Investment & Economic Snapshot

FY 2021/2022 in review

Smarter Investment Solutions

Key market and macro economic developments over the 2021/22 financial year

Jul 2021

Global central banks start talking about reducing their QE programmes, given the economic data have been improving faster than they had expected. Gold rallies. The AUD falls to its lowest level since early December 2020.

Aug 2021

Covid-19 continues to spread around the world, leading to further slowing of economic activity, disruptions to global supply chains, and pockets of inflationary pressures. The Reserve Bank of Australia (RBA) claims it will not increase the cash rate until inflation is sustainably within the 2-3% target range and that it does not expect this to happen before 2024.

Sept 2021

The Federal Reserve announces their tapering programme would begin around the end of the year. Iron ore, Australia's largest export, crashes -25%.

Oct 2021

Global inflation picks up noticeably and rapidly in the US (5.4% year on year) and in Australia (3.0%). Whilst currently higher than expected the RBA claims that inflation is unlikely to stay high. Bond market returns continue to fall as yields rise in response to a growing expectation that central banks will bring forward their timetables for raising rates.

Nov 2021

A new Covid-19 variant (Omicron) reaches Australia's shores. The volatility index shot higher as market fears take hold, resulting in intense selling pressure for risky assets in the final days of the month. The Australian Dollar falls from 75c to 71c reflecting soft commodity prices, widening interest rate differentials and a general preference for safe-haven currencies during this recent bout of volatility. Federal Reserve Chair, Jerome Powell indicates that higher inflation is likely to persist for longer than the Fed originally thought.

Dec 2021

Global and US equities enjoyed an exceptionally good calendar year. Australian equities posted a solid +17.7% total return including dividends but underperformed global equities. Rising inflation and bond yields saw Global and Australian bonds post their worst annual return in decades, falling -1.5% and -2.9% respectively.

Jan 2022

It was a poor start to the new year for financial markets with all major financial assets posting negative returns. The US Federal Reserve announces that tighter monetary policy (higher cash rates) is just around the corner. Global bond markets respond to the Federal Reserve's more 'aggressive' tone by rapidly selling bonds, which caused prices to fall heavily and bond yields to rise. The Australian share market was down (-6.6%) in January, in what was one of the worst starts to a year in decades.

Feb 2022

Russia invades Ukraine in late February. Concerns emerge that the main threat to the global economy may come in the form of an energy crisis (and higher inflation) which would hit Europe hardest given that Russia currently supplies 30% of Europe's gas and oil. With US inflation sitting at 7.5% (the highest reading in 40 years) and a very tight labour market, the Federal Reserve signals it will soon be appropriate to raise the target range for the federal funds rate. Australia posts some encouraging economic figures. The unemployment rate comes in at a 14 year low of 4.2%.

Mar 2022

The US Federal Reserve lifts rates by 0.25%, noting that whilst US economic activity and employment have continued to strengthen, inflation remains elevated and is likely to persist if no action is taken to control it. The RBA keeps the cash rate unchanged at 0.10%, but hints that it was warming to the idea of lifting rates. Global bond yields spike higher.

Apr 2022

Australia's headline inflation rate rises to 5.1%. The RBA lifts the official cash rate by 0.25% to 0.35%, the first increase in the cash rate in more than a decade. The US Federal Reserve delivers its biggest interest rate increase since 2000. Major global financial assets pull back sharply on fears that the risk of global stagflation (slow economic growth coinciding with stubbornly high inflation) is starting to rise. The price of iron ore takes a tumble this month, falling almost -9%, reflecting a marked fall in steel production in China.

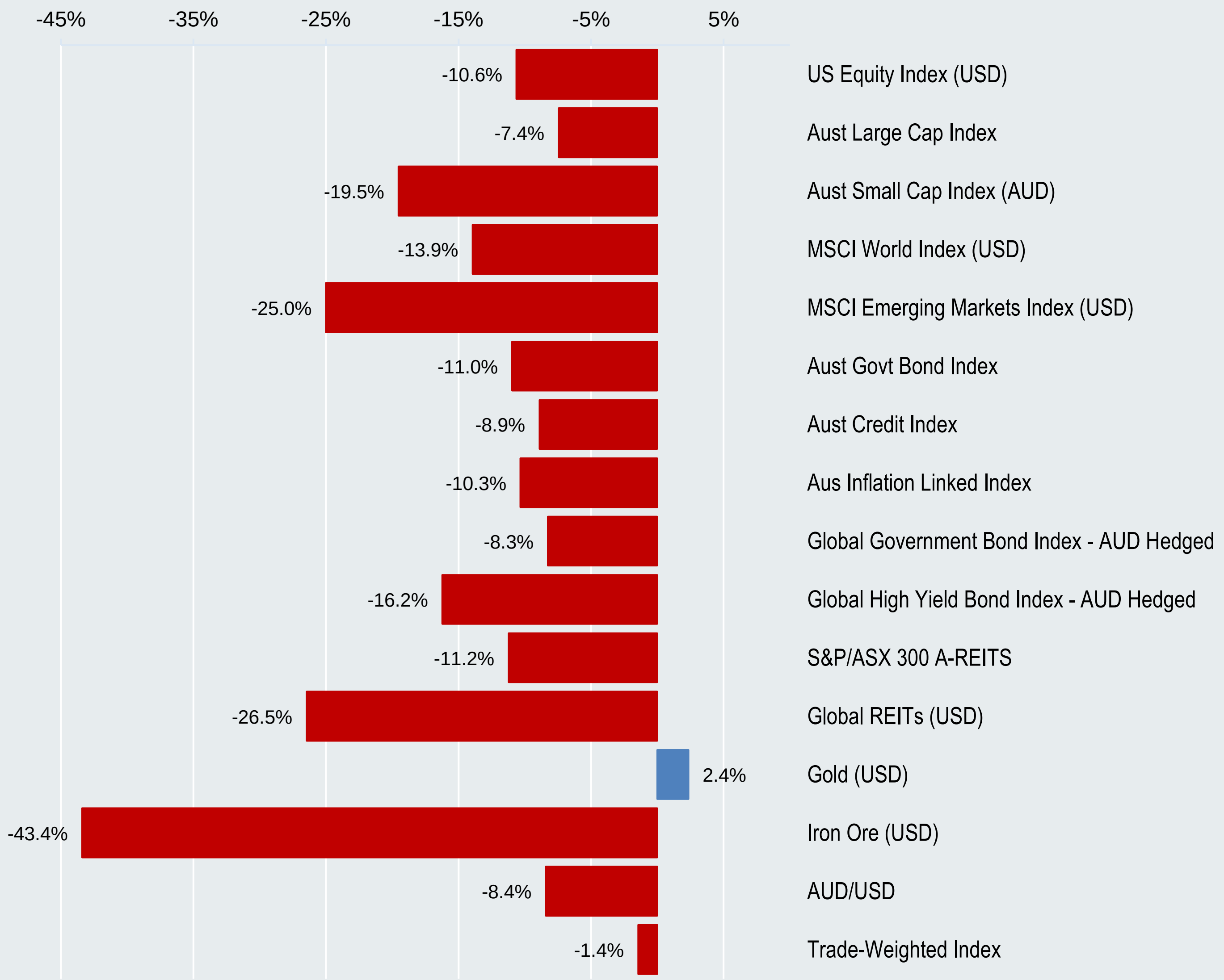
May 2022

Financial markets respond to the uncertain economic outlook by posting a mixed and volatile set of monthly results. The oil price continues its sustained rally. The US records a softer inflation reading, giving markets reason to think that the Fed may hit the pause button on tightening too hard and too fast, especially if inflation levels continue to moderate as they expect.

Jun 2022

Nearly all major global markets finish the month exceptionally poorly. The All Ordinaries was down a sobering -9.4%. The MSCI World Index (USD) and S&P 500 were down -8.6% and -8.3% respectively. Global High Yield Bonds crashed a staggering -7.4%. The US hikes rates a further 75 bps and remarks that the battle against inflation is 'unconditional' even if it comes at the expense of jobs (and a recession).

There was nowhere to hide in FY2021/22. Markets did not discriminate, with bonds and equities, and almost everything in between, falling heavily



Sources: Thomson Reuters, Bloomberg.

FY2021/22 – in review

As the calendar of events and the return chart suggests, it was an extraordinary 12 months from both an economic and financial market perspective. Whilst the 6 month period ending the calendar year 2021 showed positive signs, the second half of the financial year 2021/22 was arguably one of the worst periods we have experienced in many years for investors.

In what could be described as a game of two contrasting halves, the first half of the financial year was far more encouraging with solid investment returns to match, as the global economy continued to recover on the steam of ultra-low interest rates, healthy vaccine adoption and a general easing of lockdown conditions. There was a general feeling that the worst of the pandemic was behind us and a new normal was ahead. General confidence and sentiment were holding up. Consumer demand was strong. Labour markets were improving. In fact, the only fly in the ointment was evidence that inflation was starting to take hold. But even the threat of inflation was not enough to rattle central banks who claimed that inflation was temporary and would fall back into line once supply issues resolved themselves.

In hindsight, global central banks' expectations that inflationary pressures would quickly dissipate proved to be well off the mark. Many developed and emerging market economies saw their inflation rates hit a 40-year high during the second half of this year. Headline inflation in the US spiked to 8.6% and 5.1% in Australia, exacerbated by continued Covid-19 supply disruption and the ongoing war in Ukraine. Global financial markets, especially bond markets, all responded in a volatile fashion, struggling to come to grips with the implications for financial markets in the face of high inflation, higher interest rates and weaker growth prospects.

To put all of this into context, inflation when running at a desired 2-3% is typically considered to be a welcome development as a modest amount can help drive economic growth. However, high inflation of the order that we are currently experiencing, is cause for concern, as it reduces the purchasing power of people's incomes and devalues people's savings. Cost of living pressures caused by higher prices also disproportionately affects those on low incomes that can least afford it. It is also a cause for concern for equity markets and bond markets, as we know.

Belatedly, global central banks sought to address the pervasive inflation problem with monetary policy tightening which went up a gear in the second quarter of the year. In the case of the US, the Fed increased the funds rate by 50bp and then soon after by 75 bp to 1.5% - 1.75% in June. The RBA followed suit, hiking rates from 0.1% (a level they have maintained since November 2021) to 0.35% in May, then two quick fire 0.5% interest rate rises in June and July resulting in a cash rate target of 1.35%. This was quite a turn-around given that in August 2021, the RBA indicated that no rate hikes were expected until 2024! Bond markets naturally sold off heavily upon the news. US 10-year bond yields moved rapidly from about 2% twelve months ago to a high of 3.5% before pulling back to 3.0%. Australian 10-year bond yields finished the year at 3.8%, rising a phenomenal +225 bps this financial year. Significant bond market volatility then ensued on the back of radical yield curve movements. The Global Government Bond Index (AUD) fell -8%. The Global High Yield Index (AUD) dropped a massive -16%.

Share markets were also casualties of the market rout playing out in bond and credit markets. The S&P 500 fell almost -11% over the year with interest rate sensitive sectors of the markets such as Telecommunications, Consumer Discretionary, Industrials and Information Technology leading the race to the bottom. Global equities did not fare well either, following a similar pattern. The MSCI World (USD) was down -13.9% for the year. Closer to home, the Australian All Ordinaries Index finished -7.4% for the year as central bank hawkishness, market nervousness and signs of slowing economic momentum, raised fears of an impending global recession.

Outlook

Looking ahead, we contend that financial markets will continue to wax and wane until such time that inflation comes back under control and reverts to target. A potential risk looking forward is that if inflation continues to persist at high levels, central banks may be forced into committing to higher levels of interest rates, with the potential risk that this induces a recession. With inflation at 40-year highs, central banks everywhere are rushing to raise rates even in the face of slowing growth. Both the Federal Reserve and the RBA are on the public record that they are committed to reducing inflation and doing whatever it takes even at the expense of economic growth. This tough talk further raises the probability of a recession in 2023 if inflation does not moderate as expected.

While bonds are clearly vulnerable to further bad news on the inflation front, other asset classes including equities are not necessarily immune either as we've seen this year, especially if corporate earnings come under pressure.

Whilst the financial year 2021/22 ended with significant risk aversion and volatility, we continue to think that most of the bad news is currently priced into markets. Provided inflation starts to come off the boil as we expect to be the case, the year ahead could shape up to be a better one for investors as central banks rein in their planned monetary tightening.

In the meantime, a defensive posture, coupled with active management, is the best wealth protection strategy in these uncertain times.

Major Market Indicators

	30-Jun-22	31-May-22	30-Apr-22	Qtr change	1 year change
Interest Rates (at close of period)					
Aus 90 day Bank Bills	1.60%	1.00%	0.41%	+143.0	+157.0
Aus 10yr Bond	3.77%	3.38%	3.01%	+127.0	+225.0
US 90 day T Bill	1.66%	1.13%	0.83%	+115.0	+161.0
US 10 yr Bond	2.97%	2.84%	2.89%	+64.9	+153.0
Currency (against the AUD)					
US Dollar	0.688	0.717	0.711	-8.43%	-8.40%
British Pound	0.567	0.570	0.571	-0.58%	4.46%
Euro	0.659	0.669	0.678	-1.72%	4.26%
Japanese Yen	93.62	92.46	91.68	2.65%	12.36%
Trade-Weighted Index	61.80	63.20	63.10	-2.83%	-1.44%
Equity Markets					
Australian All Ordinaries	-9.4%	-3.1%	-0.8%	-12.9%	-7.4%
MSCI Australia Value (AUD)	-9.7%	-1.8%	-0.3%	-11.5%	-2.2%
MSCI Australia Growth (AUD)	-7.0%	-3.5%	0.7%	-9.7%	-8.3%
S&P 500 (USD)	-8.3%	0.2%	-8.7%	-16.1%	-10.6%
MSCI US Value (USD)	-8.2%	1.9%	-4.9%	-11.1%	-4.2%
MSCI US Growth (USD)	-8.4%	-2.7%	-13.6%	-22.9%	-21.8%
MSCI World (USD)	-8.6%	0.2%	-8.3%	-16.1%	-13.9%
Nikkei (YEN)	-3.1%	1.6%	-3.5%	-4.9%	-6.5%
CSI 300 (CNY)	10.4%	2.1%	-4.8%	7.3%	-12.4%
FTSE 100 (GBP)	-5.5%	1.1%	0.8%	-3.7%	5.8%
DAX (EUR)	-11.2%	2.1%	-2.2%	-11.3%	-17.7%
Euro 100 (EUR)	-7.6%	0.9%	-1.4%	-8.0%	-6.9%
MSCI Emerging Markets (USD)	-6.6%	0.5%	-5.5%	-11.3%	-25.0%
Commodities					
Iron Ore (USD)	-11.9%	-4.2%	-8.8%	-23.0%	-43.4%
Crude Oil WTI U$/BBL	-6.1%	9.5%	4.4%	7.4%	46.2%
Gold Bullion $/t oz	-2.1%	-3.3%	-1.7%	-6.9%	2.3%

Source: Quilla, Thomson Reuters Datastream

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