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Editorial

This is the last edition of *Firstlinks* for 2024. We'll have a week's break and be back on January 2.

To our readers, I'd like to wish you a safe and merry Christmas and New Year. Thank you for all the support that you've given us.

I'd like to give a shout-out to Leisa Bell and Joseph Taylor for their work on *Firstlinks*, as well as to Morningstar for its support during the year.

Onwards and upwards in 2025.

Australia is at a crossroads. For most of our history, we've been one of the world's wealthiest countries. Yet, that wealth has stagnated over the past decade.

There's been a lot of talk in economic circles about lifting productivity growth. Economists seem to agree that what's needed is further deregulation of the economy. Much of the debate seems narrow and simplistic, and based as much on politics as economics ie. if you slant right wing in politics, you support deregulation, and if you're left of centre, you don't.

The study of history and why some nations prosper and others don't, provides a broader perspective on the topic. Jarred Diamond's best seller in the late 1990s, *Guns, Germs, and Steel*, suggests that geography and the environment shape our societies and prosperity. Daron Acemoglu, who recently won a Nobel Prize in Economics, argues differently, emphasizing the quality of political and economic institutions in driving economic success.

The late Australian economic academic, Ian McLean, put forward a more nuanced thesis in his 2013 book, *Why Australia Prospered*. McLean's book is the subject of this article as I think it provides the best clues for how Australia became one of the world's richest countries, and what we need to do to grow wealth from here.

How we quickly become wealthy

Most Australians are unaware of how lucky we've been throughout our short history as a country. Founded in 1788, Australia already obtained the world's highest incomes by the mid-1800s. And we've retained our mantle as one of the richest countries ever since.

Economic and population growth rates by period, annual average percentages, 1850 to 2010

	Real aggregate GDP	Population	Real per capita GDP
1850-1860	22.3	11.0	2.9
1861-1889	4.8	3.5	1.4
1889-1905	0.8	1.7	-0.8
1905-1914	5.2	2.4	3.0
1914-1920	-1.6	1.4	-2.7
1920-1930	3.2	1.9	1.3
1930-1939	1.6	0.8	0.8
1939-1946	3.4	1.0	2.6
1946-1974	4.8	2.2	2.2
1974-1991	2.9	1.4	1.5
1991-2010	3.4	1.4	2.0

Source: Ian McLean, Why Australia Prospered

Many other nations haven't been so fortunate. Some have never been wealthy. Others were rich, then became poor. Witness Argentina, which was one of the wealthiest countries in the early 1900s but has declined, ravaged by rolling economic crises for the past 50 years, with high inflation and unemployment, increasing poverty, and political instability.

Australia has managed to maintain its standard of living over a long period. How have we done it?

Key factors behind Australia's enviable record of prosperity

McLean offers several factors behind our economic success. The first is obvious: our resource base. Yet, it isn't so obvious, is it? That's because most of us have heard of the 'resources curse' – that an abundance of resources is more a curse than blessing, and typically associated with corruption, low growth, and even failed states.

Australia offers compelling evidence to the contrary. Our farmland and minerals have been the backbone of our economy. In our early history, resources dominated the economy and was a central source of employment. Australia's exports have long been monopolized by resource-intensive products, beginning with wool and gold. Still today, most of our exports come from primary products.

Another factor behind our wealth is the quality of our institutions, according to McLean. He says institutional flexibility has been critical. What he means by this is that our political and economic institutions have adapted and changed when they haven't been working to grow our economy.

Examples from the 19th century include the transportation of convicts, the monopolization of grazing land by squatters, and the employment of immigrant, indentured labor on sugar plantations. A more recent example is the reform of labor market institutions by the Hawke Government.

McLean says institutional adaptability a critical factor:

> *"The capacity of a society to adapt its institutional arrangements in the face of changed economic conditions, or evidence of the adverse consequences for prosperity of doing nothing, is a key factor explaining why there is such a wide range of income levels across countries."*

McLean also emphasizes the importance of political institutions in Australia's growth. He says Australia benefited greatly from ties to Britain. Early on, we had privileged access to foreign capital and trade, thanks to our colonial ruler.

Also, self-government came early to five of the six colonies in the 1850s. This paved the way for a federal constitution unifying the colonies by 1901. This served us well economically.

McLean's final point on the importance of institutions highlights the significance of how institutions interacted with our resource abundance. That is, the quality of our institutions has helped us avoid the dreaded resources curse.

Another factor that McLean says is central to our economic success is how policymakers have responded to the major economic shocks, both positive and negative, through our history.

For example, Australia endured an economic depression in the 1890s. It appeared that our resource-based prosperity had come to an end, and the openness of our economy had heightened our vulnerability to events overseas. We shifted strategy to become less reliant on commodities, building up industry behind rising levels of protectionism over the subsequent 50 years.

McLean attributes luck as another factor behind our prosperity. For example, our convict heritage hasn't been a source of national pride, though McLean believes it provided an underappreciated role in our early prosperity.

That's because of the peculiar nature of our labor market back then. Most of the convicts sent to New South Wales were selected to maximise the workforce participation rate among the early colonial population. The convicts were selected by gender, age, and physical condition. Men far outnumbered women, most were in the prime working-age range, and only the healthy were transported. This 'human capital' was needed to quickly clear land, build key pieces of infrastructure such as roads and houses, and to produce food. Put simply, the convicts had the profile and skills to provide the building blocks for the economy.

Seeds for future prosperity

McLean's work offers clues for what Australia needs to do to revitalize itself today. My take is that our current institutions have failed to adapt to economic stagnation. They've been happy to ride a once-in-a-century boom in iron ore and coal and haven't wanted to face a world where the best days for these commodities may be behind them ie. there's unlikely to be another China-style boom for a long time.

They've also been content to subsidise massive investment in non-productive industries such as housing.

The complacency of our institutions has left Australia with limited exposure to so-called future facing industries: AI, robotics, biopharmaceuticals, cloud services etc.

We have an education system that could provide the foundations for leadership in the industries of the future. But we don't seem to have the ambition to want to change and invest in these industries.

We also have resources, like lithium, which can feed into these industries, and we've been late to the party in realizing this.

All is far from lost, though there needs to be a more sophisticated debate about how Australia can be bold and creative, and leverage our resources, both mineral and human, to meet the world's current and future needs.

Our country's wealth depends on it.

In my article this week, I offer nine lessons from this year, including expensive stocks can always get more expensive, Bitcoin is our tulip mania, follow the smart money, the young are coming with pitchforks on housing, and the importance of staying invested.

James Gruber

Also in this week's edition...

Financial industry icon, **Don Stammer**, is back with the 43rd edition of the X-factor report. Each year, Don picks the X-factor - a largely unexpected influence that wasn't thought about when the year began but came from left field to have powerful effects on investment returns. What wins in 2024?

We've hit the halfway point of the 2020s and **Ashley Owen** gives a score check on the Australian stock market. He says this decade's returns haven't been great versus history, though there's reason to hope for a better second half to the decade.

Four years ago, **Orbis** introduced its 'bubbles' chart to show how the market had become concentrated in one type of stock and one view of the future - namely 'defensive growth' stocks, especially lockdown beneficiaries such as Netflix and Amazon. Turning to today, and **Eric Marais** says investors are crowding into the same group of stocks, which may open up investment opportunities for those who think differently.

Regulatory tensions have weighed on the share prices of Australian listed private health insurers. **Airlie's Emma Fischer** thinks the insurers haven't profited at the expense of the hospitals, and that the Government

won't step in with a bailout of these hospitals. If right, she says Medibank Private should benefit, and with continued long-term tailwinds from an ageing population, it offers a compelling investment opportunity.

Little noticed is that the inverse correlation between bonds and stocks has returned as inflation and economic growth moderate. **PIMCO's Emmanuel Sharef** and **Erin Browne** believe this broadens the potential for risk-adjusted returns in multi-asset portfolios.

A lot has been written about what makes for a good retirement. Australian anthropologist **Shiori Shakuto** has studied Japanese seniors and that's led her to a counter-intuitive conclusion about what makes for a great retirement: the secret may be found in how we approach our working years.

Lastly, in this week's whitepaper, **Franklin Templeton** presents survey findings about the future of investing - for money, asset management, portfolios and advice.

Curated by James Gruber and Leisa Bell

9 lessons from 2024

James Gruber

It's been another eventful year in financial markets. Stocks soaring for a second year in a row, America continuing to attract a gush of money despite re-electing a convicted felon as President, 'meme coins' again back in vogue, high profile ASX owner operators coming unstuck, and commodities continuing a decade-long dry run, albeit with some exceptions.

Here are my key lessons from 2024:

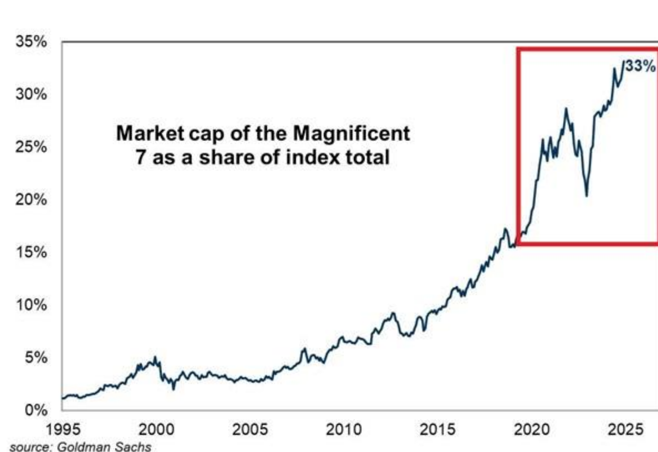
1. The expensive can always get more expensive

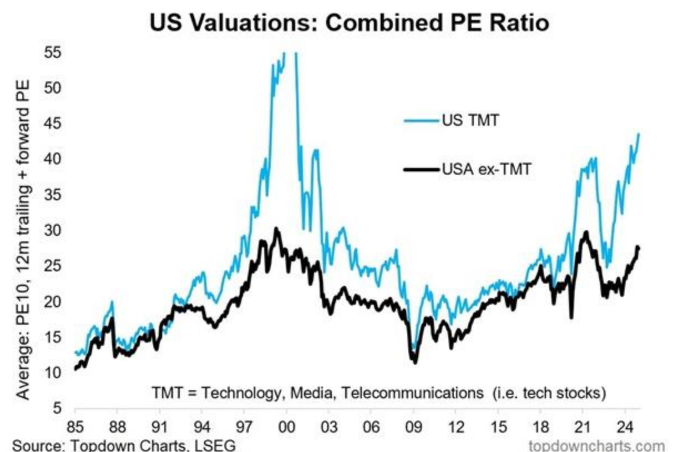
We started the year with the S&P 500 being moderately expensive on traditional valuation metrics and concerns about an increasing concentration in the Magnificent Seven tech stocks. Yet, we're ending this year with much more expensive US market and even greater concentration into the 'Mag 7' companies.

The S&P 500 is up 28% year-to-date, while the Nasdaq is 30% higher. About 10% of those gains have come from forecast earnings growth for this year. The rest has come from expansion in valuation multiples.

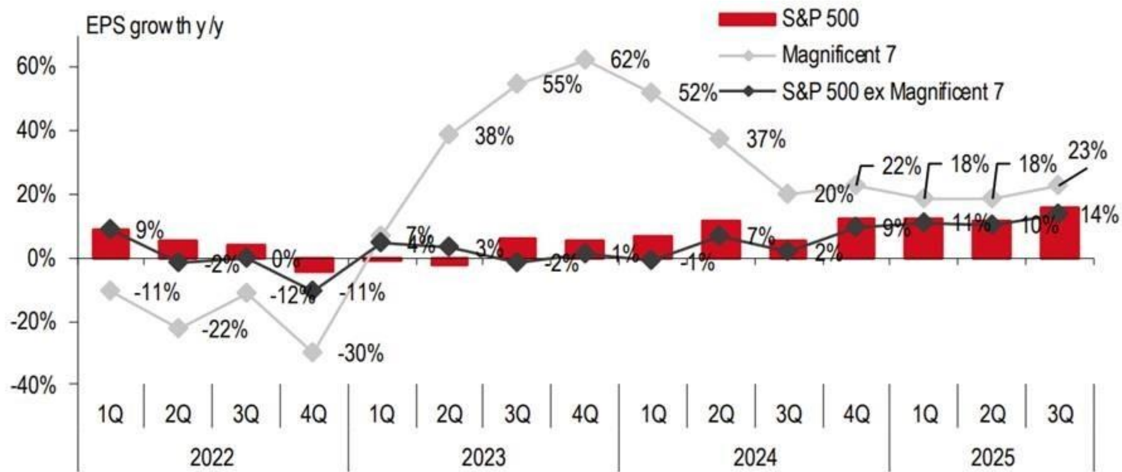
The price-to-earnings (PE) ratio of the S&P 500 has moved up to 26x today on a trailing earnings basis. That's 32% higher than the average PE ratio of 19.7x since 1989.

The Magnificent Seven stocks have rallied ~50% this year and surpassed US$18 trillion in market value for the first time in history. These stocks now account for a record 33% of the S&P 500 index.

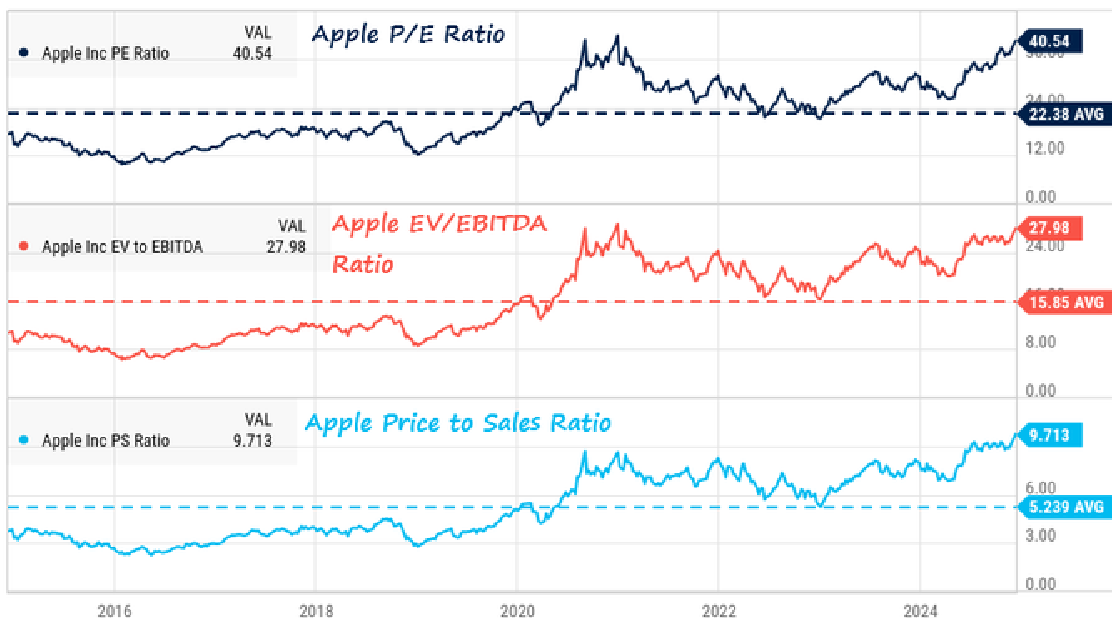




The share price rises in mega-cap tech stocks can be partly justified by strong earnings growth.



Apple (NYSE: AAPL) is the exception to that, with pedestrian single digit earnings growth, but that hasn't stopped the stock from roaring higher.



While earnings can explain some of the rise in the US, the same can't be said for Australia. EPS growth is likely to be close to flat for this calendar year, yet our market is up 23% this year. The rise is solely attributable to an increase in the price attached to the earnings, with the PE ratio rising from 17x to 22x for the ASX 200.

The extraordinary run of the Big 4 banks explains much of the market melt up. Commonwealth Bank's share price has lifted 42% in 2024, excluding dividends, and it now trades at a 28x PE ratio – not bad for a company where earnings have declined of late!

Source: Morningstar

2. America IS the market

Australia has always taken its lead from US markets, though never more so than today. We can talk about global markets but they're not really global anymore – there's America and then the rest.

US stocks now make up 65% of the global equity market. This is more than 11x bigger than the second largest country by market cap (Japan at 5.5%).

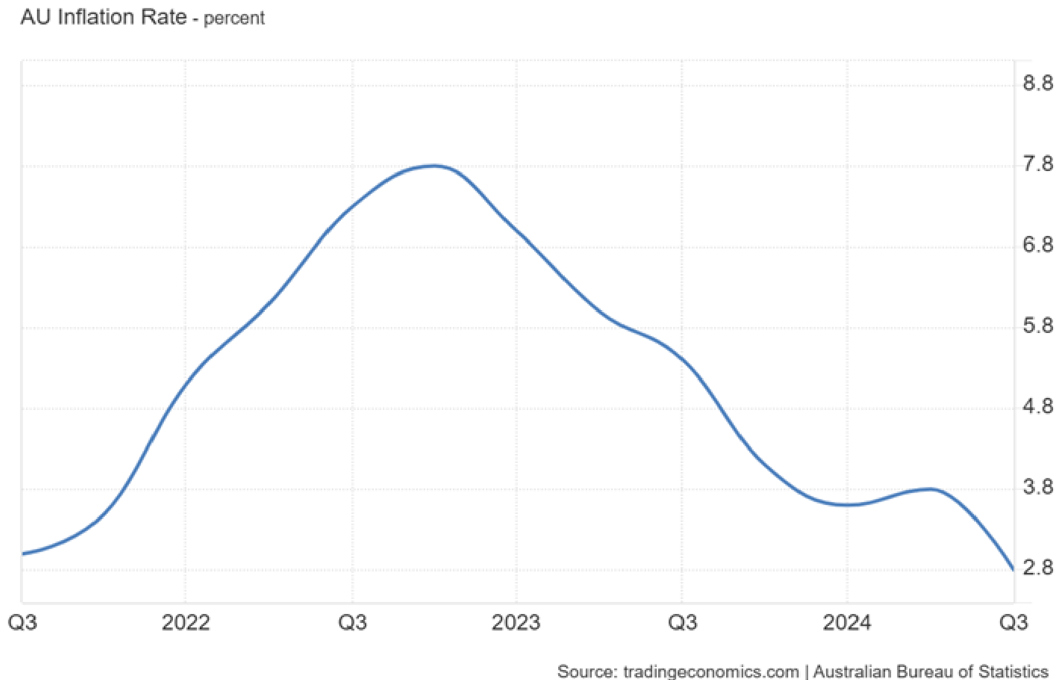
The last time that the US was at these levels was in the late 1960s when the America was at the peak of its power versus the rest of the world.

3. Markets love economic growth combined with disinflation

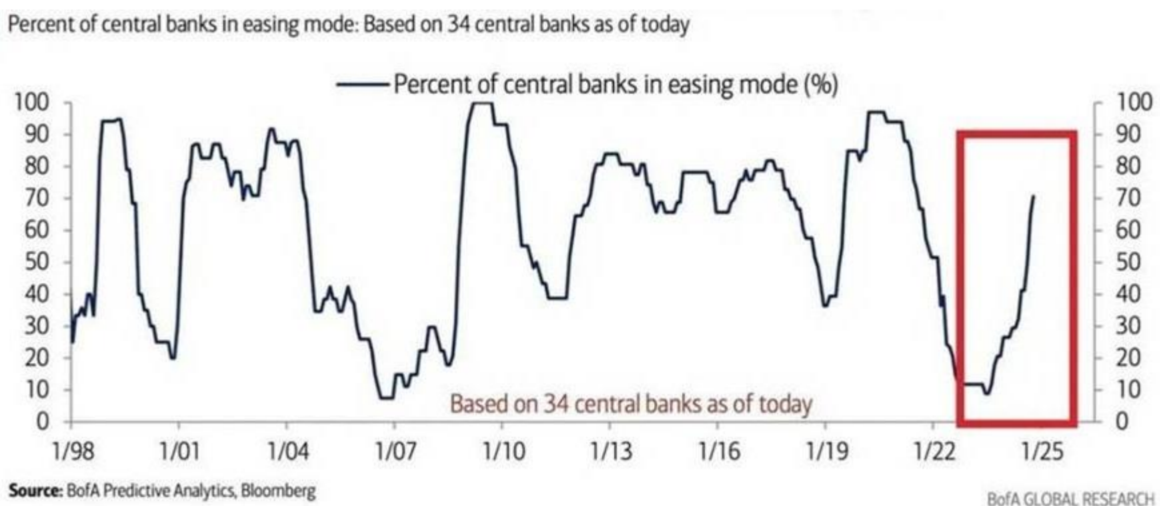
US inflation peaked at 9.1% in June 2022, and has since declined to 2.6%. It's no coincidence that the S&P 500 bottomed soon after inflation peaked and has entered a roaring bull market since. There's nothing more that markets love than a falling inflation rate combined with punchy economic growth.

Australia’s inflation rate peaked much later, at 7.8% in the fourth quarter of 2022. The rate has also been slower to fall, with the latest CPI reading at 2.8%.

This, plus lacklustre GDP growth, goes some way to explaining why Australia's share market has lagged the US and many other developed markets over the past two years.



The other thing that markets like about a falling inflation rate is that invariably leads to cuts to interest rates. Today, 71% of major central banks are in easing mode versus only 9% at the lows of July 2023**.** The RBA hasn't followed suit … yet.

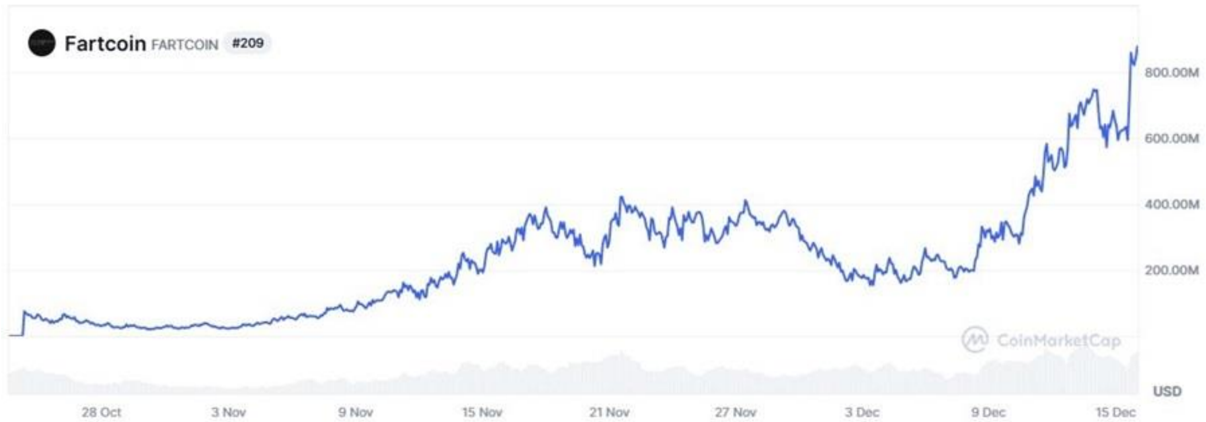


4. Bitcoin is our tulip mania

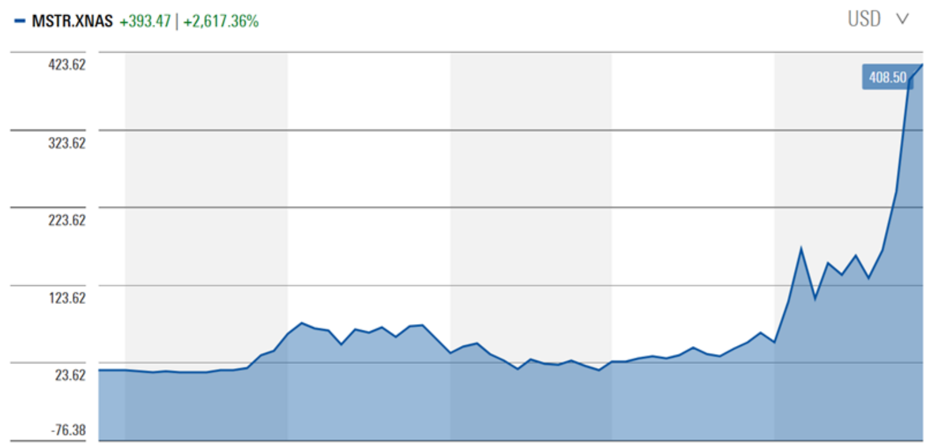
There’s always a bubble somewhere, yet the Bitcoin one has been something to behold. It could go down in the history books as a modern-day tulip mania. Tulip mania, a speculative frenzy in 17th century Holland that involved the sale of tulip bulbs, is widely regarded as the biggest bubble in history.

Bitcoin might be rivalling that. It’s climbed 140% this year, after a gain of 156% the prior year. It’s up an annualised 149% since 2011. Put another way, one dollar invested in Bitcoin 14 years ago has turned into about $338,000.

Off shoots such as ‘meme coins’ are taking off. One of them, fartcoin (you read that right), recently rose 300% in one week and now has a total value of close to US$900 million.



MicroStrategy (NASDAQ: MSTR), whose main business is buying Bitcoin, has just been admitted to the Nasdaq 100 index with a market capitalization of US$98 billion. The share price is up a cool 546% this year. The company is run by a man who was charged with accounting fraud in the late 1990s tech bubble. And the company's strategy seems to involve issuing new shares and debt to acquire more Bitcoin, which invariably pushes the Bitcoin price up – a seemingly virtuous circle. A flywheel to some, but a Ponzi scheme to others.



Source: Morningstar

The whole thing is likely to end in tears for one reason: Bitcoin has no real-world use. It was invented 16 years ago with hopes to decentralize the world of currencies. It's done nothing of the sort and, ironically, may become a tool of the state, with Donald Trump's plans for a Bitcoin strategic reserve.

5. Beware of investment bankers bearing gifts

I've always been bemused by the Australian media's love affair with investment bankers, though it isn't hard to figure out the reasons behind it. The bankers are a reservoir of gossip and 'background' information for journalists looking for a story.

My background in stockbroking and funds management has led to a more sceptical, nay cynical view, of these bankers.

So, the latest story involving DigiCo (ASX: DGT) hasn't come as a surprise. For those who haven't been following it, DigiCo is a date centre play recently listed in the ASX. It was quickly cobbled together by prominent former investment banker, David Di Pilla. DigiCo was the biggest float on the ASX since 2018, raising almost $2 billion in equity. There was a lot riding on the IPO.

It didn't turn out as planned as the stock tanked 14% over the two days after listing. Di Pilla and his bankers are desperately trying to shore up the growth story, while retail investors, who gobbled up the IPO, have been left holding the can.

From the outset, there were many red flags with DigiCo as investment bankers rushed to put together a float based on the hot theme of AI.

It's yet another reason to beware investment bankers bearing gifts…

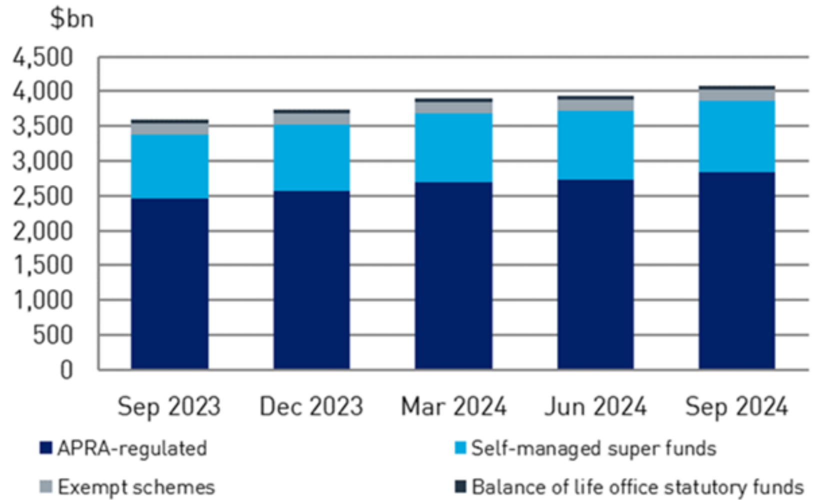
6. Scale in superannuation comes with benefits and costs

Australia's superannuation sector continued its unstoppable growth this year. Super assets now total more than $4 trillion, having increased 13% in the year to September, driven by strong asset returns.

Regulators have promoted consolidation in the sector, resulting in the big funds getting larger. Increased size has resulted in several benefits, including lower fees for members. However, the costs of increased scale are also becoming apparent, with more member complaints and heavier regulatory scrutiny.

Whether we're expecting too much from the super funds may become a bigger issue going forward.

Assets of superannuation entities



Source: APRA

7. Smart money is backing private investment, further squeezing active equity managers

It always pays to look at where the smart money is investing, and there's not many smarter in the financial sector than BlackRock's CEO, Larry Fink. BlackRock is an ETF giant, having moved aggressively into the space with the acquisition of Barclays Global Investors in 2009.

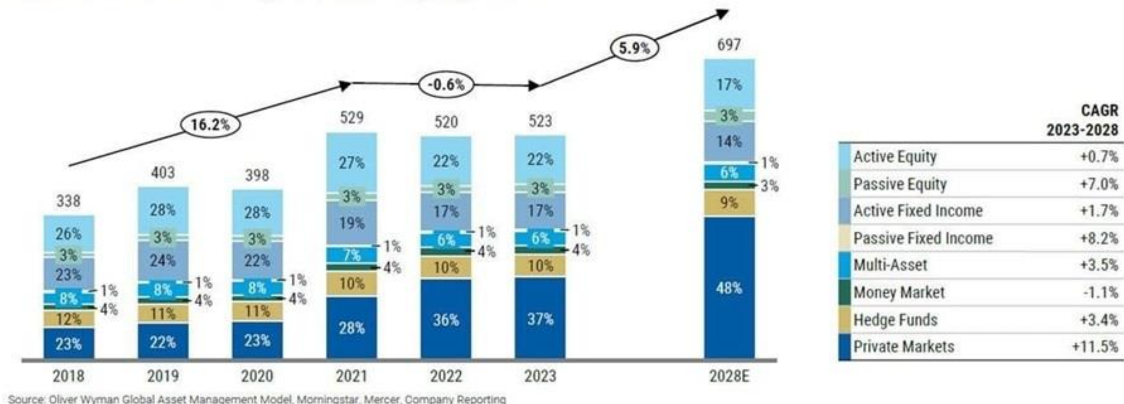
It's noteworthy that the firm is now moving aggressively into a new area: private investments. Recently it announced a US$12 billion acquisition of private credit firm HPS Investment Partners, which will turn into top five player in private credit. It comes two months after the company acquired infrastructure manager Global Infrastructure Partners.

These businesses appear to be small at first glance. The firm says alternatives will account for just 4% of its assets, compared to 67% for passive strategies. However, they'll be heftier from a profit perspective. Blackrock expects alternatives to be around 25% of earnings, versus 40% for passive.

Fink and others see several tailwinds for private investment, including a pullback from banks in lending, fewer public listings and more companies choosing to stay private, and the ability to charge steeper fees vis-à-vis other asset classes such as equities.

BlackRock has ridden the wave of growth in passive investing, and with these acquisitions, it hopes to do the same in private investment.

With passive investment on the one hand and private investment on the other, active fund managers are being squeezed from both sides. The struggles of local fundies like Perpetual are testament to this.



8. The young are reaching for pitchforks on housing

For several decades, Governments, banks, and vested interests have been juicing housing returns with all their might. Younger generations have been slow to cotton on to the racket, but cotton on they have.

I've previously said that the Governments have no intention of doing much about housing, despite their endless announcements and soothing words to the masses. That's for personal reasons, because the politicians have much of their own wealth tied up in housing, and for electoral reasons, because most voters own residential property.

This was clearly spelled out by the Federal Housing Minister, Clare O'Neil, in a recent interview with ABC youth radio station, Triple J. Pushed on whether she wanted to see house prices come down to give young people a chance to get into the market, she didn't deflect like a good politician normally does.

"That might be the view of young people," she said of the idea that sustained price falls are actually a good thing. "But it's not the view of our government. We want to see sustainable price growth. We want to see more houses come online. We want to see that rental vacancy rate go up a bit … and we certainly want to see more homeowners."

O'Neil's interview went viral as Triple J listeners vented their anger at Government intentions to keep house prices rising, putting them further out of reach of younger people.

In a recent *Firstlinks* article, Alan Kohler, suggested the best outcome may be for policies to ensure that house prices stay stagnant for up to a few decades, allowing incomes to catch up to make housing affordable again.

Unfortunately, that benign scenario may be too long for the young, many of whom are angry about skyrocketing rents and being unable to afford to buy their own home.

9. The importance of staying invested and diversified

2024 has again proven that forecasting future is difficult, and it's prudent to stay invested and diversified.

Many investors switched to cash in 2022 as both stocks and bonds swooned. Yet, holding more cash has been a significant drag on returns over the past few years.

On the flip side, retail and institutional investors are pouring money into US stocks today, hoping for a slice of the seemingly easy returns of 2023-2024. Whether that's wise remains to be seen.

James Gruber is Editor of Firstlinks.

Time to announce the X-factor for 2024

Don Stammer

In mid-1982, people working in finance were surprised to hear that Japanese life offices and pension funds had quickly bought 7% of all the Australian Government bonds on issue. At a lunch-time discussion on how these unexpected inflows would help our low-saving nation draw on Japan's abundant savings, I suggested we call it "the Factor-X for the year and a highly positive one at that".

43 years on, I still enjoy keeping a watch out for the unexpected but powerful influences that impact investment markets - though I readily admit to deriving even greater pleasure when opportunities come up to spread the word on the magic of compound interest.

In 2009, a sub-editor in the Australian re-named my Factor-X the X-Factor, and I moved with the times.

As each year draws to a close, I like to list the main X-Factors of the preceding 12 months. Then I select *the* X-Factor for that year. My list of the X-Factor in each of the last 43 years is provided at the end of the article.

In financial markets, an X-Factor is a major influence on investment returns that had not been generally expected, predicted or allowed for but comes out of left field and has a powerful impact in financial markets.

To be a fan of the X-Factor, as I am, doesn't preclude taking a view on where economic conditions, shares, interest rates, property or the exchange rate seem to be heading. Rather, it's a reminder that investors always need to allow for the many uncertainties and surprises that hit markets from time to time. Investors need to maintain a thoughtful diversification of assets and adopt sensible forms of risk management, such as having enough liquid assets to meet living costs in the early years of retirement, rather than risk having to sell quality assets cheaply in a market panic.

Sometimes, the X-Factor is favourable for investors. Examples of positive X-Factors include, in chronological order:

- the floating of the Australian dollar in 1983
- the collapse of inflation here in 1991
- our economy being little affected during the global financial crisis of 2008 thanks to China's continuing growth
- the powerful surge in share prices that began in March 2009
- the boost to most commodity prices in each of 2016, 2018 and 2020 as China avoided the hard landing forecast for its economy
- the sharp recoveries in share markets in February 2022, soon after the Covid-induced panic.

At other times, the X-Factor has been unfavourable. Examples include, in chronological order:

- the sharp rise in bond yields in the fake crisis of 1994
- the terrorist attacks in the US in 2001
- the Enron frauds in US markets in 2002
- the near meltdown of the global banking system in 2008
- the powerful disinflation during the 2010s
- the Covid pandemic in 2020
- the sharp increases in inflation during 2022 and 2023, with inflation often turning out to be 'stickier' than was initially expected
- the non-delivery by central banks of the four or five cuts in their cash rates that were widely expected in financial markets between 2022 and early 2024.

The finalists for X-Factor 2024

In discussions over the years, I have occasionally made a flippant comment (which I now regret) that, if a year were to come along without an X-Factor, I could call its absence the X-Factor for that year.

The reality is that many years – including 2024, 2022, 2013, 2008, and 2007 – have more than one strong contender for the title. Selection of a single winner each year is not just a challenging task, it also trivialises the challenges that investors face when there are lots of X-Factors to contend with.

The year now ending certainly had an abundant harvest of X-Factors, among them:

- The success of Donald Trump in winning the US presidency while Republicans hold a majority in both houses. Many people are still scratching their heads, wondering what the consequences might be.

- Over the last six years, the US has been by far the world's best performing economy and the most innovative. In those six years, the US has not experienced a recession, though the National Bureau of Economic Research, which dates US recessions, says it spied a glimmer of one in 2022.

- What makes this clean record of zero recessions so mind-blowing is the many thousands of predictions that an imminent and severe recession was about to hit the US. A conga line of forecasters – many of them people who work in financial markets – has repeatedly claimed that the US economy would soon be upended by a major recession that would also cripple the rest of the world.

- In the early 1980s, Paul Samuelson, a well-known economist and author of the textbook that dominated macroeconomics in my undergraduate years, famously observed that "Wall Street has predicted nine of the past five recessions". This time around, the gap between "Wall Street predictions made", and "Wall Street predictions made successfully" is unthinkably wide and lopsided.

- Patient investors holding US shares and who ignored the naysayers have made attractive gains over recent years (and specifically in the last 12 months when average share prices have risen more than 20% and average dividends were increased).

- This year's positive lead from US shares has also boosted prices in other share markets including the ASX, which reached record highs two weeks ago – something that would not have happened if our share market had been tracking just local factors.
- Another feature of 2024 has been the widely different views on how 'sticky' inflation is likely to be. For Australian investors, the two countries that matter for inflation are the US (where tariffs have been increased sharply and the budget deficit is 6% of GDP) and Australia (where wage demands are running at levels well above the rate of inflation and where productivity growth is negligible).
- In my view, underlying inflation in Australia could well be in the troublesome range of 4-5% in 2025 - a couple of notches above both prospective inflation in the US and the medium-term target of the Reserve Bank.
- The price of Commonwealth Bank shares has risen strongly in recent months, perplexing many advisors who had expected banks to suffer increasing losses on their housing loans. In my view, the gains in CBA share price reflect changes in the strategies of many fund managers, particularly among industry superannuation funds, which are now investing more of their clients' money in exchange-traded funds that track the market and less in actively managed funds run-in house that aim to out-perform market returns through their stock selection. With the record of actively managed funds unimpressive when additional fees are charged, and with the CBA making up an impressive 8.2% of the ASX 200 index, the effect on that bank's share price has been significant.
- In Australia, economic growth has slowed to near-zero rates over the first three quarters of 2024 despite the massive increases in spending by federal and state governments. The combination of our heavy reliance on variable rate debt when we borrow for housing, and the high levels of mortgages taken on during the extremely low interest rates of the pandemic period, have caused severe financial pain for many mortgagees.
- The Federal Treasurer has made it clear he would like the Reserve Bank to reduce its cash rate to ease theses strains, blaming the Reserve Bank for 'smashing' the Australian economy by leaving its cash rate unchanged while other countries have cut their rates. Unsurprisingly, the Reserve Bank Board suggests (my words here) it awaits convincing signs that inflation is on the way down with reasonable prospect of return to the target range over the next year to 18 months.
- The Chinese economy has also slowed, mainly because of the cutback in bank lending and the strains on bank balance sheets after the housing market collapsed from oversupply a couple of years ago. The Government has eased monetary and fiscal policies to stimulate growth, but most commentators say more needs to be done to lift growth to the target rate of 5%. Nonetheless, Chinese share markets have made some useful gains, with the price of FXI, the exchange traded fund made up of large companies listed on the Shanghai Stock Exchange having risen by 33% in the last 11 months, including a one-day move of +9% in the last fortnight.

And this year's winner of the X-Factor award is …

The US economy is in its sixth year without experiencing recession, despite the many predictions of an imminent and deep economic downturn.

Don Stammer has been involved in investing for more than six decades as an academic, senior official of the Reserve Bank, an investment banker, the chairman of nine companies listed on the ASX, and a columnist for The Australian and Business Review Weekly.

In recent months, Don has joined with Ashley Owen and Shani Jayamanne in setting up the Dr Don Academy, which aims to provide guidance – to young investors particularly –by drawing on the three founders' combined investment experience of 124 years.

This article is general information only and does not consider the circumstances of any investor.

43 years of the X-Factor file

2024 The US economy is in its sixth year without experiencing recession, despite the many and frequent predictions of a deep and imminent economic downturn

2023 The surge in share prices of US tech stocks, and the better understanding of how they should be valued

2022 High inflation, tighter monetary policies, and sharp rises in interest rates

2021 The fracturing of the long-dominant view low inflation is here to stay

2020 Covid-19

2019 Strong share markets despite repeated predictions of global recession

2018 The impact from the royal commission on financial services

2017 The positive macro influences that, globally, restrained volatility, boosted shares and kept bond yields low

2016 Election of Donald Trump as US president

2015 Widespread experience of negative nominal interest rates

2014 Collapse in oil price during severe tensions in middle east

2013 Confusion on US central bank's "taper" of bond purchases

2012 The extent of investors' hunt for yield

2011 The government debt crises in Europe

2010 The government debt crises in Europe

2009 The resilience of our economy despite the GFC

2008 The near meltdown in banking systems

2007 RBA raises interest rates 17 days pre-election

2006 Big changes to superannuation

2005 Modest impact on economies from high oil prices

2004 Sustained hike in oil prices

2003 Marked fall in US dollar

2002 Extent of US corporate fraud in Enron etc

2001 September 11 terrorist attacks

2000 Overshooting of exchange rates

1999 Powerful cyclical recovery across Asia

1998 Resilience of our economy despite Asian crisis

1997 Asian financial crisis

1996 Global liquidity boom created in Japan

1995 Powerful rally in US markets

1994 Sharp rise in bond yields

1993 Big improvement in Australian competitiveness

1992 Souring of the vision of "Europe 1992"

1991 Sustainable collapse of inflation**1990** Iraq invasion of Kuwait

1989 Collapse of communism

1988 Boom in world economy despite Black Monday

1987 Black Monday collapse in shares

1986 "Banana Republic" comment by Paul Keating

1985 Collapse of A$ after MX missile crisis

1984 Measured inflation falls sharply

1983 Free float of Australian dollar

1982 Substantial Japanese buying of Australian bonds

Australian shares struggle as 2020s reach halfway point

Ashley Owen

Yes, it's halfway through the 2020s decade already! Time flies.

The decade started out with governments everywhere locking citizens in their homes and out of their businesses and schools for months on end, then they cut interest rates to zero and racked up war-time like debts spraying free money around everywhere, fuelling speculative bubbles in everything from housing to meme stocks, cryptos and 'NFTs', then we get a massive inflation spike (Duh!), followed by savage rate hikes – and before you know, it the decade is half over.

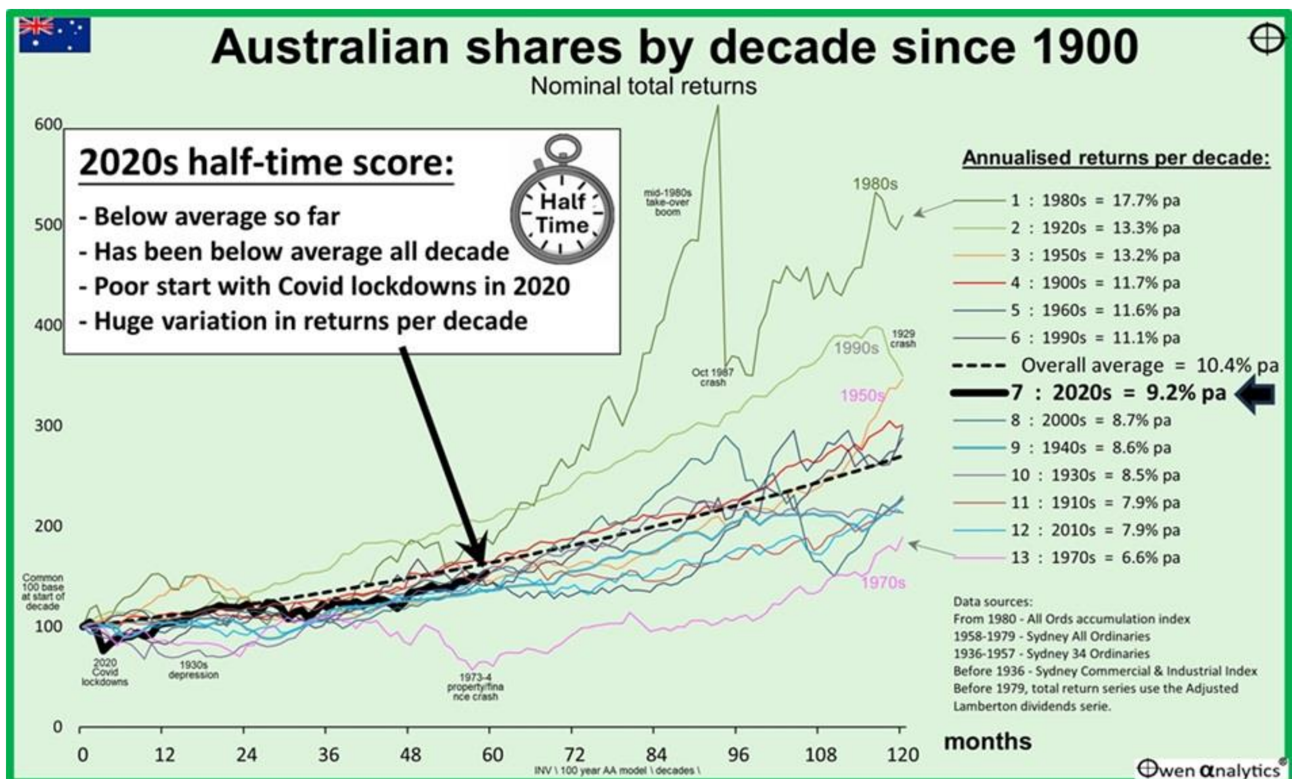
Meanwhile, Trump started out in the White House, then out, then sort of in, then really out, and now nearly back in again.

Time to take a look at half-time scores for investment markets. First up - the Australian share market.

The picture is not good:

- Aussie shares are having a **below-average** decade so far (and below other markets including the US).
- It has remained below average all decade – after a poor start with the 2020 Covid lockdowns.
- But all is not lost – some past decades also started out slow but ended up with good full decade returns.
- There is plenty of time left this decade for the next big speculative boom to lift the share market – history is on our side.

This chart shows nominal total returns from the broad Australian share market per decade since 1900. ('Nominal' means not adjusted for inflation. 'Total returns' means price gains/losses plus dividends reinvested).



To the right of the chart are the average annualised returns per decade sorted from best decade (1980s) to worst (1970s). The average decade return has been 10.4% pa (dotted black line), and the current decade is running below that at 9.2% pa at half-time (solid black line).

Best decades

By far the best decade for the Aussie share market was the 1980s, with returns averaging 17.1% pa or a total gain of 409% for the decade. It started out strongly with the early 1980s property construction and mining booms, but those booms quickly collapsed in the 1981-83 recession after cash rates were hiked to 20% to attack inflation running at 12%.

Our early 1980s recession was milder than the US inflation-busting Volcker recessions because the government and RBA opted not to attack inflation with interest rates but use the Accord process instead.

In the mid-1980s, we had an extraordinary speculative boom driven by Labor's raft of economic reforms, including floating the dollar, deregulating capital markets, interest rates, and banks. This fuelled a wild speculative lending and take-over boom that collapsed sharply in the October 1987 crash, but even after the overall market dropped by 50% in the crash, it was still much higher than when the boom started. Essentially the market doubled, then halved again in a little over a year in 1986-87.

At the end of the 1980s decade following the 1987 crash, the deregulated banks survived but switched from mad lending on crazy take-over deals in the mid-1980s, to mad lending on crazy property construction deals in the late 1980s. This boom would also collapse of course, but that was in a new decade – the 1990s.

The 1990s was also a very good decade for the local share market, with returns averaging 11.1% pa, or 188% in total. It started out poorly with the 1990-91 recession and 1992-93 bank crisis caused by the orgy of bad lending in the 1980s coming home to roost. However, despite this poor start, the 1990s turned out to be a very good decade, thanks to the late 1990s 'dot-com' boom. That boom also collapsed, of course, but the '2001-02' tech wreck was in a new decade.

Worst decades

The worst decade for Australian shares since Federation was the 1970s, with total returns averaging just 6.6% pa, or 89% in total. (Actually the 1890s was even worse, but that's another story for another day)

The 1970s started out badly with the early 1970s collapse of the wild late-1960s speculative mining boom. Then things went from bad to worse with spiralling inflation and the Whitlam government's chaos and spending sprees. The share market collapsed in the 1973-74 credit crunch, and it recovered only weakly by the end of the 'stagflation' decade.

After the 1970s, the next worst decade for Australian share market was the 2010s. Unlike the 1970s, there were no major crashes during the 2010s decade, just a succession of minor crises – 'Greece 1' in 2010, 'Greece 2' and the US debt downgrade crisis in 2011, the China slowdown and commodities collapse in 2014-5, and the US rate hike/recession scare in 2018. Overall, a very poor decade with returns of just 7.9% pa, or 113% in total.

2020s at half time?

At the half-way point in the current decade, the overall Aussie share market has returned and average of 9.2% per year. This is below the overall average return of 10.4% pa since 1900.

If the last decade (the 2010s) was a poor decade, and the current one is poor so far, can we have two poor decades in a row? Sure. The 1930s and 1940s were both poor decades with below-average returns. The 2000s and 2010s were also both poor decades with below average returns. Unfortunately, there is no magic rule that says that one poor decade will be followed by above-average returns next decade.

All is not lost

The fact that we have had a poor first half does not necessarily mean that it will end up being a poor decade overall. There were several times in the past when a **poor** first half decade turned into an **above-average** full decade. For example:

- The **1900s** decade was at a similar below-average level at half-time, thanks to severe drought in the early years, but still ended up returning an above-average 11.7% pa for the full decade. The drought ended and we had a strong revival of wool and wheat in the latter years.
- The **1950s** decade had a worse first half than we are now in the 2020s, with the Korean War inflation spike and recession in the early years but ended up returning a very strong 13.2% pa for the full decade. The inflation spike was resolved, and a consumer finance boom boosted the market in the late 1950s (but collapsed in the early 1960s).
- The **1960s** decade also had a worse first half than the 2020s but ended up returning 11.6% pa for the full decade, thanks to the wild late-1960s speculative mining boom.
- The **1990s** decade also had a worse first half than the 2020s, with the first half marred by the 1990-1 recession and 1992-3 bank crisis. But the 1990s decade ended up returning 11.1% pa for the full decade, thanks to the late 1990s 'dot-com' boom (which collapsed in early 2000s).

We need another speculative boom

Do you see a common pattern here? It is a strange phenomenon that speculative booms have tended to occur in the latter part of decades. For example: housing, suburbanisation, and motor cars in the late 1920s, gold in the late 1930s, consumer finance in the late 1950s, mining in the late 1960s, construction and mining in the late 1970s, take-overs, housing, and construction in the late 1980s, 'dot-com' stocks in the late 1990s, mining in the mid-late 2000s.

Each of these booms collapsed of course – mostly at the end of the decade or early in the new decade.

Where are we now?

So far in the 2020s decade, Australia has largely missed out on the current US-led social media /AI boom (hence the relatively poor returns here) – but we have another half a decade to find the next boom.

The good news is that humans have a never-ending ability to come up with new ideas to fuel the next speculative boom. They always eventually collapse, but there is still a good chance the next boom will power the local share market to good returns by the end of the current decade.

There is ALWAYS another speculative boom - I just don't know what it will be yet.

Pricing expensive

Although the first half of this decade has been below average, the local share market is at very expensive levels at present. Share prices have risen by below average levels so far this decade, but aggregate profits and dividends have been even weaker. Consequently, the current market is very expensive relative to aggregate profits, dividends, book values, and returns on equity.

The current poor share price performance this decade is masking an even weaker performance of the local economy, profits, and dividends.

The problem is that expensive pricing on fundamentals usually means below average returns ahead. Therefore, if the market is going to surge ahead and end up with an average (or better than average) decade from the current halfway point, it will need to be an almighty speculative boom in the next few years to do the job.

Fortunately, our market has a history of wild speculative booms that have run well ahead of fundamentals, so there is no reason that this regular pattern will end now. We just need another one soon.

Huge variation in returns in different decades

This chart highlights the huge variations in returns in different decades. Finance textbooks say that 10 years is 'long-term', and share funds always warn potential investors that the minimum holding period for shares is 7-10 years.

The implication is that if you should be prepared to hold for a minimum of 7-10 years because the share market is volatile - ie result in very different outcomes over shorter holding periods. The problem is that the outcomes are very different even over 10 year holding periods, like the different decades on the chart.

Time in the market' only works if you pick the right decade/s

The chart shows that even 10 years is a not nearly long enough to reduce the variability of returns and provide investors with any degree of confidence that a 10-year holding period will result in returns mor or less around the long term average. Unfortunately, in the real world, the share market can generate returns well below average (or well above average) even for 20 year holding periods or more sometimes.

If you are relying on **'time in the market'**, then much of it comes down to pure **luck** – when you happen to have been born – which more or less determines when you start working and investing, and when you retire.

For example – if you happened to retire at the start of the 1930s or at the start of the 2000s with a pot of money to fund your lifestyle, you would have immediately faced two decades of **very poor returns** (lower lifestyles and/or run out of money sooner) in both cases.

But if you happened to retire at the start of the 1950s or at the start of the 1980s, then would have faced 20 years of significantly **above average returns** (better lifestyles and/or larger legacy) in each case.

That's the great lottery of birth, but it's too reliant on luck for my liking.

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: We're half-way through the 2020s decade! Here's the half-time score check on Aussie shares.

Is FOMO overruling investment basics?

Eric Marais

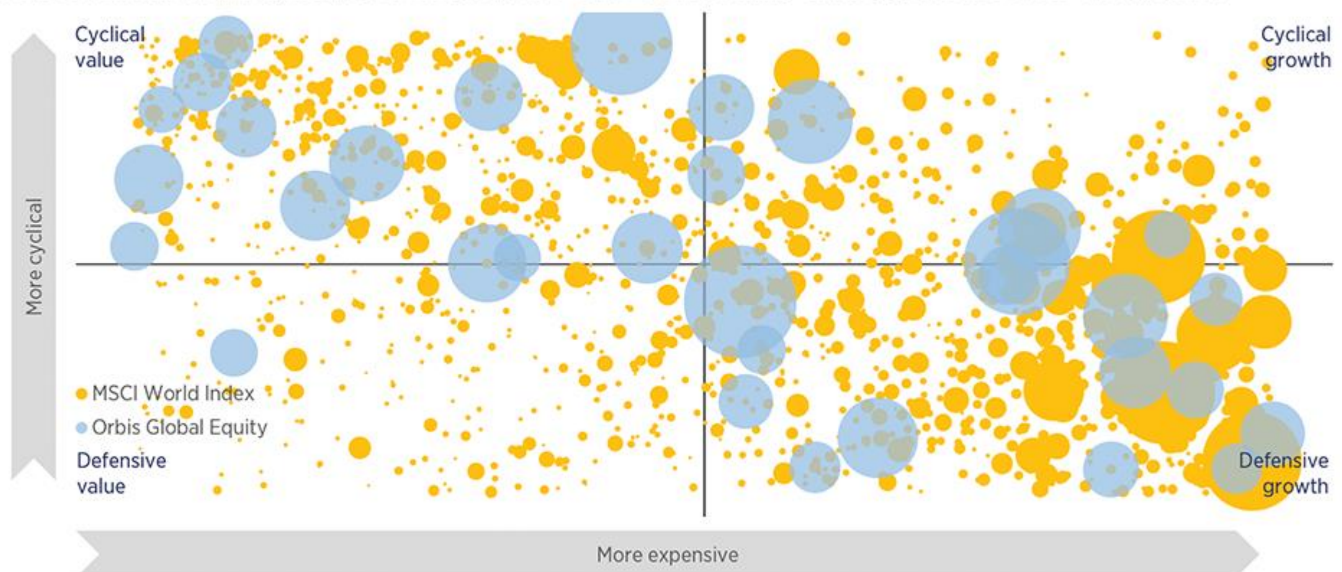
Four years ago, we introduced our 'bubbles' chart to show how the market had become concentrated in one type of stock and one view of the future. The chart maps every stock in the MSCI World Index, with the size of each bubble representing a stock's weight in the Index. Cheaper stocks are on the left, and richer ones on the right, with defensives at the bottom and cyclicals at the top.

In 2020, we wrote that the market had become concentrated in the 'defensive growth' quadrant on the bottom right, particularly among lockdown beneficiaries, like Netflix and Amazon, whose positions looked unassailable.

That period also saw the rise of pandemic darlings such as Zoom and Peloton—where valuations looked exuberant to say the least. At one point, the exercise bike maker was valued more highly than Honda Motor, the world's largest motorbike maker (and a pretty big automaker too). The prices of lockdown darlings subsequently collapsed, as did those of speculative SPACs, meme stocks, non-fungible tokens, and hundreds of crypto currencies.

Over the past year, some of that market exuberance has returned. In equities, artificial intelligence is now the dominant theme, but signs of froth abound, spurred by the US election. Bitcoin's price has blown past previous records. Tesla, which a few months ago was facing relegation from the Magnificent Seven, has added $200bn to its market value since the election—despite earnings expectations declining. And, thanks to the Tesla CEO's role at the new Department of Government Efficiency, or DOGE, the joke cryptocurrency dogecoin has seen its price surge by 150%.

All that to say, while much has changed since 2020, much remains the same. A few years on, our bubbles chart tells the same story, and today over 60% of the World Index sits in the 'defensive growth' quadrant. Investors remain focused on one theme and one view of the future, and seem more afraid of missing out than losing money.



Source: Orbis analysis. Statistics are compiled from an internal database and are subject to subsequent revision due to changes in methodology or data cleaning. Stocks are ranked based on a composite valuation metric and on their sensitivity to changes in bond yields (a proxy for cyclicality). Bubble size reflects the weight of each stock in the MSCI World Index and, for positions >1%, a representative account of the Orbis Global Equity Strategy.

Alternatives that can deliver returns

So what is an active investor to do? Some are becoming active with passive characteristics—we have heard several cases of investors simply buying the Magnificent Seven to the index weight, a decision that explicitly ignores price and fundamentals. Providers of exchange traded funds are making that easier, introducing super concentrated funds that only own the biggest stocks. Throwing investing basics out the window does not typically end well.

The global stock market is a big place, and we think it's unlikely that the most richly-valued part of it has a monopoly on good opportunities. In contrast, our bottom-up process has uncovered opportunities across all four corners of the market—the blue bubbles in the chart.

As a sample, the Korean banks sit across the 'value cyclical' and 'value defensive' buckets. Some quality companies like Nintendo are in the 'growth cyclical' quadrant, while a handful of owner-led businesses such as Corpay, RXO, GXO, and XPO sit in the 'growth defensive' bucket.

Rather than being concentrated in similar stocks, our portfolio is well diversified across characteristics, regions, and sectors. Crucially, we believe that every stock in the portfolio trades at a discount to its intrinsic value. In many cases, we are paying low price-to-earnings multiples on cyclically depressed earnings. Such stocks offer the potential for a double win, as both earnings and valuations recover. This stands in stark contrast to some of the high-flying stocks in the Index, where expectations for stellar growth are already baked into the price. Paying a high multiple on cyclically high earnings is a dangerous game.

Eric Marais is an Investment Counsellor at Orbis Investments, a sponsor of Firstlinks. This article contains general information at a point in time and not personal financial or investment advice. It should not be used as a guide to invest or trade and does not take into account the specific investment objectives or financial situation of any particular person. The Orbis Funds may take a different view depending on facts and circumstances. For more articles and papers from Orbis, please click here.

Is Medibank Private a bargain?

Emma Fisher, Vinay Ranjan

The Medibank and ahm private health insurance brands serve over 4.2 million customers and play a vital role in funding medical care in Australia. In the most recent financial year, Medibank paid out $6.3 billion in health insurance claims, taking a significant burden off the public healthcare system.

Yet recently, the sector has come under fire from both the government and hospitals accused of making too much profit. In this article, we explore this regulatory tension and why we think Medibank looks an attractive investment opportunity.

Private hospital profits affected by new models of care

There is no doubt the past few years have been challenging for hospitals – labour shortages have affected service levels and inflation has been rampant. Private hospital operators have responded by launching a campaign against the health insurers and pressuring the government for a bailout. While additional payments or a tax may provide short-term relief to hospitals, they do not solve the structural issues facing the sector and ultimately would drive up the cost of healthcare and premiums for millions of Australians. To build a sustainable private healthcare system, all participants must work together to find efficiencies and drive down the overall cost of care.

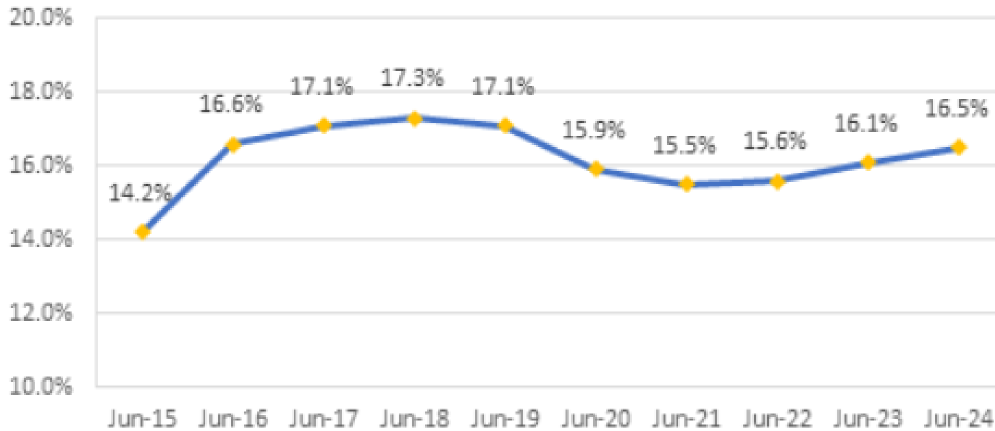
Medibank is doing its part to lower costs by investing in new models of care away from overnight stays in expensive acute care hospitals to virtual, short-stay hospitals and home care. Without this transition, Medibank estimates the government will need to spend 50% more on healthcare as a percentage of GDP in 40 years. While this transition does come at the expense of hospitals that typically earn more for longer in-hospital stays, it is beneficial for the wider healthcare system. Higher hospital costs would simply translate to higher premiums, which are likely to push more members out of private health insurance and place further strain on an already stretched public healthcare system.

It is for this reason the Federal Health Minister following a review has conceded, "There's no silver bullet from Canberra or funding solution from taxpayers to deal with what are essentially private pressures in the system". Ultimately, it is not the government's job to prop up unprofitable business models and in some cases, it is healthy for some private hospitals to shut where there is overcapacity in the system.

Has Medibank profited at the expense of hospitals?

Medibank has stuck to its promise not to profit from the pandemic and returned a total of $1.46 billion in givebacks to customers for permanent claims savings due to COVID-19. This is evident in the chart below which shows Medibank's health insurance gross profit margin is still below FY19 levels.

Figure 1 – Medibank Health Insurance Gross Margin



Source: Company filings

Fear of regulation creates opportunity to invest

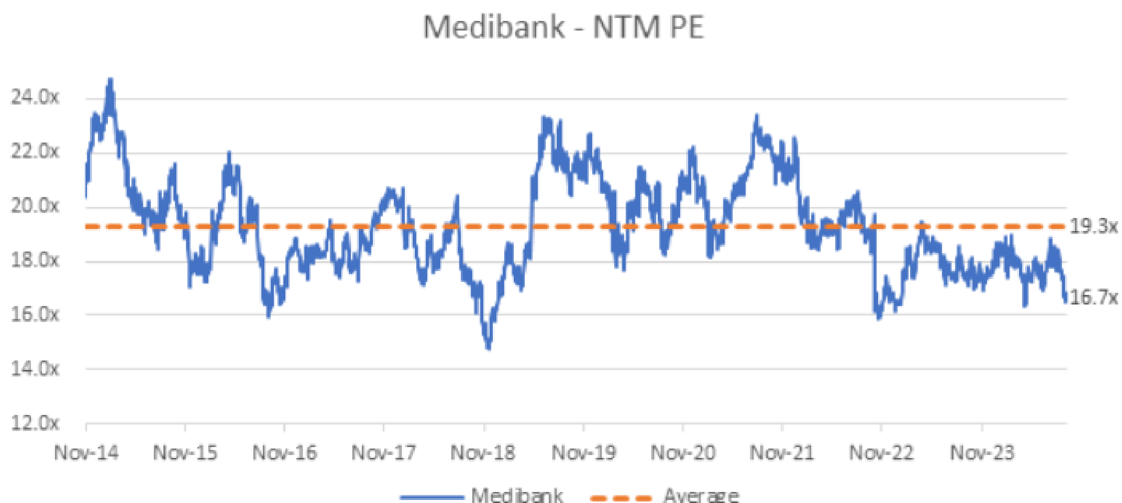
While there remains uncertainty as to how the regulatory situation will unfold with a federal election coming up, we think it's unlikely the government will step in and prop up private hospitals where there is a clear shift to lower-cost care outside the hospital. In the meantime, we believe this creates an opportunity to invest in Australia's largest health insurer, which has grown its earnings per share at 8% p.a. over the past decade.

Medibank screens as a high-quality business under our investment process for the following reasons:

1. **Financial strength**: Medibank has a strong capital position with a capital ratio of 14.1%, well above its 10-12% target range, and has zero debt on its balance sheet.
2. **Business quality**: Medibank is Australia's largest health insurer with 4.2 million members (27% market share). This scale enables Medibank to negotiate better terms with hospitals keeping a lid on claims inflation while sharing these savings with members to lower premiums and improve retention.
3. **Management quality**: David Koczkar has been the CEO since 2021 and prior to this was the COO since 2014. Over this period, the company has seen a return to policyholder growth, expanded its health offering and tightly managed its costs.

Finally, from a valuation perspective, Medibank is trading on less than 17x P/E (below its long-term average of 19x) and offers investors an attractive dividend yield of 4.6%.

Figure 2 – Medibank NTM Rolling PE



Source: FactSet

Emma Fisher is a Portfolio Manager and Deputy Head of Australian Equities, and Vinay Ranjan is Deputy Portfolio Manager at Magellan-owned, Airlie Funds Management. Magellan Asset Management is a sponsor of Firstlinks. This article has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not consider your investment objectives, financial situation or particular needs.

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Negative correlations, positive allocations

Emmanuel Sharef, Erin Browne

If the prevailing theme in asset allocation since early 2023 has been that bonds are back, a nascent theme today is correlation: specifically, the negative relationship between stocks and bonds has reemerged as inflation and economic growth moderate.

This is great news for multi-asset investors: it means they can increase and broaden their allocation to risk assets, seeking potentially higher returns with the potential for adding little to no additional volatility within the overall portfolio. Equities and bonds can complement each other in portfolio construction, and both are likely to benefit in our baseline economic outlook for a soft landing amid continued central bank rate cuts.

PIMCO's multi-asset portfolios therefore focus both on equities, with a slight overweight in the U.S., and on fixed income – especially in high quality core bonds, which we believe offer notable risk-adjusted return potential. Strategic investments in options and real assets can help manage risks, and systematic equity trades may enhance returns and help mitigate risks.

Investors are also considering the potential impact of U.S. policy under the second Trump administration and a narrowly unified Republican Congress. Bond markets had largely anticipated the Trump victory, and given the prevailing economic landscape, we expect bond yields will remain in an attractive range amid the transition to new leadership in Washington. In equity allocations, investors may want to consider U.S. companies that don't rely as heavily on imports (given potentially higher tariffs), as well as those likely to be buoyed by deregulation and more favorable tax policies. Finally, an allocation to inflation-linked bonds or other real assets could help hedge against the potential risks of increasing inflationary pressures arising from fiscal policy or tariffs.

In our view, staying invested in core, high-conviction trades within a well-balanced portfolio can help investors achieve target objectives while navigating unexpected twists ahead.

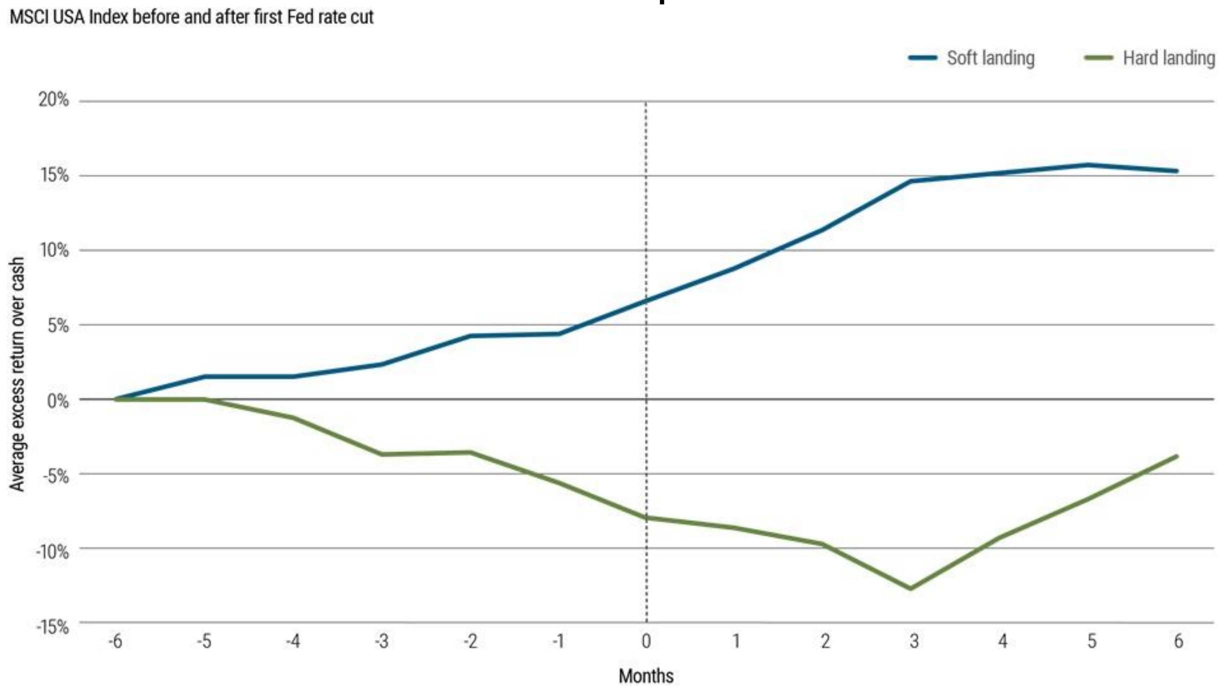
Equity markets in rate-cutting cycles

While this business cycle has experienced pandemic-related surprises, inflation has now moved down the list of concerns. The precise trajectory of monetary policy may vary, but the Federal Reserve and most major central banks have clearly indicated their intentions to lower interest rates toward neutral. (Learn more in our latest *Cyclical Outlook,* "Securing the Soft Landing".)

How do rate cuts affect stocks? Basic principles of asset valuation teach that, all else equal, lower central bank rates (as proxies for 'risk-free' rates) lead to higher equity prices. Yet all else is rarely equal, and our historical analysis shows that economic activity has been the dominant driver of equity returns during rate-cutting cycles. If an economy slides into recession, rate cuts alone may not prevent stock market losses. However, if economic activity stays buoyant, rate cuts have potential to boost stock valuations.

There is no guarantee, of course, that these historical patterns will continue, but they can offer a guide. In Figure 1, we focus on the performance of the MSCI USA Index, a broad measure of large and mid-cap equities, six months before and after the Fed's first rate cut in cycles from 1960 through 2020 (the most recent rate-cut cycle prior to the one that began this year). This dataset encompasses nine soft landings and 10 hard landings. In the median soft landing, U.S. equities rallied through the first Fed cut, but performance tapered off three months after the cuts began. In the median hard landing, U.S. equities declined both before and after the first cut, bottoming about three months after the cuts began.

Figure 1: Historical U.S. equity market performance during rate-cut cycles depended on economic backdrop



*Source: MSCI data and PIMCO calculations through September 2020. **Past performance is not a guarantee or a reliable indicator of future results.** Hard landings are defined as periods in which U.S. unemployment increases at least 0.5 percentage points from six months prior to six months after the first Fed rate cut.*

In both hard and soft landings, the initial rate cut typically led to stronger equity performance, at least in the first month or so, as cuts generally boost sentiment and real economic activity. However, before long, equity markets usually start to reflect the prevailing macro environment.

Examining historical equity market performance by factor and sector in the six months after the first rate cut shows that, on average, growth outperformed value, large caps outperformed small caps, and dividend yield and quality offered positive returns overall. Homing in on the six rate-cutting cycles accompanied by soft landings since 1984, we find that later in the rate-cut cycle (approaching 12 months), small caps began to overtake large caps as economic growth accelerated. Additionally, technology, healthcare, and consumer staples generally outperformed, while energy, communications, and financials lagged.

Every cycle is different, as is the macro environment that accompanies it. However, the historical pattern suggests that an equity allocation today could effectively combine secular growth themes with more defensive, rate-sensitive beneficiaries, such as real estate investment trusts (REITs).

Bond markets in rate-cutting cycles

Historical analysis also shows that bond returns have been positive during Fed rate-cutting cycles across a range of macroeconomic environments. Moreover, analysis indicates that the starting yields of high quality core fixed income securities are strongly correlated (r = 0.94) with five-year forward returns.[1] Thus, today's attractive starting yields bode well for fixed income investments.

As the Fed proceeds with rate cuts, bond investors may benefit from capital appreciation and earn more income than what money market funds provide. In multi-asset portfolios, conservative investors can seek higher risk-adjusted returns by stepping out of cash and onto the curve, while balanced portfolios can increase duration exposure. Of course, high quality bonds may also offer downside mitigation in the event of a hard landing.

Within fixed income, high quality credit and mortgages can enhance yields and serve as diversifiers. In particular, agency mortgage-backed securities (MBS) appear attractively valued, with spreads over U.S. Treasuries near historical highs, making them a liquid alternative to corporate credit.[2] Historically, agency MBS have also provided attractive downside resilience for portfolios: During recessionary periods, they have delivered an average 12-month excess return of 0.91 percentage points above like-duration U.S. Treasuries, versus -0.41 percentage points for investment grade corporates.[3]

Negative stock/bond correlation: portfolio implications

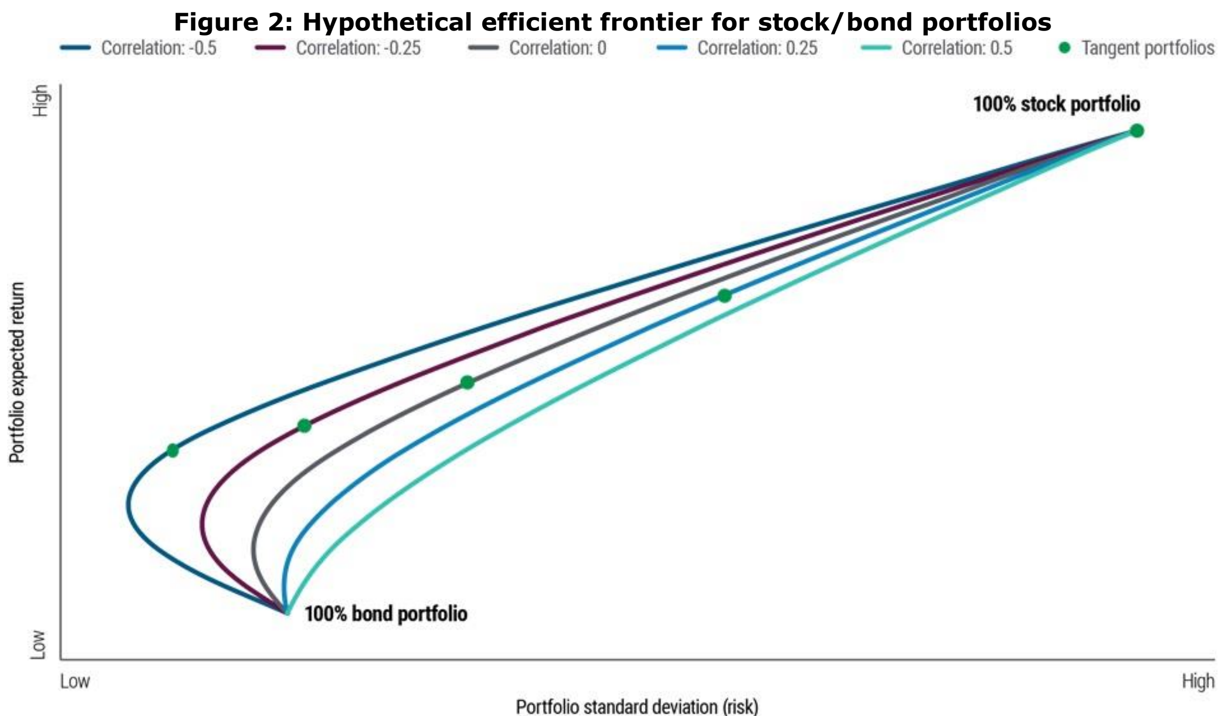
The stock/bond correlation tends to turn lower and then negative as inflation and GDP growth moderate, as is the case in the U.S. and many other major economies today. Analysis of monthly measures of stock/bond correlation data since 1960 tracked against inflation rates indicates a clear trend: When inflation is at or near central bank targets (around 2%), as has generally been the case in developed markets since the 1990s, the stock/bond correlation has been negative or very narrowly positive.

In practice, a low or negative stock/bond correlation means that the two asset classes can complement each other in multi-asset portfolios, enabling investors to broaden and diversify their exposures while targeting return objectives.

For instance, investors with a specific risk budget can own a greater range and number of risk assets while staying within their tolerance, while investors with a predefined asset allocation mix can target lower volatility, smaller drawdowns, and higher Sharpe ratios (a measure of risk-adjusted return).

In general, negative correlations can enable asset mixes that experience lower volatility than any individual asset, while still targeting attractive returns. A hypothetical efficient frontier exercise helps illustrate this (see Figure 2): When the stock/bond correlation is negative, there are regions along the lower-risk portions of the frontier where investors may target an asset mix that offers a somewhat higher potential return profile despite a drop in expected volatility.

Figure 2: Hypothetical efficient frontier for stock/bond portfolios



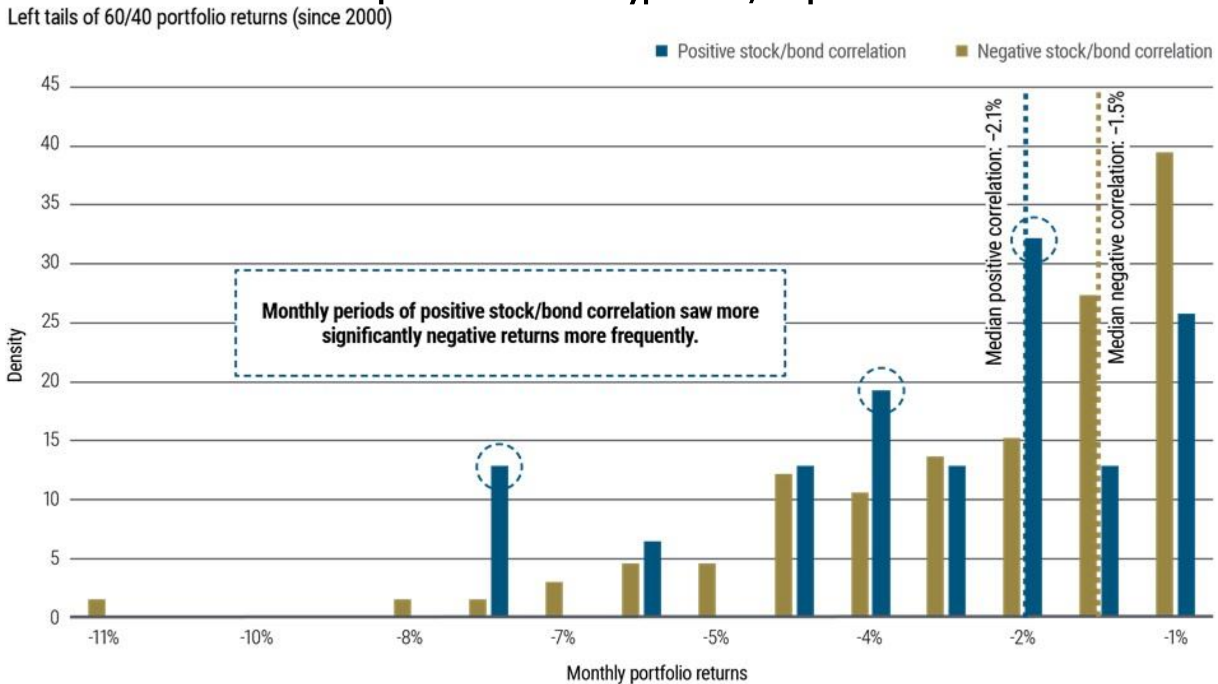
Source: PIMCO as of 31 October 2024. ***For illustrative purposes only. Figure is not indicative of the past or future results of any PIMCO product or strategy. There is no assurance that the stated results will be achieved.*** *This figure shows simple hypothetical two-asset efficient frontiers for different assumed stock (proxied by the S&P 500 Index) / bond (proxied by the 10-year U.S. Treasury) correlations. The efficient frontier models represented in this report are bound by the data sets and date ranges used in those models. Different time periods or data sets may produce different results. Past performance is not a guarantee or a reliable indicator of future results. Certain assumptions were made in this analysis, which have resulted in the returns detailed herein. Changes to the assumptions may have an impact on any returns detailed. Transaction costs (such as commissions or other fees) are not included in the calculation of returns reflected. If these fees and charges were included the performance results would be lower.*

A lower volatility from portfolio beta could also free up space for more exposure to alpha strategies, such as systematic equities.

For multi-asset investors able to access leverage, negative stock/bond correlations could allow even higher total notional levels for a given risk target, as long as the portfolio returns exceed borrowing costs. The value of leverage in a diversified portfolio tends to be greater when correlations are negative.

A look at the historical extreme ('tail') scenarios of negative returns in a simple multi-asset portfolio consisting of 60% stocks and 40% bonds further illustrates the beneficial characteristics of a negative stock/bond correlation (see Figure 3). Periods with positive stock/bond correlation have typically seen more severe (worse) left-tail outcomes for multi-asset portfolios than periods with negative correlations. This is true even though most recessions have had deeply negative stock/bond correlations, because equity drawdowns were partially offset by gains in the fixed income allocation.

Figure 3: Periods of negative stock/bond correlation historically have seen less severe underperformance in a typical 60/40 portfolio



Source: Bloomberg data and PIMCO calculations as of October 2024. ***Past performance is not a guarantee or a reliable indicator of future results.*** *Data is based on a portfolio of 60% stocks (proxied by the S&P 500 Index) and 40% bonds (proxied by the Bloomberg US Aggregate Index). Density is defined as the normalized frequency of negative return periods under both negative and positive stock/bond correlation environments.*

Mitigating risks

While the opportunity set for multi-asset portfolios is rich, elevated risks related to public policy, geopolitics, and monetary policy mean that investors should consider designing portfolios capable of withstanding unlikely but extreme tail events. Even as one of the biggest global election years in history (by voting population) concludes, uncertainty remains about how policies could affect inflation, growth, and interest rates. Additionally, ongoing conflicts in the Middle East and between Russia and Ukraine, and potential for geopolitical unrest elsewhere, could roil markets.

While the negative stock/bond correlation means portfolios may be better positioned to navigate downturns, it can't prevent and may not mitigate all the risks of tail events. But investors have other strategies available, such as dedicated tail risk management. Active drawdown mitigation may include selectively using options when volatility is reasonably priced. The availability of volatility-selling strategies in recent years, including the rapid growth of options-selling ETFs, has increased the supply of volatility options, especially in the short end of the yield curve. This trend can make downside hedging more economical during opportune times.

We also believe it is prudent to hedge multi-asset portfolios against upside risks to inflation. Although restrictive central bank rates have brought inflation levels down close to targets, the long-term fiscal outlook in the U.S. includes continued high deficits, and geopolitical surprises could cause a spike in oil prices or snarl supply chains. Trade policies, such as tariffs, and deglobalization trends could also pressure inflation higher. We believe inflation-linked bonds (ILBs) remain an attractively priced hedge, offering compelling return potential as long-term real yields are currently near their highest levels in 15 years. Furthermore, long-term breakeven inflation rates are priced around or below the Fed's target, reflecting little to no risk premia despite the recent memory of a sharp inflation spike.

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Download our investor handout for details on how we are positioning portfolios across global asset classes.

[1] Source: Bloomberg, PIMCO as of 30 September 2024 based on the Bloomberg US Aggregate Bond Index.
[2] Liquidity refers to normal market conditions.
[3] Sources: Bloomberg, National Bureau of Economic Research (NBER), and PIMCO calculations. Date range is October 1998 – October 2024; recessionary periods during this range are per NBER. Agency MBS is represented by the Bloomberg US Fixed Rate MBS Index and investment grade corporates are represented by the Bloomberg US Corporate Index.

The secret to a good retirement

Shiori Shakuto

What makes a good retirement? I've been researching the lives of 'silver backpackers': Japanese seniors who embark on a later-life journey of self-discovery.

Many experienced Japan's high-growth economy, characterised by rigid gender roles. For many men who worked as iconic cultural figures of *sarariiman* (white collar workers), excessive working hours were normalised and expected. Their absence from home was compensated by their female partners, many full-time stay-at-home mothers.

Entering their 60s meant either retirement from work, or children leaving home. For men and women, retirement is understood as an opportunity to live a life for themselves, leading to a journey of self-discovery.

Dedicating life to work

I interviewed more than 100 older Japanese women and men and found a significant disparity in the quality of life between them.

Japanese retired men who led a work-oriented life struggled to find meaning at the initial stages of retirement.

One man I spoke to retired at the age of 60 from a large trading company. He was a successful businessman, having travelled the world and held various managerial positions in the company. His wife looked after the children most of the time.

They bought a house with a yard in a suburb so the children could attend a good school. It significantly increased his commute, and further reduced his time with children. He also worked on weekends. He barely had time to develop his hobbies or get to know his neighbours.

He idealised his retirement as a time to finally spend with his family and develop his own hobbies. When he retired, however, he realised that he and his family didn't have any common topics of conversation.

Through decades of excessive hours spent at work away from home, the rest of the family established a routine that did not include him. Taking up new hobbies at the age of 60 was not as easy as he thought, nor was making new friends at this age.

"I became a *nureochiba*," he lamented. *Nureochiba* refers to the wet fallen leaves that linger and are difficult to get rid of. The term is commonly used to describe retired men with no friends or hobbies who constantly accompany their wives.

The retirement for many former *sarariiman* was characterised by boredom – having nowhere to go to or having nothing to do. The sense of boredom led to a sense of isolation and low confidence in old age. Many older

Japanese men I spoke to lament not having built a connection with their children or communities at a younger age.

Dedicating life to family and community

Older Japanese women I spoke with were more well-connected with their children and local communities in later life. Many were in regular contact with their children through visits, phone calls and messages. Some continued to care for them by providing food or by looking after grandchildren. Children very much appreciated them.

Many older women who had been full-time stay-at-home mothers had already taken up hobbies or volunteering activities at community organisations, and they could accelerate these involvements in their old age.

Even women who worked full-time seemed to maintain better connections with their family members because working excessively away from home was simply not possible for them.

Older men relied on these women's networks and activities conducted at the scales of home and communities – from caring for others to pursuing hobbies – to enact a meaningful retirement. The sense of connection with family and communities, not to mention their husbands' reliance on them, led to a high confidence and wellbeing among older women.

I saw many instances where older women preferred spending time with their female friends than their retired husbands and embarked on adventurous trips alone. One woman went on a three-month cruise alone. Feeling liberated, she sent a fax message to her husband from the ship: "When I get off this ship, I will devote the rest of my life to myself. You will have to take care of your own mother."

Upon disembarking, she moved to Malaysia to start her second life.

The silver backpackers

Malaysia has become a popular destination for silver backpackers looking to embark on a journey of self-discovery. Some travel as couples, while others go alone, regardless of their marital status.

For many male silver backpackers I spoke to, moving to Malaysia offers a second chance at life to make new friends, find hobbies and, most importantly, start anew with their partners.

For many female silver backpackers, visiting Malaysia means being able to enjoy an independent lifestyle while having the security of friends and family in Malaysia and Japan.

The experiences of older Japanese men and women can be translated into the experiences of anyone who spent excessive hours at work and those who spent more time cultivating relationships outside of work. The activities of the latter group are not as valued in a society that narrowly defines productivity. However, my research shows that it is their activities that carry more value in old age.

Are you under pressure to work long hours? If you can, turn off your phone and computer. Instead of organising events for work, organise a dinner with your family and friends. Take up a new hobby in your local community centres. You can change how you work and live now for a better old age.

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