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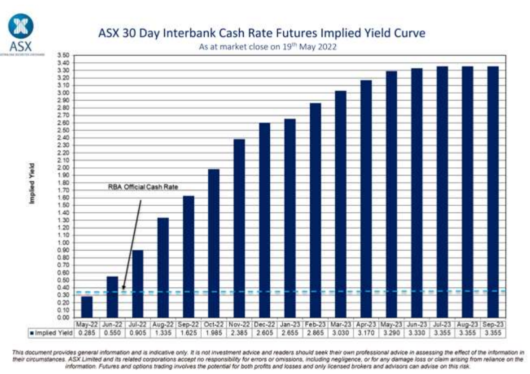
May 2022 Market Commentary

MARKET REVIEW

The month of May was a busy one with both political and economic news. The month started with the Reserve bank of Australia (RBA) lifting its official interest rate by 0.25% from the historic low of 0.1% (basically zero %). The official interest rate now sits at 0.35% and the expectation is that by this time next year this same rate will be 3.3% p.a.! Of course, this is just a forecast at this stage and in our estimates this forecast is too aggressive.

The reality is that the recent rate hike of 0.25% has already caused quite an uproar in the markets and has started to affect the consumer and business sentiment. So, we don't believe that official interest rate would have to be lifted to 3.3% by next year to slow down inflation, which is the ultimate goal of the reserve bank of Australia.



Why do we believe current expectations of interest rate increases are too aggressive? The blue bars in the above chart show the market's projection of the official interest rate over the next 12-16 months. While these are official interest rates, the reality is that average borrower on the street pays at least 2-3% on top of the official rates, that's how banks make their profit. On our estimates, the current projections of interest rate increases imply that variable interest rate on an average household mortgage will get to 6%-6.5% p.a. by this time next year. That would be excessive and, in our opinion, too fast a rate increase for borrowers to absorb. Simply because, in such a short time, businesses will struggle to pass through sufficient wages growth to their employees. And, there are a range of other higher cost of living expenses that would make it harder for borrowers to afford higher monthly repayments at +6% p.a. mortgage rates.

We have done same back of the envelope numbers on mortgage affordability, as can be seen on the chart top right. The average home loan size for a double income household in Sydney is $750,000. Assuming negligible wages growth, we estimate, that if variable mortgage rates rise to even 4.6% p.a., households will go in significant financial stress which is the point where the RBA will likely hit the brakes on rate increases. Therefore, official interest rate from the RBA may top around 1.5%-2% p.a. (implying 4.6% p.a. variable mortgage rate) in the short term and sit there for a while.

MORTGAGES ON THE RISE
Average loan size for owner-occupier dwellings
September 20201

	February	September	% change
SYDNEY	$618,987	$750,119	▲ 21.2%
MELBOURNE	$524,615	$605,563	▲ 15.4%
NATIONAL	**$495,093**	**$574,427**	**▲ 16.0%**
CANBERRA	$539,000	$555,100	▲ 3.0%
BRISBANE	$435,177	$483,319	▲ 11.1%
PERTH	$419,882	$436,393	▲ 3.9%
ADELAIDE	$382,324	$414,172	▲ 8.3%
HOBART	$378,590	$405,272	▲ 7.0%
DARWIN	$409,322	$396,624	▼ -3.1%

Source: ABS, CoreLogic

Worked Example
Sydney $750k loan service @2.29% p.a. variable rate is $2900 per month repayment (P&I) (or annual $34,800) which is on two household median income $136.9k (after tax) a ratio of 25%. ***Double the interest rate to 4.6% p.a. and you will have 50% of income servicing the loan and all out stress !***

What does that mean for investors? A benefit of rising interest rates is that income focused investors will begin to have more options when choosing income generating investments. We can already see investment options emerging in the market which have been in hibernation in recent years due to the low rates. These emerging options are forecast to pay 3%-5% p.a. in income return. Until recently, this level of income return was mainly available through dividends on shares.

What should investors expect in the next three years of federal labour government? Turning to politics, Anthony Albanese led federal labour government is set to bring in micro-economic reforms across a range of sectors which will have their plusses and minuses but in the main will seek to keep the consumers whole from the impact of rising cost of living. In government funded industries such as healthcare, aged care, and education there will likely be a push for significant wage growth for workers. There will be targeted support packages for the consumer to keep their head above water during this period of adjustment to higher inflation for longer. The supports will come along the lines of lower petrol excise tax (which is due to expire in September but extension of this period would not surprise us), lower child care costs, cheaper medicines, and vouchers to households facing energy price shock for gas and electricity. There is going to be a tangible policy directive for investing in the cheaper renewable energy. Labour aims to transform the energy grid to 82% renewables by the end of the decade.

There is also going to be a review into the organisational structure and operations of the ATO and the Reserve Bank of Australia (RBA). The reason for this imminent review is primarily because of the widely held view that both organisations have not delivered to the expectation of the Australian public. The RBA has been accused of erroneously anchoring the expectations of investors and borrowers that interest rates will not rise until 2024. The bank is now raising interest rates two years ahead of the expected schedule. RBA is also accused of not understanding the risks of banks over-lending combined with the effect of money printing by the RBA, these miss-steps have pushed up the price of houses and mortgage sizes to balloon. RBA is also said to have not understood the risk of builders signing up to fixed price contracts given the escalating inflation in material costs.

All of the above means, that with the ATO and Reserve bank under the cloud of major inquiries in the coming year, the borrowers, tax payers, and welfare recipients may benefit from these organisations not being overzealous in their activities.

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	**Value**	**1-day**	**1-mth**	**6-mths**	**1-year**
Developed Markets Equities						
ASX 200	AUD	7,211	-1.03%	-3.01%	-0.62%	0.69%
ASX 200 Futures	AUD	7,212	-1.14%	-2.66%	0.97%	3.38%
Dow Jones	USD	32,990	-0.67%	0.04%	-4.33%	-4.46%
S&P 500	USD	4,132	-0.63%	0.01%	-9.52%	-1.71%
Stoxx Europe 600	EUR	443	-0.72%	-1.56%	-4.24%	-0.76%
FTSE 100 (UK)	GBP	7,608	0.10%	0.84%	7.77%	8.33%
DAX (Germany)	EUR	14,388	-1.29%	2.06%	-4.71%	-6.70%
CAC (France)	EUR	6,469	-1.43%	-0.99%	-3.75%	0.34%
Nikkei 225	JPY	27,280	-0.33%	1.61%	-1.95%	-5.48%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,078	1.18%	0.14%	-11.11%	-21.69%
Shanghai Composite	CNY	3,186	1.19%	4.57%	-10.59%	-11.87%
South Korea	KRW	2,686	0.61%	-0.34%	-5.39%	-16.17%
Taiwan	TWD	16,808	1.19%	1.30%	-3.56%	-1.53%
Brazil	BRL	111,351	0.29%	3.22%	9.26%	-11.78%
South Africa	ZAR	65,431	0.15%	-0.07%	2.13%	5.91%
Foreign Exchange						
AUDUSD	Currency	0.7177	-0.26%	1.64%	0.70%	-7.20%
AUDGBP	Currency	0.5695	0.11%	1.41%	6.26%	4.66%
AUDEUR	Currency	0.6687	0.15%	-0.15%	6.38%	5.72%
AUDCNY	Currency	4.78	-0.29%	1.96%	4.95%	-2.97%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,787	-3.51%	-8.70%	6.17%	12.24%
LME COPPER 3MO ($)	USD/mt	9,448	-1.00%	-3.30%	0.05%	-7.90%
LME NICKEL 3MO ($)	USD/mt	28,392	-3.03%	-10.64%	42.69%	56.75%
SILVER FUTURE Jul22	USD/oz	21.69	-1.85%	-6.05%	-5.22%	-23.02%
ICE Newc Coal Fut Jul22	USD/mt	410.10	9.01%	45.48%	244.48%	345.04%
62% Import Fine Ore in USD	USD/t	133.34	1.25%	-0.19%	41.26%	-33.63%
Gold Spot $/Oz	USD/oz	1,837	-0.96%	-3.14%	3.54%	-3.65%
WTI Oil	USD/bbl	114.67	-0.35%	11.39%	78.81%	88.51%
Henry Hub	USD/mmBtu	8.45	2.57%	23.69%	86.55%	196.87%
Corn	USD/Bu	753.50	-3.06%	-7.91%	32.89%	14.73%
Wheat	USD/Bu	1,087.50	-6.05%	4.19%	40.55%	63.90%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.35%	+0.10%	+0.23%	+1.66%	+1.64%
US	USD	2.84%	+0.11%	-0.09%	+1.40%	+1.25%
Germany	EUR	1.12%	+0.07%	+0.18%	+1.47%	+1.31%
Japan	JPY	0.24%	+0.01%	+0.01%	+0.19%	+0.16%
Italy	EUR	3.12%	+0.12%	+0.35%	+2.15%	+2.21%
Australian Rates						
Cash Rate	AUD	0.35%	+0.00%	+0.25%	+0.25%	+0.25%
90-Day BBSW	AUD	1.19%	+0.02%	+0.49%	+1.15%	+1.15%
180-Day BBSW	AUD	1.95%	+0.03%	+0.51%	+1.81%	+1.86%
CBOE Options						
CBOE VIX (Volatility Index)	Index	26.19	-1.32%	-21.59%	-3.68%	56.26%

Data as of 31 May 2022

ECONOMIC NEWS

• The Reserve Bank of Australia (RBA) increased its official cash rate by +25bps to 0.35% with its quarterly monetary policy statement revealing RBA will need to raise interest rates further. Unemployment is forecast to drop to the lowest level since 1974 fuelling wages growth and underpinning inflation. Predictions are for both headline and core inflation to remain above the central bank's 2-3% target through this year and next before easing to 2.9% at the end of the forecast period in June 2024. The cash rate is assumed to be 1.75% in September quarter 2022 and 2.5% at the end of 2023.

The Australian economy expanded faster than forecast in March quarter 2022 with GDP advancing at annual pace of +3.3%, outpacing the pre-pandemic average of +2% p.a. Business investment in the first quarter fell -0.3% to A$33.6bn with contraction in buildings and structures, mining and non-mining, partially offset by increase in equipment and machinery, however, ABS upgraded its outlook with firms intending to invest A$130.5bn in the 12 months through June 2023, +11.8% higher than the previous estimate. Wages advanced at less than half the pace of consumer-price gains in the March quarter. Anthony Albanese became Australia's new Prime Minister following Labor party's election victory.

• In the U.S., the Congressional Budget Office predicted the U.S. federal budget deficit will shrink in 2022 to an estimated $1 trillion due to a surge in tax revenue and the expiration of pandemic-related aid programs. The budget deficit is expected to narrow further to $984bn in fiscal 2023. US manufacturing activity unexpectedly advanced in May as new orders and output growth quickened, however, US consumer sentiment deteriorated further in May to a fresh decade low with a gauge of current conditions dropping to the lowest in 13 years amid escalating concerns over inflation.

• Over in China, its central bank (PBOC) cut a key interest rate for long-term loans by a record amount, cutting the 5-year rate for home mortgages by -0.15% to 4.45%, while keeping the 1-yearrate, the de facto benchmark lending rate, unchanged at 3.7%. Beijing also ordered state-owned policy banks to set up an 800bn yuan line of credit for infrastructure projects.

• In Europe, the European Commission downgraded its GDP growth forecasts for 2022 to 2.7% and for 2023 to 2.3% while upgrading inflation forecast for 2022 to 6.1%

p.a. and for 2023 by to 2.7% p.a. The ECB President Christine Lagarde announced the regulator is likely to start raising interest rates in July and exit sub-zero territory by the end of September. Euro-zone inflation accelerated to an all-time high in May with CPI increasing +8.1%p.a. driven by food and energy costs.

• In the U.K. The bank of England (BOE) hiked interest rates by +0.25% to 1%, highest level since the GFC and issued a gloomy outlook, warning Britain to brace for double-digit inflation and a prolonged period of stagnation or even recession. BOE is predicting GDP to collapse by close to 1% in December quarter 2022, annual GDP to shrink by 0.25% in 2023 and economy continuing to stagnate in 2024. Inflation is expected to climb above 10% in October 2022 leading to households facing a 1.75% drop in real disposable income this year, the second-biggest fall since 1964. The Chancellor of the Exchequer Rishi Sunak announced around £15bn of additional aid for households to see them through a painful spike in energy bills this year. He also announced to impose a 25% windfall tax on the profits of oil and gas companies.

• In India – the Reserve bank of India (RBI) increased the official interest rates to 4.40% in an unscheduled decision and moved to drain 870bn rupees of liquidity from the banking system by increasing the retail banks cash reserve ratio to 4.5%. The government unveiled inflation-fighting fiscal measures estimated to cost $26bn that includes lower fuel taxes and import levies.

GLOBAL MARKETS UPDATE

• US markets were mostly flat, with the Dow Jones up +0.04% and S&P500 up +0.01%, as growth stocks remained under pressure. ASX performance - The ASX200 declined -3.0%.
• Asian markets were mostly higher, with the Shanghai Composite up +4.6%, as China vowed to ease its regulatory crackdown and rolled back some strict pandemic-triggered restrictions
• Commodities. WTI oil price gained +11.4%, as EU leaders agreed to pursue a partial ban on Russian oil. U.S. announced a plan to begin purchasing oil to refill the nation's emergency. Oil ministers of Saudi Arabia and the

UAE have warned that spare production capacity is decreasing in all energy sectors as producers slash investment.

THE LONG READ

China versus US: the fight for supremacy

Investors should try to stay out of the firing line

In a series of foreign policy addresses in recent years the Chinese President Xi Jinping has declared that the world is undergoing 'great changes unseen in a century'. Tensions
between China and the US are palpable. Other countries' geopolitical differences between each other are also becoming clearer in their nexus to the greatest political theatre on the global setting right now: the contest between China & the US for global hegemony. China believes the next ten years will determine the outcomes for this competition for global influence. Consequently, how this theatre plays out in the short, medium, and long term will clearly not only have implications for the positioning of investment portfolios but also the political, social, and economic dimensions. A lot could be at stake!

Some years ago, Singapore's founding father Lee Kuan Yew, who had intimate knowledge of China, agreed to the suggestion that Chinese leaders are serious about displacing the United States as the number one power in Asia and globally. Some studies have suggested that this goal of displacement of the US is backed by a grand strategy with strategic objectives across the military, economics, and politics. To achieve these strategic objectives the grand strategy has three broad 'forms of control' to regulate the behaviour of US, its allies, and other states that China is seeking to bring under its influence or control. These three
controls are coercive capabilities (to force compliance), consensual inducements (to incentivise it), and legitimacy (to rightfully command it). One recent example of application of
coercive capabilities is when China sought to restrict imports from Australia over political differences.

The US also uses the same three forms of control and currently has the upper hand as the global hegemon. China sees itself as the rising power and it is trying to weaken US' forms of control over other states by firstly trying to weaken US' controls in Asia and then globally.

Strategically speaking, once the hegemon becomes weakened in its exercise of the three forms of control the rising power then builds and expands its forms of controls over other states. This is the template being described by China watchers as the grand strategy of displacement.

The implementation of the strategies to weaken the hegemon's controls and the building and expansion of the rising power's controls comes in phases and usually those phases are connected by major world events. So far China has implemented three phases of displacement against the US. The first strategy of displacement was between 1989-2008 where China quietly weakened US' power over China in Asia. The second strategy of displacement was between 2008-2016 when China moved forward to build the foundations for regional hegemony in Asia e.g. One Belt One Road project. This phase was launched after the financial crisis in 2008 in US and China became emboldened to take a more confident approach. And the third phase is now when China is seeing the great changes unseen in a century as it seeks to capitalise on a range of issues weakening the US & its allies' controls on other states particularly following UK's Brexit - a major power withdrawing from a global stage. Then there was President Trump's revisionist policies which saw US becoming more domestically focused, then Covid-19 pandemic hit which further distracted and weakened the US (& allies) on the domestic front, supply chain issues have stoked inflation and interest rates in the US & allied countries, and adding to this the Russian invasion of Ukraine with China's blessings has further strained the energy supplies with soaring prices.

China becoming more assertive will bring with it authoritarianism which is not compatible with liberal democratic governance systems revered by the US and other western allies. But, it would be premature to hold firm the view that US cannot hold its current global status in the face of China's ascent. The US has shown time and again in history that it can make a comeback against threats to its hegemony. The US was seen as written off during the great depression in 1930s and Germany and Japan were seen as the emerging economic powers then. But the US president Roosevelt delivered innovative New Deal programs which saw US climb back to prime position after world II.

In the 1960s and 70s the US was humbled by the loss of Vietnam war, social unrests, Bretton woods collapse, stagflation, President JKF's assassination, impeachment of President Nixon, all this against the backdrop of soviet advancement at the time. But the US managed to come through its challenges. It landed its astronauts on the moon in 1969 demonstrating its global lead in cutting edge science. In the 1980s and 90s there was the erosion of the industrial base in the US which saw Japan and Germany again rise in comparative advantage. But against those pressures the US harnessed Information Technology and the rest is history as they say.

US has the advantage of younger population, financial dominance, abundant resources, peaceful borders, strong alliances, innovative economy, and openness that attracts the best talent from across the world.

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