INFORMED INVESTOR

November 2022

threePILLARS wealth management

CONTENTS

ECONOMIC UPDATE

INTRODUCTION

Welcome to the latest edition of our quarterly newsletter 'Informed Investor.'

Pleasingly, global share markets fared well in October and recovered most of their lost ground from September. Locally, the S&P/ASX 200 Index returned 6.0%.

The sharp reversal in sentiment was typical of this year; market volatility has picked up meaningfully over the past few months, resulting in substantial swings in equity prices.

Fixed income performance was mixed. Yields drifted lower in Australia, resulting in modest positive returns from the domestic bond market. Yields continued to rise in the US, however, which resulted in negative returns from Treasuries and from global bond indices.

Investors remained focused on the persistence of inflation and, in turn, the outlook for interest rate policy in key regions.

Continued over...

FURTHER INFORMATION

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Capstone FINANCIAL PLANNING

ECONOMIC UPDATE
CONTINUED

AUSTRALIA

Headline inflation quickened to an annual pace of 7.3% in the September quarter; the highest level for more than 30 years. The trimmed mean – central bank officials' preferred measure – also increased, to 6.1% year-on-year.

The Reserve Bank of Australia continued to tighten policy settings against this background, raising official interest rates again on 1 November, by 0.25 percentage points. This could be an indication that official borrowing costs will not be raised as meaningfully as previously thought.

Official interest rates are now 2.85% and may be raised again in December. Consensus forecasts currently suggest interest rates could peak at around 3.75% in mid-2023.

NEW ZEALAND

As expected, interest rates were increased by a further half percentage point, to 3.50%, as policymakers remained focused on bringing down inflation. Headline inflation quickened to an annual pace of 7.2% in the September quarter.

Substantial rate hikes in the year to date appear not to have had their desired effect, suggesting further policy tightening may be required. Forecasts currently indicate that interest rates could be 5%, or higher, by mid-2023.

US

The latest data showed the US economy expanded at an annual pace of 2.6% in the September quarter. This represented a sharp rebound from the June quarter, when the economy contracted slightly.

Headline inflation remained above 8% year-on-year, although the Federal Reserve did not meet in October and interest rates were therefore unchanged over the month. That said, further policy tightening is anticipated.

The labour market remains buoyant. More than 250,000 new jobs were created in September, taking the total in the year to date to nearly four million. A low unemployment rate – currently just 3.5% – means firms are typically required to pay up to attract new employees. Wages are rising at an annual pace of 5.0%.

EUROPE

The European Central Bank raised interest rates by a further 0.75 percentage points, as officials continued to battle persistently high inflation. Borrowing costs have been raised to their highest level since 2009.

CPI in the Eurozone remained around 10% year-on-year, partly reflecting the impact of elevated energy prices.

Political developments continued to dominate attention in the UK. The new chancellor swiftly reversed the mini-budget that had been proposed by his predecessor. This saw the UK currency and bond market claw back their lost ground from September.

The new leaders must address a slowing economy and spiralling inflation. CPI is currently running above 10% year-on-year, resulting in sharp falls in real wages for most workers and clouding the outlook for spending.

ASIA

It seems Chinese officials are likely to persevere with their 'zero Covid' policy, which is dampening growth prospects. President Xi tightened his grip on power during the month, by appointing various loyalists into key government positions.

The Chinese yuan remained under pressure, owing to the deteriorating economic outlook. The currency depreciated to a 15-year low against the US dollar during October.

In Brazil, left wing candidate Lula da Silva was elected as the new President; a remarkable turnaround in fortunes given the former leader was in prison for corruption three years ago. His victory was welcomed by environmentalists given his pledge to address soaring deforestation rates in the Amazon rainforest.

AUSTRALIAN DOLLAR

The Australian dollar briefly fell below 62 US cents in mid-month, but clawed back losses and closed October little changed from its end-September levels (around 64 US cents).

The AUD was similarly flat against other major currencies. The dollar trade-weighted index declined just 0.3% over the month.

AUSTRALIAN EQUITIES

Australian shares added 6.0% in October, recouping most of September's losses.

A fall in domestic bond yields supported a 'risk-on' attitude among investors and enabled nine out of the 11 industry sectors to generate positive returns.

The Financials (+12.2%) sector was the strongest performer, led by strong gains among the major banks. Shares in all of the 'big four' banks enjoyed gains of between 12% and 17%.

Oil prices rose following OPEC+'s decision to lower production quotas and after the European Union announced further sanctions against Russia. This added 9.3% over the month in the Energy sector.

Stocks in the Materials sector (-0.1%) struggled as Chinese officials reiterated their commitment to a 'zero-Covid' policy. Stocks in the Consumer Staples sector also struggled, resulting in the sector returning -0.2%.

Small caps outperformed their larger peers and all sectors in the S&P/ASX Small Ordinaries Index posted positive returns.

LISTED PROPERTY

Global property securities benefited from the general improvement in sentiment towards equity markets, with the FTSE EPRA/NAREIT Developed Index adding 3.6% in Australian dollar terms.

There were particularly strong inflows into western markets. France (10.1%), Australia (9.9%) and Spain (7.3%) all enjoyed strong gains, for example.

More defensive Asian property markets such as Hong Kong and Singapore fared less well, declining by 11.4% and 6.0%, respectively.

GLOBAL EQUITIES

According to a recent report, inflows into global share markets picked up sharply following September's weakness.

The influential S&P 500 Index in the US rose 8.1%, while the MSCI World Index closed the month 7.8% higher.

In the US, releases of quarterly financial results from tech giants disappointed investors and meant returns from the NASDAQ failed to keep pace with the broader S&P 500 Index.

Asian indices performed poorly, partly due to significant weakness among Chinese shares. The CSI 300 fell 7.8%, while Hong Kong's Hang Seng slumped 14.7%.

Japanese stocks fared quite well in contrast, with the Nikkei adding 6.4%.

European shares also registered solid gains. The Euro Stoxx 50 closed the month 9.0% higher.

Finally, the world's richest person – Tesla founder Elon Musk – bought Twitter for US$44 billion.

GLOBAL AND AUSTRALIAN FIXED INCOME

The federal funds rate was unchanged in October, remaining in a range between 3.0% and 3.25%.

Money markets have priced in the likelihood of a 0.75 percentage point increase in the federal funds rate when policymakers meet in November, and an additional rate hike in December.

In October as a whole, 10-year Treasury yields rose 22 bps, closing above 4% for the first time since before the Global Financial Crisis in 2008. In fact the whole yield curve rose. These moves resulted in negative performance from the Treasury market, as well as from global fixed income indices.

Government bond yields were little changed in either Germany or Japan over the month.

In the UK, gilt yields fell back sharply from their September highs after the previous chancellor's proposed tax cuts were abandoned by the incoming government. This resulted in favourable returns from UK bonds and helped ease pressure on pension funds in the country.

Australian Commonwealth Government Bond yields also trended lower, closing the month down 13 bps.

Reserve Bank officials slowed the pace of their policy tightening, raising official interest rates by 0.25 percentage points.

GLOBAL CREDIT

Investment grade credit spreads were little changed in the month as a whole.

With spread movements providing a neutral performance contribution, returns from corporate bonds were dominated by the receipt of regular coupon income. This steady flow of income supported positive returns from the asset class.

Returns for mixed-grade credit portfolios were also boosted by much-improved performance from high yield securities. Spreads in this part of the market had widened meaningfully over the past few months; seemingly sufficiently to help attract value-oriented investors.

Source: This was prepared and issued by First Sentier Investors (Australia) IM Ltd (ABN 89 114 194 311, AFSL 289017) (FSI AIM), which forms part of First Sentier Investors, a global asset management business. First Sentier Investors is ultimately owned by Mitsubishi UFJ Financial Group, Inc (MUFG), a global financial group.

WHY STAYING INVESTED MATTERS WHEN MARKETS FALL

It's natural to feel nervous when markets fall.

News about inflation and rising interest rates may prompt you to make an emotional investment decision. But history tells us that markets trend upwards in the long run – and switching investment options at the wrong time can have a negative impact on your overall long-term investment return. If you feel anxious when you see your balance drop and worry about your retirement savings, know that it's a common reaction. And it's natural to consider switching your super into a more defensive portfolio mix to avoid market turmoil. But doing so could mean locking in losses and missing out on the recovery which follows.

A year with a negative return can be stressful, although the general long-term trend is for markets to grow, not contract.

The Australian share market has only recorded five negative years in the three decades since compulsory superannuation was introduced in 1992.

Here are three examples of market falls, and their following recoveries.

GLOBAL FINANCIAL CRISIS 2007 – 2009

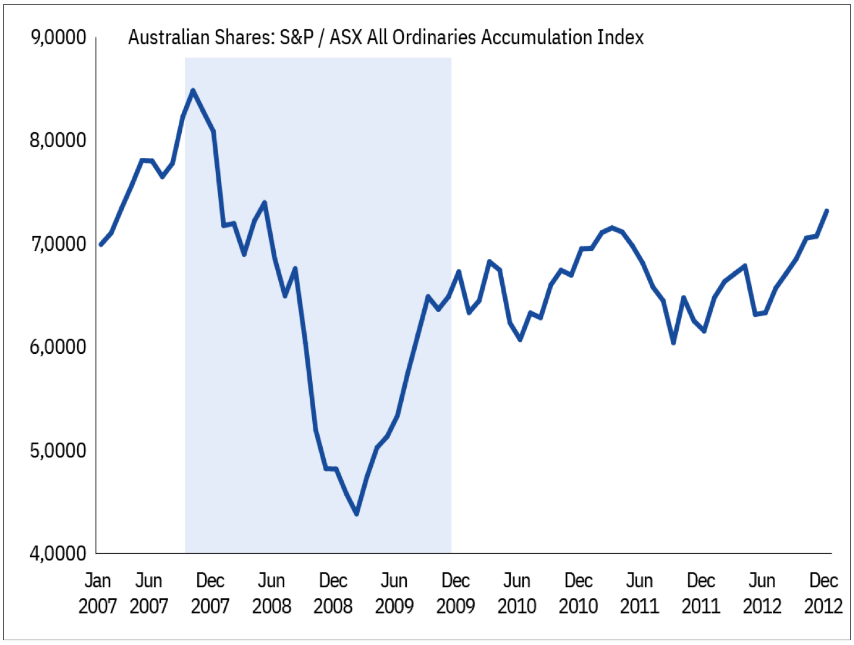
Why did this happen?

The mid 2000s was a prosperous period for developed countries and mortgage lending became a lucrative business for banks. With house prices rising and regulators unworried about the potential risks, banks in the US began lending increasingly large sums to borrowers. included lending to borrowers with a high risk of default. US banks packaged up and on-sold those risky loans to investors.

Then in 2007 interest rates rose and house prices fell. Homeowners found themselves unable to make the repayments on their mortgage and owed more than their homes were now worth.

As people walked away from their obligations, banks quickly racked up massive losses. The investors who'd bought the risky loans also lost money. The interconnectedness of global finance meant banks around the world experienced significant losses with some collapsing.

The resulting fallout remains one of the worst economic downturns since the Great Depression of the 1930s.



Source: S&P Index Data Services. S&P/ASX All Ordinaries Accumulation Index. Date from 31 January 2007 to 31 December 2012.

What did it mean for investors at the time?

The Australian share market fell 54% – a painful, drawn-out decline over 16 months from November 2007 to March 2009. But by 2013, US markets had returned to their pre-crisis highs. Australia took a little longer to regain its losses, finally breaking back above its pre-crisis levels in 2019.

What was the best thing investors could do at the time?

Staying invested during the Global Financial Crisis proved the best strategy, despite testing investor nerves. Yet anyone who switched their investments to cash locked in those original losses and missed out on the multi-year gains that followed.

THE COVID CRASH 2020

Why did this happen?

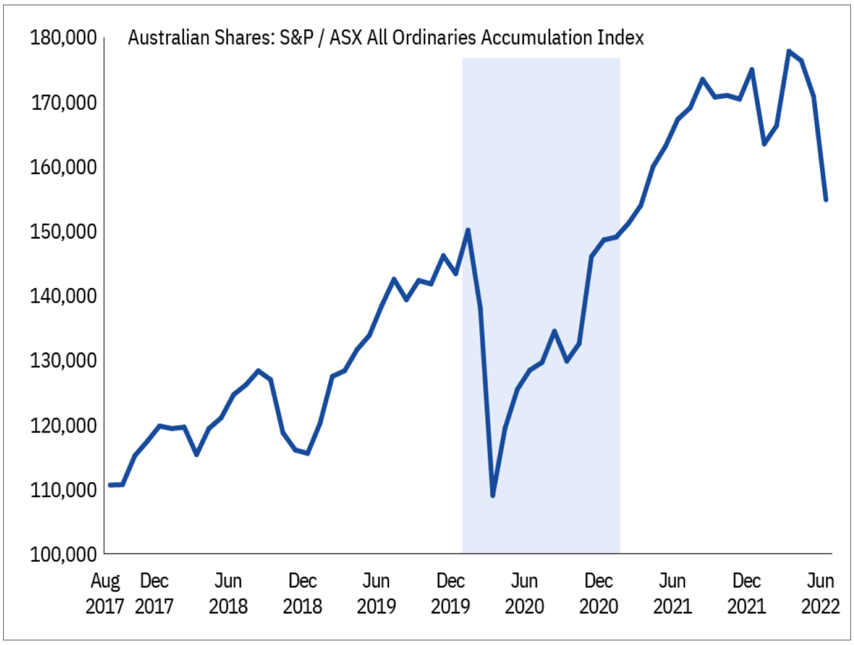
In March 2020, the world started to realise how serious the rapid spread of COVID-19 really was. Governments enforced lock-downs, air travel was all but outlawed and investors desperately sold off their shares fearing these restrictions would hurt companies' growth plans and profit margins.

What did it mean for investors at the time?

It all came to a head on 16 March 2020, when the ASX 200 recorded its worst day ever (down 9.7%) while in the US, the S&P500, Dow Jones Industrial Average and NASDAQ indices all lost 12% or more.

What was the best thing investors could do at the time?

Investors who switched to cash at the end of March, hoping to protect themselves, were 22% to 27% worse-off on average than those who held on through the drop.



Source: S&P Index Data Services. S&P/ASX All Ordinaries Accumulation Index. Date from 31 August 2017 to 30 June 2022.

Share markets didn't just recover – they grew to new highs. And people who stayed invested benefited from that growth.

SEPTEMBER 11 ATTACKS 2001

Why did this happen?

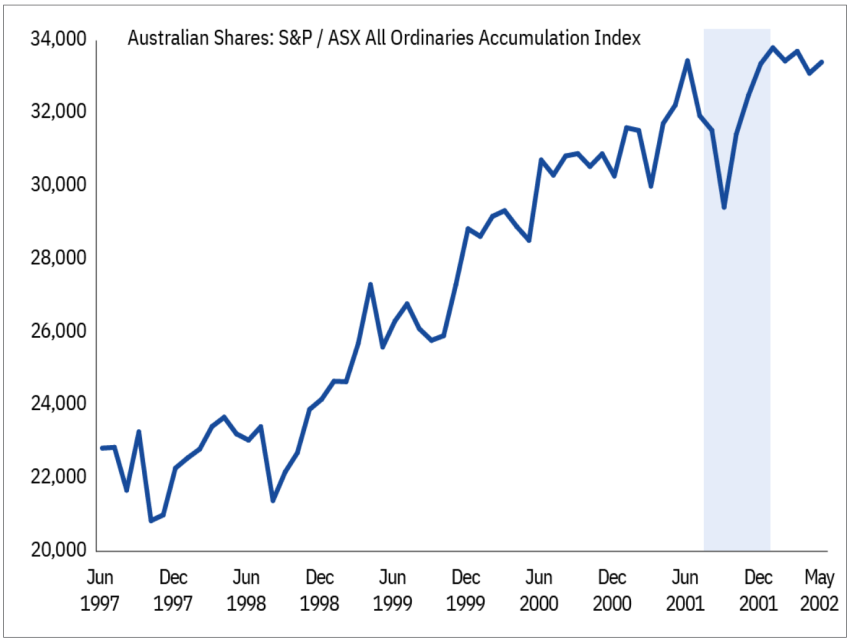
Almost 3000 lives were lost when four planes were deliberately crashed into strategic locations around the US on 11 September 2001. Almost all of these deaths were in New York, where al-Qaeda destroyed the World Trade Centre towers which sat at the heart of the financial district.

What did it mean for investors at the time?

In the days after the attack, markets dropped. The S&P500 fell 11% (extending the losses from the tech wreck earlier that year) while in Australia, the ASX200 lost 4.11% in a single session, before reaching a bottom on 24 September, 9.79% below its pre-attack level.

What was the best thing investors could do at the time?

Both the US and Australian share markets recouped all these losses only a month later. By taking a long-term view of investing, you can ride out any short-term dips in the market and take advantage of growth opportunities over the long term.



Source: S&P Index Data Services. S&P/ASX All Ordinaries Accumulation Index. Date from 30 June 1997 to 31 May 2002.

What's the key thing to take away from these three examples?

When markets fall sharply, it's only natural to be concerned and think about moving money to less risky investment options – with a plan to switch back later. Yet as history has shown, it is important to consider staying invested at times of market volatility to enable your investments to benefit when the market rebounds.

Source: Colonial First State

IMPACTS FROM FALLING HOME PRICES: THE WEALTH EFFECT

The impacts of interest rate hikes on consumers are well known.

Higher interest means that mortgage debt servicing costs will go up which is negative for consumer spending.

Rate hikes are also bad news for home prices, which will create another negative for households via the destruction of wealth and the associated "wealth effect".

Housing as a Source of Wealth

Household wealth is a measure of the value of physical assets owned like homes and the land they sit on and business premises as well as financial assets like shares.

Housing is both a source of wealth but also a form of consumption. Households can be a homeowner while non-homeowners "consume" housing through paying rent. As a result, changes in home prices do not have an equal impact across households, which can make measuring a direct wealth effect difficult.

For example, higher home prices are positive for investors and homeowners with no plans to upgrade but are negative for households looking to get into the market or upgrade. Renters may also be worse off as higher home prices could lead to higher rents. However, the composition of home ownership in Australia means that the majority of the population benefits from higher home prices, with two thirds of households (or around 7 million households) either owning a home outright or paying a mortgage. Housing is the largest single source of wealth for households, at 65% of total household wealth.

National home prices peaked in April 2022 and have fallen by nearly 5% to mid-September. We expect a peak-to-trough decline in prices of 15-20% with prices declining into 2023 before stabilising late next year.

Our expectations for a further fall in home prices means we also expect household wealth to decline.

The Wealth Effect

The "wealth effect" is an economic concept referring to a change in consumer spending following an adjustment to household wealth. The historical relationship between wealth and consumer spending shows that rising wealth coincides with rising consumer spending and vice versa. Intuitively this makes sense – when you feel like your assets are worth more, you feel more confident to spend.

Our expectations for declining home prices in 2022/23 and, as a result, household wealth, means that consumer spending growth will also slow. We expect a weakening in consumer spending to just under 1% (year on year) by December 2023 which will weigh on GDP taking it well below normal levels of around 3% growth in consumer spending.

Other Impacts of Falling Home Prices

There are also other impacts of falling home prices including:

Higher risk of negative equity loans (which means that the market value of the home is less than the debt taken against the home) which increases the risk that the household will default if they can't repay the debt by selling the property.

Lower bank profitability and increased risk of bank stress. Declines in home prices mean lower lending which is negative for banks as housing makes up 60% of bank lending. Falling home prices also increases the risk of defaults, which means that banks could take a hit to their capital. The loans which are most at risk are those with high loan-to-value ratios but the share of new lending to these areas is low (at around 5% of new lending).

Conclusion

So far, consumer spending has held up well in Australia despite high inflation (especially on essential items), rising interest rates, a collapse in consumer confidence and the negative wealth effect. Spending is holding up thanks to high household savings, housing prepayments, a shift in spending from goods to services and lags of changes in RBA interest rates to minimum housing repayments.

In our view, consumer spending is set to slow down significantly in 2023 as consumers start to feel the impacts of rate rises, household wealth deteriorates and accumulated savings decline.

On our forecasts, annual growth in consumer spending will be under 1% by late 2023, well below its usual levels of around 3% per annum. This will weigh on GDP growth (household consumption is over 50% of GDP) and we see GDP growth slowing to under 2% per annum by late 2023.

Source: AMP Capital

3 THINGS TO CONSIDER IF YOUR SUPER BALANCE FALLS

From time to time, market movements may cause your super balance to fall.

While this can be alarming, you'll find that it usually recovers in due course.

However, if you feel like you need to make some adjustments to your super, here are three things to think about first.

CONSIDER HOW COMFORTABLE YOU ARE WITH RISK

Almost every type of investment carries some level of risk. Generally speaking, the greater the risk, the higher the potential returns.

Your super is usually made up of different kinds of investments (called asset classes) and they all have different levels of risk. The most common asset classes are:

Shares (also known as equities)

Shares give you part ownership of an Australian or international company and earn dividends through capital growth.

Shares are generally considered a higher-risk asset because they're susceptible to market fluctuations, but they can also provide higher returns over the long term.

Property securities

Property securities are common in super portfolios. Rather than investing in direct property, property securities invest in commercial, retail and industrial property holdings via the share market. They're considered a higher-risk asset with high potential returns over the long term.

Fixed interest

The most common types of fixed interest investments are bonds. They're issued by governments and large corporations when they want to raise money – for example, to fund a government or business initiative.

They typically pay regular interest over a fixed term – anywhere between one and thirty years. Bonds are considered low risk, low return investments.

Cash

This can include money held in short and medium-term investments that earn interest, such as term deposits, bank bills and treasury notes. Their value is impacted by changes to the interest rate. These types of investments are considered very low risk because their returns are generally low but stable.

The higher your allocation to riskier investments, such as shares and property securities, the more likely it is that you'll experience market volatility – and this will be reflected in your super balance. You'll also have the potential to receive higher returns over the long term.

On the other hand, if your super portfolio has a higher allocation to low-risk investments, like cash and fixed interest, you'll probably experience less market volatility and therefore less fluctuations in your super balance. However, you'll most likely receive lower returns over the long term.

Everyone is different and you need to decide how much risk you're willing to accept in your super. This might change throughout your lifetime. For example, you might find that you're less comfortable with risk as you approach retirement, because you have less time for your super to recover from short-term fluctuations.

DIVERSIFY YOUR SUPER

One of the ways to lower the overall risk in your super is to invest your super across several asset classes (an investment strategy known as diversification). This is because every market moves in its own cycles, and no matter what type of investments you have in your super it's likely that they'll experience a downturn at some point. Each type of investment can perform differently under the same market conditions – so when the value of one falls, another may go up.

While there are no guarantees that diversification will fully protect you against loss, spreading your investments across a range of asset classes can help balance out the overall levels of risk and return in your portfolio.

CHECK THAT YOUR INVESTMENT STRATEGY IS APPROPRIATE

Your investment strategy and risk profile (how comfortable you are with risk) go hand in hand. Your financial goals and investing timeframe should also be considered as part of your strategy. Here are some different investment strategies that you may come across in super:

Growth

Around 80% allocation to growth assets like shares and property securities, with an investment timeframe of 5 years or more.

Balanced

Around 70% allocation to growth assets like shares and property securities, with an investment timeframe of 5 years or more.

Moderate

Around 60% allocation to growth assets like shares and property securities, with an investment timeframe of 5 years or more.

Diversified

Around 50% allocation to growth assets like shares and property securities, and 50% allocation to defensive assets like fixed interest and cash, with an investment timeframe of 5 years or more.

Conservative

Around 70% allocation to defensive assets like fixed interest and cash, with an investment timeframe of 3 years or more. Another common investment strategy is ethical or responsible investing. This involves choosing investments that align with your personal moral or ethical views relating to factors such as people, society and the environment.

Whatever type of investment strategy you chose, it shouldn't be something you set and forget.

It's worth revisiting your investment strategy from time to time – and not just when markets move significantly – to make sure it's appropriate for where you are right now. That way, you'll be better prepared if markets do become volatile.

Source: Colonial First State

BOOMS, BUSTS AND INVESTOR PSYCHOLOGY

Why investors need to be aware of the psychology of investing.

Up until the 1980s the dominant theory was that financial markets were efficient.

In other words, all relevant information was reflected in asset prices in a rational manner.

While some think it was the Global Financial Crisis that caused faith in the so-called "Efficient Markets Hypothesis" (EMH) to begin unravelling, this actually occurred in the 1980s. In fact, it was the October 1987 crash that drove the nail in the coffin of the EMH as it was impossible to explain why US shares fell over 30% and Australian shares fell 50% in a two-month period when there was very little in the way of new information to justify such a move.

It's also hard to explain the 80% slump in the tech heavy Nasdaq index between 2000 and 2002 on the basis of just fundamentals. Study after study has shown share market volatility is too high to be explained by investment fundamentals alone. Something else is at play, and that is investor psychology.

INDIVIDUALS ARE NOT RATIONAL

Numerous studies by psychologists have shown that people are not always rational and tend to suffer from various lapses of logic. The most significant examples are as follows.

Extrapolating the present into the future:

People tend to downplay uncertainty and assume recent trends, whether good or bad, will continue.

Giving more weight to recent spectacular or personal experiences in assessing the probability of events occurring:

This results in an emotional involvement with an investment strategy.

If an investor has experienced a winning investment lately, he or she is likely to expect that it will remain so. Once a bubble gets underway, investors' emotional commitment to it continuing steadily rises, thus helping to perpetuate it.

Overconfidence:

People tend to be overconfident in their own investment abilities.

Too slow in adjusting expectations:

People tend to be overly conservative in adjusting their expectations to new information and do so slowly over time.

This partly reflects what is called "anchoring" where people latch on to the first piece of information they come across and regard it as the norm.

This partly explains why bubbles and crashes in share markets normally unfold over long periods.

Selective use of information:

People tend to ignore information that conflicts with their views. In other words, they make their own reality and give more weight to information that confirms their views. This again helps to perpetuate a bubble once it gets underway.

Wishful thinking:

People tend to require less information to predict a desirable event than an undesirable one. Hence, asset price bubbles normally precede crashes.

Myopic loss aversion:

People tend to dislike losing money more than they like gaining it. Various experiments have found that a potential gain must be twice the potential loss before an investor will consider accepting the risk. An aversion to any loss probably explains why shares traditionally are able to provide a relatively high return (or risk premium) relative to "safer" assets like cash or bonds.

THE MADNESS OF CROWDS

As if individual irrationality is not enough, it tends to get magnified and reinforced by "crowd psychology". Investment markets have long been considered as providing examples of crowd psychology at work. Collective behaviour in investment markets requires the presence of several things:

A means where behaviour can be contagious:

Mass communication with the proliferation of electronic media is a perfect example of this. More than ever, investors are drawing their information from the same sources, which in turn results in an ever-increasing correlation of views amongst investors, thus reinforcing trends.

Pressure for conformity:

Interaction with friends, monthly performance comparisons, industry standards and benchmarking, can result in "herding" amongst investors.

A precipitating event or displacement that gives rise to a general belief that motivates investors:

The IT revolution of the late 1990s, the growth in China in the 2000s and crypto currencies more recently are classic examples of this on the positive side. The demise of Lehman Brothers and problems with some crypto currencies/markets are examples of displacements on the negative side.

A general belief which grows and spreads:

For example, a belief that share prices can only go up – this helps reinforce the trend set off by the initial displacement.

BUBBLES AND BUSTS

The combination of lapses of logic by individuals in making investment decisions being magnified by crowd psychology go a long way to explaining why speculative surges in asset prices develop (usually after some good news) and how they feed on themselves (as individuals project recent price gains into the future, exercise "wishful thinking" and get positive feedback via the media, their friends, etc). Of course, the whole process goes into reverse once buying is exhausted, often triggered by contrary news to that which drove the rise initially.

WHAT DOES THIS MEAN FOR INVESTORS?

There are several implications for investors. First, recognise that investment markets are not only driven by fundamentals, but also by the often-irrational and erratic behaviour of an unstable crowd of investors.

The key here is to be aware of past market booms and busts, so that when they arise in the future you understand them and do not overreact (piling into unstable bubbles near the top or selling everything during busts and locking in a loss at the bottom).

Second, try and recognise your own emotional responses. In other words, be aware of how you are influenced by lapses in your own logic and crowd influences like those noted above. For example, you could ask yourself: "am I highly affected by recent developments? Am I too confident in my expectations? Can I bear a paper loss?"

Thirdly, to guard against emotional responses choose an investment strategy which can withstand inevitable crises whilst remaining consistent with your financial objectives and risk tolerance. Then stick to this even when surging share prices tempt you into a more aggressive approach, or when plunging values suck you into a defensive approach.

Fourthly, if you are tempted to trade, do so on a contrarian basis. Buy when the crowd is bearish, sell when it is bullish. Extremes of bullishness often signal eventual market tops, and extremes of bearishness often signal bottoms.

Successful investing requires going against the crowd at extremes. Various investor sentiment and positioning surveys can help. But also recognise contrarian investing is not foolproof – just because the crowd looks irrationally bullish (or bearish) doesn't mean it can't get more so.

Source: AMP