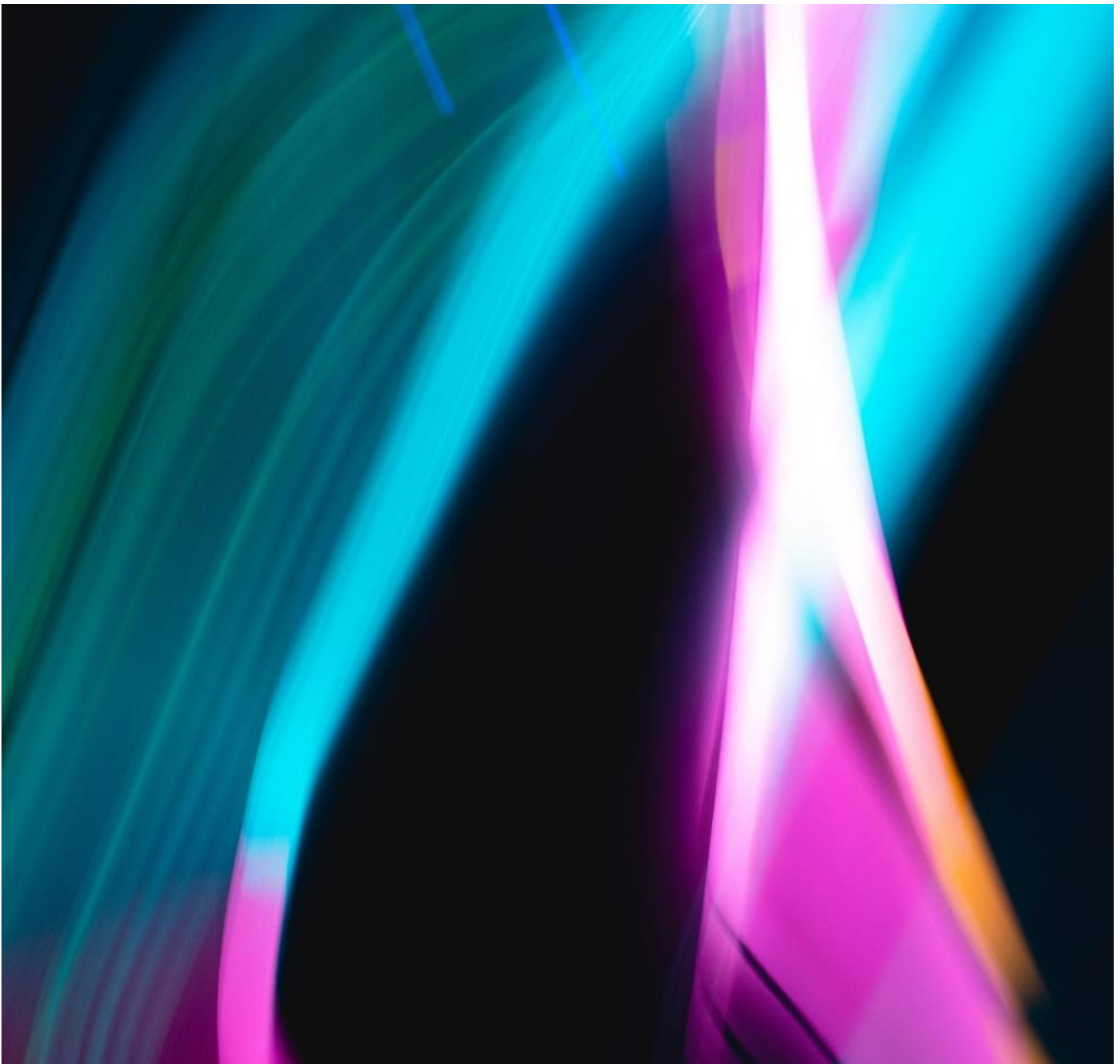
SEPTEMBER
2022

# INVESTMENT ENVIRONMENT UPDATE

PATRIZIA ADVISERS



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# Investment Environment Update

Markets continued to grapple with global economic uncertainty over the past month. A firm commitment by the US Federal Reserve to contain inflation despite the potential impacts of hawkish policy on economic growth prospects led to increased pessimism on outlook, with inflation remaining at multi-decade highs in much of the developed world. Additionally, an unexpectedly stimulatory fiscal tilt by the new UK government provided a flashpoint as September drew to a close, with Bank of England intervention appearing to avert a crisis in the country's pension system. While recession is now firming as increasingly likely in many countries, the impact of the COVID-19 pandemic continues to ebb away; the seven-day rolling average of daily confirmed deaths has fallen to just over 1,000 per day worldwide, less than one-tenth of the 2022 high reached in February, and the lowest since late March 2020. Geopolitically, significant advances by Ukrainian forces in the conflict with Russia have led to increased sabre-rattling by Russian leader Vladimir Putin and, possibly, the as-yet unexplained rupturing of both Nord Stream pipelines supplying Russian gas to continental Europe.

In Australia, August employment data continued to reflect a strong labour market. The unemployment rate increased by 0.1% from its 48-year low in July to 3.5%, with the increase mainly the result of a healthy improvement in the participation rate. Nearly 35,000 new jobs were created in August, mitigating much of the July decline of just over 40,000 jobs. Meanwhile, the first ever monthly release of inflation data was issued in early October. While some components will still only be measured at quarter-end and have not yet been released, data for July and August suggested some moderation in prices, with implied headline CPI increases of 0.5% and 0.2% per month, respectively.

Australian retail sales slightly beat consensus forecasts, recording a 0.6% increase in August driven mainly by food retailing and restaurants. While a potential softening in volume has been likely offset by higher prices, the data suggests the RBA's recent spate of 0.5% rate hikes has yet to materially curb retail demand.

| Asset Class Returns | September (%) | 3 Months (%) | 12 Months (%) | 3 Years (% p.a.) |
|---|---|---|---|---|
| Cash | 0.15 | 0.42 | 0.52 | 0.38 |
| Australian Fixed Interest | -1.36 | -0.64 | -11.36 | -3.42 |
| Overseas Fixed Interest | -3.50 | -3.78 | -12.81 | -3.63 |
| Australian Equity * | -6.29 | 0.45 | -8.00 | 2.73 |
| Developed Overseas Equity (unhedged) * | -3.23 | 0.35 | -9.79 | 6.33 |
| Developed Overseas Equity (fully hedged) * | -8.91 | -5.18 | -17.51 | 4.03 |
| Emerging Markets Equity (unhedged)* | -5.87 | -5.42 | -19.24 | -0.49 |

** Returns reflect the relevant accumulation indices.*
*Source: Bloomberg, Datastream, PATRIZIA Advisers.*

At its early October meeting, the RBA surprised markets with a 25 basis point hike. Consensus among economists and market-implied pricing suggested another 50 basis point hike was highly likely, and the lower increase prompted a rally in risk assets amid expectations the decision reflected a pivot to a slower pace of tightening. The market-implied terminal rate declined from over 4.0% just prior to the meeting to just 3.5% by close of trade, with many economists now tipping four more 25 basis point increases through to early/mid-2023. Governor Phil Lowe noted that, given the lag from policy tightening in impacting the broader economy, now would be a prudent time for lower hikes as the economic effects of rate increases start to flow through. The relatively high proportion of Australian households with variable rate mortgages has also been cited as a factor supporting a more dovish policy stance compared to other central banks.

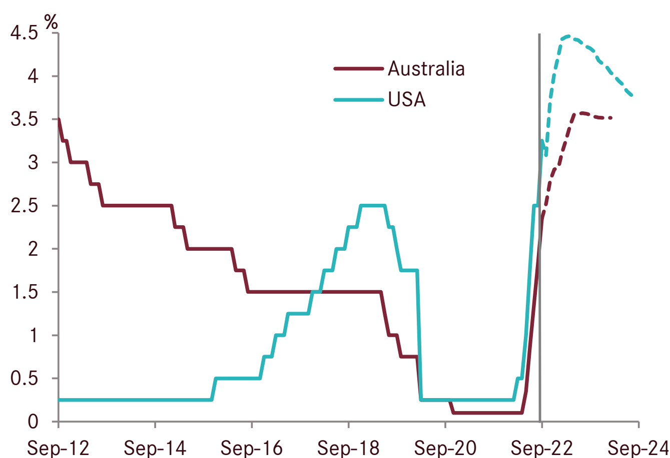
Confidence indicators recorded some improvement. The Westpac-Melbourne Institute survey of consumer confidence increased 3.9% in the latest release in mid-September, albeit remaining at an absolute level of just under 85 – a figure more often associated with recessions and major risk-off conditions. The moderate improvement reflects increases in nominal wage growth, with household finance expectations improving 5% month-on-month. The NAB business survey suggested firms were more sanguine about economic outlook, with business conditions rising one point to +20 and confidence up two points to a reading of +10; both above-average levels, and confidence broad-based across sectors and regions, with labour force and capital utilisation high.

Economic news in the US centred on the August inflation print and subsequent central bank signaling. Headline CPI came in at 8.3% year-on-year; while 0.2% lower than the figure to 31 July, it was 0.2% above consensus forecasts and the highest figure in 40 years. The core CPI print also recorded an upside surprise, rising 0.6% for the month relative to consensus forecasts of 0.3%, and suggesting elevated inflation was likely becoming more embedded. The Federal Reserve's Open Market Committee (FOMC) followed the inflation print with a third successive 0.75% rate increase to lift the target rate to 3.00% to 3.25%. The FOMC also revised its terminal rate upward, indicating a peak rate above 4.5% by early- to mid-2023, with no rate cuts until 2024 at the earliest. The guidance from Chair Powell that officials would not waver in their battle to contain inflation – even to the detriment of economic growth and employment – was more hawkish than expected, leading to a sell-off in both equities and bonds.

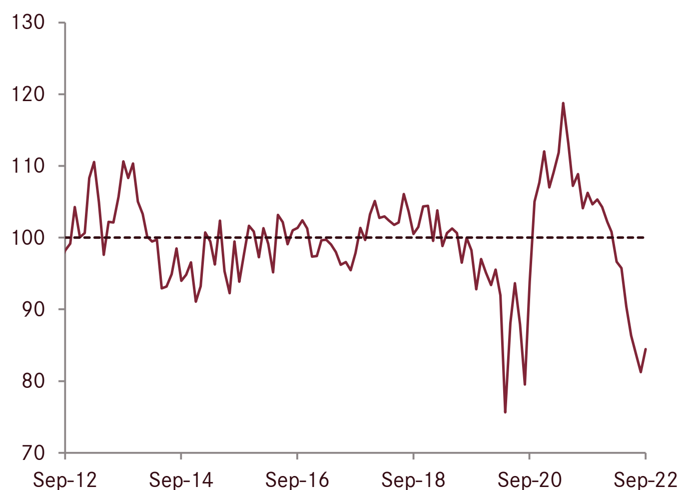
In China, the near-term outlook remains relatively neutral as government stimulus and the resolution of a power supply shortage in Sichuan province led to an uptick in manufacturing optimism, with the official PMI figure rising above expectations to a marginally optimistic reading (that is, just over 50) of 50.1. That said, the equivalent Caixin gauge was more contractionary, coming in at a below-50 reading of 48.1 amid concerns around easing global demand. Services sentiment was also near the 50-point mark, falling from 52.6 to 50.6 in September.

New UK Chancellor of the Exchequer Kwasi Kwarteng's mini-budget 'Growth Plan' in late September rattled investors. Announcing tax cuts skewed to higher income earners, reversing planned increases in company tax rates, stamp duty concessions for new home buyers, and an energy price guarantee for households and firms, the measures are expected to be financed with around £72 billion in additional debt issuance for the current financial year.

**Australia and US Cash Rates**




**Westpac-Melbourne Institute Consumer Sentiment**




*Source: Bloomberg*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The expected inflationary impact of the measures at a time when inflation is already at its highest level in four decades, the likely need for a more hawkish policy tilt from the Bank of England, and fears of rising government indebtedness all triggered a sharp sell-off in the pound, which declined to a record low against the US dollar of just $1.04. Two-year gilt yields also spiked to nearly 4% - the highest level since the global financial crisis.

The spike in yields placed pressure on a number of British pension funds invested in leveraged long duration gilt strategies, which incurred substantial losses requiring investors to raise sizeable collateral. This in turn risked a sell-off in other pension fund assets - including gilts - to meet margin requirements. To avert the chance of pension fund insolvency, the Bank of England rapidly implemented a £65 billion bond-buying scheme to generate liquidity, which helped stabilise markets. A subsequent about-turn from Kwarteng on high income tax cuts also helped assuage market jitters. That said, the Bank of England is still expected to follow its 0.50% September rate hike with a more aggressive increase in early November, with a 0.75% increase the median economist forecast, which will in turn lift the cash rate to 3.0%.

As with the UK, the Eurozone also faces the prospect of sharp tightening. Following its 0.75% rate hike in early September, the European Central Bank is expected to continue to tighten rates aggressively, with inflation and employment data for the region continuing to run hot. The latest Eurozone headline inflation reached a new high for an eleventh straight month in September, rising by an annal 10% year-on-year, above consensus and a 0.9% increase on the annual figure to end-August. While the reduction in gas supplies to Europe from Russia amid the conflict in Ukraine – not helped by suspicious major leaks in the Nord Stream pipelines in late September – continues to lift energy prices, core inflation, which excludes energy and good, also remained elevated, coming in at 4.8% year-on-year. Eurozone unemployment stabilized over August, with data released in September revealing an unchanged jobless rate at a record low of 6.6%.

In a major political development, Italy's general election on 25 September, which was called following the dissolution of parliament in July, saw a centre-right coalition emerge with an absolute majority of seats. The alliance was led by Giorgia Meloni, who is expected to become prime minister and whose party, Brothers of Italy, is considered far-right, populist and Eurosceptic. The result follows a recent increase in votes by far-right parties in France, Sweden and Spain.

The hawkish signaling from the US Federal Reserve and its commitment to containing inflation continued to weigh on market sentiment. Australian equities fell 6.3% for the month. Developed overseas equities similarly sold off, declining 8.9% on a currency hedged basis for the month, and -17.5% for the year to 30 September 2022. Fears of elevated inflation and swifter central bank action increased front-end rates, causing some sovereign yield curves - such as the US and UK – to invert. Australian fixed interest's 1.4% fall for the month takes the annual return to -11.4%. Overseas fixed interest, which has a higher skew to credit (and the negative impact of higher spreads), declined 3.5% in September, and has now fallen 12.8% over the past twelve months. The sharp negative return performance by both equities and fixed interest is atypical in recent decades, and reflects the combination of elevated price pressures coupled with a weakening global economy after unprecedented levels of stimulus during the COVID-19 pandemic.

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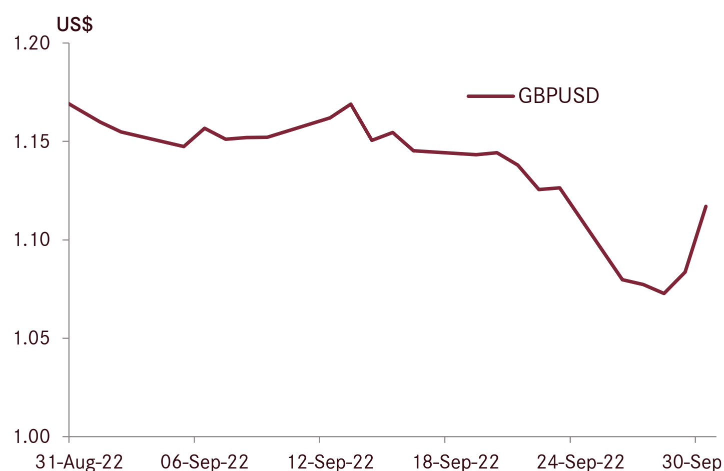
10 Year Government Bond Yields

GBPUSD Exchange Rate




*Source: Bloomberg*

Index Returns to 30 September 2022

| | MONTH (%) | 3 MONTHS (%) | FYTD (%) | 12 MONTHS (%) |
|---|---|---|---|---|
| **Australian Equities** | | | | |
| S&P/ASX 300 Accumulation Index | -6.3 | 0.5 | 0.5 | -8.0 |
| S&P/ASX Small Ordinaries Accumulation Index | -11.2 | -0.5 | -0.5 | -22.6 |
| **International Equities** | | | | |
| MSCI World (ex Australia) Index (hedged A$) | -8.9 | -5.2 | -5.2 | -17.5 |
| MSCI World (ex Australia) Index (unhedged A$) | -3.2 | 0.3 | 0.3 | -9.8 |
| MSCI Emerging Markets Index (unhedged A$) | -5.9 | -5.4 | -5.4 | -19.2 |
| **Property** | | | | |
| S&P/ASX 200 A-REIT Accumulation Index | -13.6 | -6.7 | -6.7 | -21.5 |
| FTSE EPRA Nareit Developed ex Aus Rental hedged AUD | -12.4 | -10.9 | -10.9 | -20.9 |
| FTSE EPRA Nareit Developed ex Aus Rental unhedged AUD | -6.9 | -5.5 | -5.5 | -13.6 |
| **Australian Fixed Interest** | | | | |
| Bloomberg AusBond Composite Index | -1.4 | -0.6 | -0.6 | -11.4 |
| **Global Fixed Interest** | | | | |
| FTSE WGBI ex-Aust (hedged A$) | -3.4 | -4.3 | -4.3 | -13.2 |
| Barclay's Global Capital Aggregate Bond Index (hedged A$) | -3.5 | -3.8 | -3.8 | -12.8 |
| **Cash** | | | | |
| Bloomberg AusBond Bank Bill Index | 0.1 | 0.4 | 0.4 | 0.5 |
| **Commodities** | | | | |
| Gold (US$ per ounce) | -2.6 | -8.0 | -8.0 | -4.1 |
| Copper (US$ per metric tonne) | -3.1 | -8.5 | -8.5 | -15.4 |
| WTI Crude Oil (US$ per barrel) | -11.2 | -24.8 | -24.8 | 5.9 |
| RBA Index of Commodity Prices (A$) | 2.1 | -15.8 | -15.8 | 30.0 |

Australian Dollar versus Foreign Currencies to 30 September 2022

| AUSTRALIAN DOLLAR VERSUS | AS AT 30 SEPTEMBER 2022 | MONTH (%) | THREE MONTHS (%) | FYTD (%) | 12 MONTHS (%) |
|---|---|---|---|---|---|
| **US Dollar** | 0.64 | -6.2 | -6.5 | -6.5 | -11.0 |
| **British Pound Sterling** | 0.58 | -2.2 | 1.7 | 1.7 | 7.5 |
| **Euro** | 0.66 | -3.7 | -0.2 | -0.2 | 5.3 |
| **Japanese Yen** | 93.06 | -2.1 | -0.4 | -0.4 | 15.5 |

*Source: Bloomberg*

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