WATERHOUSE
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Inside:

DNR investment review

In this edition, we review the current economic growth in China and the US, discuss the impact of the Delta strain, and implications of the recent US Federal Reserve (Fed) meeting.

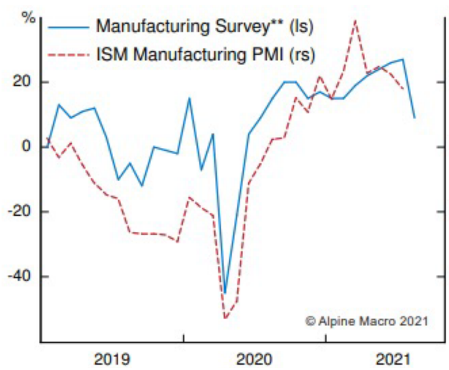
GROWTH

Over the past three months, a tightening of the Chinese economy and concerns over the impact of the Delta variant, have overhung the outlook for the global economy. The US economic growth rate has peaked as evidenced by OECD leading indicator.

US cycle based on change in OECD leading indicator

Source: Jeffries

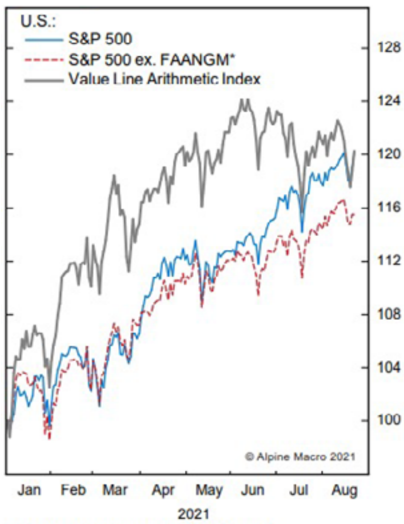
Manufacturing still exhibits solid expansion, albeit off its highs however.



*Source: Federal Reserve Bank of St. Louis
**Source: Federal Reserve Bank of Richmond

The US market has steadily moved higher. Notably, the S&P500 excluding leading technology stocks has corrected, highlighting market concerns around the growth outlook.

S&P 500 Vs S&P 494



Note: All series are rebased to Jan 2021 = 100
*Market cap weighted average of Facebook, Apple, Amazon, Netflix, Alphabet's Google and Microsoft

Source: Alpine Research

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DNR investment review

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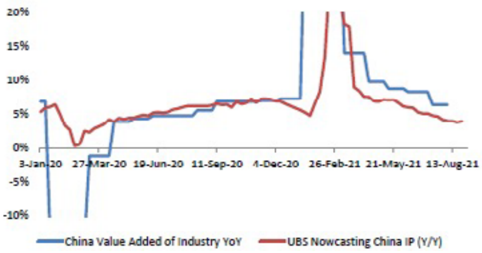
Chinese economic growth has also rolled in response to tightened economic conditions.

Industrial production



Source: UBS Evidence Lab, Bloomberg, UBS Research

The lagged impact of Chinese policy tightening combined with catastrophic flooding in Central China and domestic outbreaks of COVID-19 have increased the downside risks to the economy. Escalating property restrictions have resulted in two straight months of declining home sales, while construction starts accounted for nearly half the forecasted GDP slowdown. We have seen some signs of a political response in relation to this softening. The People's Bank of China (PBOC) Governor Yi Gang promised to boost credit support and improve efforts to moderate real lending rates for businesses.

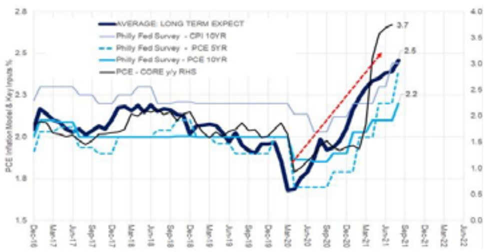
The PBOC vowed financial support for the rural sector with the monetary policy tools at its disposal. When in doubt, central banks are conditioned to go deep and to go fast, hence, it is not unthinkable that both the Reserve Requirement Ratio (RRR) and Loan Prime Rate (LPR) are cut.

US FEDERAL RESERVE RESPONSE

From the July meeting statement and minutes, we have become all too familiar with the idea that the Fed is looking for "substantial progress" on both inflation and job creation fronts. With this in mind, Chair Powell has conceded that "substantial progress" has been made on the inflation front. He has resisted suggestions that "substantial progress" has been made on the job creation front however. The Chair describes the Fed as seeing "clear progress" on the pace of job market recovery, but also suggests the recent coronavirus surge has clouded the outlook.

In response to Powell's dovish comments, real bond yields, equity market volatility (VIX) and the US dollar (USD) dropped. Inflation expectations moved slightly higher however, mitigating the decline in nominal yields.

The US will continue to leave rates low and run the economy hot until there is overwhelming evidence of sustainable inflation. The market is focused on the fact that sequentially growth rates and inflation are slowing down and that fiscal policy is turning from a tailwind to a headwind. Asthe second derivative of COVID-19 cases growth turns we should see cases peaking. As we get better data, interest rates have room to sell off which would support a rotation in the market (subject to Chinese growth slowdown not impacting the broader market).

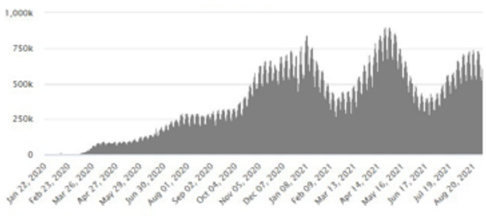


Source: Endeavour Research

COVID-19

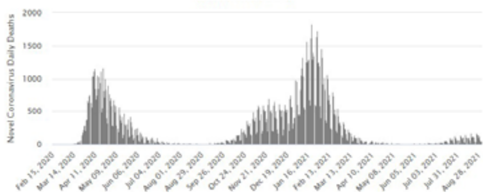
Case numbers across the globe are experiencing a third wave as the Delta variant spreads. For regions with a high number of prior cases and/or a high number of vaccinations, deaths have fortunately remained modest.

Daily new cases



Source: Worldometers.info

Daily new deaths in the United Kingdom



Source: Worldometers.info

Consequentially, in major economies such as UK and US, populations and governments appear to have little appetite for further lockdowns and economies are returning to a level of normality. Australia is clearly lagging this trend, but under Delta, zero COVID-19 targets appear increasingly unachievable. We believe accelerating vaccination rates are helping shift the conversation around opening up but clearly a level of uncertainty remains.

CONCLUSION

Global growth is slowing following a strong bounce back from the depths of COVID-19. The Fed remains supportive and evidence of sustainable inflation will take time to emerge. The fly in the ointment is China and the new COVID-19 variants. China is slowing and authorities have pivoted to a more domestic focused economy, and further redistribution of wealth. A slowing of recent economic data however, has seen authorities appear to begin to loosen monetary policy again. Further stimulus would be supportive of cyclicals, particularly in a normalising post COVID-19 world. We retain a balanced portfolio with a range of strong franchise companies, offering defensive resilience combined with quality businesses trading cheap due to the pandemic impacts.

Article source: DNR Capital

A proven way to build wealth

By Tony Kaye

When it comes to investing, nothing speaks louder than actual results.

The 2021 Vanguard Index Chart shows what investors would have achieved over 30 years from a starting balance of $10,000 invested into different asset types.

The dollar returns are based on the measured returns of those assets and assume all the income received from them over time was reinvested back into the same asset type. But the returns don't take into account buying costs (primarily brokerage fees) or any taxes.

The tables below relate specifically to the performance of the Australian share market since 30 June 1991.

The 30-year average annual return for the broad index of Australian shares to 30 June 2021 was 9.7 per cent per annum.

Table 1 shows the growth of an initial $10,000 investment at five-year intervals for an investor who made no additional contributions over the entire time except for reinvesting their income distributions back into the whole Australian share market.

This would have been achieved by investing through a managed fund or an exchange traded fund (ETF).

After one year the Australian market, combined with income distributions, had delivered a return of around $1,300.

By five years the starting investment had grown to more than $17,000, and by 10 years it had trebled to more than $30,000.

By 20 years the original $10,000 had increased by more than 550 per cent, and by 25 years it had grown to over $92,000.

Then, at the end of June this year, that initial $10,000 would have been worth more than $160,000, showing an impressive total return since mid-1991 of more than 1,500 per cent.

Table 1

Year	Reinvestment of income distributions only	Compound % growth
1	$11,304.33	13.0
5	$17,267.29	72.7
10	$32,076.07	220.8
15	$57,445.51	474.5
20	$65,354.35	553.5
25	$92,963.09	829.6
30	$160,498.17	1,505.0

Based on All Ordinaries Accumulation Index monthly returns from 30 June 1991 to 30 June 2021.

RESULTS WITH A REGULAR CONTRIBUTIONS STRATEGY

There's no denying the 30-year return from the Australian share market, based on a $10,000 starting investment with no extra contributions, is strong.

Yet the numbers are even more compelling using an example of someone who started with the same $10,000 investment amount but who had decided to make extra regular contributions of $500 per month and reinvest their income distributions.

It's only when you compare the results side by side that the full return picture becomes much clearer.

An initial contribution combined with a regular investment savings strategy and the reinvestment of distributions will deliver much higher long-term results.

Investing the same amount of money at set intervals is known as dollar-cost averaging. That means you're averaging out the cost of your investments through incremental investing - regardless of whether market prices are up or down.

At year one table 2 below shows that there was little difference in compound growth between someone making no additional contributions versus a person who added a further $6,000 in contributions over the first 12 months.

Table 2

Year	Reinvestment of income distributions only	Contributions of $500 per month plus reinvestment of income distributions
1	$11,304.33	$17,577.36
5	$17,267.29	$57,072.67
10	$32,076.07	$147,406.84
15	$57,445.51	$312,052.84
20	$65,354.35	$386,774.68
25	$92,963.09	$586,285.33
30	$160,498.17	$1,052,982.13

Based on All Ordinaries Accumulation Index monthly returns from 30 June 1991 to 30 June 2021.

But after five years, the gap began to widen. After making $30,000 in extra contributions on top of their initial $10,000, an investor would have achieved a balance of almost $60,000.

After a decade and $60,000 in contributions, the balance would have grown to around $150,000, and after 20 years (by 2011) to more than $380,000.

At the end of June this year that starting balance of $10,000, based on the monthly returns of the All Ordinaries Accumulation Index and $180,000 in total contributions, would have been worth more than $1.05 million.

The overall comparison numbers really tell the story.

In addition to the benefits of long-term market returns and reinvesting income distributions, having the discipline to make investment contributions on a regular and structured basis really pays off.

That's the true power of compounding returns.

Article source: Vanguard Investments

What does inflation mean for the Australian bond market?

By Ron Mehmet

Australia's inflation rate has been stubbornly below the RBA's target band of 2–3% for several years now, but the 0.9% rate realised in 2020 was, even in this paradigm, exceptionally poor. However, economists are projecting an increase in inflation this year, driven by increased expenditure from households.

The reasoning behind these expectations is households looking to spend the savings they built up over the last year, as the household savings rate grew from 5.3% in the December 2019 quarter to 12% in the December 2020 quarter. However, this inflationary spike is expected to be short-lived and over the next two to three years inflation is expected to remain below the RBA's target.

Turning to the labour market, Australia's unemployment rate sits at 5.6% in March 2021, down 0.2 points from February and continuing its downward trajectory since October 2020. The overall unemployment rate for the nation is now only 0.5 points higher than in pre-COVID February 2020.

This suggests that there is significant demand for labour that could continue to drive the downward trend in the unemployment rate. Vacancies are up for all sectors of the economy, except for Retail Trade, and Arts and Recreation Services, both of which were hit hard by COVID lockdowns. However, with the expiry of fiscal stimulus such as JobKeeper and the Coronavirus supplement for JobSeeker, it remains to be seen whether the downward trend in unemployment will continue.

The impact of the economic recovery and the uptick in inflation has been evident in the bond market. The Australian sovereign yield curve has steepened since the end of 2020, reflected in the spread between the 10-year and two-year government bond yields, which has risen from 90 basis points at the end of December to 158 basis points at the end of April.

The Australian yield curve's steepening has been driven by a multitude of factors. The rise in the 10-year yield has been recently buoyed by expectations of an increase in the cash rate prior to the RBA's stated 2024 target, as measured by interest rate futures, which can be used to deduce probabilities of future rate hikes or cuts and the respective implied policy rate.

However, the rise in the 10-year yield is also partially explained by continued growth in inflation expectations, commonly referred to as 'breakeven inflation'. The Australian 10-year breakeven rate, which is measured as the difference between the nominal yield of the Australian 10-year bond and the real yield of the Australian 10-year inflation linked bond. This measure peaked at 222 bps in early March and ended the quarter at 210.7 bps, an increase of 35 bps.

More importantly, when considering the overall changes in both the steepness and level of the curve, both have risen over the quarter due to significant moves in longer-dated government bonds. Given the RBA's explicit three-year government bond yield target of 10 bps, the short end of the curve has effectively been pinned to the floor in a bid at reducing short-term funding costs for institutions.

While the RBA notes the rise of the long end of the yield curve, its announcements have indicated a firm stance in relation to the official cash rate remaining at its current level until a sustained rise in inflation. The RBA has briefly acknowledged a temporary rise in inflation "due to reversals in some COVID-19 related price reductions", however they note that "underlying inflation is expected to remain below two percent over the next few years". Considering the latter, the market continues to price rosier times ahead (more than what the RBA contends).

A rise in yields is potentially a welcome sign for economic conditions ahead, but the inverse is that they also represent higher borrowing costs for market participants such as corporations and governments. For investors, the rise in yields has represented significant losses considering the magnitude of the shift across the curve, especially when considering the duration (interest rate risk) attached to longer-dated bonds. Typically, duration is one of the more difficult risks to trade for bond managers. Furthermore, as yields rise, so do their attractiveness relative to other asset classes such as equities and hybrids.

Lonsec's base case is that we may see a modest rise in inflation over the next 12 months, but that over the medium term inflation will remain under control as broader structural deflationary pressures such as the continual impact of technology in society and the aging population continue to weigh down on most developed economies. However, even a modest rise in inflation will have consequences for financial markets, and the bond market is where the action will be.

Article source: Vanguard Investments

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