NEWSLETTER

May 2022

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FINANCIAL SERVICES

Introduction

Welcome to our May newsletter. We hope you like it. Earlier this week, the RBA decided to increase their target for the cash interest rate by 0.25%. Markets have been expecting this given the presence of inflation. This month we look at the way inflation and interest rates can impact on share markets.

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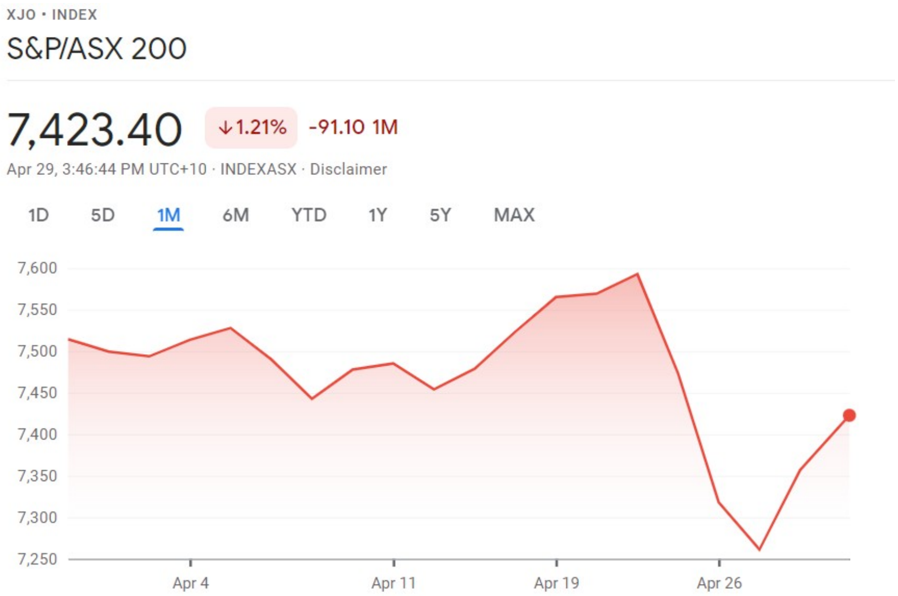
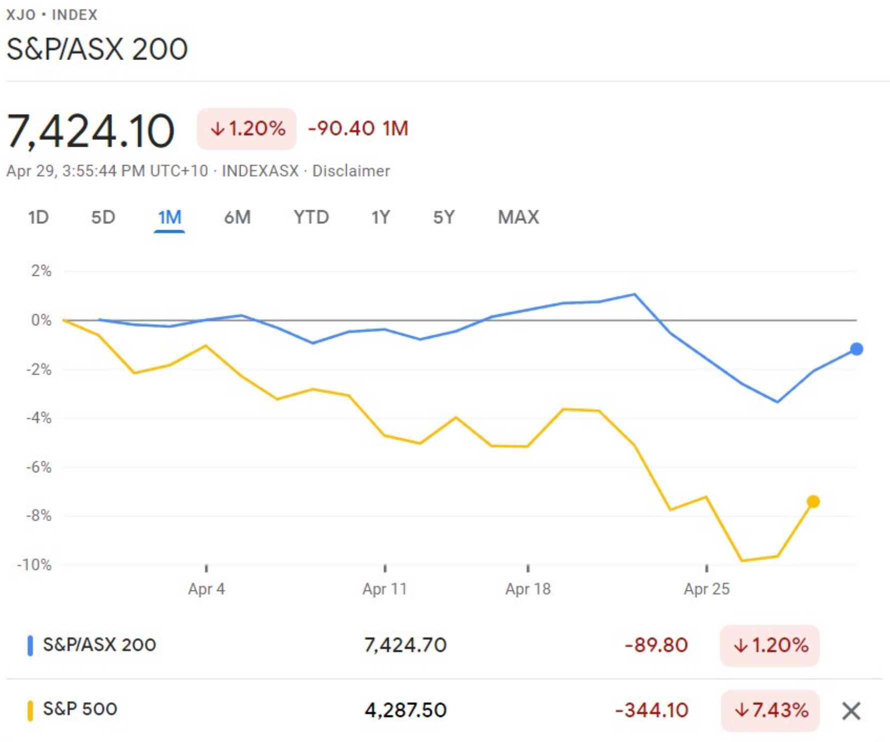
The Share Market

April was a slightly down month for the ASX. Here is how the market performed for the month, as measured by the ASX 200 index. Thanks to Google and the ASX for the graph:



The market was progressing quite boringly for most of the month, before it started to fall on Friday the 22nd. This fall was mostly triggered by an even larger fall in the US market. This can be seen in the following graph comparing daily changes in the ASX 200 to the US index S&P 500:



So, falls on the US market nudged 10% during the month, and the month ended with the market down by 7.43%. Compared to this, the Australian market did relatively well.

There are a number of factors that have seen confidence fall in the US. Chief among these is the appearance of inflation in that country. US inflation is approaching 8% per annum and is steadily rising, as this graph from Trading Economics shows:

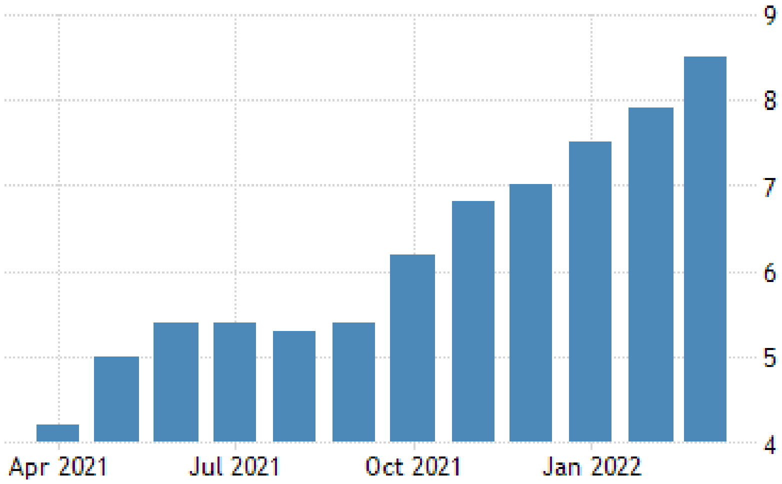


Figure 1 US Monthly Inflation Last 12 Months

Indeed, the current inflation rate in the US is the highest in the last 25 years, as Trading Economics again demonstrate with this graph:

Figure 2 US Monthly Inflation Last 25 Years

The US market is particularly spooked by the fact that the inflation trend is still rising and thus similar or even higher US inflation can be expected next month.

Here in Australia, the trend is also towards higher inflation, although not to the same extent as in the US. Once again, here are some graphs from Trading Economics showing quarterly inflation for Australia for the past three years (we do not measure inflation monthly) and for the last 25 years:

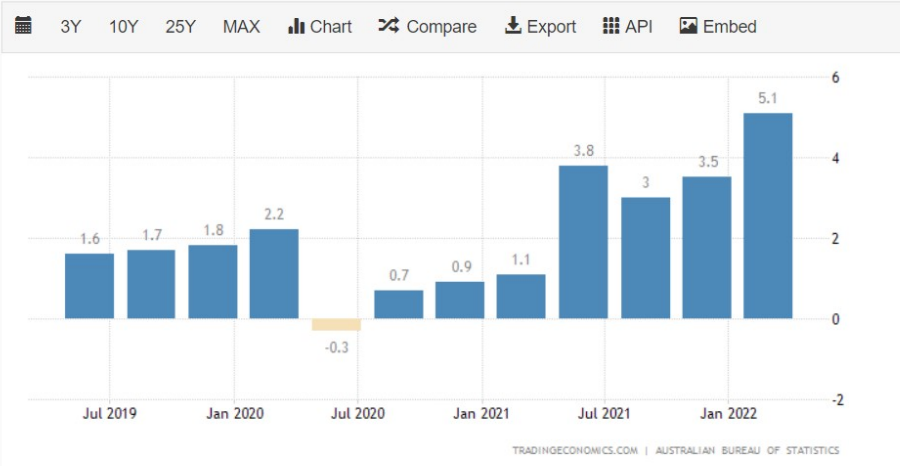


Figure 3 Australian Quarterly Inflation Last Three Years

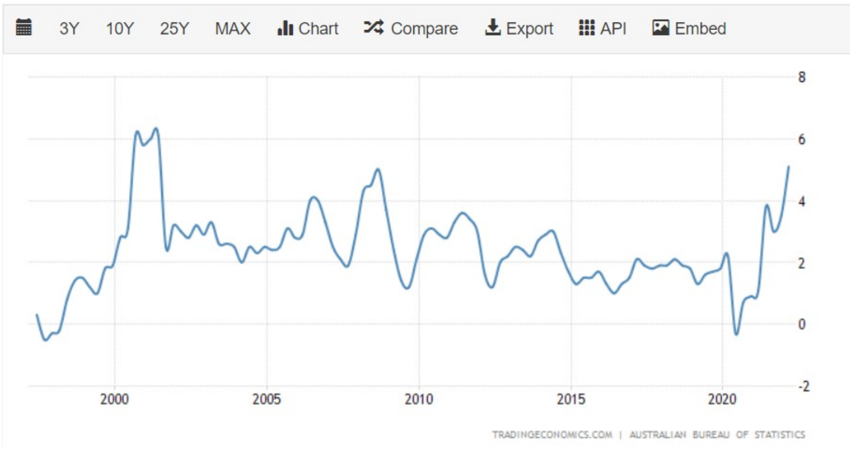


Figure 4 Australian Inflation last 25 years

In response to its inflation, the US Federal Reserve has increased interest rates, from a base of 0.25% to 0.5%. This has dragged the US market lower. To read about how interest rates impact share markets (and to see what is happening to Australian interest rates), please read on.

Interest Rates (and their Impact on Share Prices)

On Tuesday of this week May 3), Australia's RBA decided to increase the target cash rate by 0.25%, from 0.1% to 0.35%. This will likely flow on quite quickly to things like home loan and business interest rates, although be concerned if your interest rate rises by more than 0.25%.

As we saw in the previous discussion on the US market, interest rates impact share prices. They do this in several ways. Firstly, because interest payments represent a cost to businesses, an increase in interest costs will reduce profits. Falling profits mean that shareholders get a lesser return from holding shares, which will discourage some investors from holding shares. This creates downward pressure on share prices. That said, this downward pressure might be negated if the business is able to pass on the higher cost in the form of higher prices.

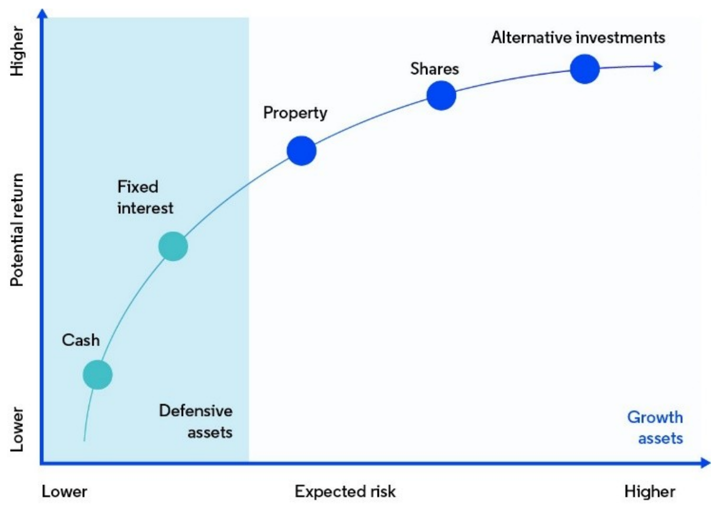
But there is another, more complicated relationship between interest rates and the share market. To understand it, we will use the example of a personal investor, although we are sure you can understand that these factors also play out on larger, institutional levels.

Think of the safest investment you or I could make. This would probably be an investment in a term deposit or cash management account at our local bank, for which the interest rate has recently been next to nothing.

Interest on these kinds of investment is sometimes referred to as the 'risk-free rate of return,' because there is essentially no risk that you will lose money held in a term deposit or similar with a major bank. If you put your money in the bank, then there is basically no risk that it will not still be there some time in the future when you want to take it out.

Many investors require their investments to generate a particular rate of return. When the risk-free rate is low, these investors can be encouraged to invest in riskier assets (such as the share market), to achieve their required rate of return.

The 'standard' risk and return profiles of different kinds of asset is shown in this image sourced from www.moneysmart.gov.au. You can see that if an investor wants to get a higher rate of return, they need to move away from cash-like investments towards things like shares:



A move towards riskier assets in the pursuit of higher returns has been happening to some extent over the last two years in Australia. Investors who traditionally were satisfied with interest from lower-risk cash-type investments shifted at least some of their money into the riskier share market. The potential returns in that market are higher, especially in terms of income received while you hold shares (dividends, which compare to interest on a bank deposit).

When interest rates rise, higher returns can be achieved for people holding cash or cash-like investments. This means that some investors can achieve their preferred rate of return while investing in less risky assets such as term deposits. These investors are encouraged to 'switch' their investment back to that asset class. This takes some money out of the share market, which will suppress prices in that market.

So, basically, when interest rates are very low, some investors are encouraged to invest in the share market because they are chasing a higher income return. If interest rates rise, these investors can move their money out of the riskier share market. This will suppress prices in that market.

Of course, income return (dividends or interest) is not the only kind of return. In the share market, there is also the capital return. This is the change in price between buying and selling a share.

Capital returns in the share market can be positive or negative. That is, you can lose money on shares when the time comes to sell them. This is what makes the share market so much more risky than cash-like investments such as term deposits. It is also why investments in the share market should only be made by people who can afford to take the risk of such an investment – and who have taken as many steps as possible to manage the risk of capital loss.

The best way to manage the risk of capital loss from the share market is to be in complete control of when and how you sell your shares. This lets you choose the time of sale, giving you the best chance to avoid selling when your investment is priced below where you expect and want it to be.

We try to build this control into all of the investments that we recommend, so that our clients are not 'caught short' when things like interest rates change on them.

For many people, the change in the current interest rate will change their risk profile. So, as interest rates start to rise again, we encourage to you get in touch so we can review things with you and make sure your money is where you need it to be.

The Legal Stuff

General Advice Warning

The above information is general in nature and does not take into account your personal situation. You should consider whether the information is appropriate to your needs, and where necessary, seek professional advice from a financial adviser.

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