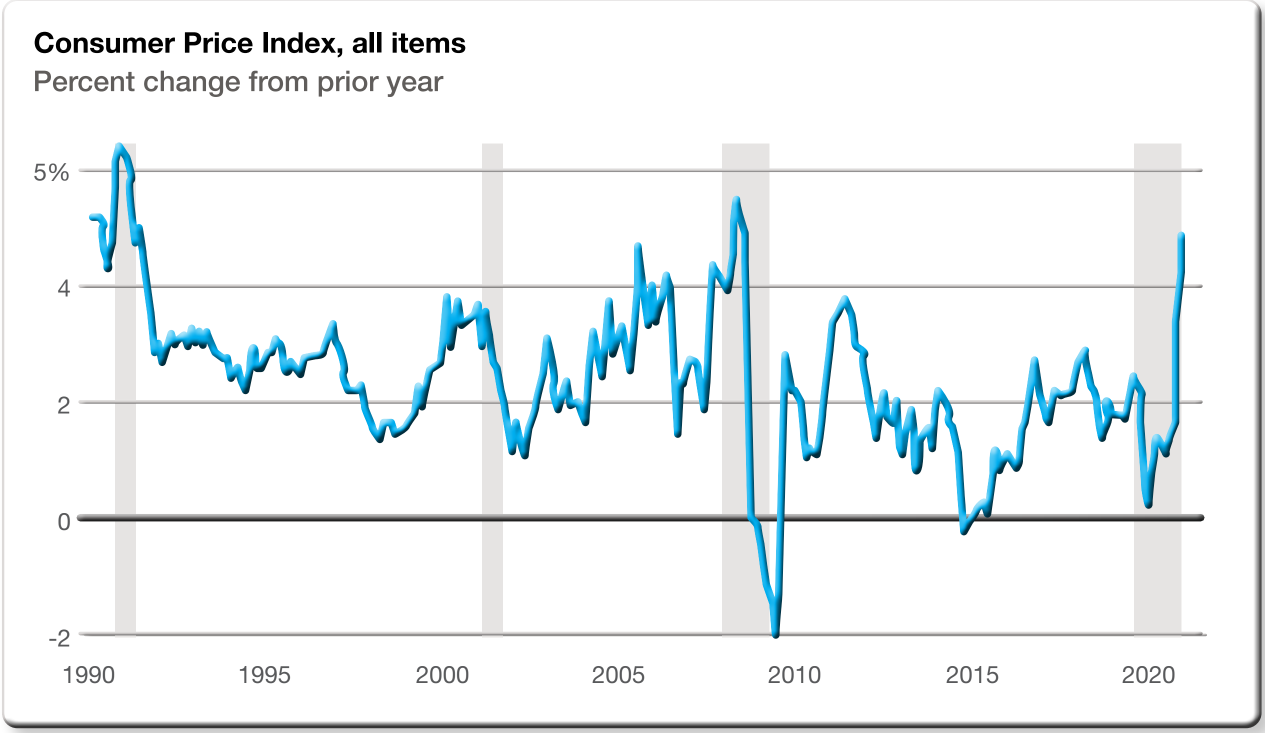


Despite there being fewer people in the office on a daily basis, the amount of space required appears to be the same, meaning that many businesses are likely opting to remain in their existing space and continue on with their lease agreements. The greater change is instead the way office space is used. Rather than devoting 80% of space to workstations and 20% to meeting rooms, it is expected that only 20% of space will be devoted to workstations and the remainder to spaces for large meetings or gatherings.

After some initial weakness in the office rental market, the continued use and relevance of office properties has allowed valuations to remain fair, and the expectation is that this should continue as the office retains its position as an essential piece of infrastructure in the modern world. The expectation is also therefore that companies that are responsible for owning or managing office property assets should also continue to trade at fair and reasonable values into the future. This has a bearing on investment portfolios as exposure to commercial property typically forms a portion of any diversified portfolio. All told, we expect the current weakness in the commercial property market (specifically in regard to office space) to be temporary in nature.

Inflation on the rise?

After many years where central banks around the world were more concerned with deflation as opposed to inflation, evidence of rising inflation is starting to appear both here in Australia and around the globe, most notably in the United States. For the year to June, consumer prices increased by 5.40% in the US, followed by a similar increase in May, with inflation levels now sitting at one of the highest levels seen in the country since 1991.



In the United Kingdom, from May to June an increase from 2.1% to 2.5% was experienced, taking inflation to the highest level in three years. A slight lag occurs in the release of official domestic inflation data, but as of March 2021, Australian inflation measured 1.1%, which was an increase from the previous measure of 0.9% in the December 2020 quarter. With both domestic and international inflation levels appearing to rise, albeit slightly, our attention starts to turn to the prospect of increased interest rates, and whether there is enough evidence to suggest when, or if, this may happen.

Inflation is the rate at which the level of prices for goods and services rises, and consequently, the level at which the purchasing power of money decreases. Many things influence the level of inflation, but the key items usually include rising production costs increasing the price the final good is sold at, or if a surge in demand for a limited supply of goods pushes prices up. An increase in inflation can be described as either transitory (i.e. temporary) or structural (i.e. sustainable). While the signs of increasing inflation, particularly in the US, is a sign of hope for many, a growing number of economists are describing this as only transitory inflation, with large rises in goods and services mostly seen in industries and areas impacted by the pandemic. Until conditions normalise, and the transitory inflation moves to structural, there is little justification for increasing interest rates in the immediate term.

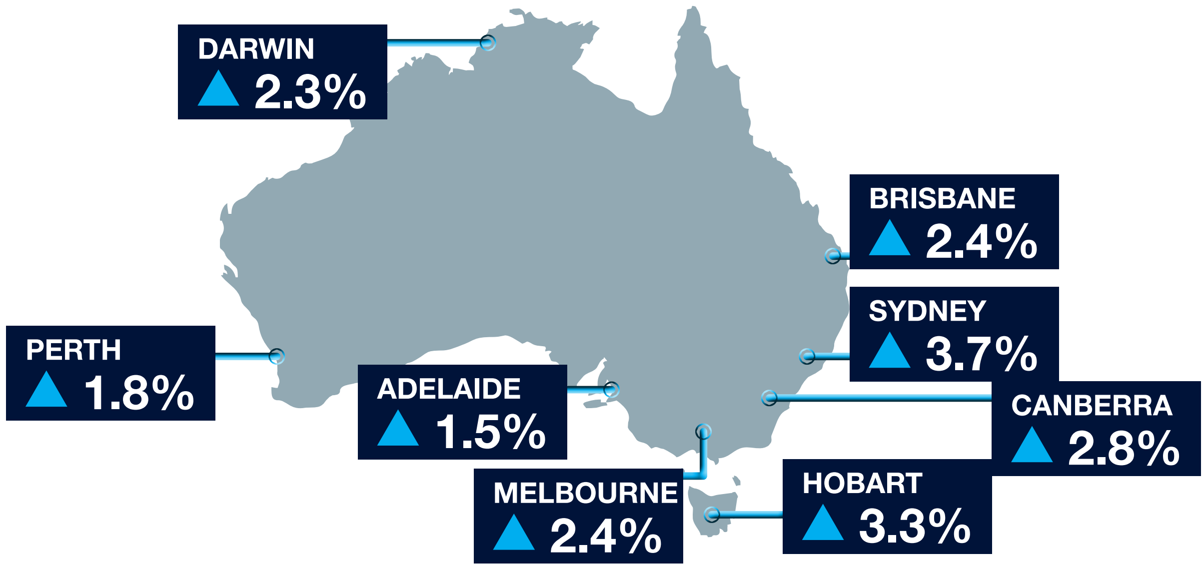
Looking to Australia, the Reserve Bank has indicated that interest rate rises will not occur until at least 2024. However, given the level of activity seen in the economy in the past year, such as rapidly declining unemployment levels and the expectation that a tight labour market will lead to wage growth, several economists have made their predictions that this may be brought forward to as early as the first half of 2023.

That said, many question the accuracy of falling unemployment as an indicator of rising interest rates. The reduction of migration levels to virtually zero since the closing of international borders has allowed for a rise in the number of reported job openings, which in usual conditions will lead to rising wage growth. However, assuming that international borders will open in the next year or so, and job vacancies are filled by migrants, the bargaining power of employees reduces, thereby limiting the potential for any increase in wages growth. Given doubts surrounding the potential for wages growth, the RBA has remained firm in its position that interest rate rises will not occur until April 2024 at the earliest. While there is some debate amongst economists on how early the first interest rate rise will come, there is broad agreement to the fact that when increases begin to occur, they will be small and gradual in nature.

Property market heat

Defying all expectation, Australian house prices have increased at the fastest pace in 32 years following the short-lived COVID-19 induced downturn. Prices in Sydney, Melbourne, Canberra, Hobart, and Brisbane are all at record highs, with the monthly home value index, as measured by Core Logic, rising by 2.8% in March – the biggest monthly growth since October 1988.

Change in dwelling values
March 2021



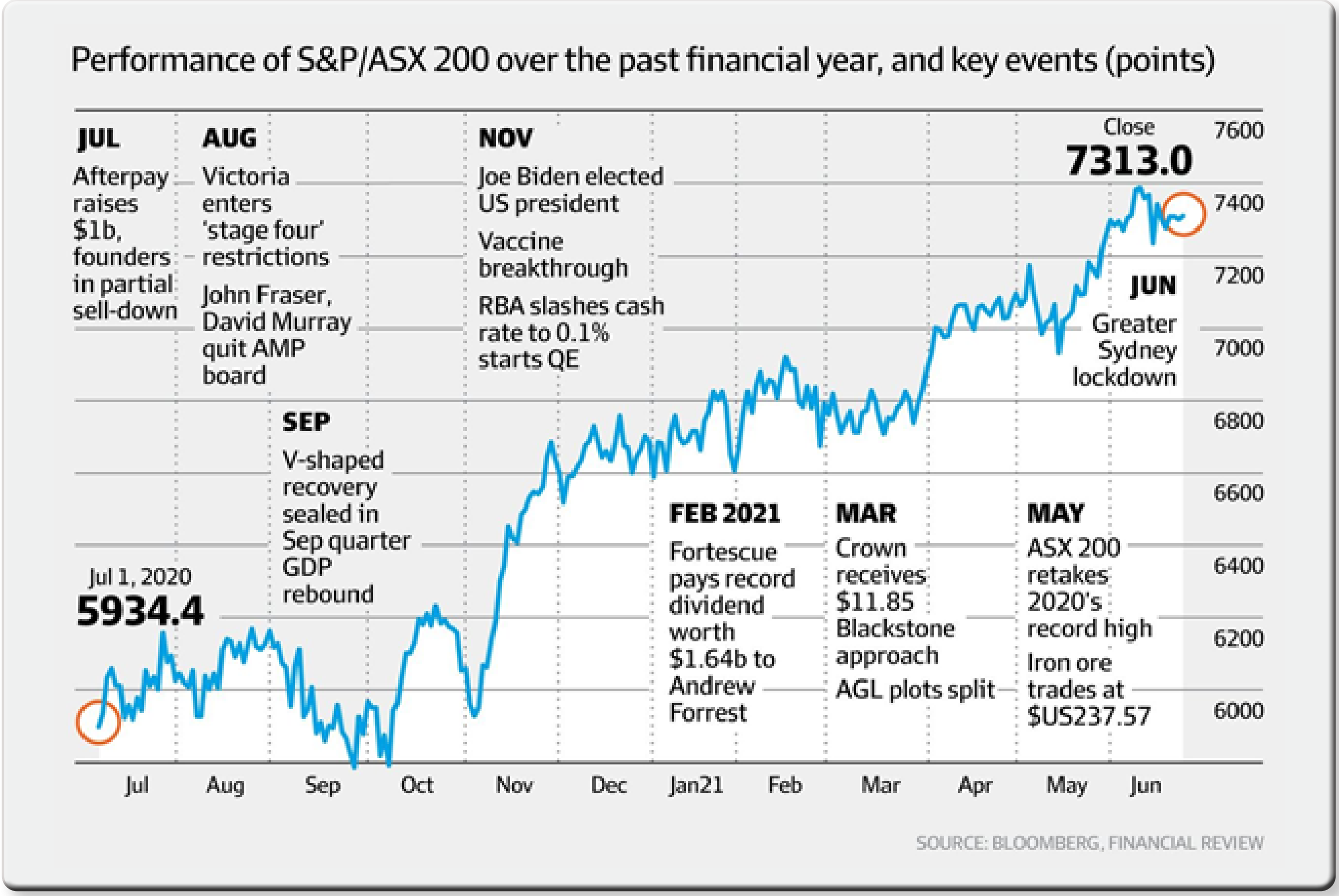
One of the more significant driving forces behind the property market's rapid increase is record low interest rates, which both increase the borrowing capacities of buyers, and encourage first home buyers to enter the market, the combined effect being an increased demand for limited supply of dwellings. An imbalance between demand and supply is also credited with accelerating the 'fear of missing out' (also known as 'FOMO') amongst buyers. FOMO drives buyers to pay a higher than preferred price for a property for fear of having to pay an even higher price for the same property (or securing a lesser quality property for the same price) as a result of delaying the purchase decision. On the investor side, the expectation of a large and quick profit is attracting additional competitors into the market, pushing prices up even further.

All of these factors have culminated in significant increases to property values, with Sydneysiders expected to pay around $125,000 more for a property than they would have done prior to the COVID-19 pandemic. Interestingly, the issue of a red-hot property market is not just an Australian problem. Property prices in New Zealand, the UK and the United States, to name just a few, have also seen incredible growth over the past 18 months or so.

With such rapid growth seen in the property market over the past 18 months, many are beginning to observe signs of the risks that are present with such an overheated market. For real property, this can include households taking on unsustainable levels of debt, and borrowers lending to riskier applicants in pursuit of credit growth. With credit growth outpacing income growth by a significant margin (and property prices growing ten times faster than wages), regulators are taking notice, and as has recently happened in New Zealand, there is the possibility that intervention will be necessary to curb lending activity. However, in the absence of a mandate targeting house prices or housing affordability, this is unlikely. Regulators can impose limits on lending activity and rules, but whether this is to occur and have any impact, is still to be seen.

THE STOCK MARKET DURING FY 2020/21

30 June marked the conclusion of an extraordinary 12-month period. Coming off the market crash caused by the onset of Covid in early 2020, the stock market managed a recovery of historic proportions. In fact, the performance of the Australian stock market in the 2020/21 financial year was the best yearly performance in the past 34 years. The All Ordinaries Index, the broadest stock market measure, rose by an exceptional 26% over the financial year, with the ASX 200 Index recording equally impressive growth of 24%.



Of course, the recovery from a market crash is always impressive, as one would expect, however it is fair to say that the speed and extent of the market's recovery would have come as a surprise. Certainly, there would not have been many people that would have predicted growth of over 20% for the stock market if asked the question in June last year. At that stage, the majority of the world was in strict lockdown, with global deaths from Covid at around 6,000 per day and little prospect of an immediate vaccine. It must be remembered however, that the stock market is not focused on what is occurring today, but what might be occurring in 12- or 18-months' time. Share prices (usually) don't reflect the past or the present, they reflect expectations of the future. And while the world was certainly in a dark place 12 months ago, it was already apparent that the world was not going to end, that life would go on and at some stage, normality (or perhaps a new normal?) would return. Still, it is one matter to hold those opinions and another to back them up with cash.

Aside from the fact that share prices were pushed to panic levels at the onset of the crisis and have inevitably been revalued upwards, one of the main drivers of the strong performance by the stock market has been the impact of interest rates. In an environment where a 12-month term deposit offers a return of only 0.25%, the potential returns offered by the stock market can be difficult to ignore. There are dangers in viewing the stock market solely as an alternative to other low-yielding investments however – if current stock market valuations are being supported by central bank actions in keeping interest rates at close to zero, what might happen should that process begin to reverse? This is just one of the questions facing investors in the current environment.

In terms of the market itself, the past year was characterised by broad gains across most sectors, although there are specific pockets where the pandemic continues to have an impact. Interestingly, some of the strongest performing sectors in the last six months of 2020 have been among the weakest performers in the first six months of 2021. These include the bevy of companies whose business models were perfectly suited to the pandemic: Harvey Norman, JB Hi-Fi, Temple & Webster in the domestic environment and high-flying technology names like Zoom and Netflix in a global context.

Foreseeing the end of the pandemic, the market has already begun to rotate away from those companies who benefitted from the unique circumstances last year, preferring those companies who stand to benefit from a 'business as usual' approach. This strategy too is not without risk; as we have seen recently in Sydney, the virus is neither gone nor forgotten and lockdowns in some form or another may be with us for some time. That said, one of the strongest performing sectors over the past 12 months was the banking sector. Initial expectations that the pandemic was likely to lead to a collapse in the housing market (due to the inability of laid off workers to meet their mortgage commitments) were wholly incorrect, as we have discussed earlier in this newsletter. As the property market gathered steam in the second half of 2020, bank shares increased with it, posting gains not seen for many years.

The table below outlines the returns (including dividends) generated by a number of widely held companies over the past financial year.

COMPANY	CODE	12 MONTH RETURN
Reece Limited	REH	164%
Westpac Bank	WBC	49%
Commonwealth Bank	CBA	48%
Goodman Group	GMG	44%
BHP Group	BHP	42%
Wesfarmers	WES	36%

As the numbers indicate, the past 12 months saw a significant turnaround in fortunes for sectors as diverse as banking, plumbing, commercial property, retailing and mining.

In regard to the outlook for the forthcoming financial year, it's fair to say that the most pressing question is whether the market will continue to rise at the pace experienced during 2020/21, or are we more likely to see flat returns or even a retraction from current levels? Unfortunately, the lingering influence of the pandemic in terms of its impact on GDP growth, interest rates, employment trends, the global supply chain and overall economic conditions, makes the direction of the next twelve to eighteen months harder to predict than usual. In general terms, the market appears fully valued, with the opportunities evident last year no longer obvious. Company earnings will need to exhibit an appropriate level of growth in order to justify current share prices, which may prove challenging for those sectors still adversely impacted by the pandemic or where market exuberance has led to overly optimistic valuations. Certainly, returns over the next 12 months should be lower than those just experienced, with a balanced and disciplined investment approach, as usual, likely to best position investors for the year 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)	1.1% (Sep)	+0.2%
Australian unemployment rate	4.9% (June)	-0.02%
RBA Cash rate	0.10% (June meeting)	flat
ASX 200 Index	7,313	+726 points
Australian $ vs. US $	$0.7518	-0.84c
Australian $ vs. UK £	$0.5429	-1.09c
Australian $ vs. Euro €	$0.6320	-1.73c

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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