The Russian invasion of Ukraine and its associated upward pressures on energy and commodity prices continued to dominant market sentiment during March. Equities again traded through large intraday ranges with the first half of the month being very weak, before staging a strong comeback in the second half, despite little positive developments in Ukraine.

Policy Watch: The US Federal Reserve lifted its target cash rate by 25bps, the first increase after holding near zero for 2 years. Bonds sold off aggressively on the hawkish tilt from the Fed, particularly at the shorter end of the yield curve as investors repriced how many rate increases were likely in the next couple of years. Towards the end of the month, several parts of the bond curve inverted (short date yields higher than longer dated). Rather than this pointing to an imminent recession, we believe that markets are betting that the Fed moves quickly to subdue inflation but pauses for an extended period in the low 2-2.5% range.

Inflation Watch: The conflict in Ukraine and sanctions against Russia continue to impact energy and commodity prices, while the continuation of China's covid-zero and associated lockdowns are further impacting already disrupted supply chains. These factors are likely to lead to higher short-term inflation prints, before subsiding in the second half of the year as pressures ease and base effects are worked through. There is a clear concern that structural inflation is increasing, and policy remains too stimulatory. Wages are beginning to increase in many jurisdictions and will likely put pressure on companies to pass on higher prices through 2022.

Risk Budget: Equity volatility measures remained elevated in the early weeks of March before subsiding, while bond volatility continues to rise with yields. With markets particularly weak in the first half of March, we were able to add to our developed and emerging market equity exposures at attractive levels.

Call to Action: We maintain that heightened volatility will continue this year and that will offer investors opportunities to nimble investors. In the first half of the month, we believed that German equities had sold off too aggressively versus other European markets, we were able to add a short-term position in DAX at depressed prices. In previous months we had previously flagged Chinese equities were approaching an inflection point after months of weakness given regulatory concerns. We have increased our exposure to large capitalisation Asian equities in the middle of the month based on that belief. To date, both positions are performing well, but are unlikely to be held for an extended period of time.

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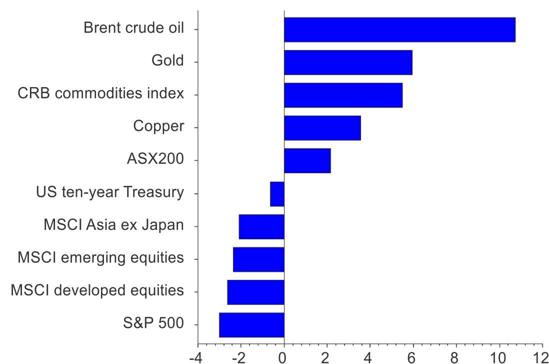
March Review

March was a strong month for equity markets after some initial weakness. The ASX200 outperformed other markets, rising 6.9% on the back of strengthening commodity prices. US equities bounced back from last month's losses with the S&P500 rising 3.7%. Large capitalisation technology names recovered from early losses, with the Nasdaq 100 up 4.3%. Brent Oil rose $7 to US$108/bbl on continuing geopolitical tensions impacting supply. Iron Ore recovered to US$153/Mt as markets expect robust restocking. Gold rose US$32 in March to US$1,942 continuing its strong gains.

Chart 1: March Asset Class Performance
Percentage Change (total return in local currency)



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

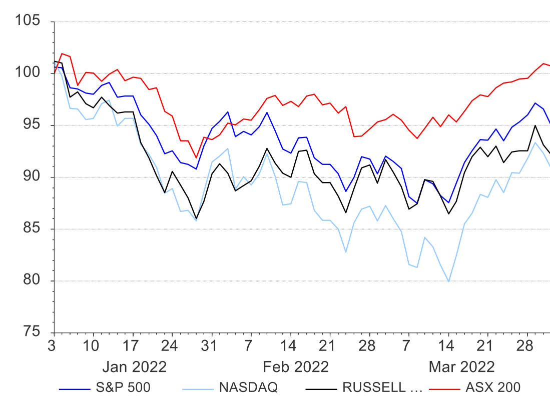
It was a volatile month for bond markets, with US 10-year yields rising materially by 49bps to close at 2.32%. Short tenor yields in the US rose dramatically as well, with the difference between the 10- and 2-year yield trading in negative territory (curve inversion) towards the end of March.

In Australia equities, the IT sector (+13.2%) was the strongest performer following global peers, while Energy (+9.8%), and Materials (+8.9%) also outperformed and drove the ASX higher. The REITs sector (+1.2%), Health Care (+2.5%) and Consumer Discretionary (+4.2%) sectors all underperformed on a relative basis.

The US Utilities Sector (+10.3%) was the best performing sector in the S&P500 in March, Energy (+8.9%) and Materials (+6.1%) also performed well.

In the first two weeks of March, the technology-heavy Nasdaq Composite was 8.5% per cent lower as markets positioned for the Federal Reserve's anticipated increase in interest rates. But since the Fed's meeting, the Nasdaq has rallied more than 13 per cent, at the same time as the yield on the US 10-year note has jumped 24 basis points.

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2022)



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Year-to-date the S&P500 is down 4.6% and the Nasdaq Composite down 8.9%. The FTSE100 is up 2.8% and ASX 200 up 2.2%, both outperforming other markets.

The conflict in Ukraine continues to dominate news headlines and impacting market sentiment. Throughout the month there were signs that the conflict might deescalate, however ongoing negotiations between Russia and Ukraine are yet to make any meaningful progress. Economic sanctions are significantly impacting the Russia economy, with shortages of goods and high inflation. The conflict and associated sanction against Russia have resulted in supply constraints and higher energy, food and commodity prices.

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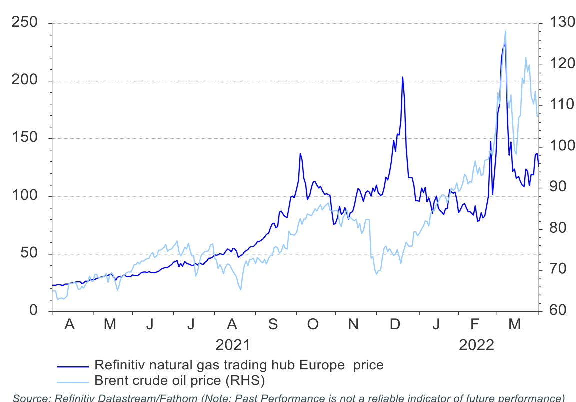
Chart 3: Brent Oil & EU Natural Gas (USD)

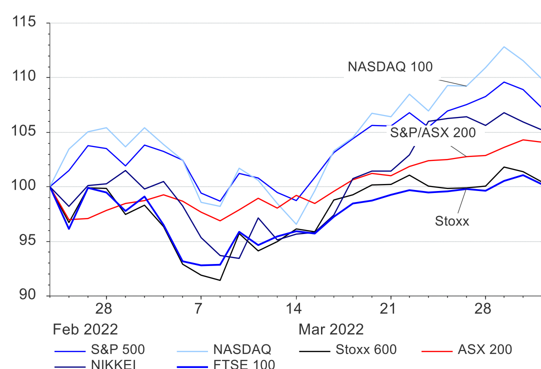


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

With much of the European Union heavily reliant on Russian natural gas supplies, the race is on for major importers such as Germany to find alternative sources of gas before next winter. In March, the US announced it would provide an extra 15bn cubic meters of gas to the EU this year. This is about 10% of the supply it currently gets from Russia, which supplies about 40% of the EU's total gas demands.

Chart 4: Equities since Russian Invasion

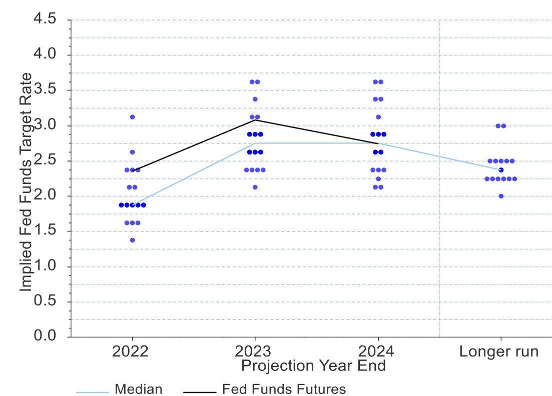
100 = 23/2/22 (Close day before invasion)



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Equities have recovered any ground lost since the invasion and in some cases rallied further. The strong rally in large capitalisation technology names (Nasdaq 100) despite higher bond yields has been put down to retail 'buying the dip' as well as major institutions covering their short positions.

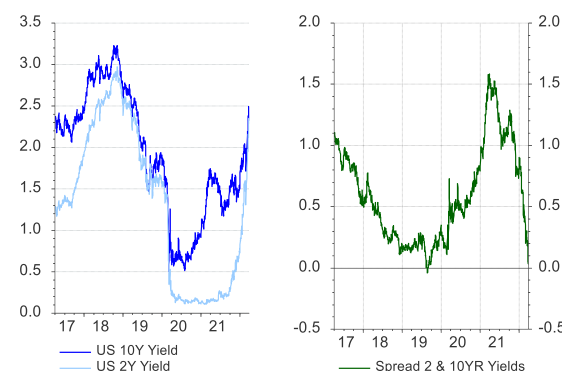
Chart 5: FOMC Dot Plot



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The Federal Open Market Committee (FOMC) voted 8-1 to lift their key rate to a target range by 25bps, after holding rates near zero for the past two years. The updated "Dot Plot" shows the median committee member seeing rates finishing this year at 1.9 per cent (in line with the market) and then to about 2.8 per cent by the end of 2023. Seven policymakers see rates above the median. With the first hike expected by the market, equities rallied on increased certainty of what lies ahead. Powell stressed the need for flexibility, and that the economy is strong and the risk of a recession is not high.

Chart 6: US 2 & 10 Year Yields & Spread



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

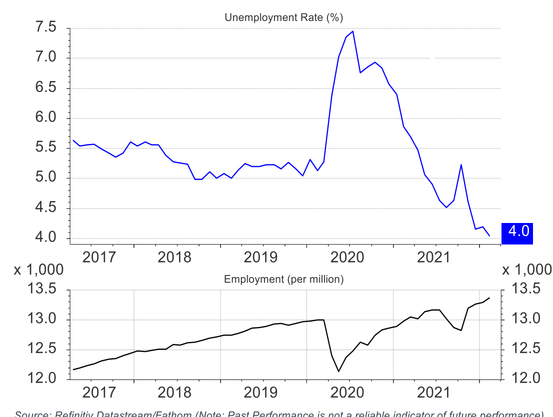
Government bonds continue to sell off (yields higher, prices lower). US 10-year yields rose materially by 49bp to 2.32% in March. 2-year yields rose further and traded above 10 years – in what is known as 'Curve inversion'. While this is often seen as predictor if a recession, we believe it is more of a signal that markets think the Fed will raise interest rates quickly, but not beyond 2-2.5% and indeed they may need

to reverse some of this tightening as inflation subsides.

The Australian economy continues to strengthen and at a quicker pace than the Reserve Bank of Australia forecast. Real GDP in Q4-21 rebounded sharply by 3.4% q/q - the equal largest rise since 1976. This came after Q3-21 dropped 'only' 1.9% q/q. GDP is now 3.4% above the pre-COVID peak level in Q4-19.

Employment surged by a much stronger than expected 77k, the largest gain since Nov-21; after January also surprisingly rose by 28k. Compared with the pre-COVID peak level in Mar-20, employment is 2.9% higher. The unemployment rate is now at 4%, the same as the cycle lows in 2008, and is equal lowest level since 1974. With the labour market a key input into RBA decision making, market pricing for the RBA's first hike continues to be pulled forward. Economist estimates now putting the cash rate at 0.5% by the end of 2022.

Chart 7: Australian Employment Data



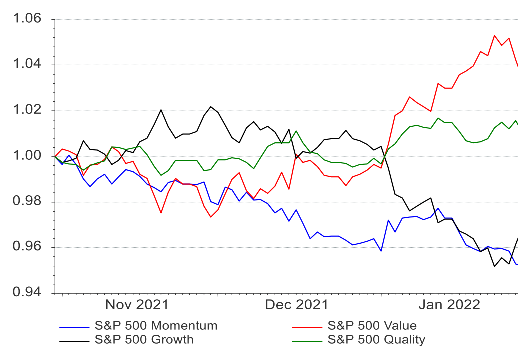
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The Australian Federal Budget was not market moving. The Government has again chosen to spend a significant portion of the near-term improvement in the budget position due to the strengthening economy. There is no attempt to reduce the budget deficit more quickly, instead relying on nominal growth in the economy stabilising the budget and then reducing debt as a share of GDP. The deficit is expected to fall to $43.1bn in 2023-26, equivalent to 1.6% of GDP.

Major policy and spending initiatives were as expected: a 50% cut in petrol/diesel excise for six months (worth $3bn); a one-off $250 cash payment to welfare and pension recipients (worth$1.5bn); and a one-off $420 cost of living tax offset for low-and-middle-income earnings (worth $4.1bn); $17.9bn additional for road and rail; and $9.9bn for cyber security.

There was a strong rotation back to growth and out of value, reversing the trend of the past few months. Momentum continues to underperform, while Quality is trending sideways.

Chart 9: S&P500 Equity Factor Relative Performance (3 months)

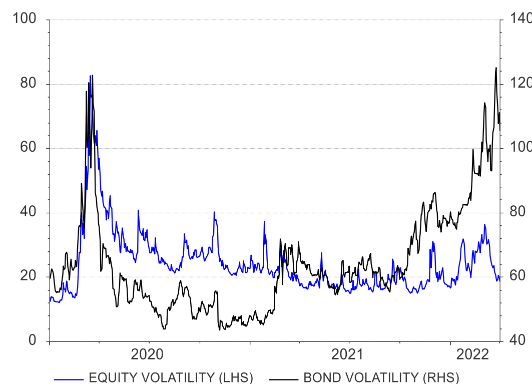


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

As equity markets recovered through the second half of the month, equity volatility fell away. However bond volatility continued to rise as shorter tenor bonds rose significantly.

Chart 10: US equity & bond Volatility (MOVE)



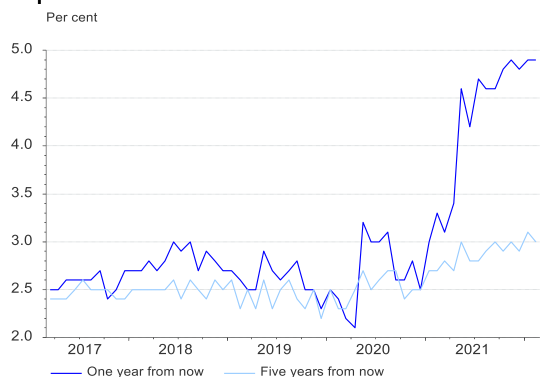
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

The rise of inflationary expectations is likely to play a significant role in shaping the future path of markets over the balance of 2022.

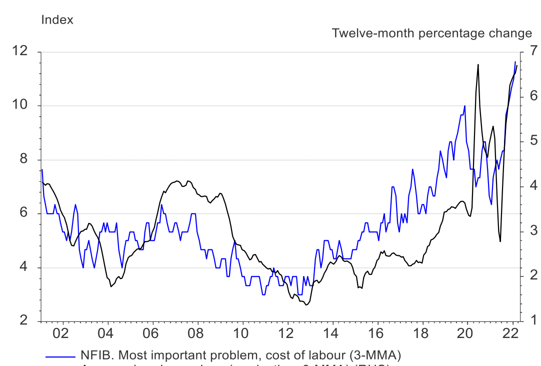
Central banks are now leaning in significantly with both commentary and actions. The move back towards a more normal level of cash rates and the debate about the scale and speed of quantitative tightening (reducing the size of central bank balance sheets) will add volatility to market pricing over the months ahead.

Chart 12: US, Uni of Michigan Inflation Expectations



While supply disruptions are likely to continue easing through the rest of 2022, sporadic pockets of pain are likely to persist, as is currently being demonstrated by the lockdowns in China. Inflation prints are likely to peak in the next few months (driven by the base effects of lifting prices back towards pre-pandemic levels). Markets will struggle to look through headline CPI prints in 8-9 per cent region without reacting.

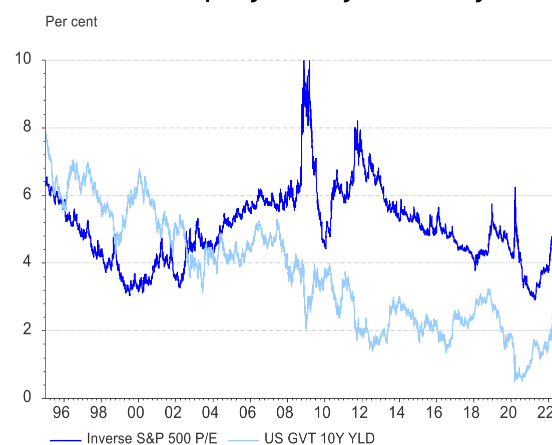
Chart 13: US Wages



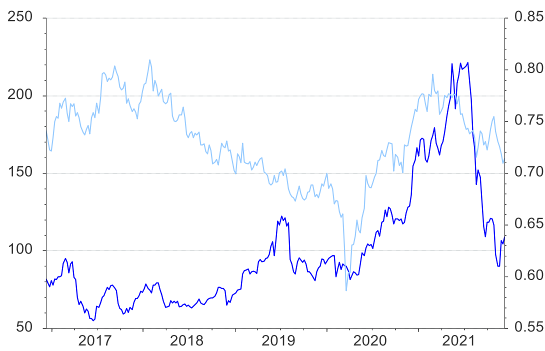
The more difficult question is estimating the rise of wages across various countries and sectors. Unionisation appears to be increasing (Amazon workers in the US) and industrial action is commencing in Australia across a range of lower paid sectors. While higher wages should be welcomed from an equity perspective and a higher propensity to consume (driving growth), although the impact on government fiscal positions and corporate margins could be substantial if not balanced with enhanced productivity. With economic growth likely to moderate over the next couple of years, the risk to margins could be a double hit to earnings.

Long tenor bonds remain in negative yield territory (return after inflation), and markets are likely to remain volatile as inflation flattens out, bond yields find their natural trading range, and central banks feel comfortable that they have moved to a new equilibrium level.

Chart 12: US Equity & 10-year bond yields



Long term equity market valuations will continue to be questioned and short-term opportunities in dislocated equity markets will arise. The sector leadership within equity markets is also likely to be volatile. Cross sectional volatility is increasing, and global investors are being more dynamic in order to capture short run mispricing between relative sectors.



Currencies are also likely to be volatile. Energy and commodity export currencies (like the $A) are likely to be benefit while those countries with more hawkish central banks are likely to attract short term capital inflows in the front parts of their yield curves – putting upward pressure on their currencies ($US).

James Wright and Luke Hansen
Sayers Capital Solutions Group

6 April 2022

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