ASSET ALLOCATION REPORT

June 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

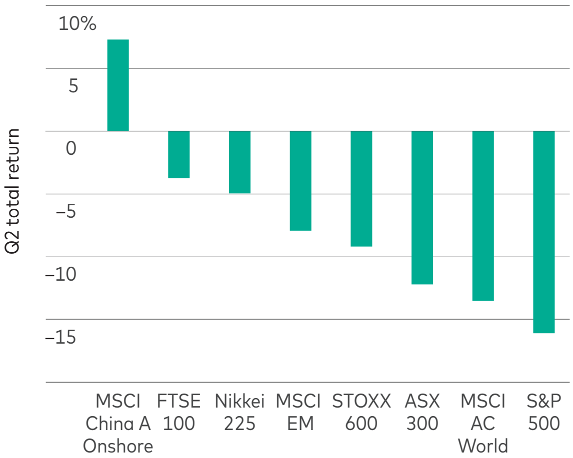
QUARTER IN REVIEW

Investors navigated yet another volatile quarter as a deteriorating economic outlook saw risk appetite take a downward turn. Inflation remained a key focus as central banks aggressively hiked rates in efforts to contain it. Equity and bond markets continued to sell off as recession risks emerged, with global equities returning their first negative financial year in a decade (as measured by the MSCI World Index AUD).

Equities were once again led lower by tech stocks and other interest rate-sensitive sectors, while concerns over corporate earnings and slowing economic growth weighed on the broader market. Global equities fell 14% over the quarter, with Australian equities following developed market peers down by 12% (**Figure 4**). European markets remained concerned over energy supply disruptions and elevated inflation, while China's easing of COVID lockdowns spurred a rebound in Chinese markets from the first quarter's woes. A weaker Australian dollar provided some respite from declines in global equities, dampening losses to 8% for AUD investors (**Figure 5**).

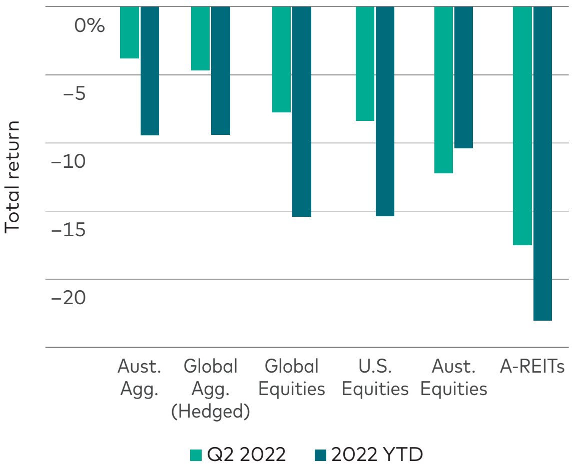
Bond markets continued to endure the nearterm pain of tightening monetary policy as central banks persisted with hiking interest rates. Yields trended upwards as markets weighed the prospects of increasingly hawkish policy against a picture of slowing growth and rising recession fears. Global bonds fell a further 4.7% and Australian bonds fell 3.8% over the last quarter as yields on U.S. and Australian 10-year government bonds rose by 66 basis points (0.66%) and 83 basis points (0.83%) respectively.

Figure 4. Global equities broadly declined



Notes: Returns are cumulative total returns in local currency.
Source: FactSet, as of 30 June 2022.

Figure 5. AUD indices continued to retreat



Notes: Returns are cumulative total returns denominated in AUD.
Source: FactSet, Refinitiv, as of 30 June 2022.

ECONOMIC OUTLOOK

A lot has changed since Vanguard published their Vanguard economic and market outlook for 2022: Striking a better balance. At the start of the year, Vanguard expected global economies to continue to recover from the effects of the COVID–19 pandemic, but at a more modest pace than in 2021. While that holds true, the pace of change in macroeconomic fundamentals such as inflation, economic growth, and monetary policy has failed to live up to expectations.

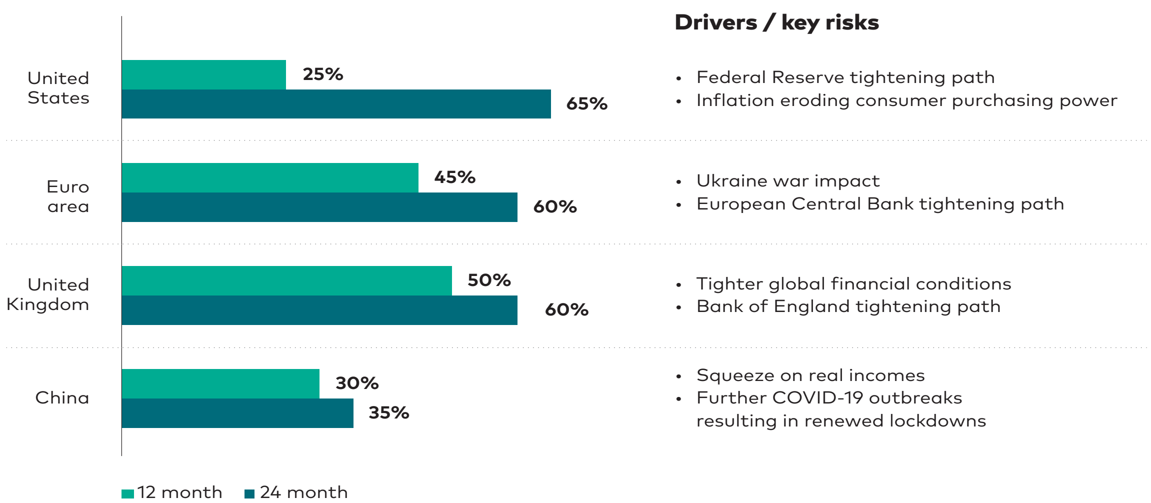
Labour and supply-chain constraints were already fuelling inflation before the year began, but Russia's invasion of Ukraine and China's zero-COVID policy exacerbated the situation. Central banks have been forced to play catchup in the fight against inflation, ratcheting up interest rates more rapidly, and possibly higher than previously expected. But those actions risk cooling economies to the point where they enter recession.

Global economic growth will likely stay positive this year, but some economies are flirting with recession, if not this year, then in 2023. Compared with the start of the year, Vanguard has downgraded its 2022 GDP growth forecasts for all the major regions, increased its inflation forecasts, and become more hawkish about monetary policy.

INFLATION, POLICY ELEVATE THE RISK OF RECESSION

In the United States, inflation has reached 40-year highs, eroding consumers' purchasing power and driving the Federal Reserve to aggressively raise interest rates. Vanguard expect the target federal funds rate landing in the 3.25%–3.75% range by year-end. Vanguard expect a terminal rate of at least 4% in 2023—higher than what Vanguard consider to be the neutral rate (2.5%) and above what's currently being priced into the market (the neutral rate is the theoretical rate at which monetary policy neither stimulates nor restricts an economy).

Figure 6. Probability of recession for select regions



Source: Vanguard, as of 30 June, 2022.

Vanguard have downgraded expected U.S. GDP growth from about 3.5% at the start of the year to about 1.5%. The factors that led to their downgrade will likely continue through 2022— namely, tightening financial conditions, wages not keeping up with inflation, and lack of demand for U.S. exports. Labour market trends are likely to keep downward pressure on the unemployment rate through year-end, though increases in 2023 are likely as the impacts of Fed policy and slowing demand take hold. Vanguard assess the probability of recession at about 25% over the next 12 months and 65% over 24 months. Vanguard believe that a period of high inflation and stagnating growth is more likely than an economic 'soft landing' of growth and unemployment rates around or above longerterm equilibrium levels (about 2% for growth and 4% for unemployment).

Australia's status as a commodities exporter has partly insulated it from some of the economic woes elsewhere, but global factors and rising inflation still have an impact.

Broadbased and persistent inflation has the Reserve Bank of Australia on course to raise its target rate to at least 2.5% in 2022. The labour market is robust, with the unemployment rate falling to an historical low. Unemployment should stabilise as growth slows, but upward pressure on wages is likely to persist for a while. Vanguard have reduced their growth forecast by a percentage point from the start of the year, to 3%–3.5%.

China will fall far short of policymakers' GDP growth target of about 5.5%, given the challenge in achieving all three of their goals: growth, financial stability, and zero-COVID (the latter affects not just China's economy, but the global economy as well). Vanguard believe the actual 2022 GDP growth rate will be 3–4%, far below China's pace for many years. Given China's zero-COVID policy, additional outbreaks resulting in renewed lockdowns could further detract from growth.

In the euro area, headline inflation driven by high energy prices may spike to near 9% in the third quarter. Inflation has become widespread, spurring the European Central Bank on in what it expects will be a "sustained path" of interest rate increases.

Figure 7. Vanguard's forecasts for year-end 2022

	ECONOMIC GROWTH	HEADLINE INFLATION	MONETARY POLICY	UNEMPLOYMENT RATE
United States	~1.5%	7%–7.5%	3.25%–3.75%	3%–3.5%
Canada	~4%	~6.5%	~3%	~5.5%
Mexico	~2%	~5%	8%–9%	~3.5%
Euro area	2.5%–3%	~7.5%	0.5%–0.75%	~7%
United Kingdom	3.5%–4%	~10%	2.25%–2.5%	~4%
China	~3%	<2.5%	2.75%	~5.5%
Australia	3%–3.5%	~7%	~2.5%	~4%

Notes: Forecasts evolve with new data, and our views will inevitably change. Growth is the change in annualised GDP year over year. Inflation is the headline consumer price index, which includes the volatile food and energy sectors. Monetary policy is our year-end projection for the central bank's short-term interest rate target.
Source: Vanguard forecasts as of 30 June 2022.

In September, rates will likely be out of negative territory for the first time in a decade. Vanguard forecast economic growth to be about 2.5%–3% for the full year. However, Europe's dependence on Russian natural gas and the challenges of managing monetary policy for 19 countries put the euro area at a higher risk of recession than the United States in the next 12 months. A complete cut-off from Russian gas would likely lead to rationing and recession.

In the United Kingdom, energy prices will likely drive the headline inflation rate to roughly 10% late in the year. Vanguard expect the Bank of England to raise the bank rate by an additional 1.25 percentage points over the next 12 months to reach their estimate of a 2.5% neutral rate. The bank has signalled that it's prepared to enact rate hikes larger than 25 basis points, depending on the economic and inflation outlook.

Even with rising inflation and a slowing economy, the labour market will likely stay strong, given record job vacancies and unemployment near a 50-year low. But a drop in real wages, combined with diminished consumer and business confidence and tightening financial conditions, could push the United Kingdom into recession. Vanguard sees the probability of recession at about 50% over the next 12 months. For 2022, Vanguard has downgraded their 5.5% forecast at the start of the year to 3.5%–4%.

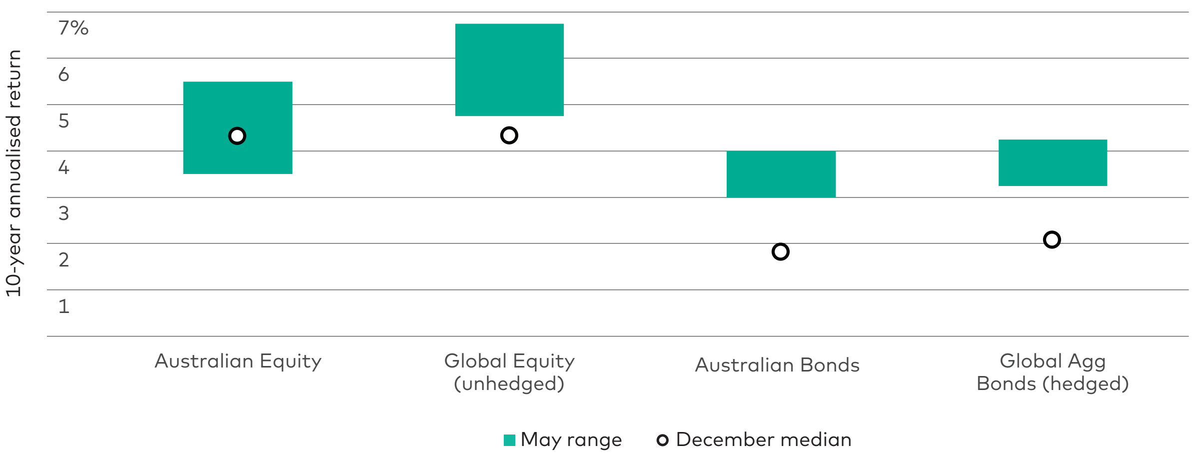
MARKET OUTLOOK:

Stock and bond markets have been hit hard so far in 2022, but there is an upside to down markets. Because of lower current equity valuations and higher interest rates, Vanguard's model suggests higher expected long-term returns.

Vanguard's 10-year annualised return forecasts for equity markets are largely 1 percentage point higher than at the end of 2021. More attractive equity valuations improve their return outlook on a relative basis, particularly internationally, although volatility is expected to persist as markets navigate the earnings season and further policy tightening.

Bond yields have continued to rise in many regions and improve the return outlook, which has broadly increased by 1.5 percentage points year-to-date. Rising yields may detract from bonds' current prices, but that means higher returns in the future as interest payments are reinvested in higher-interest bonds.

Figure 8. An improved outlook



Source: Vanguard, 30 May 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