BAIOCCHI GRIFFIN
PRIVATE WEALTH

Summer 2022
Issue 37

POINTS OF **INTEREST**

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we review some of the major issues which confronted financial markets during 2021 and consider what the year ahead may hold for markets.

EXECUTIVE SUMMARY

- 2021 proved to be another year of uncertainty, dominated again by the impact of the pandemic
- A blowout in global debt, surging house prices and supply chain constraints were just a few of the issues which arose during the year
- Looking ahead, we see increasing interest rates as being the most significant factor for 2022, while stock markets may underperform following two years of strong growth

Looking backwards, looking forwards

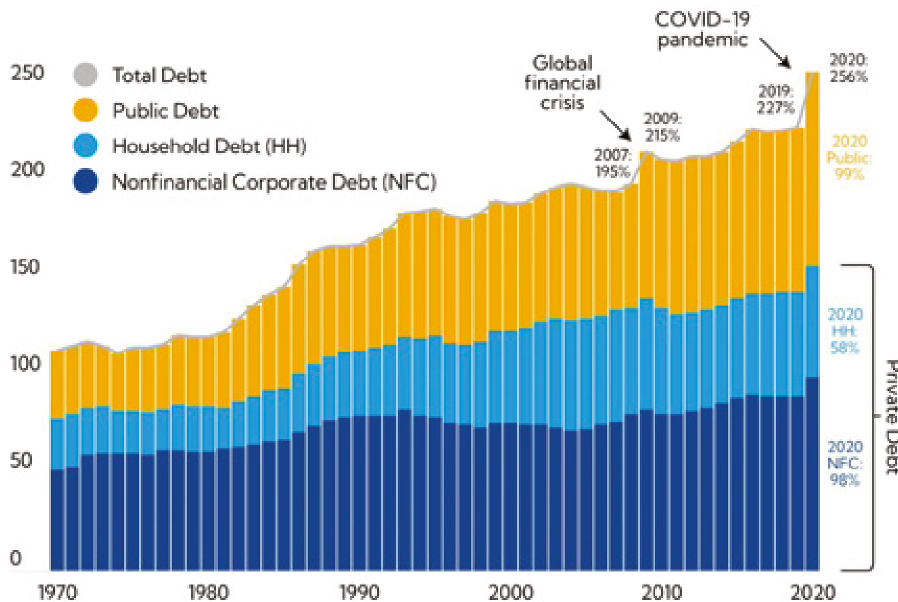
The start of a new year is always a good opportunity to look back over events of the previous year (not that 2021 is likely to be a year many will remember with fondness) and also consider possibilities for the year ahead. While hindsight is always perfect, predicting the future is more challenging, and we profess to be no better than others at guessing what may transpire over the next 12 months. That said, there are a number of clear factors which look likely to impact financial markets during 2022 and we discuss a number of these in this edition of ***Points of Interest***.

When reviewing the major events and influences during 2021, one is tempted to simply cut and paste the discussion from the edition of ***Points of Interest*** we produced in January 2021. After all, was there any real difference between 2020 and 2021? In 2020, for example, the top 3 talking points, ranked in importance, were Covid, Covid and Covid. In 2021 on the other hand, the top 3 talking points were Covid, Covid and Covid. There's also the fact that after nearly two years of pandemic-related news and events, most people are probably suffering a significant level of pandemic-associated information fatigue. Daily case numbers, testing rates, available ICU beds, test result wait times…at the office water cooler, sports, politics and the weather has made way for a daily discussion of the latest Covid news and numbers. The Novak Djokovic visa saga, as ridiculous and trivial as it was, was almost a welcome relief from the daily grind of Covid stories.

When all is said and done however, it's clear that, nearly two years later, the world is still under the thrall of the pandemic. From a financial perspective, the most significant (and ongoing) impact has been the high level of government spending on a global scale, coupled with central bank intervention to keep interest rates at historically low levels. While most governments attempted to limit their financial support during 2021, repeated lockdowns still led to a situation where governments had little choice but to keep the money flowing. The figures for 2021 are not yet available, however during 2020 total global debt increased by 28 percentage points to 256 percent of global GDP, and of that increase half was attributable to increased government debt. By the end of 2020 total global debt was around US$226 trillion and was expected to soon reach US$300 trillion. To put that figure into perspective, it represents around US$37,500 for every man, woman and child on the planet.

Historic highs

In 2020, global debt experienced the largest surge in 50 years.
(dept as a percent of GDP)

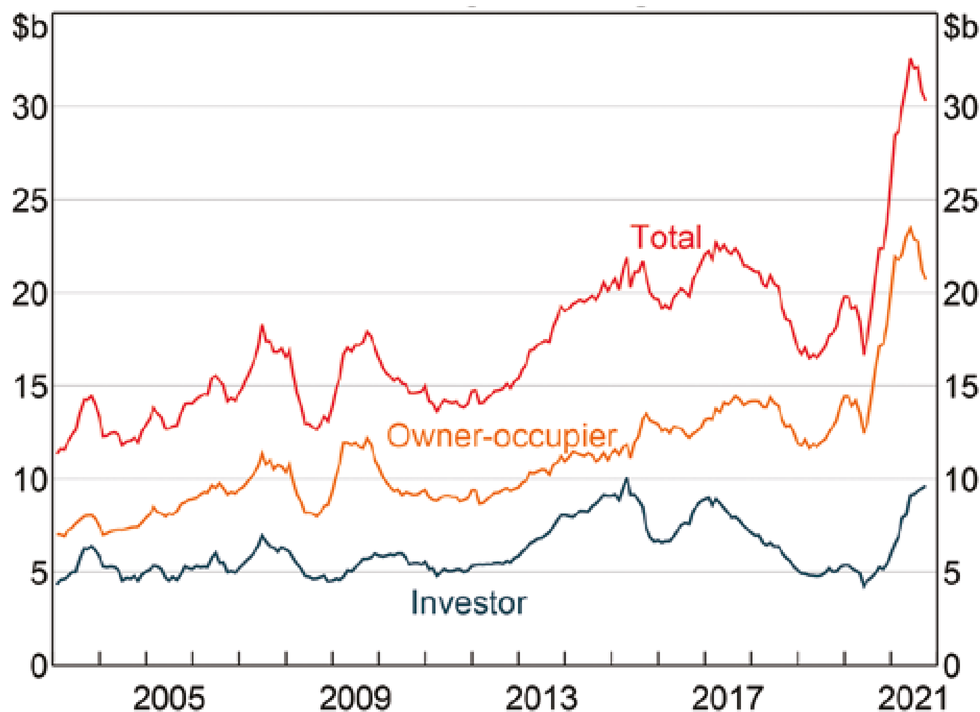


Sources: IMF Global Debt Database and IMF staff calculations.
Note: The estimated ratios of global debt to GDP are weighted by each country's GDP in US dollars.

IMF

The question of how much debt is too much is an interesting one. A common conspiracy theory back in the global financial crisis, was that debt levels had reached a peak and a 'global debt reset' was imminent. In this irrational hypothesis, all debt was to be swept away and 'reset', a theory which conveniently ignores the fact that what is one person's debt is another person's asset. However, we digress. In truth, the total global level of debt is largely irrelevant - it is much more important at an individual country, company or household level. From an Australian perspective, despite a blow-out in spending at both state and federal levels, government debt is not really a major concern. Fortunately, Australia started from a relative position of strength prior to the pandemic, notwithstanding the increase in debt associated with the GFC (pink batts, school halls etc.).

The increase in Australian household debt during the past year is more concerning however, as households typically lack the ability to simply raise revenue through new or higher taxes. The problem is simple and readily understood: very low interest rates (as we have at present), encourage borrowers to borrow larger amounts than they would otherwise be able to afford. Should interest rates rise, at some point borrowers are unable to meet their loan requirements and must either sell or default on their loans. For many years the high level of household debt (most of which is associated with housing) has been of concern, however the prevailing downward trend in interest rates over the past 30 years or so has protected households from their high levels of debt. Given that interest rates are effectively at 0% and can only go up, this may not always be the case. The sharp increase in mortgage commitments over 2020/21 is clearly evident in the following chart.

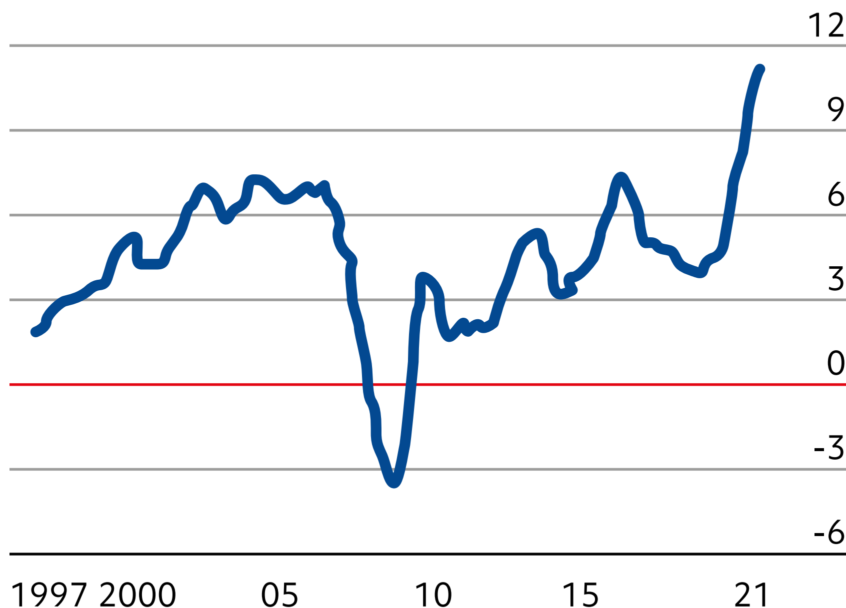


Interest rates are likely to be one of the major influences on financial markets during 2022. At this stage there is almost no doubt (barring some unforeseen event) that interest rates across the globe will increase this year. The US Federal Reserve, which effectively sets global monetary policy, is expected to increase interest rates at least three times this year, albeit that each increase is likely to be relatively small given the starting point (essentially 0.00%). To a large extent financial markets have already taken these expected rate changes into account, as evidenced by weakness in global equity markets generally, but more specifically in sectors that are considered vulnerable to higher interest rates.

Chief among these is the technology sector, where fast-growing but unprofitable tech companies tend to move inversely to interest rates (when interest rates fall, their share prices go up and vice versa when interest rates rise). The clearest indication of this phenomenon is a comparison of the Dow Jones Index versus the Nasdaq Index. Since mid-November 2021, the Nasdaq, which is dominated by tech companies such as Apple, Amazon, Microsoft and Facebook, has fallen by over 5% in value, while the Dow Jones Index (which has significantly lower tech exposure) is up around 1% over the same period. We expect this relationship to continue to play out over the coming year.

House prices, up, up and away…

Another defining feature of 2021 was the continued rise of house prices. Interestingly this is not a purely Australian phenomenon, with significant house price growth in nearly every major economy. While Byron Bay made the news here with a 58% increase in house prices last year, in New Zealand for example, house prices increased on average by 24%. While on the other side of the world, in the town of Halifax in Nova Scotia, Canada, house prices increased by nearly 50% over the same period.



Reasons for the rapid increase in house prices are varied, ranging from low interest rates, excess savings, and overseas travel restrictions, to supply constraints and the 'cocooning effect' (a desire to upgrade due to spending more time at home during the pandemic). While the ongoing impact of the pandemic is difficult to predict, it is likely that at least some of these factors will cease to contribute to rising house prices over the coming year. As a result, we tend to agree with the general consensus that house price growth during 2022 is likely to be flat, if not negative in certain markets.

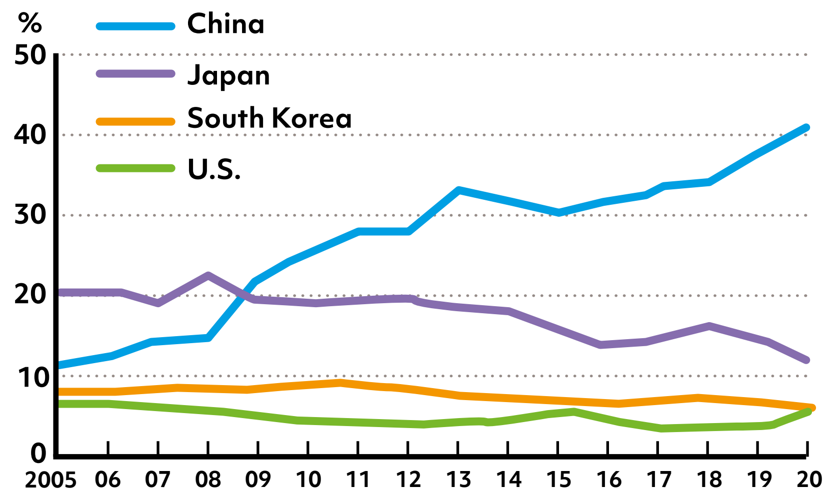
Linked to the overall issue of interest rates and their likely impact on financial conditions over the coming twelve months, is the issue of inflation. This is something we have covered in detail in past editions, so will not do so in depth here again. However, it is apparent that there is still as yet no clear answer to the question of whether current inflationary pressures are temporary or permanent. The distinction is important as a period of sustained higher inflation can only be managed through higher interest rates, with negative consequences for asset prices generally.

Geo-political tensions

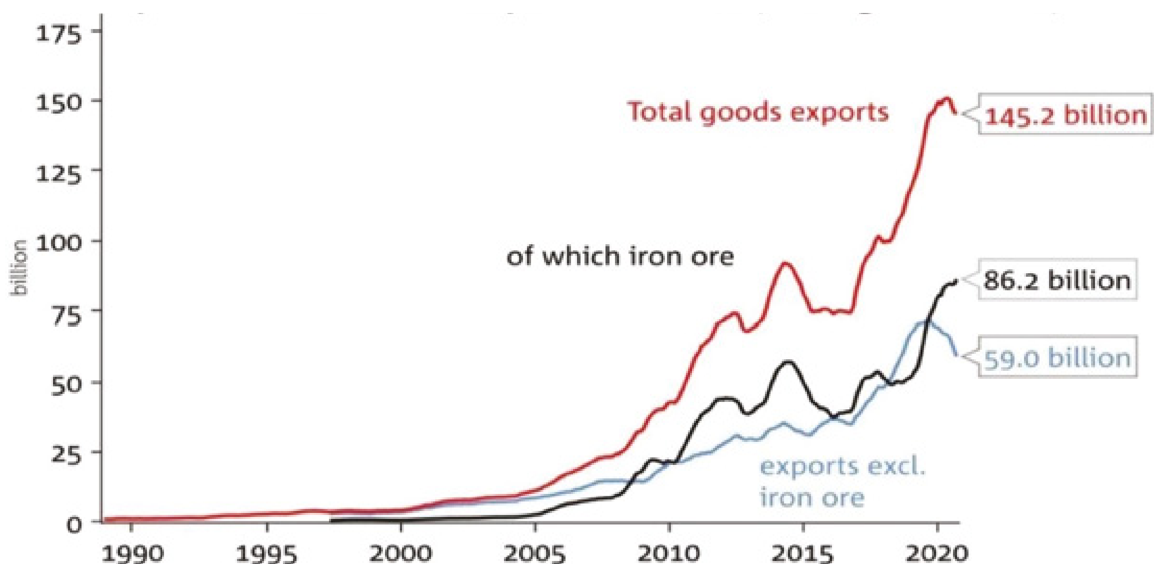
Almost forgotten in the day-to-day focus on the pandemic are ongoing geo-political developments. While not strictly finance related, geo-political events can impact financial markets, unfortunately usually with negative consequences.

From an Australian perspective, the most serious issue remains the relationship with China. While we are not privy to backroom diplomatic discussions, it seems evident that there has been little or no improvement in the relationship between China and Australia at diplomatic levels. This has translated into ongoing difficulties in relation to trade, where both countries exist in a mutually dependant relationship. China's primary weakness is a dependence on Australian mineral resources, although this also poses problems for Australia, where many companies (and indeed entire sectors of the economy) are reliant on China as the sole source of demand for their products.

The reliance on China is illustrated in the following chart, showing how over 40% of Australia's exports are to China alone, while exports to other major markets have declined as exports to China have grown.



The industry most exposed to China is iron ore mining, which is a victim of its own success. The ability to provide immense quantities of quality ore at low prices has led to a situation where the industry is captive to the Chinese market. Indeed, so successful is the iron ore industry, that over 50% of Australian exports to China are solely iron ore exports, as shown below.



Our main concern in relation to China and iron ore are the apparent long-term plans by China to reduce its reliance on iron ore imports from Australia. In the short term, these plans principally revolve around an increase in scrap recycling and local iron ore mining, while longer term plans focus on cultivating alternative supply sources in Africa and South America. While there is no certainty that these plans will come to fruition, even if they are only partly successful there will be a significant impact on the fortunes of Australian iron ore miners, and principally on BHP, Rio Tinto and Fortescue. For now, the stock market seems willing to look past the longer-term risks to current windfall mining profits, however we view the sector with a far greater level of concern.

Russia, Ukraine, China and Taiwan

Of less obvious concern to financial markets is the possibility of some form of military conflict involving Russia/Ukraine and China/Taiwan. A discussion of these matters is largely outside the scope of this newsletter; however, it behoves us to remain alert to the risks and the potential impact on markets. A popular view is that Russia and/or China may take advantage of the West's preoccupation with Covid to resolve their long-standing disputes with Ukraine and Taiwan respectively. While it is not possible to invest in anticipation of such an event (or otherwise), the possibility of an escalation in geo-political tensions in this regard is perhaps another piece of the puzzle in relation to formulating an investment strategy as we enter 2022.

The stock market during 2021

In regard to the performance of the stock market over the past twelve months, it is probably best described as a year of two halves. The first six months of the year saw a continuation of the recovery from the pandemic induced falls of early 2020. To a certain extent this recovery was warranted, given that much of the developed world appeared to be on track in regard to managing the pandemic and restarting their economies.

Unfortunately, as we are by now painfully aware, both the global and domestic recovery was derailed mid-year initially by Delta and later in 2021 by Omicron. This caused financial markets to stall, as investors assessed the longer-term impact on global growth caused by the newer and more contagious Covid variants.

Although the benchmark ASX All Ords Index managed a respectable gain over the calendar year, increasing by 928 points, or 13.56%, the majority of this was achieved in the first seven months or so. The index peaked at 7,897 points on the 13th of August and finished the year 118 points lower at 7,779.

In terms of the outlook for 2022, it's fair to say that uncertainty remains elevated and potential returns over the next 12 months are anyone's guess. That said, certain key factors appear evident. Rising interest rates (or even the prospect of a rise in future rates) are likely to weigh heavily on markets. Similarly, another wave (or two) of Covid, similar to the 2021 experience, would also negatively impact markets. The other issue is that when considered by most traditional metrics, the stock market as a whole is relatively expensive, with many share prices near record highs, or at least significantly higher than pre-Covid. Further confusing the issue is that company earnings are still skewed by the pandemic, with certain sectors and industries (online retailers and medical equipment manufacturers, just to name two) continuing to benefit from the pandemic, while others such as travel, tourism and many service-related industries continue to be negatively impacted by the pandemic.

On the other hand, a more optimistic view of potential returns over 2022 would include the fact that a (relatively) widespread global vaccination program may bring about the end (or perhaps the beginning of the end) of the pandemic, which would certainly provide a positive boost to global economic activity. Such an outcome may also assist in solving the world's current supply chain issues, which have been an important factor in driving up inflation over the past year and a half (although supply constraints are not solely responsible in that regard). There is also the possibility that market concerns over the prospect of higher interest rates are an over-reaction. While interest rates may go up, any such increases are likely to be small and gradual. We are certainly not heading back to the days of late 1989 any time soon, where home loan rates in Australia peaked at 17%. The RBA will attempt to manage both rate hikes and expectations to the point where little disruption is caused in the ability of both business and households to meet their loan obligations. The real risk is if the RBA is forced to increase rates sharply over a short period of time, leaving the economy little time to adjust.

It's also important to remember that the 'normalisation' of interest rates, where they are moved away from emergency levels, is an important part of the monetary process. The dilemma confronting central banks is that keeping interest rates too low leaves them no room to adjust at some future date, if required. That is, if interest rates are already close to zero percent, how does a central bank respond to the next economic shock? Although it does sound counterintuitive, central banks need to increase interest rates from their current low level if only to have the capacity to cut them again when needed.

Given the high level of general uncertainty regarding economic growth, interest rates and the pandemic, and including the usual potential issues which confront financial markets, it's reasonable to conclude that our expectations for market returns over the coming year are modest. At the very least, strong market growth since April 2020 has left the market vulnerable to a negative shock, the source of which could be any one of the factors we have discussed in this newsletter.

Justin Baiocchi

Ray Griffin

Michelle Higgerson

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us. We trust that you and your families remain safe and healthy in these uncertain times.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	3.0% (Sep)	-0.08%
Australian unemployment rate	4.6% (Sep)	-0.6%
RBA Cash rate	0.10% (Dec meeting)	flat
ASX 200 Index	7,444	-185 points
Australian $ vs. US $	$0.7256	+0.05c
Australian $ vs. UK £	$0.5376	+0.15c
Australian $ vs. Euro €	$0.6411	+1.96c

This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.

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