2021 calendar year in review

The global economy continued to recover in 2021 but is still being challenged by rising virus cases as well as high inflation and persistent supply disruptions.

The pandemic's path evolves from Alpha to Delta to Omicron

For the second year running, the pandemic was the key health and economic concern. The opening months of 2021 brought both pain and promise. A rapid acceleration in virus cases across the globe saw constrained economic activity. However, there were rays of sunshine with the rollouts of the AstraZeneca, Moderna and Pfizer vaccines. Rising vaccination rates during 2021 allowed global economic activity to recover.

The 2021 report card for the global economy was mixed. The US economy saw a solid recovery in 2021 with improving jobs growth and the unemployment rate falling from 6.7% to 3.9%. Europe's recovery has been a 'stop-start' sequence with lockdowns in early 2021, then a brief rebound later in the year. China's sharp economic slowdown and the financial woes of their property developers also filled the headlines in 2021.

Commodity prices had some tumultuous twists and turns during 2021. Iron ore started the year in 'boom' conditions. The spot iron ore price surged from US$156 to US$230 per tonne in May given high levels of global steel production. However, China's sharp economic slowdown and property development woes then saw demand slump.

Consumers experienced the commodity gyrations in their weekly visits to supermarkets and service stations. In Australian dollar (AUD) terms, global coffee prices surged 82%, sugar by 28%, bacon by 22% and wheat prices for your daily bread rose by 26%. Oil prices skyrocketed by more than 56%.

Given this commodity price spiral as well as congested supply chains with the shortage of computer chips and container ships, rising inflation has also become a key economic and social concern this year. Global annual inflation measures surged to multi-year highs in 2021. US consumer inflation ended 2021 at 7% which is the highest since 1982. European inflation was 5% while Brazil's inflation surged to nearly 11%.

Australia's consumer inflation was running at 3% in the year to September 2021. This 3% inflation rate still represents a loss of purchasing power. For Australian savers, the current 0.1% nominal cash rate by the Reserve Bank of Australia provides minimal compensation for inflation.

Australia's economy had a rollercoaster year in 2021. There were encouraging gains in economic activity up until mid-2021. However, the virus outbreaks in NSW and Victoria in June then saw the Australian economy hit reverse gear. Since October, there have been more promising signs. Employment and retail spending have recorded sharp gains after NSW and Victoria emerged from lockdowns. Yet the surge in virus infection cases in the closing weeks of December are a troubling reminder of the continuing virus threat entering the new year.

The world's most important central bank, the US Federal Reserve, announced in November that it will taper its asset purchase program by $15 billion per month and hinted that it is prepared to undertake a faster tapering. While both the Federal Reserve and the RBA have signalled that they would not raise policy rates in 2022, financial markets hold very different views and have priced in three rate increases by the Federal Reserve and two rate increases by the RBA before the end of 2022.

A remarkable year for investment returns

Global share investors had a rewarding year**.** The primary drivers of this very strong global share performance were surging corporate profits and supportive low interest rates.

Strong business surveys and job gains also provide encouragement that the US economic recovery is progressing. Yet there have been some dark clouds amidst the blue skies for share investors. Brazilian share prices declined by nearly 22% amid rising inflation and interest rates. Chinese share prices fell by 22% through a combination of increasing government regulation of education and technology companies as well as the debt woes of property developers such as Evergrande.

Australian shares as represented by the ASX 300 delivered a strong 18% return for 2021. The Communication Services (33%) and Financial sectors (25%) led the charge. There were some exceptional share gains from mining companies in Lynas (156%) and South32 (66%) as well as Sonic Healthcare (48%) and Telstra (46%).

Prospects for 2022

We are reasonably optimistic on the outlook for global economic growth. While central banks, in particular the Federal Reserve, and governments will reduce the level of fiscal and monetary stimuli in 2022, private sector demand should further recover to fill this gap. Global economic growth will likely be lower in 2022 but the main economies, with the exception of China, are still expected to generate above trend economic growth.

Higher inflation will translate into more challenging monetary policy environment for the main developed central banks as they attempt to balance the need to control inflation with the need to maintain strong economic growth. It is likely that the main central banks will tighten monetary policies in a measured and cautious manner. Given the persistent, if diminishing, threat of Coronavirus and the high level of public sector debt, central banks' strong preferences are slow and steady monetary tightening in the form of higher interest rates.

Inflation and Central banks

The greatest risk to financial markets is significantly higher than expected inflation in the main economies leading to faster and more severe monetary policy tightening in 2022. The Federal Reserve is the central bank to watch, given the US Dollar's status as the global reserve currency as well as the challenges faced by the US economy. The US economy is experiencing a lack of supply, centred on its labour force as the pandemic caused a sharp decline in the labour participation rate. It is likely those pressures will ease in 2022 as a combination of higher wages, re-opening of schools and higher vaccination lures more Americans to re-enter the labour force.

However, there is a possibility that this process will be more drawn out than expected. Given the current high rate of US inflation, any negative external supply shock such as higher energy prices, driven by supply side disruption, or persistent bottlenecks in supply chains, may lead to a vicious cycle with expectations for higher inflation becoming more entrenched among both workers, employers and investors. Under such a scenario, the Federal Reserve will be forced to play "catch up" with financial markets and increase interest rates.

The promising prospect of vaccinations ending this pandemic in 2022 needs to be weighed against a wide array of potential risks. These risks could involve further dangerous virus variants emerging, global political risks escalating (such as potential issues arising between

Russia / Ukraine as well as China / Taiwan tensions) and persistent inflation pressures requiring sharply higher interest rates. There can also be major events that shock and surprise investors which are not currently on our radar screen such as natural disasters.

In order to maximise returns over time it is important to get the balance right between understanding opportunities and managing risks. Diversifying investment portfolios allows returns from a diverse range of assets while also keeping a watchful eye out for any potential setbacks.

As 2021 has shown with the viruses destructive path, gradual vaccine rollout, and rising inflation – investment performance is a continual challenge. We hope you have a very happy and healthy new year. If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

All the best,

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