Economic News January 2023 - The year in Review

The global economic recovery is being threatened by high inflation and rising interest rates

Global economic activity started 2022 with promise. Vaccines were becoming more readily available, allowing employees to return to workplaces and even cafes and restaurants began re-opening. Extraordinarily low interest rates set by central banks as well as significant government budget support measures allowed global economic activity to make an initial strong recovery in early 2022.

With the global economic recovery came stronger demand but also acute disruptions in supply chains, such as a shortage of computer chips and transport ships. This scarcity in goods led to price increases and was evidenced by consumer inflation being above 5% in Europe and above 7% in the United States in January 2022.

Russia's devastating invasion of Ukraine on 24th February 2022 dramatically intensified inflation increases by pushing up key commodity prices. Russia accounts for 16% of global natural gas production, 15% of fertilizer, 12% of crude oil and 11% of wheat production. Ukraine is also a major supplier of wheat with 10% of global trade. These key commodity prices increased about 30% by April 2022 following Russia's invasion.

Consumer inflation then surged to multi-decade highs. US inflation hit a peak of 9.1% in June 2022 while European inflation climbed to a peak of 11.5% in October 2022. Everything on the consumer's shopping list was going up in price. Inflation had become the key economic and social concern across the globe in 2022. Alarming annual inflation readings were recorded in Britain (10.7%), Egypt (22%), Turkey (64%) and Argentina (92%).

In response to this inflation surge, central banks began a rapid sequence of raising interest rates to cool these inflation pressures. US interest rates increased by more than 4% in 2022 while Europe raised interest rates by 2%. The Reserve Bank of Australia (RBA) raised the cash interest rate by 3% despite Governor Philip Lowe saying he did not expect rates to rise until 2024!

The US economy once again proved resilient with robust employment growth in 2022. The US unemployment rate ended the year at a very low 3.5% given the acute shortage of American workers.

China's government had been imposing harsh lockdowns with virus outbreaks which cut both production and spending. This had also materially contributed to problems in global supply chains with extensive delays in obtaining goods from China's factories and shipping ports. There was some economic hope at year end with China's government removing the 'Zero-COVID' lockdown strategy.

A turbulent year for Australia's economy

Australia's economy started the year on a strong note. The benefits of high vaccination rates, low interest rates and resilient businesses and consumers had seen the Australian economy make a rapid recovery. Robust jobs growth had allowed the unemployment rate to fall to 3.5% in November 2022, the lowest since 1974.

However, Australia is also confronting the challenge of high inflation and rising interest rates. Australia's consumer inflation was running at 7.3% in the year to November 2022. Leading this inflation surge was higher annual prices for housing construction (+17.9%), petrol (+16.6%), holiday travel (+12.8%), bread (+12%), food (+10.9%) fruit & vegetables (+9.5%) as well as meat (8.1%). This high inflation rate represents a significant loss of purchasing power for consumers.

Australia's housing market has also hit reverse gear with falling prices and construction. There are also concerning signs that consumers are becoming more cautious with milder readings for retail spending recently in response to these higher prices.

From an investment point of view, 2022 proved to be a year where cash was the prudent measure for safety. By contrast, the two largest crypto currencies in Bitcoin and Ethereum suffered falls of more than 60% in US Dollar terms and FTX crypto went bankrupt.

US share prices made new record highs in early January 2022 given low interest rates and the robust gain in corporate profits in 2021. Strong business surveys and job gains also provided encouragement that the US economic recovery was improving. There were similar sharp gains for European shares at the start of 2022 given this optimism on global growth and that the virus threat was gradually diminishing.

Yet the inflation storm clouds rained on these share gains. Global share prices slumped in response to accelerating commodity prices, rising interest rates and energy prices which were squeezing profit margins. Investors became alarmed that central banks would need to continue increasing interest rates to slow demand. Russia's invasion of Ukraine also damaged sentiment by casting a shadow over European national security.

The only 'safe havens' for global share investors were the energy sector, healthcare and consumer staples. Emerging markets such as China (-20.7% return) and Taiwan (-22%) also struggled in 2022.

Continuing tensions over Taiwan's independence from mainland China is an issue that is likely to trouble investors over coming years.

Future outlook for investment markets

The main issues to monitor in 2023 include inflation rates; central banks and interest rates; US politics and its "debt ceiling"; China tensions; and Australian residential property prices.

There are some hopeful signs that lower global oil prices and shipping costs suggest that global inflation may have peaked. Labour market tightness is showing signs of easing which should take pressure off wages – this is flowing from slowing demand and in Australia will be helped by foreign workers returning. However, price pressures are still very evident with rising food costs, residential rents, and energy prices. Thus, the inflation threat remains on the radar for 2023.

The US dollar also looks to have peaked – which should ease debt servicing pressure in emerging countries with US dollar denominated debt. Vaccines, anti-virals and fortunately so far the less harmful virus mutations have assisted global growth since Covid although China has some way to go to get back to full production.

While investment returns should improve, volatility is likely to stay high. Geopolitical risks persist around Ukraine, China and Iran. Raising the US debt ceiling as needed by mid 2023 could be difficult given the increased power of fiscal conservatives in the House of Representatives.

Much of the forecast will hinge on whether central banks can safely navigate the challenge of moderating inflation without severely damaging economic activity by raising interest rates too quickly. Providing central banks can navigate this successfully, we see investment markets performing better in 2023 with alternative assets continuing to be an important part of a diversified portfolio.

For investors, assessing these considerable inflation and interest rate risks for the year ahead is very challenging. Given the current investment climate is dynamic with multiple positive and negative scenarios possible, investors should maintain a disciplined and diversified strategy to manage these risks.

Key measures pass Parliament

Legislation has passed Parliament introducing a range of new measures.

- Downsizer eligibility age reduces to 55 - the reduction in the eligibility age from 60 to 55 will enable more Australians to make super contributions from the sale of their home.
- Assistance for working age pensioners – a range of new measures will help Australians of pension age who plan to keep working, including an increase in the Work Bonus.
- Social security recipients may benefit from the extension of the assets test exemption that applies to proceeds from the sale of the principal home from 12 months to 24 months, as well as lower deeming rates which will apply to the exempt amount.
- New Income limits for the Commonwealth Seniors Health Card are now: $90,000 a year for a single person and $144,000 a year for couples.

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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