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SNOWGUM QUARTERLY

INTRO

Seemingly temporary, inflation pressures have morphed into structural inflation, driven by a shortage of housing and workers. This has resulted in higher interest rate expectations and being hugely disruptive to markets.

Central Banks are slamming on the brakes. Where the Fed goes, the world follows, sometimes unwillingly.

The sharp change in central bank policy settings has been a catalyst for a decline across all asset classes.

Could 2022 be the year market psychology transitions from flawless to hopeless?

KEY STATS

- Cash rate is on the up, presently 2.60%
- Unemployment in Australia is 3.4%
- Inflation is 6.1%

WHAT'S INSIDE THIS QUARTERLY:

Key Statistics

Economic Update

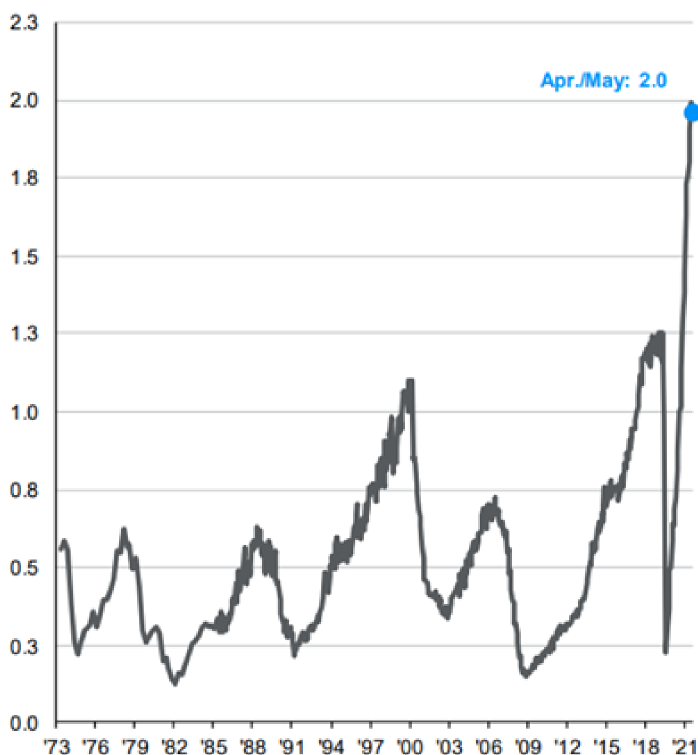
Investment Update

- Overview
- Asset Class Summary

ECONOMIC UPDATE

COVID and associated stimulus packages were catalysts for changes in spending; in addition, COVID disruptions caused supply chain bottlenecks. These factors combined to kick-start inflationary pressures.

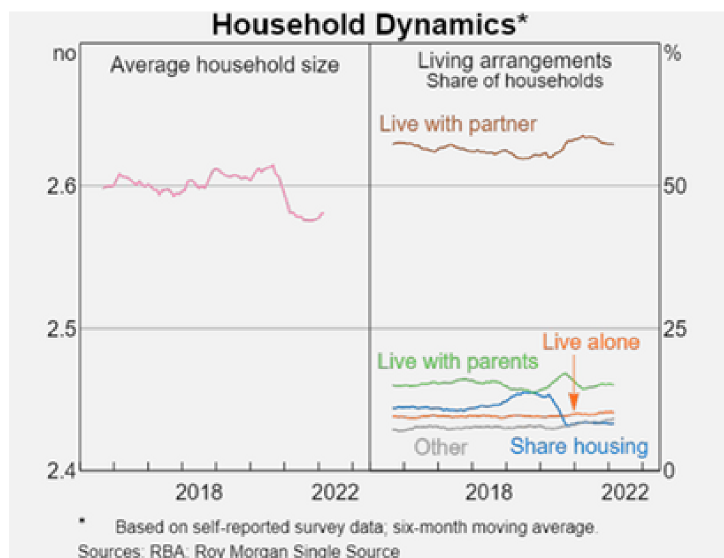
Seemingly temporary, **inflation** pressures have morphed into structural inflation, driven by a shortage of housing and workers. This is most pronounced in the US but is a feature of many developed economies. Rising rental costs and wage growth is driving up core inflation, a growing concern for central bankers. This has resulted in higher interest rate expectations and being hugely disruptive to markets.



Home starts remain below trend in the US. In Australia, where the home-builder scheme saw home starts at record highs, starts are now falling rapidly. Committed home starts may ease some pressure, however, there appears no quick supply-side fix.

COVID induced changes in household dynamics (see chart on following page), includes a reduction in average household size. This further increased rental pressures with lower utilisation of existing accommodation.

Labour markets remain in uncharted territory in most developed economies, with more job openings than unemployed persons. Aggregate demand is well above economic capacity.



Central Banks are slamming on the brakes. Federal Chair Jerome Powell said he “will keep at it” battling inflation until “the job is done”, as demonstrated by a further 0.75% rate hike in September. The ‘keep at it’ reference relates back to former Fed Chair Paul Volcker, who took the Federal Reserve cash rate to 20%.

The US cash rate is 3.00-3.25%, with the market pricing a US Fed cash rate peak of 4.75% in 2023. To date, US tightening has outpaced international counterparts, leading to a significant rally in the USD. Capital is rushing into the USD, seeking higher risk-free asset returns.

Where the Fed goes, the world follows, sometimes unwillingly. Emerging markets have begun suffocating under elevated debt servicing costs (as these are typically set in USD). Nearly 20% of the emerging world risks default. More robust economies in Asia, many of which are not burdened by inflation, risk a Foreign Exchange collapse as the interest rate disparity with the US grows.

In particular, the Japanese Yen has materially devalued and may collapse further. **ASEAN** Central Banks are now forced to explore tightening policy to protect currency values, dampening economic growth (an unwelcome consideration given they are not struggling with inflation).

The current **Australian** household debt to income ratio is c.144%, the highest on record. Markets are pricing a 3.5%+ cash rate by mid-2023. This would translate to the highest household interest rate payment to income ratio in history. This should supress house prices and will bring about a slowdown in the Australian economy.

For the first time since 1990 **China’s** growth is now slower than the rest of Asia. China’s central bank is easing interest rates to counter slowing growth, but in doing so escalates capital flows out of China. The Chinese central bank is drawing upon Foreign Exchange reserves to stabilise a depreciating Yuan.
China’s property crisis appears to be the catalyst that exposed broader economic frailties. Demographic decline, COVID mismanagement, deteriorating trading relationships with key markets (which are themselves slowing), and high debt levels, often funding inefficient capital allocations like building ghost cities and roads to nowhere, may drag on the Chinese economy for years.

Bearish commentators see China entering a material decline, akin to Japan from the 1990's. The desire to deleverage the property sector was good governance. Having let the problem get so out of hand, somewhat bad governance. In China, good government policy to manage these challenges has never been so important.

If we needed a reminder of the importance of good governance, look no further than the UK and their disastrous mini-budget. Unfunded stimulatory tax cuts to an economy with inflation nearing 10% saw investors dump UK sovereign bonds. It was the financial market's vote of no confidence.

UK pension funds, shoehorned into safe assets like UK bonds, are nursing >10% losses on long-dated bonds. This saw some Pension Funds become insolvent in the space of a week. So dire was the market response that the Bank of England (BOE) was forced to step in and buy government bonds (QE) to avoid pension funds collapsing. The BOE in that moment lost some of its independence.

The BOE must now undertake an unprecedented schedule of interest rate rises to tame inflation and reassert stability. It seems it will get no assistance in tackling inflation from fiscal policy. This will occur against the backdrop of an already slowing UK economy. **The UK is very likely headed into recession and a period of stagflation.**

The IMF sounded an alarm to the UK budget and the British pound dropped to its lowest level on record against the USD. In addition, a potential ratings downgrade would be embarrassing and put the Pound under further pressure. Fitch and Moody's have ratings reviews coming up. This could fast become the stuff of banana republics, and should that sentiment grow in markets, the pound could fall further still.

The UK needn't look to far to see what happens if economic orthodoxy is not obeyed. The anticipated inflation rates for 2022 in Argentina (78.50%), Turkey (71.70%), Lebanon (178%) and Sri Lanka (70.20%) stimy the chance of economic development in those markets.

"*Between the pandemic and the war and the crazy policy response in the United States and worldwide, this is the hardest environment I've ever encountered to try and have any confidence in a forecast 6 to 12 months. There are brewing issues; when you get the price of oil doing what it's doing historically, and when you get interest rates doing what they're doing historically, and it becomes a global phenomenon with tightening liquidity, and you've got war -* ***the odds of having a global recession and a change in the macro economy are about as high and as severe as I've seen them in in decades***" – Stanley Druckenmiller (CEO Duquesne Capital)

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INVESTMENT UPDATE

Investors began the year with an equity, property, and fixed income complex of stretched valuations and low yields. The sharp change in central bank policy settings has been a catalyst for a decline across all asset classes. The only bright spots amongst the negativity have been commodities, driven by energy, as well as utilities, a subset of infrastructure assets.

Investors were not protected in safe assets like treasury securities. The lowest risk asset class, aside from cash, delivered performance of -9.1% as of June 30… it's gotten worse since then.

Quantitative Tightening (QT) has also begun. It's never been done in earnest, so it's difficult to gauge its impact. Perhaps a starting point is to propose an opposing impact to Quantitative Easing (QE). QE pushed investors up the risk curve, culminating in frothy valuations at the highest risk and most opaque asset classes. An early sign of QT might be the unwinding of excesses in some asset classes.

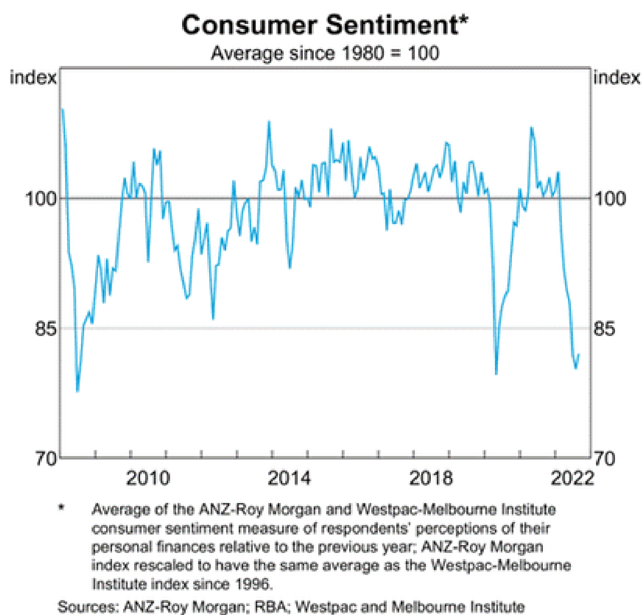
- By May, 50% of NASDAQ stocks were down by 45%, and 33% were down by 70% (May 17 EoTM), and by June, the average Russell 1000 Growth and Small Cap stock was down by 50% (June 7 EoTM)
- Investor capitulation: an all-time high of the percentage of stocks trading below their cash value (June 27 EoTM)
- The Crypto/NFT market is reacting like other speculative equities and risky assets. Bitcoin has fallen from above $60,000 to below $20,000.

"*The job of an investor is to exercise both sound intellectual and emotional judgment. [] In the real world, things fluctuate from pretty good to not so hot. But in markets, people go from flawless to hopeless*" (Howard Marks).

It's possible 2022 will be the year we transition from flawless to hopeless. Markets appear to be pricing strong earnings into next year. This seems optimistic given the depressed levels of consumer confidence and the impact that higher interest rates will have on household and business spending. We believe this warrants caution in equity markets as deteriorating fundamentals could be a catalyst for further declines.

"*Changes in fundamentals, filtered through changes in psychology, produces changes in prices*" (Howard Marks).

Consumer confidence has dropped back towards levels seen during the initial wave of COVID, fairing only slightly better than the GFC. Psychology isn't particularly robust.



Sharp interest rises will negatively impact fundamentals. How psychology synthesises that information to translate into changes in investment markets is unknown. Psychology does appear to be coming off a low base.

“*It is a messy and potentially dangerous environment; one that has reduced the value of all risk assets and even some, like government bonds, regarded as safe havens. Equities and bonds are in bear markets triggered largely by the surge in US interest rates. The risks, however, remain, as the OECD noted, tilted to the downside and the prospect of something worse - some form of global financial crisis - looms while the Fed keeps tightening US monetary policy faster than its peers and interest rate and currency relativities continue to diverge*”. – Stephen Bartholomeusz

“*When there is nothing clever to do, the mistake lies in trying to do something clever*” – Howard Marks

Timing markets remains impossible, in our opinion. An about face from central bankers, which is equally unpredictable, could lead to a sharp rebound in markets. Being out of the market for that event would be a considerable mistake. Similarly, being overly exposed to equities could be considered a mistake… As Stanley Druckenmiller’s quote alluded to earlier, it’s a difficult time to invest.

Investors should find some optimism in that for the first time in nearly a decade there are reasonable yields in lower risk assets. This should encourage a return to more sensible capital allocation and greater diversity and resilience in portfolios, assuming portfolios are adapted to reflect this opportunity set.

The below is an asset class summary of returns, including the Year to Date (YTD). Apart from commodities, which may decline over the last few months of this year with slowing economies, 2022 is on track to be the worst performing year since the GFC in 2008.

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Asset class returns

																2007 - 2021	
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	Ann.	Vol.
EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	REITs 41.3%	Comdty. 18.4%	Large Cap 10.6%	REITs 23.2%
Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	Large Cap 28.7%	Cash 0.2%	Small Cap 8.7%	EM Equity 22.9%
DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Comdty. 27.1%	Fixed Income -10.3%	REITs 7.5%	Small Cap 22.5%
Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 14.8%	Asset Alloc. -14.6%	High Yield 6.6%	Comdty. 19.1%
Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	Asset Alloc. 13.5%	High Yield -16.9%	Asset Alloc. 6.1%	DM Equity 18.9%
Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	DM Equity 11.8%	EM Equity -17.5%	EM Equity 4.8%	Large Cap 16.9%
Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.0%	REITs -19.2%	DM Equity 4.1%	High Yield 12.2%
High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	DM Equity -19.3%	Fixed Income 4.1%	Asset Alloc. 11.7%
Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	Fixed Income -1.5%	Large Cap -20.0%	Cash 0.8%	Fixed Income 3.3%
REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	EM Equity -2.2%	Small Cap -23.4%	Comdty. -2.6%	Cash 0.7%

Source: Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Fixed Income: Bloomberg US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg US Aggregate, 5% in the Bloomberg 1-3m Treasury, 5% in the Bloomberg Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/2006 to 12/31/2021. Please see disclosure page at end for index definitions. All data represents total return for stated period. The "Asset Allocation" portfolio is for illustrative purposes only. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2022.

J.P.Morgan
ASSET MANAGEMENT

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