Economic & Investment Update - October 2022

The September quarter was another challenging period for investors, as aggressive interest rate tightening aimed at controlling inflation plus surging bonds yields led to continued volatility within investment markets. Central banks in most developed markets raised rates while signalling that further rates hikes were likely to be necessary.

In the US, despite softer economic conditions, the US Federal Reserve raised the Federal Funds rate to 3.25%, the highest rate since 2008. With inflation above 8%, the US Federal Reserve announced that fighting inflation was now its top priority, even with the risk of a recession.

Strong demand for short-dated US Treasury Bills and interest rate increases in the US led to a stronger US dollar, most notably against the Japanese Yen. The Australian Dollar was also impacted and ended the quarter at USD 0.643 (7.3% lower for the quarter).

In Europe, the European Central Bank finally exited its "zero interest rate" policy, pushing rates to 1.25%. Annual inflation in the Eurozone jumped to 10% as energy prices soared. Meanwhile, the UK was thrown into financial turmoil following proposed sweeping tax cuts announced by short-lived Prime Minister Liz Truss, which caused the British Pound to collapse and UK bond yields to reach their highest level since the global financial crisis. Both have since recovered.

Geopolitical risks in the region also escalated as Vladimir Putin mobilised army reserves and warned that Russia would use all means at its disposal if its territorial integrity was threatened.

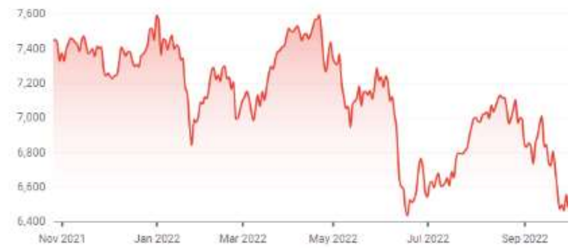
In Asia, despite inflation hitting 3% in September, Japan remained the outlier within developed markets by maintaining its ultra-low interest rate of -0.1%. Chinese economic data was mixed. While annualised inflation fell in August and consumption strengthened, GDP growth stumbled (3.9% annualised) as China grappled with strict zero-Covid controls and significant debts within the property market and banking sector.

In Australia, economic data released was generally robust despite the Reserve Bank increasing cash rates to 2.60% by early October, in a bid to lower inflation. However, these rate rises were before the release of the September inflation data which indicated that the consumer price index had risen by 7.3% in the past year (a 32 year high).

MARKETS

While the September quarter started promisingly, as investors focused on a potential interest rate pivot by the US Federal Reserve, markets gave up gains in September to finish at or below their recent June 2022 lows.

In Australia, following a significant fall in the June quarter, the S&P/ASX 200 Accumulation Index ended slightly higher over the September quarter (finishing up 0.4%) but remained down 7.7% over the last 12 months.



S&P/ASX 200 Acc Index (Source: Google Finance)

During the September quarter, the Energy sector produced the best return, up 5.8% on stronger-than-expected results and record cash flows. While crude oil traded at its lowest level since January, the prospect of OPEC announcing oil production cuts bolstered the sector return. The Utilities (-12.5%) and Consumer Staples sectors (-3.0%) generated the lowest returns as rising interest rates and inflation headwinds impacted sector performance.

Smaller ASX-listed companies (top 100-300) returned -0.5% for the quarter and -22.6% for the last 12 months, underperforming the S&P/ASX 200 Accumulation index.

Global equity markets produced negative returns during the September quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) down 5.2% (down 17.5% for the previous 12 months). With the Australian Dollar weaker against most major currencies, this offset market falls with the quarterly unhedged return, +0.4% and the annual unhedged return, -9.8%.

Within developed markets, US shares produced the lowest returns for the quarter with the Dow Jones Industrial Index down 6.7%. US markets fell on worries about surging inflation and ongoing US Federal Reserve rate hikes. Japanese shares fared best, with the Nikkei 225 PR Index down -1.7% for the September quarter. Weakness in the yen assisted businesses with sizeable offshore revenue bases. Within emerging markets, Chinese shares (as measured by the Shanghai Shenzhen CSI 300 Index) returned -15.2% for the September quarter with the disruptive COVID lockdowns, a struggling housing market and weakening demand for exports impacting the domestic market.

Property markets fell significantly during the September quarter as interest rates and bond yields rose. During the quarter, Australian listed property securities finished down 6.7% while global property securities finished 10.5% lower.

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 0.30% over the September quarter, the Australian bond market, as measured by the Bloomberg AusBond Composite Index, fell by 0.6% over this period. Overseas bond markets saw a larger fall with the Bloomberg Barclays Global Agg TR Index (AUD Hedged) down 3.8% 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	0.4	-7.7	6.8
	S&P/ASX Small Ordinaries TR (Accum) Index	-0.5	-22.6	4.1
International	MSCI World ex Aust NR Index (AUD)	0.4	-9.8	9.7
	MSCI World ex Aust NR Index (AUD Hedged)	-5.2	-17.5	5.3
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-5.4	-19.2	2.2
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-6.7	-21.5	2.6
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-10.5	-19.7	-0.5
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	-7.1	-0.5	3.3
Currencies				
AUD v USD	Against US Dollar	-7.3	-11.4	-4.0
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-0.6	-11.4	0.8
	Bloomberg Ausbond Credit All Maturities	-0.1	-9.2	1.5
International	Bloomberg Global Agg TR Index (AUD Hedged)	-3.8	-12.8	-0.2
Commodities				
Gold	Gold – USD	-8.1	-5.5	5.4
Oil	WTI Oil $/b – USD	-24.8	5.9	9.0

Outlook

The global economy continues to face steep challenges as Central Banks focus on raising interest rates to tame persistent and broadening inflation. To stop inflation from becoming embedded, Central Banks currently seem willing to sacrifice growth and jobs in the short-term to avoid an even bigger problem down the track.

Central to this approach is the US Federal Reserve and with inflation in the US above 8% and broad-based, it is likely that the Fed will need to keep lifting interest rates well into future to bring inflation back down to the targeted rate of 2%. However, rising interest rates are already having an impact on US consumer spending and it is likely that this will ultimately lead to further weakness in the US economy and ultimately a recession.

While the focus is now turning to whether this will be a soft or deep recession, should economic conditions deteriorate significantly, investors are hoping for a potential interest rate pivot.

On top of increasing inflationary pressures, Europe and UK are also experiencing an energy crisis and to try and preserve sufficient supplies of electricity over winter, the European Union has proposed a cut of 10% in overall energy consumption. If adopted, the caps will last until the end of March and will be a drag on regional growth.

In Asia, while inflation in China appears under control, Chinese growth remains lower than forecast and structural issues remain. President Xi Jinping's recent consolidation of power within China is also likely to create further unease about what this would mean for the worlds' second largest economy and financial markets.

In Australia, the Reserve Bank is likely to raise interest rates again in November and December in an attempt to counter inflation. While economic growth remains relatively strong, rising prices, higher interest rates and an overall high level of indebtedness are impacting consumer sentiment and housing. Further rate rises could ultimately lead to a contraction in economic growth.

Our general views on the various asset classes are outlined below.

Australian Equities

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

While the domestic equity market remains reasonably well placed to outperform other developed markets given a slightly more constructive economic outlook and valuation support, 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. This is likely to put downward pressure on share prices.

Within portfolios, preference should therefore be considered for sectors that are well insulated from downgrade risk and able to weather macroeconomic headwinds.

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 slowdown in economic activity associated with interest rate tightening will have a negative impact on earnings and share have a negative impact on earnings and share prices. With the Australian dollar currently weak relative to the US dollar, we also suggest that consideration be given to hedging US focused holdings.

While valuations are more attractive in emerging markets, these are likely to remain highly volatile given macroeconomic conditions.

Property (REITs)

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

While the out of favour domestic property sector has experienced significant falls, following rises in interest rates/bond yields, we believe that future interest rate rises and a reduction in property valuations are already largely factored into the domestic property sector. However, we note the continued risks associated with the office sector as employees retain flexible work arrangements and office space requirements potentially reduce.

As Global property is likely to continue to experience significant volatility, we prefer domestic options over international global property. This is despite international global property trading at a reasonable discount to Net Asset Value.

Fixed Interest

We suggest that investors move to an overweight position to Australian sovereign bonds. Following further increases in domestic bond yields, Australian sovereign bonds now provide a reasonable level of income and effective hedging to growth assets. However, investments in sovereign bonds may fall in value should inflation remain high, 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, further market volatility may lead to losses in this area. Given the economic risks, we suggest that a cautious approach be maintained.

Alternatives

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

Private Equity investments are expected to continue to be well supported, underpinned by strong returns. Unlisted holdings also help to mitigate volatility in portfolios.

In this climate of market uncertainty, we believe that an allocation to gold or silver is appropriate within portfolios. Exposure to gold, either through gold producers or via an investment in physical gold, provides additional diversification within portfolios and some protection against ongoing inflation. While recent strength in the US Dollar has muted returns from gold holdings, this is likely to improve should the attractiveness of the US Dollar as an alternative safe haven diminish.

Sources: Lonsec, Colonial First State, IMF, RBA