HARRIS WATERHOUSE WEALTH

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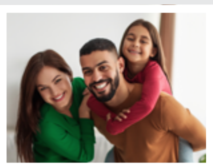
Inside:



DNR investment review

This month we further explore the impact of higher inflation, with particular focus on the actions of governments in addressing the problem. In reviewing the response to higher energy prices, we observe further pressure on inflation, which continues to build. In framing the impact for portfolios, we then assess the impacts on corporate profitability and market valuations.

FISCAL RESPONSE

As we are all aware, cost of living pressures are climbing. Higher energy prices, rising rents and food costs are increasing the pressure on governments around the world. In recent years, government popularity has been correlated with their preparedness to solve problems for the community – from financial crises to natural disasters. Populist measures to deal with inflation, however, often exacerbated the problem. Looking across economies we note:

- New Zealand is handing out NZ$350 to lower income earners to alleviate cost of living pressures, but this will stimulate demand, placing further pressure on prices.
- The United Kingdom announced a temporary profits levy on energy companies (which will reduce investment) to support cost of living support (which will drive higher demand).
- California has announced an US$18b inflation relief package which will further fuel demand.
- In Australia, a temporary fuel excise relief was implemented, and one-off payments have been proposed, with potential stimulatory effects.

If the response of government is to throw petrol on the fire, then central banks will need to further lift interest rates to dampen demand, and poses several questions. Firstly, how aggressively will they lift rates? Given a substantial proportion of inflation is driven by supply, higher rates may attack demand but also potentially crimp investment that could alleviate a supply response. Will the central banks' commitment to crushing inflation require pushing the economy into recession by design?

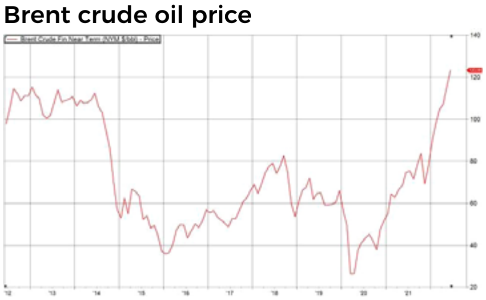
In the US, a number of labour reports highlight a very tight employment market, and SEEK job advertisements up 30% year to date (YTD) evidences a similar environment in Australia. Labour costs in the US are rising at 8.2% year on year, the fastest since 1982. Labour costs are now "chasing" prices higher, with workers, empowered by tight conditions, able to extract better wages and benefits. Firms will inevitably attempt to pass these costs onto consumers, creating a positive feedback loop between wages and prices.

To break the feedback loop, the Federal Reserve (Fed) needs to slow demand by lifting rates, but job openings remain stubbornly high. The mistake in the 1960's and 70's was to lift rates too cautiously, and then cut too aggressively. Will we see higher for longer rates? Will the Fed be aggressive enough in addressing inflation? It is difficult to be certain, but we view the risks to broader earnings forecasts as elevated and seek to position ourselves accordingly.

ENERGY COSTS

Higher oil and energy prices are causing significant consumer angst. Whilst populations are resuming travel and general economic activity, a range of severe hydrocarbon supply challenges remain. Markets are tight after a decade of underinvestment, compounded by the Ukrainian war. Environment, Social and Governance (ESG) pressures to transition to net zero carbon means companies are reluctant to commit capital to new projects, strangling the supply responses that high prices would traditionally illicit.

Brent crude oil price



Source: Factset

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DNR investment review

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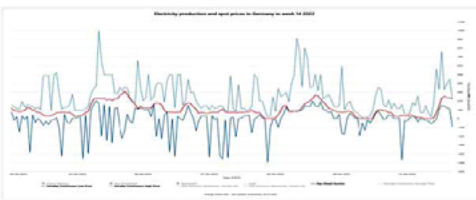
We observe a number of problems in the current environment:

1. Given we do not, at present, have feasible storage solutions, high levels of renewables cause extreme volatility in electricity grids. When the sun is not shining and wind not blowing, electricity prices are spiking, then collapsing when they are. In Europe, the balancing factor has been Russian gas, but its use is now an open question. Countries are quickly appreciating the role gas needs to play in the energy transition, and securing supply becomes critical for long term economic health. The chart below highlights the German electricity prices are negative in the middle of the day and then explode at night. This volatility is driving electricity prices higher.

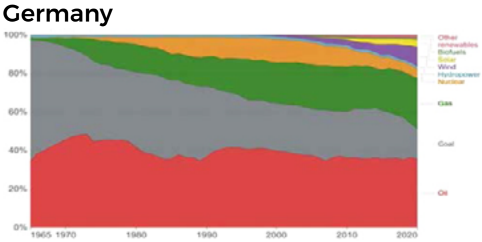
Electricity production and spot prices in Germany in week 14, 2022



Source: https://energy-charts.info/

2. While the world is moving towards a more sustainable future, the path forward is challenging. Germany has invested heavily in renewables for 20 years but is still heavily reliant on fossil fuels for its energy needs, and its cost of energy has increased substantially which creates risks for its manufacturing capabilities.

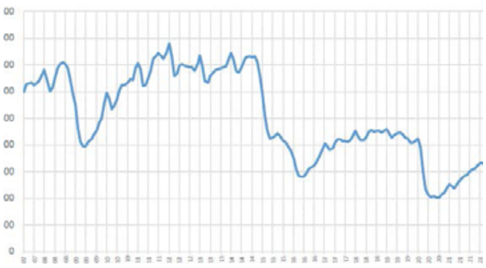
Energy consumption by source, Germany



Source: BP Statistical Review of World Energy

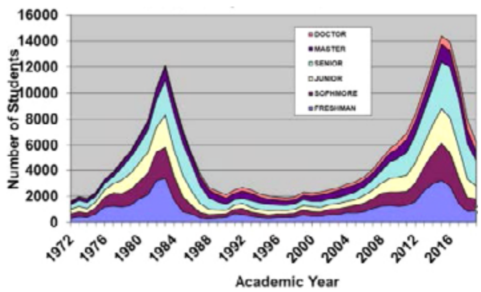
3. Pressure to divest energy assets means we have not seen an appropriate supply response. By denying capital to energy companies, markets have hamstrung the economy's ability to balance increased demand for oil and gas, in a supply restricted environment. The rig count remains low despite the spike in oil price. Rusting equipment having sat idle since the last boom and a lack of skilled labour further slows any response.

Total world oil and gas rotary rig count



Source: Bloomberg

Petroleum engineering enrollment



Source: Lloyd Heinze

4. High inflation and energy costs further increase the cost of renewables. Prices for wind and solar are up 30%. Transitioning to renewables is itself highly resource intensive, with generation assets, transmission and transport capabilities requiring inputs such as oil, carbon, lithium and mineral sands. By increasing the cost of energy, we potentially delay the transition to a lower carbon world.

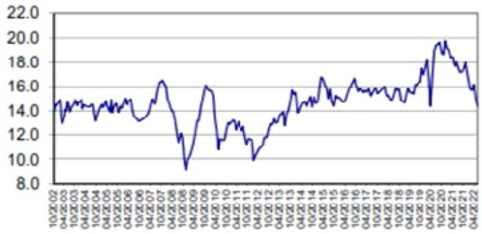
5. The final issue that could delay the transition to net zero carbon would be possible political instability that high energy prices cause. Higher food costs, higher costs of warming the home and getting to work have a large social cost and create an instability which governments will be keen to avoid.

So with no imminent supply side response, energy prices are shifting higher until we stimulate supply or create demand destruction. In a rising energy market, consumers have to sacrifice discretionary goods to meet energy necessities.

VALUATIONS HAVE DE-RATED

This changing macroeconomic backdrop has resulted in a fall in market valuations towards long term averages. We note however, that the headline price to earnings ratio (PE) masks dispersion within the index. Resources and energy stocks continue to trade at low multiples, especially in context of spot commodity prices. Growth stocks have de-rated but remain well above ten year averages, and arguably have further to fall. The chart below displays the price to earnings multiple of the market which has pulled back sharply.

ASX 200 forward multiples have retracted significantly



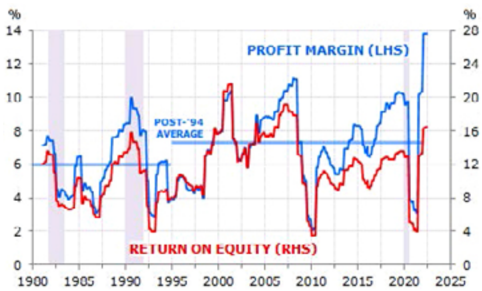
Source: DNR Capital, Factset

EARNINGS OUTLOOK

In this environment, it is not surprising that the consumer is beginning to feel the pressure, although business confidence remains strong.

The risk, as we see it, is that profit margins will suffer as softening demand meets higher costs. The chart below highlights the large expansion in profit margins post the fiscal stimulus that accompanied COVID-19. Profit margins are typically mean reverting, meaning they revert to an average as competition competes away excess returns.

Market excluding resources and financials



Source: Minack Advisors

Over the past three months we have seen downgrades to consumer discretionary companies, alongside upgrades to energy and material companies, which should not surprise. The consumer is being squeezed out in a similar manner to the 1970's.

So while the de-rate for the market appears well progressed, the risk remains that further earnings downgrades will be a negative headwind for markets. Within the market we see opportunities across:

1. Energy names whose returns are improving sharply
2. Quality companies which have de-rated materially yet have resilient earnings.
3. Select defensive companies whose earnings should improve as economies recover from COVID-19.

Article source: DNR Capital

Tips to navigate market volatility

The best thing investors can do when markets are volatile is to stay invested.

Of course, that's often easier said than done, especially when market commentators point to a market correction or when your portfolio is down for consecutive days or weeks.

For those new to investing, particularly those who jumped into the market when shares were booming last year, the recent market turbulence feels something like a rude awakening.

In times like these however, it's useful to remember a few grounding investment principles that can get you through the good and the not-so-good.

Stick to your plan

Before you invest your first dollar, new investors need to have well-defined investment goals and a realistic investment plan. This means understanding how much money you have to invest, how much you can contribute regularly, how comfortable you are if that money goes down in the short-term, and how long you have to reach your desired outcome.

It's easier to stick to a plan if you've got one written down. Investors who fare best are the ones who don't regularly tinker with their portfolio and are in it for the long-haul.

A good example of this is that during the COVID crash in March 2020, investors who stuck to their plan and stayed invested were able to reap the benefits of a swift market recovery. Those who cashed out at market lows lost the opportunity to regain portfolio value when markets picked back up.

Tune out the noise

Social media is rife these days with market commentary, stock predictions and portfolio strategies. Each corner of the internet will espouse a different investment philosophy, and while this might make for interesting debate, it can also be a little overwhelming for new investors.

In times like these, it's not about disengaging from market information altogether, but rather about choosing what to listen to.

Investing can be emotionally charged at times which can lead to investors making impulsive decisions. So, when you're struggling to decide who and what to listen to, first examine the source for credibility and bias, and then consider if the information is relevant before you take action (if any at all).

Remember, what might work for one investor may not work for the next as there's a multitude of individual considerations (i.e. risk tolerance, investment confidence, timeframe, and objectives) that define an investor's individual approach.

The best thing you can therefore do is to remind yourself of your investment plan, and the fact that no advice online has been tailored specifically to your circumstances.

Markets will consistently rise over the longer-term

For younger investors with a longer investment time frame, short-term market volatility is unlikely to materially impact long-term returns.

What might seem like a downward trend for markets right now is, importantly, only temporary.

Markets are cyclical, but history shows will rise over the longer term even when there's been sharp falls in the past.

For example, a $10,000 investment in Australian shares 30 years ago would still have grown to $160,498 even with significant market downturns such as the Great Financial Crisis in 2007–2008 and the COVID-19 outbreak in 2020.

Vanguard's annual Index Chart can serve as a good reminder to investors of the importance of perspective, and how sticking to a long-term investment plan, with diversification across a range of asset classes, allows you to grow your wealth even in the face of market crises and short-term volatility.

Article source: Vanguard

Risking your retirement

If you're already retired or on your way to retiring, have you been obsessively checking your portfolio balance and dreading the next piece of news that might cause it to dip further? Or have you been keeping up with the news as you usually do, but confident that your portfolio will largely weather the volatility it is currently experiencing?

If you nodded at the former, it's a good indicator that you may need to revisit your asset allocation; it's likely that it is no longer aligned to your risk appetite and thus unlikely to achieve the goals you've set out in the time horizon you have.

If you said yes to the latter, good on you – you've likely set yourself up well. But whether or not you're feeling comfortable with how your portfolio is doing, it is important to regularly think about the risks that you face as a retiree (or a soon-to-be-retiree), and put in place strategies to mitigate them.

Market risk

Without a regular pay check to counterbalance capital losses, retirees inevitably feel it more when market volatility is in play. But while you cannot control the market and what it returns, you can control your discretionary spending. Temporarily reducing your spending could help alleviate financial stress through this momentary dip. And spending plans can resume once markets are back in the black.

Inflation risk

Inflation continues to be a hot topic but the risk it brings is nothing new. Planning for inflation should be part of your investment strategy. Also don't get caught out during your retirement planning process – using 'real returns' rather than 'nominal returns' is important when punching in the numbers.

Longevity risk

Australians are living longer than we ever have. According to the Australian Bureau of Statistics, the average person can now expect to live past 81 if you're male, or 85 if you're female. You should plan for your retirement savings to last you at least 16 years and possibly up to 30 years, assuming you retire at 67. And if you're retiring before 67, plan accordingly. Don't forget to factor in expenses to account for health issues as you age.

History has shown that investors who remain invested in the financial markets despite troubling headlines are rewarded when the market eventually picks up. As such, maintaining discipline and focusing on the long-term will help you navigate the years ahead.

Article source: Vanguard

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