WHITEHELM ADVISERS

MONTHLY UPDATE ON THE INVESTMENT ENVIRONMENT

December 2021

Prime Super

MARKET UPDATE

The December quarter saw 2021 end on a note of cautious optimism. With inflationary pressures proving more persistent, jobs data improving and promising signs of the emerging Omicron COVID-19 strain's lower severity, risk assets rallied. That said, central bank policy missteps, geopolitical tensions between Russia and NATO, property sector concerns in China, and further virus mutations are all material risks heading into 2022.

By end-2021, confirmed COVID-19 cases neared 300 million globally, with around 5.5 million confirmed deaths. The recent spike in cases attributable to the emergence of the more transmissible – albeit ostensibly less severe – Omicron strain has triggered renewed concerns. In mid-December the Netherlands became the first European Union country to reintroduce lockdowns, and Austria and Germany imposed new travel restrictions.

Risk assets had a stellar quarter amid strong economic performance. Developed overseas equities were the standout asset class, returning 7.9% on a currency hedged basis for the quarter; the US S&P 500 Index ended 2021 at a record high. Australian equities were comparatively more subdued amid weaker export commodities demand, although nonetheless returned 2.2% for the quarter. Fixed interest returns proved weak, with growing inflationary concerns and a potentially hastened unwinding of bond purchase programs driving up yields; in Australia the RBA's abandonment of its yield curve control program during the quarter contributed to a surge in front-end yields, driving down local bond returns to -1.5%. 2021 proved to be a poor year overall for fixed interest as yields increased from pandemic-era lows, with Australian and overseas fixed interest returning -2.9% and -1.5%, respectively. Equities, by contrast, had yet another excellent year; three year returns for Australian equities currently sit at 14.0% per annum, with fully hedged developed overseas equities at 20.2% per annum.

The United Nation's Climate Change Conference, more commonly known as 'COP26', was held in Glasgow in early November. The summit resulted in the Glasgow Climate Pact – the first climate pact to explicitly commit to reducing coal use, which also encouraged urgency in emissions cuts and finance for developing nations to address climate change. Over 140 countries, representing 90% of global GDP pledged to reach net-zero emissions, while over 100 countries agreed to reverse deforestation by 2030. Nonetheless, the final terms were considered weak overall, with China and India tempering measures to end coal power and fossil fuel subsidies.

AUSTRALIA

A successful vaccination rollout and relaxed social distancing worked in tandem with the Omicron strain to trigger an exceptional spike in COVID-19 cases, passing 50,000 daily in early January. While hospitalisations from the virus were low early in the new year, risks exist around the health system's ability to handle the looming peak in cases.

Third quarter Australian GDP, released in November, recorded a contraction of 1.9% – the third largest quarterly drop in history – but it beat market forecasts and saw improving household disposable income and savings. With lockdowns having since ended, the figure is expected to recover in upcoming prints. Jobs data, meanwhile, smashed forecasts and saw unemployment fall to a 13-year low of 4.6% in November. The figure of 360,000 new jobs created was nearly double consensus, while underutilisation hit its lowest level in a decade.

Third quarter inflation provided an upside surprise, with the RBA's preferred measure – the trimmed mean – beating consensus forecasts to rise to 0.7%, taking the annual rate to 2.1% – the first time inflation has entered the RBA's target range in six years. The data prompted a major policy development in Australia over the quarter; the capitulation of the RBA on its 0.1% three year yield curve control target, with bond markets having bet that the RBA would have to tighten rates well ahead of its prior guidance of 2024. While the RBA's revised outlook suggests a potential rate hike as early as 2023, markets are far more hawkish, pricing in three hikes in 2022 alone. The RBA's December meeting minutes suggested that it expects to taper its bond purchase program by half to A$2 billion per week at its February meeting and end the program in May; that said, more favourable economic data and other central bank developments may lead to the cessation of quantitative easing in February.

The nation's housing sector recorded the best calendar year since 1989, returning over 22%. That said, December price growth was markedly slower, suggesting a combination of tighter lending standards and rising borrowing costs are weighing on purchaser concerns.

UNITED STATES

The US Federal Reserve decided at its early November meeting to proceed with a tapering of asset purchases, noting that required employment and inflation criteria had been achieved. While the central bank originally planned to cut its US$120 billion in monthly purchases by US$15 billion and scale it back further thereafter, the speed of tapering was doubled by the Fed at its December meeting to US$30 billion per month after further strong economic data, putting it on track to cease purchases in March 2022, with markets now considering a rate hike probable in that month. The Fed's 'dot plot' now expects three hikes over 2022.

US inflation data remained high. The Federal Reserve's preferred gauge, the Core PCE deflator, which removes more volatile components, hit 4.7% for the year to 30 November; the highest level since 1989. November CPI data saw annual price growth hit a 39-year high of 6.8%, with core CPI hitting 4.9% year-on-year. Officials have noted that recent price rises are increasingly broad-based across the economy. Producer prices also beat forecasts, rising to 9.6% year-on-year. The broadening out and persistence of inflationary pressures prompted a notable tilt in policy signalling from Fed Chair Powell, who noted in late November that the term 'transitory' inflation may be worth retiring from the central bank's usage, conceding that inflation had grown more persistent, and that the Fed had been behind the curve in containing price growth.

President Biden succeeded in garnering enough bipartisan support for the passage of his flagship US$1.2 trillion infrastructure bill into law. The bill includes over US$500 billion in spending on airports, broadband networks and roads. Biden also renominated Jay Powell for a second term as Chair of the US Federal Reserve, naming the other major contender for the role, the more dovish Lael Brainard, as Vice-Chair. Despite its success on the infrastructure bill, the Biden administration suffered a major setback in Congress in December, with its flagship US$1.7 trillion 'Build Back Better' bill, intended to support childcare, tackle climate change and raise taxes for the wealthy, rejected by a Democrat senator from 'coal state', West Virginia, costing the Democrats the Senate majority required to approve the bill. December also saw Congress approve an increase in the US government debt ceiling, raising the limit by US$2.5 trillion.

CHINA

In China, small COVID-19 outbreaks led to fresh lockdown measures as the year ended, particularly in the region of Xi'an.

China's third quarter GDP data reflected a weakening rate of growth, falling to an annual rate of 4.9%. An ongoing energy crisis within the manufacturing sector, property sector concerns (in particular relating to ailing property developer Evergrande), and a zero-tolerance approach to COVID-19 containment all curbed consumer spending. That said, manufacturing activity beat expectations in the final month of 2021, with both official and Caixin PMI gauges in slightly positive territory.

The People's Bank of China responded by cutting its reserve requirement ratio during the quarter, cutting the one-year benchmark loan prime rate for the first time in nearly two years in an attempt to stimulate the economy.

EUROPE

At its December meeting, the European Central Bank announced the discontinuation of asset purchases under its pandemic emergency purchase programme (PEPP) from March 2022 onwards, although maturing bonds will be reinvested through to end-2024. However, its asset purchase program will likely be increased to partly offset the end to PEPP.

In the UK, meanwhile, the Bank of England increased the bank rate at its December meeting after defying consensus forecasts of a hike in November, lifting it 0.15% to 0.25%, while maintaining an unchanged level of asset purchases.

Table 1: Index Returns to 31 December 2021

	MONTH (%)	THREE MONTHS (%)	FYTD (%)	ONE YEAR (%)
Australian Equities				
S&P/ASX 300 Accumulation Index	2.7	2.2	4.0	17.5
S&P/ASX Small Ordinaries Accumulation Index	1.4	2.0	5.5	16.9
International Equities				
MSCI World (ex Australia) Index (hedged A$)	4.0	7.9	8.5	23.9
MSCI World (ex Australia) Index (unhedged A$)	1.7	7.2	11.5	29.6
MSCI Emerging Markets Index (unhedged A$)	-0.6	-1.9	-6.3	3.4
Property				
S&P/ASX 200 A-REIT Accumulation Index	4.9	10.1	14.7	26.1
Australian Fixed Interest				
Bloomberg AusBond Composite Index	0.1	-1.5	-1.2	-2.9
Global Fixed Interest				
FTSE WGBI ex-Aust (hedged A$)	-0.9	0.1	0.1	-2.4
Barclay's Global Capital Aggregate Bond Index (hedged A$)	-0.4	0.0	0.1	-1.5
Cash				
Bloomberg AusBond Bank Bill Index	0.0	0.0	0.0	0.0
Commodities				
Gold (US$ per ounce)	0.1	3.6	2.4	-4.3
Copper (US$ per metric tonne)	2.9	8.8	3.7	25.2
WTI Crude Oil (US$ per barrel)	16.3	2.6	4.8	58.7
RBA Index of Commodity Prices (A$)	3.3	7.5	0.7	28.5

Table 2: Australian Dollar versus Foreign Currencies to 31 December 2021

AUSTRALIAN DOLLAR VERSUS	AS AT 31 DECEMBER 2021	MONTH (%)	THREE MONTHS (%)	FYTD (%)	ONE YEAR (%)
US Dollar	0.73	2.5	0.7	-3.2	-5.8
British Pound Sterling	0.54	0.2	0.2	-1.2	-4.9
Euro	0.64	1.5	2.6	1.0	1.4
Japanese Yen	83.72	4.0	3.9	0.5	5.1