March 2022 Market Commentary

MARKET REVIEW

Let's commence this month's letter on a positive note with Australian share market now decisively in the green territory. Considering much macro uncertainty, the investment returns are nothing short of impressive at 10.4% for twelve months to 31 March 2022; six months return at 2.3%; and one month return of 6.4%. In fact, the share market is a mere 2% short of reclaiming the historic high it reached in August last year.

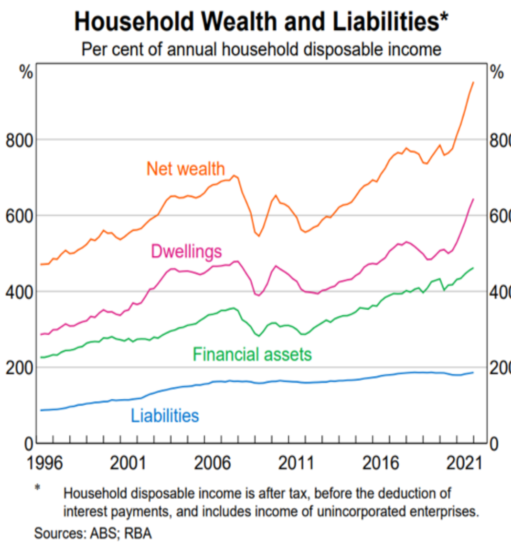
You may be scratching your head and wondering what about the risk of inflation that everyone seems to be focusing on right now and how it is expected to lead to interest rate increases and affect the economy?

We don't believe the share market is making light of the risk of inflation to the economy. In fact, it is acutely aware of the risk of inflation potentially being mismanaged by companies resulting in margin squeeze and lower sales volume, particularly in discretionary expenditure as consumers cut their spending to balance their ever-tightening household budgets.

But, the market is also aware that many of the Australian industries and companies hold strong market positions to pass on the higher cost of doing business by raising prices for the goods and services they sell. Take the banking sector for examples, every time there is even a hint of rising interest rates the banks are sure to pass on the rate increases in equal measure (sometimes more) to the borrowers. In fact, during periods of rising interest rates banks' profitability also increases, and it is for this reason banks' share prices have shown a decent turn around in recent weeks.

Other examples of companies with strong market positions include Telstra, Coles & Woolworths, Wesfarmers, and Insurers such as Suncorp. Costumers of above companies are price takers. For instance, Telstra recently raised the price of its monthly mobile data packages and announced to their existing customers to expect the price increases at the next bill. Whilst not a great outcome for customers of Telstra as they are dependent on its strong network coverage but great for its shareholders as it seeks to maintain its profitability. Telstra's market power increased even more recently after the merger of TPG and Vodafone.

The other reason why the market is, thus far, taking inflation in its stride is that it knows the consumers are sitting on considerably strong financial position built up in recent years – please see the chart above right. Which means consumers have the financial fire power to afford higher prices for goods and services. Moreover, the unemployment rate is expected to remain at record low over the next couple of years which should continue to support economic growth.



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Thirdly, the Australian politicians are now in campaign mode for the next federal election possibly in May 2022, which means policies are being rolled out to alleviate the financial pressure on voters. A number of announcements in the recently delivered federal budget are stimulatory e.g. the fuel excise tax is cut by 22 cents per litre for six months plus $250 cash handout to millions of Australians within weeks. All this extra money will inevitably transmit to businesses through purchases of goods & services.

The other major uncertainty for the market at present is the war between Ukraine & Russia. The threat of significant disruptions to the supply of oil & gas from Russia to Europe and the world remains elevated. The base estimate of the market is that energy will continue to flow despite the war, however, if the flow of energy does stop then inflation will rise significantly, globally. That would slow down economies everywhere and cause markets to come off. However, there are stark parallels between Russia/Ukraine War and Israel/Egypt war in October 1973 which also caused significant disruption to oil supplies for six months (October 1973 to March 1974) and caused 300% increase in oil price. At that time, whilst equity markets did have a sell off during 1973 and 1974, the markets did bounce back strongly in double digits over 1975 and 1976.

So, the message for investors is to remain invested in good quality companies with strong market positions across range of sectors, primarily selling essential or value adding goods & services.

MOVERS FOR THE MONTH

Top 10 Monthly Contributors

ASX 200		Performance		
Stock	Ticker	1mth perf	6mth perf	1yr perf
AVZ MINERALS LTD	AVZ	56.3%	268.7%	533.3%
UNITI GROUP LTD	UWL	43.8%	22.2%	105.7%
LIONTOWN RESOURCES LTD	LTR	31.0%	30.6%	359.3%
WHITEHAVEN COAL LTD	WHC	29.3%	28.5%	135.1%
IGO LTD	IGO	28.6%	58.3%	123.9%
ALLKEM LTD	AKE	26.0%	31.5%	140.1%
EML PAYMENTS LTD	EML	24.9%	-22.6%	-38.6%
NOVONIX LTD	NVX	23.3%	-6.8%	187.0%
INCITEC PIVOT LTD	IPL	22.7%	28.9%	30.2%
CHAMPION IRON LTD	CIA	21.3%	61.7%	42.5%

SHAKERS FOR THE MONTH

Bottom 10 Monthly Detractors

ASX 200		Performance		
Stock	Ticker	1mth perf	6mth perf	1yr perf
ZIP CO LTD	Z1P	-32.8%	-79.0%	-79.9%
NICKEL MINES LTD	NIC	-17.0%	34.6%	3.3%
TELIX PHARMACEUTICALS LTD	TLX	-15.4%	-30.7%	-2.3%
SANDFIRE RESOURCES LTD	SFR	-15.2%	3.6%	13.9%
MAGELLAN FINANCIAL GROUP LTD	MFG	-13.4%	-54.9%	-64.7%
CITY CHIC COLLECTIVE LTD	CCX	-13.0%	-47.7%	-14.6%
FISHER & PAYKEL HEALTHCARE C	FPH	-12.5%	-26.8%	-23.6%
UNITED MALT GRP LTD	UMG	-10.8%	-7.8%	-7.1%
INGHAMS GROUP LTD	ING	-9.7%	-25.9%	-8.4%
VIRGIN MONEY UK PLC - CDI	VUK	-9.4%	-24.0%	-10.5%

GLOBAL MARKETS OVERVIEW

	Units	Month End Value	Price Performance (% Chg) 1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,500	-0.20%	6.39%	2.28%	10.44%
ASX 200 Futures	AUD	7,479	-0.07%	6.92%	3.76%	13.37%
Dow Jones	USD	34,678	-1.56%	2.32%	2.47%	5.14%
S&P 500	USD	4,530	-1.57%	3.58%	5.17%	14.03%
Stoxx Europe 600	EUR	456	-0.94%	0.61%	0.23%	6.11%
FTSE 100 (UK)	GBP	7,516	-0.83%	0.77%	6.06%	11.95%
DAX (Germany)	EUR	14,415	-1.31%	-0.32%	-5.54%	-3.96%
CAC (France)	EUR	6,660	-1.21%	0.02%	2.15%	9.77%
Nikkei 225	JPY	27,821	-0.73%	4.88%	-5.54%	-4.65%
Emerging Markets Equities						
MSCI Emerging Markets	USD	1,142	-0.65%	-2.52%	-8.88%	-13.27%
Shanghai Composite	CNY	3,252	-0.44%	-6.07%	-8.86%	-5.51%
South Korea	KRW	2,758	0.40%	2.17%	-10.14%	-9.92%
Taiwan	TWD	17,693	-0.27%	0.23%	4.48%	7.68%
Brazil	BRL	119,999	-0.22%	6.06%	8.13%	2.89%
South Africa	ZAR	68,508	-0.03%	-1.60%	18.40%	12.53%
Foreign Exchange						
AUDUSD	Currency	0.7482	-0.36%	3.02%	3.53%	-1.53%
AUDGBP	Currency	0.5695	-0.40%	5.22%	6.17%	3.31%
AUDEUR	Currency	0.6762	0.46%	4.46%	8.35%	4.40%
AUDCNY	Currency	4.76	-0.21%	4.07%	1.85%	-4.61%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	3,491	-1.69%	3.64%	22.13%	57.82%
LME COPPER 3MO ($)	USD/mt	10,375	0.07%	4.97%	16.10%	18.09%
LME NICKEL 3MO ($)	USD/mt	32,107	-2.39%	32.23%	79.01%	99.82%
SILVER FUTURE May22	USD/oz	25.13	0.08%	3.15%	13.64%	1.66%
ICE Newc Coal Fut Apr22	USD/mt	259.00	-0.38%	2.98%	43.89%	205.06%
62% Import Fine Ore in USD	USD/t	142.49	0.18%	12.86%	18.32%	-7.62%
Gold Spot $/Oz	USD/oz	1,937	0.24%	1.49%	10.27%	13.45%
WTI Oil	USD/bbl	100.28	-6.99%	7.25%	39.72%	82.29%
Henry Hub	USD/mmBtu	5.49	3.20%	27.97%	-1.08%	120.48%
Corn	USD/Bu	748.75	1.46%	7.35%	39.50%	32.70%
Wheat	USD/Bu	1,006.00	-2.07%	8.41%	38.66%	62.78%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	2.84%	+0.05%	+0.70%	+1.35%	+1.05%
US	USD	2.34%	-0.01%	+0.51%	+0.85%	+0.60%
Germany	EUR	0.55%	-0.10%	+0.41%	+0.75%	+0.84%
Japan	JPY	0.22%	-0.01%	+0.03%	+0.15%	+0.13%
Italy	EUR	2.04%	-0.09%	+0.33%	+1.18%	+1.37%
Australian Rates						
Cash Rate	AUD	0.10%	+0.00%	+0.00%	+0.00%	+0.00%
90-Day BBSW	AUD	0.22%	+0.01%	+0.15%	+0.20%	+0.19%
180-Day BBSW	AUD	0.71%	+0.00%	+0.46%	+0.67%	+0.63%
CBOE Options						
CBOE VIX (Volatility Index)	Index	20.56	6.36%	-31.81%	-11.15%	5.98%

Data as of 31 March 2022

ECONOMIC NEWS

Reserve Bank of Australia's (RBA) decided to keep the benchmark interest rate unchanged, however, warned Russia's invasion of Ukraine has the potential to prolong a period of elevated consumer-price growth and is clouding the economic outlook.

Purchasing Manager's Index (PMI) increased in March with both input cost and output price inflation hitting records and consumer sentiment tumbled to lowest since September 2020, amid Russia's invasion of Ukraine, flooding in the nation's northeast, rising prices and the prospect of higher interest rates.

Over in the U.S., President Joe Biden unveiled a $5.8 trillion budget for 2023, marking a +5.7% increase from the omnibus spending bill for 2022 that was signed by Biden earlier in March. The budget includes significant increases in funding for the military and police departments, along with higher taxes on corporations and the wealthiest Americans. The most notable spending increase was US$773 billion military proposal, a 10% rise amid threats including Russia's invasion of Ukraine and concerns about China's ambitions. Incidentally, the budget put far less emphasis on the types of grand social, climate and economic policies that Biden announced last year which have since run into resistance from moderate Democrats. The budget is also addressing rapid inflation which has dented Biden's ratings. He is expanding port infrastructure and inexpensive housing stock as measures to bring down prices over time by improving supply.

U.S. business activity advanced to an eight-month high in March and hiring remained robust in the month with nonfarm payrolls increasing by 431,000 which combined with an increase in labour force participation rate and saw unemployment rate decline to 3.6%, near pre-pandemic low.

In Europe, inflation surged in March with CPI increasing +7.5% p.a. to an all-time high, however, European Central Bank (ECB) signalled it would accelerate winding down its asset purchase program despite the economic uncertainty from the war in Ukraine. This would involve slowing down its bond buying to 30 billion euros in May followed by 20 billion euros in June. ECB has downgraded Europe's economic growth (GDP) forecast for 2022 to 3.7%, and 2.8% in 2023 while 2024 was unchanged at 1.6%. The unemployment rate forecasts for 2022 at 7.3% is unchanged and should remain at these levels for the next two years. ECB upgraded the inflation outlook for 2022 to 5.1% but expects it to come down to 2.1% in 2023 and even lower in 2024 at 1.9%. In actual numbers though Euro-area inflation surged in March with CPI increasing +7.5% p.a. to an all-time high.

United Kingdom's Central Bank (BOE) raised interest rate for the third successive policy meeting, increasing by 0.25% to take borrowing costs back to their pre-pandemic level of 0.75%, and warned the war in Ukraine may push inflation well above 8% in June quarter 2022 vs prior forecast of 7.25%. U.K. Chancellor Rishi Sunak announced a 6-billion-pound tax cut for workers, slashed fuel duty and signalled a future reduction in income tax, after UK Treasury downgraded its 2022 economic growth forecast for U.K. to 3.8% and for 2023 to 1.8%, however, upgraded 2024 to 2.1%. U.K.'s inflation is forecast to hit a 40 year high of 8.7% at the end of 2022 (vs BOE's outlook of 8%) and average 7.4% for 2022, almost double prior forecast of 4%, outpacing wage growth and causing a -2.2% decline in real living standards in the 2022-23 fiscal year, largest financial year fall on record. Living standards are not expected to recover to their pre-pandemic level until 2024-25.

Over in Japan, the Bank of Japan (BOJ) left its interest rates and asset purchases unchanged and downgraded its assessment of the economy, however, doubled down on its commitment to continue with stimulus, offering for the first time to buy an unlimited amount of 10-year government bonds for three straight days. This was despite predicting annual inflation could accelerate to around 2% from April onwards.

In political news:

- Geopolitical tensions continued to escalate with no compromise being reached between Ukraine and Russia, leading to more countries imposing sanctions on Russia, making it the world's most-sanctioned nation and U.S. President Joe Biden calling for an end to normal trade relations with Russia and barring imports of the nation's vodka, caviar and diamonds.
- U.S. and U.K. struck trade deal to end tariffs on British steel and, American whiskey and motorcycles.

THE LONG READ

STAY POSITIVE WHEN INFLATION STRIKES

New research reveals what sectors and strategies do well as the cost of living rises

Inflation is here – and it doesn't matter if you think it is transitory or not. The question that needs to be asked is, what investment strategies have historically done well or poorly in periods of high and rising inflation?

A recent paper titled The Best Strategies for Inflationary Times by Henry Neville and others analysed 34 episodes of inflation over the past 95 years. They reviewed the historical performance of both passive and active strategies across a variety of asset classes for the US, UK and Japan.

They found that when inflation was 5% p.a. or higher at the country level (not necessarily international) it had the greatest impact on investment returns. Neither equities nor bonds perform well in real terms during inflationary periods though there are exceptions of course and we will mention those shortly.

Fixed interest with duration (where investors lend at fixed interest rate for many years to either corporates or governments) and high yield bonds, on average, posted negative annual returns (-8%). The longer the maturity in years, the greater the sensitivity to rising inflation.

The annualised real return during inflationary periods is -3% p.a. for two-year bonds, -5% for 10 years and -8% for 30 years. Inflation-linked bonds (TIPS), which can also be referred to as floating rate credit, were the only type of fixed-interest category that posted a positive real return of 2% p.a. during past inflationary periods.

As for equities, the study found that energy was one sector that delivered a positive real return (1% p.a.) during inflationary periods. Healthcare also held up well. The worst sector was consumer discretionary at -15% p.a. The poorer performing sectors are exposed to the individual consumer, who is likely to curb spending habits as their purchasing power is diluted by rising prices.

Hard assets such as commodities overall delivered 14% p.a. during inflationary periods. Among the commodities, the best performer was energy at 41% p.a. followed by industrial metals at 19% p.a., gold at 13% p.a., silver at 12% and precious metals at 11% p.a. Softer agricultural commodities delivered more modest but still positive real returns of up to 8%. So, all commodities have positive annualised real returns and have strong positive correlation to inflationary periods. The opposite is true during non-inflationary periods, when commodities deliver more modest returns of 1%.

Now, let's review investment strategies. The quality factor performs positively in inflationary periods - which basically means investing in companies with low debt, stable earnings, consistent asset growth, and strong corporate governance. On the other hand, low-beta strategies can struggle, which maybe because low beta usually is linked to long duration and stable cashflows, specifically where they are not entirely linked to CPI. Incidentally, momentum equity strategies have shown to be a standout performer in inflationary periods. These could be funds that are driven by short term movements in prices e.g. hedge funds. Please note past performance is not a guarantee of future performance and not every momentum strategy is expected to perform well.

Another factor found to impact investment returns is the relative inflation rates between different countries. The varying inflation rates between countries and regions can be used as a basis for applying regional diversification in portfolios. For example, it was found that when inflation runs low in the US and Japan but high in the UK, the investment real returns in the US and Japanese equities were actually positive 6% and 9% during the UK's inflationary period over the past 95 years. To put it another way, UK investors would have been well served to invest in US and Japanese equities when UK inflation was running much higher than US and Japanese inflation.

Right now, inflation is running at over 7% in the US and almost 6% in Europe, but in Australia it is currently 3.5%, which puts Australian equities in a good position to generate positive returns and may well be attractive to US and European investors.