Independent Advisers WA

Investment Newsletter – September 2022

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

Oil Producers – birds of a feather flock together

Part of the joy of writing this monthly letter is that it allows us the opportunity to rise above the day-to-day fixation on market movements and economic news. This is an opportunity to steal a few quiet hours and take a wider glance over the economic landscape and notice if there have been subtle or noticeable shifts in the view.

We wish to commence this month's letter with the following quote uttered on occasions by the notables of the past century, including Henry Kissinger and Winston Churchill.

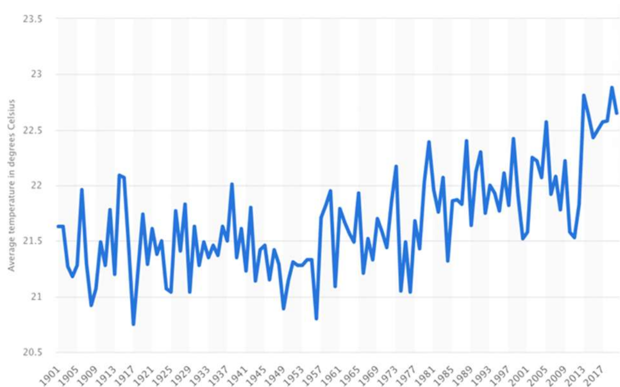
"There are no permanent friends or permanent enemies, just permanent interests"

So, with that, let us start with the widening schism between those groups of countries that produce energy (OPEC+), specifically oil, and those that consume it. The oil producing countries led by Saudi Arabia and Russia (OPEC+) have come out swinging recently and have announced that they will be reducing the daily export volume by 2 million barrels that they deliver to the world oil markets, the reason is clear that they will not accept the oil price to fall to $USD70 per barrel. A fair price for oil for the producers will be around $100 per barrel, higher would be nice!

Before we get to the point of why it matters to us investors. Please afford us your attention for a little longer on why this schism is unlikely to improve and could possibly get worse.

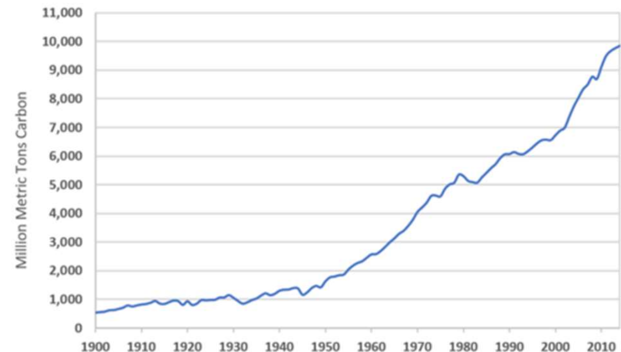
Interests of the two groups, from here on, will just continue to diverge in the years to come. Here is why? We all know that climate change is on (chart below of rising Australian temperature), well at least that is what the world leaders backed by their scientists have told us. The chart below shows how much the observed temperatures have risen in Australia over the past 120 years. Small movements have big impacts on the environment (droughts, floods, fires, inhabitable heat levels in peak summer etc) and the long-term viability of humans on earth is at stake. So, action clearly needs to be taken to thwart this rise in heat.

Observed annual average mean temperature in Australia from 1901 to 2020*(in degrees Celsius)*



Source: Statista

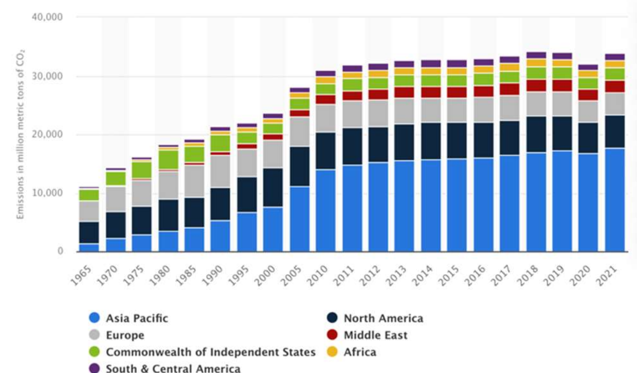
The main culprit, but not entirely, behind this warming is carbon emissions from burning fossil fuels and oil as we know is one of these fuels. The chart below shows the unchecked rise in carbon emissions (in metric tonnes) from fossil fuels over the past 100 plus years.



Source: Boden, T.A., Marland, G., and Andres, R.J. (2017). Global, Regional, and National Fossil-Fuel CO2Emissions. Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory, U.S. Department of Energy, Oak Ridge, Tenn., U.S.A. doi 10.3334/CDIAC/00001_V2017.

For further granularity, please see the following chart showing the regions that burn most fossil fuels and thus emit carbon dioxide.

Carbon dioxide emissions from energy worldwide from 1965 to 2021, by region *(in million metric tons of carbon dioxide)*



Source: Statista

Anyway, we digress. Let's get back to the oil producers. In short, recognising the enormity of the challenge of slowing down global warming, the global climate action group now includes the mainstream actors comprising advanced economies' governments, their societies, and economic institutions, all fast aligning behind the single target of reducing carbon emissions and reliance on fossil fuels. This change is going to be dramatic in the next 10-15 years, but certainly a fast tracked one beyond those years.

OPEC+ leaders watching this tectonic and irreversible shift of the world's reliance on fossil fuels clearly know full well that this does not bode well for their economic future. With oil revenues being the main source of funding of the livelihood and entrenched ways of modern life in OPEC+ countries there will also be internal political and social implications for these countries in and after the transition years.

In fairness to OPEC+ countries, some (well actually one out of the 13) such as Saudi Arabia, has significant plans to pivot

IMPORTANT DISCLAIMER – Please read carefully
This newsletter is copyright and is for the clients of Independent Advisers WA. The reproduction of any part of the letter, for any purpose, is not permitted. The view expressed in the newsletter are for general information purposes only and are not meant to be taken as personal financial advice. I.F.S. (WA) Pty Ltd t/as Independent Financial Advisers WA and Michel Steffan are Authorised Representatives of Impartial Financial Advisers, AFSL 533684

its economy away from reliance on oil revenues and become a diversified economic grandee in the low carbon emissions world of the future with focus on renewable energy production, advance healthcare, tourism, education, IT, and banking. They call it the Vision2030 plan backed by an ambitious and emerging new generation of leadership. The year 2030 is not that far away and just one of this vision's projects alone is going to cost $USD500 billion – yes, it's not millions but billions! It's a development of a mega city on the red sea integrated with smart technologies and will be a major tourist attraction. For context, it will be 33 times the size of New York City. Ok so where will they get all that money from to fund this pivot to a diversified economy? it's not the international debt markets as they will see the lending risk as being too high to fund such ambitious projects with very long dated pay offs, if at all. That doesn't leave much else for funding other than oil and selling more of it. But the world doesn't want more oil as they are switching to renewables, then the last remaining lever left to pull is to raise the oil prices, which is what is happening.

Even before funding these visionary projects the Saudi government needs the oil price of $76 per barrel just to break even its existing government budget expenditure to run the economy, according to the Carnegie Endowment Institute's numbers[1]. So, will the Saudis successfully pivot in time? Only time will tell, but it would be a rational assumption to make that they will be having a sincere go at investing lots of money attempting to pivot while they face the certainty of the grip of fossil fuel transition tightening around them.

As for Russia's plans (the other major oil exporter) to pivot its economy; it doesn't seem like they are in a rush, in fact, it's the other way around. Russia is focused on selling as much fossil fuels in the next couple of decades as possible. The following observation on Russia's energy transition plan was made by an independent research group named Climate Action Tracker which we would hold as credible as they are funded by a range of governments and foundations.

"[Russia's] Energy Strategy to 2035, adopted in 2021, focuses almost exclusively on promoting fossil fuel extraction, consumption, and export to the rest of the world. Such a strong focus on increasing reliance on fossil fuel revenues poses a considerable economic risk in a future Paris Agreement compatible world."[2]

In fact, it's quite plausible under current economic sanctions and intensifying and lengthening war with Ukraine that Russia's dependence on higher oil price is now even more relevant to fund its war efforts and keep the economy afloat.

On the other side of the oil market demand-supply equation is the demand destruction being coordinated by tightening monetary policies of advanced countries' central banks, i.e. increasing of interest rates. The assumption taken by these central banks is that by raising interest rates the economic activity will slow down enough to burn less oil and gas vis-à-vis, they hope, unchanged supply side response and thus it is hoped that energy inflation will slow down. It is important to remind ourselves that ultimately every price point for goods and services rendered in the economy has energy as one of its basic inputs, one way or another.

But here is the issue with this one-sided attempt at managing inflation. The suppliers of energy, OPEC+ countries, are beginning to respond with cuts to volumes in equal measure in the case of global oil supply and with gas supplies Russia has gone all rogue in response to the war, this has sent energy prices high and higher. This is rational market activity as each side is responding to its self-interest of self-preservation.

When you add all of that up, it is thus clear that the past incentives of a sustainably growing fossil fuel market for OPEC+ countries to continue delivering to, where they could increase more volumes to offset price reductions in global economic downturns, such prospects are just not there anymore in the face of the transition to the renewables. Taking that into account, this energy shock is very different to that of the 1970s and 2008 where the positive long-term prospects of fossil fuels forced everyone to eventually play nice with each other.

Let's bring the discussion home to what it all means for inflation and interest rates and investment returns. Based on the above discussion, it is self-evident that there is a material probability of oil (& gas) prices remaining high and higher. That means, if central banks can just stop inflation rising from the current levels then that would increasingly be seen as achieving success and the chorus of global institutions such as the UN & IMF is getting louder in asking the central banks to stop raising rates and damaging the global economy. As we have said earlier this year that the goal posts of central banks trying to get inflation down to 2% will move higher to closer to the current prevailing averages (Australia is 6.1% on last print). Meanwhile, the OPEC+ will get to keep their oil prices at closer to $100 per barrel and balance their budgets, ideally!

The investment returns going forward will be very much about trying to keep in line with or ahead of the new levels of inflation. Let's look at Australian stocks right now, the ASX200 is inexpensive at 12.9x Price Earning multiple but even put that aside and look at dividends from these stocks. The dividend yield is 4.9% p.a. and most companies attach franking credits to their dividends, so a decent part of the investor base will see the gross yield on stocks at 7% p.a., there is a real return (ahead of inflation) of almost 1% on dividend income with inflation running at 6.1%. We are not expecting Australia to experience a recession at this point, so most companies and banks, should manage to deliver to this expected dividend return or close to it. Bonds are delivering negative real returns right now with coupon rates in 3-4s% vs inflation at 6.1%. Cash and Bank Term deposit rates are improving but still not keeping up with inflation.

As a final comment, the transition to renewable energy will now just accelerate as the conversations at weekend BBQs turn to how much the joneses are beginning to save in energy bills through roof-top solar panels and EVs/hybrids, you got to keep up don't you?

[1] https://carnegieendowment.org/sada/82104

[2] https://climateactiontracker.org/countries/russian-federation/

IMPORTANT DISCLAIMER – Please read carefully

This newsletter is copyright and is for the clients of Independent Advisers WA. The reproduction of any part of the letter, for any purpose, is not permitted. The view expressed in the newsletter are for general information purposes only and are not meant to be taken as personal financial advice. I.F.S. (WA) Pty Ltd t/as Independent Financial Advisers WA and Michel Steffan are Authorised Representatives of Impartial Financial Advisers, AFSL 533684

GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	6,474	-1.23%	-7.34%	-13.67%	-11.70%
ASX 200 Futures	AUD	6,466	-1.24%	-6.51%	-12.35%	-9.19%
Dow Jones	USD	28,726	-1.71%	-8.84%	-17.17%	-15.12%
S&P 500	USD	3,586	-1.51%	-9.34%	-20.85%	-16.76%
Stoxx Europe 600	EUR	388	1.30%	-6.57%	-14.92%	-14.72%
FTSE 100 (UK)	GBP	6,894	0.18%	-5.36%	-8.27%	-2.72%
DAX (Germany)	EUR	12,114	1.16%	-5.61%	-15.96%	-20.62%
CAC (France)	EUR	5,762	1.51%	-5.92%	-13.48%	-11.62%
Nikkei 225	JPY	25,937	-1.83%	-7.67%	-6.77%	-11.94%
Emerging Markets Equities						
MSCI Emerging Markets	USD	876	0.29%	-11.90%	-23.30%	-30.11%
Shanghai Composite	CNY	3,024	-0.55%	-5.55%	-7.00%	-15.24%
South Korea	KRW	2,155	-0.71%	-12.81%	-21.84%	-29.76%
Taiwan	TWD	13,425	-0.81%	-11.07%	-24.13%	-20.73%
Brazil	BRL	110,037	2.20%	0.47%	-8.30%	-0.85%
South Africa	ZAR	57,390	0.82%	-5.51%	-16.23%	-0.82%
Foreign Exchange						
AUDUSD	Currency	0.6400	-1.54%	-6.46%	-14.46%	-11.44%
AUDGBP	Currency	0.5735	-1.90%	-2.59%	0.70%	6.92%
AUDEUR	Currency	0.6531	-1.37%	-4.05%	-3.42%	4.65%
AUDCNY	Currency	4.58	-0.73%	-3.07%	-3.63%	-1.85%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,162	-1.59%	-8.35%	-38.07%	-24.37%
LME COPPER 3MO ($)	USD/mt	7,560	0.24%	-3.10%	-27.13%	-15.40%
LME NICKEL 3MO ($)	USD/mt	21,107	-5.55%	-1.42%	-34.26%	17.68%
SILVER FUTURE Dec22	USD/oz	19.04	1.75%	6.47%	-25.08%	-14.37%
ICE Newc Coal Fut Nov22	USD/mt	417.70	0.13%	2.95%	88.83%	188.67%
62% Import Fine Ore in USD	USD/t	95.48	0.00%	0.24%	-32.99%	-20.72%
Gold Spot $/Oz	USD/oz	1,661	0.00%	-2.95%	-14.29%	-5.48%
WTI Oil	USD/bbl	79.49	-2.14%	-10.72%	-12.30%	16.55%
Henry Hub	USD/mmBtu	6.40	-2.74%	-28.33%	16.58%	15.32%
Corn	USD/Bu	677.50	1.19%	0.56%	-9.52%	26.22%
Wheat	USD/Bu	921.50	2.82%	13.91%	-8.40%	27.02%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.89%	-0.05%	+0.29%	+1.05%	+2.40%
US	USD	3.83%	+0.04%	+0.64%	+1.49%	+2.34%
Germany	EUR	2.11%	-0.07%	+0.57%	+1.56%	+2.31%
Japan	JPY	0.24%	-0.01%	+0.02%	+0.02%	+0.17%
Italy	EUR	4.52%	-0.13%	+0.63%	+2.48%	+3.66%
Australian Rates						
Cash Rate	AUD	2.35%	+0.00%	+0.50%	+2.25%	+2.25%
90-Day BBSW	AUD	3.06%	+0.01%	+0.59%	+2.84%	+3.04%
180-Day BBSW	AUD	3.57%	+0.01%	+0.55%	+2.86%	+3.52%
CBOE Options						
CBOE VIX (Volatility Index)	Index	31.62	-0.69%	22.23%	53.79%	36.65%

Data as of 30 September 2022

ECONOMIC NEWS

• **In Australia** the Reserve Bank of Australia (RBA) raised interest rates by 0.5% for a fourth consecutive meeting to 2.35%, the highest level since 2015, and signalled interest rates are getting closer to "normal settings," with the board expecting to increase interest rates further over the months ahead and RBA governor Philip Lowe signalling the pace of interest rate rises could soon slow.

Australia's economy powered ahead in June Quarter 2022 with GDP expanding +0.9% over the quarter (+3.6% p.a.), buoyed by high export prices and household spending despite high inflation leading to savings rate falling for a third consecutive quarter to 8.7%. Budget outcome for FY22 improved significantly with the deficit coming in at A$32bn (1.4% of GDP), however, Treasurer Jim Chalmers dismissed prospects for the books to return to the black over the next four years. Consumer sentiment edged up for the first time since November in September as inflation expectations eased to 4-month low of 5.4%, however, business sentiment across the private sector slipped further to among the lowest levels in six years.

• **Global growth outlook 1** - The World Bank warned the global economy may face a recession next year caused by an aggressive wave of policy tightening that could yet prove inadequate to temper inflation, forecasting 2023 GDP growth slowing to +0.5% and contracting -0.4% in per capita terms, meeting the technical definition of a global recession.

• **Global growth outlook 2 -** OECD cut world economic growth projections for 2022 and 2023 by -1.51% and -1.05% to 2.95% and 2.19%, respectively, cutting growth forecasts for most of G- 20 for 2023, while anticipating further interest-rate hikes.

• **In the US -** Fed raised interest rates by +0.75% for the third consecutive time to 3.25%, the highest level since before the 2008 GFC and forecast they would reach 4.4% by end of 2022 and 4.6% in 2023 before declining to 3.9% in 2024 and 2.9% in 2025, as it downgraded GDP forecasts by -1.50%, -0.50% and -0.2% to +0.2%, +1.2% and +1.7% for 2022, 2023 and 2024, respectively, while upgrading inflation forecasts by +0.20% for both 2022 and 2023 to 5.4% and 2.8%, respectively and by +0.10% for 2024 to 2.3%, with Fed Chair Jerome Powell signalling policy will remain aggressively tight and the odds of a soft landing look increasingly elusive.

U.S. consumer sentiment climbed to the highest since April in September as US long-term inflation expectations fell to the lowest in more than a year with consumers expecting prices to climb at an annual rate of 2.7% over the next 5-to-10 years, the lowest since July 2021, and rising +4.7% over the next year, the lowest since September 2021. However, uncertainty over near-term price views reached a four decade high given energy prices are falling but those of food are rising. Manufacturing stumbled in September to a more than two-year low, moving closer to outright stagnation as orders contracted for the third time in four months.

• **China.** Economic recovery faltered in September with manufacturing improving slightly, however, the services industry contracted for the first time since May as virus outbreaks and the Covid-19 Zero policy continued to weigh on consumption.

• **Europe.** ECB hiked interest rates by +0.75% to 0.75% and President Christine Lagarde said borrowing costs will be raised at the next "several meetings" despite increasing concerns about recessions in Germany and the euro zone, as the bank upgraded 2022 GDP forecast by +0.30% to 3.1%, however, downgraded 2023 and 2024 forecast by -1.20% and -0.20% to 0.9% and 1.9%, respectively, mainly owing to the impact of energy supply disruptions, higher inflation and the related fall in confidence. Inflation projections for 2022, 2023 and 2024 were revised up by +1.30%, +2% and +0.20% to 8.1%, 5.5% and 2.3%, respectively. Euro-area consumer confidence slumped to its lowest level on record in September as economic crisis intensified with the first ever reading of double-digit inflation, with CPI rising +10% p.a. in the month and core-CPI reaching an all-time high of 4.8% p.a.

• **U.K.** BOE delivered a second consecutive +0.5% interest-rate hike to raise rate to 2.25% and projected a technical recession in June Quarter 2022 and September quarter 2022, as the economy takes a hit from the extra bank holiday for the funeral of Queen Elizabeth II. However, later in the month reversed its monetary tightening policy by pledging

IMPORTANT DISCLAIMER – Please read carefully
This newsletter is copyright and is for the clients of Independent Advisers WA. The reproduction of any part of the letter, for any purpose, is not permitted. The view expressed in the newsletter are for general information purposes only and are not meant to be taken as personal financial advice. I.F.S. (WA) Pty Ltd t/as Independent Financial Advisers WA and Michel Steffan are Authorised Representatives of Impartial Financial Advisers, AFSL 533684

unlimited purchases of long-dated bonds to stave off an imminent crash in the gilt sparked by government's plans to slash taxes, as it lowered its forecast for peak inflation from more than 13% to less than 11% and suggested a deep recession may be averted as a result of new Prime Minister Liz Truss's energy relief plan.

THE LONG READ

STEER THROUGH THE TURMOIL

Investors who take a long-term view, remaining calm during the market's ups and downs, will reap the rewards

One of the forgone conclusions of life is that almost all decisions and choices you will make in life will come with a level of risk or potential for losses. Your choice of driving your car today to work or otherwise comes with your acceptance of risk of an accident. If you are elderly and frail, your choice of getting out of bed and going for a walk for the health benefits it will bring to you comes with a fall risk. If you are an investor, you are accepting the share prices to go negative over the short term, and make you feel poorer, against your well rationalised basis for investing for wealth generation over the long term. For some of us, the fear of loss can be too intense and debilitating. In fact, loss aversion can be one of the key impediments or hindrances that prevent investors from making logical and rational investment decisions that have a high probability of delivering prosperity over the long term.

My view is, the level of loss aversion obviously varies in each of us as it is shaped by our upbringing, our influences, our socio-economic background, our knowledge and education. Let's call this type of loss aversion resulting from idiosyncratic factors (I just made up the term, but you know what I mean) which are more personal to an individual investor. However, there are also other transient and exogenous factors for loss aversion such as pandemics, job losses, wars, climate change, accidents, and major social-political events that can make people risk averse for a period of time. These transient influences can be shorter term such as Covid-19 which in due course will pass, and we all know that the fear of loss of life from Covid-19 has gone from being very high and scary two years ago to negligible now. Equally there are other transient factors that can go on for months and years but eventually pass, though, I think climate change mitigation risks will take some years. Nevertheless, transient influences often play out at societal (group) level and we (investors) all experience them together and we are likely to feel the level of fear and anxiety as a group.

Moreover, investors and fund managers are living and breathing individuals from amongst us. They are currently experiencing and navigating the challenges of highly uncertain times ranging from managing health setbacks due to Covid-19, caring for ageing parents if not aged themselves, constantly reminded of the fear of outliving their retirement nest eggs, gradually developing chronic medical conditions as they age (median age in Australia is close to 40), career uncertainties, rising cost of living, highly indebted, living with the uncertainty of global political tensions and what it could mean for our way of life etc. So, it is not at all surprising that mental health and anxiety levels in the community have been on the rise in recent years and the latest figures from the ABS show that almost a quarter of our population 21.4% have had some mental disorder or anxiety related issue in the past 12 months. That in my view is highly under-reported as I would hazard a guess that most people experiencing anxiety and fear don't seek help.

Now with that background of the anxiousness in the community, it should not at all be an illogical inference that loss aversion will be quite high amongst investors right now. That is not to say that investors don't want to generate great returns, they just have diminishing emotional reserves to deal with the fear and pain of losses along the way, unfortunately a necessary evil of investing.

To give you a sense for how short-term focused investors have become, the average stock holding period in the US has consistently been declining over the past seventy years from 8 years in 1950 to now a mere 5 months! In comparison, the oracle of Omaha and the godfather of long-term investing, Warren Buffet's holding period is 20 years. In my humble view, investors need to at least hold stocks for 5 years (average holding period in their portfolio) or more to call themselves long term investors and reap the benefits of 8-12% p.a. returns the markets should deliver through various multi-year cycles. Just as a quick rule of thumb, you can quickly work out how long-term focused a fund manager is by asking for their portfolio's turnover rate. A portfolio with a five to ten-year average holding period would turnover somewhere between 10%-25% annually. Contrastingly, with the average 5 month holding period of average an investor in the market the assumption is that such an investor or fund manager has annual turnover rate of 300%, so lots of buying and selling and they are very short term focused and ripe with risks of losing money.

Short termism raises the risk of locking in the losses by selling when shares decline and also can mean missing out on the gains in market rallies by being too risk averse and sitting on too much cash. A good way to manage your fear of investing is by having a professional and experienced advisor by your side

IMPORTANT DISCLAIMER – Please read carefully
This newsletter is copyright and is for the clients of Independent Advisers WA. The reproduction of any part of the letter, for any purpose, is not permitted. The view expressed in the newsletter are for general information purposes only and are not meant to be taken as personal financial advice. I.F.S. (WA) Pty Ltd t/as Independent Financial Advisers WA and Michel Steffan are Authorised Representatives of Impartial Financial Advisers, AFSL 533684

through thick and thin. Work out your risk profile with your advisor and develop a long-term investment plan and stick to it as an ongoing process and just steer through the market turmoil.

For enquiries:

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

IMPORTANT DISCLAIMER – Please read carefully

This newsletter is copyright and is for the clients of Independent Advisers WA. The reproduction of any part of the letter, for any purpose, is not permitted. The view expressed in the newsletter are for general information purposes only and are not meant to be taken as personal financial advice. I.F.S. (WA) Pty Ltd t/as Independent Financial Advisers WA and Michel Steffan are Authorised Representatives of Impartial Financial Advisers, AFSL 533684