2021-2022 financial year in review

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"The promising global economic recovery is now being threatened by high inflation, rising interest rates and the conflict in Ukraine. Global share markets have delivered disappointing returns given these prominent risks and the possibility that a recession may occur in the next year."

Global economic recovery is being threatened by high inflation and rising interest rates

The financial year can be separated into two contrasting halves. The first half from July to December 2021 was promising. The global economy had turned for the better with improving vaccine access. Global interest rates were low to support economic growth given that inflation appeared mild. Then the storm clouds gathered with lightning strikes from rising commodity prices, supply disruptions and Russia's invasion of Ukraine. The second half of the financial year from January to June 2022 has been a troubling climate for consumers and investors with high inflation and rising interest rates.

Global economic activity began the financial year in July 2021 with more promising prospects. Vaccines became more readily available, allowing employees to return to workplaces and even cafes and restaurants began re-opening. There was a sharp setback with the emergence of the Omicron virus variant in late 2021. However, the extraordinary low interest rates set by central banks as well as significant government budget support allowed global economic activity to pick up speed.

The US economy made a strong recovery with robust business conditions and jobs growth for most of the financial year. The US unemployment rate rapidly fell from 5.9% in July 2021 to 3.9% in May 2022. Indeed, the shortage of American workers became so acute that job vacancies surged to record highs and wages growth accelerated to a 5% annual pace.

However, storm clouds were developing given rising inflation pressures. The first sign of thunder was the acceleration in US consumer inflation above 7% in December 2021. The US central bank responded by signalling that interest rates could rise "sooner and faster" in January 2022. Then Russia's brutal invasion of Ukraine on 24 February 2022 dramatically intensified the inflation threat by pushing up key commodity prices such as oil, gas, copper, fertiliser and wheat. Consumer inflation surged to 40 year highs with annual US inflation at 8.6% in May. In response to this inflation surge, the US central bank began a rapid sequence of raising interest rates in March 2022. US interest rates have increased by 1.5% since March with the US central bank also signalling further interest rate rises *"will be appropriate"* in the next year[1].

Europe's recovery had been a 'stop-start' sequence during the first half of the financial year with setbacks given the Delta and Omicron virus waves. Yet Europe's economy was showing more promising signs as business and consumer confidence improved at the start of 2022. However, this confidence was shattered by Russia's invasion of Ukraine. The devastating loss of lives, traumatic flight to safety by Ukrainian women and children westwards to Europe as well as Russia's importance as a key energy supplier of natural gas and oil has had a dramatic negative impact. European annual consumer inflation has surged above 8%. European businesses and consumers are very worried about meeting their future energy needs given Russia's threat of cutting supply of natural gas and oil.

China's sharp economic slowdown and the financial woes of their property developers also made the headlines. China's economy has recorded subdued industrial production and weak retail sales given the combination of falling house prices and the government's "Zero-Covid" strategy. Virus outbreaks in Shanghai, Shenzhen and Beijing this year has seen China's government impose harsh lockdowns which cut both production and spending. This has also materially contributed to problems in global supply chains with extensive delays in obtaining goods from China's factories and shipping ports.

[1] US Federal Reserve Chair Jerome Powell press conference, 15 June 2022.

Commodity prices had some tumultuous twists and turns during the financial year. Iron ore prices started the year in 'boom' conditions at US$210 per tonne. However, China's sharp economic slowdown and property development woes then saw a slide in demand. Iron ore prices ended the year around US$112 per tonne, which is a 47% annual decline. This was a key factor driving the Australian dollar (AUD) lower against the strong US dollar over the past year.

More problematic has been the sharp surge in energy and food prices. Given stronger global demand and concerns over Russia as a key source of supply, both energy and food prices have skyrocketed. Russia accounts for circa 16% of global natural gas production, 12% of crude oil and 11% of wheat production[2]. Over the past year, natural gas prices have climbed by 138%, crude oil by 46% and wheat prices by 53%[3]. Globally, consumers felt both angrier and poorer with every visit to the supermarket and service station.

Inflation has become the key economic and social concern with this commodity price surge, as well as congested supply chains given production and transport delays. Global annual inflation measures have risen to multi-year highs. Consumer inflation ended the financial year above 8% in Europe and the US[4]. Even more alarming inflation readings have been seen in Brazil (11.7%), Egypt (13.5%), Sri Lanka (55%) and Turkey (79%). Australia's consumer inflation was running at 5.1% in the year to March 2022. However, the Reserve Bank of Australia (RBA) Governor, Philip Lowe, indicated in mid-June that Australian consumer inflation is expected to peak at 7% at the end of 2022[5]. This high inflation rate represents a significant loss of purchasing power. Australian workers are particularly feeling the price squeeze given that wages growth was only 2.4% in the year to March.

A roller coaster year for Australia's economy

Australia's economy has experienced a roller coaster financial year. The virus outbreaks in NSW and Victoria in mid-2021 as well as virus cases across Australia from late 2021 did constrain consumer spending. However, given the benefit of high vaccinations, low interest rates and resilient businesses and consumers, the Australian economy has made a rapid recovery. Robust jobs growth has seen the unemployment rate fall from 5.2% in October 2021 to 3.9% in May 2022, the lowest since 1974.

Australia now confronts the challenge of high inflation and rising interest rates. The RBA has rapidly raised the interest rate from 0.1% in April 2022 to 1.35% in July 2022. Further interest rate rises have been signalled by the RBA to reduce inflation. This suggests a very challenging climate for borrowers and investors in the coming year.

A disappointing year for investment returns

Asset class returns in Australian dollars – periods to 30 June 2022

Asset class	Returns			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	0.1%	0.3%	0.9%	1.7%
Australian bonds	-10.5%	-2.6%	0.9%	2.6%
Global bonds (hedged)	-9.3%	-1.6%	0.8%	3.1%
Global listed infrastructure (hedged)	5.4%	3.7%	5.9%	9.8%
Global property securities (hedged)	-10.5%	-1.4%	1.9%	6.6%
Australian shares	-6.5%	3.3%	6.8%	9.3%
Global shares (unhedged)	-8.0%	6.9%	9.4%	13.2%
Global shares (hedged)	-13.6%	5.6%	6.7%	10.4%
Emerging markets (unhedged)	-18.4%	1.2%	4.4%	7.3%

Past performance is not a reliable indicator of future performance.

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2 Estimates for Russia's share of global commodity production in 2021. JP Morgan, Global Data Watch , 4 March and 18 March 2022.
3 IMF Commodity Price Index in US$ terms. Price measures are for Brent crude oil, natural gas price for Europe, Japan and US and the Wheat Hard Red Winter Kansas City.
4 Inflation data is from Australian Bureau of Statistics, Eurostats, US Bureau of Labour Statistics and Reuters.
5 RBA Governor Philip Lowe on ABC 7.30 Report, 14 June 2022.

Sources: FactSet, MLC Asset Management Services Limited. Benchmark data: Bloomberg AusBond Bank Bill Index (cash), Bloomberg AusBond Composite 0+ Yr Index (Aust bonds), Bloomberg Barclays Global Aggregate Index Hedged to $A (global bonds), FTSE Global Core Infrastructure 50/50 Index Hedged to $A, FTSE EPRA/NAREIT Developed Index (net) hedged to $A (global property securities), S&P/ASX300 Total Return Index (Aust shares), MSCI All Country World Indices hedged to $A and unhedged (net) (global shares), and MSCI Emerging Markets Index (net) unhedged to $A (emerging markets).

Global share investors had a disappointing year with a market return of -13.6% for hedged and -8% for AUD unhedged portfolios. The primary drivers of this very weak performance are high inflation, supply disruptions and increasing interest rates, which are threatening corporate profit prospects.

US shares made new record highs in early January 2022 given low interest rates and the robust +45% annual gain in corporate profits in 2021. Strong business surveys and job gains also provided encouragement that the US economic recovery was strengthening. There were similar sharp gains for European shares at the start of 2022 given this optimism on global growth and that the virus threat was gradually diminishing.

Yet storm clouds were gathering that eventually rained on these share gains. Global share prices slumped in response to accelerating commodity prices, rising interest rates and wage pressures which were squeezing profit margins. Investors became alarmed that central banks would need to continue increasing interest rates to slow demand until supply disruptions could be resolved. Russia's invasion of Ukraine also severely damaged sentiment by casting a shadow over European national security.

The slide in global share markets over the last six months to June 2022 has been dramatic and intense. The largest 500 companies in the US as measured by the S&P 500 Index declined -20%, while the technology focused Nasdaq 100 fell -29%. Europe's STOXX50 and Germany's DAX indices recorded similar falls of -20% in the last six months.

There were no 'safe havens' amongst this global storm. In local currency terms, Chinese share prices as measured by the MSCI China Index fell by 10% in the final six months and 31% for the financial year. The mix of increasing government scrutiny of Chinese education and technology companies as well as the continuing debt woes of property developers such as Evergrande undermined Chinese shares.

Australian shares as measured by the ASX 300 declined by -6.5% for the financial year. The sharpest annual falls were in the Information Technology (-38.2%) and Consumer Discretionary (-21%) sectors as investors cut their growth expectations. Financial shares (-7.5%) and Health Care (-9.4%) also disappointed as rising interest rates curbed their appeal. There were some bright spots amidst the gloom with the Energy (30.1%) sector on fire given the surge in natural gas and oil prices. Resources (3.3%) benefitted from gains in select metal prices and a weaker AUD.

Bond investors had a brutal year with negative returns given rising inflation and alarm that central banks will continue to rapidly raise interest rates over coming years. The Australia fixed interest market return came in at -10.5% while the benchmark global bonds (hedged) return was -9.3%.

Prospects for the next financial year

The troubling trio of rising inflation, higher interest rates and the war in Ukraine is providing a more challenging and painful investing climate. Inflation has moved to multi-decade highs around the world. Central banks with inflation targets are compelled to rapidly raise interest rates to cool these price pressures. This implies that the cost for lowering inflation is to reduce demand to meet the limited available supply of goods.

Accordingly, investors are worried about whether central banks can safely navigate the challenge of moderating inflation without severely damaging economic growth. As interest rates sharply rise and financial conditions for borrowers become tougher, investors become naturally concerned that a recession could occur.

Investors face a difficult task in assessing these considerable inflation, interest rate and economic activity risks in the coming financial year. Given the current investment climate is dynamic with multiple positive and negative scenarios possible, investors should maintain a disciplined and diversified strategy to manage these extraordinary risks.

MLC portfolios have been building inflation resilience for a number of years

We are trying to create a balance in our growth and defensive assets that will perform irrespective of whether growth is price or demand-driven.

With that in mind we have minimal risk exposure to traditional bonds, preferring to use inflation-linked bonds to replace government bonds and corporate bonds with relatively short maturity dates. This positioning was beneficial for the portfolios during the recent spike in global bond yields (global bond values fell). The addition in 2021 of global listed infrastructure in the Horizon and Inflation Plus portfolios provided a valuable inflation linked revenue stream. This allocation has been resilient during recent unsettled financial markets, outperforming broader global shares by over 18% in the year to 30 June 2022[6]. Insurance-related investments, which provide a return stream that is uncorrelated to inflation, were added to the Horizon and Inflation Plus portfolios to serve as a defensive source of meaningful income. We've also accessed share markets through 'participate and protect' option strategies which enable our portfolios to participate in rising markets, but thanks to options strategies, also receive payments when markets decline. Options strategies have been central to our US and Chinese share markets investments.

MLC's investment process is ideally suited to deal with an uncertain future

Rather than basing portfolio decisions on a single future, we attempt to understand the many ways in which the future may unfold and the trade-offs between risk and return that each future may entail. A continuation of the current environment is only one of many scenarios that could unfold. By understanding how our multi-asset portfolios are likely to perform in many potential market scenarios, both good and bad, we can adjust their asset mix to manage possible risks and take advantage of potential return opportunities. This careful analysis means our portfolios are prepared for the range of outcomes that may occur, including having adequate diversification, being risk-aware and being positioned for a range of future market environments.

[6] This refers to the outperformance of FTSE 50/50 Global Core Infrastructure Index versus MSCI All Country World Index both hedged to the AUD.