Market Update – Week Ending 19 June 2022

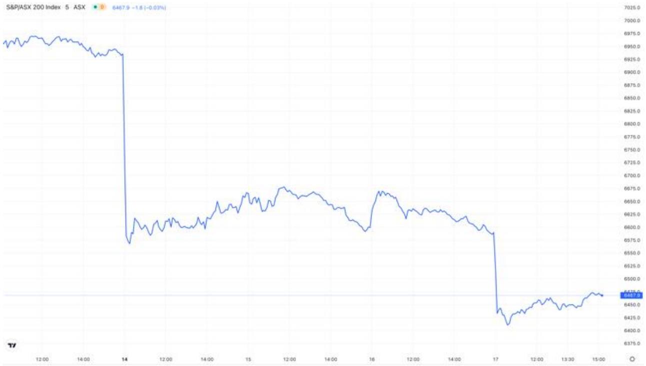
BIG SHIFT IN ASSET PRICES

Investors in the past week, no doubt, would have come across a torrent of news reports on the selloff in global share markets, rising inflation & interest rates, and energy shortages on the east coast of Australia with a real possibility of ongoing blackouts. Therefore, investors can be forgiven for feeling a little anxious about what the near-term future may hold economically. Let us settle investors' nerves with the words that *this too shall pass, it always does*. Focus on what you can control which is to fix your cash flow requirements for the next couple of years. Your excess capital should remain invested across various asset classes, in line with your risk profile. The value of your investment portfolio will be volatile from time to time but that is the price you must pay to receive the eventual reward of wealth creation.

In the following sections, we will discuss recent volatility in stocks, bonds, interest rates & inflation. At the back end of this update, we will address some common questions investors have been asking their advisors.

SHARES LOSE THEIR NERVE AGAINST RISING INTEREST RATES

The Australian share market finally lost its nerve in the past week after holding up relatively well for many months compared to other major share markets. The below chart of the Australian share market (ASX200) shows the two major sell-offs that took place last week. On Tuesday it shed around -4% in value and on Friday it shed further -2%. Overall, the Australian share market is now down -15% from its all-time peak in August 2021.



Source: Banyantree Investment Group

BONDS LOSE THEIR NERVE AGAINST RISING INFLATION

Simultaneously, the other major sell-off was in the bond market which is the source of all the loans that eventually run the economy from households' mortgages, student loans, car loans, credit cards, personal loans, to commercial loans. In fact, an average person is more likely to be a borrower than own shares. Thus, the bond market is kind of a big deal with its impact on the economy as far reaching.

The 10-year government bond is a popular security traded in the bond market. The 10-year government bond is now offering investors an interest rate return of 4.12% p.a., while just a week ago this bond was offering 3.65% p.a. This is considered a big move in the bond market. So, while these rising interest rates will eventually be good for income focused investors, the adjustment process to higher interest rate returns, unfortunately, is going to cause some pain.

Adjusting to living in a world with higher interest rates is going to cause borrowers and businesses to cut spending in the near term. Eventually, everyone will adjust to higher interest rates with household incomes improving from wages growth and businesses will find relief through growth in prices of their goods and services and/or volumes. Roll back just a few months ago, not many would have forecasted that minimum wages could start growing by 5.2% p.a. in Australia from June 2022; well, they have just been passed in as law last week.

Fixed interest investors who have remained invested in funds and securities that were producing 1% or 2% income return at the start of 2022 are now finding that their holdings have had to endure capital losses as their investments get priced at higher interest rates of 4% or more. We expect investors should receive healthy income returns in the future as 4% or 5% return on fixed interest security is a lot better than 1%-2% returns of the past when many conservative investors were pushed out to owning shares for income and/or had to dip into their savings to fund retirement. In the coming years, and provided you don't chop and change your fixed interest exposures too much right now, higher interest income should provide offset for the losses incurred to the value of the bonds and credit part of the portfolio. Investors have to be patient and let this process take place over the next 2 plus years.

Some investors may be wondering if bond prices (interest rates) could continue adjusting adversely in the near term. The short answer is yes, they may. You may notice on the chart below that the Australian 10-year government bond yield could still go higher from current level of 4.12% p.a. Between the years 2000 and 2007, these bonds traded in the 5%-7% p.a. range, they are currently offering 4.12% p.a. And those of us who are old enough to remember the 1970s and 80s would know that inflation was in double digits in that era. We discuss the outlook for bonds in more detail later in this article.

Source: Banyantree Investment Group

INFLATION IS CAUSING CENTRAL BANKS TO LOSE THEIR NERVE

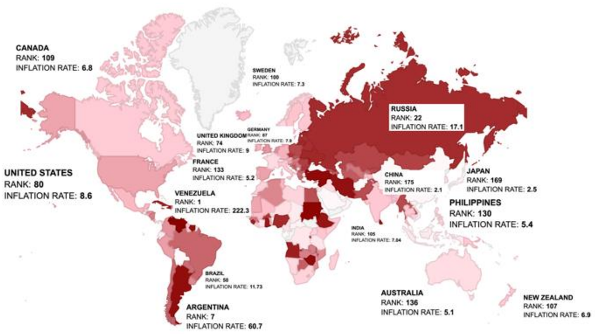
Another big news last week was that inflation in the US rose to 8.6% in May. Inflation rising every month makes everyone nervous. Businesses find it difficult to maintain profit margins as it is not entirely possible to frequently increase their prices while facing the hit to margin from rising costs. Investors in shares become nervous about the impact of shrinking profit margins which cause a decline in the value of shares, all else being equal. Central Banks get nervous about out of control inflation, its impact on economic activity, consumer's loss of buying power, currency weakens, as does the economic well-being of the population.

It is not as such that inflation is a problem it's actually inflation that is getting higher every month that is the problem. And that is why you are seeing central banks move hard with interest rate increases to bring down consumer spending in the hope that brings down inflation. Businesses, consumers, and central banks want to see price stability in the economy as currently all major economies are seeing inflation rise each month. Until the inflation rate settles down, you will see that share prices, bond prices, and economic activity will continue to come under pressure. ***But inflation will eventually settle down. Again, a reminder here that investors should focus on what they can control i.e. fix your cashflow requirements for the next couple of years and let other parts of your portfolio adjust over time.***

Below are some specific questions received from investors in recent days, let us address the questions one by one.

HOW HIGH WILL INFLATION GO?

The chart below shows inflation in various countries around the globe. The darker the colour the higher the inflation. Generally speaking, Australian inflation of 5.1% in March (may well be a lot higher now in June) ranks 136 in the world, there are many more countries with much higher inflation than ours. Asia generally has much a lower single-digit inflation compared to Europe and the US in high single-digit % (e.g. UK 10%, US 8.6%).



Source: Banyantree Investment Group

There are two key reasons right now for rising global inflation.

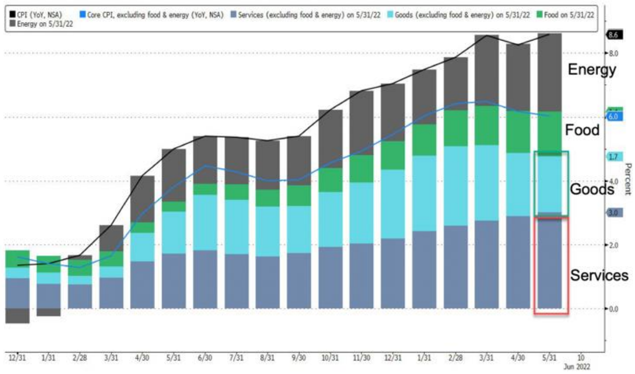
Firstly, China is currently dealing with the Covid-19 related lockdowns of hundreds of millions of people. These lockdowns, as we know from our experience in Australia, cause demand disruption. Demand heading into lockdowns gets destroyed, supply chains respond with running down inventories and put-off future orders to conserve cashflows. Then people come out of months of lockdowns with pent-up need to spend which is stoked further by government stimulus to pump start the economic growth. Supply chains start from little inventories to service this surge in demand and rush to order at-once from the factories and no factories in the world can deal with demand surges of the magnitude we have seen when economies reopen after covid-19 lockdowns. That results in inflation. China's supply chain not only supplies to the world but also services their domestic demand which is currently majorly disrupted and is coming out of lockdowns. All this points to ongoing risks of supply chain related inflation.

Secondly, Russia's war in Ukraine has caused major disruptions to the global supplies of agricultural, industrial, and energy commodities. It does not appear the war is going to be over anytime soon and in fact each side is becoming more entrenched in their position against the other. Thus, investors should expect ongoing pulses of inflation moving wider and deeper into everything that is manufactured, built, and consumed globally.

Moreover, supply chains globally are very tight right now. There is just no room for another adverse global event; which , if it happens, will set inflation speeding at rates higher than even current levels and then double-digit inflation could well be a reality, the UK government is already expecting the next inflation number to be 11%.

In the near-term there is little optimism that the abovementioned issues will abate and so the supply side inflationary impact is set to continue. Where there is hope is that central banks across the advanced economies will raise interest rates enough to reduce excess consumer spending in their respective economies which will lessen the pressure on supply chains and thus reduce inflation. This may well happen but there is a price to be paid for using the blunt tool of interest rate rises, that price may well be a recession. The hope is that there won't be one, well not at least a deep recession that causes high unemployment. Unemployment in Australia is 3.9%, which is at a 39 year low. Even if interest rates increases and high wages growth cause businesses to shed some labour off their payrolls we are still seeing low unemployment in the 4%-5% range. Which indicates a resilient economy.

You can see in the below chart that even though inflation in the US rose in May to 8.6%, the goods component of inflation which blew up to be quite significant between April 2021 and March 2022 has since been shrinking again. It's the services inflation (i.e. wage growth) that has been rising for the past nine months, but we feel, as the Federal Reserve hits the brakes on consumer spending through interest rate increases, that should loosen the tightness in the labour market and push up unemployment just enough to bring down the wages growth component of services inflation.



Source: Banyantree Investment Group

So, while we have made the case for goods and services components of inflation in the US (likely Australia also) potentially easing in future months, the energy and food prices remain a upside risk to inflation from supply chain issues mentioned above.

Finally, it's important to note that inflation runs in very long cycles. We have just come out of a 25-year period of falling inflation, but it is important to remember that there was a 20-year period (1970s & 1980s) of high inflation and prior to that during 1950s and 1960s was a 15 year period of low inflation and we can keep mentioning cycles further back. Usually major global events set off these long inflationary or deflationary cycles, and they can be set-off by significant wars, energy embargos, pandemics etc. So, the point is that we may not be going back to 2%-3% inflation rate that we have been accustomed to and the inflation in the future may settle at a much higher level. The operative word is 'settle', we need inflation to settle and at even 5-7% would be fine for economic growth. We have seen that before and the world would just get on with it.

Prepare for more volatility in the near term. ***Again, control what you can in your portfolios and let the rest of it participate in the ebbs and flows of the markets.***

HOW HIGH WILL INTEREST RATES GO?

Let us make a quick comment on interest rate increases. The market is expecting the Reserve Bank of Australia (RBA) to raise its official interest rate by roughly 3.5% by June next year. RBA's threat of interest rate increases is a scaremongering tactic used to get people to slow down spending in the economy. If it feels that people are not responding by curbing their spending then RBA follows through with the threat and applies interest rate increases to effectively take real money out of people's cashflows, ***what they don't have they don't spend is the theory!***

Our view is that after the RBA last week moving to 0.85% official interest rate, there is probably another 1%-1.5% in further rate rises before it stops at 1.85% to 2.35% in this rate increase cycle. That would amount to average variable home loan rate of 3.85% to 4.35% p.a. within the next 12 months.

We think the RBA will sit at those levels and assess how borrowers will progressively digest higher monthly repayments with spending cuts in the near term and longer term will likely get reprieve from wages growth.

HOW LONG WILL THE SHARE MARKET REMAIN VOLATILE?

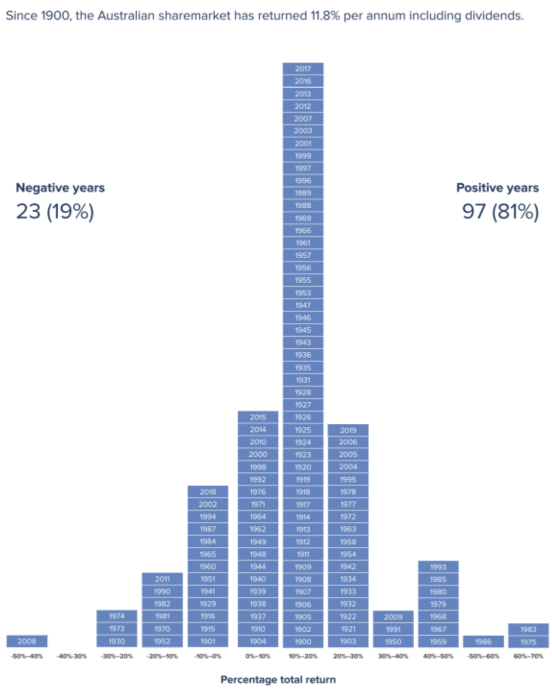
Inflation is the main indicator investors need to watch to predict when the market volatility will settle. The market needs to see inflation stabilise over the next few months and if it does the market volatility should reduce.

From there onwards it will be about the speed of economic growth, ability for businesses to pass price increases to their customers, manage and reduce costs and grow profit margins again. Share prices will react to that as positively.

If inflation continues to get worse in the coming month then investors should expect further sell off in the markets. ***Again, be diversified in your portfolios and control what you can.***

On the positive side, there is talk of major infrastructure spending stimulus announcements likely from Biden Administration, China, and the global transition to renewables energy will also require new development expenditure. All of this would be supportive of employment and economic growth. Stimulus funding through infrastructure development, from past experiences of downturns, we know works well in cushioning the economy from an economic recession.

We thought we might end our letter with a positive chart. The chart below shows the Australian share market, over the past 120 years, has delivered positive annual returns 80% of the time.



Source: AXA

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