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Economic Snapshot

December 2022

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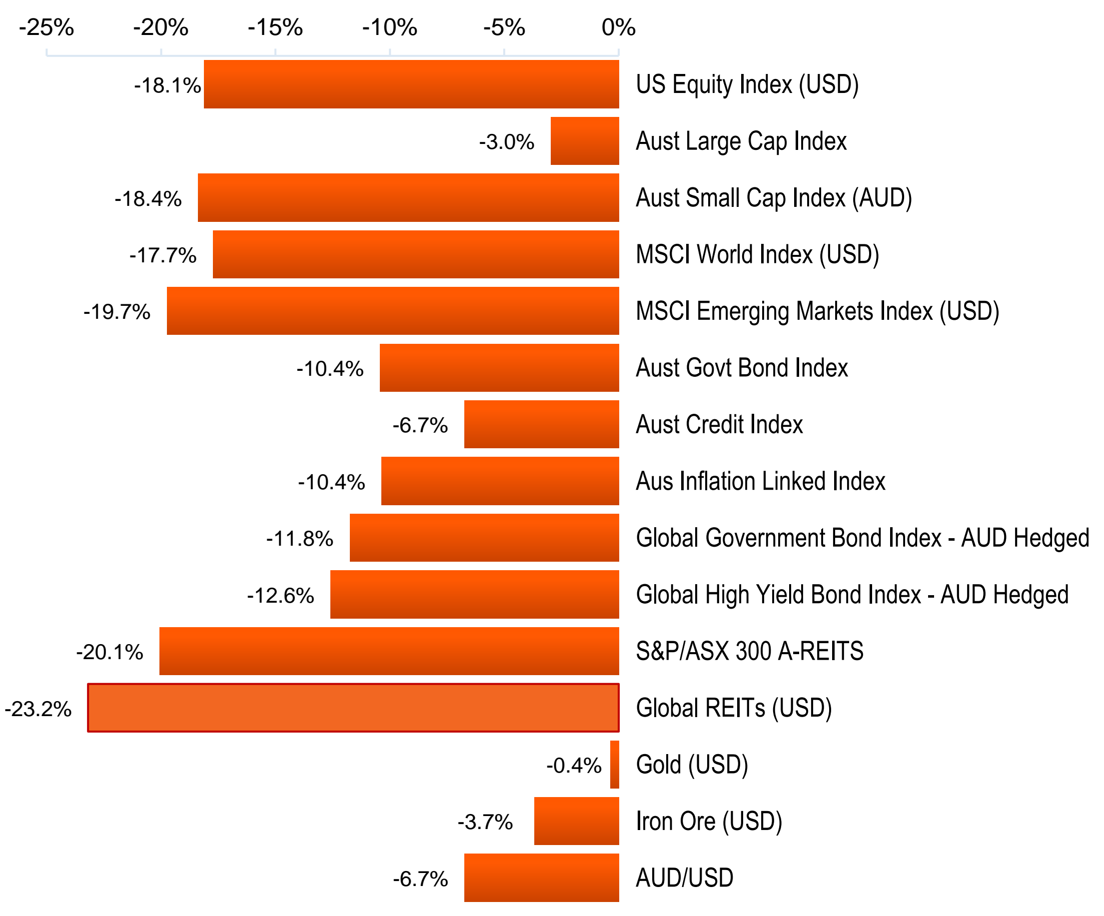
Key market and macroeconomic developments over the 2022 calendar year

Jan 2022	It was a poor start to the new year for financial markets with all major financial assets posting negative returns. The US Federal Reserve announces that tighter monetary policy (higher cash rates) is just around the corner. Global bond markets respond to the Federal Reserve's more 'aggressive' tone by rapidly selling bonds, which caused prices to fall heavily and bond yields to rise. The Australian share market was down (-6.6%) in January, in what was one of its worst starts to a year in decades.
Feb 2022	Russia invades Ukraine in late February. Concerns emerge that the main threat to the global economy may come in the form of an energy crisis (and higher inflation) which would hit Europe hardest given that Russia currently supplies 30% of Europe's gas and oil. With US inflation sitting at 7.5% (the highest reading in 40 years) and a very tight labour market, the Federal Reserve signals it will soon be appropriate to raise the target range for the federal funds rate. Australia posts some encouraging economic figures. The unemployment rate comes in at a 14 year low of 4.2%.
Mar 2022	The US Federal Reserve lifts rates by 0.25%, noting that whilst US economic activity and employment have continued to strengthen, inflation remains elevated and is likely to persist if no action is taken to control it. The Reserve Bank of Australia (RBA) keeps the cash rate unchanged at 0.10%, but hints that it was warming to the idea of lifting rates. Global bond yields spike higher.
Apr 2022	Australia's headline inflation rate rises to 5.1%. The RBA lifts the official cash rate by 0.25% to 0.35%. The US Federal Reserve delivers its biggest interest rate increase since 2000. Major global financial assets pull back sharply on fears that the risk of global stagflation (slow economic growth coinciding with stubbornly high inflation) is starting to rise. The price of iron ore takes a tumble this month, falling almost -9%, reflecting a marked fall in steel production in China.
May 2022	Financial markets respond to the uncertain economic outlook by posting a mixed and volatile set of monthly results. The oil price continues its sustained rally. The US records a softer inflation reading, giving markets reason to think that the Fed may hit the pause button on tightening too hard and too fast, especially if inflation levels continue to moderate.
Jun 2022	Most major global markets finish the month exceptionally poorly. The All Ordinaries was down a sobering -9.4%. The MSCI World Index (USD) and S&P 500 were down -8.6% and -8.3% respectively. Global High Yield Bonds plummets -7.4%. The US hikes rates a further 75 bps and remarks that the battle against inflation is 'unconditional' even if it comes at the expense of jobs (and induces a recession).
Jul 2022	The Australian 10-year bond yield peaked at 4.2% in mid-June, before dropping to 3.1% by month-end. The US market (S&P500) closed the month up (+9.2%), after falling (-8.4%) in June. In part, the strong showing reflected a better-than-expected US corporate earnings season, but it was also driven by 'lofty' market expectations that central banks may pivot away from lifting rates aggressively and may even consider cutting rates next year.
Aug 2022	A brief rally kicked off the month as evidence of easing price pressures and deteriorating demand conditions led investors to continue to speculate that the Federal Reserve will be forced to abandon its hawkish stance. However, all bets of the Fed cutting rates were abruptly put to bed following comments from the Fed that they are committed to bringing inflation under control even at the expense of the economy at large. Other than Australian equities (+1.3%), most major global markets closed the month lower.
Sep 2022	All major financial markets except for the rallying US dollar, rapidly retreat. Global and US fixed income markets posted poor returns as global central banks continue to fight fire with fire with outsized interest rate hikes. Meanwhile, global manufacturing activity continues to contract adding to the growing weight of evidence that the global economy is slowing.

Oct 2022	Most global financial assets rebounded this month. In China, the 20th Communist Party Congress took place with Xi Jinping extending his grip on power for a third term. The RBA surprised markets with a less than expected 25bp rate hike. Australia was also the first among developed market economies to slow its pace of hikes despite elevated inflation.
Nov 2022	Financial markets celebrated the silly season early with another brief rally. Global equities and emerging markets benefited from preliminary signs that inflationary pressures are gradually falling and that tough Chinese Covid-19 lockdowns may soon be lifted. The RBA eased off the interest rate brake with another ‘down sized’ 25bp hike.
Dec 2022	The fabled Santa Claus rally fails to materialise. The performance of the major financial assets was mixed in December. Global bonds, global equities, and the US dollar were among the worst performers. Chinese equity indices were the main exception, as they continued to profit from improving investor sentiment following the relaxation of Covid-19 policies. The year comes to a disappointing end for investors. The US dollar, crude oil, and cash were the only major financial assets that generated positive gains in a volatile world dominated by inflation and hawkish central bank policies.

2022 Calendar Year Returns

An exceptionally poor and highly unusual year for global financial markets. It was the only time in recorded history where both bonds and stocks fell by more than -10%.



2022 Year in Review

2022 was an extremely challenging and highly unusual year, with investors experiencing the longest bear market since the Global Financial Crisis. What made 2022 so unique was the fact that both global stocks and bonds fell by more than 10% after coming into the year with promising prospects.

The US S&P 500 fell -18.1% in 2022, its worst year since 2008. Up until then, corporate profits were growing at their fastest pace since 2010. Pent-up demand and pricing power led to strong revenue growth and record profit margins. But circumstances turned for the worst throughout 2022. Events related to disrupted supply chains, strong consumer demand, and elevated food and energy prices conspired to push inflation higher. This, along with higher wages ate into company profit margins and put pressure on the cost of living.

Central banks responded aggressively to the velocity of inflation, led by the US Federal Reserve and the plucky Reserve Bank of NZ. Investors who had been conditioned to years of low inflation and near zero interest rates, suddenly were forced to digest what the new environment meant for their portfolios and respond to volatility in most asset classes. Long dated bonds and growth stocks were the most notable losers from the new investment paradigm; however, few asset classes were completely spared. The combination of higher interest rates, reversal of some Covid-19 era consumer preferences, zero-Covid-19 disruption in China, and numerous other stock specific issues caused havoc with mega-cap tech-sector market darlings. The famed FAANG stocks suffered significant declines.

That said, the general decline was global in scope. The MSCI ACWI (World) Index fell 17.7%. Australia fared better, thanks to our energy, materials, and utilities sectors, but weakened 3% in sympathy. Global government bonds - considered a very safe asset - capitulated, plunging almost 12% in what proved to be one of the most volatile years for bond markets in history. Flavour of the month cryptocurrency also had a nightmare run, with Bitcoin plunging 64.2% in 2022. It was truly an environment that proved to be a major headache, for conservative and more adventurous investors alike.

While central banks continued to push short-term interest rates higher throughout the year, long-term rates did most of the damage in the first three quarters of the year. The widely followed difference (spread) between the 10-year / 2-year US Treasury yields turned negative (inverted) in July, followed by the 10-year / 3-month spread in October. These inverted yield curves have been one of the most accurate predictors of a recession. This contributed to a growing consensus amongst leading economists of a high likelihood of a US and global recession developing in 2023.

The combination of the horrendous stock and bond returns and the highest short term interest rates in 15 years meant that cash was king in 2022. It was the best performing asset class. US Treasury bills outperformed all major equity and fixed income benchmarks. US Treasuries returned over 2% for only the second time since 2007 outperforming bonds by a record 15.1% and stocks by 20.2%.

The most critical event of the year, in terms of geopolitics, was Russia's invasion of Ukraine on February 24. Sadly, the tragic war continues almost 12 months on, with no clear end date in sight. Human lives aside, the other casualty of this deplorable conflict has been a recession for many European economies, still struggling with the aftermath of the pandemic, cost of living pressures, and high dependency on energy sourced from Russia. In fact, Eurozone energy inflation hit a record 44.3% in March and was 34.9% as of November 2022. Energy stocks soared with commodities early in the year, but as crude oil prices reversed, energy stocks continued to climb well into the latter part of the year. The S&P 500 Energy sector peaked for the year on November 15, but it still rose 59.0% on the year and outperformed the S&P 500 by 78.5%.

Broad based inflation was the other big talking point and a principal driver behind central banks' decisions to raise rates this year. The US CPI peaked at 9.1% in June, its fastest rate since November 1981. Inflation was a global phenomenon, with the Eurozone, UK, and Canada facing their highest inflation rates since the 1980s. Australia was also not immune from global price pressures and domestic factors. Inflation is currently sitting at 7.3% (a 32 year high).

You may recall that central banks spent 2021 telling the world that inflation was a temporary problem that would resolve itself as global supply chains improved. Well, persistent pandemic restrictions in China and the ongoing war in Ukraine put an end to that idea. The Fed took the Federal Funds rate from 0-0.25% to 4.25- 4.50%, including four consecutive 75-basis point hikes, and reversed quantitative easing to tightening in the blink of an eye. Other central banks followed suit, including Australia.

While the rest of the world 'reopened,' China continued with its zero-Covid-19 policy through most of 2022. Entire cities were locked down for weeks if a handful of cases were detected. Not only was the Chinese economy hit hard by the closures, but trade to and from China was volatile. After widespread protests over zero-Covid-19 in November and December, the government lifted most of its harsh restrictions, giving some hope that a recovering China may help to ease some of the growing global pain.

Outlook

12 months ago, we correctly forecasted a volatile year ahead and today we view 2023 as a year when inflation will subside as monetary tightening naturally runs its course. However, recent experience informs us that it may take a further 6-12 months before inflation is tamed and it falls back to the desired two percent target of many central banks. There is a risk that central banks could overdo monetary tightening and drive economies into a deeper recession than need be.

Regardless of the direction of central bank policy, there is little doubt that an economic slowdown is currently underway. Global manufacturing is contracting, and company earnings forecasts are far too optimistic given this scenario. In such a recessionary scenario, global equities could potentially fall heavily before staging a recovery once all the bad news is fully priced in. Currently, this is not the case, but we will have a clearer picture once the current reporting (earnings) season concludes.

For now, our base case is that equities will find their bottom somewhere in the middle of this year. If the expected recession turns out to be mild, there could be an attractive re-entry point into risk assets at that time.

In the meantime, we continue to maintain that investors should remain defensive and patient. 2022 taught us to expect the unexpected and to always plan for the worst and hope for the best. There may be more pain to come this year but once the initial phase of recessionary dynamics has played out, we are confident that you will be well positioned to participate and profit as markets rebound.

Major market indicators

Interest Rates (at close of period)	31-Dec-22	30-Nov-22	31-Oct-22	Qtr change	1 year change
Aus 90 day Bank Bills	3.17%	3.06%	2.95%	+41.0	+311.0
Aus 10yr Bond	3.57%	3.71%	3.92%	-17.0	+196.0
US 90 day T Bill	4.30%	4.27%	4.06%	+108.0	+424.0
US 10 yr Bond	3.83%	3.70%	4.08%	+2.7	+233.3
Currency (against the AUD)					
US Dollar	0.678	0.670	0.639	5.47%	-6.73%
British Pound	0.563	0.559	0.554	-3.60%	4.63%
Euro	0.636	0.647	0.645	-3.91%	-0.81%
Japanese Yen	89.38	93.45	95.31	-3.45%	6.87%
Trade-Weighted Index	61.40	62.10	61.30	-0.16%	0.49%
Equity Markets					
Australian All Ordinaries	-3.3%	6.4%	5.7%	8.8%	-3.0%
MSCI Australia Value (AUD)	-2.3%	6.9%	6.7%	11.4%	6.8%
MSCI Australia Growth (AUD)	-4.7%	4.7%	5.9%	5.7%	-8.8%
S&P 500 (USD)	-5.8%	5.6%	8.1%	7.6%	-18.1%
MSCI US Value (USD)	-3.7%	6.1%	11.1%	13.5%	-6.2%
MSCI US Growth (USD)	-8.1%	4.7%	4.6%	0.6%	-32.0%
MSCI World (USD)	-4.2%	7.0%	7.2%	9.9%	-17.7%
Nikkei (YEN)	-6.5%	1.4%	6.4%	0.8%	-7.3%
CSI 300 (CNY)	0.6%	9.8%	-7.7%	2.0%	-19.8%
FTSE 100 (GBP)	-1.5%	7.1%	3.0%	8.7%	4.7%
DAX (EUR)	-3.3%	8.6%	9.4%	14.9%	-12.3%
Euro 100 (EUR)	-4.2%	8.0%	7.3%	10.9%	-7.0%
MSCI Emerging Markets (USD)	-1.4%	14.8%	-3.1%	9.8%	-19.7%
Commodities					
Iron Ore (USD)	15.7%	25.9%	-16.5%	21.6%	-3.7%
Crude Oil WTI U$/BBL	-0.3%	-7.0%	8.2%	0.4%	6.7%
Gold Bullion $/t oz	3.6%	7.0%	-2.2%	8.5%	-0.4%

Source: Quilla, Thomson Reuters Datastream

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