Count

Market Wrap

May 2022

Economic and market overview

- With inflation at 40-year highs in the US and UK and at a 60-year high in Europe, central bank policy remained front and centre of attention globally.
- The ongoing war in Ukraine and further upward pressure on energy prices also cast a shadow over markets.
- Risk assets continued to struggle against this background. In fact, the bellwether S&P 500 Index in the US has recorded the worst five-month start to a year since 1970.
- Fixed income markets have also been hampered by evolving interest rate expectations. We need to go even further back in time to find a worse start to the year for bonds. US Treasuries, for example, have not performed as poorly in the first five months of a calendar year since the late-1700s!
- Other asset classes have struggled too. Gold is down more than 10% from its March peak and cryptocurrencies have endured a torrid run; Bitcoin is down by a third since late March and has now lost around half of its value over the past six months.

- **US**: As had been widely anticipated, the Federal Reserve finally raised US interest rates. Official borrowing costs were lifted by 0.50 percentage points, to between 0.75% and 1.0%. This was the biggest single upward move in the Federal Funds rate in more than 20 years.
- More importantly, a further 2 percentage points or so of additional rate hikes have been priced in before the end of 2022.
- Even if these expectations prove inaccurate, it seems clear that policy settings will continue to be tightened in the remainder of this year. Inflation shows few signs of abating, which is essentially forcing policymakers to act. Indeed, various Federal Reserve officials have hinted that borrowing costs could continue to be raised in 0.50 percentage point increments.
- There was a fair degree of scrutiny on the latest jobs report, to see whether economic activity levels were moderating. 428,000 jobs were created in April, which compared to consensus expectations of 380,000. This was broadly in line with the increase in March and suggests the economy continues to rebound strongly from last year's virus-related disruptions.
- The big question is whether this momentum can be maintained as borrowing costs are raised – some commentators are already forecasting a recession in the US in 2023 or 2024.

- **Australia:** The Reserve Bank of Australia followed the lead of other central banks and raised interest rates. The official cash rate was lifted by 0.25 percentage points, to 0.35%. In fact, this was the first interest rate hike in Australia since 2010. Further rate hikes are anticipated in June and later in the year.
- Australia's unemployment rate remained at 3.9% in April, the lowest level for around 50 years. The labour force has been swelled by rising full-time job creation and an increase in part-time hours worked.
- In spite of the tight labour market, wages increased by just 2.4% in the 12 months ending 31 March 2022. This fell short of consensus forecasts and is below the current rate of inflation. Accordingly, the average Australian worker is currently faced with the prospect of negative real earnings growth.
- The Labor Party's win in May's Federal election is not expected to meaningfully impact the Australian economic outlook, or conditions in local financial markets.

- **New Zealand:** Interest rates were raised across the Tasman too, by a further 0.50 percentage points. Official borrowing costs have now been lifted by 1.75 percentage points in the past few months. The accompanying outlook statement suggested policy settings will continue to be tightened. Two further 50 bp hikes are expected in July and August, followed by subsequent increases later in the year. Consensus forecasts suggest interest rates could be as high as 3.5% by year end.
- At the same time, the Reserve Bank of New Zealand is expected to reduce its bond holdings, similar to the 'quantitative tightening' process that is about to get underway in the US.

- **Europe**: There has been increasing speculation that the European Central Bank (ECB) is preparing to lift official interest rates, possibly as soon as July. Officials had indicated that rate hikes were off the table for this year, but the ECB President has suggested officials are changing their view as inflation becomes more entrenched. Alarmingly, CPI has quickened to an annual rate of 8.7% in Germany, Europe's largest economy.
- The Bank of England continued to tighten policy settings in the UK. Borrowing costs were raised by a further 0.25 percentage points, to 1.0%, as inflation quickened to 9.0% year-on-year.
- Away from central bank news, it emerged that the European Union was considering a ban on Russian oil. Seaborne imports will be prohibited initially, while imports via pipelines will still be permitted temporarily.
- In the UK, business confidence rose for the first time in three months and unemployment fell to 3.7% – the lowest level since1974. No European Union member state currently has a lower unemployment rate. UK retail sales also ticked up in April, despite increases in the cost of living owing to rising energy prices and higher taxes.

- **Asia/EM:** Ongoing lockdowns in China seem likely to hinder growth this year. Leading economists lowered their 2022 GDP growth forecasts for the world's second largest economy to between 3.0% and 3.7%; much lower than the Chinese government's official 5.0% target. If they are right, 2022 will be the second slowest year of growth since 1976.
- Undoubtedly, the rapid spread of Omicron – and the Chinese government's 'zero-Covid' policy – means the economy faces a more severe slowdown than was previously anticipated.
- The Chinese central bank and the banking regulator asked banks to boost their lending in an effort to underpin activity levels. Interest rates on long-term loans were also lowered, to help revive demand for mortgages and other borrowing.
- Activity levels remain subdued in Japan too and the economy shrank modestly in the March quarter. Industrial production, for example, is currently nearly 5% below 2021 levels.
- There was an uptick in geopolitical tension in Asia. President Biden indicated the US military would intervene if China ever attacked neighbouring Taiwan.

Australian dollar

- The Australian dollar was mixed against other major currencies over the month.
- The 'Aussie' appreciated by 1.6% against the US dollar – closing May at 71.8 US cents – but declined by 0.8% against a trade-weighted basket of other major currencies.

Australian equities

- The S&P/ASX 200 Index declined 2.6% in May, with investor confidence being tested by inflation and interest rate concerns.
- Higher-than-expected inflation data in the US initially drove the market around 6% lower, to a level last seen in late January. The market subsequently recovered some of this lost ground, following a stream of encouraging economic data and news that China's lockdowns might be about to ease.
- The 'risk-off' sentiment returned towards month end, however, as investors again focused on recession risk in the US.
- The rising rate environment hampered various areas of the market, including the IT sector (-8.7%). Lithium battery materials and technology company Novonix performed particularly poorly (-21.8%). Codan (+10.8%) and Technology One (+0.1%) were the only stocks in the IT sector to appreciate over the month.
- Oil prices rose for a sixth straight month, the longest run since 2011. WTI crude prices closed May at around US$115/barrel, following the European Union's sixth package of sanctions against Russian seaborne oil and petroleum imports. Nonetheless, energy stocks ultimately succumbed to market volatility and the sector finished 0.7% lower.
- Materials (+0.1%) was the only sector to finish higher in May, supported by positive contributions from diversified miner BHP (+4.4%) and global packaging company Amcor (+9.5%).
- Small Caps again underperformed their large cap peers, with the S&P/ASX Small Ordinaries Accumulation Index falling 7.0%. In general, market volatility prompted investors to favour the perceived stability of larger, more established companies in the S&P/ASX 100 Index.

Listed property

- Global property securities struggled in May, with most closing the month lower. Overall, the FTSE EPRA/NAREIT Developed Index fell 5.2% in Australian dollar terms.
- Sentiment continued to be hampered by concerns about potentially slower GDP growth in 2023-24. A moderation in growth seems almost inevitable as economies react to rising interest rates. Against this background it appears that investors are de-risking their portfolios, to help preserve capital in case of a period of stagflation or recession in major economies.
- Although macroeconomic concerns are adversely affecting performance, recent operational updates from companies in most property sub-sectors have been quite resilient. This may provide some comfort for shareholders and long-term investors in the asset class.
- Regional performance was mixed. The best performing regions included Hong Kong (+4.2%) and Japan (+1.8%), although the French and Spanish markets also registered modest gains. Laggards included the US (-6.3%) and the UK (-5.3%).
- The Australian market also struggled, declining in value by 8.7%. Comments made at the end of April by US-based e-commerce giant Amazon – which alluded to excess warehouse capacity – weighed on sentiment. The Reserve Bank of Australia's decision to raise interest rates to 0.35% also added to selling pressures.

Global equities

- Investors continued to fret about the impact of rising interest rates on economic activity levels and, in turn, company profitability. The MSCI World Index lost 0.8% in AUD terms.
- In the US, the S&P 500 Index and the Dow Jones Industrial Average both eked out modest gains, in spite of the release of subdued earnings outlooks from various firms. Retailers including Target, Costco and Walmart all provided underwhelming market updates, for example, as did sportswear apparel maker Under Armour.
- Technology shares struggled, which weighed on the performance of the tech-heavy NASDAQ (-2.1%).
- Snap – the operator of the popular Snapchat app – released underwhelming earnings forecasts, which hampered its share price along with those of social media peers including Twitter, Pinterest and Meta, the owner of WhatsApp.
- Not all markets lost ground over the month. Equity valuations had already fallen quite a long way in the year to date and some markets found support from value-oriented investors. News that inflation might be starting to moderate in the US and that Chinese officials were considering relaxing some Covid-related restrictions in key cities also boosted sentiment towards month end.
- European markets were mixed over the month. The German, Spanish, Italian and UK markets registered gains, while French and Swiss stocks lost ground.
- There were signs of a pickup in merger and acquisition in the region. In Italy, investment bank UniCredit received interest from several parties for the sale of its Russian divisions and it emerged that energy giant Shell may have found a bidder for some of its Russian assets. At the same time, tobacco company Swedish Match received a US$16 billion takeover offer from Philip Morris.
- In Asia, Singapore's Straits Times Index closed the month 2.8% lower although markets in China, Japan and Hong Kong enjoyed gains of between 1% and 2%.

Global and Australian Fixed Income

- Major bond markets were also mixed over the month. In the US, Treasury yields initially rose ahead of the Federal Reserve's interest rate hike, but drifted lower later and closed the month 9 bps below their end-April level. This resulted in modest gains from the US bond market.
- A process of 'quantitative tightening' is due to commence in the US in June. This will involve the Federal Reserve selling down bond holdings that were accumulated following the Covid shock. The central bank is believed to have nearly US$9 trillion of bonds on its balance sheet, which is comfortably the highest amount on record. Other things being equal, the sell-down process will drain liquidity from the financial system and should – at least theoretically – prevent the economy from overheating.
- Yields continued to rise in other major markets. German Bund yields rose 18 bps, rising above the 1.0% level for the first time since 2014. There was a similar move in the UK, with gilt yields closing the month 20 bps higher.
- Australian yields rose very sharply early in the month around the time of the Reserve Bank of Australia's interest rate hike. Ten-year yields rose above the 3.5% level for the first time in nearly eight years, although yields subsequently drifted lower.
- Despite this move, Australian Commonwealth Government Bond yields closed May above their end-April level, resulting in negative returns from the local fixed income market.

Global credit

- Despite some volatility over the month as investors digested the latest economic and company-specific news flow, investment grade credit spreads were little changed in May.
- Spreads on US names actually narrowed modestly, although those in Europe widened – this most likely reflected the increasing probability of forthcoming interest rate hikes in the region. It remains to be seen how higher borrowing costs will affect companies and whether default rates will start to increase.
- Spreads in the more speculative high yield segment of the market also widened, although moves were quite modest compared to recent months.

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