



QUARTERLY ECONOMIC AND MARKET UPDATE

March 2022 Quarter



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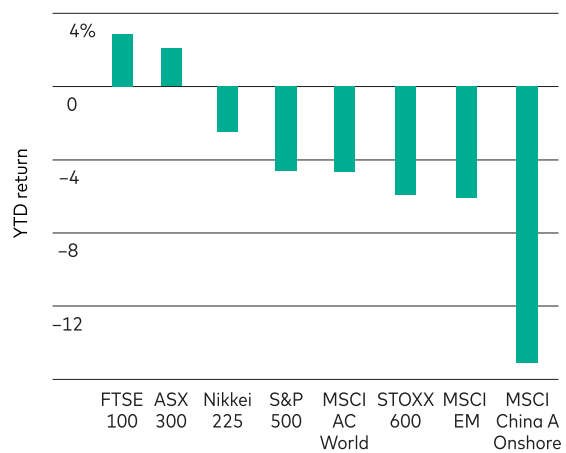
QUARTER IN REVIEW

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. Share market returns were more dispersed in January as expectations for rate rises 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.

Shares sold off over the quarter and prices remained volatile, with tech stocks leading global equities lower to a 4.6% loss (see chart). Meanwhile, energy and materials companies capitalised on elevated commodity prices, while banks and financials benefitted from higher interest rates. Heavy exposure to these sectors saw the Australian share 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%.

Bond 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 expectations for central bank rate rises 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 pushed higher, resulting in losses of 5% and 5.9% across international and domestic bonds.

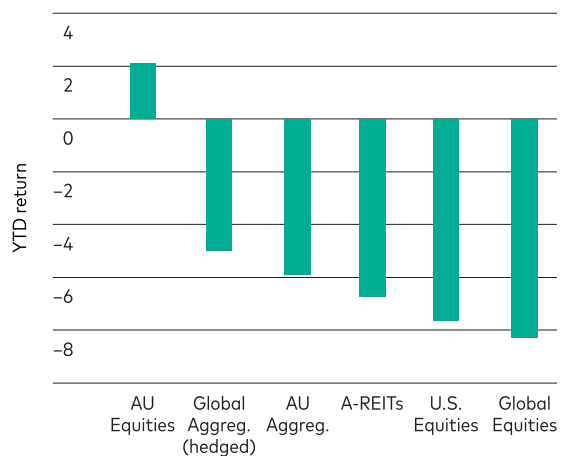
Figure 1. Australian and U.K. equities lead YTD



Notes: Returns are cumulative total returns in local currency.

Source: FactSet, as of 31 March 2022.

Figure 2. AUD indices broadly retreated



Notes: Returns are cumulative total returns denominated in AUD.

Source: FactSet, Refinitiv, as of 31 March 2022.



ECONOMIC AND MARKET OUTLOOK

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

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. Vanguard maintain a constructive but guarded view of risk assets like equities, particularly when compared with the returns of the past decade.

Meanwhile, bond yields have risen materially across many regions, improving Vanguard's international and local outlooks 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, shares 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.

INFLATION TO FORCE THE RBA'S HAND POST ELECTION

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 later this year.

The pandemic took a big toll on the Australian economy. During the first major outbreak of COVID in 2020, gross domestic product (GDP) contracted by around 7%, the largest decline in modern history. With the rollout of the vaccine and the end of lockdowns, GDP has once again bounced back, and is likely to recover its precrisis trend in 2022.

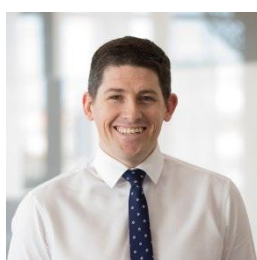
The economic recovery has also helped the labour market bounce back from the pandemic shock. By February this year, unemployment had fallen to 4% for the first time since 2008, and underemployment, which includes people insufficiently employed relative to what they desire, is also back at pre-GFC levels. Vanguard expect unemployment to fall below 4% and remain at low levels for the foreseeable future. Consequently, they expect wage growth to steadily rise, although this process tends to be drawn out due to multi-year enterprise agreements that cannot be immediately renegotiated.

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, inflation has now risen to 3.5%, putting upward pressure on the cost of living.

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. Vanguard's view is that the RBA will wait until after the May federal election before moving on rates. 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.



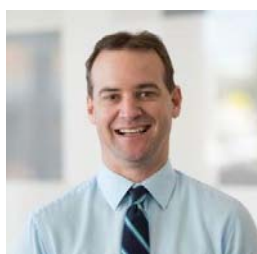
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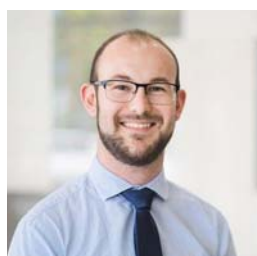
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