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SNOWGUM QUARTERLY

INTRO

Snowgum Financial Services

2021 was another harrowing year. Many businesses continue operating on life support. As we commence 2022, the Omicron variant reminds us that a return to normality is impossible to predict.

Meanwhile, markets remain near all-time highs, although cracks are emerging.

The growing and ignored elephant in the room remains government debt. We explore how this might be resolved, and what impact this may have on investors.

KEY STATS

- Cash remains unchanged at 0.10%
- Unemployment in Australia is 4.20%
- Inflation is 3.50%

WHAT'S INSIDE THIS QUARTERLY:

Key Statistics

Economic Update

- *Intro*
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ECONOMIC UPDATE

Intro

- 2021 was another harrowing year.
- Many businesses continue operating on life support.
- Supply chains remain disrupted with critical workers furloughed through waves of COVID-19.
- A troubling and contradictory picture of China's growth miracle is emerging.
- More American's have died from COVID-19 than both World Wars combined.
- As we commence 2022, the Omicron variant reminds us that a return to normality is impossible to predict. A more transmissible sub-variant of Omicron is emerging in Europe.
- Meanwhile, markets remain near all-time highs, although cracks are emerging.

Economists were absorbed by the spectre of inflation in 2021 and 'Transitory' was the overused word in finance circles. Inflation, having been subdued for many years, was a growing concern. Camps were formed, those who believed inflation would pass – team transitory – and those who felt inflation would continue. Mounting inflationary pressures have seen the Fed announce they are likely to raise interest rates in March.

"I would say that the committee is of a mind to raise the Federal Funds rate at the March meeting," Mr Powell, Fed Chair.

Government Debt

The growing and ignored elephant in the room remains government debt. Following on from the GFC, COVID-19 has seen fiscal balance sheets continue to balloon. Government debt will be the hangover waiting for us on the other side of COVD-19 (whenever that might be). In places like the US, EU, China and Japan, fiscal imbalances (some hidden as in China) are sufficiently dire that there are limited pathways for budget repair. The options are:

1. Default – Heavily indebted governments could default on government bond repayments.
2. Austerity – Indebted governments could exercise fiscal constraint, dramatically curtailing spending and/or raising taxes.
3. Deflate – Have inflation remain elevated for the medium term to deflate debt relative to GDP.
4. Something new – This covers other possible options, including quantitative forbearance (QF)- something we've made up.

Defaulting on government debt would be painful. It would lead to a crash in that government's currency and a rapid decline in that country's living standards. If in the US, it would upend USD fiat currency systems[1].

A government in default would be unable to issue new bonds or rely entirely on central banks for borrowing, further devaluing currency. A default would likely force an instant balancing of budgets, requiring dramatic cuts to essential services and social security benefits. It could even lead to hyperinflation should currency devaluation be sufficiently severe that inflation was imported[2].

That currency might even lose it's standing as an acceptable store of value. Defaulting is a poor pathway to budget repair.

Political will for Austerity does not exist and even if it did, COVID-19 economic frailties make curtailing government support economically risky.

That leaves Deflating Debt. This requires inflation to run above trend for an extended period. This worked post WW2, when government debt, accumulated from fighting a war, needed to be 'rationalised'.

Inflation spiked to nearly 20% and was above 5% for many years. We are not suggesting such dramatic pricing instability, but inflation running between 3-5% for several years is a palatable solution to budget repair.

Psychology is fascinating. The fear of modestly elevated inflation is misplaced (although hyperinflation is to be avoided). In fact, we welcome elevated inflation (so long as it is accompanied by wage growth) in the context of global fiscal imbalances. Government policies can support a debt deflationary pathway through targeted policies that address inequities inflation exacerbates.

Government policies should target elevating wage growth and keeping/making housing affordable. Governments might consider, for example, raising public servant wages, a catalyst for wage competition in the private sector.

Quantitative Forbearance

This next section comes with a warning – sleep inducing monetary policy theoretical discussion.

How else might fiscal balance sheets be rationalised?

Central banks set cash rate targets through open market operations (transacting bonds, repos[3] and exchange settlement accounts).

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[1]Fiat money is a government-issued currency that is not backed by a commodity such as gold.
[2] Imported inflation occurs when a currency declines in value, causing a relative increase in the price of imported goods and services, increasing the price of consumer goods. I.e. a 50% drop in USD relative to AUD would make Australian beef 50% more expensive in USD terms for US consumers. Thus, lead to an increase in US consumer prices. This is a concern for central bankers.
[3] Repos are Repurchase Agreements of loaned exchange settlement accounts. A good explainer - How the Reserve Bank Implements Monetary Policy | Explainer | Education | RBA

When targeting a cash rate, central banks transact in both directions, buying and selling to manipulate markets to drive the ‘cash rate’ to their desired target. Quantitative Easing (QE) introduced money creation to facilitate the purchase of government bonds. This too was to manipulate the market pricing of government bonds to ensure governments retained access to funding at stable and low rates. However, whilst governments operate elevated deficits, Central Banks have no mechanism to contract money supply without triggering a spike in government debt funding costs.

The idea of Quantitative Tightening (QT) [1] was more broadly introduced 4 years ago when Janet Yellen indicated the Fed may not rollover all government bond positions at maturity. QT occurs when a central bank does not fully repurchase all government bonds at maturity. In doing so, central bank government bond assets will contract over time (and with-it money supply). This is the natural pathway for unwinding the unorthodox policy of printing money to buy government bonds (QE).

Unfortunately, most indebted governments are operating deficits, so continue to issue an increasing supply of bonds to fund spending commitments. If Central Banks undertook QT (not that they are considering it) the market would quickly resume price setting of government bonds.

This would drive bond yields vastly higher, increasing government debt funding costs, exacerbating the demise of government balance sheets as bonds are rolled over at maturity.

A missing Central Bank tool is the somewhat exotic idea of debt forbearance (or Quantitative Forbearance/forgiveness (QF)). Should Central Banks write-down government debt, a corresponding monetary value would be removed from the Central Bank’s balance sheet and government debt ledger.

Esoterically, and a question for academics, is whether that money has disappeared from circulation? Or, because that money was spent by government, does the value of the write-down only evaporate from central bank asset and government debt ledgers via *accounting measures*, whilst simultaneously not impacting money supply?

The question then follows, how is QF accounted? That is beyond us and reserved for the academic accountants; a wild cohort of people to be sure.

Two big headaches with QF are:

1. There is no precedent, and legal wrangling is required to ensure QF is not classified as a default (allowing ongoing bond issuance).
2. Morale hazard. Once a central bank forgives debt, is pandora’s box opened on government spending prudence?

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[1] A good explainer of QT - What's Quantitative Tightening? Why Does It Follow the Fed's Quantitative Easing - Bloomberg

What stops governments taking advantage of central bank forbearance, crowding out private markets from limited resources and driving inflationary pressures that ultimately results in financial market instability? So, counterintuitively as some might argue QF is reducing money supply, yet QF could be inflationary. Like other monetary tools, QF has an inflationary edge and it might best be deployed modestly in benign inflationary conditions, but that is our speculation.

It may seem an unnatural tangent, but the debt positions, political gridlock in the US and demographic headwinds faced in China, make traditional fiscal rationalisation difficult to imagine. **Perhaps the right question is – is QF worse than a government succumbing under the weight of their own debt whilst the economy struggles? Probably not.**

Inflation

To be or not to be' is still the question.

An uptick of COVID-19 has furloughed critical supply-chain staff. Resultant cost increases boost inflation pressures as does demand pull inflation via heightened pricing instability (think Rapid Antigen Tests).

Looking at the year ahead, even as some temporary supply chain disruptions abate, moderate inflationary pressures are likely to remain. The most recent inflation data in Australia surprised on the upside at 3.5%.

Our rationale for the likelihood of more persistent inflation is the interplay of two drivers – Employment and Money Supply.

1. Employment

Unemployment has recovered remarkably quickly, but that only tells half the employment picture.
In the US, the employment rate measures the number of people who have a job as a percentage of the working age population. This is a different measure to unemployment or the participation rate. As the below graph demonstrates, the employment rate has been on a broadly downward trend. Earlier retirement, intergenerational wealth and prolonged periods of education are increasingly keeping working age people out of labour markets.

One biproduct of COVID-19 stimulus was increased household savings and higher asset prices. The resultant increase in household wealth, and reduced willingness to participate in health risk employment activities, led to an increase in the retirement of baby boomers.

Older workers are generally more productive than younger workers. Although younger workers are often more technologically advantaged, older workers have superior experience. 30+ years of experience can deliver increased productivity gains through the nuanced application of learned skills at senior levels within business.

In short, there has been a rapid decline of human capital within the economy. Human capital scarcity supports labour competition and wage growth.

2. Money supply

Central bank government bond purchases, suppressing yields, has forced investors to allocate capital into other financial assets.

These capital flows have driven asset prices higher. With a lower cost of capital now available to businesses, there is increased capacity to fund competition for labour. All things equal, this *should* support wage growth and we anticipate this bringing the first significant increase in wages for some years.

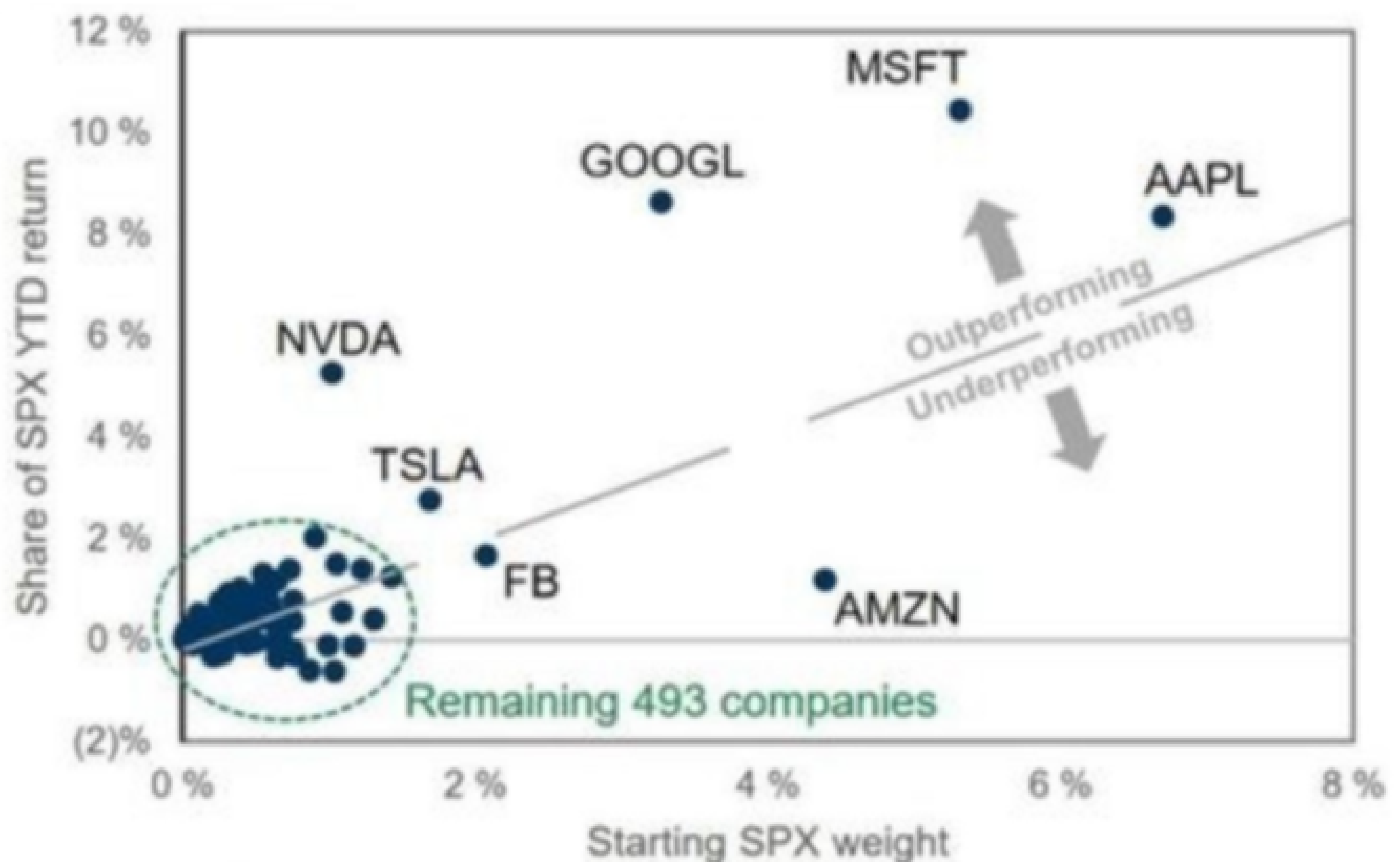
3. Technology innovation

Technology adoption has worked against traditional inflationary pressures. The marginal-cost of supplying an additional software license is negligible. That is, when Xero sells another software subscription, it is not resource constrained by factory/worker output capacity.

The traditional resource constraints economists discuss that lead to cost push inflation as economies expanded are less of a feature of the digital revolution.

Digital productivity improvements are also highly profitable. They have fuelled economic expansion without inflationary consequences. Because they have become an increasingly larger component of capital expenditure of businesses, they have diminished employee bargaining power, supressing wage growth. Furthermore, software/digital innovation has increased the productivity of existing labour, diminishing the need to expand an employee base.

Vendors of these mass digital productivity innovations have captured some of the forfeited wages of employees. The graph below demonstrates how immense an impact seven technology businesses have on the US S&P500 performance.



Digital innovation may continue to supress inflation pressures. However, the growing labour constraints in human dependant industries like hospitality, tourism and professional services make it inevitable that wage growth will arise in these sectors.

China

We've discussed China's economic challenges in previous quarterlies. The demise of China's overleveraged property development businesses and deflation of their property bubble continues to gather pace. 2021 saw a 9% fall in property prices and 17% fall in land sales (by area).

The second order impact of a deflating property bubble will be the financial collapse of local government municipalities.

The first municipality to go into financial distress appears to be Hegang, Northern China, where officials announced on December 23, 2021 that they have frozen hiring and begun 'fiscal restructuring'.

"*Their [all Chinese municipalities] outstanding debt amounted to $8 trillion at the end of 2020, Goldman Sachs estimated, equivalent to around half of China's gross domestic product; last year they also replaced property developers as the biggest Chinese debt issuers offshore, with $31 billion of dollar bonds coming due in 2022*" – Reuters, Yawen Chen, January 11, 2022.

Xi Jinping has called for interest rates to remain low in western countries. As mentioned above, municipalities are saddled with dollar bond debts. China is presently lowering rates to stimulate a faltering economy.

Should the west begin raising rates, the relative cost of dollar bond exposures is further exacerbated. That would lead to an increased flight of capital out of China.

Within state owned enterprises there is further evidence of poor governance and excessive leverage. For China's high speed rail network, the cost of servicing interest on debt has been higher than operating profit since 2015. The solution has been to issue more debt to cover the interest servicing shortfall. This puts the state-owned enterprises into a compounding debt trap. The CCP has quashed further investment in high-speed rail.

Headline Chinese government debt to GDP appears modest at approximately 66% in 2020, but that is in part because;

1. Data is unreliable; and
2. State owned company debt and municipality debts are not included.

In addition to a slowing economy struggling to execute a zero-covid policy, with mounting debts, there is a longer-term demographic challenge. As the saying goes, China looks to be growing old before it grows rich.

Predictions of Chinese economic collapses have abounded for decades. We are certainly not making such a forecast. However, the deeper you dig into the Chinese economy, the more troublesome the picture appears.

And, if interest rates begin climbing in Western economies, that may expedite China's challenges.

Will 2022 be the year of financial reconning for China?

INVESTMENT UPDATE

Our central thesis is that inflation is somewhat desirable to address fiscal imbalances and central banks may be more accommodative in allowing inflation to persist at slightly elevated levels.

Being long term investors, in inflationary conditions, investors should focus on real assets (property and infrastructure) and equity within businesses that possess some form of pricing power. Cash should be avoided where possible.

In the past we utilised iShares Asia 50 within portfolios to take a tactical weighting to Asian markets (where portfolio scale lacked capacity for direct investment). Our growing pessimism towards China has warranted a shift in exposure. We believe technology exposures within this market remain reasonable and are complimentary to a traditional Australian ‘blue-chip’ share investor. We have largely exited iShares Asia 50 and incorporated a more targeted Asian market exposure in BetaShares Technology Tigers ETF (ASIA).

A recent inclusion into some portfolio’s has been Magellan Financial Group (MFG.ASX). Valuation makes this attractive. The market appears to be pricing in a permanent loss of performance fees (unlikely) and ascribing negligible value to direct investments in an investment bank (Barrenjoey) and Guzman y Gomez (Mexican fast food retail chain).

The business actively manages capital and if share-market weakness abounds, is likely to outperform.

Establishing an investment in a business succumbing to negative market sentiment can be challenging. It is impossible to predict when market participants decide negative sentiment is no longer justified relative to valuation. Morningstar retain a fair value estimate of $38 (as opposed to current $18-20 share price range).

Some negativity towards Magellan Financial Group from UBS and other investment banks may need to be taken with a grain of salt. Magellan Financial Group are part owners of Barrenjoey Investment Bank, which poached a swath of investment banking talent and have begun eating into investment banking market share. Therefore, some banks may have a bias against Magellan.

Another business we think remains undervalued is Alibaba (BABA:US). This business has suffered with general negative sentiment towards Chinese listed businesses. Although geopolitical risks are problematic, the negativity has made the business very attractive in respect to the current share price.

By way of comparison, Alibaba (BABA:US) has a current price to earnings (P/E) ratio of 18.66x with a 3-year annualised revenue growth rate of 42.05%. By comparison, Coles, Woolworths, WBC and CBA all have P/E ratios between 15-25x with 3-year annualised growth at less than 4% and in some instances negative growth!! Charlie Munger has doubled his position in Alibaba and that shows his confidence in this company.

Our most recent material shift in asset allocations occurred in the beginning of 2021 when we further shifted asset allocations weightings away from fixed interest and into floating credit. We also increased exposures into infrastructure assets and where clients were eligible, explored private equity opportunities. Investment and asset allocation positions remain much in line with previous quarterly updates.

If the Global economy, and particularly China, slow, it would lead to weakness in the AUD as commodity demand diminishes. Australian investors should continue to remain unhedged to their international positions.

Any advice contained in this update is of a general nature only and does not take into account your circumstances or needs. You must decide if this information is suitable to your personal situation or seek advice. Prior to investing in any particular product, you should read the Product Disclosure Statement.

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