INVESTWISELY
THE ONLY WAY TO INVEST

June 2022 Market Commentary

WILL THERE BE A RECESSION SOON?

The share market is forward looking they say, it is a pretty good predictor of the future economic activity. *Why is that the case you might ask?*

Well, there are thousands of profit-seeking and well researched investors and economists investing daily in the market with real money. Their collective opinion of the future economic conditions is reflected in the direction of the share market movements in the short term.

On that basis, the share market, so far, is down roughly -13% from its peak about a year ago and it is telling us that the economic conditions have turned for the worse. The market is not always right though, particularly when it tries to second guess the future economic manoeuvres of the central bankers and politicians. We don't have to look far back for the evidence of market's miscalculation of the economic outlook when during the first breakout of the Covid-19 pandemic in 2020 saw the share market sell off nearly -35% only to recover just as quickly when it was clear the central bankers and governments were going to prop-up the economy in unprecedented ways.

What was the lesson learned? Expect central banks and politicians (let's call them collectively as feds for the purposes of this article) to come out swinging if the economy does enter a serious recession. Each recession brings with it unique set of challenges but there is pretty strong evidence between Global Financial Crisis of 2008 and Covid-19 pandemic crisis of 2020, each very unique and unprecedented in their challenges, that the government & central banks end up responding to economic crisis with equally unique policies. ***Is this simply a blind faith in the Feds' ability to rescue the economy in case the worst happens?*** Not really, feds can get it wrong but it is equally unlikely that the feds will just sit through a deep recession and shun immense public pressure to respond in significant ways. That being said, the feds may have greater appetite to sit through an economic slowdown or even a mild recession for the rest of this year so long as it serves to bring down inflation, which is the public enemy number one right now!

So, will there be a mild recession? The share market decline of approximately -13% so far is not indicating a recession but just much slower economic growth. While we do believe that the chance of a prolonged and deep recession is low as feds are your insurance against that scenario, it is worthwhile revisiting what a recession is.

In official economic language a recession is when there have been two consecutive quarterly declines in economic growth as measured by the Gross Domestic Product (GDP). It is just a fancy way of saying that the country has been producing less and less stuff for six months at least. Obviously when the economy produces less, there is less income earned nationally, and less requirement of resources by businesses e.g. labour, thus higher unemployment. For comparison, the last major recession we had in Australia lasted for over 12 months between 1990-1991. During that recession unemployment rose above 10%. The recession came in response to the unwinding of the asset price boom in Australia during the 1980s, the international recession of the early 1990s, and high interest rates, which were necessary to help reduce Australia's high inflation rate at the time.

Yes, we also had an official recession during the Covid-19 pandemic in 2020 when Australia's GDP contracted for two consecutive quarters ending March 2020 and June 2020 and in subsequent quarters the GDP bounced back hard. You may not strictly consider that to be a serious recession, although a lot of businesses and individuals did suffer extraordinary hardship at the time.

While the economy tends to grow over decades it never grows in a straight line, the economic journey over the long term is very much punctuated by ups & downs of business cycles. In business up-cycles people are growing their businesses, making money on the stock market, buying cars & houses, and feeling lucky. Sounds

like the past ten years! But when the cycle turns down, the business activity and income fall across the nation. During this time companies are getting smaller, revenues & profits fall, workers are losing their jobs, and families are tightening their belts, and everyone is stressing out. That's a recession.

The central bank's role is to smooth out the extreme highs and lows of the business cycles by raising or lowering interest rates.

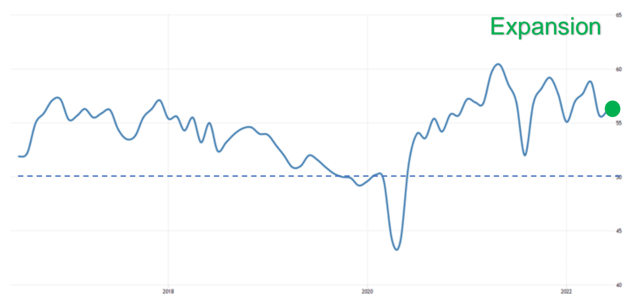
What are some warning signals of a recession? Overall, the warning signals so far in this slow down, we would say, are flashing amber light as opposed to an all-out red light. The real question is will we go from amber to red, or will there be amber conditions for the foreseeable future, will the amber conditions turn back to green, or will amber turn to red soon?

Based on the main data indicators we will share below we would conclude for now that the amber conditions are likely to continue for the foreseeable future i.e. a case of a muddle through economic condition (which are also referred to as stagflation i.e. stagnant growth and higher inflation).

The main indicators to watch are as follows:

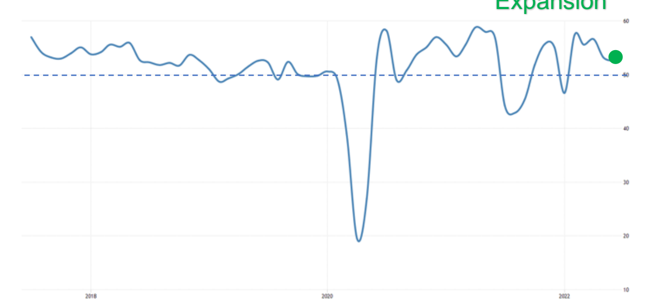
Firstly, a couple of positive indicators. The below chart (see top of next page) is illustrating current operating conditions in Australia's manufacturing industry. Overall conditions are still positive and manufacturing businesses were still growing in May.

Australia Markit Manufacturing PMI



Secondly, while the services industry has been expanding the growth rates have been slowing for few months now, as last reported in May 2022 per the chart below. This includes activity in sectors like real estate, transport & storage, finance & Insurance. Companies in the services industry continued to expand their staffing levels to cater for demand surge after national borders re-opened. We feel, the staff shortage problem may ease in the coming months as the economy slows.

Australia Markit Services PMI

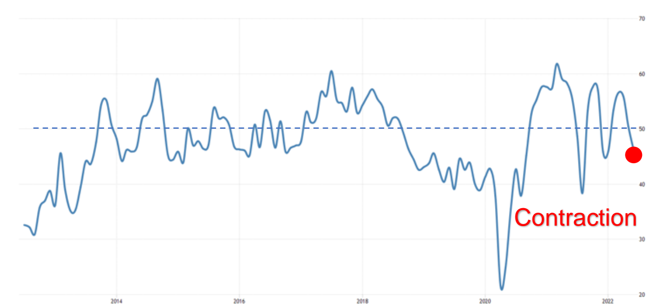


In regards to the above two indicators, please bear in mind these latest numbers are reporting conditions in manufacturing and services industries in the months leading up to and including May 2022, the indicators may well have deteriorated in June and July.

The next set of numbers point to a much sombre economic environment ahead.

Firstly, the residential & commercial construction industry's composite indicator below includes data for sales, new orders, employment, deliveries and prices started to shrink as soon as the Reserve bank of Australia started raising interest rates in May. *The faster the interest rates rise the worse the conditions will likely get for construction industry.* A lot of trades & services sectors and even white goods retail rely on the construction industry to produce new houses for people to move in, keep the economy ticking along, and keep employment high.

Australia Construction PMI

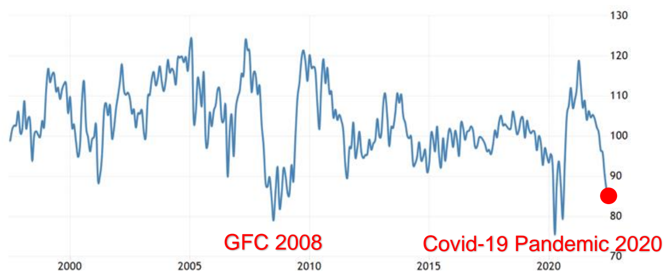


Secondly, the consumer confidence indicator shown below has, well, tanked in May & June. Which is not entirely a bad thing because the RBA actually wants to instil the fear of the monstrous interest rate increases ahead. RBA wants consumers to help bring down inflation by spending much less on everything from essentials of life to the non-essentials.

Australia Consumer Confidence (monthly)

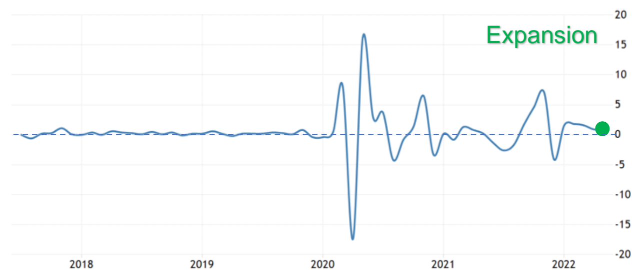
Investwisely Corporate Authorised Representative 1280984
ABN 34 619 736 248
Australian Financial Services Licence Number 246638
Interprac Financial Planning Pty Ltd

Phone 02 9634 6698
Shop 7, 1 Circa Boulevard
Bella Vista NSW 2153
www.investwisely.co



But entrenched spending habits take time to go away. Looking at the latest **retail sales** growth numbers below, it is clear that while consumers' confidence in the economy is low, they are still not cutting back on spending enough to make a dent in inflation! And that is why you are seeing RBA continuing to push up interest rates until consumer spending actually starts to move down materially and slow down inflation, which is currently estimated at 6-7% p.a.

Australia Retail Sales (monthly)



So, there you have it, a quick synopsis above of the most relevant economic indicators paint a mixed picture of the economy right now. The RBA is hoping to achieve a soft landing of the economic growth to more sustainable levels but their central banking comrades in the US have started to shift their language from a soft landing to a bumpy landing. We continue to expect a muddle through economic environment ahead. Investors with a long-term outlook will have opportunities in the months ahead to pick up stocks and assets at more attractive valuations, while conservative investors should seek to minimise the volatility in their income assets (to the extent possible) to help them ride through the current muddle through economy.

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	Value	1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	6,568	-1.97%	-8.92%	-11.77%	-10.19%
ASX 200 Futures	AUD	6,461	-2.05%	-9.05%	-11.18%	-8.51%
Dow Jones	USD	30,775	-0.82%	-6.71%	-15.31%	-10.80%
S&P 500	USD	3,785	-0.88%	-8.39%	-20.58%	-11.92%
Stoxx Europe 600	EUR	407	-1.50%	-8.15%	-16.52%	-10.08%
FTSE 100 (UK)	GBP	7,169	-1.96%	-5.76%	-2.92%	1.87%
DAX (Germany)	EUR	12,784	-1.69%	-11.15%	-19.52%	-17.69%
CAC (France)	EUR	5,923	-1.80%	-8.44%	-17.20%	-8.99%
Nikkei 225	JPY	26,393	-1.54%	-3.25%	-8.33%	-8.33%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,001	-1.24%	-7.15%	-18.78%	-27.20%
Shanghai Composite	CNY	3,399	1.10%	6.66%	-6.63%	-5.36%
South Korea	KRW	2,333	-1.91%	-13.15%	-21.66%	-29.24%
Taiwan	TWD	14,826	-2.72%	-11.79%	-18.62%	-16.50%
Brazil	BRL	98,542	-1.08%	-11.50%	-5.99%	-22.29%
South Africa	ZAR	60,109	-2.35%	-8.13%	-10.36%	-0.09%
Foreign Exchange						
AUDUSD	Currency	0.6903	0.33%	-3.82%	-4.96%	-7.94%
AUDGBP	Currency	0.5669	-0.12%	-0.45%	5.57%	4.56%
AUDEUR	Currency	0.6586	-0.03%	-1.51%	3.07%	4.14%
AUDCNY	Currency	4.62	0.19%	-3.47%	0.08%	-4.66%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,446	-1.03%	-12.25%	-12.89%	-3.09%
LME COPPER 3MO ($)	USD/mt	8,258	-1.70%	-12.59%	-15.05%	-11.91%
LME NICKEL 3MO ($)	USD/mt	22,698	-4.52%	-20.05%	9.35%	24.62%
SILVER FUTURE Sep22	USD/oz	20.35	-1.86%	-6.56%	-13.23%	-22.91%
ICE Newc Coal Fut Sep22	USD/mt	356.00	1.42%	-3.43%	190.73%	274.34%
62% Import Fine Ore in USD	USD/t	115.53	-1.07%	-13.36%	1.26%	-45.30%
Gold Spot $/Oz	USD/oz	1,807	-0.58%	-1.64%	-1.20%	2.10%
WTI Oil	USD/bbl	105.76	-3.66%	-5.50%	46.54%	61.47%
Henry Hub	USD/mmBtu	6.50	-1.22%	-23.17%	77.60%	74.73%
Corn	USD/Bu	743.75	-3.44%	-1.29%	25.37%	3.30%
Wheat	USD/Bu	868.75	-5.11%	-20.11%	12.71%	29.37%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.66%	-0.03%	+0.31%	+1.99%	+2.13%
US	USD	3.01%	-0.08%	+0.17%	+1.50%	+1.54%
Germany	EUR	1.34%	-0.18%	+0.21%	+1.51%	+1.54%
Japan	JPY	0.23%	-0.00%	-0.01%	+0.16%	+0.17%
Italy	EUR	3.26%	-0.14%	+0.14%	+2.09%	+2.45%
Australian Rates						
Cash Rate	AUD	0.85%	+0.00%	+0.50%	+0.75%	+0.75%
90-Day BBSW	AUD	1.85%	+0.03%	+0.66%	+1.78%	+1.82%
180-Day BBSW	AUD	2.72%	+0.04%	+0.77%	+2.50%	+2.65%
CBOE Options						
CBOE VIX (Volatility Index)	Index	28.71	1.95%	9.62%	66.72%	81.36%

Data as of 30 June 2022

ECONOMIC NEWS

• Australian RBA decision. RBA raised interest rates by +50bps to 0.85% and Governor Philip Lowe reiterated that Australians should be prepared for further interest-rate increases and expects the board to discuss 0.25%-0.5% hike in July, as the bank expects inflation to accelerate to 7% in December quarter 2022 and only begin to ease back early in 2023. Consumer sentiment dropped in June to lowest since August 2020, amid accelerating inflation.

• Global growth outlook. The World Bank further cut its forecast for global economic expansion in 2022, downgrading by -1.2% from January estimate to +2.9% with growth in advanced economies decelerating -2.50% p.a. to 2.6%p.a. (U.S. expanding +2.5%, down -1.20% from prior forecast in January and Euro area growing +2.5%, down – 1.70%) before further moderating to 2.2% in 2023. Economic growth in emerging economies is seen decelerating -3.2% p.a. to 3.4% (China growing +4.3%, down -0.8% and India expanding +7.5%, down -1.2%), well below annual average of 4.8% from 2011-2019. *World bank warned that several years of above-average inflation and below-average growth lie ahead with potentially destabilizing consequences for low-and middle-income economies* with real income per capita remaining below pre-Covid-19 levels in about 40% of developing economies in 2023.

• U.S. Fed raised interest rate by +0.75%, the biggest increase since 1994, to 1.5%-1.75% and signalled to keep hiking aggressively this year, as it downgraded outlook for the economy from the soft-landing scenario of March to a bumpier touchdown. The Fed upgraded 2022 inflation forecast by +0.9% to 5.2% while downgrading 2022 GDP forecast by -1.1% to 1.7%. Fed Chair Jerome Powell warned that steep rate hikes could tip the US economy into recession.

• U.S. Business activity took a decisive step back in June with a measure of services registering the slowest pace of expansion since the start of the year as rapid inflation reduced demand for services and manufacturing growth slowing

abruptly, marking one of the largest monthly declines in data back to 2007. High prices, weaker demand, and materials shortages pushed the Manufacturing index to a two-year low. US consumer confidence dropped in June to the lowest in more than a year and a measure of expectations, which reflects consumers' six-month outlook, dropped to the lowest in nearly a decade.

• **China Economy** showed further signs of improvement in June with official manufacturing PMI rising above 50-mark for the first time since February, indicating an expansion in output compared with May and non-manufacturing PMI, which measures activity in the construction and services sectors, climbing to highest in more than a year.

• **Euro-area inflation** surged to a fresh record in June with CPI jumping +8.6% p.a., with France, Italy and Spain reporting new all-time highs and consumer confidence approached its lowest level since the early months of the pandemic. Germany's Inflation eased in June with CPI increasing +7.6% p.a. vs 7.9% p.a. in prior month, amid temporary government relief measures.

• **U.K.'s Bank of England raised interest rates for a fifth straight meeting**, increasing the benchmark lending rate by +0.25% to 1.25%, while raising its forecast for the peak of inflation this year to "slightly above" 11% p.a., and announcing it expects the economy to contract in the current quarter.

• **India's central bank (RBI) raised the key interest rate** by +0.50% to 4.9% and pledged to withdraw the pandemic-era accommodation, while raising its inflation forecast for 2022 by +1.0% to 6.7%, inflation is outside the RBI's mandated target range of 2-6%.

• **Japan's central bank (BOJ) kept its policy settings for yield curve control and asset purchases unchanged** and downgraded its assessment on production, exports and overseas economies, while taking an improved view of consumer spending.

GLOBAL MARKETS UPDATE

US markets declined, with the Dow Jones down -6.7% and S&P500 down -8.4%, amid worries the Fed will plunge the economy into a recession as recession-signalling indicators jumped the most since 2020.

The ASX200 declined -8.9%.

In commodities, WTI oil price declined -5.5% to US$105.8/bbl, as OPEC+ ratified an oil-production increase that completes the return of supplies halted during the pandemic, rubber-stamping plans to add 648k barrels a day in August.

THE LONG READ

Bonds – hang on or bail out?

Self-funded retirees are being squeezed by negative returns and a rising cost of living

There is palpable angst amongst bond investors right now, particularly amongst those who are of a mature age and nearer-to or already in retirement. Investors have gone from reading about the well-covered macro-economic risk factors in the media, since at least the beginning of this year, to actually now feeling the real impact of the said risks in their investment portfolios and their hip pocket as consumers. Specifically, we are referring to inflation and its financial consequences for bond investors who also happen to be consumers and maybe even borrowers.

Since May, Mortgage holders (owner occupiers and property investors) on variable interest rates have started to feel the impact of interest rate increases through higher monthly repayments. Most investors would have filled up their fuel tanks with petrol at least twice in the past month at prices well above $2 per litre for common fuel variants- this is after the excise tax relief from the government. Their regular grocery bill now feels much higher than in the past and, all of a sudden, the money left in the bank after paying all the month's expenses seems a lot lower than what it used to be. In some cases, they may be chipping down their savings to balance the monthly household budget. They are wondering which areas of their regular household expenses they will have to cut fast as they are told the energy bills are set to soar and further increases in interest rates remain in the offing. To add to their woes, particularly the conservative investors, they are seeing parts of their investment portfolio in the red. The self-funded retirees are feeling the double impact of negative investment returns in the income parts of their portfolios vis-à-vis the rising cost of living.

What words of financial wisdom can we offer bond investors who are rightfully concerned about the direction and thus returns from this asset class?

We divide investors in terms of two broad groups; accumulators and those in transition-to or already in retirement. The former we consider as having a genuine 10-year outlook if not more, and the latter we refer to those who need to draw down their investment portfolio to fund the living expenses now and in the next 1, 2, 3 years. Beyond that, such investors expect to capture some growth on the invested principle together with the income return to fund expenses (ideally). For such investors, the way big macro shifts are playing out right now and the uncertainty they bring with them, we recommend prioritising capital preservation out to 3 years for the part of their investment funds they need to cover the living costs. And for other parts of their portfolio with a 3+ year outlook we would consider longer dated bonds at these levels and other income options such as hybrids, AREITs, and infrastructure.

Lately, we have heard from many conservative investors asking the question that have bonds been sold off far enough? Should they hold on to their negative positions or bail out for more safer substitutes of cash equivalents? Our usual response to that is, as a conservative investor seeking to place bonds in the income part of your portfolio, you should be looking to minimise the risk, as much as possible, of making a directional call on government bond yields. If bond yields (or income returns) change materially then that will also affect your invested principle in bonds (positively or negatively). Ideally, bonds should deliver consistent income with not much movement in their price. Right now though, we can make a convincing case for a further sell off in bonds and equally we can make a case for bond sell off as being overdone in the near-term and could even rally if our economy enters a recession.

Our belief is that for conservative investors with 1-3year cash requirements, to consider bonds right now, they would need inflation numbers to settle down over the coming quarters before

adding punchy weights to bonds and duration in the portfolio. Until bond prices and yields settle down we would keep the 1,2,3-year allocation of capital reserved for bonds in bank term deposits and or annuities. This may apply to investors who have held on to duration through the recent bond market sell-off as much as those looking to deploy new money.

For accumulators or younger investors, time is on their side as they can afford to take the long-term view by being in bonds right now for diversification and have higher income returns (over the long range) provide offset to any prospects of a near term sell off in bond prices.

This document is produced in conjunction with our research partner Banyan Tree Investment Group. The information contained in this report is for general information only, it does not take into account an investor's needs or objectives. You should not undertake any investment decisions without first contacting your adviser.