Monthly Investment Insights and Outlook

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June 2021

Section 1: Investment Thesis

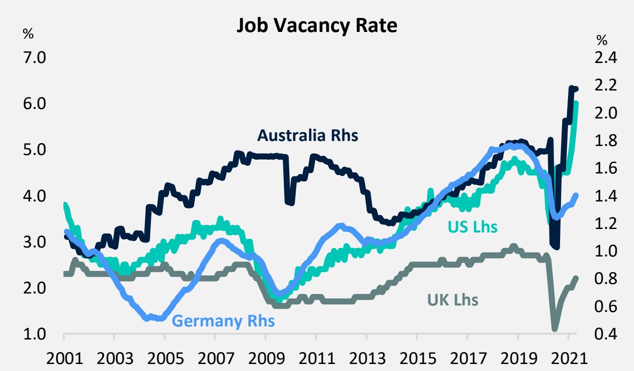
Our core investment views remain unchanged from the last report which was sent out on 22nd May. The key points were:

- **The global economy is emerging from last year's pandemic induced recession.** With continued unprecedented policy stimulus and the labour market recovering quicker than expected, momentum should build further.
- **Bubbles are emerging and must not be ignored.** The most concerning "bubble" is in developed market sovereign bonds. This market is defying fundamentals as highlighted by the recent rally despite significantly higher inflation prints.
- **Valuations remain full/elevated.** Traditional valuation measures suggest that "bubbles" are evident across most asset classes. It is still too early to be de-risking on overheating concerns as several uncertainties remain.
- **US Inflation remains the key data point to watch.** US CPI is well above its official target band, with one-off factors contributing. Key is the extent to which current transitionary inflation pressures become permanent, requiring tighter policy settings.
- **For portfolios we remain fully invested with quality assets that will endure.** This is not the time to be taking excess risk and following the herd mentality when the fear of missing out is extreme. Our portfolios are comprised of solid assets whose investment cases are somewhat agnostic to Wall Street gyrations and thematic risk.

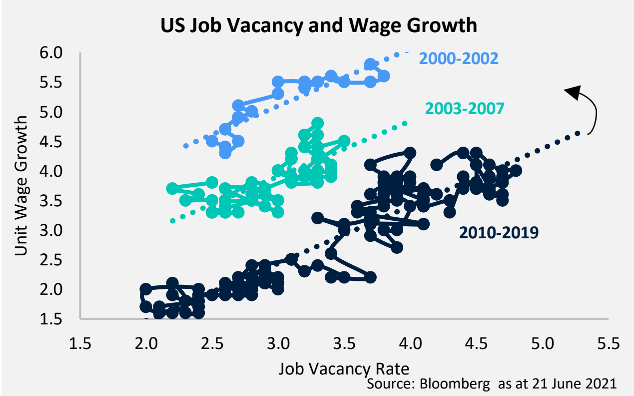
Since this report the key market developments have been:

- **Multi-national agreement across the G7 regarding tax evasion or "domicile-shopping."** This is a step forward in reducing income inequality by limiting the opportunity for jurisdictional arbitrage for global corporates. However, in reality this would need to be much wider, *i.e.*, a G20 or similar agreement, and with sanctions for genuine change.
- **New and tighter regulations on cryptocurrencies and exchanges.** These include new/tighter controls on cryptocurrency gains and losses, policy measures directed at using cryptocurrencies for money laundering, and controls on cryptocurrencies entering the real economy, *i.e.*, using Bitcoin to buy a house or car.
- **COVID-19 remains a core global problem.** Although an increasing number of people have been vaccinated, outbreaks continue. High levels of daily transmission are occurring in developed countries and much higher rates in less developed countries. This is evidenced by ongoing dislocations in supply chains and rising pipeline and inflation pressures. Data releases will remain highly choppy on a quarterly basis as activity distortions continue.
- **CPI prints are high and surprising to the upside.** CPI is now way above the US Federal Reserve's 2% target. Key is the extent to which current high inflation prints are transitory as opposed to one-off in nature. This is not just US centric. Even Eurozone, which has experienced a prolonged period of disinflation, has reported 2% headline CPI growth (although well-controlled core CPI). A global inflation paradigm shift appears to be well underway.
- **Wages are rising and flowing into inflation.** Labour shortages are increasing and have become a widespread problem across the US, UK and Australia. Our recent travels to Northern Queensland, northern Western Australia and Northern Territory have all highlighted labour issues in hospitality, transport and construction. Reasons cited included lack of foreign labour due to the international border closure, movement across industries due to layoffs and shutdowns in 2020, and lack of rental accommodation in currently thriving domestic tourism areas. Labour markets and wages are discussed in more detail in the next section, with the charts below highlighting the key issues.
- **The AUD is oversold.** At less than $0.75 to the USD, the AUD is out of line with its fundamentals. With commodity prices soaring, a strong domestic economy as evidenced by the labour market strength, and a rising short end yield curve, the AUD should be closer to $0.80. Near term caution is a must if translating AUD into USD at present.
- **The US Federal Reserve is paving the way for higher interest rates.** Mindful that COVID-19 remains the core global problem and a rerun of the 2013 taper tantrum is to be avoided, the Federal Reserve has started to signal that inflation numbers are for "real" and its tolerance for consistent overshoots of its inflation target is not infinite.

For portfolios, now is not the time to be dialling up risk or cashing up. Both options will come at a cost – particularly the former. Quality assets which are largely agnostic to the economic cycle should increasingly form the core part of your investment composition. Our latest add to portfolios is fishing quota ("individual transferable quota") - an investment that is both cheap at present and with return drivers very different to Wall Street.



Source: Bloomberg as at 21 June 2021



Source: Bloomberg as at 21 June 2021

Market Indicators at a Glance

As at 21 Jun 2021	LEVEL			PRICE CHANGE %					
Equities	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
ASX 200	7237	7406	5763	2.9	7.9	8.5	21.8	9.9	22.7
ASX Small	3321	3393	2540	3.9	3.9	7.7	23.8	7.5	27.8
S&P 500	4166	4257	3000	0.3	6.5	12.8	34.5	10.9	34.4
Nasdaq	14030	14212	9664	4.2	6.2	10.1	41.1	8.9	39.5
Russell 2000	2238	2360	1374	1.0	-2.2	13.6	57.7	13.3	55.3
MSCI Europe	150	153	112	1.8	6.8	16.9	23.1	13.4	24.9
Japan Nikkei 225	27981	30715	21710	-1.2	-6.1	4.7	24.5	2.0	25.5
Israel Tel Aviv 125	1747	1788	1295	-0.3	5.9	17.6	26.6	11.4	31.8
UK FTSE 100	7017	7218	5526	0.0	4.6	9.4	11.5	8.6	13.7
MSCI China All	3790	4425	2914	1.4	-0.5	2.6	30.0	0.6	29.0
Russia RTS$	1647	1695	1040	4.9	11.7	23.3	31.8	18.7	35.8
MSCI World	2954	3026	2149	0.4	5.7	11.7	33.7	9.8	34.2
MSCI EM	1361	1449	989	2.3	1.8	8.3	35.9	5.4	36.8
MSCI Frontier	637	645	463	2.1	10.4	13.9	32.9	11.4	32.7

	YIELD LEVEL			YIELD CHANGE (BPS)					
Bond	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
3M BBSW Rate	0.0	0.1	0.0	-2	-1	1	-8	1	-8
2yr Aus Treasuries	0.1	0.3	0.0	1	-1	-1	-18	-3	-17
10yr Aus Treasuries	1.5	1.9	0.7	-22	-29	55	65	51	64
Aus Corporate Spread	0.9	1.3	0.8	-4	-4	4	-44	4	-42
2yr US Treasuries	0.3	0.3	0.1	11	11	14	7	14	11
10yr US Treasuries	1.4	1.8	0.5	-25	-35	43	68	46	71
Global Agg Spread	0.8	1.5	0.8	-3	-9	-13	-61	-11	-62
Global HY Spread	3.5	6.6	3.5	-9	-35	-66	-278	-58	-309
EM USD Bond Spread	2.7	4.1	2.6	-2	-4	-15	-141	-15	-142

	LEVEL			PRICE CHANGE %					
Commodities	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
Baltic Dry Index	3218	3267	1111	12.2	41.1	143.2	106.9	135.6	78.9
Aluminium ($/t)	2385	2603	1562	-3.8	7.6	16.0	48.5	20.5	47.3
Brent Oil ($/bbl)	74	75	39	11.6	16.6	45.7	69.1	44.1	70.3
Coking Coal (CNY/t)	2106	2159	1165	28.4	29.9	33.6	67.7	40.4	69.1
Copper ($/t)	9146	10748	5807	-12.1	1.0	14.5	57.5	17.8	52.0
Gold ($/oz)	1775	2075	1677	-5.7	2.0	-5.5	1.1	-6.5	-0.4
Iron Ore ($/t)	201	230	137	8.2	41.4	27.1	154.8	43.8	156.9
Silver ($/oz)	26	30	17	-6.1	0.5	-1.1	46.1	-2.0	42.1
Thermal Coal (CNY/t)	909	985	535	10.6	37.0	21.0	62.6	14.4	59.4

	LEVEL			PRICE CHANGE %					
Currencies	Current	1 Year High	1 Year Low	1 Month	3 Month	6 Month	1 Year	CYTD	FYTD
AUD/USD	0.7491	0.8007	0.6805	-3.1	-3.3	-1.3	8.4	-2.6	8.5
USD Index	92.3	97.8	89.2	2.6	0.4	2.5	-5.4	2.7	-5.2
EUR TWI Index	123.9	127.3	121.7	-1.2	-0.1	-2.3	1.6	-1.8	1.3
AUD TWI Index	62.7	65.4	59.3	-2.5	-3.5	0.0	4.5	-1.1	4.5
JPY TWI Index	111.1	119.0	109.2	0.7	-0.5	-4.9	-6.2	-5.3	-5.0
GBP TWI Index	75.3	76.2	69.4	-0.5	-0.2	5.3	7.2	5.0	7.2
CNY TWI Index	98.2	98.2	91.4	0.9	1.5	3.5	6.8	3.5	6.7

Source: Bloomberg as at 21 Jun 2021

Investment Style Monitor	Four Weeks Return/Index Point				
	Now	4 Weeks Ago	One Year Average	Ten Years Average	Long Term Average
Growth - Value Spread	6.3	-5.2	0.2	0.5	0.2
Cyclical - Defensive Spread	1.7	-2.7	0.9	0.5	-0.1
Emerging – Developed Markets Spread	3.0	-2.8	0.3	-0.4	0.1
US - Non-US Spread	0.4	-1.7	0.3	0.7	0.3
US - Europe Spread	-1.9	-1.3	0.7	0.5	0.3
Australia - Developed Markets Spread	3.2	-0.4	-0.8	-0.3	-0.1
Australia - Emerging Markets Spread	0.1	2.5	-1.1	0.2	-0.1
COVID Impacted - Non-Impacted Spread	-2.3	2.4	0.4		
Cyclical - Haven Currency Spread[1]	-2.5	1.5	1.0	-0.1	0.0
Tech - Non-tech Spread	7.0	-3.5	0.6	3.2	0.1
Market Volatility Monitor					
Equity Volatility VIX Index	20.7	18.4	23.6	17.6	20.2
Bond Volatility Move Index	60.5	54.9	51.5	66.7	88.8

Source: Bloomberg as at 21 Jun 2021

Negative
Positive

Economic Heatmap - Jun 2021					
	US	Eurozone	Australia	China	Japan
Headline Unemployment Rate %*	↑ 5.8	↓ 7.5	↑ 5.1	-	↑ 2.8
Real Unemployment Rate %[2]*	↑ 7.9	↓ 8.8	↑ 4.2	-	↓ 3.4
Employment Million[3]	↑ 151.6	↑ 42.1	↑ 13.1	-	↓ 66.6
Manufacturing PMI	↓ 61.2	↑ 63.1	↑ 61.8	↓ 51.0	↑ 53.0
Service PMI	↑ 64.0	↑ 55.2	↑ 61.2	↑ 55.2	↓ 46.5
Retail Sales Yr Growth %	↓ 28.1	↑ 23.9	↑ 25.0	↓ 12.4	↑ 11.9
Consumer Confidence	↑ 86.4	↑ -5.1	↓ 107.2	↓ 121.5	↓ 34.1
Business Confidence	↑ 99.6	↑ 1.5	↓ 19.8	↑ 54.2	↓ 46.8
Industrial Production Yr Growth %	↑ 16.3	↑ 40.9	-	↓ 8.8	↑ 15.8
Housing Starts Yr Growth %	↑ 50.3	-	↑ 39.2	↓ -6.1	↑ 7.1
Official Interest Rate %*	→ 0.3	→ 0.0	↑ 0.1	↓ 2.6	↓ -0.1
Producer Prices Yr Growth*	↓ 6.6	↓ 7.6	-	↓ 9.0	↓ 4.9
Inflation CPI Yr Growth*	↓ 5.0	↓ 2.0	↓ 1.1	↓ 1.3	↓ -0.1
Money Supply Trillion	↑ 20.1	↑ 14.8	↑ 2.5	↑ 227.6	↑ 1508.5
Google Mobility Index	↑ 2.5	↑ 8.4	↓ -10.7	-	↑ -8.2

Source: Bloomberg and Google as at 21 Jun 2021

vs. prior	
↑	Improving
↓	Deteriorating
→	Steady

vs. history
Better
Worse
In line

[1] "Cyclical" currencies are Australian Dollar and Canadian Dollar. "Haven" currencies are Japanese Yen and Swiss Franc.
[2] Real unemployment rate adjusts the change of labour force participation.
[3] European employment is proxied by German data.
*Color and arrow reversed

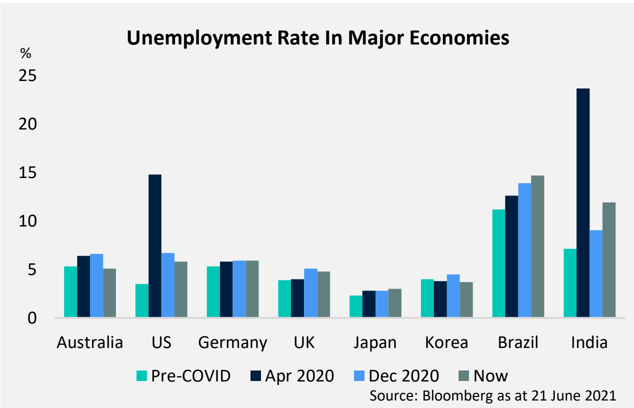
Section 2: Labour Markets Are Stronger Than Expected

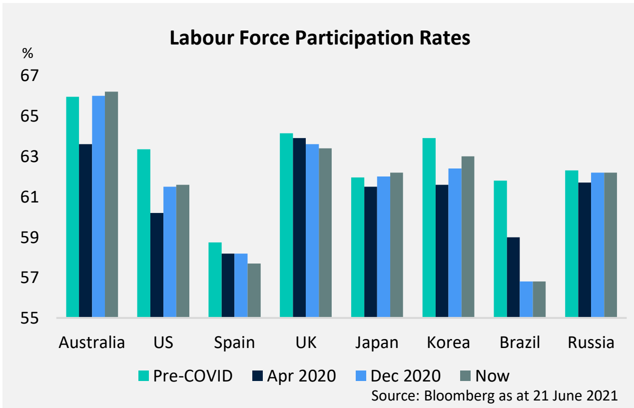
The global labour market recovery has been uneven across the major economies. Countries with improved COVID-19 numbers and/or accelerated vaccinations are typically reporting faster and stronger rebounds.

Australia has been a top economic performer, with both the official unemployment and labour force participation rates now stronger than pre COVID-19 levels. The Australian underemployment rate, which measures how many people are insufficiently employed relative to the amount of time they wish to work or their skill level, is now back at average levels. The domestic labour market looks to have coped very well with the end of the JobKeeper subsidy scheme.

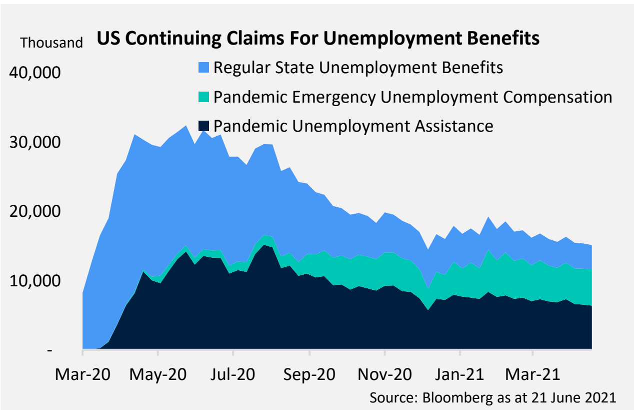
In the US, unemployment rate has declined to 5.8% in May, from 6.7% in Dec 2020. However, the labour force participation rate remains 1.7% points below the pre-COVID level. In Europe, despite some signs of improvement, labour markets remain heavily distorted by the payroll protection programs, extended to reflect recurring lockdowns.

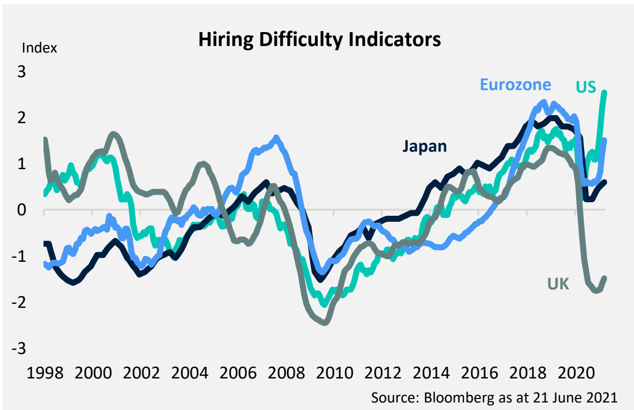
In emerging markets, populous countries which have suffered most from the pandemic in absolute terms continue to report deteriorating unemployment rates. Specifically, jobless rates in Brazil and India are rising due to ongoing COVID-19 outbreaks and participation rates are low.



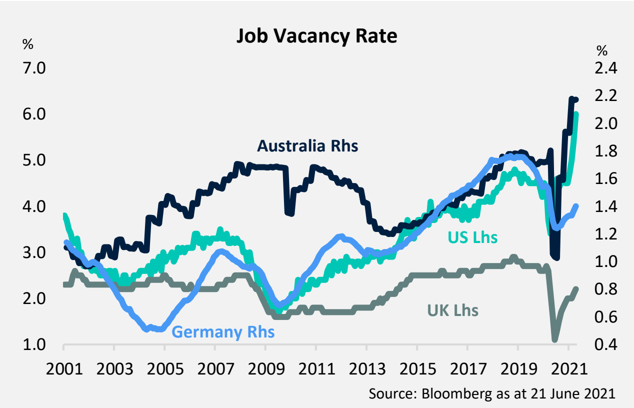


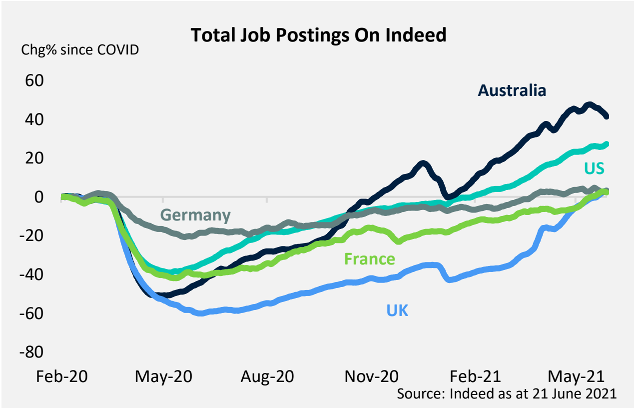
Despite generally improving headline unemployment data, labour market dislocations are very high. By way of example, in the US, some 15 million people are receiving unemployment benefits, yet the country is reporting severe labour shortages and record high hiring difficulties. This begs the question as to the actual amount of slack in the US labour market with the resulting ramification for wages and critically policy settings.





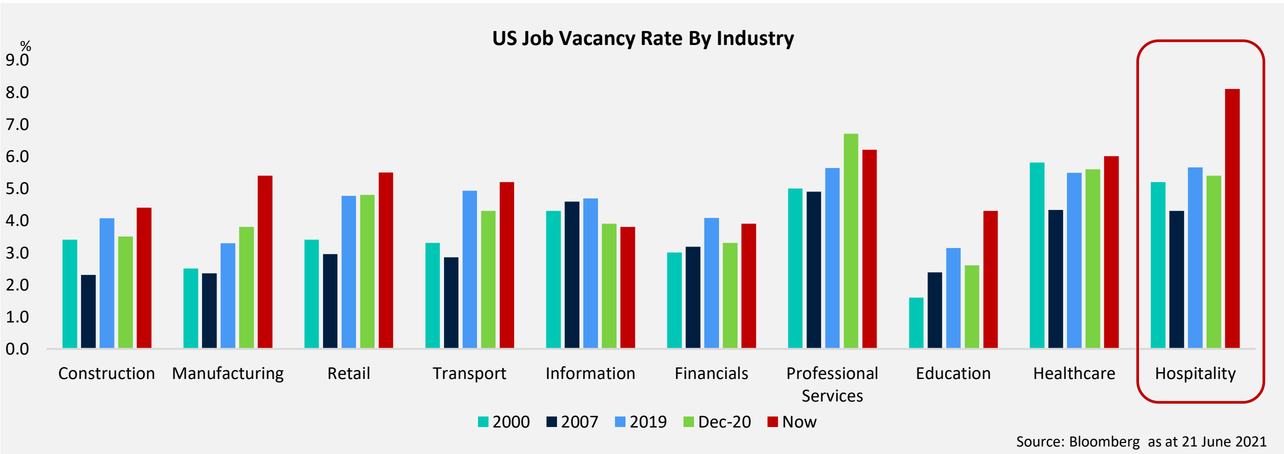
In Australia, the labour market is tight with blue collar labour shortages widespread. As the following two charts highlight, job vacancy rates are elevated, and online job postings have surged. Highlighting this dislocation thematic, the employment of resident workers is currently 1% above pre-COVID level, but critically the number of non-resident workers is 280k lower and continuing to fall.





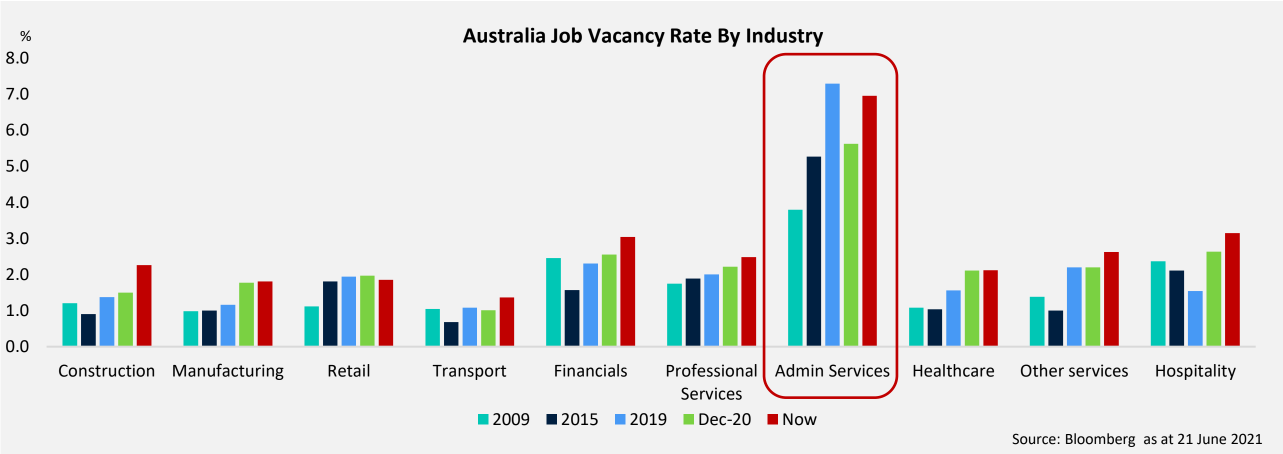
Although the US and Australia are both experiencing severe labour shortages, the reasons are vastly different. In the US, industries which were hit hardest by the pandemic last year are now reporting the biggest deficiencies. These industries include hospitality, transport and construction. The main drivers of this include:

- **Generous/ too generous job subsidies:** Biden's government has extended the unemployment benefits duration to the end of September and given extra $300 weekly boost to the standard benefits. On average, an unemployed worker in the US can receive $678 per week, making up ~70% of the normal wage. This weakens people's willingness to seek a job. Some businesses are resorting to paying candidates just to attend an interview!
- **Psychological effect:** many people want to do something different from what they did before the pandemic. COVID-19 has changed people's behaviour and priorities. Survey suggests around 67% of those unemployed had "seriously considered" changing the field of work. They are not only looking for higher salary, but also seeking jobs with physical safety (COVID-safe) and more resilience to an economic downturn. Hospitality has been a big loser here.
- **Changing demographics**: Ageing baby boomers are adding to staff shortages in blue-collar positions. For example, in manufacturing industry where nearly one-fourth of the workforce is age 55 or older, the job vacancy rate has climbed to a record high. Younger generations are reluctant to become factory workers due to concerns that these jobs could be outsourced or replaced by machines. This situation is further exacerbated by the decades-low US labour force participation rate of those over 55 years old. Workers are retiring early as their retirement portfolios have surged in past two years and the pandemic has taught them to maximise the years ahead.

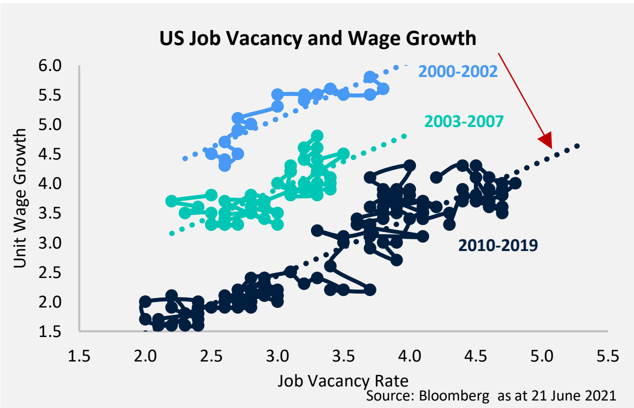


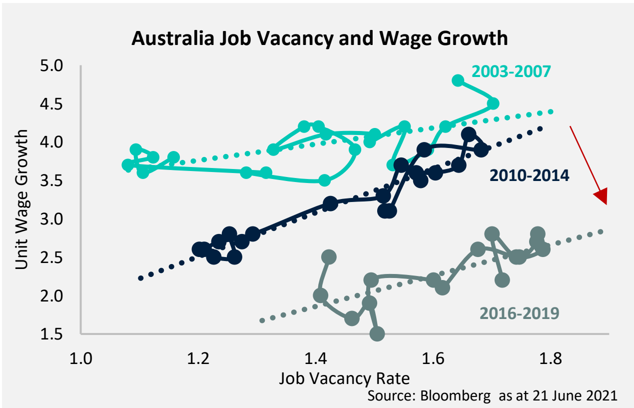
In Australia, labour shortages are more prevalent in industries which have a higher concentration of foreign workers, such as agriculture, hospitality, and administrative services. The ongoing international border closure has essentially stopped the immigration of workforce. Positions, such as cleaning, loading and food preparation, have historical high job postings. Accordingly, routine business operations are distorted. Some Sydney hotels can only operate at 90% capacity on weekends due to the lack of housekeepers. Restaurants are operating for fewer days in the week. Service retailers are closing earlier. In the auditing industry, the lack of foreign auditors forced ASIC to allow some companies to defer reporting the financial results.

Also, as evidenced on our recent domestic research trips, the lack of infrastructure is another key reason of labour shortages in regional Australia. Since the COVID-19 outbreak, regional towns have outperformed urban cities in property prices, population growth and domestic tourism. However, these towns do not have sufficient infrastructure to cope with such demand. Hotels, car hire, tours and restaurants are fully booked. New migrants and workers cannot find available rental accommodation, and property prices become unaffordable. By way of example, house prices in Byron Bay are up over 70% on a year-on-year basis and rental of a two-bedroom ***apartment*** (*not house*) has topped Sydney CBD level.

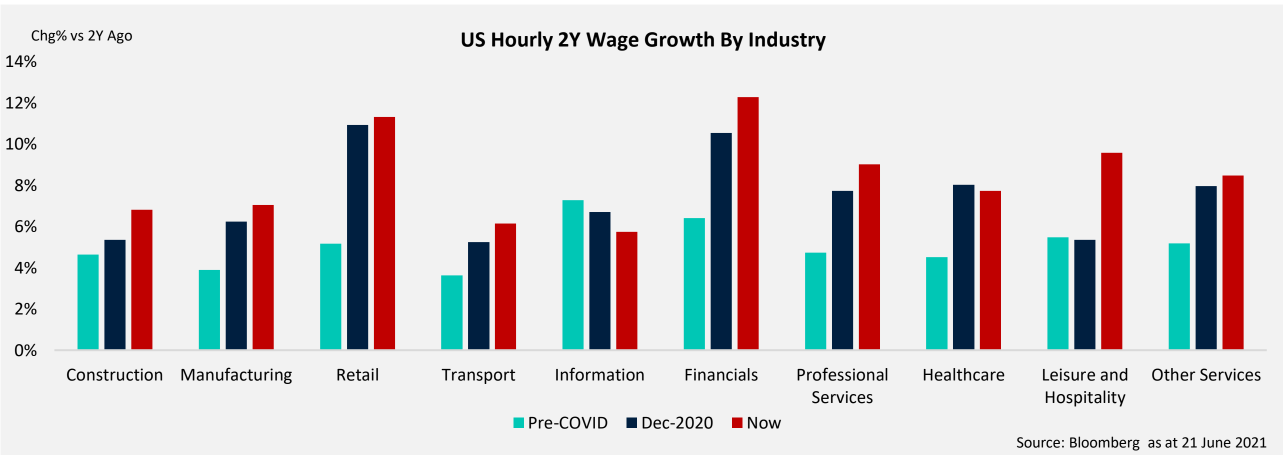


The key implication of labour shortage is mounting wage pressures. Recent economic cycles have seen wages move structurally lower due to increased globalisation, outsourcing, automation and a greater profit share going to corporates as opposed to labour. The following charts track the relationship between job vacancies and wages in the US and Australia over recent cycles and show how wages are positively correlated to the job vacancy rate and how the wage rate for the same job vacancy rate has consistently declined though recent cycles. Our assessment is that the latter is about to reverse and that the wage rate will start to structurally increase this cycle and beyond. This reflects a more deglobalised and fractionalised world, a greater focus on sustainability, demographics, and Government debt repayment in developed markets – but also deliberate reflationary and redistributive government policies. This change has significant consequences for inflation and underpins our view that inflation is moving structurally higher in the years ahead and accordingly alters portfolio investment assumptions and returns.



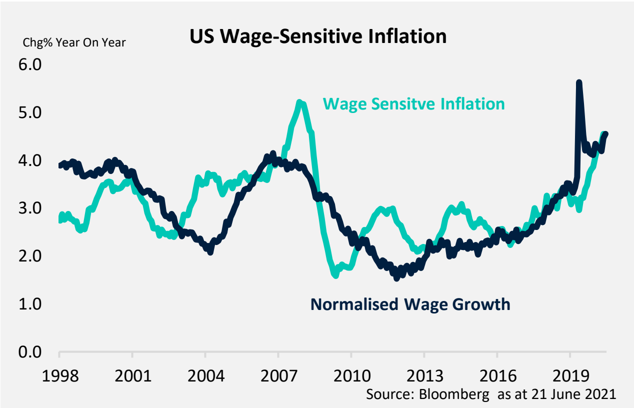


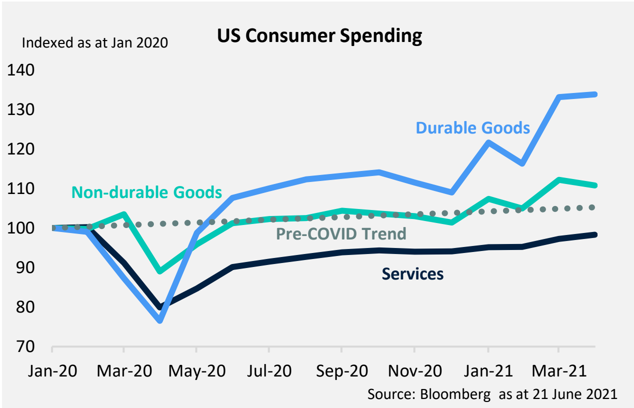
Recent data from the US is highlighting higher pay bills. Excluding data distortions from the pandemic layoffs, US 2-year wage growth has significantly outpaced the pre-COVID trend in almost every sector. In particular, the leisure and hospitality, retail and financials industries have reported the strongest pay rises. Large companies, such as Walmart, Costco, McDonald and Bank of America, have lifted their minimum wage by 20-90% to retain the staff. This is no doubt just the beginning.



Stronger wage growth also boosts household income, and this is turn flows through into higher consumer spending and inflation. The influences of wage growth on inflation are two-fold:

- 11% of US headline CPI inflation is directly linked to wages growth. This includes dining-out, household services, repairs, personal care services and laundry services. Between 30% to 90% of the payment from consumers directly flows through into the earners' pocket.
- 35% of inflation is indirectly associated with wage pressures *via* the traditional channel of the supply and demand equilibriums. Simply put, the more workers earn, the more they spend. As a result, when consumer demand outpaces supply in items with capacity constraints, businesses raise prices. This has already been seen in a range of items, such as cars, home appliances and regional travel.





Looking ahead, the duration of current labour shortages is unknown. In Australia, this largely depends on the timing of international border reopening as well as student/backpacker exemptions where some progress is being made. Recent outbreaks in Melbourne and Sydney could moderate the job market in June and July, as well as see teetering businesses fail due to restrictions and foot traffic numbers. In the US, the labour tightness could persist well into Q4 after the job subsidies end in September. All in all, the US labour market is stronger than expected and is consistent with a higher inflation trajectory than experienced in recent decades. The US Federal Reserve is starting to signal that interest rates will need to go higher and that recent inflation readings have a greater degree of stickiness than in the past. A new higher inflationary investment environment lies ahead and one that we will discuss in much more depth for your portfolios in the forthcoming quarterly report.

Other Publications

➢ To see the recent market developments and what we are watching, please see *ISG Chart Pack – May 2021* issued on 11th June 2021

➢ To read more about our views on asset bubbles of equities, bonds, commodities, and cryptocurrencies, please see *Monthly Investment Insights and Outlook May 2021 – Bubble Troubles!* issued on 26th May 2021

➢ To read more about our thoughts on the Bitcoin and other cryptocurrencies, please see *Investment Market Update – Cryptocurrencies Are Not the New Gold!* issued on 19th May 2021

➢ To read more about our portfolio positioning, economic backdrop, and views on the mega trends, please see *Quarterly Investment Insights and Outlook – April 2021* issued on 19th April 2021

➢ To read more about our views on inflation, please see *Monthly Investment Insights and Outlook March 2021 – Inflation, Is This the Big Market Risk?* issued on 30th March 2021

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Chief Investment Officer | Partner

Brigette Leckie has worked in financial markets since the early 1990s. Previous roles have included Chief Strategist, Chief Economist and Head of Research at Australian, New Zealand and multinational firms including BNY Mellon, Alliance Bernstein, Perpetual and BNP. She has also worked in New Zealand Treasury and served on numerous public and private sector committees. Brigette holds an MCom and BCom from the University of Canterbury.

Bi Zhou, CFA
Research Analyst

Bi Zhou is responsible for undertaking macro-economy/multi-asset research and data analytics at Koda Capital. Previous roles have included analysis and consulting roles at Aon Hewitt and LVMH Fashion Group. Bi is a Chartered Financial Analyst (CFA) and holds a Master of Professional Accounting from the University of Sydney and a Bachelor of Commerce from Shanghai University of Finance. Bi is a Paraprofessional Interpreter (Mandarin and English) of NAATI in Australia.

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