Independent Advisers WA

Mick Steffan
M.Taxation, B.Bus & Dip.FP,
Registered Taxation Agent

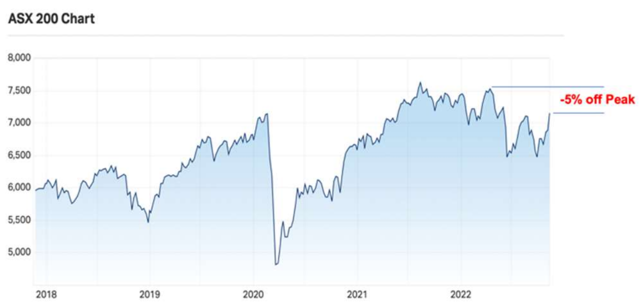
Investment Newsletter – October 2022

Has inflation peaked? Will we now see a stop to further interest rate increases?

In this month's letter we are happy to be the bearers of some positive news after months of downbeat economic news of the doom & gloom. Investors are certainly not out of the economic wilderness yet, but, we are happy to report that share prices have had a decent +10% jump from their lows in September. In fact, the Australian share market is now (as at 14 November) trading just 5% below its near all-time peak set earlier this year.

That is an amazing performance considering we can roll out a long list of issues that the market could get worried about. Note: the share market may well advance in the year ahead while the general economy enters a slower period or even a recession in 2023. That would happen as the market starts to get clearer visibility on how bad the economy will get near term before it starts to improve again. With clearer visibility the market will start focusing on the inevitable economic recovery even though that may be months away.

Figure 1: Australian share price index of the largest 200 stocks



Source: Market Index, Banyantree Investment Group

What is driving the current market rally & will it last?

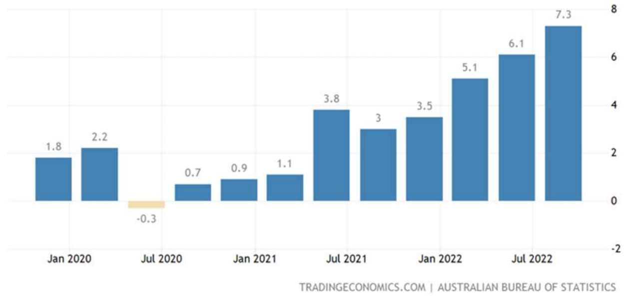
The market has concluded that inflation has peaked and the only way forward for inflation is down.

The rate of inflation in the US actually peaked back in June at 9.1% and has since gradually declined to 7.7%. The aggressive interest rate increases in the US, from 0% to 4% over six months, appear to be bringing inflation under control.

Figure 2: Inflation in the US

Contrastingly, Australian inflation rate hasn't actually peaked yet. In fact, it is expected to jump from its last reading of 7.3% in September quarter to 8% in December quarter. However, the Australian share market is taking its positive cue from the US and concluding that given the overall similarities of our economies and the alignment of the central banks' aggressive policy of interest rate increases, we should also soon see a peak in our inflation rate.

Figure 3: Inflation in the Australia



All that is good news for stocks as inflation coming under control of central banks means the run-away costs experienced by companies in 2022 will also come under control and the outlook for corporate profitability will improve, which means higher share prices.

But, there is always a but, it is still early days to call it a day on this inflation cycle as a number of risks remain for inflation to persist or even start rising again. The Ukraine & Russia war remains very much on and any further disruptions to oil, gas, and agricultural commodities exported from these countries will almost certainly spike prices of energy and broader commodities. That would result in inflation spiking again in the wrong direction and the markets will be back under pressure.

Adding to that is the risk that Australia's reserve bank (RBA) has arguably raised interest rates too much over the past six months and may potentially tip the economy into a deeper recession in 2023. RBA raised the official interest rate from almost 0% to 2.85% over the past six months which caused the average mortgage rate to rise from 2% to 5.5% p.a.

Consequently, we are starting to see some deeply discounted property sales now appear in our channel checks both in residential and commercial. If there is indeed a deeper than expected slowdown or a recession then investors should expect sales revenues of companies will fall and profitability and share prices will also be dragged down.

The first half of next year will likely remain turbulent for the share market and some wobbles should be expected. That being said, the franked dividend yield of around 6.5% p.a. from a basket of large Australian stocks is, no doubt, attractive. That should see income focused investors step into a sell off and support the market. Stay invested &

maintain bias to high quality companies delivering well-funded dividend income.

GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	6,863	1.15%	6.01%	-7.69%	-6.28%
ASX 200 Futures	AUD	6,856	1.18%	6.03%	-6.22%	-3.48%
Dow Jones	USD	32,733	-0.39%	13.95%	-0.74%	-8.62%
S&P 500	USD	3,872	-0.75%	7.99%	-6.29%	-15.92%
Stoxx Europe 600	EUR	412	0.35%	6.28%	-8.48%	-13.31%
FTSE 100 (UK)	GBP	7,095	0.66%	2.91%	-5.96%	-1.98%
DAX (Germany)	EUR	13,254	0.08%	9.41%	-5.99%	-15.52%
CAC (France)	EUR	6,267	-0.10%	8.75%	-4.09%	-8.25%
Nikkei 225	JPY	27,587	1.78%	6.36%	2.75%	-4.52%
Emerging Markets Equities						
MSCI Emerging Markets	USD	848	0.31%	-3.15%	-21.19%	-32.94%
Shanghai Composite	CNY	2,893	-0.77%	-4.33%	-5.04%	-18.43%
South Korea	KRW	2,294	1.11%	6.41%	-14.90%	-22.79%
Taiwan	TWD	12,950	1.26%	-3.54%	-21.95%	-23.77%
Brazil	BRL	116,037	1.31%	5.45%	7.57%	12.11%
South Africa	ZAR	60,031	0.58%	4.60%	-8.32%	-1.28%
Foreign Exchange						
AUDUSD	Currency	0.6399	-0.19%	-0.02%	-9.38%	-14.88%
AUDGBP	Currency	0.5583	1.17%	-2.65%	-0.57%	1.66%
AUDEUR	Currency	0.6474	0.61%	-0.87%	-3.33%	-0.48%
AUDCNY	Currency	4.66	0.35%	1.62%	-0.67%	-3.11%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,222	0.47%	2.78%	-27.21%	-18.20%
LME COPPER 3MO ($)	USD/mt	7,450	-1.32%	-1.46%	-23.74%	-21.55%
LME NICKEL 3MO ($)	USD/mt	21,809	-1.47%	3.33%	-31.36%	12.14%
SILVER FUTURE Dec22	USD/oz	19.12	-0.15%	0.42%	-17.91%	-20.71%
ICE Newc Coal Fut Dec22	USD/mt	356.05	-5.07%	-13.73%	32.98%	256.58%
62% Import Fine Ore in USD	USD/t	78.91	-3.79%	-17.46%	-40.93%	-28.45%
Gold Spot $/Oz	USD/oz	1,634	-0.69%	-1.63%	-13.88%	-8.40%
WTI Oil	USD/bbl	86.53	-1.56%	9.92%	-7.29%	21.31%
Henry Hub	USD/mmBtu	5.02	3.51%	-21.56%	-26.56%	-7.38%
Corn	USD/Bu	691.50	1.58%	2.07%	-15.49%	21.69%
Wheat	USD/Bu	882.25	6.39%	-4.26%	-15.47%	14.17%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.76%	+0.02%	-0.13%	+0.63%	+1.67%
US	USD	4.05%	+0.04%	+0.22%	+1.11%	+2.50%
Germany	EUR	2.14%	+0.04%	+0.03%	+1.20%	+2.25%
Japan	JPY	0.25%	+0.00%	+0.00%	+0.02%	+0.15%
Italy	EUR	4.30%	+0.13%	-0.22%	+1.53%	+3.13%
Australian Rates						
Cash Rate	AUD	2.60%	+0.00%	+0.25%	+2.50%	+2.50%
90-Day BBSW	AUD	3.09%	+0.01%	+0.03%	+2.39%	+3.02%
180-Day BBSW	AUD	3.67%	+0.05%	+0.10%	+2.23%	+3.45%
CBOE Options						
CBOE VIX (Volatility Index)	Index	25.88	0.50%	-18.15%	-22.51%	59.16%

Data as of 31 October 2022

ECONOMIC NEWS

• **In Australia** the Reserve Bank of Australia (RBA) downshifted to smaller rate hikes, increasing cash rate by +0.25% to 2.6% in October, and by another +0.25% to 2.85% in November, the highest level since April 2013. However, the RBA signalled further interest rate increases are still to come as it projected inflation to peak at 8% vs 7.75% forecast previously. According to RBA's quarterly statement on monetary policy, the bank increased its forecasts for inflation with headline inflation now seen peaking at 8% in 2022 from 7.75% previously and both the headline and core measures predicted to remain above the RBA's 2-3% target over the next two years. Wages growth is expected to jump to 3.9% in December 2023 and stay there through end-2024 compared with the most recent reading of 2.6%, and highlighted the risk of a wage spiral emerging among key reasons it expects to raise interest rates further. At the same time, RBA is forecasting the economy to expand +3% in 2022, supported by consumer spending, before easing to 1.5% in 2023 and 2024 as higher borrowing costs begin to weigh on demand, leading to household consumption growth slowing to 1.3% by end-2023 from a forecast of 6.6% in December 2022 and unemployment ticking higher to 3.75% in December 2023 and 4.25% at end-2024, compared with 3.5% at present.

• **Global growth outlook.** The International Monetary Fund (IMF) forecast about one-third of the world economy to have at least two consecutive quarters of contraction in 2022 and 2023 with the lost output through 2026 being $4 trillion as it downgraded 2023 world forecast to 2.7% with advanced economies down to 1.1% (U.S. unchanged at 1.0%, euro area down to 0.5%, U.K. down to 0.3% and Japan down to 1.6%) and developing economies down to 3.7% (China down to 4.4% and India unchanged at 6.1%), adding that it sees 25% probability that the world growth will slow to less than 2%.

The IMF is warning of worsening living conditions as it upgraded world inflation forecast for 2022 to 8.8% (advanced economies up +0.6% to 7.2% and developing economies up +0.4% to 9.9%) and for 2023 by +0.8% to 6.5% (advanced economies up +1.10% to 4.4% and developing economies up +0.8% to 8.1%).

• **In the US -** The Fed Reserve (central bank) raised interest rates by +0.75% for the fourth time in a row to 3.75-4%, with U.S. Fed's Chair Jerome Powell making very unequivocally hawkish comments, announcing it's very premature to think about a pause in interest rate hiking cycle and suggesting the terminal rate of Fed Funds will be higher than previously expected.

U Economy grew at a solid pace in September quarter, with economy (GDP) growing at +2.6% p.a. and marking the first advance this year with consumer spending rising +1.4% over the quarter, capping the weakest three quarters since the demand destruction of early 2020. Investment in residential housing slowed significantly with final sales to domestic buyers showing an annualized growth rate of +0.5% vs an average of almost 2.6% over the five years before the pandemic. For the month of October, (1) Year-ahead inflation expectations rose for the first time in seven months with consumers expecting prices to climb +5% over the next year, up from prior expectation of +4.7% in September, and the long-term outlook also crept up with costs expected to rise at an annual rate of +2.9% over the next five to 10 years, a pickup from +2.7% expectation previously. (2) Businesses reported strong hiring and wage increases with nonfarm payrolls increasing 261k and average hourly earnings increasing +0.4% over the month (+4.7%p.a.), although the unemployment rate climbed to 3.7% as participation rate edged lower to 62.2%. (3) Consumer confidence fell to a three-month low. (4) Business activity contracted for a fourth-straight month and manufacturing neared stagnation.

• **China.** GDP growth rebounded to 3.9% in September quarter from 0.4% in June quarter, fuelled by increasing investment in infrastructure, though retail sales weakened, and unemployment increased with PBOC's (central bank) employment sentiment index declining to a record low.

• **Europe.** European Central Bank raised interest rate to 1.5%, the highest level in more than a decade, however, signalled it's making progress in its battle with record inflation. Euro-area inflation surged to a fresh all-time high in October up +10.7% p.a. (core up +5% p.a.), while the bloc's economy lost momentum with GDP expanding +2.1% p.a.

• **Japan.** Bank of Japan left their negative rate, 10-year yield cap and asset purchases unchanged amid fresh government support with Prime Minister Fumio Kishida ordering an extra budget of 29.1 trillion yen to fund an economic stimulus package, predicting the package to shave more than 1.2% from overall inflation and add about 4.6% to real GDP.

THE LONG READ

WHY WATER IS SUCH A SOLID ASSET

This precious resource can add sustainability and diversification to a portfolio in times of volatility

For a range of economic and political reasons, volatility is at the forefront of investors' concerns. Although the worst of the pandemic is (hopefully) behind us, share price volatility has been even higher in 2022 than it was in 2021.

The problem with volatility is that it keeps you nervous and fearful of potential losses, even if at the end of the year your actual losses are not as bad as feared. That we feel the pain of actual and potential losses more than the joy of profits is often mentioned in behavioural finance. So, at times like these, you wish you had some investments in your portfolio that helped to at least partially offset the losses with some gains and you wish the price of some investments didn't move up and down as much. Well, I think I have one such asset that you might want to consider: water rights for use in agriculture.

First, what is a water right? In simplest terms, it is a quota of water from natural river systems that a working farm may use in agricultural activity, such as growing crops. Water rights used to be attached to the land titles of rural properties until they started becoming unbundled in the 1990s, which meant that farmers could sell the water rights they didn't want.

They sold them to other farmers or, more recently, there have been water funds that invest in water entitlements and lease out the water to irrigators for a recurring fee. There is also a government body that purchases entitlements for allocating water back to the ecosystem to ensure environmental sustainability.

A water right has two main parts. There is the entitlement, which is a permanent right to a certain amount (gigalitres) of the capacity of a lake, river system or aquifer. Water entitlement is a freehold asset.

The second part is allocation. This is the amount of water allocated each year to the farmers holding an entitlement, depending on the level in the river or other water source during that year. Think of an entitlement as owning an empty glass of water and allocation as the water inside the glass, which depends on whether there has been enough rain in any season to either fully or partially fill the glass.

Allocations can fall in drought years and the price of water that can be drawn from an entitlement thus goes up. Holders of water entitlements can sell their annual allocation. These allocations are like leases and can be short term or cover a number of years.

The benefit to the entitlement holder is that they can earn an income from leasing out their annual allocation while continuing to hold the ownership of their entitlement as an asset. Alternatively, a farmer can sell the entitlement altogether and either lease water back from the market or just cease the farm operation and continue holding the land without access to water, or separately sell the land as well.

If you are still wondering how water entitlement can be considered an asset, let me put its value in context. Consider an average rice or dairy farm in Australia. All the assets of such a farm include livestock, trading stock, fixtures, land and water entitlement. Then water entitlement on average comprises 30%-40% of the total value of the farm assets.

Tighter regulation

Water rights used to be issued relatively freely to farmers without always respecting the limits of the resources of rivers such as the Murray-Darling system, which spans four states on our east coast. The Murray-Darling basin supplies water to the biggest food producing region in Australia.

While the free allocation of water served Australia reasonably well, by the 1980s pressures and problems were emerging. These included environmental issues (such as salinity, algal blooms, and deteriorating river and wetland health) and a growing awareness that traditional approaches to providing water infrastructure services were costly and lacked incentives to improve service delivery over time. With the drought of the late 1990s and the drying up of the river systems in the Murray-Darling basin but no let-up in the agricultural use of water, the impact on the environment and ecosystem was severe. The need to regulate the use of water became immediate.

In response, some state and territory governments began reforming aspects of water policy. A national approach commenced in 1994 with the Council of Australian Governments framework. Reform of the water sector has continued, reflecting the fundamental importance of water to our economy and the significant challenges involved in managing a shared natural resource often impacted by periods of scarcity.

Regulation of water use has tightened through subsequent initiatives such as the National Water Initiative (2004), the Water Act 2007 (commonwealth) and the Murray-Darling Basin Plan (2012). The end destination of these policy reforms is to have a marketbased cap-and-trade system where the inefficient users are priced out and those with a focus on efficiency and value-added crops will use the water. This is called the Australian water market.

Let's now turn to investing in water entitlements. The Aither Entitlement Index (AEI) is the only index that tracks the capital value of entitlements throughout the southern Murray-Darling basin (the largest trading region).

The compound annual growth rate of the AEI was 8%pa between 2008 and June 30, 2022. Since 2015-16, the entitlement prices have appreciated even faster at 17%p.a. – those were the drought years. Included in that return is yield income from leasing the allocations, which should earn around 4% p.a. Turning to annual volatility in the value of the entitlements, the correlation analysis done by Riparian Water Fund suggests there is no evidence of a correlation of their water fund to listed stocks, with a low positive correlation to bonds.

More droughts ahead

From a timing perspective, you might wonder why you would invest in water rights now when there has been plenty of rain on the east coast and, if anything, there is too much water and dams are overflowing.

My response would be that La Niña, which is causing the heavy rainfall, lasts for two or three years and then disappears. The longer-term climate-warming trend continues as carbon emissions, which are the root cause of global warming and droughts, are not being abated fast enough.

At any rate, it will take a couple of decades at least to curb carbon emissions and bring global warming/climate change under control. So long as it remains a threat, we should expect abnormal droughts and a trend towards efficient use of water.

However, access to investing in water is not straightforward and not without risks, as the government is still trying to regulate the trading and information sharing aspects of the market. Active funds are an option but most only directly give access to sophisticated investors. You probably have the rest of this La Niña period, likely to last to the end of 2023, to consider learning about and investing in water assets.

For enquiries:

Independent Advisers WA

- Micksteffan@ifswa.com.au
- Phone: 0466414321
- Write to: Independent Advisers WA, 58 Hillview Drive, Drummond Cove, WA 6532