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Contents

Editorial

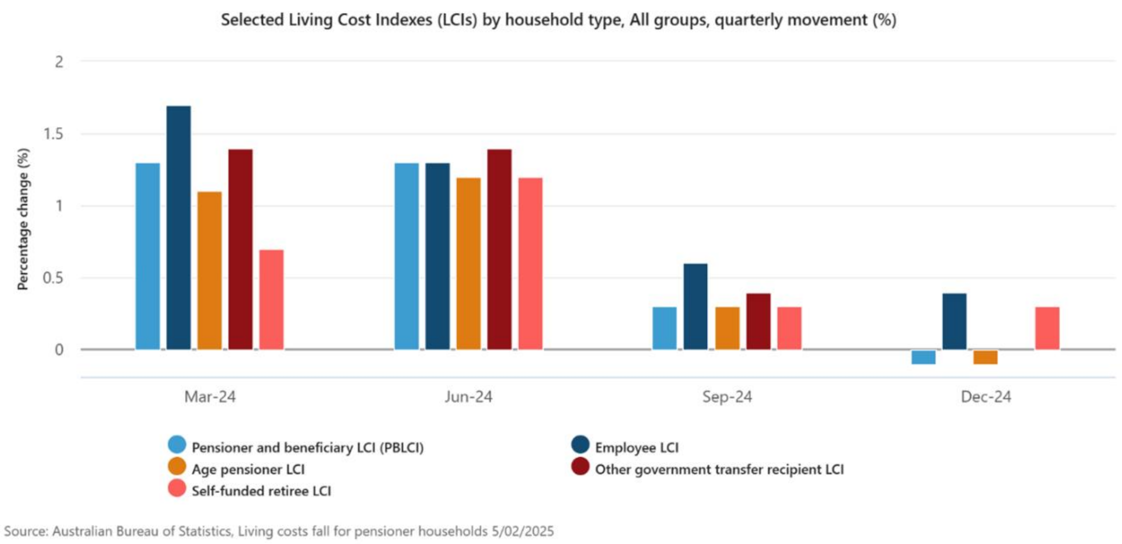
As we head into an election year, the cost-of-living crisis will be at the forefront of voters' minds. The good news for the Government is that cost inflation is continuing to ease.

The Australian Bureau of Statistics' (ABS) cost-of-living indices show living costs for age pensioner and pensioner and beneficiary households fell by 0.1% in the December quarter. For these groups, it was the first fall in quarterly living costs since the height of the Covid crisis in mid-2020.

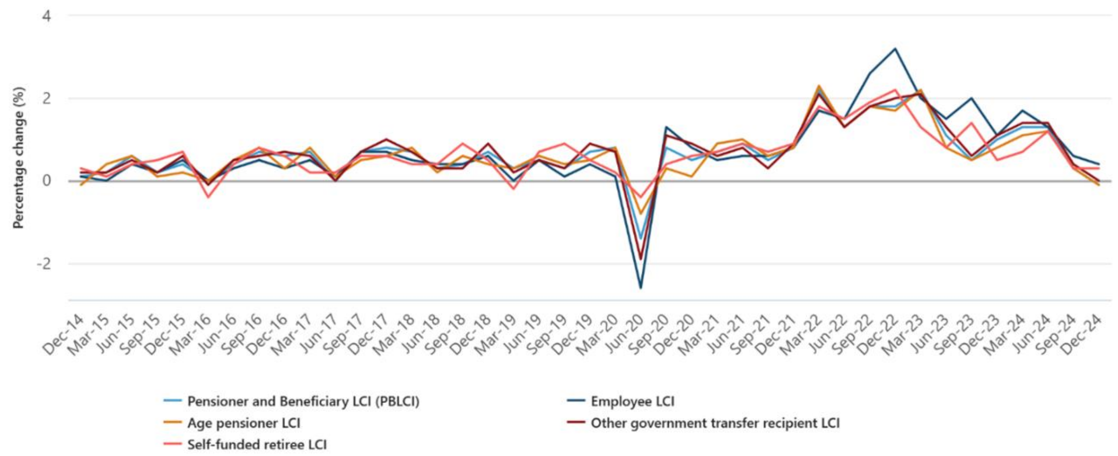
They were helped by two things. First, lower prices for electricity due to the 2024-25 Commonwealth Energy Bill Relief fund rebates. Second, an increase in Commonwealth Rent Assistance in the quarter, especially for age pensioner and pensioner and beneficiary households. This increased assistance reduced the amount of rent payable by eligible households.

So-called 'employee households' didn't fare as well. Their living costs went up 0.4% in the December quarter due to this group being more impacted by higher mortgage interest charges, partly from the continued rollover of expired fixed rate mortgages to higher variable rate mortgages.

However, living costs increases for workers for the December quarter were still considerably lower than the 0.6% and 1.3% recorded in the September and June quarters of last year.



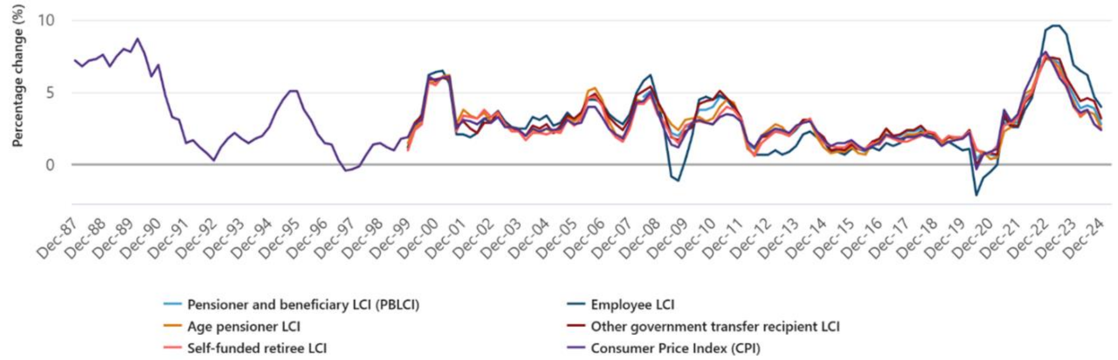
Selected Living Cost Indexes (LCIs) by household type, All groups, quarterly movement (%)



Source: Australian Bureau of Statistics, Living costs fall for pensioner households 5/02/2025

In the year to December, there was also progress. The ABS says it was the lowest rise in annual costs in more than two years. Households benefited from declines in electricity and fuel, as well as slowing growth in food prices, insurance premiums and mortgage interest charges.

Selected Living Cost Indexes (LCIs) by household type and Consumer Price Index (CPI), Australia, annual movement (%) (a) (b)

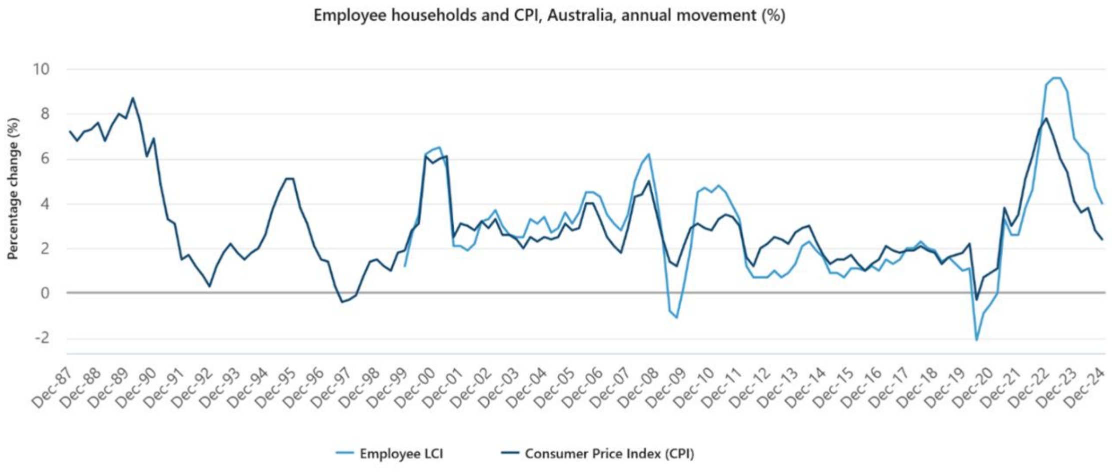


a. The Pensioner and beneficiary household series commenced in 2008.
b. The series for the remaining four household types commenced in 1999.

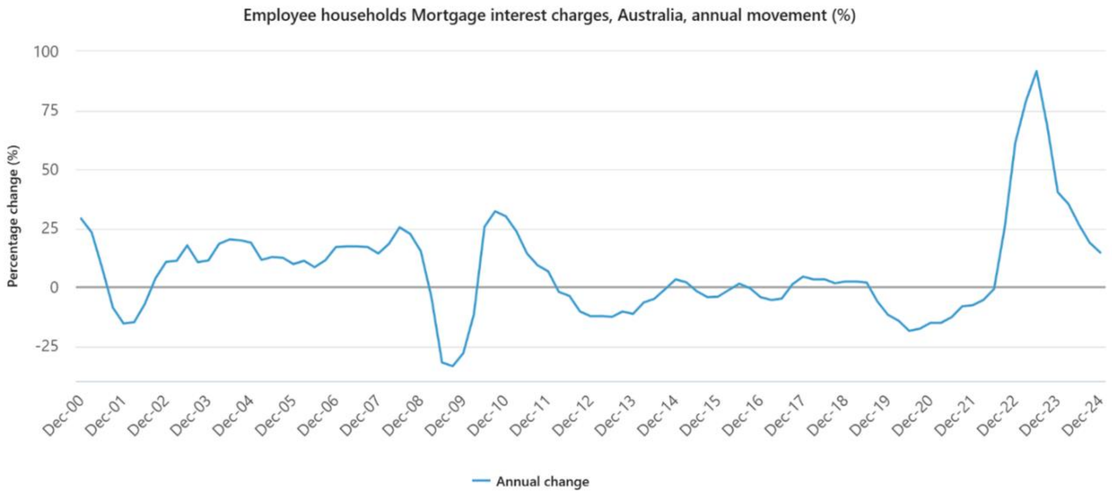
Source: Australian Bureau of Statistics, Selected Living Cost Indexes, Australia December 2024

Despite slowing increases, annual costs for each group were still above official CPI figures. Worker household costs rose 4% in the year to December, while those of pensioner and beneficiaries were up 2.8%, and aged pensioners and self-funded retirees were both 2.5% higher respectively – compared to the 2.4% increase in annual CPI.

The cost-of-living increase for workers was higher principally because of mortgage interest charges. These charges went up 14.7% for the year. Though worker cost growth of 4% was high for the year, it was still well down from the 6.9% recorded the previous year.

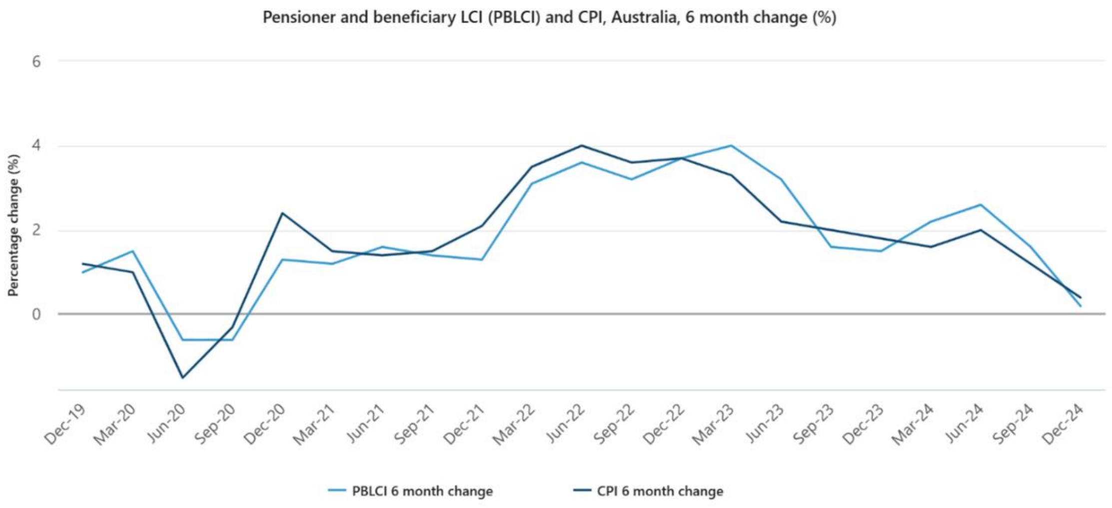


Source: Australian Bureau of Statistics, Living costs fall for pensioner households 5/02/2025



Source: Australian Bureau of Statistics, Selected Living Cost Indexes, Australia December 2024

Age pensioners and self-funded retirees saw the smallest annual rises in living costs due to mortgage interest charges and rents, both of which rose over the year, making up a smaller proportion of spending for these households.



Source: Australian Bureau of Statistics, Living costs fall for pensioner households 5/02/2025

It's positive for the Government that the cost-of-living crisis is largely in the rearview mirror. The problem is the cumulative inflation that's happened over the past few years. In the three years to December 2024, the CPI is up 15.3%, but the living costs for workers has risen 21.2%, while for pensioners it's up 16%, and for other groups it's been largely in line with official inflation. For all the different households, there's been a significant increase in costs over a short period.

Unfortunately for the Government, people don't celebrate when costs don't rise as fast as they once did. Instead, they remember that the $5 that they paid for a coffee a few years ago is now $6.

Let's see how it plays out in the upcoming election.

**For the un-initiated, the ABS cost-of-living indices are a useful alternative to the wide-quoted consumer price indices (CPI). While the CPI measures price changes, cost-of-living inflation is the change in spending by households required to maintain a given standard of living. The main difference between the CPI and the living cost indexes is that 'living costs' include interest paid on mortgages whereas 'consumer prices' do not.*

In my article this week, many assume that with rate cuts pending, house prices will again rebound after tepid growth last year. I crunch the numbers on housing affordability and suggest that it's likely to cap further price rises.

James Gruber

Also in this week's edition...

How do you start accessing your super funds when you stop working, or maybe even before you stop working? **Vanguard's Tony Kaye** provides a primer on moving into pension mode.

Glenn Davies and **Chris Evans** examine the capital gains tax main residence exemption and declare that it's no longer 'fit for purpose', due to its inequities, inefficiency, and complexity. They suggest ways that the concession could be adapted or curtailed.

Schroders Group CIO, Johanna Kyrklund, says investors face two key risks this year: the potential for higher bond yields to threaten equity valuations and any slip-up from the Magnificent Seven tech stocks given the market's heavy reliance on these companies. She outlines how to position your portfolio to meet these challenges.

There's been a lot of talk in the media about 'Big Super' and the systemic risks that it may pose. **David Bell** and **Geoff Warren** detail how these risks are likely overplayed and that we're better off having the mega super funds.

DeepSeek has hit the share prices of data centre companies, including Goodman Group and DigiCo. **Resolution Capital's Andrew Parsons** says data centre operators aren't just an AI story, and he remains optimistic on the industry outlook.

Gold was the best performing major asset class in Australian dollar terms last year. **Ray Gia** looks at what's in store for the yellow metal in 2025.

Finally, in this week's whitepaper, **RQI Investors** investigate market concentration and its implications for equity investors.

Affordability issues cap further house price rises

James Gruber

Most economists expect the RBA to cut rates by 25 basis points this month. They also expect that this will fuel renewed demand for housing, and lead to a bounce in home prices.

I get frustrated by the almost universal forecasts for house prices to increase by 8-10% annually, like they've done in the past. It's extrapolation and it's lazy. For instance, it doesn't consider how expensive current housing is. My valuations indicate housing in Australia is about 40% overvalued.

The forecasts are lazy also because they don't look at the implications of rising prices and what it will mean for affordability. In other words, whether people will be able to afford more expensive homes.

Some context

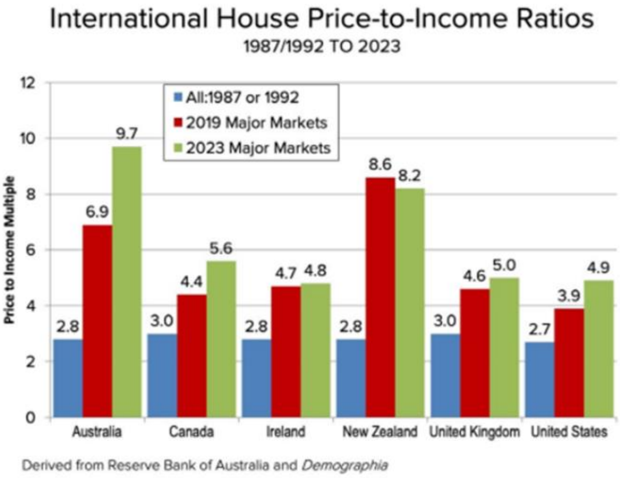
House prices across Australia rose 4.9% last year, and in capital cities, they were up 4.5%. Including rents, prices were 8.3% higher in 2024.

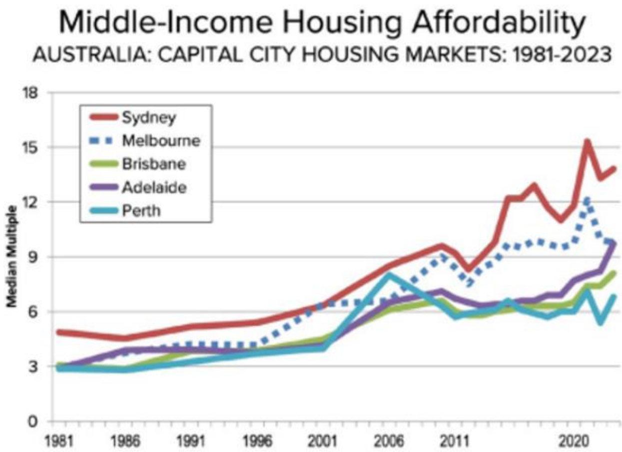
Over the past 10 years, 'hedonic' house values (including rental income) increased 133%, at a compound annual rate of 8.8%, according to CoreLogic.

It's been a stellar decade for the property market and it's continued an almost uninterrupted 35 years of prices rising in the high single digits annually on average.

The median house is now valued at $986,000 (this includes apartments, townhouses as well as houses).

International consultants, Demographia, say Australia's median price-to-income ratio of 9.7x puts it among the most expensive housing markets in the world. They categorise our five major capital cities, excluding Canberra, Hobart, and Darwin, as either severely unaffordable, or impossibly unaffordable.





Despite being arguably expensive, many economists, along with most Australians it would seem, expect houses to replicate the returns of recent decades moving forward.

Here I crunch the numbers to see if that's plausible.

The current state of play

Let's first try to calculate how affordable current housing is. Imagine a couple, Jack and Jill, who are looking to buy a home in Brisbane's outer northern suburbs. They're in their mid-30s, childless, and Jack has a full-time government job while Jill works part-time. Together, they have combined salaries of $101,000. After taxes, their household income is $71,000 (applying a 30% tax rate).

The house they have their eyes on is valued at $986,000. Jack and Jill have saved up for a deposit and can get a loan from the bank with a loan to value ratio (LVR) of 70%, at a rate of 6%.

That means interest payments will be $41,412 each year. With net household income of $71,000, before accounting for everyday expenses, it's not hard to see how challenging it will be for Jack and Jill to be able to afford the home they want. Remember, those annual interest payments don't include possible loan principal payments each year.

Jack and Jill	Dec-24
Median house price	986,000
Median household income	101,000
Tax rate	30%
Post tax household income	71,000
LVR	70%
Mortgage rate	6%
Interest payments p.a.	41,412

Source: Firstlinks, ABS

Jack and Jill's situation isn't unusual. In fact, they represent the typical Australian household. Their household income is identical to the median household income across the country. And the house they want to buy is in line with the median national house price.

Given these figures, some of you may wonder how the average family can afford a home at all. The median numbers don't factor in that Jack and Jill are entering their prime salary earning years and therefore may have a higher household income than the norm. Also, they may not be on the 30% tax rate applied above. They could have saved up enough to have money to put towards future interest payments. Or they could possibly have the Bank of Mum and Dad to help them out.

In other words, the numbers are approximate and are meant to give a rough guide on the affordability of houses for the typical Australian family.

Scenario 1: Jack and Jill buy later

Let's say Jack and Jill hold off buying now. Instead, they look to purchase a property in 10 years' time. Let's assume that house prices rise by 8% per annum over the next decade, largely in line with what they've done in recent decades. Let's also assume that salaries grow at 3.5% each year, in line with recent wage rises. Finally, let's also assume that the mortgage rate remains at 6%.

How do the numbers stack up for Jack and Jill by the end of 2034? The median house price will have risen to $2.13 million, from $986,000. Their household income, in line with the Australian median, will have grown to $142,470 and, assuming a 30% tax rate, post-tax income will be just under $100k.

How affordable will a mortgage be, then? At a 70% LVR and 6% interest rate, annual interest payments would be more than $89,000.

Scenario 1	Dec-34
Median house price	2,128,000
House price growth p.a.	8%
Median household income	142,470
Median household income growth p.a.	3.50%
Tax rate	30%
Post tax household income	99,729
LVR	70%
Mortgage rate	6%
Interest payments p.a.	89,405

In this scenario, the annual interest payments would take up about 90% of Jack and Jill's post tax income. Remember, that income doesn't include everyday expenses incurred each year. And the scenario excludes any loan principle that may need repaying.

It's easy to see that if the prospect of Jack and Jill buying a house is difficult now, then it would be impossible in 10 years' time in this example.

Zooming out, 8% annual property price increases alongside 3.5% annual wage rises would result in the median price to income ratio expanding from around 9.8x now to 15x in 2034.

Scenario 2: Lowering interest rates

I can foresee that some of you may push back, suggesting that mortgage rates I applied in the above examples are too high. Actually, 6% rates aren't high versus history; they're only high when compared to the past decade.

Scenario 2 (a)	Dec-34
Median house price	2,128,000
House price growth p.a.	8%
Median household income	142,470
Median household income growth p.a.	3.50%
Tax rate	30%
Post tax household income	99,729
LVR	70%
Mortgage rate	5%
Interest payments p.a.	74,505

However, the RBA may lower rates soon, and perhaps they could stay low for some time. Let's then assume a 5% mortgage rate for Jack and Jill in 2034. Would it make buying a home more affordable for them?

Not really. Assuming the same property price rises and a 70% LVR, it would result in annual interest payments of $74,505, compared to post-tax household income of $100k. That won't work.

What about with 4% mortgage rates? With the same assumptions for prices and LVRs, it would equate to annual interest payments of $59,603. This *might* be affordable on an interest only mortgage, but barely. For a principal and interest loan, forget about it.

Scenario 2 (b)	Dec-34
Median house price	2,128,000
House price growth p.a.	8%
Median household income	142,470
Median household income growth p.a.	3.50%
Tax rate	30%
Post tax household income	99,729
LVR	70%
Mortgage rate	4%
Interest payments p.a.	59,604

Scenario 3: Lower property prices

Instead of lower rates, let's assume that house prices don't increase as much as 8% annually over the next decade.

What if prices only rose 3.5% per annum? Would that make property more affordable for Jack and Jill? Assuming the same 3.5% annual wage growth and 6% mortgage rate as per scenarios 1, then affordability for them would be the same in 2034 as it is now. And at a broader level, the price to income ratio would remain the same at 9.8x.

Scenario 3 (a)	Dec-34
Median house price	1,390,850
House price growth p.a.	3.5%
Median household income	142,470
Median household income growth p.a.	3.5%
Tax rate	30%
Post tax household income	99,729
LVR	70%
Mortgage rate	6%
Interest payments p.a.	58,415

What if house prices didn't rise at all out to 2034? Assuming the same 3.5% annual wage growth and 6% mortgage rate as per scenarios 1, then affordability for Jack and Jill would improve markedly. The median property price would remain at $986,000, but their household income would swell from $101k now to $142k in 10 years. Post-tax household income would be $100k in 2034. Meanwhile, interest payments would be $41,412 each year.

Scenario 3 (b)	Dec-34
Median house price	986,000
House price growth p.a.	0.0%
Median household income	142,470
Median household income growth p.a.	3.5%
Tax rate	30%
Post tax household income	99,729
LVR	70%
Mortgage rate	6%
Interest payments p.a.	41,412

A decade of stagnant house prices starts to make property a much more affordable option for Jack and Jill.

The problem is house prices

The above scenarios indicate that the key problem for housing affordability isn't interest rates. It isn't credit availability. It isn't wages. The biggest swing factor is house prices.

If property prices continue to rise as they have done in the past, then housing will go from very expensive now to impossibly unaffordable for most Australians in a decade's time.

Because of that, it's my view that affordability issues cap house price growth going forward.

Some caveats

The above scenarios are necessarily simplistic. I realise that they are rough numbers and are based on median house prices and incomes. I also realise that there are a host of other things that can influence the price of property - from supply, to taxes, to inherited wealth, to immigration etc. This article has deliberately on one critical factor – affordability.

James Gruber is Editor of Firstlinks.

How to shift into pension mode

Tony Kaye

If our working years can be regarded as the time when we aim to build up our superannuation savings, our retirement years can equally be regarded as the time when we aim to spend them.

At least that's the objective for most Australians. Which generally leads to the question: how do I start accessing my super funds when I do stop working, or maybe even before I stop working?

This article focuses on the basics, including the general eligibility rules around accessing your super and how to switch your super accumulation account to an account-based pension.

What age can I access my super?

To legally access your super, you generally need to have met a condition of release after turning 60-years-old.

You can do so by either stopping work completely (retiring) or by keeping working and starting a transition to retirement income stream (TRIS). Doing so can enable you to reduce your current working hours and use your TRIS pension payments to top up your part-time income.

In either case, you have the options of turning on a pension income stream, making a lump sum cash withdrawal, or doing a combination of both.

How do I start a pension account?

Importantly, to start accessing your super, you will need to roll some or all of it over from your accumulation account into a newly created pension account.

Those starting a TRIS continue to receive compulsory super guarantee payments from their employer (which are taxed at the normal rate of 15%) into their super accumulation account. The funds held in a pension account can be accessed, however keeping in mind that investment earnings in the pre-retirement phase are also still taxed at 15%.

Most super funds offer pension account products and different investment options, similar to their accumulation account products. Those with a self-managed super fund should contact their SMSF accountant and/or financial adviser to facilitate the super rollover and pension account conversion processes.

You may need to contact your super fund to find out their process, which is typically as simple as lodging a request with your fund by filling out a form and providing information such as how much of you super you want to roll over, and where to.

Once your funds are in a pension account you could then take some out as a lump sum. The Australian Tax Office (ATO) has mandated minimum annual withdrawal amounts, which depend on your age.

There is a limit on the maximum amount that can be transferred as a tax-free retirement income stream from super to a pension account, known as the transfer balance cap. This is currently set at $1.9 million. The ATO keeps track of how much you transfer, and if you go over the cap it will levy an excess transfer balance tax.

If you have more than $1.9 million in super you have the option of keeping the excess in your super account and paying up to 15% tax on your earnings, or you can withdraw the excess super as a lump sum.

What are the tax considerations in pension mode?

If you're aged 60 or over and fully retired, any income earned on your pension assets is tax free and so are the pension payments you withdraw.

Also, a major advantage is that the profits from any investments sold within a pension account are completely capital gains tax free.

What are the minimum pension withdrawal amounts?

Once you've rolled over some or all of your super to an account-based pension you are required by law to withdraw a minimum pension amount each financial year, which is a percentage of your account balance based on your age.

For new pensions, the minimum withdrawal amount is calculated on a pro-rata basis from when a pension commences to the end of the financial year.

There are restrictions on how much can be withdrawn tax free through a TRIS in a financial year if you're under 65, until you've met a condition of release. The minimum withdrawal amounts is 4% of your super balance and the maximum is 10%.

The table below shows the required minimum withdrawal rates if you're in pension phase and are fully retired.

Age on 1 July of pension commencement and on each 1 July thereafter	Minimum withdrawal amount based on pension balance for 2024/2025
Under 65	4%
65 to 74	5%
75 to 79	6%
80 to 84	7%
85 to 89	9%
90 to 94	11%
95 and over	14%

Source: Australian Tax Office

Any amounts leftover in your pension account when you die will go to your nominated beneficiaries. Depending on the type of beneficiary (reversionary, spouse, dependant or non-dependant) the amounts can be paid as an ongoing pension stream until the account runs out or as a lump sum.

Consider getting professional advice

If you're wanting total financial flexibility in retirement, you could consider leaving part of your money in super, rolling over some of it into an account-based pension, and also withdrawing lump sums whenever you need to.

There are a range of benefits from adopting a combination of your options, although there may also be potential tax consequences for both you and your beneficiaries.

Managing the combination of a super accumulation account, an account-based pension, an Age Pension entitlement (if eligible), potential investment earnings outside of super, and irregular lump sum payments, can be highly complex.

Using the services of a licensed financial adviser is a worthwhile consideration as you weigh up all of your retirement options.

Tony Kaye is a Senior Personal Finance writer at Vanguard Australia, a sponsor of Firstlinks. This article is for general information purposes only and does not consider the investment objectives, financial situation or needs of any individual.

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Reform overdue for family home CGT exemption

Glenn Davies, Chris Evans

In a recent journal article, we explore both the policy underlying the capital gains tax (CGT) main residence exemption and the legislative provisions introduced to give effect to that policy.

We argue that the underlying policy is unclear and uncertain. It has failed to provide an appropriate set of foundations for the CGT main residence exemption, owing more to political pragmatism than to any notions of equity, efficiency or simplicity.

These poor foundations have, in turn, meant that the legislative provisions are overly complex, uncertain and inconsistent. The provisions often do not operate effectively or as intended, except in the simplest of cases.

A very generous exemption

Although lower than at any time since the Australian Bureau of Statistics started the data series in 1994, home ownership in Australia remains relatively high.

In 2019-20, roughly two thirds (66.3%) of Australian households owned their own home. This is very similar to home ownership in other comparable countries, such as the United Kingdom (63%), New Zealand (64.5%), the United States (65.7%) and Canada (66.5%).

However, all of these countries including Australia are also experiencing problematic and potentially harmful outcomes related to home ownership. This includes rising housing unaffordability, wealth inequality, as well as intergenerational inequity.

The exemption for the family home impacts tax revenue significantly. Treasury estimates indicate that the revenue forgone in 2023-24 from the exemption totals $47.5 billion.

This is a significant sum that is foregone in support of the notion that widespread home ownership is a political goal that should be fiscally encouraged. Indeed, given that the exemption is not just limited to the sale of the first home, opportunities such as 'flipping' and 'upscaling' are also effectively encouraged.

Policy considerations

Despite the clear political rationale for some exemption from CGT on the disposal of the family home, there is considerable debate about whether it is appropriate on economic or tax policy grounds. While existing homeowners, who otherwise would be subject to CGT on sale, may appreciate the concession, it is predicated on uncertain, even shaky, foundations so far as equity, efficiency and simplicity considerations are concerned.

The exemption runs counter to the equity principle on several levels. It very obviously offends the principle of horizontal equity as homeowners obtain an advantage that is not available to those in rented accommodation. Critics also point out that the exemption is of far more value to high income taxpayers than to lower income taxpayers, thus offending the principle of vertical equity. The main residence exemption also falls short in relation to notions of intergenerational equity.

The rapid growth in house prices in Australia and around the world in the last few decades, is attributable, to some extent at least, to the existence of the very generous tax shelter treatment afforded to the family home. The exemption not only makes it increasingly difficult for low-income households to gain a step on the housing ladder, it also disproportionately disadvantages younger generations *vis-à-vis* their older peers.

Perhaps most critically in the Australian context, the growth of house prices well beyond the rate of household income growth is fuelling intergenerational inequality and destroying social mobility.

On efficiency grounds, the main residence exemption has biased investment away from productive commercial and industrial activities and into owner-occupied housing. This in many cases leads to over-investment in houses relative to the occupants' real needs. The exemption also encourages over-capitalisation in main residences since any increase in their value is tax free.

Moreover, over-investment in housing, with consequent increases in house prices, has meant that homes have become unaffordable for all but the very wealthy or very fortunate younger members of society.

The main residence exemption also adds significantly to the complexity of the Australian CGT regime. If complexity is measured by reference to the length of legislative provisions (a crude but useful measure), the exemption must rank highly. More pages of the *Income Tax Assessment Act 1997* (ITAA 1997) are contained in the subdivision devoted to this exemption than to any other of the core provisions of the CGT regime.

The main residence exemption provisions are among the most difficult and complicated of all the CGT provisions to navigate, unless the scenario under consideration 'fits neatly' into the provisions of the legislation.

Conclusion

In conclusion, Australia's main residence exemption is not entirely 'fit for purpose', and its foundations may be less stable than should be the case. There are several reasons for this unsatisfactory situation, including confused and uncertain policy parameters, and poor legislative drafting.

In addition, the impact of compliance cost savings measures made to the regime in 1996-97 may not have been fully thought through and interactions with other provisions not made clear. This includes the use of 'precipice' tests (for example, looking at circumstances just before a CGT event) which may not interact well with other provisions and are capable of manipulation.

Notwithstanding the strong equity, efficiency and simplicity arguments against the family home exemption, and despite the provisions not being 'fit for purpose', it is highly unlikely that any mainstream politician or political party would suggest that the exemption should be removed, whether in Australia or any other country. The dream of owner-occupied housing represents a national aspiration in Australia, as elsewhere, and support for owner-occupied housing holds a high priority for leaders of all political parties. Therefore, it is unlikely to be removed.

There may, however, be stronger arguments in favour of adapting or curtailing the concession. This could be done in any one of a number of ways. One possibility lies in 'capping' the amount of the gain that is exempt (as in the US and South African provisions). An alternative to 'capping' is to introduce a form of rollover relief (as in some of the Scandinavian and other countries such as India) where the exemption applies only if capital proceeds from the sale of the family home are used to purchase a new family home.

A further alternative may be to provide an exemption only in certain circumstances, such as relocating for employment or business or selling and relocating because of ill-health. And finally, the government may also consider leaving the exemption entirely intact but accompanying it with a progressive annual property tax designed to claw back some of the benefit of the exemption.

We argue it may be possible to reformulate the current main residence exemption provisions in such a manner as to provide firmer foundations through greater certainty in their operation and interpretation. Revisiting the technical provisions of the exemption with less focus on the prevention of abuse and more attention to the intention of the provisions to provide a sensible measure of relief in an equitable, efficient and less complex manner might indeed give credence to the apparent Confucian quote that 'the strength of a nation derives from the strength of the home'.

Citation: Davies, Glenn & Evans, Chris, (2024), ***CGT Exemption on Family Home: Firm Foundations or Uncertain Footings?****, Austaxpolicy: Tax and Transfer Policy Blog, 2 December 2024.*

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The two key risks facing investors

Johanna Kyrklund

In the middle of 2024, my mantra was 'don't overthink it': positive nominal growth and interest rate cuts were supportive of equity markets, even against the backdrop of stretched valuations in the US.

Moving into 2025, I maintain that stance as I expect corporate earnings to hold up and, for now, inflation is still moving in the right direction. But two risks weigh on my mind.

First, will higher bond yields imperil equities? Since 2020 we have been talking about a shift in the market regime. The 2010s were characterised by tight fiscal policy and zero interest rates. It was an era we might describe as "Adam Smith on steroids", the theory being that individuals and businesses acting in their own self-interest would create positive outcomes for the economy. It was the invisible hand operating on a global scale.

However, this led to excessive income inequality and a feeling that the average person in the West wasn't doing well enough out of the system. This, in turn, has led to political support for populist policies and a new consensus focused on looser fiscal policy, protectionism and higher interest rates.

Looser fiscal policy implies higher borrowing. Right now, the UK is under scrutiny with a significant rise in gilt yields since the Budget in October 2024. This volatility highlights how fiscal policy is a much more important driver of markets than was the case a decade ago. But while the UK may be feeling the heat today this is not a one-country problem.

In many regions, an ageing demographic plus the need to spend elsewhere, including on defence, will lead to higher debt levels. These will then become the ultimate speed limit to market returns.

This is because the ultimate constraint on populist policies will be their consequences for inflation and debt levels and the willingness of bondholders to accept this. Government spending has helped support economies, but this might be storing up problems for equities in the future with excesses in the system that would normally be addressed in a downturn.

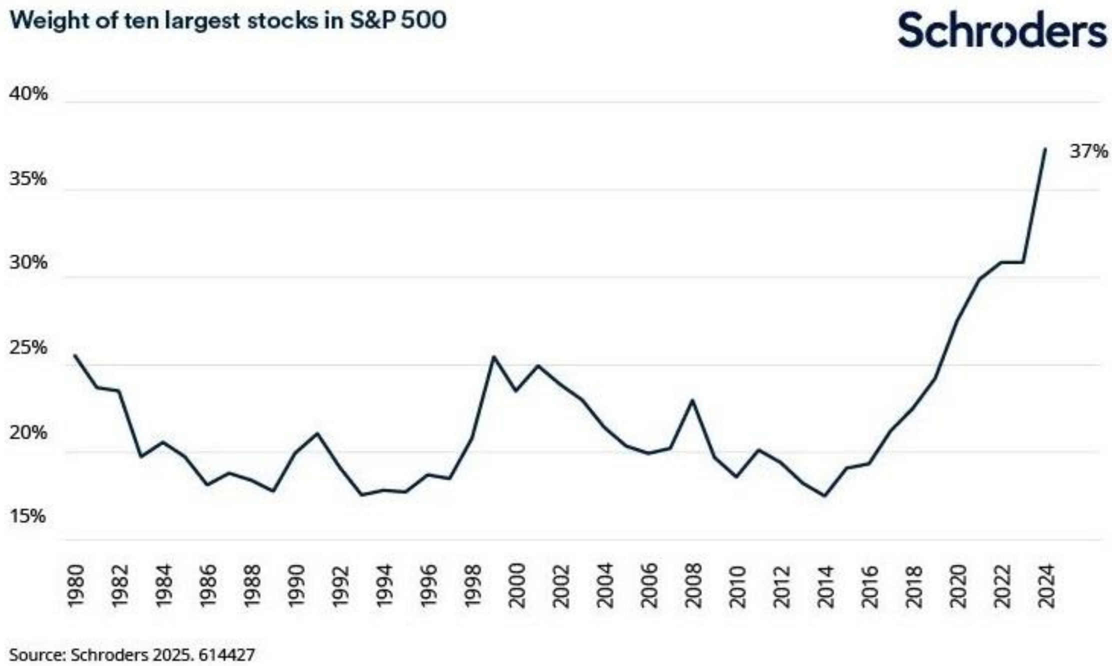
Equity valuations can be sustained as long as bond yields don't rise too far. With the US 10-year government bond yield now around 4.8%, we are starting to move into a more dangerous zone for equity valuations relative to bonds. Higher bond yields can draw money away from the stock market as well as increasing borrowing costs for corporates.

Tactically, I find it interesting that after a couple of years of predicting a US downturn or recession, most market commentators including us are predicting a positive outcome for the US economy. This could mean that, from a contrarian perspective, we get some relief on bond yields in the short term, especially as US interest rate cuts are almost priced out for 2025. But high bond yields are a risk we need to keep an eye on for the year.

The second challenge is the level of concentration in market-cap weighted indices. In recent years, when comparing the current environment with the late 1990s dotcom era, our view at Schroders was that the strong earnings growth delivered by the mega cap tech stocks in this cycle made it very different to the speculative bubble of 1999/2000.

Back then, valuations were impossible to justify. This time around, many of the large US tech companies are delivering earnings that support their valuations. However, a misstep by one of these companies would pose risk to overall market returns given their dominance of major indices.

Wall Street's blue-chip benchmark has a high concentration in just a handful of stocks



In fact, the level of index concentration far surpasses that of the late 1990s. From a portfolio standpoint, having such a high exposure to just a handful of stocks does not feel prudent. What's more, the dynamics behind each of the 'Magnificent 7' vary. Treating them as a block underestimates the different business drivers between the individual companies. Given the concentrated nature of the market, this is not a time for unintentional bets.

These US risks are shared with other markets. Market concentration is similarly high in Europe and Japan. Investors relying on previous winners to drive performance are already starting to miss out. Since mid-2024, we have seen a much more interesting path for markets with different sectors performing at different times.

The full implications of DeepSeek's technology still need to be understood. But it highlights that markets are vulnerable to a misstep by one of the large US megacaps, or by the emergence of new competition.

At a time when major equity indices do not offer the diversification they did in the past, and the shift in the political consensus is altering correlations across asset classes, investors will need to work harder to build resilient portfolios.

This article first appeared in The Financial Times on 15 January 2025.

Johanna Kyrklund is Group Chief Investment Officer (CIO) and Global Head of Multi-Asset Investments at Schroders, a sponsor of Firstlinks. This material is general information only and does not take into account your objectives, financial situation or needs. Schroders does not give any warranty as to the accuracy, reliability or completeness of information which is contained in this material. For important information and disclaimers, click here.

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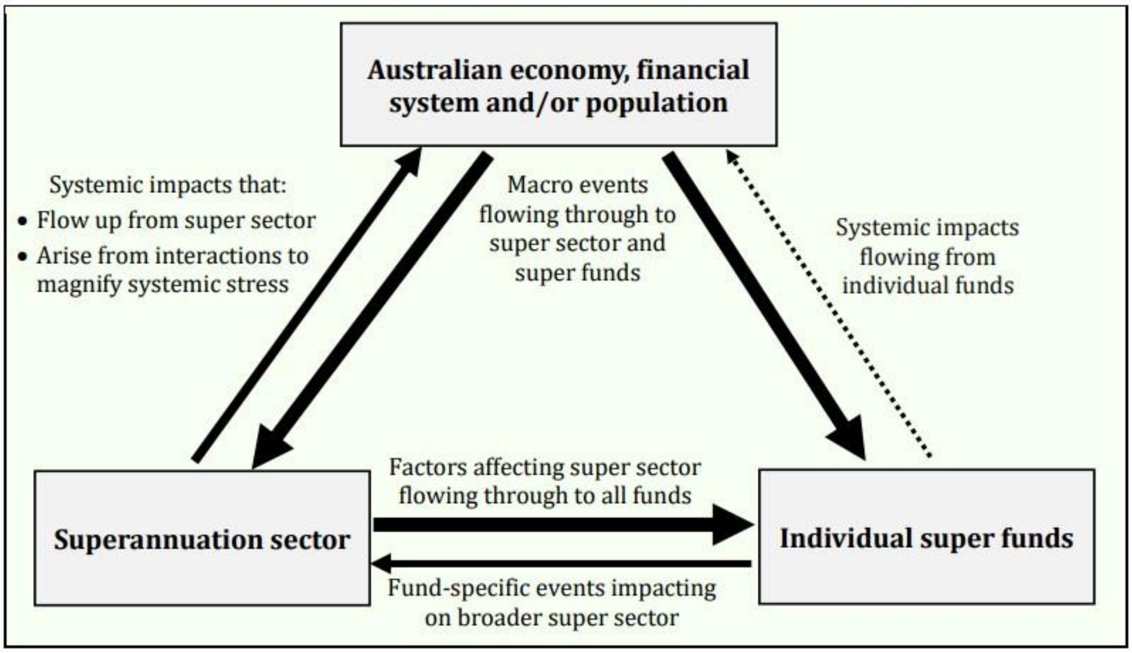
Why systemic risks from 'Big Super' may be overplayed

David Bell, Geoff Warren

Increasing attention is being directed at whether the activities of super funds may have 'systemic' effects, with particular focus on the potential for adverse impacts. We define 'systemic' for the purpose of our research as: "*aspects of the super system that have widespread and significant implications for either the Australian economy, Australian financial markets or a significant number of Australians*".

Figure 1 outlines the interactions that are considered between three broad areas – the Australian economy, financial system and/or population; the superannuation sector (the collective of all funds); and individual super funds. To be denoted 'systemic', an aspect needs to have a significant impact on one or all of the three 'macro' components identified in the top box.

Figure 1: Framing the interactions examined in this report



The width of the arrows that interconnect each area in Figure 1 represents our evaluation of the degree to which the interconnection is consequential. For instance, we consider impacts flowing from the broader macro environment to be quite consequential for the super sector and individual super funds. Meanwhile, the systemic impacts flowing up from the super sector are seen as moderately consequential and those flowing up from individual funds to be of limited consequence.

Key theme #1: Big super is a boon overall

Australia benefits from having a large super industry for four main reasons, which together well-outweigh any problems and risks:

- Super establishes a significant pool of retirement savings that may not have otherwise existed.
- Super funds operate as a vehicle for professional management of those savings by fiduciaries who are subject to various regulatory requirements.
- Super funds are well-positioned to act as effective stewards of the capital that they invest.
- The super sector rounds out the sources of finance within the Australian economy in ways not well-accommodated by other providers such as banks and direct investment by private investors.

The benefits of big super might be appreciated by considering the counterfactual. In the absence of the super industry having developed into its current form, many individuals would be left to their own devices in saving for retirement. The outcome probably would have been many people under-saving for retirement, poorer decisions by some as they attempt to invest for themselves, heightened agency risk and higher fees for individuals who invested via commercial operators, and greater potential exposure to scams and fraud.

In short, Australia and Australians are much better off with a large super industry than without.

Key theme #2: Super as an unlikely source or propagator of systemic stress

A key theme that sits at odds with the tenor of current commentary is that we view super as having limited consequences for systemic risk. First, we see super as an unlikely *source* of major systemic stress due to an absence of financial leverage and a lack of clear mechanisms for spreading problems from super to the broader system. Basically, problems within super may cause harm to fund members, but the damage is likely to remain within the sector's perimeter rather than the cause of major disruption in the Australian economy or financial markets.

We are more open to the idea that super might *magnify* stress arising from elsewhere. This could occur if the super sector becomes a forced seller of assets and/or withdraws funding from a key sector. However, super could equally act as a stabilising force through buying assets most under pressure or providing funding where it is most needed (as in the GFC). What happens will depend on how the situation unfolds.

An important element is that we see limited potential for broad impacts to arise from a *liquidity squeeze* within the super sector or a run on a large super fund. The notion that super funds offer redemption at call with up to 30%-35% invested in unlisted assets coupled with potential for cash calls on foreign exchange (FX) hedges has been highlighted as a possible source of liquidity risk. Potential for this situation to result in major liquidity strains is limited by:

- Low member propensity to switch or redeem;
- Accumulation balances needing to remain within the super system;
- Asset sales merely transfer assets, which may lead to wealth transfers if assets are sold cheaply, but likely quite limited wealth destruction;
- Liquid assets can be sold to satisfy cash demands, merely resulting in 'out-of-shape' portfolios; and,
- The authorities can take action if required, e.g. APRA can suspend redemptions, RBA can step in if super funds withdraw funding from the banks.

While a sector-wide liquidity event or run on a big super fund could cause harm to the members of the funds or fund involved, it is hard to envisage significant systemic impacts arising given the above.

Nevertheless, super does have potential to give rise to adverse consequences that could impact on many Australians. Our two main areas of concern are discussed as theme #3 and theme #4.

Key theme #3: Super serves to heighten exposure to economic and market risk

Super funds expose their members to economic and market risk in order to seek higher expected returns, with a sector weight in growth assets of about 70%. This is entirely appropriate, as it boosts expected outcomes for members, e.g. likelihood of higher income in retirement. Such exposures also come with some danger. We sense that the risks associated with economic and market exposure are underappreciated, probably because the lived experience is that markets have always gone up. History contains ample examples of risk assets such as equities suffering declines that result in substantial loss of wealth spanning multiple decades. Never say never!

While extended weakness in markets is unlikely, if it were to occur the impacts could be dire for the wealth, retirement income and possibly confidence of super fund members. Further, any extended loss through super is likely to occur in conjunction with major economic problems that are causing broader harm. Super is effectively doubling down on economic exposure on behalf of its members.

Key theme #4: The sector's operational infrastructure is an area of concern

Underdeveloped operational infrastructure is our other main area of concern. Failures in member servicing – as highlighted by regulators and media – stand as an indication that something is not quite right somewhere in the system. We suspect this may reflect issues with the systems, processes and staffing on the operational side, particularly in relation to member administration. The likely root cause is that super is transitioning (quickly) from something of a cottage industry into a major financial sector but is struggling with legacy systems and processes.

Upgrading the operational infrastructure in the industry will be challenging and is likely to entail considerable cost, time and effort. We would like to see greater recognition of the situation, rather than presuming the underlying problems can be easily addressed and that 'super funds are failing their members' simply because they are incompetent or uncaring. What matters is whether super funds are working towards addressing any problems.

Other potential risks

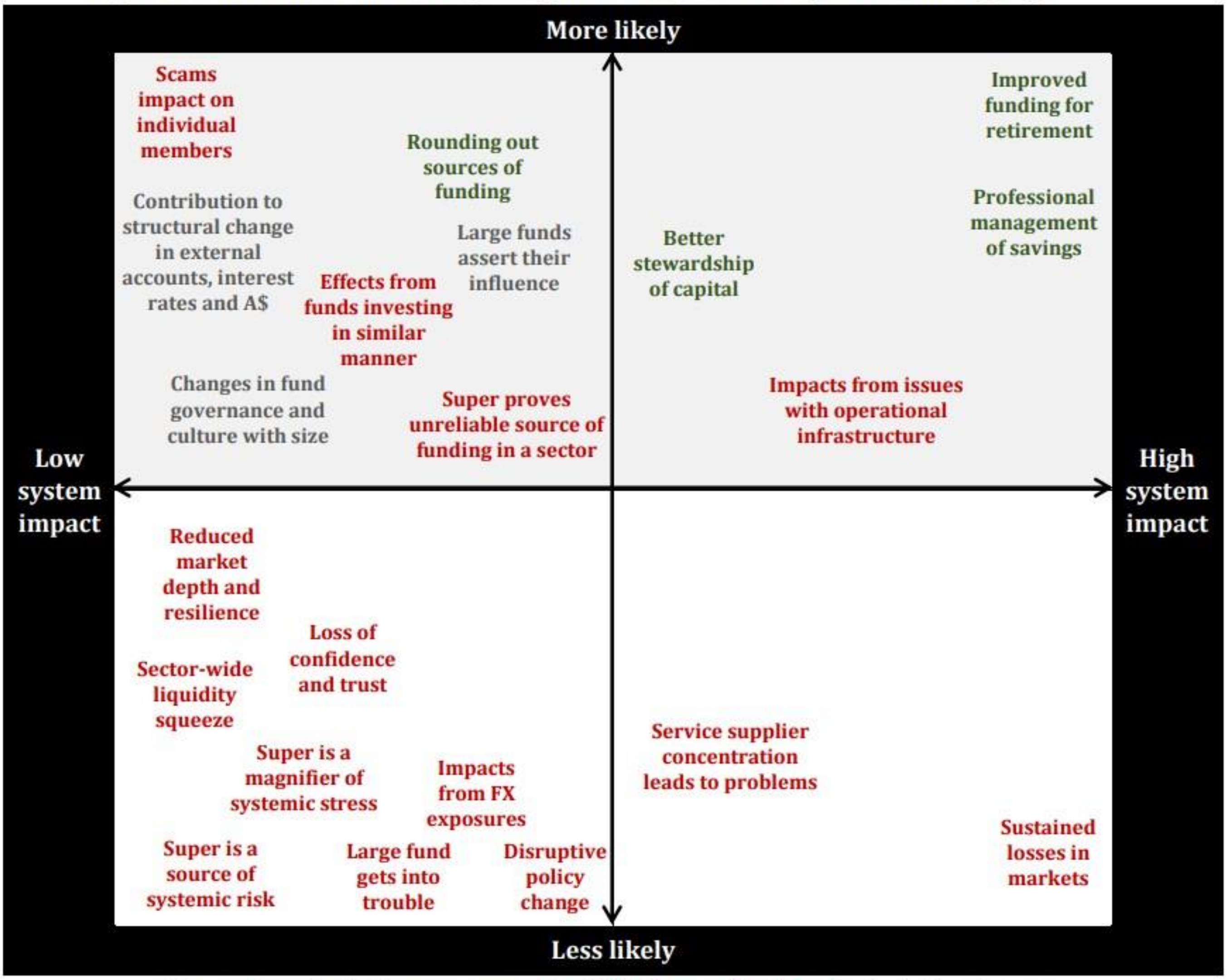
Other aspects typically offer limited potential for systemic impacts of any major significance and/or have mixed or debatable implications. The following are notable:

- **FX exposure** – FX amounts to a significant exposure, with large super funds having about 43% in overseas assets. It is difficult to see how either direct FX exposure or FX hedges could be a major source of system stress, especially as any liquidity impacts should be manageable (see theme #2).
- **Concentration of service suppliers** – The super industry relies on a limited number of suppliers in custody, insurance, consulting and cloud computing (as well as member administration). It is hard to see how these relationships could result in significant harm or disruption to the system.
- **Vulnerability to scams** – While scams are a major concern in themself, the impacts tend to be felt by those affected rather than the overall system.
- **Common approaches to investing** – Super funds tend to invest in a similar fashion, giving rise to the possibility of herding and potential reduction in market depth and resilience. Systemic impacts should be limited by the presence of other investor types.
- **Unreliable source of funding** – We hold some concern over the potential for 'feast or famine' cycles in the funding provided by super as assets fall in and out of favour. While there could be potential harm within sectors affected, any systemic impacts will depend on the size of the sector and whether other funding sources exist.
- **Loss of confidence and trust** – Any loss of confidence and trust in super funds could play through via outflows and diminished ability of super funds to effectively service their members. While potentially disruptive, major systemic impacts are unlikely.
- **Large fund getting into trouble** – A large fund getting into trouble, potentially involving a run by its members, could harm the members of that fund but is unlikely to be a systemic event.
- **Influence** – Large super funds wield significant influence over their investments and possibly policymakers that could be used for good or ill. Either or both is possible.

How it all lines up

Figure 2 maps out the potential systemic impacts that could arise from the aspects identified and discussed within the report, with each notionally positioned according to likelihood of experiencing a systemic impact (vertical axis) and the potential strength of any impact (horizontal axis). Potentially beneficial systemic impacts appearing in **green** are skewed towards the upper right. Aspects with potentially adverse impacts appearing in **red** are greater in number but tend to sit to the left and lower in the diagram as they are considered either of lesser likelihood and/or lower magnitude. The overall mapping conveys a message that big super is beneficial on balance, with a few major benefits being squared off against more minor problems and threats.

Figure 2: Likelihood and strength of potential systemic impacts from 'big super'



*Legend: Beneficial effects in **green**, potentially adverse effect in **red**, mixed effects in **grey***

Our overarching conclusion is that Australia is much better off with a large super industry than without it. In short, the growth of super has been a major boon for Australia on balance. However, no system is perfect, and big super gives rise to issues and risks to be considered or addressed. A key theme of this article is that problems within the super sector or a large super fund are likely to remain localised, causing harm to the fund members involved, but probably not having adverse systemic impacts to any significant degree due to a lack of clear channels through which problems in super can lead to stress across the Australian economy, financial markets or population.

** This is a edited extract from a more comprehensive report that can be found [here](#).*

David Bell is the Executive Director of [The Conexus Institute](#). Geoff Warren is a Research Fellow with the Conexus Institute, and an Honorary Associate Professor at the Australian National University.

What AI's 'Sputnik moment' means for data centres

Andrew Parsons

AI-related stocks sold off heavily on 27th January 2025 as news emerged about DeepSeek R1, a Chinese developed AI large language model (LLM). DeepSeek has asserted it can deliver performance comparable to U.S. developed AI models, such as ChatGPT, but at a fraction of the cost and with much less physical computing power required.

While there is some healthy scepticism towards certain aspects surrounding DeepSeek, advancement in its algorithm has been widely recognised by the tech community including the leaders of NVIDIA, OpenAI and Meta.

DeepSeek's open-source program allows it to be quickly studied and adopted globally, and therefore, it could represent a step-change in resource intensity required for the continued development of AI. This has led investors to re-assess the bullish trajectory of demand for advanced computer chips (GPUs), physical infrastructure and power required for the build-out and training of AI models.

As a result, stocks ranging from chip manufacturers, utilities, data centre equipment manufacturers and data centre landlords experienced significant share price declines following the DeepSeek news.

Given our overweight position and broader interest in data centres, we provide here an outline of our current thoughts on the potential implications for the data centre real estate sector, with the caveat that there are still a lot of unknowns.

Potential negatives:

- AI-related demand for data centres may not live up to previous bullish expectations as future AI model developments could become more resource efficient, requiring fewer advanced chips, less power and cooling, and less data centre capacity than previously anticipated.
- The potential reduction in demand could eventually lead to oversupply conditions in data centres - although this is not anticipated in the near-term given significant supply bottlenecks and lengthy lead times for electricity grid upgrades, electrical transformers and air-conditioning components required to satisfy current demand levels.
- Big tech companies could reduce capex on data centre build outs. While previously announced capex might continue in the short term, it may be re-oriented towards software development rather than hardware (AI training infrastructure). Nevertheless, on its earnings call on 29th January, Meta re-iterated its plans to increase total capex spending to US$60-$65 billion this year – including increased investment in generative AI.
- Investor enthusiasm for AI-related stocks (GPU's, data centres, utilities etc) since AI emerged as a significant demand driver two years ago, has pushed valuation multiples to elevated levels relative to other sectors.

Potential positives:

- DeepSeek may have over-stated its efficiency, and as such, it may not prove to be as great a departure from current AI infrastructure needs as initially feared. DeepSeek's capabilities benefited from US developed large language models, which muddies the claim that DeepSeek R1 was trained for <US$6 million. If R1 had to be trained from scratch, the cost would have been significantly higher.
- There is a long history of technology efficiencies driving increased adoption and ultimately growing the total demand pool. Microsoft's CEO was quick to reference Jevons Paradox, the observation that improvements in resource efficiency often leads to increased, rather than decreased, overall consumption of that resource.
- The emergence of cheaper and more efficient AI models could potentially spawn new entrants (previously precluded due to the significant upfront costs, sometimes referred to as the 'money moat' that benefited incumbent big-tech companies).
- Cheaper AI development could speed up AI adoption. Greater adoption could drive greater AI inference demand, benefiting existing data centre owners located in major population centers, as they cater to end users requiring strong network connectivity and lower latency.

- While DeepSeek is more efficient and its advancements are likely to be widely adopted, major tech companies remain focused on developing more sophisticated artificial general intelligence (AGI), which will likely still require increased computing power for both training and inference.

- National security concerns and geopolitics could drive duplication of AI investment. DeepSeek's emergence may compel tech companies and governments globally to increase capex to further improve AI capabilities.

Location, location, location

Our conviction in data centres is predicated on the expansion of the digital economy across a broad range of use cases, not just AI. Admittedly, AI has attracted disproportionate attention in recent years thanks to the potential impact it could have on the economy and society.

The data centre industry is presently supply constrained for a multitude of reasons mentioned herein. No doubt those with current capacity are enjoying pricing power and the question now is how long this will last if the more immediate demand side has been dampened.

We also acknowledge that many players are trying to get entitlements (real estate planning and power) to bring on material supply in future years. Our exposures are focused on superior in place platforms that provide space to a multitude of users for a variety of IT use cases, located in major metropolitan areas where there is deep tenant demand and dense fibre connectivity.

This is in contrast to some of the more recent wave of proposed AI training data centres that are mostly being developed by private capital and, by necessity, are often located in more remote locations where there is available land, cheap power, and typically oriented to a single tenant user.

If there were a reduction in AI training demand, we believe the more remote data centres would be more negatively impacted.

Data centre rent hikes not just about AI

As illustrated in the following chart, wholesale data centre rents inflected positively in 2022, after a decade of declining rents. Context is important here as it is important to note that rents declined during that period despite solid demand from broader digitalisation trends including the shift to cloud computing.

The rental decline can mostly be attributed to conditions that were conducive to profitable data centre development including benign construction cost inflation, declining interest rates and, tangentially, declining real estate cap rates. Despite a competitive rental market, these conditions allowed data centre developers to maintain healthy profit margins even as rents were falling.

Wholesale data centre rents inflected positively in 2022 as most of these conditions reversed (construction cost inflation spiked, interest rates rose dramatically and real estate cap rates increased), coinciding with the emergence of large-scale AI as an additional demand driver, together with significant supply bottlenecks in securing power to data centre sites and lengthy lead times for certain building components including electrical transformers and air conditioning equipment.

Importantly, it was a confluence of factors that drove the inflection, not only the emergence of AI demand.

You can see the full version of Resolution Capital's research note "AI's Sputnik Moment" here.

Andrew Parsons is a Co-Founder and Chief Investment Officer at Resolution Capital, an affiliate manager of Pinnacle Investment Management. Pinnacle is a sponsor of Firstlinks. Resolution has launched the only active GREIT Fund in Australia (ASX:RCAP).

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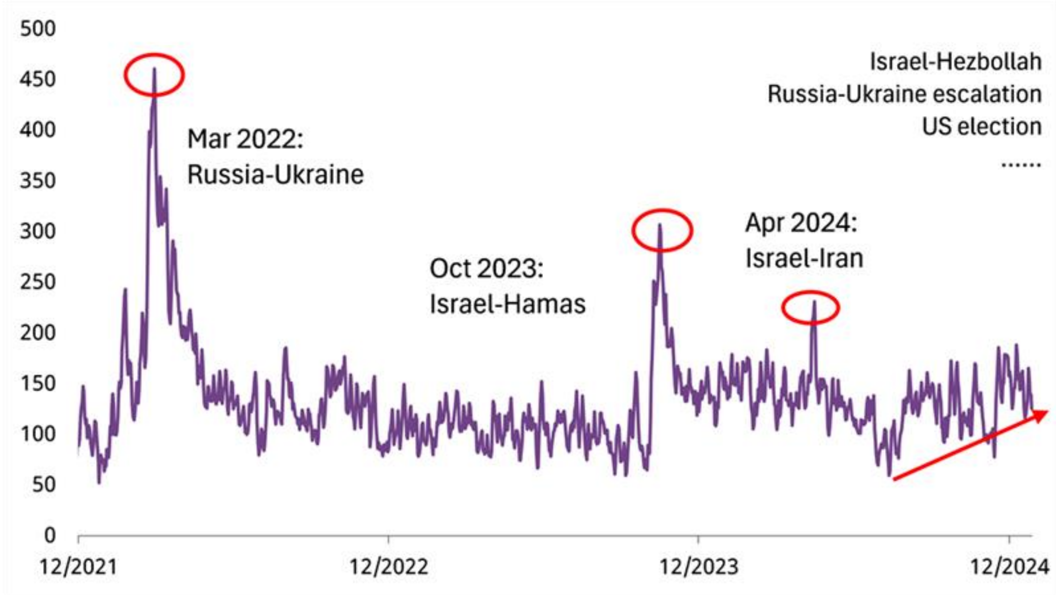
Will 2025 be another banner year for gold?

Ray Jia, Marissa Salim

2024 witnessed a variety of events which shaped investor sentiment and asset performance. US elections stirred markets, while ongoing geopolitical tensions kept global investors cautious (**Chart 1**). The US Federal Reserve initiated an easing cycle with three rate cuts totalling 100 basis points, while the Reserve Bank of Australia (RBA) held rates steady, lagging its peers.

Chart 1: Relentless parade of geopolitical risks kept casting shadows over global landscape
Geopolitical risk index*

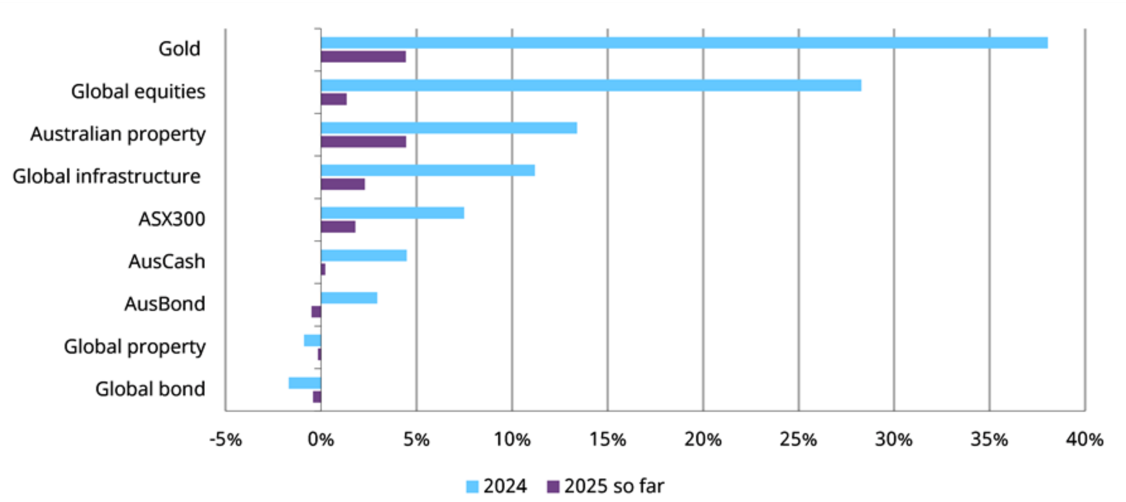


As of 31 December 2024, on a 5-day rolling average basis. Source: GPR, World Gold Council

Assets saw varied performances (**Chart 2**). The AUD weakened by 10% against the dollar - the widening US-Australia yield spread, particularly in Q4 amid diverging stances from the Fed and the RBA, was a key contributor. Local equities finished the year stronger and Australian properties also powered higher.

However, gold, denominated in AUD, led all others in 2024, delivering a stunning 38% surge. Strong investment demand, rising geopolitical risks and a weaker AUD supported gold's rally. And similar drivers have extended gold's strength into 2025, delivering a 4.9% return so far.

Chart 2: Mixed bag domestic asset performance and gold held the lead
Various assets' performances in AUD during 2024*



**As of December 2024 & 17 January 2025. Based on LBMA Gold Price PM, MSCI World Index, ASX REITs Index, Bloomberg AusBond Bank Bill Index, ASX300 Index, FTSE Global Infrastructure Index, Bloomberg AusBond Composite Index, Bloomberg Global Agg Index and FTSE Nareit Developed Index. All calculations in AUD. Source: Bloomberg, World Gold Council*

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2025 outlook: A case for gold in AUD to thrive?

This year is likely to be supportive for gold. As our 2025 Gold Outlook noted, while US Treasury yields and the dollar may stay elevated, upside potential for gold could come from continued central bank gold purchases and possible spikes in geopolitical risks. Meanwhile, volatilities in equities and bonds as well as potential weaknesses in non-US currencies could all provide additional boosts to investment demand for gold. Also, with uncertainties in US bond market staying elevated, we believe the impact from yield changes may be less pronounced on gold as our recent analysis shows.

Furthermore, we believe potential weakness in the Australian dollar may provide an additional boost to gold in local currency terms. Such currency weakness may stem from two main fronts:

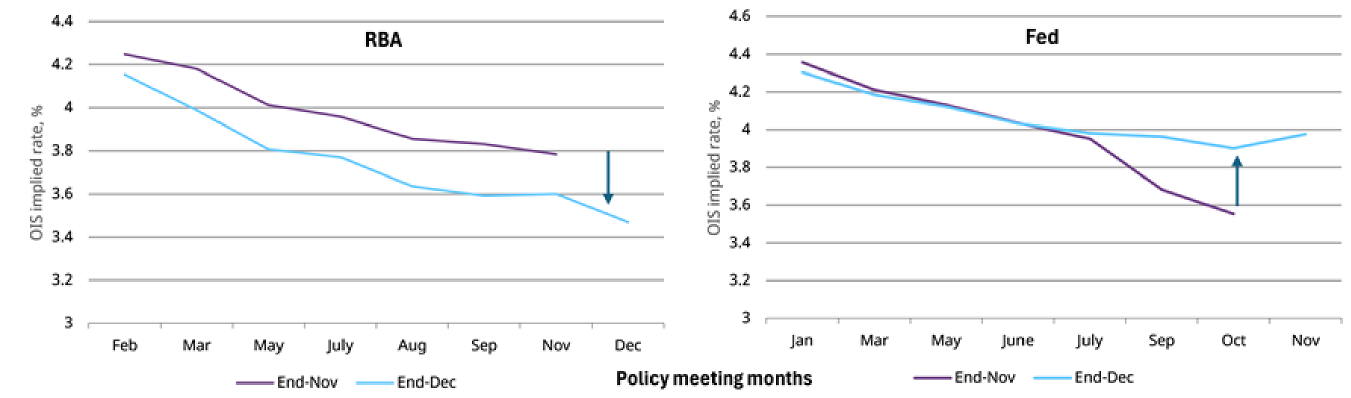
1. Changes in monetary policy expectations

Although the RBA left rates unchanged in their December meeting, they noted that growth momentum has weakened and the upside risk of inflation has also diminished. And while labour market prints may muddy the case for a cut in February, Q4 inflation data should have more weight in the rate decision – and the cooling momentum may continue judging from November's downward trend in the trim-meaned monthly CPI. Currently, the market is pricing in a 70bps cut in total for 2025, much higher than the previous expectation (**Chart 3, left**).

Conversely, reflation concerns in the US and the surprising strength in both growth and the labour market have made investors push back their expectations of further rate cuts – now the market is only pricing in around 50bps rate reduction in 2025, a pivotal change from around 100bps in December (**Chart 3, right**).

Thus, there is a possibility that the RBA delivers more rate cuts than the Fed, further widening the interest rate spread between the two countries, weighing on the AUD.

Chart 3: Diverging rate expectations
Policy rate expectations reflected in OIS futures*



**As of January 2025. Source: Bloomberg, World Gold Council*

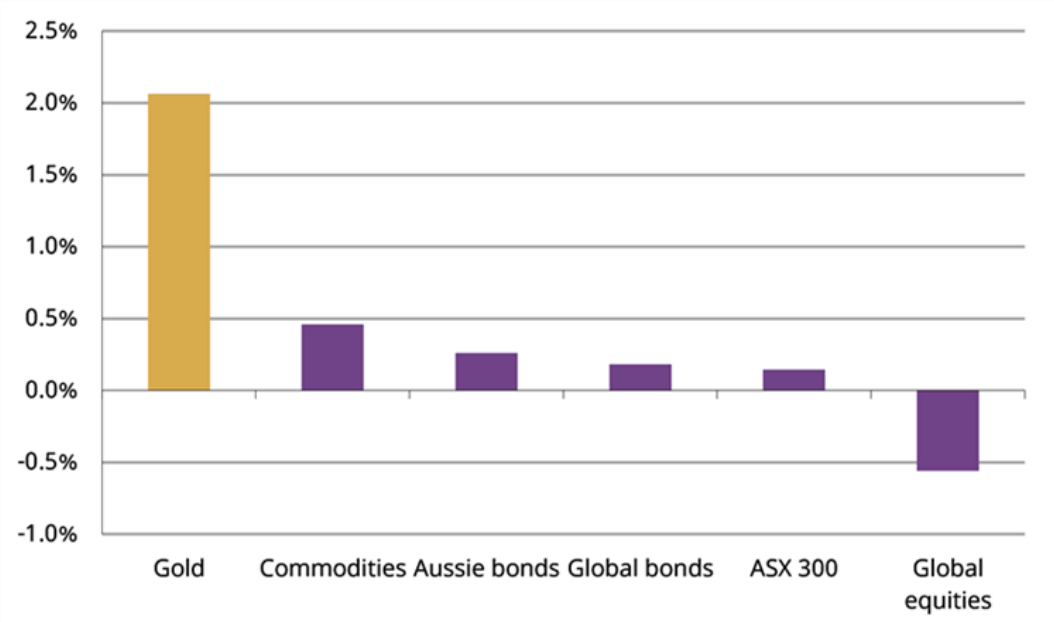
2. Potential growth risk

Restrictive financial conditions, declining real income and cooling momentum in the housing sector have weighed on Australian growth in 2024. And these risks may continue into 2025 if rates remain restrictive or the lagging effect of elevated interest rate continues to kick in. Additionally, uncertainties surrounding Chinese economic development may also pose challenges.

As historical data shows, sluggish growth usually lead to weakening currency of the country.

Other risks such as geopolitical challenges may also induce volatilities in local assets, creating stress for Australian portfolios. This was a key topic of concern among APAC investors discussed in our previous research. We believe gold's positive outlook and its ability to cushion geopolitical risks should make it a key asset in local portfolios (**Chart 4**).

Chart 4: Gold has performed well during geopolitical risk surges
Performance of various assets during geopolitical risk spikes*



**Based on average weekly performances in AUD of the LBMA Gold Price PM, Bloomberg Commodity Index, Bloomberg Australian Bond Index, Bloomberg Global Bond Aggregate Index, ASX300 Index, and MSCI World Index. We show here the average of the top 10 geopolitical risk surges based on the Geopolitical Risk Index. Source: matteoiacoviello.com, Bloomberg, World Gold Council.*

In conclusion, after an exceptionally strong year, we believe gold could continue to shine in 2025. Although the macro development this year may bring some headwinds, the global geopolitical landscape and risks stemming from financial markets will keep attracting attention from both official institutions and retail investors. Meanwhile, the potential risk of the AUD weakness could make gold more attractive in local investors' portfolios. And over the longer term, we anticipate a resilient return from gold, largely in line with global GDP growth.

Ray Jia is a Senior Research Analyst and Marissa Salim is a Senior Research Lead, APAC, at World Gold Council, a sponsor of Firstlinks. This article is for general informational and educational purposes only and does not amount to direct or indirect investment advice or assistance. You should consult with your professional advisers regarding any such product or service, take into account your individual financial needs and circumstances and carefully consider the risks associated with any investment decision.

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