WILSONS

Can the World put the Inflation Genie Back in the Bottle?

Our weekly view on asset allocation.

28 March 2022

Why Inflation has Surged

After decades lying dormant inflation has picked up dramatically in most major economies over the past 12 months.

Australia has so far lagged this inflation surge, though we expect local inflation to accelerate significantly through the first half of this year.

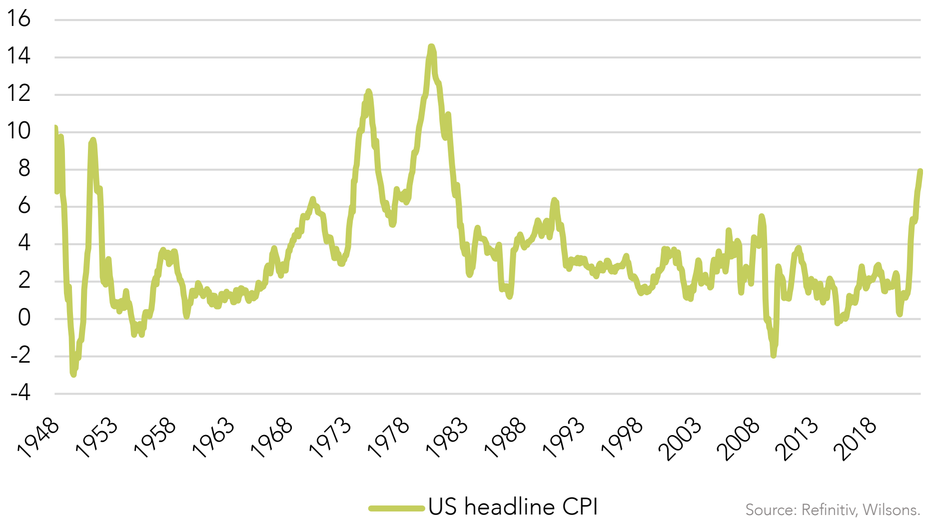
US inflationary pressures appear to be particularly acute, with the US headline inflation recently hitting a 40 year high of close to 8%. We expect US inflation will move higher again in March to peak at around 8.5%. While we see the March reading as the likely peak and expect a significant easing in the inflation rate over the next 12 months, there is still considerable uncertainty around the extent to which inflation eases from its current torrid pace.

So why has the inflation rate surged over the past year?

The recent increase in inflation appears to have been driven by a confluence of several inter-related factors including:

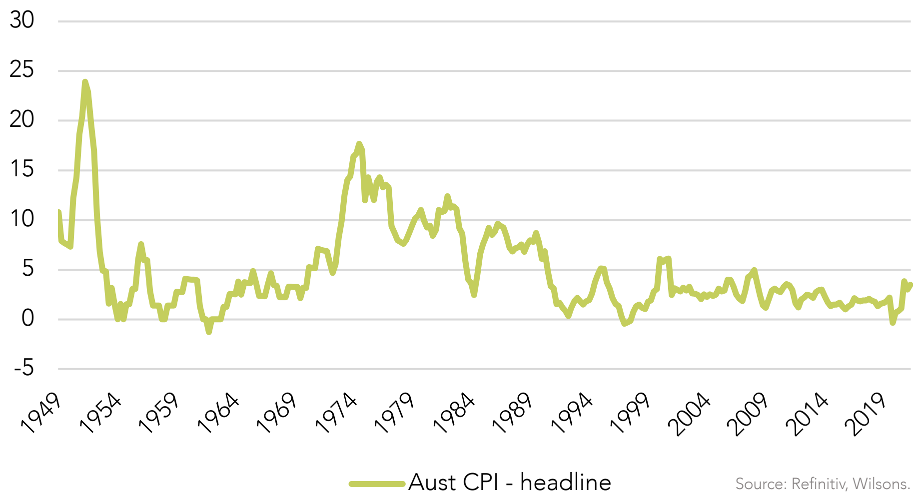
1. A significant disruption to the global supply chain.
2. Unprecedented policy stimulus fueling above-trend demand.
3. A significant shift in consumption toward production constrained goods markets.
4. A surge in the cost of energy and other key commodities, most notably "soft" commodities.
5. A rapid tightening in labour market conditions.

Exhibit 1: US headline inflation has surged to a 40 year high



Source: Refinitiv, Wilsons.

Exhibit 2: Australian inflation has picked up less dramatically. We expect a sharp near-term pickup



Source: Refinitiv, Wilsons.

Is the Low Inflation Regime Dead?

While space restricts a detailed analysis of each of these five inflation drivers, at the heart of the current debate is whether these five factors pushing up inflation prove to be transitory or structural.

We still side with the view that the inflation surge is more transitory than structural, though we believe both transitory and structural drivers are likely at play.

One important distinction we feel is that a "transitory" inflation impact does not have to be extremely short-lived in terms of having an impact of just a few months. Some of these inflationary impacts could persist for more than 12 months but ultimately still prove "transitory".

Of course, markets can grow impatient, and indeed last year we highlighted "inflation impatience" as a key risk for markets in the first half of 2022.

Read Stagflation - Should Investors be Worried?

A Fair Portion of Inflation Could Still Prove Transitory

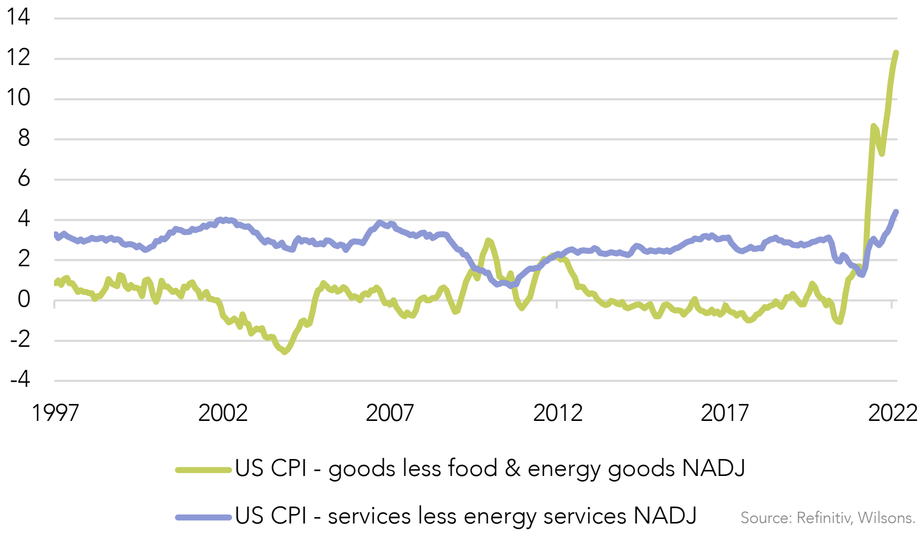
The concept of distinguishing between core and non-core inflation originated in the 1970s as the oil price surged ahead of broad price indices. The idea that the oil shock of the 1970s was a temporary influence on the inflation environment proved wide of the mark. Surging energy prices helped ignite a decade-long price and wage spiral that drove both headline and core measures of inflation to multi-decade highs.

Notwithstanding this rather unnerving historical caveat, we think the concept of distinguishing between headline and core inflation still has merit. In short, while there are some parallels, we do not think we are facing a "back to the 70s" inflation scenario at present. Certainly, as was the case in the 1970s, the energy markets are front and centre in the recent inflation surge. Being commodity price-driven, energy and food price inflation is inherently more volatile than the trend in "core prices". While the risk of food and energy-driven inflation spilling over to wages and core inflation cannot be dismissed, we think the risk of a genuine sustained wage-price spiral is fairly low. We still think the most likely scenario is for energy and food prices to ease over the coming year, with a high potential for a negative contribution to the inflation rate later in the year and or in early 2023.

The other key surge in US inflation over the past year is in what economists call "core goods" inflation. This is really another name for manufactured consumer goods. Problems with the global supply chain as well as unusually strong demand for goods during the pandemic (in place of COVID impacted services) are the key culprits here.

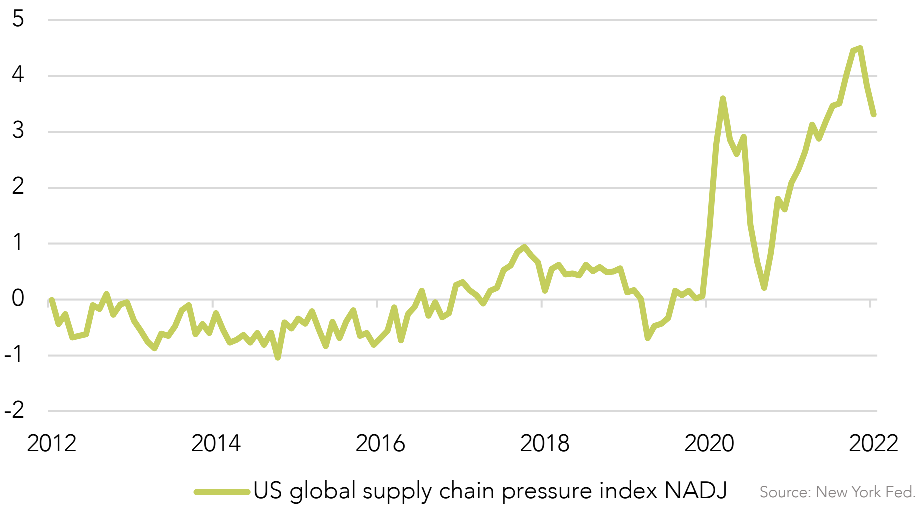
It is stark how closely the US core good inflation measure correlates with the pandemic (exhibit 3). It is currently running at 12% after averaging close to zero over the past 25 years as globally cheap goods, mostly manufactured in Asia, flooded the economy.

Exhibit 3: Core US goods inflation has surged. Services CPI has picked up less dramatically



Source: Refinitiv, Wilsons.

Exhibit 4: Supply chain pressures remain elevated but seem to have peaked



Source: New York Fed.

Once again, we see reasonable prospects for this measure to turn negative over the coming year as supply chains unblock, stimulus-fuelled growth fades, and the demand for manufactured goods shifts back to more normal patterns.

The fading of the inflationary pulse in food, energy, and broader goods inflation components of the CPI is likely the key to inflation coming back down toward more moderate levels. As a result we expect US inflation to more than halve over the coming year.

To a large extent we think this transition is more an issue of timing. Of course, the Russia/Ukraine situation has made the timing of the inflationary deceleration more uncertain.

The Danger Inflation is Already Re-ingrained in the System

There are other forces within the inflation picture that might keep inflation above "target" levels over the next few years to which we now turn. One cautionary trend is the broadening trend of rising prices beyond energy, food, and manufactured goods. Inflation seems to be well and truly seeping into services as well.

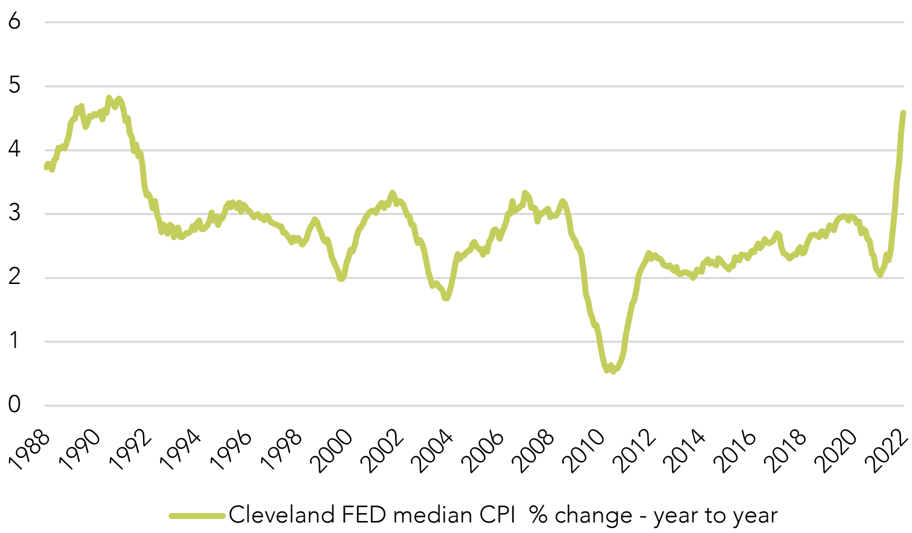
Alternative measures of inflation that focus on the "central tendency" of inflation, such as the Cleveland Fed measure of median US inflation has risen to well over 4%. So, the claim that just a few outlier categories are driving inflation does not have the same validity as 6 months ago. "Outlier categories" (e.g. oil, food, and car prices) are still making a significant contribution to the 8% US headline rate. However, a median inflation rate of more than 4% is cautionary in indicating there is a fair amount of breadth in the inflation pulse.

While we think the pick-up in services inflation may prove stickier than the spike in oil, food, and manufactured goods, we believe an overstimulated US economy is a factor in the high services inflation. Higher interest rates and fading fiscal stimulus should cool the US economy over the coming year and see some ebbing in services inflation in key areas such as housing costs. However, we concede sticky services inflation is a key risk to monitor.

Wages growth is the other key risk to inflation. US Wages growth is elevated with a number of measures running at close to 6%. There has been a remarkably quick recovery in the labour market in this cycle, with US unemployment spiking from 3.5% to 15% in the heart of the pandemic before recovering dramatically to drop back to below 4%. In comparison, post the GFC, the US unemployment rate took 8 years to return to pre-GFC levels compared to less than 2 years this cycle.

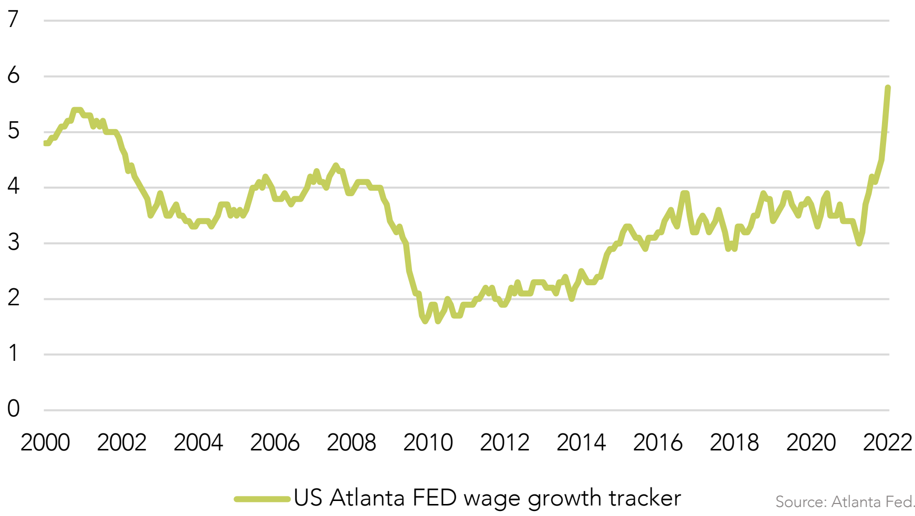
A decline in the size of the labour force is a contributing factor. The participation rate is markedly lower compared to pre-pandemic levels. Workers remain reluctant to return to work in some sectors (e.g. hospitality) and within some age categories (over 55s).

Exhibit 5: Alternative measures of US CPI suggest inflation is now quite broad



Source: Refinitiv, Wilsons.

Exhibit 6: US wage growth is elevated



Source: Atlanta Fed.

Exhibit 7: US bond futures are still not pricing high inflation over the long-term

Source: Refinitiv, Wilsons.

We expect workforce participation to improve over the coming year and migration should return as a balancing item. Labour market tightness should ebb a little over the coming year though we expect unemployment to remain very low. So wages remain a key risk factor to monitor. We believe a price to wage-price spiral is unlikely but cannot completely rule out this dynamic being a contributing factor to stubbornly high inflation this year.

Investing Against an Uncertain Inflation Backdrop

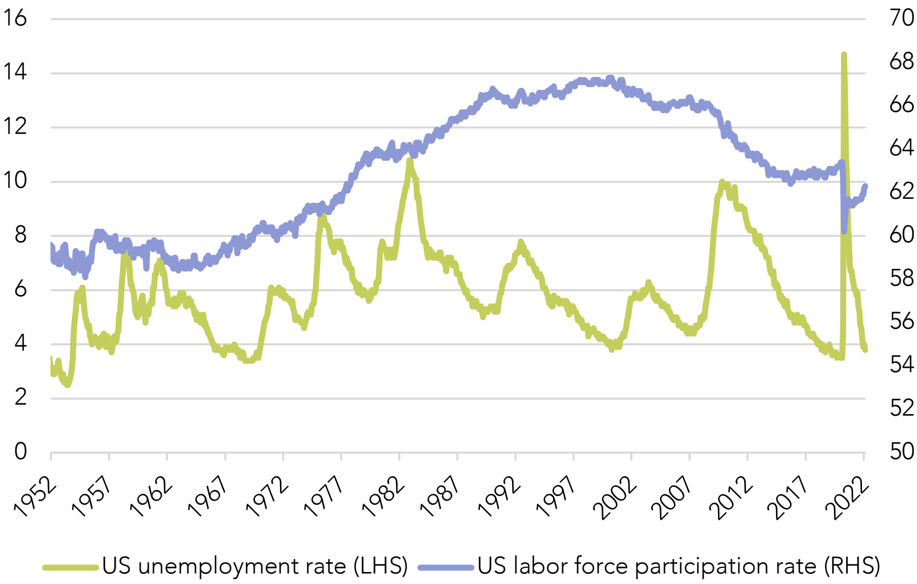
We still think a decline in energy, food, and manufactured goods price inflation will ease pressure significantly over the coming year. We believe there is a reasonably strong chance that US inflation will peak in March and at least halve by the end of the year.

Australia is in a slightly different position with a significant pick-up in inflation likely still ahead of us over the first half of this year. However, a likely peak of around 5% is likely versus over 8% in the US, with easing pressure beginning in the second half of this year. The RBA is likely to hike 2-3 times in the second half of this year, well short of the 7 hikes expected from the Fed.

Global inflation is taking longer to come down than expected and the Russia/Ukraine-induced commodity shock is adding to upside pressure near-term. Wage pressure is an additional source of risk over coming quarters with the potential for feedback into the corporate cost base. A 1970s wage-price spiral is unlikely, though some feedback from prices to wages and back into prices seems inevitable.

The global supply chain is improving and should improve further, notwithstanding the impact of Russia/Ukraine and China's recurring COVID outbreaks. Consumption patterns should encourage a significant drop in goods price inflation over the coming year; however, with so many moving parts, the extent of the inflation decline of the next 12 months is still an open question.

Exhibit 8: The US has returned to full employment remarkably quickly



Source: Refinitiv, Wilsons.

We expect enough easing in inflation to keep equity markets moving higher over the next 12 months but are alert to the risk case of a more stubborn trend than currently priced by bonds and equities.

The prospect of a moderate (3%-4%) inflation regime rather than a return to outright low inflation seems logical. We stay moderately overweight stocks (tilted to Australia) and significantly underweight fixed interest, though higher local yields are becoming more interesting.

We continue to be overweight floating rate (private) debt and retain some additional inflation hedges (real assets and gold) for the risk that inflation proves more stubborn than our base case.

Disclaimer and Disclosures

Recommendation structure and other definitions

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

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