Economic & Investment Update - July 2022

The 2022 Financial Year concluded with another challenging quarter for investors, as inflation and recession fears continued to erode investor risk sentiment worldwide. Equity markets and bonds fell over the period, marking only the second time in more than 40 years that both bonds and equities have posted two consecutive quarterly losses.

Inflation surged across many countries, driven higher by a combination of post-lockdown demand, supply constraints and rising energy prices. Rising prices intensified the cost-of-living crisis and put pressure on most Central Banks to deliver aggressive interest-rate increases.

In the US, while unemployment remained steady at 3.6%, annualised inflation reached 9.1% in June, a 40-year high. In response, the US Federal Reserve raised its benchmark interest rates to a range of 2.25% - 2.50% with the 0.75% increases in June and July, its most aggressive hikes since 1994. With high inflation, record trade deficits, supply constraints and worker shortages weighing on the economy, the US economy contracted by -1.6% (annualised), the first contraction since the pandemic-induced recession in 2020.

In Europe, a sharp acceleration of energy and food prices in many counties due to supply disruptions caused by Russia's invasion of Ukraine, led to soaring Eurozone inflation (8.6% annualised). With its asset purchase program ending in June, the European Central Bank raised interest rates by 0.5% in July, the first increase in more than 11 years. The UK continued to raise rates (currently 1.25%) with five back-to back 25 basis point increases.

Within Asia, the Bank of Japan left its key short term interest rate unchanged at -0.1% albeit amid growing inflationary pressures. Unemployment in Japan rose to 2.6%. In China, a reduction in Covid case numbers and subsequent easing of containment measures led to a renewed improvement in business conditions. Output expanded sharply as disruption to operations receded. Annual inflation remained relatively low at 2.1%.

In Australia, economic growth remained strong and unemployment remained steady at 3.9%, the lowest rate since 1974. However, inflation rose to 6.1% in June, with increases impacted by both global and domestic factors, including strong demand, a tight labour market, capacity constraints and shortages linked to recent floods. The Reserve Bank of Australia raised official interest rates by 0.75% during the June quarter with a further 0.5% increase announced in early July.

MARKETS

In Australia, the S&P/ASX 200 Accumulation Index finished down 11.9% over the June quarter and -6.5% over the 2022 Financial Year. This was the worst quarter since the initial Covid-19 market sell-off in March 2020.

During the June quarter, the Information Technology and Materials sectors produced the lowest returns, down 27.2% and 16.2% respectively. Within the Materials sector, several large resource/commodity-based stocks including BHP Group and Rio Tinto were sold off, as weaker commodity prices saw resource companies underperform. Energy was the only sector to produce a positive quarterly return (1.5%) as oil, gas and coal prices strengthened.

Smaller ASX-listed companies (top 100-300) returned -20.4% for the quarter and -19.5% for the financial year, underperforming the S&P/ASX 200 Accumulation index.

Global equity markets produced negative returns during the June quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) down 15.1% (down 12.5% for the financial year). With the Australian Dollar weaker against most major currencies, this reduced market falls with the quarterly unhedged return, -11.9% and the annual unhedged return, -6.5%.

Regionally, US shares produced the lowest returns for the quarter with the Standard & Poor's 500 Index down 16.5% for the June quarter. US markets fell on worries about surging inflation and Federal Reserve rate hikes. UK and Japanese shares fared better, with the FTSE 100 PR index down -4.6% and the Nikkei 225 PR Index down -5.1% for the June quarter. Asian markets outperformed developed markets over the June quarter with Chinese shares (as measured by the Shanghai Shenzhen CSI 300 Index) returning 6.2%. Chinese markets responded to a domestic economy that was showing signs of improvement as the latest wave of Covid lockdowns eased, while the government increasingly turned its attention to stimulating the economy.

Property markets fell significantly off the back of continued increases in bond yields, with Australian listed property securities falling 17.7% and global property securities finishing down 15.6%.

Within fixed interest markets, rising bond yields and widening credit spreads led to further losses across fixed interest securities. With the Australian 10-year bond yield increasing by 0.82% over the June quarter, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, fell by 3.8% over the June quarter. Overseas bond markets saw a larger fall with the Bloomberg Barclays Global Agg TR Index (AUD Hedged) down 4.7% 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	-11.9	-6.5	6.8
	S&P/ASX Small Ordinaries TR (Accum) Index	-20.4	-19.5	5.1
International	MSCI World ex Aust NR Index (AUD)	-11.9	-6.5	6.8
	MSCI World ex Aust NR Index (AUD Hedged)	-15.1	-12.5	7.3
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-3.3	-18.4	4.4
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-17.7	-12.3	4.4
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-15.6	-10.5	1.9
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	-4.7	10.3	5.2
Currencies				
AUD v USD	Against US Dollar	-7.7	-7.9	-2.1
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-3.8	-10.5	0.9
	Bloomberg Ausbond Credit All Maturities	-3.2	-8.9	1.7
International	Bloomberg Global Agg TR Index (AUD Hedged)	-4.7	-9.3	0.8
Commodities				
Gold	Gold – USD	-6.7	2.1	7.8
Oil	WTI Oil $/b – USD	5.5	44.0	18.1

Outlook

The global economy is currently facing significant uncertainty as Central Banks focus on raising interest rates to tame inflation. However, tighter monetary policy will inevitably have real economic costs and Central Banks face a balancing act to cool demand and beat inflation while not derailing economies or causing a crash in property values.

While a recent retreat in commodity prices may help provide some relief to inflationary pressures, the retreat is largely driven by recession fears.

Whether countries enter recession territory, and in particular the extent of any such downturn, will be a significant driver of returns over the short term. The US economy may have a soft landing, but Europe, with significant energy security risks, is potentially more fragile. The risk of stagflation also remains elevated.

Geopolitics will, as ever, play an important role. In particular, US mid-term elections will be one event to watch, along with the prime minister leadership contest in the UK.

Regionally, in the US, following the contraction in US growth in the first quarter of 2022, recent rate rises are likely to increase the chance of a US recession with a slowdown in consumer purchases and economic activity. However, following the most recent 0.75% interest rate rise, the US Federal Reserve have left the door open about its next move, saying that future rate rises would depend on the data. Along with rate increases, the US Federal Reserve also plan to commence reducing the size of asset holdings on its nearly $9 trillion balance sheet.

In Europe, to reduce inflation to the targeted 2% level, further interest rate rises have already been promised. In conjunction with further interest rate rises and their impact on the economy, attention will move to the effectiveness of assistance promised to currency bloc's more indebted nations, intended to cap the rise in their borrowing costs and limit financial fragmentation.

In China, while recent economic signs have been encouraging, we remain cautious given the zero Covid policy can quickly result in controls being re-established which shut down key economic zones, the potential trade impacts from a slowing global economy and a worsening property market, particularly residential apartments.

In Australian, the Reserve Bank is likely to raise interest rates for the fourth month in a row in August in an attempt to counter inflation. While economic growth remains relatively strong, rising prices, higher interest rates and an overall high level of indebtedness could erode consumer and business confidence further.

Our view on various asset classes is outlined below.

Australian Equities

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

We anticipate that the general economic slowdown associated with higher inflation and less accommodative interest rates will have a negative impact on corporate earnings/profitability and will put downward pressure on share prices.

In light of the future market volatility expected within the Australian market, we also suggest that investors tilt portfolios toward value stocks and away from growth stocks. Due to expected volatility, consideration may be given to long short Australian equity fund options.

International Equities

We recommend investors hold an underweight position to developed markets and a neutral to underweight position in emerging market economies.

Within developed markets, despite recent falls and more attractive valuations, we believe that the increased likelihood of a slowdown in economic activity associated with rising interest rates will have a negative impact on earnings and share prices. We continue to suggest that investors tilt portfolios toward value stocks and away from growth stocks

While valuations are more attractive, emerging markets are likely to continue to come under pressure as rising interest rates in developed markets lead to an outflow of funds from those regions.

Property (REITs)

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

While the domestic property sector has recently experienced significant falls, following recent rises in interest rates/bond yields, we believe that future interest rate rises are already factored into the domestic property sector. Holding unlisted property may also help to mitigate further volatility.

As Global property is likely to continue to experience significant volatility, we prefer domestic options over international global property.

Fixed Interest

We suggest that investors move to an overweight position to Australian sovereign bonds. Following recent increases in domestic bond yields, Australian sovereign bonds now provide a reasonable level of income and effective hedging to growth assets. While we do not anticipate yields will rise much further, longer term risks remain if inflation lingers, and the RBA is required to tighten interest rates beyond current market expectations.

While investor demand for credit is likely to remain strong, following a widening in credit spreads, market volatility may lead to losses in this area and we suggest that a cautious approach be adopted.

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 and excess liquidity. 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.

Sources: Lonsec, IMF, RBA