Lonsec Client Newsletter - February 2022

Summary of Key Views

Insights from our CIO: 2022 starts with a bang

Markets have kicked of 2022 with a bang. Inflation is on everyone's lips and we saw markets gyrate widely ahead of the US Federal Reserve's meeting in January. What is certain is that markets do not like uncertainly and in this instance the market was trying to process whether the Fed will raise rates, and if so by how much and when. Additionally, markets were eager to understand the Fed's direction on their liquidity support for the economy via quantitative easing (where the Fed buys government bonds), which has been an anchor for markets for the best part of the last decade. The Fed essentially indicated that inflation may increase further before it moderates, that a rate rise in March is possible and that liquidity support through quantitative easing will continue to slow down. In addition to inflation, the ongoing flow on effects from the pandemic and growing geopolitical tensions between Russia, the Ukraine and western powers has also contributed to market volatility.

As we have learned from previous periods of volatility, it is important not to react emotionally in such periods and focus on fundamentals. In periods of market volatility quality assets often get oversold. During the last two years we have witnessed a record level of new retail investors enter the market, as reflected by the surge in new online share trading accounts being opened and for many this will be their first encounter with a market downturn. No doubt there will be some nervous investors.

Market developments during January 2021 included:

Australian Equities

The Australian share market closed out January 2022 with the S&P/ASX 200 losing -6.4% with eight out of the eleven sectors within the Index finishing lower. Specifically, Energy was the standout sector with a return of +7.9%, whilst Utilities (+2.6%) and Materials (+0.8%) also finished positive. A heavy decline in the Information Technology sector (-18.4%) and Health Care sector (-12.1%) led what was a dismal month for the broader market.

The Energy sector was boosted by surging prices and a bullish outlook for Brent and Crude Oil in light of various tailwinds for the sector such as tight supply, geopolitical tensions and reduced fear around future lockdowns. Once again, the Information Technology sector suffered substantial losses as investors rotated from growth stocks. The catalysts included rising rates along the yield curve and several central banks indicating forward guidance of tightening monetary policy and quantitative easing to combat inflationary pressures.

Growth and Equal Weight led the decline amongst factors for the month with losses of -8.4% and -7.9% respectively. All factors finished with negative returns with growth providing the largest fall. Over the past 12 months, value is the leading factor (+14.2%), with Equal Weight (-5.7%) delivering the lowest 3-month returns.

Global Equities

Subsequent to a positive end to 2021, global markets struggled in the first month of the year, challenged primarily by prospective interest rate hikes and geopolitical tensions in Ukraine.

As the AUD fell over the month of January, all of the following figures are in local currency terms for relative comparability. Developed markets slumped over the month of January declining by -4.9%, Global small caps continued to lag their broad cap counterparts posting a -7.0% loss for the month. Emerging and Asian markets fared somewhat better with monthly returns of -1.8% and -3.8% respectively.

The key focus for investors worldwide continues to be the impact that inflation will have on markets. This has seemingly created favourable market conditions for value stocks over the last month, with value displaying monthly outperformance of over 7.4% relative to growth according to the respective MSCI ACWI Value and Growth indices in local currency terms. This is only the second time since the inception of the index that Value has outperformed growth in excess of 5%.

Fixed Interest

Fixed Income markets performed poorly throughout January, as concerns surrounding high rates of inflation and tight labour markets resulted in increasing yields. The Reserve Bank of Australia recently announced an end to their quantitative easing program on 10 February, but Governor Phillip Lowe has not given any indication of an increase to the cash rate in the short term, with the Board wanting to see inflation sustainably within their 2-3% target range, and increased wage growth first. Despite these statements, markets are currently pricing in 3-4 rate hikes before the end of 2022.

Over the course of January, yields for 10-year Australian Government Bonds increased by more than 20bps. This was the primary driver behind the Bloomberg AusBond Composite 0+ Year Index's performance of -1.0% throughout January. Credit spreads also widened over the course of the month, further contributing to the Index's poor performance.

Internationally, the US has been facing high levels of both inflation and wage growth, which has driven the Federal Reserve to adopt a more hawkish stance. While there has been no rate hike yet, the Federal Reserve's forward guidance suggests that an increase will occur within the next few months, which is in-line with current market expectations. This, among other events, resulted in the Bloomberg Barclays Global Aggregate Index (AUD Hedged) returning -1.6% over the course of January, with currency fluctuations resulting in the unhedged variant returning 1.1%.

REITs (listed property securities)

The S&P/ASX 200 A-REIT Index (AUD) started off the year with a material drawdown, finishing the first month of 2022 down -9.5%.

Global real estate equities (represented by the FTSE EPRA/NAREIT Developed Ex Australia Index (AUD Hedged)) also had a poor month, closing -5.4% lower in January. The sell-off likely stemmed from the growing concern of the Omicron variant and a hawkish Federal Reserve.

M&A activity was quieter during January across the ASX200 A-REIT sector. Centuria Capital Group (ASX: CNI) announced it has secured, off-market, the West Village in Brisbane, for $202 million, as part of an existing institutional mandate on behalf of an international sovereign wealth fund. Centuria Industrial REIT (ASX: CIP) announced a portfolio acquisition of six high-quality industrial assets across the eastern seaboard of Australia totalling $132m in value.

Despite the volatility in financial markets during January, the Australian domestic housing market advanced, with all CoreLogic reported cities experiencing positive growth during the month. Brisbane led the charge, advancing 2.3% in January. Brisbane (incl Gold Coast) is on top for YoY returns, up 30.1%, closely followed by Brisbane with 29.2%. The CoreLogic 5 capital city aggregate rose by 0.8% in January.

Alternatives

Preliminary estimates for January indicate that the index increased by 3.8% (on a monthly average basis) in SDR terms, after increasing by 4.8% in December (revised). The non-rural and base metals indices increased in the month, while the rural index was unchanged. In Australian dollar terms, the index increased by 3.6% in January.

Over the past year, the index has increased by 25.3% in SDR terms, led by higher LNG, coking coal and thermal coal prices. The index has increased by 30.9% in Australian dollar terms.