Baiocchi Griffin
Private Wealth

Spring 2022
Issue 40

POINTS OF **INTEREST**

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we discuss the ongoing stock market volatility, largely driven by the actions of central banks around the world, who are increasing interest rates at an unprecedented pace.

EXECUTIVE SUMMARY

- Dismal investment returns in the June quarter were followed by similar returns over the past three months
- The uncertainty associated with rising interest rates across the world has led to extreme levels of volatility on global markets
- Indications suggest a potential improvement in mid to late 2023, although the conflict in Europe is just one of many matters of concern

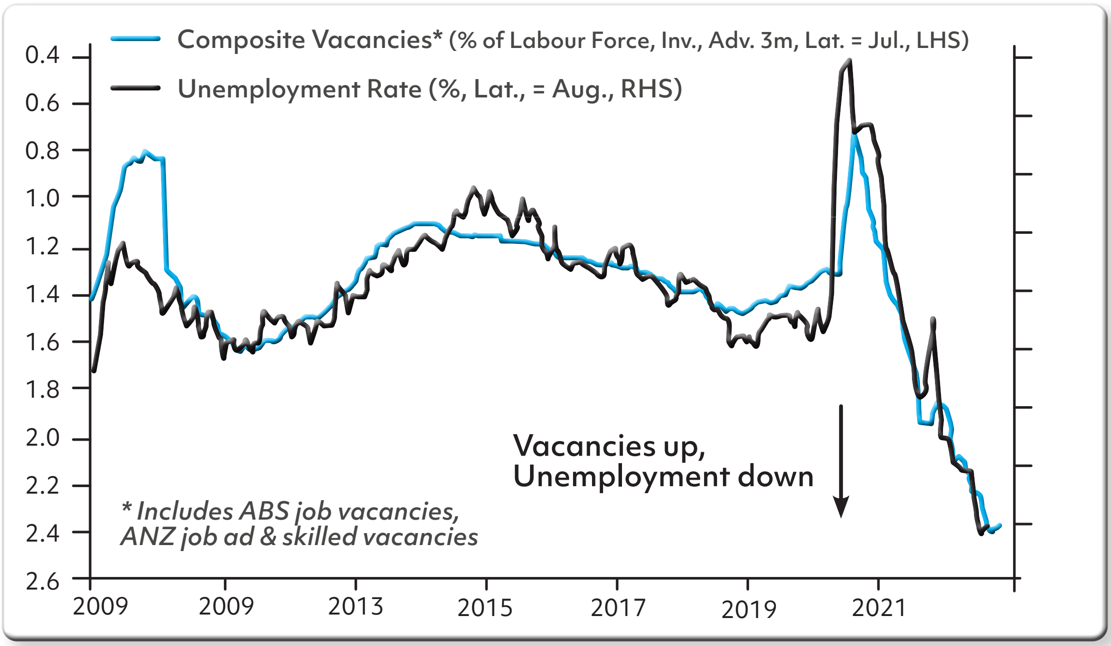
2022 – *annus horribilis?*

Clients with good memories will remember 1992, when Queen Elizabeth II described that year as her “annus horribilis”, a phrase which had all of us reaching for our Latin phrasebooks. The translation is, of course, ‘horrible year’, and unfortunately, from the perspective of investors, 2022 appears to be shaping up in that manner as well.

The end of the September quarter brought to a close another three months of volatility on global stock markets. Investors hoping for a mid-year turnaround were disappointed. Although the quarter started promisingly, with a substantial rally through July, the old patterns re-emerged as markets fell heavily through August and September (with most of the falls occurring in September). The past nine months have shown investors that the post-Covid share market rally is well and truly dead, with investors now questioning just how bad it can get. Is the end in sight, or are we still a long way from even seeing the light at the end of the tunnel?

The background economic narrative has not changed greatly over the past few months – central banks around the world are united in their efforts to combat inflation, brought about by Covid-induced supply constraints, ultra-loose fiscal policy and the war in Europe. The only weapon at their disposal in this battle is interest rates and the trigger has been pulled higher and faster than any time in recent history. Desperate investors have looked for any sign that central banks may relent, any sign that inflation is responding to the relentless rate hikes, but to little avail. The share market rally in July was a false start by investors, who believed that a few weak economic data readings in the US might presage a pivot by the US Federal Reserve (Fed). This forlorn hope was crushed in late July, when the Fed increased rates by 0.75%, reinforced by another 0.75% hike in late September.

The complicating factor as far as the Fed is concerned (and one shared by our own central bank, The Reserve Bank of Australia) is that the labour market is unusually strong. That is, unemployment is near record lows while job vacancies are near record highs. This is illustrated in the chart below, which shows both the Australian unemployment rate (the black line) and job vacancies (the blue line). The job vacancy axis has been inverted, so a falling job vacancy line shows an increasing number of job vacancies. The chart clearly shows why employers nominate finding staff as their key challenge during 2022.



Even as interest rates have continued to increase, household spending has hardly budged. Central banks are finding that it is hard to slow an economy (and hence inflation) when job openings are plentiful and everyone who wants a job has one. Related to this, is the fact that wage growth is usually a key driver of inflation. Up to this point in time, wage growth has played only a minor role in the context of spiralling inflation, however at some point this will change. A weaker labour market is an essential requirement for driving down inflation, yet in Australia, the United States and other developed economies, a shortage of workers is starting to push wage growth in the opposite direction.

This outcome significantly complicates the job of central bankers. While the global supply chain crunch seems to be finally easing, the most important component of inflation relates to services, not the buying, selling and transportation of goods. And the primary input cost to services prices is of course wages (picture a hairdressing business, for example: apart from rent, the only other meaningful expense is likely to be employees' wages). In effect, central banks need to increase unemployment if they are to have a meaningful impact on the inflation rate, an outcome which is unlikely to be popular with either the public or the government.

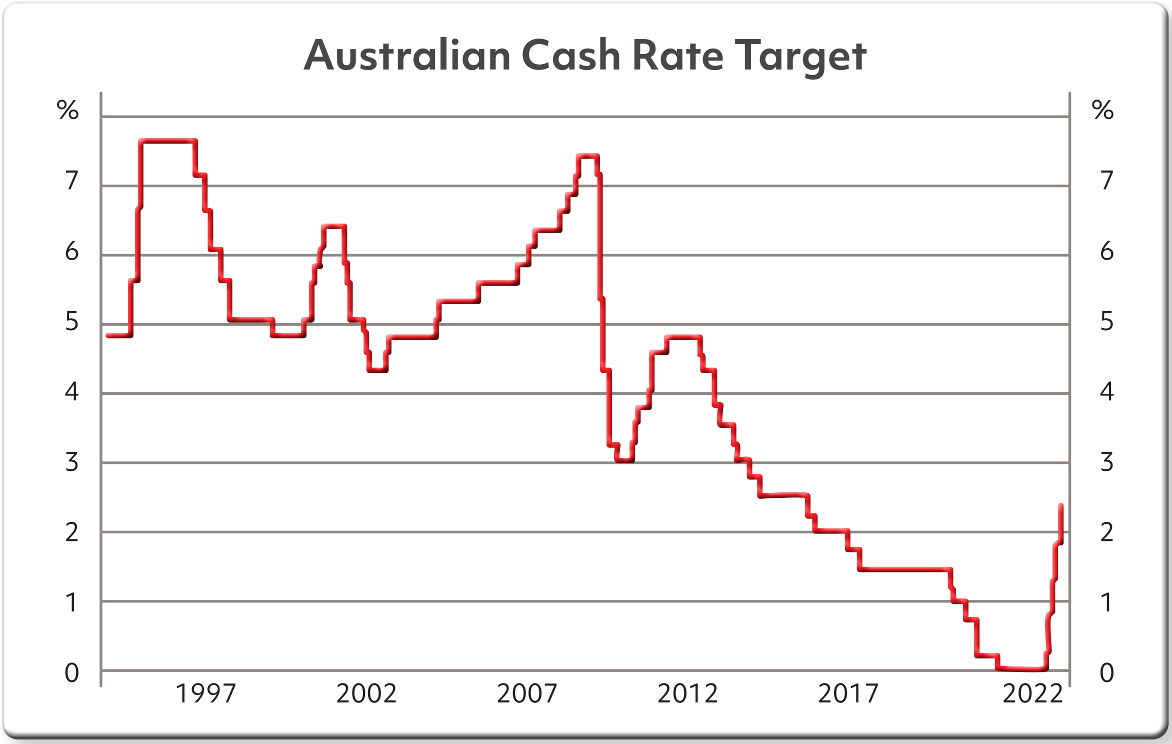
Until now, investors have been hoping that a slowdown in consumer demand and the eventual resolution of the global supply chain issues, will allow central banks to stop raising interest rates (and perhaps even look forward to a few cuts?). The strength of the labour market and the corresponding pick-up in wages has effectively ended the prospect of a quick end to the current interest rate cycle. Therefore, the message from the Fed (and other central banks) has been loud and clear – interest rates will keep on increasing until inflation is beaten.

The question investors must now try to answer is, when will the impending global recession arrive and just how bad it will be? That there will be a synchronised global recession, there can be little doubt. Seldom in history have so many developed economies embarked on such a rapid interest rate tightening cycle at the same time. In fact, a recession may be the preferred outcome, given that the alternative is a period of low-growth high inflation – better known as stagflation.

Of course, the technical definition of a recession is simply two consecutive quarters of negative GDP growth, which hardly seems alarming. Hidden behind this bland description, however, is the economic outcomes that typically occur at the same time: a rise in unemployment; low or no wage growth; a fall in house prices; an increase in business failures and most significantly for investors, a fall in company earnings. It is this last item, falling company earnings, which will determine the outcomes associated with a recession. In previous 'normal' US recessions (i.e., not recessions brought about by events such as Covid-19), corporate earnings in the US have fallen by 20% to 40%. At the moment, few economists are predicting a fall in company earnings of this magnitude, but there is no doubt that earnings expectations are beginning to move lower. This has negative implications for stock market valuations over the next six months or so and suggests that we may not have yet seen the low point of the market in this cycle.

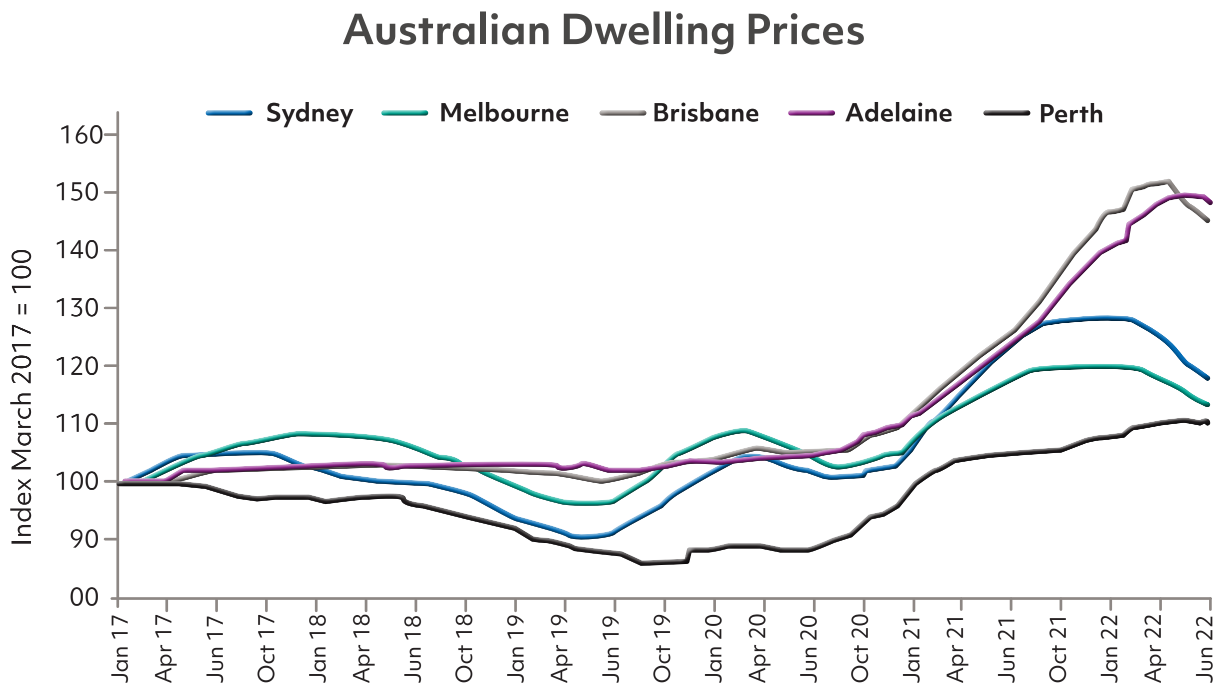
An Australian story

In Australia, we confront a situation very similar to that facing the US. Fortunately, the increase in inflation has not been as significant as that experienced in the US, which in turn has allowed the Reserve Bank to increase interest rates at a slower rate than their US counterparts. It's also worth keeping in mind where interest rates were at the start of this process. Even after increasing interest rates by 2.25% in five months (the fastest increase since 1994), the cash rate is still only 2.60%, a rate which is still relatively low on a historical basis. A repeat of the 1980's, where mortgage rates neared 20%, this is not.



An additional factor which provides assistance to the RBA in its battle with inflation, is that the majority of mortgages in Australia are variable rate mortgages, unlike in the US, where home-owners are able to fix their mortgage rate for as long as 30 years, should they wish. As a result, an increase in the RBA cash rate flows through to household budgets far quicker than an increase of the same magnitude in the United States. This feature also provides for far quicker feedback to the RBA – within a reasonably short period of time the impact of an increase in the cash rate should (ordinarily) be visible in household spending and consumption. This reduces the risk of the RBA over-shooting with regard to interest rates and increasing them to a level well beyond where they need to be. Contrast this to the US, where in some cases it might be decades before borrowers actually feel the financial impact from an increase in interest rates (insofar as their mortgage is concerned).

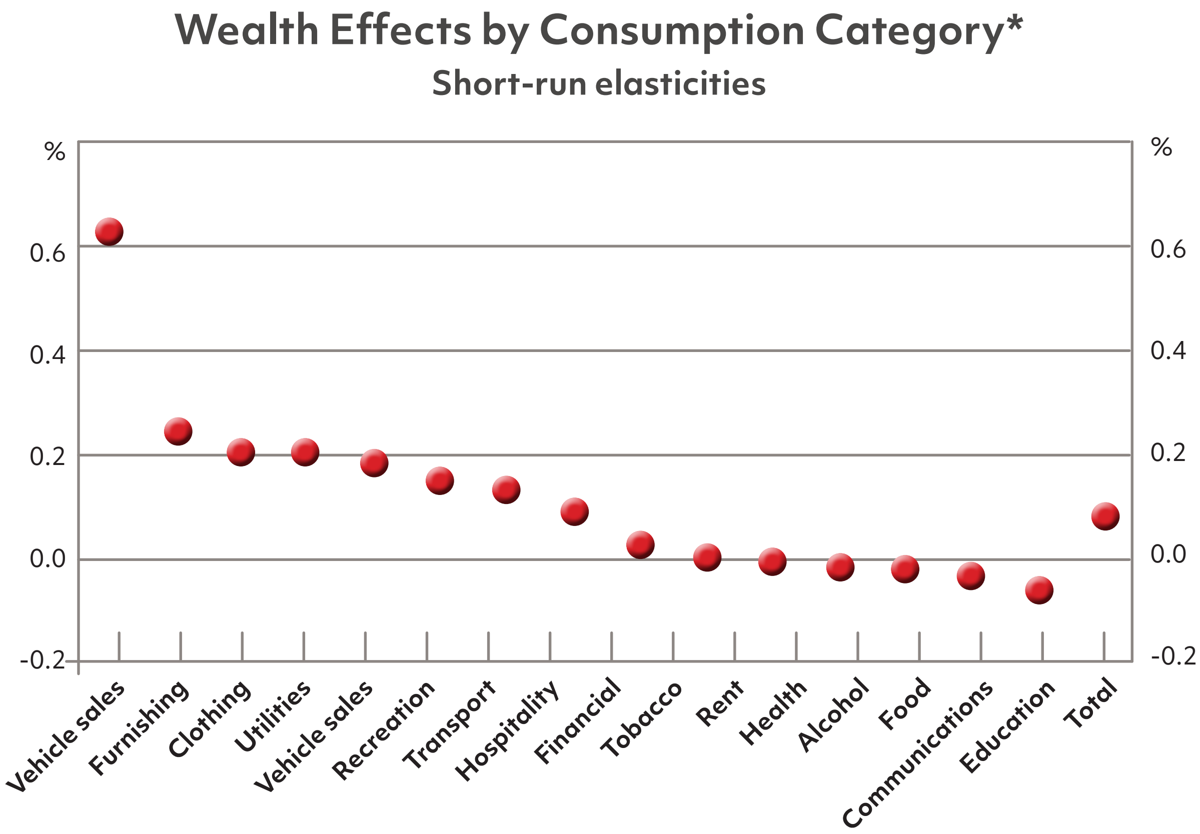
As one would expect, recent increases in the RBA cash rate are having a negative impact on house prices. While it's almost impossible to meet an estate agent who doesn't believe that it's always a great time to be buying property, the chart below would suggest otherwise. After the extraordinary increase in house prices during the pandemic, the impact of rising interest rates is plain to see.



Source: Corelogic

The extent of the decline in house prices depends largely on the level at which interest rates peak and how long they remain at that level. Despite the rapid increase in mortgage rates over the past four months, there is as yet little evidence of mortgage stress, despite the definite decline in house prices in recent months. We expect this to change as the RBA continues to push interest rates higher, albeit at a slower pace than past months. Beyond just house prices, the housing cycle plays a significant role in determining the overall health of the Australian economy. One interesting impact of housing on the broader economy is the wealth effect. In short, rising house prices tends to be associated with an increase in household spending – even though it may only be on paper, it appears that people feel 'richer' when house prices are increasing, and they respond to this increased wealth by increasing their spending. The RBA estimates that a 10% increase in net housing wealth increases spending by around 0.75% in the short term, and by 1.5% in the longer run. While these percentage increases may seem small, it's important to remember that consumption (i.e. spending) is the largest driver of overall economic growth, so even a small change in spending patterns can have an outsized impact on the economy.

Further RBA analysis showed that this increased spending effect was stronger in certain areas than others. As might be expected, motor vehicles and household furnishings in particular, were sensitive to changes in house prices, while clothing, recreation and transport also exhibited a correlation with house price changes. This is outlined in the chart below, showing the reaction in various spending categories to changes in house values. The implication here is reasonably clear – house prices are now declining at a rapid rate across many parts of Australia, and we should expect this to flow on to the broader economy (although such an impact may not be immediate, given there is likely a time lag between falling house prices and a reduction in household spending).



* Effect of a 1 per cent increase in per capita housing wealth over six months

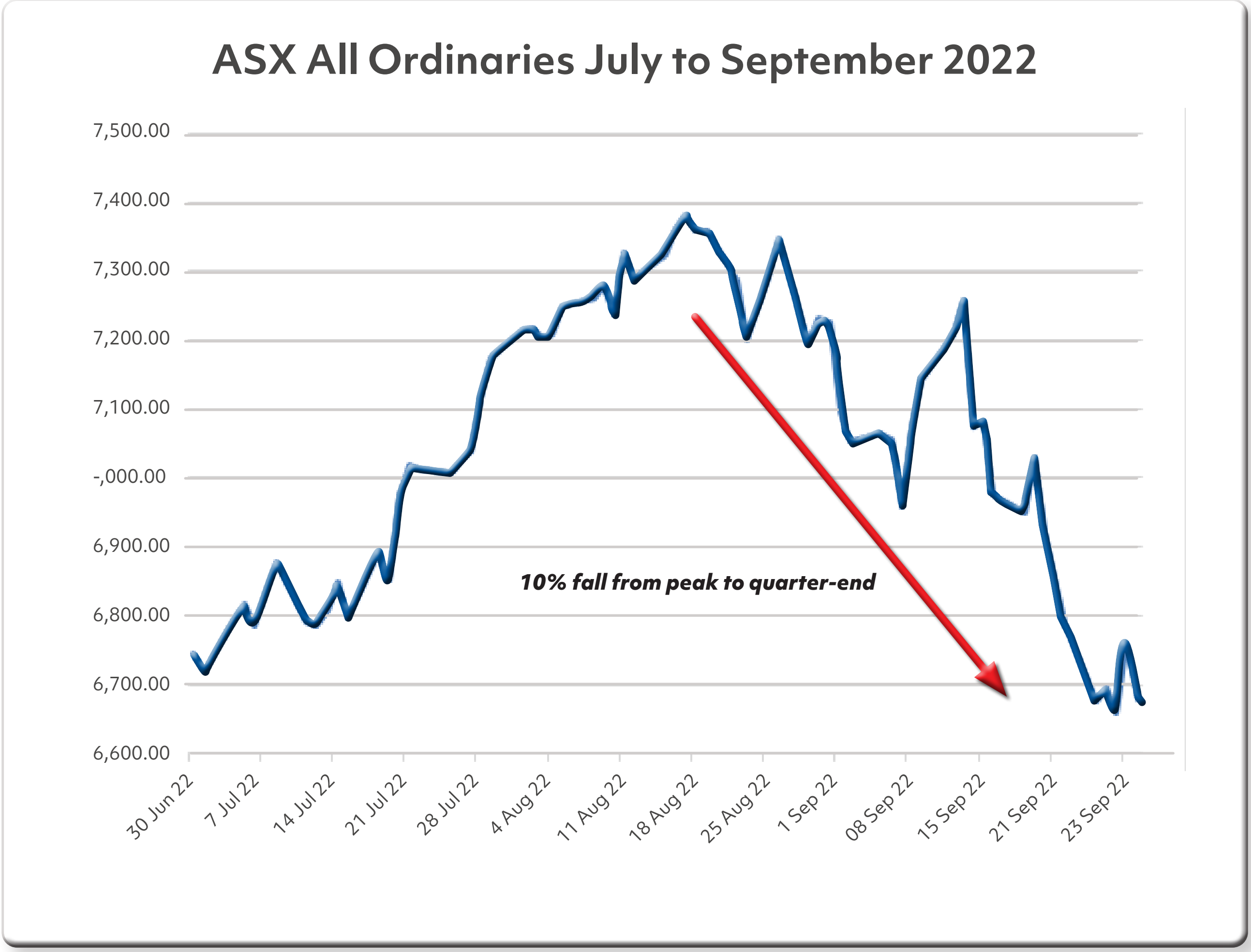
Source: ABS, Corelogic, RBA

To a certain extent, the Australian economy has been protected by the performance of the mining, oil and gas sectors, where strong demand across a range of materials and energy products has delivered windfall profits and an unexpected bump in federal government tax receipts. Unfortunately, we do not see this strength continuing into 2023, as slowing economic growth in the US, Europe and much of the developed world is likely to lead to lower demand for raw materials and energy. It also appears unlikely that China will come to the rescue, as the country struggles with the fallout of the ongoing collapse of the property market. Issues with the Chinese property market first became evident nearly a year ago, with news that major property developer Evergrande was in financial difficulty. Twelve months later the issues identified back then still remain, with Citigroup recently estimating that nearly a third of Chinese property loans were classified as bad debts.

With slowing growth across every major economy in the world, we expect Australia to follow suit, with a high likelihood of a recession next year. In fact, this time next year, we expect the RBA to be cutting interest rates, not hiking them, as it reacts to a significant slowdown in domestic economic growth.

The stock market over the past quarter

As outlined earlier in this newsletter, the past quarter provided little comfort to investors, with a continuation of the volatility first experienced at the start of the year. A minor rally in late July and early August proved fleeting, with the ASX All Ordinaries index falling heavily through September, as shown in the following chart.



For the quarter as a whole, the return for the index was relatively flat, falling only around 1% over the three-month period. But as is evident in the chart, this masked a significant level of volatility, with the index falling by nearly 6% in September alone, and a fall of around 10% from the quarterly peak set in mid-August. These falls were replicated on global markets, with the S&P 500 Index (the key US stock market index) falling by 10% in September alone, its worst monthly performance since the onset of the Covid pandemic.

As is discussed elsewhere in this newsletter, in the near term we expect there to be a continuation of the level of volatility experienced during the September quarter. In our view, the catalyst for a recovery in share markets is a definite and sustained reduction in global (and domestic) inflation rates. Were this to occur, this will provide the opportunity for central banks around the world to either cease raising interest rates, or to even begin to lower them. Depending on events over coming months, we believe this may occur in six to twelve months' time, potentially setting up positive investment returns for calendar 2023.

Looking ahead to 2023

With less than three months remaining in the year, it seems unlikely that annual returns will be positive for calendar 2022. At the time of writing (mid-September), the stock market has recorded a fall of 10.68% since the start of January 2022. At this stage, we expect the remainder of the year to exhibit a significant level of volatility, behaviour we have already witnessed during September, where markets have see-sawed wildly in response to differing sets of economic data. Paradoxically, bad news is seen as good news by financial markets – that is, investors appear to believe that the worse the economic situation, the greater the likelihood of central banks slowing down (or even reversing) interest rate hikes. This approach seems somewhat superficial, given that central banks have made it clear that inflation is their over-riding concern and interest rates will continue to rise until there is sufficient evidence to confirm that prices have stopped rising. Central banks have also made it clear that no matter the impact to the housing sector or the broader economy, interest rates will continue to increase to whatever level is needed to stamp out inflation.

A further complication is the invasion of Ukraine by Russia, a conflict now over seven months' old. Apart from the humanitarian aspect of the conflict, which has caused the death of an estimated nearly 30,000 people, and the destruction of property and infrastructure, the war continues to negatively impact the global inflationary environment. This is most evident in global oil and gas prices, where continued sanctions against Russian energy companies and the ongoing efforts by European countries to diversify away from their reliance on Russia for their energy needs, has maintained upwards pressure on prices. That said, our expectation is that a potential global recession in early to mid-2023 may result in a significant fall in energy prices, regardless of the situation vis-à-vis Russia.

Overall, while we remain concerned in the short-term, we expect that in 2023 slowing global growth (and falling inflation) may allow central banks around the world to cut interest rates, possibly leading to an economic and stock market recovery in mid to late-2023. No doubt, like us, investors around the world are looking forward to the prospect of some light at the end of this very long tunnel.

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)	6.1% (Jun)	+1%
Australian unemployment rate	3.50% (Aug)	-
RBA Cash rate	2.60% (Oct 2022 meeting)	+1.35%
ASX 200 Index	6,678	-67 points
Australian $ vs. US $	$0.6502	-3.87c
Australian $ vs. UK £	$0.5835	+1.64c
Australian $ vs. Euro €	$0.6618	+0.29c

BaiocchiGriffinPrivateWealth | www.bgprivatewealth.com.au

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