Hi, and welcome to Conversations, a monthly podcast from GSFM. This series will focus on investment concepts and outcomes of interest to you and your clients. Our first series focuses on income, and this is the fourth podcast in the income series. Today's podcast features GSFM's CEO, Damien McIntyre, along with our investment strategist and rates and bond expert, Steven Miller. Together, they'll look at the income landscape in light of the current environment where inflation is firmly marching forth, rates are likely to increase, and income, well, what does this environment mean for income from cash, bonds, equities and other assets?

Before I hand over, I need to read this important notice: The information contained in this podcast is general and does not consider your objectives, financial situations, or needs. The information and views contained in this update reflects as at the date of recording, the current opinions of the participants and are subject to change without notice. Before making an investment decision in relation to a fund, investors should consider the appropriateness of this information, having regard to their own objectives, financial situation, and needs. This podcast was recorded on Wednesday, the 16th of March 2022.

Damo and Steve, over to you…

Damien McIntyre

Thank you, Tracey. Welcome Steven, and welcome to all of our listeners to our previous Conversations podcasts. We're actually going back to the beginning of the series when Steven and I spoke, I think it was September or October of last year. And by golly, by crikey, the landscape was a lot different then, Steven.

Stephen Miller

It was, Damien, it was different, and it wasn't. I think even at that stage we were canvassing the fact that the bond yields were low and possibly going to increase. We were canvassing that the central banks might have been proximate to a tightening cycle. We were canvassing, I think, the difficulties for investors in accessing income because yields were so low. So, a bit has changed since then, but arguably too, that's thrown up a different set of problems that investors now face.

And I think it also must be said that notwithstanding the fact that we're now confronting the possibility of policy rate increases in 2022, and notwithstanding the fact that bond yields have risen a bit; the fact is, in generating income, it's still difficult because bond yields are only just off their historic lows. So, there's challenges still there, even though things have changed since September, October when we last spoke.

Damien McIntyre

Yeah. I think the principle change I was thinking of was, well, inflation was starting to accelerate, certainly in the United States it's really accelerated. We've had prints in the sevens in recent times.

Stephen Miller

Yeah. I think the last one was 7.9. So, we're close enough to eight on a headline basis.

Damien McIntyre

Yeah. Which is a big number historically. Certainly, it's a big number for recent history. And then of course, here we are now with war, which really just complicates everything. Because since, I think it's the 23rd or the 24th in February, when Putin entered Ukraine or Russia entered Ukraine, markets really have been quite erratic. Haven't they?

Stephen Miller

Look, they have. And I think the issue here is that inflation was already on the march before this conflict got going in earnest in late February. And so, we had a lot of inflation momentum. And what we've seen since the invasion is an explosion in commodity prices, albeit in a quite volatile fashion. And if you like, a likely accentuation of pre-existing inflation pressures, but at the same time, I think they're also taking us back to something that we might have last seen in the '70s.

Now, I'm not going to overplay the parallels, but there are some parallels in the sense that what the war might do is turn what was a period of inflation potentially into a period of stagflation, in a context similar, not exactly the same, but similar to that that we saw in the '70s with the Yom Kippur War, and then later on the second oil price shock with the Iranian revolution. And we all know what happened after that. Paul Volcker raised interest rates to 20-odd-percent, US 10-year bond yields went to 14%. We had a recession, but that was what was necessary to get inflation out of the system.

And the reason that that harsh medicine was required at that time, was that central banks had dithered and not treated the inflation scare seriously throughout much of the '70s. So, that's where we find ourselves at the moment. Now, I don't want to overplay the parallels, but they do exist, albeit that some of the magnitudes involved are very, very different.

Damien McIntyre

It's an interesting conundrum we face. I see the parallels you're drawing. However, was the world as indebted relative to GDP or other measures back then as it is now? And what happens with these high levels in absolute terms of debt?

Stephen Miller

No, look, it's a good question. And the short answer to your question is, no, it wasn't. The second answer to that question is, what levels of debt there were, were quickly inflated away. So, if governments issued me a bond at 1% and inflation's suddenly at five, I'd much prefer to be the debtor than the creditor. And that's what happened in the '70s. And to be honest, I won't be surprised if something similar happens in the current period. However, I think the other point that you're getting to is this, is that does play into this stagflation theme, given the level of indebtedness, and this time I think we're talking more private indebtedness.

So, let's look at Australia for example, where household debt is very high. It'll only take a small increase in interest rates relative to say 30, 40, 50 years ago, for households to really start to feel the pinch and cut back on their spending in other areas. It only takes a small increase in interest rates in 2022, to have the same impact as a large increase in interest rates back in 1970. Now, I think that's an important point, and it is a conundrum. Because when you think about it, that's been the price of an over reliance on monetary policy. It sort of seems funny that whenever we've had a problem of excessive leverage, whether that's the tech wreck, whether that was the European bond crisis, whether that was the GFC, the response has been to reduce interest rates so people can increase their leverage, increase their amount of indebtedness. So it's been a little bit of a vicious circle. Though I acknowledge your point that there is a limit to how far interest rates can go up without causing severe pain in the current cycle.

But it might be that there's no alternative that this is the day of reckoning, whereby we, at last, do have to bite the bullet, and we do need to draw a line in the sand, or policy makers, I should say, need to draw a line in the sand as to how far they're allowed to let households get in debt, because arguably they've been too forgiving in the past, which means that they have to be less forgiving in the current circumstance. But it's big conundrum for policy makers. And what it does argue is that in times of stress, we probably need to push fiscal levers rather than rely too much on monetary leavers because of the debt consequences of that.

Damien McIntyre

Well, one last question on this subject. With the inflationary impacts to consumables and notably this rapid acceleration in the oil price, I filled the car at $2.30 a litre on Sunday, it was quite an eye opener. Doesn't this have the net effect or the same net effect as an interest rate [rise]? If consumers are spending more on their cost of living, isn't that the same effect as an interest rate, right?

Stephen Miller

It has the effect. If you are spending more on petrol or heating your house or running your air conditioner or whatever, you got less to spend on other things, that's true. But both either saying token because monetary policy is being run at pedal to the metal levels. Households are sitting on a big pool of savings. There is the wherewithal that exists at the moment for households to keep spending. But what generally happens, and this goes back to where we started, is that higher oil prices can crimp household budgets, but have an ongoing impact on the price level. That's what happened in the seventies. So we got high inflation and low growth together. We don't often see that, normally it's high inflation and high growth or low inflation and low growth. What happens with an increase in prices in petrol that finds its way through to inflation expectations, which is what happened in the '70s, didn't happen in the intervening period. Looks like it's happening now.

This means you get this sort of stagflation type outcome rather than the one I think you are hinting at, which means that growth slows, and inflation are both naturally. I think in some sense, what we're talking about is, if higher oil prices spark an increase in inflation expectations and lead to broad based inflation, we can have high inflation and low growth at the same time. We had that in the seventies, we cured it at the eighties and nineties. We didn't see it again till arguably the last year or two. And we're seeing it again because I think central banks were a bit too tardy, a bit too relaxed about inflation last year. The inflation genie looked to have got out of the bottle. And if we increase interest rates and oil prices and commodity prices, and so on, go up now, we may again be, at least for a period, maybe not as extended as the second half of the seventies, but at least for a period where we are in a high inflation, low growth world. Now we haven't got the low growth here, but it looks to be coming.

Damien McIntyre

Well, it'll be interesting to see how this all unfolds, particularly given that the major driver of inflation in recent times has been supply issues coming out of COVID, supply lines right across the world in hundreds of different products and consumables has been interrupted or there's being scarcity. So, I don't know if total growth necessarily fixes that for cures as you say, for a period of time.

Stephen Miller

You're most certainly right. It doesn't. I think this is a mistake that a lot of the central banks made last year, that we had Jerome Powell and Philip Lowe, and Christine Lagarde telling us, this is transitionary, don't worry about it. And it's supply driven, and sooner or later the supply chains will become unclogged, and we'll all get back to normality. Now that's fine, but that's not always the case. It doesn't matter where it comes from. It comes from supply chain blockages or oil prices or whatever, if it starts to impact on expectations, that's when the problem starts. And because the central banks were so relaxed about it last year, and I've got to say they underestimated the magnitude persistence and momentum in inflation. They did let the genie get out of the bottle. They did let it filter into expectations.

And that meant that we've got this perpetuation, this sort of increasing spiral that's taking place. Now, I must say I personally, this isn't a fashionable view, but my sense is becoming a little bit more commonplace. It's not just energy prices or supply chain blockages attended on the pandemic that were behind the re-emergence of inflation. My old professor, Charles Goodheart at the LEC telling us in 2019, that two great structural trends that account for the deflationary force of the last three decades. In other words, the globalisation of the labour supply that occurred after the fall of the Berlin wall, and if you like the export of labour from emerging market economy, such as China and India, on the one hand plus peak baby boomer, workforce participation, that was a structural wage deflationary shop that suppressed inflation for arguably three decades.

That's coming to an end now. We're sort of seeing that a little bit in this great resignation phenomenon. So that was a factor along with energy prices and supply chain blockers. And also a factor was the extended period. A period more than was necessary of excessively accommodative monetary policy was a factor. And I also think governments are including resorting to protectionist policies. Now that's inflationary. There's a renewed market regulatory agenda among the developed country governments. Now that might have loadable intent and loadable objective. I'm not contesting that. But what that regulatory agenda does do is it will inevitably add to price pressures.

Now it might be the judgment is made that that's a price worth paying, but that doesn't deny the fact that renewed market regulatory agenda has unintended consequences. And one of which is that it adds to price pressure. So it's not just those blockages you point about. These other things are happening at the same time, which is served to give inflation this big push, which is happening in different orders of magnitude in every developed country around the world. And indeed in all the emerging market economies as well.

Damien McIntyre

One last question on this subject. I agree with you that central banks have to raise interest rates, if for no other reason, that they're way too low. If there is a future economic shock from where they are today, there's just no margin for error on safety. So this concept of normalising rates just has to happen. But from where we are today, with the war in Ukraine, is that an unwanted complication. Will central bankers be like rabbits in the headlights here?

Stephen Miller

Look, I don't think so. It's certainly an unwanted complication. Not just for monetary policy reasons, for a variety of reasons. I think central banks face an awkward choice. They can either raise rates now and I think need to raise them quite significantly from where they are from historic levels that are historic low as you mentioned. They can either raise rates by a significant margin now and then have a pause in growth and perhaps a pause, perhaps a slight increase in the unemployment rate. We can wear that now, but the longer we delay it, the bigger, the impact of the day of reckoning. Central banks delay doing that now, the consequences will be a bigger increase in rates down the track is necessary, a bigger decline in output and a bigger increase in the unemployment rate. That is what happened when Paul Volcker, as I said, presided over a Fed funds rate, close to 20% in 1980, '81, it was because central banks did it for five or six years in the wake of the oil shock in '73, '74, '75.

And the second one that came with the Iranian revolution in '78, '79. It's not a pleasant choice. You're right. It's not a choice that we want to face. It is one of the unwanted consequences of the war. The old saying is, "A stitch in time saves nine." We can make a concerted modest increase in interest rates now from low levels to something that is still in an historical sense that is still reach low levels. Or we can wait and have the sort of dislocatory shock that we had in '80 '81 when Paul Volcker raised federal funds rates to 20%.

Damien McIntyre

Goodness gracious me. That's-

Stephen Miller

Look, Damien, they don't call economics the dismal science for no reason.

Damien McIntyre

I thought I'd failed it for another reason, but anyway…

Stephen Miller

Perhaps you're just too jolly.

Damien McIntyre

Can we just have a quick round the grounds of inflation numbers? The latest print of the US was 7.9.

Stephen Miller

Yeah. 7.9 On the headline.

Damien McIntyre

Can we just have a quick round the grounds of inflation numbers? The latest print of the US was 7.9.

Damien McIntyre

Can you see an eight in front of that anytime soon?

Stephen Miller

Oh, yes. Yes. Look, there's some people that were sort of hanging their hat on the fact that, well, this started about April may last year, and when those numbers start falling out, it'll start to decelerate. I think that's a bit hopeful.

I look at three month annualised measures. So, for example, the February on November measure and annualised the number, and you're still getting numbers close to seven then. And I think with the extra bump provided by the commodity price boost, as a consequence of the Ukraine conflict, we'll easily see an eight incoming. And I don't think we'll see a rapid return to the 2% type levels that were prevailing say late 2020, early 2021.

I think certainly this will be years in working out, not months. Which is what the central banks were telling us a year ago. They were saying it was months. I think they're reconsidering that timeframe or have reconsidered that timeframe.

Damien McIntyre

Yeah. What I meant was we've had 2% inflation for a decade prior. What they were hoping for is a transition or a short transition. You're right. It's going to be around for a year or two, at least. So I suppose the next question is, I mean, we have to come back to this concept of real rates and real returns because the cost of living is going to be worse off in a high inflation re-environment, isn't it?

Stephen Miller

Oh, yes, yes. At some stage, wages will catch up as they should. And as we hope they would. So inflation in the US is close enough to eight. Wages are running at five. Inflation in Australia is close enough to four. Wages are running at three. So wage earners are losing purchasing power. It might be because unemployment rates are close to historic lows, and what has been a little bit of a puzzle.

And I suspect it's in the process of being resolved, at least in the short term, is the fact that wages haven't accelerated more. I think they're on the cusp of growing and growing quite sharply. And I think they should. That's what happens when labour markets are tight, but at least for the past... Well, for a long time, actually wage growth has not kept pace with the growth in prices and the standard of living of wages, wage earners, or that the income of wage earners has in real terms, as you say, gone backwards.

Damien McIntyre

So, what does this do, how we look for income? And what does it do to the asset classes that traditionally we've invested? Let's start with bonds.

Stephen Miller

Well, the good news might be that bond yield will rise. The bad news is the mark to market on your bond portfolio while that's happening will mean that there'll be a negative mark to market effect on any bond portfolio. But the good news is that bonds might get back to a level where that investors can invest and earn some decent income. Term deposits might get back to a level where investors can earn some decent income. So that's the good news.

The bad news is that through that adjustment phase bond prices, so the market to market value of a bond portfolio will fall. But the good news is a yield to getting back to more sensible levels. And there will come a time when investors can buy a bond or buy a bond fund and get a reasonable level of income.

That's the first point.

The second point is you can always look around for alternatives. This does mean as we've emphasised in the past, stepping out on the risk curve. So looking at privately issued debt. Whether that's corporate bonds or mortgage back securities, or something of that nature, or if you're adventurous a private debt fund, that's another option.

Third option, if you're worried about inflation has been to look at inflation link bonds. So what happens with these bonds is their capital value is linked to the rate of inflation. What you can do, though, if you buy those bonds currently is you are locking yourself into a small, negative, real yield. And if you argue that market based inflation expectations haven't caught up with the likely coming reality, you'll still do better than investing in a nominal bond, but that's an option.

A fourth option. And I'll probably get kicked out of the bond manager's union for mentioning this if I haven't been kicked out already. And that's to look at what I'd call alternative defensive assets. And in the current environment that might include commodities, it might include gold. Now, the problem with those is, as people will tell me straight away, well, they don't earn any income. Or of course they don't.

So what you're going to have to do in order to create income is to, in a multi-asset portfolio context, if you've got some gold in your portfolio, or you're going to have to actually redeem units, now there might be some tax advantages that come with that. At least for certain classes of taxpayers, I should mention, I'm not a tax advisor. I don't know people's tax circumstances, but there could be tax advantages in doing it that way. So in other words, you get your income through realising capital gain. That's an option.

A fifth option is to look at absolute return funds or unconstrained funds. So this means in the bond space, looking at funds that aren't tied to a benchmark level of duration. So you don't cop the capital depreciation and they're active managers that hopefully choose good high credit quality income earning assets that will deliver you a level of income above and beyond the prevailing cash rate. And as I say, you're not copying the negative mark to market effects that come as rising bond yields, because these aren't constrained to a particular index, you could do the same with equity fund. Another option is to look at equity income portfolios. So looking at equity managers that invest for income. Looking at high cashflow companies that deliver income, that deliver dividends.

So there are some options out there other than just looking at buying straight up government bond. They're not without risk, whether that's credit risk, whether that's equity risk, whether that's choosing the right manager, whether that's having to administratively take your income through realising gains all the time, which is administratively a little more complex for investors, even if it might, might I emphasise enjoy some tax benefits. So they're the options that we are looking at in my view. So you might have other ideas as well.

Damien McIntyre

I agree with you broadly on all of those ideas or options. Looking at them sequentially, with government bonds, it might pay to given that in a rising interest rate environment until the cycle is peaked, at least, taking on too much duration risk is a red flag. So just be careful about entering 10 year instruments, for example, or long duration instruments. Credit is interesting to look at, particularly credit where it has a variable interest rate. So as interest rates rise, you do get the benefit of that.

You've mentioned inflation link bonds, commodities are interesting, and gold has come back into focus as an inflation hedge. From an execution standpoint, investors could look at perhaps... Well, you can either ship your money off to the Perth Mint and buy gold directly there, as one of our friends and colleagues once did. Or there is a gold ETF, which has been trading on the Australian market out here for decades, its only asset of course is gold. So at least that's accessible. Other commodities are a bit harder for the retail investor to do.

Certainly equities are, as you say, they're an interesting proposition. Because at least to some extent, they provide a hedge to inflation insofar as some of those companies. And hopefully most of those companies will have the ability to pass prices onto the consumer. Of course, gives them an earnings uplift. And historically those companies that have been able to pass on price rises have performed well during these periods. Now we haven't talked about property. Do you have a view on property, generally?

Stephen Miller

I don’t.

Damien McIntyre

Unfortunately, Australia and indeed the US and the world is obsessed with property. And I'm trying to work out whether that's because this is all self-interest, whether it's the media that own or domain.com where they're flogged real estate, or if it's because they're making shows about flipping houses and it's funny, every flip seems to win. I haven't watched a show where flippers have lost the toss so to speak, but we are obsessed with property. And I wonder if that's just indulging our PAs rather than common sense.

Stephen Miller

Property is an option. It feels courageous. Office, property, rates, whatever, they're an option. They're a bond alternative, but there's some credit risk that attaches to that. I'd include those within the realm of credit-based or corporate-based or securitised investments. There are some that are very high credit quality, but yes, they're an option, but there is some credit risk attached to that. With residential property, we know property prices have gone through the roof, certainly in Sydney and Melbourne, well in and in other places. But rates also appear to be on the March too, in certain areas. If you look at some of the real estate reports. So property's an option. I guess the thing I worry about in terms of property is it can be sensitive. It's, A, sensitive to interest rates and they're going up, your income might be okay, but your capital is somewhat at risk.

I think the second thing that attaches to property is there seems to be in public policy debates, a lot of taxation suggestions for changes to property. And whilst we sort of saw some of the political dangers in running tax suggestions up the flagpole prior to an election with the last federal election, it sort of seems to me inevitable that we are going to have to at some stage address the taxation of property and whether we do it in the right way or the wrong way is yet to be seen. But there could be sort of changing taxation arrangements that attached to property, whether that's changes in capital gains tax, changes in negative gearing, changes in taxes that are attached to the family home, potentially a wealth tax. All of these things have merits in a public policy sense, but all of them will have an impact on house prices and investment in housing.

So yes, you're right. Property is an option. Whether in the conventional corporate/commercial space through rates, or whether in just by buying a rental property. But there are undercurrents there that I think the investor needs to be wary of. What strikes me in this whole conversation is that where we are going with this, I think, is there's two elements. One is investing for income. One is the level of risk you want on your portfolio. And it seems to me it's more important than ever now that in looking at the defensive/income part of one's portfolio, one needs to make sure that the overarching principle is one of diversification.

So I'm not saying get rid of your government bond, make sure your defensive part of your portfolio is a little bit of everything. Some government bonds, some inflation link bonds, some corporate credit, some securitized, maybe some exposure to commodities, maybe some exposure to inflation link bonds, and maybe some exposure to equity income. If investors can do that through accessing funds or whatever, I think the payoff to diversification now, if only it's so you can sleep better at night is greater, given the uncertainties that we face, then it arguably it has been in a decade gone by.

Damien McIntyre

Yes, I think you're right. And I think one overarching message is that until the inflation genie does appear to be out of the bottle, we have to deal with.

Stephen Miller

Certainly, that's my view.

Damien McIntyre

An eight print and perhaps higher in the US. We're horribly close to four, if not on the way high here. Common sense tells you to pause for caution. So I think that any adjustments to that investors want to make to their portfolios let's err on the higher side of quality and let's not be too cavalier, until things at the least settle down and then deal with things more sensibly or in a more considered way.

Stephen Miller

Oh, look, I think that's excellent advice now. It's not the time to be brave. And now, as I said is the time to remember that first principle of investing, which we're all taught, which we're all lectured upon. And that is diversification. Diversification, as we know is also a good way to de-risk your portfolio. And that seems, to me at least, to be a prudent approach, certainly for someone in my age bracket, put it that way. Seems to be a prudent approach toward assembling a portfolio now and more important than it has been, as I say, in recent time.

Damien McIntyre

I'll pinch an observation made by Nick Griffin, who's the chief investment officer at Munro. And he makes the observation that sometimes the sun's out and it's time to go out and play. And other times it rains and-

Stephen Miller

Well, we shouldn't be saying that to a Sydney-sider, but anyway…

Damien McIntyre

Well forgive my insensitivity to those who live north of Melbourne. But I think we're just in a period of time now where markets are unsettled, the weather's unsettled. Let's just be careful about what we do. Every pullback, every correction in markets allows you to adjust and also make good investments.

Stephen Miller

Yeah

Damien McIntyre

Either close to the bottom or at the bottom, if you're very lucky.

Stephen Miller

Look, you don't even need to get the bottom. For the time being, just be satisfied with a good night's sleep, and in a month or two or three, it might be clearer, if it's not, have a month or two or three more of good night's sleep.

Damien McIntyre

That's exactly right. Steven, as always it's great to talk to you. Thank you very much for your time.

Stephen Miller

My pleasure.

Damien McIntyre

We look forward to doing this again in another couple of months.

Stephen Miller

Yep. I look forward to it. It'd be interesting to see what happens in the intervening period.

Damien McIntyre

It will indeed. Thank you.