



April 2023

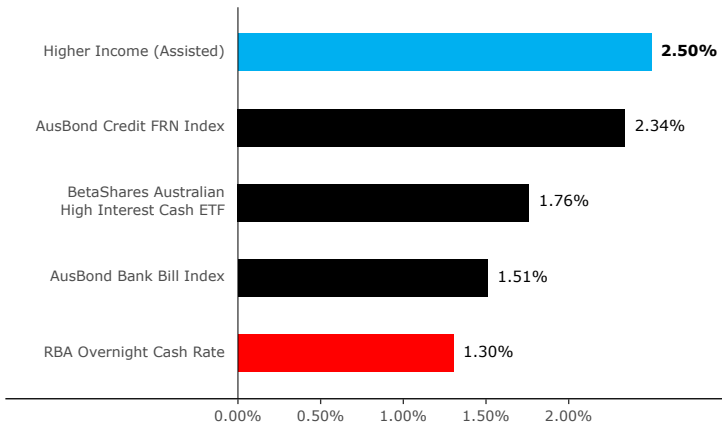
**Objective:** An independently-rated/recommended strategy targeting low-risk cash and fixed-income returns that exceed the RBA's cash rate by 1.5%-3.0% pa after fees, over rolling 12 month periods.

**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 2023-04-30	Gross Return (Assist.)	Net Return (Assist.) <sup>†</sup>	RBA Cash Rate	Gross Excess Return <sup>‡</sup>	Net Excess Return (Assist.) <sup>†‡</sup>
1 month	0.64%	0.53%	0.27%	0.37%	0.26%
3 months	1.43%	1.15%	0.81%	0.62%	0.34%
6 months	3.48%	2.99%	1.56%	1.92%	1.43%
1 year	3.03%	2.19%	2.30%	0.73%	-0.11%
2 years pa	1.44%	0.68%	1.16%	0.27%	-0.49%
3 years pa	2.59%	1.66%	0.80%	1.79%	0.86%
4 years pa	2.57%	1.65%	0.81%	1.75%	0.84%
5 years pa	2.81%	1.89%	0.95%	1.86%	0.94%
<b>Inception pa Oct. 2014</b>	<b>3.47%</b>	<b>2.50%</b>	<b>1.30%</b>	<b>2.16%</b>	<b>1.20%</b>

**Smarter Money Higher Income Fund Returns (Net) vs Comparisons**

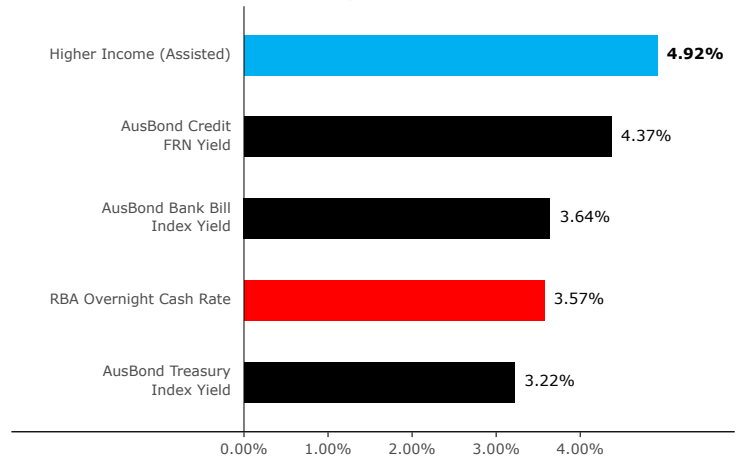
Annualized Total Returns Since Inception in October 2014 to April 2023



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

**Annualised Yield to Call/Maturity**

30 April 2023



Data Source: RBA, Bloomberg, Coolabah Capital Investments

<sup>†</sup> Net returns are calculated from the historic gross returns using the current fee structure as displayed in the Product Disclosure Statement. <sup>‡</sup> 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	77%	Modified Interest Rate Duration	< 0.1 years
Portfolio Weight to Cash Securities	1.4%	Gearing Permitted?	No
Portfolio Weight to Bonds	99.2%	1 Year Av. Portfolio Weight to Cash	4.0%
Av. Portfolio Credit Rating	A	Portfolio Weight to AT1 Hybrids	0.4%
Portfolio MSCI ESG Rating	A	Cash Securities + RBA Repo-Eligible Debt	43.1%
No. Cash Securities	12	Net Annual Volatility (since incep.)	0.86%
No. Notes and Bonds	95	Net Sharpe Ratio (since incep.)	1.39x
Av. Interest Rate (Gross Running Yield)	4.78%		

**Awards:** FE Alpha Manager 2019: Christopher Joye; **Ratings:** Lonsec available to advisers; Highly Recommended (Atchison); 'Superior Relatively Simple' (Foresight Analytics)

Signatory of:



Principles for Responsible Investment



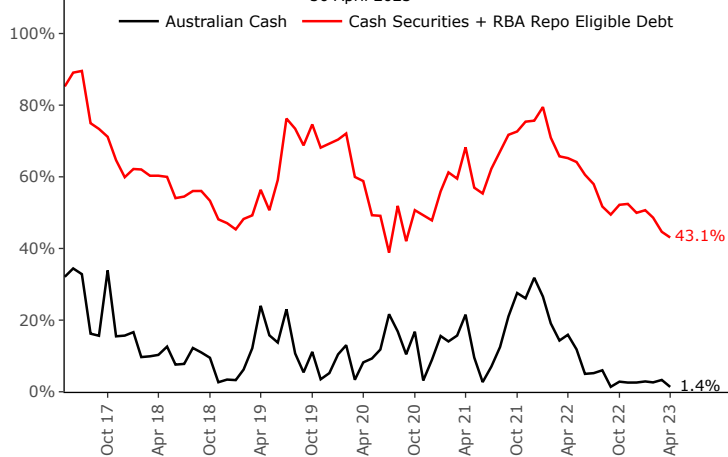
**ALPHA MANAGER 2019**  
Christopher Joye



Asset weighted average rating

**Portfolio Weights: Cash + RBA Repo Eligible Debt**

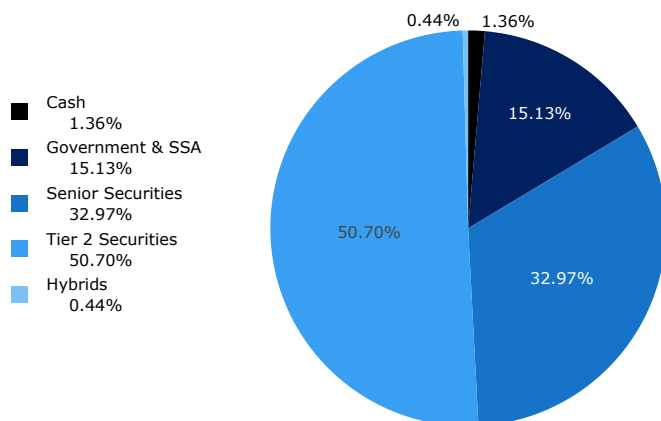
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Data Source: Coolabah Capital Investments

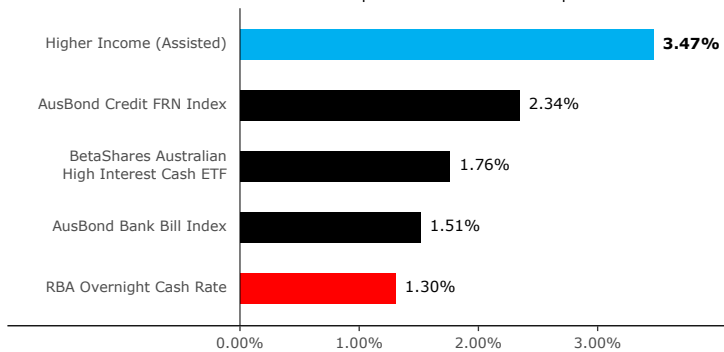
**Smarter Money Higher Income Fund Portfolio Composition (NAV)**

30 April 2023



**Smarter Money Higher Income Fund Returns (Gross) vs Comparisons**

Annualized Total Returns Since Inception in October 2014 to April 2023



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

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The since inception gross (net) return of 3.47% pa gross (2.50% 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 0.86% 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, Roger Douglas, 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	APEX Fund Services	Perf. Fee	22.5% of returns over RBA cash + 2.19% pa

**Portfolio commentary:** The zero-duration daily liquidity Smarter Money Higher Income Fund (SMHI) ended April with an annualised yield to call/maturity of 4.92% pa, a weighted-average credit rating of A, and a portfolio weighted average MSCI ESG rating of A. In April, SMHI returned 0.64% gross (0.53% net), outperforming the RBA Overnight Cash Rate (0.27%), the BetaShares High Interest Cash (AAA) ETF (0.28%), and the AusBond Bank Bill Index (0.30%). Over the previous 6 months, SMHI returned 3.48% gross (2.99% net), outperforming the RBA Overnight Cash Rate (1.56%), the AusBond Bank Bill Index (1.60%), and the BetaShares High Interest Cash (AAA) ETF (1.64%).

Since the inception of SMHI 8.6 years ago in October 2014, it has returned 3.47% pa gross (2.50% pa net), outperforming the RBA Overnight Cash Rate (1.30% pa), the AusBond Bank Bill Index (1.51% pa), and the BetaShares High Interest Cash (AAA) ETF (1.76% pa). Since inception, SMHI's Sharpe Ratio, which measures risk-adjusted returns, has been 2.45x gross (1.39x net). While SMHI's return volatility since inception has been low at around 0.86% 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 a strong month for all Coolabah's strategies with excess returns across the board. Key drivers included primary and secondary asset-selection in senior-ranking bank bonds, Tier 2 bonds, and Commonwealth and State government bonds. This has been summarised in a new, unscripted episode of our Complexity Premia podcast, [which can be accessed here](#).

The Long Short Credit Fund, which has zero interest rate duration and carries an average A+ credit rating, returned 2.18% to 2.43% net in April and has delivered 3.30% to 3.60% net over the past three months. Over the past 6 months, the Long Short Credit Fund has returned between 9.19% and 9.57% net of fees.

The new Coolabah Floating-Rate High Yield Fund, which has zero interest rate duration and an average A rating, returned 1.00% net in April and 2.78% net over the prior quarter (it launched in mid-December). One focus for the Floating-Rate High Yield Fund is furnishing a healthy cash running yield, which ended the month at 8.52% pa.

Coolabah's only long-duration solution, called the Active Composite Bond Strategy, returned 1.05% net in April, beating its benchmark, the Composite Bond Index, by 0.86%, and has delivered 3.34% net over the last three months. Over the past 6 months, the Active Composite Bond Strategy has returned 7.90% net of fees compared to its benchmark's 4.23%.

This portfolio has an average A rating and 5.4 years of interest rate duration. Performance has been powered by the abovementioned active credit asset selection combined with a modest rally in duration (higher fixed-rate bond prices) as Australia's 10 year government bond yield declined from 3.55% to 3.34% over the quarter.

Coolabah's RBA cash + 1% Smarter Money Fund and RBA cash + 1.5% Smarter Money Higher Income Fund, which contest the cash enhanced space, returned 0.60% and 0.57% in April and 1.22% and 1.23%, respectively, over the quarter after all fees. Over the prior 6 months, these funds have returned 3.05% and 3.03% after all fees.

Past performance is of no guide to future returns. Please read the product disclosure statements to better understand the risks.

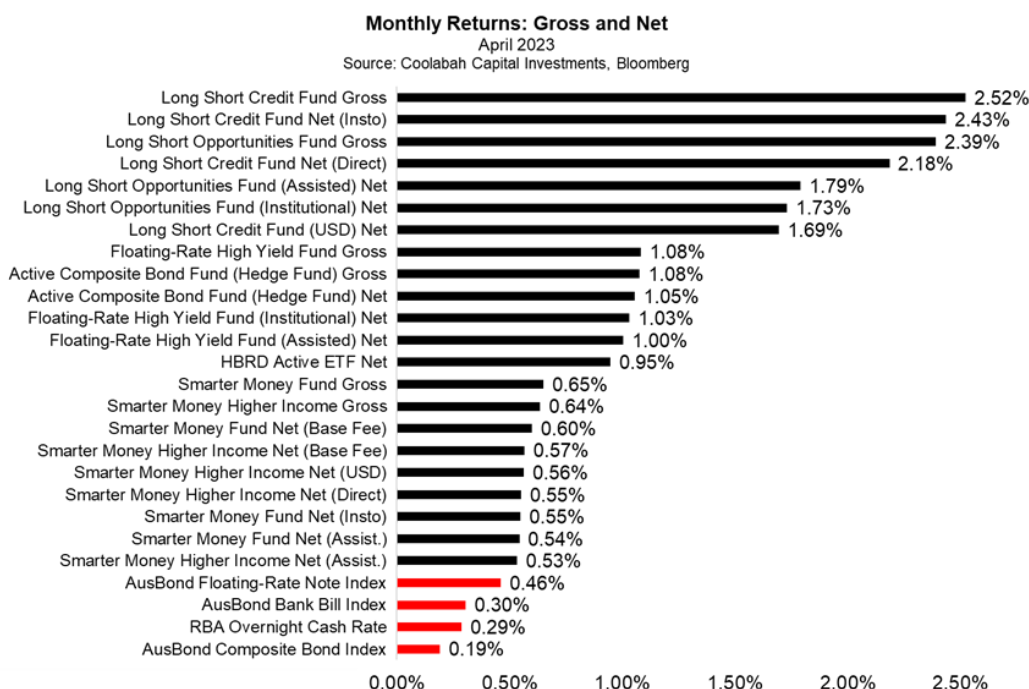
In April, the AusBond Floating-Rate Note Index returned 0.46% while the AusBond Composite Bond Index did 0.19%. The AusBond Bank Bill Index returned 0.30%.

Within the Aussie credit market, 5-year major bank senior bond spreads compressed from 97bps to 86bps over the quarterly bank bill swap rate (BBSW), the latter of which finished April around 3.67%. One step down the capital stack, 5-year major bank Tier 2 spreads contracted from 226bps to 214bps over BBSW. And on the ASX hybrid market, 5-year major bank securities profited from spreads falling from 287bps to 276bps over BBSW.

**Strategy commentary cont'd:** Aussie major bank senior and, in particular, Tier 2 bond spreads remain materially higher than their post-2013 averages. As the major banks come out of black-out in May, we would expect to see both senior and Tier 2 supply at attractive levels. On the ASX, major bank hybrid spreads are trading inside their post-2013 averages, but with BBSW at 3.67% and running yields sitting around 6.5%, investors are gravitating to the historically high all-in yields on hybrids (including franking).

In the high-grade government bond market, 10-year NSW bonds also performed in April with their spreads over Commonwealth government bonds declining from about 80bps to 76bps over the month. The spreads remain sharply wider than their post-2013 averages of around 34bps.

(We have enclosed below further analysis on the prospect of NSW liquidating its \$15 billion Debt Retirement Fund for deleveraging purposes along the lines of the \$11 billion draw-down from this fund in 2021 as a result of Coolabah's unprecedented ESG activism campaign at the time.)



**Sticky Core Inflation & Wages Headache for Fed**

The Fed meets on 2-3 May and should raise the funds rate by 25bp to a range of 5-5.25%. Recent instability in regional banks will tighten financial conditions, but the problem for the Fed is that core inflation and wages growth are not decelerating as fast as policy-makers would like and remain uncomfortably high.

The stickiness of consumer prices and wages growth is clear from the most recent readings of the Fed's preferred measures of consumer prices and labour costs:

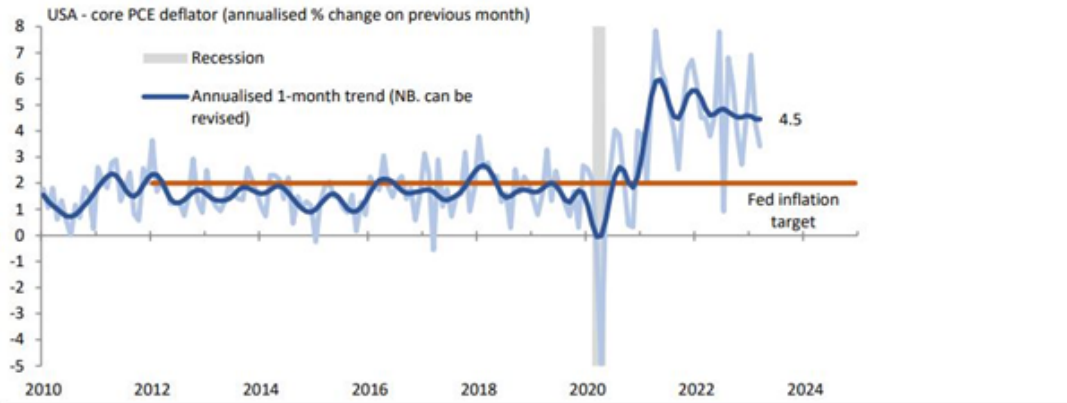
- Monthly trend inflation for the core PCE deflator is running at 4.5%, which is still very high relative to history and well above the Fed's 2% target; and
- Annualised trend growth in the private-sector employment cost index is running at 4.75%, which is still the strongest growth in years and well above trend growth of 3.5% in the more volatile average hourly earnings series.

This makes it very hard to imagine the Fed cutting rates in 2023 and raises the risks of a second hiking cycle at some point in the future. As we have noted before, pauses during monetary policy tightening cycles are very common in Australia and the US.



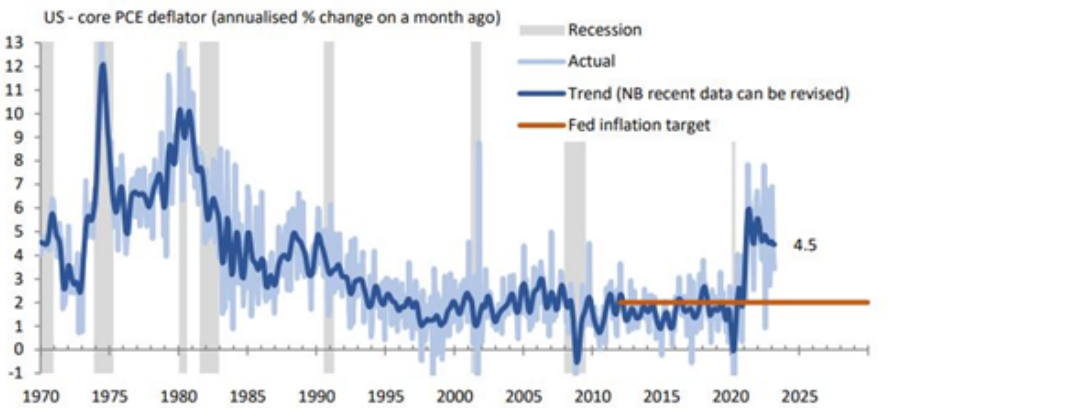
Strategy commentary cont'd:

**Figure 1: Core inflation remains sticky on the Fed's preferred measure ...**



Note: Trend estimates were calculated by CCI.  
Source: Federal Reserve Bank of St Louis, National Bureau of Economic Research, Coolabah Capital Investments

**Figure 2: ... with trend inflation still at its highest level in years and well above the Fed's inflation target**



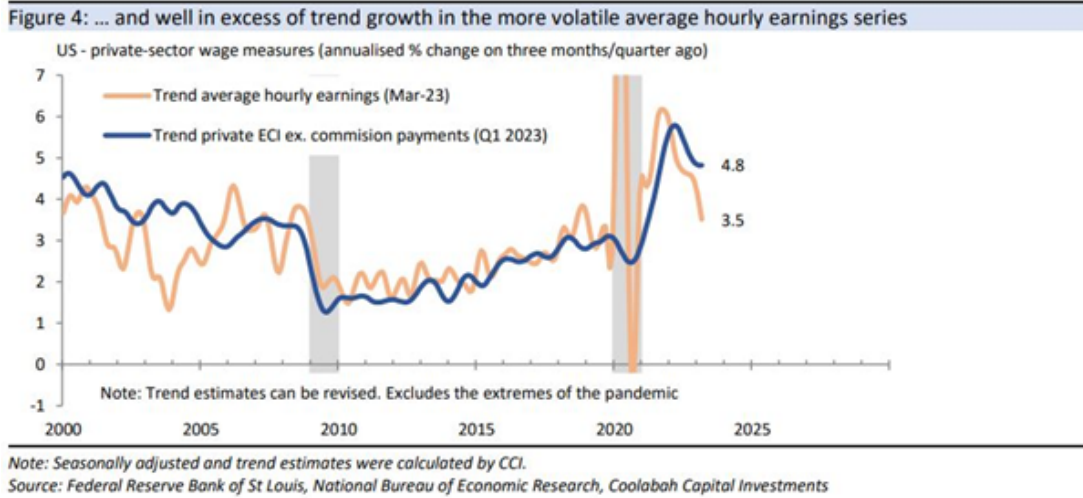
Note: Trend estimates were calculated by CCI.  
Source: Federal Reserve Bank of St Louis, National Bureau of Economic Research, Coolabah Capital Investments

**Figure 3: The Fed's preferred measure of wages growth is still growing strongly in trend terms ...**



Note: Seasonally adjusted and trend estimates were calculated by CCI.  
Source: Federal Reserve Bank of St Louis, National Bureau of Economic Research, Coolabah Capital Investments

Strategy commentary cont'd:

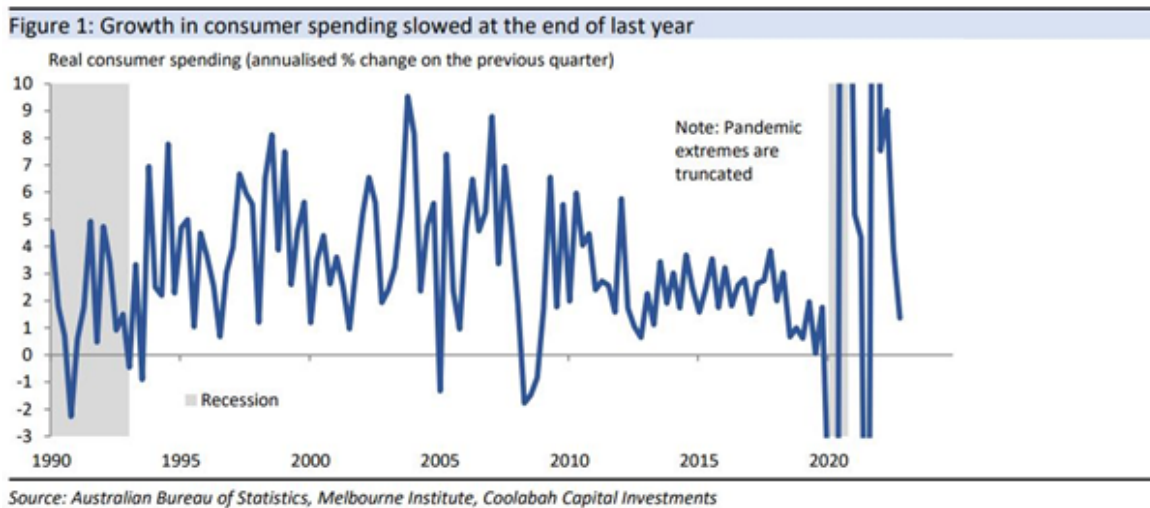


**Consumer Buffers May Elongate Hiking Cycle**

Consumer spending is widely expected to be weak over the next few years given the significant squeeze from a higher cost of living and higher interest rates. However, spending could hold up for longer than thought given:

1. the squeeze on cash flows from interest rates is partly offset by higher interest income;
2. households could save less or even return to spending all they earn; and/or
3. more importantly, households could dissave, tapping the massive excess savings that were accumulated during the pandemic, which are worth about 20% of annual income in aggregate and are broadly distributed across the community relative to incomes.

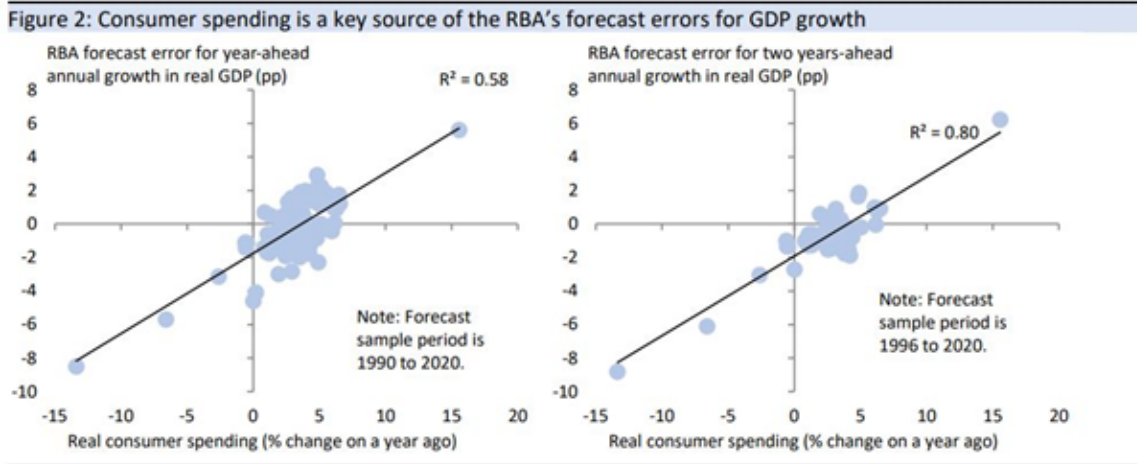
Consumer spending has been extraordinarily volatile during the pandemic, but slowed sharply at the end of last year, with annualised growth of 1.5% in Q4 marking the smallest increase since the spell of weak growth in the year or so before COVID.



Forecasting consumer spending is difficult, which is why the mistakes made in forecasting spending often account for most of the errors involved in forecasting the broader economy.

This is not surprising considering that spending accounts for about half of output and is clear from the close correlation between growth in consumer spending and the Reserve Bank's forecast errors for real GDP growth over a one-year and two-year horizon.

Strategy commentary cont'd:

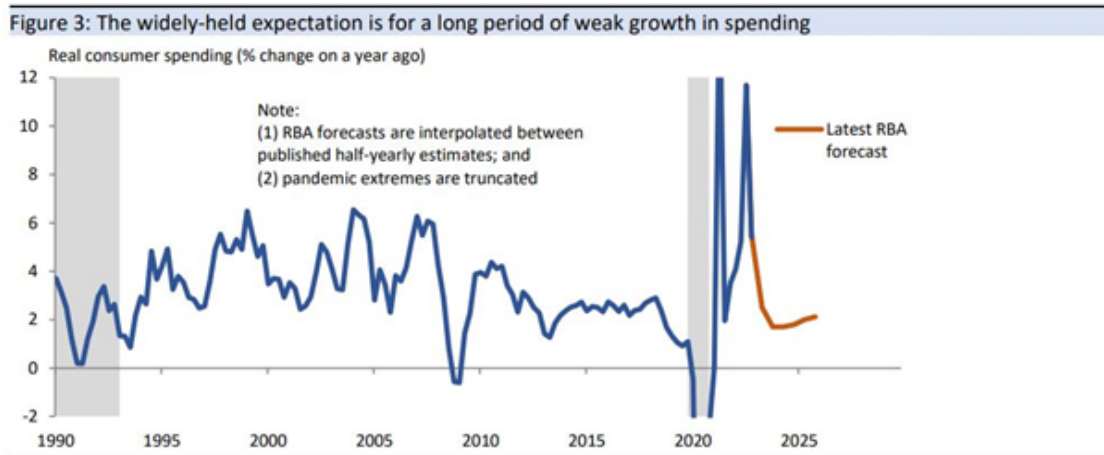


Source: Australian Bureau of Statistics, Reserve Bank of Australia, Coolabah Capital Investments

At present, the market and the Reserve Bank are united in thinking that consumer spending is facing a long period of weak growth, assuming, of course, that interest rates are near a peak and that the economy avoids a recession.

This is captured in the Reserve Bank forecasting average annual growth in real spending of about 2% over the next two-and-a-half years of its forecast horizon.

To place this in perspective, the only time average growth has been weaker than this has been in the immediate aftermath of the global financial crisis and post-WW2 recessions.



Note: The Reserve Bank forecasts are from the February 2023 Statement on Monetary Policy.  
 Source: Australian Bureau of Statistics, Reserve Bank of Australia, Coolabah Capital Investments

Constructing the bear case for consumer spending is straightforward, with a prolonged period of weak growth justified by:

- The deep pessimism of consumers;
- The squeeze on household income from a higher cost of living;
- The cash-flow squeeze from the impact of higher interest rates on repayments of household debt, and
- Lower asset prices, particularly house prices.

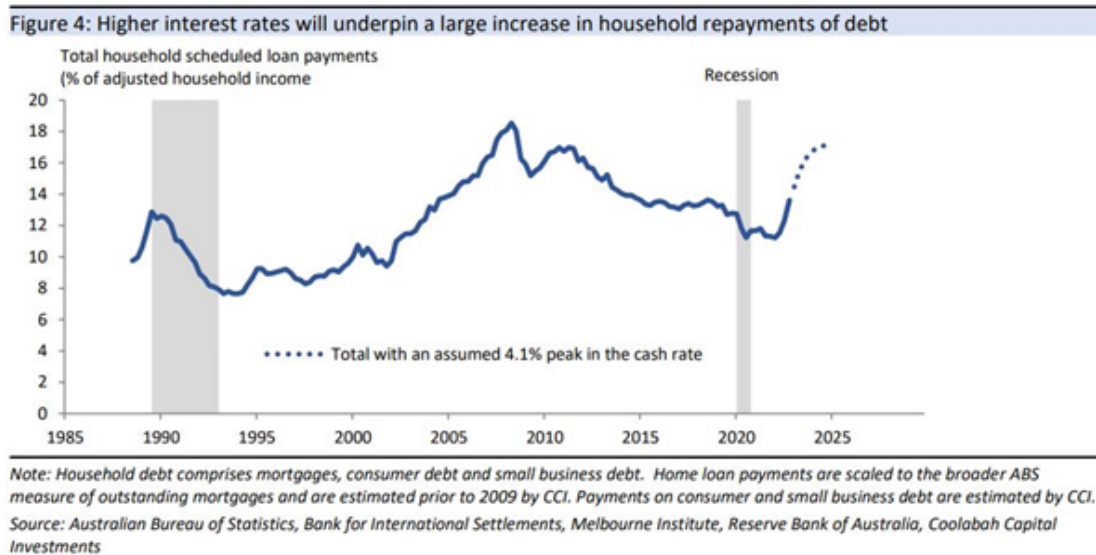
**Strategy commentary cont'd:** However, playing devil’s advocate, we have examined the risk that spending might hold up for longer than expected, focusing on the cash flow mechanism and the saving behaviour of households.

This risk is important because if it is realised then additional demand would place upward pressure on underlying inflation and hence interest rates.

We examined the cash flow-effect of higher interest rates because it is the part of the transmission mechanism of monetary policy that receives outsized attention from market participants.

At face value, the story regarding cash flows is straightforward, pointing to interest rates placing a large squeeze on household incomes via higher repayments of household debt.

On our calculation, total payments of household debt – comprising scheduled payments of principal and interest on mortgages, consumer debt, and small business debt – should increase from a multi-decade low of 11% of household income in early 2022 to around 17%, assuming the cash rate peaks at around 4%. This would almost match the 18.5% peak reached in mid-2008, back when the global financial crisis was well under way and the cash rate peaked at over 7%.

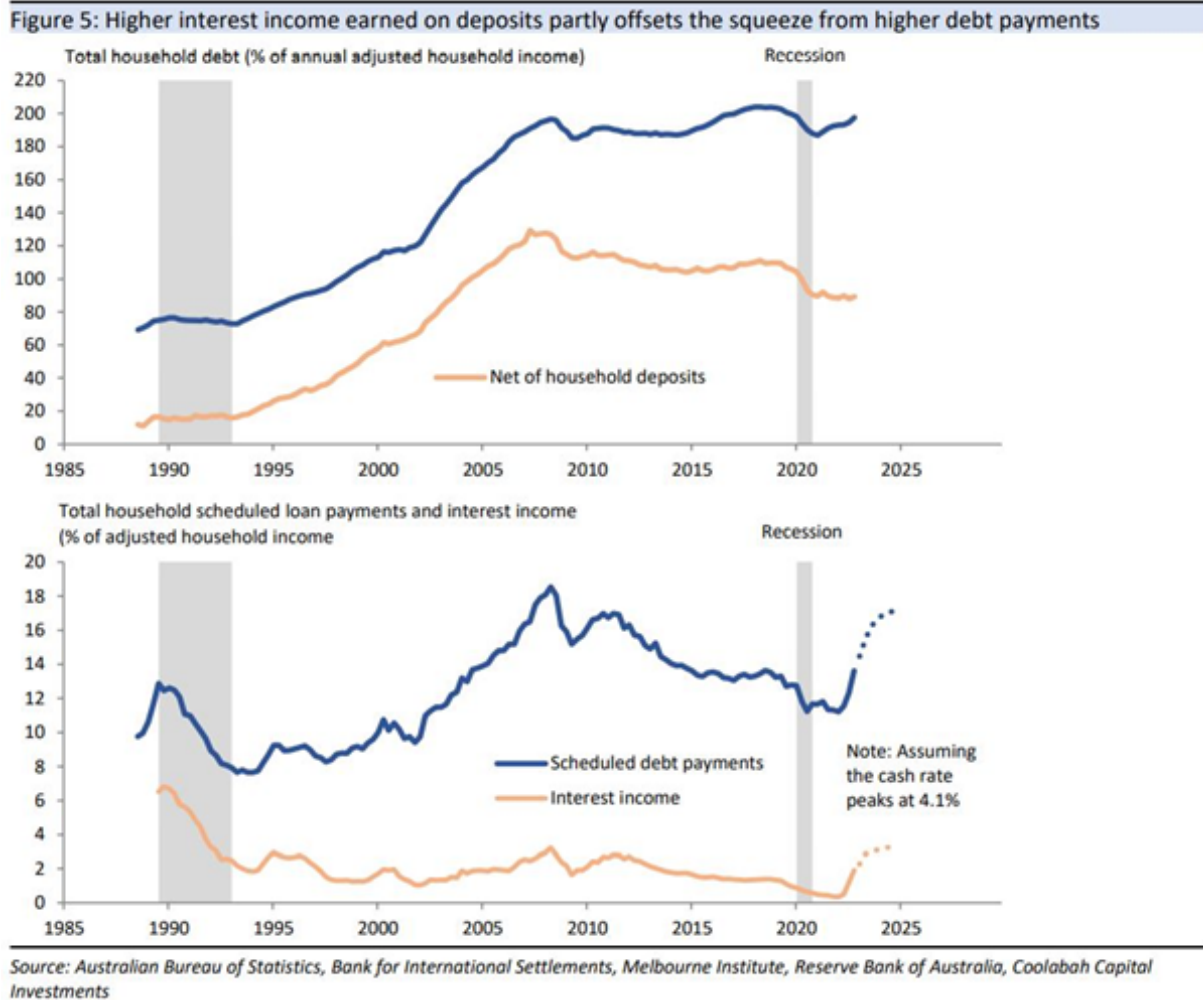


This substantial squeeze on household income will be muted by higher interest income, where deposits held by households have increased sharply during the pandemic.

On our estimation, interest income should increase from a recent multi-decade low of near zero as a share of household income to about 3% by next year (there is more uncertainty around the likely path for interest income related to how the higher cash rate is reflected in higher deposit rates).

Higher interest income will encourage some households to save more – which is another channel of the transmission mechanism of monetary policy – but some households will probably spend some of the money after several years of near-zero returns on deposits.

Strategy commentary cont'd:

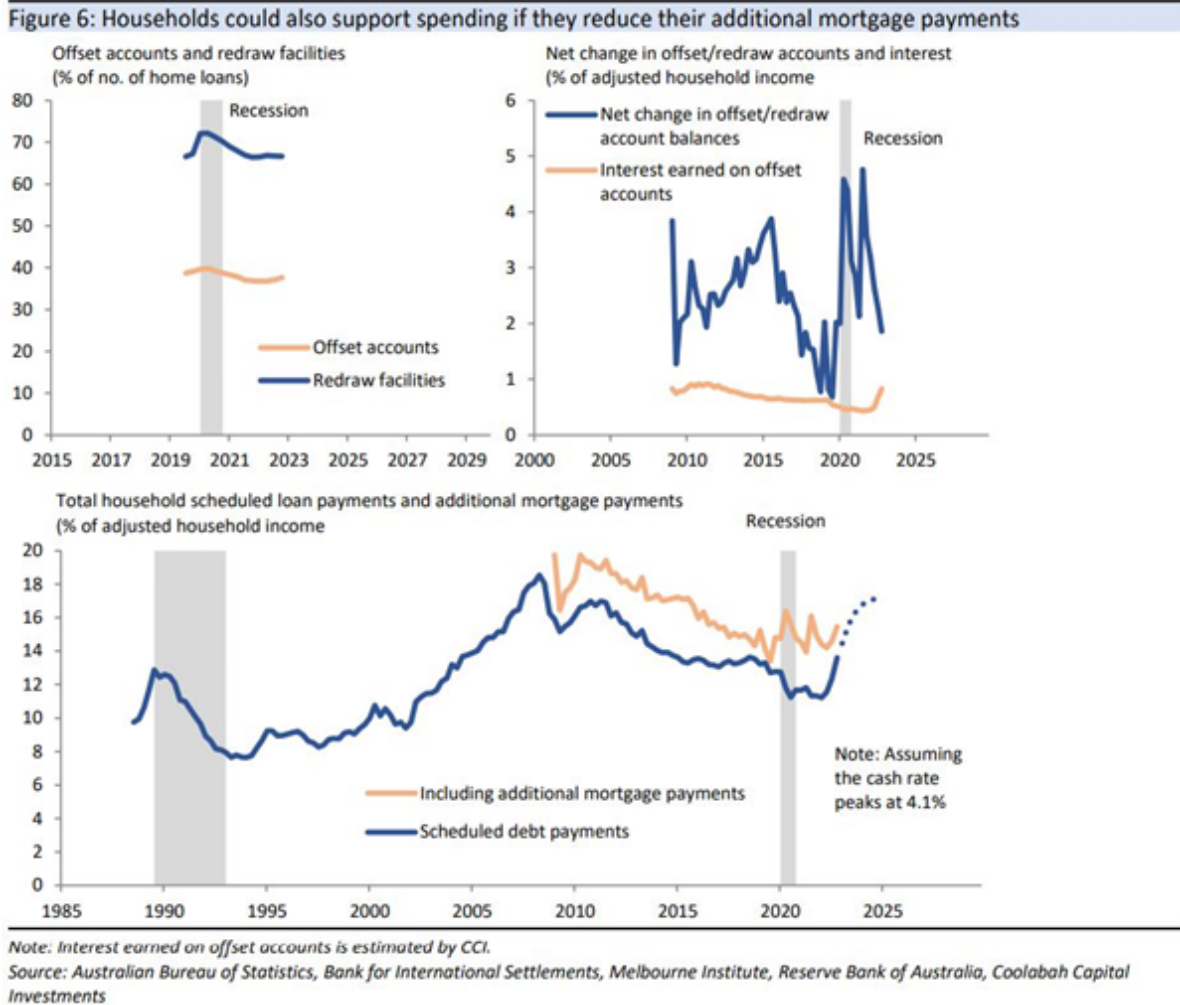


Another way households can support spending is by making smaller – and potentially no further – additional mortgage payments into offset accounts and redraw facilities (most mortgages have redraw facilities, while about 40% of mortgages have offset accounts).

Households have been making sizeable additional payments into these types of accounts for more than a decade, with net additional payments equalling about 2% of household income at the end of last year.

Additional payments fell as low as 0.5% of income prior to COVID, which suggests that households could make smaller extra payments if they want to support spending in the face of a higher cost of living and the cash-flow squeeze from higher interest rates.

Strategy commentary cont'd:



In a similar vein to potentially reducing additional mortgage payments, more significant support for spending could be provided by households changing their saving behaviour, either by continuing to save at a slower rate or even dissaving to tap the excess savings built up during the pandemic.

The scope for saving at a slower rate is shown by the best measure of households’ overall net cash flow, which is net lending, defined as gross saving less investment in physical assets (note that in comparison the widely-quoted household saving ratio is a narrower measure of cash flow).

Cash flow on this metric briefly peaked at a record 21% of household income at the height of the pandemic and fell to about 1% at the end of last year.

Prior to the pandemic, net lending was broadly zero, which suggests that households could support spending by further saving at a slower rate and potentially returning overall cash flows to balance.

Strategy commentary cont'd:

**Figure 7: Consumer spending could be further supported if households continue to save at a slower rate**



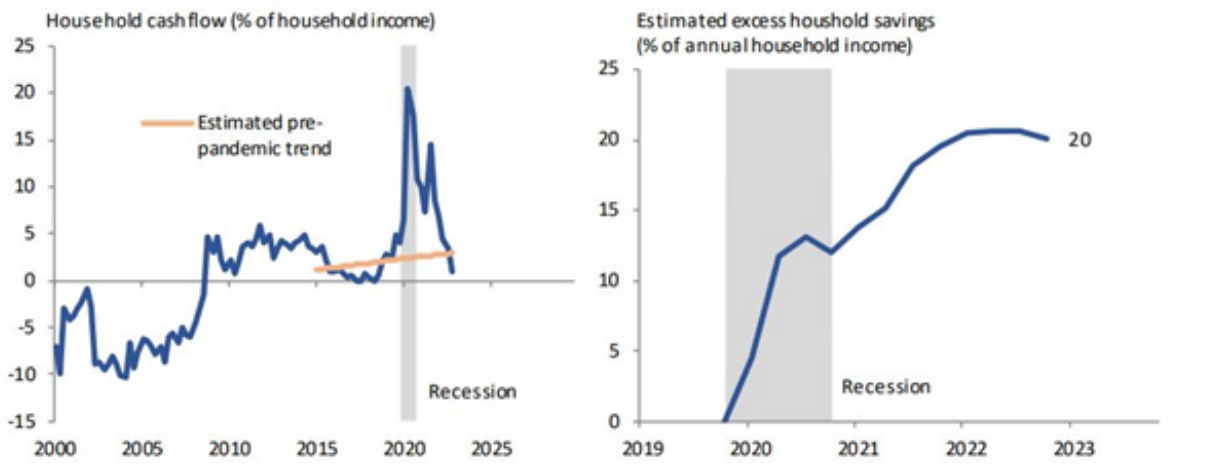
Source: Australian Bureau of Statistics, Melbourne Institute, Coolabah Capital Investments

A much larger support to spending could come from households dissaving and running down the excess savings built up during the pandemic, something already happening in the US.

Replicating work by the Federal Reserve, we estimate excess savings built up during COVID total about \$0.3 trillion, or around 20% of annual household income.

The excess savings mainly reflect the extraordinary financial support provided by the government during the pandemic, as well as sharply lower consumer spending, particularly greatly reduced spending on services during the lockdowns.

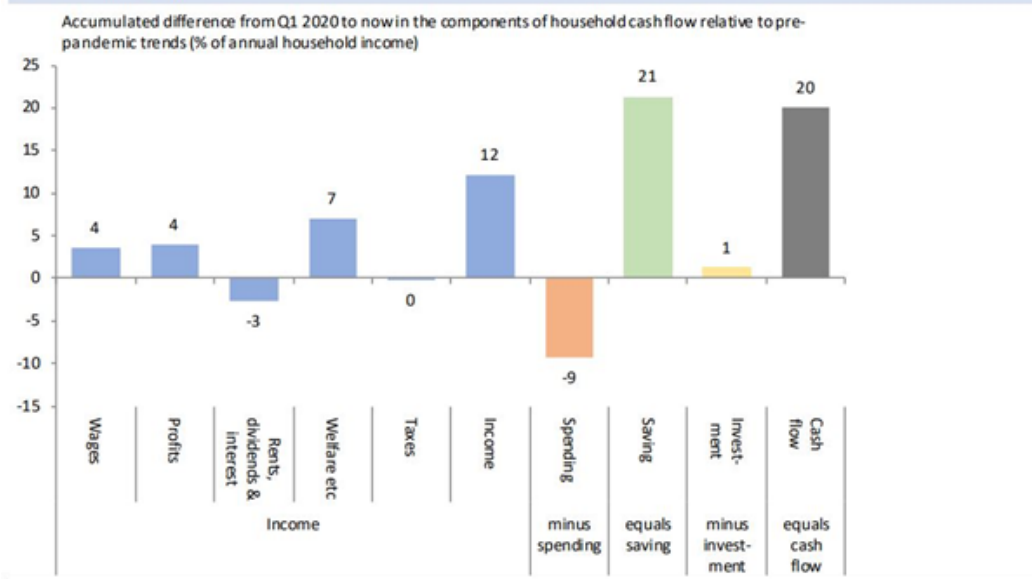
**Figure 8: Much larger support to consumer spending could come from households dissaving and tapping the massive excess savings built up during the pandemic**



Source: Australian Bureau of Statistics, Federal Reserve, Melbourne Institute, Coolabah Capital Investments

Strategy commentary cont'd:

**Figure 9: Estimated excess savings mainly reflects government financial support during the pandemic and reduced consumer spending**



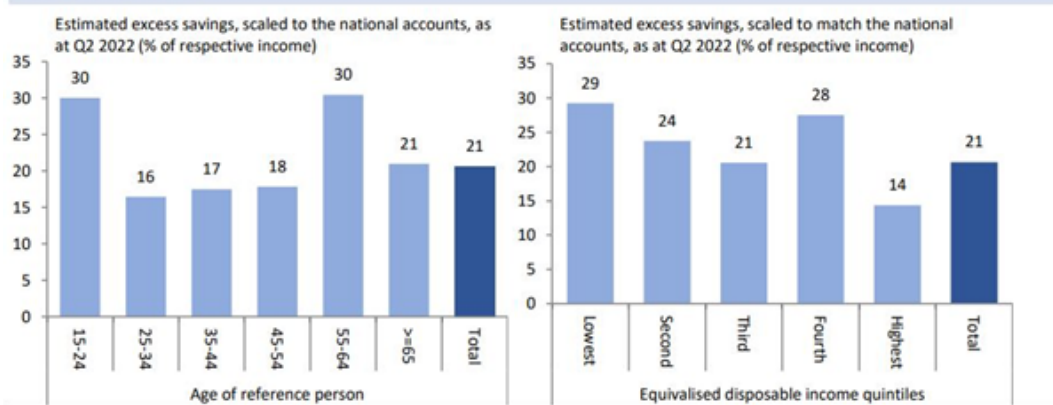
Source: Australian Bureau of Statistics, Federal Reserve, Melbourne Institute, Coolabah Capital Investments

In dollar terms, our analysis of cross-sectional data suggests that the distribution of excess savings is skewed towards older, wealthier households.

However, the distribution across age groups and incomes is much more even when excess savings are expressed as a share of each cohort's income.

This suggests scope for households across age groups and the income distribution to prop up spending for longer than currently anticipated.

**Figure 10: The distribution of excess savings across households is more even when expressed as a share of the income of respective cohorts**



Source: Australian Bureau of Statistics, Federal Reserve, Coolabah Capital Investments

**Dead Cat Bounce**

Acquire everything! It's a bull market! Equities are cheap! The buy-the-dip-reflex will prevail! Central banks will slash rates and lift their inflation targets! Residential and commercial investment properties paying net yields that are half the return on risk-free cash are still a bargain! Cryptocurrencies with zero intrinsic value and no government guarantees will go to the moon!

**Strategy commentary cont'd:** One hears these arguments from those loaded to the gills with stocks, property, tech, crypto, venture capital and risky debt. To believe this, you have to close your eyes and pretend to occupy a parallel universe.

You must ignore the biggest interest rate increases in history and the fact that they are deliberately designed to destroy demand, kill businesses, create job losses and slash the highest core inflation central banks have faced in 40 years back to their legislated 2% targets.

You have to ignore the US Federal Reserve's advice that the world's largest economy will probably experience a recession, which this column has been warning about since the start of last year.

You have to turn a blind eye to the waves of defaults and business bankruptcies that are starting to materialise, and the fact that 15% of all listed companies cannot service the interest bill on their debts (let alone principal repayments).

If that number sounds high, it just happens to be the same proportion of borrowers the Reserve Bank of Australia believes do not have enough income to meet their mortgage repayments and essential living expenses.

Finally, you have to ignore the harsh reality that perfectly liquid, government-guaranteed and risk-free cash deposits are paying interest rates of 4 to 5% annually. To even contemplate allocating capital to something that is illiquid and/or carries high risks of substantial loss, you would want to be banking near-certain risk premia of three to five percentage points above that 4 to 5% risk-free hurdle rate. And because most asset classes have yet to fully adjust to the new normal of structurally elevated interest rates, it is awfully hard to find anything that satisfies this test.

The concern is that central banks have yet to get close to dealing with their inflation woes, notwithstanding that headline rates peaked last year.

Global unemployment rates remain way below estimates of full employment, which means labour markets are still far too tight, fuelling buoyant wage growth despite poor productivity.

The nub of this challenge is revealed by a decomposition of the headline inflation data into its "goods" and "services" components.

Goods inflation was massively boosted by the closing of supply chains during the pandemic, peaking in double-digit territory. If we annualise goods inflation over the past six months, it has slumped from 12% in the US last year to effectively zero in the first quarter of this year. In Australia, the story is similar: goods inflation dropped from a peak of 12% last year to 5.5% in the March quarter.

This is why headline inflation rates have rolled over.

Yet excessively strong demand continues to power incredibly strong services inflation. In the US, annualised services inflation over the past six months has accelerated to 6%, which is the highest rate since the early 1980s. In Australia, services inflation is loftier still at almost 8%.

Even allowing for the dampening influence of the one-off reduction in goods inflation, overall core inflation in Australia and the US was expanding at a 4.8% and 4.9% pace, respectively, on a three-month annualised basis in the first quarter of this year.

This was the highest quarterly inflation the US has suffered since 1988 (excluding the post-pandemic period). In Australia, it is the worst quarterly inflation outcome since 2008 when a 7.25% RBA cash rate and the global financial crisis conspired to eviscerate demand (again excising the post-pandemic data).

The central banks' battle with high inflation is, therefore, far from over. We are much more likely to be living in a world where interest rates remain high for a number of years. And it is entirely plausible that central banks will be forced to embark on a second phase of interest rate increases after this pause expires, which has been a common feature of past cycles.

### Strategy commentary cont'd: Valuation Puzzle

Given this challenge, let's consider valuations in one of the most important markets on the planet, US equities, which tends to be the tail that wags many dogs. The cyclically adjusted price/earnings ratio (or CAPE) for the US share market peaked at 39 times in late 2021. This was, amazingly, the second-highest level on record, surpassed only by the tech bubble mark of 44 times in 1999. (It also exceeded the third-highest recording of 29 times touched in 1929, just before the Great Depression.)

Since 1880, the average CAPE has been 16 to 17 times. It is currently 29.5 times. In the exuberance immediately before the 2008 crisis, the CAPE traded a bit above 25 times. After that shock, it climbed from a low of 15 times to north of 30 times just before the pandemic. This was powered by the belief that we were living in a world in which inflation was dead and interest rates would remain low for a long time, combined with the central bank response of spending trillions of dollars buying bonds and equities to bid up the value of all assets.

The pandemic pushed these policies to new extremes with zero or negative interest rates and the biggest central bank buying programs in history coupled with unprecedented fiscal stimulus. The CAPE subsequently soared to 39 times in 2021.

Since the Fed launched its existential battle against inflation, and jacked up its policy rate by a stunning 475 basis points, the US equities CAPE has started to normalise, falling from 39 to 29 times.

History shows that high inflation is bad for share prices because the rise in discount rates crushes valuations. Coolabah's chief macro strategist, Kieran Davies, finds that "based on more than 70 years' worth of data, the current US core inflation rate around 5.6% is consistent with a CAPE of 10-15 times".

"This implies that even though the CAPE has fallen, there is still significant downside risk to share prices, particularly if inflation remains elevated."

Those who are long risk argue that central banks will simply lift their legislated commitments to price stability from 2% to, say, 3 to 4%, avoiding the need for further aggressive interest rate increases. Davies counters that "this solution would still lead to higher interest rates that would challenge the valuation of current asset prices".

"This is because interest rates equal the real or inflation-adjusted rate plus expected inflation – and a higher inflation target would lead to higher expected inflation," he says.

"If markets thought that central banks could credibly hit their new higher inflation target, the increase in expected inflation would be 1:1. And if a higher inflation target caused markets to doubt whether central banks were serious about containing inflation, expected inflation could rise by much more, leading to higher ongoing inflation in an echo of the disastrous experience of the 1970s."

Another argument is the inflation problem is being propelled by companies expanding profit margins, particularly as wages have lagged the rise in consumer prices.

Australian analysts have replicated work by the European Central Bank that uses an accounting identity to explain economy-wide inflation through labour costs, profits and net taxes. At face value, this work is alarming because it found that profits have been fuelling inflation.

This is not, however, that surprising given economy-wide inflation includes export prices, where the surge in commodity prices has resulted in a near-doubling of mining profits since the start of the pandemic.

Coolabah has adopted a different approach, replicating the ECB's analysis by approximating consumer prices using industry statistics on household services and retail trade. Preliminary analysis suggests that higher consumer prices mainly reflect higher unit labour costs rather than profits.

**Strategy commentary cont'd:** “We find that unit labour costs added 6 percentage points to inflation over the last year, with unit net taxes contributing 3 percentage points and unit profits adding another 2 percentage points,” Davies says.

“This would not come as a surprise to the RBA since it has recently started highlighting strong growth in unit labour costs, which reflects stronger wages growth combined with poor productivity.”

The RBA has stressed that for current wage growth to be consistent with low inflation, workers will need to improve their productivity. A recession may be precisely the jolt lackadaisical Millennials require to lift their game.

### States’ Fiscal Revolution

The election of Chris Minns’ government in NSW appears to be heralding a revolution in fiscal responsibility that has otherwise been missing in action in Australia’s two largest states since the advent of the pandemic.

Egged on by the Reserve Bank of Australia promising not to raise interest rates until 2024, the states were encouraged to borrow and spend aggressively. But it turned out that rates did, in fact, start rising at an unprecedented pace in May last year. And given the strongest inflation in more than 30 years, it has proved to be the worst possible time to be building infrastructure.

In 2016, the budgets of NSW and Victoria were in surplus (NSW delivered another one the next year). In 2018, Victoria had just \$46 billion of total government debt; NSW taxpayers owed only \$58 billion.

In that year, then-NSW treasurer Dominic Perrottet had the prescient idea of setting aside his surpluses and any asset sales in a rainy-day Debt Retirement Fund (DRF), held within his newly established NSW Generations Fund (NGF). This was to be managed by NSW’s investment arm, TCorp.

Under the NGF’s legislation, the DRF would be used to reduce NSW’s gross debt to protect the state’s AAA rating and to alleviate the interest bill that taxpayers have to pay. Through consistent budget surpluses and the proceeds of the sale of WestConnex, the DRF eventually exploded to almost \$26 billion in size.

But even after NSW lost its AAA rating in December 2020, and the cost of debt servicing rocketed, the Liberal government did not want to use the NGF to pay back a cent of debt. In 2021, it was advised by TCorp and NSW Treasury that it would be better off gambling this money on global markets in the hope that equities would climb while rates remained low for a long time.

More scandalously, TCorp and Treasury advocated that NSW should issue \$20 billion in extra taxpayer debt to put into the DRF to punt stocks. Of course, TCorp’s staff would be paid handsomely for the privilege of managing this money.

Since 2018, Victorian taxpayer debt has exploded by \$119 billion to what will be \$165 billion this financial year. NSW has not done much better: debt has leapt by \$102 billion to \$160 billion in just five years.

During the pandemic when rates were at all-time lows, and the RBA promised to keep them there, taking on debt seemed smart. NSW and Victoria paid only 0.94% in annual interest to issue a standard 10-year government bond in late 2020. But today that interest rate has jumped to 4.3%.

If NSW and Victoria refinanced all their current debt at prevailing 10-year interest rates, which they will have to do over time, they will be forking out almost \$7 billion a year just in interest repayments (forget actually repaying the principal they have borrowed).

Both states forecast that their debts will rise to \$226 billion by 2026, which means the annual interest bill using current 10-year interest rates would be almost \$10 billion a year each.

There is clearly a case that Victoria is the worst-run state in the country. Since Dan Andrews’ government came to power in 2014, Victorian government debt has increased 194%, substantially more than any other big state, including NSW (116%), Queensland (60%) and Western Australia (45%).

**Strategy commentary cont'd:** In dollar terms, Victoria has been borrowing as much, if not more, than NSW notwithstanding that NSW has a 35% larger economy and a 23% larger population.

Victoria's budget deficit as a share of state output (or gross state product) was 4.8% in 2021-22, strikingly larger than NSW (3.7%), South Australia (2.0%) and WA and Queensland, which reported surpluses of 1.2% and 0.3%, respectively.

What is especially worrying is that most of Victoria's budget deficit appears to be structural, or discretionary, in nature given the state's unemployment rate is the lowest in decades. That suggests there is no spare capacity left in the economy: public demand is exceeding supply.

Last year, Victoria sold part of VicRoads for \$7.9 billion, which Premier Andrews and Treasurer Tim Pallas repeatedly told taxpayers would be used to repay the enormous pandemic debts they have accumulated. Yet none of this money has been used to repay a dollar of debt. Like NSW's NGF, it appears Victoria intends to punt this money on global markets, which is madness given the fiscal challenges the state faces.

NSW's new Treasurer, Daniel Mookhey, might be about to change all this. In 2021, Mookhey, who was shadow treasurer at the time, ran an activist ESG campaign in concert with this columnist to convince NSW's Liberal government to use the NGF's DRF for its legislated purpose. That included not allowing it to lend money to Russia and Saudi Arabia.

We argued that it would be crazy to issue \$20 billion of extra debt to punt on markets as TCorp and NSW Treasury had proposed. We called on Perrottet to stop diverting billions of dollars of state royalties into the DRF at a time NSW was running huge budget deficits, which meant he was debt funding risky investments in global equities when taxpayers could not afford to do so. And we asked Perrottet to start drawing down on the DRF for prudent debt repayments.

To Perrottet's great credit, he did all these things, dumping the debt issuance plan, halting the royalty diversions then using \$11 billion from the DRF for debt repayments. The problem is that NSW has kept on spending like a drunken sailor, burning through massive improvements in the budget deficit through relentless pork-barrelling.

We need to have a conversation about what are fair choices for current and future generations.

Minns and Mookhey actively campaigned on fiscal responsibility and the need to balance the state's books given higher rates and a soaring cost of living. And the new treasurer has not disappointed. In several interviews this week, Mookhey has signalled that he will look at using the remaining \$15 billion in the DRF for aggressive debt reduction. There is more than \$10 billion in other special TCorp investment funds that Mookhey could also use to help cauterise the state's fiscal crisis.

If Minns and Mookhey deliver on their promises, it will in time put enormous pressure on Victoria to do the same and use the \$7.9 billion it raised last year from the partial sale of VicRoads to repay debt.

More fundamentally, we need to have a conversation about what are fair choices for current and future generations. The increasingly reflexive desire of politicians to burden future Australians with massive amounts of unsustainable debt just to satisfy the hedonistic needs of current voters is not tenable in the long run.

And, as we have seen in NSW, the electorate cannot be continuously bribed into systematic stupidity. At some point, voters will call your bluff.

The hope is that Mookhey and Minns chart a course back to responsible government that others such as Andrews can emulate. This is not just fanciful speculation. Mookhey is the smartest and hardest-working politician I have dealt with. He seems deeply committed to fiscal reform and making NSW a stronger and more viable place to live and work. All power to him if he can pull it off.



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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