ASSET ALLOCATION REPORT

March 2022 Quarter

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P **07 4924 9100** / E **kennas@kennas.com** / **www.kennas.com**

5th Floor Capricornia Electricity Centre Cnr Fitzroy & Alma Streets / PO Box 201 / Rockhampton Qld 4700

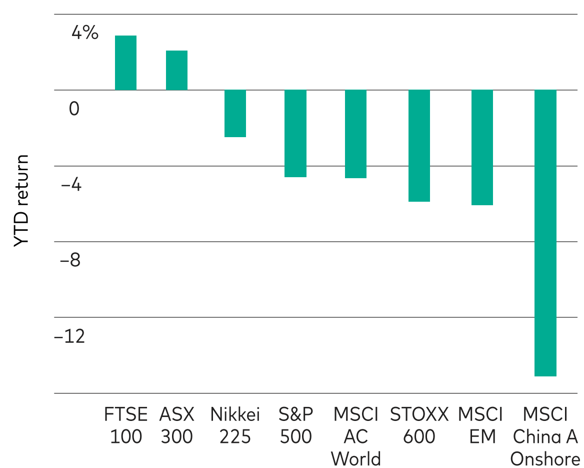
QUARTER IN REVIEW

Global markets entered the new year facing familiar headwinds, as rising inflation pressures and the prospect of higher interest rates remained top of mind for investors. Equity markets became more dispersed in January as policy tightening weighed on rate-sensitive growth stocks and dampened risk appetite. However, the conflict in Ukraine further stoked inflation and supply chain concerns as commodity prices were sent soaring.

Volatility remained elevated as equities sold off over the quarter, with tech stocks leading global equities lower to a 4.6% loss **(Figure 4)**. Meanwhile, energy and materials companies capitalised on elevated commodity prices and financials benefitted from higher interest rates. Heavy exposure to these sectors saw the Australian equity market among the few ending the quarter in positive territory, up 2.1%. Emerging markets continued to be weighed down as the impacts of the Ukraine war and COVID outbreaks in China pulled the overall index down 6.1%.

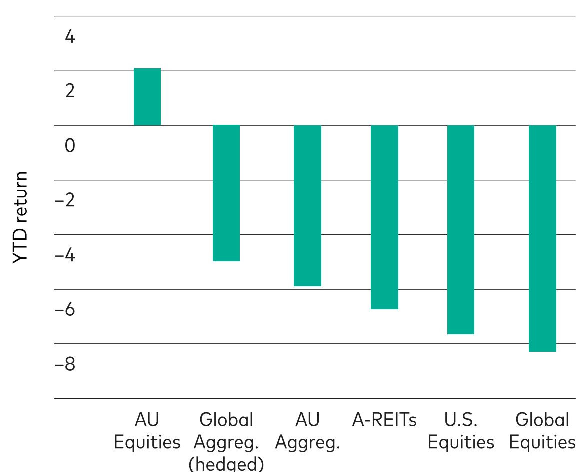
Fixed income markets similarly sold off as yields climbed (as prices fell) throughout the quarter. Despite a brief rally in bonds as the war began in Ukraine, the overwhelming trajectory of yields was upwards. Markets priced in increasingly hawkish responses from central banks as concerns focused on the compounding effects of surging commodity prices and further supply chain shocks on already heated and inflationary economies. 10-year government bonds in the United States and Australia rose by 81 basis points and 116 basis points respectively, translating to losses of 5% and 5.9% across international and domestic bonds **(Figure 5)**.

Figure 4. Australian and U.K. equities lead YTD



Notes: Returns are cumulative total returns in local currency.
Source: FactSet, as of 31 March 2022.

Figure 5. AUD indices broadly retreated



Notes: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv, as of 31 March 2022.

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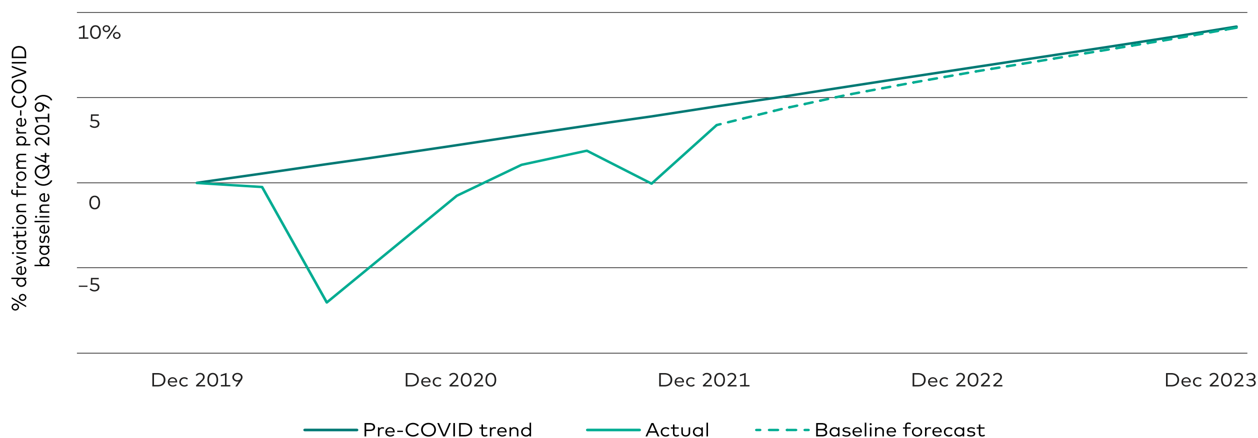
ECONOMIC OUTLOOK

Since lockdowns ended in late 2021, the Australian economy has come back to life. Many restaurants, cafes and retail stores are bustling again, tourists are slowly returning to Australia's shores, and unemployment is lower than before the pandemic. This has prompted the Reserve Bank of Australia (RBA) to shift its tone on the outlook, which suggests that interest rates are likely to rise this year.

The pandemic took a big toll on the Australian economy. During the first major outbreak of COVID in 2020, GDP contracted by around 7%, the largest decline in modern history **(Figure 6)**. As the initial lockdowns ended, the economy quickly recovered. It was only when a second major outbreak occurred that the economy contracted once more, this time by only 2%. With the rollout of the vaccine and the end of lockdowns, GDP has once again bounced back, and is likely to recover its pre-crisis trend in 2022.

Figure 6. GDP has nearly recovered to its pre-COVID trend



Source: Vanguard calculations based on data from Bloomberg, as of 31 March 2022.

Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance.

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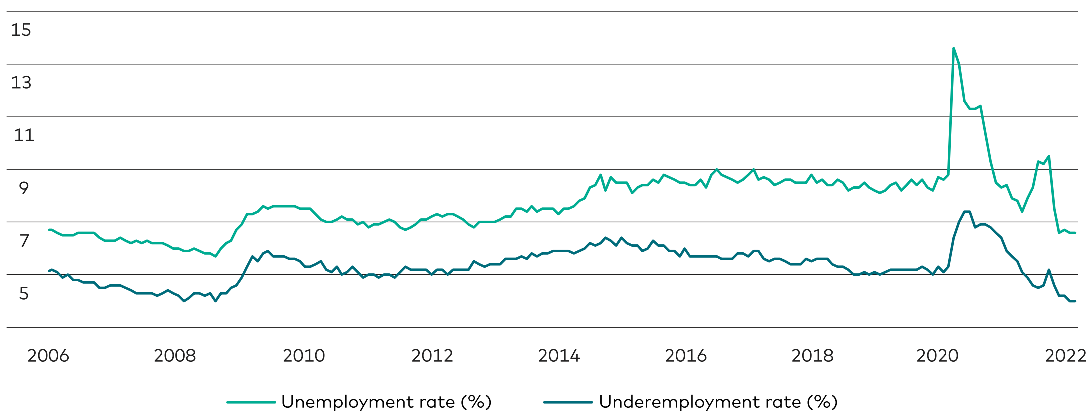
The economic recovery has also helped the labour market bounce back from the pandemic shock. Unemployment peaked at over 7% during 2020 **(see Figure 7)**. This does not include furloughed workers who were technically still employed, so the true peak in unemployment was likely much higher.

By February this year, unemployment had fallen to 4% for the first time since 2008, and underemployment, which includes people insufficiently employed relative to what they desire, is also back at pre-GFC levels.

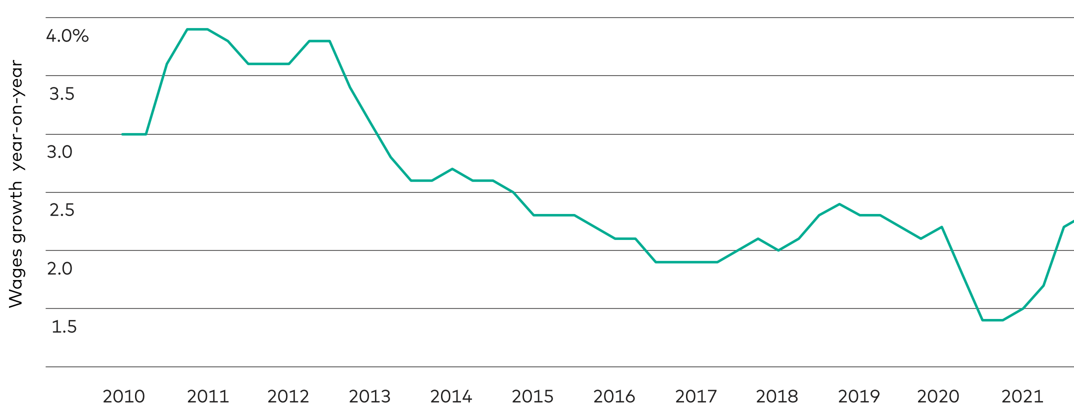
Vanguard expect unemployment to fall below 4% and remain at low levels for the foreseeable future. Consequently, they expect wage growth to steadily rise **(Figure 8)**, although this process tends to be drawn out due to multiyear enterprise agreements that cannot be immediately renegotiated.

Figure 7. Unemployment and underemployment have fallen to pre-GFC levels



Source: Bloomberg, as of 31 March 2022. Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance.

Figure 8. Wages growth is recovering



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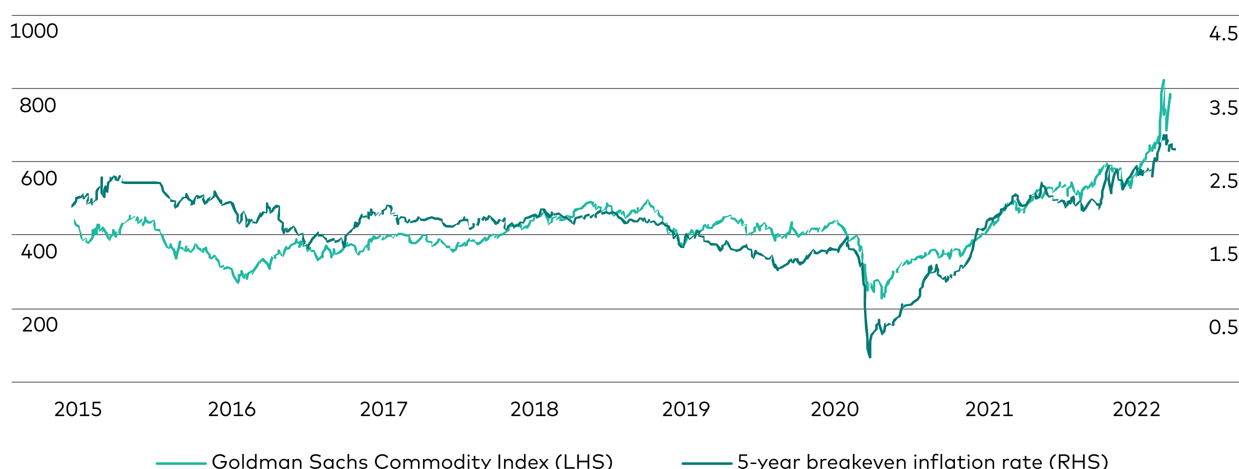
These events are broadly positive news for Australia. The one major downside is that, due to the strong economic recovery coupled with supply chain bottlenecks, headline inflation has now risen to 3.5%, putting upward pressure on the cost of living. The Russian invasion of Ukraine and the associated rise in fuel prices have added to the problem and are likely to push inflation above 4% this year. Indeed, medium-term inflation expectations, as measured by the 5-year breakeven inflation rate, have followed the rise in commodity prices **(Figure 9)**.

This is a key source of concern for the RBA, whose aim is to keep inflation within the 2–3% target range and to anchor inflation expectations. At a recent event in Sydney, RBA Governor Phillip Lowe stated that "it is only possible to achieve a sustained period of low unemployment if inflation remains low and stable". This hints that the RBA will not tolerate runaway inflation and may soon be forced to start raising interest rates.

Vanguard's view is that the RBA will wait until after the federal election, in May. This means that the first rate rise is likely to occur midyear. In the past, the RBA has tended to raise interest rates once per quarter during hiking cycles. This is a rough guide to what may happen this cycle. Hence, Vanguard expect two rate hikes in 2022 and four in 2023, taking the cash rate to 0.5% by year end, and to 1.5% by the end of 2023.

For many Australians, a rise in interest rates is unwelcome news. With cost of living pressures already an issue, a rise in rates will lead to higher mortgage payments and greater financial strain. For this reason, it will be difficult for interest rates to climb too high, although Vanguard do expect the cash rate to climb towards 2.5% to 3.0% this cycle. The one silver lining is that, after years of near-zero interest rates, a rise in rates will mean that the expected return on less risky assets, such as fixed income and cash, will slowly improve.

Figure 9. Rising commodity prices have pushed inflation expectations higher



Source: Bloomberg, as of 31 March 2022. Past performance information is given for illustrative purposes only and should not be relied upon as, and is not, an indication of future performance.

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MARKET OUTLOOK:

Following a strong 2021, the March quarter saw markets process the realities of higher inflation and tightening monetary policy as stocks and bonds sold off. Uncertainty and volatility are expected to persist as the conflict in Ukraine continues and China navigates COVID outbreaks.

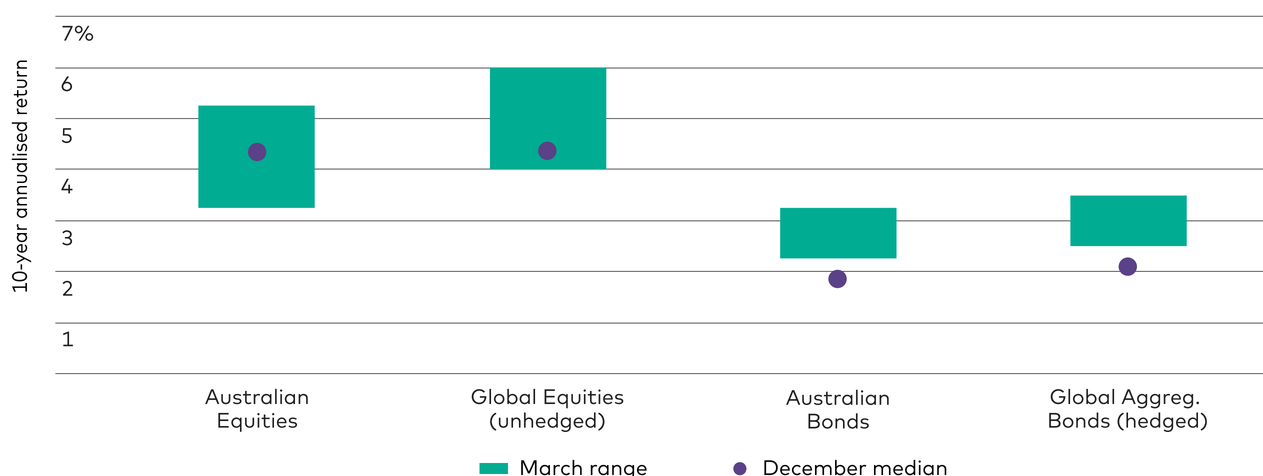
Given the pace of change in the investment environment over the past quarter, Vanguard have contrasted their December forecasts with their interim March expectations, accounting for market movements and volatility. The median 10-year annualised return for December is shown alongside a range of central expectations for March **(Figure 10)**.

Cheaper but still elevated valuations in international markets have driven an upgrade in Vanguard's long-term outlook on global equities of around 70 basis points to 5% per annum over the next ten years. They maintain a constructive but guarded view of risk assets, particularly when compared with the returns of the past decade.

Meanwhile, bond yields have risen materially across many regions, improving their international and local fixed income outlooks by 80 to 100 basis points over the next decade. Echoing previous commentary, rising yields can provide long -term investors with improved return prospects as income is reinvested at higher rates. However, equities are still expected to do the heavy lifting when it comes to delivering returns.

As markets continue to navigate a period of heightened uncertainty, we encourage investors to maintain a long-term view of their investment journey and focus on the factors within their control. This means keeping sight of investment goals, aligning their portfolios and plan, and maintaining the discipline to tune out the noise and stay the course.

Figure 10. An improved outlook



Source: Vanguard, March 2022 using interim March 2022 and 31 December 2021 VCMM Simulations

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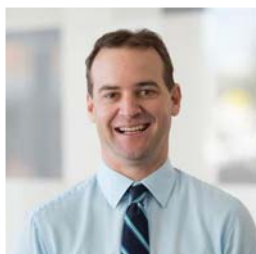
FOR MORE INFORMATION CONTACT

Brent Giles
Partner / Director

Certified Financial Planner
Aged Care Specialist
Life Risk Specialist

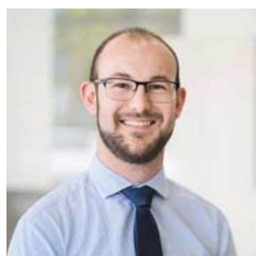
07 4924 9100
brentgiles@kennas.com



Andrew Landsberg
Partner / Director

Financial Planner

07 4924 9100
andrewlandsberg@kennas.com



Jake Duivenvoorden
Financial Planner

Certified Financial Planner

07 4924 9100
jakeduivenvoorden@kennas.com