

# ***Wealth Update***

Winter 2022



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Welcome to our latest Wealth Management Update.

This edition covers the following topics:

- Australian banking reporting season update
- International shares reporting season update
- Russia-Ukraine conflict update
- Investment interest rate hikes

## Australian banking reporting season update

Three of the Australian banking majors reported their H1FY22 financial results during the month of May (CBA having already reported in February). A broad summary of these results can be seen in the table below.<sup>1</sup>

H1FY22 results (% changes are relative to H1FY21, (Mar'21 to Mar'22) <sup>2</sup>						
Bank	Net Interest Margin (%)	Cash earnings (\$b)	Operating expense (\$b)	Return on equity, cash (%)	CET 1 capital ratio <sup>3</sup> (%)	Dividend (\$)
ANZ	1.58 (-0.05)	3.11 (+4.1%)	4.79 (+6.9%)	10.0 (+0.3)	11.5 (-0.90)	0.72 (+0.02)
CBA	1.92 (-0.14)	4.75 (+22.7%)	5.59 (-0.1%)	12.3 (+1.8)	11.3 (-0.80)	1.75 (+0.25)
NAB	1.63 (-0.11)	3.48 (+4.1%)	3.96 (+2.6%)	11.3 (+0.2)	12.5 (+0.11)	0.73 (+0.13)
WBC	1.85 (-0.24)	3.10 (-12.4%)	5.14 (-1.9%)	8.7 (-1.5)	11.3 (-1.01)	0.61 (+0.03)

H1FY22 results (% changes are relative to H2FY21, (Sep'21 to Mar'22)						
Bank	Net Interest Margin (%)	Cash earnings (\$b)	Operating expense (\$b)	Return on equity, cash (%)	CET 1 capital ratio (%)	Dividend (\$)
ANZ	1.58 (-0.07)	3.11 (-3.0%)	4.79 (+4.9%)	10.0 (-0.2)	11.5 (-0.80)	0.72 (0.00)
CBA	1.92 (-0.17)	4.75 (-0.8%)	5.59 (-3.1%)	12.3 (-0.3)	11.3 (-1.30)	1.75 (-0.25)
NAB	1.63 (-0.06)	3.48 (+8.2%)	3.96 (+0.2%)	11.3 (+1.0)	12.5 (-0.52)	0.73 (+0.06)
WBC	1.85 (-0.14)	3.10 (+71%)	5.14 (-9.9%)	8.7 (+3.7)	11.3 (-0.99)	0.61 (+0.01)

### Net Interest Margins

Net Interest Margins (NIMs) declined over the half (and indeed the year) for all majors as a result of fierce competition for loans and a continued customer switch into lower margin fixed rate loans. Notwithstanding the

<sup>1</sup> CBA's fiscal year ends in June, therefore FY21 is the fiscal year ending June'21, H1FY22 is the fiscal half year ending Dec'21.

<sup>2</sup> ASX, Home [online], <https://www2.asx.com.au/>, (accessed 9 June 2022).

<sup>3</sup> The CET1 capital ratio is the Common Equity Tier 1 capital ratio.

continued contraction in NIMs, banks should benefit from margin expansion over the next year as interest rates rise. CBA's NIMs continue to be sector-leading.

### **Cash earnings**

Cash earnings benefited from writebacks of large loan loss provisions recorded in the prior period (H2FY21). Westpac's earnings, in contrast with peers, benefitted from a ramp-up in its cost-out programme (pre-provision profit growth was around 3%), with the bank being the only one of the majors to record an impairment charge (approximately 14 basis points) and also posting the worst revenue decline in the sector. Cash earnings should normalise over coming periods as banks cycle off low earnings.

### **Operating expenses**

As noted, WBC has significantly cut-back on operating expenses and reiterated its ambitious targets to make further reductions in coming years. ANZ's operating costs were significantly higher during the half, driven by a spike in investment spending. This has led to ANZ abandoning its previously announced expense targets. Similarly, NAB has abandoned its ambitious cost targets as it grapples with cost pressures, namely a result of inflation and increased regulatory costs.

### **Return on equity**

CBA's Return on Equity (RoE) continues to lead that of peers.

### **Capital ratios**

All banks have adequate CET1 capital ratios, above the Australian Prudential Regulation Authority (APRA)<sup>4</sup> benchmark.

### **Dividends:**

All banks increased their dividends when compared to H1FY21, as banks continue to cycle off low earnings.

### **Conclusion:**

In general, the banks reported solid results for the first half of FY22. NAB's result was particularly strong, as earnings were not predominantly a product of cost-cutting, as was the case with Westpac's. CBA posted a strong result in February, once again justifying the reason why it commands a share price premium relative to the other three. The question remains, given CBA's Price to Earnings (P/E) ratio of 18, compared to Westpac's of 16 and the two other majors (approximately 12), as to whether its share price premium is justified. Although it can be argued that CBA has the strongest brand, better economies of scale, more advanced IT systems and investments in high growth companies like Klarna, we would argue that the premium is still excessive. Nevertheless, the immediate outlook for bank earnings remains buoyed by higher Net Interest Margins, although these tailwinds could well be challenged should interest rates move much higher where the prospect of rising loan defaults by overstretched borrowers are likely.

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<sup>4</sup> APRA is an independent statutory authority that supervises institutions across banking, insurance and superannuation and promotes financial system stability in Australia.

# International shares reporting season update

Note: Results referring to percentage changes (increases/decreases) relate to the previous corresponding period (pcp), e.g., Q4FY22 results are compared to those of Q4FY21.

## Adobe (ADBE:US)<sup>5</sup>

<b>Share price</b>	8/6/2022: US\$428.84
<b>Result</b>	Q1 FY22
<b>Revenue</b>	US\$4.26b, up 9% on the pcp.
<b>Underlying Earnings per Share (EPS)</b>	US\$3.37, an increase of 7% on the pcp.
<b>Key points</b>	<ul style="list-style-type: none"> <li>• Faces headwinds from a stronger US Dollar (reducing international earnings).</li> <li>• However, it still maintained guidance for double-digit revenue growth in FY22 across its key segments of Digital Media and Digital Experience.</li> <li>• Continues to grow its reach across creative applications with offerings under the Creative Cloud umbrella seeing use cases e.g. new media such as 3D.</li> <li>• Continues to invest in organic and acquired research and development to maintain attractiveness for existing and new clients.</li> <li>• Result achieved despite ceasing all sales into Russia and Belarus with an expected hit to revenue of US\$75m in FY22 (also including expected decline in Ukraine demand).</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>• Results show continued execution of the broader Adobe platform business with partners (businesses that piggyback off Adobe solutions and help spread their usage) continues to grow. Russia-Ukraine conflict had a relatively minor impact on overall business performance.</li> </ul>

## Amazon.com Inc (AMZN:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$121.18
<b>Result</b>	Q3 FY22
<b>Revenue</b>	US\$116.4b, up 7.3% on the pcp.
<b>Underlying EPS</b>	-US\$7.56 (not adjusted for share split).
<b>Key points</b>	<ul style="list-style-type: none"> <li>• Inflationary pressures continued to impact the retail business, including higher shipping costs (partly due to lockdowns in China and higher energy prices).</li> <li>• Another contributor to higher expenses was higher wages and weaker productivity with Amazon management citing a situation of being overstaffed (relative to customer demand).</li> <li>• Amazon Web Services (AWS), the cloud computing offering of Amazon, saw net sales of US\$18.4b in the March quarter, reflecting growth of 37% for the year as the company continues to be a market leader.</li> <li>• The net loss in this quarter was US\$3.8b largely driven by a pre-tax valuation loss of US\$7.6b for its holding in automotive business Rivian (partly reversing a US\$12b gain in the previous quarter).</li> <li>• The previously announced 20-for-1 stock split occurred in early June, potentially improving liquidity for retail shareholders (although this impulse in the US is weakening between lower fiscal stimulus and higher interest rates).</li> </ul>

<sup>5</sup> Reuters, company transcripts, CapitalIQ.

<b>Our comments</b>	<ul style="list-style-type: none"> <li>• AWS continues to be the core part of the Amazon value proposition with strong sales and stronger profitability growth a hallmark, particularly notable given its already large size relative to other providers.</li> <li>• Inflation remains a risk given the scale of the retail business for Amazon, in particular, the number of employees and capital spending requirements.</li> </ul>
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#### Apple (AAPL:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$147.96
<b>Result</b>	Q2 FY22
<b>Revenue</b>	US\$97.3b, up 8.6% on the pcip.
<b>Underlying EPS</b>	US\$1.52, an increase of 9% on the pcip.
<b>Key points</b>	<ul style="list-style-type: none"> <li>• Sales and earnings both came in ahead of consensus for the March quarter.</li> <li>• iPhone sales remain a key driver with revenues of US\$50.6b following release of the new generation of iPhone 13, up 5.5% on Mar-21.</li> <li>• Apple Services also continues to play an important role with revenue growth of 17% to US\$19.8b in sales.</li> <li>• The accessories category (e.g. the Apple Watch) saw revenue rise 12% to US\$8.8b, the only segment missing consensus forecasts, attributed to weaker demand in non-Watch/AirPods accessories.</li> <li>• The subscription base also continued to grow with 825m paying subscribers, up 40m from the 785m reported in the December quarter.</li> <li>• Supply chain issues (e.g. China lockdowns) remain a headwind with an estimated drag of US\$4b-8b on sales in the third quarter. Cuts to sales in Russia would also impact revenue more sharply in the June quarter (only one month was affected for March).</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>• Demand remains robust across Apple's product suite most notably its flagship iPhone.</li> <li>• Broadening its services base and the range in service offerings is also making the product set more integral to consumers, which should ensure a degree of pricing power is maintained.</li> <li>• Building out its ads business could in time be another lever for profitability as we have seen with the Amazon experience (US\$31b in revenue for 2021).</li> <li>• Supply chain issues remain a point of concern that could drive weaker profitability (beyond consensus forecasts).</li> </ul>

#### Abbott Laboratories (ABT:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$114.69
<b>Result</b>	Q1FY22
<b>Revenue</b>	US\$11.9b, up 13.8% on the pcip.
<b>Underlying EPS</b>	US\$1.73, an increase of 31% on the pcip.
<b>Key points</b>	<ul style="list-style-type: none"> <li>• Overall result was strong with underlying EPS surprising on the upside.</li> <li>• One point of concern was the Nutrition business, particularly infant formula products. This followed the product recall of these products and the shutdown of a Michigan factory, which was linked to bacterial infections in infant formula that saw two babies die. The company is subject to an ongoing FDA investigation but has maintained that the infections were not related to contamination at the factory and has since resumed production.</li> <li>• COVID-19 test sales continue to be a strong revenue driver with the Diagnostics division growing sales by 35% on pcip (12% excluding COVID-19 test sales). The Medical Devices segment also saw double-digit growth of 11.5% in the quarter with some surgery-reliant segments expected to normalise as COVID-19 cases decline and more operations can occur.</li> </ul>



<b>Our comments</b>	<ul style="list-style-type: none"> <li>Maintained adjusted EPS guidance of US\$4.70 for FY22 with total sales (excluding COVID-19 tests) expected to grow by approximately 5-9% for the year, a slight downgrade due to the impact of the product recall in Nutrition.</li> </ul>
	<ul style="list-style-type: none"> <li>Sustainability of COVID-19 test volumes remains a question mark on the business. Market consensus continues to include a decline in top-line revenues as testing volumes are assumed to decline.</li> <li>The infant formula recall does not impair the value of the overall business in our view. Paediatric Nutrition sales of US\$2.2b in 2021 represented 13.2% of overall revenues. This is meaningful, but we do not expect this part of the business will be permanently impaired and the resumption of factory production (in line with FDA requirements) should allow for recovery in sales over the remainder of 2022.</li> </ul>

#### Alphabet Inc. (GOOGL:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$2,343.88
<b>Result</b>	Q1 FY22
<b>Revenue</b>	US\$68b, up 23% on the pcip.
<b>Underlying EPS</b>	US\$24.62, a decrease of 6% on the pcip.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Missed expectations for both earnings and revenue (only US\$0.1b miss) in the March quarter.</li> <li>YouTube advertising sales of US\$6.9b (consensus: US\$7.5b) were a notable driver of the result. This followed the cessation of business in Russia while brand advertisers in Europe also reined in spending after the Russian invasion began.</li> <li>Their "Other" business representing a collection of long-term plays also saw revenue come in below expectations at US\$6.8b (consensus: US\$7.3b).</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>Revenue growth and profitability have been challenged by the Russian invasion with Russia accounting for 1% of Google revenues in 2021. This is a figure that will need to be impaired following Alphabet's decision to not continue selling into Russia in line with other multinational businesses.</li> <li>Google Cloud is also providing an important source of revenue growth (+44% year-on-year) and continues to narrow operating losses as it gains greater operating leverage.</li> <li>The combination of these factors has seen earnings estimates soften for 2022 (current consensus expects no growth before recovery in 2023).</li> <li>The core value of Google, specifically its search franchise, remains intact with ventures, such as Google Cloud, offering additional optionality and value.</li> </ul>

#### Johnson & Johnson (JNJ:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$177.28
<b>Result</b>	Q1 FY22
<b>Revenue</b>	US\$23.4b, up 5% on the pcip.
<b>Underlying EPS</b>	US\$2.67, up 3% on the pcip.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Maintained its 2022 guidance for underlying EPS and sales of 8.2-10.2% and 7-8.5% respectively.</li> <li>Consumer Health continued to show signs of supply chain pressure due to commodity price inflation.</li> <li>Medical Devices saw a stronger-than-expected recovery in the March quarter supported by declining COVID-19 cases in the US.</li> <li>The COVID-19 vaccine saw US\$500m in sales for the quarter but the company suspended guidance (US\$3b in sales for 2022) due to a mix of a surplus of vaccine supply globally and hesitancy seen in developing markets.</li> </ul>

<b>Our comments</b>	<ul style="list-style-type: none"> <li>Foreign exchange (a stronger US Dollar) also remains a headwind with the CFO suggesting a hit of up to US\$0.45 to underlying EPS for 2022.</li> </ul>
	<ul style="list-style-type: none"> <li>Remains positioned for a mix of organic and acquired earnings growth with recent new approvals across medical devices and pharmaceutical showing the R&amp;D pipeline paying dividends.</li> </ul>

#### Microsoft Corporation (MSFT:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$270.41
<b>Result</b>	Q3 FY22
<b>Revenue</b>	US\$45.3b, up 21.8% on the pcp.
<b>Underlying EPS</b>	US\$2.22, an increase of 14%.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Outperformed consensus forecasts for both revenue and earnings finishing ahead of both by 0.6% and 1.4% respectively. This was the smallest revenue beat since 2018.</li> <li>Cloud revenue growth also saw a 46% increase over the year, slightly ahead of analyst forecasts for 45.3%.</li> <li>Guidance for Q4 revenue of US\$52.4-53.2b saw the midpoint slightly below consensus of US\$52.95b.</li> <li>In early June, Microsoft cut back its forecasts for Q4 due to a stronger US dollar, which has reduced the earnings of overseas operations (these account for half of Microsoft's total revenue).</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>Microsoft software partners continue to position the firm attractively as an ecosystem to carry on growing earnings in low double-digits over the next four years (according to current consensus estimates).</li> <li>Currency headwinds are difficult to anticipate and do not impair the overall attractiveness of the Microsoft business, which is trading at reasonable levels given its growth profile and the quality of its earnings.</li> </ul>

#### Nestle S.A. (NESN:CH)<sup>4</sup>

<b>Share price</b>	8/6/2022: CHF 112.38
<b>Result</b>	Q1 FY22
<b>Revenue</b>	CHF 22.2b, up 5% on the pcp.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Continued strength in organic sales with growth of 7.6% in the March quarter. This was comprised by a mix of higher prices (contributing 5.2% to counter higher cost inflation), as well as stronger volumes (contributing 2.4%).</li> <li>Repositioning the portfolio of brands was another feature of the quarter with net divestitures decreasing sales by 1.3%.</li> <li>As with US-based firms, a strong currency (here the Swiss Franc) was a headwind, subtracting 0.8% from sales for the quarter.</li> <li>Consumer demand across both developed and emerging markets remains strong with growth of 6.7% and 8.8% respectively (the split in emerging markets was roughly equal between higher prices and underlying volume growth).</li> <li>Management guided to higher pricing to counteract strong inflation with the war in Ukraine adding to their expectations. To date they have not seen material elasticity in demand due to higher prices (i.e. consumers are still maintaining spending).</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>Overall, portfolio remains well-positioned for mid-single digit revenue growth and slightly higher earnings growth thanks to pricing power.</li> <li>Valuation remains reasonable in our assessment for a strong compounder able to grow at a reasonably high level and return excess capital back to shareholders as dividends and buybacks.</li> </ul>

## Union Pacific Corporation (UNP:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$221.68
<b>Result</b>	Q1 FY22
<b>Revenue</b>	US\$5.86b, up 17% on the pcp.
<b>Underlying EPS</b>	US\$2.57, an increase of 28% on the pcp.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Revenue growth was boosted by stronger freight volumes, up 4% due to bulk and industrial commodities.</li> <li>The operating ratio (proportion of operating expenses relative to operating revenues) improved to 59.4% thanks to fewer negative weather events (relative to 2021), while higher fuel prices acted as a partial offset.</li> <li>Congestion on its rail lines impacted its ability to meet customer demand with labour shortages, also posing a headwind. This has led to further action by management to improve resource utilisation and increase crews and locomotives where appropriate to counteract a 6% year-on-year decline in locomotive productivity.</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>National rail volumes have remained elevated although showing signs of slowing recently, which would reduce network congestion.</li> <li>6% recovery in automobile volumes (flagged in the previous update) was also encouraging, driven by an increase in auto parts.</li> <li>Combination of high single digit earnings growth and dividends remains attractive. The more consolidated nature of US rail networks (relative to prior recessions) should also support earnings power even if US growth continues softening.</li> </ul>

## Samsung (SMSN:UK)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$1,294.50
<b>Result</b>	Q1 FY22
<b>Revenue</b>	US\$61.4b, up 19% on pcp.
<b>Underlying EPS</b>	US\$32.15, an increase of 36% on the pcp.
<b>Key points</b>	<ul style="list-style-type: none"> <li>Strong demand from data centre clients and disruption in manufacturing at Western Digital saw memory chip sales as a key driver of earnings (approximately half of the quarterly profit).</li> <li>Smartphone sales were down 13%, partly due to a later-than-usual release of its new flagship model, the Galaxy S22.</li> <li>Management also noted its order book over the next five years for chip contract manufacturing was eight times its 2021 revenue, with the company planning to win more customers in fields outside mobile phones, such as high-performance computing and the automotive industry.</li> <li>A weaker Q2 for mobile phone and personal computer chip sales was flagged due to headwinds to consumers including higher inflation.</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>The business continues to execute well in the face of ongoing supply chain disruptions.</li> <li>The different facets of the business allow it to diversify over the course of the cycle while it still retains its position as a major hardware manufacturer across smart phones, chips and other technology with its Harman acquisition allowing greater inroads into the automotive sector.</li> </ul>



## Visa Inc. (V:US)<sup>4</sup>

<b>Share price</b>	8/6/2022: US\$213.50
<b>Result</b>	Q2 FY22
<b>Revenue</b>	US\$7,189m, up 25% on the pcp.
<b>Underlying EPS</b>	US\$1.79, an increase of 30% on the pcp.
<b>Key points</b>	<ul style="list-style-type: none"> <li>• As with other companies, Visa decided to suspend operations in Russia with the overall conflict expected to see a 4% hit to revenue.</li> <li>• Unlike other businesses however it had offsetting factors such as a recovery in travel spending with other parts of Europe not seeing any material impact on cross-border travel.</li> <li>• Cross-border volumes surged 38% in the quarter with total payment volumes climbing 17%.</li> <li>• Wage pressures did contribute to rising operating costs, which rose 11% to US\$2.4b with higher marketing spend being another driver.</li> </ul>
<b>Our comments</b>	<ul style="list-style-type: none"> <li>• Secular trends remain intact with gradual transition from cash to electronic payments persisting even in more established markets, such as the US and Europe.</li> <li>• Overall, prospects for continued earnings growth (double-digits over next four years per consensus) continue to appear reasonable with the company weathering the latest bout of equity market volatility better than other peers.</li> <li>• Any flow-on impact from the Russia-Ukraine conflict appears to be limited, adding confidence to the near-term outlook.</li> <li>• One potential headwind, notwithstanding secular trends towards digital payments, would be the broader macroeconomic environment and whether consumers may pull back discretionary spending in a higher interest rate environment. Management expects the business to continue to be resilient even if a growth slowdown eventuates.</li> </ul>

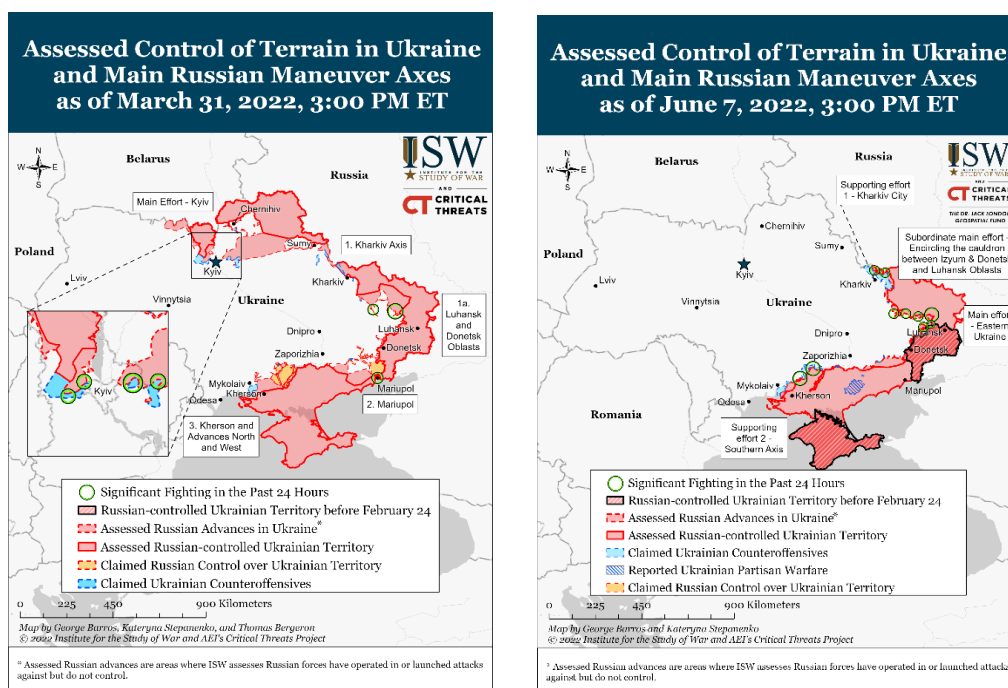
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# Russia-Ukraine conflict update

Russia invaded Ukraine on 24 February 2022 across multiple points along their shared border. While there were initial calls of a swift Russian victory, those began to falter as time wore on and Ukrainian resistance surprised outside observers.

The snapshots below compare the state of Russian inroads at the end of March and early June. As you can see, the initial phase of conquest directed against Kyiv failed. Currently, Russian forces are focusing on consolidating their gains in the Southern and Eastern regions of Ukraine. This includes attempts to take over towns and cities within Luhansk, with Severodonetsk being a major point of action as of 7 June. Russian forces are also attempting to implement administrative control of occupied regions to embed these territorial gains.

**Figure 1: Ukraine-Russia conflict progression – 31 March 2022 vs 7 June 2022**



On the other side of the ledger, Ukrainian forces continue to be supplied by Western countries including most major European nations, the US and even Australia. This is helping to offset the material advantage Russia has in both weapons and manpower. Russia also appears unwilling to escalate the conflict further. As an example, Russian authorities have refrained from launching a formal mobilisation to increase available manpower. Instead, they have tried to actively recruit from the current pool of conscripts, as well as external mercenaries to make up for casualties amongst existing forces.

## Update on base case

As Ukraine remains well-supplied from the West, and morale is holding up, the resistance looks set to continue. The picture from a Russian perspective is less clear cut. While there have been sizeable casualties, the exact number remains unknown. Having a finite supply of equipment and enlisting reservists into service suggests that there are limits on how much further the Russians can continue the conflict.

Overall, the current state of affairs suggests that an eventual peace settlement of some form is the likeliest course of action. The eventual timing remains difficult to anticipate with both Ukrainian resistance and Russian staying power continuing to surprise experts. A somewhat similar outcome in a “frozen conflict” could also occur whereby neither side pursues further conflict but ultimately, the war remains unresolved. In such a setting, we could see long-term isolation of Russia in a manner akin to the treatment of North Korea or Iran by Western powers.

## Implications

An elongated conflict impacts the global economy. The primary way it does so is by constraining global supply of key commodities. These include:

- Wheat;

- Oil and gas; and
- Coal.

This is because a mix of sanctions, as well as destroyed crops and pipelines, has reduced global availability from both Ukraine and Russia. Less supply coupled with strong demand has pushed prices higher. This does not only impact the economy as the increased cost of necessities weakens discretionary spending, but it can also erode social stability as seen during the Arab Spring uprisings in 2011. The uprisings were fuelled not only by repressive regimes but also elevated food prices (notably necessities including bread). A repeat is already underway with regime change occurring in Sri Lanka as the country, a major commodity importer, has struggled materially in the face of higher prices for both energy and soft commodities.

Australia has not been immune to these global events. In recent weeks, gas prices have surged in response to moves in offshore pricing. Excluding Western Australia, the rest of the country does not have a policy in place to reserve gas for domestic use. This leaves us susceptible to changes in global market pricing. This is particularly so during surges of demand. A recent bout of cold weather on the East Coast coupled with the temporary shutdown of coal-powered plants saw gas prices surge and compel the regulator to intervene and implement cap pricing initially. This was followed by the use of emergency powers to suspend wholesale prices entirely in order to curb recent volatility and ensure continued electricity production.

The effects of this surge are twofold:

1. It will boost headline inflation and be a detractor from discretionary spending at a time when consumer confidence has already softened materially (sitting at August'20 lows according to the Westpac-MI Index of Consumer Sentiment).
2. Secondly, this will add to pressure on the Reserve Bank of Australia (RBA) to hike interest rates, slowing economic activity.

## Conclusion

The conflict is ongoing and contributing meaningfully to both global and domestic inflation. It has raised the prospects of further interest rate hikes to reduce inflationary pressures, which can have the collateral impact of weakening the overall economy.

We maintain our bias towards businesses that have pricing power as these are better equipped to weather rising costs, as they can pass these on to end customers. The overall, weaker economic backdrop is one we continue to monitor closely as it may increase recession risks with consequences for portfolio positioning.

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# Investment interest rate hikes

## Don't let investment goals be blinded by interest rate rises.

More than \$650 million in loans<sup>6</sup> were drawn down in April alone for the purpose of personal investment, and that doesn't include financing property.

Investors have enjoyed low interest rates across the last few years, but now the cost of money is turning skywards. Indications are that the Reserve Bank are not yet finished hiking interest rates<sup>7</sup>, and as lenders inevitably follow suit, the landscape will change for leveraged investors.

Rates going up should not mean hitting the panic button and ripping up investment plans, but it might mean tweaking the strategy to make sure your goals stay in view.

Start your review with remembering why you borrowed in the first place – to deliver on your unique investment objectives. Whether it's planning for retirement or funding a project, your goals give direction and purpose to the financial plan.

## Readjust your stride

Hurdles are not just for track athletes. The hurdle rate is a factor taken into consideration when borrowing for investment.

Let's assume the cost of borrowing for investment purposes is 3%. With a salary in the top marginal income tax rate, the after-tax interest cost, or hurdle rate, is approximately 1.5%.

A borrowing to invest strategy is profitable, if the investment return exceeds the hurdle rate.

Over the last two years, the hurdle rate has been very low, around 1.5% to 2%. Most asset classes have exceeded that with ease, and therefore investors have generated a profit.

As interest rates rise, that hurdle rate will start to get higher and more challenging to get over.

It is still plausible to clear a hurdle rate that reaches 4% or 5% if you're investing in growth assets, but an annual return below the hurdle rate will become more frequent, and the strategy can oscillate more frequently between a gain and loss position. Investors will need to be more selective about the assets they invest in and focus more on the cash flow of the gearing strategy.

A buffer is an amount added to the hurdle rate to allow for interest rate increases and unforeseen cash flow issues. It is prudent for investors to review what their cash flow would look like if interest rates increased by 1.5-2.5%. If this extra interest cost is not manageable, investors can get ahead of the curve by reducing their gearing level before their financial position becomes too tight. Equally, you can re-assess whether borrowing is required at all to achieve your objectives.

If you can achieve your objectives without borrowing to invest, you may be taking unnecessary risk by implementing a gearing strategy.

## Cut down your interest bill

Many investors have multiple debts – some deductible, some non-deductible. As a rule of thumb, it makes sense to repay your non-deductible debt sooner than your deductible debt, because a tax benefit can be claimed on the deductible debt.

Consolidating debt is a common strategy for investors with multiple loans. Consider refinancing higher cost loans into your lowest cost loan to reduce your overall interest cost. Noting that it is generally not recommended to consolidate deductible and non-deductible debt.

An offset or a redraw facility is also useful for borrowers. These allow investors to offset the interest costs incurred on the loan. For investors with a debt outstanding, it does not make sense to accrue cash in a bank account, earning a lower rate of interest, while incurring a higher rate of interest on outstanding debts.

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<sup>6</sup> Australian Bureau of Statistics, 2022, <https://www.abs.gov.au/statistics/>, (accessed 9 June 2022).

<sup>7</sup> R. Mizen, 'RBA tipped for back-to-back double rate rises', *Financial Review*, 2022, <https://www.afr.com/policy/economy/rba-surprises-with-outsize-jump-in-cash-rate-to-0-85pc-20220607-p5arrl> (accessed 9 June 2022).

Any income, including a salary, could be directed straight into the offset account, even if it only saves a week or two weeks of interest cost on a loan. When that's compounded over a 10- or 20-year period, it makes an enormous difference.

### **Consider the exit strategy**

Often people get frustrated that financial institutions won't lend them large sums against a high-value asset. In the investor's mind, the calculations make sense – they want to borrow \$1 million and they have \$2 million in assets to secure it against, so why does the bank provide the financing?

The bank needs an investor to have sufficient cash flow to repay the debt because that is the primary exit for a debt. Selling the asset to repay the loan is the backup strategy, not plan A.

Use this mindset when examining a personal gearing strategy by making sure you have enough cash flow to repay the debt, plus a margin of safety. If you've borrowed at 3%, borrowing costs of 5% should be factored in as a buffer against interest rate rises in the future.

If you are relying on selling assets to extinguish the debt at retirement, there is considerable timing risk in trying to sell the asset at a high point. For a portfolio of assets, consider gradually selling down over an extended period to average your exit price. Or, for single-asset strategies, such as real property, be prepared to be flexible on your sale date. Being a forced seller when markets are down will be a painful experience.

There's no doubt there are a few investors feeling edgy about what the future holds with the rising cost of borrowing and concerns about growing their wealth.

As rates go up, use it as a catalyst for reviewing the investment plan, and factoring in the additional risk that comes with borrowing to invest. Take some time out to assess your position and make sensible adjustments but don't lose sight of your goals.

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# Making business *personal*

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