Market Watch

An ugly start to the new year for share markets

End-January 2022

Economic and market overview

- Investors continued to focus on rampant inflation and, in turn, potential changes in monetary policy settings.
- By month end, five interest rate increases in the US had been priced in to markets; a more aggressive tightening in policy settings than had been anticipated previously.
- These evolving expectations saw bond yields rise in all major regions – resulting in negative returns from fixed income markets – and spooked share markets. Major equity indices in the US, Europe and Australia all closed January substantially lower.

- **US:** With inflation running seemingly out of control, it has become clear that interest rates in the US will be raised sooner rather than later. Headline CPI has risen to an annual rate of 7.0%, the highest level in nearly 40 years.
- Most investors are now expecting officials to lift the Federal Funds rate in March. It remains to be seen whether policymakers will raise the official interest rate by 0.25%, or opt for a more aggressive 0.50% hike.
- More importantly, consensus forecasts now indicate the Federal Funds rate will be raised by around 1.25 percentage points this year. This will be the start of the 'policy normalisation' process, following two years of Covid-related zero interest rates.
- Less than 200,000 new jobs were created in December – the lowest monthly total of 2021 – although the US economy added nearly 6.5 million jobs in the year as a whole. Unemployment has fallen to 3.9%; not too far above the 3.5% pre-Covid level.
- Despite the buoyant job market and rising wages, consumer spending has been subdued recently due to Omicron.

- **Australia:** The Reserve Bank of Australia expects inflation to continue to trend higher in the short term. CPI seems likely to be above the 2-3% target range, due to a combination of effects including higher petrol prices and interruptions to global supply chains.
- The higher inflation prints are expected to be temporary, however, rather than being more structural in nature. Policymakers remain unconvinced that inflation is 'sustainably within the target band' – the stated hurdle for interest rates to be raised. Accordingly, the Reserve Bank is likely to be more patient than current market pricing suggests when it comes to raising cash rates.
- Officials again made specific reference to stronger wage outcomes being required for inflation to be sustainably within the target range. With the unemployment rate forecast to fall only modestly during 2022, the central case appears for only a gradual pick up in wages.
- All of this suggests interest rates could start to be raised in Australia in 2023, rather than this year. That timing could be brought forward if wage outcomes surprise on the higher side in the near term.

- **New Zealand:** Like elsewhere, there was an ongoing focus on inflation. CPI quickened to a 31-year high of 5.9% in the December quarter, driven by rising energy prices, higher prices for new and used cars, and rising rents and construction costs.
- Consensus forecasts suggest unemployment fell in the December quarter. With labour shortages in some areas due to border closures and a lack of immigration, wages are rising.
- House prices were also up an eye-watering 27.6% in 2021.
- All of this suggests policy settings could be tightened further in the months ahead. The Reserve Bank of New Zealand has already raised interest rates twice in the past few months, but further increases are anticipated this year.

- **Europe:** German officials reported GDP contracted 0.7% in the December quarter, raising concerns about a possible recession in Europe's largest economy. The latest sentiment gauge fell to its lowest level in nine months, as pandemic restrictions dampened confidence levels.
- More encouragingly, economic growth in France and Spain was ahead of expectations.
- In aggregate, Europe appears to be recovering from the pandemic more slowly than the US. The IMF has lowered is outlook for the euro-area for this year, and suggested inflationary pressures in the region will persist. Tensions between Russia and Ukraine threaten to send energy prices in the region even higher, which could hamper corporate and consumer spending.
- Inflation remains a concern in the UK too, having risen above 5%/year in December. Interest rates seem likely to be increased further in the months ahead, following December's initial hike.

- **Asia/EM:** Inflationary pressures are being seen in Japan, a country that has grappled with deflation for most of the past 20 years. Bank of Japan officials raised their official inflation expectations for the first time since 2014.
- Growth in China is expected to come off the boil this year and next, decelerating to an annual pace of around 5.0%. That compares with GDP growth above 8.0% in 2021, and a rate of between 6% and 7% in the five years pre-Covid.
- Slowdowns are anticipated in both industrial production and consumer spending in China, although Beijing officials have eased policy settings to help support activity levels.
- Similar themes are playing out in other emerging markets. Despite elevated energy and commodity prices, slower growth rates are expected in economies including Brazil and Russia.

Australian dollar

- The Australian dollar often underperforms during periods of 'risk-off' market sentiment, and January was no exception.
- The 'Aussie' lost ground against the US dollar, falling 3.1% to a little over 70 US cents.
- The currency depreciated by a similar margin against a trade-weighted basket of other international currencies.

Australian equities

- Australian equities experienced their worst month since the coronavirus pandemic began, and endured the worst start to a calendar year since the Global Financial Crisis.
- The S&P/ASX 200 Accumulation Index declined 6.4%. Valuations came under pressure from concerns about potential interest rate hikes, rising inflation and geopolitical tensions overseas.
- IT stocks fared particularly poorly. All constituents in the sector lost ground, with WiseTech Global, Altium and Xero all declining by more than 20%.
- The Energy (+7.9%) and Materials (+0.8%) sectors were among the few that moved higher in January. Both sectors were supported by strong commodity prices. Iron ore and oil both moved around 20% higher in AUD terms over the month. Iron ore benefited from expectations of growing Chinese steel demand, thanks to anticipated increases in infrastructure investment, along with restocking demand ahead of the Lunar New Year holiday period.
- The 'risk-off' sentiment had a particularly adverse influence on small cap stocks, as investors favoured the relative safety typically associated with larger companies. The S&P/ASX Small Ordinaries Accumulation Index declined 9.0%, with fewer than a quarter of constituents delivering positive returns.

Listed property

- Global property securities struggled, with the FTSE EPRA/NAREIT Developed Index returning -2.7% in AUD terms.
- Outperforming regions included France (+3.3%), Germany (+1.6%) and Hong Kong (+0.7%). The laggards included Sweden (-10.3%), Australia (-9.5%) and the US (+6.8%).
- Property securities were affected by inflationary expectations and an uncertain economic policy outlook.
- Sector performance in the month saw a reversal of trends seen in 2021. Strong performers such as the industrial sector, self-storage sector and convenience retail underperformed, while healthcare and lodging outperformed over the month.

Global equities

- With weakness extending across most major share markets, the MSCI World Index closed the month 5.3% lower in local currency terms (and by a more modest 2.3% in AUD terms).
- Despite pleasing results from Apple, technology stocks struggled more than most. The tech-heavy NASDAQ in the US declined 9.0%, as investors banked profits from 2021's 22% rally. Underwhelming earnings announcements from other high-profile tech stocks like Netflix appeared to un-nerve investors.
- The broader S&P 500 Index in the US closed January 5.2% lower, with stocks in most industry sectors losing ground.
- European bourses were also subdued, partly owing to rising geopolitical risk in Eastern Europe. Fears that Russia could invade Ukraine persisted throughout the month. The UK was among countries to withdraw some non-essential diplomatic staff from Kiev, in anticipation of an intensification in tensions.
- In aggregate, the MSCI Europe Index lost 3.2%. Swiss stocks were notable underperformers, closing 5.9% lower.
- The UK market bucked the negative trend, with the FTSE 100 Index adding 1.1%.
- Asian markets were mixed. The Chinese market was down 7.6%, for example, while Hong Kong's Hang Seng closed up 1.7%, in spite of the introduction of various new virus-related restrictions.
- At the sector level, some energy stocks fared well – this was primarily due to a further rally in oil, which took the price up to a seven-year high of more than US$88/barrel. Escalating tensions on the Russia/Ukraine border are helping keep energy prices in Europe particularly high, amid suggestions that sanctions could be imposed on Russia if it invades its neighbour.

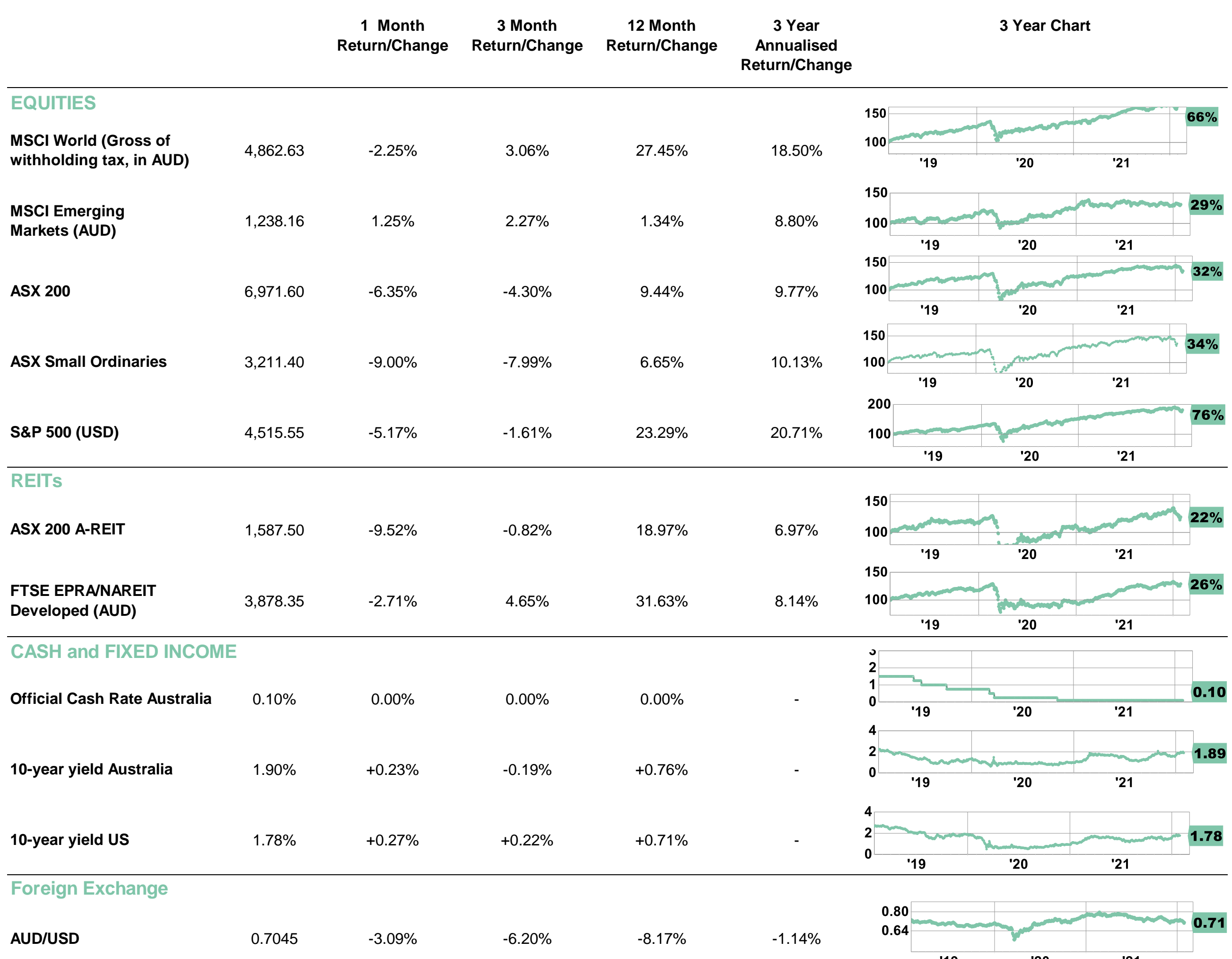
Global and Australian Fixed Income

- 10-year government bond yields in the US rose 0.27% in January. This set the tone for bond markets globally, and resulted in negative returns from most major fixed income indices.
- At around 1.80%, 10-year Treasury yields are now back to their levels from the end of 2019, before Covid-19 started to affect financial markets.
- The recent flattening in the Treasury yield curve continued. Rate hike expectations pushed short-dated yields sharply higher – yields on 2-year notes closed the month 0.45% higher, for example. Yields on longer-dated bonds rose too, but by a lesser extent. The curve movement reflects expectations for more moderate growth in the long-term, and suggestions that interest rates could remain lower than historic averages going forward.
- In Europe, 10-year German bund yields traded above zero for the first time in nearly three years. The European Central Bank continues to suggest zero interest rates remain appropriate for now, but escalating inflation and moves higher in bond yields globally have nonetheless pushed bund yields higher.
- UK gilt yields rose substantially too – by 0.33% on 10-year notes, for example. Some commentators suggested the Bank of England could quadruple base rates in the next few months, from 0.25% currently to 1.00% by June.
- Government bond yields also moved higher in Australia, despite a relatively low probability of changes to policy settings. This highlighted the inter-connectedness of bond markets globally. Movements in the domestic bond market are increasingly influenced by offshore factors – primarily those in the US – rather than economic developments closer to home. 10-year Australian government bond yields closed the month 0.23% higher, at 1.90%.

Global credit

- With equity markets struggling, it was unsurprising to see credit spreads widen. This occurred in both the investment grade and high yield sub-sectors, resulting in negative returns from global credit products.
- The prospect of monetary policy tightening was unwelcome for credit investors, as rising interest rates will increase the cost of debt for corporate bond issuers.
- That said, interest coverage – a measure showing how comfortably corporates can meet their repayment obligations – remains very healthy. Accordingly, defaults are not expected to pick up meaningfully for the foreseeable future.
- Despite headwinds including lockdowns and other virus-related closures, supply chain disruptions, and labour shortages, default rates were very low globally in 2021. According to Moody's, just 54 companies worldwide missed scheduled bond repayments over the year – the lowest annual total since 2011.

MARKET WATCH DATA SHEET



		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised Return/Change	3 Year Chart
EQUITIES						
MSCI World (Gross of withholding tax, in AUD)	4,862.63	-2.25%	3.06%	27.45%	18.50%	66%
MSCI Emerging Markets (AUD)	1,238.16	1.25%	2.27%	1.34%	8.80%	29%
ASX 200	6,971.60	-6.35%	-4.30%	9.44%	9.77%	32%
ASX Small Ordinaries	3,211.40	-9.00%	-7.99%	6.65%	10.13%	34%
S&P 500 (USD)	4,515.55	-5.17%	-1.61%	23.29%	20.71%	76%
REITs						
ASX 200 A-REIT	1,587.50	-9.52%	-0.82%	18.97%	6.97%	22%
FTSE EPRA/NAREIT Developed (AUD)	3,878.35	-2.71%	4.65%	31.63%	8.14%	26%
CASH and FIXED INCOME						
Official Cash Rate Australia	0.10%	0.00%	0.00%	0.00%	-	0.10
10-year yield Australia	1.90%	+0.23%	-0.19%	+0.76%	-	1.89
10-year yield US	1.78%	+0.27%	+0.22%	+0.71%	-	1.78
Foreign Exchange						
AUD/USD	0.7045	-3.09%	-6.20%	-8.17%	-1.14%	0.71

Source: Factset and Bloomberg, at 31 January 2022

This material has been prepared and issued by First Sentier Investors (Australia) IM Ltd (ABN 89 114 194 311, AFSL 289017) (FSI AIM), which forms part of First Sentier Investors, a global asset management business. First Sentier Investors is ultimately owned by Mitsubishi UFJ Financial Group, Inc (MUFG), a global financial group. A copy of the Financial Services Guide for FSI AIM is available from First Sentier Investors on its website.

This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs. Before making an investment decision you should consider, with a financial advisor, whether this information is appropriate in light of your investment needs, objectives and financial situation.

Any opinions expressed in this material are the opinions of the individual author at the time of publication only and are subject to change without notice. Such opinions: (i) are not a recommendation to hold, purchase or sell a particular financial product; (ii) may not include all of the information needed to make an investment decision in relation to such a financial product; and (iii) may substantially differ from other individual authors within First Sentier Investors.

To the extent permitted by law, no liability is accepted by MUFG, FSI AIM nor their affiliates for any loss or damage as a result of any reliance on this material. This material contains, or is based upon, information that FSI AIM believes to be accurate and reliable, however neither MUFG, FSI AIM nor their respective affiliates offer any warranty that it contains no factual errors. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of FSI AIM.

Any performance information has been calculated using exit prices after taking into account all ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.

Copyright © First Sentier Investors.

All rights reserved.