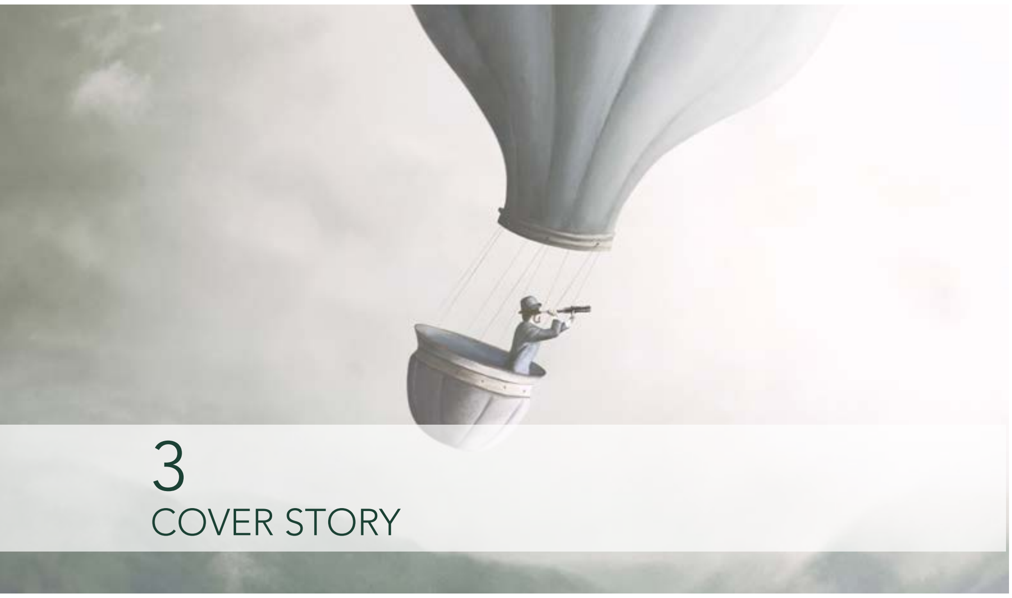
SIAA monthly

www.stockbrokers.org.au | February 2023

THE FUTURE
is closer than we think

CONTENTS



Stockbrokers and Investment Advisers Association
Serving the interests of investors

Stockbrokers and Investment Advisers Association Limited ABN 91 089 767 706

Level 2, 74 Pitt Street, Sydney NSW 2000

Email: info@stockbrokers.org.au

Tel: +61 2 8080 3200

www.stockbrokers.org.au

Advertising

Silvana Eccles, Education and Operations Manager

Email: silvana.eccles@stockbrokers.org.au

Tel: 02 8080 3204

THE FUTURE is closer than we think

By Andrew Varlamos, CEO / Co-founder, OpenInvest

Like many, I find it's always a worthwhile experience over January whilst there are fewer interruptions to catch up on some broader reading and deeper thinking. It forces me to question my assumptions, and to think again about various scenarios for the future of the Australian stockbroking and investment advisory industry.

I've concluded, as the saying goes, that the future might be closer than we think.

First, a quick restatement of the current state of play. When you take a step back and look with fresh eyes, one can only conclude that the current macro picture of our industry is, well, odd: advisers continue to exit the industry and new entrant numbers are anaemic; cost increases seem never-ending. Outcome: 90% of Australians receive no formal financial advice.

Drilling down a bit further: 60% of Australian's HNW investors do not have an investment adviser[1], whilst there is an "emerging affluent" cohort of 1.9m young Australians (under the age of 45) with an average investment portfolio balance of $700,000 and as yet, no financial adviser.[2] And of course there's the oft-quoted statistic – and I'll concede perhaps no one quotes this more than me! – that there's $3.5tr in wealth flowing to younger generations over the next two decades.[3]

What's that smell? Opportunity!

Which of course equals: an immense opportunity!

What other industry can boast about such huge pent-up demand, such an untapped market opportunity? And yet, demand and supply are just not meeting. Could they be? And if so, who is best placed to benefit?

Let's have a look at how large wealth managers are meeting demand in other countries. Morgan Stanley's recent 4th quarter results presentation makes for fascinating reading and listening.[4] In their results webcast on 17 January, CEO James Gorman speaks with clear pride at the growth achieved by their wealth management business – net new assets of over US$300bn – largely driven by cross- and up-selling to millions of new customers that came with recent acquisitions, of an employee share plan administration business and of E*TRADE, one of the original online brokers: "we are filling the funnel", in Mr Gorman's words.

Morgan Stanley has an offering for every sort of customer: self-directed trading; simple online access to the firm's managed portfolios; and for those whose wealth qualifies them, access to a Morgan Stanley adviser. Logical client segmentation, scalable technology and a constantly replenished pipeline of new clients for the firm's advisers equals incredible growth and profitability.

So, is it natural and inevitable that Australia's traditional stockbrokers will be the winners for our currently untapped market opportunity? Or are there other hungry and aggressive competitors, set to play by different rules, just around the corner?

"So, is it natural and inevitable that Australia's traditional stockbrokers will be the winners for our currently untapped market opportunity? Or are there other hungry and aggressive competitors, set to play by different rules, just around the corner?

Whose opportunity?

Let's look at three categories of challengers.

Everyone in the industry is aware of the incredible growth in new client sign ups achieved by Australia's online brokers in recent years. One statistic serves to make the point: in the year to March 2022, the number of Australians using the new breed of online trading apps (Raiz, Superhero, Stake, CommSec Pocket) had doubled to 1.8m, most under the age of 40.[5]

Are online trading apps really competition to a traditional stockbroker? Sort of....No... but then again, possibly, Yes. Could these businesses enhance and upgrade their services to offer ready access to professionally managed investment portfolios? To advisers?

In answering that question, let me refer to another big US company's results presentation I have enjoyed reading in recent days: Charles Schwab's 27 January (150 page) results update.[6] Charles Schwab of course was the pioneer of the discount brokerage model, in 1975 (yes, kids, in the Good Old Days, brokerage rates were fixed by the industry).

In their presentation, they highlight their number one ranking in active self-directed brokerage accounts (34m), but most of the presentation focuses on their progress in improving and adding to their recurring fee-based services: online access to managed portfolios, their own asset management products, wealth management advisers and even an UHNW service for clients with at least US$10m.

Like Morgan Stanley's results presentation, Schwab's focuses on their strategy of having a solution for every type of client – self-directed trading, those who want portfolio management and those who want a full advised wealth management experience; on client segmentation and on scalable technology to ensure efficient, profitable delivery of each service to each segment.

And crucially, of upselling clients to higher recurring fee services.

Because of course the boundaries between these different service propositions are not fixed: for example, Schwab's data shows a sharp increase in recent years in the willingness of their self-directed retail brokerage clients to pay for professional help.

I don't know whether Australia's online brokers have similarly ambitious plans, but I do know that the recurring revenues from portfolio management and advisory services must be looking particularly attractive in light of recent dramatic declines in retail trading volumes. And Schwab shows it can be done: that a discount broker can become a diversified wealth and asset management success.[7]

Who else might be planning to step up to target this Australian mass market opportunity?

Bancassurance 2.0

Well, we don't know for certain, but all signs point to the Government delivering at least enough regulatory changes now that the Quality of Advice Review final report is in to invite the major banks to return to wealth management.

What might this scenario look like? It surely won't resemble the banks' pre-Hayne approach: licensing armies of self-employed advisers around the country. Instead, it's likely to involve offering digital access to advice and managed investment portfolios. Just as major retail banks do in other developed markets.

Would this appeal? The bank customer won't get to sit down for a comforting chat with a suit-wearing adviser in a wood-panelled CBD office with a fine view and a coffee brought in on a silver tray. But their portfolio will be expertly managed by a recognised brand – the banks will be able to appoint any global tier one entity to perform the portfolio management function – who will keep them informed and up-to-date, with everything accessible via their bank app.

All for a much lower fee than any adviser can charge.

Two data points worth considering. First, back to the Schwab results presentation: they reference a 2022 McKinsey study showing that the share of (admittedly, US) retail investors who wish to consolidate their banking and wealth has nearly doubled since 2018 – and that a majority of young investors (aged 25-44) prefer consolidation.[8]

The second involves looking at how Australian customers are currently engaging online with their bank. There's so much data showing the ongoing shift of customers from in-branch to online banking that it seems pointless to highlight any single item - has anyone under 40 even been inside a bank branch, I wonder? – but here's something telling: the country's largest bank CommBank now has over 7m active users of its app (and over 8m digitally active users), who access the app an average of 36 times per month.

If you were running a bank, would you want to leverage this incredible level of engagement to solve all of your customers' financial needs, all from within the app?

Things that make you go hmmm

The third category of potential new entrant challenger is of course Big Tech. People write entire books on the possible/inevitable encroachment into banking/investments by Big Tech, and as I know nothing about it, I won't say anything – but no article on possible future scenarios is complete without at least referencing it. (Oh, ok then, here's one interesting statistic: 67% of Australia's 18-24 year olds use Apple Pay[9]....Hmmm).

Happy New Year!

The point of this article was not to make predictions; but the more I read and think, the more I conclude that we must be fast approaching an inflection point, that an increasing array of contenders – incumbents and challengers alike – will surely seek to reach out to better serve those millions of unadvised Australians with money to invest, who know they need professional help and are happy to pay for it.

I can't think of a more exciting time to be in this industry!

OpenInvest configures and deploys white label online investing solutions for its partners, allowing them to offer their own portfolios and associated content, in their branding, to their audience, in their way. You can find out more about the OpenInvest platform at https://www.openinvest.com.au/for-advisers/.

---

1. Investment Trends, September 2022.
2. https://www.afr.com/policy/tax-and-super/meet-the-under-45s-dubbed-the-emerging-affluent-20220421-p5af2l
3. Productivity Commission, December 2021: https://www.pc.gov.au/research/completed/wealth-transfers
4. 17 January 2023: https://www.morganstanley.com/press-releases/morgan-stanley-reports-fourth-quarter-2022
5. https://www.afr.com/wealth/investing/stop-dismissing-young-investors-stockbrokers-told-20220525-p5aogk
6. https://content.schwab.com/web/retail/public/about-schwab/schw_2023_winter_business_update_012723.pdf
7. It's worth noting that every major online broker in the US also offers online access to managed portfolio services and to advisers.
8. https://www.mckinsey.com/industries/financial-services/our-insights/us-wealth-management-a-growth-agenda-for-the-coming-decade
9. https://www.savvy.com.au/older-australians-love-online-banking-younger-generations-prefer-banking-apps/

SIAA-ACCREDITED CPD webinars

SIAA CPD accredited webinars are FREE for Principal, Practitioner and Affiliate members. Content will be delivered via panels, interactive discussion, presentation and quizzes and to be eligible for CPD you will need to participate in the live webinar.

Whether you work in executive management, sales trading, research sales, compliance, risk management, operations or in private advisory and wealth management, SIAA accredited CPD webinars offers bespoke content for all our members.

Cyber and AML/CTF – a guide to navigating the ever-growing intersections

Wednesday 22 February

1.00 to 2.00pm AEDT

Representatives from KordaMentha will present on the convergence of Cyber and AML risks and outline some of the scenarios currently presenting organisations with challenges. Discussion will include enforcement trends locally and how Australia is being viewed internationally; the implications from recent data loss events; why they are relevant to AML-CTF.

Professional standards CPD:
1.0 Professionalism and ethics

ASIC RG146: 1.0 Generic knowledge

Guillaume (Gui) Noé

Alice Saveneh-Murray

Tony Vizza

Emerging markets outlook and why you should not discount an active allocation

Tuesday 28 February

1.00 to 2.00pm AEDT

Assisted by eight analysts dedicated to India stocks and by Fidelity's global research team of 140 equity analysts and 400 investment professionals worldwide, Amit Goel, Portfolio Manager of the Fidelity Global Emerging Markets Fund, is well placed to provide insight into the risks, the opportunities and the outlook for emerging markets.

Professional Standards CPD:
1.0 Technical competence

ASIC RG146: 1.00 Generic knowledge

Amit Goel

Enhance income with covered call ETFs

Wednesday 8 March

1.00 to 2.00pm AEDT

After a tumultuous 2022, global banks and fund managers are united in their consensus that 2023 will deliver another volatile year. With sustained equity and bond market volatility, options strategies like covered calls can provide an alternative income solution that thrives in choppy or sideways markets. Join Global X ETFs Australia's Head of Distribution, Kanish Chugh as he explores how covered call strategies can help manage and diversify risk and generate income.

Professional Standards CPD:
1.0 Technical competence

ASIC RG146: 1.00 Generic knowledge

Kanish Chugh
Global X ETFs Australia

Practitioner & Organisation Members: **FREE** | Non-Members: **$55.00**

Thanks for supporting **SIAA's webinar** program during 2023

Fidelity International | investcloud | Kapstream – Janus Henderson | netwealth

FOR MORE INFORMATION OR TO REGISTER: 02 8080 3200 | education@stockbrokers.org.au

www.stockbrokers.org.au/education/cpd-webinars

CRYPTOASSETS – Trust and Custody

By Ian Love, Founder and CEO, Blockchain Early Opportunities Fund

The collapse of cryptoasset exchange FTX in November 2022 highlighted again the risk of leaving cryptoassets on unregulated exchanges. In this article I consider the Trust aspects of investing in blockchain technology through the lens of the FTX collapse.

Trust Verification Models

Our 'Subjective Centralised' Trust verification model relies on third parties (auditors and regulators) to verify the trust we place in centralised institutions. The collapse of Lehman's in 2008 exposed the systemic risk of this model. Each time there is a failure, the model is refined and improved. Over centuries this model has created esteemed trust companies like BNY Mellon, Northern Trust and State Street, to name a few.

This system is the best we have on a large scale. However, we continually seek to improve our safety and security and in the area of trust verification a new model was developed and implemented in 2009. This new model is a paradigm shift, it is based on 'Objective Decentralised Trust' and the first implementation of this model is the Bitcoin public blockchain.

Some people refer to public blockchains as trustless. I prefer to think of them as trust verification models where the human trust has been swapped out for Trust in the Code. Let's examine this model a little bit.

The starting point is the code itself, after all the code is written by humans so we have to at some point trust a human. This is where the publicly available nature of the code is important. Not only can the public read the code they can, potentially, submit changes to the community to make amendments to the code. So if the code says that '...if x happens then y will be paid z...' we know this is precisely what will happen. This is the objective part of the model.

But it is the decentralised nature of the model that is the major breakthrough. Because we now have the ability for multiple parties to simultaneously verify transactions. We do not need to rely on the centralised parties and the verification structures around those centralised parties. It is much more difficult to organise a bunch of individuals to work together to commit fraud than it is for a single individual to cook the books. Thus far the Bitcoin network has never been corrupted.

An 'Objective Decentralised Trust Verification Model' is the main value proposition of public blockchain technology. We see Ethereum and Bitcoin as being two of the most important base layers for the future trust models of humanity.

The FTX Collapse

On 1 November 2022 Sam Bankman-Fried was on the front cover of the Australian Financial Review - Young Rich List glossy magazine. On 11 November 2022 his companies filed for bankruptcy. The blow-up of FTX is an all too common story of a '...complete failure of corporate control...' and '... the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals...'.

One thing FTX has shown us is that there is significant demand for cryptoassets and what we have learnt (again!) is to never trust unregulated centralised crypto exchanges.

Custody and Cryptoassets

When I launched the Blockchain Early Opportunities Fund on 1 July 2017 there was only one properly regulated and insured Custodian. Since then a number of institutional grade service providers have emerged (although none in Australia).

What does it mean to be 'institutional grade'? Well, the most important criteria to consider is whether client assets are insulated from the bankruptcy of the service provider. Client assets should not be on the balance sheet of the service provider, they should be kept in segregated accounts and clients should never be considered as unsecured creditors in the event of a bankruptcy.

Our Fund's primary service provider is Anchorage Digital Bank National Association. Anchorage is a Federally Chartered Bank (see list here) and as such it is regulated by Office of the Comptroller of the Currency (OCC). Trust banks as they are known are subject to stringent controls including risk-based capital control adequacy assessments. They are expected to have a high degree of corporate oversight including an independent board with individual lines of responsibility for compliance, internal and external audits.

Where to next

Financial service providers are beginning to offer cryptoasset services to their clients. This can now be done in

a compliant manner. In the US we are seeing companies like Fidelity Digital offering Bitcoin and Ether to their clients via their platforms. According to Blackrock CEO, Larry Fink, the next big wave will be tokenised securities.

There is a significant opportunity here for existing investment advisors to expand their offerings and inform their clients about the dangers and opportunities of this emerging technology. It is not too early for advisors to become familiar with this space and be prepared to advise clients. The absence of good advisors is one of the reasons bad actors like Sam Bankman-Fried and FTX were able to flourish.

ASIC's revised consumer remediation Regulatory Guide RG 277: Practical considerations for stockbroking firms

By James Dickson, Managing Director and Danielle Radford, Director, Management Consulting, Oceanic Consulting Group

On 27 September 2022, ASIC released Regulatory Guide 277 (RG 277), replacing its longstanding ancestor RG 256. RG 277 outlines ASIC's expectations for how all holders of Australian Financial Services Licences (AFSL) and Australian Credit Licences (ACL) should structure policies, processes and procedures for examining compliance failures, misconduct and ultimately to compensate customers, who may have experienced loss or harm as a result.

Importantly, while RG 277 is drafted with retail customer remediation in mind, ASIC does state that consideration should be given to the application of the principals to wholesale clients and that it would consider it appropriate to include wholesale clients in some remediation efforts.

A little bit of history offers some helpful context

RG 256 was published in 2016, during a time when there was scarcity of knowledge relating to large scale, wealth management remediation programs, yet some larger programs, were in the initial stages of development. Globally, there were limited reference points, and ASIC needed to act swiftly to not only establish boundaries for operation but also a method to measure and evaluate the success of any program, particularly for advice licensees.

Fast forwarding to 27 September 2022, the landscape has changed, and there is now considerable experience onshore at Australian banks, brokers, consultancies, law firms and of course at ASIC. ASIC have drawn on the learnings now under our collective belt, and after seeking industry input of what was successful (and what was unsuccessful), ASIC has released a well drafted, user friendly Regulatory Guide RG 277 and complementary "Field Guide" *Making it right: How to run a consumer-centred remediation*.

Three crucial takeaways for leaders and risk professionals in stockbroking from RG 277

RG 277 places a heavy emphasis on proactive review and remediation. Where licensees have engaged in misconduct or non-compliance that result, or could result in, customer loss, ASIC expects that licensees will promptly initiate a program of review and remediation.

ASIC's expectations for proactive review and remediation centre around three key themes:

1. Remediation efforts should be customer-centric and should avoid an 'overly technical or legalistic approach when identifying misconduct or other failures.'
2. Licensees should not wait for customers to raise complaints or concerns prior to beginning remediation. ASIC calls on licensees to proactively initiate remediation, as soon as they become aware of the failure that caused the customer harm or loss.
3. ASIC clearly outlines that remediation efforts may not only be required for misconduct or compliance failures, that fall a foul of core obligations, but also notes that it may be appropriate to run structured remediation programs for breaches of industry codes of conduct.

ASIC's nine principals for remediation

ASIC outline nine principals in RG 277, as key considerations that should be adopted by licensees, in order to achieve fair and timely outcomes for customers:

1. The primary objective, and one that should underpin all decision making, is to restore affected customers as closely as possible to the position they would have been in had the misconduct or other failure not occurred.
2. Before commencing file reviews, licensees should understand the nature, scope and impact of the misconduct or other failure. Spending adequate time on this upfront will generally result in a more swift and complete finalisation of the program.
3. Where required, Licensees should make assumptions, in favour of customers, to avoid the possibility of undercompensating.
4. Unfortunately, decisions on remediation programs are often poorly documented. Licensees should justify and document important decisions thoroughly.
5. Licensees should ensure all reasonable efforts are made when distributing compensation payments and should document these efforts clearly. If payments cannot be made, charities or unclaimed monies schemes should only be considered as a last resort once all other reasonable attempts have been made.
6. Licensees should balance timeliness, with delivering quality customer outcomes. This will mean, from time to time, decisions will have to be made in the customers favour, to finalise matters that have been outstanding or some time.
7. Where possible, customer involvement should be limited or even eliminated. Where customers need to be involved in the process, it should be as simple as possible for the customer.
8. Licensees should have no benefit financially from misconduct or other failures.
9. Licensees should allocate sufficient resources, establish responsible leadership, governance, and accountability for the program.

Communications to customers

The aforementioned "Field Guide" that accompanies RG 277 is a well-considered and helpful document for licensees that are considering their approach to remediation and want to establish, or uplift their processes, particularly with regards to becoming more customer focused and improving communications planning. The guide assists licensees in ensuring their programs are transparent, effective, and fair. It provides practical steps for licensees to design, implement and monitor remediation programs, whilst prioritising customer outcomes, by focussing on:

- Designing, testing, and piloting a communications plan.
- Knowing your customer; engaging with affected customers and tailoring communications for their requirements.
- Ongoing monitoring and reviewing the effectiveness of the program.

'Resource C: Good Practise in Communications', is a particularly useful reference when considering the drafting of communications to customers. At the highest level, ASIC is asking licensees to keep it simple and easy to consume for customers, so they can understand their position, and make a fully informed decision as to the next steps required.

OCG is a professional services firm that delivers value through deep subject matter and industry expertise, formed with the desire to change the management consulting landscape. Our Principals have technical expertise, backed by decades of experience, leading firms in markets, wealth management and banking, in Australia, Europe, Asia and the US.

TECHNIQUES	DESCRIPTION
Personalise	Tailor the message: if different groups need different information, prepare separate materials for each group rather than forcing a one-size-fits-all message. Ensure the channel of communication suits your audience.
Layer information	Only include information necessary for the reader to make a decision or to act. Background and other information can be put at the end, on a separate page, or be left out completely.
Order information effectively	Order the information from most to least important from your reader's point of view.
Embrace white space	First impressions matter. If letters look dense or too wordy, people will not read on.
Use headlines	Use an action-oriented title, bold key points, or include a summary box with two to three of the most important key points to catch the eye upfront.
Provide signposts	Create short sections with reader-centric labels, so it's easy for the reader to find answers to their questions. Use labels that are action-oriented, instructional or written as a question.
Slash your word count	If you had to cut your words by half, how would you do it? Remove jargon and use short sentences and plain language. Aim to keep letters under one page in length.
Make it attractive	Highlight the benefits to your consumer and make the communications visually appealing. Use design elements to draw attention to key information.

Source: ASIC Making it right: How to run a consumer-centred remediation Page 17, Resource C: 'Good Practise in Communications'.

SIAA WORKSHOPS

Introduction to stockbroking

Wednesday 1 March 11.00-1.15pm

Australia's financial markets are among the most sophisticated and well-regulated markets in the world. Central to the operation of efficient markets is the role of stockbrokers. This workshop provides an overview of Australia's financial markets and the critical role that stockbrokers play both in retail and institutional markets. A high-level view of stockbroking and financial advisory operations including order taking, transaction and settlement will provide insight into the different systems involved and allow for a discussion of the different business models in stockbroking today.

RUSSELL McKIMM During his 40+ year career in stockbroking Russell has held a number of senior management positions in leading broking firms as well as providing advice to a wide range of clients. He has also been involved in numerous industry bodies, lectured in many industry courses and featured regularly on his talkback radio program.

Professional Standards CPD Area

Regulatory compliance and consumer protection 1.0 hour

Professionalism and ethics 0.5 hour

Technical competence 0.5 hour

Market Manipulation & Other Prohibited Conduct

Thursday 2 March 11.00-1.15pm

This workshop on the prohibition on creating or maintaining an artificial price for trading in various financial products, including shares and futures, will benefit all who wish to gain an understanding of markets and the consequences of breaching obligations. Designed to suit the needs of financial market professionals from the front and back office, this is a great opportunity to brush up on your obligations, learn how to protect yourself and understand the difference between manipulation and ordinary market forces.

PROFESSOR MICHAEL ADAMS is a specialist in Australian corporate law and international corporate governance. Michael has expertise in financial services regulation, information governance, consumer protection and the broader area of legal technology and education. Professor Adams was Dean of Law at Western Sydney Law School from 2007 to 2017 and from 2019 the Head of the University of New England Law School.

Professional Standards CPD Area

Regulatory compliance and consumer protection 1.0 hour

Professionalism and ethics 1.0 hour

A day in the life of a trade

Thursday 9 March 11.00-1.15pm

An excellent refresher for experienced staff and perfect for those in auxiliary roles (eg legal, IT, HR and other supporting roles associated with stockbroking), this workshop delves deep into the day of a life of a trade. You will walk away with a solid understanding of client onboarding processes, the process of share and derivative trades from order placement through to execution to settlement, sponsorship/HINS, CHESS messaging, registries and more.

ROB TALEVSKI joined Webull Securities, a Fintech empowering individuals to become life-long investors, as its CEO in November 2021. Prior to this he was the Responsible Manager who led the trade execution business of Australian Investment Exchange (AUSIEX). With over 18 years' experience across retail, wholesale and institutional channels Rob will provide great insight into a day in the life of a trade.

Professional Standards CPD Area

Regulatory compliance and consumer protection 1.0 hour

Technical competence 1.0 hour

ASIC Knowledge Area

Generic knowledge 2.0 hours

Cost

Practitioner Members $100 | Organisation Members $150 | Non-members $200

Register four or more *(Organisation Member or Non-member)* **more than a week prior to the workshop to receive a $50pp discount.**

Registration includes handouts and a quiz to consolidate learning outcomes.

TO REGISTER: Call 02 8080 3200 | Email **education@stockbrokers.org.au** or register online

www.stockbrokers.org.au/cpd-workshops

Five key themes for 2023

By Alex Stanley, Relative Value Strategist, Ardea Investment Management

Macro forecasting is not part of our investment process because we adopt a pure relative value investment approach that aims to be independent of the level of bond yields, the broad direction of interest rates and the macroeconomic factors that dominate the performance of conventional investments.

Therefore, instead of the traditional year-ahead forecasts, here we will discuss the substantial risks around consensus views and highlight five key themes that will impact global interest rate markets in 2023.

1. The peak in central bank rates

2023 is widely expected to mark the end of one of the fastest and most synchronized G10 central bank tightening cycles on record. In the face of surging inflation, central banks had to be aggressive in 2022 to get rates from ultra-accommodative to restrictive through outsized monthly hikes. Rate hikes delivered so far ought to buy central banks some time to pause and assess. Markets are well priced for the consensus peak rates theme in 2023.

The justification for central banks to pause on rates is expected to come from slower inflation and growth. After a year of large upside surprises, there are reasons to think inflation will fall materially, based a few broad factors:

- Global supply chain price pressures have fallen sharply and are at least a quarter of the levels reached at the start of 2022.
- A fading of large base effects from food and energy supply shocks.
- A further material slowdown in global growth, as the impact of policy tightening to date flows through.

The effects of surging rates and inflation in 2022 have contributed to a significantly weaker global growth outlook for 2023. On IMF numbers, global growth is expected to be 2.7%, but with advanced economy growth of just 1.1%. For the world this would mark the weakest outcome since 2001 outside the global financial crisis and the onset of COVID. Many market economists have more bearish growth forecasts, and the UK and Europe are widely expected to experience recessions.

The risks to current market pricing and consensus views on rates are significant in both directions, leaving central bank policy uncertainty a major issue for investors to navigate next year. One of the biggest risks – as with 2022 – is the outlook for inflation, where forecasting errors have reached record levels. While it's not hard to see headline measures falling from the current high levels of 8% y/y or higher, by the end of next year inflation is still broadly expected to remain above central bank target levels. Widely held views for a cycle pause are about central bankers gaining comfort in the trajectory more than the level of inflation. Ultimately, economies and in particular labour markets could hold-up better than currently anticipated, so there is a risk central banks become more concerned about ongoing high inflation becoming entrenched. This outcome would see rate hike cycles extend for longer than currently anticipated. In the other direction, a faster fall in inflation or sharper downturn in growth could see rate cuts brought forward.

Cross market differences could also turn out to be very large next year, as central banks have varying attitudes on the risks of overtightening. The Fed has been ultra-aggressive in its reaction to higher-than-expected inflation this year, while smaller central banks such as the BoC and RBA have already slowed the pace of tightening.

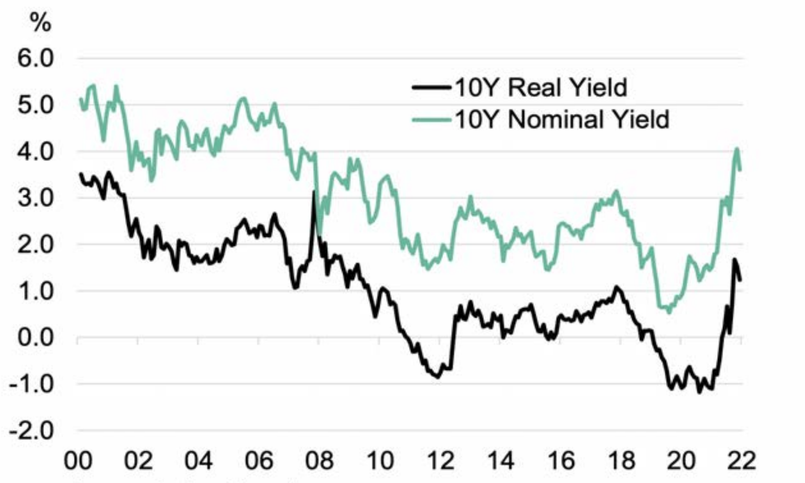
2. The improved risk/reward balance for duration

2022 has been one of the worst ever years for duration heavy portfolios. So the bar for 2023 being better is low and there is a growing chorus of market participants calling for a bond rally. We examine three factors that suggest an improved outlook for duration in 2023:

- The return of yield. Cheaper valuations following the big sell-off through 2022 improve prospects for bonds, albeit a bit less since the peak in long term yields in October. Nominal yields of 3.5-4.0% and real yields over 1.0% for 10y US Treasuries offer investors a level of pickup for the safest of assets unseen in over a decade. Through 2020 and 2021, long term government bonds were better described as return free risk (see Chart 1).
- Peak inflation and rates. The path for bonds through 2023 will come down to the resolution of the tension between slower global growth and rising inflation. If the consensus is right that the Fed, ECB and other central bank rates peak in 2023, then history suggests long duration bonds tend to perform well. Chart 2 shows owning US 10y Treasuries is reliable post the last hike, whether we see a soft or hard landing in the economy. A quicker transition to rate cuts would favour outperformance of shorter maturities - steepening the yield curve after relentless flattening in 2022 (see Chart 2).
- Improved risk asset hedge: The last hike in the cycle also tends to be good for equities, but markets could well be underestimating the significance of an impending slowdown or recession. Bonds yields are now high enough to offer a more attractive buffer in multi-asset portfolios. This hedge value of duration is one reason why longer maturity bonds still appeal to many investors despite global yield curves being steeply inverted or historically flat (depending on market).

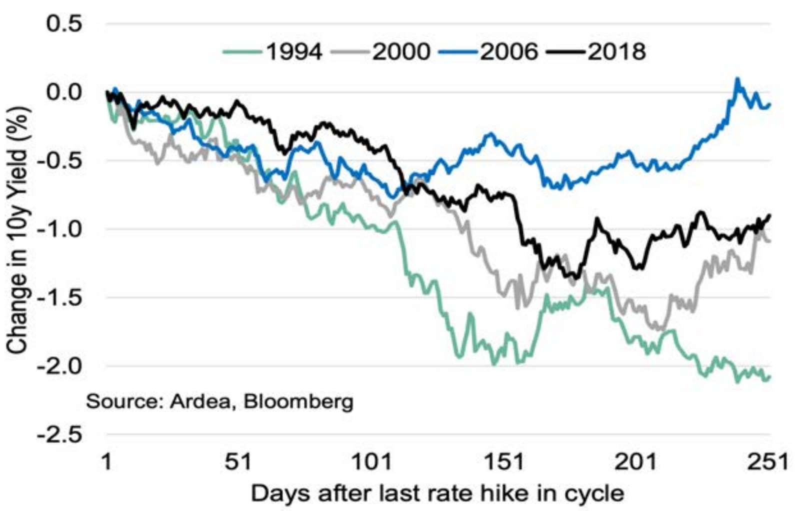
Much like we described in our key themes note this time last year, the level of global macro uncertainty is still very high. By far, getting the call on inflation wrong could again prove most costly for investors. The potential for persistent high inflation to set into wages or another surge higher in commodity prices could be enough to see the market jettison peak policy views in a hurry. These and other issues may not be resolved quickly which means yields are likely to track quite wide trading ranges.

Chart 1: US 10y real and nominal yield over the long term



Source: Ardea, Bloomberg

Chart 2: Change in US 10y yield after last rate hike in the cycle



Source: Ardea, Bloomberg

3. QT and rising net bond supply

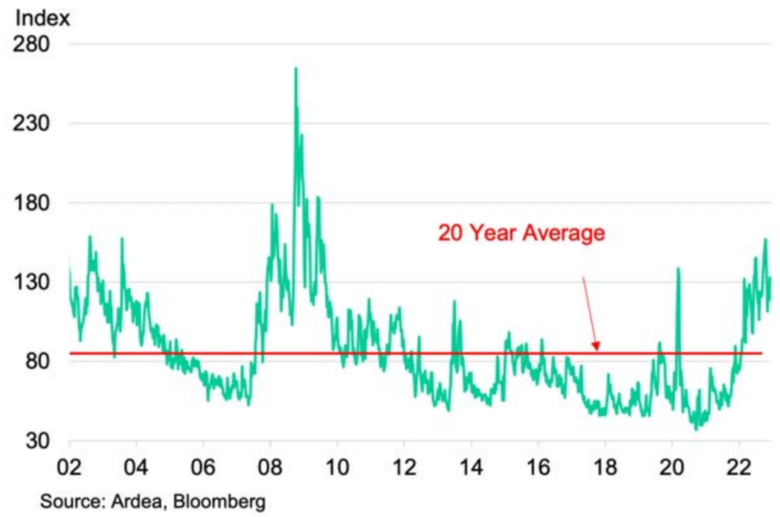
Central banks have ended their massive covid QE programs and are transitioning quickly into quantitative tightening (QT) or actively reducing balance sheets. This marks a big shift for bond markets. Across markets, central banks hold anywhere from 25% to 50% of bonds outstanding. This year is likely to see over US$1tn of QT from the largest central banks.

The main implication of QT for government bond markets is increased net bond supply for private investors to absorb (there are other effects such as reduced excess cash reserves, which can impact money markets). The shift in the demand burden to private investors to take down more of the net issuance next year poses risks for markets. For their part, central banks generally aim to implement QT in a consistent and predictable manner, in contrast to the more aggressive removal of duration from the market when entering QE. Still, the impact of QT is likely to be quite profound in 2023. The magnitude of the extra issuance will vary considerably by region and could see bond underperformance and steeper curves in markets where the relative net supply increase is largest, such as Europe and the UK.

In the US, the Fed is set to continue its existing pace of QT, which consists of allowing steady maturities of $60bn in US Treasuries and $35bn in MBS per month. For 2023, that implies an extra $720bn of bonds the Treasury will have to refund and investors therefore absorb, up from $150bn in 2023. The market impact is somewhat mitigated by an improved fiscal position.

The relative size of the increase in the free float supply is expected be largest in Europe and the UK. Over the last decade, previous larges waves of European government bond supply came at a time of simultaneous large increases in ECB purchases. For the seven years prior to 2022, negative net issuance was the norm in Europe. The tide is now turning. Many analysts anticipate the increase in the net supply of bonds after QE in 2023 to be the largest on record at €400-700bn.

Since 2008, the UK has also only seen large issuance tasks at times of QE. The BoE has resumed its QT plans after the government credibility crisis in September drove EM-like moves in Gilts. Even with new leadership and plans, the 2023 increase in bond supply is substantial. Many analysts look for issuance net of QE to rise to £250-300bn of gilts this year, compared with prior peaks closer to £100bn in the last decade.



> "Central banks have ended their massive covid QE programs and are transitioning quickly into quantitative tightening (QT) or actively reducing balance sheets. This marks a big shift for bond markets.

4. Large tail risks limit scope for volatility to fall

The shock and awe of constant inflation upside surprises and outsized interest rate increases has driven global interest rate volatility to historically high levels in 2022. As Chart 3 illustrates, the MOVE index of US Treasury option implied volatility reached the highest level since 2009, triple the late 2020 lows and the upper end of a 20-year range. Comparable measures of volatility in EUR rates eclipsed the 2008 peak and in GBP volatility surged to new record highs through the September UK market crisis (see Chart 3).

The last month has seen volatility retreat from those extremes, to what are still high levels. The catalyst has been speculation central banks will slow the pace of tightening. As discussed in themes one and two above, if central banks are nearing a cycle peak in rates, then the recent downshift in volatility could continue into 2023.

However, as also outlined above, the scale of macro uncertainty in both directions on rates remains substantial and not easily resolvable in a stagflationary regime. Therefore, volatility seems unlikely to fall back to the 2020-2021 lows in a hurry and could remain elevated in 2023. Of course, if inflation fails to fall meaningfully, then elements of the 2022 regime could linger. But even if inflation does fall as the consensus expects but remains above target, a policy pause could push up volatility if markets ponder a policy mistake.

In a broader recession scenario, a faster move to central bank rate cuts and flows into bonds from riskier assets could drive a substantial bond rally.

5. Macro uncertainty supports the RV opportunity set

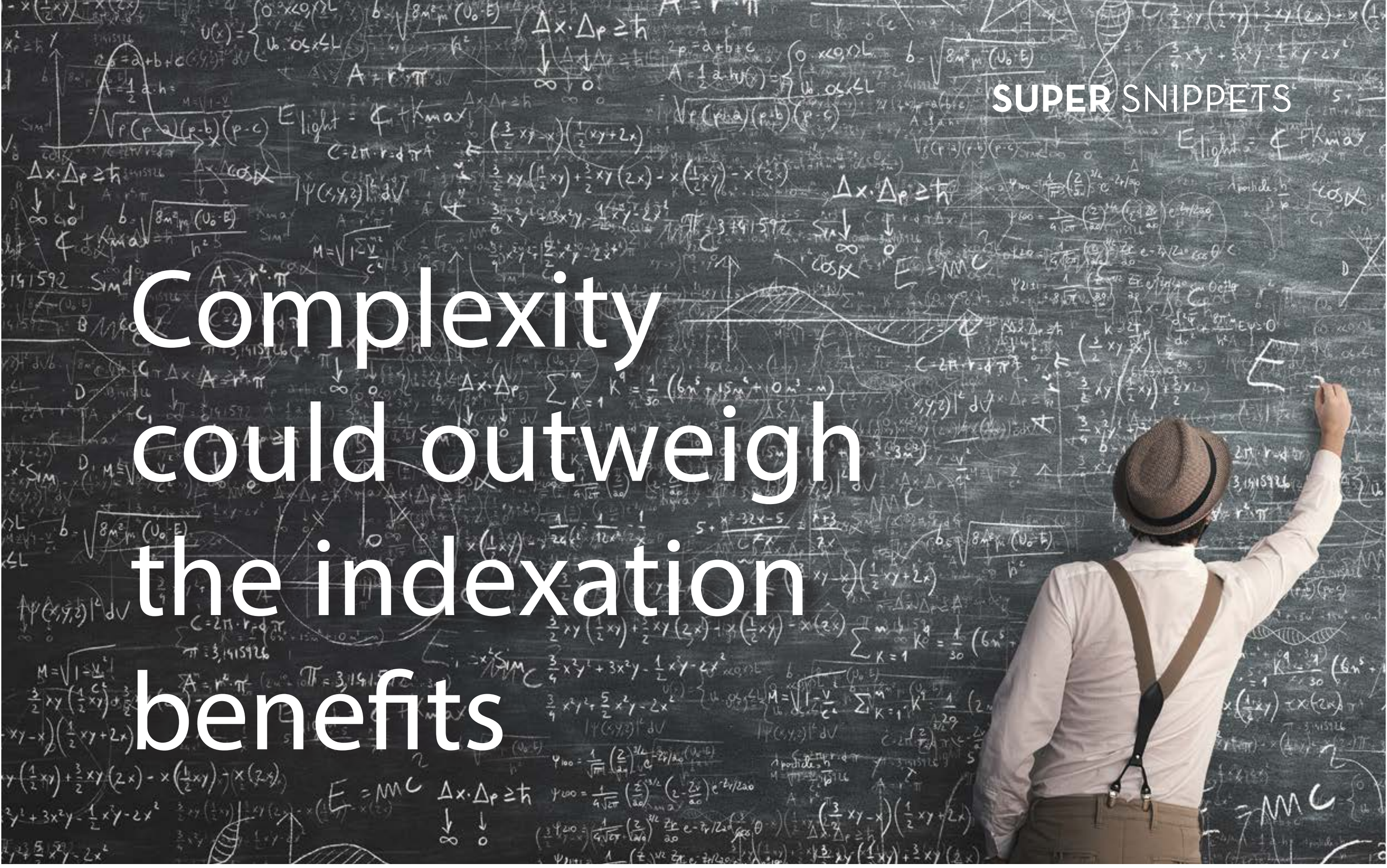
Opportunities in interest rate RV don't rely on the broader level and direction of rates, risk asset performance or macro variables like growth and inflation. While there isn't an absolute clear good or bad market for pure RV portfolios, in general the links with broader market environments are as follows:

1) Extreme low rates volatility (such as the Japan experience) is a negative.
2) Higher rates volatility is generally positive, but not in all situations.
3) RV alpha is structural, but the mix of opportunities changes with underlying market factors such as bond supply/demand dynamics.

However, the pressures on RV over the last year have been unusual. RV pricing relationships are unlikely to remain at 2022 extremes indefinitely, even if volatility remains higher than normal.

Beyond an anticipated easing in stress indicators from extremes, the high level of underlying macro uncertainty is likely to create new RV trading opportunities in 2023. The tension between high inflation and weaker growth can further distort yield curve shapes as the market struggles to price a wide distribution of rate outcomes. High macro uncertainty also gives rise to flows which leads some sectors of bond curves to cheapen or richen relative to others. The rise of net supply and QT discussed in theme three is already leading to increased risk premiums in government bonds and we anticipate this to continue this year.

This article was first published on 13 December 2022 with the original version including all charts available here https://www.ardea.com.au/5-key-themes-for-2023/.



Complexity could outweigh the indexation benefits

By Darin Tyson-Chan, Editor, *selfmanagedsuper*

The consumer price index (CPI) figure for the December quarter 2022 was released on 25 January and is very significant for superannuants. That's because the possibility indexation may be applied to the general transfer balance cap (TBC) hinges on this very data point.

And this isn't any ordinary round of indexation that might be applied. While I won't go into the minute details of how the indexation formula works, the inflation rate of 7.8 per cent, the highest in over three decades, has paved the way for two stages of CPI-driven indexation to be imparted on the superannuation system on 1 July 2023.

What this translates to is having the general TBC jump from its current level of $1.7 million to $1.9 million. The movement is very unusual considering indexation increases to the general TBC were designed to be in $100,000 increments, which is what occurred when the initial inflation-neutralising exercise was undertaken on 1 July 2021.

“... the inflation rate of 7.8 per cent, the highest in over three decades, has paved the way for two stages of CPI-driven indexation to be imparted on the superannuation system on 1 July 2023.

But of course the Turnbull government wouldn't have foreseen we would be experiencing record levels of inflation throughout 2022 when formulating the rules associated with the operation of the TBC when it was introduced.

Whenever indexation provisions are implemented they are usually seen as a positive development as it means the purchasing power of the dollar is being maintained, and this is of course true in this instance. However, the way in which the indexation has been slated to apply to individuals with an existing pension interest within their superannuation fund suggests, in this instance, the administrative complexity could actually outweigh the notion of purchasing power parity.

Observant readers may well have already noticed the use of the term general TBC throughout this column. That's because since 1 July 2021 every superannuant has had to observe the general TBC and their own personal TBC.

How did this come about? Well it's basically because indexation is to be applied proportionately to an individual's unique situation. Explaining how the system works is relatively easy in the context of the TBC jump that occurred in 2021.

As mentioned earlier, the general TBC jumped from $1.6 million to $1.7 million in the 2022 income year, but this did not mean superannuants already in pension phase could enjoy the full $100,000 increase. The amount of indexation they could take advantage of depended on the value of their pension at the time of the increase.

For example, if a person had a pension worth $800,000 in place before 1 July 2021, it would mean they had used up 50 per cent of their original TBC of $1.6 million. As such, the rules dictated when the general TBC rose by $100,000 they were entitled to include an additional $50,000 to their personal TBC. In this instance it would result in the person's own TBC totalling $1.65 million.

Similarly, if a person had an existing pension at 1 July 2021 valued at $1.6 million, they would receive no benefit from the indexation exercise as they would have already used 100 per cent of their allowable TBC.

Confusing? Maybe not for people working in the financial services industry, but it's certainly not a process you could describe as simple.

Fast forward to 1 July 2023 when the second proportionate TBC increase has to be taken into account and you can see it's going to get really complicated in a hurry. I will though try and unpick it all for you.

Let's assume in the situation I used above the super member with the $800,000 pension did not increase or decrease the said income stream. This means they would still be adjudged to have used only 50 per cent of their personal TBC. Extending the methodology to the potential $200,000 general TBC increase coming in on 1 July 2023, they would be able to increase their personal TBC by a further $100,000, being 50 per cent of the full increase.

This would result in their personal TBC settling at $1.75 million from the 2024 financial year and beyond.

In this instance I've kept the numbers and calculations involved very simple, but we all know real life is not as neat. What if the person had increased the value of that original pension? This increase would have to have been taken into account, a new calculation determining the proportion of their personal TBC that had been used would have to be performed and this new determined percentage would then have to be applied to the $200,000 to arrive at their new personal TBC.

As you can see, superannuation administration and pension strategies are about to become infinitely more complicated and no doubt there will be a significant number of genuine errors surfacing as a result.

To subscribe to *selfmanagedsuper* please visit www.smsmagazine.com.au

SIAA2023

30-31 May 2023
Sofitel Sydney Wentworth

Change.
Challenge.
Opportunity.

REGISTER TODAY

TO REGISTER OR FOR MORE INFORMATION VISIT
www.stockbrokers.org.au/siaa2023

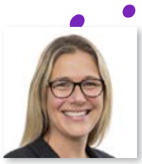
EARLY BIRD RATE until 30 April 2023

Practitioner member	Organisation member	Non-member
$950pp	$1,250pp or $950pp if registering 4 or more	$1,550pp or $1,250pp if registering 4 or more

Registration includes:

- ✓ Lunch and refreshments for the two days
- ✓ Networking drinks at the Verandah Bar at the end of day one
- ✓ Opportunity to network with other delegates, sponsors and exhibitors
- ✓ Confirmation of SIAA-accredited CPD (over 15 hours available)
- ✓ Access to video recorded presentations post-conference.

Speakers include:



Chantal Giles
Managing Director, BlackRock

Helen Lofthouse
Managing Director and Chief Executive Officer, ASX

Jeff McMillan
Head of Analytics, Data & Innovation, Morgan Stanley Wealth Management

Andrew Pridham AO
Group Vice Chairman, MA Financial Group

MAJOR PARTNER
ASX

GOLD PARTNER
FinClear

SILVER PARTNERS
Acclaim Wealth
Cboe
HALO Technologies
iress
Oceanic Consulting Group
SAXO Invested

BRONZE PARTNERS
Australian Money Market
Compli FinTech Solutions Ltd
DDH Graham Limited
HUB24
Leveraged The professional's choice
Magellan Experts in Global Investing
Mintegrity
netwealth
praemium
SecuritEase
The Perth Mint Australia

SUPPORTER
Holley Nethercote

MEDIA PARTNER
ausbiz