



April 2021

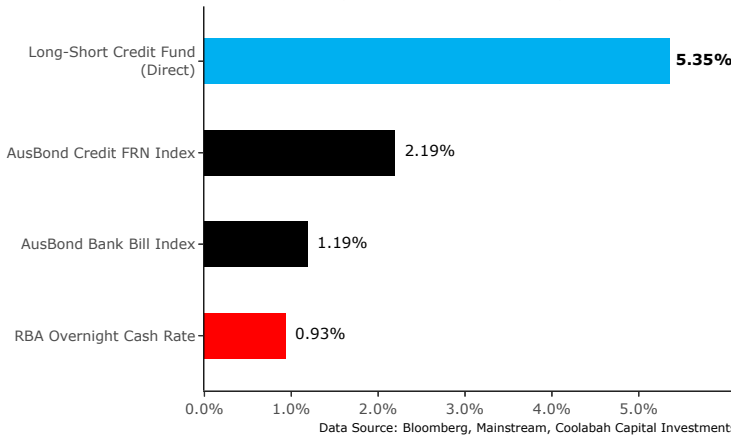
Objective: An absolute return fixed-income strategy focused on exploiting long and short mispricings in credit markets that targets high-yield like returns above the Reserve Bank of Australia (RBA) cash rate plus 4% to 6% p.a. over rolling 3 year periods with volatility of less than 5% p.a. after Management Fees, Administration Fees and Performance Fees.

Strategy: We add value via active asset-selection using a range of valuation models with the aim of delivering superior risk-adjusted returns, or alpha, to traditional hedge funds. We primarily invest in senior and subordinated debt securities, hybrids and derivatives issued by Australian entities domestically, although we can invest in these securities when they are issued overseas, or by overseas entities (into Australia or offshore). The Fund can use gearing and targets holding the majority of its portfolio in investment-grade securities. It is managed by Coolabah Capital Investments.

Period Ending	Gross Return (Direct)	Net Return (Direct) [†]	RBA Cash Rate	Gross Excess Return [‡]	Net Excess Return (Direct) ^{†‡}
2021-04-30					
1 month	0.64%	0.45%	0.00%	0.64%	0.45%
3 months	2.00%	1.41%	0.01%	1.99%	1.40%
6 months	6.29%	4.61%	0.02%	6.27%	4.59%
1 year	15.42%	11.72%	0.08%	15.33%	11.64%
2 years pa	8.91%	6.19%	0.46%	8.45%	5.73%
3 years pa	8.27%	5.79%	0.81%	7.46%	4.98%
Inception pa Aug. 2017	7.68%	5.35%	0.93%	6.75%	4.42%

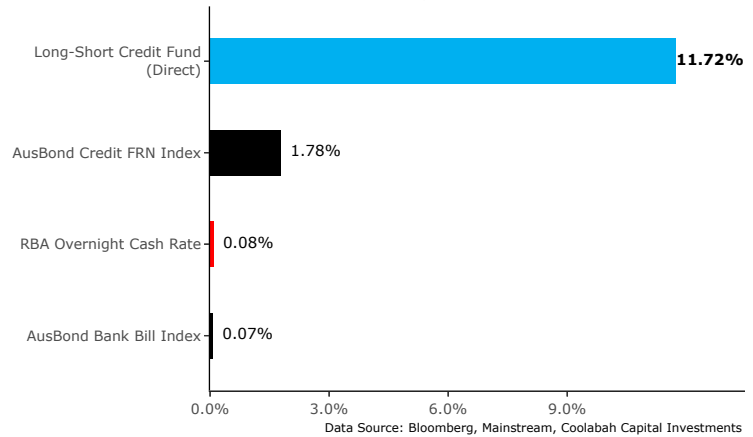
Long Short Credit Fund Returns (Net) vs Benchmark (pa)

Annualised Returns Since Inception in August 2017 to 30 April 2021



Long Short Credit Fund Returns (Net) vs Benchmark

12 Month Return to April 2021



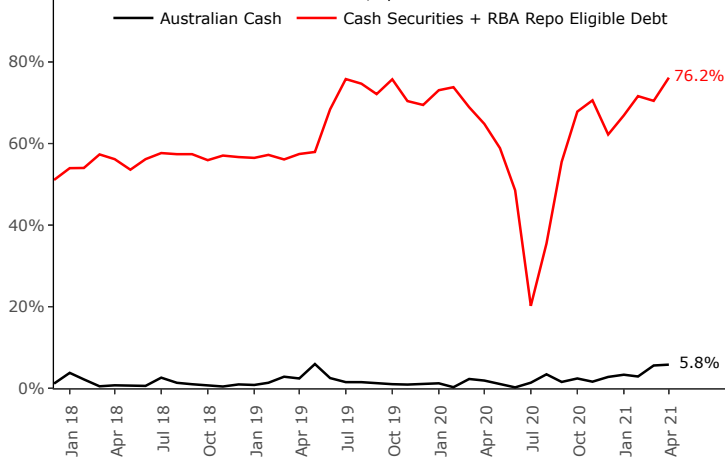
[†] Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. [‡] The Excess Return columns represent the gross and net return above the RBA cash rate.

Disclaimer: Past performance does not assure future returns. Returns are shown net of all Management and Performance fees unless otherwise stated. All investments carry risks, including that the value of investments may vary, future returns may differ from past returns, and that your capital is not guaranteed. To understand Fund's risks better, please refer to the Product Disclosure Statement available at Coolabah Capital Investments' website.

Net Monthly Returns > RBA Cash Rate	82%	Permitted Gearing	Yes
Gross Portfolio Weight to Cash Securities	5.8%	1 Year Av. Gross Portfolio Weight to Cash	2.7%
Gross Portfolio Weight to Bonds	94.6%	Gross Portfolio Weight to AT1 Hybrids	7.4%
Av. Portfolio Credit Rating	AA-	Gross Cash Securities + RBA Repo-Eligible Debt	76.2%
Portfolio MSCI ESG Rating	AA	Gross Portfolio Weight to ABS/RMBS	0.1%
No. Cash Securities	12	Net Credit Spread Duration Ex Govt	2.82 years
No. Notes and Bonds	73	Net Annual Volatility (since incep.)	3.17% pa
Av. Interest Rate (Gross Running Yield)	2.43%	Gross/Net Sharpe Ratio (since incep.)	2.06x/1.39x
Modified Interest Rate Duration	0.09 years	Awards: FE Alpha Manager 2019: Christopher Joye; Ratings: Lonsec available to clients; Recommended (Atchison); "Very Strong" (Aust. Ratings)	

Portfolio Weights: Cash + RBA Repo Eligible Debt

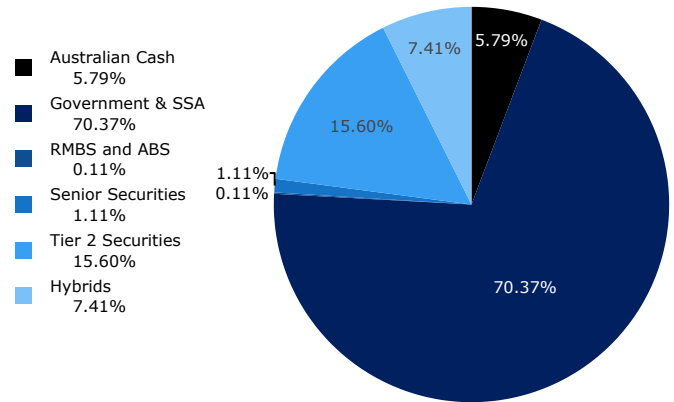
End of Month, April 2021



Data Source: Coolabah Capital Investments

Long Short Credit Fund Portfolio Composition (Gross NAV)

(Gross Levered Statistics) - 30 April 2021

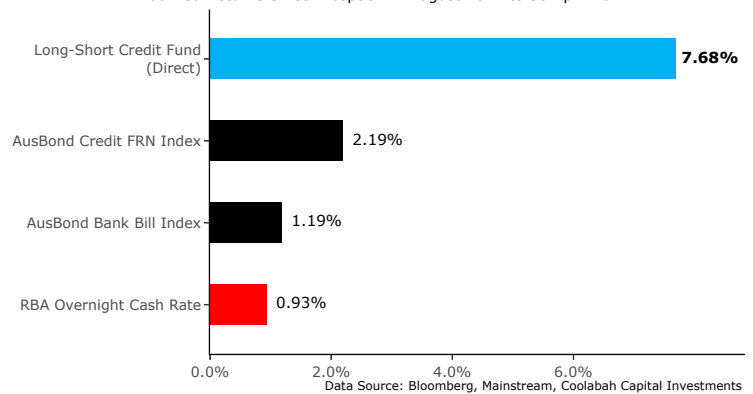


Data Source: Coolabah Capital Investments



Long Short Credit Fund Returns (Gross) vs Benchmark (pa)

Annualized Returns Since Inception in August 2017 to 30 April 2021



Data Source: Bloomberg, Mainstream, Coolabah Capital Investments

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The since inception gross (net) return of **7.68% pa gross (5.35% pa net)** is the total annual return earned by the fund since Aug. 2017, including interest income and movements in the price of the bond portfolio after all fund fees (assuming net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement). The net return quoted applies to the Smarter Money Long-Short Credit Fund - Direct Investor Class, with quarterly distributions reinvested. Each investor's return will vary depending upon their own investment date and any top-ups and withdrawals they make. The **annualised volatility estimate of 3.17% pa** is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Smarter Money Long-Short Credit Fund - Direct Investor Class.

Portfolio Managers Christopher Joye, Ashley Kabel, Dr Stephen Parker, Dr Nick Campregher ([Coolabah Capital Investments](#))

APIR Code	SLT2562AU	Fund Inception	31-Aug-17
ISIN	AU60SLT25623	Distributions	Quarterly
Morningstar Ticker	41597	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	Alternatives/Hedge Funds	Min. Investment	\$1,000
Target Return	Net 4.0%-6.0% pa over RBA cash rate	Withdrawals	Daily Requests (funds normally in 3 days)
Investment Manager	Coolabah Capital Investments	Buy/Sell Spread	0.00%/0.05%
Responsible Entity	Equity Trustees	Mgt. & Admin Fee	1.00% pa
Custodian	Mainstream Fund Services	Perf. Fee	20.5% of returns over RBA cash rate + 1.00% pa

Portfolio commentary: In April, the zero-duration and daily liquidity Long Short Credit Fund (LSCF) strategy returned 0.64% gross (0.45% net), outperforming the Benchmark RBA Overnight Cash Rate (0.00%) by 0.64% gross (0.45% net). LSCF also outperformed the AusBond Bank Bill Index (0.00%), and the AusBond Credit FRN Index (0.07%). LSCF ended April with a weighted-average credit rating of AA- and a portfolio weighted average MSCI ESG rating of AA. Over the April quarter, LSCF returned 2.00% gross (1.41% net), outperforming the Benchmark RBA Overnight Cash Rate (0.01%) by 1.99% gross (1.40% net). LSCF also outperformed the AusBond Bank Bill Index (0.00%), and the AusBond Credit FRN Index (0.06%). Over the previous 12 months, LSCF returned 15.42% gross (11.72% net), outperforming the Benchmark RBA Overnight Cash Rate (0.08%) by 15.33% gross (11.64% net). LSCF also outperformed the AusBond Bank Bill Index (0.07%), and the AusBond Credit FRN Index (1.78%).

Since LSCF's inception 3.7 years ago in August 2017, it has returned 7.68% pa gross (5.35% pa net), outperforming the Benchmark RBA Overnight Cash Rate (0.93% pa) by 6.75% pa (4.42% pa net). LSCF also outperformed the AusBond Bank Bill Index (1.19% pa), and the AusBond Credit FRN Index (2.19% pa). LSCF's since inception Sharpe Ratio, which measures risk-adjusted returns, has been 2.06x (1.39x) gross (net). While LSCF's return volatility since inception has been low at around 3.17% pa (measured using daily returns), as a daily liquidity product with assets that are marked-to-market using executable prices, volatility does exist. This contrasts with illiquid credit (eg, loans and high yield bonds) wherein assets that have very high risk can appear to have remarkably low volatility, which is, in fact, just a mirage explained by the inability to properly value these assets using executable prices.

Strategy commentary: April was another month replete with important macro and geo-political developments. Front and centre for Coolabah was new statistical research that we published on (1) [modelling the Australian housing market](#), (2) [forecasting senior bank bond supply](#), and (3) [quantifying the impact of a spike in inflation expectations on unemployment, 10 year government bond values, and equity values](#). We also revealed the advice of our panel of world-leading geo-political experts on the [risks of war breaking out in the Indo-Pacific region](#). Before we get to that, let's recap what happened in markets.

In terms of fixed-income performance, the AusBond Composite Bond Index benefited from a further decline in 10-year government bond yields, which fell from 1.79% to 1.75% (after peaking around 1.92% in February 2021). We have argued since late February that the 10-year government bond yield should range trade around the February highs given its proximity to the neutral nominal RBA cash rate, which we assess to sit somewhere between 1.5% and 2.5%.

This helped the fixed-rate only Composite Bond Index (it holds fixed-rate, rather than floating-rate, bonds), which carries 6 years of interest rate risk, report a decent 0.56% return in April following on from the 0.80% bounce in March (recall the index plunged a record 3.6% in February).

Coolabah's insto-only Active Composite Bond Strategy continued to outperform, delivering a gross, pre-fees return of 0.66% in April after increasing 1.18% in March (this product has confidential fee terms and is not currently available to retail investors).

Over the 12 months to 30 April, the Composite Bond Index has returned -1.19% compared to Coolabah's Active Composite Bond Strategy's gross return of 3.81%. That is, the Active Composite Bond Strategy has outperformed by 5.01% gross. The Active Composite Bond Strategy has an average AA- credit rating and an average AA ESG bond rating from MSCI. (We've recently retained MSCI to be able to publicly report their weighted average ESG ratings of our portfolios, which you can [read about here](#).)

In the zero interest rate duration floating-rate world, the AusBond Floating-Rate Note (FRN) Index returned 0.07% in April, above the average RBA recorded retail term deposit rate return of 0.02%, the AusBond Bank Bill Index's 0.00% and the RBA's overnight cash rate return of 0.00%.

Strategy commentary cont'd: Coolabah's zero duration, average AA- rated, Long Short Credit Fund returned 0.64% gross (0.45% to 0.47% net and 0.63% net for the USD class) in April. Over the 12 months to 31 April, the Long Short Credit Fund, which has an average AA ESG bond rating from MSCI, has returned 15.42% gross (11.72% to 11.91% net and 12.24% net for the USD class).

Coolabah runs a more aggressive, insto-only version of this product, called the Long Short Opportunities Strategy, which returned 0.90% gross in April and 19.11% gross over the last 12 months (fee terms are again confidential). It also has an average AA- credit rating and an average ESG bond rating from MSCI of AA.

Over the last year, the AusBond FRN Index delivered 1.78%, the average term deposit returned 0.44%, the average RBA overnight cash rate was 0.08%, and the AusBond Bank Bill Index offered just 0.07%.

Coolabah's two zero duration strategies that are classified in FE fundinfo's cash enhanced universe, the Smarter Money Higher Income Fund and the Smarter Money Fund, returned 0.18% gross (0.12% to 0.14% net) and 0.16% gross (0.10% to 0.11% net) respectively in April. Over the 12 months to 31 April, they have returned 4.95% gross (3.66% to 3.79% net) and 4.24% gross (3.17% to 3.21% net) respectively.

In April, 5-year major bank senior bond spreads underperformed, increasing from 42 basis points (bps) to 46bps. 5-year major bank Tier 2 bond spreads also underperformed, moving from 133bps to 135bps. The one stand-out was the ASX hybrid market, where 5-year major bank hybrid spreads contracted from 276bps to 270bps as the new Macquarie and CBA deals were finally digested by the market.

One significant event risk that Coolabah has been actively positioning for is a tsunami of senior bond issuance from Australia's banks as they seek to gradually repay the \$180 billion they will have eventually borrowed under the RBA's 3-year term funding facility (TFF).

In contrast to the consensus targeting the second half of 2021, we forecast that this wave of supply would start hitting before June 30 when the TFF expires. In March we asked two major bank treasurers at The Australian Financial Review Banking Summit what their expectations were for senior bank bond issuance, and both guided towards the second half of the year.

The day we posed this question, ANZ broke the drought with a 1-year senior deal in Aussie dollars, which was followed by a 5-year issue by Macquarie Group in the UK. And at the end of April we had Bank of Queensland launch the first 5-year senior bank issue in Aussie dollars in a very long time. (Banks have not needed to borrow from debt markets, given they had so much cheap funding available via the TFF.)

Earlier this year Coolabah's analysts built detailed financial models that allowed us to forecast the quantum of senior bank bond issuance that will be required as a function of two crucial variables: balance-sheet growth and changes in deposit funding.

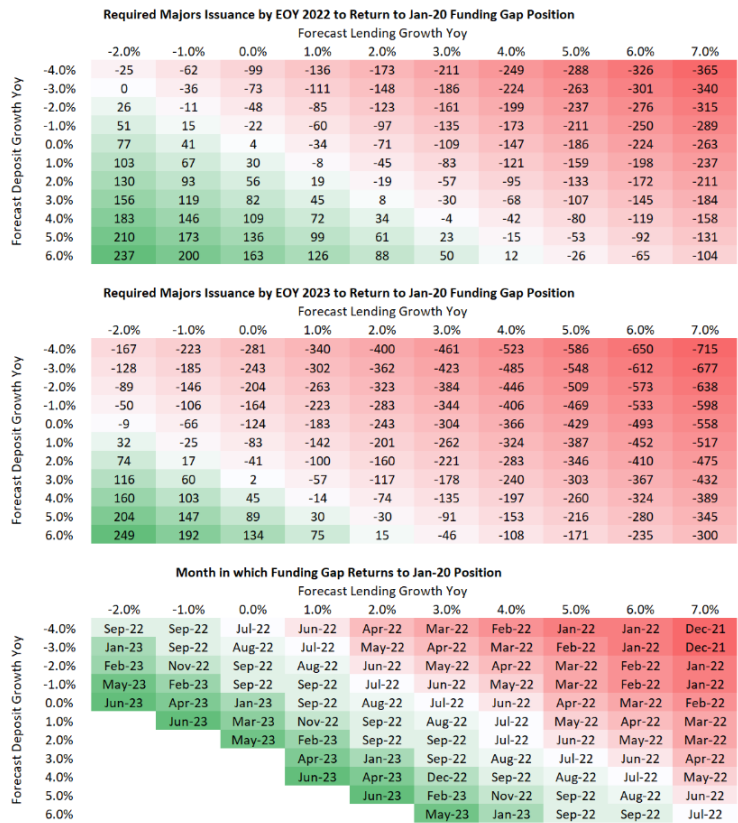
The enormous surge in deposits that flooded into the banking system in 2020 reduced the need for banks to issue wholesale bonds. Assuming, however, that this starts to slow down while balance sheets expand more rapidly on the back of the housing boom and a recovery in business lending, it is easy to arrive at the conclusion that the major banks alone will have to issue more than \$150 billion of senior debt over the next few years.

This supply shock should result in the cost of 5-year debt normalising from its historically low level around the mid 45bps area, which has not been seen since 2007, back to the 70bps region that represented the low-watermark for these spreads in the post-crisis period.

There are complex nuances that influence this analysis. First, the banks will not likely issue much, if any, 3-year paper because they need to extend their liabilities beyond the three-year repayment date of the TFF to avoid concentrated refinancing cliffs. This is why we are predicting longer tenor issuance with a focus on 5-year deals in Australia and 10-year deals in US dollars and euros.

Second, the banks will have to shift more of their funding offshore given they will be restricted from being the biggest buyers of their own bonds in Aussie dollars as APRA winds-back the RBA's Committed Liquidity Facility (CLF).

Strategy commentary cont'd:



When Australia had few government bonds on issue, the RBA and APRA created the CLF as a substitute. But with massive coronavirus-induced issuance, now underscored by the federal government’s military procurement needs, there is no real need for the CLF.

This eliminates what has historically been the single-biggest buyer base for senior-ranking Aussie bank bonds: the banks themselves.

A related development in April was Standard & Poor’s banking analysts making a raft of changes to their credit rating assessments. S&P has upgraded the “negative” economic risk trend for Australia to “stable” (as Coolabah had suggested) while also upgrading the banking sector’s industry risk score from “stable” to “positive”, which was a welcome surprise.

S&P advises that there is now a one-in-three possibility that it will lift Australia’s Banking Industry Country Risk Assessment (BICRA) score to put our financial system alongside Canada, Singapore, and Switzerland in safety terms. Bizarrely, S&P reckons that a now non-democratic Hong Kong is the safest banking jurisdiction in the world, which is exhibit A in farcical rating agency decisions.

If S&P does belatedly decide to normalise Australia’s BICRA score to being equal with Singapore and Canada, it would trigger a chain reaction in ratings. The major banks’ Tier 2 bonds would jump from BBB+ to A-. Their hybrids would likewise lift a notch from BBB- to BBB. While the major banks’ senior bond ratings would not change, all regional banks would benefit from rating upgrades to their senior, subordinated and hybrid ratings.

Another important research area for Coolabah has been modelling inflation shocks. The most daunting challenge Australia’s central bank boss Philip Lowe faces is surmounting the formidable slopes of what is known as the “Phillips curve”. This basically depicts an inverse relationship between the economy’s labour market slack, or unemployment, and consumer price pressures across the economy. As the jobless rate rises, inflation tends to decline. Conversely, as that spare capacity gets exhausted through, say, stimulatory fiscal and monetary policy, the bargaining power of employees improves, flowing through to stronger wages and ultimately consumer prices.

Strategy commentary cont'd: The last time Australia experienced a real bout of consumer price inflation, in 2008, the unemployment rate had declined to about 4%, which pushed wages growth up to 4%. The RBA's core benchmark for consumer price inflation, called the trimmed mean measure, jumped to almost 5%, materially above its 2% to 3% target band. This was, in fact, the biggest overshoot since the target was adopted in 1993.

In an important 2019 paper on the RBA's inflation forecasting models, the RBA economist Natasha Cassidy and three co-authors demonstrated that the RBA's Phillips curve model does a decent job of explaining historical trend movements in inflation, including the spike around 2008. As you would expect, the RBA's Phillips curve model is a little more complex than simply using the jobless rate to predict inflation innovations.

Martin Place's proxy for labour market slack is actually what it calls the "unemployment gap", or the distance between the jobless rate (5.6%) and what is unhelpfully described by economists as the "non-accelerating inflation rate of unemployment" (NAIRU). The NAIRU might be better characterised as the "wage increasing jobless rate" (WIJR). It is that very low level of unemployment at which point it is hard for companies to find workers, and this competition for staff results in companies bidding up pay levels.

The problem is that the WIJR is constantly evolving. According to Cassidy et al, the WIJR has been falling since the early 2000s from an unemployment rate north of 6% to about 4.5% in 2018. Importantly, Lowe and deputy governor Guy Debelle think that the WIJR has continued to edge lower and could now be in the 3s, as has been seen in other advanced economies such as the US.

In addition to the magnitude of labour market slack, the RBA's Phillips curve inflation-forecasting model incorporates several other variables. These include changes in the value of imported goods, which can affect domestic inflation (cheap Chinese goods historically reduced local price pressures), and variables that represent inflation expectations. Cassidy et al's research suggests, for instance, that the community's subdued expectations of inflation dragged down actual inflation outcomes between 2015 and 2020. (If you are not expecting big pay rises, you are unlikely to demand them.)

Decomposing the key drivers of inflation into different variables is important because it highlights that an overheating economy and/or inflation expectations can push up consumer prices, among other things (eg, supply chain bottlenecks and the reversal of temporary price cuts during the pandemic).

With the unemployment rates in Australia and the US—5.6% and 6%, respectively—still a long way above the RBA and the Federal Reserve's best guess of the WIJR (which are both at, or below, 4%), it is unlikely that wages growth will fuel inflation in the short term.

But in a new Coolabah research paper, our chief macro strategist, Kieran Davies, observes that there is less certainty about the influence of expected inflation, especially in the US, where the government is delivering significant additional fiscal stimulus.

Central banks such as the Fed and the RBA have been generally good at keeping inflation close to their circa 2% targets. This hard-won inflation-fighting credibility has in turn kept inflation expectations well anchored around the same level.

"If a crack appeared in the Fed's credibility and expected inflation started to respond to higher headline inflation – which should temporarily spike on the recovery in oil prices, pandemic costs related to supply chain disruptions, and the reversal of price cuts made during lockdowns – this could feed into higher ongoing inflation," Davies says.

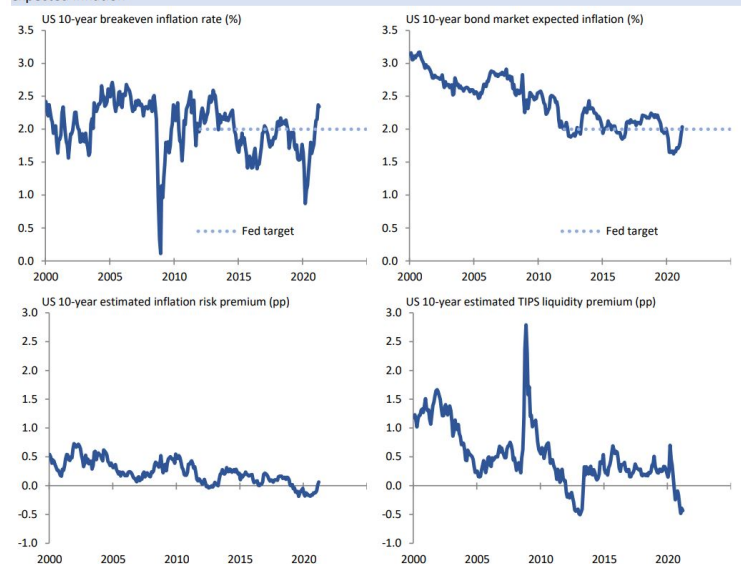
One recent concern among investors has been the jump in the more timely, and widely watched, 10-year bond market "break-even inflation rate", which is another measure of inflation expectations that has climbed from a pandemic low of 0.9% last year to 2.4% in March. This is its highest level since 2013.

Strategy commentary cont'd: In contrast to surveys of inflation, the break-even inflation rate in the bond market measures the difference in yield earned on two types of 10-year government bonds. The first is just a normal 10-year government bond that pays you an interest rate that is the market's best guess of where the central bank's cash rate will be over the next decade plus a bit of extra interest to compensate you for the risk that this estimate is wrong (ie, it turns out to be different to the actual cash rate). The second is an inflation-linked bond, where the principal is indexed to the change in the official consumer price index over time. So as the CPI increases, you get more income. The gap between these two yields provides an indication of the market's best estimate of CPI inflation over time.

Davies points out, however, that life is not this simple. The 10-year government bond yield also includes a premium for inflation risk, which is the compensation investors expect for bearing the risk of higher prices over the next 10 years. And then inflation-linked bonds are affected by their illiquidity, or low trading volumes, which means that investors demand higher yields to compensate them for this risk.

Davies says that once you adjust for these two corrupting influences, "expected inflation has increased much more modestly from last year's virus-affected low of 1.6% to 2% in March, which matches the Fed's official target". That is, the spike in break-even inflation expectations is not as worrying as it seems. While this is good news, there have been abrupt shifts in inflation expectations in the past. As former IMF chief economist Olivier Blanchard has observed, "the history of the Phillips curve is one of shifts".

Figure 1: The widely-used breakeven inflation rate overstates the rebound in the bond market's measure of long-term expected inflation



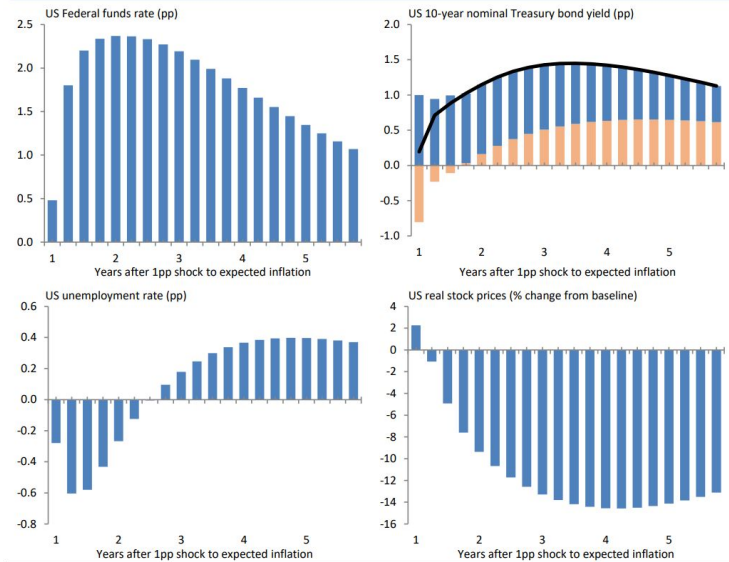
Source: Federal Reserve Bank of New York, Federal Reserve Bank of St Louis, Coolabah Capital

To assess the potential impact of such a shock, Davies estimated the effect of a 1 percentage point increase in inflation expectations on US financial markets using a vector autoregression (VAR) model. This is a relatively large rise compared to the 0.6% annual standard deviation of expectations in the US. Davies' key conclusion is that a material jump in inflation expectations would result in sharply higher interest rates and a large fall in stock prices.

The process starts with tighter monetary policy to bring inflation under control, with Davies estimating that the Fed's cash rate would climb by almost 2.5 percentage points (from near-zero today). Persistence in sticky inflation expectations and tighter monetary policy settings drives a big, 1.5-percentage point rise in the 10-year government bond yield. Higher discount rates hurt stock prices, which decline by about 15% over the next 3 to 4 years in real, or inflation-adjusted, terms. Lots of people have lazy opinions about inflation and interest rates. A more rigorous approach to thinking about these questions often furnishes superior insights.

Strategy commentary cont'd: In April Coolabah also published a very big research report that replicated and extended the pioneering 2019 housing model developed by RBA economists Peter Tulip and Trent Saunders. Tulip and Saunders controversially concluded that reductions in interest rates, rather than inelastic supply and/or population growth, explained most of the rise in house prices over the last big boom between 2013 and 2017.

Figure 2: Modelling suggests a material increase in inflation expectations would lead to sharply higher interest rates and sharply lower stock prices



Source: Federal Reserve Board of Governors, Federal Reserve Bank of New York, Federal Reserve Bank of Philadelphia, Federal Reserve Bank of St Louis, Coolabah Capital

The co-authors noted, however, that this was just the monetary policy transmission mechanism in practice, observing that “a large part of the effect of interest rates on dwelling investment, and hence GDP, works through housing prices”.

Coolabah’s chief macro strategist, Kieran Davies, spent considerable time updating and re-estimating the model. This is an important exercise because the Saunders-Tulip model is used by Martin Place to better understand the relationships between interest rates, residential investment, rents and house prices.

“We’ve used this RBA model to calculate internally consistent forecasts that allow for feedback between quantities and prices,” Davies comments. “The RBA’s model contrasts with the usual academic approach of estimating house prices using a single equation, furnishing richer detail on the housing market than the central bank’s own MARTIN macroeconomic model.”

The Saunders-Tulip model embeds a long-run relationship between real house prices and the ratio of real rents to the “user cost of housing”, where the latter captures the cost of owning a home (ie, interest payments and running costs less expected capital appreciation). This means that dwelling values adjust over the long term to keep the cost of owning a home close to the cost of renting. In the short term, the model allows for a gradual adjustment of house prices to this long-run equilibrium, including momentum in these prices and the short-run impact of real interest rates.

“In estimating the Saunders-Tulip model, some inputs, such as household income, working-age population and inflation, are driven by past trends, while the unemployment rate is determined by an Okun’s Law relationship with income,” Davies explains.

“In using the model to forecast house prices, we overwrote these estimates with forecasts from the RBA’s latest statement on monetary policy and the Commonwealth’s budget update. Interest rates were based on market pricing prevailing at the end of last year, when the curve was near zero, out to three years.”

The key finding is, unsurprisingly, a central case encompassing a 25% increase in nominal Australian house prices between December 2020 and December 2023, with a confidence interval spanning 14% through to 36%. This is similar to Coolabah’s prevailing official forecast anticipating cumulative capital gains of 20% to 30% over the two to three years after the last housing peak in April 2020.

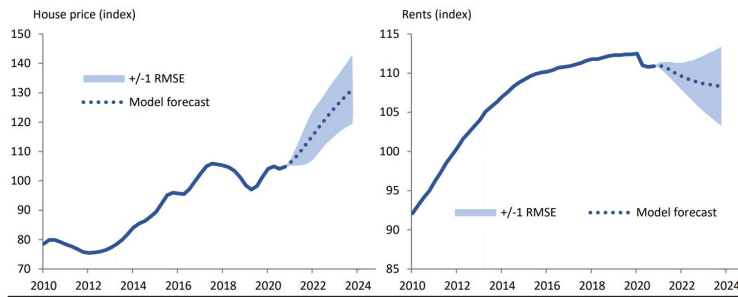
Strategy commentary cont'd:

Figure 3: Model forecasts and confidence intervals

	Q4 2018	Q4 2019	Q4 2020	Forecast: Q4 2021	Q4 2022	Q4 2023
National house prices						
- % change on a year ago	-4	0	3	8	9	7
- % cumulative forecast gain				8	17	25
with +/-1 RMSE band				1-15	9-26	14-36

Source: Australian Bureau of Statistics, CoreLogic, Reserve Bank of Australia, Coolabah Capital Investments

Figure 4: There is considerable uncertainty around the model's forecasts for house prices and rents



Source: Australian Bureau of Statistics, CoreLogic, Reserve Bank of Australia, Coolabah Capital Investments

The RBA's model also points to much stronger residential construction, with investment projected to increase by 26% over 3 years, although much of this materialises in 2021.

The housing boom, which has boosted consumer and business confidence, and investment intentions, is a direct result of the record fiscal and monetary stimulus that is seeking to ensure that the spike in excess labour market capacity wrought by COVID-19 can be fully utilised as quickly as possible. (The longer folks remain unemployed, the harder it is to get a job.)

This is why it is also a global phenomenon: Davies finds that house prices have increased in almost every advanced economy (23 of 26), with an average capital gain of 7% in nominal terms from their pre-pandemic levels through to the end of last year.

In April we received more good news on Australia's fiscal position. The Commonwealth budget recorded a technical surplus in March, albeit it remained in clear deficit on a seasonally-adjusted basis. Along similar lines, the NSW budget deficit almost disappeared in March, underscoring the point that bond supply from both the Commonwealth and the States will be a lot less than investors had been expecting, as Coolabah has repeatedly argued. Since late 2020 we've asserted that Commonwealth and state budget deficit projections were overly pessimistic, and would surprise very materially on the upside, which would be a technical positive for semi-government bond spreads.

The latest monthly data that Coolabah assesses show that the Commonwealth and NSW governments should announce substantial downward revisions to their forecast budget deficits for 2020-21. While the annual budget shortfalls are still enormous because they capture the brunt of the pandemic, the rapid turnaround in the budget positions has been remarkable, albeit in line with our expectations.

On Coolabah's seasonal adjustment, the Commonwealth budget has more than halved from about \$20bn per month late last year to about \$9bn per month early this year (the budget was actually marginally in the black in March in unadjusted terms).

Similarly, the New South Wales budget has improved from an average monthly shortfall of about \$1.5bn per month in late 2020 in seasonally adjusted terms to about \$0.8bn in recent months (the budget was almost in balance in March with a seasonally adjusted deficit of about \$0.2bn). This good news should continue into next financial year, which points to a substantial reduction in bond issuance for the government bond market. The Commonwealth budget is due on 11 May and should show a substantial improvement in the nation's finances, something that has been clear for some time in our tracking of monthly budget data.

Late last year, the Commonwealth forecast an underlying cash deficit of \$198bn in 2020-21. On our seasonal adjustment, data for March that were released today show that the budget in the financial year to date is tracking about \$30-40bn better than expected and the deficit for the year as a whole could print around \$150-155bn.

Strategy commentary cont'd: This improvement will carry over into 2021-22, where there should also be an additional company tax windfall from the significantly higher-than-forecast price of iron ore. That said, the Commonwealth could allocate some of the improvement to spend more on defence. In terms of the improvement in 2020-21 to date, the substantially better outcome reflects both stronger revenue and weaker payments relative to the Commonwealth's forecast profile.

The NSW budget will likely be delivered in June and the state's finances are also substantially better than the government had expected in its half-year budget update.

Coolabah's seasonal adjustment of the monthly budget data show that the cash deficit is tracking around \$5-6bn better in 2020-21 to date than the run rate implied by a simple interpolation of the annual estimate of a deficit of \$21.6bn. Based on recent trends, the deficit for the year as a whole could end up at about \$13-15bn.

The improvement to date mainly reflects lower-than-expected payments, mainly non-wage payments, including infrastructure investment (however, we assume that the underspend on investment will carry over to next financial year). Revenue is also tracking below expectations, even as residential stamp duty reached a new all-time high in March. National GST revenue continues to track about \$3-4bn above the Commonwealth's forecast for the financial year to March.

A final word on the risks of major power conflict. Long-time readers of Coolabah's research have been hearing about the drum beats of war between China and the US for the best part of a decade. Back in May 2020, Coolabah gave a detailed private seminar to hundreds of our wholesale clients assessing these risks and advised that the probability of major power conflict in the Indo-Pacific had lifted to as high as 50%.

While none of our geopolitical advisers had quite such a pessimistic perspective (they tended to be in the still-elevated, circa 25% camp), most are now handicapping war as a toss-of-a-coin prospect. In fact, one of our most accurate foreign policy advisers says that the conflict probabilities have lifted above 50%. A "tell" in this regard is the combatants probing the contours of the cyber-security battlespace much more aggressively than before.

The prospects for war are actually higher in the next 5 years than the period thereafter because of how successfully China has closed the military capability gap with the US. Every day President Xi Jinping delays, his potential adversaries in a battle over Taiwan (which would undoubtedly include the US, Japan, Australia and the UK) are investing enormous effort to prepare for war and once again expand the capability gap. Sadly, the wider Australian community has yet to come to grips with these morbid contingencies.

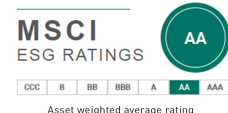
Perhaps the first time non-readers of our research would have heard the drum beats of war was when the Home Affairs secretary, Mike Pezzullo, sensibly sounded them during the week. Presumably with the blessing of government, he warned that "as free nations again hear the beating drums and watch worryingly the militarisation of issues that we had, until recent years, thought unlikely to be catalysts for war ... let us continue to search unceasingly for the chance for peace while bracing again, yet again, for the curse of war". This followed a similar warning from Defence Minister Peter Dutton, who cautioned that the spectre of major powers battling over Taiwan "should not be discounted".

At around the same time, the federal government has subordinated defence's glacial procurement processes in favour of urgent capability decisions, including, among others, the ability to manufacture missiles locally and upgrading Australia's military bases to ensure they are operationally ready for the advent of war. Expect much more news in this vein as our government radically ramps up its otherwise anaemic defence spending.

Anyone telling you not to worry about the risk of war frankly does not know what they are talking about. The one thing we can do to reduce the chances of conflict erupting is by massively increasing the costs of our largest trading partner crossing the Rubicon.

Experts agree that in any conflict over Taiwan, China will consider targeting strategic military assets located in Australia with its long-range land and submarine-launched ballistic missiles. Facilities like Pine Gap are, for instance, essential to the Western war-fighting machine. The homeland is, therefore, absolutely in the cross hairs.

Signatory of:



Asset weighted average rating

Strategy commentary cont'd: In May last year we asked the CEO of one of Australia’s largest resources companies whether his team had evaluated a downside scenario whereby the federal government banned his business from selling critical war-fighting inputs, such as iron ore, natural gas, and coal, to China in the event a conflict erupted. The CEO responded that neither he nor his team had ever contemplated this idea.

We’ve been thinking through and forward-planning for these risks for years and have a clear vision of precisely what we would do. We would encourage everyone to do the same. You cannot simply rely on the assumption that war will not happen: ask yourself the question, what are the personal and financial costs that you will wear if you are wrong?



Don’t forget to listen to Coolabah Capital’s popular Complexity Premia podcast. You can listen on your favourite podcast app, or you can find it on [Apple Podcasts](#) or [Podbean](#).

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