Melbourne Capital Group

Comprehensive, Transparent, and Independent
Wealth Management

Mid Year Outlook - 2022

Welcome to Melbourne Capital Group

Everyone has a story – we start by listening to yours.

Melbourne Capital Group believes in the uncompromised pursuit of one's path in life. We believe in the ability to seize opportunity, wherever and whenever it should present itself.

Becoming a client of Melbourne Capital Group is the beginning of a long and favourable partnership. It is our belief that Wealth Management is first and foremost a relationship built on trust. Our clients feel secure knowing that they are moving forward with a responsible and independent partner managing and growing their wealth.

We have a passion for understanding the details of our client's lives, in a much wider sense than their finances alone. Wealth Management is far more than the oversight of an investment portfolio, and must consider a client's values, ambitions, family needs, health, and stability in life. Our relationship with each and every client is embodied by respect and integrity.

Melbourne Capital Group delivers transparent, cross-border Wealth Management services. We take pride in our ability to help our clients navigate their path in life

2022: Global Transformation

As at the middle of 2022, the global economy is beginning to show signs of slowing down. 2021 was an exceptionally strong year for global growth, consumer sentiment, and the world economy.

This is a year of global transformation, as the world economy reacts to geopolitical challenges and changing economic support from the government.

2022: Introduction

Drivers of Change

There are three primary drivers of change in the world economy for the second half of 2022: the effect of the Russian invasion of Ukraine; the changing nature of China in the global economy; and reduced sovereign support for the economy in both government spending and money supply.

The Russian invasion of Ukraine is an unpredictable and complex military conflict; however, some clear effects are emerging. The most immediate impact of the conflict will be on European economies, as many European countries fulfil most of their energy requirements from Russia.

At this stage, China continues to pursue a "Covid-Zero" strategy which involves continuous lockdowns and has resulted in very negative consumer sentiment. China is a major component of the world economy, representing approximately 18% of the world's population, and 18% of global GDP.

Governments around the world are now reducing Covid support spending, while central banks are increasing interest rates. The US Federal Reserve in particular has increased rates by 0.75% in June, and is anticipated to increase by a further 0.50% to 0.75% in July as they fight strong inflation. Inflation in the U.S. is at multi-decade highs, and the labour market remains strong, setting the scene for continued interest rate rises.

The global financial system is in a delicate position, and if problems emerge in market functionality there could be significant economic turmoil. Red flags would be problems in liquidity, sovereign debt markets, and debt serviceability. Pockets of the global economy are likely to see negative impact, such as Australian residential real estate, and regions with food or energy import dependence, or smaller states which mismanage monetary policy.

The economy underlying financial markets is returning to normal conditions as these drivers of change play out. In 2021 there was a historically rare combination of heavy government spending, ultra-low interest rates, and liquidity intervention from central banks around the world. When this support is reduced, it is reasonable to expect a short-term decline in prices as the market finds its natural centre of gravity and returns to a normal mode of operation.

In our view, high quality companies which generate income and deliver quantifiable value will do well in the long run.

Our strategic investment team have been focusing on preparing our clients for this change with a clarity of vision and purpose. We are positioning client portfolios to do well in this period of transformation, as well as the market environment which emerges.

Russia: The End of the End of History

“What we may be witnessing is not just the end of the Cold War, or the passing of a particular period of postwar history, but the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government.”

— Francis Fukuyama, "The End of History?", The National Interest, No.16 (Summer 1989)

The Russian invasion of Ukraine was completely unanticipated and has been unpredictable. In addition to economic concerns, this represents a pivotal point as the post Cold War era of peace between major powers appears to be ending. Beyond our discussion in this outlook, the conflict has had a devastating impact on millions of lives.

Economically, it represents a paradigm shift. Rather than the world economy existing in a single globalised market as it has done since the end of the Cold War, it is beginning to fragment into multiple large markets which are connected more narrowly. For instance, the single European energy market is beginning to segment into a British energy market, a European Union energy market, and finally a Russian energy market. The decision of the European Union to cease using Russian energy will have the most definite impact on the European economy.

This is particularly the case in Germany, where the industrial economy is especially dependent on energy. Before the conflict, Russia supplied approximately 20% of Europe’s crude oil and 40% of its natural gas. Energy is essential for the chemical industry, in which Germany is a global leader. The other likely impact of the conflict is on global food security, as Russia and Ukraine account for a significant portion of global trade in wheat, cooking oil, and fertiliser.

If this energy supply cannot be rapidly substituted, it will effectively be the end of a competitive industrial economy in Germany and other parts of Europe. The essence of the problem is that the German government has invested in energy infrastructure and economic programs which are designed to succeed with open borders, cheap energy, and political stability – all of which have now reversed suddenly.

China: Global Supply Chains

The Chinese economy in 2022 is defined by the strategic thinking of the Chinese government. Broadly speaking, major focus areas of the government in the economic sphere include mitigating the impact of the Covid-19 pandemic, managing a slowdown in the domestic real estate market, and supporting key industries.

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Covid-19 mitigation measures such as lockdowns and behavioural change have undoubtedly had a huge impact on consumer activity in China as they have in the rest of the world. China is continuing to exercise Covid-19 measures such as lockdowns in major cities. Shanghai is the largest population centre in China at 25 million people, the 7th largest city in the world by GDP, and contains the world's busiest shipping container port.

Throughout 2022, there has been a large scale lockdown in Shanghai which has heavily affected consumer sentiment and global shipping. In April, not a single automobile was sold in Shanghai, which is a significant decline in consumer spending and financing activity. However, Shanghai port container traffic has almost reached pre-pandemic levels, and the lockdown appears to be coming to a conclusion.

The reduced real estate activity (thus construction) in China is already beginning to cause a decline in iron ore prices which will negatively impact major iron ore producers globally. Separately, these lockdowns have likely reduced energy demand for oil. Should air travel normalise, this would likely be a catalyst for higher crude oil prices.

Our key view is that the Chinese economy will function well despite the social impact of managing the pandemic, however the economic effects of these changes will have much more pronounced impact outside China. We also note that in the last weeks of June, the government has substantially reduced Covid-19 measures, such as reducing the quarantine period in China from 21 days to 7 days.

Governments and Inflation

Inflation in western economies has been the biggest driver of change in global financial markets so far in 2022. In 2020 and 2021, governments around the world provided huge economic support to counteract the economic disruption of Covid-19.

This took the form of direct government spending, stimulus packages such as furlough schemes, and strong intervention in the financial sphere by central banks.

Confidence is the most important ingredient to the success of financial services and financial markets. When confidence is lost, assets are sold irrationally, there are runs on banks as deposit holders rush to withdraw their money, and financial services become dysfunctional.

One of the most important requirements in financial markets is confidence in prices. Prices in the long run should be stable, slightly increasing over time. When people begin to feel that money is increasing or decreasing in value rapidly, it leads to consumer behaviour which damages the economy.

The US Federal Reserve is anticipated to continue to increase interest rates at the end of the year and will begin to sell its assets. The anticipation of high inflation and increasing interest rates have already been quite prominent, with the US Federal Reserve narrative changing entirely from “transitory” inflation to one of broad and more permanent inflation. An additional factor here is the Russian invasion of Ukraine which has led to strong price increases across the economy.

In Europe, the European Central Bank is facing a serious loss of confidence in the Eurozone. The struggle in the European continent is to continue having a unipolar central banking system, despite very different political and economic structures in different European countries.

Our takeaway is that the tightening credit environment will lead to an increased recession risk in global markets, however the underlying economy will continue to perform well; tight credit will mostly impact structurally weak companies. The exception to this is continental Europe, where a combination of expensive energy, a complex political structure, and tightening credit is more likely to lead to a recession and financial issues.

Positioning for Change

We believe in the success of a well structured portfolio in the new economic environment.

The key change in 2022 is that key assumptions over the last decades can no longer be relied upon in the market.

Even amidst high energy prices, inflation shock, and the end of cheap money, we believe investors can see compelling returns through 2022 as volatility introduces new opportunity into the market.

Positioning Portfolios for Change

"We must free ourselves of the hope that the sea will ever rest. We must learn to sail in high winds."

— Aristotle Onassis

Strategic Approach

In this environment, our strategic approach is built on the pillars of Discipline, Thematic, and Defined Investments.

Discipline

In summary, focusing on high quality stocks provides more certainty in a poor macroeconomic environment.

On a macro scale, the economy is facing many challenges. This means that positioning a portfolio to be exposed to the entire economy will likely have poorer outcomes than one which focuses in on key areas of the economy.

We aim to gain exposure to high quality companies in areas which have exposure to long term secular growth themes, rather than companies whose share prices are driven by short term trends or retail investor hype.

At this time, high quality companies are being sold as part of a broader selloff, as the market begins to move away from speculative stocks that have little underlying value.

We believe that many companies with good earnings potential, a solid long-term outlook, and high-quality management teams are being included in this sell off – which presents an excellent opportunity for fund managers with a long-term vision and disciplined approach.

Defined Investments

High quality fixed income and debt securities are a powerful way to deliver growth in a challenging economic environment.

Institutional grade products can provide a structured investment which delivers a return based on the performance of underlying assets. The potential return and level of capital at risk is pre-defined at outset, providing certainty and functioning as ballast for the portfolio.

We believe that corporate debt needs to be evaluated very selectively at this stage, with many companies turning to capital markets to raise funds when their earnings may not be ideal.

Investment grade sovereign debt also provides an essential part of any portfolio, with market volatility providing great yields and entry points to investors internationally.

Thematic

Thematic investing involves a strategy which focuses on long-term trends and specific thematic areas in the economy.

Areas we focus on including in our portfolios in the thematic space now include water, digital technology, environmental, and healthcare.

One of the main objectives of a thematic investment is providing returns which are uncorrelated to broader equity markets.

For instance, thematic water funds invest in water technologies, water usage rights, and the water industry. Pure water is essential to human life and health, manufacturing, and agriculture. No matter where we are in the economic cycle, demand for water, water technologies, and the knowledge to manage water will remain strong.

Another key thematic area is healthcare. Rather than companies which are driven by the short term trends of Covid-19, we are looking towards conventional medical treatment and healthcare providers. Demographic trends in developed world nations indicate that elderly people requiring complex medical care will make up a larger portion of the population over the next 20 years at least. Healthcare companies with top quality management teams, strong balance sheets, or consistent earnings growth are well positioned to prosper. Most importantly, global spending on healthcare is unlikely to change based on the credit environment or changes in broader economic growth.

Our Investment Mission

2022 will provide many challenges and opportunity for clients, in a year defined by transformation.

Ultimately, it is our aim to integrate a correct analysis of risk, long term vision, and investment impact, to deliver results to our clients which meet all of their requirements.

We believe in an approach to markets which is founded on a responsible and long term vision, focusing on quality assets which will be rewarding to investors.

Beyond markets, we believe first and foremost in the values of partnership, and it is our purpose to ensure our clients are positioned to meet their goals, stay informed on markets, and have a high quality Private Wealth Manager they can rely upon.

We are here to help you navigate the next steps forward in your story.

Contact Us

Please feel welcome to contact our team at wealth@melbournecapitalgroup.com and a member of our Private Wealth Team will be in touch.

You can also learn more about us on our website, at www.melbournecapitalgroup.com

Should you already be a client of Melbourne Capital Group, please don't hesitate to contact your Private Wealth Manager who can answer any questions or provide any information you require.

Legal Information

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Melbourne Capital Group Ltd is authorised and regulated by the Labuan Financial Services Authority (LFSA) as an Insurance Broker with Licence Number BS2021140

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