



# POINTS OF INTEREST

**W**elcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we review the general economic situation and the performance of the stock market, which suffered one of the worst quarters in recent memory, as stock markets around the world reacted negatively to rising global interest rates.

## EXECUTIVE SUMMARY

- The combination of rising interest rates and even faster increases in inflation resulted in the worst quarterly performance for the stock market for many years
- Not since 1970, has the US stock market fallen as heavily over a six-month period as it has done since the start of 2022
- Unfortunately, we expect the current market volatility to persist for perhaps six to twelve months, until there is greater clarity regarding the future direction of interest rates

## Six months to forget

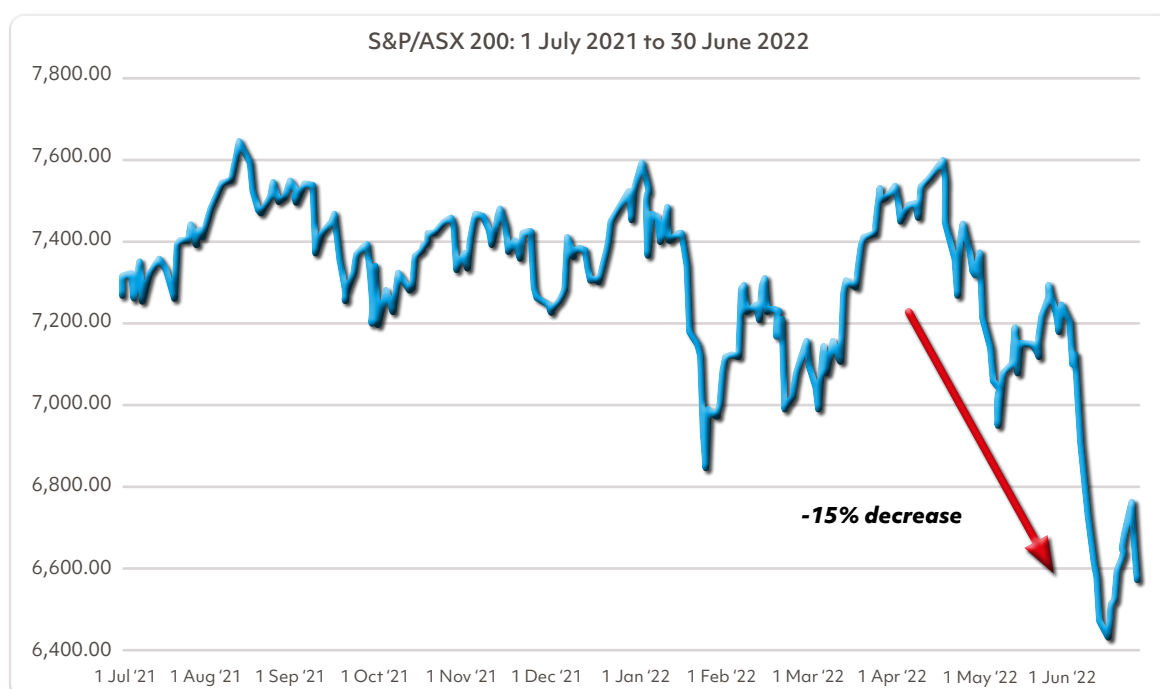
When writing our quarterly newsletters, the first step is to review past editions. How did we do? Was our interpretation of the financial situation accurate? Were we able to accurately predict (usually an almost impossible task) the future course of events? A quick look shows that, if anything, the cautious and pessimistic tone we struck in our December 2021 newsletter proved to be overly optimistic, as markets around the world fell heavily in the first six months of 2022.

Page 9 of our December 2021 newsletter included this comment: *"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..."*

In the event, calling future returns 'modest' proved to be an understatement as stock markets around the world started falling in early January and continued this trend through to the end of June. For the record, the performance of the benchmark S&P/ASX 200 Index is shown below, covering the last twelve months, the last six months, and the most recent quarter:

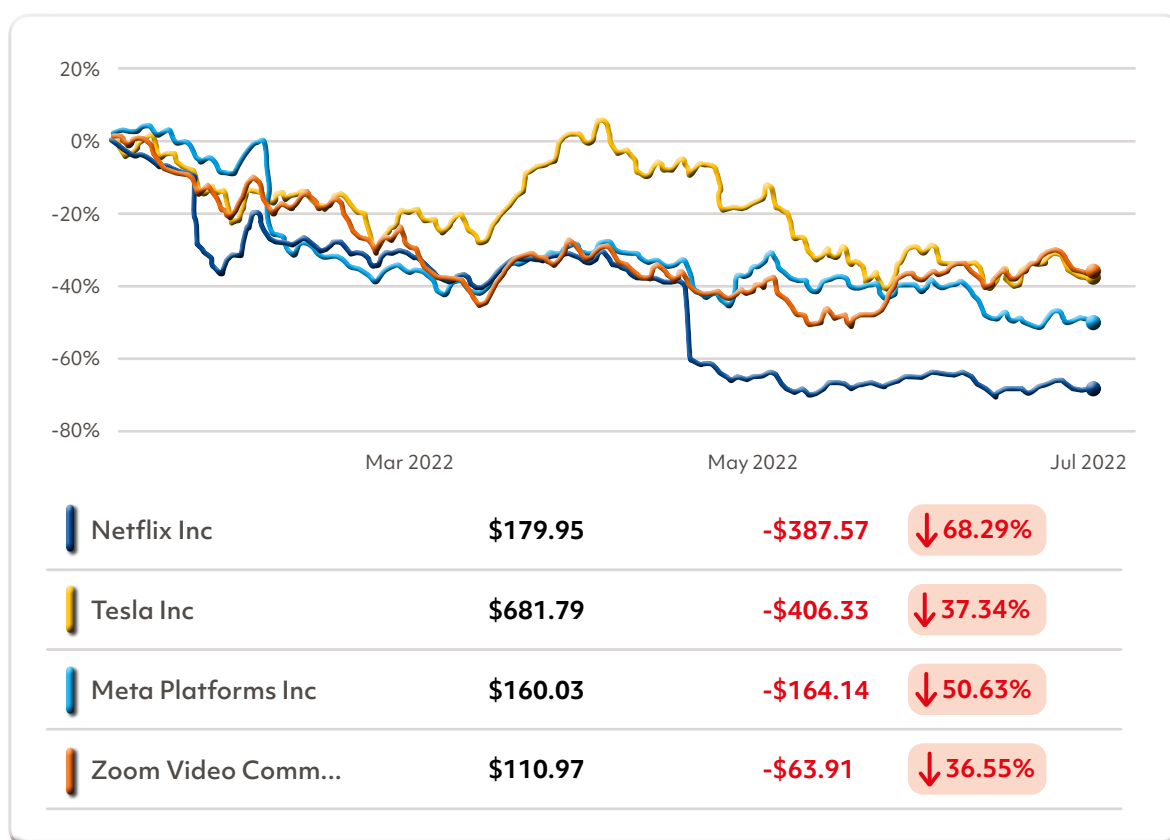
S&P/ASX 200 Index Performance	
1 July 2021 to 30 June 2022 (1 year)	-10.19%
1 January 2022 to 30 June 2022 (6 months)	-11.77%
1 April 2022 to 30 June 2022 (3 months)	-12.42%

A more meaningful representation of the performance of the Australian stock market is the chart of the index over the 12 months ended 30 June 2022, which is shown below.



As can be seen in the chart, the stock market moved sideways for the second half of calendar 2021, trading in a relatively narrow range. This continued until the end of year before the market initially fell sharply in January 2022, as concerns over inflation and interest rates became more prominent. A recovery during February and March saw the market almost regain its previous high, however, in mid-April the market began a precipitous decline, culminating in the fall of just under 12.50% over the June quarter.

While it's likely of little comfort to investors, and it may seem difficult to believe, but the Australian stock market was one of the world's better performing markets over the past six months. In the United States for example, the benchmark S&P 500 Index fell by over 20% in the first six months of 2022. To find the last time the US stock market recorded a worse performance, one must go back to 1970 – in essence, as far as US investors were concerned, the past six months was the worst for investors in 52 years, which certainly puts the decline into perspective. For investors in the tech-focused NASDAQ, the fall was even worse, with the index falling by 30% over the six-month period. These falls were led by some of the previously high-flying technology stocks, which gave up much of their gains made during 2020 and 2021. The graphic below shows a small selection of these, including popular companies such as Netflix (-68% return), Tesla (-37%) and Facebook (these days called Meta, with a -50% return).



For those investors who were happy to gamble with their savings in 'investments' such as Bitcoin and other cryptocurrencies, returns were equally poor, with Bitcoin falling by over 60% since January 2022, and many other cryptocurrencies performing even worse.

A feature of the market volatility was that no sector, apart from oil and gas, was spared. It made little difference if a company was a bank, supermarket, insurer, retailer or a healthcare business – all suffered over the past six months. Sanctions on Russia, in retaliation for their invasion of Ukraine, helped push up global oil and gas prices, which as mentioned, turned out to be the only bright spot for investors.

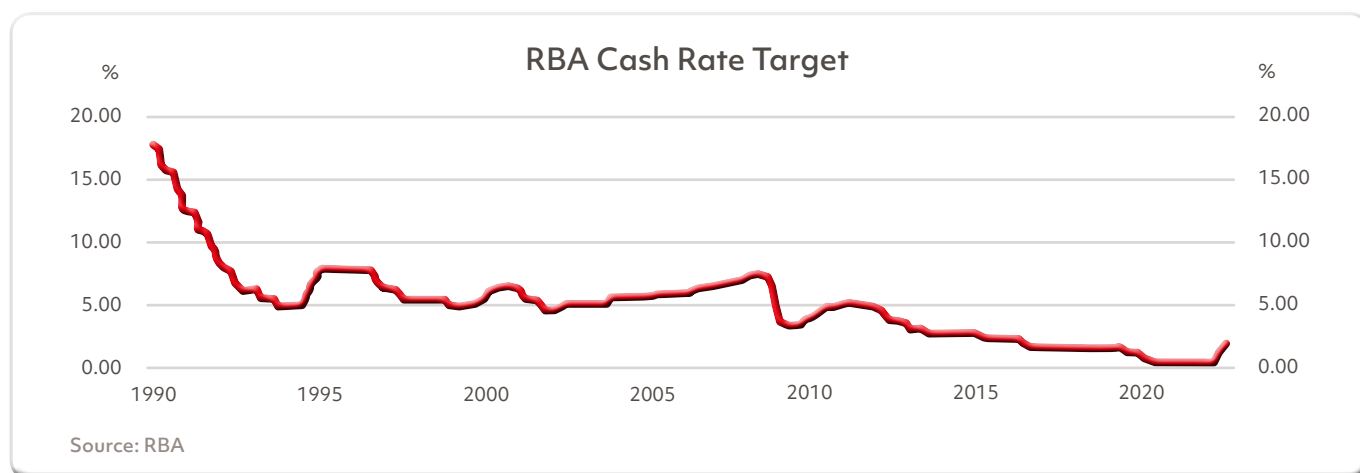
In searching for a reason behind the falls, investors need go no further than the issues identified in our March 2022 newsletter (and online presentation published in May) – interest rates and inflation. As is by now well-known, the rate of inflation has increased considerably over the past six months. While inflation had actually started to increase in the second half of 2021, the prevailing view at the time was that it was most likely a temporary phenomenon, brought about by most of the world ending the lockdowns and shutdowns deemed necessary to combat Covid. It was logical that the pent-up demand for goods and services would result in what was expected to be a short-term increase in prices. In the opinion of most economists and central bankers, the inflationary spike was expected to be ‘transitory’, a word much used in the second half of 2021. As we now know however, inflation did not slow as expected and was made worse by the decision by Russia to invade Ukraine.

Possibly the single most important factor which has a bearing on inflation, at least in the short to medium term, is the oil price. It’s not hard to see why when one considers that an increase in oil prices, and thus petrol prices, imposes extra costs on nearly every activity – extra costs which must then be recouped if possible. Think of every item in a supermarket, for example. It may have been shipped or flown in from a foreign country, a cost directly impacted by the oil price. It would have then been trucked to your local store, a cost also impacted by the oil price. The cumulative effect of this increase in transportation costs is eventually outed at the supermarket till, a pattern repeated throughout the economy. Higher oil prices are not solely to blame however, the congestion of the global supply chain as a result of the Covid pandemic has also led to upward pressure on prices. Locally, flooding along the east coast of Australia has also led to rising food costs and logistical problems.

While an increase in prices in this manner is not necessarily a problem in itself (after all, eventually oil prices will fall as increased supply meets falling demand), problems start to arise where society in general (but workers specifically) begin to believe that higher prices are here to stay. As a result, employees begin to factor in permanently higher living costs into their wage demands, leading to agitation for higher wages (witness the recent strikes by teachers, nurses and transportation workers). This process soon becomes self-reinforcing: demands by workers for higher wages leads to increased prices for goods and services as businesses look to protect their margins, which leads to higher inflation, which leads to higher wage demands and on it goes.

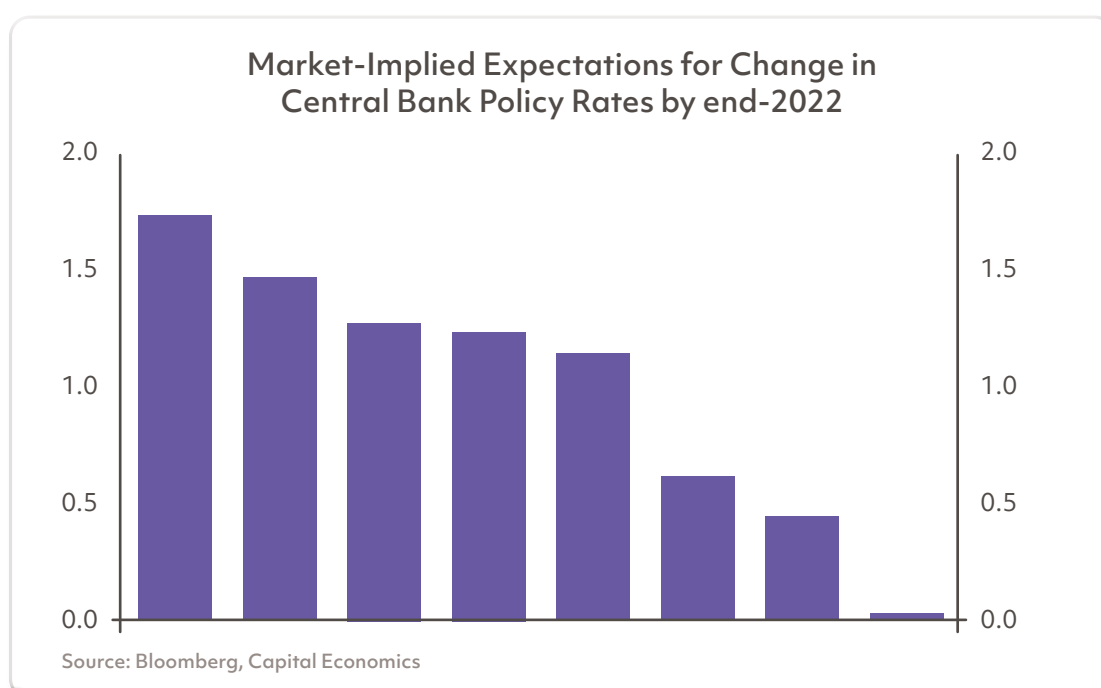
It is this nexus that the Reserve Bank seeks to interrupt with its series of interest rate hikes. In effect the RBA is trying to send a message to the public – we will stop inflation by raising interest rates, so don’t start (or keep) believing that prices will keep rising. The problem is that it appears that this message is either too late or it is simply not being believed by workers. It is at this point that the inflation problem stops being transitory and becomes more permanent.

The RBA’s determination to bring down the inflation has manifested itself in three consecutive monthly interest rate hikes: 0.25% in May, and 0.50% in both June and July. This change in monetary policy is shown in the following chart, which depicts the RBA cash rate since 1990:



While the actual interest rate is still low on a historical basis, it is not so much the absolute level of interest rates, as much as the rate of change which matters. In essence, the cost of money is now 13 times more expensive than prior to the RBA's actions. If a mortgage holder could have borrowed at the RBA cash rate (which is impossible of course, but will suffice for this example), a \$1m mortgage would have incurred an interest bill of \$1,000 per year. Only three months later, that same mortgage would cost \$13,500 per year. Still a relatively low nominal amount, however the interest bill is now thirteen times greater than before.

With regard to increasing interest rates, Australia is not unique. High inflation is a global phenomenon, with almost no country spared the impact. As a result, interest rates have been increasing at a similar rate in most developed economies. The chart below illustrates the expected increase in interest rates for a number of countries during the course of 2022. These data points were sourced in February 2022 and already it is clear that market expectations have been significantly below actual outcomes. It was expected that interest rates would increase by 1.15% in Australia during calendar 2022, while the actual increase is 1.25% only seven months into the year. The general consensus among economists is that interest rates will go no higher than around 3.00%, although as with many things, this is just a matter of opinion.



Interestingly, the bond market expects that interest rate increases will stop by April 2023, at which point they are expected to gradually decline. The reasoning behind this expectation is that the bond market expects the past and future rate hikes to slow the economy to the point where the RBA will be required to reverse course and begin cutting rates in order to stimulate economic growth. This risk is particularly elevated if the RBA increases interest rates beyond the level where they are required to combat inflation – an outcome that is all too easily achieved due to the fact that any change in interest rates takes time to have an impact on the economy. Central Banks around the world (including the RBA) are often guilty of misreading the direction of the economy and either keeping their foot on its neck too long, or as we saw last year, continuing to spike the punchbowl when the party was already well underway.

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## The outlook for the remainder of the year

If we accept that interest rates in Australia will continue to increase throughout the remainder of the year, potentially ending the year at around 3.00% or so, what are the likely implications for the economy, the stock market and the housing market?

First, however, it's worth considering whether or not interest rates will follow the trajectory expected by the bond market. Is there a risk that interest rates end up at a higher level than 3.00%? In our view, this is a high probability outcome. This view is based on the very simple assessment that the inflation problem in Australia is not primarily driven by the domestic situation. That is, while the Australian economy is growing at a reasonable rate and unemployment is low, it would be inaccurate to describe the economy as booming. Rather, a significant proportion of the inflation problem is being driven by events outside Australia, specifically high oil prices and supply chain issues. Yes, domestic demand for goods and services may be currently slightly elevated as a result of the relaxation of Covid- related restrictions, however this is almost certainly outweighed by international factors. In economist-speak, rising prices are mostly a supply-side crunch, not a domestic demand boom.

Under these conditions, the RBA can increase interest rates as high as they wish, but there is little chance that those rate hikes are going to bring down the global oil price or fix the global supply chain constraints. This increases the risk that inflation does not respond as readily as expected (or as readily as it has done in the past) to interest rate hikes and the RBA reacts in the only way it can, by pushing interest rates even higher (it's like the old saying, when the only tool you have is a hammer, everything looks like a nail).

In regard to the expected impact on the housing market, one needs only read the newspaper headlines. Here are just a few:

### **Aussie house prices could fall more than 30pc**

New research shows that house prices could fall more than 30 per cent if the Reserve bank of Australia meets the market's interest rate expectations.

Source: Australian Financial Review, 17 June 2022



## **Deutsche Bank forecasts house prices to tumble 15 per cent, biggest fall in 50 years**

Australia's housing market is on track for a 15 per cent year-on-year fall, the weakest performance in more than fifty years, says Deutsche Bank.

Source: The Australian, 1 July 2022

## **House prices are falling, but buyer beware of holding out for a better deal**

Some property buyers are putting off their purchase, banking on finding a cheaper home later this year, but experts warn trying to pick the bottom of the market has risks.

Source: The Sydney Morning Herald, 23 June 2022

## **Buyers and sellers buckle up for the biggest correction in 40 years**

A glut of unsold homes in Sydney and Melbourne is forcing vendors to discount their asking prices and creating bargains for buyers willing to take the risk of prices falling further, as the largest housing market correction in at least 40 years accelerates.

Source: Australian Financial Review, 8 July 2022

Interestingly, the negative media over the future direction of house prices can make the situation even worse. Supposedly forewarned regarding lower future prices, potential buyers may delay a house purchase or offer lower amounts, thereby bringing about the future declines so breathlessly forecast in the national media.

Unfortunately, the outlook for the stock market for the remainder of the year is not necessarily any better. In our view, the current market weakness is being driven by the uncertainty associated with rising interest rates – how high will they go and how quickly will they reach their peak? Will interest rates cap out at around 3% as is widely predicted, or will they go higher? Will they continue to increase at half a percent each month, or will the rate of increase accelerate even further (or perhaps slow)? It is the uncertainty associated with these key questions which has put downward pressure on the market, and we expect this weakness to continue until there is some clarity regarding the extent of the current interest rate cycle. It may be that inflation begins to slow significantly in the second half of 2022, in which case the market may feel comfortable with the interest rate outlook and begin to recover. Regardless of the exact timing, we still believe that it could be six to twelve months away before we see a meaningful recovery.

That said, the exact timing of the recovery also depends on other unknown factors. How does the conflict in Ukraine play out? Is the US likely to enter recession next year, as is widely predicted? And if so, does Australia follow suit? And then of course there is the pandemic – with around 40,000 new cases per day in Australia at the moment, it's clear that there is still an ongoing impact in regard to issues such as staffing, logistics and general workforce productivity.

We end this section with a look at the long-term trend of the stock market. The image below shows the All Ordinaries Index from around mid-2005 to June 2022. The two red lines are trend lines showing the average annual increase of the market over the past 40 years or so. Broadly speaking, when the market (the blue line) is above the top red line, it is deemed to be approaching 'expensive' levels, as it has broken out of the 40-year trend; and similarly, when the market is below the bottom red line it can be said to be 'cheap'. You can clearly see on the chart the pre-GFC high (then fall) and the sudden market collapse in 2020 with the arrival of Covid.



The intent of this chart is to show that at current levels, the stock market can be viewed as 'fairly valued' – that is, it is right in line with the long-term trend and neither 'expensive' nor 'cheap'. This suggests that, while further falls are still possible, any such falls may be seen as potential long-term investment opportunities.

We conclude this edition of our quarterly newsletter with a discussion regarding estate planning. For many of us this is a boring topic – make a Will, stick it in the bottom drawer and forget about it. However, this approach severely misjudges the importance of a well-considered Estate Planning Plan.



## Estate planning and why it matters

Estate planning is an important part of the wider financial planning discipline. In this section we look at the two most common estate planning tools, why they are necessary, and the circumstances that would warrant their review.

The first key estate planning tool is a valid Will. A Will specifies how property is to be dealt with after a person's death and provides directions about who is responsible for distributing an estate's assets (the executor/s) and to whom. If a person dies without a valid Will, the estate will be distributed in accordance with the relevant state's intestacy laws, which prescribe the order of persons who will share and the extent that they benefit. Intestacy laws are unlikely to precisely match the deceased's wishes and dying without a valid Will, or one that is outdated, may result in the distribution of assets in a way that was not intended.

The second key estate planning tool is a Power of Attorney (POA), which is a legal instrument that authorises another person to act on your behalf. Under a POA, the attorney can sign legal documents, buy and sell property, invest and enter into contracts on behalf of the donor (i.e., the person delegating the power), making it an important estate planning tool, but also one that must be appointed carefully. One person may be nominated as the attorney, or multiple people under the instruction of acting either jointly or independently of one another.

In general, there are two types of POAs; general and Enduring. A general POA authorises the attorney to stand in your place and make any financial and legal decisions for you, and it remains in force until it is either revoked, or you become mentally incompetent. An Enduring POA grants the same extensive powers as a general POA, however, the most significant difference is that the arrangement remains in force even if you lose mental capacity. That is, your attorney can continue to act on your behalf when you are no longer able to manage your affairs yourself (for example, if you are suffering from dementia). For this reason, an Enduring POA is the preferred arrangement over a general POA. Somewhat ironically, the key to establishing an Enduring POA is to do so whilst you are healthy and capable of managing your own affairs, as you must be mentally competent to establish or update a POA; it is not possible to implement a POA arrangement once cognitive decline commences, which is often the point at which an Enduring POA becomes most required.

It is important that your estate planning arrangements are reviewed regularly, and while the definition of 'regularly' will differ for everyone, generally speaking, reviewing the documents every three to five years is considered sufficient. A review can be as simple as pulling the documents out of their safe-keeping place and reading them over – in most cases any changes or the involvement of a solicitor won't be necessary. Key life events that would warrant a review (and potentially an update) include, but are not limited to, a change in your relationship status, the establishment of an SMSF (as only Enduring POAs can act on behalf of SMSF members), the provision of lump sum amounts to children (perhaps in the form of a 'loan' which we all know is unlikely to be repaid), an interstate relocation (as the laws regulating estate planning are state based) or a change in the circumstances of your executor or Attorney that would impact their ability to fulfil their role (such as their death or loss of mental capacity). Ensuring your estate planning arrangements are not only valid but also current will help ensure that your wishes are followed, both during your lifetime and after.

The key takeaway from this section is, if you don't have a Will or Enduring Power of Attorney in place, see a solicitor as soon as possible. And if you do, but haven't reviewed them for many years, make sure they are still fit for purpose.



BAIOCCHI GRIFFIN  
PRIVATE WEALTH



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)	5.1% (Mar)	+0.6%
Australian unemployment rate	3.50% (Jun)	-0.5%
RBA Cash rate	1.35% (Jul 2022 meeting)	+1.25%
ASX 200 Index	6,746	-1,043 points
Australian \$ vs. US \$	\$0.6889	-6.38c
Australian \$ vs. UK £	\$0.5671	-0.74c
Australian \$ vs. Euro €	\$0.6589	-1.85c

*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.*



BaiocchiGriffinPrivateWealth



[www.bgprivatewealth.com.au](http://www.bgprivatewealth.com.au)

T: 02 6766 9000 | F: 02 6766 9779 | Email: [enquiries@bgprivatewealth.com.au](mailto:enquiries@bgprivatewealth.com.au) | PO Box 590 Tamworth NSW 2340