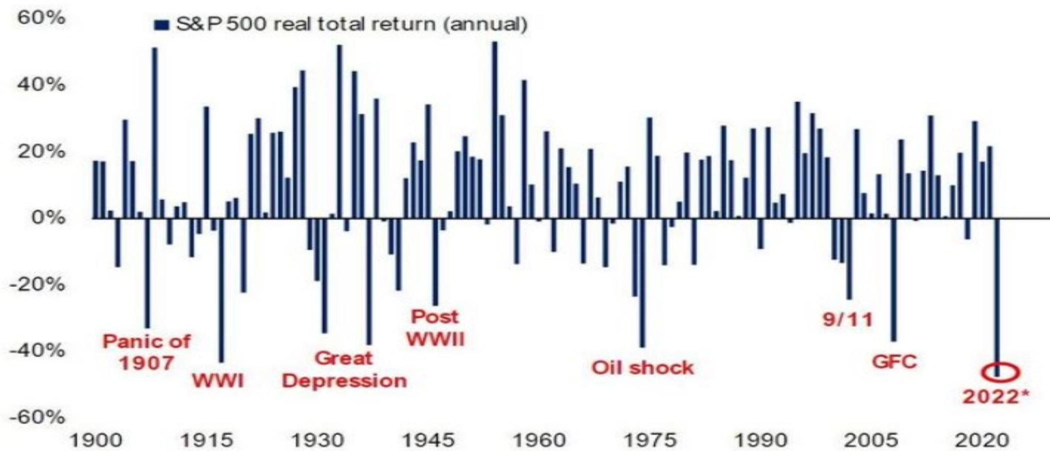
Fin-X Wealth End of Financial Year 2022 update

30 June 2022

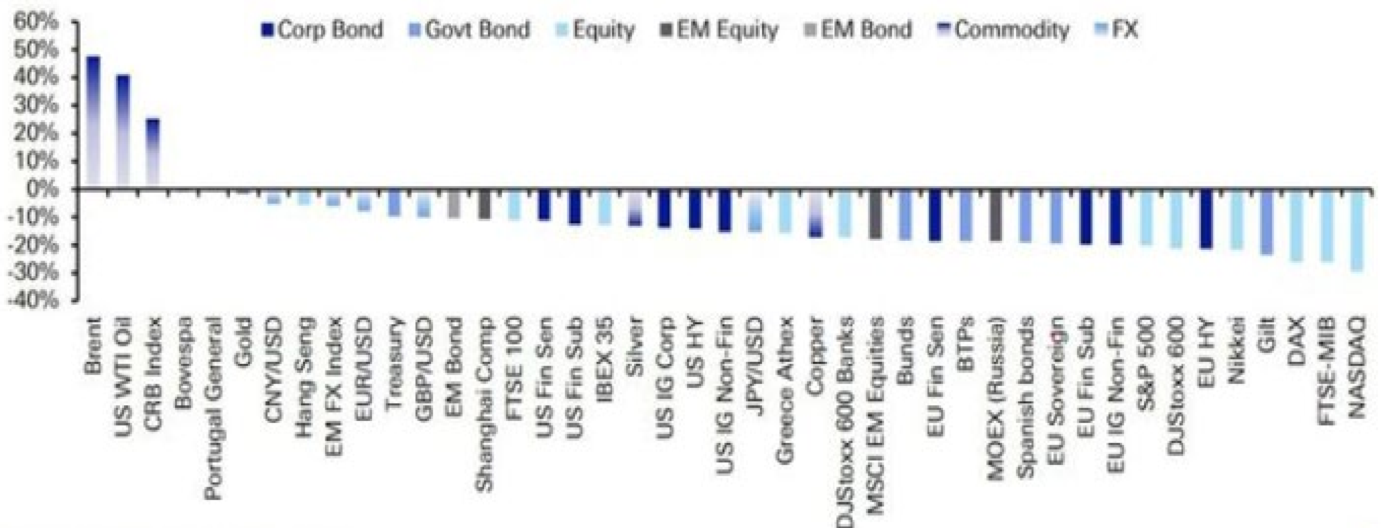
As we commence a new financial year, we reflect on the past 12 months and the first half of 2022. The first half of 2022 has been the worst start to a year in many years in terms of returns, as asset classes have converged and moved as one with a high degree of correlation, providing investors with nowhere to hide.



Market Performance

The disappointing market performance that began in early 2022 continued into the second quarter as concerns over inflation and tightening financial conditions weighed heavily on asset prices. Only global hedge funds and cash were able to generate positive returns.

Total return performance of major global financial assets year to date (USD)



Source: Bloomberg, Deutsche Bank, Markit

Bonds have not provided the degree of downside protection that investors would generally expect since tightening monetary conditions have depressed returns across all categories. The end of central bank purchases is withdrawing some of the demand for government bonds and mortgage-backed securities. Government bonds also

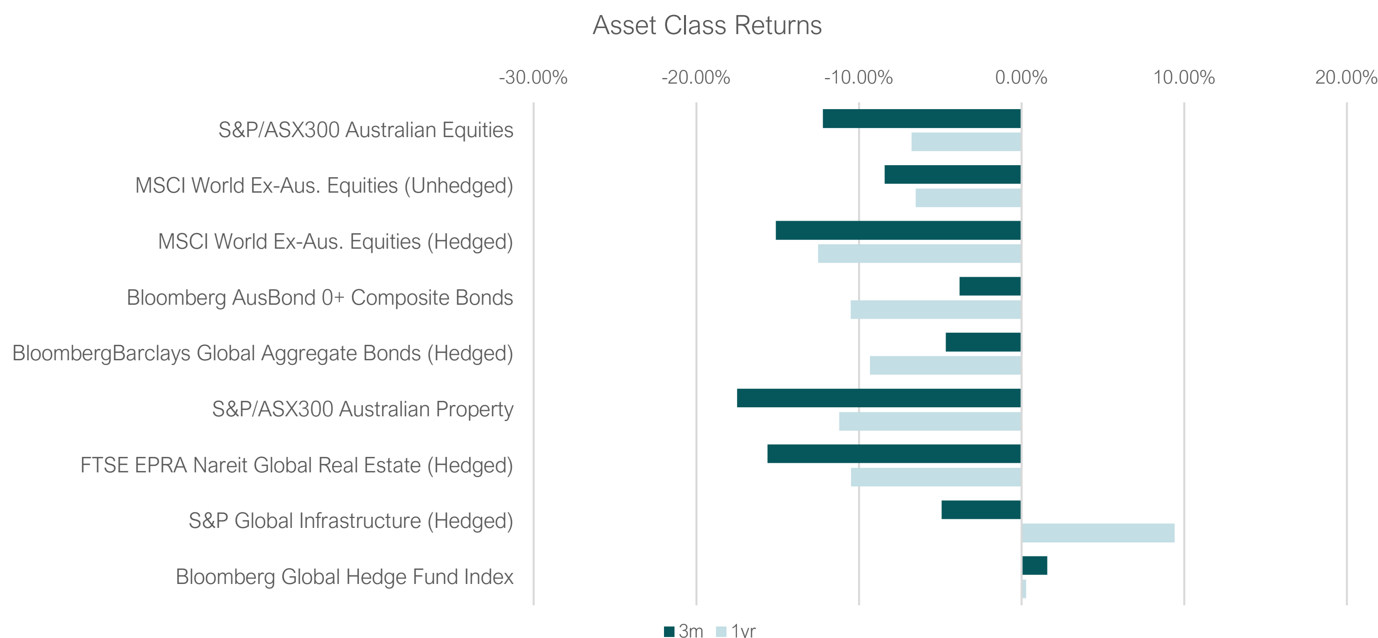
tend to have longer average maturities and are therefore more sensitive to changes in interest rates. Rising rates have pushed yields higher, lowering bond prices. Corporate bonds usually have shorter maturities but are also more responsive to the level of economic growth. As tightening monetary policy also lowers expected growth, both investment grade and higher yield “junk bonds” values fell as investors were more reluctant to assume credit risk.

Often seen as a hedge against rising inflation, Australian and international real estate began the quarter on relatively high valuations. Those valuations have come down as monetary tightening has started to gain traction. Infrastructure achieved positive annual returns but was also caught in the sell-off during the quarter, despite many index members benefitting from CPI-linked revenue contracts and an increase in traffic.

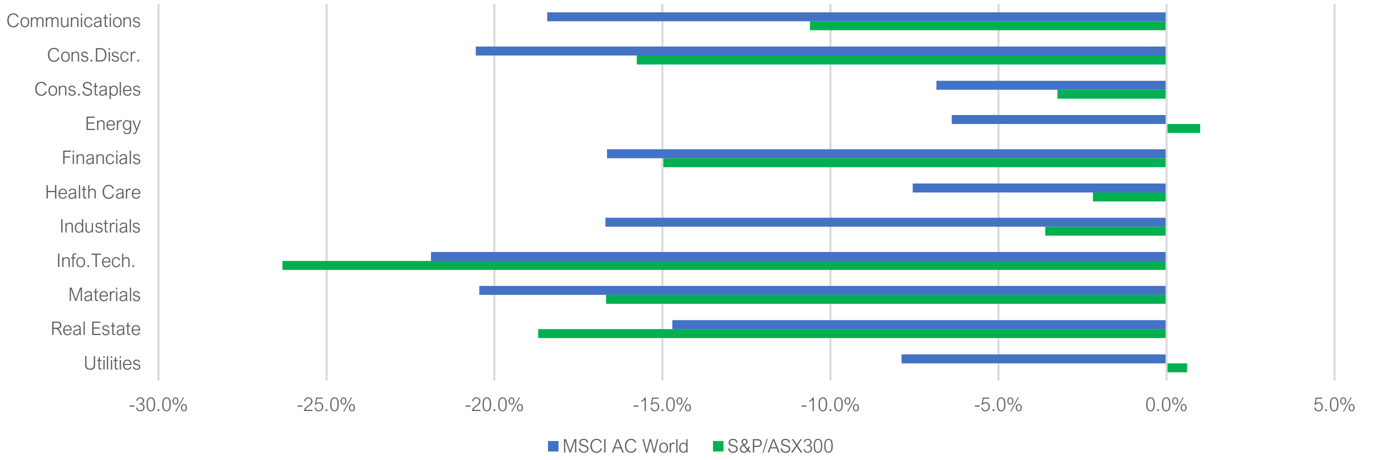
Unsurprisingly, within equities, the defensive sectors outperformed. Consumer staples, healthcare, and utilities tend to have more stable revenue streams and be less sensitive to economic cycles. Moreover, companies in these sectors often have higher dividend yields, making their share prices more resilient to rising interest rates than higher growth stocks more reliant on external finance.

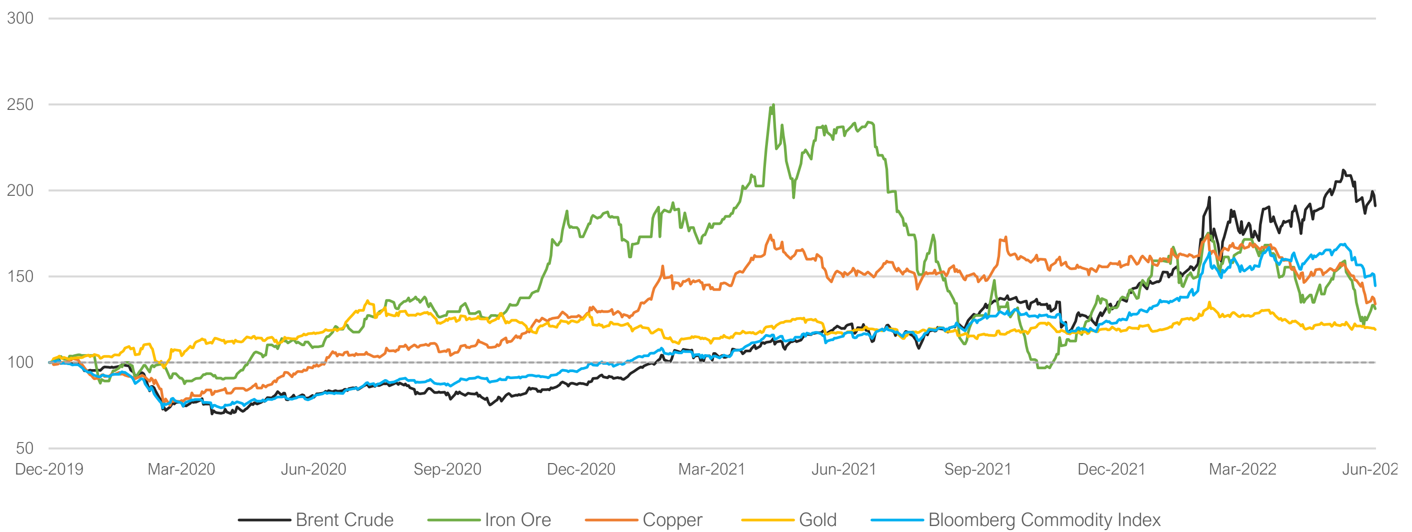
Energy was the top performing sector globally as oil and gas prices have soared since the start of the year. According to the Energy Information Administration, Russia represented 11% of total global oil production in 2021. Following the invasion of Ukraine in February, sanctions have attempted to reduce Russian access to global markets, increasing oil and gas prices. Energy producers have experienced a substantial rise in earnings but still trade on a discounted multiple compared to the market average. The sector is priced as if the gains are only temporary as the demand slows and cleaner replacements become available.

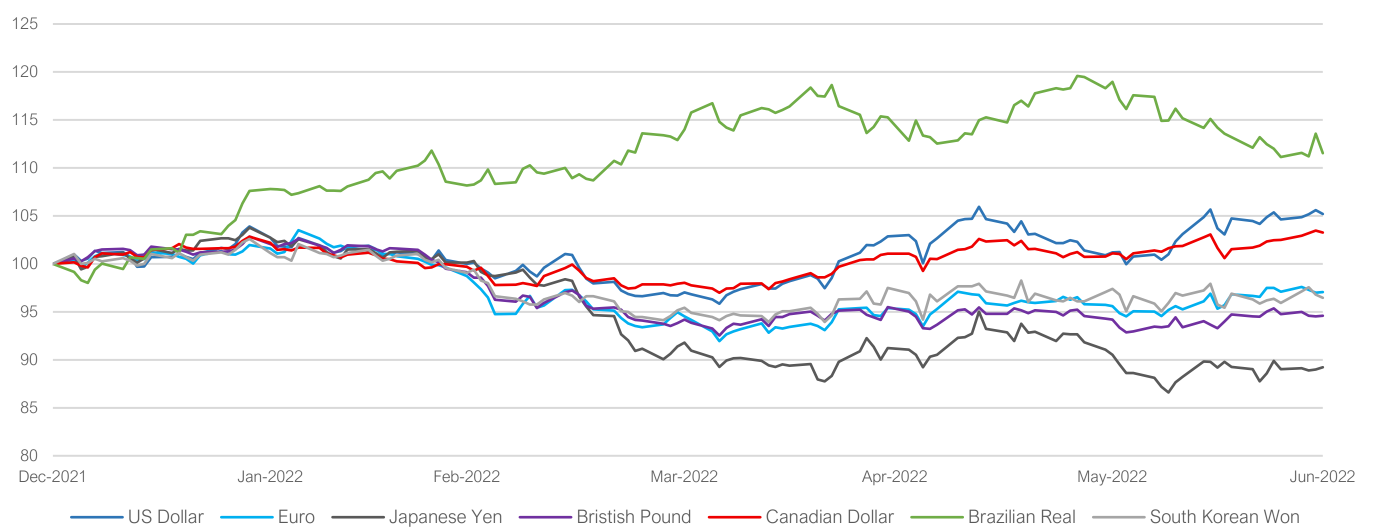
The rapid rise in energy prices has also led to substantial movements in the foreign exchange market. European and Asian manufacturing economies reliant on energy imports have experienced a significant deterioration in net trade, weakening their currencies. In contrast, oil producers such as Brazil and Canada have seen their currencies appreciate.



Source: Bloomberg, S&P Dow Jones, MSCI, FTSE Russell, 7th July 2022







Source: Bloomberg, MSCI, S&P Dow Jones, 7th July 2022

Source: Bloomberg, Federal Reserve Bank of New York, 7th July 2022

A combination of domestic energy resources, the prospect of higher yields, and rising investor risk aversion have also led to a significant appreciation in the US dollar. Since the US dollar represents more than half of the foreign currency exposure in the MSCI World ex-Australia equity index, the unhedged version outperformed the currency-hedged counterpart.

Global Economy

The outlook for the economy and markets is closely tied to the outlook for inflation and future monetary conditions. There are several contributing factors to the global rise in inflation, but three main causes stand out.

Firstly, the effects of the *global pandemic* have not been fully resolved. Global *supply chains* have become increasingly concentrated as globalisation progressed and China became the world's manufacturing leader. *Chinese lockdowns* have continued longer than in the west due to the zero-COVID policy, impacting the production of a range of goods. Even in countries where lockdowns are not imposed, ongoing infections are causing absenteeism leading to production, service, and distribution delays. Measures of stress on supply chains, such as the index published by the New York Federal Reserve, suggest that backlogs may be gradually easing. But a few sectors may see disruptions persisting into 2024.

Secondly, the large amounts of *pandemic stimulus* created additional demand over and above the lower levels of supply. Fiscal stimulus proved to be particularly potent since lower-income households benefitted more from direct cash payments than low interest rates. Since poorer consumers tend to spend more of each additional dollar of income, there seems to be a high correlation across countries between the degree of demand-driven inflation and the size of government handouts.

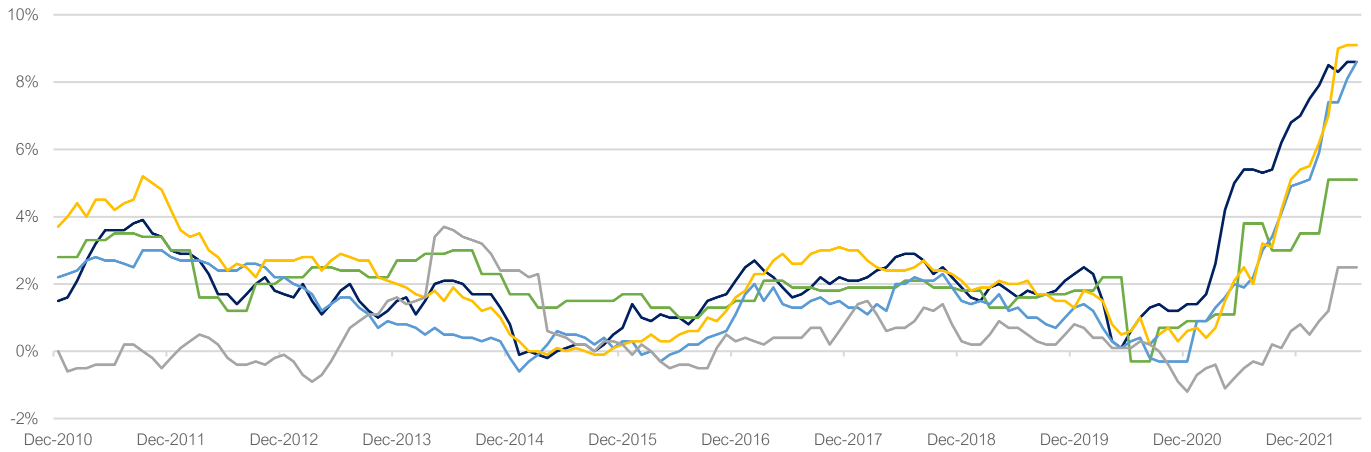
Thirdly, *energy prices* have a high correlation with *total inflation* figures. Every sector uses energy of some form, so an energy price shock reverberates across the entire economy and causes knock-on price effects.

Since policymakers have little power to resolve the supply-side issues, the response has focused on slowing demand enough to stem the rise in prices. There is also a sense of urgency related to the risk that inflation can rise permanently if expectations of future inflation become entrenched, leading to more pressure on wages and an eventual wage-price spiral.

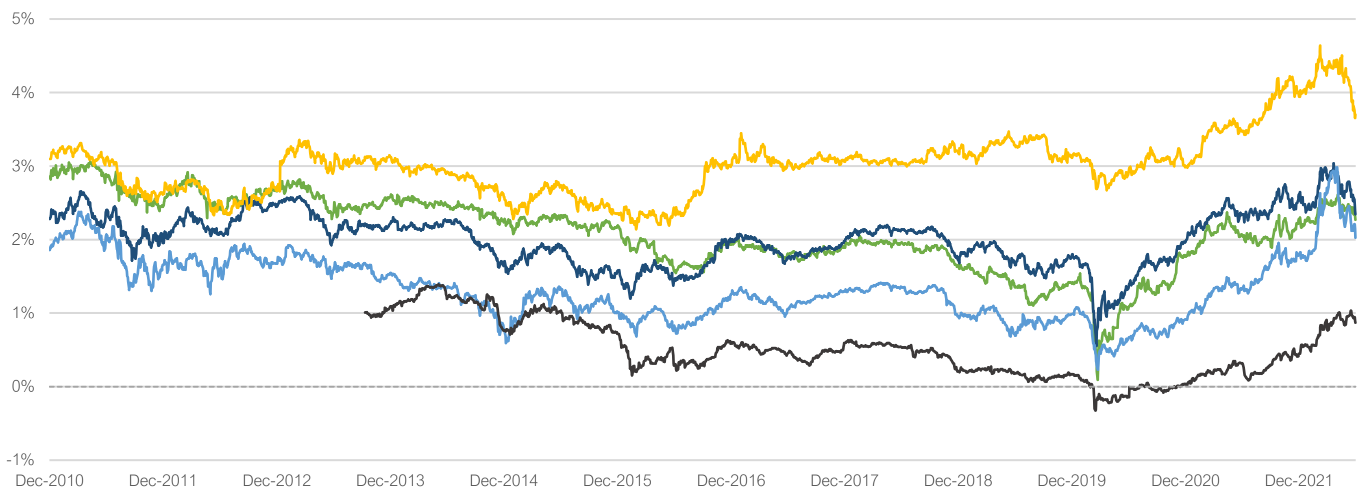
As the last quarter progressed, central bankers realised that supply chains were also taking longer to clear than previously envisaged and feverishly began to raise interest rates. The Federal Reserve had increased interest rates by 0.25% in March but soon followed with a 0.50% rise at the next meeting in May and then by 0.75% in June. The RBA raised by 0.25% in May, then by 0.50% in June and again in early July.

It has been remarkable how little disagreement there has been among central bankers on the need to fight higher inflation with tighter monetary policy, even though rapid tightening also risks damaging the economy. Households are already experiencing higher food, energy, and housing costs, so aggressively raising interest rates may seem excessive. But the

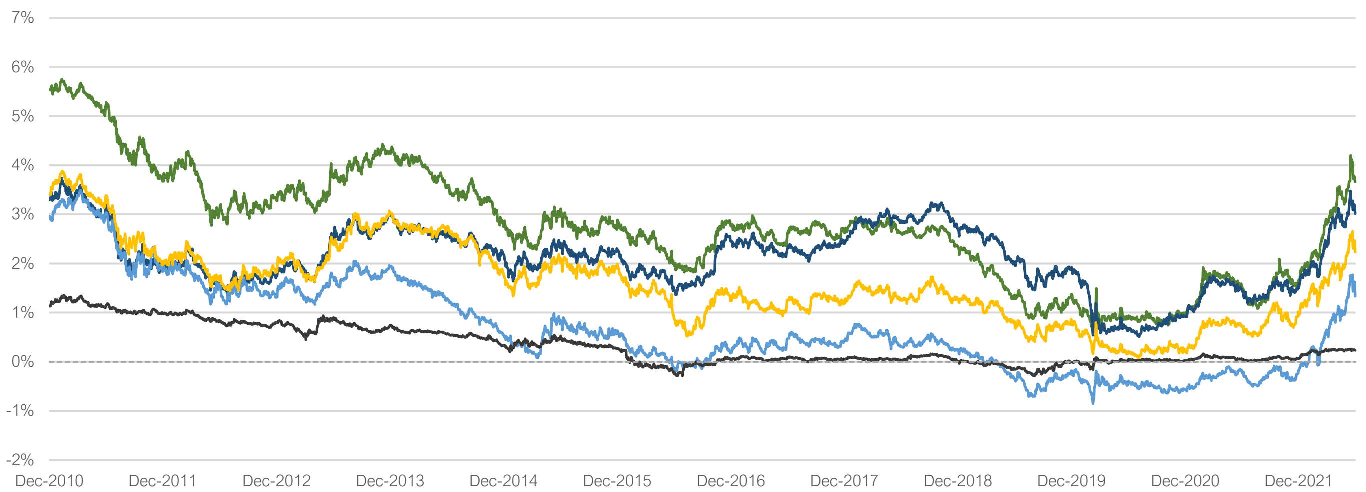
CPI Inflation, Annual %



10 yr Expected Average Inflation



10 yr Government Bond Yields



Australia US Germany Japan UK

Source: Bloomberg, ABS, BLS, Eurostat, ONS, MIAC, 7th July 2022

Source: Bloomberg, MSCI, 7th July 2022

risks of not acting are perceived to be far greater. Agustín Carstens, a former governor of the Bank of Mexico and the current general manager of the Bank for International Settlements recently stated that "*the key for central banks is to act quickly and decisively before inflation becomes entrenched. If* [inflation] *does* [become entrenched]*, the costs of bringing it back under control will be higher. The longer-term benefits of preserving stability for households and businesses outweigh any short-term costs.*" Those costs are likely to include falling asset prices.

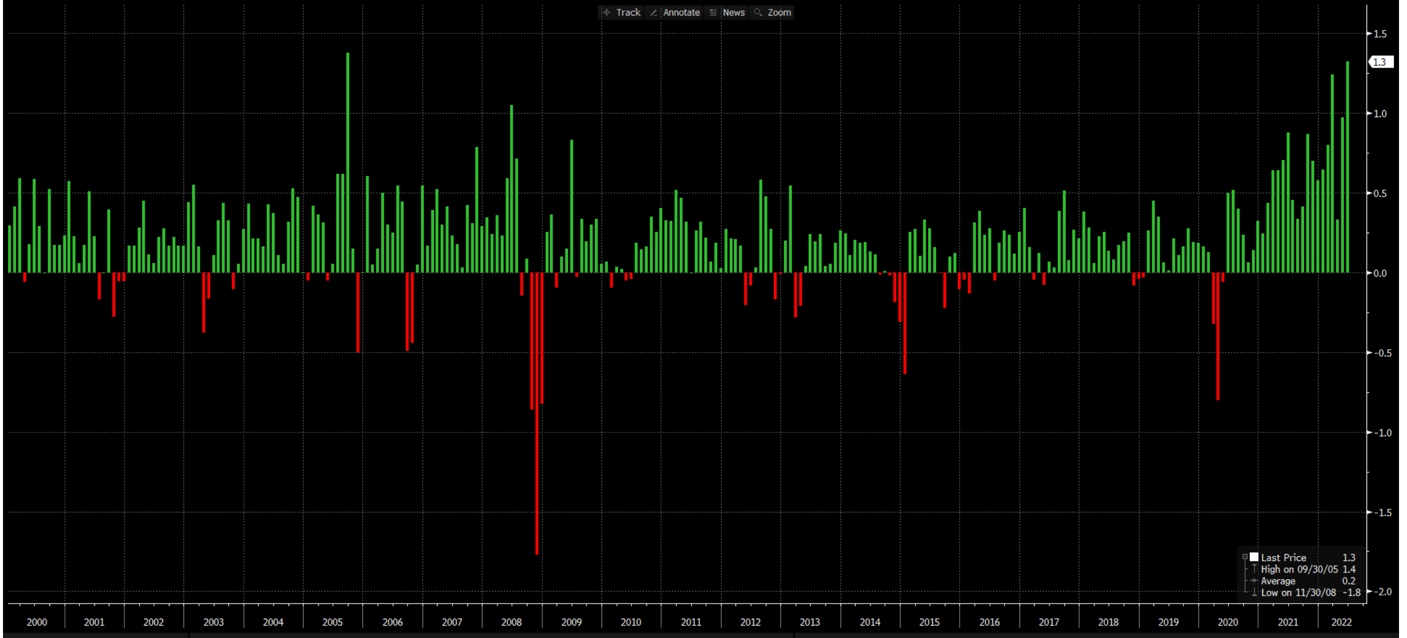
The extent of monetary tightening and the potential damage to the economy largely depends on how persistent inflation proves to be. Reserve Bank Governor, Philip Lowe, sees Australian inflation peaking at around 7% at the end of this year. It is then forecast to moderate next year as global tightening begins to take effect, supply chains continue to recover, and the energy shock dissipates. Falls in home and other asset prices are also expected dampen demand as consumers feel less wealthy.

Investors now see some form of global economic slowdown as inevitable, and a US recession does appear increasingly likely. Moreover, Europe and the UK are all but certain to experience a material reduction in economic activity as the impact of the energy shock has been much greater and structural economic growth is lower.

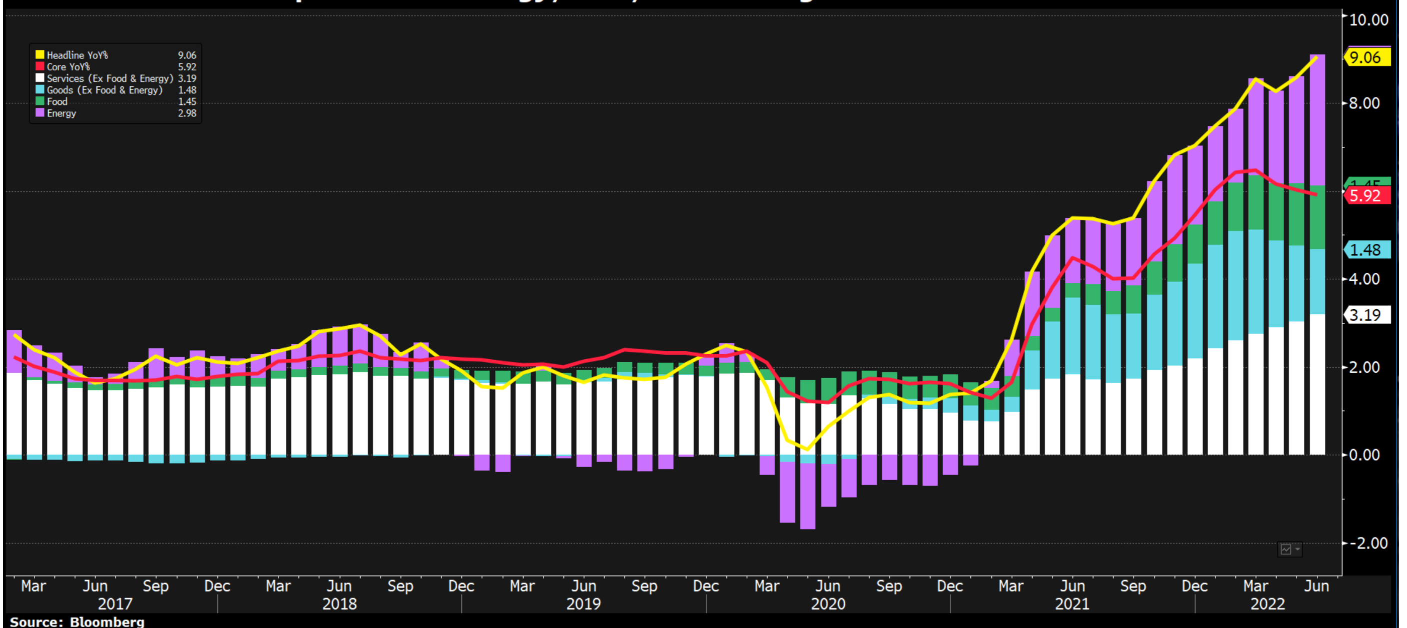
Despite the weaker global outlook, Australia may be able to avoid a recession. Unlike America, lower unemployment has not yet resulted in rapidly rising wage costs which would require an even tighter monetary policy setting.

Market Outlook

The market is pricing an imminent peak in inflation in the northern hemisphere but has already been wrong-footed by a higher American CPI print in June (9.1% yoy).

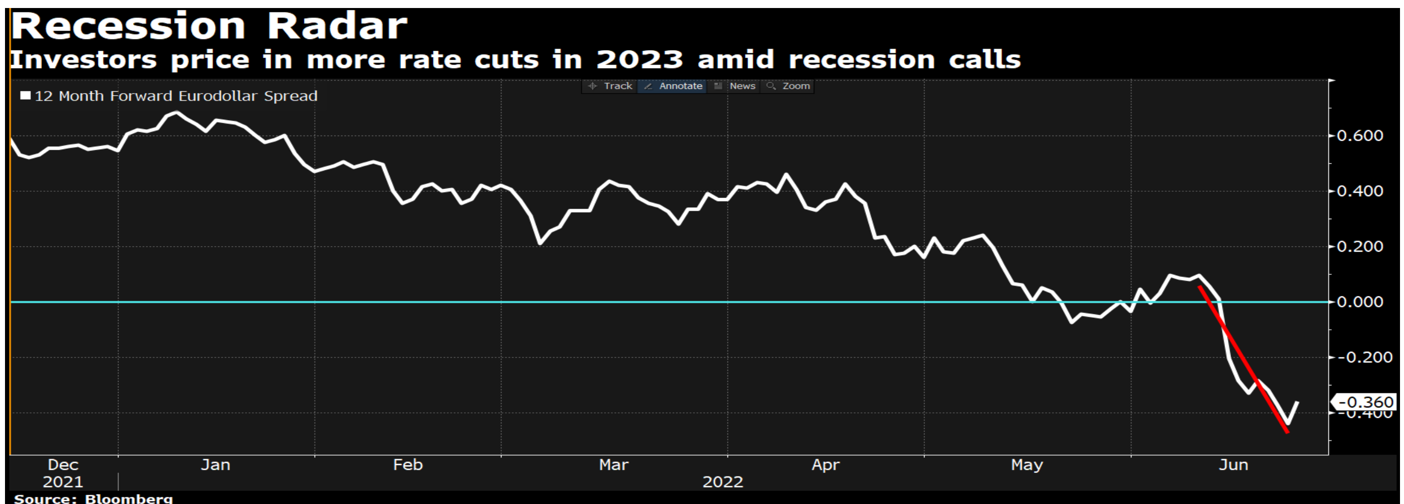


Source: Bloomberg



Source: Bloomberg

The precise timing of the inflation peak is difficult to predict. However, longer-term market measures have already begun to fall back toward target rates. Indeed, current interest rate pricing indicates that by the middle of 2023, the Federal Reserve will already be easing.



If inflation moderates, bond prices and yields should stabilise, and the higher level of income should lead to positive returns, even without rising prices. The main risk for bonds is that inflation settles at a higher-than-expected rate, which could still occur even if economic activity turns negative. However, that scenario seems somewhat unlikely since central banks seem determined to continue raising until inflation falls, regardless of whether unemployment rises. The deeper and more prolonged the slowdown turns out to be, the better bonds are likely to perform.

The outlook for the equity market is more complex. Thus far, rising yields have returned forward price-to-earnings multiples to more normal levels. But macroeconomists are sceptical that rising energy, commodity, and wage costs are fully reflected in analyst forecasts. Rising prices are likely to squeeze profit margins. Moreover, slowing growth is also expected to curtail revenue streams and implies that equities may have further to fall in the short term.

However, it's important to note that the macroeconomic outlook is evolving very rapidly. Inflation forecasts are changing from week to week as more data is received. Even the Federal Reserve has confessed to increasing their June hike based on inflation data received just three business days before the meeting. While it is relatively straightforward to predict how the market will respond to different policy responses, forecasting changes in policy is incredibly difficult when policymakers so suddenly change course. Hedge fund trading strategies are best suited to respond to these conditions, and the superior performance seems likely to continue.

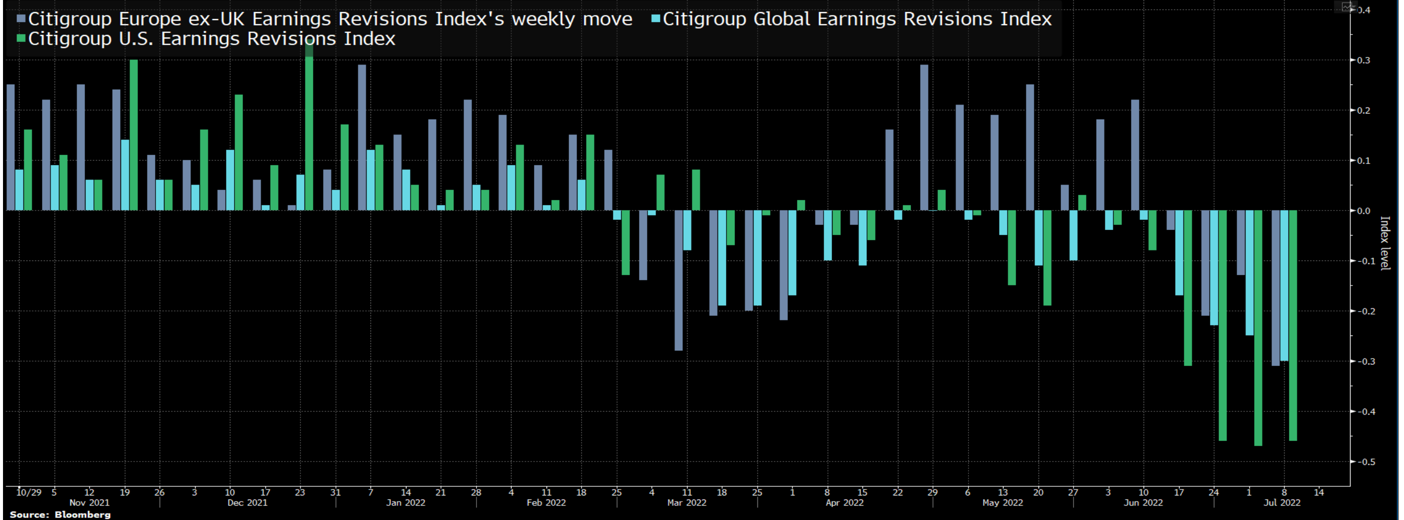
Thankfully, there are already brighter skies on the horizon. The stock market tends to do less well in years when there are mid-term elections in the US, generally appreciating afterwards. By December, the elections will be out of the way, and in China, Xi Jinping should have secured his third term, opening the door to easing restrictions and a faster unclogging of global supply chains. Chinese infrastructure stimulus is likely to increase demand for Australian exports. As a result of renewed western solidarity, it is also reasonable to expect a more stable geopolitical environment than in the first half of the year. Despite the challenging short-term outlook, Governor Lowe's optimism may yet prove justified.

Corporate profitability

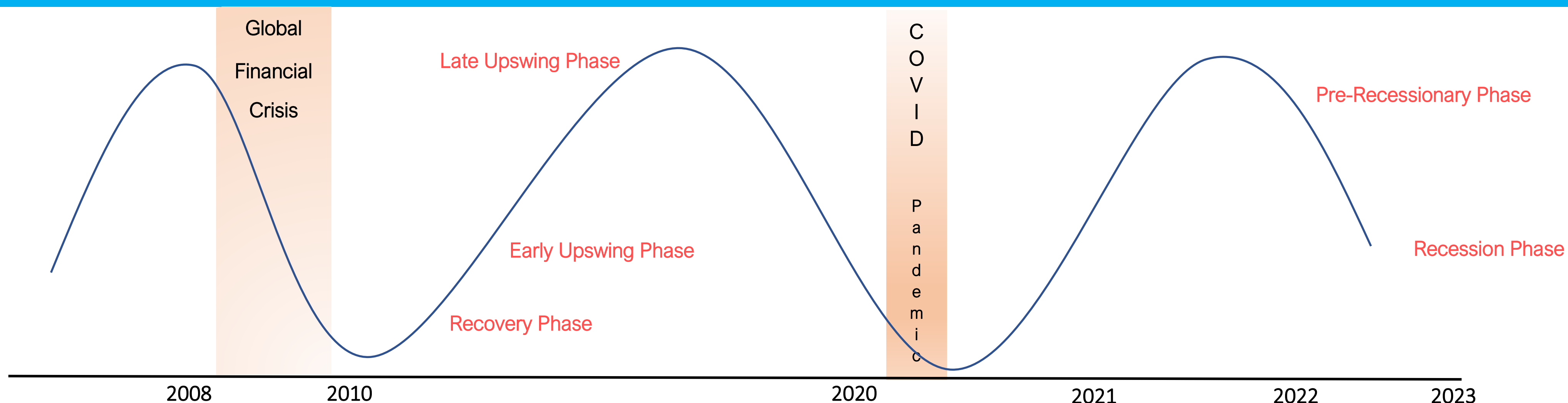
The current US earnings season which commenced this week will be eagerly watched to slowing earnings growth and margin pressure. So far, we have not seen significant declines in earnings, however margins are under pressure as a result of input costs increasing from higher energy costs permeating across the economy.

The tempo of the market is rapidly transitioned from inflation, which is anticipated to peak to recession fears. This has resulted in the yield curve inverting (2/10 year), which is a precursor to recession – refer to image on p9. Keep in mind that historically, when the yield curve inverts it takes about 9 quarters for the economy to enter a recessionary period.

The concern is that markets are telling Central Banks that the rate of monetary tightening currently is too aggressive. The market is pricing in rate decreases into 2023. The concern for Central Banks is the reliance on lagging indicators such as CPI to dictate the trajectory of interest rates and broader monetary policy. These were the same Central Banks that maintained the mantra the inflation was *transitory* until late last year.



Treasury – 2-year to 10-year yield curve



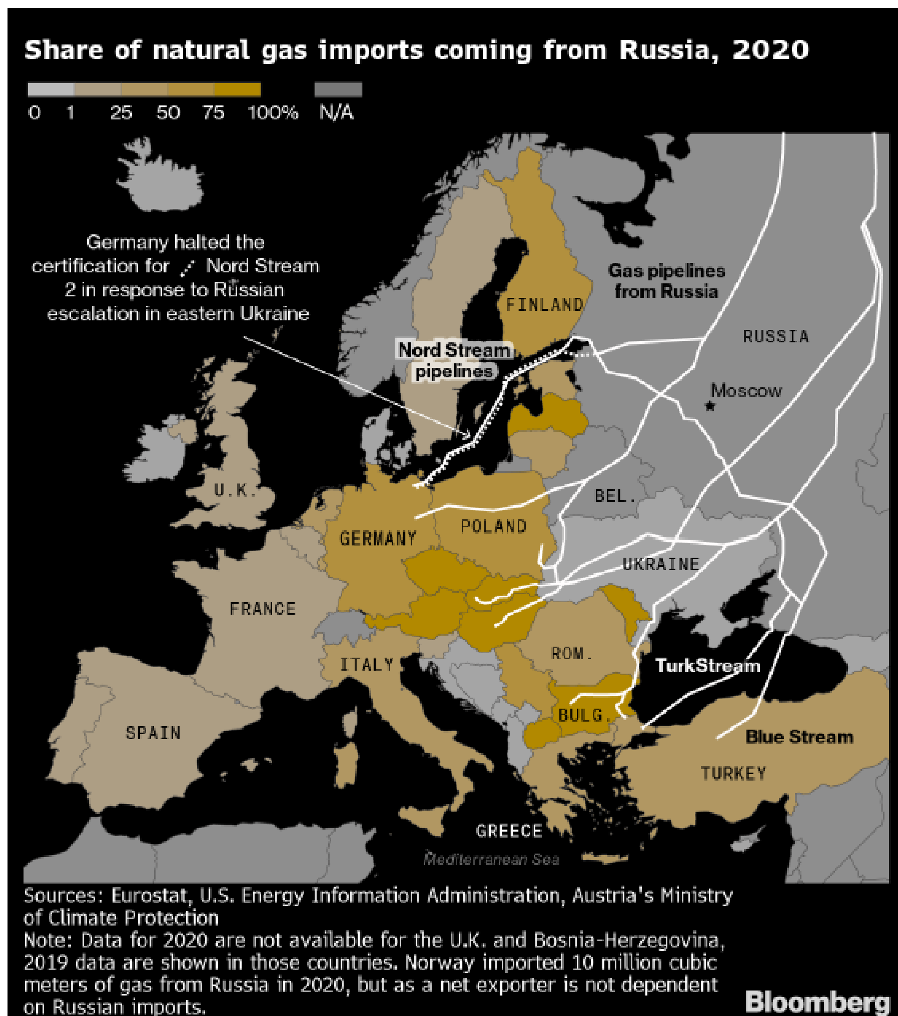
Recovery	Early Upswing	Late Upswing	Pre-Recessionary	Recession
• Stimulatory economic policies – easy monetary and fiscal policies • Confidence improves • Inflation falling	• Increasing confidence • Economic growth improving • Inflation remains low • Unemployment falling	• Boom mentality (chasing yield and growth at any price), irrationality • Inflation increasing • Policy becoming restrictive – tightening monetary and fiscal policy	• Confidence suddenly falls • Uncertainty • Inventory correction begins • Inflation continues to rise	• Confidence weak • Inflation peaks • Production falls (GDP) • Unemployment rises • Fiscal stimulus • Central bank stimulus

Market pulse				
• Short rates low or falling • Bond yields bottoming • Stock market rising • Commodities rising • Property prices bottoming	• Short rates are neutral • Bonds stable • Strong stock market • Strong commodities • Increasing property prices	• Short rates rising • Bond yield rise • Stock market topping out • Commodities rising strongly • Property prices rising strongly	• Short rates peak • Bond yields peak • Stock market starts falling • Commodities start falling • Property prices peak • Volatility rises (rapidly) • Credit markets showing signs of stress • Signs of panic and irrational behaviour • Yields invert	• Short rates drop • Bond yields drop • Stock market bottoming • Commodities weak • Property prices weak

Left field events

One of the main risks facing global markets is increasing geopolitical uncertainty. The Russia – Ukraine conflict has caused a seismic shift to energy and commodity prices which has impacted every economy globally. A further escalation in this conflict could add sustained pressures to energy prices, especially as we head into a Northern hemisphere winter when energy consumption increases.

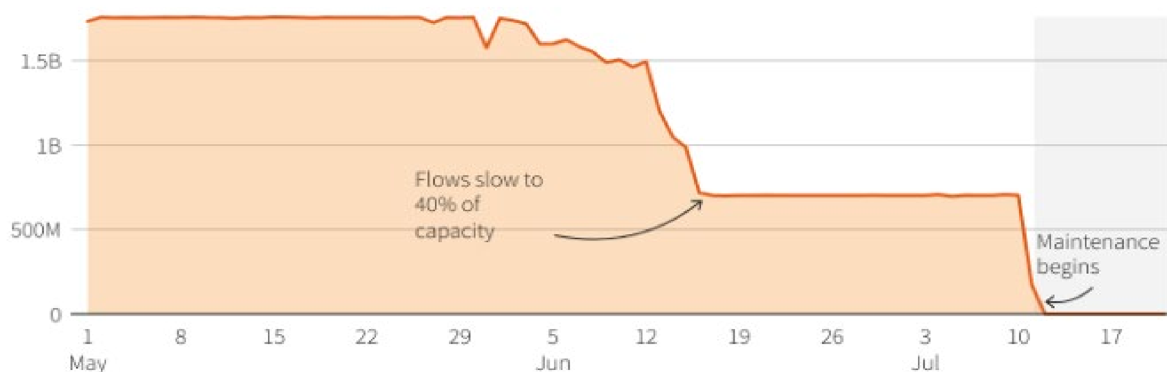
This week the biggest pipeline (Nord Stream 1) carrying Russian gas to Germany commenced annual maintenance, resulting in gas flows stopping for 10 days. Nord Stream 1 pipeline transports 55 billion cubic metres of gas annually to Germany. The risk is Russia suspends gas flows through Nord Stream 1 beyond the scheduled maintenance period in a tit-for-tat over Western sanctions due to the Ukrainian conflict.



Germany is now at stage two of a three-tier emergency gas plan. The next phase will be to ration fuel. If Russia stops gas flows, the impact on the German economy is expected to be 193 billion euros in the second half of 2022, putting it and the European economies into recession. The Euro Dollar in the last few days has traded below parity and if the above scenario unfolds could see lows of 0.85

A temporary stop?

The flow of gas from Russia to Germany through the Nord Stream 1 pipeline stopped on Monday for maintenance until July 21. The question now: Will it then resume? Flows, in kilowatt-hours per day.



Note: Figures from July 11 to July 21 are projections.
Source: Nord Stream AG
Reuters Graphics

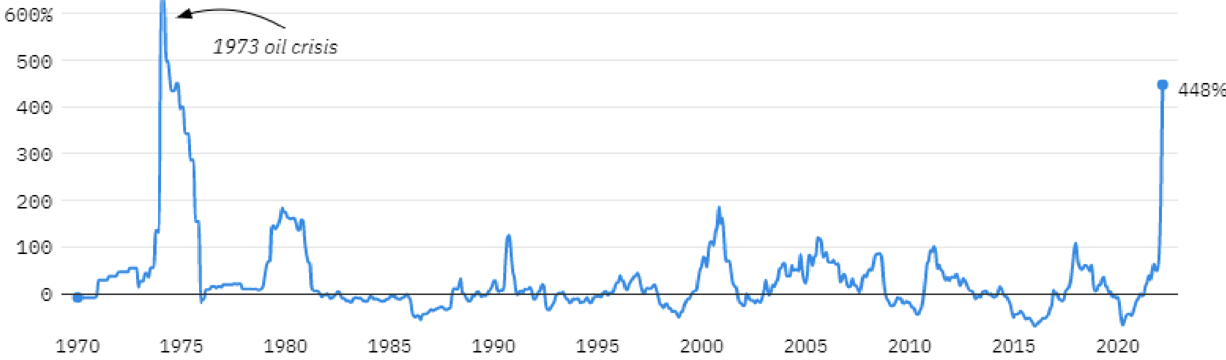
The war has delivered a shock to commodity prices

Commodity price growth, 2021–22

Commodity	Latest forecast	Pre-war forecast*
Fertilisers	+69%	+7%
Energy	+51%	+2%
Oils and meals	+30%	+0%
Base metals	+22%	−1%
Grains	+20%	−8%
Raw materials	+3%	−0%
Precious metals	+3%	−3%
Timber	−4%	+1%

*October 2021 Commodity Market Outlook
Source: World Bank

INVESTMENT MONITOR


The sharpest energy price rise in nearly half a century
Year-on-year energy price inflation, 1970–2022
600%
500
400
300
200
100
0
1973 oil crisis
448%
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
2020
Source: World Bank
INVESTMENT MONITOR

The way forward

For the moment, we maintain a cautiously optimistic view, maintaining the current cash weightings. We believe the second half of the year will present opportunities to keep building on long positions for our core investments at prices and valuations which will be attractive when viewed through a long-term lens. If we do enter a recessionary period or a sharp economic slowdown, expect Central Banks to pause and possibly reverse direction on QT (quantitative tightening). This may have a reversal effect to what is happening now, and growth assets may reinflate as funding costs go lower. Remember the old playbook from previous crisis? Markets react well the bad news, as it has resulted in Central Bank stimulus. For the moment the "Fed put" has been benched, but it may come back into play at some stage.

When we do reach peak inflation, which should not be far away, fixed income such as government bonds will be a good place to invest.

If there is one take home message we can give you, it is to stay calm, focused and above all be patient.

As always please feel free to reach out to us for further discussion or comment.

NAV

BRETT

Disclaimer

The contents of this communication is prepared by Brerona Capital Asset Management Pty Ltd (A.C.N. 627 650 293; AFSL 520526). The information contained in this communication is general in nature and does not take into consideration any investors personal objectives, goals, needs and financial situation. You should not rely on the information contained in this document to make any investment decisions without first consulting an investment professional such as your financial adviser. Any unauthorised use of this document is prohibited. This document (including any attachments) is intended only for the addressee, it may contain information of a privileged and confidential nature. If you are not the addressee of this communication, you must not copy, reproduce, disseminate or use this email and its contents. If this communication has been received in error by you, please inform us immediately and securely delete. Sharing, transmitting, copying, disseminating all or part of the contents of this document may result in a breach of the Federal Privacy Legislation and or copyright and trademark infringement of Brerona Capital Asset Management Pty Ltd and its related entities.