16 JUNE 2022

Logical Thoughts

MARKET RALLY COLLAPSES AS EQUITY AND BOND MARKETS SELL OFF

Following falls on Wall Street last week and the Australian share market, it is almost certain that we will see volatile prices over the next few weeks and possibly months as investors try to find the right level for stocks and bonds. We could even see further falls in key market sectors such as technology and financials.

The heavy falls in markets and collapse in the recent rally was due to the recent higher-than-expected US inflation data (+8.6%) and a larger than expected rate hike by the US Federal Reserve Bank (now expected to be 0.75% instead of 0.50%, it will be the biggest since 1994), combined with a hawkish tone from European and Australian central banks (rates rose 0.50% instead of expected 0.25% to 0.40%).

At the same time US bonds aggressively sold off (price falls and yields rise), with a “bear flattening” of the curve as 2-year yields rose 41 basis points and 10-year yields rose 22 basis points (at Friday’s 10th June close). This risk off event saw the US dollar and gold hold up, while equities and bonds fell and crypto currencies such as Bitcoin sold off heavily and dropped briefly below $21,000 USD.

The S&P 500 (US) was off 5% last week, the NASDAQ lost 5.6% and the Euro STOXX 50 was down 4.9%. For the year-to-date the S&P 500 (US) is down -17.0%, the NASDAQ

-27.0% (technology index) and the Australian share market -5.1% (see table 1). Bitcoin has fallen nearly 70% from its all-time high in November 2021. The market is concerned that longer-term inflation will continue to rise, and this will result in higher interest rates and a recession.

Table 1: Australian, international & US equities total return (calendar year to date, 1, 3 & 12 months & 3 years p.a.)

As at 13th June 2022	Year to Date (1st Jan 2022 to 13 Jun 2022)	1 month	3 months	6 months	12 months	3 years (p.a.)
Australian Equities TR*	-5.08%	-1.81%	-1.38%	-4.13%	-1.29%	+5.46%
International Equities TR**	-16.95%	-5.94%	-4.87%	-16.91%	-4.77%	+7.63%
NASDAQ 100 TR (AUD)	-27.13%	-8.99%	-10.13%	-27.62%	-9.68%	+15.41%
S&P 500 TR (AUD)	-16.86%	-6.88%	-5.39%	-16.89%	-0.42%	+10.79

*S&P/ASX 200 Total Return AUD
**MSCI World ex Aust Net Dividend Reinvestment (AUD)

US Federal Interest Rate Decision – 16th June 2022 (overnight news)

The US Federal Reserve Bank (Fed) raised rates by 0.75% to a range of 1.5% and 1.75%. It was the biggest single increase in the Fed Funds rate since November 1994 and will not only have ramifications in the US but across the globe.

Jerome Powell (Chairman of the Fed) noted he would like to get real rates (the Treasury Inflation-Protected Securities (TIPS) yield) positive right across the curve. At the moment the TIPs curve is positive from the 3-year onwards. Powell also noted that the Fed would like to get monetary policy moderately restrictive by year-end. This would mean a Fed Funds rate at 3% to 3.5%. This is the current projection by Fed members. In their new 'dot-plots' Fed members raised their year-end Fed funds forecast to a median of 3.4%. This is up from the 1.9% forecast made at the March dot-plots. As of yesterday, the Futures market implied a Fed Funds rate of 3.5% by year-end. **This means a 0.50% or 0.75% rate rise at the next meeting to achieve a positive real rates and moderately restrictive policy by year-end.**

This was not a dovish but a hawkish meeting of the Fed. The market went into this meeting shocked that the Fed signalled a 0.75% increase instead of a 0.50% increase. However, the US equity markets bounced on the decision and bond yields declined (price up) on the fact that Powell noted a 0.75% increase is unusual. Also, Powell may have restored confidence (with the market) that the Fed is in front of the inflation curve and now has a chance of keeping inflation under control.

It is clear the Fed is laser focused on getting inflation down and to do this they will need to get real interest rates higher. The Fed acknowledged that getting inflation down will require slower growth and they seem prepared to endure this. Powell noted that an unemployment rate of around 4% (vs 3.6% now) will still be a great achievement if inflation is also under control.

We believe bond yields have further to rise (price down) and further volatility in equity markets is the most likely outcome especially if you're invested in growth stocks/investments. Investments/stocks less vulnerable to rising discount rates/interest rates and less sensitive to slower economic growth will perform better.

What are the implications for our Clients?

Many of you are now facing low positive to negative short term performance numbers due to the substantial sell-off of global and domestic equity and bond markets. While this is disappointing, in many cases your portfolios are generating better performance numbers than relevant benchmarks and index funds.

Clients must be prepared to accept continued volatility in these markets as interest rates continue to rise. In particular, clients must accept the possibility that these markets could fall further before they begin to regain some positive price momentum.

In any market environment investors should stay focused on long-term investment plans which meet their particular financial goals such as capital price growth. The benefits of investing in equities have been proven that in return for accepting short-term volatility, these assets historically deliver higher long-term returns than other asset classes.

Depending on your circumstances, over the last few years Logical have attempted to include investments in portfolios <u>that have cushioned the impact of market volatility both at an income and capital price level</u>.

These investments include:

- A strategy that invests in Corporate Loans to Australian companies (predominantly floating rate unlisted instruments), with the aim of income streams keeping pace with inflation during market volatility;
- Unlisted well diversified direct property, with the aim of reducing portfolio volatility;
- Value Investment Style & Long / Short Fund, where the manager aims to profit from companies which they expect to fall in price (shorting) and appreciate in price (long).

Concluding Comments

Many of our clients have been with us for many years and understand and accept that an investment in more growth-oriented investments like shares are volatile over the short term, especially in a rising interest rate and inflationary environment. Our clients also understand and do not overreact to the recent market movements. Be prepared for markets to continue to soften on the back of rising rates and inflation, repricing of risk and the withdrawal of liquidity from the financial system.

Logical has attempted to ensure your portfolio meets your needs and long-term objectives such as:

- Your portfolio has the appropriate time horizon in place.
- Your portfolio is sufficiently diversified (not over diversified) across asset classes and fund manager styles and invested in quality investments.
- Your portfolio is not invested in speculative investments or highly leveraged (e.g. Bitcoin or large overweight to Technology Stocks).
- Your portfolio generates enough tax effective cash during retirement and provides some protection (cushion) during normal volatile markets while still growing your capital over the long term.

Clients should also understand that timing entry or exits into financial markets is fraught with danger and it has been shown that it is becoming increasingly difficult to achieve. Volatility in markets has been increasing and inflection (or turn around) points in markets are becoming sharper which makes timing entry and exit into a market even more difficult.

As always, we advocate taking a long-term view to successful portfolio outcomes and avoid making knee jerk reactionary changes in the short term which inevitably end poorly.

Key Take Outs

- **The global market rally collapsed last week due to the recent higher-than-expected US inflation data (+8.6%) and a larger than expected rate hike by the US Federal Reserve (+0.75%).**

- **US Federal Reserve Bank raised rates by 0.75% to a range of 1.5% and 1.75%. It was the biggest single increase in the Fed Funds rate since November 1994. Fed members raised their year-end Fed funds forecast to a median of 3.4%. This means a 0.50% or 0.75% rate rise at the next meeting to achieve a positive real rates and moderately restrictive policy by year-end.**

- **We believe bond yields have further to rise (price down), and further volatility in equity markets are the most likely outcomes. Investments less vulnerable to rising discount rates/interest rates and less sensitive to slower economic growth will perform better.**

- **Over the last few years Logical have attempted to include investments in portfolios that should cushion the impact of market volatility, higher inflation, and interest rates. This included unlisted investments that invest in direct property and corporate loans and an active value long short fund. At this stage, these investments have shown to be effective.**

- **In any market environment investors should stay focused on long-term investment plans which meet their particular financial goals such as capital price growth and income needs. The benefits of investing in equities have been proven, that in return for accepting short-term volatility, these assets historically deliver higher long-term returns than other asset classes.**

- **We have built portfolios that are sufficiently diversified across asset classes and fund manager styles and invested in well researched, and highly regarded investments. The portfolios are not invested in highly speculative assets nor are they highly geared (e.g. Bitcoin or large overweight positions to sectors such as technology).**

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Gavin has been an investment specialist for more than 20 years and is the head of Investment Research at Logical.

Gavin's qualifications include a Masters of Applied Finance (Macquarie University), Bachelor of Agricultural Economic (Sydney University), Graduate Diploma of Applied Finance and Investment (Finsia) and he is currently studying a Master of Financial Planning at the University of New South Wales.

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