



April 2022

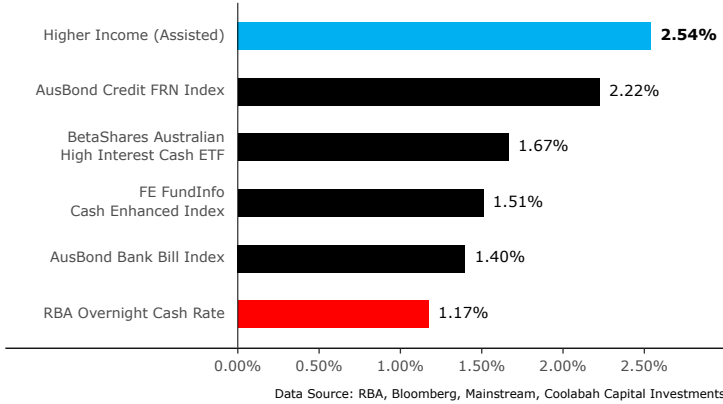
Objective: An independently-rated/recommended strategy targeting low-risk cash and fixed-income returns that exceed the RBA's cash rate by 1.5%-3.0% pa after fees, over rolling 12 month periods.

Strategy: We actively invest in a diversified portfolio of Australian deposits, investment grade floating-rate notes and hybrid securities with a weighted-average "A" credit rating. We do not invest in fixed-rate bonds (unless interest rate risk is hedged), direct loans, use leverage, or take currency risk. We add value via active asset-selection using a range of valuation models with the aim of (1) delivering lower portfolio volatility than traditional bond funds and (2) providing superior risk-adjusted returns, or alpha, without explicitly seeking interest rate risk, credit risk or liquidity risk. The strategy is managed by Coolabah Capital Investments, which is a specialist active credit manager.

Period Ending 2022-04-30	Gross Return (Assist.)	Net Return (Assist.) [†]	RBA Cash Rate	Gross Excess Return [‡]	Net Excess Return (Assist.) ^{†‡}
1 month	-0.16%	-0.20%	0.00%	-0.16%	-0.21%
3 months	-0.02%	-0.18%	0.01%	-0.04%	-0.20%
6 months	-0.32%	-0.65%	0.02%	-0.34%	-0.67%
1 year	-0.14%	-0.82%	0.04%	-0.18%	-0.85%
2 years pa	2.37%	1.40%	0.06%	2.31%	1.34%
3 years pa	2.41%	1.47%	0.32%	2.09%	1.15%
4 years pa	2.76%	1.81%	0.62%	2.14%	1.20%
5 years pa	2.89%	1.98%	0.79%	2.10%	1.18%
Inception pa Oct. 2014	3.52%	2.54%	1.17%	2.35%	1.37%

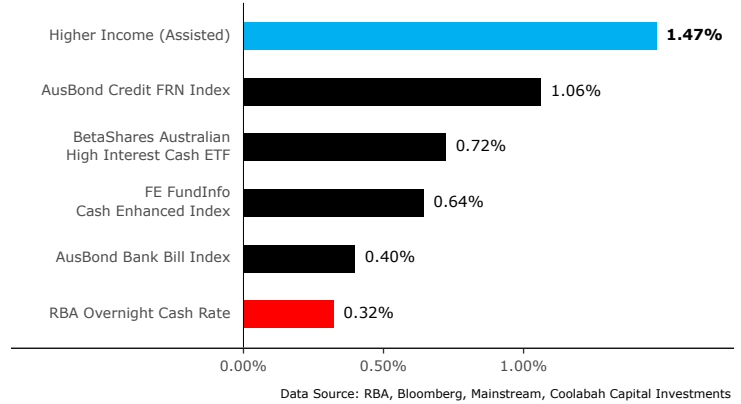
Smarter Money Higher Income Fund Returns (Net) vs Comparisons

Annualized Total Returns Since Inception in October 2014 to April 2022



Smarter Money Higher Income Fund Returns (Net) vs Comparisons

3 Year Annualized Returns to April 2022

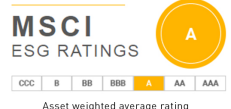


[†] Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. [‡] The Excess Return columns represent the gross and net return above the RBA cash rate.

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 Overnight Cash Rate	78%	Gearing Permitted?	No
Portfolio Weight to Cash Securities	15.9%	1 Year Av. Portfolio Weight to Cash	17.8%
Portfolio Weight to Bonds	81.9%	Portfolio Weight to AT1 Hybrids	6.9%
Av. Portfolio Credit Rating	A+	Cash Securities + RBA Repo-Eligible Debt	65.2%
Portfolio MSCI ESG Rating	A	Portfolio Weight to ABS/RMBS	0.0%
No. Cash Securities	12	Credit Spread Duration Ex Govt	0.17 years
No. Notes and Bonds	100	Net Annual Volatility (since incep.)	0.85% pa
Modified Interest Rate Duration	0.05 years	Gross/Net Sharpe Ratio (since incep.)	2.69x/1.61x
		Awards: FE Alpha Manager 2019: Christopher Joye; Ratings: Lonsec available to advisers; Highly Recommended (Atchison); 'Superior Relatively Simple' (Foresight Analytics)	

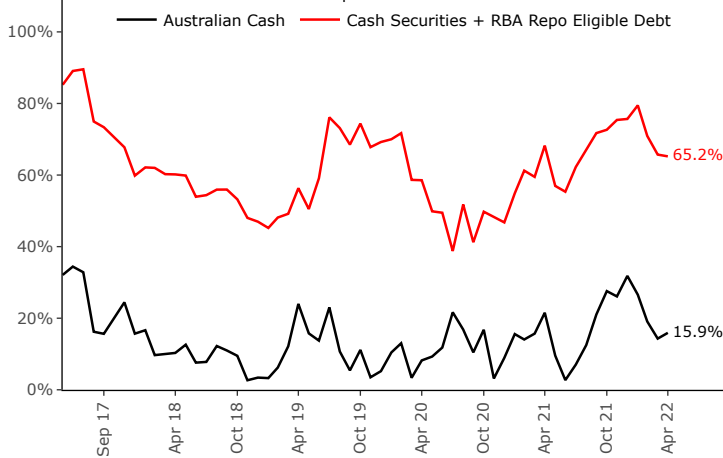
Signatory of:



Asset weighted average rating

Portfolio Weights: Cash + RBA Repo Eligible Debt

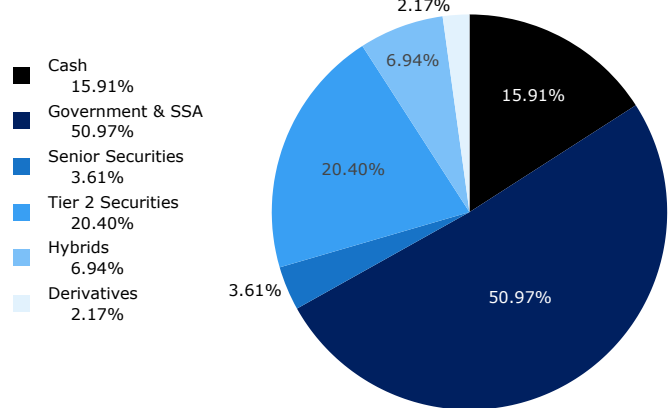
30 April 2022



Data Source: Coolabah Capital Investments

Smarter Money Higher Income Fund Portfolio Composition (NAV)

30 April 2022

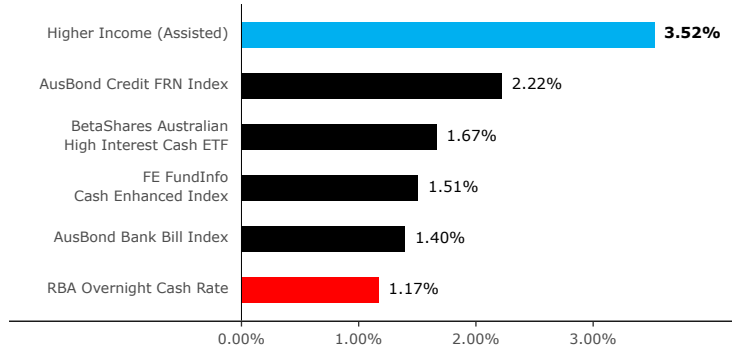


Data Source: Coolabah Capital Investments



Smarter Money Higher Income Fund Returns (Gross) vs Comparisons

Annualized Total Returns Since Inception in October 2014 to April 2022



Data Source: RBA, Bloomberg, Mainstream, Coolabah Capital Investments

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.

The since inception gross (net) return of 3.52% pa gross (2.54% pa net) is the total annual return earned by the fund since Oct. 2014, 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 Higher Income Fund - Assisted 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 0.85% pa is based on the standard deviation of net daily returns since inception, which are then annualised, attributable to the Smarter Money Higher Income Fund - Assisted Investor Class.

Portfolio Managers	Christopher Joye, Ashley Kabel, Dr Stephen Parker, Dr Nick Campregher (Coolabah Capital Investments)		
APIR Code	SLT0052AU	Fund Inception	30-Sep-14
mFund Code	SMF02	Distributions	Quarterly
Morningstar Ticker	40536	Unit Pricing	Daily (earnings accrue daily)
Asset-Class	Short-Term Fixed-Interest	Min. Investment	\$1,000
Target Return	Net 1.5%-3.0% pa over RBA cash rate	Withdrawals	Daily Requests (funds normally in 3 days)
Investment Manager	Coolabah Capital Investments (Retail)	Buy/Sell Spread	0.00%/0.025%
Responsible Entity	Equity Trustees	Mgt. & Admin Fee	0.69% pa
Custodian	Mainstream Fund Services	Perf. Fee	22.5% of returns over RBA cash + 2.19% pa

Portfolio commentary: The zero-duration and daily liquidity Smarter Money Higher Income Fund (SMHI) ended April with a weighted-average credit rating of A+, and a portfolio weighted average MSCI ESG rating of A. Over the previous 3 months, SMHI returned -0.02% gross (-0.18% net), compared to the FE Cash Enhanced Index (-0.39%), the AusBond Credit FRN Index (-0.35%), the AusBond Bank Bill Index (-0.01%), the RBA Overnight Cash Rate (0.01%), and the BetaShares High Interest Cash (AAA) ETF (0.05%).

Since the inception of SMHI 7.6 years ago in October 2014, it has returned 3.52% pa gross (2.54% pa net), outperforming the RBA Overnight Cash Rate (1.17% pa), the AusBond Bank Bill Index (1.40% pa), the FE Cash Enhanced Index (1.51% pa), the BetaShares High Interest Cash (AAA) ETF (1.67% pa), and the AusBond Credit FRN Index (2.22% pa). Since inception, SMHI's Sharpe Ratio, which measures risk-adjusted returns, has been 2.69x gross (1.61x net). While SMHI's return volatility since inception has been low at around 0.85% 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: Coolabah's negative forecasts on global equities, interest rate risks, credit spreads, house prices and crypto came to further fruition in the month of April, which was generally a brutal month for risk assets as markets wrapped their minds around the spectre of elevated core inflation results and the corollary of protracted central bank hiking cycles.

Market Update

In April, the S&P500 index fell 8.8% while the NASDAQ index lost 13.3%. From the S&P500's peak, the index has now lost 14% while the NASDAQ is off a more material 23%. In December, Coolabah argued that US equities had to correct 30% to 60% based on the expectation of much higher long-term discount rates.

Both Australian and US 10-year government bond yields continued their march higher. The US 10-year yield started April at 2.33% and finished at 2.94%, just shy of Coolabah's December forecast for this yield to rise above 3.2%. It is currently 3.14%.

The Australian 10-year government bond yield likewise soared, climbing from 2.84% at the start of April to 3.13% by the end of the month, and is currently substantially higher again at 3.56%. Notably, Australian 10-year yields remain very elevated relative to US yields – some 46 basis points (bps) above their US counterparts at the time of writing.

This resulted in yet another losing month for the fixed-rate benchmark AusBond Composite Bond Index, which fell 1.49% in April, bringing losses over the first four months of 2022 to a historically unprecedented 7.3%.

If we extend this data into early May at the time of writing, the losses increase to 8.9%. And if we start the analysis at the Composite Bond Index's peak in late August 2021, the losses sum to a never-before-seen 11.95%.

This index only contains fixed-rate as opposed to floating-rate bonds. It benefits from interest rates declining and suffers during periods when rates rise, like the current time.

The flip-side of the coin is that the Composite Bond Index is now benefiting from much higher yields. In August 2021, the index was yielding only 0.79%. Today it is yielding 3.30%.

So there has been an enormous increase in the income being paid by the index. Total returns are likely to swing positive once the increase in yields has stabilized. If markets think the US economy is going to go into recession at some future juncture, the Composite Bond Index, which is long interest rate duration risk, would deliver very attractive returns.

It was a similar story in global credit markets. In the case of euro-area bonds, the Bloomberg Aggregate Corporate credit spread moved from 130bps at the beginning of April to 151bps by the end of the month: it is currently at 161bps. That is circa 66bps higher than the level of spreads at the start of the year.

Strategy commentary cont'd: Euro-area credit spreads are now once again wider than the mid-March 2022 peak following which there was a brief rally. They are also in line with their 2018 highs, which had been a key Coolabah forecast since late 2021: that is, that global credit spreads would hit their 2018 wides.

According to Bloomberg Aggregate Corporate benchmark, US credit spreads similarly gapped from 116bps to 135bps over April, and are 42bps above their levels at the start of the year. US spreads have outperformed their Euro-area equivalents, partly because they have not been as directly impacted by the Russia-Ukraine war. US spreads are also still a bit tight of 2018 peaks.

In Australia, 5-year major bank senior bond spreads were relatively tame, with Coolabah's proprietary 5-year index climbing from 90bps to 94bps, in a classic lag to offshore markets. Early May has been more punishing, with 5-year spreads pushing out to 101bps following a new deal that ANZ priced at 97bps.

Long-time readers will recall that Coolabah exited all of its major bank senior bond holdings in late 2020 and early 2021 when 5-year spreads were at about 35bps (we have been de facto short ever since). Since mid-2021, Coolabah has forecast that major bank senior bond spreads would increase sharply, looking for a long-term range between 75bps and 125bps.

Much bigger moves were observed in the Tier 2 subordinated bond market where Coolabah's 5-year index for major bank spreads jumped from 184bps to 212bps over April, which compares to the 2021 tights around 125bps.

According to Bloomberg, generic Aussie corporate credit spreads rose from 140bps to 153bps in April, which is about 40bps above their 1 January 2022 levels.

All of this meant that the AusBond Floating-Rate Note Index recorded its third consecutive monthly loss in a row, which is only the second time in history that this has occurred. The Aussie FRN Index has lost 0.6% since its peak in early September 2021, which is substantially superior to the circa 12% loss suffered by the fixed-rate Composite Bond Index over the same period. Since it only contains floating-rate as opposed to fixed-rate bonds, the FRN Index is expected to outperform in a climate in which short-term and/or long-term interest rates are moving higher.

The big outperformer in April was the ASX hybrid market, where Coolabah's 5-year index had spreads compressing from 240bps down to 228bps as the two recent new deals from ANZ and CBA started to settle, rallying well above their par \$100 prices. ANZPJ hit a peak around \$101.90 in April while CBAPK rallied to \$101.60.

The ASX Hybrids Major Bank Index accordingly delivered stellar relative returns, posting a 0.53% unfranked return in April.

Contrarian Forecasts

Since [late last year](#), Coolabah has had several contrarian views. First, US markets needed to price in the Federal Reserve lifting its cash rate to 2.5-3.0%. At the time, markets were pricing in a tiny 1.5% terminal Fed cash rate. They've now lifted that to around 2.9%.

A second forecast was that the US 10-year government bond yield needed to rise above 3.2%. Markets strongly disagreed, pricing in just a 1.3% yield. Yet four months later, the US 10-year yield is now above 3.1%.

A third expectation was that US equities would mean-revert back to normal, cyclically-adjusted, price/earnings multiples. This required a 30-60% draw-down in US stocks. Since that time, the S&P500 has fallen about 14% while the NASDAQ is off 23%. We estimate that [the S&P500 has another 20-35% to go](#). The NASDAQ should fall much further.

A fourth view was that while Aussie house prices would continue climbing for a while, they would [have to correct 15-25% after the first 100 basis points of cash rate hikes](#), which we thought would commence in mid-2022.

Strategy commentary cont'd: The Reserve Bank of Australia obliged in early May with its first 25bps increase. It was a classically jejune Martin Place: doing the one thing nobody on the planet expected just to prove everyone wrong. Markets and economists thought no hike, 15bps, or 40bps were all possible. Desperate to claim a supercilious victory, the RBA lifted its target rate 25bps.

The RBA's governor, Phil Lowe, then gave an impressive press conference, where he delivered a *mea culpa* on the central bank's woeful forecasting track-record, describing it as "embarrassing" and something that had to be fixed. This extremely rare bout of humility was way overdue, but nonetheless carried an enormous contradiction.

It is not just that the RBA's forecasts have been pathetically poor. It is that the RBA has then lurched into huge, multi-year policy pre-commitments on the basis of these specious perspectives.

Recall the commitment to not raise rates until at least 2024. This was also accompanied by the promise to keep buying the 2024 government bond yield to ensure its yield remained equal to the 0.1% cash rate. And, more recently, the pre-commitment to wait for the May and June wages data before hiking rates, ruling out a May move. All these de facto promises have been overturned, torching the RBA's credibility.

Despite admitting that his economists could not forecast their next footstep, Lowe then repeatedly told the world that the RBA expected to lift its cash rate to a 2.5% "neutral rate". Over and over again. On what planet can the RBA have confidence in this expectation?

All of this tells us is that the RBA has learnt absolutely nothing about the perils of pre-commitments. It demonstrates that it is not yet willing to concede defeat about its deep intellectual deficiencies. It cannot help but reflex into pretending to be an all-seeing, all-knowing diviner of our destinies.

The bad news is that the RBA has an especially distinguished track-record of getting the Aussie housing market's reactions to its cash rate changes horribly wrong. This is all the more surprising because the housing cycle is exceptionally easy to forecast.

Whether the RBA wants to admit it or not, its interest rate decisions will be heavily influenced by the direction of house prices, which after years of uber-cheap money have never been more inflated. This will be amplified by two dynamics. First, there are hundreds of billions of dollars worth of circa 2% fixed-rate loans that will roll into variable rate products carrying much higher interest rates in the next 2 years. Second, households are much more sensitive to interest rate changes than they have been before: our household debt-to-income ratio is sitting around 186%, in line with all-time highs.

Coolabah projects that the RBA will likely be forced--if it acts prudently--to pause its monetary policy tightening process after the first 100-150 basis points of hikes as a result of the commencement of a record 15-25% decline in Aussie home values (as we outlined in [October last year](#)).

It will also be held back by banks unilaterally lifting mortgage rates out-of-cycle as their funding costs normalise. Put differently, banks will do some of the heavy-lifting on interest rates for the RBA.

Since the total value of residential real estate is [currently worth \\$9.9 trillion](#), the RBA will likely impose losses on households worth some \$1.5 trillion (assuming just a 15% draw-down). Superannuation will also shrink in value as listed equities, infrastructure, property, and private equity are smashed.

Banks have already been forced to lift their 3-year home loan rates from 1.98% 12 months ago to 4.5% today. Non-bank lenders are likewise wearing an overdue repricing in their cost of funding via a sharp increase in the credit spreads on their residential mortgage-backed securities (RMBS).

What makes the RBA's history of housing misses so odd is that their own staff have actually developed an [outstanding model of the market](#), which we have [refined and used ourselves](#). While Martin Place has been historically insouciant to the insights rendered by this analysis, which explain the 2012-17 and 2020-22 booms, it did unfurl the "Saunders-Tulip" model for the first time in its [latest Financial Stability Review](#).

Strategy commentary cont'd: Our updated version of the model points to a 33% correction in house prices after a permanent 100 basis point increase in mortgage rates. Our official forecast involves a more modest, 15-25% correction, which would still be the largest loss in housing market history.

The risk is that the RBA once again gets wrapped-up in its flawed projections of the future, and hikes too hard and fast. Lowe himself seemed to endorse financial market expectations for 150-175 basis points of hikes this year alone, which has now become a consensus view. Goldman Sachs has taken this to an absurd extreme, alleging the RBA will hike 260 basis points by the end of 2022. Can you imagine what our world will be like when the discounted variable mortgage rate jumps from 2.25% right now to 5% (allowing for bank top-ups)?

Back in 2013, we repeatedly warned the RBA - publicly and privately - that by slashing its cash rate it was going to precipitate the mother of all housing bubbles, powered by double-digit house price appreciation. Between 2011 and 2017 the RBA dropped the cash rate from 4.75% to 1.50%. Over this time, national prices soared a stunning 41% based on CoreLogic's all regions index, which includes both the capital city and regional markets.

We further advised the RBA in 2013 that they would have to embrace the application of macro-prudential constraints on credit creation, which it was - at the time - opposed to. By late 2014, APRA had been compelled to start introducing these measures, which were progressively ramped-up in the years that followed.

Between 2015 and 2017, APRA's limits on credit creation forced lenders to materially jack-up rates on investment loans. In 2017, we argued this would trigger a 10% decline in national prices. Between 2017 and 2019, the 8 capital city index slumped 10.2% (the all regions index fell 8.3%).

In mid-2019 we forecast that future RBA rate cuts would drive house prices up 10% over the next year, which is what we got: the 8 capital city index rose 10.3% while the all-regions index climbed 8.9%.

The real howler for the RBA - and bank economists - was their forecasts for 10%-plus house price declines during the pandemic coupled with their inability to anticipate the stonking recovery. In March 2020, we projected a very short, and shallow, correction of 0-5% followed by capital gains of up to 20%, starting in September 2020.

CoreLogic's all regions price index fell 2.1% between March and September (the 8 capital city index declined 2.8%), and thereafter started climbing quickly.

The RBA claimed there would not be a housing boom in response to its pandemic policies because population growth was non-existent. We countered that the profound change in purchasing power care of a huge reduction in the cost of debt combined with robust income growth would power a sharp, 20% increase in prices.

By October 2021, the all-regions dwelling value index had indeed increased by 20%. In that month, we updated our forecasts to include at least another 5% of national price growth until the RBA started increasing its cash rate in the second half of 2022. More controversially, we also projected that [national home values would thereafter correct 15-25% following the first 100 basis points of rate increases](#).

Since this forecast was released, most bank economists have subsequently embraced the proposition, looking for a 10-15% correction in house prices over the 2022 to 2024 period.

It's worth putting this payback in context: home values across all markets have appreciated by 37% since mid-2019 when the RBA first started cutting its cash rate from 150 basis points down to the 10bps level that prevailed prior to the RBA's May hike.

There is no precedent for the RBA hiking through a period in which house prices are falling materially. We think the RBA will try to persist through the initial draw-down. Yet it is hard to imagine the RBA tightening financial conditions once they have wiped more than 10 percentage points off Aussie households' most valuable asset. If the RBA's hikes trigger the minimum correction we expect, households will have lost \$1.5 trillion.

Strategy commentary cont'd: There are potential mitigants. Wage growth is expected to recover robustly. If the RBA is gradual with its rate increases - spreading them over a number of years - a nontrivial share of the correction in prices could come via household income growth.

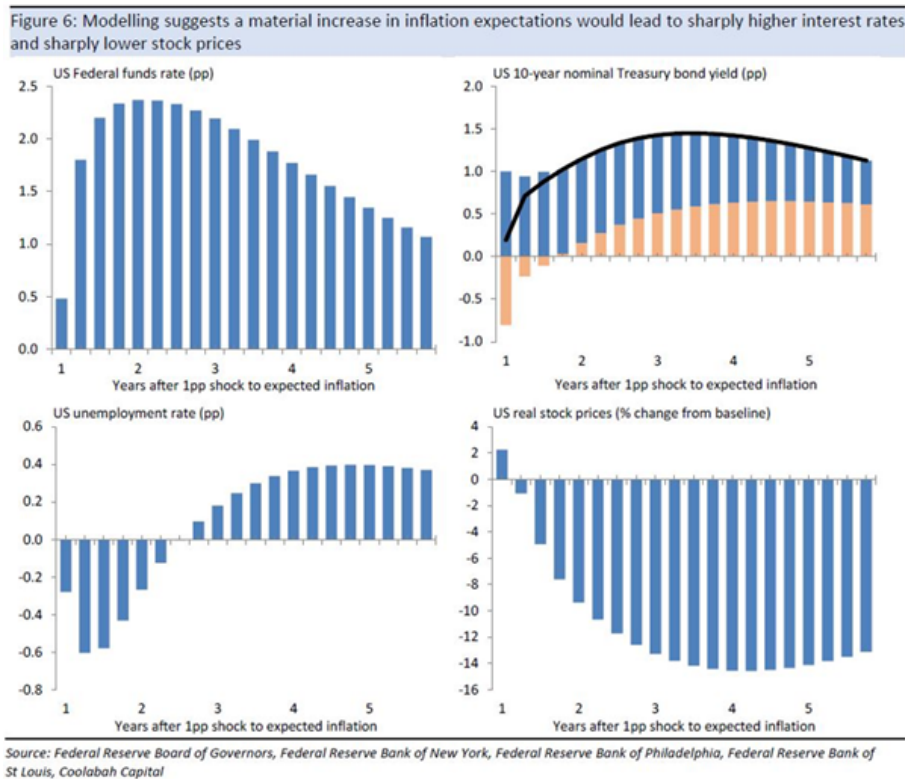
And the last thing the RBA wants to do is to tip us into a recession that would deny workers their jobs and the healthy wage growth that the RBA has been trying for years to stimulate. It will, therefore, be very closely following the [world-leading daily hedonic house price indices produced by CoreLogic](#), which revalue the entire 10.5 million dwelling housing stock every day using 100% of the incoming sales (as reported by agents and checked using land titles data).

As house prices start rolling over, we expect the RBA to materially modulate the pace of its monetary policy tightening process in response to clear evidence that its transmission mechanism is working.

If Martin Place has learnt anything from the pandemic, it should be the importance of being data-dependent. But that's a big "if".

Further Risks in Listed Equities

In May 2021, we [presented modelling](#) looking at the impact of a modest increase in inflation expectations in the US, which we showed could slash real equity valuations by 15% as the Fed's cash rate increased by ~250bps. Consumer inflation expectations have risen much more sharply than the 1 percentage point change in market inflation expectations that our analysis assumed. The key charts from that piece is enclosed below.

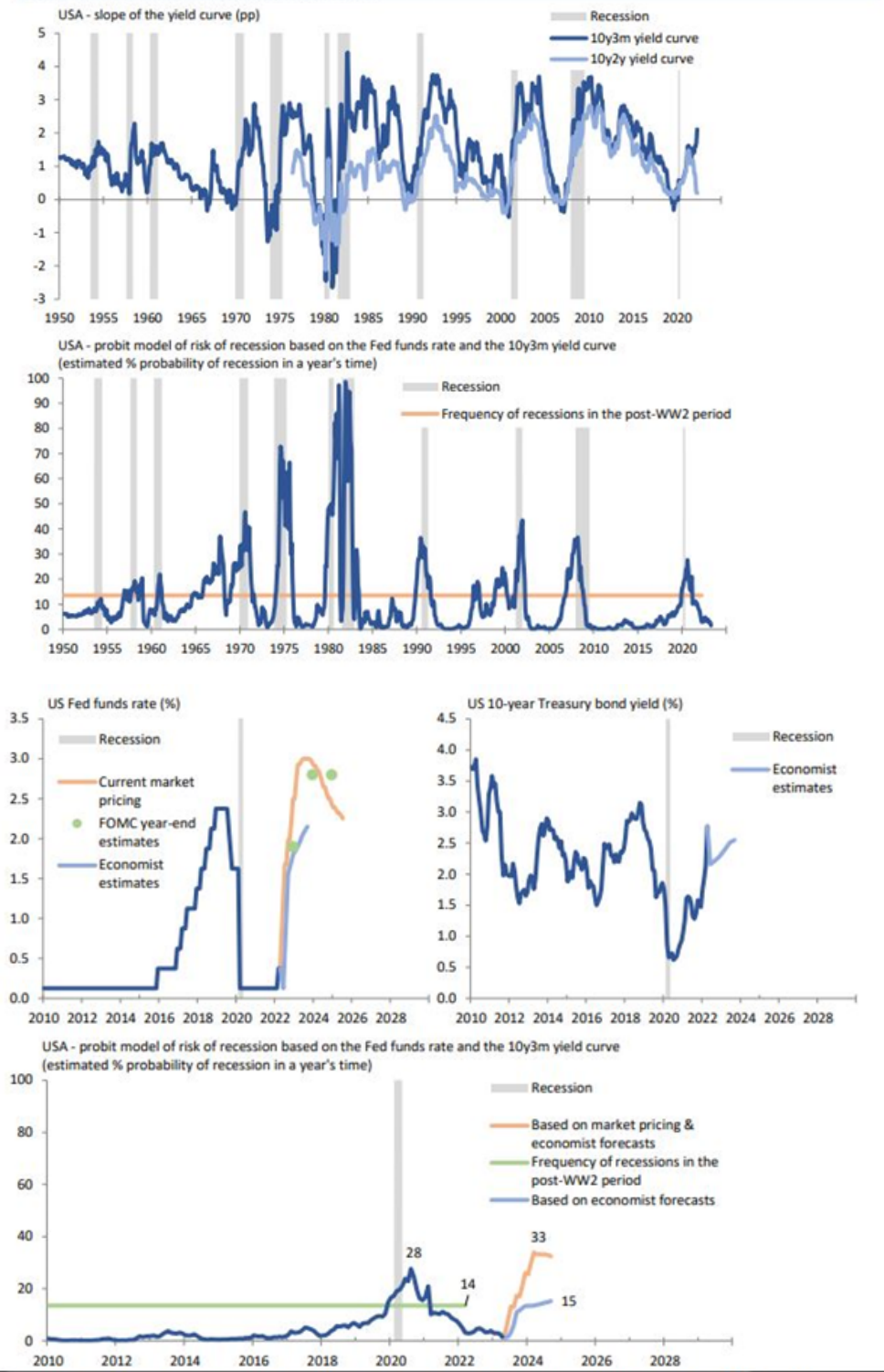


In April 2022, we [published additional research](#) showing that there appears to be a reasonably high likelihood of a US recession in late 2023 or early 2024 based on the market and economist expectations for future interest rate increases (see the charts immediately below). While talk of a US recession remains subdued right now, we think that this will ramp-up over time and compel price/earnings multiples to mean-revert back to their post-tech wreck and pre-pandemic range. The key conclusion from our April analysis was as follows:

Strategy commentary cont'd:

The estimated probabilities based on market pricing of the funds rate are higher and would strongly signal a recession in late 2023/2024, if realised... The eventual risk of recession will also hinge on how much the 10-year bond yield increases, noting that it is already materially above the peak economists' forecast of 2.6% (current US 10-year yields are 2.8%).

Figure 1: A modified yield curve suggests that the risk of recession embedded in economist expectations and market pricing accelerates in late 2023 and peaks in 2024



Source: Bloomberg, Board of Governors of the Federal Reserve, Federal Reserve Bank of St Louis, Westpac, Coolabah Capital Investments

Strategy commentary cont'd: Although US equities only slumped 20% in 2018 as 10-year yields soared above 3.2%, we believe that this cycle is very different because core inflation, wages growth, and inflation expectations in the US are running at multiples their 2018 levels. Acute global military conflict risks are not helping either.

Concurrently, post-pandemic asset prices have become much more stretched as investors naively priced in the low-rates-for-long paradigm in perpetuity. In 2021, investors were assuming (hoping) that the US 10-year government bond yield would remain around 1%-1.5% over the long-run, which helped rationalise uber-lofty equities and property valuations, amongst other things.

Way back in March 2021, we [released research showing](#) that the S&P500's unusually elevated cyclically-adjusted [price/earnings multiples \(developed by Nobel prize winner Robert Shiller\)](#), which were sitting at their second-highest levels over the last circa 140 years of data, implied that there was a high risk of a US recession. Specifically, we wrote:

US equities are extremely expensive according to long-term valuation measures such as the cyclically-adjusted PE (CAPE) ratio. The CAPE ratio for the S&P500 is currently about 35, which is the second-highest level in the roughly 140 years for which there are data... The US stock market's current CAPE points to a high risk of either a significant market correction or sustained market underperformance. In turn, this raises the risk of a spillover to other advanced economies given most other equity markets have a high correlation with US share prices.

We think that there is a reasonable prospect that the S&P500's cyclically-adjusted P/E will normalise back into a 20-25x range, with the risk it falls further down towards 10-15x. In our central case, we expect that the S&P500 will continue to correct, losing at least another 20%-35% as US recession risks become fully priced.

The risks are skewed towards materially larger losses if P/Es revert back towards longer-run averages around 10-15x. There are arguably parallels here with the 2001 tech-wreck (and the associated mispricings), which led to a US recession. In the 2001 correction, the S&P500 price index slumped 49% while the NASDAQ price index lost 78%.



All of these risks are amplified by the fractured global geo-polity and the possibility of another "world war" between the major powers cleaved by Western democracies, such as the US, UK and Australia, and non-democracies, the most obvious candidates of which are the firmly allied Sino-Russian axis. We have published advanced statistical modelling using 160 years of data, and an interactive website at predictingwar.com, which puts the probability of a kinetic US-China conflict, including a declaration of war, at a worryingly high ~45% over the next 10-years.

Victorian budget surprises with debt issuance downgrade on underlying strength

Strategy commentary cont'd: While media reporting on Victoria's budget has been confusing, it has surprised the market, investors and analysts with material downward revisions to the size of the budget deficit in both this 2021-22 financial year (FY22) and in the next 2022-23 year (FY23).

While Coolabah had the most aggressive forecast in the market for these deficit revisions, the size of the improvement in the current FY22, which was \$4.2 billion, is double our **~\$2 billion estimate** and four times bigger than projections published by Adept Economics (see [here](#)). The improvement in FY23 is more modest at just \$0.4 billion, which with rounding sums to a circa \$4.5 billion total reduction in Victoria's budget deficit over FY22 and FY23. This has allowed Victoria to announce a big reduction in its FY23 debt issuance program, which has been reduced from the \$25.8 billion originally announced in May 2021 to only \$21.3 billion for FY23 today (at the mid-year update in December it was reduced to \$23.6 billion). This implies that total state government debt issuance for FY23 is likely to be much lower than official and market estimates: in December, official estimates across all the states and territories totalled about \$84 billion in FY23, while the market was anticipating \$90 billion or more.

Assuming similar budget improvements across all states, Coolabah retains its contrarian forecast for a very large reduction in official debt issuance in FY23 to somewhere in the \$65 billion vicinity with further downside risks if NSW chooses to draw down the \$15 billion of available capital left in its Debt Retirement Fund (\$11 billion of which is already been used for debt reduction).

There is a huge lacuna in sell-side research with no analysts publishing independent forecasts for the state budgets, which means investors and the market rely heavily on the state estimates. Coolabah spends a lot of time trying to secure superior insights into the path of both federal and state budgets, and we have been predicting for the last 2 years that state budgets would very materially outperform official estimates, as has generally been the case.

One key complexity when it comes to budget analysis is differentiating between the narrow "general government" budget numbers and the much broader "non-financial public sector" budget results. The latter public sector numbers represent the entire consolidated budget, including state-owned non-financial corporations. It is the public sector budget, not the general government budget, that analysts, the market, and investors should be focused on, although this distinction does sometimes confuse even the sell-side.

The budget reported an improvement in the state finances, reflecting a stronger-than-expected economic recovery and delays to capex spending, as we had predicted (see [our research on infrastructure delays here](#)), although the extent of the improvement was tempered by increased spending on public services (the increased spending on services includes more spending on health, with the government facing an election in November).

The stronger recovery is also evident in the reasonable economic forecasts, comprising stronger growth and wages/inflation and lower unemployment, where the main risks to the outlook reflect ongoing uncertainty around COVID and the eventual impact of higher interest rates.

The profile for the narrower general government cash deficit improved in each year of the forecast horizon with stronger revenue and lower capex more than offsetting increased spending on government services. The deficit for 2021-22 improved by \$2.9bn to \$25bn, while the deficit for 2022-23 narrowed by \$1.1bn to \$13.2bn, with the deficit ranging between \$10bn and \$16bn over the three subsequent forecast years.

The more important, and much broader, non-financial public sector deficit also improved in each year of the forecast horizon for the same reasons as the general government sector, albeit with more volatility. The deficit for 2021-22 improved by \$4.2bn to \$28bn, while the deficit for 2022-23 improved by \$0.4bn to \$16.4bn, with the deficit ranging between \$13bn and \$20bn over the three subsequent forecast years (the still-high deficit reflects a large investment programme).



Strategy commentary cont'd:

Figure 1: Key budget forecasts

		'20-21	'21-22 (f)	'22-23 (f)	'23-24(f)	'24-25(f)	'25-26(f)			'20-21	'21-22 (f)	'22-23 (f)	'23-24(f)	'24-25(f)	'25-26(f)
General government cash budget balance								Non-financial public sector cash budget balance							
Revenue								Revenue							
- total	\$b	69.1	82.8	86.2	83.4	87.1	90.7	- total	\$b	72.7	88.6	92.8	90.1	94.0	97.7
	% yoy	-0.7	19.7	4.1	-3.1	4.3	..		% yoy	1.4	21.7	4.8	-2.9	4.3	3.9
Payments								Payments							
- current	\$b	82.1	94.5	84.9	82.7	83.5	85.1	- current	\$b	73.3	99.8	90.1	87.9	88.9	90.6
- capex etc	\$b	11.8	13.2	14.4	17.1	17.9	15.7	- capex etc	\$b	25.1	16.8	19.1	22.6	23.2	20.5
- total	\$b	93.9	107.8	99.3	99.8	101.3	100.8	- total	\$b	98.4	116.6	109.2	110.5	112.0	111.1
	% yoy	14.4	14.8	-7.8	0.4	1.6	-0.5		% yoy	15.3	18.5	-6.3	1.2	1.4	-0.8
Balance								Balance							
- operating (ex-capex)	\$b	-13.0	-11.8	1.3	0.8	3.6	5.5	- operating (ex-capex)	\$b	-0.5	-11.3	2.7	2.3	5.2	7.1
- total	\$b	-24.8	-25.0	-13.2	-16.3	-14.3	-10.2	- total	\$b	-25.6	-28.0	-16.4	-20.3	-18.0	-13.4
Vintages of the general government cash budget balance								Vintages of the non-financial public sector cash budget balance							
- as at May-21	\$b	-29.0	-21.3	-16.4	-16.2	-16.0	..	- as at May-21	\$b	-31.7	-23.7	-18.5	-18.5	-18.6	..
- as at Dec-21	\$b	-24.8	-27.9	-14.2	-18.9	-18.5	..	- as at Dec-21	\$b	-25.6	-32.2	-16.8	-22.0	-21.7	..
- now	\$b	-24.8	-25.0	-13.2	-16.3	-14.3	-10.2	- now	\$b	-25.6	-28.0	-16.4	-20.3	-18.0	-13.4
- revision	\$b	..	2.9	1.1	2.6	4.2	..	- revision	\$b	..	4.2	0.4	1.6	3.7	..
Key economic forecasts															
- real GDP	% yoy	-0.4	5%	3%	2%	2%	2%								
- employment	% yoy	-1.1	3	1%	1	1%	1%								
- unemployment	% avg	6.2	4%	4	4%	4%	4%								
- wage price index	% yoy	1.4	2%	2%	3	3	3								
- CPI inflation	% yoy	1.4	3	2%	2%	2%	2%								
Non-financial public sector annual net borrowing								Non-financial public sector stock of borrowings							
- as at May-21	\$b	31.0	23.7	18.8	19.2	19.2	..	- as at May-21	\$b	110.9	138.3	159.6	180.8	201.1	..
- as at Dec-21	\$b	27.8	31.8	16.7	22.2	22.2	..	- as at Dec-21	\$b	110.9	142.8	163.1	187.5	210.7	..
- now	\$b	27.8	27.8	22.7	21.1	19.4	15.1	- now	\$b	110.9	138.5	165.3	189.2	210.1	226.3
- revision	\$b	..	-4.0	6.0	-1.1	-2.8	..	- revision	\$b	..	-4.3	2.2	1.7	-0.6	..

Note: ".." not available, tba = to be announced
Source: Department of Treasury, Coolabah Capital Investments

The combined \$4.5 billion total reduction in Victoria's budget deficit over FY22 and FY23 has allowed it to announce a large reduction in its FY23 debt issuance program, which has been significantly reduced from the \$25.8 billion originally announced in May 2021 to only \$21.3 billion for FY23 today (at the mid-year update in December it was reduced to \$23.6 billion).

One devil in this detail is Victoria appears to have a policy of pre-funding a lot of the next 12 months of bond maturities as part of its official debt issuance program. While Victoria appeared to have issued very precisely the amount of debt in the current FY22 that was required by its official funding task, and had therefore not superficially engaged in pre-funding, TCV announced last night that the state had already, in fact, pre-funded \$8.6 billion of FY23's requirements. This continues a pattern we have observed in past financial years, with very large completed pre-funding programs that are not otherwise easy to reconcile.

In the FY23 budget, there is a \$6bn increase in Victoria's borrowing needs despite a \$0.4bn decrease in the public sector cash deficit. Combined with the improvements in the FY22 deficit compared to official forecasts, it appears that Victoria is once again embedding in its FY23 funding task enough pre-funding to allow it to refinance forward 12 month maturities.

All of this implies that total state government debt issuance for FY23 is likely to be much lower than official and market estimates; in December, official estimates were \$84 billion in FY23, while the market was anticipating \$90 billion or more.

Assuming similar budget improvements across all states, Coolabah retains its contrarian forecast for a very large reduction in official state debt issuance in FY23 to somewhere in the ~\$65 billion vicinity with further downside risks if NSW chooses to draw down the ~\$15 billion of available capital left in its Debt Retirement Fund (\$11 billion of which is already been used for debt reduction).

Another important development is that Victoria is following NSW's lead by establishing a Future Fund that will be managed by VFMC, with the seed capital coming from asset sales and later investments sourced from land sales and a portion of budget surpluses once net debt stabilises. The fund is expected to reach \$10bn, where the "initial investment and future returns will be used to repay COVID-19 borrowings".

This fund is clearly an effort by Victoria to replicate the success of NSW's novel Debt Retirement Fund (DRF), which, as noted above, has been applied in an unprecedented fashion to reduce NSW's debt by \$11bn initially with at least a further \$15bn available in the DRF for future debt repayment should NSW decide to draw-down on it.



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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