Count

Market Wrap

March 2022

Economic and market overview

- The war in Ukraine overshadowed financial markets throughout the month, but hopes of a breakthrough in peace talks lifted sentiment towards risk assets. Solid gains among US-listed stocks helped the MSCI World Index rise more than 3%.
- Australian shares performed well too, clawing back January's losses and finishing the quarter in positive territory.
- Government bonds performed poorly globally, dragging down returns from fixed income products.
- As anticipated, official interest rates were raised in the US. Officials also signalled that borrowing costs will be lifted significantly over the next two years, to help dampen inflation.

- **US**: The Federal Reserve raised interest rates for the first time in more than three years. This was the first step in 'normalising' monetary policy settings following the Covid crisis. The Federal Funds rate was increased by 0.25%, lifting the target band to between 0.25% and 0.50%.
- More importantly, US officials signalled that borrowing costs are likely to be raised more significantly than previously anticipated. A 0.50% hike at the Federal Reserve's next meeting in early May seems possible. In total, investors are anticipating at least another 2.00% of interest rate hikes in the US this calendar year.
- Inflation remains a genuine concern for policymakers, with consumer prices having risen 7.9% in the past year. Inflation is being seen across all categories including goods, services, food, and energy.
- 678,000 new jobs were created in the US in February, which was more than 250,000 above consensus forecasts.
- Unemployment is now back down at 3.8%, not too far above the pre-Covid level of 3.5%. Moreover, labour shortages are being reported in some areas, which is pushing wages higher and exerting upward pressure on inflation. On average, wages in the US have increased more than 5% in the past 12 months.

- **Australia:** Treasurer Josh Frydenberg announced cash support for Australian households in the Budget, to help soften the impact of rising living costs. The latest survey from National Australia Bank showed the second largest rise in retail prices on record in February, which is eroding consumer sentiment.
- The Budget boost for low to middle income earners, in particular, was designed to improve the Government's approval ratings ahead of May's Federal Election.
- The Treasury has benefited from elevated commodity prices and rising employment, both of which have lifted tax revenue and markedly improved the budget position. Australia's budget deficit is now expected to narrow in each of the next four years.
- Other forecasts released alongside the Budget provided further grounds for optimism. Officials expect unemployment to fall to 3.75% later this year – from 4.0% currently – and annual wage growth to rise above 3% for the first time in a decade.
- If these forecasts prove accurate, the Reserve Bank of Australia is more likely to follow other central banks and start raising official interest rates in the months ahead.

- **New Zealand:** The Reserve Bank of New Zealand did not meet in March and official interest rates were unchanged, at 1.00%. Official cash rates are expected to be raised again during April, however, and further still in the remainder of this year.
- Consensus forecasts suggest official interest rates will be above 3% by the end of 2022.
- Mortgage rates continued to rise against this background. One- and two-year fixed rate mortgage rates have nearly doubled over the past year, increasing households' repayments and impeding the outlook for discretionary spending.
- Additionally, most economists are predicting house price falls as rising mortgage rates start to affect demand. This could further erode consumer confidence, which has already dipped due to rising living costs.

- **Europe**: The military conflict in Ukraine is having a meaningful impact on European economies. Consumer prices in Germany, for example, rose 2.5% in March alone owing to rising energy and food prices. At an annual pace of 7.6%, inflation in Europe's largest economy is similar to that in the US. For now, the European Central Bank has held off raising interest rates, but the probability of a hike this year has undoubtedly increased.
- Separately, there has been talk of gas supply rationing in Germany, as authorities try and reduce reliance on Russian energy imports. This could affect manufacturing output, in particular, and act as a headwind for growth in the region.
- Interest rates in the UK were increased for the third time in the past four months, to 0.75%. Again, this move primarily reflected policymakers' concern about rampant inflation. Consumer prices in the UK are up more than 6% year-on-year, the fastest rate of increase for more than 30 years.
- Consumer confidence is already down sharply owing to surging fuel and energy costs and concerns about potential implications of the war in Ukraine. Higher borrowing costs could result in further angst and potentially hinder discretionary spending.

- **Asia/EM:** Stripping out mobile phone charges and hotel room prices – which are being controlled by government policies – economists estimate inflation in Japan is running above 2%/year. This is the highest level since 2008.
- The Bank of Japan seems reluctant to amend policy settings, however, and continues to support its bond market via a process of 'yield curve control' similar to what we saw in Australia until late last year. The divergence in policy settings between Japan and other major markets has hindered the yen. The currency depreciated by nearly 6% against the US dollar during March – a sizeable move among one of the world's major currency pairs.
- In China, activity levels are being hampered by new Covid lockdowns in some provinces amid a fresh wave of infections.
- Nonetheless, most of the latest Chinese economic data – including industrial production, retail sales and fixed asset investment – came in ahead of expectations. These encouraging indicators suggest annual growth in the world's second largest economy could be around 5% this calendar year.

Australian dollar

- The Australian dollar continued to appreciate over the month. The 'Aussie' added more than 2 US cents, or 3.5%, against the US dollar.
- The Australian dollar performed even more strongly against some other major currencies, rising by 9.1% against the Japanese yen, for example, and by 5.0% against a trade-weighted basket of other international currencies.

Australian equities

- The S&P/ASX 200 Accumulation Index rallied 6.9%, erasing losses made earlier in the year. The market appeared to be supported by comments from Federal Reserve officials in the US, suggesting the central bank is serious in its fight against spiralling inflation. Optimism regarding peace talks in Ukraine, along with generally favourable local economic data, also supported valuations and earnings expectations.
- Improving confidence and more palatable valuations following recent selling pressure supported the IT sector (+13.2%). Block – the parent of buy-now-pay-later company Afterpay – was the best performer in the sector, climbing 19.3% and reaching its highest level since listing on the ASX in January.
- Commodity prices were volatile over the month. A 10% rise in Brent crude oil prices over the month, for example, masked a period of even more aggressive price swings. Oil prices moved between ~US$98 and ~US$128 per barrel over the month, reflecting an uncertain outlook for both supply (from Russia) and demand (partly owing to moderating activity levels in China).
- At the same time, nickel experienced an unprecedented 'short squeeze'. Prices nearly doubled, to nearly US$50,000 per metric tonne, before the London Metal Exchange halted trade. The price pressure subsequently eased and the metal ended the month up around 30%.
- Despite the volatility, general strength in commodity prices supported the performance of the Materials (+8.2%), Energy (+9.6%) and Utilities sectors (+6.7%).
- The major banking stocks all rallied, helping the Financials sector gain 8.3%. A rising interest rate environment is typically supportive of net interest margins and earnings. Commonwealth Bank of Australia (+13.2%) was the best performer in the sector, closely followed by Macquarie Group (+12.4%).
- Australia's Small Cap companies also generally fared well, with the S&P/ASX Small Ordinaries Accumulation Index increasing 5.3%. Similar to their large cap counterparts, Materials stocks were a key pillar of strength. The sector rose by around 15% over the month.

Listed property

- The FTSE EPRA/NAREIT Developed Index added 1.1% overall in AUD terms, but regional performance was mixed.
- The best performing markets included Spain (+7.7%), Japan (+6.3%), Singapore (+6.3%) and the US (+5.6%).
- Laggards included Germany (-8.1%) and France (-3.2%). Ongoing geopolitical tension in Eastern Europe has particularly affected European property companies exposed to higher energy prices.
- Elsewhere, capital was attracted to insulated markets such as Japan and Singapore, and to stocks in defensive sectors such as self-storage, logistics and senior housing.

Global equities

- Sentiment towards share markets weakened further early in the month. Concerns about rising energy costs and other potential impacts of the war in Ukraine saw major share markets extend losses from January and February. In fact, the bellwether S&P 500 Index in the US dipped to its lowest level since June 2021.
- The mood improved markedly in the second half of the month. This helped erase earlier losses and enabled the MSCI World Index to rise 3.1% in March as a whole (in local currency terms). Energy prices came off the boil and there were suggestions of progress in peace talks between Russia and Ukraine.
- US stocks – including those in the technology sector that dominate the NASDAQ – made solid progress. The broader S&P 500 Index closed the month 3.7% higher.
- European shares typically fared less well. In spite of modest gains among UK and Swiss shares, the Euro Stoxx 50 Index of Europe's leading companies closed March down 0.6%. Weakness extended across Italy, Spain and Germany, partly reflecting the region's reliance on Russian energy imports and the potential impact on activity levels if supplies are cut or constrained.
- Asian markets were mixed. Stocks rose by around 5% in Japan and Singapore, but struggled in China and Hong Kong. In fact, Hong Kong's Hang Seng Index slumped to its lowest level in the past 10 years. China's repeated promises to provide stability have failed to support sentiment, partly owing to the ongoing risk of unexpected regulatory changes from Beijing. Fresh Covid restrictions in Hong Kong and mainland China also continued to weigh on confidence levels.

Global and Australian Fixed Income

- Government bond yields continued to rise sharply as investors revised their future interest rate expectations. This resulted in disappointing returns from most fixed income products.
- In fact, the quarterly return from US government bonds was the lowest since the early 1980s and among the worst on record.
- Whilst unsettling, the unfavourable performance should not necessarily come as a surprise. Remember, prior to the Global Financial Crisis (GFC), 10-year Treasury yields in the US were above 5%. Their gradual decline down to a low of just 0.50% in mid-2020 – initially following the GFC in 2007 and 2008 and later during the Covid crisis in 2020 – provided a strong tailwind for government bond markets worldwide and helped boost returns from fixed income products. But with interest rates so close to zero and with limited scope for them to fall further, it always seemed unlikely that this strong performance would be sustainable.
- Increases in official interest rates, as central banks look to reverse emergency policy settings introduced during the Covid crisis in 2020, are now exerting upward pressure on government bond yields in the US and elsewhere. Since bond yields and prices are inversely correlated, this uptrend in yields is resulting in unfavourable returns from government bond markets.
- In the US, 10-year Treasury yields soared 51 bps in March, to 2.34%. This is their highest level since mid-2019.
- The US Treasury curve briefly inverted during the month, with yields on 2-year notes rising above those on comparable 10-year securities. This was an interesting development, as yield curve inversions have historically been indicative of forthcoming economic recessions.
- Government bond yields rose in the UK and Germany too, albeit by a smaller margin than those in the US.
- The most significant move of all was seen locally, where 10-year Australian Commonwealth Government Bond yields soared 0.70%, to 2.84%. This fed through to the Bloomberg AusBond Composite 0+ Year Index, which is among the most commonly-used yardsticks for Australian fixed income products. The Index returned -3.8% in March, and is now down nearly -6% in the first three months of 2022.

Global credit

- The improvement in risk appetite that supported equities extended to credit markets. Following two months of widening and disappointing performance from corporate bonds, credit spreads narrowed in March.
- There was a fair amount of new issuance in the market, as companies looked to lock in relatively attractive borrowing costs before central banks raise official interest rates further.
- Higher yielding names generally performed well alongside higher quality, investment grade issues. The high 'all in' yields available in the high yield sector continued to appeal to income-seeking investors, particularly with default rates remaining very low in most industry sectors.