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BUSINESS SOLUTIONS
Financial Planning

Market wrap

January 2022

ECONOMICS OVERVIEW

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Economic and market overview

- December saw an uptick in Covid infections worldwide. Daily case numbers in the US topped one million for the first time, underlining the ongoing challenge of the pandemic.
- There was a perceived rise in geopolitical risk too. Russia massed troops along the Ukraine border, China practiced naval and other military exercises in the South China Sea around Taiwan, and tensions rose in the Middle East amid rumours that Iran continues to develop nuclear capabilities.
- Global share markets shrugged off these concerns, rising to fresh all-time highs in several countries.
- Australian bonds also registered positive returns, although fixed income struggled in most other major markets as an ongoing focus on rising inflation saw bond yields move higher.

US

Core inflation – which strips out volatile food and energy prices – has quickened to an annual pace of 4.9%. Inflation was just 1.6% at the beginning of 2021, underlining how the pandemic has affected the prices of goods and services. 'Headline' inflation has risen even more strongly, to an annual rate of 6.8%. help provide liquidity in the financial system and encourage lending.

- The Federal Reserve announced it will withdraw its quantitative easing program by March; more quickly than previously indicated. Officials also suggested interest rates could rise more significantly than markets were anticipating. Three interest rate hikes both this year and next year now seem plausible, with the Federal Funds rate likely rising above 2% in 2024.
- Wage pressure appears to be stoking inflation. Average earnings are up nearly 5% over the past year. Unemployment has fallen to 4.2% – its lowest level since the pandemic began – which augurs well for further increases in wages this year.
- President Biden's proposed 'Build Back Better' social spending plan has still not passed, due to ongoing opposition among senators. Political wrangling seems likely to persist in early 2022.

Australia

Unemployment has come down to 4.6%, after the latest increase in jobs beat expectations.

> **Australia is in the midst of its biggest decline in immigration for more than 100 years.**
> **That suggests housing construction activity could slow and that that the labour force could shrink in the years ahead.**

- Effectively, the labour market has regained its lost ground - Whilst admitting that wages are increasing, the Reserve Bank of Australia is suggesting inflation will remain lower than in other countries. Accordingly, there appears a very low probability of interest rates being raised in the foreseeable future.
- Perhaps more importantly, officials indicated that the spread of Omicron is not expected to derail the economic recovery. As the booster rollout continues, the Government appears willing to 'live with Covid' rather than try and eliminate the virus.
- In other news, residential property prices were up more than 20% in the year ending 30 September, supporting consumer confidence and discretionary spending.

New Zealand

The latest data showed Covid-related disruptions hampered GDP in the September quarter. Growth is not expected to rebound to previous levels until the second half of this year at the earliest, when borders may have reopened and the as economy benefits from inbound tourism.

Europe

Energy prices in Europe continued to rise, as gas flow from Russia via a key route was disrupted. The worsening energy crisis in Europe threatens to dampen growth rates, as companies and households face sharply higher energy costs.

- The Bank of England raised UK interest rates by 0.15%, to 0.25%. Markets have another three interest rate hikes priced in for this year. Inflation has risen above 5% in the UK and some observers are forecasting a move above 6% in early 2022.
- New Covid restrictions were introduced in the UK, to try and limit the spread of the Omicron variant. These measures – including working from home requirements – are projected to cost the economy around £2.7 billion (~$5 billion) a month. Reduced footfall in urban areas due to the closure of offices seems likely to affect the retail andhospitality sectors, in particular.

Asia/EM

Chinese property developer Evergrande Group finally defaulted on its bond repayments. The company has more than US$300 billion (~$400 billion) of liabilities and has struggled to reduce indebtedness to comply with new regulations.

- The company pledged to "actively engage" with creditors, which seems likely to result in sizeable losses for bondholders.
- Some observers have warned the default could have broader implications for the Chinese financial system, but authorities have shown no sign of stepping in to bail out the company.
- The Chinese central bank did, however, lower reserve requirements for financial institutions by 0.5% to inject liquidity into the system and help support the economy.
- In Japan, there was more evidence of bottlenecks in supply chains. Toyota was forced to close two of its production facilities temporarily during the month, citing difficulties sourcing parts.
- In Latin America, there was some concern that an election victory for a reformist, left-wing candidate could result in meaningful economic change. Victory for 35-year old Gabriel Boric – a former student protester – suggests taxes could rise as the new leader pushes for greater equality and less investor-friendly policies.

Australian Dollar

- The 'risk on' mood benefited the Australian dollar, which appreciated by 2.5% against the US dollar.
- That said, the 'Aussie' lost ground in 2021 as a whole, falling from around 77 US cents at the beginning of the year to 72.6 US cents by the end of December.
- Monthly performance was favourable against a broad range of other major currencies too. The Australian dollar gained 3.8% against the Japanese yen, for example, and 1.5% against a trade-weighted basket of other international currencies.

Australian Equities

- Australian shares closed out the 2021 calendar year strongly, as research from epidemiologists suggested Omicron is the least potent variant of Covid-19 to date. Some economists went a step further, suggesting countries with high vaccination rates may be nearing a state of 'endemic', rather than pandemic.
- These developments helped support consumer and business sentiment, and enabled the S&P/ASX 200 Accumulation Index to finish December 2.8% higher.
- After underperforming for a large part of the calendar year, the Utilities sector rallied nearly 7% on the back of strong performances from AGL Energy (+13.7%), Origin Energy (+9.2%) and APA Group (+5.6%).
- The Materials (+6.4%) and Financials (+4.3%) sectors also outperformed, thanks to rising commodity prices and the improving economic outlook.
- A 23.7% fall in Afterpay dragged the IT sector more than 5% lower. Buy-Now-Pay-Later firms struggled after the United States Consumer Financial Protection Bureau announced it had launched a probe into the industry – several companies are required to disclose information on their business practices.
- Buoyant sentiment extended to small caps, with the S&P/ASX Small Ordinaries Accumulation Index rising 1.4%. The gains were driven by strong performances in the Real Estate (+7%) and Consumer Staples (+6%) sectors. However, oil and gas explorer Strike Energy was the best performer in the index, rallying more than 30% after announcing better-than-expected drilling results.

Listed Property

- Global property securities added 3.8% in Australian dollar terms, outperforming wider equity markets.
- Property securities benefited from further strong performance in the self-storage and industrial sectors, which were relative outperformers in the calendar year as a whole.
- Concerns over the potential impact of Omicron moderated a little, as data suggested the variant is less dangerous than its predecessor, Delta. Although case numbers continue to rise around the globe, the more heavily affected hotel and leisure sectors rebounded in the month.
- The best performing countries included the US (+8.6%), Canada (+6.6%) and Australia (+4.9%). Laggards included Sweden (-2.5%), Germany (-0.4%) and Spain (+0.3%).

Global Equities

- Despite rising numbers of Covid infections in almost all key regions and an increase in geopolitical tensions, global share markets powered on.
- The S&P 500 Index in the US – whose performance tends to set the tone for other share markets worldwide – rose 4.5% over the month, extending gains in 2021 as a whole to more than 28%.
- 2021 was the third consecutive year in which US shares posted annual returns above 15%. This had only occurred once before since the 'great stock market crash' of 1929.
- Other major share markets performed well too, enabling the MSCI World Index to rise 4.0% over the month.
- Despite the introduction of various virus-related restrictions in the region, European markets fared particularly well. The Euro Stoxx 50 added 5.8%, buoyed by strength in France, Germany Italy and Switzerland, all of which gained between 6% and 8%.
- In Asia, the Japanese, Chinese and Singaporean share markets all rose between 2% and 4%, although Hong Kong's Hang Seng bucked the positive trend, closing the month 0.3% lower.

Global and Australian Fixed Income

- Bond yields were volatile in 2021, as investors responded to the latest economic indicators and the evolving tone of commentary from central bank officials.
- This trend continued in December, with 10-year Treasury yields in the US trading in a range of more than 20 bps. The benchmark yield closed the month 7 bps higher, at 1.51%, which hampered returns from global fixed income markets.
- Attention was on the Federal Reserve's latest meeting, where it was confirmed that the pace of bond purchases will be reduced at double the previously-indicated pace. With inflation running well above the official target, the central bank is essentially being forced to tighten accommodative policy settings.
- Yields rose in Europe too. In Germany, 10-year Bund yields closed the month 17 bps higher. They remain negative, at -0.18%, but are threatening to break through zero for the first time since mid-2019 as European Central Bank officials consider raising official interest rates.
- In the UK, gilt yields rose in response to the Bank of England hiking interest rates. Official borrowing costs had already been raised (twice) in New Zealand, but the Bank of England was the first of the major global central banks to make the move. Markets are pricing in the prospect of one more interest rate hike in the UK during 2022.
- Australian yields bucked the trend, with yields on 10-year Commonwealth Government securities closing the month 2 bps lower. This resulted in positive returns from the local bond market.

Global Credit

- Corporate bonds benefited from the strength in equity markets and investors' healthy appetite for risk.
- Spreads narrowed in both the investment grade and high yield sectors, supporting returns from credit markets.
- Investment grade spreads were little changed in the calendar year as a whole, meaning 2021 was a relatively calm period for credit investors following a tumultuous 2020. High yield spreads narrowed quite sharply over the year, underlining the extent of risk appetite among investors and the appeal of the additional prospective income on offer in this part of the market.
- At the sector level, issues in the Energy sector were among the best performers over the year, boosted by a 55% rally in the price of oil.
- More than US$1.5 trillion of new corporate bonds were sold in 2021 – the second highest annual total ever – underlining the scale of demand for higher yielding securities among income-oriented investors.
- Despite the probability of higher interest rates in 2022 – which will increase the cost of debt for corporate borrowers - most companies can comfortably afford to service their debt repayment obligations currently. Revenues are holding up well in most industry sectors and firms continue to focus on cost control in order to support profitability. All of this suggests corporate default rates will remain low in 2022.

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