Market Update – May 2022

Asset class total return to 31/05/2022	1M (%)	3M (%)	6M (%)	1Y (%)	3Y (% p.a.)	5Y (% p.a.)	Current Yield (%)
Cash	0.1	0.2	0.3	0.2	0.4	0.7	0.9
Fixed Term Deposits	0.2	0.3	0.4	0.5	0.7	1.2	2.8
Australian Bonds	-0.9	-6.0	-8.0	-8.5	-1.8	1.0	3.3
Australian Bank Hybrids	-1.2	-0.9	-0.3	1.3	2.9	3.5	3.3
Australian Property	-8.6	-6.6	-9.6	4.6	3.1	6.3	4.3
Australian Shares	-2.6	3.2	1.4	4.8	7.8	8.8	5.0
Global Shares (unhedged)	-0.8	-4.8	-10.6	2.6	11.4	10.6	2.1
Global Infrastructure (hedged)	2.2	8.0	11.5	14.1	7.5	7.7	2.9

Source: Refinitiv, Fixed Term 12M, Australian Bonds Composite, Hybrids gross yield to call, Property ASX 300 AREIT, Australian Shares S&P/ASX 200, Global Shares MSCI World ex-Aust unhedged, Global Infrastructure FTSE Developed Core 50/50, hedged

Financial Indicator movement	31/05/22	1M	3M	6M	1Y
AUD/USD	0.72	0.02	0.01	0.01	-0.05
Aust. 10-year bond yield (%)	3.35	0.18	1.19	1.62	1.70
Gold (US$/oz)	1,837	-3.1%	-3.7%	3.6%	-3.6%
Brent oil (US$/bbl)	123	14.0%	21.6%	74.1%	77.2%
Iron ore (US$/t)	131	-13.6%	-7.7%	37.9%	-36.3%
Copper (US$/lb)	4.30	-2.3%	-3.4%	0.4%	-8.3%

Note: Past performance is not a reliable indicator of future performance.

Global

High inflation continues to remain the key global issue, with Russian sanctions and China's lockdowns likely to exacerbate and extend inflation and supply chain problems into FY23. Central Banks are increasing cash rates rapidly and the yield curve is moving higher. Interest rates are now considerably higher than at the start of 2022, which is a positive for cash and fixed interest investors, but a negative for property and equity assets, which have been falling. Infrastructure and commodities have been resilient thus far.

The first leg of the downturn in equity and property markets has related to higher bond yields, which increase discount rates and lower market valuations. We expect a second leg down, relating to issues around company earnings and leases. Companies are facing rising costs and higher interest rates, which will place pressure on company margins.

With US inflation persisting at high levels (8.6%), the US Federal Reserve (the Fed) has no choice but to keep increasing interest rates until demand falls. It is a very blunt instrument, considering most of the inflation problems relate to supply chain problems, but that is the only instrument it has to reduce inflation.

The chance of a recession has increased, and it is likely that housing and equity markets will remain under pressure until Central Banks ease up on interest rate hikes. And that is only possible, once inflation recedes.

Australia

The new Labor government has had a baptism of fire, with the RBA lifting interest rates by an unexpected 50bps in June and a looming energy crisis on the East Coast of Australia. Cost of living pressures are coming to the fore and there is not much governments can do after blowing out their budget deficits and debt, during the COVID pandemic.

Households are facing higher living expenses and higher mortgage repayments. With debt levels continuing to rise, during the COVID pandemic (encouraged by ultra-low fixed rates) there is likely to be some major problems ahead as households revert to considerably higher variable mortgage rates over the next 1-2 years.

It is likely that households will need to reduce consumption materially (which is what the RBA wants) but it could sow the seeds of a recession that the central banks and government may not be able to prevent.

On the positive side, the Australian economy remains resilient thus far and unemployment is low. The savings rate is generally high and there may be some capacity to absorb higher costs and interest rates in the short term. Australia is also benefiting from high commodity prices across the resource and agricultural sectors.

But falling housing and equity markets indicate trouble ahead. With the market expecting the RBA cash rate to be over 2.0% (currently 0.85%) by the end of the year, we would expect higher mortgage rates to have a materially negative impact on the economy in 2023.

Outlook

Sanctions on Russian commodity supply and lockdowns in China have worsened the supply chain problems that have driven inflation. Central Banks can only respond with higher interest rates to reduce demand. The key questions are: **how high will interest rates go and what level of inflation will Central Banks accept?**

If the Fed keeps to its 2% inflation target, we could be looking at an ugly period of high interest rates to slay inflation, similar to the Paul Volcker led Fed in 1979. We find this hard to believe in the modern age, where governments do whatever they can to promote growth and jobs. We think it is likely that the Fed expands its inflation target to 2-3%, similar to the RBA.

In Australia, inflation is lower at 5.1% but it is likely to rise at the next June quarter result, due in July 2022. The RBA may well be forced to increase the cash rate to 2.0% or higher (as the market expects). This is going to have a major impact on household mortgage repayments and the housing market. However, we think the RBA is likely to 'blink' at some stage, as the housing and equity markets continue to retreat.

We went bearish in late April 2022 on concerns that rising interest rates and rising costs would be too much for companies and households to handle. There is an increased chance of recession ahead. We are recommending a defensive approach, which includes exposure to quality growth assets, some gold exposure and a re-evaluation of cash and fixed interest (minimum BBB credit rating) as an opportunity.

The next key events on the calendar include:

- Fed meeting – 14/15 June 2022
- RBA meeting – 05 July 2022
- Australian FY22 profit season – August 2022

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