Published April 2022

Lonsec Client Newsletter - April 2022

Lonsec

Summary of Key Views

Insights from our CIO: The winds of change are coming

Years of accommodative monetary policy combined with ample liquidity from central banks, remnants of the global financial crisis of 2008, may be coming to a gradual end. We are arguably entering a transition period in the economic environment from one of low inflation, low interest rates backed by unconventional monetary policy (quantitative easing), to one of higher inflation and the potential of higher interest rates. Adding fuel to inflationary pressures has been a global pandemic where supply chains have been disrupted like never before, heightened geopolitical risks with the Russian invasion of Ukraine, known as the breadbasket of Europe, putting price pressures on everything from crude oil, wheat to sunflower oil, and globalisation, the accepted mantra for economic growth for decades, which is now under increased scrutiny with talk of a deglobalised world.

Periods of transition from a market perspective are always challenging. They are characterised by increased uncertainty and subsequently increased market volatility. In such environments it is a balancing act between defense and offence. In recent years, an offensive game has been a clear winner, however defense has become increasingly important. While we do not have a crystal ball on how high inflation will be and by how much interest rates may rise, the likely trend is up. With this in mind, considering assets that can assist in navigating a higher inflation environment is important. While there is no perfect hedge for inflation there are assets that can benefit from a higher inflation environment. Some of these include real assets such as infrastructure and property, commodities including gold, floating rate notes and inflation linked bonds.

Market developments during March 2022 included:

Australian Equities

The Australian market closed out the quarter with the S&P/ASX 200 up 6.9% in March and all 11 sectors finishing positively. The Technology sector (+13.2%) led the index and rebounded from a February selloff, with Energy (+9.8%), Materials (+8.9%), Financials (+8.5%) and Utilities (+7.6%) all performing strongly.

The Energy and Materials sector continued their stellar year-to-date performances as commodity prices continued to soar. Meanwhile, Information Technology rebounded strongly from a perceived 'bottom' in February amidst rising interest rate pressures in overseas markets. However, volatility in this sector persisted given the uncertain macroeconomic backdrop. The Financials sector continued its sturdy performance as the major Australian Banks contributed to the strong Australian broad market performance. The S&P/ASX 200 finished the month within 2% of its August 2021 historical high. Overall, whilst the geopolitical issues in Ukraine remain a point of concern, Australian equity performance has been more robust than other markets with greater geopolitical risk.

In March, Momentum (+9.0%) and Growth (+7.2%) were the top performing factors. All factors performed strongly with Low Volatility (+3.8%) being the weakest factor. Over the past 12 months, Momentum is the top performer (+23.3%). Moreover, Shareholder Yield (-2.8%) has provided the lowest returns over the past quarter.

Global Equities

Global markets continued their downward trend over the month of March as the Ukrainian conflict continued with no certain end in sight. Developed markets fared better than in February closing -0.9% lower by month end, Global small caps performed worse than their large cap counterparts closing with a -2.7% loss. Emerging and Asian markets loosely mirrored the return profile of the previous period, continuing to fall by -5.6% and -5.7% respectively.

Geopolitical uncertainty continues to be the core focus for investors as upward price pressure on energy and commodities hastens the pace of inflation across the globe. Momentum and quality factors were the best performers over the month returning 4.3% and 3.1% respectively, whilst equal-weighted and value factors were the laggards returning -0.7% and 0.4% respectively according to MSCI ACWI Single Factor Indices reported in local currency terms.

Fixed Interest

March saw Fixed Income markets deliver another poor result, a continuation of the trend throughout 2022 so far. With inflation remaining elevated across the world, central banks have begun to raise rates, most notably, in March the US Federal Reserve issued its first rate hike since COVID began. This has resulted in yields surging around the world, and Australia is no exception, with the 2- and 10-year yields of Australian Government Bonds increasing by approximately 70bps over the month. When combined with credit spreads which continued to widen, this resulted in the Bloomberg AusBond Composite 0+ Yr Index returning -3.8% over March, the worst monthly return in the indices history.

In the US, yields also rose across all durations, but the rate of increase was much higher at the short end of the yield curve, with 2-year yields increasing by 90bps compared to the 50bps increase in 10-year yields. This resulted in an inversion of the US yield curve, as 2-year rates surpassed 10-year rates, which some market participants have interpreted as a recessionary signal. The rapid yield increases internationally have resulted in the Bloomberg Barclays Global Aggregate Index (AUD Hedged) returning -2.1% over March, with currency fluctuations resulting in the unhedged variant returning -6.3%.

REITs (listed property securities)

March was a positive month for both the local A-REIT market and the broader Global real estate equities market with the S&P/ASX 200 A-REIT Index (AUD) and the FTSE EPRA/NAREIT Developed Ex Australia Index (AUD Hedged) advancing 1.25% and 4.99% MoM, respectively.

The strong monthly move in global REITs may be attributable to investors seeking higher income-producing assets that have the ability to keep pace with inflation. The S&P/ASX Infrastructure Index TR, comprising 9 constituents of the ASX300, advanced 6.81% MoM, equating to 8.87% YTD. The recent Federal Budget may provide a tailwind to the sector, with infrastructure spending announced that includes $17.9bn of road and rail as part of a $120bn 10-year infrastructure investment pipeline.

M&A activity during March across the A-REIT sector included Charter Hall (ASX: CHC) managed partnership with Dutch pension fund PGGM entering into a scheme implementation agreement to acquire Irongate Group, which will result in Charter Hall owning a 12% stake in the partnership. Additionally, Centuria Capital Group (ASX: CNI) formed a healthcare JV with Morgan Stanley Real Estate Investing which has been seeded with three healthcare real estate assets of $220m collective value.

CoreLogic reported that the national rental index increased by 1.0% during March to a total of 2.6% for Q1 2022, with national unit rents rising at a faster pace than houses. Growth in the value of the housing market has slowed in some major cities, with Melbourne and Sydney both recording negative numbers for March, -0.1% and -0.2% respectively (CoreLogic). Adelaide and Brisbane, however, tell a different story, both advancing strongly with 1.9% and 2.0% growth respectively (CoreLogic).

Alternatives

Preliminary estimates for March indicate that the index increased by 8.4% (on a monthly average basis) in SDR terms, after increasing by 8.0% in February (revised). The rural, non-rural and base metals indices all increased in the month. In Australian dollar terms, the index increased by 3.9% in March.

Over the past year, the index has increased by 40.9% in SDR terms, led by higher LNG, coking coal and thermal coal prices. The index has increased by 42.7% in Australian dollar terms.