GPS WEALTH

Inflation, Invasion and Infections

"Interest rates continue to increase in an effort to curb inflationon"

GPS Wealth Monthly Market Update

It was another very volatile quarter for financial markets as share and property markets took their lead from the interest rate market. Inflation remains highly elevated and concerns are building that the current inflation pulse could become long lasting, as pay rises adjust to reflect the high cost of living. This fear has prompted a near uniform response from central banks to tighten policy to slow demand, such that demand and supply come into better balance. Whether this is the correct policy action remains to be seen because its hard to fix supply issues using interest rates. The fact is that **central banks have chosen inflation over economic growth suggesting that the odds of recession (particularly in the US) increased over the period.** As the quarter unfolded, it became clear that the path to a soft economic landing was looking increasingly narrow. For most asset classes, the combination of high inflation, rising rate expectations and increased recession risk has been an unpleasant cocktail and the extent and breadth of asset market declines has been historic.

Many central banks continued to tighten policy to hold back inflation whilst **the prolonged invasion of the Ukraine by Russia kept the oil price inflated and inflation high.** Persistent Covid infections kept workers at home with chaos raging at hospitals and airports around the world, whilst in China, a zero-tolerance policy to the virus proved very economically unfriendly. The US Federal Reserve increased the official interest rate by 0.50% in May and then by 0.75% in June bringing the official interest rate to 1.75%. Financial markets rightly expected the rise which is by no means complete. The interest rate is expected to increase again in July with market participants expecting a peak at over 3%. Whether that is realised remains to be seen as economic data like the Services PMI index, (a survey of service companies including IT, hotels, financial institutions and communications – just to name a few) is beginning to show weakness. Employment for now remains strong and commodity prices have fallen recently suggesting that economic growth will remain positive but continue to slow.

In China economic growth slowed due to Covid lockdowns in Shanghai and Shenzhen. China has been facing a new round of virus spikes in July although the economic impacts look manageable so far. Authorities appear to be adopting more targeted measures to flight flare-ups. Despite the rising cases, authorities do not intend to nationally re-impose a cross-province travel ban or re-tighten the quarantine for cross-border travellers, but rather impose mass testing and fresh restrictions on social distancing. With the Chinese border closed until March 2023, growth is likely to remain weak for the foreseeable future.

Emmanuel Calligeris
Chairman of the Investment Committee

In Australia, the Reserve Bank increased the official cash rate to cool inflation that has been rising for the same reasons cited above. Although house prices are cooling, the labour market remains exceptionally tight with labour in short supply and costing more. The unemployment rate fell to a 48–year low of 3.5%. Australia's labour market is clearly in unprecedented territory, with one unemployed person per job vacancy and a record–high employment–to–population ratio. Gains over the remainder of 2022 will depend on how much further participation can rise as well as the outlook for immigration. On the consumer and business front, the Westpac–MI consumer sentiment survey continues to signal confidence in the labour market and the longer–term economic outlook, however household's near–term personal financial outlook is of great concern given historic inflation and rapidly rising interest rates. The survey recorded a seventh consecutive fall to a level only seen during times of significant economic disruption. According to NAB's latest business survey, while business conditions continue to show strength across the economy, confidence has fallen below its long–run average. Arguably this deterioration stems from the availability and price of labour and other inputs as well as growing uncertainty over the global outlook.

Over the quarter, the Australian 10-year bond yield reached 4.20% whilst the rate for the US 10-year bond hit 3.50% resulting in further capital losses for bond investors following losses in the first quarter. To put this into context, the Australian 10-year bond was trading at just 0.71% in March 2020 as the RBA printed money to buy government bonds driving yields to historically low levels. The government used that printed money keep our population safe and fed through the lockdowns. That is over. Surprisingly, the Australian interest rate market has priced in more aggressive rate rises than the US, despite a lower inflation reading and higher consumer debt in Australia.

Importantly, in early July, as this publication went to press, investors realised that the combination of high inflation, higher gas, oil and coal prices, a lockdown in China and higher interest rates were likely to sap economic growth. The added threat of overzealous central banks looking to re-establish their inflation fighting credentials (having fallen asleep at the wheel) could potentially throw the world's major economies into recession by raising rates too aggressively. We have subsequently seen a sizable decrease in bond rates since the June peak.

Share markets were not spared. The S&P 500 index of the largest companies in the US is down just over -20% over the last 6 months, while the technology heavy NASDAQ index is down almost -30%. The Australian share market decreased -10.39% over the last 6 months, to be -6.78% lower over the year to June. Iron Ore was down 21.6% over the quarter as major consumer China imposed strict Zero COVID lockdowns which effectively stifled economic activity, albeit restrictions started easing near the quarter end.

We find ourselves at the toughest part of the investment cycle where prices have adjusted lower suggesting that valuations are cheap. However, analyst expectations for future profits are yet to be revised materially lower. Share prices around the world have fallen in expectation that profits will follow over the course of 2022 and 2023. If profits don't fall much, share market valuations seem fair. However, we do know that higher input costs are affecting profit margins. The company profit reporting season has just started so we will better gauge company health in the next few weeks. Volatility remains high as markets balance the risks of recession due to higher interest rates aimed at curbing higher inflation around the world. Growth has slowed and inflation will fall with a lag. We expect inflation is likely to be higher than it was in the past decade but should settle between 2.5%-3% by the end of 2023.

Returns

30th June 2022

ASSET CLASS RETURNS ARE BASED ON

Australian Cash
RBA Bank accepted Bills 90 Days

Australian Bonds
Bloomberg AusBond Composite 0+ Yr TR AUD

International Bonds Hedged
BarCap Global Aggregate TR Hdg AUD

Australian Listed Property
S&P/ASX 200 A-REIT TR

International Property Hedged
FTSE EPRA/NAREIT Dv REITS TR Hdg AUD

Australian Shares
S&P/ASX 200 TR

International Shares
MSCI World Ex Australia NR AUD

Emerging Market Shares
MSCI EM GR AUD

RETURNS TO THE 30TH JUNE 2022

	1 Month	3 Months	1 Year	3 Years	5 Years
Australian Cash	0.13	0.25	0.29	0.35	0.94
Australian Bonds	-1.48	-3.81	-10.51	-2.58	0.87
International Bonds Hedged	-1.64	-4.66	-9.33	-1.63	0.78
Australian Listed Property	-10.33	-17.68	-12.26	-2.75	4.41
International Property Hedged	-7.65	-15.84	-8.44	0.03	3.14
Australian Shares	-8.77	-11.90	-6.47	3.34	6.83
International Shares	-4.64	-8.42	-6.52	7.83	10.12
Emerging Market Shares	-2.61	-3.30	-18.43	1.25	4.44

GPS WEALTH

GPS Wealth Ltd | AFSL 254 544

Level 7, 115 Pitt Street, Sydney NSW 2000

+61 2 8074 8599

info@gpswealth.com.au

www.gpswealth.com.au

Prepared by DWA Managed Accounts Pty Ltd

ABN 89 104 065 250 | AFSL 264 125