Local Government Finance Authority

Financial Market Conditions – February 2022

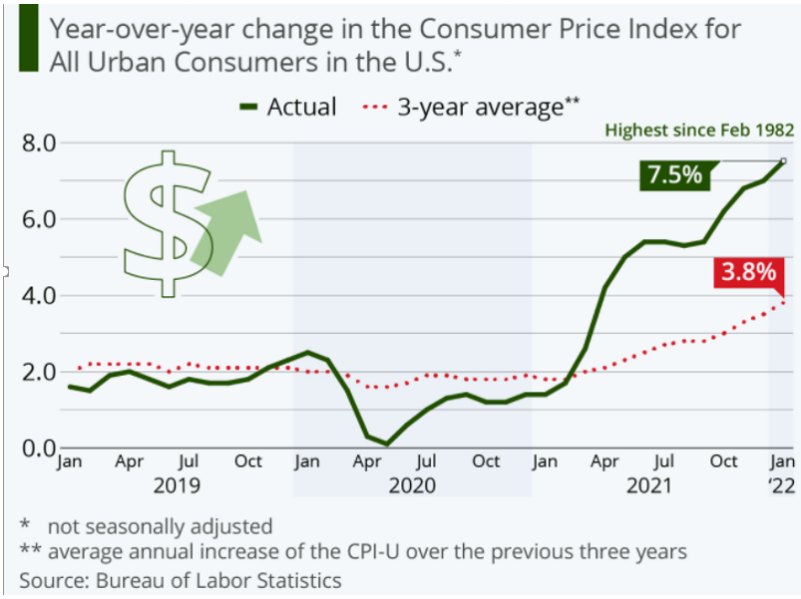
The end of February witnessed a profound shift in global focus, with the Russian invasion of Ukraine on 24 February 2022, continuing the Russo-Ukrainian War that began in 2014. Markets continue to be dominated by headlines on Ukraine, with equities globally falling heavily. Countries around the world have imposed sanctions in response to Russia's invasion, with a scarcity of buyers for Russian oil, as well as cutting off Russian banks from international payments systems. Commodity prices have reached decade highs, with Brent oil touching the highest level in 10-years.

Despite clear impacts on the inflation outlook, the impact on the crisis will be exposed much more to Europe, reliant on exports to Russia and Ukraine and a heavily reliance on Russian gas. Despite potential inflationary issues of higher energy and commodity prices, the risk of contagion and war will likely mean that central banks will act more cautiously with rate strategy than previously anticipated.

In terms of the European Central Bank, board member Philip Lane advised the Russia-Ukraine conflict may reduce Eurozone GDP by 0.4% to as much as 1%, and markets are seeing that any perspective early rate hikes are now likely off the table. In fact, the immediate result of the Russian invasion has seen markets paring back rate hike expectations, globally. Markets now price hikes from the US Fed at 5 hikes from 6, notably a 0.25% move priced in for March rather than a high chance of a 0.50% move. For the UK, BoE pricing for hikes has fallen to 4 for 2022 compared to 6 hikes in early February. Even locally, in Australia, markets are now pricing in just a 50% chance of a rate hike by June, falling from 140% a month ago.

Despite this, data published throughout February (despite not capturing the Russian/Ukraine invasion), continues to illustrate the pricing impact that has resulted from ongoing supply chain issues, leading to a persistent and growing issue of inflation. In the UK, inflation rose by 4.9% in the 12 months to January 2022, the fastest pace in 30 years. The expected economic side effects from Russian military action in Ukraine is expected to result in further inflationary pressure in the months to come. The UK are seeing wage pressure close to 4%, with low unemployment levels.

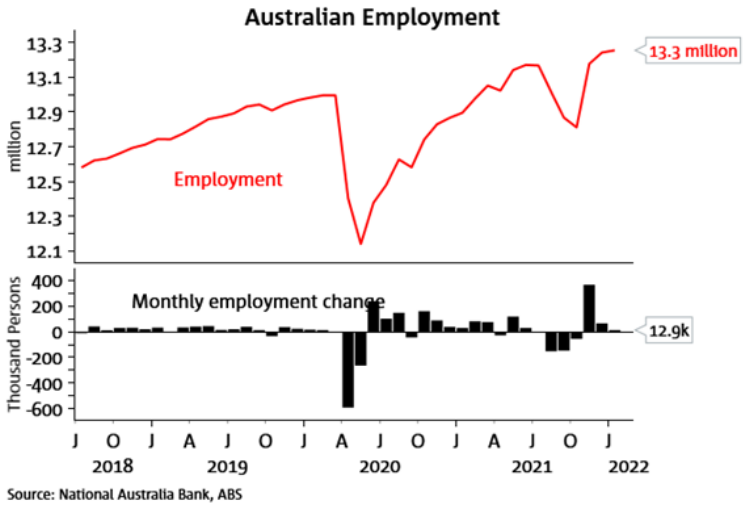
As the US continues to post strong economic data, markets have accepted that a number of rate hikes in 2022 are necessary to manage continuing price pressures. US employment continues to print stronger than expected numbers, with an astonishing level of wage growth at 5.7% over the year. US inflation once again came in higher than expected, with headline inflation at 7.5% its highest annualised rate in almost 40 years.

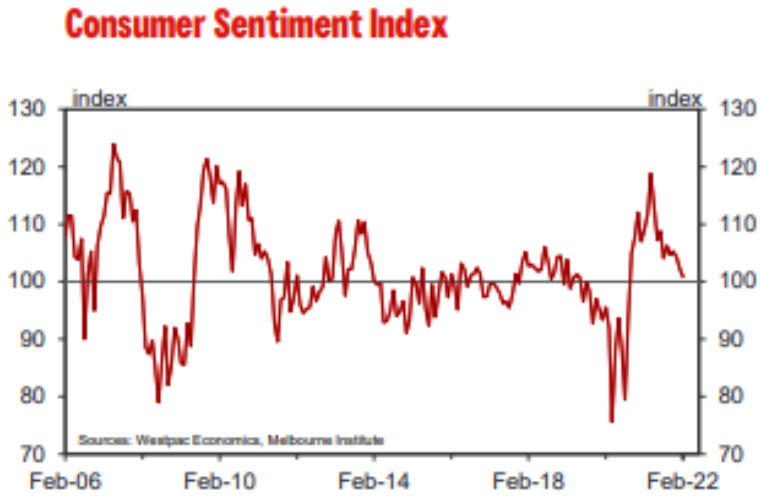


Whilst China is the one region not witnessing the same inflationary pressures as the rest of the globe, the signs that China's economy is readying for a strong 2022 has been illustrated with financing data much higher than expected, and trade surplus outperforming expectations for the first two months of 2022. The Chinese government has outlined that stabilising growth as a top priority, which will require significant increased government spending in 2022. The government is targeting 5.5%, which is a rebound in growth compared to 2021 levels.

In Australia, despite further easing in COVID restrictions, business surveys and consumer sentiment has seen confidence deteriorate further, due to increasing concerns about rising living costs and the potential for higher interest rates. Employment continues to illustrate strength with the employment to population ratio lifting to a record high, with unemployment remaining at 4.2%. GDP data for the December quarter expanded by 3.4%. The surging oil prices has supported strength in the AUD and the first release of the trade balance for 2022 was the 2nd highest surplus, with commodity prices behind the trend seeing a 17% increase in export earnings on the back of a 30% gain in prices. Whilst inflation pressures are apparent, wage growth remains modest with wage prices increasing by 0.7% in the December quarter, taking annual growth to 2.4%. While it is hard to gauge the economic effects of the recent floods in Southeast Queensland and New South Wales, it is likely that the high demand for labour to re-build cities like Lismore will further increase inflation expectations nationally.

Chart 1: Employment edged higher, up 13k in January despite Omicron impacts





The RBA left rates on hold as expected at its March meeting, and their statement continues to signal that they will remain 'patient' despite the recent strength in inflation and low unemployment data. With the rise in tensions in Europe, Dr Lowe expects that "[CPI] will spike higher than this due to the higher petrol prices resulting from global developments," however with wage growth remaining modest it would likely be some time yet before growth in labour costs is at a rate consistent with inflation being sustainably at target, emphasising that the RBA does not intend to rush the raising of interest rates.