July 2022

GPS WEALTH

GPS Wealth Monthly Market Update

A Change in Rhetoric from the Federal Reserve

INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 12 AUGUST 2022

The S&P/ASX 200 Accumulation Index returned 5.75% in July. The share market increase was driven by a decline in both domestic and global bond yields and a better than expected (feared) US quarterly reporting season. The Australian 10-year bond yield decreased by 50 basis points whilst in the US, the 10-year bond yield decreased 30 basis points as markets realised growth was cooling quickly. Wheat futures have fallen back to US750 per tonne having reached US1200 per tonne when Russia invaded the Ukraine. **The price of oil also eased suggesting that inflation globally may have peaked.** Indeed, the US inflation data for July was better than expected, recording an increase of just 0.1%. It is possible however that lingering supply-side and pandemic-related effects keep the rate of change in consumer prices stubbornly high. The speed at which headline inflation will come down is uncertain. Shelter inflation will be an extremely important driver of how low US core inflation ultimately falls. The rapid shift in mortgage rates implies that shelter inflation will eventually slow in response to lower house prices, but this process is only just beginning and will take some time to feed into actual inflation measures.

The US economy added a healthy 372 000 jobs and the unemployment rate steadied at an historically low level of 3.6%. **There are now roughly two vacancies for each person unemployed in the US, making this one of the tightest labour markets in recent history.** The US recorded two consecutive quarters of negative growth meeting the commonly held definition that the economy is in recession. However, it is up to the National Bureau of Economic Research (NBER) that declares a recession which comes after a lengthy lag. The judgement is based on measures including monthly jobs growth, consumer spending and industrial production. The NBER characterises a recession as significant decline in economic activity that is spread across the economy and lasts for more than a few months. On this definition given the unemployment situation, it would be hard to argue that the US is in recession at present. Having said that, the Conference Board's leading economic indicator is now essentially pointing to a recession. The indicator peaks in advance of the Conference Board's coincident indicator, and we have now seen four consecutive month-over-month declines.

The Federal Reserve delivered another 0.75% increase in the Fed Funds rate however it was the acknowledgement of a softening in economic activity that led markets to temper rate hike expectations and drive risk assets higher over the month. The Federal Reserve may decide to slow its pace of tightening in response to decreasing house prices if supply-side/pandemic-related inflation eases, but it may instead retain its data dependency bias and set monetary policy in a fashion that causes a rise in the

Emmanuel Calligeris
Chairman of the Investment Committee

unemployment rate. That would almost certainly be recessionary, meaning that risk assets will likely remain volatile.

The RBA raised the official cash rate by 0.50% to 1.85% in July and signalled continued tightening ahead.

Consumer price inflation is at 6.1% for the recent June 2022 quarter, supported by a weaker currency, stimulative policy conditions and resilient domestic demand. However, the domestic economy is showing early signs of slowing, most noticeably in housing where prices nationally are now 2.6% below peak levels. Housing weakness has yet to be translated to the labour market with employment growth stronger than expected and the unemployment rate falling to a cycle low of 3.5%. The NAB business survey for June showed confidence and conditions turning lower on the back of higher borrowing costs and greater economic uncertainty although business conditions remain well-above the long run average.

The European Central Bank is facing multiple dilemmas with a looming recession and high inflation. The energy picture continues to deteriorate, with natural gas prices now closing in on the level that was likely to prevail in a full cut-off scenario by Russia. If Russia's decision to severely tighten Europe's natural gas market is in response to Europe's success at building gas inventories, then that points to quite a negative outcome for European industrial activity in the second half of the year.

Markets took solace that the Federal Reserve and the RBA understand the fragility of the highly indebted world that has been created post Covid.

Small increases in interest rates by historical standards coupled with geopolitical events could materially slow growth and lead quickly to recession. While both the Australian and to a lesser extent, the US economies remain in fair shape in the face of early increases in interest rates, the bond market rallied (bond yields decreased) in anticipation of subsequent economic weakness. This has sent the share prices of companies most sensitive to interest rates higher in the recent rally.

The Australian Shares outlook centres around the outlook for inflation and the interest rate level on the 10-year bond.

As mentioned last month, Central Banks around the world remain laser focused on inflation as they look to re-establish their inflation fighting credentials (having fallen asleep at the wheel). Understanding where the 10-year bond yield will settle after inflation (also known as the real bond yield) will be half the battle in gaining a fundamental assessment of fair value for the share market and growth assets more broadly and that now depends on the level of inflation that is expected over the next 10 years. Inflation is likely be closer to 3% than 2% at least in the next few years even if unemployment increases. Assuming the real rate on the 10-year bond is zero in this highly indebted world and a risk premium of between 25-50 basis points, a fair value bond yield of 3.5% seems appropriate. The Australian share market looks a little cheap to fair value at current levels (7032 on the ASX 200) however analysts are likely to be downgrading earnings in the coming year as economic growth slows. A small shift in the fundamental view, that things are not as bad as feared, has prompted a material shift into shares and has caught institutional investors off-guard. In the short term, we're likely to have a quiet couple of weeks ahead of the Jackson Hole central banking conference on August 25-27 and the northern hemisphere's summer holidays.

Returns

31st July 2022

ASSET CLASS RETURNS ARE BASED ON

Australian Cash
RBA Bank accepted Bills 90 Days

Australian Bonds
Bloomberg AusBond Composite 0+ Yr TR AUD

International Bonds Hedged
BarCap Global Aggregate TR Hdg AUD

Australian Listed Property
S&P/ASX 200 A-REIT TR

International Property Hedged
FTSE EPRA/NAREIT Dv REITS TR Hdg AUD

Australian Shares
S&P/ASX 200 TR

International Shares
MSCI World Ex Australia NR AUD

Emerging Market Shares
MSCI EM GR AUD

RETURNS TO THE 31ST JULY 2022

	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Australian Cash	0.17	0.39	0.44	0.46	0.37	0.95	1.68
Australian Bonds	3.36	0.93	-5.46	-9.10	-1.81	1.49	2.88
International Bonds Hedged	2.49	0.61	-5.61	-8.23	-1.04	1.21	3.21
Australian Listed Property	11.93	-8.39	-5.40	-2.06	0.12	6.80	9.80
International Property Hedged	8.15	-5.26	-6.31	-5.12	2.23	4.57	7.99
Australian Shares	5.75	-6.04	1.71	-2.17	4.27	8.03	9.44
International Shares	6.40	0.62	-8.76	-4.39	9.24	11.87	15.00
Emerging Market Shares	-1.70	-4.74	-15.43	-15.82	0.48	3.71	7.15

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