PATRIZIA

Monthly Update on the Investment Environment

March 2022

Prime Super

Market Update

The first quarter of 2022 saw a marked dissipation in global economic optimism. While the COVID-19 pandemic's economic and social impact continues to ease and economic data locally and overseas is positive, there have been significant adverse developments over the past three months.

Firstly, the Russian invasion of Ukraine in late February triggered a humanitarian catastrophe in addition to significant expected economic implications. Hoped by most to be a display of brinksmanship that would not escalate into armed conflict, the mass build-up of Russian troops along Ukraine's border in recent months sadly culminated in a full-scale invasion of the country. What began with Russia's recognition of the independence of two breakaway, Russian-backed eastern regions of Ukraine quickly turned into an armed invasion from Ukraine's south, east and north, with the apparent goal to topple the democratically elected Ukrainian leadership and install a Kremlin-friendly puppet. That said, the highly unified front presented by western nations in imposing sanctions and supplying weaponry to Ukrainian forces has led to Russian forces failing to take Kyiv and retreating to the east of the country to refocus their campaign on the Donbas region. Russian military failures have increased hopes for a face-saving 'off-ramp' for Russia, although precisely how the conflict will end remains unclear.

Secondly, inflation across a number of developed economies continues to remain at exceptionally elevated levels, triggering a sharp hawkish tilt from central banks in an attempt to temper prices. That said, the risk of a policy error is now heightened, with an overtightening potentially leading to recession, and possibly a stagflationary environment where both prices are soaring while economic growth remains tepid.

Given concerns around inflation and the geopolitical escalation in eastern Europe, risk assets sold off at the end of February, while commodities prices soared amid expected sanctions and reduced global supply. At one point in early March, the price of brent crude oil reached US$139 per barrel – its highest level since mid-2008 – while gold, considered a safe haven asset and an inflation hedge, neared a record high price of over US$2,070 per troy ounce in early March. Similarly, the price of agricultural commodities such as wheat and corn, of which Russia and Ukraine are major exporters, also surged.

While risk assets sold off in the imminent aftermath of the start of Russia's invasion of Ukraine, developed equity markets recovered as the quarter drew to a close. Australian shares ended the quarter with a positive return of 2.1% owing to higher commodity prices, while developed overseas equities failed to claw back negative returns earlier in the quarter, returning -5.0% to 31 March. The uptick in commodities prices also benefitted the Australian dollar, which increased from 72 to 75 US cents over the quarter.

Fixed interest returns had a poor three months, with the combination of both higher inflation expectations and the rising potential for a swift and sharp policy tightening cycle driving up bond yields, particularly at the front end of the curve. In the US, the spread between two- and ten-year bond yields 'inverted' at the end of March, turning negative. An inversion in the curve is considered a harbinger of looming recession, anticipating weaker growth and inflation over the longer-term relative to the short term. While the Australian yield curve has not inverted as yet, the front end of the curve saw a sharp increase in yields, with the two-year government bond yield passing 2%; the highest level since 2018, and a far cry from mid-2021, when its yield fell to just 0.01%. As a result of the spike in yields, both Australian and overseas fixed interest posted negative returns over the quarter, returning -5.9% and -5.0%, respectively.

Australia

In Australia, the impact of the Omicron strain of the virus dissipated over the quarter with limited economic impact owing to both the strain's mildness and a successful vaccination rollout program. While March saw a fresh surge in new COVID-19 cases across Australia, its impact continues to ease. The latest jobs data for February, released mid-March, saw unemployment continue its downward trajectory, falling to just 4.0% - the lowest level since the onset of the Global Financial Crisis in 2008. The participation rate, meanwhile, hit an all-time high of 66.2%.

With a federal election looming in mid-May, the ruling Liberal/National coalition delivered an earlier-than-usual budget in late March. The surge in commodity prices and sharp economic recovery have improved the government's fiscal health, with a nearly $80 billion reduction in forecast cumulative deficit through to 2025 compared to the government's outlook in December last year. As can be expected in an election year, the improved government finances have led to an increase in budgetary stimulus, with tax offsets and one-off payments to lower income Australians, as well as a temporary reduction in the fuel excise to counter recent rises in fuel prices.

While the RBA made no changes to its policy settings in early April, signalling continues to move in a hawkish direction, with Governor Phil Lowe's post-meeting statement removing prior references to 'patience' before tightening policy. This change in language follows RBA guidance in March that it would consider broader gauges of wages other than the Wage Price Index, and reinforces the notion that the RBA is more open to raising rates in the coming months. Markets are expecting an aggressive rate trajectory, pricing in a first hike in June 2022 followed by at least one hike per meeting through to the end of 2022.

United States

The major policy outcome in the US over the quarter was the Federal Reserve's decision to lift its target rate by 25 basis points to 0.50%. This first hike since late 2018 was widely anticipated following an ongoing surge in inflation, with headline CPI reaching a forty year high of 7.9% year-on-year in February, and unemployment falling 0.2% to 3.6% in March. Signalling from the central bank also took a more hawkish tilt, with the revised 'dot plot' suggesting the median FOMC member projection is for a rate hike at every meeting in 2022. Market pricing is even more aggressive, fully pricing in two 0.5% rate hikes in the next two meetings. The Fed's decision-makers have also intimated the start of a reduction in their balance sheet in the coming quarter.

US Inflation data for February, released in mid-March, met expectations to rise by 7.9% year-on-year – a four decade high. Core inflation, which strips out food and energy prices, also increased to an annual pace of 6.4% – a level not seen since 1982. Employment data, meanwhile, continued to impress, with the unemployment rate for March falling by 0.2% to 3.6% – the lowest since February 2020, and just 0.2% above the record low set in 1969. While the participation rate increased to 62.4%, it is still below the pre-pandemic level of 63.4%.

China

China saw a surge in COVID-19 cases as the quarter drew to a close, with the government's strict approach to curbing outbreaks leading to Shanghai entering lockdown. The outbreak dampened sentiment among both manufacturing and services firms. Chinese equities, meanwhile, declined amid both the geopolitical tensions over Ukraine as well as a crackdown by the US SEC on Chinese firms listed on US exchanges that failed to meet US accounting standards.

Europe

The European economy saw strong employment and inflation data, although the conflict in Ukraine remains the primary focus from both a political and economic perspective, driving down sentiment data. The spike in energy prices associated with the conflict in Ukraine pushed Eurozone headline inflation up 2.5% over March, taking the annual print to 7.5%. Core CPI was somewhat more subdued, albeit at a still-high annual rate of 3.0%.

Unemployment on the continent also fell over the month, reaching an equal record low of 6.8%. Both data sets support the case for policy tightening from the ECB later in 2022. The Bank of England is more advanced in its hiking cycle, raising its cash rate to 0.75% by quarter-end.

Table 1: Index Returns to 31 March 2022

	MONTH (%)	THREE MONTHS (%)	FYTD (%)	ONE YEAR (%)
Australian Equities				
S&P/ASX 300 Accumulation Index	6.9	2.1	6.2	15.2
S&P/ASX Small Ordinaries Accumulation Index	5.3	-4.2	1.1	9.7
International Equities				
MSCI World (ex Australia) Index (hedged A$)	2.9	-5.0	3.1	10.9
MSCI World (ex Australia) Index (unhedged A$)	-0.9	-8.4	2.1	11.6
MSCI Emerging Markets Index (unhedged A$)	-5.6	-9.9	-15.6	-10.1
Property				
S&P/ASX 200 A-REIT Accumulation Index	1.2	-7.1	6.6	17.7
Australian Fixed Interest				
Bloomberg AusBond Composite Index	-3.7	-5.9	-7.0	-5.5
Global Fixed Interest				
FTSE WGBI ex-Aust (hedged A$)	-2.2	-4.8	-4.7	-4.0
Barclay's Global Capital Aggregate Bond Index (hedged A$)	-2.1	-5.0	-4.9	-4.0
Cash				
Bloomberg AusBond Bank Bill Index	0.0	0.0	0.0	0.0
Commodities				
Gold (US$ per ounce)	1.7	7.5	10.2	14.9
Copper (US$ per metric tonne)	5.0	6.7	10.7	18.1
WTI Crude Oil (US$ per barrel)	4.8	30.3	36.5	69.5
RBA Index of Commodity Prices (A$)	3.9	15.4	21.5	42.7

Table 2: Australian Dollar versus Foreign Currencies to 31 March 2022

AUSTRALIAN DOLLAR VERSUS	AS AT 31 MARCH 2022	MONTH (%)	THREE MONTHS (%)	FYTD (%)	ONE YEAR (%)
US Dollar	0.75	3.5	3.3	0.0	-1.4
British Pound Sterling	0.57	5.5	6.3	4.9	3.3
Euro	0.67	4.5	5.6	6.6	4.1
Japanese Yen	91.15	9.1	8.9	9.4	8.3