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Market wrap

October 2022

ECONOMICS OVERVIEW

Consumer price inflation rose by 1.8% in the June quarter, and by 6.1% on a rolling 12-month view. Whilst high, these measures were below consensus expectations. In turn, this prompted hopes that local interest rates might not need to increase as much as previously feared.

Economic and market overview

- Pleasingly, global share markets fared well in October and recovered most of their lost ground from September. Locally, the S&P/ASX 200 Index returned 6.0%.
- The sharp reversal in sentiment was typical of this year; market volatility has picked up meaningfully over the past few months, resulting in substantial swings in equity prices.
- Fixed income performance was mixed. Yields drifted lower in Australia, resulting in modest positive returns from the domestic bond market. Yields continued to rise in the US, however, which resulted in negative returns from Treasuries and from global bond indices.
- Investors remained focused on the persistence of inflation and, in turn, the outlook for interest rate policy in key regions.

US

The latest data showed the US economy expanded at an annual pace of 2.6% in the September quarter. This was ahead of consensus forecasts and represented a sharp rebound from the June quarter, when the economy contracted slightly.

- Despite the more favourable reading, there is ongoing debate about whether the economy will dip into recession next year as much higher borrowing costs start to bite.
- Headline inflation remained above 8% year-on-year, although the Federal Reserve did not meet in October and interest rates were therefore unchanged over the month.
- That said, further policy tightening is anticipated. At least 1 full percentage point of interest rate hikes has been priced into the market before the end of 2022.
- The labour market remains buoyant. More than 250,000 new jobs were created in September, taking the total in the year to date to nearly four million. A low unemployment rate – currently just 3.5% – means firms are typically required to pay up to attract new employees. Wages are rising at an annual pace of 5.0%.
- Mid-term elections will be held during November and are not expected to go well for Democrat President Biden. The latest polls suggest the Republicans are attracting strong support; potentially enough to retake control of the Senate and House of Representatives. If so, it will be difficult for the government to pass any new legislation in the second half of Biden's term.

Encouragingly, Australian employment increased quite sharply in June, with more than 88,000 jobs created. This pushed the unemployment rate down to 3.5%; a record low.

Australia

Headline inflation quickened to an annual pace of 7.3% in the September quarter; the highest level for more than 30 years. The trimmed mean – central bank officials' preferredmeasure – also increased, to 6.1% year-on-year.

- The Reserve Bank of Australia continued to tighten policy settings against this background, raising official interest rates by 0.25 percentage points. This was less than the half percentage point move that the market had anticipated and could be an indication that official borrowing costs will not be raised as meaningfully as previously thought. Consensus forecasts currently suggest interest rates could peak at around 3.75% in mid-2023.
- Australia has a high level of household debt, with a largeproportion of borrowers on variable-rate mortgages. Rate hikes can therefore be particularly painful for Australians.
- Policymakers therefore have a challenging task, balancing the need to dampen inflation through tighter monetary policy settings, without strangling growth by crippling homeowners with sharply rising mortgage repayment costs.
- *The Reserve Bank of Australia raised rates again on 1 November, by a further 0.25 percentage points. Official interest rates are now 2.85% and may be raised again in December.*

New Zealand

- As expected, interest rates were increased by a further half percentage point, to 3.50%, as policymakers remained focused on bringing down inflation.
- Substantial rate hikes in the year to date appear not to have had their desired effect, suggesting further policy tightening may be required. Forecasts currently indicate that interest rates could be 5%, or higher, by mid-2023.
- Despite being one of the most isolated countries in the world, New Zealand has not been immune from global pricing pressures. Headline inflation quickened to an annual pace of 7.2% in the September quarter. This was broadly in line with theprevious reading and well above consensus forecasts.

Europe

The European Central Bank raised interest rates by a further 0.75 percentage points, as officials continued to battle persistently high inflation. Borrowing costs have been raised to their highest level since 2009, which is dampening consumer confidence and impeding discretionary spending.

- CPI in the Eurozone remained around 10% year-on-year, partly reflecting the impact of elevated energy prices.
- Political developments continued to dominate attention in the UK. Liz Truss – who became Prime Minister in September – stepped down and was replaced by Rishi Sunak. Truss became the shortest-serving governor in British history, holding the top job for less than seven weeks.
- A new chancellor was also appointed, who swiftly reversed the mini-budget that had been proposed by his predecessor. This saw the UK currency and bond market claw back their lost ground from September, when the controversial plans had been announced.
- The new leaders must address a slowing economy and spiralling inflation. CPI is currently running above 10% year-onyear, resulting in sharp falls in real wages for most workers and clouding the outlook for spending.

Asia/AEM

- It seems Chinese officials are likely to persevere with their 'zero Covid' policy, which is dampening growth prospects. President Xi tightened his grip on power during the month, appointing various loyalists into key government positions to help stave off any challenge on his leadership.

- The Chinese yuan remained under pressure, owing to the deteriorating economic outlook. The currency depreciated to a 15-year low against the US dollar during October.
- In Brazil, left wing candidate Lula da Silva was elected as the new President; a remarkable turnaround in fortunes given the former leader was in prison for corruption three years ago. His victory was welcomed by environmentalists given his pledge to address soaring deforestation rates in the Amazon rainforest.

Australian Dollar

- The Australian dollar briefly fell below 62 US cents in mid-month, but clawed back losses and closed October little changed from its end-September levels (around 64 US cents).
- The AUD was similarly flat against other major currencies. The dollar trade-weighted index declined just 0.3% over the month.

Australian Equities

- Australian shares added 6.0% in October, recouping most of September's losses.
- The strong gains masked a reasonably high degree of volatility, caused by companies' trading updates, news flow emanating from annual general meetings, and a stream of local and international economic data releases.
- A fall in domestic bond yields supported a 'risk-on' attitude among investors and enabled nine out of the 11 industry sectors to generate positive returns.
- The Financials (+12.2%) sector was the strongest performer, led by strong gains among the major banks. Shares in all of the 'big four' banks enjoyed gains of between 12% and 17%.
- Sentiment towards this area of the market was buoyed by Bank of Queensland, which released a pleasing set of FY22 results. The update highlighted that rising interest rates have started to benefit net interest margins. We may see a similar theme when the majors release their latest results during November.
- Oil prices rose following OPEC+'s decision to lower production quotas and after the European Union announced further sanctions against Russia. The rising oil price benefited stocks in the Energy sector, which added 9.3% over the month.
- Stocks in the Materials sector (-0.1%) struggled as Chinese officials reiterated their commitment to a 'zero-Covid' policy. Investors appeared concerned that ongoing restrictions in the country could curtail growth and adversely affect demand for bulk commodities. St. Barbara, Adbri and Fortescue Metals Group fared particularly poorly, falling 31.1%, 14.4% and 12.6% respectively.
- Stocks in the Consumer Staples sector also struggled, resulting in the sector returning -0.2%. Supermarket giants Woolworths and Coles weighed on performance, as management teams highlighted an increasingly challenging operating environment due to rising costs.
- Small caps outperformed their larger peers and all sectors in the S&P/ASX Small Ordinaries Index posted positive returns. Polynovo and Novonix were the best performers in October, both adding more than 50%. These stocks contributed to a 6.5% return from the Small Ords.

Listed Property

- Global property securities benefited from the general improvement in sentiment towards equity markets, with the FTSE EPRA/NAREIT Developed Index adding 3.6% in Australian dollar terms.
- Macroeconomic news continued to dominate headlines, although persistently high inflation in key regions and the prospect of even higher interest rates did not seem to deter investors.
- There were particularly strong inflows into western markets. France (10.1%), Australia (9.9%) and Spain (7.3%) all enjoyed strong gains, for example.
- More defensive Asian property markets such as Hong Kong and Singapore, which had outperformed during the recent sell-off, fared less well. These markets declined by 11.4% and 6.0%, respectively.

Global Equities

- According to a report from a leading investment bank, inflows into global share markets picked up sharply following September's weakness. This helped most major indices rebound strongly from their recent lows.
- The influential S&P 500 Index in the US rose 8.1%, while the MSCI World Index closed the month 7.8% higher.
- In the US, attention was focused on the release of quarterly financial results from large listed firms. Releases from tech giants including Microsoft and Alphabet – owner of the search engine Google – disappointed investors and meant returns from the NASDAQ failed to keep pace with the broader S&P 500 Index.
- Asian indices performed poorly, partly due to significant weakness among Chinese shares. The CSI 300 fell 7.8%, while Hong Kong's Hang Seng slumped 14.7%. Covid-related disruptions to activity levels in the world's second largest economy do not augur well for corporate profitability.
- Semiconductor stocks in the region fared particularly poorly, following fresh curbs on Chinese access to US technologies.
- Japanese stocks fared quite well in contrast, with the Nikkei adding 6.4%.

- European shares also registered solid gains. The Euro Stoxx 50 closed the month 9.0% higher, boosted by strong returns from German, French and Italian stocks, in particular.
- Finally, the world's richest person – Tesla founder Elon Musk – bought Twitter for US$44 billion, ending a protracted purchase process that had dragged on for six months.

Global and Australian Fixed Income

- The federal funds rate was unchanged in October, remaining in a range between 3.0% and 3.25%. Nonetheless, US Treasury yields continued to rise over the month in anticipation of further increases in official borrowing costs in the period ahead.
- Money markets have priced in the likelihood of a 0.75 percentage point increase in the federal funds rate when policymakers meet in November, and then an additional rate hike in December.
- nvestors are still expecting interest rates to peak around 5% in mid-2023, although by month end there were increasing suggestions that policymakers might start reducing the size of rate hikes in the months ahead. Officials may be preparing to pause for breath, perhaps seeing how the economy responds to the substantial policy tightening that has already occurred. This possibility saw yields dip lower into month end.
- In October as a whole, 10-year Treasury yields rose 22 bps, closing above 4% for the first time since before the Global Financial Crisis in 2008. In fact the whole yield curve rose, with yields on 2- and 30-year notes closing October meaningfully higher. These moves resulted in negative performance from the Treasury market, as well as from global fixed income indices.
- Government bond yields were little changed in either Germany of Japan over the month.
- In the UK, gilt yields fell back sharply from their September highs after the previous chancellor's proposed tax cuts were abandoned by the incoming government. This resulted in favourable returns from UK bonds and helped ease pressure on pension funds in the country.
- Australian Commonwealth Government Bond yields also trended lower, closing the month down 13 bps.
- Reserve Bank officials slowed the pace of their policy tightening, raising official interest rates by 0.25 percentage points instead of an anticipated 0.50% hike. Time will tell whether this represents a shift in mindset among policymakers.

Global Credit

- Investment grade credit spreads were little changed in the month as a whole.
- With spread movements providing a neutral performance contribution, returns from corporate bonds were dominated by the receipt of regular coupon income. This steady flow of income supported positive returns from the asset class.
- Returns for mixed-grade credit portfolios were also boosted by much-improved performance from high yield securities. Spreads in this part of the market had widened meaningfully over the past few months; seemingly sufficiently to help attract value-oriented investors.

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