BAIOCCHI GRIFFIN
PRIVATE WEALTH

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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 a number of the key issues which impacted 2022 and those we see likely to play a similar role in 2023.

EXECUTIVE SUMMARY

- 2022 proved to be a volatile and disappointing year for investors, with significant falls in nearly every asset class
- The key driver of negative returns was rising interest rates across the world, as central banks battled to contain inflation
- While a recession in Australia during 2023 seems possible, current indications suggest it may not be as severe as that experienced in other developed nations
- We expect volatility to remain high during 2023, but an anticipated reduction in interest rates in late 2023 may provide support to asset valuations

INVESTMENT PORTFOLIO MANAGERS

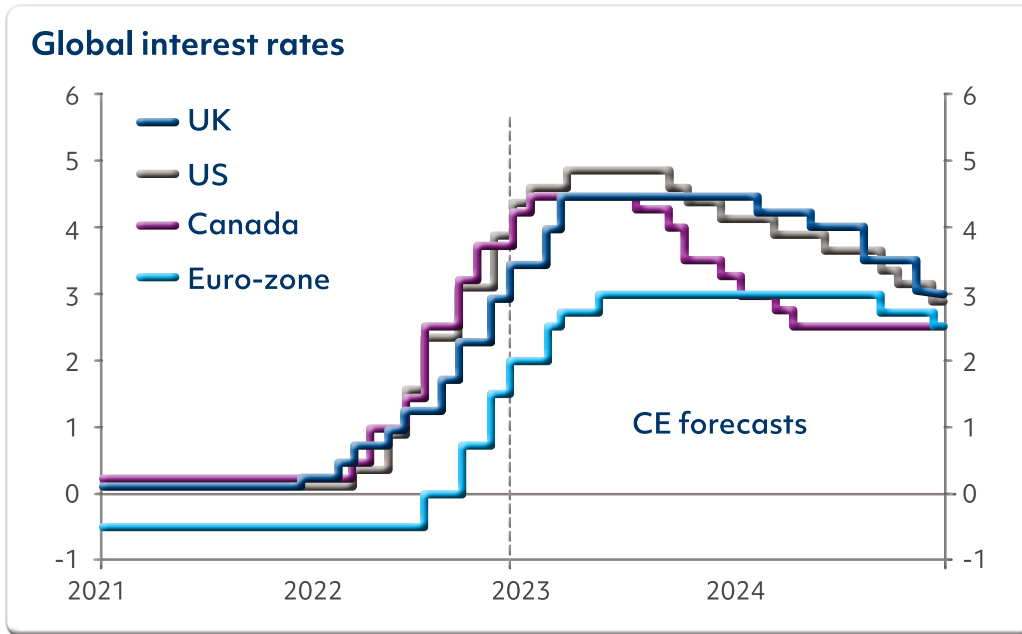
GOOD-BYE 2022

The start of a new year provides an opportunity to both review key events of the preceding twelve-month period, as well as to consider what lies ahead for investment markets. That said, there is little doubt that most investors would prefer to gloss over events and investment returns during 2022, preferring to focus on the potential for a recovery in markets in 2023.

It is not hard to blame investors for adopting this attitude. 2022 may have marked the year when the Covid pandemic all but ended (we hope), but it will also go down in history as one of the most volatile and worst performing years for nearly every asset class in decades. In terms of pure investment returns, the US benchmark index, the S&P 500, fell by just under 20%, while the NASDAQ index fared even worse, falling by 33.10%. This represents the S&P 500's worst year since 2008, which happened to be in the depths of the global financial crisis. By comparison, the Australian stock market fared significantly better, falling only 1.08% for the year (though it must be said that this figure is somewhat distorted by the relative outperformance of BHP, whose share price increased by 7.67% over the year and whose size is such that it makes up around 13% of the entire index). Certainly 2022 was not a good year for investors who opted for significant exposure to international markets.

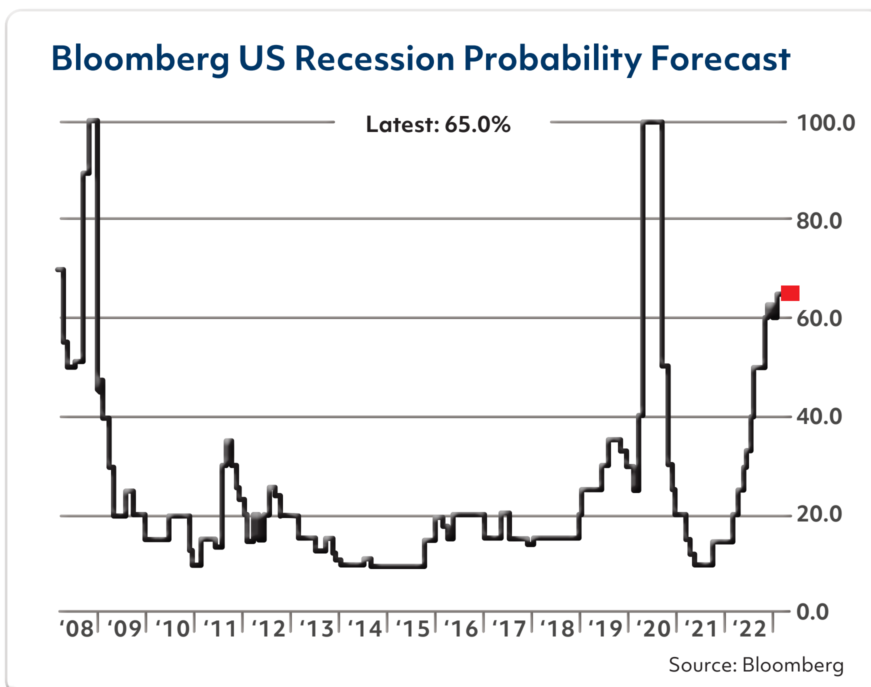
A secondary factor impacting markets during 2022 has been the extreme level of volatility – this refers to the extent of market movements, both up and down. By September 2022, for example, 87% of trading days on the S&P 500 index resulted in intra-day swings of more than 1%. This volatility was also evident in the Australian market, where the number of days when the market rose or fell by more than 2% exceeded any year since the GFC. Of course, falls in prices and values were not contained to just the stock market – bonds, property, Bitcoin, precious metals… there were few asset classes which managed to avoid losses through 2022. It is only a slight simplification to state that only investors in mining, oil and gas made any money during 2022.

As is by now well known, the primary cause of the falls in asset values across the world has been the action taken by central banks to increase interest rates in an effort to combat unusually high rates of inflation. Rather than cover this topic in detail again, we thought that a series of charts outlining some of the major events of 2022 and the outlook for 2023 may be of greater interest. Hopefully this will assist in gaining some insight into the key questions we face as we enter 2023, namely: how high will interest rates go, will there be a recession and most importantly, when will global asset prices recover?



The most important factor, in regard to both events during 2022 and likely to impact 2023, is of course interest rates. From the emergency Covid lows of 2020 and 2021, interest rates across the world have increased at near record speed, as central banks took action to bring inflation under control. As shown in the chart above however, the general consensus is that global interest rates are nearing their peak and should stop rising in major economies by mid-2023. This is on the basis that inflation is expected to slow considerably in the first half of the year as global economic growth slows in response to the rapid increase in interest rates.

In fact, many economists are now expecting interest rates to begin to fall in the second half of 2023, as central banks are forced to undo some of their interest rate hikes in the face of a global recession. Some economists put the probability of an economic recession in the United States within the next 6 months as high as 90%, a forecast with which we agree. The chart below shows Bloomberg economists forecast the likelihood of a US recession at 60% and rising.

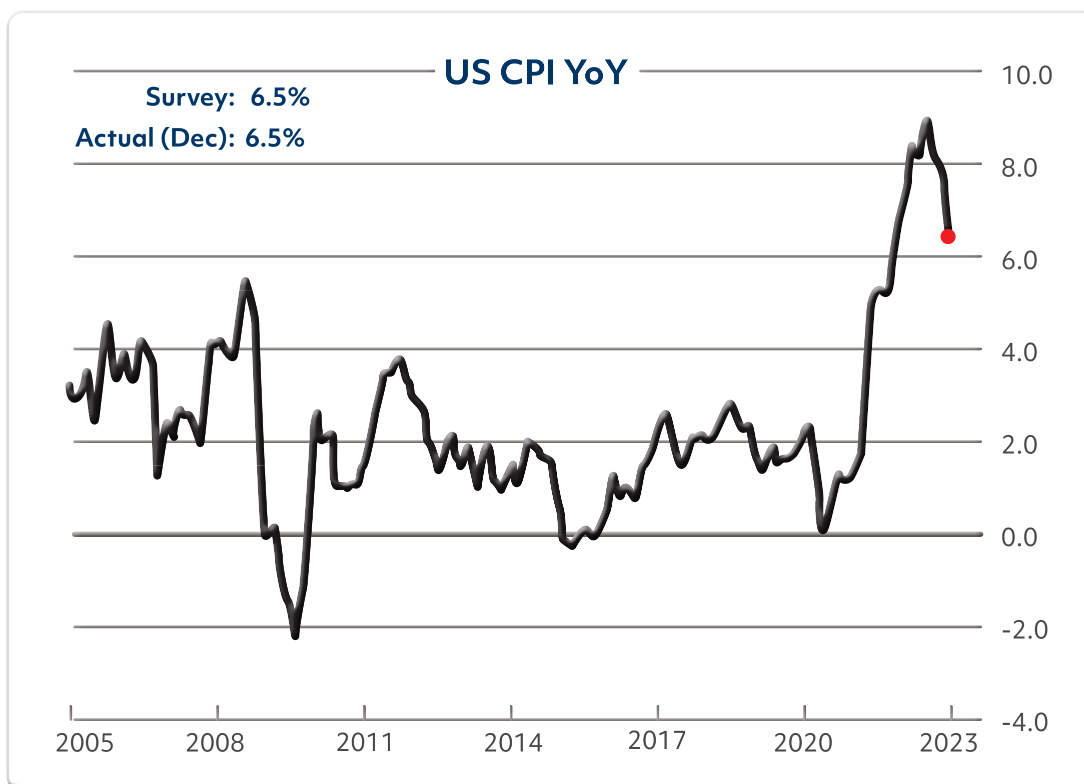


From an Australian perspective, we also consider it possible that Australia experiences a recession during 2023, although at this stage a severe recession seems unlikely. Nevertheless, we would expect the Reserve Bank to increase interest rates only marginally in the first half of 2023, with the potential for small reductions later in the year.

Inflation

Inseparable from interest rates is the outlook for inflation. As discussed, we expect central banks in key countries to begin to lower interest rates in late 2023 as inflation ceases to be a major problem. Even though inflation is still relatively high, the rate of increase of inflation is beginning to fall, which is the precursor of a general easing in inflation rates. This is most evident in the United States, where it is now becoming evident that inflation peaked in early 2022 and while still high, is no longer increasing at the same rate.

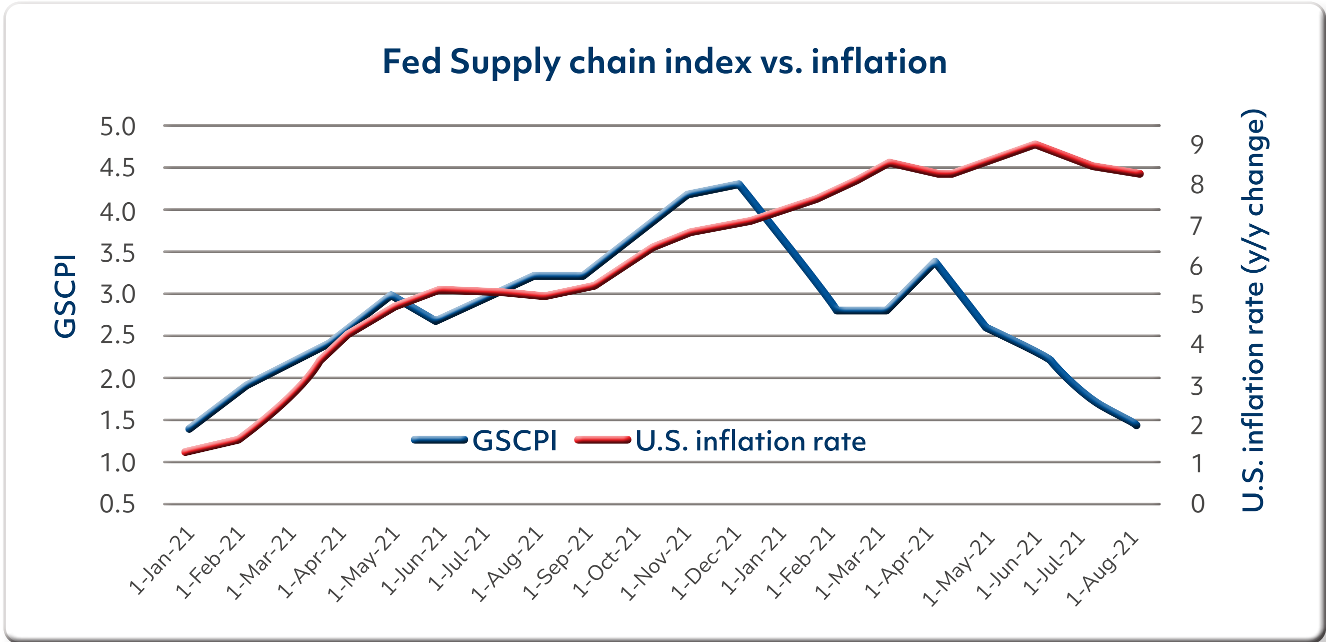
This is shown in the chart below, which illustrates the year-on-year change in the inflation rate in the US. The chart clearly shows inflation peaking in 2021 and early 2022, and slowing significantly in the latter half of 2022. Again, this reinforces our view that the inflationary threat is almost over, and interest rates are likely to be lower by the end of 2023.



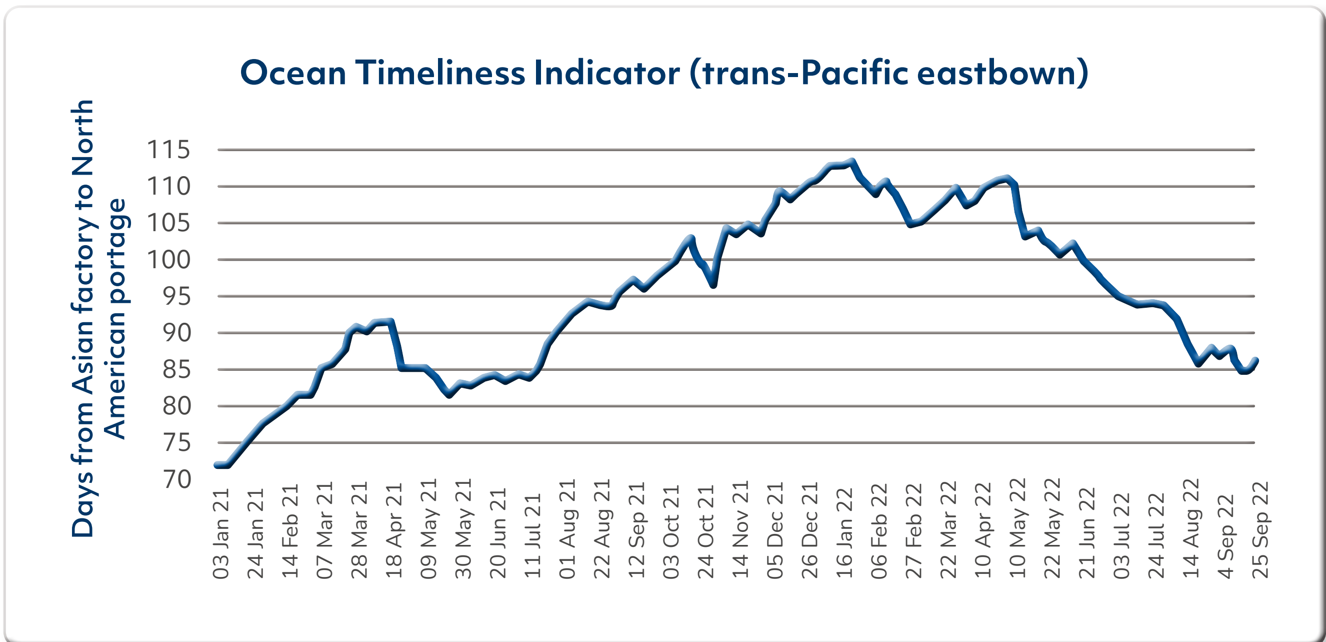
Supply Chain Problems

One of the factors responsible for the spike in inflation since the onset of Covid 19, has been the problems impacting global and domestic supply chains. By now we are all familiar with these issues, which have included factory shutdowns in China, clogged up ports, lack of drivers, excess demand and changes in spending habits – all of which conspired to push up the prices of the production and transportation of goods on a global scale. The good news is that many of these problems are diminishing in their severity. China has belatedly realised that mass lockdowns are no longer an appropriate tool in tackling Covid, which should result in less interruption to manufacturing. Global shipping has also nearly fully recovered from the impact of the pandemic, with shipping costs beginning to fall back to pre-pandemic prices. In general, the easing of Covid-related restrictions on movement should allow for a continued improvement in supply chain issues as we move through 2023.

These factors are illustrated in the two charts below. The first shows the relationship between the inflation rate in the United States and US Fed Supply Chain Index (effectively a measurement of the costs of transporting goods). As shown, supply chain related costs peaked in early 2021 and have been falling since, which is starting to have a similar effect on US inflation rates.

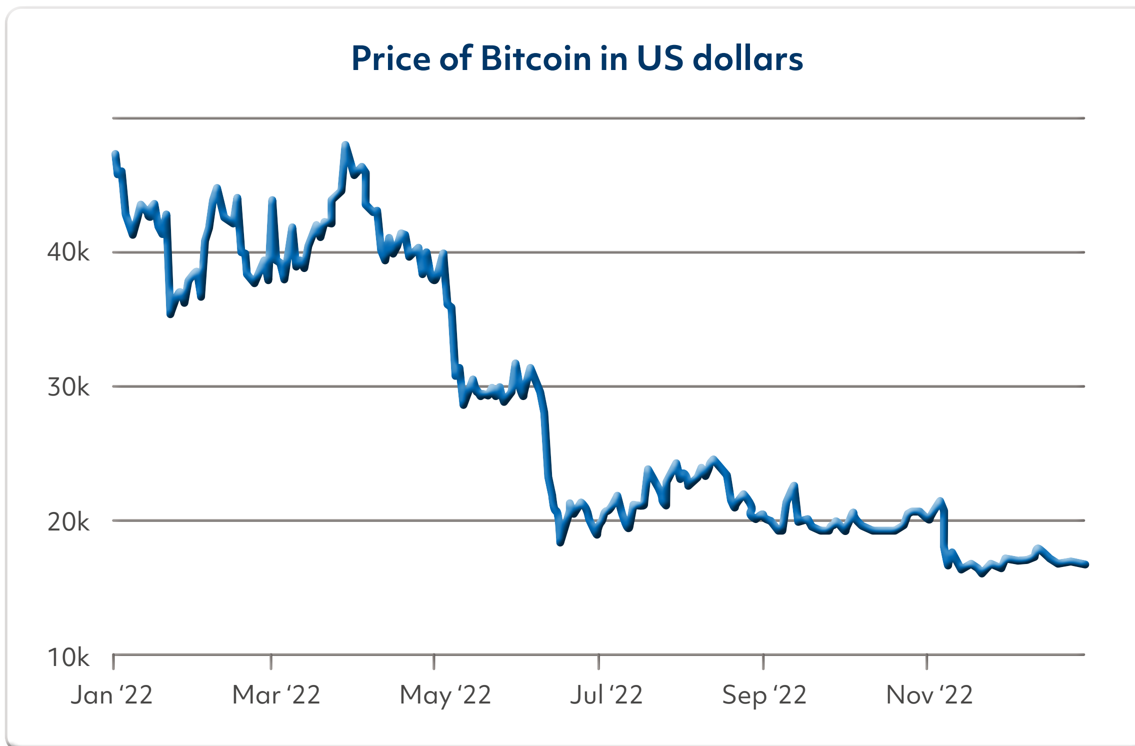


On a more specific level, the chart below shows the average number of days it takes for cargo to leave an exporter to the time it is collected at the destination port - in this instance, from Asian factories to ports in the USA. As shown in the chart, the indicator has decreased significantly during 2022, reflecting the improvement in the ability of firms to ship their products to their customers.



The Bitcoin Bubble and Bust

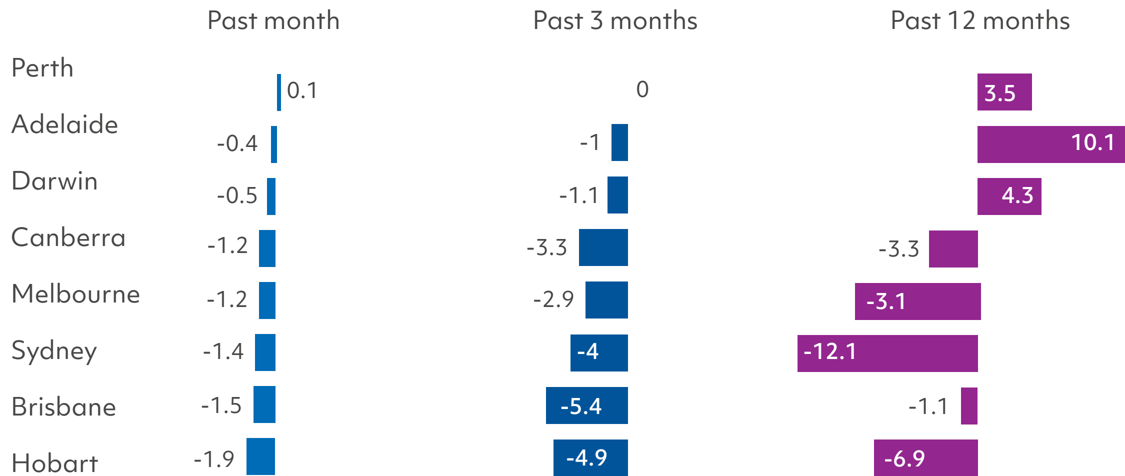
For many years now we have communicated our sceptical view of the Bitcoin and cryptocurrency mania which has attracted far more than its fair share of headlines. We draw no joy from being correct in this instance, as 2022 was a year where Bitcoin and cryptocurrencies more generally behaved exactly as we expected – something that belongs in the casino and not your investment portfolio.



Trouble in the Housing Market

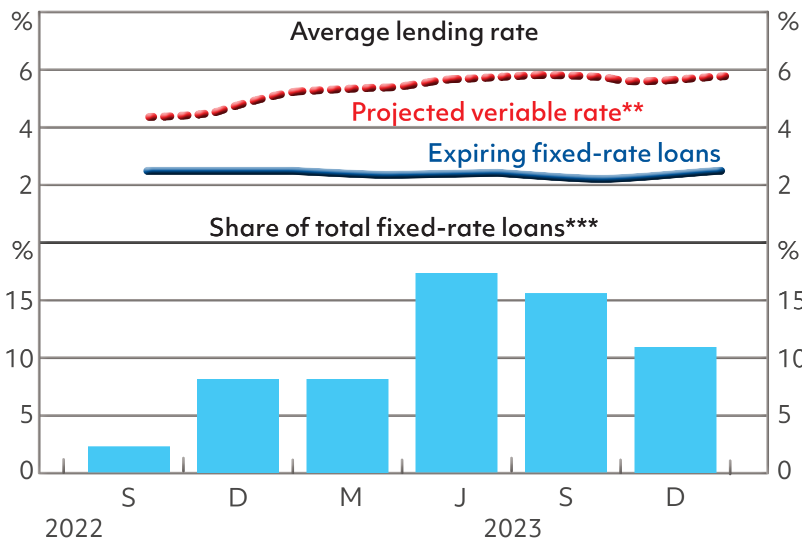
Along with nearly every other asset class, property prices both here and abroad suffered as a result of the increase in interest rates during 2022. This is not unexpected, as property prices are directly correlated with the prevailing level of interest rates, which is essentially the cost of money for buyers. As the cost of borrowing money rose, the borrowing capacity of borrowers fell, bringing about significant falls in property values in many markets.

That said, the property market is in fact many markets within the market – houses in Wagga Wagga, for example, are not typically directly comparable to houses in Potts Point. This is evident in the following graphic, showing the change in house prices across key Australian cities. Adelaide, Darwin and Perth in fact experienced a gain in house prices during 2022, while Sydney led the way downwards, with prices falling by 12.10%.



An important issue facing the property market during 2023 is the number of fixed-rate mortgages which are due to revert to variable rates during 2023. These are borrowers who took out two- or three-year fixed rate mortgages in 2020 and 2021, when mortgage rates were less than 2%. These fixed-rate mortgages will reset to much higher variable interest rates during the course of 2023, with borrowers typically expecting a tripling of their mortgage interest rate.

This is shown in the following charts. On average, around 35% of mortgage holders in Australia can expect their mortgage interest rate to increase by up to 4% during 2023. This help explains the conundrum evident in Australia today – with interest rates having increased so sharply during 2022, why isn't this evident in the property market or the broader economy? The answer is that homeowners savvy enough to fix their mortgage in 2020 and 2021 were able to defer the impact of interest rate hikes, although not indefinitely.

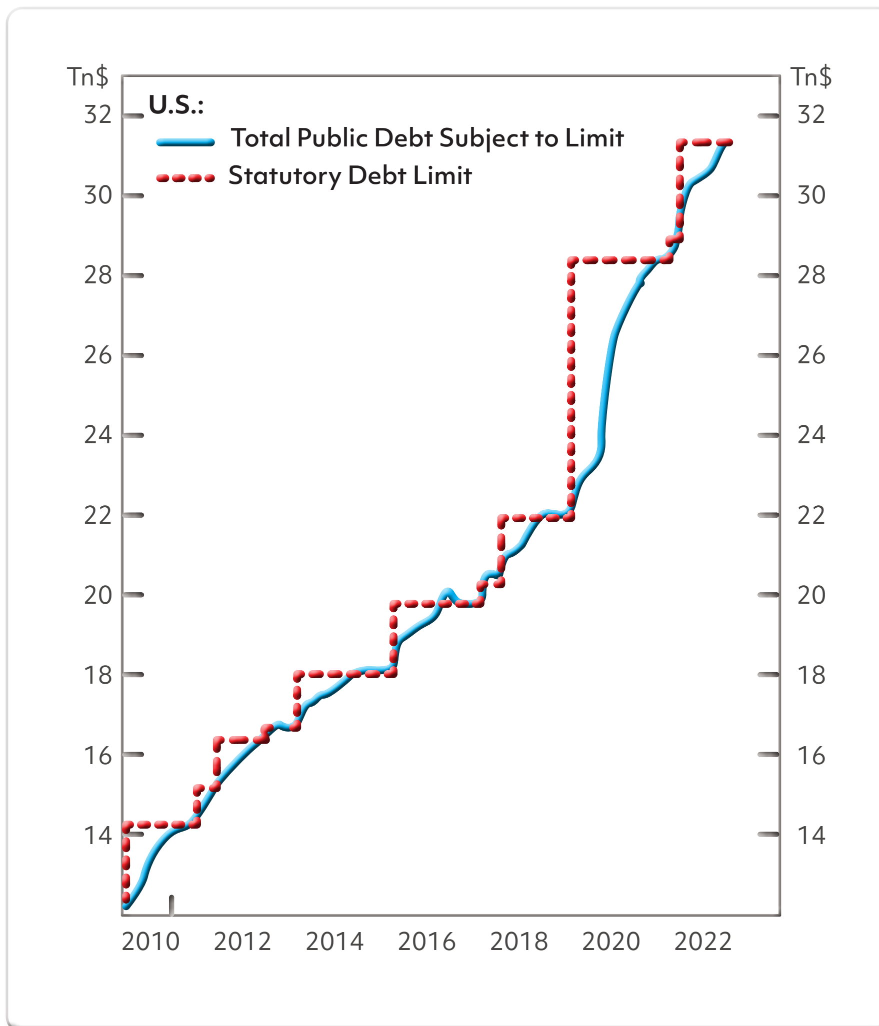


Global Debt

One issue which has so far escaped much attention is how governments around the world deal with the significant increase in government debt as a result of the pandemic. The fiscal stimulus undertaken by governments in an effort to offset the impact of mass lockdowns severely stretched government budgets and there has been little discussion as to how these debts will be managed. In this regard the United States sets a particularly poor example. The Federal government in the US operates under a debt ceiling which seeks to impose limits on government borrowing.

However, as the debt ceiling is simply a self-imposed limit, it is a relatively trivial matter to increase the limit when borrowings begin to reach their maximum.

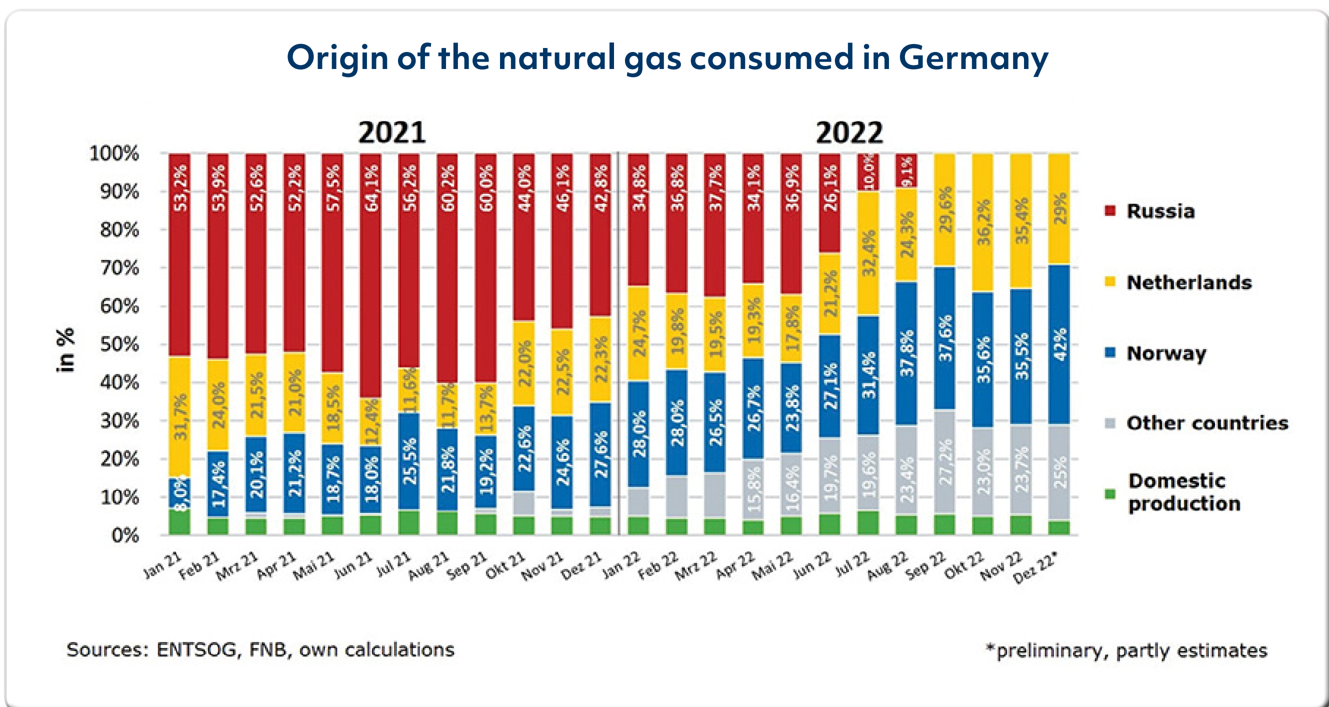
This is shown in the chart below, which highlights the inability of the world's largest economy to constrain government debt and spending. In the past the debt ceiling has simply been pushed upwards when total debt begins to approach the limit, however, the current dysfunctional political situation in the US may make this task more difficult than usual.



The Energy Crisis

One of the defining features of 2022 was the war in Ukraine and its impact on the global energy market. With much of the developed world imposing trade sanctions on Russia in retaliation for the attack on Ukraine, the interruption of important oil and gas exports from Russia had an immediate impact on the market. Much was made of Europe's reliance on Russian energy imports, with concerns that the withdrawal of Russian energy supplies would cripple European economies. Fortunately, it appears that a full-blown crisis has been avoided, with European nations able to source energy supplies from other countries (one beneficiary being Australia), coupled with a relatively benign winter.

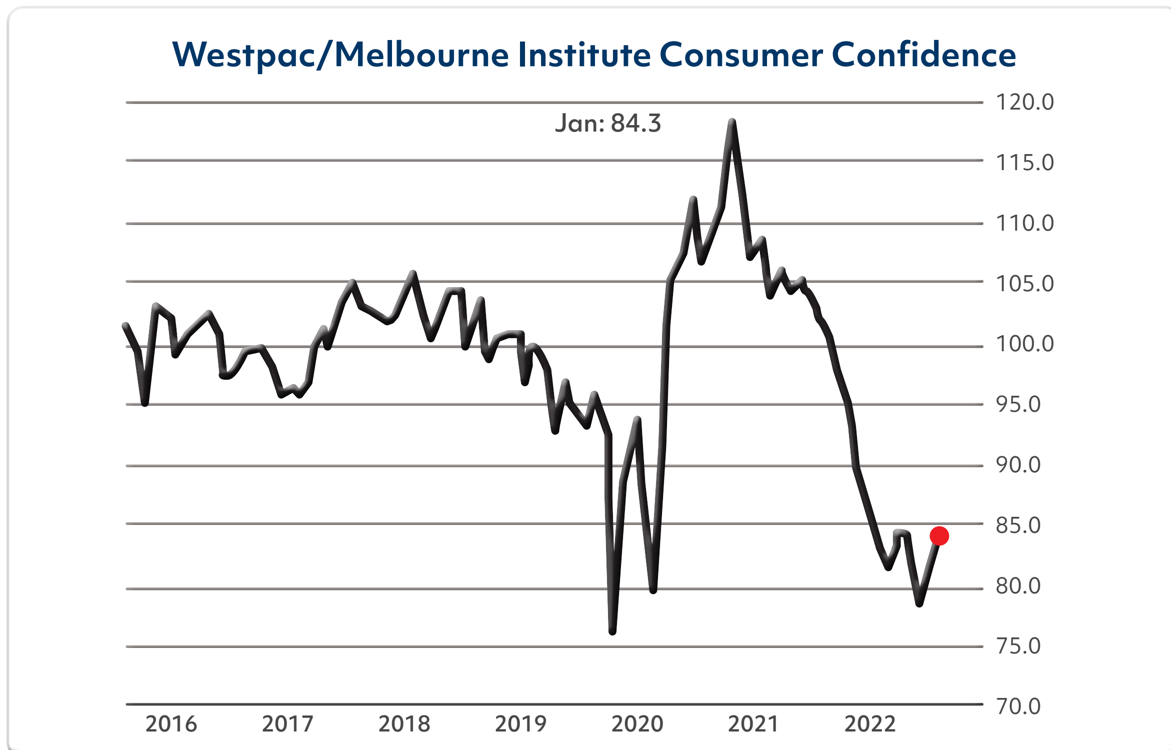
The chart below shows how Germany in particular was able to replace Russian gas supplies by accessing alternative markets, helping to soften the impact of the sanctions on Russia. Note how in June 2021 Russia supplied 64% of German natural gas needs, but by September 2022 this had fallen to 0%.



The Resilience of the Australian Consumer

One of the interesting developments through 2022 was the willingness of Australian consumers to spend, even in the face of a record hike in interest rates. To a certain extent this resilience was somewhat unexpected, as the usual narrative is that households cut back their spending as the interest rates on mortgages increase. The existence of a large proportion of fixed rate mortgages, as discussed earlier, partly explains the ability of households to continue to spend, regardless of interest hikes. Plus, it is acknowledged that during the pandemic years households built up a considerable level of savings, through both government handouts and the simple fact that it was difficult to spend money while in lockdown.

However, a worrying sign for the Australian economy, which is highly dependent on household spending, is the collapse in consumer confidence through 2022, as shown below. In fact, consumers in Australia are almost as pessimistic now as they were in the depths of the pandemic in mid-2020. A low level of consumer confidence tends to eventually be reflected in lower levels of spending, which is another indicator of a potential economic recession at some stage during 2023.



LOOKING AHEAD TO 2023

We hope that clients have enjoyed this series of charts, which hopefully provide some insight into a number of the major factors influencing the global economy, both over the previous twelve months and looking ahead to 2023.

After a difficult year for financial markets, an improvement in returns would be welcome, and our expectation is that 2023 proves to be a more favourable year for investors than was 2022. While a recession in Australia (and in most major economies) during 2023 seems possible, current indicators suggest that it may not be overly severe. That said, the global situation is in a high state of uncertainty at present, with major concerns over issues such as inflation and interest rates, geo-political issues such as the Russia-Ukraine war and US-China tensions, and the lingering after-effects of the pandemic, to which can be added the usual array of global and domestic crises and emergencies.

We again expect volatility to remain high, as investors grapple with conflicting messages over corporate earnings and stock market valuations. From our perspective, our investment methodology remains at its heart unchanged: a focus on quality, reliable businesses and investments, with due heed paid to appropriate diversification and risk management. We recognise we cannot control the outcomes of global and domestic events and issues, however we can control our investment selections and exposures, an approach which has proved its worth for nearly a quarter of a century.

Justin Baiocchi

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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 wish you all the best for the year ahead.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate (annual)	7.4% (Nov)	+0.5%
Australian unemployment rate	3.3% (Nov)	-
RBA Cash rate	3.10% (Dec meeting)	+0.25%
ASX 200 Index	7,221	+543 points
Australian $ vs. US $	$0.6775	+2.73c
Australian $ vs. UK £	$0.5625	-0.0210
Australian $ vs. Euro €	$0.6359	-0.0259

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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