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Economic Snapshot

2021- a year in review

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In summary

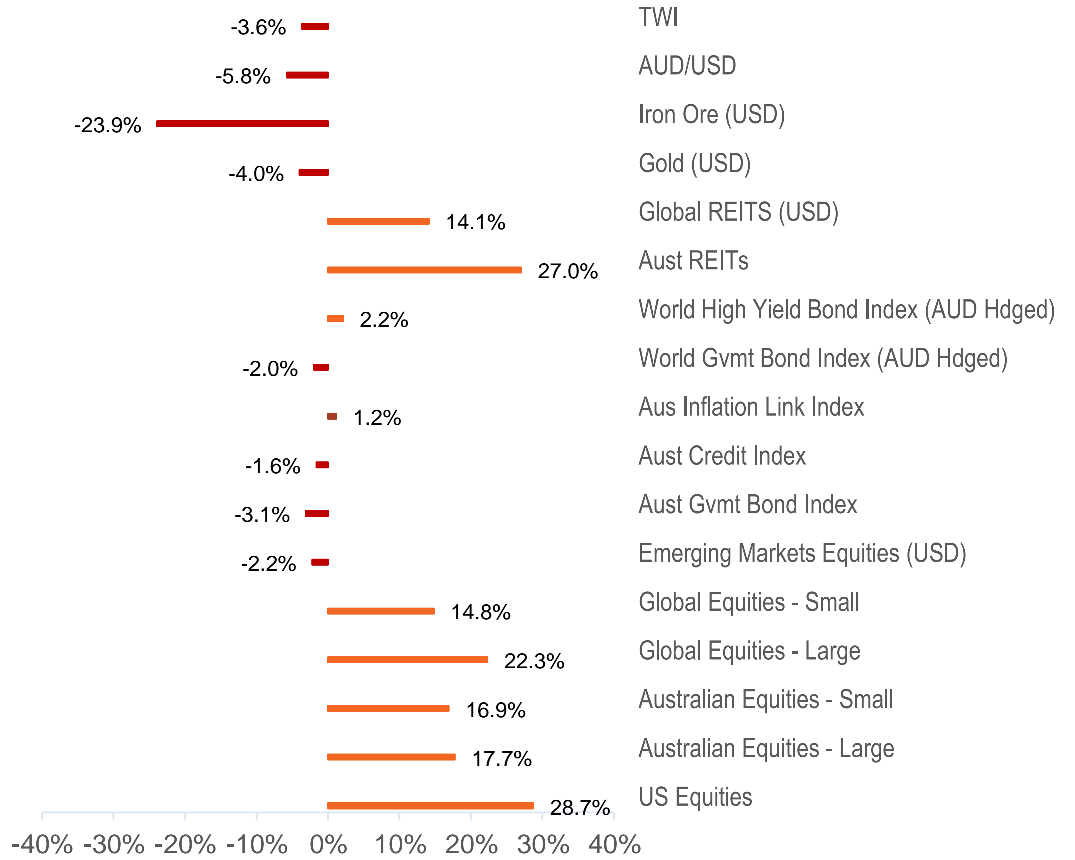
- The global economy continued to recover throughout 2021 courtesy of an ultra-low interest rate environment and a slow but steady vaccination roll out.
- Consumption of services rebounded strongly following a general easing in restrictions giving economic recovery the shot in the arm it needed!
- Ongoing strength in global demand for goods coupled with supply chain bottlenecks, contributed to rising inflation this year and prompted some central banks to commence withdrawing stimulus and to raise interest rates.
- Global equities enjoyed an exceptionally good year. US equities was the standout performer again while China and Emerging Markets underperformed.
- Australian equities posted a solid +17.7% total return including dividends but underperformed global equities.
- Rising inflation and bond yields saw Global and Australian bonds post their worst calendar year return in decades, falling -1.5% and -2.9% respectively.
- There are several known risks on the horizon, including a persistent pandemic and the prospect of higher for longer inflation, but we are cautiously optimistic about the prospects for the year ahead. Monetary policy is still highly accommodative, savings rates are high, corporate balance sheets are strong, and confidence is returning. Lower returns and higher volatility however will be features of the year ahead

Key investment themes/issues to watch in 2022 include:

- As we head into 2022, the emergence of the Omicron variant represents a new source of uncertainty for markets in the short term.
- Central banks have commenced ‘normalisation’ of their respective monetary policy settings, starting with tapering their Quantitative Easing (QE) programmes. All eyes will be on the US for when they inevitably raise rates in response to inflationary pressures.
- Rising rates impact asset valuations. Asset returns are likely to be much lower than the 2021 experience. Expect greater volatility too. Geopolitical risks are also on the rise.
- Significantly higher than expected inflation in the main economies could lead to faster and more severe monetary policy tightening (than potentially required) in 2022. While bonds are clearly vulnerable to an inflation shock, other asset classes including equities are not necessarily immune either.
- A weaker than expected Chinese economy could potentially negatively impact the global economy given China’s dominant role as a global manufacturing hub.

Selected Market Returns, 2021

US equities led the way in 2021 on the back of strong global economic recovery.



Sources: Thomson Reuters, Bloomberg. Equity returns are total return

Key Economic Developments

The beginning of the 2021 calendar year heralded the welcome arrival and approval of several promising vaccines which were rolled out to the masses at speed. As of 31 December, 59.2% of the world's population had received at least one dose of a Covid-19 vaccine. In Australia, 78% of the country are now fully vaccinated. The distribution and success of the vaccines allowed developed economies with higher vaccination rates to 're-open' and economic growth to flourish on the back of continued improvement in labour markets and a recovery in household consumption across advanced economies.

Among the major developed economies, the US is expected to record GDP growth of around 5.6% in 2021, compared to 5.2% for Europe, 3.8% for Australia and 1.8% for Japan. Even China, which experienced twin shocks in September in the form of the default of Chinese property developer Evergrande and a nationwide energy crisis, is predicted to have expanded by a healthy 8%.

	Average 2013-2019	2020	2021	2022	2023	2021 Q4	2022 Q4	2023 Q4
				Per cent				
Real GDP growth[1]								
World[2]	3.3	-3.4	5.6	4.5	3.2	3.8	3.9	3.2
G20[2]	3.5	-3.1	5.9	4.7	3.3	4.1	3.8	3.3
OECD[2]	2.2	-4.7	5.3	3.9	2.5	4.4	3.3	2.2
United States	2.4	-3.4	5.6	3.7	2.4	5.1	3.0	2.3
Euro area	1.9	-6.5	5.2	4.3	2.5	4.9	3.3	2.1
Japan	0.8	-4.6	1.8	3.4	1.1	0.0	3.1	0.9
Non-OECD[2]	4.3	-2.2	5.8	4.9	3.8	3.2	4.3	4.0
China	6.8	2.3	8.1	5.1	5.1	3.9	5.5	5.0
India[3]	6.8	-7.3	9.4	8.1	5.5			
Brazil	-0.3	-4.4	5.0	1.4	2.1			
Unemployment rate[4]	6.5	7.1	6.2	5.5	5.2	5.7	5.4	5.1
Inflation[1,5]	1.7	1.5	3.5	4.2	3.0	4.9	3.4	3.1
Fiscal balance[6]	-3.2	-10.4	-8.4	-5.2	-3.7			
World real trade growth[1]	3.4	-8.4	9.3	4.9	4.5	6.1	5.2	4.2

1. Percentage changes; last three columns show the change over a year earlier.
2. Moving nominal GDP weights, using purchasing power parities.
3. Fiscal year.
4. Per cent of labour force.
5. Private consumption deflator.
6. Per cent of GDP.

Source: OECD Economic Outlook 110 database.

With solid progress on the vaccine front and evidence of economic recovery, many governments and central banks flagged their intentions to unwind the extraordinary level of fiscal and monetary stimulus they had deployed to cushion and protect economies.

The central banks of the UK, Norway, and New Zealand, all raised their policy rates during 2021 for the first time since the start of the pandemic.

The US Federal Reserve announced in November that it had decided to begin to reduce the monthly pace of its net asset purchase programme by $15 billion per month. This rate was in fact doubled in December, in light of inflation

developments and the further improvement in the labour market there. The Reserve Bank of Australia (RBA) also got on board and abandoned its yield curve target of 0.10% for three-year bond yields.

While the Federal Reserve and the RBA signalled repeatedly during the year that they were prepared to be patient before lifting rates, the message from the recent December Federal Reserve meeting was that the Fed was prepared to accelerate the lift-off of raising rates well ahead of schedule if inflationary pressures continue to mount. Whether the RBA will follow the US lead if the US starts ratcheting up interest rates early in the new year is still not a given. The RBA has repeatably announced that it remains committed to keeping rates low and that it does not plan to increase the cash rate until such time that full employment is reached, and inflation is consistent with their 2-3% target. At this stage, Australia is still falling short on both fronts compared to the US.

Covid aside, inflation has been the other major talking point of late. Throughout 2021 we witnessed a sharp increase in inflation in multiple developed economies. The US recorded 6.1% annual inflation by November 2021, its highest level in decades. Inflation also rose sharply in Europe and to a lesser extent in Australia, although materially higher than what we have experienced over the years. Many factors contributed to driving consumer prices higher. Pent up demand for goods and services was exacerbated throughout 2021 during periods of lockdowns. There was also a fair amount of disruption caused by the pandemic to global supply chains. Whilst inflation is expected to persist at elevated levels for a while yet, the consensus is that once demand starts to revert to more normal levels, and current supply chain issues resolve themselves, inflationary pressures are expected to moderate in the back half of 2022.

Financial Markets

Global shares climbed the wall of worry this year, benefitting from the historically low interest rate environment, better than expected corporate earnings results, and general market optimism that the end of the pandemic was in sight. At the country level, the US continued to be the strongest performing equity market. The S&P 500 rose an incredible 28.7% (USD).

Australia posted a respectable 17.7% for the year. Information Technology and Energy were the worst performing domestic sectors, in direct contrast to global trends. The list of strongest performers on the ASX was dominated by resource companies including lithium producers Pilbara Minerals (PLS), Allkem (AKE), Mineral Resources (MIN) and rare earths producer Lynas Rare Earths (LYC).

Emerging Markets was a mixed bag with countries such as India doing very well. But overall, Emerging Markets (down -2.2%) were weighed down by an underperforming China which was impacted by China's economic slowdown. The Chinese stock market was down -3.5% for the year.

At the sector level, Energy was the best performing sector, benefitting from sharply rising oil, gas, and coal prices. Other cyclical sectors (Information Technology and Financials), tied to economic recovery, also performed well.

Bonds on the other hand, fared poorly as global bond yields rose. The upward pressures on bond yields were further aggravated by persistently higher than expected inflation. The US 10-year bond yield started the year at 0.91%, reached a peak of 1.73% in early March before settling at 1.50% by year end. The Australian 10-year bond followed suit, closing at 1.61%. Corporate bonds outperformed as credit spreads stayed tight as financial conditions improved steadily throughout the year.

Over the course of the year, the Australian Dollar (AUD) depreciated from $US0.77 to $US0.72 in response to the collapse in the iron ore price, and trade tensions with China which hurt terms of trade. The other factor working against the AUD was the widening expectation gap that the US will move to increase rates well before Australia making the safe-haven USD a more attractive investment destination.

Surprisingly, given the market's one-eyed fixation on inflation this year, the traditional inflation hedge, gold, fell slightly. The oil price on the other hand rose to a seven year high on rising demand. Coal also rallied strongly. Other commodities such as lithium, copper and nickel all performed strongly in part due to the cyclical recovery underway but also on the back of the global move towards 'decarbonisation' and green technology such as wind turbines, solar panels, and electric vehicles. Iron ore, in contrast, crashed -23.9% following reduced demand from China as steel production there was curbed.

Outlook

Looking ahead in 2022, we expect periodic volatility as the pandemic continues to play out and global central banks look to increase historically low interest rates amidst a backdrop of heightened inflation.

Financial markets face a more uncertain future throughout 2022 and are expected to deliver far more modest results compared to the stellar returns from last year.

Global Equities are likely to be challenged by rising bond yields and higher inflation. Both forces will pressure corporate earnings and constrain valuations, especially in the US. That said, we believe equities will remain attractive relative to bonds if the predicted rise in bond yields is moderate.

We are cautious on Emerging Markets over the short term as emerging market economies commence tightening monetary and fiscal policy in response to inflationary pressures. China is also a source of uncertainty.

Further reductions in asset purchase programmes by central banks will exert continuing upward pressures on bond yields. We think nominal bond yields will rise further in 2022 as inflation in the main developed markets stay at the upper end of the central banks' target ranges.

The big issues we are monitoring closely include the following:

Omicron

The emergence of the Omicron variant in November set a sombre tone as we approached the end of the year. The good news is that the World Health Organisation confirmed that Omicron is far less severe and deadly than Delta. However, it is far more contagious than previous strains. Whilst the spike in positive cases of late is disconcerting, there is cause for optimism that this virus will be short lived, and that any social and economic disruption caused by Omicron will be temporary.

Inflation and monetary policy

Central banks expect inflation in developed economies to moderate over 2022 as bottlenecks in supply chains ease. However, if inflation is likely to be more persistent it could pose a challenge for policy makers in balancing the need to control inflation and not sacrificing economic growth in the process.

China

Economic developments in China surprised markets on the negative side over the past year, amid growing headwinds from an energy crisis, a major property downturn, weakening exports and the roll out of Xi Jinping's Common Prosperity agenda. Can the Chinese engineer a soft landing? Time will tell.

Major Market Indicators

	Quarterly change	1 year change
Cash rates		
Australia	+5bp	+4bp
USA	+2bp	-3bp
10 Government bond yields		
Australia	+33bp	+63bp
USA	-3bp	+59bp
Equity markets		
Australian All Ordinaries	2.5%	17.7%
Australian Small Ordinaries	2.0%	16.9%
MSCI Australian Value	1.3%	19.3%
MSCI Australian Growth	3.4%	15.3%
AREITs (AUD)	10.1%	27.0%
S&P 500 (USD)	11.0%	28.7%
MSCI World (USD)	7.9%	22.3%
Nikkei (YEN)	-2.1%	6.7%
Hang Seng (HKD)	-4.7%	-11.8%
CSI 300 (CNY)	1.6%	-3.5%
FTSE 100 (GBP)	4.7%	18.4%
Euro 100 (EUR)	7.1%	26.1%
MSCI Emerging Markets	-1.2%	-2.2%
Global REITs	1.2%	14.1%
Currency markets (AUD/)		
US Dollar	0.65%	-5.78%
British Pound	0.28%	-4.97%
Japanese Yen	3.88%	5.04%
TWI	0.49%	-3.63%
Commodity markets		
Gold	3.5%	-4.0%
Oil	0.0%	55.8%
Iron Ore	3.4%	-23.9%

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