ZANACORP

Investment Insight

June 2023

The passing of time and its accompanying changing social norms and financial conditions never ceases to amaze. The debt induced 2008 GFC that humbled the US and Europe and painfully stunted investment portfolio growth for 4 long years, is long forgotten by most. Yet it birthed a radical new era of economic thought. One where debt apparently didn't matter. Interest rates kept falling, money and credit was freely created by bankers, to be borrowed and spent by governments and people alike, at will and seemingly without consequence. Though most of us knew this brave new world was unnatural, it felt good, saved the world and lasted just long enough to deceive us as the "new normal". So we learned to be reckless as the economic stars aligned with global harmony and free trade, low inflation, ever rising asset prices and plentiful goods and services on demand, climaxing in an extreme misdirected pandemic borrowing, spending and liquidity rush. It all ended in 2022. REALITY, in the form of INFLATION opened the eyes of the Western world to its profligate ways and its vulnerability to expanding totalitarian nations. Nations that in only 20 years discreetly became rich and powerful, being permitted to dominate global manufacturing, energy and the supply lines of everything. Bringing us to where we are today. Hostages of global distrust and military conflict, uneasy alliances, fiscal deficits, rising living costs, stagnant share and house prices, egregious interest rates, labour shortages and serious social and generational unrest. Old debt now needs to be serviced and new debt is not easy to come by. Both are now expensive, just as global growth stalls. That's Murphy's Law. Then, Artificial Intelligence (AI) emerges, just as the internet did 25 years earlier, threatening to make many white collar jobs redundant before this decade ends. The rest of 2020s faces a cold war, kinetic war, climate war and a social war. Wolf. Winter is coming.

When Two Tribes Go To War

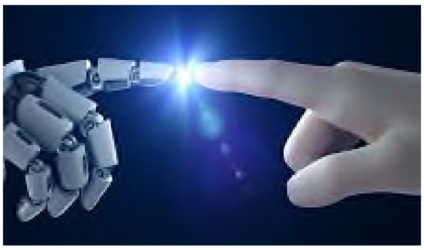
Be Prepared To Be Scared

"Two Tribes" is a song by British band Frankie Goes To Hollywood, released in 1984. The song was written during the Cold War era, a time of heightened tensions between the US and Soviet Union. It serves as a commentary on the potential devastating consequences of a nuclear war between these two superpowers.

"Two Tribes" also contains political and social messages, urging people to reject violence and seek peace. It conveys a sense of desperation and calls for unity in the face of a global crisis. The song's catchy and energetic electronic sound, combined with its thought provoking lyrics, made it a major hit, reaching the top of the charts in several countries.

Overall, the lyric serves as both a reflection of the political climate of the 1980s and a cautionary tale about the nature of human conflicts. It remains a powerful reminder of the importance of peace, diplomacy and the potential consequences of failing to resolve international disputes.

The "scary" feature of the above synopsis, has nothing to do with its content (though this will be discussed shortly). It is its authorship. Having input all prior Zanacorp newsletters into a software program (GPT-4), the above piece was "created" entirely by a machine being instructed to compose it in the "Zanacorp writing style". **It took 10 seconds,** and your writer will concede, he could not have done a better job in 10 minutes.



This is **Artificial Intelligence (AI)**, in this case applied to a quite simple task. It is capable of doing so much more in nearly all fields of endeavour potentially making swathes of people and jobs largely redundant. This technology is truly frightening.

The above image and its haunting resemblance to Michelangelo's Sistine Chapel fresco known as the **"Hand of God"**, was created by a computer.

Though deep AI is still in its infancy, it is already transforming the way many large IT, marketing and professional businesses collect, collate and process data to generate human-like solutions and create products, services, images and content. All with minimum need for human input. AI is destined to disrupt the future workplace, even more than the internet did.

US based OpenAI (ChatGPT) and Nvidia are the front runners in this space while Microsoft is embedding AI features into its Bing search engine aiming to de-throne Google. AI has set the US Nasdaq alight, at least for now.

Though we have only scratched the surface of emerging AI trends, we invite all readers to consider how AI is already an unseen part of our daily lives. For example, if you open your phone with facial recognition, get shopping suggestions/pop-ups after you Google search something or Siri hears you, use Live Chat or accept personalised recommendations on Instagram, Facebook or YouTube, use GPS to find you the best travel route - **that is AI technology already "helping" you, watching you, knowing you.**

Two Sides Of A Changing World Order

For the first time in a long time, the world presently finds itself at a re-defining inflection point. Expeditious solutions are being sought to many malignant concerns, be they national, political, financial, climate, generational or social. Tribalism takes many forms and each is divisive. Our interest in such matters extends only to the **unavoidable adverse impact of conflict on our clients' financial wellbeing.** Investing money demands we consider them.

With powerful forces tugging markets equally in both directions, humility dictates we advise with **balance and caution**, but we must take a position.

Change has been an ongoing theme of ours for many years. We are believers in the Strauss/Howe Fourth Turning narrative that **the current saeculum will end by the late 2020s** and many 20th century institutions with it.

Typically, major changes only occur as a result of major discontent. When existing systems are no longer fit for purpose. The global disturbance to all life caused by COVID in 2020, has immutably reshaped the 2020s. The world has became more insular and friends and foes easier to identify. We all feel a little cheated of life, so **how we each see the world**, the workplace, politicians and many society norms **is being questioned.** Our expectations of governments, businesses, schools, the media and other institutions have changed as tribes demand **"their fair share"** of today's global bounty.

A disorderly world is not conducive to orderly trade or asset pricing. Your wealth relies on the ongoing confidence in the current global financial system, where markets operate under known and predictable rules and risks. This is the basis of the asset pricing mechanism. **The GFC was the last experience we had of a systemic failure to hurt everyone.** Few saw it coming.

The Generational Divide - Boomers v Gen X and Millennials

Increasing wealth disparity is at the core of widespread financial/social discontent. Reversing a long held natural expectation, **a generation is being set up to enjoy a lower standard of living than the one before it.**

The generation who endured the Great Depression and fought WW2 **(the Silent Generation)** lived modestly. They did without to provide a better life for their children, **(the Boomers),** just as their WW1 parents did before them.

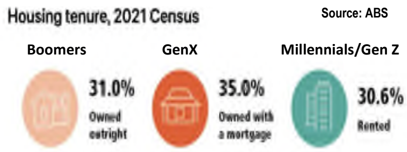
Although everyone wants a better life for their kids, younger people, quite fairly, see scant evidence of this. Many generous and largely **unfunded** tax, welfare and health care benefits make it appear **Boomers were given their cake, are eating the cake and leaving them with the bill.** How did we get here?

Where do we start?

The general prosperity and enhanced lifestyles of today's Boomers was NOT the result of some mischievous plan to grab the world's wealth. Relative global peace, better education, higher wages, liberal social norms, improved gender opportunities, technological innovation and advances in medicine enhancing longevity all fused together after the 1950s as Boomers came of age. It was a massive once in a millennium tailwind.

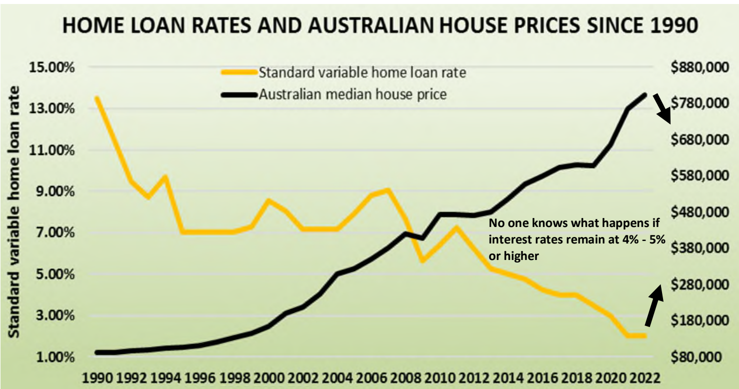
In monetary terms, the global deregulation of financial markets in the early 1980s was a game changer. It profoundly altered global economic trade and finance. Prior to this time, access to debt and credit was highly regulated. Bank home loans were difficult to qualify for and relatively **few people owned shares or investment properties.** Non-banking institutions supported the banking system providing credit at higher rates.

Let's talk a little about property ownership, the major wedge dividing the generations and "the haves" and "have nots", at least in Australia. It is the largest asset most of us will ever own and our largest debt. Home loans used to be wholly income based and strictly limited to **3 times household income** (with females' capacity penalised). **Proof of savings capacity was mandatory** and a bank manager's decision and approval was final. Most Boomers first bought houses under these strict rules and borrowed within their means.



In 2021, around 66% of us own homes, 35% have a mortgage. Peaking at 72% in 1966, these rates are largely unchanged since the 1970s. **The main change has been easier lending for everyone, that led to larger loans.**

For generations, property prices remained affordable, in part, because **everyone borrowed under the same inflexible rules.** Consistent long term house price growth was closely correlated to rising post WW2 population growth. **Deregulation opened the floodgates** to global competition, relaxed borrowing rules and new NON-INCOME TESTED home equity loans. **Housing changed from being a place to live, to become a low yield high growth financial asset. Ideal for investors and negative gearing.**



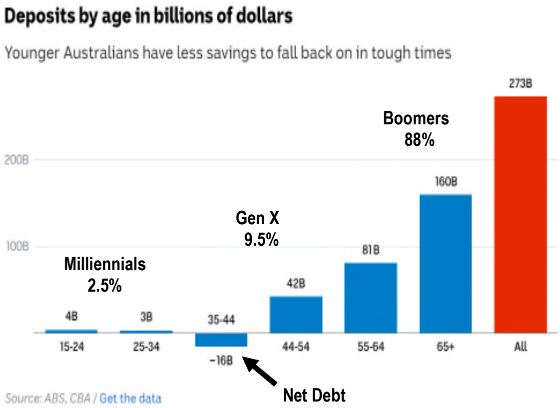
Like kids in a lolly shop for the first time, by the mid 1980s, more people could get their hands on more money, more easily. Both home buyers and investors bid up house prices to lofty levels. In spite of interest rates reaching 17.5% house prices kept rising until we suffered "**the recession we had to have"** in 1990. Prices stagnated for the next 3-4 years. Many chastened Boomers were given a first hand lesson in the **risks of too much debt**. Naturally, most then paid off their homes and saved rather than borrowed. That is **until Gen Xs turned up in the late 1990s!**

Study the chart above. Gen Xs, have enjoyed a mostly uninterrupted decline in interest rates for 32 years. With access to ever cheaper debt, they competed with investors and migrants to drive Aussie house prices and debt levels to extreme highs. In this new cycle, **with few lending rules and no fear of debt**, house prices have been elevated to **6-8 times income.** 1999 CGT concessions for investors, GST and rising building costs added to price pressures. Boomers debt free homes (& land), were simply lifted by a tidal wave of rising debt, not by any unique efforts or sacrifice. **It was as easy as getting rich keeping Pokemon cards in their original wrap.**

Millennials experienced life differently, being too young to borrow, but observers of the GFC and all that followed. They are the first generation **locked out of the property market** entirely, as a result of both unaffordable home prices and high rent, but at least they can shift.

There is no injustice here, just the confluence of recent history and the monetary conditioning of 32 years falling interest rates. There are many complexities and structural problems compounding our simplified mini extract of the **direct correlation of debt and house prices**. What happens from here is unknown, but an intractable housing shortage and rising population will probably mitigate any nominal house price declines. What is **more likely than price declines is price stagnation for 2,3 or 4 years** with investors deterred by lower growth and higher holding costs, like land tax.

As a result of interest rate increases, **borrowing capacity has fallen by over 20%** yet prices have declined less than 10%, peak to trough. Assuming an orderly cooling of employment conditions and rising wages, home borrowing capacity will grow to meet house prices. If left alone, we trust the market will find its pricing equilibrium. History has shown regulated rents, buyer subsidies, borrowing concessions or mortgage holidays will most likely create more problems rather than solutions. Remember **The Cobra Effect**.



Who's Got All The Cash?

We often read that Australians are **well placed to manage higher interest rates** since we still hold much of the ScoMo COVID stimulus money.

Before anyone buys into this misleading average statistic we suggest you digest more granular data as at 31st March 2023. **Millennials have 2.5% of our cash pool, Gen X hold 9.5% while Boomers hold 88%**. The group with the debt, actually have no money.

We have said it is unfair to blame Boomers, just as it is to blame Gen Xs. Fate has dealt out uneven cards to both Xers & Millennials, so far. However, as they assume the reins of power, rightly or not, **many affluent Boomers may end up paying many NEW taxes, yet to be devised.** They are likely to be means tested, based on capital and wealth rather than income. **$3m looks like a magic number.** Change is coming soon. As It must.

BRICS+

Tribal warfare amongst nations potentially poses a greater risk to our collective wealth than generational disputes. It affects both the availability and cost of most of what we buy, including money.

For the first time in decades, global free trade, goodwill and harmony are compromised. The 20 year global economic windfall of cheap imported goods along with imported disinflation ended with the Ukraine invasion. Along with Putin, the US has belatedly identified China as an economic and military adversary and both are forming alliances and posturing as if engaged in a cold war.

Brazil, Russia, India, China and Sth Africa (BRICS) along with **Saudi Arabia and Iran**, are de-coupling from the US dollar for trade and finance, seeking to create a 2nd global currency. They are concerned that the weaponisation of the US dollar against Russia could be levelled against them if they do not accede to US wishes. Their retaliation is the first genuine threat to the post WW2 US-centric world order and the Reserve Currency status its dollar commands. Rejection by 42% of world population, 23% of world GDP and 17% of world trade is a brutal repudiation of the status quo.

This **de-dollarisation** based disruption to the world order has only just begun. It may have a profound impact on global peace, the cost of the US$ 32tr debt, the valuation of international currencies, assets, energy and commodities. This is a slow burning fuse, we just need to be aware it is lit.

Xi Jinping's 3rd term as China's ruler comes with a disturbing objective:- the **unification of China**. Meaning, **Taiwan is in its sights.** Watch this space.

Who Should Bear The Cost?

We are unable to address the numerous tribal grievances currently in play. There are simply too many and they extend across borders and across society. Look at France. How the world pays for **defence, aged care, health care, the disadvantaged, decarbonisation, reskilling workers** etc are all very large and currently unresolved issues. Each imposes a new burden on already over-indebted countries. Yet **each program requires new money to fund it**. Where exactly should the money come from?

Is it fair that younger people bear an income tax burden not borne by their parents? Clearly not. **New 21st century based laws will be framed, from which there will be winners and losers**. With an eye to what lies ahead, being financially nimble and able to shift future capital allocations to dodge future bullets appears to be essential. We believe our sector specific range of super and investment funds are very well suited to this.

Tribalism as we have outlined, between countries, generations, social economic groups or energy providers is reminiscent of the era in the late 1960s, 1970s and early 1980s, when almost all assets performed poorly.

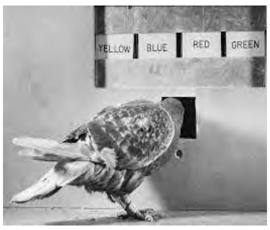
Rational Behaviour

Most people are familiar with the work of Ivan Pavlov and his experiments with dogs teaching them to salivate at the sound of a bell. This became known as classical conditioning. Many parents would have adapted this well known technique to teach their children to behave appropriately (until they became teenagers).

In the 1930s a lesser known but equally recognised field of psychology known as **operant conditioning** was developed by B.F. Skinner. His work was undertaken as he believed classical conditioning was too simplistic to apply to complex human behaviour. His point of experimental difference was to study the link between actions and behavioural consequences.

Working with pigeons and rats using a purpose built "Skinner Box", the experiments applied positive, negative and neutral reinforcement as well as random delivery of each. The findings of this work are applied in many fields today not only in education, but in sport, economics and gambling.

Skinner found that by altering the timing of any reinforcement, pigeons would learn to modify their behaviour to get a reward or avoid a punishment. Moreover, he found that through random repetition, whatever specific action was done BEFORE a reward was given, that **action could be attributed by the pigeon to the reward** to become part of the pigeon's routine behaviour. For example, if turning in circles before pecking a red light was rewarded, the bird began to turn in circles even if no reward was given. Issuing random rewards, "trained" the bird to keep doing it thinking the turning was the cause of the reward. It became a ritual.



Superstition

As humans, we can recognise this as superstition (eg having a lucky number, a lucky charm or a routine). These behaviours are irrational but are "learned" even though we know they have no bearing on the result.

The Behaviour Of Investors

As investors, Skinner's work goes a long way to explaining how many people invest and how markets behave. If an investor suffers an initial loss or poor result from investing in one or a number of investments (negative reinforcement), they are quite likely to avoid similar investments in the future and possibly miss many opportunities. Alternatively, fortuitous timing or a lucky investment may give rise to false confidence and result in severe and ongoing losses (as gamblers mostly experience).

Skinner And Markets

Although hard to believe, the pigeon behaviours identified by Skinner have been seen to be replicated by people (and poorly designed investment algorithms) during secular (long) market cycles. Remember, many **regulators study group behaviour** and they believe they can anticipate investors' response. They introduced **"forward guidance"** for this purpose. Let's revisit recent history cognisant that bankers know and see themselves as a modern type of B.F. Skinner. Guess who the pigeons are?

Investors Learn From History and B.F. Skinner Repositioning Accordingly

32 years of falling interest rates (accelerating after the GFC) lifted assets and markets across the globe. People now feel both smart and safe, happy to borrow and spend **on demand,** rather than save. Regulators fearing deflation, have not allowed markets to decline for any extended period, aggressively re-deploying monetary tools to save the system and keep investors nourished. Investors have "learned" to buy the dips because if markets fell badly, action would be taken to save them and those that bought on the down days made a "motza". That positive reinforcement if repeated sufficiently, creates a powerful "**I can't lose"** financial reflex**.**

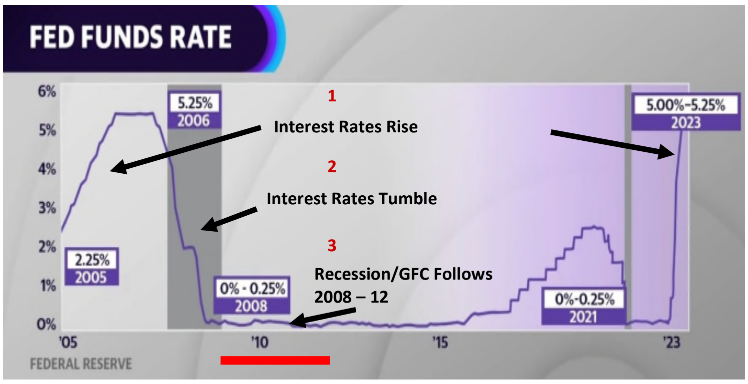
We believe that era is now over, ended by the inflationary fallout from the COVID response re-igniting inflationary expectations and higher wage demands at a time when unemployment is at a 50 year low. The security, energy and other concerns emanating from the now highly charged geo-political landscape, suggest **very little of the past experience will reflect that of the future**. The most astute analysts we engage identify these issues as critical to their current investment themes, we must concur.

The West is again aware of old truisms: countries pursue their own agendas, peace is temporary, energy is life, manufacturing matters, inflation is real, interest rates rise, climate change infrastructure is slow to build and more expensive than imagined, workers can quit, civil unrest gets unruly.

In the period ahead, it may pay to **act like intelligent beings rather than trained birds.** It is plainly naïve to believe **the global interest rate shift from 0.1% to over 5% will not affect governments, businesses, jobs, households and asset prices**. Read the room. Though we cannot yet see the effects of these rises, it is foolish not to expect consequences after such a swift and severe monetary response. **It's like driving a car through the rear vision mirror and failing to see the brick wall ahead.** The only uncertainty is how long and how many more interest rate hikes will it take before spending eases, inflation falls and jobs are lost. The war is not over.

Despite the rhetoric from politicians, we are not experiencing the conditions that sustain asset booms. They resemble the conditions that precede declines. Many young borrowers must be thinking to themselves "nothing is as good as they say it is, I'd wish I'd known before, can I go back?" Nup. Innocence is often the first casualty of a broken trust. Thanks Dr Lowe, your misdirection to unsuspecting younger borrowers leaves a legacy.

As long as property and share markets keep rising, people keep spending, inflation persists and the jobs market is tight, **bankers will raise rates** further and **they will go too far.** Their first mission was to beat inflation and they will, accepting around 4% p.a. To moderate aggressive asset prices they are shifting focus to the jobs market. Intent on **causing enough pain to snuff out any residual inflationary expectations in 2024/25. Having been in this position before, we believe only the wait is excruciating.**



Keeping our April 2023 **long and variable lag** in mind, we submit the following facts for review. Track the steps of this chart closely. 1,2 and 3.

1.Interest rates rose from **1% in 2004** to **5.25% in 2006** (paused till 2008)

2. Rates then **fell in 2008/09** to **0.25% too late** to avert the severe GFC

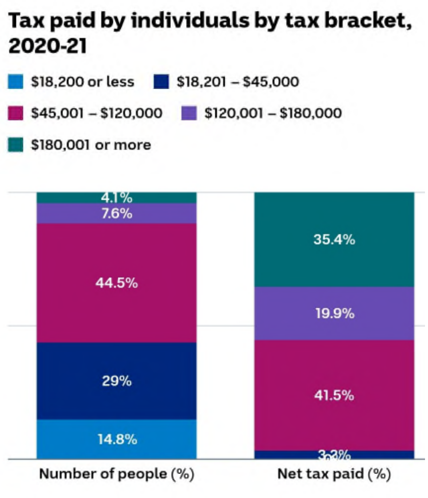
3. The GFC began mid **2008** lasting until 2012, 18 months AFTER the pause.

Concluding interest rate policy discussion we must draw attention to both **Australian and US 2 /10 year bond rates,** each is **INVERTED**. This is a bond market signal. When short term rates are higher than long term rates, an **economic downturn is anticipated** and inflation controlled. Though imperfect, inverted yields usually point to an imminent recession.

Like 1990, 1999 and 2007, the first correction did not end the investment party. A strong rally followed, before it ended badly. Be aware it's late.

SGC Increases to 11% and Super Cap to $1.9m from 1st July 2023

On a bright note, the future savings of workers will be enhanced as the employer mandated payment to their super savings increases to 11% p.a. Compulsory super as introduced by Paul Keating in 1992 (at 3%). A hard won tax reform from a time when politicians had spines. It significantly increased the retirement savings of today's Boomers whilst also providing a growing pool of capital for Australia. Tax concessions entice people to save so that they can have better lives. Our retirement system is the envy of the world. The counter factual poses an interesting question. **Would people have saved (as) much, if employer super wasn't compulsory?**



ABC News / Source: Australian Taxation Office

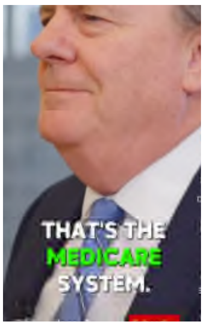
INCOME TAX

Boomers leaving the workforce are being replaced by many high income Gen Xs.

In 2020-21 ATO data illustrates who shoulders the bulk of our tax burden.

The 4.1% earning over $180k pay 35.4% of our taxes. The top 11.7% pay over 55%. **It is not correct to say the richest people are not paying their fair share.**

In 2023 Australia enjoyed a commodities boom and low unemployment windfall increasing tax revenue to a record high 24% of GDP. Although the government has tried to be responsible, this windfall was largely spent meeting the diverse wants of its tribal interests, young and old. Government spending programs reached a new high with **nothing left to reduce Australia's debt**. So what, one may ask?



In a recent "fireside chat" with John Anderson, former Deputy PM, ex-Treasurer Peter Costello who crafted our last genuine tax reform, the **GST,** when asked about the future INTEREST PAYABLE on Australia's A$1tr debt said "**That's the Medicare System"**. Absorb that for a moment. The annual interest bill alone on our debt costs us our health system, forever. **No one seems to care.** Just print more money, right?

Let's pivot our minds to the annual cost of our world high household mortgage interest. Are the majority of people cutting back on anything yet? Or is it the government and RBA's job to make it all go away, so we can just keep on borrowing, spending and pretending we are collectively okay?

We respect the fact that no one knows the future and we could "muddle our way" through tomorrow's challenges. As such, each Zanacorp client holds a personalised and diversified portfolio, retaining appropriate levels of both growth and defensive assets. **We don't bet on single outcomes.**

Our somewhat bleak forecasts need to be read understanding the chasm between what is **IMMINENT** and what is **INEVITABLE.** Put simply, our short term view is most markets will continue to melt up in the hope that problems are fixable. However, our longer term view is that markets will melt down as the fixing brings with it pain. **Today's FOMO** is **tomorrow's FEAR.**

Market Round Up

Markets have metaphorically given bankers "the finger". Apparently interest rates don't matter and they will be dropped anyway. Our market round up this year reflects the market is either intuitive or "turning in circles".

Overseas Shares

As bankers are trying to execute an economic **soft landing**, markets do not want a landing at all. Exemplifying these polarised positions, **global markets are challenging their 2021 all time highs**. Comparing 2023 returns to 2022, in brackets, observe the contrast. **US↑12%(↓11%)**, **Japan ↑25%(↓8%)**, **Germany ↑26%(↓18%)**. The **UK ↑5% (↑2%)** & Hong Kong **↓13%(↓25%)** markets are outliers impacted by domestic matters. Disguising the 2022-23 index performances is the disproportionate rise in a very small number of perceived "defensive" growth stocks. Most investors are manic over Nvidia, Microsoft, Apple, Tesla and other highly priced stories. Such crowded trades very often over-price future earnings and disappoint. We'll see, in 2024.

Australian Shares

The All Ords shadowed world markets rising **9.7% (↓11%).** Resource stocks rose as commodity prices rebounded while index heavy financials and large retailers & banks regained some of their heavy 2022 losses. Smaller companies underperformed as rising wages costs and less pricing power damaged the bottom line. We are comforted that our preferred investment funds are skewed towards value based businesses able to withstand a challenging environment. Looking ahead we favour Australian equities to overseas as our current earnings multiples are less demanding. Paradoxically, we expect markets will rally one last time on weak economic news, before rolling over.

Residential Property

Residential supply is currently extremely tight, keeping prices high. People are not so much borrowing as they are swapping houses (downsizing) or paying cash at the mid to top end of the market. **Buyers are now fighting the RBA. So long as prices go up, so will interest rates**, until one tribe buckles. Consistent with our longer term view, in time we expect more ven dors for many reasons will present properties to the market increasing supply and easing upward price pressures, until prices match affordability, at whatever level that may be. Real estate agents see hands go up, often blind to where the money comes from. We see the other side of the transaction and many investors beginning to feel the pinch of rising holding costs.

Interest Rates & Cryptocurrencies

Interest rates are peaking, with spending now beginning to fall sharply. However, unlike other episodes when rates fell to protect markets, we sense all central bankers are determined not to repeat their past errors. In the 1980s FED Chair **Paul Volker** famously crushed markets by raising rates to 18%, holding them there until all inflationary impulses were eliminated by a global recession, after his "flip-flop" predecessor Arthur Burns failed.

Current FED Chair, **Jerome Powell** has declared he is "Keeping At It", emulating Volker needing to see **pain**. The RBA similarly sees wages pressures and excess demand, the roots of inflation, as its nemesis. This cycle looks destined to fall into the rates **higher for longer** category which does not augur well for anyone. It is uncommon to see sustained asset price rises at the same time as credit is contracting. Could it be **"this time is different"**? Crypto owners believe so, with coins **rising 20%-80%** since January 2023.

We do not apologise for our sombre outlook. Much is at stake for all of us. At this late stage of a mature cycle, we expect the battle between potentially **marginal and short lived gains** and **weighty enduring capital losses** to be a no contest. In an old story, **it wasn't raining when Noah built his ark**.

MARKET FACTS	June 2023	June 2022	June 2021	5 Years Ago 2017	7 Years Ago 2016	10 Years Ago 2013	15 Years Ago 2008	20 Years Ago 2003
Australian All Ordinaries	7,401	6,746	7,585	5,764	5,310	4,775	5,333	2,999
Dow Jones (US)	34,407	30,775	34,502	21,349	17,930	14,909	11,350	8,985
FTSE 100 (UK)	7,531	7,168	7,037	7,313	6,504	6,215	5,626	4,031
Nikkei (Japan)	33,189	26,393	28,791	20,033	15,576	13,677	13,481	9,083
Hang Seng (Hong Kong)	18,916	21,793	28,905	25,765	20,727	20,803	22,102	9,577
Dax (Germany)	16,147	12,784	15,531	12,325	9,680	7,959	6,418	3,221
Gold - Spot US$	$1,909	$1,821	$1,762	$1,244	$1,315	$1,236	$926	$346