Goodbye ‘21, Hello ‘22....Better the devil we knew??

It’s January and the start of a new year. Whether you are back at work or enjoying a summer break, we wish you all a Happy New Year and a return to “normal life” in 2022, whatever that even means in the ‘20s!

The global economy and financial markets ended the year as they began, all over the place, as the world grappled with a new wave of COVID-19. In December, speculation about interest rate hikes grew on the back of rising inflation. US Federal Reserve chair, Jerome Powell said the Fed would not lift rates until it finished scaling back/tapering bond purchases in March. Fed officials expect three increases in the federal funds rate this year from the current 0-0.25% target to around 1.0%. In Australia, Reserve Bank governor Philip Lowe said he would not consider further scaling back bond purchases until the bank’s next meeting in February. He insists the cash rate will remain on hold at 0.1% until 2023, but the market anticipates a rate rise later this year.

Australia’s economic growth fell 3.9% in the year to September, as household spending fell during extended lockdowns. As lockdowns ended and businesses began hiring, the unemployment rate fell from 5.2% to 4.6% in November. The ANZ-Roy Morgan consumer sentiment index hit a six-week high of 108.4 in the lead up to Christmas. One cause for optimism may have been rising house prices, which were up 1% in December and 22% over the year.

Consumers also enjoyed some relief at the petrol bowser ahead of Christmas, but global oil prices remain volatile as markets weighs up reduced travel and falling demand for fuel due to Omicron and uncertain supply from OPEC producers. The Aussie dollar finished 2021 at US72.5c, a big drop from where it started at US77c.

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2021
YEAR IN REVIEW

For the second year running, the pandemic was the focus for policy makers, markets, businesses, and individuals alike.

The year began with hopes that the rollout of vaccines would stem the spread of COVID-19 and allow economies to reopen. Instead, most countries were hit by wave after wave of the virus, periodic lockdowns, and ongoing disruption to lives and livelihoods.

Yet there were also positives. Australia's vaccination rate exceeded all expectations while property and share markets soared. Investors who stayed the course enjoyed double digit returns from their superannuation, with the median growth fund tipped to return more than 12 per cent for the year.[i]

The big picture

If the pandemic has taught us anything, it is to expect the unexpected as new variants of the coronavirus – first Delta and now Omicron – hampered plans to return to a 'new normal'.

Yet through it all, the global economy picked up steam. In the year to September the two global powerhouses the US and China grew at an annual rate of 4.9 per cent, while the Australian economy grew by 3.9 per cent.

The Australian economy is estimated to have grown by more than 4 per cent in 2021, with unemployment falling to 4.6 per cent ahead of the Christmas rush.

But challenges remain. As global demand for goods and services picked up, ongoing shutdowns disrupted manufacturing and supply chains. The result was higher prices and emerging inflation.

Inflation and interest rates

Australia's inflation rate jumped from less than one per cent to 3 per cent in 2021. This is lower than the US, where inflation hit 6.8 per cent, but it still led to speculation about interest rate hikes.

The Reserve Bank insists it won't lift rates until inflation is sustainably between 2-3 per cent, unemployment is closer to 4 per cent and wages growth near 3 per cent. (Wages were up 2.2 per cent in the year to September.) The Reserve doesn't expect to meet all these conditions until 2023 at the earliest, but many economists think it could be sooner.

While Australia's cash rate remains at an historic low of 0.1 per cent, bond yields point to higher rates ahead. Australia's 10-year government bond yields rose from 0.98 per cent to 1.67 per cent in 2021.

Shares continue to shine

Global sharemarkets made some big gains in 2021 on the back of economic recovery and strong corporate profits. The US market led the way, with the S&P500 index up 27 per cent to finish at near record highs.

European stocks also performed well while the Chinese market suffered from the government's regulatory crackdown and the Evergrande property crisis.

In the middle of the pack, the Australian market rose a solid 13.5 per cent in 2021. The picture is even rosier when dividends are added, taking the total return to 17.7 per cent.[ii]

Volatile commodity prices

As the global economy geared up, so did demand for raw materials. Commodity prices were generally higher but with some wild swings along the way.

Oil prices rose around 53 per cent, thermal coal prices soared 111 per cent and coking coal rose 37 per cent. Australia's biggest export, iron ore, fell 25 per cent but only after hitting a record high in May.

Despite demand for our raw materials and a sound economy, the Aussie dollar fell from US77c at the start of the year to finish at US72.5c, providing a welcome boost for Australian exporters.

Property boom

Australia's residential property market had another bumper year, although the pace of growth shows signs of slowing. National home prices rose 22.1 per cent in 2021, according to CoreLogic. When rental income is included the total return from property was 25.7 per cent.[iii]

Regional areas (up 25.9 per cent) outpaced capital cities (up 21.0 per cent), as people fled to the perceived safety and affordability of the country during the pandemic. Even so, prices were up in all major cities.

Looking ahead

The pandemic is likely to continue to dominate economic developments in 2022. Much will depend on the supply and efficacy of vaccines to protect against Omicron and any future variants of the coronavirus.

Financial markets will also keenly watch for signs of inflation and rising interest rate. In Australia, inflation is likely to be constrained while wages growth remains low, and the Reserve Bank keeps rates on hold.

The wild card is the looming federal election which must be held by May. Until the outcome is known, uncertainty may weigh on markets, households, and business.

i https://www.chantwest.com.au/resources/remarkable-a-10th-consecutive-positive-year

ii https://www.commsec.com.au/content/dam/EN/Campaigns_Native/yearahead/CommSec-Year-In-Review-2022-Report.pdf

iii https://www.corelogic.com.au/news/housing-values-end-year-221-higher-pace-gains-continuing-soften-multi-speed-conditions-emerge

Unless otherwise stated, figures were sourced from Trading Economics (www.tradingeconomics.com) on 31/12/21

INVESTING FOR INFLATION

Inflation appears to be firmly on the rise and while that is bad news for consumers it's not necessarily bad news for investors. In fact, inflation may provide new opportunities.

In the September quarter, the consumer price index (CPI) rose 3 per cent year on year, a level previously not forecast to be reached until 2023. The underlying rate of inflation, which removes extreme price changes and is generally considered a more accurate reflection of what is happening on the ground, increased 2.1 per cent on an annual basis.

Now the Reserve Bank of Australia (RBA) is looking at bringing forward interest rate rises in the wake of this growing inflation rate. When it does, it will be the first time in 11 years that the bank has raised interest rates.

This development is highlighted by the RBA's relaxing and then abandoning its target for the 3-year government bond rate (the benchmark) which it had originally set at 0.10 per cent. By the start of November, the market had pushed this rate above 1 per cent, 10 times the RBA's original target, effectively forcing its hand.[i]

The RBA's stated aim is to keep the inflation rate within its 2-3 per cent target range. But some seasoned market observers are forecasting the rate could get as high as 3 to 5 per cent by 2023, and perhaps a touch higher.[ii]

So why is this happening now?

Factors behind the rise

There has been a combination of factors leading to the uptick in inflation, mostly resulting from events stemming from the COVID-19 pandemic and the prospect of a recession fading fast.

These influences include cost pressures from global and local supply chain bottlenecks along with higher energy prices, an uptick in rents and rising insurance costs.

A shortage of labour, partly on the back of the absence of migration and casual overseas workers throughout the pandemic, is now also putting pressure on wages.

For some months, there has been debate over whether inflation was just a transitory event in the wake of COVID, but it is beginning to look more permanent as the months go by.

Opportunities for investors

Inflation is not all bad news for investors, but it may change the way you think about your investments.

The low interest rate regime that led to soaring property prices has left many investors with healthy gains in asset prices, adding to their wealth. While the move to higher interest rates may make borrowing money harder and take some of the boom out of the housing market, it is worth remembering the gains made to date are unlikely to be completely wiped out.

But it's not just property; all major asset classes are highly valued at present.

Rising inflation traditionally erodes the value of bonds and cash. As interest rates move north, the appeal of those bonds offering the current low rates will fall and in turn so will the price.

As a result, it may be worth assessing whether your asset allocation to bonds is still appropriate for your circumstance and long-term goals, as floating rate bonds or inflation linked bonds may be more appropriate.

Quality stocks still attractive

The reduced appeal of longer-term bonds traditionally increases the appeal of equities as a better hedge against rising inflation.

Also, with a once-feared double dip recession now looking unlikely in North America, Europe, China and Japan, many companies are expected to enjoy continued growth in what is still a low interest rate environment.

While sharemarket returns may be more modest than in recent times, many companies still offer potential. Quality companies offering a high return on earnings, a lowly geared balance sheet and the ability to set prices, will continue to provide attractive investment options.

Inflation and interest rates

The challenge with a higher inflation rate is that it could outpace any growth in interest rates, leaving those weighted towards long-term fixed interest investments in a situation where their money is being eroded over time.

As the global economy begins to shift gears, now may be the time to consider reviewing your portfolio to reflect the changing conditions.

If you would like to know more about whether your current investment mix is appropriate for your circumstances and the times, please give us a call to discuss.

i https://www.rba.gov.au/media-releases/2021/mr-21-24.html

ii https://theconversation.com/australias-reserve-bank-signals-the-end-of-ultra-cheap-money-heres-what-it-will-mean-170928

Investing on FACTS not FOMO

Prices for property, cryptocurrencies and shares have all hit records recently. While great news for investors, there's always a risk that some people will jump into the market because they are afraid of missing out on easy money.

FOMO, or the fear of missing out, has always been around on financial markets, but social media and reality television have taken it to a whole new level.

In the lead-up to the 1929 Wall Street Crash, the saying was that when the shoeshine boy or taxi drivers started giving you share tips, it was a sure sign the market was running ahead of itself. Rather than a signal to buy, it was probably time to bail out or bide your time.

These days, social media has become the new shoeshine boy.

A long history

This fear of missing out goes back even further to the mid-1600s Dutch tulip market bubble. At its height, the cost of the rarest tulip bulb was the equivalent of six times the average wage. People rushed to buy tulips on credit for fear of missing out. Inevitably, the tulip bubble burst, devastating investors and the Dutch economy.

A much more recent example of a market getting overheated was the dotcom boom at the turn of the century when people paid top dollar for shares in companies with no history of profits.

Two decades later, and there are concerns that FOMO may be a factor in the rise of property, shares and cryptocurrencies.

Over the past year, Australian house prices have jumped 22 per cent on average and more in some parts of the country.[i]

People are scared that if they don't get in now, then they will never get a foot on the property ladder.

Global share price to earnings (PE) ratios are also at high levels. Some argue that high prices are justified by low interest rates while others worry that some companies may be valued on an overly optimistic view of future earnings.[ii]

Cryptocurrencies are complex

But it's the focus on cryptocurrencies that has some market veterans concerned, not least because these are complex new instruments that are not well understood.

At the end of the day, you should always understand where you are putting your money and how it fits your investment objectives and risk profile. If a big drop in price would keep you awake at night, then crypto may not be for you.

In its typically understated style, the Reserve Bank has warned that "the current speculative demand for cryptocurrencies and their surge in value is likely to reverse".[iii]

Meme stocks are also an area of concern. These are companies made popular with retail investors through social media sites like Reddit. Examples include AMC and Gamestop.

They are what used to be called pump-and-dump stocks, popularised in the movie The Wolf of Wall St. The only investors to really benefit are those who got in at the beginning and sold in time to realise their gains; not the ones who bought at the peak of the frenzy.

Think long term

Investments should always reflect your long-term objectives. Jumping from one investment to another just because somebody says it's a good thing can be dangerous.

In the words of Warren Buffett, it pays to be counterintuitive with the market. Rather than follow the crowd "be fearful when others are greedy and greedy when others are fearful".

But humans being human, tend to do the opposite and pay the price. It's an age-old maxim that in the long run, growth assets like shares and property tend to outperform other asset classes. You won't enjoy those long-term gains if you are buying and selling in reaction to short-term market moves.

That's not to say you should set and forget your investments. For instance, when the market is booming, it may present an opportunity to realise some of your gains, sell any duds, and reinvest the proceeds when bargains emerge.

If you are considering an investment but unsure about its worth or where it might sit within your overall portfolio, give us a call.

i https://www.corelogic.com.au/sites/default/files/2021-10/211101_CoreLogic_Oct_homevalueindex_Nov1_2021_FINAL.pdf

ii https://www.forbes.com/sites/bradmcmillan/2021/09/20/how-can-we-tell-if-the-market-is-overvalued

iii https://www.smh.com.au/politics/federal/fads-and-fomo-rba-predicts-the-surge-in-cryptocurrencies-will-end-20211118-p59a28.html