ATCHISON CONSULTANTS

Market Review – December 2021

2021 Year in Review

The availability and rapid distribution of vaccines enabled the global economy to re-open in 2021. With the approval of several vaccines in early 2021, the main developed economies started aggressive, mass scale vaccination programs. While the level of vaccines varied across countries, the overall results are better than expected. Most developed economies have achieved a vaccination level of around 70%. These are impressive results given logistical challenges and vaccine hesitancies. However, the emergence of the more infectious Delta variant means that the threshold for herd immunity is significantly higher, leading to waves of pandemic and episodic regional lockdowns. By the end of 2021, most of the main developed economies have adopted a "living with the virus" approach which reduces the level of economic disruption.

The main developed economies enjoyed robust, if uneven and volatile, economic growth in 2021. Episodic outbreaks of the pandemic led to more localised lockdowns and disruptions which were temporary in nature. Among the major developed economies, the US will likely record GDP growth of around 5.6% in 2021, compared to 5.0% for Europe, 2.3% for Japan and Australia's 3.8%. While the likely GDP growth figures are inflated by the Coronavirus driven low GDP levels in 2020, they still represent a very sharp economic recovery. China, despite negative headlines and sharply decelerating growth in the second half of 2021, will likely grow by around 8.0% in 2021 which is still very robust.

Risky asset classes enjoyed a spectacular 2021 for the 12 months to 31 December 2021, powered by a potent combination of low interest rates, re-opening of economies and a strong earnings recovery. Developed equity markets returned 24.9% (hedged) and an even higher 30.2% (unhedged), while the Australian equity market returned 17.2%. Small capitalisation Australian shares marginally underperformed large capitalisation and returned 16.9%. Emerging markets significantly underperformed global developed markets and returned 3.8% (unhedged). The relative under performance was partly due to the mediocre performance of Chinese equities, as investors struggled with lower Chinese economic growth.

As 2021 ended, a year of partial rather than full recovery from COVID-19, global investors face a more uncertain outlook as central banks begin to withdraw liquidity and extraordinary fiscal stimulus, has the potential to turn into an extraordinary fiscal drag. Inevitably, the withdrawal by governments and central banks of massive post-pandemic stimulus may set to become a headwind for global growth in 2022. This matters for a trade dependent, open economy like Australia.

It is expected that the average balanced growth superannuation fund (41% – 60% Growth Assets) would have returned 9.9% pa for the 12 months to 31 December 2021. This followed around 3% return in 2020 year. Balanced growth super funds returns have averaged around 7% pa over the last five years which is well above inflation and bank deposit returns.

2022 Outlook

At the tail end of 2021, across a number of developed economies, inflation has emerged as a threat to central banks to continue their extraordinarily accommodative monetary policies, keeping interest rates at record lows. The last time US central bank raised interest rates was back in December 2018. The US recorded 6.1% annual inflation by November 2021, its highest level in 20 years. Inflation also rose sharply in Europe and Australia. There are several common drivers behind the surge in inflation in developed economies. Firstly, a rapid recovery in demand driven by demand for goods, as social distancing measures and fear of the pandemic depressed demand for services. Secondly, dislocation in the supply chains severely reduced the supply side response to the increased demand for goods.

The general view among economist is that they are reasonably optimistic on the outlook for global economic growth. While central banks, in particular the US Federal Reserve, and governments will reduce the level of fiscal and monetary stimuli in 2022, private sector demand should further recover to fill this gap. Global economic growth will likely be lower in 2022 but the main economies, except for China, are still expected to generate above trend economic growth.

The outlook for financial markets is more uncertain than twelve months ago due to the withdrawal of central banks' liquidity coupled with the ongoing impact of the Delta and Omicron COVID-19 variants on economic activity. It is unlikely that global equity markets will replicate their stellar 2021 performance and are expected to be more volatile. More cautious and risk adverse investors may consider allocations to alternatives which have low correlations with both bonds and equities.

Shares

In 2021, Australian shares continued their robust performance from the tail end of 2020 despite ongoing macroeconomic uncertainty. The S&P/ASX 200 index was up 17.2% for the year. The recovery has been supported by a positive recovery in earnings as the Australian economy, backed by government stimulus and positive sentiment with the vaccine rollout, continued to grow.

Australian small caps marginally underperformed broad cap calendar year to date. Small caps benefitted from robust performance in the resources sector. Lithium and copper stocks outperformed, driven by a transition to a lower carbon economy.

Australian shares are likely to outperform (at last) helped by stronger economic growth than in other developed countries, leverage to the global cyclical recovery and as investors continue to search for yield in the face of near zero deposit rates but a grossed-up dividend yield of around 5%.

Global shares especially developed market equities had a spectacular year as economies re-opened following mass vaccination programs. The MSCI World ex Australia index (unhedged) was up 30.2% for the year. At a country level, the US continued to be the strongest performing equity market. Among the main developed equity market indices, Hong Kong's Hang Seng index was by far the worst performer as investor sentiment towards China deteriorated through 2021.

In contrast to the stellar returns generated by developed market equities, emerging market (EM) equities had a positive but subdued year. China is a major factor in the relative lacklustre performance of EM equities given its large weight of around 34% in the benchmark. The heterogenous nature of EM equities is again demonstrated by the large disparity in returns from different countries. India and Taiwan surged whilst China fell.

The outlook for developed market equities in 2022 is not as bullish as for domestic equities, valuations seem to be expensive, higher inflation and interest rates are all potential headwinds. The prolonged underperformance of the value style and its attractive valuation, compared to its historical average, suggest that there is a slightly higher than average probability of a relative outperformance outcome for the value style.

The attractive valuation of EM equities, relative to developed market equities, is a feature which should support its return in 2022. However, China will be the key driver of EM's outcome, due to its size of the economy and its weight in the benchmark. This means Chinese domestic political and economic developments, as well as Sino-US relationship will be critical.

Property

Both listed Australian and global property returns for the year to 2021, driven primarily by a recovery of assets hit by Coronavirus in 2020 produced solid returns 26.1% and 28.6% respectively.

In Australia, retail and offices gained ground, although the Sydney and Melbourne lockdowns dampened their gains. Childcare centre and self-storage sub-sectors were among the strongest performing sub-sectors.

Globally, the US led the property recovery in 2021. Relatively relaxed Coronavirus restrictions supported retail malls as mobility recovered.

The outlook for property remains positive in 2022, with tailwind of a continued recovery from most severe Coronavirus restrictions. Recent unlisted property transactions suggest further upside to asset values held by listed property trusts.

In respect of domestic residential property values, it is expected that in 2022 residential property will experience growth in prices but not everywhere, and not to the same extent as they have over the last two years, constrained by affordability issues and pent-up demand waning.

Interest Rates

Fixed interest investors had a difficult 2021. The main drivers of higher equity markets, vaccination rates and re-opening of economies, also mean a "normalisation" of macroeconomic conditions and higher interest rates. The upward pressure on bond yields were further aggravated by persistently higher than expected inflation in a number of developed economies, including the US, since mid-2021. The benchmark US 10-year bond yield started 2021 at 0.84%, rose sharply and reached a peak of 1.73% in early March before concerns about Delta drove the yield lower. The Australian 10-year bond yield followed a similar pattern with even greater volatility – reaching a peak of 2.08% after the Reserve Bank of Australia (RBA) announced a tapering of its bond purchase program and abandoned its yield curve targeting for three-year bonds. Corporate bonds outperformed as credit spreads stayed narrow and corporate fundamentals improved as economies re-opened.

Looking forward in 2022, further reductions in asset purchase programs by central banks will likely exert continuing upward pressures on bond yields. However, bond prices have already aggressively priced some of the policy tightening and unwelcome news on inflation. Sovereign bonds, despite their low yields, are still regarded as a diversifier against equity. The outlook on corporate bonds, especially investment grade corporates remain attractive.

Commodities

Commodities performed well in 2021 based on demand and structurally constrained supply. However, 2022 may prove to be a difficult year for commodities., with the pandemic's impact on economic activity set to influence trading, rising production costs and ongoing transition to a lower carbon global economy.

Currencies

Since June 2021, the Australian dollar (AUD) has been falling against the US with a minor rebound towards the end of the year. Many economists have lowered their AUD forecasts for 2022 to remain between 75 and 80 cents, but also expect a bumpy ride.

The Global Economy

2021 was a year of economic recovery – but also a year of supply chain bottlenecks, rising inflation and Omicron. It is expected that the global recovery is set to decelerate amid continued COVID-19 flare-ups., diminished policy support and the lingering supply bottlenecks.

After rebounding to an estimated 5.5% in 2021 global growth is expected to decelerate markedly to 4.1% in 2022 and softened further to 3.2% in 2023, based on The World Bank's - Global Economic Prospects Report, January 2022. However, economic forecasting incorporating the impact of the last two years has resulted in far more guesswork than typically applied when trying to identify the macroeconomic year-ahead outlook.

Sentiment around the pandemic can shift quickly and there are signs that developed economies have transitioned to "living with COVID." Many developed countries GDP and employment have returned to pre-COVID levels. There is some evidence of growing consumer, corporate and investor confidence, and proliferating opportunities in digital transformation, ESG and the energy transition, indicating that momentum should continue into 2022 and beyond.

In conclusion: Overall, Atchison Consultants see the following asset class implications for 2022:

- Equities over fixed income, as equity valuations do not seem to be too stretched
- Preference for inflation-linked bonds over nominal government bonds
- Overweight developed market equities and neutral Emerging Market equities
- The U.S. dollar may strengthen against the Aussie as Australia's terms of trade weaken and should the US raise interest rates ahead due to higher inflation, lower unemployment, and stronger wages growth
- The value equity factor to continue to outperform the growth factor. The prospect of central banks raising rates is a key challenge facing companies with low or zero profits because it typically reduces the value of their future earnings

Table 1: Market Performance – Periods to 31 December 2021

Sector	1 Month %	3 Months %	1 Year %	3 Years % pa	5 Years % pa
Australian Shares	2.8	2.1	17.2	13.6	9.8
Australian Shares Small Cap	1.4	2.0	16.9	15.7	11.2
International Shares Ex-Aus (Unhedged)	1.7	7.3	30.2	21.2	15.7
International Shares Ex-Aus (Hedged)	4.1	8.4	24.9	22.3	15.2
Emerging Markets (Unhedged)	-0.6	-1.9	3.8	10.1	10.2
Emerging Markets (Hedged)	1.5	-0.8	0.1	12.4	10.9
Australian Listed Property	4.9	10.1	26.1	-0.4	4.3
International Listed Property (Unhedged)	5.9	10.2	28.6	12.8	9.3
Australian Direct Property*	0.6	1.1	6.4	3.5	7.1
Australian Fixed Interest	0.1	1.5	-2.9	2.9	3.4
International Fixed Interest (Hedged)	-0.4	0.0	-1.5	3.5	3.2
Cash (BAUBIL)	0.0	0.0	0.4	0.6	1.1
		Change over the month			
Australian Govt. 10 yr Bond Yield	1.72%	-2 bps			
AUD/USD	$0.72.65	+$0.135			

*As at 31 December 2021

Australian Shares (S&P/ASX 200 Accumulation Index)

The S&P/ASX 200 Accumulation Index climbed +2.8% in December and managed to finish the year with a healthy gain of +17.2%. The economy roared back to life on high vaccination rates and substantial government policy.

The difference in performance between the ASX and other exchanges came down to diversification. ASX relies heavily on financials and materials whilst the US market has the world's biggest tech names listed. (e.g. Amazon, Tesla, Apple Microsoft etc.). ASX only has a handful of much smaller stocks in this growth sector.

The top performing ASX sectors over the year to 31 December 2021 were Telecommunications (+32.6%), Small Resources (+29.1), A-REITs (+26.1%).

At the end of December, the index finished trading at a P/BV of 2.4x and a P/E Ratio of 17.1x and equity yield (dividend) of 3.5%.

The VIX was at 10.62 (the average since 1 October 2010 is 16.4) indicating below average level of market volatility.

Australian Shares Small Cap (S&P/ASX Small Ordinaries Index)

Australian small caps (stocks 101-300 in the ASX) returned +1.4% for the month of December, outperforming large caps over the December quarter and closing out the year +16.9% higher than at the end of 2020. Over the year small companies marginally underperformed larger companies (ASX top 50) by 0.1%.

Commodity markets remained robust despite the slowing growth in China. The highlight over the year was the performance of graphite producer Syrah Resources and nickel and lithium producer IGO Limited.

At the end of December, the trailing P/E Ratio was at 15.5x at the end of the month, P/BV is at 2.2x and equity yield (dividend) of 2.3%.

International Shares (MSCI World ex Australia Index, Net AUD and the MSCI World ex Australia Index, Net LCL)

The MSCI World ex Australia Index (Unhedged) returned +1.7% for December whilst the MSCI World ex Australia Index (Hedged) returned +4.1%. Shares rallied to record levels as money poured into stocks, deal-making soared, and the gamification of investing hit new highs. The S&P 500 gained +26.9% for the year. The Dow Jones Industrial Average was up +18.7% in 2021, while the Nasdaq Composite gained +21.4%.

In USD terms value stocks started to come back into vogue over the year closing the gap with growth stocks. The MSCI World Value Index in USD returned +21.9% whilst the MSCI World Growth Index posted a return of +21.2%.

At the end of December, the index ended trading at a forward P/E Ratio of 22.0x and P/BV of 3.3x and equity yield (dividend) 1.5%.

US markets: US equity markets advanced strongly, despite the news that the Omicron variant has greater transmissibility than the Delta variant. Research eventually showed that Omicron caused fewer hospitalisations, and initial concerns were alleviated. By year-end, these worries had largely subsided, while data continue to indicate that the economy overall remains stable and corporate earnings are robust.

UK markets: In the UK, the equity market ended higher as some of the initial fears about Omicron were alleviated. But the pound dropped to its lowest level in a year against the dollar as restrictions clouded the outlook for the British economy.

European markets: European shares ended higher on the hopes that further restrictions to fight the new Covid variant seemed unlikely given the low hospitalisation rates. The European Central Bank (ECB) announced it would scale back its crisis bond-buying in response inflation. The central bank said its €1.85tn Pandemic Emergency Purchase Programme, would reduce net purchases this year and halt them altogether in March.

Chinese markets: China finished the year in negative territory as many expensively valued Chinese equities (e.g. platform economy companies, online education, gaming etc.) have been caught in the net of changing regulations.

Asian markets: Asian equity markets were up, but gains were muted relative to Europe and the US as performance was dragged down by China, the economic heavy-weight equity market lagged amid mixed economic data and clusters of Covid-19 cases. Gains were made by other Asia Pacific countries such as Thailand, Korea, and Australia.

Emerging markets: Global emerging equity markets posted positive return but underperformed relative to the developed markets. All regions posted gains, led by Latin America, and followed by Europe, Middle East, and Africa (EMEA) and Asia.

Emerging Markets Shares (MSCI Emerging Markets Index, Net AUD)

The MSCI Emerging Markets Index unhedged returned +3.8% for the year while the hedged equivalent returned +0.1% for the year. Emerging equity markets performance was constrained in 2021 as the Chinese sharemarket retreated (China makes up around 30% of the benchmark).

One of the most notable trends of the past year has been the EM shift to value stocks, +4% compared to -8% for emerging market growth stocks.

At the end of December, the index ended trading at a forward P/E Ratio of 12.9x and P/BV of 2.1x and equity yield (dividend) 2.3%.

Australian Listed Property (S&P/ASX 200 A-REIT Accumulation Index)

The S&P/ASX 200 Property Accumulation index returned +4.9% in December, outperforming the S&P/ASX 200, which returned +2.1%. For 2021, A-REITS returned +26.1% outperforming the broader share market, which returned +17.2%. Outperformance in 2021 was driven by the investment themes of funds management, logistics and storage.

The best A-REIT performers over the month of December were Centuria Industrial (CIP) at +13.2% and Waypoint (WPR) at +11.7%. Key underperformers were Unibail Rodamco Westfield (URW) at -0.6% and Stockland Corporation Limited (SGP) at -0.3%.

At the end of December, the index was trading on a dividend yield of 3.5% with a P/BV 1.4x and a P/E Ratio 12.6x.

International Listed Property (FTSE EPRA/NAREIT Developed ex-Australia Index, AUD)

Globally, REITs were up +5.9% for the month of December and -+28.6% for the year. The US was the top-performing region (+8.6%). The worst-performing region over the month was Japan (+1.0%).

At the end of December, the index was trading on a dividend yield of 2.8% with a P/B 2.0x and a P/E Ratio 23.5x.

Australian Direct Property (Atchison Consultants Unlisted Property Funds Index)

Australian direct property posted a return of +1.1% over the December 2021 quarter and 6.4% for the year. Capitalisation rates across property sectors continued to trend downwards. Cap rates across office, industrial and retail properties range are 5.0%, 4.2% and 5.2% respectively.

Australian Fixed Interest (Bloomberg AusBond Composite Bond Index)

Australian fixed interest returned +0.1% for the month of December and -2.9% for the year. Australian government 10-year bond yields increased by 2bps to 1.72% over December. At this point, 10-year Australian bond yields were 21bps above US 10-year yields (1.51%). 3-year single A corporate credit spreads tightened from 0.79% at the end of November to 0.74% at the end of December.

International Fixed Interest (Barclays Global Aggregate TR Bond Index, Hedged to AUD)

International fixed interest returned -0.4%% over the month and -0.05% over the quarter and -1.5% for the year. The 10-year US government bond yield increased by 6bps to 1.51%

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