

Be prepared for rising interest rates

End-April 2022

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Economic and market overview

- Inflationary forces continued to intensify in key regions, which suggested interest rates could be raised more quickly and more aggressively than previously anticipated.
- Government bond yields continued to rise sharply, resulting in negative returns from fixed income markets.
- The likelihood of rising borrowing costs also appeared to spook equity markets, which performed poorly over the month. Central banks are essentially being forced to tighten policy settings to combat rampant inflation, but risk an economic slowdown or recession if borrowing costs are raised too substantially. Corporate earnings growth could slow in this environment.
- Further Covid lockdowns in China also hampered sentiment towards risk assets, and could add to inflationary pressures. Various shutdowns and the likelihood of supply-chain interruptions seem likely to push prices higher.
- The threat of energy and food shortages owing to the ongoing conflict in Ukraine caused further unease among investors.
- **US:** Following the increase in interest rates in March, all eyes were on the next Federal Reserve Board meeting in early May to see whether borrowing costs will be raised again and, if so, by how much.
- Consensus forecasts suggest US interest rates will be raised by 0.50 percentage points as policymakers continue to grapple with spiralling inflation. CPI has soared to an annual rate of 8.5%.
- There was a surprise drop in GDP in Q1. Growth was -1.4% in the period, compared to expectations for a 1.0% increase.
- More encouragingly, unemployment in the US fell to 3.6% in March, only a whisker above the pre-pandemic level of 3.5%.
- Wage growth has picked up too, partly due to labour shortages in some sectors. Nationally, average hourly earnings are up 5.6% over the past year; double the average rate over the past 15 years.
- **Australia:** Trimmed mean inflation – the Reserve Bank of Australia's preferred underlying measure of price increases – rose 1.4% in the March quarter; almost double the official forecast from as recently as February.
- On an annual basis, inflation has quickened to 3.7%; up from 2.5% in the December quarter and well above the Reserve Bank of Australia's 2% to 3% target range.
- In turn, it seems likely that Australian interest rates will be increased in either May or June – the beginning of the 'policy normalisation' process.
- The Federal Election has been called for 21 May, but is not expected to influence the timing of any interest rate changes by the Reserve Bank of Australia.
- **New Zealand:** The Reserve Bank of New Zealand raised official cash rates by a further 0.50 percentage points, to 1.50%. The move seemed understandable given the extent of inflationary pressures, but does risk dampening house prices and, in turn, consumer sentiment.
- That said, the overall economic outlook brightened somewhat due to the imminent reopening of the country for tourists. From early May, overseas visitors will be able to visit New Zealand for the first time in more than two years – good news for the country's tourism-related businesses.
- This development should be a welcome boost for the economy, which appears to have lost momentum recently. The monthly employment indicator deteriorated in both February and March, for example, prompting suggestions that New Zealand could print a negative employment report for the first quarter.
- **Europe:** Until recently the European Central Bank was not expected to amend monetary policy settings this year. Persistently high inflation, however, and the prospect of intensifying pricing pressures owing to the war in Ukraine has prompted investors to revise these forecasts.
- With Eurozone inflation running at an annual rate of 7.5%, observers are now anticipating as many as four interest rate hikes in the remainder of 2022. The first could occur in early May, following the European Central Bank's next meeting.
- The conflict in Ukraine is affecting economic prospects for the broader region. Rising fuel costs and risks of energy shortages have dampened consumer confidence in both France and Germany, for example.
- The inflation situation in the UK is being exacerbated by rising taxes. In real terms, wages could fall by as much as 4% this year; one of the worst outcomes since World War II. This prospect is dampening consumer confidence and clouding the outlook for discretionary spending. Against this background, it is plausible that economic growth in the UK could moderate in the medium term.
- **Asia/EM:** With virus cases increasing sharply, tough new Covid restrictions were implemented in several cities. This could have implications for global growth, given the associated impact on supply chains.
- Economic activity levels in China in the March quarter were quite resilient and supported a better-than-expected growth outcome. The latest wave of infections has clouded the outlook for GDP growth, however, and prompted authorities to suggest stimulus will be ramped up to help support activity levels and investor sentiment.
- Separately, data confirmed that energy demand has fallen sharply in China. Oil consumption is down the most since the initial Covid shock two years ago, owing to the latest shutdowns.
- In Japan, the yen deteriorated to its lowest level against the US dollar for around 20 years. In spite of some inflationary pressures, the Bank of Japan seems reluctant to amend policy settings and continues to support its bond market via a process of 'yield curve control' similar to what we saw in Australia until late last year. The divergence in policy settings between Japan and other major markets is hindering the yen.

Australian dollar

- The Australian dollar struggled in April, declining in value by 5.4% against the US dollar. By month end, the 'Aussie' bought just over 70 US cents.
- Commodity prices edged higher, providing some support, but concerns over the global growth outlook hampered the currency.
- As well as weakening against the US dollar, the Australian dollar lost ground against a trade-weighted basket of other international currencies.

Australian equities

- Australian equities were quite volatile during April and lost ground in the month as a whole. The S&P/ASX 200 Accumulation Index closed 0.9% lower.
- Investors contemplated the potential implications of a longer conflict in Ukraine, China's zero Covid policy and associated lockdowns, as well as the release of higher-than-expected local inflation data.
- March's recovery in the IT sector unwound in April, with the sector falling 10.4%. Block (-21.7%) revealed semi-annual results (ending December 2021) for its latest acquisition – Afterpay – which highlighted a record 55% increase in revenue. Other metrics missed consensus expectations, however, and the positive headline figure was masked by unexpected increases in bad debts and operating expenses. These headwinds resulted in a net loss of \$345 million.
- Stocks in the Materials sector (-4.3%) struggled as the impact of Shanghai's city-wide lockdown and new restrictions in Beijing cast doubt on Chinese demand for metals including iron ore – a key input in the manufacture of steel. Late in the month, assurances from Chinese officials regarding infrastructure spending provided some support.
- Utilities (+9.3%) continued to benefit from elevated energy prices.
- Similar to their large cap counterparts, the Information Technology sector was the biggest detractor from the S&P/ASX Small Ordinaries Index.
- EML Payments and Megaport – which fell 46.8% and 37.6%, respectively – were among the worst performing small caps following the release of unfavourable trading updates.

Listed property

- Like broader equity markets, global property securities struggled in April. The FTSE EPRA/NAREIT Developed Index declined by 0.1% in Australian dollar terms, although this outcome was assisted by currency moves. In local currency terms, the Index declined by more than 5%.
- The best performing regions included Switzerland (+2.0%), Hong Kong (+1.0%), Singapore (+0.9%) and Australia (+0.6%).
- Laggards included Sweden (-15.8%), Germany (-9.5%) and Canada (-5.0%).
- The recent thematic of moving capital to relatively insulated property markets persisted. Markets such as Hong Kong and Singapore benefitted as investors looked for defensive exposures to help preserve capital, amidst volatile market conditions.

Global equities

- Share markets performed poorly in April, as investor sentiment soured. The MSCI World Index declined 6.9%, extending falls in the calendar year to date to more than 11%.
- The prospect of meaningfully higher interest rates in key regions was concerning for investors, given the possible adverse impact on economic growth and corporate earnings.
- Weakness in the US set the tone. The bellwether S&P 500 Index closed the month down 8.7%, with weakness extending across most areas of the market. This was the worst monthly performance since March 2020, following the initial Covid shock.
- The tech-heavy NASDAQ performed even worse, falling 13.3%; its worst monthly return since 2008 in the midst of the Global Financial Crisis. Index heavyweights including Amazon and Apple reported underwhelming earnings for the first quarter, which hampered sentiment towards the broader sector.

- Streaming services company Netflix also performed poorly, losing almost half of its value after announcing it lost subscribers for the first time in a decade.
- Financials stocks in the US were also impacted by subdued first quarter earnings updates from companies including J.P. Morgan and State Street.
- All major markets in Asia lost ground. The Japanese Nikkei, Hong Kong's Hang Seng and China's CSI 300 all declined between 3% and 5%, for example.
- European stocks were the best performers, despite ongoing economic concerns in the region owing to the Ukraine conflict. Selected markets – including the UK and Spain – actually closed the month in the black, although collectively the region's equity markets declined by around 2.5%.

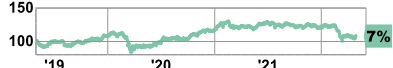
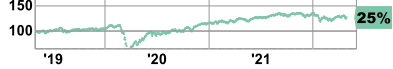
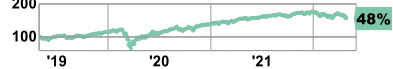
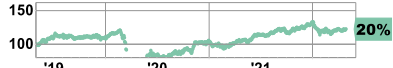
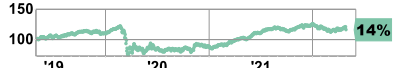
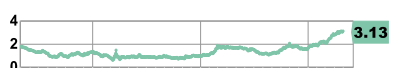
Global and Australian Fixed Income

- Government bond yields continued to rise in major regions, resulting in another month of negative returns from global fixed income markets.
- US Treasury yields rose particularly strongly, after Federal Reserve policymakers reaffirmed that taming inflation is "absolutely essential". Yields on 10-year securities rose by 60 bps over the month, to 2.94%. The yield has nearly doubled in the calendar year to date, underlining how quickly interest rate expectations have evolved.
- Government bond yields rose in Germany and the UK too – by 39 bps and 30 bps, respectively – as investors priced in the likelihood of higher official interest rates in the region.
- There was further movement in the domestic bond market too, amid suggestions that the Reserve Bank of Australia is preparing to start tightening policy settings. 10-year Australian Commonwealth Government Bond yields closed the month 29 bps higher, at 3.13%; the first time they have traded above the 3% threshold since the middle of 2015.
- Volatility extended into the cash space too. Short-dated bank bill yields soared, reflecting the likelihood that official cash rates will be raised in the near term. This resulted in a negative monthly return from the Bloomberg AusBond Bank Bill index, a commonly-used yardstick for the performance of cash funds in Australia.
- Local credit spreads widened too, consistent with offshore moves. This hampered returns from the domestic corporate bond market, and weighed on the performance of the Australian fixed income sector more broadly.

Global credit

- The same themes that affected share markets hampered credit too. Central bank policy was front and centre of attention, particularly as higher interest rates will increase the cost of debt for companies when they refinance existing bonds or look to raise fresh capital.
- The Covid-related lockdowns in China also dampened enthusiasm for credit, given anticipation of supply chain disruptions and the potential for earnings impairment in some industry sectors.
- On a positive note, rising Treasury yields and wider credit spreads have increased the 'all in' yields available from credit and increased the appeal of the asset class among income-oriented investors.
- Most forecasts suggest default rates will increase from current levels, but they seem likely to remain below long-term averages. Again, this appears to be providing some comfort for credit investors.

MARKET WATCH DATA SHEET

		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised Return/Change	3 Year Chart
EQUITIES						
MSCI World (Gross of withholding tax, in AUD)	4,405.74	-3.07%	-8.84%	5.33%	10.60%	
MSCI Emerging Markets (AUD)	1,093.38	-0.19%	-11.17%	-10.93%	2.27%	
ASX 200	7,435.00	-0.85%	8.24%	10.16%	9.42%	
ASX Small Ordinaries	3,298.70	-1.50%	3.68%	2.91%	7.64%	
S&P 500 (USD)	4,131.93	-8.72%	-8.17%	0.21%	13.85%	
REITs						
ASX 200 A-REIT	1,628.60	0.57%	3.27%	15.06%	6.27%	
FTSE EPRA/NAREIT Developed (AUD)	3,679.83	-0.08%	-4.31%	11.36%	4.54%	
CASH and FIXED INCOME						
Official Cash Rate Australia	0.10%	0.00%	0.00%	0.00%	-	
10-year yield Australia	3.13%	+0.29%	+1.23%	+1.38%	-	
10-year yield US	2.93%	+0.60%	+1.16%	+1.31%	-	
Foreign Exchange						
AUD/USD	0.7107	-5.37%	0.87%	-8.00%	0.32%	

Source: Factset and Bloomberg, at 30 April 2022

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