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Editorial

This editorial has been warning for some time that markets have been overhyped and overvalued. A correction was overdue.

Yet, perspective is needed. As I write, the ASX 200 is off 6% from record highs. The index is back to levels reached in late May.

The US has been hit harder, especially the Nasdaq, which entered correction territory. However, the S&P 500 and Nasdaq are still up 9% and 8% year-to-date, and 15% and 16% over the past 12 months, respectively.

Of course, investors are looking for causes for the sharp recent declines, with various explanations, including:

- A bounce in the Yen catching out over-leveraged investors.
- Growing concerns of an economic slowdown in the US.
- A realisation that expectations for US tech stocks were excessive and won't match reality.

It's likely to be a combination of these factors and others.

The big question is whether this pullback is the start of something larger. As I noted last week, there are decent odds that a large rotation out of US tech stocks into neglected assets such as value and markets outside America will happen at some point. Whether that's now remains to be seen.

For investors with a plan, the past week's events shouldn't be of concern. The key is to stick to the plan. For those without a plan, it should hopefully spur them to get one ... fast.

A recent article in *Firstlinks* on the [economic impacts of climate change](#) has generated a lot of debate. What strikes me about comments on the piece is how polarised the debate on energy and the environment has become. There are climate change denialists on the one extreme, and fossil fuel abolitionists on the other, with little in between. And people appear intent on seeking out opinions and research that confirm their firmly held views.

Today is my attempt to get more facts on the table and less opinion. Hopefully, this can give readers greater context and nuance to the energy and climate change debate.

Latest figures on energy and emissions

Despite what you may read in the media, oil and coal consumption grew to record levels last year. Oil demand rebounded strongly after China relaxed its Covid lockdown policies. That resulted in oil consumption breaking through the 100 million barrels per day level for the first-time ever. Coal demand beat the previous year’s record level, while natural gas consumption was flat.

According to the Energy Institute, that helped lift total energy consumption 2% above 2022, and 0.6% above its ten-year average as well as over 5% above its 2019 pre-COVID level.

Meanwhile, renewable energy consumption grew at 6x the rate of total energy demand and electricity demand increased 25% more than total energy consumption.

However, fossil fuels continue to dominate our energy needs. As a percentage of total energy demand, fossil fuel consumption fell just 0.4% to 81.5% in 2023. Renewables’ share increased 0.4% to reach 14.6% of total energy demand. Nuclear makes up the remainder at close to 3% of global energy consumption.

Here is a split of renewables usage by country below. As you can see renewables account for 15% of Australia’s energy consumption.

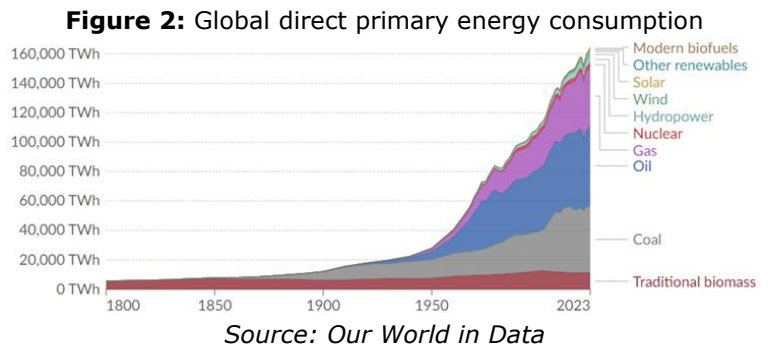
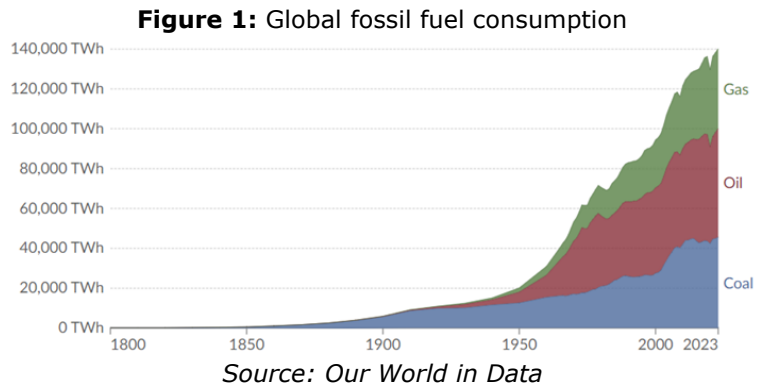
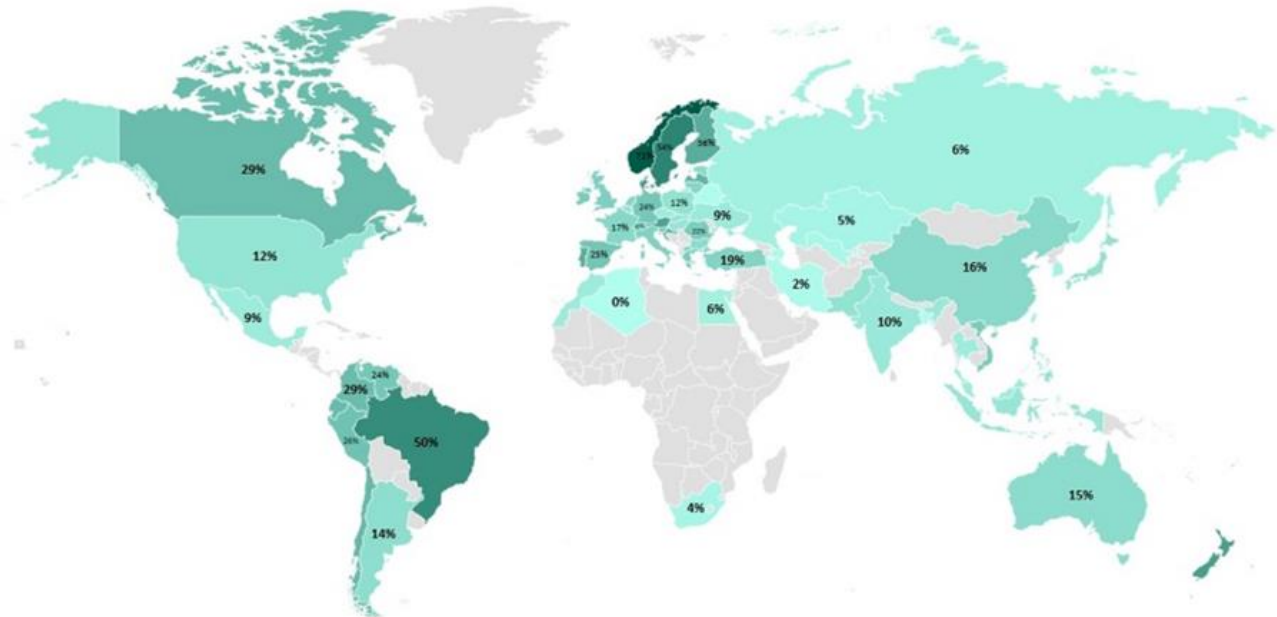


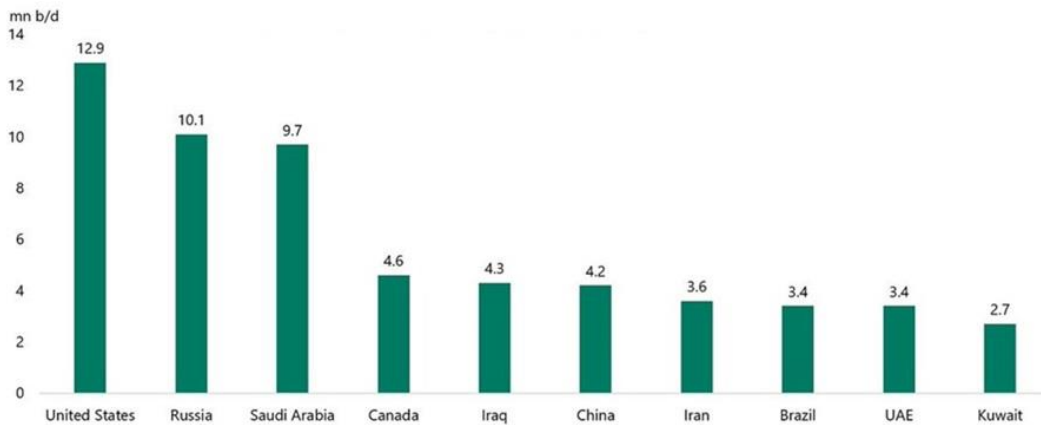
Figure 3: Share of primary energy consumption from renewable sources, 2023



Source: Apollo

On the production side, the US is now the dominant oil producer. America produces 12.9 million barrels per day of crude oil. That’s nearly 30% more than the 10.1 million barrels per day that Russia produces and 33% more than Saudi Arabia.

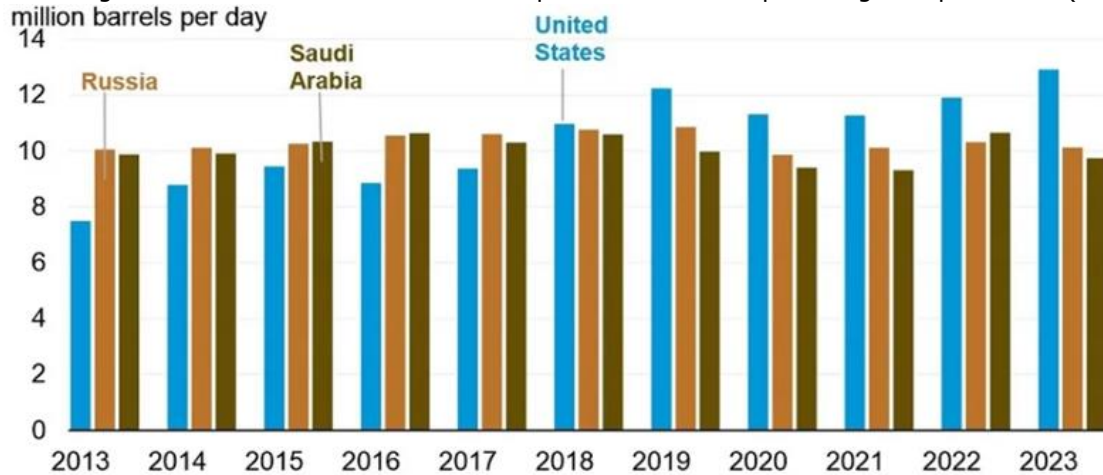
Figure 4: Global crude oil and condensate production 2023, selected countries



Source: Apollo

US dominance in oil production has only happened recently. It passed Russian and Saudi production in 2018, after being far behind a decade ago.

Figure 5: Average annual crude oil and condensate production from top three global producers (2013-2023)

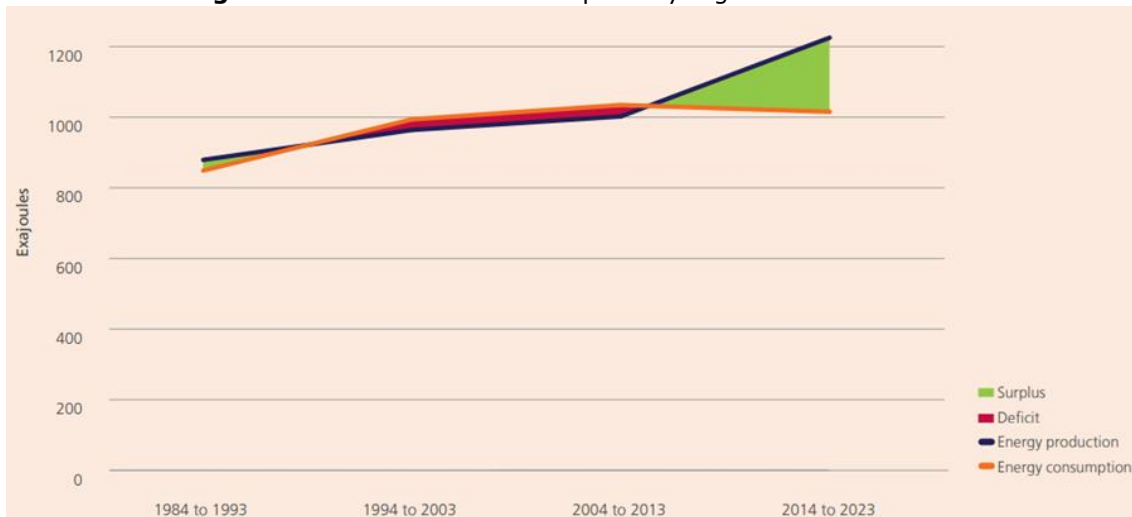


Data source: U.S. Energy Information Administration, International Energy Statistics

Source: U.S. Energy Information Administration (EIA)

It means that not only does America have cheap oil to fuel its needs for decades to come, but it changes the geopolitical equation as they no longer depend on other countries for oil imports.

Figure 6: Production vs consumption by region: North America



Source: Energy Institute's 'Statistical Review of World Energy'

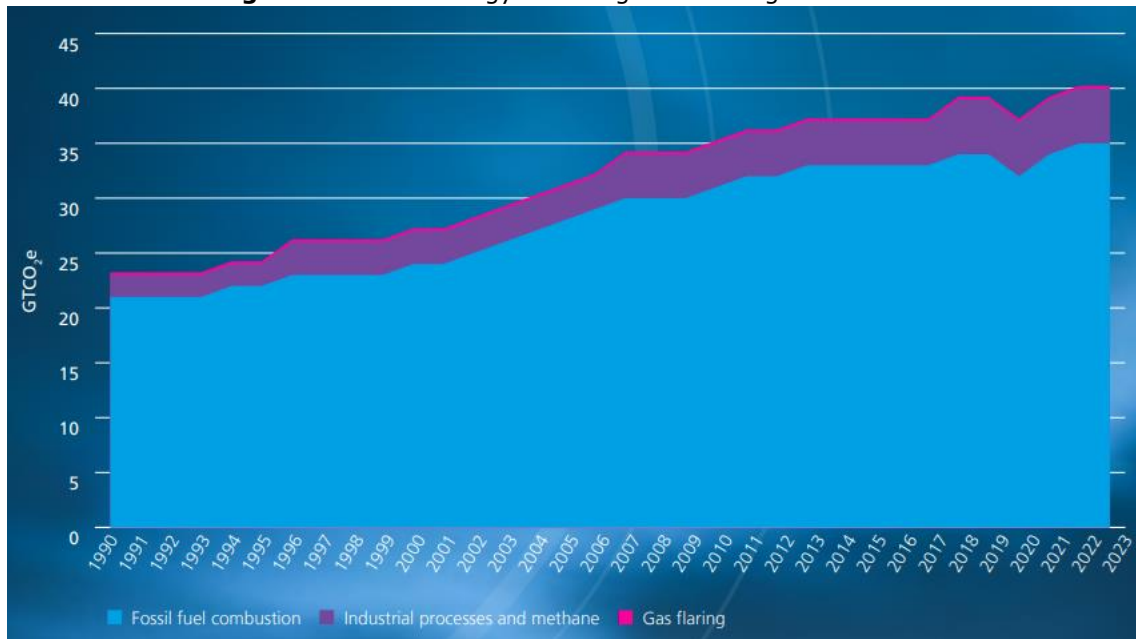
For coal, global production reached its highest ever level in 2023. Nearly 80% of coal supply comes from the Asia Pacific region, including Australia. Meanwhile coal consumption increased 1.6% last year. China remains the largest consumer by far, accounting for 56% of world consumption. Interestingly, India has also exceeded the combined consumption of North America and Europe.

For gas, production was flat last year. The US is the largest producer of gas, delivering about 25% of the world’s supply. Global gas demand was also steady last year and is only marginally above pre-Covid levels.

It’s a different story for solar and wind. Their capacity grew 67% in 2023, much of it from China. China’s installed wind capacity now equals that of Europe and North America combined.

Meantime, greenhouse gas emissions from energy use are continuing to climb. In 2023, they climbed 2.1% to beat record levels set the year before.

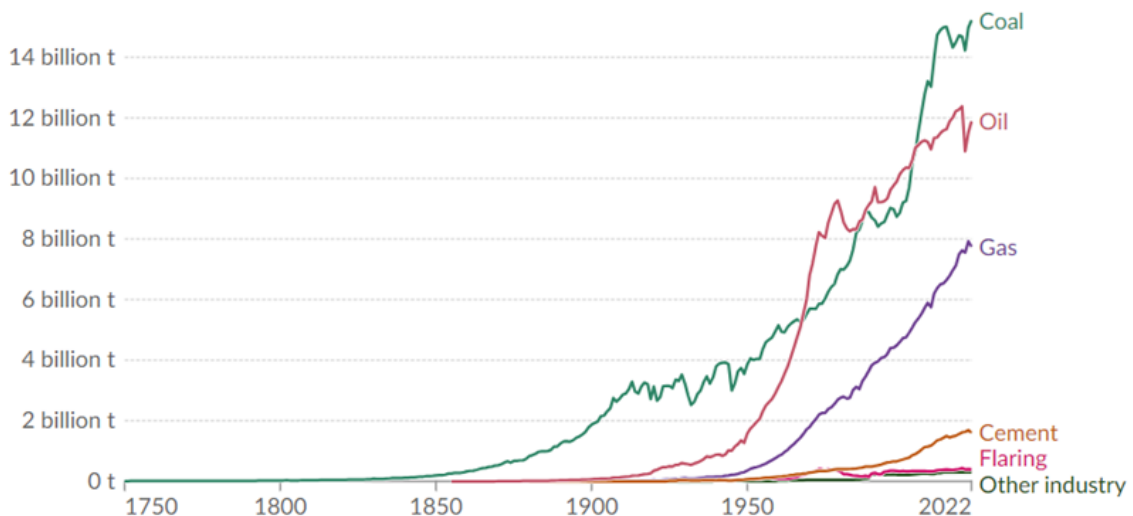
Figure 7: Global energy related greenhouse gas emissions



Source: Energy Institute’s ‘Statistical Review of World Energy’

The biggest culprit for energy-related emissions continues to be coal, followed by oil.

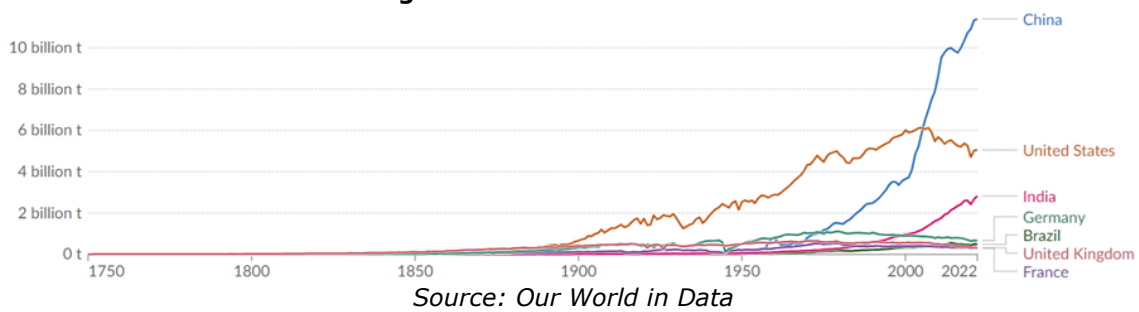
Figure 8: Global CO2 emissions by fuel or industry



Source: Our World in Data

In terms of countries, Asia is the biggest CO2 emitter, with China far ahead of other countries.

Figure 9: Annual CO2 emissions



Energy underlies everything in the modern world

For up-to-date science on energy and climate change, I consulted various sources, though found academic Vaclav Smil's work to be the most objective and factual. His latest book, [How the World Really Works](#), is especially useful.

The book first provides context for how much energy that we have at our disposal. Where once we had to rely on our physical labour to power things, now that's rarely the case. And that's been driven by the extraordinary rise in the use of fossil fuels.

Smil says his calculations show "a 60-fold increase in the use of fossil fuels during the 19th century, a 16-fold gain during the 20th century, and about a 1,500-fold increase over the past 220 years".

Much of what we take for granted has been fuelled by this increase in usable energy:

"An abundance of useful energy underlies and explains all the gains – from better eating to mass-scale travel; from mechanization of production to transport to instant personal electronic communication – that have become norms rather than exceptions in all affluent countries."

Smil emphasizes that energy, and the conversion of it, is central to modern life. It's also central to our economic system. Smil quotes physicist Robert Ayres who said that "the economic system is essentially a system for extracting, processing and transforming energy as resources into energy embodied in products and services".

Some forms of energy are more useful than others

Fascinatingly, given the debate on nuclear power in Australia, Smil says the science is definite – nuclear power is the most reliable form of electricity:

"... large nuclear reactors are the most reliable producers of electricity: some of them now generate it 90-95 percent of the time, compared to about 45 percent for the best offshore wind turbines and 25 percent for photovoltaic cells in even the sunniest of climates – while Germany's solar panels produce electricity only about 12 percent of the time."

Smil says green sources of electricity don't have the energy density of liquid hydrocarbons and aren't suitable for things like transport. And he believes scale is a big problem for renewables:

"In large, populous nations, the complete reliance on these renewables would require what we are still missing: either mass-scale, long-term (days to weeks) electricity storage that would back up intermittent electricity generation, or extensive grids of high-voltage lines to transmit electricity across time zones and from sunny and windy regions to major urban and industrial concentrations."

Smil notes that even if a country rapidly turns to renewables, it will continue to rely heavily on fossil fuels for its energy needs. He cites the case of Germany which generates about half of its electricity from renewables yet the share of fossil fuels in the country's energy supply has only fallen from 84% to 78% over the past two decades. Also, the world's dependence on fossil fuels has only decreased from 87% to 85% (note these figures are a little outdated as the book was written in 2022. Fossil fuels as a percentage of primary energy usage is down to 82%) over the past 20 years, despite a 50-fold rise in renewables.

Smil thinks that decarbonizing modern long-distance transport is especially problematic. Yet the problems with the developed world's rush to renewables and net zero emissions don't stop there. He says a rapid shift is impossible without accepting a significant drop in our living standards:

"Both the high relative share and the scale of our dependence on fossil carbon make any rapid substitutions impossible: this is not a biased personal impression stemming from a poor understanding of the global energy system – but a realistic conclusion based on engineering and economic realities."

Food, glorious food

Smil is also sceptical of a rapid transition to net zero because of the centrality of fossil fuels in food production. He says such production relies on two things: the sun and fossil fuels. Fossil fuels power field machinery like tractors, transportation of harvests from fields to storage and processing sites, and irrigation pumps. They are also essential to the production of fertilisers and chemicals which feed into agriculture.

Smil says how fossil fuels will be replaced by renewables in the production of food is unclear.

The four pillars of modern civilization

Smil says the world relies on four key materials: cement, steel, plastics and ammonia. It cannot do without any of them. The world consumes about 4.5 billion tons of cement, 1.8 billion tons of steel, 370 million tons of plastics, and 150 million tons of ammonia, and they aren't readily replaceable by other materials – not soon and certainly not on a global scale.

And all four materials depend heavily on fossil fuels.

Smil also points out that green electricity relies on these materials too. Wind turbines need enormous amounts of cement, steel, plastics, and ammonia, which all in turn require fossil fuels.

Another example is electric cars. A typical lithium car battery weighing about 450 kilograms contains about 11 kilograms of nickel, more than 40 kilograms of copper, and 50 kilograms of graphite – as well as 181 kilograms of steel, aluminium, and plastics.

To drive his point home, Smil says that for 25-50% of the global car fleet to become EVs by 2050, it would need 18-20x the amount of today's lithium, 17-19x the cobalt, and 28-31x the nickel.

Global warming is real

If you're thinking Smil is a fossil fuel fanatic, you're wrong. He says global temperatures have undoubtedly risen over the past century. The temperature averaged across global land and ocean surfaces is almost 1 degree above the 20th century mean. The five warmest years in the past 140 years have happened since 2015, and nine of the 10 warmest years have been experienced since 2005.

Smil says recent studies show that a 1.5 degree increase in temperatures would be tolerable, but the problem is we may hit that mark within the next 15 years.

Smil doesn't wade into the debate about whether human beings are behind the increase in temperatures. However, he does link the rise of fossil fuels with climate change.

He says though decarbonization is unrealistic, there are a lot of different things that can be done to reduce emissions without impacting our standard of living, including:

1. Simple technical fixes from mandating triple-glazed windows to designs for more durable cars
2. Halving food waste
3. Reducing global meat consumption

A swipe at Elon Musk and co

Finally, Smil takes a large whack at the tech billionaires who believe technology can solve all of our problems:

"Despite the near constant flood of claims about superior innovations ranging from solar cells to lithium-ion batteries, from the 3-D printing of everything (from microparts to entire houses) to bacteria able to synthesize gasoline. Steel, cement, ammonia, and plastics will endure as the four material pillars of civilization; a major share of the world's transportation will be still energized by refined liquid fuels ... grain fields will be cultivated by tractors pulling plows, harrows, seeders, and fertilizer applicators and harvested by combines spilling the grains into trucks."

James Gruber

Also in this week's edition...

In my article this week, I outline how a recent health scare has [changed my investment plans](#).

We're hearing growing calls from the likes of YIMBYs (Yes in my backyarders) for Australia to increase housing density in inner city suburbs to ease the affordability crisis. **David McCloskey** and **Bob Birrell** think that would be an error. They suggest that it hasn't worked in the past and won't work in future. Instead, they offer [alternative solutions to address the problem](#).

Like many others, **Ashley Owen** thinks Commonwealth Bank is headed for a fall from current expensive valuations. If right, he believes it will be a [significant drag on the overall share market](#) in coming years. Ashley says it's a risk that investors need to consider when deciding on how to allocate assets for long-term portfolios.

There's been a lot of commentary from economists and the media of late about how budget deficits create inflation. **Clime's John Abernethy** takes issue with that. And he says there's nothing wrong with fiscal deficits if they're [appropriately set for desired economic outcomes](#) such as attacking the cost of living, the cost of doing business or the cost of housing.

Life expectancy numbers are often interpreted as the likely maximum age of a person, but that's incorrect. The odds are in favour of [people outliving life expectancy estimates](#), and that needs to be taken into account in financial planning, according to **David Orford** and **Jim Hennington**.

2024 started with incredibly strong market returns, although this moderated in the second quarter. Yet, **David Pennell** says the period has been one of [positive dividend growth](#) for investors allocating to global equities.

Former ACCC Chair, **Rod Sims**, is fired up about the downfall of Rex. He thinks it's principally due to a bizarre government policy that prevented Rex from getting crucial landing slots at Sydney Airport. Without those slots, the airline couldn't fly the [highly profitable capital city routes](#).

Lastly, in this week's whitepaper, **Schroders** details its current views on [markets and different asset classes](#).

A health scare changes my investment plans

James Gruber

Recently I spent a week in hospital for pneumonia. It wasn't fun.

It began about two and a half weeks prior, initially as a cold, then flu-like symptoms and finally pneumonia. For nine days, I struggled to breathe properly. I went from being a fit and healthy 48-year-old to one that struggled to do basic chores like hanging out the laundry without running out of breath.

During that time, I went to the local GP three times, and on each occasion, it seemed like a herculean effort to get to the doctors' clinic and wait for my appointment. I had to get various tests done – blood tests, chest x-rays, and nasal and mouth swabs.

It didn't help that I was home alone as my family had to go interstate for my son's soccer tournament. It also didn't help that I lost my appetite and didn't eat for six days. Sleeping was a challenge and I had to resort to a sitting position to get rest. Oddly, I gained a heightened sense of smell, yet it made food and other things like deodorant quite off-putting.

In hindsight, I should have gone to hospital during those nine days. However, I thought that I wasn't dying, and I didn't want to burden an emergency department with my non-life-threatening illness.

On day five of nine, I got confirmation that I did have pneumonia. It was the common mycoplasma infection, otherwise known as walking pneumonia. The problem was that antibiotics to treat the infection weren't working. I was put on steroids which gave me a minor boost for a few days, before I went downhill again.

Eventually, the doctor said I needed to go to hospital immediately.

I went to St Vincent's Hospital in Sydney, and I must have got lucky by going on Friday afternoon before the weekend rush, because I went almost straight through to the emergency department.

After the first night (a noisy affair!), I was put in an isolation ward because I was highly contagious. I was on a ventilation machine from minute one, but after 24 hours, they increased the dose to maximum levels because my oxygen levels were so low. It would remain that way for six days. After 36 hours, I got moved to the respiratory ward, and ended up with a nice, large room probably because they needed to keep me far away from other patients.

Hospitals aren't enjoyable. They see people often at the lowest point, as it was with me.

The food wasn't too bad, though Wi-Fi was non-existent, and the free-to-air television was truly horrific. I hadn't watched free-to-air for many years, and didn't realise how bad it had become, with a plethora of reality shows that were 20 or even 30 years old, and endless remakes of other old shows that were terrible. It made me think of youngsters today who've never watched free-to-air and almost certainly never will.

It left a lot of time for reading and keeping my own company.

What does and doesn't matter

During the long days and nights in hospital, two things struck me. First, I yearned to connect with family and friends. I've got many good friends interstate and overseas, yet what surprised me is that I wanted to connect more with those closer to home. It reminded me of evolutionary psychologist, Robin Dunbar's theory that people need friends close to home because it builds deeper connections.

The other thing that struck me was how irrelevant news is to our daily lives. During the week in hospital, Trump's assassination attempt and the CFMEU shenanigans were the lead stories. And my immediate and ongoing reaction to these news items was that I couldn't care less.

Perhaps being unhealthy makes us selfish, but my wish to connect with those close to me took overwhelming precedence.

News seemed irrelevant. Hobbies like sport seemed irrelevant. Social media seemed irrelevant. And, yes, even work seemed irrelevant.

Suddenly, life's priorities were remarkably clear and simple.

Falling back into bad habits

Eventually, after a cocktail of antibiotics and steroids, I was able to go off the ventilation machine. My oxygen levels were still not great, though I was intent on going home and the doctors finally agreed.

Apparently, it would be 4-6 weeks before my energy levels would return to normal. Thankfully, though, it happened much faster, and I now feel back to my former self.

I've noticed that I've already started to revert to old habits. As I'm writing this article, an email comes in and I'll automatically check it. Or a Teams message. Or my Twitter feed. Or anything else that comes along to distract me from finishing the article. "Just do the work, nothing else matters right now", I plead to myself.

I worry about my son and whether he'll get into an advanced soccer squad and have to remind myself that it doesn't really matter in the grand scheme of things. The same goes for my daughter's grades in her first year of high school. "It's early days", I tell myself.

And I'm still trying to make good on the promise to connect more deeply with those close to me.

Changing investment priorities

By now, you might be asking: what the heck does this have to do with investing? My thoughts on priorities did naturally switch to the world of investing. What stands out to me is the ratio of how much information that we read daily versus that which will make us successful long-term investors.

You could invest in a portfolio of ETFs to suit your goals and risk profile, and not read anything about investing, and you'll probably come out ahead of most investors over a long-term timeframe of, say, 10 years.

You could invest in solid, growing businesses, and ignore all information on the economy and politics, and you're likely to do just fine.

Prioritising a simple portfolio with realistic goals means most investors can largely ignore a lot of the day-to-day market noise.

Saving versus spending

We get taught about how to save money in investing, but not how to spend it. Obviously, one is needed to do the other. Yet how and when to spend money is rarely discussed.

With my health scare, I started to think more about the here and now. The overseas holiday that I'd like to do may be more difficult in 10-20 years' time.

I've even given thought to purchasing silly consumer items I'd like to have. I've always loved watches yet have held off buying one for years because I wanted to save the money rather than spend it. Now, I'm willing to splurge, albeit on one that's not flashy or expensive.

This switch in thinking reminds me of the book that I once reviewed in Firstlinks called [Die with Zero](#). While the book overstates its point, a better balance between saving and spending makes more sense to me now.

James Gruber is Editor at Firstlinks.

New strategies to fix the housing crisis

Bob Birrell, David McCloskey

When Labor came to power in May 2022, housing prices in Sydney and Melbourne were already higher than in almost all other developed world cities. Since May 2022, the crisis has deepened as dwelling and rental prices have continued to rise, along with interest rates, thus generating a serious rental crisis and a slide in the affordability of detached houses, especially in Sydney and Melbourne.

Though much less of a focus for Governments than the rental crisis, the first homeowner affordability crisis is nonetheless of huge significance. For younger households wanting family friendly housing and to get a foot on the property ownership ladder, their inability to do so is a catastrophe.

By 2021, the share of households in Sydney headed by a 30-39-year-old who were renting had reached 53%, and 37% for 40-49-year-old household heads. (Note that census data also refers to household heads as reference persons.)

Tenure patterns 2011 and 2021 by age of head of household for Greater Sydney, Greater Melbourne and the remainder of Australia							
Age of household head	Tenure Type	Greater Sydney		Greater Melbourne		Remainder Australia	
		2011	2021	2011	2021	2011	2021
20-29 years	Owned	6%	5%	6%	5%	5%	5%
	Buying	29%	19%	30%	24%	33%	31%
	Rent	65%	76%	64%	70%	62%	64%
30-39 years	Owned	7%	5%	8%	6%	7%	6%
	Buying	48%	42%	54%	51%	53%	52%
	Rent	44%	52%	38%	43%	40%	42%
40-49 years	Owned	16%	11%	19%	13%	16%	13%
	Buying	53%	52%	57%	57%	54%	56%
	Rent	31%	37%	25%	30%	30%	31%
50-59 years	Owned	33%	26%	37%	30%	35%	28%
	Buying	43%	45%	45%	48%	43%	47%
	Rent	24%	29%	18%	23%	22%	25%
60+ years	Owned	70%	64%	75%	70%	72%	68%
	Buying	13%	16%	12%	16%	12%	15%
	Rent	17%	20%	12%	14%	16%	17%
Total	Owned	32%	29%	34%	31%	34%	34%
	Buying	36%	34%	38%	38%	36%	36%
	Rent	32%	37%	27%	31%	30%	30%

Tenure by age of head of household Source: ABS Table Builder 2021 Census dataset

Melbourne was trending in a similar direction, though from a lower base. The situation has worsened since 2021 as housing prices have continued to rise.

The result is that, for many of these households, home ownership is a receding dream. It is being replaced by continuing rental. Given how important home ownership is in retirement years, it implies a spectre of financial insecurity in this phase of life.

Federal and state governments have committed massive funds, especially to fix the rental crisis. Yet despite this commitment, building permit approvals for medium and high-density dwellings in Sydney and Melbourne were lower in 2023 than a decade ago. They continued to fall in 2024.

Housing approvals 2012-2023 Greater Sydney and Greater Melbourne				
Year	House approvals Greater Sydney	Other dwelling approvals Greater Sydney	House approvals Greater Melbourne	Other dwelling approvals Greater Melbourne
2012	9,240	19,233	18,764	22,834
2013	11,331	25,123	18,578	21,666
2014	14,057	27,235	22,394	27,637
2015	16,918	38,634	24,495	33,372
2016	17,800	40,772	26,559	31,598
2017	18,613	37,016	27,025	32,435
2018	18,533	28,926	27,957	26,862
2019	14,818	21,338	23,935	21,992
2020	15,863	20,016	26,655	22,423
2021	17,802	25,671	30,911	22,508
2022	15,305	21,436	24,485	24,342
2023	12,810	17,445	23,213	17,561

Annual building approvals for houses and other dwellings for Greater Sydney and Greater Melbourne 2002-2023 Source: 8731.0 Building Approvals, Australia – Number of dwelling units approved by Greater Capital City Statistical Area- ABS Feb 2024

How could this be?

The dominant explanation, held by governments, planners and most expert commentators is that current zoning laws and building approval procedures are restricting development. If they were loosened, so it is argued, much more medium density housing will result in middle suburban areas. Similarly, if constraints on high rise apartment buildings are eased, many more of these projects will start.

According to this dominant perspective, both resident and new migrant demand can be satisfied, notwithstanding the huge increase in the migrant influx in 2022 and 2023. Net overseas migration to Australia was 433,150 in 2022 and 547,267 in 2023. This compares with near 250,000 each year prior to the 2019-2020 pandemic (which was itself a steep increase from the long-term average from 1950 to 2005 of 88,700)¹. Some 67.5% of this net influx reside in NSW and Victoria (which comprise 57% of Australia’s population), the great majority locating in Sydney and Melbourne.

However, irrespective of zoning laws and building approvals, the densifying strategy is not working. We show that in the current setting developers cannot make a profit from providing affordable rental accommodation, either from medium density projects in the middle suburbs (the ‘missing middle’) or from high-rise inner-city apartment projects. In the case of the ‘missing middle’, developers can’t build such units or town houses because of escalating site costs, mainly due to the high price of the land on which they have to be built.

Site costs continued to escalate because of competition for detached housing not just from aspiring first homeowners. The escalation is also from a large cohort of financially strong upgraders who are switching houses in pursuit of the tax-free capital gains flowing from the price escalation of higher end houses. Investors, too, are adding to the demand. In addition, there is a lagged demand for the purchase of detached housing from earlier arrived migrants. This latter source is very important but has not been recognized in the housing literature.

This competition is occurring at a time when just over half the detached housing stock in Sydney and Melbourne is held by household heads aged 50+. A remarkably small share of these households is exiting or downsizing, thus gumming up the supply of established houses.

Share of detached houses occupied by age of head of household			
Region	Age of head of household	Count	Percent
Greater Sydney	20-29 years	54,105	5%
	30-39 years	164,468	16%
	40-49 years	220,213	22%
	50-59 years	217,487	21%
	60+ years	363,021	36%
Greater Melbourne	20-29 years	79,835	7%
	30-39 years	229,058	19%
	40-49 years	255,775	21%
	50-59 years	243,589	20%
	60+ years	398,086	33%
Rest of Australia	20-29 years	368,970	8%
	30-39 years	754,222	17%
	40-49 years	835,843	19%
	50-59 years	864,908	19%
	60+ years	1,644,413	37%

Share of detached dwellings occupied by age of head of household Source: Census of Population and Housing, 2021, Table Builder

In the case of high-rise apartments, developers cannot make a profit unless they target the high end of the apartment market.

What to do?

The key goal must be to restore the housing market to equilibrium. The factors contributing to the current crisis have been building up over many years. Therefore, resolving the crisis will take time, and will need investments and policies. These will transform the housing industry from small scale operators to larger companies that can operate with scale and improve productivity and leverage advanced manufacturing techniques to allow more pre-fabrication.

Solving the crisis will also need an adjustment to the current reliance on interest rates in managing inflation pressures.

We also need to lift the level of thinking on our understanding of how people choose and use housing, in particular, understanding the typical flows that occur through different types of housing stock at different life stages. When a housing market is in equilibrium this can help planners to identify 'stuck' market sectors and to shape policies to improve normal flow.

In the short term, the only realistic strategy likely to soften the rental crisis is a slowdown in the immigration influx. This is because recently arrived migrants are the main source of new rental demand in both Sydney and Melbourne.

Other dwelling approval counts, average cost, established other dwelling transfer prices and counts in SA4 areas of Melbourne 2021					
SA4 Areas of Greater Melbourne	Median price established house transfers (\$)	Private sector approvals dwellings excluding houses (no.)	Avg build cost for other	Median price established other transfers (\$)	No. established other transfers
Melbourne – West	630,000	3,526	285,309	530,000	3,898
North West	660,000	1,027	290,166	549,000	1,993
South East	687,000	1,911	304,553	588,400	5,475
North East	750,000	1,827	262,726	630,000	3,385
Outer East	860,000	1,157	315,471	643,000	3,154
Mornington Peninsula	835,000	474	367,089	565,000	2,102
Inner East	1,705,000	2,301	469,361	735,000	3,945
Inner South	1,646,000	2,839	463,191	739,000	5,370
Melbourne – Inner	1,500,000	4,091	440,968	610,000	13,980

Detached dwelling and other dwelling approvals, transfers and build costs in 2021 Greater Melbourne Source: ABS Data Explorer Regional Statistics

Some industry and government sources argue that any such curb would be counter-productive because migrant tradies are needed to build the extra dwellings. We show that this belief is wrong. Few migrant tradies are currently being visaed. This will not change because Australia's construction trade qualification system will not allow it. The focus must be on domestic training.

Slowing immigration, at least in the short term, will not solve the first homeowner crisis. Relatively few recently arrived migrants have the resources to compete in the detached housing markets of Sydney and Melbourne. However, they can and do compete successfully a decade or so after arrival. We show that those arriving before 2016 are currently the biggest source of demand in these markets and they dominate the ranks of buyers in the fringe suburbs of Melbourne.

Number of new rentals or property purchases between 2016 and 2021 per 100 population in migrant and Australian born cohorts				
	Greater Sydney		Greater Melbourne	
	Rent	Buying	Rent	Buying
1st 5 years in Australia (arrive 2016-2021)	24.54	4.52	22.35	6.64
5-10 years in Australia (arrive 2011-2015)	18.68	9.82	14.75	12.22
10-15 years in Australia (arrive 2006-2010)	13.87	12.65	10.38	15.56
15-20 years in Australia (arrive 2001-2005)	11.59	10.78	9.64	12.51
Arrived > 20 years ago (before 2001)	6.96	6.96	5.36	7.63
Australian born	8.07	6.05	7.88	7.36

Number of new rental or property purchases 2016-2021 per 100 population in Australian born and migrant groups

Source: ABS Tablebuilder Census of Population and Housing Place of Enumeration 2021

Greater Sydney approvals, transfers and build costs for houses in 2021				
SA4 Areas of Greater Sydney	Private sector house approvals (no.)	Avg build cost for separate house (\$)	Median price of established house transfers (\$)	Number of established house transfers (no.)
South West	3,775	309,934	775,000	6,476
Blacktown	3,500	290,000	820,000	6,333
Baulkham Hills and Hawkesbury	2,280	450,000	1,330,000	4,748
Outer South West	2,096	347,328	717,000	5,033
Outer West and Blue Mountains	1,032	415,698	750,000	5,332
Inner South West	1,024	458,008	1,240,000	5,014
Parramatta	863	409,038	1,090,000	3,752
North Sydney and Hornsby	497	1,732,394	2,500,000	4,174
Northern Beaches	438	1,319,635	2,310,500	3,016
Ryde	343	720,117	1,950,000	1,723
Sutherland	314	863,057	1,420,000	2,732
Inner West	307	1,182,410	2,000,000	2,459
Eastern Suburbs	139	3,438,849	3,120,000	2,197
City and Inner South	105	1,676,190	1,685,000	1,959

Greater Sydney detached dwelling approvals, average build cost and count and value of established house transfers in 2021 Source: ABS Data Explorer Regional Statistics

Greater Melbourne approvals, transfers and build costs for houses in 2021				
SA4 Areas of Greater Melbourne	Private sector house approvals (no.)	Avg build cost for separate house	Median price established house transfers (\$)	No. established house transfers
Melbourne – West	12,287	303,329	630,000	11,112
North West	4,330	327,945	660,000	5,655
South East	6,130	346,819	687,000	10,814
North East	3,882	362,442	750,000	5,980
Outer East	1,143	599,300	860,000	5,683
Mornington Peninsula	915	838,251	835,000	6,059
Inner East	655	1,235,115	1,705,000	3,562
Inner South	586	1,445,392	1,646,000	3,962
Melbourne – Inner	333	2,726,727	1,500,000	3,228

Greater Melbourne detached dwelling approvals, average build cost and count and value of established house transfers in 2021 Source: ABS Data Explorer Regional Statistics

Even if migration stops, the impact of this lagged demand will be felt for years. The huge wedge of migrants locating over the years 2022, 2023 (and probably 2024) will give an unprecedented push to this demand.

The only realistic medium-term option that can significantly provide for this need is to open up the respective city fringes for detached housing. This can be delivered at a fraction of the cost of medium and high-density housing in the middle and inner suburbs of Sydney and Melbourne. It is not being utilized because of deliberate policy decisions by the Victorian and New South Wales Government to restrict outer suburban expansion.

Though fringe developers, needless to say, agree with this stance, they face almost uniform opposition from State Governments, housing experts and commentators. One exception is Alan Kohler who, in his recent Quarterly Essay, reached the same conclusion as we do, if by a slightly different route.²

Therefore, the strategies to fix the housing crisis need to cover all the levers that can be applied – opening the fringe, new industry policy, reducing migration levels, improved workforce training, changes to monetary policy, new transport links, innovation in construction techniques and adoption of advanced manufacturing methods – all these factors have a role to play in restoring our housing system to equilibrium.

Recommendations

At the outset, we highlighted the likelihood of the housing crisis both worsening and also lasting longer when policy makers take a narrow lens to the problem. It will also worsen when recommendations are made based on an incomplete and inadequate understanding of the housing market.

To build a sound evidence base for proposed policy initiatives the first step is to build an understanding of the current situation. This requires thinking about housing as a system with interconnected parts, and to develop nuanced thinking. For example, buyers are not a single group – the options available to buyers, the preferred type of housing and location vary across first home buyers, upgraders, re-locaters and downsizers.

The second step is to work out, at a system level, what we want our future to look like. The system in focus here needs to be the overall dynamics of the housing market, not specific arbitrary benchmarks. We suggest a goal for the future of the housing market in Australia is a system that is close to equilibrium, with home prices rising each year, but below inflation. This would slowly improve housing affordability and avoid the economic calamity that would arise from a severe collapse in home prices.

The third step is to put forward hypotheses as to how we can move towards our broad goal. We believe that initiatives must address issues of both demand (across all market segments) and supply (including workforce, productivity improvements and capacity), as well as macro-economic policy settings and regulatory settings.

We have prepared a number of recommendations to tackle the crisis gripping Melbourne and Sydney, which can help restore housing affordability and equilibrium to the housing market.

Recommendation 1 – Stop adding fuel to the fire.

We have highlighted the long-term nature of the problems of housing affordability, including the fact that the majority of housing demand over the next 10-15 years is already locked in through the lag effect of migration.

Actions are required now to give the housing system a chance to return to equilibrium in the future. This means that net overseas migration (NOM) must be reduced very significantly. While it will take around 10 years for the impact of recent levels of high migration to wash through the system, significantly lower levels of NOM will reduce short term pressure on rental markets and allow the housing market to reach equilibrium in the longer term.

Recommendation 2 – Recognise the impact of the migration lag effect and fast track urban fringe development.

The scale of the housing crisis is such that 'the least worst' option to improve supply of affordable house and land options is to allow increased urban development on the city fringe.

It is important to recognise that a significant component of the response to the housing shortages that followed the return of servicemen after WW2 and high levels of European migration was relatively unrestricted development on the city fringe.

There is a need for State governments to commit to increased investment in infrastructure in the fringe. The goal should be that 50% or more of new builds will take place on the fringe, until we approach equilibrium in the housing market.

Fringe development is not ideal, however not doing this now will make the housing crisis worse for many years longer.

This will require ditching the dominant 'up not out' policies of the NSW and Victorian Governments. It must include opening up the precinct planning system so that new developments can proceed much quicker than is presently the case. Also, there will have to be a commitment to increased government investment in infrastructure in the fringe.

Recommendation 3 – Increase the capacity of the non-unionised builders to construct multiple medium density developments simultaneously

Recognising the small builder is typically the most productive provider of housing (producing housing at substantially lower cost than large builders with unionised workforces), they need to be supported with improved access to capital to fund multiple jobs simultaneously to accelerate the number of dwelling units that can be completed each year.

Recommendation 4 – Explore the opportunities to increase productivity in the sector through investment in advanced manufacturing that can prefabricate modules, reducing the need for skilled labour on building sites.

Government R&D funding and programs can focus on technology to reduce time, cost and material wastage in construction. This funding can not only improve housing outcomes but also develop expertise that can be sold around the world.

Recommendation 5 – Reduce the transaction costs and increase local downsize options for empty nesters to make the choice to downsize from a detached dwelling to a townhouse or other medium density development across middle ring suburbs.

Importantly, this means a decentralised approach for encouraging town house and low-rise flats and apartments, rather than clustering them into specific precincts that suit planners but not the prospective buyers.

Recommendation 6 – Improve transport links between the capital cities and major regional cities so that upgraders have an extended choice of areas in which to purchase, reducing asset inflation pressures on high amenity detached dwelling stock.

Recommendation 7 – Reduce reliance on the blunt instrument of interest rate management to control inflation.

Give the Reserve Bank the power to vary the GST rate within a pre-set range. This will allow both interest rates and GST to be used as tools to manage the levels of economic activity and spread the impact of these controls across the community, rather than hitting home buyers only. With less distortion of the capital market the costs for developers in building new homes is reduced.

¹ Calculated from Table 3 in J. Phillipa and J. Simon Davies, Migration: A Quick Guide to the Statistics, Parliament of Australia, January 2017

² Alan Kohler, The Great Divide, Quarterly Essay No. 92

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CBA could drag down the ASX 200 in coming years

Ashley Owen

CBA has been in the headlines of late for a few reasons – for re-taking the lead from BHP to be the largest ASX-listed company by market value, for being the most over-priced bank in the world, and also for having the most mysterious share price surge this year.

My main interest in CBA (aside from being a former shareholder), is that it will probably be a significant drag on the overall Australian share market in coming years. This is critical when deciding asset allocation in diversified long-term portfolios.

Even if investors, advisors, and portfolio managers have no interest in stock picking or stock valuation, they need to take a view on CBA, given its heavy weighting in the local share market, and its impact on overall portfolio returns.

Unfortunately, all good things come to an end

This is not a bold new call from me – the turning point was in 2015, nearly a decade ago. (I am no longer a CBA shareholder). CBA and the rest of the 'big-4' retail banks peaked in 2015, and their underlying fundamentals have deteriorated significantly since then.

CBA's share price may have soared, but the underlying business has stalled.

My worry is that people who benefited from CBA's past growth are now expecting it to continue the same upward trajectory and generate the same great returns in the future. Many are hanging on to CBA in the hope that its dividends will continue to form the core of their retirement incomes.

My fear is they will be disappointed. Rather than lead the overall market, as it did up until 2015, CBA is likely to lag the market in future.

Quick background – CBA: the 'Steven Bradbury' of the big-4 retail banks

CBA was one of the great stars of the 1990s government privatisation program, which was a key part of the productivity-boosting Hawke/Keating reforms of the 1980s and early 1990s. (Just don't mention that to Smiling Jim Charmer as he desperately tries to drag Australia back to the dark ages of the pre-reform era!)

CBA was a sleepy government department when it was sold off and floated in 1991. It was the least favoured and second smallest of the 'big-4' banks, but it is now by far the largest of the banks in terms of market value, profits and dividends.

How did this happen? Essentially, because the other three big banks did their best to blow themselves up!

CBA is thus the 'Steven Bradbury' of Australia's big banks. It has done nothing spectacular - it just kept a steady, somewhat boring course (aside from the Hayne revelations of institutionalised greed that drove a dizzying array of unsavoury and unethical activities), but the others did a lot worse and tripped over themselves.

After bank deregulation in the mid-1980s, the two most aggressive business lenders - Westpac and ANZ - went mad in a wild lending spree and suffered huge, near-existential losses in the early 1990s 'recession we had to have' and have never fully recovered. NAB, which sensibly (or luckily) was asleep during the 1980s lending frenzy, leapfrogged into the lead.

But then NAB also went mad in the 1990s and 2000s and blew its lead thanks to a string of costly own goals, mainly with its disastrous overseas adventures. As NAB fell by the wayside, CBA overtook it to become the largest and most profitable of Australia's big-4 retail banks.

For a run-down on the recent history of the big banks, see [Which Bank? is winning the Battle of the Banks?](#)

Share price has run well head of dividends or profits

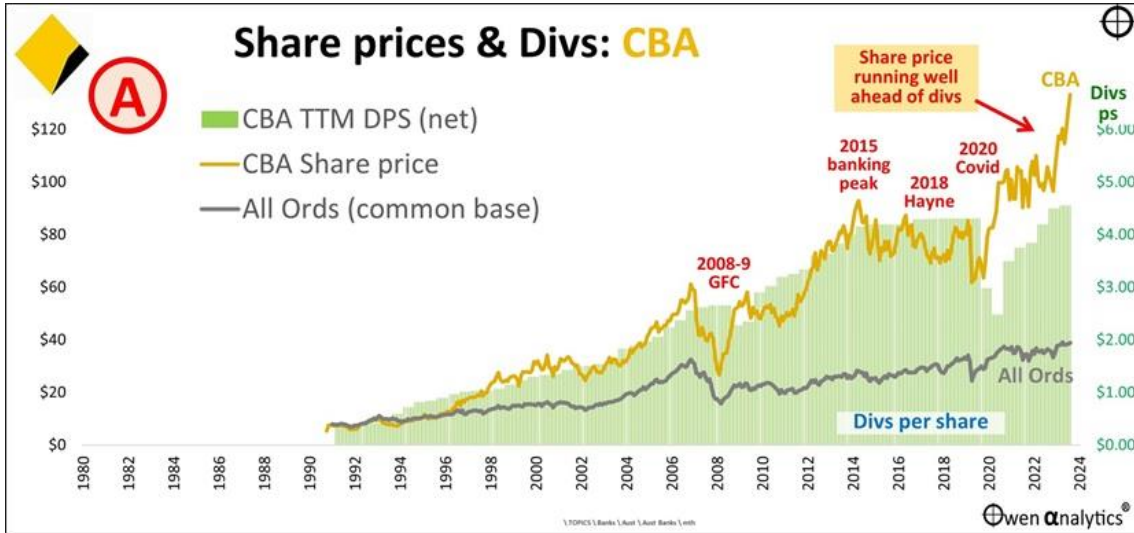
In terms of share price gains, CBA has been a star in recent years. Its share price had been stuck at around \$80 pre-Covid, then fell below \$60 in the 2020 Covid lockdown recession sell-off, but more than doubled to \$130 by mid-2024.

Why? It's a mystery to me and most analysts. One theory is that much of the buying has come from global institutions selling out of China but having to retain exposure to Asia-Pacific. Australia is a 'safe haven' in Asia, but they wanted to avoid the big miners because of their exposure to China, so they went for the banks instead. A related theory is that passive index funds have been forced to buy CBA due to its sheer weight in the index, forcing it up even further.

Either way, CBA's share price has run up well ahead of fundamentals. This is the focus of today's story.

Chart A – share prices -v- dividends

This chart shows CBA's share price (yellow) since the 1991 float, thoroughly beating the market benchmark 'All Ordinaries index' (grey line).



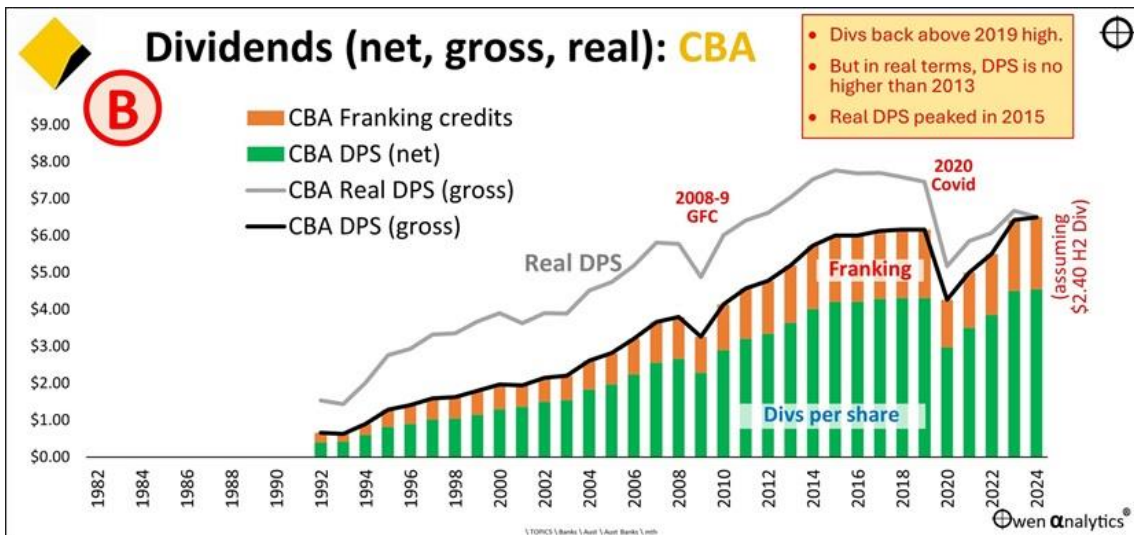
The problem is that the share price has run well ahead of cash dividends (green bars). Dividends were cut in Covid and have only just rebounded to 2015 levels, but the share price has doubled. ('TTM' means 'trailing twelve months').

This means buyers are now paying two times per dollar of dividends than they were a decade ago.

Chart B - Dividends, franking, and real dividends

In the next chart, the green bars represent cash dividends per share each year (same as Chart A), but here we also show franking credits attached to the dividends (orange bars). Adding the two together, we arrive at the 'grossed-up' dividends per share (black line) for tax-free investors (eg Australian pension funds, charities, but notably not foreign shareholders).

The grey line shows the 'grossed-up' dividends in real terms (after CPI inflation).



This grey line highlights the problem. Real dividends per share peaked in 2015 and are still well **below** those levels a decade later.

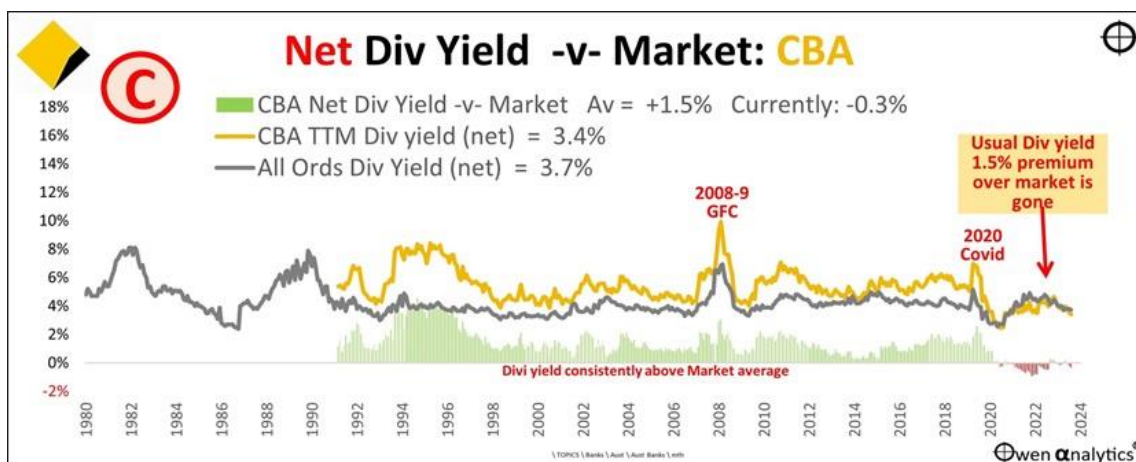
Dividends per share in nominal (pre-inflation) terms are at least back above their 2019 pre-Covid high. But in real terms after inflation, dividends per shares are no higher now than they were in 2013 - that's more than a decade of no real growth in dividends.

Chart C - Pricing – expensive relative to dividends (dividend yields)

So, the pricing of CBA shares relative to dividends is now unusually expensive.

Chart C below shows CBA’s net (cash) dividend yield (yellow) compared to the cash dividend yield for the overall ASX market (grey line).

CBA’s dividend yield has always been around 1.5% **above** the dividend yield of the overall market. The reason for this traditional dividend yield premium is the fact that CBA (and the other big retail banks) are low-growth, mature giants with little room to grow, and they are highly cyclical, with extremely high leverage. (CBA is currently geared 17:1, or in home lending terms, has a ‘Loan-to-Value’ ratio of 94%).

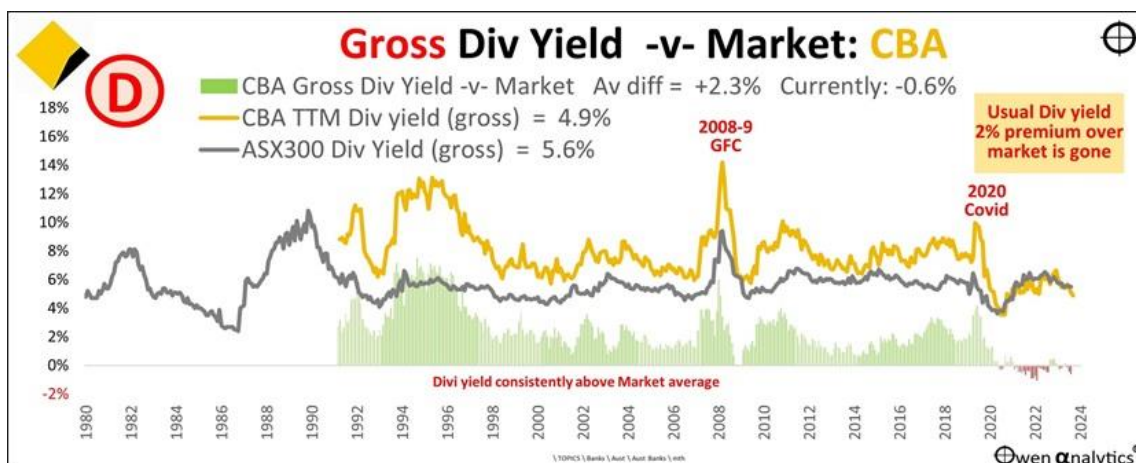


The green bars running along the bottom show the dividend yield premium to the overall ASX market (ie CBA div yield less overall market div yield). This is normal for all large banks in all markets around the world.

However, this traditional dividend yield premium to the overall market (positive green bars) is gone. In fact, for most of the past three years CBA has traded at a **lower** dividend yield than the market (ie the positive green bars have been running at negative red bars).

Chart D - Pricing – expensive on grossed-up dividend yields

Chart D is the same as C except it is based on grossed-up dividend yields (including franking credits).



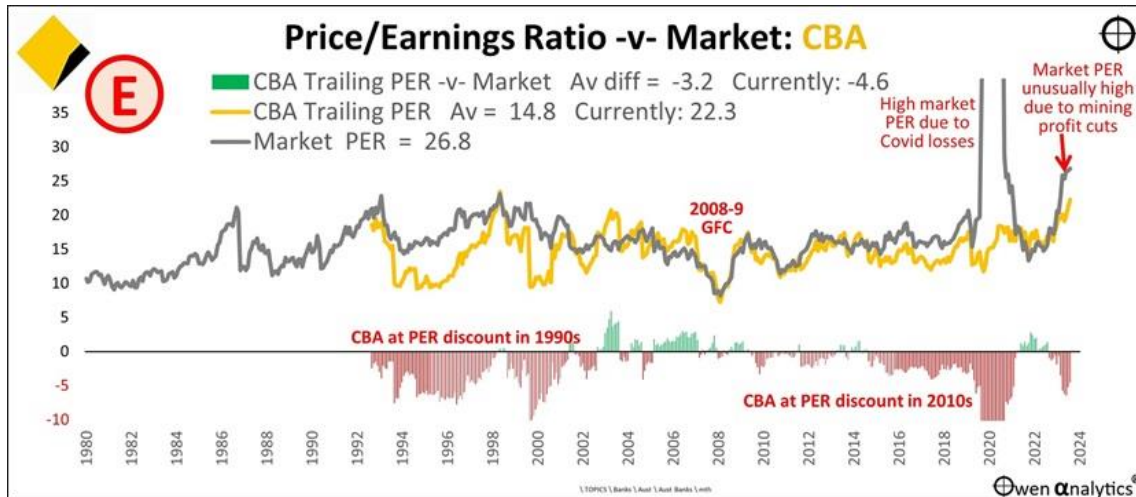
The traditional grossed-up yield premium of +2.4% pa **above** the overall market is also now negative (negative red bars instead of positive green bars) in recent years.

Chart E - Pricing – expensive relative to profits (price/earnings ratios)

Here we show CBA’s share price relative to profits (‘price/earnings ratio’) – ie how much are buyers paying per dollar of profits.

CBA’s p/e ratio (yellow line) has traditionally been **lower** than the overall market p/e (grey line) – again because CBA is a highly cyclical, highly geared, mature, low-growth giant. This is normal for all large banks in all markets around the world.

The negative red bars at the bottom (CBA p/e less overall market p/e) indicate CBA’s traditionally lower p/e for most of the past three decades as a listed company.



To the right we see CBA’s current price/earnings ratio has now shot up to a very high 22 times earnings – ie buyers are paying \$22 per \$1 of profit. Ordinarily it would make no logical sense to pay any more than around \$15 per \$1 of profit for a low-growth, mature big bank like CBA.

On the chart we see that this high current p/e of 22 for CBA is actually still lower than the overall market p/e ratio of 26 times earnings, but that is unusually high at the moment because of last year’s disappearance of much of the windfall post-covid iron ore profits from BHP, RIO, and FMG. The market p/e is high because the market is expecting these windfall iron ore profits will suddenly re-appear. (That is by no means certain).

You can’t look at CBA’s very high p/e of 22 and say: “That is ok because it is still lower than the market p/e of 26!”

The fact that the market p/e is temporarily high because of the temporary ups and downs of windfall iron ore profits has nothing at all to do with CBA.

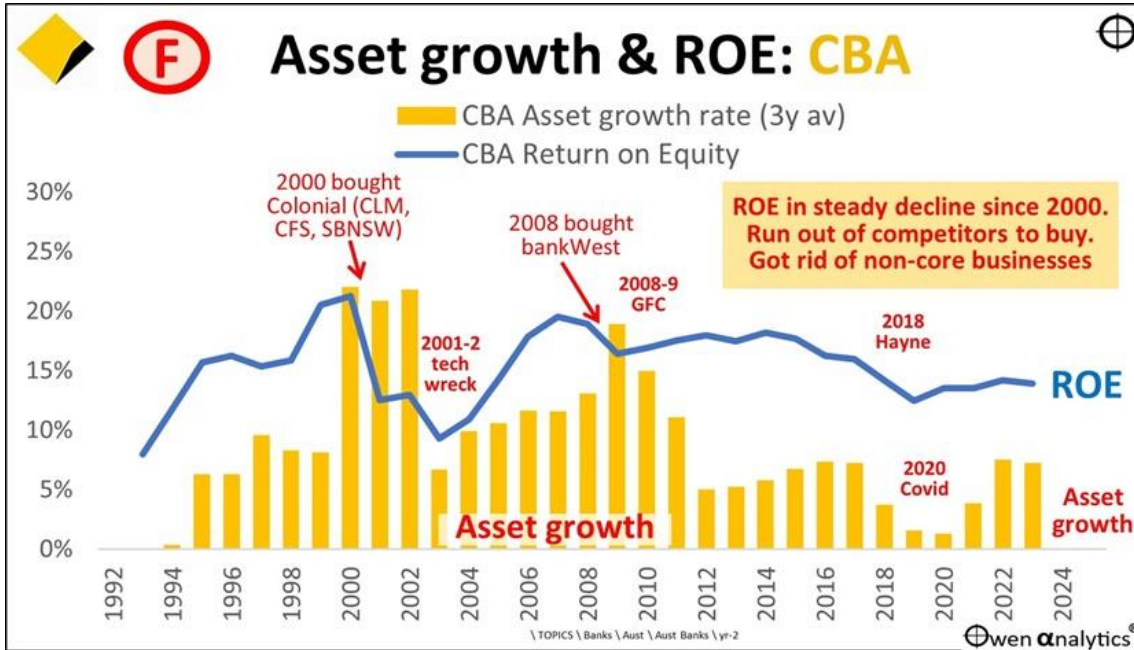
We should ignore the completely unrelated iron ore/China story and ask instead: why are buyers suddenly paying \$22 per \$1 of CBAs profit?

Over the past year, CBA has suddenly been fundamentally re-rated by the market – either it has suddenly become a ‘growth stock’, or it has suddenly become less risky.

Neither is the case. It is still just a bloated building society confined to property lending in Australia, it is still highly geared, and highly exposed to the highly-geared Australian property market.

Chart F - Declining growth + declining returns on equity

Here's the twin problem. CBA is the **opposite** of a growth stock:

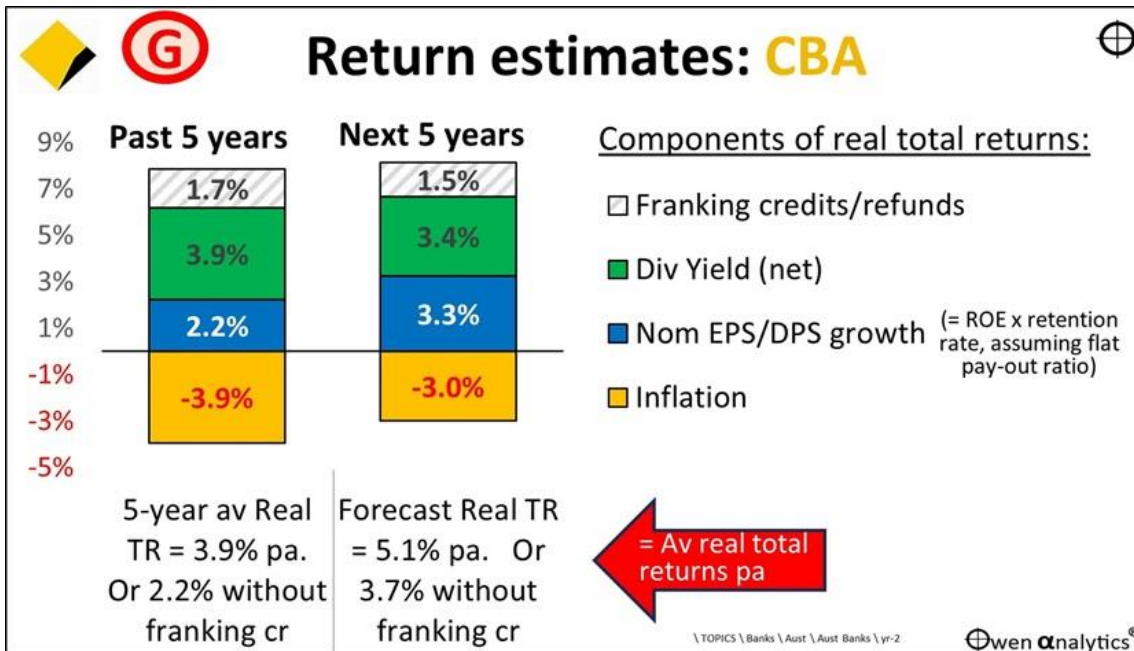


Returns on equity (blue line) have been declining for the past 25 years. ROE peaked at more than 20% in 2000 but is down to a rather ordinary 13-14% pa in recent years.

Asset growth rates (yellow bars) have also been declining for the past 25 years. CBA has run out of things to buy, and has been forced to shed its non-core, conflicted, cross-selling businesses. Asset growth rates in recent years have barely kept pace with inflation.

Chart G - Outlook? – better than recent years, but the early glory days are over

This chart breaks down returns from CBA (based on underlying fundamentals) into its main components, for the past five years (left bars) and the likely future five years (right bars):



(For the purpose of this outlook, I ignore short-term impacts like recessions – where profits, dividends, and share prices would fall temporarily but then rebound, with little or no long-term damage).

This approach estimates real total returns at around 5% pa over the next five years. The components are:

- Current trailing cash dividend yield of 3.4%
- Plus franking credits of 1.5%
- Plus likely nominal earnings growth of around 3.3% pa
- Less likely CPI inflation of around 3.0% pa.
- = real total returns of around 5% pa **ignoring any share price reversion to fair pricing**

Or, excluding franking credits to zero-tax investors, a real total return of around 3.7% pa. That's very ordinary.

NB: This assumes that the current level of over-pricing can be maintained. If the share price falls back to more reasonable levels relative to profits and dividends, this would reduce total returns. For example, based on the very ordinary fundamentals, a 'fair price' would be well below \$100.

The key variable here for long term returns is likely future earnings growth. I assume that future sustainable ROE is going to be around 13% at best (the average in recent years). If CBA retains just 25% of its earnings (ie continues to pay out 75% in dividends), then that caps EPS growth to just 3.3% pa. That's barely above inflation.

And that doesn't allow for likely increases in regulatory and compliance costs, nor any increase in competition (future competition from the US big tech is the main threat here, not the other local banks).

The 'good news' from this chart – particularly for retirees who are relying on dividends rather than share prices - is that dividends per share may be able to at least keep pace with inflation – which is a lot better than the past decade when dividends lagged inflation (chart B).

What to do?

Potential buyers would need to ask – why pay \$22 (or anything above say around \$15) per dollar of profits for a low-growth, highly geared, highly cyclical, highly political, bloated building society, with rising compliance and regulatory costs, increasing competition on all fronts, and limited growth potential?

For existing shareholders, much would depend on their cost base and potential capital gains tax on sale.

Extreme concentration of risk factors

Australia has an extraordinarily broad and diverse economy and business landscape, but decisions about allocations to Australian shares in diversified portfolios come down to two very narrow factors that dominate the local share market - the current over-pricing and likely poor performance of the big banks (led by CBA), and iron ore profits.

Those two very narrow and specific questions dominate the fate of the overall local share market, and diversified fund returns.

Ashley Owen, CFA is Founder and Principal of [OwenAnalytics](#). Ashley is a well-known Australian market commentator with over 40 years' experience. This article is for general information purposes only and does not consider the circumstances of any individual. You can subscribe to OwenAnalytics Newsletter [here](#). Original article is here: [CBA in 7 charts – the 'Steven Bradbury' of Australian banking – now suddenly a 'growth stock'?](#)

Clime time: Do budget deficits create inflation?

John Abernethy

Macroeconomic analysis is extremely useful in explaining both the past and describing the present. Whilst its utility at forecasting the future is subject to debate – in my view it is a pointless one. That is because there can be no doubt that macro events constantly move markets. Simply reflect (if you need a recent example) upon how markets reacted to the announcement of Australia's June CPI – the share market lifted, bond yields fell and the AUD sank, all within minutes of the data release. Then when there were signs (a few days later) of the US economy slowing with poor industrial output and weak employment data - the equity market slumped, bond yields collapsed and the AUD rallied as the USD devalued on higher probabilities that the Federal Reserve will

cut cash rates in September. Macro events caused a liquidity rush towards assets regarded as low risk or defensive.

Whilst macro readings have an immediate effect on daily prices of assets, these prices are driven by sentiment shifts that are magnified in large part by traders and hedge funds. Long-term investors reflect on macro-observations to reconsider their acquisition (accumulation) price of assets or adjust their thoughts for asset allocation. Traders jump in, trying either to front run the trend or to stimulate short-term price movements for their advantage. They seldom have a thoughtful macro approach and are increasingly matching wits with computer-driven trading programs. The result is short-term price volatility that often reflects little of longer-term consequence and are the result of a programmed thought process – human into computer, and reflects noise rather than analysis.

The importance of both macro analysis and macro thought is not necessarily about forecasting the actual economic numbers. Rather, it is about connecting the projected economic outcomes with a considered view about how the new information might influence one's expectations of returns from the various investment asset classes.

Invariably, the world economy grows each year and global recessions are rare – over the last 40 years there have been just two – the GFC and the Covid pandemic. Therefore, almost invariably, long-term investment returns result from staying invested and from compounding returns.

Economic dogma is everywhere

To undertake macro analysis requires more than a dogmatic approach to economic theory. However, much economic analysis has become overwhelmed with economic group think driven by Central Bank speak. For example, quantitative easing (QE) was widely adopted as the major monetary policy tool that dominated economic management following the GFC – but which Central Bank openly admits to it or explains its precise processes and objectives?

This introduction brings me to discuss the topic featured in my headline – “Do budget deficits create inflation?”

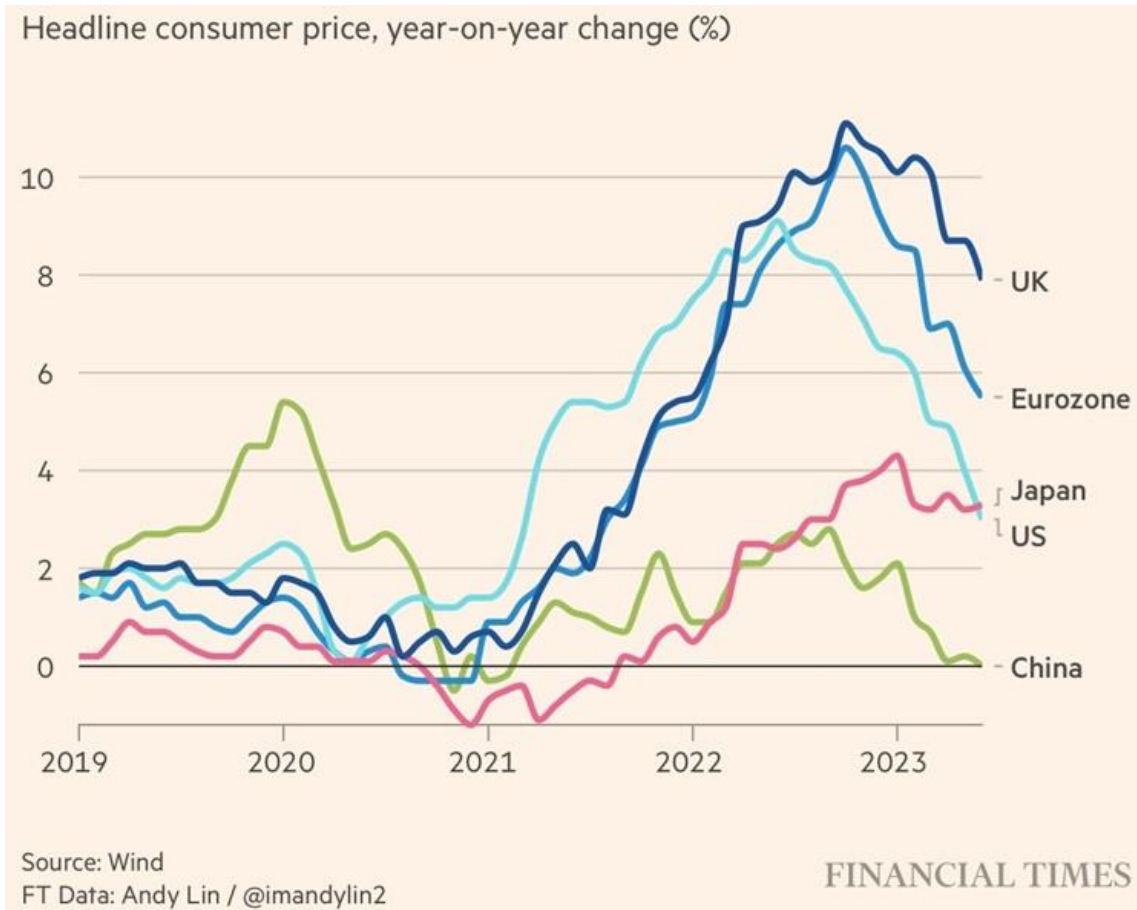
They can and have, but they don't always. At present in Australia, I would argue that an extremely focused inflation-fighting budget (substantial attacks on both the cost of living and of doing business) would see a budget deficit that would drive down inflation and interest rates. Breaking an inflation cycle can be undertaken by aggressive fiscal policy. Importantly, it would be a fiscal policy (i.e. a deficit) that is highly consistent with fiscal policies around the world.

It does not take too many observations of major economies and their fiscal outcomes to show that fiscal deficits did not create inflation following the GFC. More pointedly, specific observations of Japanese fiscal outcomes (massive fiscal deficits) since 2000 did not lead to runaway inflation.

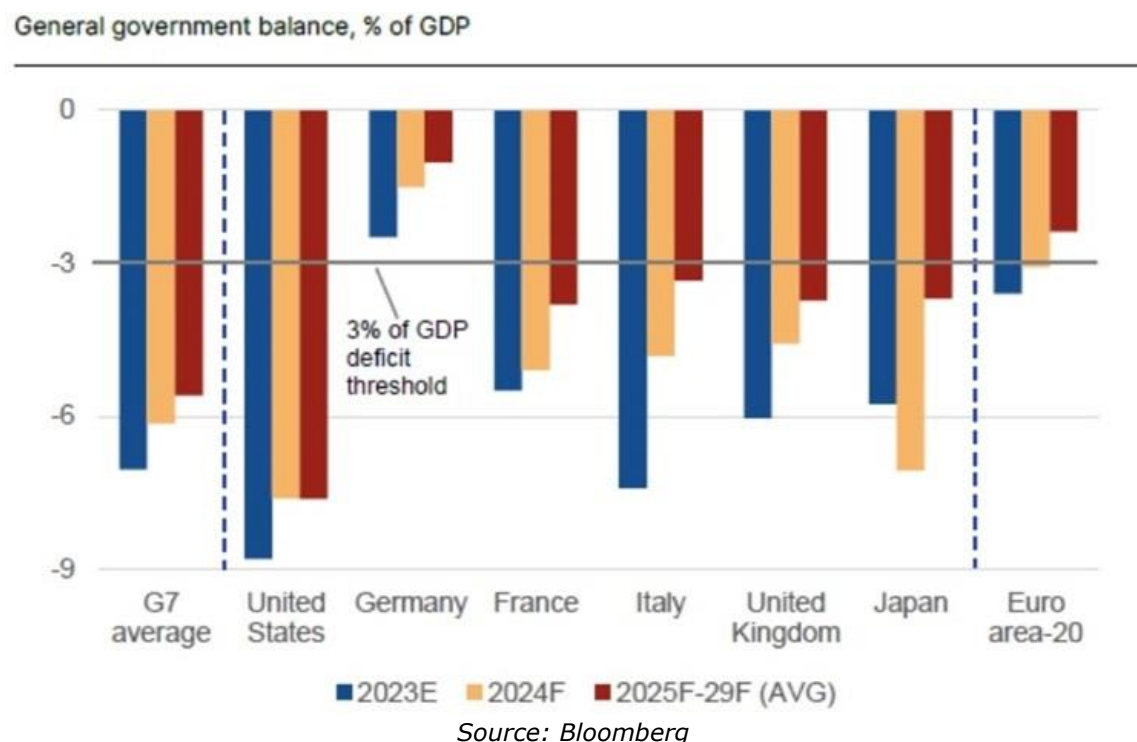
So why is there a chorus of claims by so many economists, commentators, and politicians that the government needs to reign in its expenditure or run a budget surplus to fight inflation? Why is there a dogmatic belief that a budget deficit will add to inflationary pressures? Why is there little analysis of government deficits to differentiate between those that attack inflation outcomes as opposed to those that add to them?

Before touching on Australia's fiscal outlook and inflation, let's look at world inflation at present and investigate the history of US and Japanese budgets, their debt blowouts and inflation outcomes.

First, inflation across the world's major economies has peaked. It was clearly stoked by the consequences of Covid and the Ukraine war. Indeed, inflation surged in 2022 to exceptional levels reminiscent of the 1970s when an oil price shock created 'cost inflation' across the world.

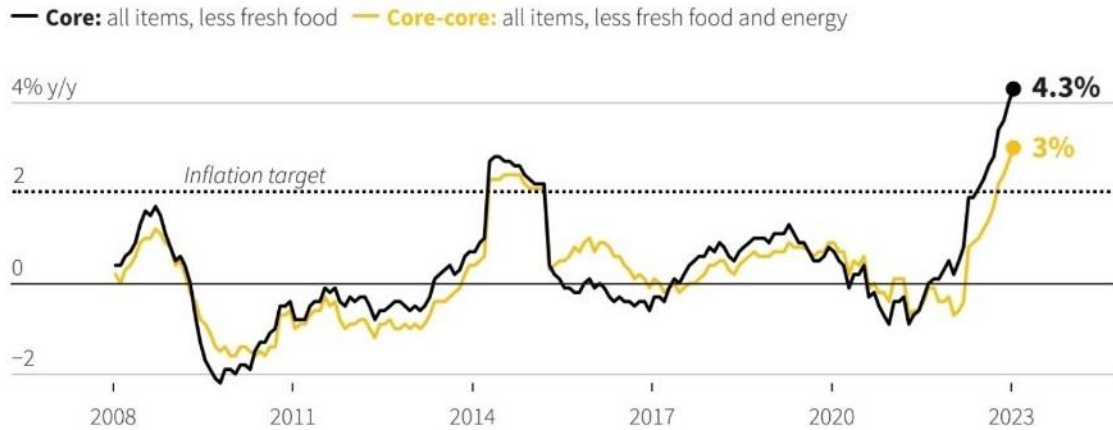


Further, the inflation surge had nothing to do with the budget outcomes or policies of major economies. Whilst all major economies are suffering large fiscal deficits, those deficits were in existence prior to Covid – but just at lower levels compared to GDP.



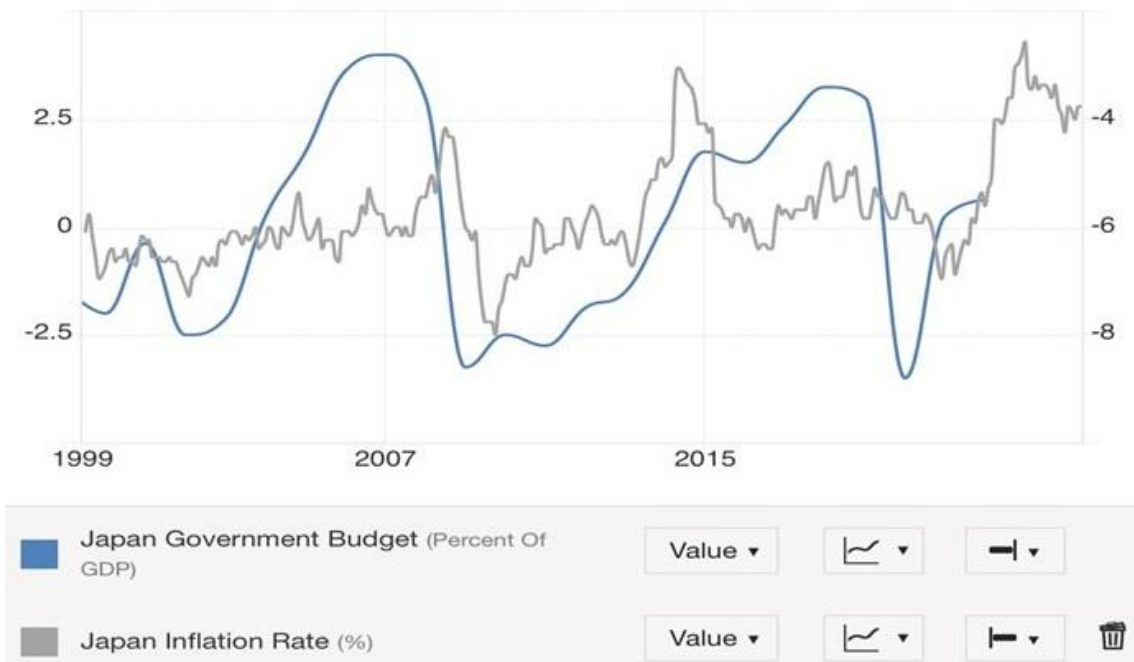
The following chart from Trading Economics compares the Japanese budget outcomes to inflation outcomes over the last 25 years. Fiscal deficits since the GFC have rarely been less than 4% of GDP and surged to 10% in

Covid. Meanwhile, inflation readings have hovered around zero, with a mild outbreak in 2015 and a more recent surge following Covid.

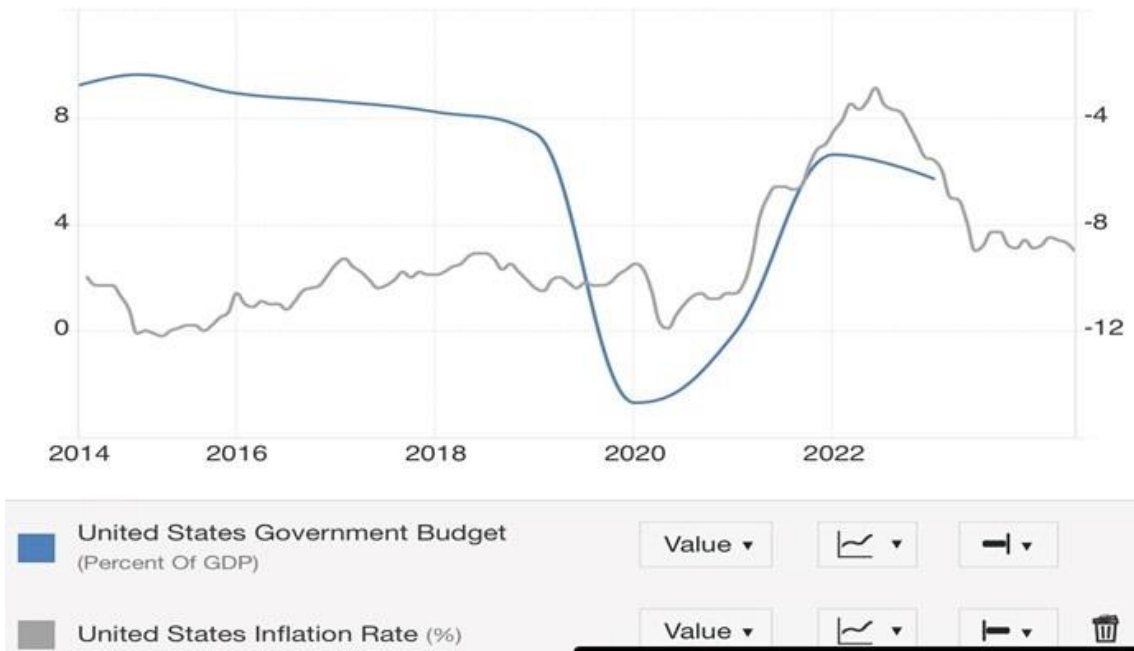


Source: Refinitiv Datastream | Reuters, Jan. 27, 2023 | By Pasit Kongkunakornkul
Reuters Graphics

There is no discernible correlation between Japan’s large budget deficits and inflation. Indeed, the opposite is true. On reflection, one could argue that the maintenance of extremely low interest rates (sometimes negative) added to dis-inflation in Japan. There is too little reflection by economists on the role of the cost of money (credit) on the cost of living or the cost of doing business.



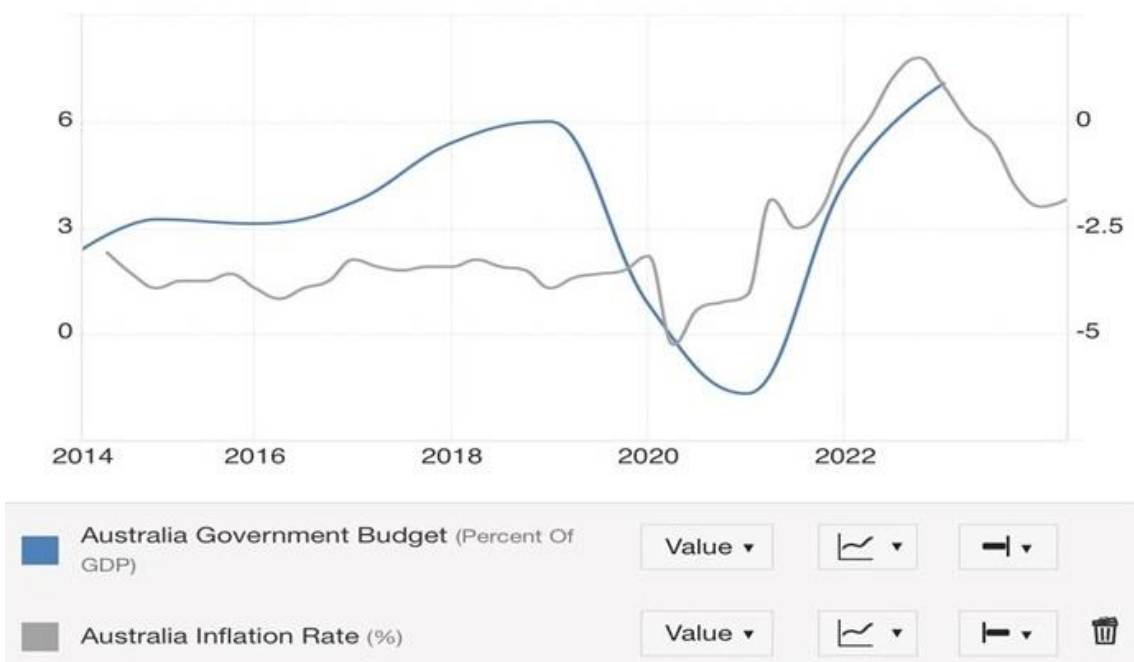
The next chart covers US fiscal and inflation outcomes over the last ten years.



It is worth remembering that the US government has only achieved 2 fiscal surpluses over the last 50 years. More recently from 2014 to 2019, the deficit sat around 4% of GDP and inflation hovered between negligible and 2%.

Simply stated, fiscal deficits did not result in an inflation surge in the US in the period from the GFC to Covid. However, a surging fiscal deficit created by 2 unforeseeable events (Covid and Ukraine), with its far-flung range of global economic and financial consequences (e.g. supply-line disruptions, shortages of goods, labour market upheavals, power price spikes, working from home, etc) resulted in but did not create inflation from 2022 to 2024.

In Australia, observations of fiscal deficits (2014 to 2020) show no correlation with inflation. Whilst commentators point to a surge in fiscal deficits during Covid (7% of GDP) that pre-empted an inflation surge coming out of Covid, that is not indicative of any economic connection. The inflation flowed from supply dislocation, recovering demand and energy price surges. The deficit directly flowed from Covid.



What does this mean for investors?

My suggestion is that whilst investors should note reality, acknowledge Central Bank manipulation, and watch the daily trading noise, they should ignore much of the economic commentary, especially that which originates from traders or proffered by politicians.

There is too little commentary that is focused on the core of investing – understanding the calculation of the risk-free rate of return and how it is or should be calculated?

Bond yields are a fundamental case in point. What is the common explanation for Australia's 'AAA-rated' ten-year bonds yielding 0.7% higher than 'BBB-rated' Greek bonds? The answer lies in the QE policy of the European Central Bank. It is the result of monetary manipulation and Australia's dogmatic approach to economic management.

Why is this important?

It explains why bond yields have increasingly decoupled from inflation readings. Also, that the normal measure of risk-free return is less emphatic than it was prior to the turn of this century.

That is not a judgement as to whether this development is good or bad, but rather that it exists and should be acknowledged.

To me this means the following for macroeconomic outcomes for the rest of this decade:

1. Government deficits (US, European and Japan) will not be reined in;
2. Government debt (US, European and Japan) will remain at high levels;
3. Interest rate settings will be driven lower (by Central Banks) to reduce government debt servicing costs;
4. QE will therefore return in waves as Central Banks are forced to deal with government debt through manipulating bond markets;
5. Government bonds remain low returning asset classes and will struggle to match inflation;
6. Economic downturns in major economies (ex-China and India) will be mild and so will economic upturns – think Japan over the last 20 years.

Importantly, it suggests a return to economic management policies that dominated prior to Covid. That in turn drives the tailwinds of 'asset inflation' rather than 'consumer price inflation'.

As for Australia, I have a strong view that continued asset price inflation will mean that the housing crisis will soon overwhelm economic focus and require a complete reset of both fiscal management and monetary policy. Dogmatic economic thoughts will need to be jettisoned to ensure that housing is affordable for future generations.

What should happen?

Policies need to be developed to prepare for a managed decline in housing prices and these include:

1. Targeted and aggressive fiscal deficits designed to drive down cost inflation;
2. Aggressive fiscal policy aimed at increasing housing supply;
3. Well-designed migration policy to slow population growth whilst tooling the workforce for needed essential skills;
4. Mild QE policy through the issuance of bonds to move marginal housing loans (negligible equity loans) from the banks to the public sector, so that price declines can be managed; and
5. A reset of credit policy by regulating the requirement for higher minimum deposit ratios for housing loans.

There is nothing wrong with fiscal deficits if they are appropriately set for a desired economic outcome. Attacking the cost of living, the cost of doing business and the cost of housing are proper reasons to have a fiscal deficit. However, it does require a breakaway from dogmatic economic thought and an ability to acknowledge the dramatic changes that have occurred in economic management over the last few decades.

John Abernethy is Founder and Chairman of [Clime Investment Management Limited](#), a sponsor of Firstlinks. The information contained in this article is of a general nature only. The author has not taken into account the goals, objectives, or personal circumstances of any person (and is current as at the date of publishing).

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What are the key trends in global dividend income?

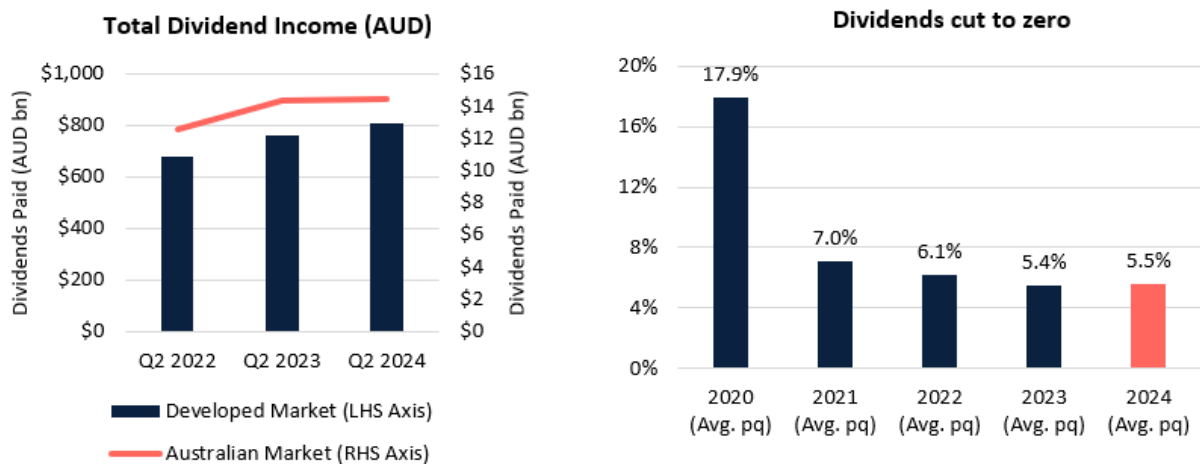
Daniel Pennell

Q2 continued the positive trend, providing great news for retirees invested globally for income. Global markets are up nearly +15% YTD (MSCI World in AUD), and although Q2 was relatively flat with respect to total return, there was +6.5% (in AUD terms) dividend growth.

When comparing Q2 2024 to Q2 2023, dividends grew +6.3% in local currency terms, with only a marginal boost to +6.5% when revalued in AUD.

Global developed market companies had a strong quarter, paying out A\$807 billion of dividends.

The number of companies cutting to zero remained low in Q2 (5.4%). This supports our ongoing view of continued dividend strength from global equities.



Source: Factset

Over half, 56.8%, of dividend paying companies increased or initiated dividends when compared to the same quarter last year. The number of companies decreasing payouts remained relatively constant, at 10.6%.

We continue to see large companies, for example Nestle, LVMH Moet Hennessy Louis Vuitton and Microsoft increase their dividends per share and distribute large dollar payouts. In addition, businesses that omitted dividends in the pandemic and tentatively paid special dividends, are now back to regular distributions. One example is HSBC holdings, who in addition to the now regular dividend paid a special dividend given the completed sale of their Canadian business to RBC.

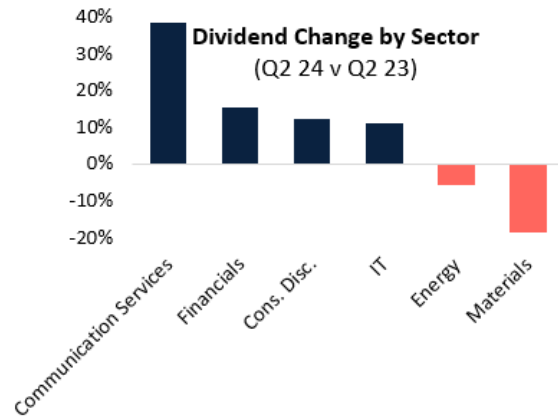
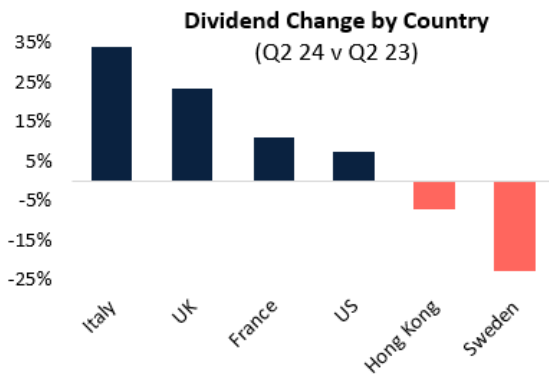
Two of the three regions increased income, in AUD terms, when comparing Q2 to the previous corresponding period in 2023. (North America +5.4%, Europe +9.1%, Asia -4.8%).

Which countries are leading the charge?

Q2 is traditionally when many large single dividends are paid in Europe. Europe was responsible for over half of the income in the most recent quarter, with over 30% from Germany, France and the UK alone. When comparing Q2 2024 with Q2 2023 we saw strong growth in many countries, including Italy (34%), UK (+23%) and France (+11%). This was partially offset by cuts in Sweden (-23%) and Finland (-22%).

The US grew dividends over +7% and paid 34% of the overall quarterly income payout.

Australia remained a strong dividend payer, with a small (+1%) growth in dividends, when comparing Q2 2024 with the corresponding period last year. There were significant payouts from the major banks, Westpac (including a special dividend), NAB and ANZ, backed up by large percentage increases in the dividend payouts of Aristocrat Leisure and Stockland.



Source: Factset

What happened in global sectors?

There was considerable difference in sector payouts. Communication services (+38%) led the charge, followed by increases from Financials (+15%), Consumer Discretionary (+12%) and IT (+11%).

Whilst growth sector dividends reflected strong market returns, more defensive sectors, who have had weaker total return, had softer payouts (Real Estate +0%, Utilities -1.5%).

Communication services got a substantial boost from large businesses that initiated dividend payments in 2024 (Alphabet and Meta), reflecting strong company performance and solid balance sheets.

Discretionary companies increased payout, despite rampant cost of living pressures globally. The most significant payouts came from auto and luxury companies, that included Mercedes Benz, Stellantis, Volkswagen, LVMH and Hermes. Although significant in dollar terms BMW decreased dividends per share, due to falling net profit after years of strong dividend increases.

Energy (-6%) and Materials (-18%) companies decreased their payout the most, reflecting weakness in commodity prices. Large dollar decreases came from UK materials business Glencore Plc and US energy company, ConocoPhillips.

Interesting facts in global income

When incorporating dividend cuts and initiations, 3.9 companies increased or initiated dividends for every one company that reduced or completely cut dividends versus the previous corresponding period. This is further proof of dividends continuing to strengthen.

49% of US companies paid a dividend in Q2. Given it is the second quarter, a lot of European countries had a strong percentage of companies paying dividends (France 63%, Germany 65%, Italy 77%, Belgium 88%).

What's the outlook for global income?

Our model continues to predict a lower-than-average probability of dividend cuts in global developed markets. Dividend growth has been strong, at the market level, despite increased interest rates, cost of living pressures and continuing geopolitical turmoil in Europe and the Middle East.

Materials/Energy significantly decreased dividends in Q2 and remain one of the higher risk areas in the market. After a strong 2022, they have decreased yields on the back of falling commodity prices and challenges to the demand side.

Global Dividend Cut Probability Monthly



Source: Plato Investment Management

In conclusion

2024 started with incredibly strong market returns, although this moderated in Q2. As we stand halfway through the year, this has been another period of positive dividend growth for investors allocating to global equities.

Recent market returns have been dominated by growth names, and dividend payouts have benefitted from large companies in this space, like Meta and Alphabet, starting to pay dividends. The disparity between yields from different sectors continues to demonstrate the importance of active management, and a strong risk management framework, for income investors.

Methodology

1. The methodology uses dividends paid, in AUD, however the ex-dividend date is used to allocate the dividends in the relevant time period e.g. Q3 2020.
2. Dividend paid (\$) for each stock in each calendar quarter is calculated as the shares outstanding as of quarter end multiplied by the total gross dividend per share (DPS) paid out in the calendar quarter. The DPS paid excludes spin offs but includes capital returns and special dividends. Conversion to AUD is done using the prevailing WM/Reuters London exchange rates at the time of dividend payment.
3. Full year dividend paid (\$) is the summation of dividend paid (\$) from Q1 to Q4 using the methodology (1).
4. DPS movement is based on total DPS paid out (in local currencies) over each calendar quarter. DPS movement from quarter to quarter is then categorised as initiating, increasing, unchanged, decreasing or cut to zero.
5. Secondary issues are removed from the calculations to prevent double counting of income.

Daniel Pennell is Portfolio Manager of the Plato Global Shares Income Fund.

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Why life expectancy numbers are widely misunderstood

David Orford, Jim Hennington

The Encyclopaedia Britannica website explains that life expectancy is "an estimate of the average number of additional years that a person of a given age can expect to live." The key word here is average, and there are different ways of calculating it.

How is life expectancy calculated?

There are two main calculation methods used: *Period Life Expectancy* and *Cohort Life Expectancy*. While these may sound technical, it's important for everyone working in financial planning, superannuation, the media, etc, to know the difference.

1. Period life expectancy

Period Life Expectancy is the simpler method, and it's the one typically quoted in the media and in legislation—however, it is highly misleading. Part of the reason it's so commonly used is it's easier to look up, and the life expectancies don't change until the next Life Tables are produced.

Period Life Expectancy figures are just one part of the latest Australian Life Tables published by the Australian Government Actuary (AGA) every five years. The most recent life tables are based on the three calendar years centred on the 2016 census (the 'period').

The AGA looks at the total number of deaths in those three years, by age, as a percentage of the number of people who were alive at each age. This data informs a set of 'mortality rates' for the Australian population, which are the basis for life expectancy calculations.

Mortality rates give us the probability that a male or a female of any age passes away in the year before their next birthday. The probability an average 30-year-old passes away within a year is under 0.1%. But for older people, the probabilities increase markedly. The probability an average 90-year-old man dies within a year is around 15%.

By looking at the mortality rate at each and every future age of a person's life, we're able to calculate the probability they will survive to each future age. For a 60-year-old, we calculate the probability they will survive to age 61, then to age 62, then to age 63, and so on, all the way up to the end of the Australian Life Tables (age 109). This lets us calculate the average age they'll live to based on all these probabilities.

Using the latest Australian Life Tables, a 60-year-old male's Period Life Expectancy is 84.0; for a 60-year-old female, it is 86.9.

It is called their Period Life Expectancy because the mortality rates are based on a specific period, in this case, the calendar years 2015 to 2017.

2. Cohort life expectancy

In reality, because of ongoing medical developments and trends toward healthier lifestyles (e.g., a reduction in smoking), mortality rates have been decreasing steadily over the past decades, particularly since the 1970s. This means that life expectancy calculations based only on mortality rates from a specific period are simply wrong for most practical purposes.

Actuaries don't 'expect' that the number of years a person will live in practice is their Period Life Expectancy. We've got to allow for these improvement trends. This is where Cohort Life Expectancy comes in.

Cohort Life Expectancy allows for the fact that mortality rates change during the lifespan of a group of people, or cohort, as they get older. Improvements in medical treatments and healthier lifestyles result in a reduction in their mortality rates from one period to the next.

Each time the Australian Life Tables are updated, the AGA carefully analyses how the mortality rate at each age has been changing by looking at data for up to the last 125 years. More recently, each set of Australian Life Tables comes with accompanying estimates of how mortality rates may change (improve) in the future. These assumptions are called improvement rate assumptions.

Cohort Life Expectancy calculations use this extra information. It means a significant improvement in accuracy. Instead of looking up mortality rates from, say, 2015, which effectively assumes each person spends their entire life in 2015, we acknowledge that people reach each birthday in a *different* future calendar year when mortality rates will have changed (reduced) relative to when the tables were produced.

Chart 1 shows an example of how mortality rates change. It shows the estimated mortality rate at age 75 years over time. For a 65-year-old in 2024, by the time they reach age 75 (in 2034), the mortality rate for 75-year-old males would be nearly 40% less than when the tables were based 18 years ago.

In Chart 2 below, each column shows the Period Life Expectancy for a 65-year-old male using the mortality rates from historic life tables (noting that today's 65-year-olds were born in 1959).

The blue bars show strong, steady upward improvement. The red line shows their Cohort Life Expectancies, which are higher because the people's assumed mortality rates will continue to reduce in the future.

Chart 1: Reducing mortality rate for a 75-year-old male

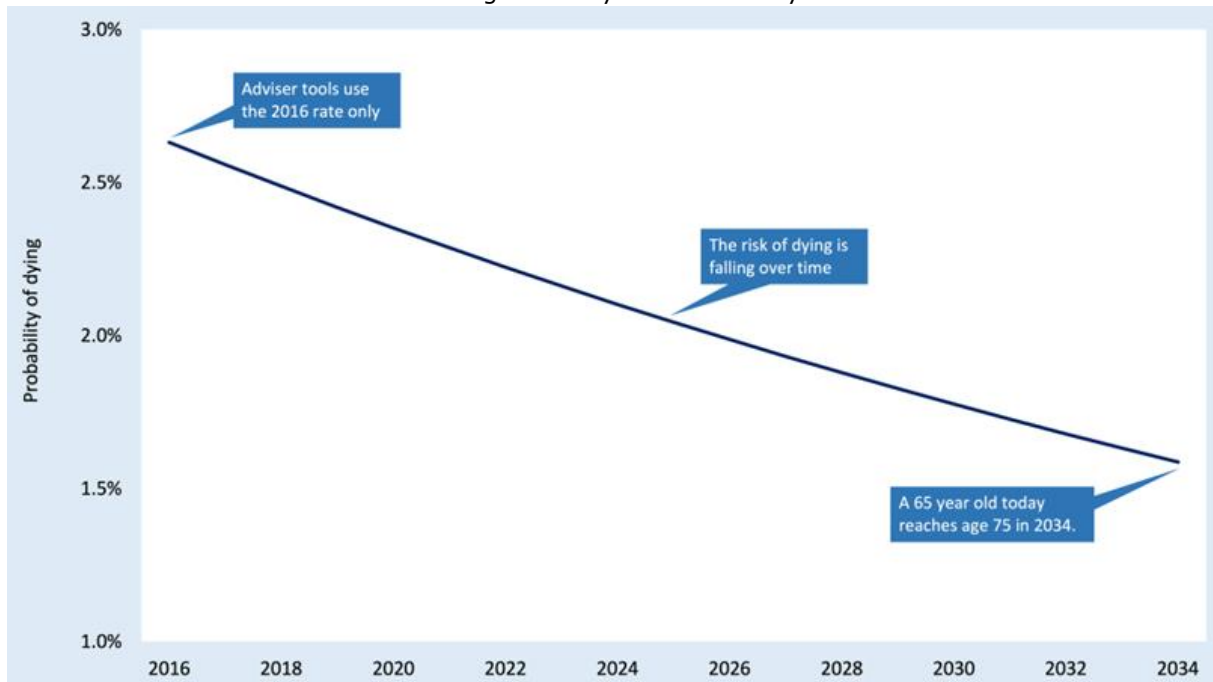
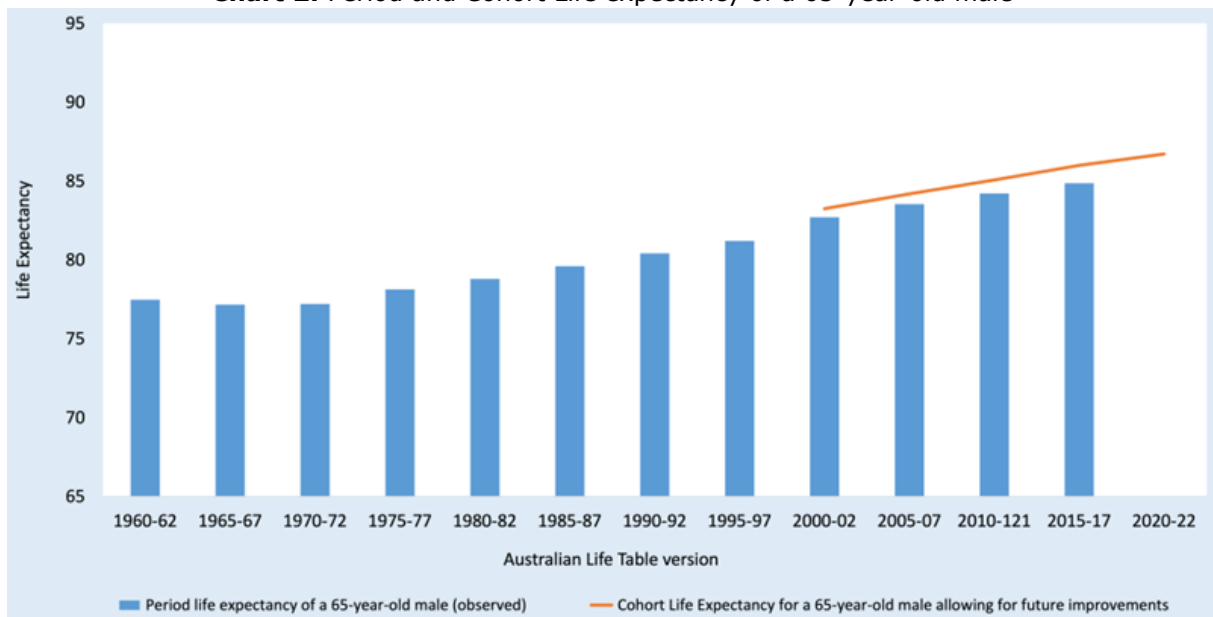


Chart 2: Period and Cohort Life expectancy of a 65-year-old male



Using the latest Australian Life Tables with the 25-year improvement rate assumptions, the Cohort Life Expectancy of a 60-year-old male is 87.9—about four years more than his Period Life Expectancy. For a 60-year-old female, it’s 89.8—about three years more than her Period Life Expectancy.

Estimates are only that, however. Actual rates of improvement can vary from the estimates. Variation can occur if positive future medical advances are different to the estimates or if negative changes occur, such as increases in obesity, drug deaths, pandemics, etc.

At the end of this article, we show that the impact of COVID-19 on population mortality rates was less than many people might expect. The Australian Bureau of Statistics reports that total deaths in 2020 and 2021 were fewer than they anticipated prior to COVID-19, and that this is because public health measures also caused a reduction in deaths from several other causes. Since then, the total number of deaths increased but fell again in 2023. We therefore await the next Australian Life Tables at the end of the year. What is more important for longevity isn’t the mortality experience during a few years but over the long term.

Concluding comments or pearls of wisdom

Life expectancy is not a prediction of how long any individual will live—it's just an average for a group or cohort at each age. None of us are average. We are all different, with different lifestyles, different genes, different attitudes to risk, and so on. This means the average is only relevant to a very small percentage of people.

Cohort Life Expectancies are a more realistic representation of the average number of years an individual or a group of people will live. However, as you can see, they are more complex to calculate and not as easy to simply look up in a table—as they depend on the year that you are doing the calculations.

No one should rely on Period Life Expectancy figures in practice, despite being easier to look up. They are only based on mortality rates that applied during a certain historic period. We know there are strong trends for these mortality rates to reduce in future years, resulting in higher life expectancies.

Don't forget: Life expectancy calculations are based on the *range* of lifespans that can transpire for the individuals within a group. They are not a prediction. There is a large standard deviation around average life expectancy figures. For new retirees, the standard deviation is roughly eight years.

For financial planning, it's vital to recognise that some people will have short lifespans, and others will have very long lifespans. What happens to each individual is subject to randomness. A more appropriate rule of thumb might be to focus on the age when *most* people in a group will have passed away.

David Orford is the Founder and Managing Director of, and Jim Hennington is Head of Innovation at [Optimum Pensions](#). Optimum Pensions was launched in late 2017 with the objective of providing innovative sustainable retirement income solutions. This article is general information and does not consider the circumstances of any investor.

The bizarre government policy that led to Rex's downfall

Rod Sims

Editor's note: This is an edited transcript of [an interview](#) between the ABC Radio National's Patricia Karvelas and Former ACCC Chair, Rod Sims, on August 1, 2024.

Patricia Karvelas: Next time you book a domestic flight, it's likely you'll have fewer options to choose from after Australia's third biggest airline, Rex flagged it will roll back its offerings. With a company in administration, others are pointing the finger at Qantas, accusing the company of anti-competitive behaviour, something it has long denied. The federal government has defended its efforts to increase competition in the airline industry. Rod Sims is the former chair of the Australian competition regulator, the ACCC, and a Professor of Public Policy at the ANU, and our guest. Rod Sims, welcome.

Rod Sims: Good morning, PK.

Karvelas: Rex tried to shake up the Australian airline market by flying between Brisbane and Sydney and Melbourne. I think people living in those cities were pretty happy about that. Do you think they should continue to have a role doing that?

Sims: I think that the failure of Rex is obviously due to many things, but it's essentially a public policy failure. We certainly can have more than two airlines on these capital city routes, certainly on the Melbourne-Sydney route. But public policy is simply stopping that happening. And I don't know why, because if we had more airlines, if we had -- all evidence shows that when you have three airlines flying a route, the prices are much lower. It's just unquestionable that that's the case. So why the government doesn't change the policy levers to bring that about, I really do not understand.

Karvelas: Well, the government believes, and I've had many private conversations that actually you can only really sustain two airlines for that part of the market, the capital cities. Do you disagree?

Sims: Totally. I think that's just nonsense. Obviously, Qantas will say that because it's in their self-interest to do so. But all evidence from around the world is when you get routes which have this amount of traffic on them, you can sustain three players.

The problem, and this is the biggest public policy failure, is our slot allocation system. To fly the capital city routes, obviously the Sydney-Melbourne route, but the others as well, you have to get the scarce slots at

Sydney Airport. Now, and I think this is unbelievable, but let me just lay it out. The government outsources the management of the slots at Sydney Airport to a company that's majority owned by Qantas and Virgin. I mean, it is just unbelievable. So, when Rex or indeed Bonza, who also wanted extra slots at Sydney Airport. When they want those key slots that they must have to be viable, they have to go and essentially ask for them from Qantas and Virgin. And of course, they've also got to put their business plans before them. So, the government sets this system up for failure. It sets this system up for a duopoly and therefore sets the system up for higher airline prices than Australians should be paying.

Karvelas: The Federal Transport Minister Catherine King says Australia is a small market and this is an industry with high costs. They've also talked about the internal issues at Rex. Some of that is absolutely true, right? They got lots of money during the pandemic. They also have had their internal issues on the board. Are they not responsible for their own problems?

Sims: You can always assess responsibility in various ways. The point I make is that it's necessary -- we won't get the competition until we reform the slots. If we reform the slots, we will get the competition. Now, quite what that meant for Rex, I don't know. What I do know is that Rex, and I have to say Bonza as well, were constantly tapping on my door complaining about the fact that they could not get the slots they needed. Now, should they have anticipated that the system was so rigged against them that they were doomed to fail? Well, you can argue they should. But let's identify the real public policy issue here. It is that you cannot have Qantas and Virgin controlling slots at Sydney Airport. That cements the duopoly and cements higher prices for Australians. We have to fix that. You can't say this is a natural duopoly when you've got this situation occurring.

Karvelas: The federal government says it's getting on with this legislation that will stop this slot hoarding. Do you give them credit for that? Are they doing that already?

Sims: I don't give them credit for it, frankly. They've had the report from Peter Harris, the ex-chair of the Productivity Commission for around about three years, admittedly so did the Coalition government. There's been no response to the Harris report. I mean, no response. Why is that would have actually, I think, fixed this problem? So, when you sit on a report for three years, well, in this government's case, two years, and it's not just sitting on that report. You've got a system where Qantas and Virgin control the management of slots at Sydney Airport. I mean, you just cannot let that continue. You should stop it immediately. And I don't think they've done that.

Karvelas: The Treasurer says their priority is essentially intervening in the regional space because they don't want the airline to fail for the regions. Is that good enough?

Sims: Look, we need Rex flying to the regions. There's no doubt about that. If you're in a regional town, many of those regional routes are natural monopolies. That is, you can really only have one airline coming in and out of them. Traditionally, in many of those routes, not all of them, but in many of them, that's been Rex. And those cities, those country towns need that service. So, I certainly agree that from an Australian perspective, the highest priority is getting the regional routes restored. But I don't think far behind is the idea that we need real competition. And we need to see whether it can happen. My point and my frustration is we're actually stopping it happening. To talk about whether it can or can't happen, when you're actually doing, the government is doing something to stop it happen, is really what is making me, yes, a little bit angry.

This is an edited transcript of [an interview](#) between the ABC Radio National's Patricia Karvelas and Former ACCC Chair, Rod Sims, on August 1, 2024.

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