Economic & Investment Update – January 2023

The December quarter saw a rebound in equity markets as falls over the first nine months of the calendar year started to reverse.

The US Federal Reserve raised official interest rates to 4.5% in December with interest rates expected to reach 5.1% in 2023. In line with expectations, inflation slowed in December for a sixth straight month to 6.5%, but still three times the target rate of 2%. Despite rising interest rates, unemployment ended the quarter where it started at 3.5%, lower than expectations.

In Europe, the European Central Bank (ECB) raised interest rates to 2.5% at its December meeting marking the fourth increase of the year. The annual inflation rate dropped to 9.2% in December, below expectations. Further rate rises are expected due to the substantial upward revision in the inflation outlook with inflation expected to be 6.3% in 2023 and 3.4% in 2024. Business sentiment remains historically subdued, reflecting company concerns about the energy market outlook, high inflation and the rising risk of recession. Geopolitical risks in the region remain as Russia commences a revised offensive to recapture land in the east of Ukraine.

In Asia, China abandoned its zero Covid policy in response to widespread protests and increasing Covid infection numbers. Infections remain high with the resulting labour shortages affecting economic activity, particularly in the manufacturing sector. The opening up of the economy is expected to result in a more sustained and less volatile economic recovery. Unemployment rates are expected to start to fall.

In a surprise decision, the Bank of Japan widened the band around its 10-year bond yield target, whilst keeping its key interest rate at -0.1%. Inflation rose in November to an annualised rate of 3.8%, the highest in 30 years amid higher commodity prices and a weak yen.

With inflation remaining persistently high in Australia, the RBA raised the cash rate in December to 3.1%. They noted that inflation is expected to have peaked at around 8% in 2022, easing in 2023 before reaching 3% in 2024. The unemployment rate at the end of December remained steady at 3.5%. Households continue to grapple with high consumer prices and rising interest rates.

MARKETS

Equity markets rebounded in October and November before the broader market "Santa Rally" faded in December.

In Australia, off the back of falls in the first 9 months of the calendar year, the S&P/ASX 200 Accumulation Index rallied 9.4% over the December quarter but remained down 1.1% over the last 12 months.

The Utilities sector produced the best return, up 28.0% over the quarter – benefiting from Brookfield's proposal to take over Origin Energy. The Resources sector also produced a very strong quarterly return of 14.2% buoyed by China's exit from the zero Covid policy. Albeit still positive, the Consumer Staples sectors (1.7%) and IT sectors (1.9%) generated the lowest returns.

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

Smaller ASX-listed companies (top 100-300) returned 7.5% for the quarter and -18.4% for the calendar year, underperforming the S&P/ASX 200 Accumulation index.

Global equity markets rebounded over the December quarter with the MSCI World (ex-Australia) Net Return Index (AUD hedged) up 7.2% (down 18.1% over the calendar year). With the Australian Dollar strengthening, this partially offset market gains, with a quarterly unhedged return of 4.0% and an annual unhedged return of -12.5%.

Within developed markets, US shares reversed the fall of 6.7% in the September quarter, producing the highest regional returns for the quarter with the Dow Jones Industrial Index up 15.4% (-8.8% for the calendar year) as inflation slowed for a sixth straight month. Japanese shares fared the worst, with the Nikkei 225 PR Index up just 0.6% for the December quarter amid falling consumer confidence. Chinese shares (as measured by the Shanghai Shenzhen CSI 300 Index) returned 1.7% for the December quarter (-21.6% over the calendar year) as the country dumped its zero Covid policy.

Listed property also rebounded over the quarter as official interest rate rises slowed. Australian listed property securities finished up 11.5% (-20.5% over the calendar year) while global property securities finished up 4.0% (-24.2% over the calendar year).

Within Australian fixed interest markets, falling bond yields in October and November were reversed in December as the Reserve Bank raised rates by 25bpts. Volatility was also evident in the US with bond yields increasing in December off the back of a 50bpts rise. The Australian bond market, as measured by the Bloomberg AusBond Composite Index, rose by 0.4% over the quarter (-9.7% over the calendar year). Overseas bond markets saw a marginally larger rise with the Bloomberg Barclays Global Agg TR Index (AUD Hedged) up 0.6% over the quarter (-12.3% for the year).

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	9.4	-1.1	7.1
	S&P/ASX Small Ordinaries TR (Accum) Index	7.5	-18.4	2.9
International	MSCI World ex Aust NR Index (AUD)	4.0	-12.5	9.3
	MSCI World ex Aust NR Index (AUD Hedged)	7.2	-18.1	5.6
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	4.0	-14.3	1.5
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	11.5	-20.5	3.3
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	4.0	-24.2	-0.4
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	7.4	2.1	4.3
Currencies				
AUD v USD	Against US Dollar	6.4	-6.2	-2.7
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.4	-9.7	0.5
	Bloomberg Ausbond Credit All Maturities	1.1	-6.7	1.5
International	Bloomberg Global Agg TR Index (AUD Hedged)	0.6	-12.3	-0.2
Commodities				
Gold	Gold – USD	9.8	-0.3	7.0
Oil	WTI Oil $/b – USD	1.0	4.2	5.8

Outlook

Central Banks are faced with the conundrum of how much further to lift interest rates in order to reduce inflation back to target rates. This is complicated by the time lag between interest rate rises and the slowdown in economic activity. If rate rises are too aggressive, a deeper recession is likely to result, followed by a subsequent reduction in interest rates.

Global inflation is starting to fall as supply chain constraints are resolved, energy prices fall and interest rate rises start to bite. However, there is a risk of inflation staying higher for longer due to increased wage demands. Central Banks may also adjust their target inflation rates in the short term to allow for current rate rises to take effect.

US December quarter GDP came in slightly above expectations at an annualised rate of 2.9%. This is potentially the last quarter of solid growth before the impact of higher interest rates start to bite. A future full blown global recession is still possible, but is reducing amid an increase in consumer confidence and a tight labour market, held up in part by a decrease in supply from an ageing labour force. A shallow global downturn is more likely, however the quantum of interest rate rises remains uncertain given that Central Banks have a long way to go until inflation is under control.

The risk of a deep recession in Europe remains higher as high inflation combined with energy security concerns continue to impact on markets. The ongoing war in Ukraine has the potential to weigh heavily on markets especially if hostilities escalate. Thankfully, a warmer than normal winter has eased European energy concerns in the short term.

In China, the abandonment of the zero Covid policy is expected to result in a more sustained and less volatile economic recovery.

In Australia, the expectation is for between one and three more 25 bpts rises in the official cash rate in 2023. The likelihood of a deep recession in Australian remains low with the resources sector expected to be supported by weakness in the US Dollar and the removal of Chinese Covid restrictions.

Our view on the various asset classes is outlined below.

Australian Equities

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

The domestic equity market remains reasonably well placed to outperform other developed markets given a slightly more constructive economic outlook. However, the surge in stock values over the quarter, continuing through January, means valuations are likely to become inflated in the future especially if a slowing economy puts pressure on corporate earnings.

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.

The current bullish sentiment driving the recent rise in global equity markets is not supported by fundamentals. Rising input costs and higher borrowing costs will slow global economic growth, putting downward pressure on corporate earnings. The US still looks particularly expensive.

Despite appealing valuations on offer in emerging markets and the removal of Covid restrictions in China, the risk factors remain elevated given the expected global economic contraction.

Property (REITs)

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

We believe 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.

We are less confident on global property especially in Europe where the risk of a significant economic downturn is heightened. As global property is likely to continue to experience significant volatility, we prefer domestic options over international global property.

Fixed Interest

The recent reduction in long term yields on Australian Government bonds has led us to reduce our recommendation for that sector from an overweight position to a neutral to overweight position.

The inversion of the yield curve in the US has led us to increase our recommendation for international sovereign bonds from a neutral to underweight position to a neutral position. This is on the expectation of short to medium term rates falling in the future.

We remain pessimistic on global corporate bonds given the chance of a global recession.

Alternatives

We retain a neutral setting for Infrastructure investments despite the recent rally.

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 continue to 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. The recent weakness in the US Dollar has supported gains in gold holdings.

Sources: Lonsec, The Economist

Please note that the information above is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation and needs. In particular, you should speak to Kevin Smith of The Professional Super Advisers on (02) 9955 5800 prior to acting upon this information.