Market Wrap

June 2022

Economic and market overview

- At the half-way mark, 2022 is shaping up to be a miserable year for financial markets. Major asset classes would have to rally hard in the next six months to offset weakness in the first half of the year.
- Global shares shed nearly 8% of their value in June alone, extending losses in the first half of the year to more than 18%.
- The bellwether S&P 500 Index in the US endured its worst H1 performance since the early 1960s, returning –20.0%.
- Local shares have struggled too. The S&P/ASX 200 Index declined nearly 9% in June alone and is down 9.9% in the calendar year to date.
- Bond markets have also generated negative returns, owing to persistently high inflation in key regions and rising official interest rates.
- Government bond yields continued to rise in June – both in Australia and elsewhere – in anticipation of further increases to interest rates by central banks.

- **US**: It has become increasingly clear that the Federal Reserve – the US central bank – is serious about combating inflation.
- Official borrowing costs were raised by 0.75 percentage points in June; the biggest single move in interest rates since 1994.
- Following the announcement, policymakers suggested further rate hikes of that magnitude would be rare going forward.
- Later in the month, however, Jay Powell – Chair of the Federal Reserve – noted "the process [of tightening policy settings] is highly likely to involve pain, but the worst pain would be from failing to address this high inflation and allowing it to become persistent". Consequently, investors are now anticipating another 0.75 percentage point interest rate hike when the Federal Reserve meets again in late July.
- Much higher official interest rates seem likely to dampen economic growth. Indeed, whilst official forecasts remain encouraging, increasing numbers of economists are suggesting a recession in the world's largest economy is probable in 2023.
- All of this is important; the anticipated path of US interest rates and the economic outlook are currently setting the tone for financial markets worldwide.

- **Australia:** Official interest rates were raised by 0.50 percentage points, following May's hike in borrowing costs.
- Policymakers explained that near-zero interest rates are no longer appropriate given rising inflation and the strong rebound in the economy following the Covid pandemic.
- The Governor of the Reserve Bank of Australia made an unusual television appearance, effectively telling Australians to expect much higher interest rates in the months ahead.
- The Treasury is forecasting a further pick-up in inflation, from the 5.1% annual rate seen in the March quarter. Like elsewhere, food and energy prices are rising particularly strongly.
- The latest survey of households suggests Australians are expecting inflation to reach nearly 7%, eroding their purchasing power.
- The local labour market remains quite strong, with firms continuing to hire following the relaxation of Covid-related restrictions. More than 200,000 jobs have been created in Australia in 2022-to-date, although wage growth is currently not keeping up with inflation.

- **New Zealand:** GDP growth slowed sharply in the March quarter, to an annual pace of 1.2%. The Reserve Bank of New Zealand and the Treasury are both forecasting an extended slowdown in the remainder of this year and throughout 2023, owing to the impact of higher interest rates.
- A recession is not currently anticipated, although officials are projecting almost zero growth in employment for the next year and a half, at least.
- Consensus forecasts suggest official borrowing costs will be raised by a further 0.50 percentage points when the central bank convenes in mid-July. Higher borrowing costs are expected to dampen house price growth and consumer sentiment, thereby lowering demand and reducing inflation.

- **Europe**: The European Central Bank has still not raised interest rates from zero, but appears to be under increasing pressure to do so. Inflation is now above 7% in both Germany and France – the two largest economies in the Eurozone – and has risen above 10% in Spain. Accordingly, it seems almost certain that borrowing costs will be raised in the near term.
- Like elsewhere, persistently high inflation is eroding consumer confidence and dampening economic growth prospects.
- The war in Ukraine shows no signs of ending any time soon, suggesting food and energy prices could remain elevated for a prolonged period.
- The Swiss National Bank raised official interest rates by 0.50 percentage points; the first upward move in 15 years. Switzerland is not in the Eurozone and therefore has a separate policy agenda than the European Central Bank. Nonetheless, the move affirms that policymakers in the region are becoming increasingly concerned about pricing pressures.
- In the UK, the pace of inflation quickened to 9.1%. Even more alarmingly, the Bank of England suggested inflation could rise to 11% in October, when utility bills are set to rise again.
- Economic growth has turned negative in the UK – raising the prospect of a recession later this year. Consumer confidence is at its lowest level for more than 40 years, since records began.

- **Asia/EM:** Overall activity levels are rising in China as lockdowns and other virus-related restrictions are being lifted. This is supporting a rebound in confidence levels among small firms.
- That said, while output is increasing, there is no sign of any improvement in profitability among Chinese industrial firms. According to the Bureau of National Statistics, industrial profits in May were 6.5% below 2021 levels, owing to ongoing production and logistics issues and rising costs.
- In Japan, the latest consumer confidence and retail sales data were both below consensus forecasts, suggesting overall weakness in the economy probably persisted in the June quarter.

Australian dollar

- The Australian dollar struggled in June, partly reflecting weakness in the prices of bulk commodities including iron ore and coking coal.
- The 'Aussie' depreciated by around 4% against the US dollar, closing June below 69 US cents; a two-year low.

- The AUD declined by a more modest 1.3% against a trade-weighted basket of other major currencies.

Australian equities

- The unpredictable economic background continued to affect sentiment and dictated Australian equity market movements in June. Pressure mounted early in the month, as higher-than-expected inflation prints in the US and Europe sparked speculation that interest rates would continue to be raised worldwide.
- The associated drop in consumer sentiment helped drive the S&P ASX 200 Accumulation down as much as 11% in mid-June. A rally later in the month helped recover some of these losses, although the S&P/ASX 200 Index was still down 8.8% in the month as a whole; the worst month of performance since March 2020.
- The Materials sector (-12.4%) struggled the most as global growth forecasts were downgraded. Despite positive growth policy commentary from Chinese officials, Iron ore prices declined 2.3% in June. A combination of heavy rainfall and weaker steel margins in China weighed on iron ore demand from the world's largest steel producer.
- Following the Reserve Bank of Australia's decision to increase official cash rates to 0.85%, the market continued to extrapolate potential implications of higher borrowing costs on Australia's highly-leveraged housing sector. This hampered sentiment towards the Financial sector, which returned -11.9%. The 'big four' banks – Commonwealth Bank, ANZ Bank, Westpac and National Australia Bank – fell sharply, between 12% and 18%.
- Tight global supplies continued to support energy stocks, including Woodside Energy (+7.0%), Ampol (+2.6%) and Viva Energy (+1.8%).
- Consumer Staples stocks also fared relatively well, supported by steady performances by supermarket giants Coles (+1.6%) and Woolworths (+2.7%), and hospitality and retailer Endeavour (+4.3%).
- Small cap companies underperformed their larger peers, as 'risk off' sentiment prevailed. Overall, the S&P/ASX Small Ordinaries Accumulated Index returned –13.1%.
- Lake Resources (-49.4%) and Champion Iron (-29.1%) were among the worst performers in the small cap sector.

Listed property

- Global property securities struggled in June and registered negative returns. The FTSE EPRA/NAREIT Developed Index closed the month 4.6% lower in Australian dollar terms.
- Property securities were down in the month as rising interest rates and sustained inflation continued to dominate attention.
- Although there is no immediate risk of recession in key regions, predictions of slower growth in 2023-24 has eroded sentiment towards property stocks. This is unfortunate, as firms in many property sub-sectors continue to enjoy reasonable pricing power and have provided reassuring operational updates recently.
- The best performing regions in June included Japan (+0.1%), Singapore (-0.8%) and Hong Kong (-1.4%).
- Property markets throughout Asia have shown strong defensive characteristics over the last few months and continued to do so in June. Countries such as Japan, Hong Kong and Singapore have benefitted from their unique economic positioning, which has led to resilient performance amidst wider market sell-offs.
- At the other end of the scale, laggards over the month included Sweden (-26.4%), Germany (-18.2%) and France (-17.1%).

Global equities

- Disappointing returns in June rounded out a miserable first half of the year for major share markets.
- Collectively, the MSCI World Index shed 7.8% in June as investors focused on the deteriorating economic outlook in key regions.
- Weakness in the US set the tone, with the S&P 500 Index and NASDAQ both declining by around 8% over the month. The S&P 500 Index is now down 20.0% in the year to date, while the NASDAQ is down nearly 30%. Technology shares tend to be quite sensitive to interest rate movements, and have therefore been hampered by the sharp rise in borrowing costs this year.
- Various other market sectors were down sharply in June too. Cruise lines, for example, were hampered by rising fuel prices and a deterioration in consumer sentiment.
- Returns were poor in Europe too. The German and Italian markets were both down more than 10%, while the French and Spanish markets closed around 8% lower. The UK's FTSE 100 was a relative outperformer, down 'only' 5.8%.
- Asian markets were the best performers. The Japanese and Singaporean markets lost a little ground, but Chinese shares appreciated. The CSI 300 Index jumped 9.6% as Covid-related restrictions started to be lifted. A lockdown was removed in Shanghai, a city with a bigger population than the whole of Australia.
- Finally, shares in Hong Kong marked the 25th anniversary of Chinese rule with a solid performance. The Hang Seng returned 3.0% in June, clawing back further lost ground from earlier in the year. Like on the Chinese mainland, sentiment has improved following the gradual relaxation of strict Covid-related mobility and travel restrictions.

Global and Australian Fixed Income

- Government bond yields remained volatile in June, typically rising sharply early on before drifting a little lower as the month progressed. In June as a while, yields moved meaningfully higher in most major regions, which resulted in another month of negative performance from fixed income.
- Like in the equity market, developments in the US continued to set the tone. A 0.75 percentage point uplift in the Federal Funds rate and affirmation that officials will continue to tighten policy settings quite significantly in the months ahead pushed yields higher in the US and elsewhere.
- Following weakness in June, US Treasuries recorded their lowest H1 return since the 1700s. This underlines just how extraordinary bond market moves have been in the past few months.
- Over the Atlantic, the European Central Bank indicated it would cease its bond purchase program, removing a key pillar of support for local financial markets. Thereafter, investors are expecting interest rates to be raised. A 0.25 percentage point move is most likely as officials start to move official borrowing costs above zero. Caution is required; raising interest rates too much and too quickly would risk strangling growth in some of the weaker countries in the Eurozone, in particular.
- In Australia, government bond yields skyrocketed as investors revised their interest rate forecasts following television comments by the Governor of the Reserve Bank of Australia.

Global credit

- The prospect of a slowdown in economic growth rates as interest rates are lifted in key regions eroded sentiment towards credit markets. A deterioration in consumer sentiment does not augur well for profitability among companies whose revenues are reliant on discretionary spending.
- Moreover, higher official interest rates will increase the cost of debt for firms when new bonds are issued. Higher repayment costs could become an issue for the most indebted companies, or those that experience a material drop in revenues and profitability.
- Credit spreads widened in both the investment grade and high yield sub-sectors against this background, as investors priced in the likelihood of an uptick in defaults worldwide.

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