An Australian equity manager perspective

Current inflation: transient or persistent?

September 2021

frontier

Summary

Current inflation: transient or persistent?

- Frontier surveyed over 40 active Australian equity managers to compile a broad market view on the outlook for inflation
- Over the 12 months to 30 June 2021, CPI rose 3.8%, the fastest annual pace of inflation growth in almost 13 years
- The overwhelming view from our active Australian equity managers is that inflation will be transitory with the short-term spike driven by constraints in supply chains and expansionary monetary policy
- Vaccines remain a key component of the debate on whether inflation will be transient or permanent as it is the cornerstone of the national reopening plan
- Collectively the managers surveyed thought re-opening may curtail some inflationary forces (as a result of supply chains opening up), although with household savings having increased and a potential increase in economic activity on re-opening, doubts remain on the precise future inflation path
- Managers also expect that interest rates will remain at or close to all time lows, even if the RBA needs to hold the rates low
- Despite these views, we observed that most manager portfolios had exposures expected to be resilient if inflation or interest rates rises persist – this makes sense to us as managers aren't experts at forecasting macro factors

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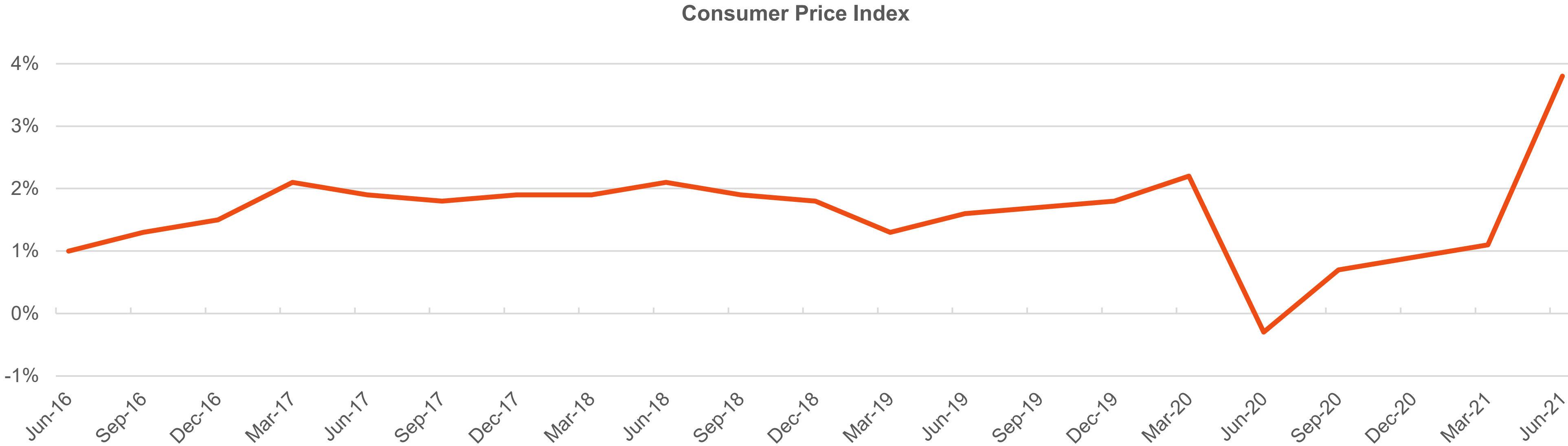
Why the spike in inflation?



Source: ABS

- Over the 12 months to 30 June 2021, CPI rose 3.8%, the fastest annual pace of inflation in almost 13 years.
- According to Australian equity managers, the overwhelming view is that inflation in the near term has increased predominantly due to temporary labour shortages and raw material price increases driven by border closures, lockdowns, supply chain disruptions and increased freight cost.
- Expansionary monetary policy and government stimulus activities were also mentioned as contributing to the near-term spike in inflation.

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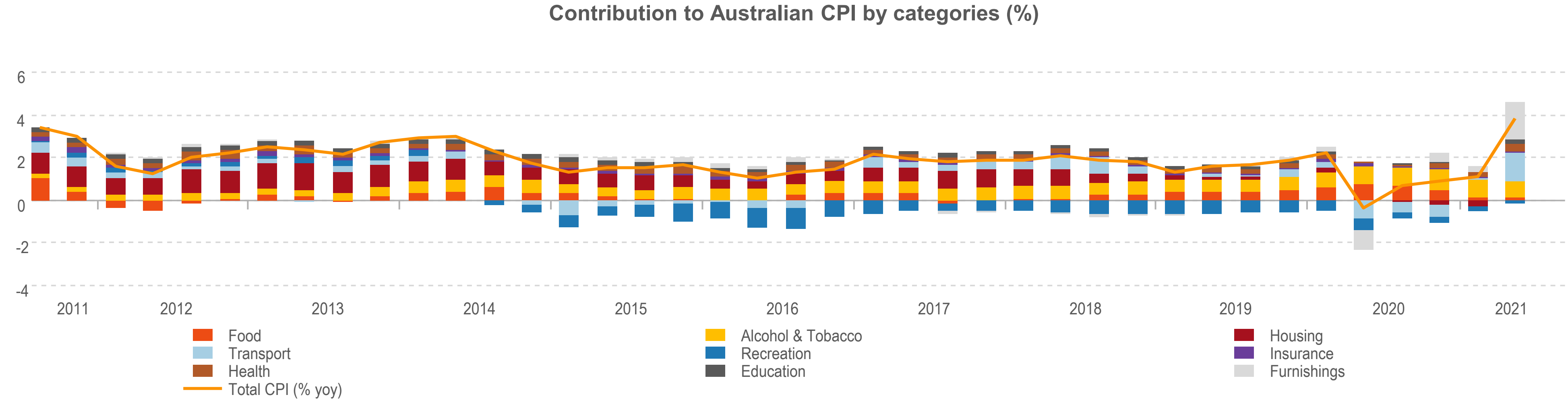
Inflationary drivers



Source: Refinitiv Datastream

- The general consensus of the managers we surveyed is that the spike in inflation is a short term/transient spike driven by supply bottlenecks which has caused an increase in prices across a raft of goods and services.
- The above chart breaks down the contributions to inflation. A significant proportion of the spike in inflation is due to transport and furnishings – factors that align with those views of managers around bottlenecks.
- However, there is a view from the managers Frontier surveyed that the trajectory of government deficits as a result of the pandemic may prolong the inflation increase. If the government continues with its stimulus longer term, then inflation could become permanent.
- Vaccines also remain a key component of the debate on whether inflation will be transient or permanent. Vaccination rates will have a significant impact on many of the drivers of inflation as they will influence the reopening the economy. Reopening is expected to address many of the trade constraints and reduce government spending and stimulus.

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More details from Australian equity managers

The overwhelming majority of active Australian equity managers stated that the current spike in inflation was transitory. The broad view of the survey participants was that this transitory nature was mainly driven by the following factors:

- Global and domestic supply constraints:
  - The supply constraints have driven up the cost of commodities, including raw materials and oil
  - Freight costs remain elevated due to global restrictions, further compounding supply costs
- Consumer confidence:
  - Consumer companies are pointing to price increases being passed on to the consumer to offset cost inflation. This has been evident in both US company and Australian results
- Government deficits and supply of government debt:
  - Increased level of government spending through COVID-19 stimulus packages
- Central bank intervention:
  - Interest rates are expected to remain at historically low levels for the next couple of years, and that that longer dated hikes (from 2023) will be a gradual process

In the last 3 months to 30 June 2021, it was noted that we have seen some peaking of key commodities, including lumber falling 45% from the peak and copper retracting significantly from its peak. While many commodities remain elevated, we should not expect commodities to sustain the peak levels we have seen so far in 2021. It is expected that the impact on commodities will be more transitory in nature as supply chains normalise with the rollout of vaccines in a post COVID-19 environment.

Australian equities managers see the current spike in inflation as temporary in nature and the expectation is that inflation will fall once mass vaccination in key geographies enables normal travel and people movement.

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What are the risk of higher inflation being permanent?

Despite the overwhelming view that current inflation is likely to be transitory, Australian equity managers still see a number of risks that could see the spike in inflation persist.

- Managers suggested several factors could lead to a structural change and permanent increase to inflation:
  - If the government fails to curtail spending and the deficit continues to grow
  - Short-term supply constraints morph into a longer-term supply issue (continued raw material price increases)
  - Sustained wage inflation. While there is no evidence of wage inflation as yet, there is wide political appetite to increase minimum wages in places like the US and some European jurisdictions

With regards to interest rates, there was little concern about significant interest rate increases occurring.

- Managers expect that interest rates will remain at or close to all time lows, even if the RBA needs to hold the rates low
- In the eyes of Australian equities managers, it seems the presence of the RBA in controlling interest rates will limit the scope for significant interest rate increases to occur any time soon

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Australian equity managers and portfolio positioning

Despite the overwhelming view that current inflation is likely to be transitory and the expectation that interest rates would remain low too, we observed that most manager portfolios had exposures expected to be resilient if inflation or interest rates rises persist.

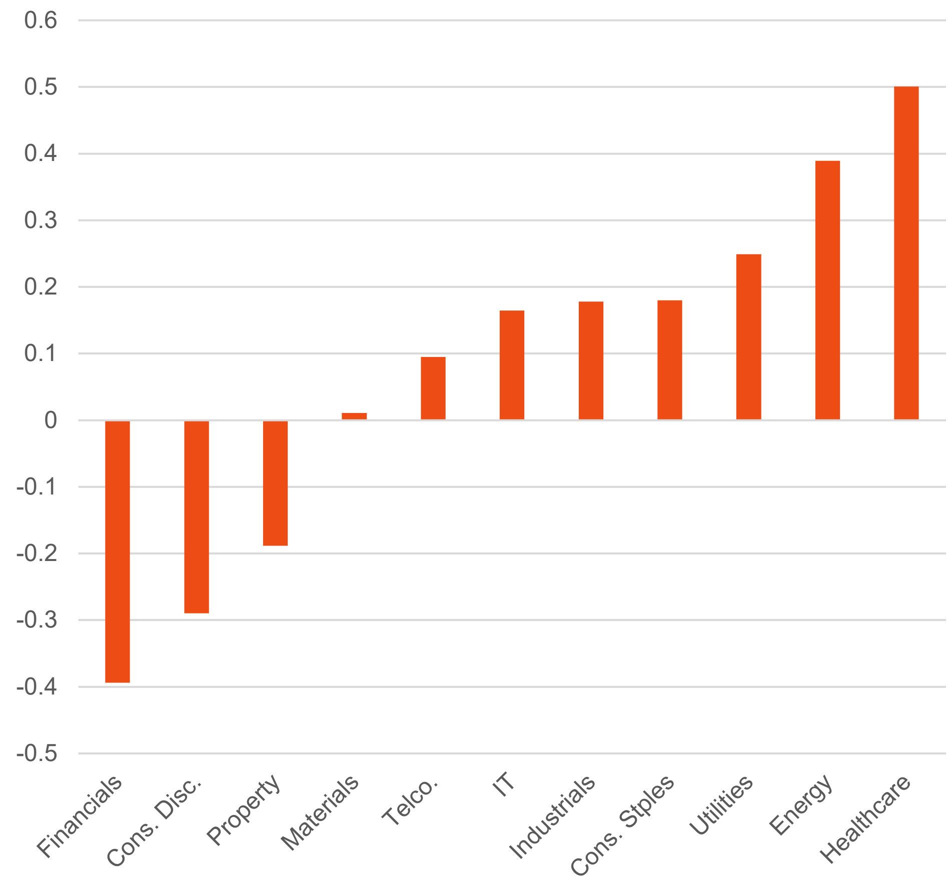
- Managers regularly listed their portfolio exposures that would benefit if inflation persists or interest rates rise
- As one regularly mentioned example, some managers believe they are positioned to benefit from rising inflation by being overweight energy and mining

Overall, Australian equities managers do not want their portfolio positioning to hinge on getting their inflation (or interest rate) call correct. This makes sense to us as managers aren't experts at forecasting macro factors.

For those seeking inflation protection, what does a portfolio look like that is likely to have resilience if inflation rises sharply?

- Based on Australian GICS sector data from 2001, the types of sectors that tend to do well in rising inflation are Healthcare, Energy, Utilities, Industrials, and Consumer Staples. Commodities, which are part of Materials, also tend to do well in inflationary environments
- Interestingly, we have looked at US and global data and this correlation profile is not the same elsewhere (e.g. while Energy is certainly correlated with rising inflation, we observed that Healthcare is not)
- Our expectation is that value manager portfolios are more likely to be overweight the sectors most suited to an inflationary environment (particularly commodity related)
  - While growth portfolios may own stocks with the greatest pricing power, we note this feature mostly helps offset inflation on the cost side, rather than being a benefit in an inflationary environment

Correlation between S&P/ASX 300 GICS sectors and Y/Y% change PPI minus headline CPI (July 2001 – June 2021)



Source: Bloomberg

Note: Purchase Price Index less Consumer Price Index i.e. the degree to which inflation is absorbed by a company and not passed on via price increases. The graph shows those sectors whose relationship moves more in sync with inflationary increases versus those which do not.

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Level 17, 130 Lonsdale Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

frontieradvisors.com.au

@frontier_adv