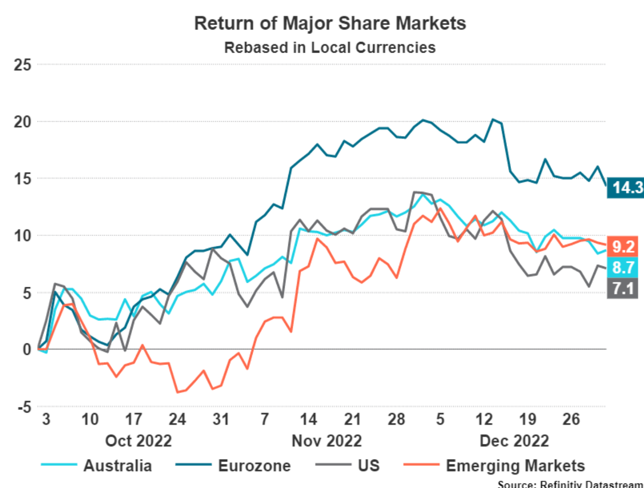
MARKET AND ECONOMIC UPDATE

December Quarter 2022

1. MARKETS IN REVIEW

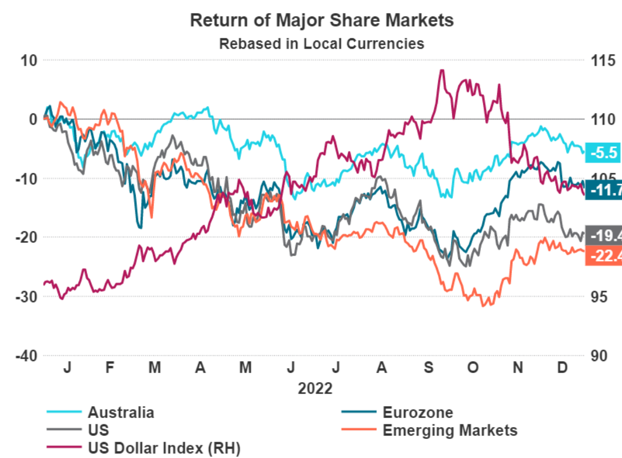
2022 in markets was filled with volatility, surprises, and extreme central bank policy. From the Russian invasion in Ukraine to begin the year, to a four-decade spike in inflation and the subsequent vertically upward interest rate increases, this has not been an easy year by any means.



The December quarter ended with an element of reprieve as all major markets ended positively. A surprising 14.5% increase in European stocks lead the way, followed by Emerging Markets rising 9.2%, Australia 8.7% and the United States (US) 7.1%, in their local currencies. Significant easing in financial conditions occurred across the quarter as a softer-than-expected inflation print in the US caused a significant drop in the US Dollar (USD). A rising USD puts significant pressure on the global economy, whilst the reverse is true.[1]

A look at the full year of stock market returns alongside the USD (red) makes it easy to see that the market responds positively when the Dollar falls and does not like the Dollar rising.

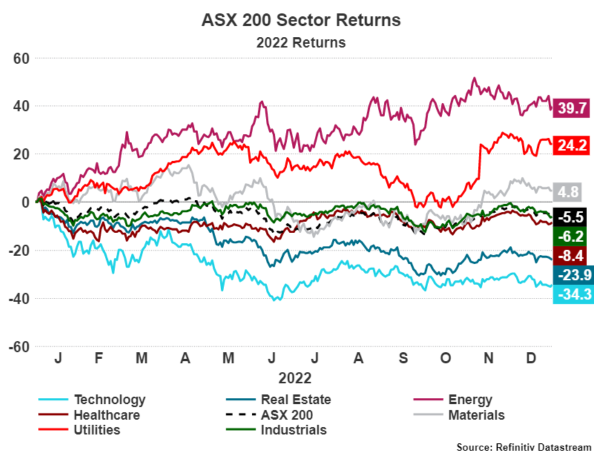
Australia ended the year as the best performer only down 5.5%. Europe followed with an 11.7% fall, followed by the US (-19.4%) and Emerging Markets (-22.4%).[2]



Europe's ~12% drop on the year is the most surprising as a war and energy crisis has ravaged the continent. The explanation of this is that European equities have been suppressed for a significant amount of time as economic growth has been hard to come by for the last 10 years, i.e. there is already significant amounts of negativity already priced into this market. Any positive surprises will therefore buoy these equities.[3]

[1] Refinitiv, 2023
[2] Refinitiv, 2023
[3] Refinitiv, 2023

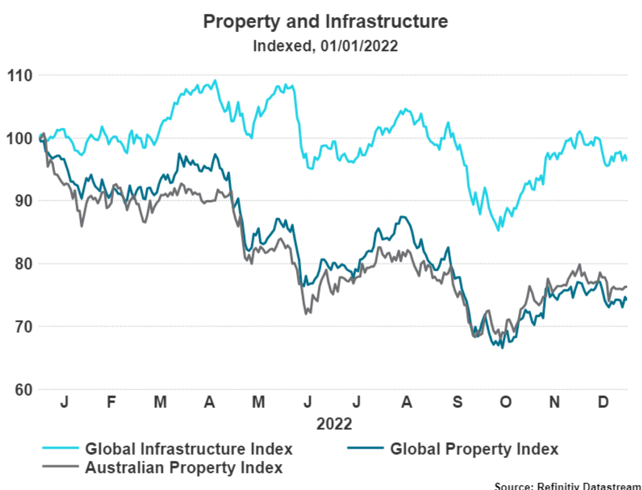
1.1 Australian Sector Returns



Australian sector returns continued to diverge to end 2022. Energy (39.7%) was the strongest returning sector, followed by utilities (24.2%) and materials (4.8%). The weakest sectors were the most interest rate sensitive areas namely, technology (-34.2%) and real estate (-23.9%).[4]

1.2 Property and Infrastructure Returns

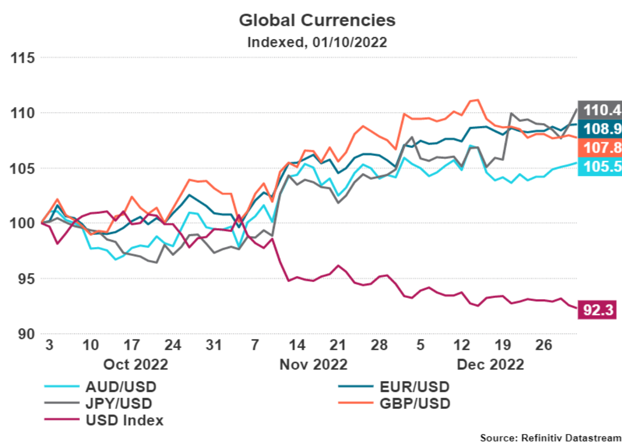
The importance of having both infrastructure and property exposures in portfolio's is exhibited by the above chart. Our significant overweights to infrastructure relative to property within the Strategic Asset Allocation (SAA) has ensured that the strength of infrastructure across 2022 was realised in portfolios. Relative to markets and property returns infrastructure retained its value and showed its resilience in turbulent periods.



[4] Refinitiv, 2023

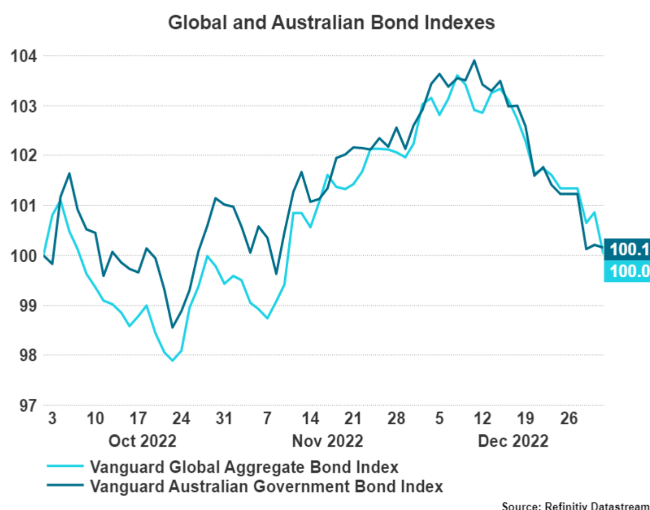
2. FOREIGN EXCHANGE MARKETS

As mentioned earlier in the paper, the USD finally showed some weakness. This gave all currencies that are priced in USD a chance to rally to close 2022. Japanese Yen returned 10.4% after having a dismal year. Euro (8.9%), the Pound (7.8%) and the Australian Dollar (5.5%) all returned positive in the final quarter. Across the year however, the USD was strongly positive and the other currencies still negative.[5]



3. FIXED INCOME MARKETS

The fixed income markets have been the primary source of pain for investors over the year. Whilst equity markets are down, fixed income being down as much as they are is unusual and often does not occur at the same time that equity markets are down.



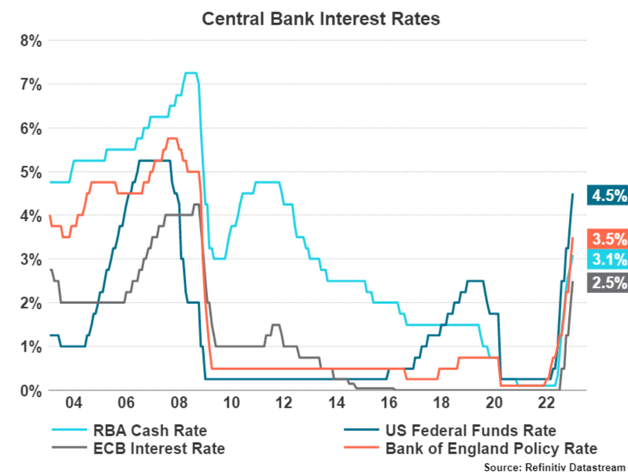
[5] Refinitiv, 2023

This last quarter has shown somewhat of a near term bottom as interest rates have not been increasing like they did to begin the year.

On the quarter, both domestic and international indexes were exactly flat. There was significant intra-quarter volatility as fixed income markets have attempted to find a direction. A battle between fixed income traders and central bankers is currently underway. The traders are trying to price in some sort of a recession (bonds prices go up) but central bankers are stating they will keep rates high and may even continue to raise (bonds prices go down). The Federal Reserve (United States Central Bank) have blatantly stated rates will remain elevated throughout all of 2024 and into 2025. Bond traders do not believe them. Traders think the elevated interest rates will cause a slowdown in economic activity that will warrant a need for rate cuts towards the end of the year.

4. OUTLOOK

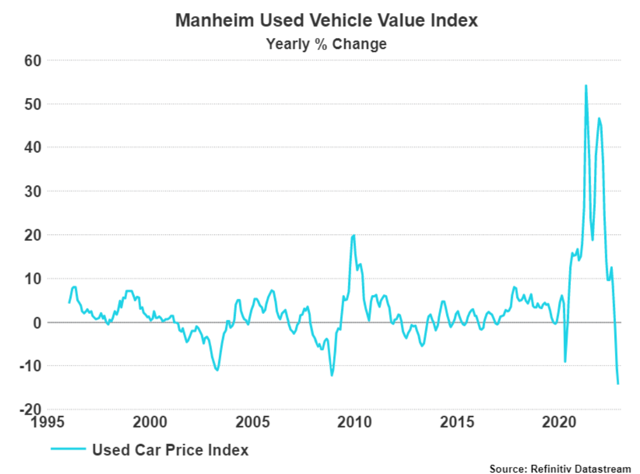
2023 looks to be the year in which the interest rate increases that occurred in 2022 begin to impact economies. A rise in interest rates tend to have a lag period of 12-18 months to take full effect. Central banks started raising rates in January 2022 and have continued to do so every month since. The results of this will therefore play out across this year and will likely continue to slowdown the global economy.



This is the explicit goal of central banks as an economic slowdown will supress the four decades high inflationary numbers.

Now, what is the good news in all of this? The more economies slow down, the more inflationary pressures slow down, and the less pressure central banks have on them to keep rates high. If central banks eventually get to this point, they can relieve the pressure on both bond and equity markets but beginning to talk about holding or even cutting rates. This is clearly yet to be seen as central banks will wait for absolutely clear evidence they are on top of inflation and this could take some time.

Research believe that inflationary numbers will continue to fall throughout this year as this extremely tight monetary policy does its job. This may eventually provide the relief markets are looking for. This however may take time and expecting continued volatility would be warranted. Early signs of easing inflationary pressures can be seen in the price of used cars shown below.



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