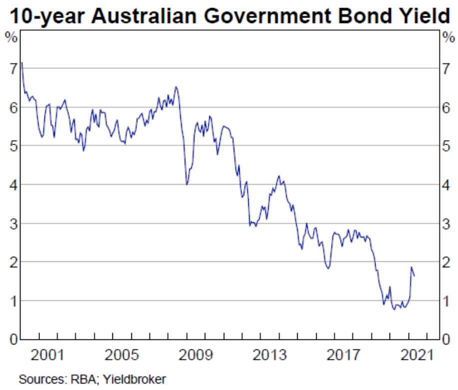
Economic Update

Inflation Implications

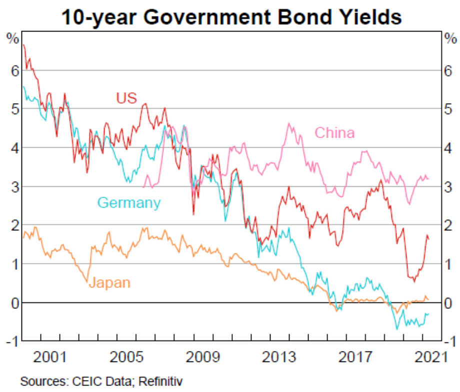
May 2021 edition, By Chris Boag

Everywhere you look, economic indicators are highlighting how good the economic recovery from the COVID-19 pandemic is. Be-it economic data that is being assessed or leading indicators, everything is highlighting the recovery and the improving economic outlook. There have been large sums of fiscal stimulus from global governments to support their central bank's ultra-low monetary policy settings. This has buoyed investor sentiment and company reporting has justified this with profitability broadly beating expectations. The vaccine rollout is a clear catalyst for the jubilation with large portions of the developed world's population to have the opportunity to be vaccinated over the course of the year. A return to some sort of 'normal' raises investor hopes.

With easy money and large sums of fiscal spending there is an increasing chorus of concern over inflation. A lot of the fiscal spending to date has been in the form of government handouts which, in the absence of things to do, has largely been saved by consumers. With some freedoms, that savings ratio has begun to fall, and consumers are willing to pay more for goods. Let's face it, even if you lost your job during the pandemic, you were still getting paid, and now with the strength of the recovery there is confidence to go and spend. Bond markets have again noted the 'rising expectations' for inflation yet as I have highlighted, despite yields rising significantly from their pandemic lows, yields remain locked in a long term down trend that is yet to be broken.



The Australian Government 10yr bond is almost double wat it was at circa 1.7%. The result has highlighted the cracks in the current bond fund investment strategy of buying bonds for capital gain (instead of income they proport to provide) and seen losses across the sector especially for bonds with longer maturities. It must be immensely difficult for portfolio managers trying to invest in an asset class that is being actively and purposefully manipulated by the central bank. At Royston Capital we continue to prefer the corporate sector and shorter duration. This has continued to protect investors capital (despite short term volatility during the pandemic) with a clear view to capital being returned at maturity along with floating rate interest being paid in quarterly or half yearly payments.



Inflation is difficult to predict. No doubt, the risks of an uptick are becoming more evident. A rise in inflation has profound implications for portfolio construction, particularly in relation to interest rate sensitive assets. This goes someway to explaining the recent moves in asset prices. However, with GDP figures reclaiming lost ground, it appears economies are at least heading in the right direction to create the right environment for inflation to build.

US Treasury Secretary, Janet Yellen (you may remember her from her previous role as US Federal Reserve Chairperson), commented on US President Joe Biden's proposal to rebuild the nations infrastructure and restore full employment, noting that "it may be that interest rates will have to rise somewhat to make sure the economy doesn't overheat, even though the additional spending is relatively small relative to the size of the economy". Her statement is correct, interest rates will eventually need to rise. However, Janet Yellen is supremely well versed in making frequent, well measured statements to ensure financial stability and

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integrity, so her comments have been widely seen as mistimed or even a mistake (hard to believe) as it is not the message that the government or central bank want to be sending at this time.

If we shall dismiss Janet Yellen then perhaps we will listen to Warrant Buffet and Charlie Munger of Berkshire Hathaway. Buffet told shareholders at Berkshire Hathaway's recent annual general meeting in Omaha, "We are seeing very substantial inflation. It's very interesting. We are raising prices. People are raising prices to us and it's being accepted."

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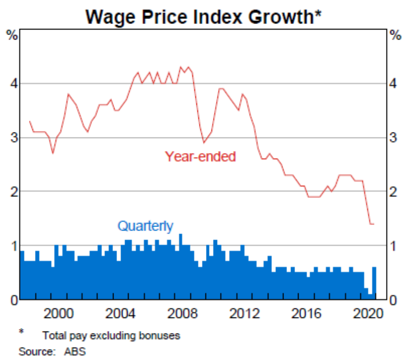
Buffet and Munger are saying that they are seeing inflation starting to move into their businesses now and that consumers, with government handouts in their pockets, are willing to spend. Berkshire Hathaway, being a major conglomerate, is a good indicator of for US business, inflation, and sentiment. Last month we highlighted the expectation of higher inflation readings in the short term that are expected to dissipate, but that is not what Buffet and Munger are seeing, they are seeing a sustained rise in inflation pressures.

The RBA in its recent policy statement upgraded everything, except inflation expectations. The CBA is of the view that inflation and wages growth will not remain dormant against a backdrop of quickly tightening labour market, very strong growth in domestic demand and some supply constraints. The RBA will be keeping an eye on wages growth as key to their inflation crystal ball gazing. As seen in the chart, wages growth is far from spiralling out of control. The CBA argues that so long as the Australian borders remain closed, net overseas migration will remain non-existent so virtually impossible to recruit from abroad to fill skills shortages. The RBA acknowledges this and states "a sustained period of economic recovery could lead to wages pressures emerging more quickly if new labour supply remains constrained, particularly in foremost areas of domestic skills shortages and where sustained time is involved in upskilling domestic workers". It seems there is more to keeping the boarders closed than just COVID-19.



Meanwhile, the NAB Monthly Business Confidence Survey for April 2021 revealed confidence and conditions have hit new highs. Business confidence and business conditions are at all time highs with trading, profitability, and employment also at all time highs. The expectation is that favourable conditions will remain in the near term. Looking forward, indicators such as forward orders and capacity utilisation also topped previous highs. The strength in capacity utilisation points to an expansion in business investment and ongoing hiring. Reported cashflow has maintained its strength over recent months and the survey measure of capex is also at a new high – suggesting that the strong expectations for business investment in the NAB Quarterly Survey may be beginning to materialise. Price pressures appear to be building with survey measures trending higher, but for now official measures and the inflation outlook remain soft. This is consistent with the US economy and Berkshire Hathaway's report.

Finally, the Federal Government on Tuesday 12th of May will release its budget. We know that the budget bottom line will be greatly improved due to significantly higher commodity prices. This allows the Government to add yet more stimulus. Some of the fiscal spending has been pre-announced like to $10b spend on infrastructure. Investors will also be interested in further relation of superannuation contribution rules. We look forward to the details and providing clients and with an update at our Smart Investor Market Update on the 18th.

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Sources: Commbank Global Markets Research, RBA, Morningstar, NAB Business Survey.