Economic & Investment Update - January 2022

Global growth was mixed during the final months of 2021 as the Omicron Covid-19 variant led to further supply chain disruptions and global inflationary pressures increased.

The emergence of the highly contagious Omicron variant in November disrupted global markets as many governments reintroduced restrictions. However, markets calmed as data from the first countries significantly affected by the variant showed a lower risk of severe disease than anticipated.

In the US, economic growth of 1.7% was recorded during the December quarter (5.5% annualised – the highest annual figure in 38 years). Growth was fuelled by business reinvestment and consumption growth. However, inflation (consumer prices) also surged, hitting its fastest pace in nearly four decades as pandemic-related supply and demand imbalances, along with stimulus intended to shore up the economy, pushed prices up at a 7% annual rate - the highest since 1982. With prices remaining higher for longer than expected, the US Federal Reserve announced that it would end its pandemic-era bond and mortgage-backed securities purchases in March and drop its rhetoric that inflation was transitory.

In Europe, Eurozone economic growth decelerated in the final months of 2021, dragged down by Covid-19 restrictions, lacklustre consumer spending and global supply chain bottlenecks. Gross Domestic Product grew at a rate of 0.3% in the three months through December (5.2% annualised). Annual inflation rose to 5.0% in December, with higher energy prices mainly contributing to this rise. While the European Central Bank made no change to interest rates, holding them at 0.0%, it announced the winding up of its asset purchases in March 2022.

In Japan, inflation rose (0.6% annualised) as rising energy costs added to pressure on households. However, the Bank of Japan did not change its accommodative monetary policy stance as inflation remained below its 2% target.

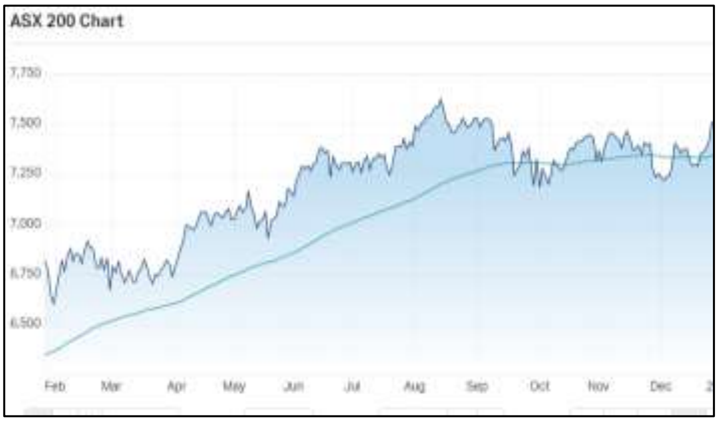
In China, the real estate crisis continued with Evergrande Group defaulting in December after missing payments on several bonds. However, Chinese government officials sought to prevent a disorderly collapse of the world's most indebted developer from disturbing China's financial markets and economy. Despite issues with Evergrande, the Chinese economy grew strongly with December quarter growth of 4.0% (8.1% annualised).

In Australia, despite the emergence of the Omicron variant, economic conditions remained strong with the unemployment rate dropping to its lowest level in more than 13 years (4.2%). The RBA left the cash rate unchanged at 0.1%, as widely expected, and advised that it would continue its $4-billion-a-week bond-buying stimulus program until at least mid-February 2022. However, inflation in Australian surged by 1.3% during the December quarter to be 3.5% higher over the 2021 calendar year, with rises in the cost of fuel and new homes driving the increase.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index finished up 2.1% over the December quarter and +17.2% for the 2021 calendar year.

During the December quarter, the Materials sector (+12.7%) and Utilities sector (+11.4%) produced the highest returns while the Energy sector generated the lowest return (-7.5%).



Within the Materials sector, local miners were bolstered by the iron ore price recovery given the optimism around Chinese demand for the commodity. Oil prices weighed on the Energy sector as concerns grew that the Omicron variant would further disrupt travel and lead to additional lockdowns globally.

Smaller ASX-listed companies (top 100-300) returned 2.0% for the quarter and 16.9% for the calendar year, slightly underperforming the 2.1% return of the S&P/ASX 200 Accumulation index.

Global equity markets produced strong gains during the December quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 7.9% (+23.4% for the calendar year). With the Australian Dollar stronger against most major currencies during the December quarter, the quarterly unhedged return was slightly lower (+7.2%). However, weakness in the Australian dollar over the 2021 calendar led to a stronger unhedged annual return (+29.6%).

Regionally, US shares generated the largest quarterly gains with the technology focussed Nasdaq Composite up 11.1% and the more broad-based S&P 500 up 10.7%, with US markets buoyed by strong corporate earnings and increased consumer demand. Eurozone shares generated quarterly returns of +4-5% for the December quarter.

In Asia, markets generally finished lower over the December quarter with Japan equities (as measured by the Nikkei 225 PR Index) down 2.2% and Hong Kong equities (as measured by the Hong Kong Hang Seng) down 4.8%. Most major markets across the region were down during the quarter however falls were partially offset by strength in electronic materials and the semiconductor supply chain.

Property markets performed strongly over the December quarter, with Australian listed property securities gaining 10.1% and global property securities finishing up 4.6% as concerns about the impact of the Omicron variant on the property market subsided.

Within fixed interest markets, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, fell by 1.5% over the December quarter. The bulk of this loss within the Australian bond market was driven by a sharp increase in the 2 and 3 year Australian Government Bond yields as the Reserve Bank of Australia formally dropped the 0.1% yield curve control target on the 2 year Australian Government Bond in October. Overseas bond markets finished flat for the December quarter as a fall in yields in October was offset by gains in December.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	S&P/ASX 200 TR (Accumulation) Index	2.1	17.2	9.8
	S&P/ASX Small Ordinaries TR (Accum) Index	2.0	16.9	11.2
International	MSCI World ex Aust NR Index (AUD)	7.2	29.6	15.1
	MSCI World ex Aust NR Index (AUD Hedged)	7.9	23.9	14.0
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-2.0	3.4	9.8
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	10.1	26.1	9.3
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	10.2	28.6	6.9
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	4.6	14.5	6.9
Currencies				
AUD v USD	Against US Dollar	0.5	-5.6	0.2
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-1.5	-2.9	3.4
	Bloomberg Ausbond Credit All Maturities	-1.6	-1.6	3.9
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	0.1	-1.5	3.2
Commodities				
Gold	Gold – USD	4.1	-3.6	9.8
Oil	WTI Oil $/b – USD	2.6	58.7	7.5

Outlook

Globally, with the Omicron variant of Covid-19 expected to continue to create an obstacle for the global economy, the International Monetary Fund (IMF) cut its world GDP forecast for 2022 to 4.4%. The impact of the Omicron variant is expected to fade in the second quarter of the year.

However, inflation and Central Banks attempts to control it by normalising monetary policy are likely to remain key issues well into 2022. The possibility of more rapid monetary tightening, inflationary pressures from commodity prices and supply bottle necks are likely to continue to challenge markets and impact global growth.

Within the US, while economic growth is likely to have peaked, slower expansion is expected over coming years. However, the Federal Reserve is expected to begin a series of interest rate rises in March 2022. Following this initial increase, the speed and magnitude of further rate rises is likely to have a major impact on the US economy and global equity markets.

Within Europe, while economic growth is anticipated to rebound from weakness in the December quarter, a high level of uncertainty remains about the economic recovery. It is therefore unlikely that the European Central Bank will raise interest rates in 2022. Risks remain with rising energy prices and supply chain bottlenecks potentially adding to existing inflationary pressures. Rising tensions between Russia and Ukraine also continue to cast a shadow over the region.

In Asia, China's industrial cycle appears to be bottoming after entering a recession in 2021. Monetary and fiscal policies are gradually shifting to a more accommodative stance, although the troubled property sector remains a key source of risk. China’s strict zero Covid-19 policy is also likely to lead to further lockdowns which may dent consumer confidence and affect productivity.

In Australia, while economic growth is likely to remain robust, interest rates are expected to remain on hold until after the upcoming Federal election. However, the Reserve Bank recently confirmed that is would end its bond purchasing program on February 10, 2022.

Our view on various asset classes is outlined below.

Australian Equities

Within Australian Equities, we recommend investors hold a neutral position in large cap stocks and a neutral to underweight position in smaller companies.

While the prospects of further improvement in Australian corporate earnings during 2022 should help support the market, bouts of equity market volatility are expected as interest rates are normalised.

Due to the likely impact of higher interest rates and rising costs, smaller companies are expected to underperform and are likely to exhibit greater volatility in the coming months.

Given the rise in equity markets over the past 12 months, we continue to recommend investors consider taking profits if they are overweight to this sector.

International Equities

We recommend investors hold a neutral to underweight position to both developed and emerging market economies. Within developed markets, we also suggest a tilt away from US equities to European and Japanese equities.

Markets are currently close to fully priced and in January, have already shown to be extremely sensitive to announcements regarding interest rate movements. In the US, the technology focussed Nasdaq 100 retreated by roughly 9% in January as a tightening in interest rates became more likely. Any surprises or missteps in monetary policy could lead to further volatility within highly priced growth assets, particularly interest rate sensitive stocks.

Aside from the ongoing risks in China, emerging markets are also likely to come under pressure with interest rate increases in developed markets leading to an outflow of funds from those regions.

Property (REITs)

We recommend investors retain a neutral position to Australian and International property.

The listed property sector has historically performed well (on a relative basis) during periods of above average inflation expectations. Real estate stocks are an "inflation protection sector," as unlike bonds, income streams can grow. Many lease structures also have built in inflation linked annual increases.

Property valuations continue to be underpinned by historically low bond yields however, a rise in bond yields may place downward pressure on property prices.

Fixed Interest

We recommend investors move toward a neutral position to Fixed Interest securities.

Bonds are currently looking more attractive than they have for some time with expected rate rises in the short to medium term already factored in, both domestically and in the US. Bonds look set to provide a reasonable level of income and effective hedging to growth assets once again. However, longer term risks remain if inflation lingers, and Central Banks are required to tighten interest rates beyond current market expectations.

Investor demand for credit is likely to remain strong in an environment where official cash rates are at or close to zero and investors globally continue their search for yield. Credit spreads are however historically very low.

Alternatives

We retain a neutral setting for Infrastructure investments. However, with many infrastructure businesses highly leveraged, we highlight the risk in this area from future interest rate rises.

Private Equity investments are expected to continue to be well supported, underpinned by the risk-on mood, strong returns, excess liquidity and the chase for yield.

In this climate of increased risk, long short funds and market neutral funds can offer some protection against a market correction. Furthermore, to add additional diversification with portfolios and to provide some protection against rising inflation, we continue to suggest holdings in gold and silver. With the prospect for tight market conditions and inflationary pressures continuing to support the sector in 2022, an allocation to other commodities should also be considered.

Sources: Lonsec. Vanguard