Economic & Investment Update - April 2022

Geopolitical uncertainly, including the conflict in Ukraine, continues to be a core focus for investors as upward price pressures on energy and commodities hastened the pace of inflation across the globe. With inflation remaining elevated, central banks have begun to raise interest rates, most notably in March when the US Federal Reserve completed its first rate hike since Covid-19 emerged.

This has resulted in bond yields surging around the world and Australia is no exception. Although the RBA left the cash rate unchanged in April at 0.1%, expectations are that the RBA will start raising rates in May or June. The yield on 2 and 10 year Australian Government bonds increased by around 70 basis points (bpts) in March.

The unemployment rate in Australia continued to fall and is now down to 4.0% amid further easing of Covid restrictions. Unsurprisingly, the maintenance of a low unemployment rate, along with cost of living pressures (with annual inflation now running at a 20-year high headline rate of 5.1%) are two of the major factors in the current Federal Election debate. The earlier than normal Federal Budget brought little in the way of major policy changes.

Inflation in the US jumped to a 40 year high in March of 8.5% and unemployment dropped to 3.6%. The subsequent increase in the official interest rate resulted in US Government bond yields increasing albeit that there was a higher increase in 2-year yields (90 bpts) compared to 50 bpts increase in 10-year yields. A flat (and at one stage inverted) US yield curve brought with it concerns of a future recession. Global markets sold off over the quarter given rising bond yields and as the Ukrainian conflict continued with no end in sight.

In Europe, the European Central Bank kept interest rates at 0% but sped up its asset purchase schedule, aiming to end the programme by the third quarter. Annual inflation was running at a record high of 5.9% in February. The UK raised their official rates in March by 0.25% to 0.75%.

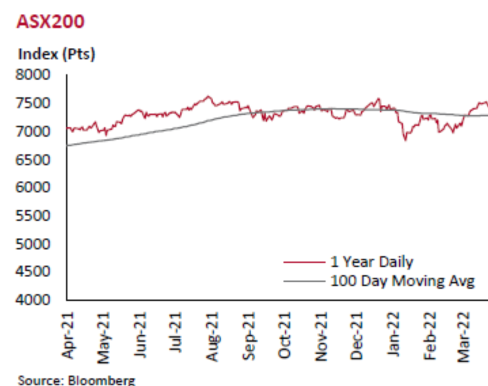
The Bank of Japan left its key short term interest rate unchanged at -0.1% albeit amid growing inflationary pressures. Unemployment fell to 2.7%.

In China, a continuation of the zero Covid policy led to lockdowns across major cities. Consequently, manufacturing across China fell to a 25 month low and export sales dropped at the fastest pace for almost two years. Annual inflation remained relatively benign at 0.9%.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index finished up 2.2% over the March quarter and +15.9% over the twelve months.

During the March quarter, the Energy, Resources and Materials sectors produced the highest returns, up 28.4%, 20.1% and 15.2% respectively due to booming commodity prices. The S&P Goldman Sachs Commodity Index USD was up 29.1%. This was in stark contrast to the IT sector which was down 13.7% over the quarter.



Smaller ASX-listed companies (top 100-300) returned -4.2% for the quarter and 9.7% for the twelve months, underperforming the S&P/ASX 200 Accumulation index.

Global equity markets produced negative returns during the March quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) down 5.0% (up 10.9% for the twelve months). With the Australian Dollar again stronger against most major currencies during the quarter, the quarterly unhedged return was slightly lower (-8.4%). However, a slight weakness in the Australian dollar over the past 12 months led to a stronger unhedged annual return (+11.6%).

Regionally, UK shares were one of the only major markets to generate positive gains over the quarter, with the FTSE 100 PR index up 1.8%. However this was in stark contrast to other markets especially emerging markets and China. Emerging markets, as measured by the MSCI Emerging Markets NI Index AUD were down 9.9% over the quarter and the Chinese index, as measured by the Shanghai Shenzhen CSI 300 PR Index was down by 14.5%

Property markets fell off the back of rising bond yields, with Australian listed property securities falling 7.1% and global property securities finishing down 3.5%.

Within fixed interest markets, rising bond yields especially over the month of March, saw losses across fixed interest securities. The Australian bond market, as measured by the Bloomberg AusBond Composite Index, fell by 5.9% over the March quarter. Overseas bond markets saw a similar fall with the Bloomberg Barclays Global Agg TR Index (AUD Hedged) down 5.0% over the quarter.

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	2.2	15.0	9.2
	S&P/ASX Small Ordinaries TR (Accum) Index	-4.2	9.7	9.9
International	MSCI World ex Aust NR Index (AUD)	-8.4	11.6	12.9
	MSCI World ex Aust NR Index (AUD Hedged)	-5.0	10.9	13.6
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-9.9	-10.1	6.3
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-7.1	17.7	7.8
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-3.5	15.7	5.9
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	7.5	18.0	7.0
Currencies				
AUD v USD	Against US Dollar	3.0	-1.5	-0.4
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-5.9	-5.5	1.9
	Bloomberg Ausbond Credit All Maturities	-4.6	-4.8	2.6
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	-5.0	-4.0	2.0
Commodities				
Gold	Gold – USD	5.9	13.5	9.2
Oil	WTI Oil $/b – USD	30.3	69.5	14.7

Outlook

As the impact of Covid 19 on the global economy starts to fade, the spectre looms of a prolonged war in Ukraine and inflation induced interest rate rises.

The war in Ukraine is producing cascading effects to a world economy already battered by Covid and climate change, with particularly severe impacts on developing countries. Projections estimate that the world economy will be a full percentage point of GDP growth lower than expected due to the war, which is severely disrupting already tight food, energy and financial markets.

Ukraine and the Russian Federation provide around 30 per cent of the world's wheat and barley, one fifth of its maize, and over half of its sunflower oil. Furthermore, the Russian Federation is the world's top natural gas exporter and second-largest oil exporter. Together, neighbouring Belarus and the Russian Federation also export around a fifth of the world's fertilizers.

As a result of the war, commodity prices are reaching record highs across the board. In addition, inflation has been fuelled by years of loose monetary policy and Covid induced supply chain issues which may continue given China's zero tolerance policy.

Yields on Government Bonds have risen as a precursor to official interest rate rises. We now expect official interest rate rises around major economies of at least 2% in the short to medium term. However, rises over the longer term many be inhibited in the US by the ability of the Government to fund higher interest payments on US Treasuries and, in Australia, by the impact on high levels of private debt.

There is a risk of stagflation if inflation remains high and economies slow due to decreased demand from higher prices and rising interest rates. However, the resulting decreased demand will in itself help take pressure off prices. A flat (and sometimes inverted) yield curve raises the spectre of a future global recession and the consequential reduction in official interest rates.

Globally, the prospects are for slowing growth rates amid a climate of uncertainty especially in Europe. However, resource driven economies such as Australia should fare better if resource prices remain high over the short to medium term.

Following the initial increase in US official interest rates, the speed and magnitude of further rate rises is likely to have a major impact on the US economy and global equity markets. Other countries may be forced to follow if they wish to protect their exchange rates.

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.

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. Due to expected volatility, consideration may be given to long short Australian equity fund options.

International Equities

We recommend investors hold a neutral to underweight position to both developed and emerging market economies.

Whilst risks remain, developing markets are likely to come under pressure as rising interest rates in developed markets lead to an outflow of funds from those regions.

However, tightening interest rates in the US are expected to have a broad impact across the global economy. Furthermore, the impact of the war in Ukraine and further Covid induced lockdowns in China will continue to have flow on affects across the globe.

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 continued rise in bond yields may place downward pressure on property prices. Holding unlisted property may also help to mitigate volatility.

Fixed Interest

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

Bonds look set to provide a reasonable level of income and effective hedging to growth assets once again. Bond yields have moved significantly over prior months and long term rates may not rise much further. If so, value is starting to emerge. 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 remain relatively low and investors globally continue their search for yield. Credit spreads, recently at historic lows, have started to widen and hence look more attractive.

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 strong returns, excess liquidity and the chase for yield. Unlisted holdings also help to mitigate volatility in portfolios.

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 within portfolios and to provide some protection against rising inflation, we continue to suggest holdings in gold and silver. With the current climate of tight market conditions and inflationary pressures continuing to support the sector in 2022, an allocation to other commodities may also be considered.

Sources: Lonsec, UN briefing papers
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