Quarterly Market Update – 31 December 2022

The Great Inflation.

The themes for the quarter continue to be around inflation and the market trying to determine the “terminal rate” for this economic cycle. Weighing on the market is the prospect of global recession in 2023.

Asset prices of stocks, bonds and property all fell in 2022 as the worst inflation numbers in decades caused central banks to repeatedly raise cash rates. Inflation was due to three main factors:

(i) the end of expansionary fiscal and monetary policy due to the Covid-19 pandemic;
(ii) demand for services curbed by restrictions, and demand for goods leading to supply chain bottlenecks; and lastly,
(iii) commodity price rises owing to strong demand, and the war in Ukraine which pushed prices even higher.

It now appears that the higher cash rates are having their desired effect - all three of these factors may be abating, and that the terminal rate for this cycle of increasing interest rates is close. However other variables, namely the low level of unemployment, building wage pressures and relatively resilient household finances may keep inflation relatively elevated.

In financial markets there were two significant rebounds in stocks and bonds during 2022 despite the overall fall in asset prices. The first was from mid-June to mid-August when comments from the Federal Reserve were interpreted as pointing to an impending pause in rate rises. However, hopes of a Fed pause evaporated as a Jackson Hole speech by its chair, Jerome Powell, triggered a further sell-off. Stocks and bonds hit their lows in mid-October.

A second rally has dominated the December quarter, resulting in positive returns for global equities and bonds. However, that rally ended on December 15th when the US Federal Reserve raised rates by an expected 50bps but projected further increases throughout 2023 as well as a rise in unemployment and a slowdown in economic growth.

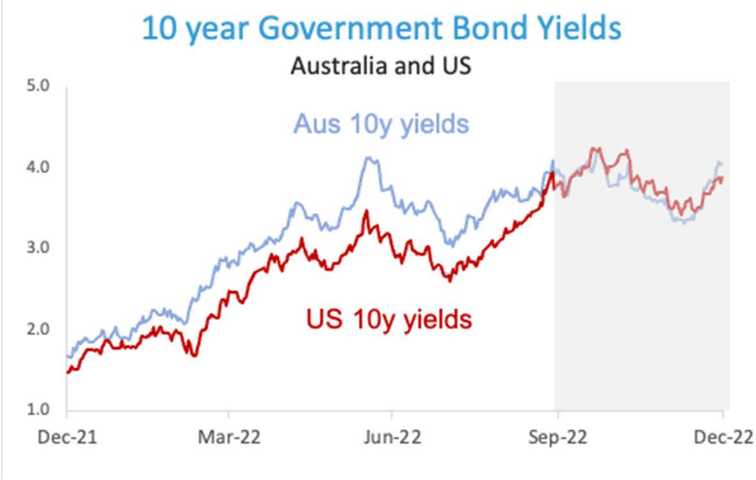
The year ended much as it started; with markets trying to come to terms with how much further rates will need to go before the "terminal rate" is reached – the rate that central banks consider enough to bring inflation back down towards their target band.

A VOLATILE YEAR IN MARKETS

A rally that saw the US S&P 500 and Australia's ASX 200 gain about 14 per cent from the start of October spluttered out mid-December. Markets are caught between hope that central banks have raised rates far enough to bring inflation down, and fear that their actions will bring on a recession of unknown depth and length. Over the quarter the Australian market is up 9.6% but is down -1.08% over the 12 months..

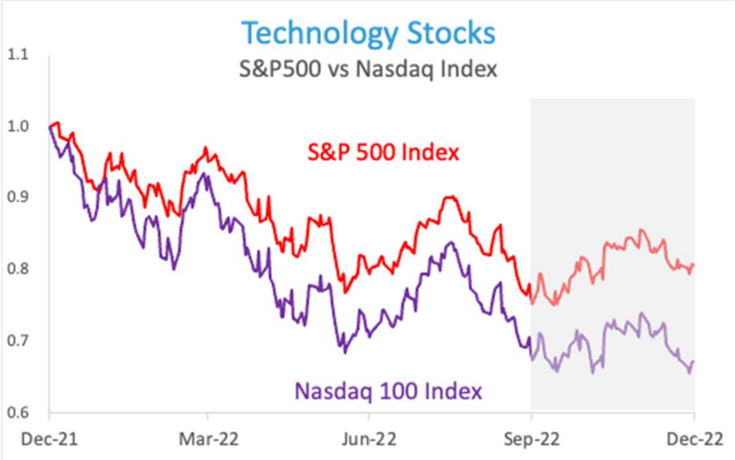
BOND INVESTORS KEEP WAITING FOR RELIEF

Bond yields ended sharply higher compared with where they began the year. The yield on the 10-year bonds closed out 2022 with their largest one-year gain for decades. But over the quarter yields fell on optimism about a downshift to smaller rate rises and a lower terminal rate. Indications of a more protracted tightening cycle ended the rally.



TECH STOCKS HARDEST HIT

High-growth tech names are more sensitive to rising interest rates as typically they are valued based on their projected profits into the future. As the Federal Reserve continued with its tightening monetary policy, the future profits of tech firms continue to be revalued. For the year the Nasdaq index is down by 32.3%, compared to the overall US market which is down 18.1%.



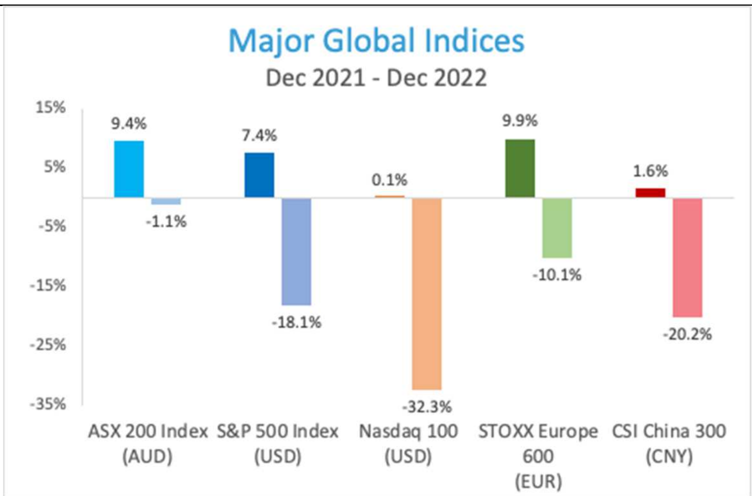
Market Overview

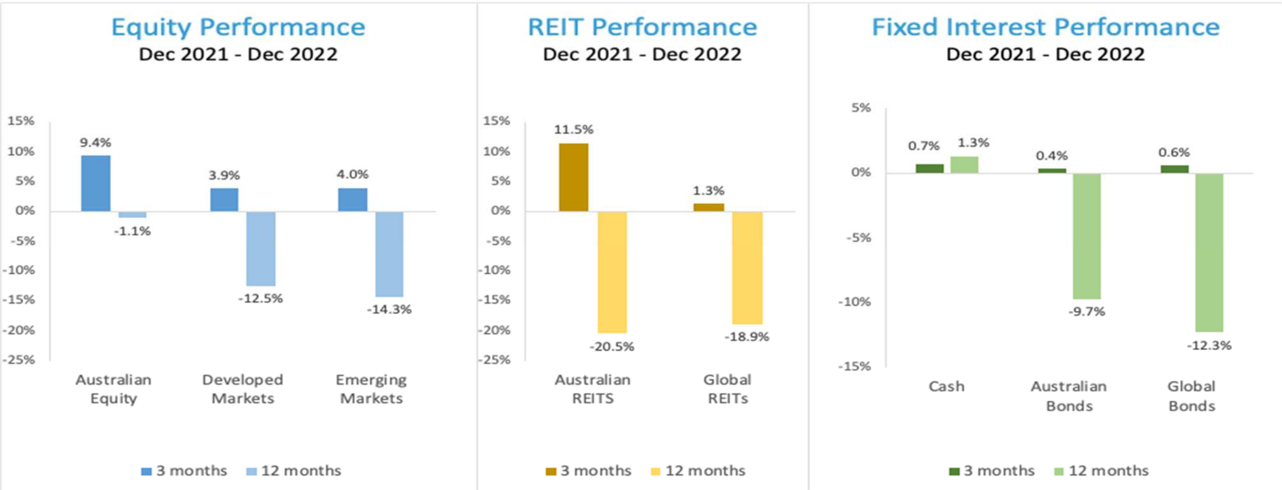
Asset Class	3 Months	1 Year	3 Year	5 Year	10 Year
Cash	0.7%	1.3%	0.5%	1.0%	1.7%
Australian Bonds	0.4%	-9.7%	-2.9%	0.5%	2.3%
Global Bonds	0.6%	-12.3%	-3.2%	-0.2%	2.3%
Australian Equity	9.4%	-1.1%	5.5%	7.1%	8.7%
Developed Markets	3.9%	-12.5%	6.2%	9.3%	13.7%
Developed Markets (hedged)	7.2%	-18.1%	3.9%	5.6%	10.4%
Emerging Markets	4.0%	-14.3%	-1.5%	1.5%	5.8%
Australian REITS	11.5%	-20.5%	-1.5%	3.3%	8.1%
Global REITs	1.3%	-18.9%	-2.2%	3.8%	8.4%

- Australian and Global Bonds have significantly underperformed cash. This has been the worst year in modern history for bond investors.
- The Australian Equity Market has been the best performing market over the quarter and the year, due to the strong performance of the Resource sector.
- The biggest influence on Developed Markets is the US, which makes up around 65% of the MSCI World Index, and then Europe which makes up a further 12%.
- The strong USD resulted in depreciation of the AUD, so that a hedged exposure to global shares underperformed an unhedged exposure by 5.6%.
- The biggest detractor in Emerging Markets was China, which makes up over 30% of the EM index and is down 20% for the year.
- Australian and Global REIT's have been hit particularly hard by rising interest rates and have been the worst performing asset class over the last year.

MAJOR MARKETS ARE NEGATIVE OVER THE LAST 12 MONTHS.

Markets around the world have been hit by rising inflation, tightening monetary policies, the strong USD, and the ongoing uncertainty from the conflict in Ukraine. The high tech stocks in the US are the biggest drag on the US market, while Chinese stocks have been hit hard with a Covid-Zero policy and a property market slump.



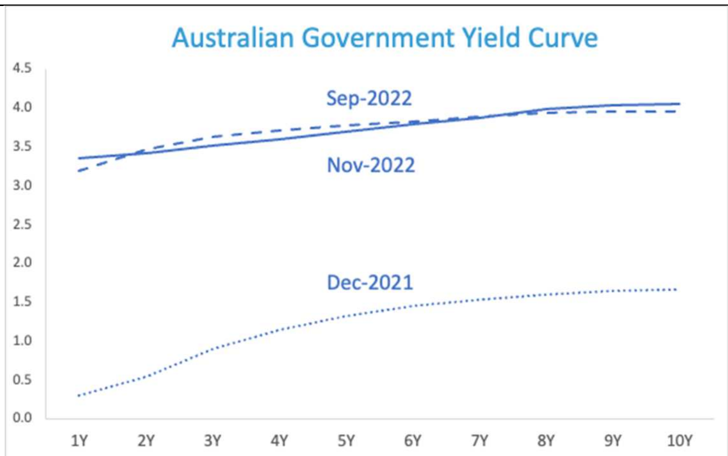


Index data sources:
Bloomberg AusBond Bank Bill Index,
Bloomberg AusBond Composite 0+ Yr Index, Bloomberg Barclays Global Aggregate Bond Index (hedged to AUD),
S&P/ASX 200 Index (Total Return), MSCI World ex Australia Index (net div., AUD), MSCI Emerging Markets Index (net div., AUD),
S&P/ASX 200 A-REIT Index (Total Return), S&P Global REIT Index (net div., AUD)

Yield Curves

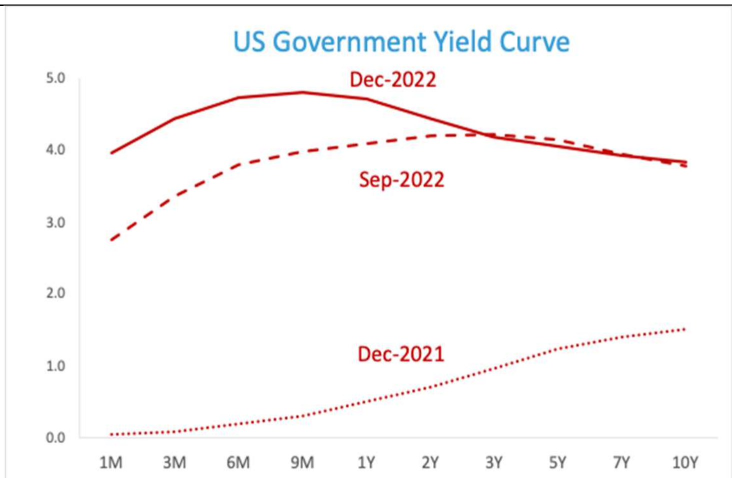
AUSTRALIA

The yield on the Australian 10-year government bond topped 4% at the end of 2022 as concerns over global inflation and the need for additional interest rate hikes re-emerged after China moved ahead with the reopening of its economy after years of covid restrictions. Borrowing costs are now at their highest in ten years, and this has been the fastest tightening cycle since 1989.



UNITED STATES

The US 2-10 year bond yield spread – closely monitored for its ability to predict the US economic outlook – is now near 80 basis points, warning of recession. However, the Federal Reserve has said its job is far from over. Inflation, while starting to cool, is still far too high, and interest rates are predicted to rise further.



Source for yield curves: www.investing.com

Sector Performance

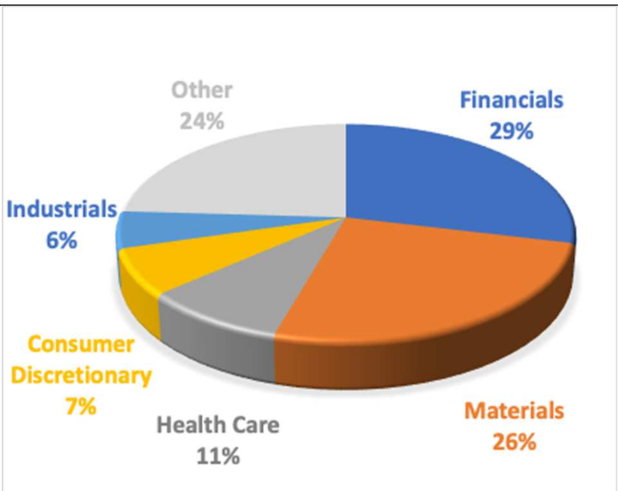
AUSTRALIA

As in other markets, the IT sector had the biggest fall; down 33.7% for the year. However, this sector makes up only 2.7% of the ASX.

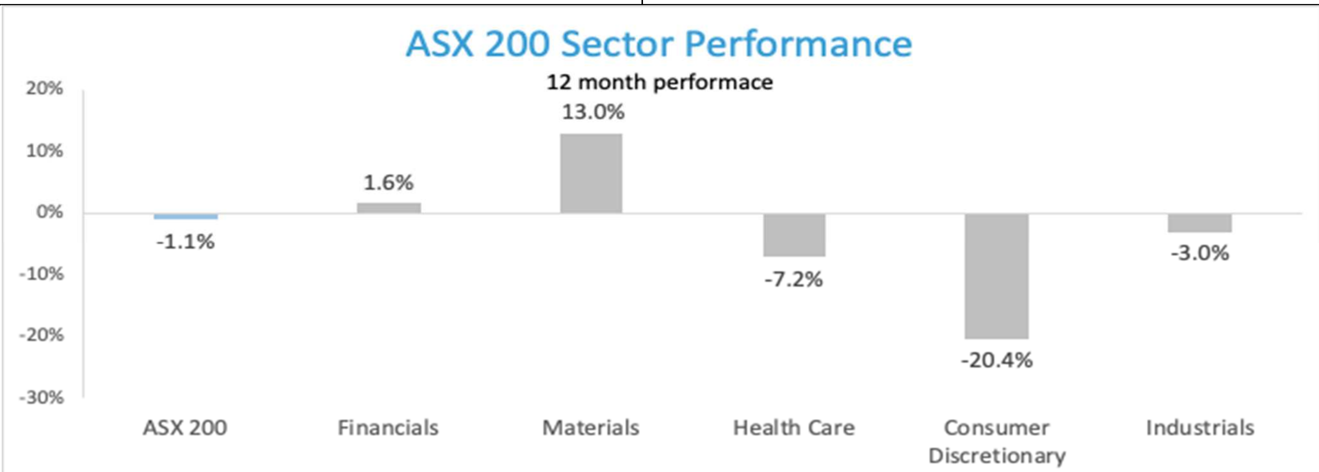
Consumer Discretionary and Real Estate also had big falls over the year, as they are directly affected by interest rates. Energy and Utilities had the highest returns in the last 12 months. Materials and Financials were both positive and the largest contributors to the overall performance of the ASX200 Index.

Sector	3 months	12 months
ASX 200	9.4%	-1.1%
Communication Services	4.4%	-10.5%
Consumer Discretionary	4.2%	-20.4%
Consumer Staple	1.8%	-4.7%
Energy	7.8%	49.0%
Financials	11.0%	1.6%
Health Care	1.9%	-7.2%
Industrials	7.3%	-3.0%
Information Technology	2.5%	-33.7%
Materials	15.2%	13.0%
Real Estate	10.4%	-20.5%
Utilities	28.0%	30.0%

Five sectors make up 75% of the Australian market, with the two largest constituting 55%. The chart below shows the 3-month and 12-month performance of the major sectors



Sector	Weight
Financials	28.8%
Materials	25.7%
Health Care	9.1%
Consumer Disc	6.9%
Real Estate	6.7%
Industrials	5.5%
Consumer Staples	4.8%
Communication Services	3.9%
Information Technology	3.6%
Energy	3.8%
Utilities	1.3%



Source: S&P Global, FE Analytics

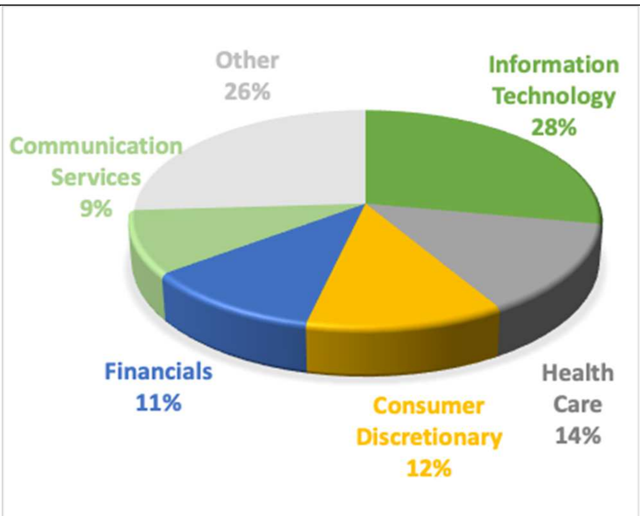
UNITED STATES

The S&P 500 is more diversified in Sector weights than the ASX 200. However, Communication Services and Information Technology make up around 40% of the index. These are home to the high P/E technology stocks, and as such have been the major detractors to the US market.

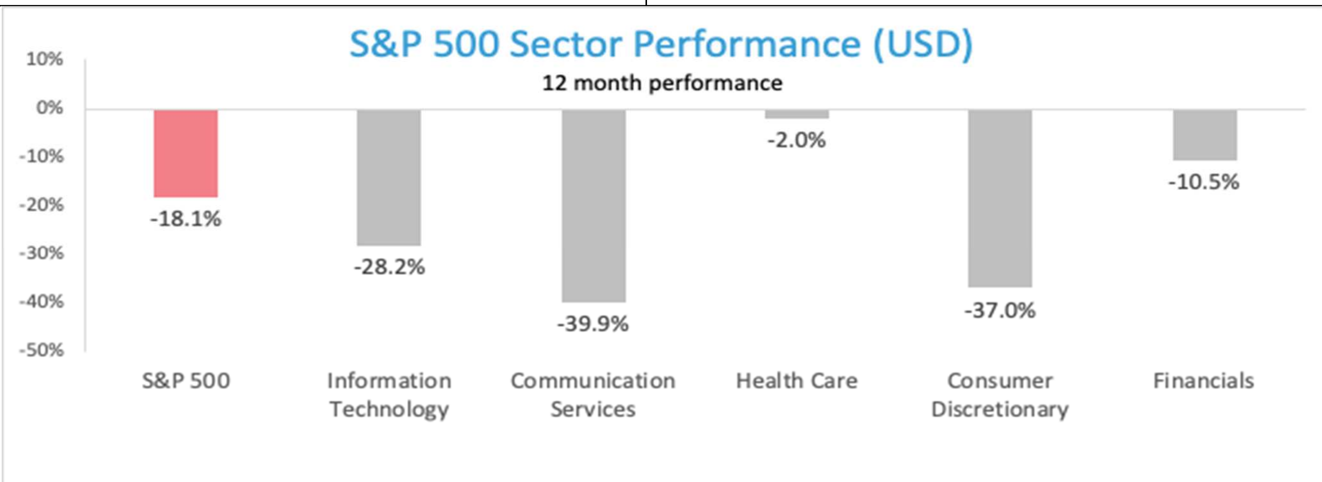
The best performing sectors were Energy and Utilities. Energy is up more than 65% for the last 12 months.

Sector	3 months	12 months
S&P 500	7.6%	-18.1%
Communication Services	-1.4%	-39.9%
Consumer Discretionary	-10.2%	-37.0%
Consumer Staple	12.7%	-0.6%
Energy	22.8%	65.7%
Financials	13.6%	-10.5%
Health Care	12.8%	-2.0%
Industrials	19.2%	-5.5%
Information Technology	4.7%	-28.2%
Materials	15.1%	-12.3%
Real Estate	3.8%	-26.1%
Utilities	8.6%	1.6%

Five sectors make up 75% of the US market, with Tech companies constituting around 37%. The chart below shows the 3-month and 12-month performance of the major sectors.



Sector	Weight
Information Technology	28.0%
Health Care	13.6%
Consumer Discretionary	12.0%
Financials	11.1%
Communication Services	9.4%
Industrials	7.9%
Consumer Staples	6.1%
Real Estate	2.8%
Energy	3.9%
Materials	2.6%
Utilities	2.7%



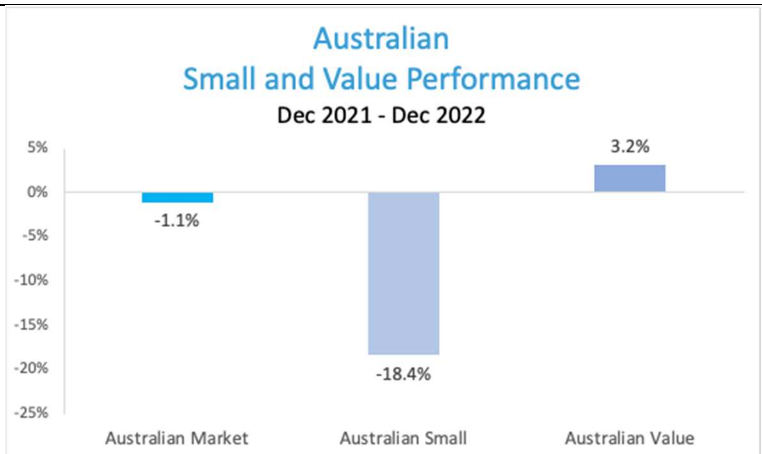
Source: S&P Global, FE Analytics

Equity Factors - Small and Value Premium

Asset Class	3 Months	1 Year	3 Year	5 Year	10 Year
Australian Market	9.4%	-1.1%	5.5%	7.1%	8.7%
Australian Small	7.5%	-18.4%	1.4%	2.9%	5.1%
Australian Value	10.0%	3.2%	6.5%	7.1%	9.4%
Australian Growth	6.3%	-8.8%	5.4%	7.9%	8.1%
Global Market	3.9%	-12.5%	6.2%	9.3%	13.7%
Global Small	4.9%	-12.9%	4.1%	6.4%	13.1%
Global Value	8.7%	0.0%	5.2%	7.1%	12.0%
Global Growth	-0.9%	-24.4%	6.1%	10.6%	15.1%

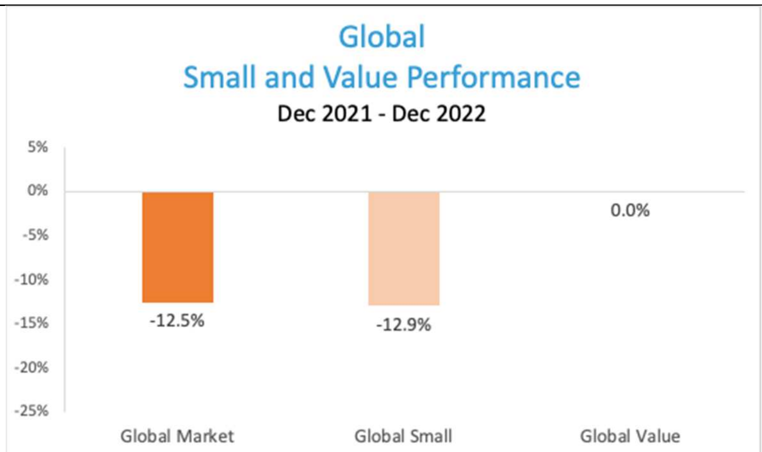
AUSTRALIAN FACTORS

Factors are very volatile over short time periods. Looking over the course of the last 12 months, value stocks out-performed growth stocks by 12%, as lower P/E companies on average did better than higher P/E companies (typically in the IT sector). However smaller companies have under-performed large caps by 17.1%.



GLOBAL FACTORS

The story is much the same in developed markets, where the rout in high P/E tech stocks has resulted in an extraordinary value premium (value – growth) of more than 24% for the previous 12 months. Unlike Australia, global small companies have performed similarly to global large caps.



Value premium = Value Index – Growth Index
Small premium = Small Index – Market Index

Index data sources:

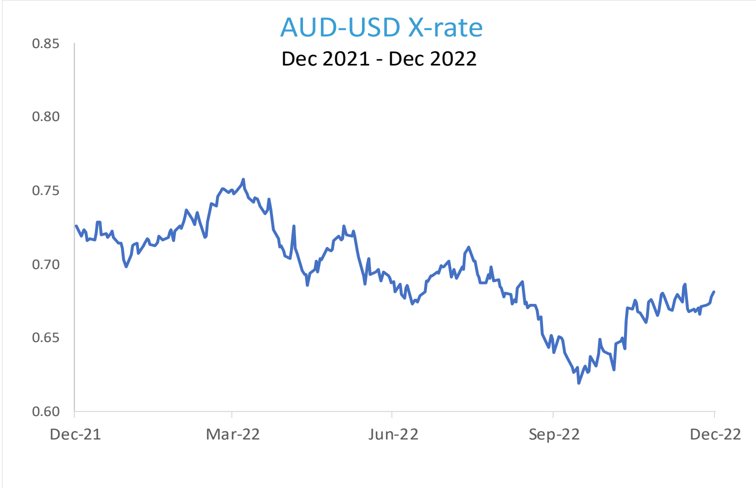
S&P/ASX 200 Index (Total Return)
S&P/ASX Small Ordinaries Index (Total Return)
S&P Australia BMI Value Index (gross div., AUD)
S&P Australia BMI Growth Index (gross div., AUD)

MSCI World ex Australia Index (net div., AUD)
MSCI World ex Australia Small Cap Index (net div., AUD)
MSCI World ex Australia Value Index (net div., AUD)
MSCI World ex Australia Growth Index (net div., AUD)

Currency and Commodities

EXCHANGE RATE

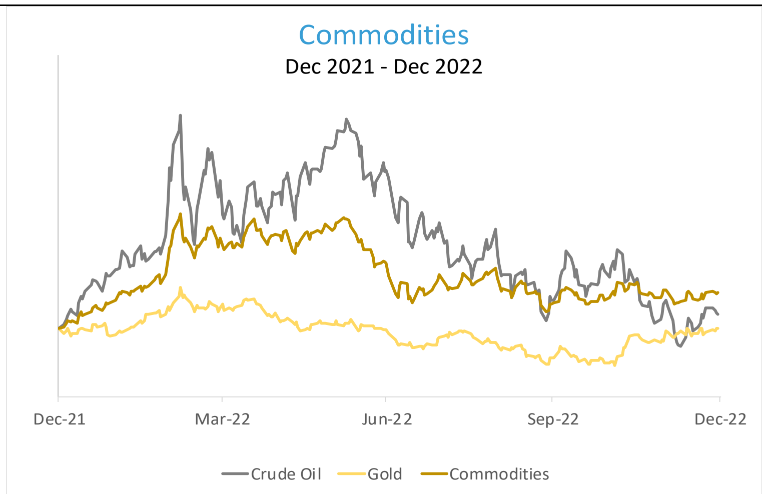
The Australian dollar is down 6.5% in 2022, falling for the second straight year as the US Federal Reserve's aggressive monetary tightening, China's economic woes and slowing global growth weighed on the currency. Commodities also played a crucial role in the volatility in Australian assets, as commodities initially rallied this year before giving up most of those gains in the second half.



COMMODITIES

Gold rose 9.2% in the fourth quarter, mainly driven by fears of a coming recession. However gold closed a volatile year flat at -0.3%, questioning its reputation as an inflation hedge.

Crude Oil is down by 3.9% for the quarter on weaker energy demand and recession fears. Oil is up 4% in a year marked by extreme volatility as various supply risks vied with demand concerns.



Source: www.investing.com

Please contact us on +61 3 9935 0970 or email admin@warrhunt.com.au if we can be of assistance.