Economic News July 2022

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

The financial year can be separated into two contrasting halves. The first half from July to December 2021 was promising. The global economy had turned for the better with improving vaccine access.

Global interest rates were low to support economic growth given that inflation appeared mild. Then the storm clouds gathered with rising commodity prices, supply disruptions and Russia's invasion of Ukraine. The second half of the financial year from January to June 2022 has been a difficult one for consumers navigating higher prices and investors with high inflation and rising interest rates causing share and property prices to decline.

Global economic activity began the financial year in July 2021 with more promising prospects. The US economy made a strong recovery with robust business conditions and jobs growth for most of the financial year. The US unemployment rate rapidly fell from 5.9% in July 2021 to 3.9% in May 2022. Indeed, the shortage of American workers became so acute that job vacancies surged to record highs and wages growth accelerated to a 5% annual pace.

However, storm clouds were developing given rising inflation pressures. The first sign was the acceleration in US consumer inflation above 7% in December 2021. The US central bank responded by signalling that interest rates could rise "sooner and faster" in January 2022. Then Russia's brutal invasion of Ukraine on 24 February 2022 dramatically intensified the inflation threat by pushing up key commodity prices such as oil, gas, copper, fertiliser and wheat. Consumer inflation surged to 40 year highs with annual US inflation at 8.6% in May 2022. In response to this inflation surge, the US central bank began a rapid sequence of raising interest rates in March 2022. US interest rates have increased by 1.5% since March with the US central bank also signalling further interest rate rises *"will be appropriate"* in the next financial year.

Europe's recovery had been a 'stop-start' sequence during the first half of the financial year with setbacks given the Delta and Omicron virus waves. Yet Europe's economy was showing more promising signs as business and consumer confidence improved at the start of 2022. However, this confidence was shattered by Russia's invasion of Ukraine. The devastating loss of lives, traumatic flight to safety by Ukrainian refugees westwards to Europe as well as Russia's importance as a key energy supplier of natural gas and oil has had a dramatic impact. European annual consumer inflation has surged above 8%. European businesses and consumers are very worried about meeting their future energy needs given Russia's threat of cutting supply of natural gas and oil.

China's sharp economic slowdown and the financial woes of their property developers also made the headlines. China's economy has recorded subdued industrial production and weak retail sales given the combination of falling house prices and the government's "Zero-Covid" strategy. Virus outbreaks in Shanghai, Shenzhen and Beijing this year has seen China's government impose harsh lockdowns which cut both production and spending. This has also materially contributed to problems in global supply chains with extensive delays in obtaining goods from China's factories and shipping ports.

Commodity prices had some tumultuous twists and turns during the financial year. Iron ore prices started the year in 'boom' conditions at US$210 per tonne. However, China's sharp economic slowdown and property development woes then saw a slide in demand. Iron ore prices ended the year around US$112 per tonne, which is a 47% annual decline. This was a key factor driving the Australian dollar (AUD) lower against the strong US dollar over the past year.

More problematic has been the sharp surge in energy and food prices. Given stronger global demand and concerns over Russia as a key source of supply, both energy and food prices have skyrocketed. Russia accounts for circa 16% of global natural gas production, 12% of crude oil and 11% of wheat production. Over the past year, natural gas prices have climbed by 138%, crude oil by 46% and wheat prices by 53%. Globally, consumers felt both angrier and poorer with every visit to the supermarket and service station.

Inflation has become the key economic and social concern with this commodity price surge, as well as congested supply chains given production and transport delays. Global annual inflation measures have risen to multi-year highs. Consumer inflation has been particularly high in Brazil (11.7%), Egypt (13.5%), Sri Lanka (55%) and Turkey (79%). Australia's consumer inflation was running at 5.1% in the year to March 2022. However, the Reserve Bank of Australia (RBA) Governor, Philip Lowe, indicated in mid-June that Australian consumer inflation is expected to peak at 7% at the end of 2022. This high inflation rate represents a significant loss of purchasing power.

A roller coaster year for Australia's economy

Australia's economy has experienced a roller coaster financial year. The virus outbreaks in NSW and Victoria in mid-2021 as well as virus cases across Australia from late 2021 did constrain consumer spending. However, given the benefit of high vaccinations, low interest rates and resilient businesses and consumers, the Australian economy has made a rapid recovery. Robust jobs growth has seen the unemployment rate fall from 5.2% in October 2021 to 3.9% in May 2022, the lowest since 1974.

Australia now confronts the challenge of high inflation and rising interest rates. The RBA has rapidly raised the interest rate from 0.1% in April 2022 to 1.35% in July 2022. Further interest rate rises have been signalled by the RBA to reduce inflation. This suggests a very challenging climate for borrowers with large mortgages in the coming year.

A disappointing year for investment returns

International share investors had a disappointing year with a market return of -13.6% for hedged and -8.0% for AUD unhedged portfolios. The primary drivers of this very weak performance are high inflation, supply disruptions and increasing interest rates, which are threatening corporate profit prospects.

US shares made new record highs in early January 2022 given low interest rates and the robust +45% annual gain in corporate profits in 2021. Strong business surveys and job gains also provided encouragement that the US economic recovery was strengthening. 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 storm clouds eventually rained on these share gains. Global share prices slumped in response to accelerating commodity prices, rising interest rates and wage pressures which were squeezing profit margins.

The slide in global share markets over the last six months to June 2022 has been intense. The largest 500 companies in the US as measured by the S&P 500 Index declined -20%, while the technology focused Nasdaq 100 fell -29%. Europe's STOXX50 and Germany's DAX indices recorded similar falls of -20% in the last six months.

There were no 'safe havens' amongst this global storm. Australian shares as measured by the ASX 300 declined by -6.5% for the financial year. The sharpest annual falls were in the Information Technology (-38.2%) and Consumer Discretionary (-21%) sectors as investors cut their growth expectations. There were some bright spots amidst the gloom with the Energy (30.1%) sector given the surge in natural gas and oil prices. Resources (3.3%) benefitted from gains in select metal prices and a weaker AUD.

Future outlook for investment markets

The troubling trio of rising inflation, higher interest rates and the war in Ukraine is providing a more challenging and difficult investing climate. Inflation has moved to multi-decade highs around the world. Central banks with inflation targets are compelled to rapidly raise interest rates to cool these price pressures. This implies that the cost for lowering inflation is to reduce demand to meet the limited available supply of goods.

Accordingly, investment markets are concerned about whether central banks can safely navigate the challenge of moderating inflation without severely damaging economic growth. As interest rates sharply rise and financial conditions for borrowers become tougher, we have seen investment markets re-priced to take into account the high inflation environment.

The challenge for Central banks is in assessing the rising inflation, interest rate and economic growth risks in the coming financial year. Given the current investment climate is dynamic with multiple positive and negative scenarios possible, investors should maintain disciplined and diversified investment portfolios.

Shares are likely to see continued short-term volatility as central banks continue to tighten to combat high inflation. However, we see shares providing reasonable returns on a six to twelve month horizon as valuations have improved given recent sharemarket falls, global growth ultimately picks up again and inflationary pressures ease through next year allowing central banks to ease up on the monetary policy brakes.

Still relatively low yields and the risk of a further rise in bond yields points to constrained returns from corporate and government bonds.

Commercial property will likely see some weakness in retail and office returns (as online retail activity remains well above pre-COVID levels and office occupancy remains well below). Alternative investments / Infrastructure is expected to see solid returns and provide a hedge against inflation pressures.

Australian home prices are expected to fall further as poor affordability and rising mortgage rates impact. Cash and bank deposit returns remain low but are improving as RBA cash rate increases flow through. The $A is likely to remain volatile in the short-term as global uncertainties persist. However, a rising trend in the $A is likely over the next 12 months, helped by still strong commodity prices.

We ultimately expect central banks to live with inflation, but only after stalling economic growth. Overall, we expect persistent inflation amid sharp and short swings in economic activity.

With the recent re-pricing of investment markets (which will not make great reading of 2022 annual reports and statements), we are comfortable that portfolios have adequate diversification, are risk-aware and positioned for a range of future market environments. Despite rising inflation and current world circumstances it remains clear that holding a well-diversified portfolio is key to successfully navigating the current economic conditions.

If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

All the best,

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