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FM Financial Investment Update

Market Correction Update

Phone: 1300 763 544 | Email: info@fmfinancial.com.au | Web: www.fmfinancial.com.au

Fear takes hold and creates "excessive" market response

In what seems to be an increasingly violently swinging pendulum, a sense of **"fear" has clearly taken over "greed"** on the "fear-greed" sentiment scale that drives short term financial market direction. Today's market sell-off is notable in terms of size, but also in the breadth of asset classes that have been sold down. After a reasonably steady first week of June, the following movements have been recorded today (at the time of writing on June 14th):

- Australian equities: negative 4.8%
- Global equities: negative 5.8%
- Australian listed property: negative 4.9%
- Global Listed Infrastructure: negative 4.3%
- U.S. 10 Year Treasury Bond Yield: up 0.21% to 3.37%
- Australian 10 Year Government Bond Yield: up 0.29% to 3.97%
- Australian dollar: down from US 71.2 cents to US 69.4 cents
- Gold: down 1.1%

The sell-off detailed above, appears to have been triggered by the release of the May inflation data in the U.S., which showed a 1.0% increase in the Consumer Price Index for the month, resulting in an annual increase of 8.6%. This is the highest inflation rate recorded since 1981. Higher inflation has prompted fears that interest rates will have to be pushed higher, thereby further constraining household expenditure, already under pressure from increased living costs. In addition to the U.S. inflation data, financial markets were also concerned by news of a surge in COVID cases in Beijing and a tempering of some of the reopening plans that were in place in Shanghai.

Although U.S. inflation is significant and well above the expectations of a few months ago, the latest market reaction to a single month's data point could be seen as excessive. The 1.0% jump in May did follow a somewhat modest 0.3% increase in April. Together, the April & May rise of 1.3% was below the 2.0% combined surge of February & March and only marginally above the 1.2% increase of December & January. It remains to be seen whether the latest inflation data will have any actual impact on the U.S. Federal Reserve's plans for interest rates. **The central bank could rightly take the view that inflation is largely a supply related issue and that any further constraints on demand via additional interest rate rises (above what is already planned) is unnecessary.**

Notwithstanding the inevitable slowing in spending that higher interest rates and living expenses will cause, it should also be emphasized that the circumstances around the current economic cycle are highly unusual. Of significance is the extremely low unemployment and record high job vacancies that characterise many developed economies now. This labour market strength, combined with a buildup in household savings over the past 2 years, may result in household sector spending being far more resilient than it has been in previous downturns.

As such, the fall in equity valuations that has already occurred over recent months may be sufficient to account for the likely lowering in company earnings and higher interest rates that will persist over the next economic cycle. Equity markets have shown a tendency to "look through" periods of short-term earnings weakness in recent times and may react positively to any evidence that the near-term economic downturn will be shorter and shallower than is typically the case in recessionary periods.

The situation in Australia

In terms of the outlook for the Australian economy and the potential impact of rising interest rates and inflation on household spending, it would appear that the domestic economy is less vulnerable than the United States. Inflation here is lower than in the U.S., suggesting less pressure on interest rates and household budgets. Some relevant data points for the Australian economy are listed below:

- Unemployment (April 2022) = 3.9%
- Job Vacancies (February 2022) = 423,500 (highest on record)
- Inflation (March 2022) = 5.1% per annum
- Wages Growth (March 2022) = 2.4% per annum
- Cash interest rate (June 2022) = 0.85%
- Household Savings Ratio (March 2022) = 11.4% (this reflects the % of disposable income that is saved and not spent and has a 20-year average of 5.4%)

Admittedly economic variables can change quickly. However, the above data points are not indicative of an imminent recession or sharp downturn in household expenditure. With savings levels elevated, and additional employment widely available, **there is scope for the Australian household sector to absorb at least some of the impact of rising costs and interest rates.**

Investment considerations

Hence the latest sell-off on financial markets may have created a disconnect between economic fundamentals and market direction. Of note, is the widespread nature of the sell-off, with assets such as gold not being immune from price falls. If uncontrolled inflation was the dominant expectation, then gold should rise in value, not fall. If a recession and contraction of spending was expected, then long term bond yields should fall, not rise. The fact that asset prices have fallen across the board (noting bond prices fall when yields increase), suggests that at least some **of what we are witnessing is related to "fear" and perhaps an absence of liquidity in markets**. As past experience has demonstrated, exiting markets in these times should be avoided. Rather, **maintaining long term investment strategies when others are at their most fearful** is the best path to accumulating wealth over the long term.