WILSONS

US CPI Peaking but Stubborn

Our weekly view on asset allocation.

16 May 2022

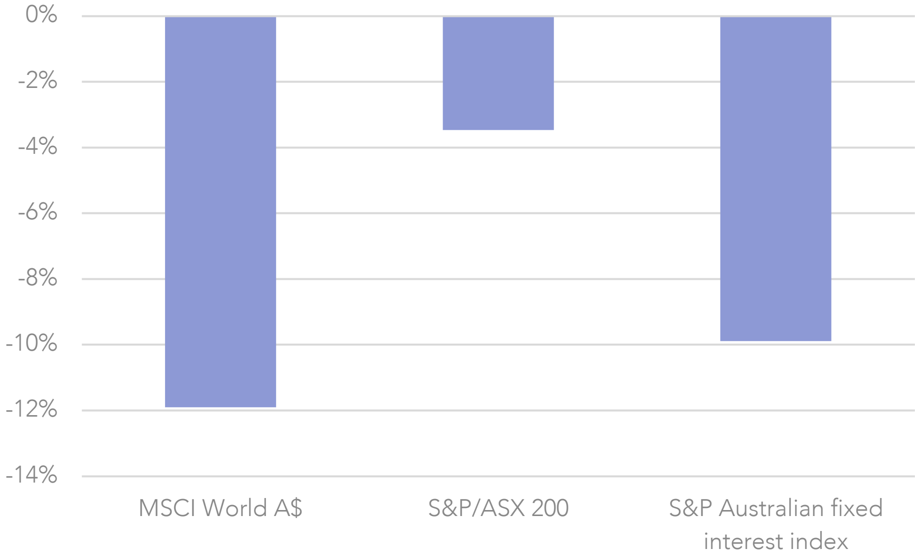
Inflation and Rate Concerns Persist

So far, 2022 has been a tough year for investors, with both equities and bonds delivering negative returns.

The Australian equity market has fared better than global equities but is still down 3% in total return terms YTD (May 11).

While the list of concerns has been growing (inflation, Russia/Ukraine, China growth), front and centre has been the fear that high inflation will prove structural, forcing overtly tight central bank policy and raising the risk of a recession next year.

Figure 1: Equities and bonds both under pressure this year (YTD total returns to May 11)



Source: Refinitiv, Wilsons.

The Inflation Peak is In (Sort of)

In this respect, last week's US inflation read will keep the markets on edge about the inflation outlook and Fed policy. The US CPI report was on balance disappointing but something of a mixed bag.

On the positive side, headline inflation CPI fell in both year-on-year and month-on-month terms. The year-on-year pace fell from the March 40-year peak of 8.5% to 8.3%.

In month-on-month terms, the fall was more significant, increasing only 0.3%, albeit after a 1.2% month-on-month spike in March.

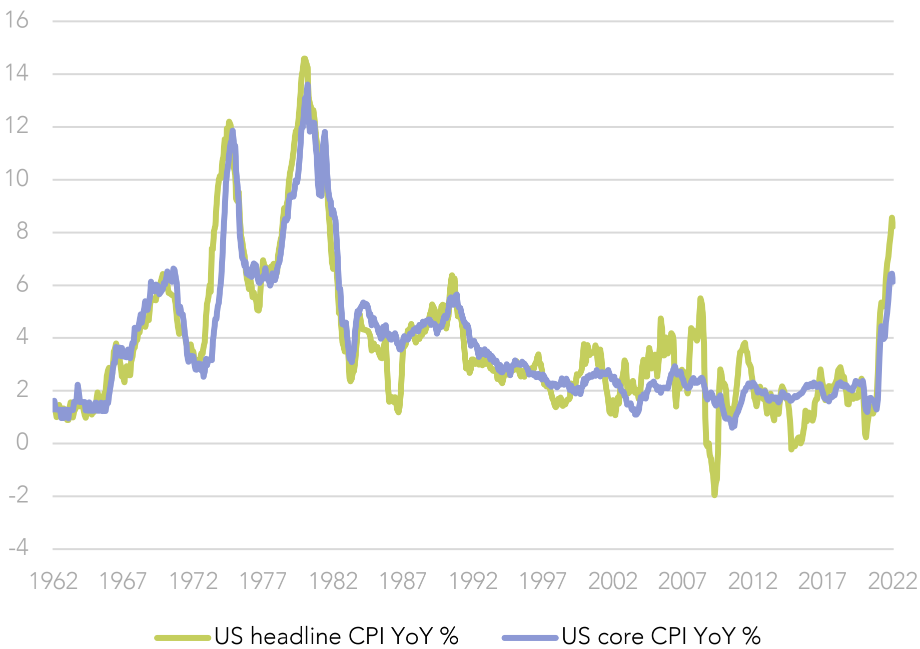
Core inflation also fell in year-on-year terms from 6.5% to 6.2%.

So, the very broad trends show some moderate easing in inflation pressures, though from very elevated peak levels. The prospect that we have now passed the year-on-year peak in US inflation seems very likely.

On a less positive note, some aspects of the report will likely keep markets on tenterhooks.

Firstly, the headline and core results were still moderately above consensus, which was 8.1% for headline.

Figure 2: US inflation is peaking but is still proving stubborn



Source: Refinitiv, Wilsons.

This repeats the trend in play for much of the last 12 months, where inflation pressures have tended to surprise professional forecasters to the upside. While this was mostly shrugged off last year as a transitory phase, it is now causing significant market angst.

In addition, the closely watched "core" measure actually rose in month-on-month terms to 0.6%, following last month's much slower 0.3% pace.

Significant price increases for shelter (a sizeable 56% of the total CPI basket), airline fares, and a fresh jump in new car prices were the main contributors to the core bounce.

After a dramatic acceleration over the past year, core goods prices are clearly decelerating (which is the core of the lower inflation thesis). However, to complicate matters, a few categories (e.g., new cars) are bouncing again. At the same time, core services have accelerated to an uncomfortable level (4.9%) and will likely prove sticky.

Wages are a key component of services inflation, and they have been rising at a very solid clip. As evidenced last week, there are signs of a peak in the US data, but wage growth remains uncomfortably high for now.

We still see enough moderation in April and recent reports to suggest that inflation is and will continue to moderate.

Base effects are clearly helping the year-on-year trend and will continue to do so, but the month-on-month buoyancy of some CPI segments is still troublesome.

The Path to Lower US Inflation

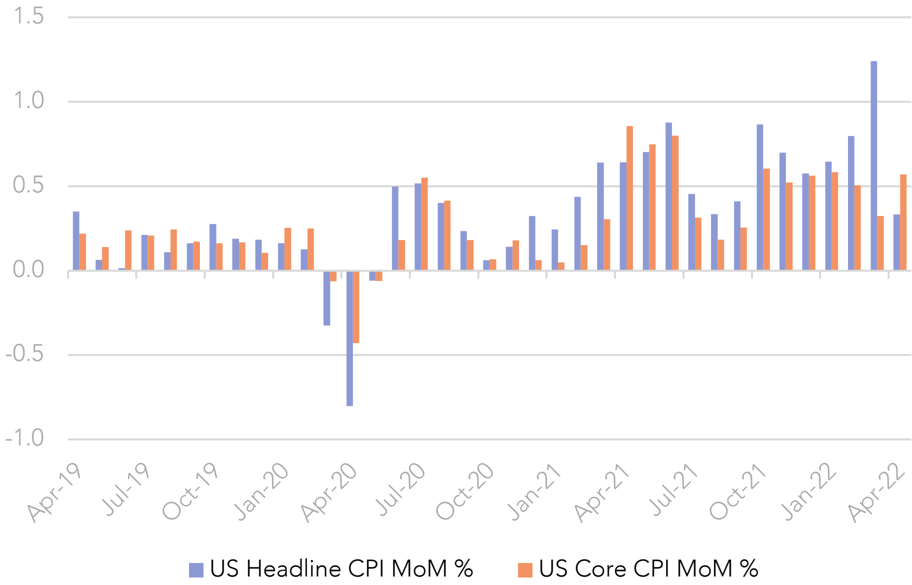
Beyond higher base effects, a number of factors should help US inflation grind lower over the coming year.

- Slower growth will normalise excess demand pressures.
- The changing consumer mix from goods to services will help alleviate acute core goods inflation.
- An improving supply chain will also alleviate acute core goods inflation.
- Likelihood of flatter to lower trends in oil and food prices should significantly lower core inflation and input cost pressures.
- A less tight labour market will provide some help to services inflation.

However, for now, inflation is fading reluctantly and sporadically, and that will continue to worry the Fed. This will keep the market on edge in respect of Fed policy and 2023 recession risks.

So, our central view remains that US inflation has now peaked and will trend significantly lower over the coming year, quite plausibly back below 3%. This should ultimately calm markets and allow a soft landing for the US economy.

Figure 3: Mixed picture. headline collapses but core spikes (month on month)



Source: Refinitiv, Wilsons.

Figure 4: Core goods Inflation has now peaked. We expect a big decline over the coming year

Source: Refinitiv, Wilsons.

Figure 5: Services inflation is still rising. We expect only a moderate decline in services inflation over the coming year

Source: Refinitiv, Wilsons.

However, it will take some time, and the markets have clearly grown impatient and nervous.

While a soft landing for the US still seems a plausible central case, risks of a hard landing have risen, given the step-up in central bank rhetoric to prioritise inflation control. Central banks rarely set out to cause a recession, but they often do. Our base case for more evidence of easing inflation should allow the Fed and investment markets to calm, over the second half of the year. However, it will likely be a gradual stop-start process with not insignificant tail risks (e.g., Russia/Ukraine, China slowdown).

Near-term Volatility But a Path to Calmer Markets Still Visible

Current markets are on edge but we take heart from several factors.

US (and Australian) economic conditions remain reasonably robust. Recent economic data has remained solid, and the US profit season was still quite decent. Markets are trying to work out where the economy will be a year from now, although at present there is no worrying deterioration. Growth will slow, but that is completely expected and indeed desirable from the perspective of helping relieve inflation pressures.

Valuations in equities and bonds look much better. Bond yields are showing tentative evidence of peaking, which ultimately should support stocks as long as the growth outlook is reasonable. We now see good value in Australian bonds while US bonds look roughly fair value. Credit spreads have widened but are not at stressed levels. Market expectations of the long term outlook for inflation also remain under control.

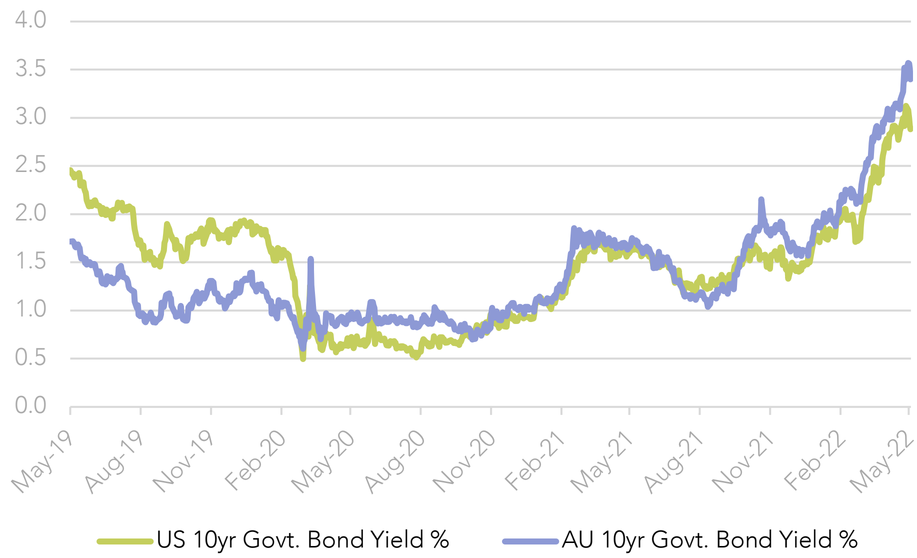
Analysis from investment bank UBS suggests equity positioning has shifted to bearish/underweight, which is bullish from a contrarian perspective.

We retain some near-term caution given the less than stellar inflation read and potential risk of further market deleveraging, but our base case for the next 12 months remains constructive, with fixed interest now looking like a plausible investment destination alongside equities and alternatives. A well-diversified high-quality balanced portfolio is the most appropriate investment stance in our view.

Figure 6: Tentative signs of a wage growth peak

Source: Refinitiv, Wilsons.

Figure 7: The bond selloff has been brutal but Australian bonds in particular look good value now



Source: Refinitiv, Wilsons.

Figure 8: Long-term market inflation expectations look to have stabilised

Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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