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Editorial

The guessing game with U.S. Federal Reserve moves continues. After Jerome Powell's speech overnight, the consensus seems to be that while the size of interest rate hikes may fall, rates will peak higher than expected.

Of course, the key remains inflation. On that front, **Amit Nath**, believes the next U.S. CPI print may be an inflexion point for both inflation and consequently rates. Due to so-called base effects, he sees U.S. inflation growth moderating, which should be good news for investors.

While Fed machinations dominate headlines, more long-term issues continue to be the focus here at *Firstlinks*. And a big issue continues to be that of demographics.

In Australia, Millennials are about to overtake Baby Boomers as the largest generational group. The implications of this are detailed in a new report by the Australian Bureau of Statistics (ABS).

The report acknowledges that there isn't universal agreement on the names or data ranges of generations, but defines the generations per the table below.

	Baby Boomers	Generation X	Millennials
	Generation born after the second World War during a period with a surge in birth rates.	Generation born after Baby Boomers during a period with a drop in birth rates.	Generation where the oldest in this group became adults around the turn of the millennium.
Age in 2021	55-69 years(a)	40-54 years	25-39 years
Census year at age 25-39 years	1991	2006	2021

a. To be consistent with the 15-year age cohort of Millennials, and to use only one Census year for comparison, the data in this article only includes Baby Boomers who were born from 1952 to 1966.

As can be seen, Millennials were aged 25-39 in 2021. The report goes on to compare Australians aged 25 to 39 years at three different time points - 1991 (Baby Boomers), 2006 (Generation X) and 2021 (Millennials).

The report finds Millennials are more mobile, much more likely to be overseas-born and are much less likely to attend church than previous generations (see table, next page).

The top countries of birth for Millennials, ex-Australia, are India and China. That compares with England and New Zealand for the Baby Boomers and Generation X in 1991 and 2006 respectively.

	Baby Boomers in 1991 (%)	Generation X in 2006 (%)	Millennials in 2021 (%)
As a proportion of the total population	23.8	20.9	21.5
Female	50.3	50.8	50.7
No religious affiliation	16.0	22.7	46.5
Born overseas	25.7	23.4	35.6
Lived at same address as 5 years previously	38.1	32.2	29.0

The living arrangements for the different generations are also markedly different. Millennials are less likely to have married or had children compared with Generation X and Baby Boomers back in their day. 53% of Millennials have never married, versus 44% of Generation X in 2006 and 26% of Baby Boomers in 1991.

It's also stark how many Millennial couples live together and don't have children, compared with previous generations.

Living arrangements of people aged 25-39 years in 1991, 2006 and 2021, by proportion(a)

	Baby Boomers in 1991 (%)	Generation X in 2006 (%)	Millennials in 2021 (%)
Couple with no children	14.6	18.1	35.7
Couple with children	51.5	40.7	21.2
Single parent with children	4.9	5.8	4.4
With parents	7.2	8.5	9.9
With other relatives	2.0	2.0	2.4
With unrelated persons in a family household	1.1	1.2	2.4
Lone person	6.0	8.2	7.7
Group household	5.8	5.2	6.8

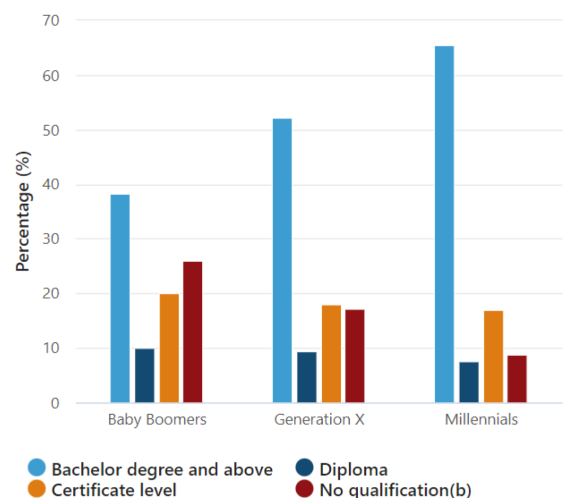
a. Proportion of all people aged 25-39 years. Total includes visitors, people living in other non-classifiable households and in non-private dwellings.

Millennials having less children may have something to do with the price of houses. More of them are renting and living in apartments than prior generations.

Millennials are studying more too. Almost 80% of them have a non-school qualification (certificates, diplomas, degrees and postgraduate qualifications) compared with nearly two-thirds for Generation X in 2006 and less than half of Baby Boomers in 1991.

The modern-day thirst for higher education is understandable given that high-income earners invariably come from the university educated. Looking at the top 15% of income earners (high earners), almost two-thirds of high earning Millennials had a bachelor degree or higher, a much larger number than previous generations.

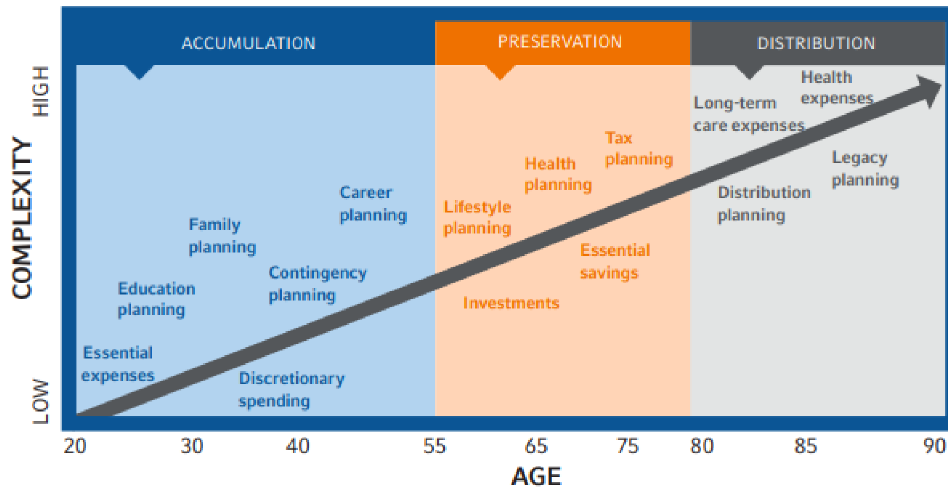
Qualifications of people aged 25-39 years with high income(a), 1991, 2006 and 2021



a. Persons in the top 15% income ranges. Total includes high income earners who did not state qualifications.
b. Includes persons with no qualification, studying for first qualification or have a qualification that is out of scope for the classification.

How Millennials fare in the coming decades will be a fascinating watch. They may get lucky given expectations that they could inherit up to $3.5 trillion over the next 15 years. Whereas financial advisers used to spend much of their time helping clients accumulate money, they appear to be dedicating more hours nowadays to helping Baby Boomers

preserve and spend their wealth, as the chart from Russell Investments shows below. And soon Millennials will need advice on the assets they're going to inherit. It could be a busy time for the wealth advisory industry.



Source: https://russellinvestments.com/us/blog/customized-experience

Also in this week's edition ...

Former Co-Chair of global consulting at Russell Investments, **Don Ezra**, looks at what those saving for retirement should do after a miserable year in markets. He has practical advice, particularly for those nearing retirement and for retirees. Meanwhile, **Noel Whittaker** examines an innovative, new retirement income product. AMP has devised a product which combines an account-based pension with an annuity, and Noel believes it has merit.

Meg Heffron is back, this time summarising the Federal Budget's implications for superannuation. She says there wasn't a lot to get excited about, but then goes on to list a plethora of changes which will impact the sector.

We also investigate how recency bias, or extrapolating recent events into the future, has undone many investors, especially this year. The big issue is how investors can mitigate this common error and build a durable portfolio that can perform through market cycles.

While most investors are down in the dumps, **Andrew Lockhart** is more optimistic, specifically on private debt as an asset class. He thinks private debt can offer both capital preservation and attractive risk-adjusted returns in a rising interest rate environment.

Lastly, **Christine Brown** and her academic colleagues, Chloe Ho, Hue Hwa Au Yong, and Chander Shekhar delve deeper into the regulatory changes for capital raisings during the COVID-19 pandemic. They find that though these changes were temporary, they've impacted company behaviour on raisings ever since. And that's been to the benefit of retail investors.

This week's White Paper from **Perpetual Investments** looks at the long and short of investing in volatile markets.

James Gruber

What can retirement savers do in bleak markets?

Don Ezra

Financial market conditions appear bleak. Inflation has driven interest rates higher, leading to falling prices in the equity and bond markets. The contrast with a prolonged period of rising prices in both markets is huge.

It's natural for retirement savers to feel depressed, not just about the present but also about future prospects. And it's particularly gloomy because the ballast traditionally provided by bonds when equities fall can no longer be taken for granted.

So the big question is: what can you do? I'll focus on three aspects.

- What can savers do?
- What can retirees do?
- And what can you do to prepare for the inevitable next episode of adverse conditions?

Falling markets can be good for savers

The first question is the most comforting to answer. Savers should recognise that their assets no longer conform to their planned allocation (whatever it might be). So the first thing is to rebalance back to it. This has the fortunate effect of buying into whatever has fallen furthest, taking advantage of the new lower prices.

In fact falling markets are, perhaps paradoxically, good for savers. Think of the falling prices as a sale. The amounts you had planned to invest regularly will now buy more units of each asset class than they would at the previous higher prices.

Of course that advantage only holds if falls are temporary. But they usually are. That's the good news. There's always the possibility that markets never recover. That's what author William Bernstein calls 'deep risk' – and frankly there's no satisfactory way to deal with that. It's little comfort that the whole world will be seriously affected, not just you – but that's the reality of it.

So let's assume that the falls are not so much long-term as short-term or medium-term. And short-term falls are not a problem if you don't panic and sell. The only defence against panic is to think rationally rather than emotionally.

The savers most affected by a medium-term fall are those who are relatively close to having to start cashing out gradually as they approach retirement. And the same problem is even worse for those who are already in retirement and see their pension pot fall in value. So let's focus on them, and get to the second question I mentioned earlier.

Retirees need to have a 'safety pot'

Retirees are particularly vulnerable to what is termed, in the jargon, 'sequence of returns risk'. They don't have the luxury of waiting to allow future high returns make up for current negative returns, because their assets are declining as they make withdrawals to sustain their spending needs, and those future high returns act on a smaller asset base. So a sequence of returns that starts low or negative can't be balanced by later high returns.

That means it's essential to have a part of your pension pot that's relatively immune to falling asset prices. And the only such assets are cash-like assets, or at any rate short-term assets, which decline little as interest rates rise.

I think of this as a 'safety pot', in contrast to the rest of the pot, which is your 'growth-seeking pot'. Of course there's a further problem right now, in that stable-value assets are no protection against high inflation.

The only protection lies in assets with returns that are themselves linked to inflation. Americans are lucky in that the US government issues what are called I-Class Savings Bonds (I-bonds for short) with returns that are constantly adjusted to match inflation.

It's these types of safety-oriented assets – or, if you don't hold any, the shortest-term bonds in your portfolio – that offer you the least costly defence against sequence of returns risk.

Lessons for the next market fall

This leads to the final question. What lessons can you learn for next time?

The answer for those of you who are more than, say, five years from having to withdraw money from your pot is nothing, other than that it's wise to have a long-term investment plan which you can stick to, such as the now traditional 'glide path' that underlies many accumulation plans for retirement.

Why five years? There's no magic to the number. It's the period of time when historically markets tend to recover to their inflation-adjusted levels after a fall. And yes, history is not a prediction of the future, but it's at least a guide.

The answer for retirees and those closest to retirement? Build up that safety pot to allow you to gradually withdraw up to five years of spending without touching your growth-oriented pot if the market takes time to

recover from a fall. (I wrote about this strategy a year ago.) And the ultimate defence: be willing to adjust your spending too. Life constantly changes. If we can adjust without too much pain, that's a big defence against panicky reactions.

Don Ezra, now retired, is the former Co-Chairman of global consulting for Russell Investments worldwide, and the author of "Life Two: how to get to and enjoy what used to be called retirement". This article is general information and does not consider the circumstances of any investor.

A new retirement income product offers hope

Noel Whittaker

Increasing life expectancies are welcome, but they present challenges for retirees. Many people have told me, "I want to be able to spend all my money, so on the day I die I have got just one dollar in the bank," but it's a fact of life that date of death is not something that can normally be predicted with precision. One study has found there is little correlation between a person's and their parents' dates of death - to make it worse, the behaviour of retirement assets can be volatile and subject to sudden changes.

To this interesting mix, add Australia's somewhat unusual post-retirement system. In many other countries retirees are used to an income for life. All the investment decisions are taken from them, but they are generally happier and feel far more financially secure. In Australia most of us retire with a lump sum and have to decide how to invest it. For us, the challenge is how to best use that lump sum.

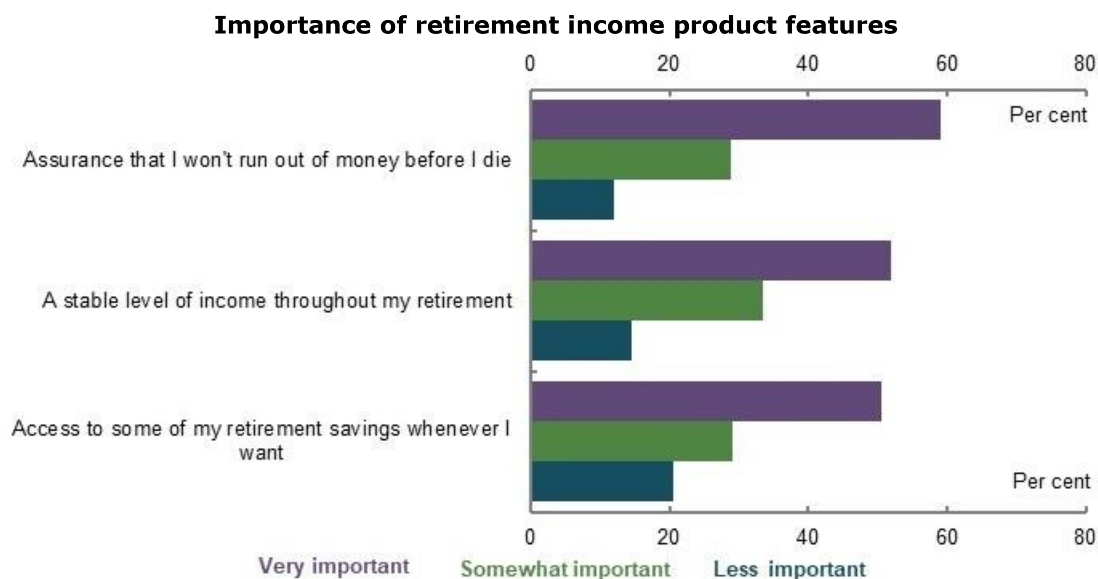
This highlights one of the major problems facing retirees, and Australia. It is now accepted by all the major political parties that the majority of retirees live far too cautiously, and in doing so both deprive themselves of a better standard of living and deprive the country of much-needed economic activity. So, the problem has been identified — the big challenge is how to solve it.

Until recently there were two major forms of retirement income streams available to retirees. Account-based pensions offer retirees flexibility, control, and transparency. They are widely available and are suitable for most retirees. However, they have one problem - there is no efficient way to draw down your balance without fear of running out. As a result, the majority of retirees draw only the minimum, resulting in many people passing away with 90% of their super left unspent according to the government's Retirement Income Review.

The traditional alternative is a lifetime annuity, which provides a guaranteed income for life but without the flexibility, control, and transparency.

Obviously, annuities get full marks for certainty, but lose marks for lack of flexibility.

Importance of retirement income product features



Extracted from the Retirement Income Review Final Report, November 2020.
Note: More than 1,000 survey respondents aged 55 and over. Source: Mercer, 2019.

As part of the May 2018 Budget, the Morrison government announced its intention to introduce a retirement income covenant requiring trustees to develop a strategy that would help members achieve their retirement income objectives, which came into law on July 1 this year. The government wants the financial services industry to develop new retirement income stream products (a form of annuity) that manage the competing objectives of high income, longevity risk and flexibility. Longevity risk is possibly the greatest risk post-retirement — living so long you run out of money and ending your days living in a caravan in someone's backyard, eating scraps.

Product innovation

The industry is starting to fill the gap with a range of enhanced account-based pensions and lifetime income streams or pensions. The account-based pension provides the flexibility — the lifetime income stream provides the certainty.

But could you combine an account-based pension with an annuity? AMP have asked this question and the result is MyNorth Lifetime, a new suite on AMP's investment wrap platform North.

MyNorth Lifetime is the latest in a series of new retirement solutions. I've previously written about the QSuper Lifetime Pension which provides income for life based on the returns of a balanced portfolio, and which attracts a generous 40% discount on the assets test, leading to higher age pension eligibility for many retirees.

MyNorth Lifetime is much closer to an account-based pension than other lifetime income products, because it allows unrestricted investment choice, account transparency and income flexibility. The biggest differences to an account-based pension revolve around an annual cash bonus that is paid into the account.

This bonus is calculated by applying an age-based rate to your account balance. It operates as a form of reverse life insurance. Instead of paying premiums every year, you receive a payout every year, that increases substantially over time just like life insurance premiums. The only premium you pay is what's left over in the account when you die (after the payment of an optional death benefit) – which is the opposite of a life insurance payout.

Effectively you are prepaying yourself – giving you the confidence to draw down at a higher rate knowing you'll never run out of money. The income rates are quite a lot higher than the normal minimum drawdown rates.

For example, the income rate for a 70-year-old single is 8.18%, and the bonus rate is 0.56%. If this customer had $300,000 in their account, they'd be entitled to draw $24,551 in income and a bonus of $1,677 would be paid into their account at the end of the year. The following year the rates rise to 8.34% and 0.62%. These percentage rates rise every year, but your account balance is being drawn down, resulting in relatively stable amounts of income if you can earn around 6% net investment returns.

The upfront 40% assets test discount for lifetime income streams applies to this account. If the customer above had another $300,000 in an account-based pension and other assets, they'd be entitled to an age pension of $11,119 compared to only $1,734 without the new account. Like other lifetime income streams, I'd never recommend retirees allocate all of their super into these solutions – it's important to keep readily accessible cash type investments as well.

The other unique thing about MyNorth Lifetime is that it can be opened pre-retirement where it can significantly increase the assets test discount. This is because Centrelink ignores the account balance and instead calculates the means test on your contributions, increased annually by the upper deeming rate (currently 2.25%). This means that as long as your super is earning more than the deeming rate, you are increasing the assets test discount, which could provide an even bigger age-pension payoff when you retire.

Case study

Jack is a pre-retiree. At age 50 he transfers $250,000 to the MyNorth super account. If the fund returns 6% per annum his balance should be almost $600,000 at age 65. However, for Centrelink purposes, his deemed balance would be close to $350,000 (the original balance increased annually by 2.25%), and therefore the assessment of his fund under the assets test would be only $210,000 after applying the 40% discount. This can make a very significant difference to the amount of age pension he would receive when he turns 67.

If this all seems a bit complicated, it's because it is, so AMP are only making this available via financial advisers. It also has a unique feature in as much as the MyNorth product can be layered across the client's existing portfolio, where it could be continued to be managed by the advisor without any changes to the

underlying assets if that was deemed appropriate. I think AMP have broken ground with this one – it's really up to anybody who feels it may be useful to them to discuss it in depth with their advisor.

Noel Whittaker is the author of 'Retirement Made Simple' and numerous other books on personal finance. See www.noelwhittaker.com.au or email noel@noelwhittaker.com.au. This article is general information and does not consider the circumstances of any individual.

Fighting the last war

James Gruber

In November 1918, France was physically and mentally scarred. World War One was ending, yet the victory had come at an enormous cost. Of the 8 million Frenchmen mobilized, more than a million had died and another million were crippled. Eastern France had been almost continuously occupied by enemy forces for four years. Consequently, the country's most advanced agricultural and industrial areas were devastated.

A big question emerged after the war: how could France best defend itself against future attack? The question took on greater urgency after the signing of the Treaty of Versailles in 1919. The treaty punished and crippled the war's aggressor, Germany, yet France believed that the Germans had gotten off lightly and war would resume soon enough.

A safe France

After a decade-long debate, a key pillar of French defence against future attack was decided. It became known as The Maginot Line. The idea came from fortifications around Verdun which had worked well during World War One. They had held up to extensive artillery fire and suffered minimal damage.

The Maginot Line would be an extended series of large-scale buildings along the south-eastern French border. It would defend the region most vulnerable to attack. With the south-east fortified, France could focus on gathering forces in the north-east of the country, to get ready to enter, and fight in, neighbouring Belgium. Belgium was a key ally of France in 1930, when the building of the Maginot Line commenced.

Not as safe as assumed

France largely completed construction of the Maginot Line (pictured below) by 1936 and the country felt safe. After all, what worked in World War One had been extended and would shield the country from future attacks.

There was one problem: Germany didn't end up attacking France via the Maginot Line. In 1940, it attacked the Netherlands, then moved through Belgium, to enter France. Germany met little resistance and France was subjected to a quick and embarrassing conquest.

After World War Two, the Maginot Line came under severe criticism both in France and abroad. In hindsight, it's easy to pick flaws with the idea. At the time though, France thought it was learning from the recent past and applying that knowledge to the future.

Recency bias

Investors often make the same mistake that undid France. Behavioural economists call it recency or extrapolation bias. It's a cognitive bias, or mental mistake, where investors incorrectly believe that recent events will happen again soon. Put another way, investors often overweight new events or information without looking into the objective probabilities of those events occurring in the long run.

Think of last year's bubble price action in the likes of Bitcoin and GameStop, and how investors (or more aptly, speculators) thought the huge increases in prices for these things would continue without looking objectively at the long-term fundamentals.

To avoid the fate of France and indeed Bitcoin and GameStop speculators, it's worth looking at recent events which investors may need to be careful extrapolating or overweighting into the future. They include:

- Rising interest rates though everyone expects them to remain relatively low.
- A pullback in bond prices making them attractive versus recent history.
- The traditional 60:40 equities/bond portfolio failing miserably this year, with calls for it to be adjusted or discarded.
- The US$ becoming 'king dollar' and the pound, Euro and Yen getting pulverised.
- Growth stocks coming back and being set for further outperformance given their superior performance since 2008.
- Most Australian superannuation funds having outperformed their benchmarks, with expectations of more to come.
- Venture capital and private equity continuing their ascent in the finance industry.
- Significant government debt having not been an issue (until very recently).
- Gold being one of the few assets to have performed well in A$ terms this year, with predictions of further outperformance going forward.
- Volatility being back. Period.

Building a durable portfolio

How can investors reduce the likelihood of them applying recency bias to their portfolios? Perhaps it's moving in the opposing direction? Instead of overweighting recent events; underweighting them. Instead of investing in what's worked for the past decade; investing in what hasn't worked.

For example, since investing in growth stocks has worked since 2008, one should take the opposite tack and invest in value stocks. The trend in growth to value has ebbed and flowed throughout history and value could make a comeback.

The problem with this contrarian approach is that though many things in markets do mean revert, they often take longer than investors think. Or they may never mean revert, as a new event may prove enduring rather than fleeting.

Instead, the best strategy for investors may be a more balanced one: to be aware of mental biases such as recency bias and build a portfolio which is neither overweight nor underweight recent events. In other words, constructing a durable portfolio of investments which will perform under most, if not all, future circumstances.

James Gruber is an Assistant Editor at Firstlinks and Morningstar.

Meg on the Federal Budget: what's changed with super?

Meg Heffron

I don't recall a Federal Budget with less to say about superannuation in my career of over 20 years. However, it did confirm some changes already in train:

- The age at which members will become eligible for downsizer contributions will reduce from 60 to 55. But those with more than a passing interest in the subject will know that legislation for this change is already

making its way through parliament. While it hasn't passed yet, it's sufficiently well progressed that we expect it to become law in the current financial year.

- Digital currency will not be taxed as foreign currency. This is important for all taxpayers that hold (say) Bitcoin and other cryptocurrencies, not just SMSFs. It had already been announced and draft legislation released for consultation (which closed in September 2022). So again, this move seems reasonably well progressed.
- While not specifically superannuation issues, there are two other changes that are very relevant to retirees, often including those with SMSFs.
    - Very significant increases to the income test thresholds for the Commonwealth Seniors' Health Card (CSHC) – up to $144,000 for couples and $90,000 for singles. Again, these are *almost* law already. The change to the thresholds themselves has been agreed by both Houses of Parliament, the Bill has just been held up by a proposed change to the start date – again, we expect this to come soon.
    - Changes to the assets and income tests for the age pension when a recipient sells their home. Currently the sale proceeds are excluded from the assets test for 12 months if they will be used to buy a new home. This is to be extended to 24 months. In addition, there will be a special rule to calculate "deemed income" on the proceeds at the lowest possible rate for 24 months. Again, both changes are already well progressed – with legislation in parliament and seemingly not contested by either side.

While all these are important measures and to be celebrated, they are definitely not news.

What was (somewhat) new

The Budget also confirmed some things announced by the last government but not specifically endorsed by the new government until now:

- Relaxation of the residency rules for SMSFs (see our last blog here). While the new government confirmed its commitment to this change, the start date won't be July 1 2022 as originally planned. Instead, it will be the July 1 after the relevant legislation receives Royal Assent. Since there's been no legislation put forward yet – even in draft form for consultation – it's likely that this is still a little way off.
- Funding for the "Modernising Business Registers" program. While that might not be a household name, it's the program that includes director identification numbers (director IDs). Like Heffron, we expect many practitioners are still struggling to mobilise all relevant clients to apply for a director ID by 30 November 2022. Unfortunately, we will have to keep pushing because it's definitely not going away.

And finally, the Budget ruled out one very bad idea that the previous government announced but never got to implement: replacing annual SMSF audits with a three yearly cycle. Given the important role audits play in supporting the ATO to manage compliance, it was always a mystery to me why this was ever suggested in the first place. A great example of a solution looking for a problem.

What the budget left out

Often with a Federal Budget there's as much interest in what is *not* said as what *is* included. Since there was nothing new this year, it's worth briefly reflecting on what might have been.

There was nothing on:

- The amnesty for legacy pensions proposed in May 2021 which would allow members with these pensions to terminate them relatively painlessly (see our blog at the time). The loud silence on this issue suggests it is simply not on the government's radar. This is bitterly disappointing. It's a change that is long overdue, creates no great revenue leakage for the government, recognises that the tax and regulatory environment has moved on enormously since people put these in place (they haven't been an option as a brand-new pension since 2007) and is simply…. the right thing to do. The fact that it hasn't been done yet beggars belief. Hand me the keyboard and I will write some draft legislation to release for consultation tomorrow. Who's with me?

There have been some changes on these pensions that help those with very large legacy pensions improve their position (even potentially exit them entirely). But the change comes at a cost – most people need to accept a short-term additional tax bill to make the change. An amnesty might not change the eventual

outcome, but it would remove the cost. The failure to even mention this amnesty does suggest that some clients who can improve their situation already should look to do so now rather than wait.

- Non-Arm's Length Income & Expenses (NALI and NALE). This has been a festering sore since the ATO first publicised its controversial view back in 2018. The last government accepted that it required a legislative fix. The current government has yet to formally commit to that fix and an announcement in the Budget would have been reassuring.
- Simplifying the transfer balance cap regime – there is a great opportunity to strip out some complexity from the system here. It wasn't taken in this year's Federal Budget and hopefully it will be in a future version.
- Some of the scarier kites flown in recent weeks – changes to limited recourse borrowing arrangements (to be fair, this is raised every single year as a possible change), a $5 million cap on superannuation balances, halting indexation of the transfer balance cap etc. We were very glad that none of these saw the light of day.

All in all, a quiet night for those of us in super. And perhaps that's a good thing – there will be another one at the usual time in May 2023, so we don't have too long to wait.

Meg Heffron is the Managing Director of Heffron SMSF Solutions, a sponsor of Firstlinks. This is general information only and it does not constitute any recommendation or advice. It does not consider any personal circumstances and is based on an understanding of relevant rules and legislation at the time of writing.

To view Heffron's FREE Post Budget Webinar for specialist SMSF accountants and advisers, click here (requires name and email address to view). For more articles and papers from Heffron, please click here.

5 charts that should give investors hope amidst market turmoil

Amit Nath

It's understandable if investors are a bit shell-shocked. Central banks around the world are hiking rates in an attempt to slow spending and lower stubbornly persistent inflation. The turmoil's impact on asset valuations has been stomach churning for investors. Nothing has been spared – from equity markets, bonds, property, FX, to crypto. Investors are probably wondering when the turbulence will end.

Some perspective may provide solace

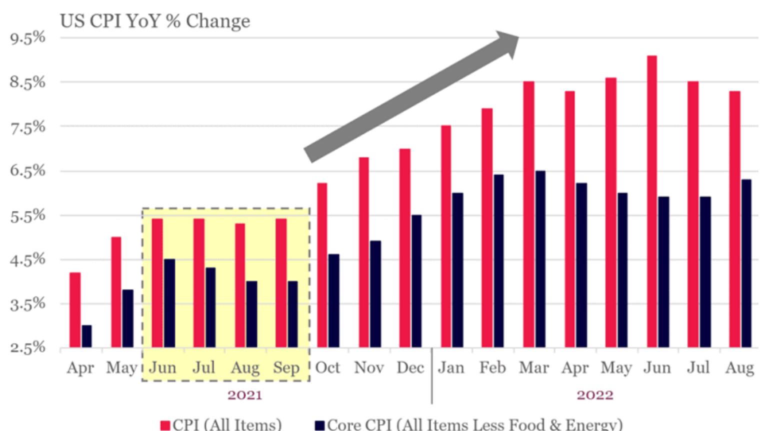
Given that, we take a step back and look at five key charts that help provide some perspective and context on the current environment for investors. The good news is the charts provide some hope that we could be reaching some form of an inflection point in the outlook for the economy (particularly surging inflation) and for listed company valuations.

1. Inflation growth may start to moderate from October 2022

As mentioned, the root cause of the current market dislocation is the relentless march toward higher inflation.

When might we see inflation moderate and a subsequent 'pause' by central banks in their aggressive interest rate increases? Interestingly, this moment may be mere months away.

If we look at the Consumer Price Index (CPI) this time last year in the chart above, we see a relatively flat path of inflation through September, then a sharp acceleration in the following months starting October.



Source: Bloomberg, Montaka Global

Since inflation is typically viewed as the rate of change over a 12-month period, this substantial uptick starting in October 2021 means that the year-on-year growth of inflation in October 2022 is going to become increasingly challenged.

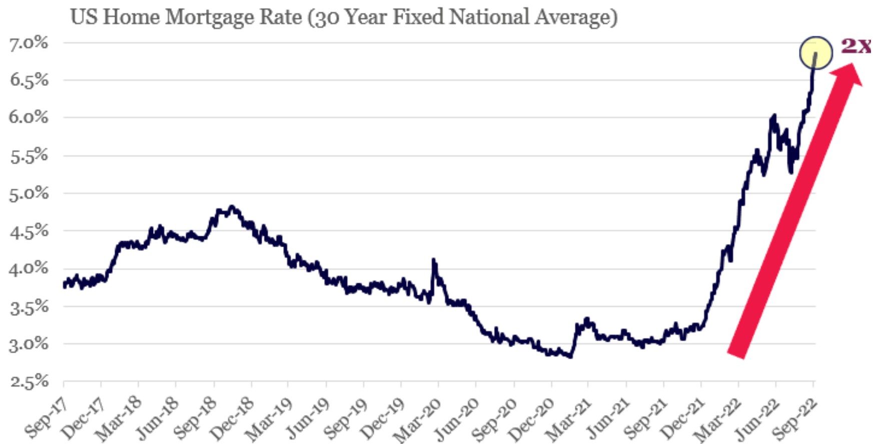
Said another way, this simple mathematical reality may lead to a more benign CPI print when the October number is reported on November 10, and potentially for several months subsequently.

This date is certainly worth marking in the calendar. It may be a turning point in how aggressive central banks, particularly the US Federal Reserve, will be in raising interest rates and could pave a path to more rational price discovery in markets.

2. US mortgage rates have more than doubled in 2022

The strength of the consumer is often sighted as a key driver of inflation. Indeed, despite sharp interest rate hikes by central banks, they don't seem to be putting a dent in consumers' voracious spending habits.

However, laying beneath the surface of a 'strong consumer', is the potential for sharp belt tightening around household budgets. This year alone, mortgage costs have doubled, which means a family that was considering a $500,000 home last year, can only afford a $250,000 home today.



Source: Bankrate.com, Montaka Global

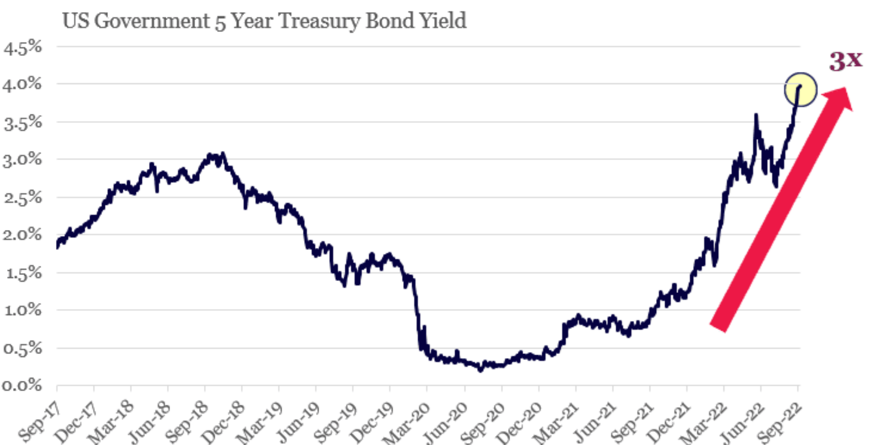
On average, mortgage payments – usually the largest single expense for a family – are around 30% of household income. If a family was required to refinance their home today, it would cost them *double* what it would have cost just 12 months ago. A family that was previously paying 30% of their household income towards their mortgage could see it rise to as much as 60% as mortgage rates have doubled. A family making $100,000 per year would see their post-mortgage cash flow drop from $70,000 to $40,000.

They very likely will cut back on discretionary expenditures, like travel, holidays eating out; and potentially also cut back on some non-discretionary items, like doctors' visits and school fees. All of this is highly contractionary and would cause inflation to fall as consumers lower the amount of spending in the economy.

3. Cost of funds for the US Government has tripled in 2022

Obviously not every household is going to have the misfortune of being in the situation described above, at least not in the immediate term.

However, one of the largest agents in the economy, the US government, is not so fortunate. Over the coming 12 months, the US government will need to refinance US$4 trillion of its US$31 trillion outstanding debt. That will result in an incremental increase in interest expense each year of around US$150 billion above what was budgeted for last year.

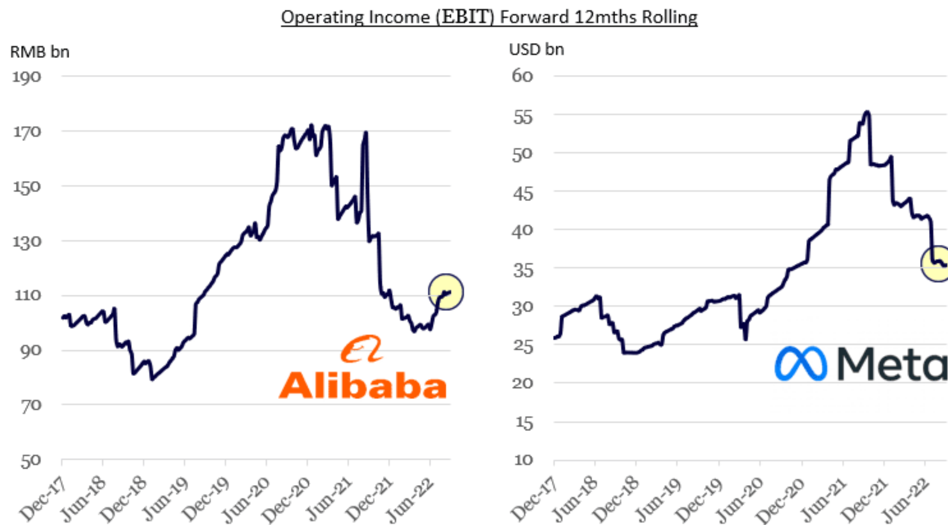


Source: Bloomberg, Montaka Global

Over time, the entire US debt would need to be refinanced at higher interest rates which would present the US economy with a crippling US$1 trillion incremental annual headwind if rates remain where they are today.

These funds may come out of public services, infrastructure spending, schools, social programs or increased taxation. All of which would send a major deflationary force through the economy, offsetting inflation, but likely resulting in a recession as well.

4. Earnings streams temporarily depressed



Source: Bloomberg, Montaka Global

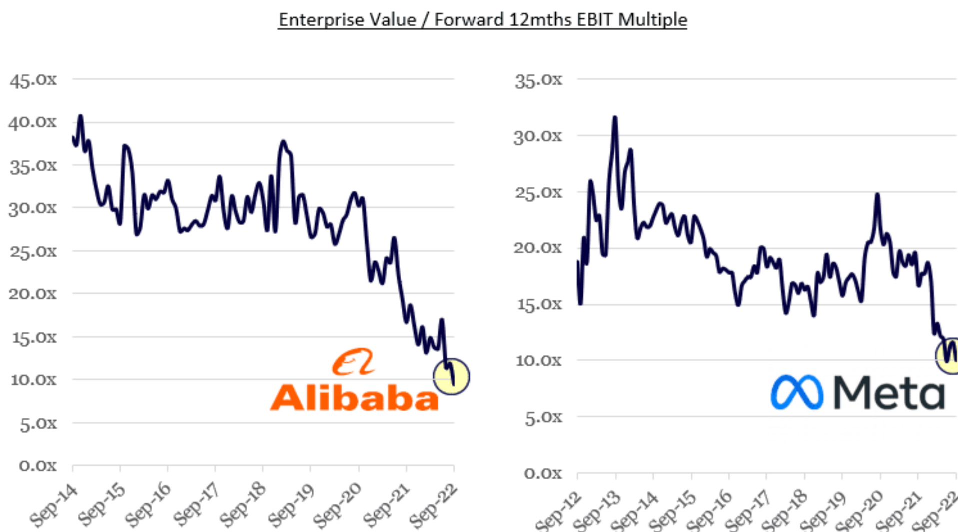
Some of the most exceptional companies in the world are experiencing cyclical headwinds tied to macroeconomic conditions and changing business environments. They may also be embarking on major investment cycles that are depressing earnings.

These factors are expected to be temporary.

Examples include Alibaba, which is affected by the hard COVID lock-down policies in China, and Meta, which is investing heavily in Artificial Intelligence (AI) and navigating an evolving digital advertising landscape (Apple's iOS changes).

It seems the market has dismissed the new opportunities these companies are building for the future. What are headwinds today will become tailwinds tomorrow. The price for substantial incremental cash flow generation has actually never been cheaper.

5. Depressed earnings attracting depressed multiples



Source: Bloomberg, Montaka Global

Higher interest rates have compressed valuation multiples. But in the case of both Alibaba and Meta, the current environment is creating an outsized impact on them. Their valuation multiples are at post-IPO lows for both companies and imply the market believes the temporary depression in earnings is a permanent situation.

This has created a double whammy for these wonderful businesses: they are being priced on a depressed valuation multiple *and* depressed earnings expectations.

As multiples normalize and earnings decompress, valuations will likely hit an inflection point followed by a sharp re-rating in stock prices. This creates an extremely rare opportunity for an investor in today's market.

Looking for opportunities

We believe the inflation-focused environment is creating some phenomenal opportunities in markets. As this major headwind recedes, as we believe it will, valuation multiples are likely to re-rate and reward the patient investor. In fact, Montaka Global has been using this opportunity to increase several portfolio holdings that appear to be significantly oversold.

Amit Nath is a Senior Research Analyst at Montaka Global Investments, a sponsor of Firstlinks. This article is general information and is based on an understanding of current legislation. Montaka owns shares in Alibaba and Meta Platforms.

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Are there lasting benefits from changes to capital raising regulations?

Christine Brown, Chloe Ho, Hue Hwa Au Yong, and Chander Shekhar

As part of our research on capital raising by public companies in Australia, we've investigated how the regulators changed the rules during the COVID-19 pandemic, and how this affected company behaviour. A key concern of securities regulators should be the protection of small and minority shareholders against loss in voting power and dilution of wealth when companies issue new equity. Reflecting this, public companies in Australia have normally been restricted to raising no more than the 15% of their existing capital base, unless shareholders approve the issue.

In addition, in recent years the Australian Securities and Investments Commission (ASIC) has emphasised the 'equal opportunity principle', which aims to give retail shareholders access to, otherwise dilutionary, discounted offers to institutional shareholders.

The changes to capital raising during COVID

In response to the 2020 onset of the COVID-19 pandemic, the Australian Securities Exchange (ASX) and ASIC made changes to capital raising regulations through waivers to existing Listing Rules. In particular, they lifted the cap on capital raising (without shareholder approval) from 15% to 25% of existing capital but required that such issues incorporated either an entitlements (rights) offer or Share Purchase Plan for retail shareholders, resulting in a 'packaged' offer, that at least partly protected small shareholders from dilution.

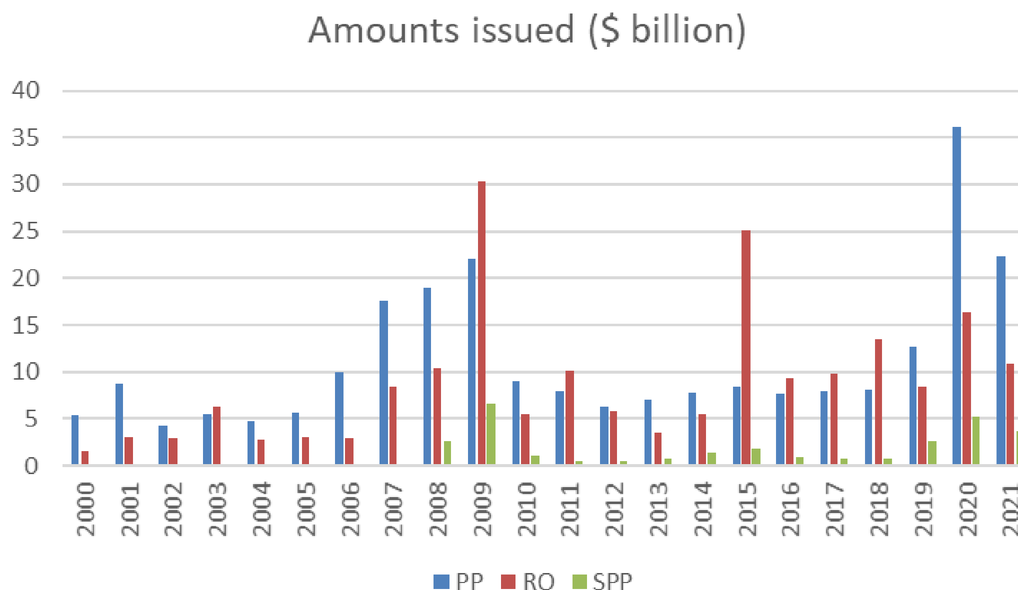
The changes were temporary, initially applying until end June 2020, with subsequent extensions until 30 November 2020. Were they needed? Were the outcomes desirable? Should such a regulatory change be considered in the event of a future, similar, shock to the economy? Did such regulatory changes have a continuing effect on company behaviour?

How companies responded to the temporary regulations

Managers of Australian companies like private placements (PPs) to institutional investors because of the speed and certainty of amount raised. But the discounted price generally involved imposes a dilution cost on non-participants such as retail shareholders. In contrast, pro-rata rights offers (ROs) are the most equitable means of raising equity capital, but take time and can involve uncertainty over the amount ultimately raised. The third method, share purchase plans (SPPs) are not pro-rata. With each shareholder permitted to purchase shares up to a fixed dollar amount (currently $30,000), an SPP sits in the middle of the three methods in terms of equitable outcomes for shareholders.

The figure below shows the amount raised from each type of issue over the years 2000 to 2021, where the total amount raised in a 'packaged offer' (such as a PP combined with a RO) is allocated according to the size of its components. A consistent pattern can be seen. PPs dominate each year in terms of total funds raised, followed in turn by ROs and SPPs. In total, over the period, PPs raised approximately $244 billion, ROs $196 billion and SPPs $30 billion.

Not surprisingly, in the years 2009 (the financial crisis) and 2020 (the onset of the COVID pandemic), the largest total yearly dollar amounts ($58.9 billion and $57.6 billion respectively) were raised. The increase in 2020 resulted both from the need for capital and the new higher regulatory limits.



Source: Authors' calculations

The 2020 regulatory change required issues over 15% (up to the new cap of 25%) to follow a PP with an SPP or RO, thus addressing some of the dilution to small shareholders arising from the private placement. For issues less than 15%, combining a RO or SPP with a PP was optional.

We find in our research that in the pandemic year 2020, around 26% of total funds raised were by companies using a PP followed by an SPP with the new higher cap of 25% of existing shares. In the accompanying figure, this is reflected in the spike in PP funding in 2020 and the jump in funding sourced through SPPs from 2019 ($2.6 billion) to 2020 ($5.2 billion).

It is evident that for companies raising above the previous cap of 15%, the response to the mandate from the regulator was to choose a PP followed by an SPP. Very few capital raisings in 2020 using the new higher cap were via a PP followed by an RO. ROs (which are the fairest in terms of equitable outcomes for small shareholders) suffered a drop in relative contribution to equity capital raising in 2020, which was taken up by the issuance of a PP followed by an SPP, reflecting the direct impact of the regulation changes. Nevertheless, it is also clear from the figure that ROs remain an important source of capital.

With the challenging market conditions in early 2020, companies reacted quickly to the new higher capital raising limits, the original intention of which was to help companies survive the pandemic. A few opportunistic companies flouted this intention and launched placements up to the new 25% cap largely unrelated to the pandemic.

However, and on the positive side, our research finds that during 2020, even companies issuing *less* than 15% of existing capital, had a significantly higher propensity to follow the PP with an SPP, even though they were not required to do so under the regulations. The important contribution of our research is to show that the changes to regulations in response to the onset of the COVID pandemic, had both a direct and an indirect effect on company choice of capital raising method, which both worked towards reducing the dilution of small shareholders.

Changes to company behaviour have proven sticky

Shedding an even more positive light on the impact of changes to the regulations, this modification in company behaviour continued into 2021. In the pre-COVID years 2000-2019, around 18.5% of total funds raised over

the period was via a PP followed by an SPP. In 2020, this figure was 44.3%, reflecting the new higher capital limits for this method during the pandemic.

However, in 2021 when the cap on capital raising had reverted to normal, companies continued to favour the PP followed by an SPP, with the method raising 45% of total funds for 2021. The increased importance of a PP followed by SPP suggests that company behaviour adjusted (at least in the short term) with potential benefits for smaller shareholders, who have the opportunity to invest in discounted capital raisings.

In conclusion, changes to the capital raising regulations at the onset of the COVID-19 pandemic, provided companies easier access to needed capital and at the same time, went some way to protecting small shareholders from dilution.

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The full research paper can be accessed here: Brown, C. and C. Ho. Raising Equity Capital during the COVID-19 Pandemic in Australia: The Efficacy of Regulatory Interventions, The Company and Securities Law Journal, 39, 4-18 (2022).

The opportunity in private debt amid rising interest rates

Andrew Lockhart

The steepest rise in official interest rates since the 1990s is fuelling the hunt for investments that can preserve capital and provide regular income. After decades of low and falling interest rates, a sudden and sustained burst of inflation has forced the RBA to reverse course and begin raising the cash rate. Investors now fear the RBA's actions could end Australia's extraordinary run of economic growth, causing stress and volatility in financial markets. Private debt is an asset class that can offer both capital preservation and attractive risk-adjusted returns to investors.

Rates on the rise

Changes to the cash rate are the RBA's main lever to keep inflation within the mandated 2-3% target band. It is also a key factor in the appeal of private debt for investors looking to protect their capital and generate regular income.

Official interest rates in Australia have been in long term decline since 1990 after peaking at 17.5%. They reached just 0.1% in November 2020 and stayed at the bottom until early this year as part of a years-long campaign by governments and central banks to stimulate economic growth in the wake of the 2008-09 global financial crisis (GFC).

The low inflation that accompanied that sustained period of economic growth came to an end in 2022 as government spending to counter the COVID-19 pandemic, supply chain disruptions, and Russia's invasion of Ukraine pushed prices for energy, housing, and consumer goods sharply higher. Central banks, including the RBA, have responded by rapidly raising interest rates.

Private debt can benefit in the current environment because most underlying loans are short-dated and provided with floating interest rates – a fixed margin above the floating benchmark Bank Bill Swap Rate (BBSY). This means, as borrowers reset their rates, this should quickly translate into higher returns for the lender and, as a result, income for investors.

Volatility in financial markets

Markets have responded to the uncertainty about how high rates may rise and fears of the impact of slower economic growth by selling off both bonds and equities.

The most recent slowdown was brief; in the middle of 2020, Australia's economic growth fell for two consecutive quarters because of pandemic shutdowns. While this was quickly reversed by government stimulus, it sparked heavy losses in share prices and the delay, reduction, or cancellation of dividends to investors.

Prices for bonds have also moved sharply post the pandemic, raising questions over their traditional role balancing the risk of more volatile equities.

By contrast, the Australian corporate loan market was largely undisturbed by these events. This is not unexpected as corporate loans hold a senior position in the capital structure of a company and are protected by the equity, which bears the risk of first losses (Figure 1).

For example, if a property is bought for $100 million with a lender providing $65 million and the rest coming from equity, the value of the property would have to fall significantly before the debt, and particularly the senior debt, is impacted.

The majority of loans in the Australian private debt market are senior secured loans. This means the lender's capital is protected by Australian laws that give them the ability to recover interest, principle, and fees from the assets of the borrower.

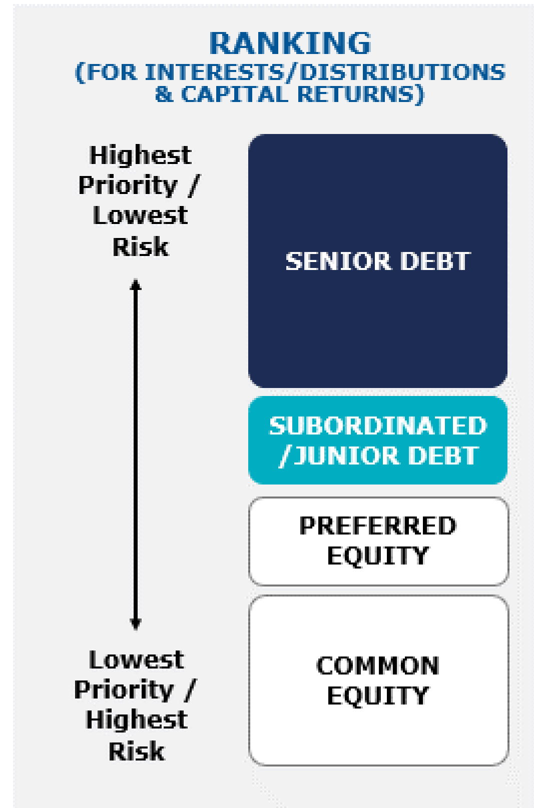

Figure 1: shows the priority of equity and debt within the capital structure.

Low credit losses

The strength of private debt's position in the capital structure is highlighted by data on the banking system, which shows that credit losses in Australia's corporate loan market have been low over a long period. Losses were just 0.08% as a share of major banks credit exposures in Australia at the end of March 2022.

Since banks began providing data to the Australian Prudential Regulation Authority under the APS 330 standard in 2009, credit losses peaked at 0.68% in March 2010. This can be seen as the fallout from the GFC, which included large corporate names such as BrisConnections, Allco and Babcock & Brown. By contrast, the peak to trough falls in equity markets during the GFC were around 50%.

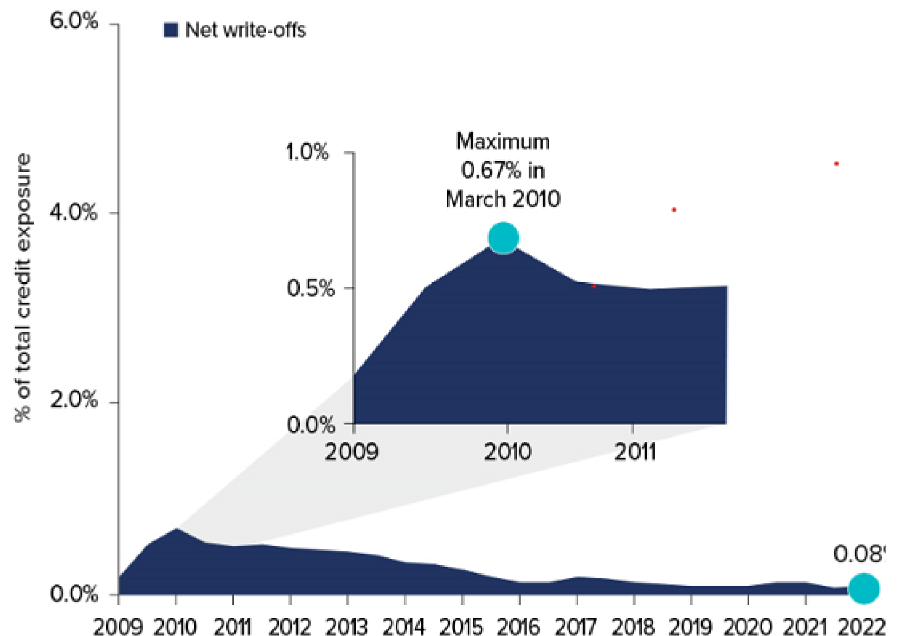

Figure 2. Source: Major Bank APS 330 reporting. Past performance is not a reliable indicator of future performance.

Credit risk within private debt investing can be effectively managed, even during periods of heightened volatility, through a stringent due diligence and selection process, as well as ongoing monitoring of the borrowers. This is where a quality private lender will demonstrate its value to investors via the processes used to select borrowers, price credit, and manage individual loan and portfolio risk. The ability to control the terms and conditions and have access to detailed company information is a key distinguisher of private debt to corporate bonds or offshore tradeable debt, where the investor has no influence over the borrower.

Processes to protect investor capital

It starts with the selection of borrowers and extensive due diligence to ensure they can generate the cashflow needed to pay the fees, interest, and principal on the loan. Lenders are looking for borrowers with a demonstrated track record in their business, and the ability to generate a strong cashflow, as that is what ultimately determines their ability to repay debt. Loans are structured to accommodate projections for rising costs and interest rates and include negotiated security and controls to protect the lender.

Lenders negotiate covenants and controls to ensure they have rights to monitor the loans over time and to set in place an early warning system for any changes in the business. With access to detailed information on the borrowers, lenders can quickly react to changes and, if required, limit the borrower's other outgoings - such as dividends - to ensure the loan is repaid. Furthermore, almost all corporate loans in Australia are secured, which provides the lender with rights to enforce on its security and recover amounts owing ahead of other unsecured creditors in the event of a default.

At a portfolio level, risk management within private debt extends beyond the relationship with the individual borrower as exposures will be diversified across multiple borrowers, sectors, and industries. In private debt, investing size and scale is also important, as a larger lender has access to better-quality lending opportunities and can provide investors with exposure to a large number of high-quality borrowers within a portfolio.

Amidst the volatility, private debt is a growing opportunity

Rising interest rates and volatile markets have created uncertainty for investors within financial markets, however some have been able to find consistent, strong income amidst the turbulence.

Private debt is an established asset class that has flourished in recent times, offering investors the benefits of:

- **Attractive, reliable income** – the majority of underlying loans in private debt funds are priced with floating interest rates. Thus, as interest rates rise, investors can expect increased returns protecting them against inflation.
- **Reduced capital volatility** – private debt exhibits a low correlation to public markets, meaning investors are shielded from much of the turbulence often seen in bonds and equities.
- **Downside protection** – the seniority and security of private loans provide protection, while tight covenants and controls ensure lenders can monitor and protect the value of their investments over time. These attributes, along with Australia's stringent insolvency laws, have resulted in historically low credit loss rates.

Andrew Lockhart is Managing Partner and Co-Founder of Metrics Credit Partners, an Australian debt-specialist fund manager, and sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. Its listed vehicles operate under the tickers MXT and MOT.

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