JBWere

The CIO View

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Putting Wealth To Work For Generations

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The CIO View – May day, inflation strikes again

JBWere View

Last week, Australia succumbed to the blight of unfavourable inflation outcomes. But unlike its US counterpart, we don't think the RBA necessarily has the luxury of just sitting with a longer period of stable policy. The RBA has left itself with little or no tolerance for upside surprises to inflation, and the distribution of risks to both labour market and growth outcomes looks to be shifting in a slightly stronger direction. Investors should thus be attuned to the risk that further rate hikes are required in Australia.

Key Points

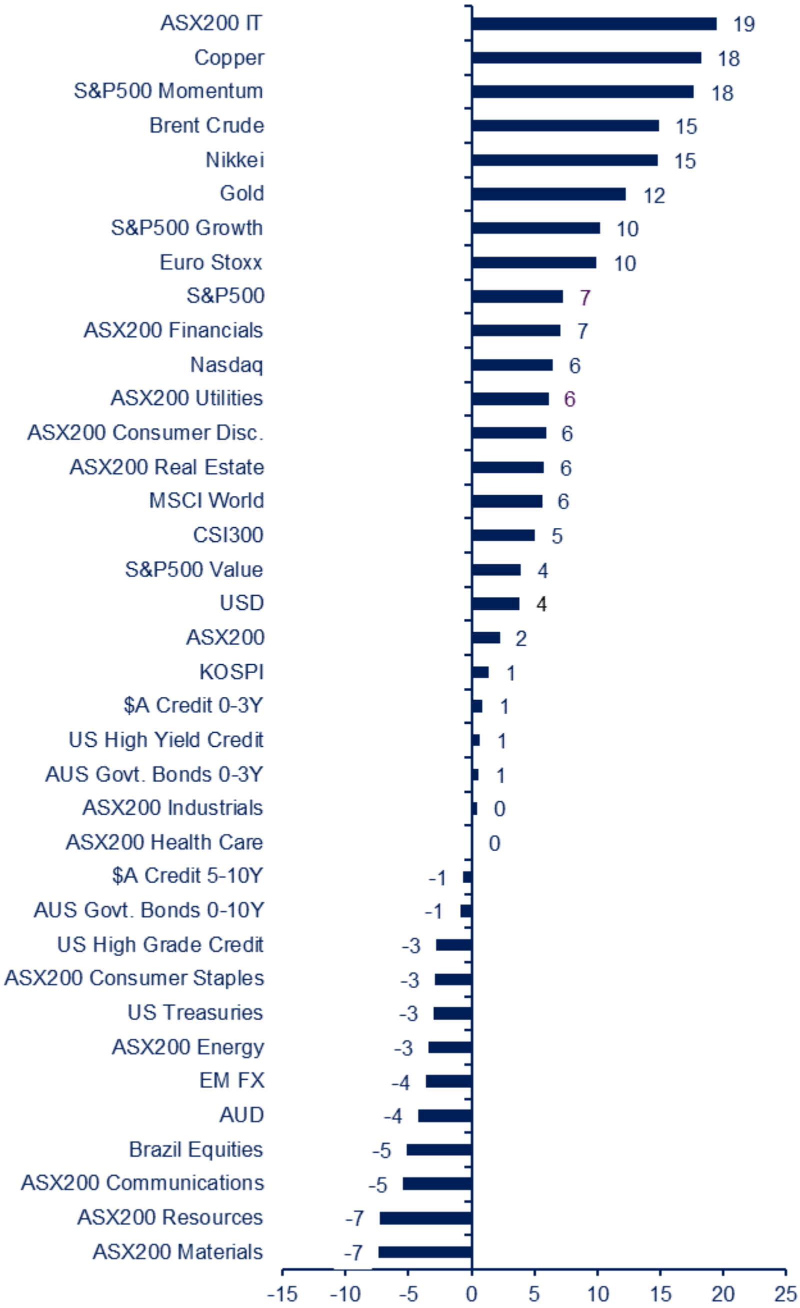
- Australian inflation printed stronger than anticipated for the first quarter of 2024. In next week's *Statement on Monetary Policy*, the RBA will likely revise *higher* near-term inflation forecasts and revise *lower* near-term unemployment rate forecasts. Both inflation and the labour market have been stronger than anticipated in the first three months of the year.
- A consequence of the RBA's current approach to monetary policy – minimal labour market disruption subject to inflation returning to the target band over a reasonable time period – is that it has little or no tolerance for upside surprises to inflation. Hence we believe the Board will probably discuss the merits of a rate rise at next week's policy meeting.
- Dynamics in both Canada and New Zealand should be sending an important signal to the RBA. In these economies, unemployment rates are now over 100bp higher than their cyclical troughs and inflation is at the top of or within respective central bank target bands. Cash rates in these economies are 5% (Canada) and 5.5% (NZ); perhaps a cash rate of this magnitude was what was always required in Australia for a successful disinflation.
- The spectre of a narrower interest rate differential between Australia and the US should be supportive for the AUD, all else equal. Hence we continue to recommend appropriate levels of hedging for foreign currency exposures in portfolios. Any rise in 10Y Australian government bond yields on a firming of rate hike expectations should be viewed as an attractive opportunity to add duration to portfolios. In the meantime, there is little urgency to switch floating rate fixed income exposure for fixed rate exposure.
- From a top-down portfolio construction perspective, the prospect of more restrictive monetary policy in Australia together with a delayed start to the easing cycle in the US suggests that defensively positioned portfolios remain appropriate. The risk to this view is a return of the soft landing narrative. As we noted in our recent *Portfolio Strategy* presentation, adding some exposure to the now attractively valued US small cap sector is a good strategy to partially ameliorate this risk.

Commodities are having a solid year so far, with copper, gold and oil performing strongly

Market summary

Commodities continue to perform well in 2024, especially Copper, Gold and Oil. This out-performance has taken place against a 4% rise in the USD, forcing an unusually negative correlation between AUD performance (-4% YTD) and the commodity complex so far this year. The Nikkei (+15%) continues to out-perform European and US equity markets (in local currency terms), while the Australian stock market has only delivered lacklustre gains this year (+2%). Fixed income outcomes are mixed as bond markets absorb unfavourable news on inflation, but Australian bond indices have generally out-performed their US counterparts.

Chart 1: Year-to-date returns, selected financial assets (local currency); %



Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance. ASX200 is TR Index.

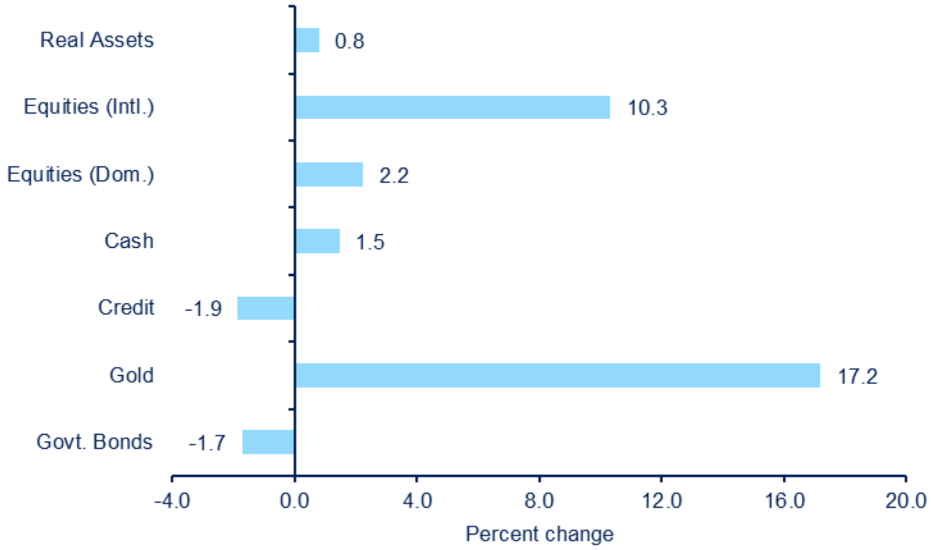
Chart 2 shows the seven asset classes we use in our Strategic Asset Allocation (SAA) at JBWere and illustrates year-to-date performance for these seven asset classes. As a reminder, the benchmarks for each asset class are as follows:

- **Cash**: weighted average of the Bloomberg AusBond Bank Bill Index (50%) and the Australian Banks' Term Deposit 1-year rate (50%)
- **Government Bonds**: Bloomberg Barclays Global Aggregate Treasuries Total Return Index, hedged into AUD
- **Credit**: Bloomberg Barclays Global Aggregate Credit Total Return Index, hedged into AUD
- **Domestic Equities**: ASX200 Total Return Index
- **International Equities**: MSCI ACWI Gross Total Return Index, AUD unhedged
- **Real Assets**: weighted average of the FTSE EPRA/NAREIT Global Index Total Return, AUD unhedged (50%) and the FTSE Developed Core Infrastructure 50/50 Total Return Index, AUD unhedged (50%)
- **Uncorrelated Assets**: we proxy using the $A price of gold

For $A multi-asset investors, global equities and gold have been the best performing assets so far this year

The combination of a rising gold price and falling AUD has been very favourable for holders of Gold in $A terms, such that Gold is now the best performing part of the multi-asset portfolio for an Australian domiciled investor. Elsewhere, international equities continue to perform well, up 10% for the year as losses in the AUD continue to provide a cushion for this asset class. Other asset classes – real assets, domestic equities, cash, government bonds and credit – have registered small gains or losses so far this year.

Chart 2: Strategic Asset Allocation – Year-to-date $A returns



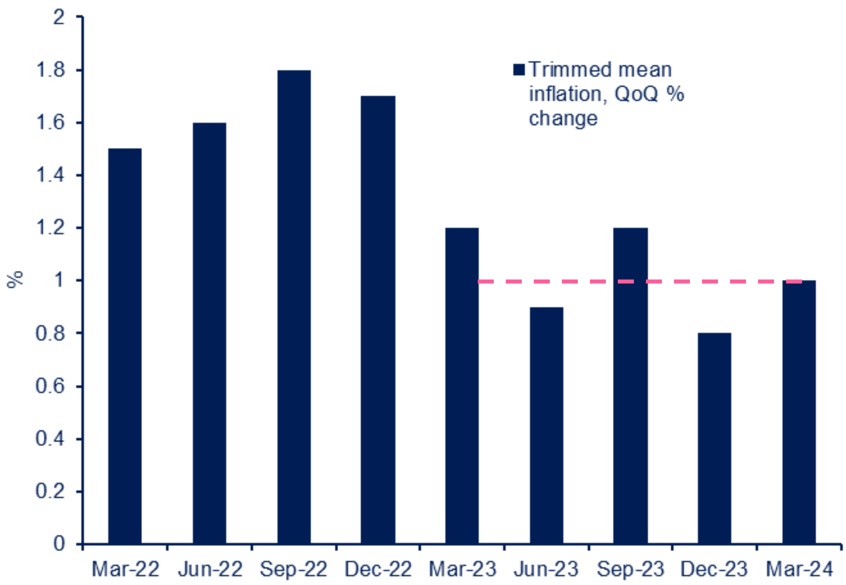
Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Inflation strikes again

After three consecutive higher than expected inflation prints in the US this year, markets have pushed back the timing of the Federal Reserve's easing cycle. **Last week, the inflation narrative changed for the worse in Australia too, with the release of the 1Q inflation data on 24th April.**

Inflation surprised to the upside in Australia in 1Q, prompting the market to reconsider the prospect of rate hikes in Australia

Chart 3: Core inflation has averaged 1% over the past 5 quarters



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Core inflation rose 1.0% in the quarter, stronger than the consensus and RBA expectation. As **Chart 3** shows, core inflation has averaged 1% over the past 5 quarters. While this represents progress relative to the outsized increases in 2022, it is nonetheless reflective of some stickiness in underlying measures of price pressures.

Markets have responded to this information by removing any chance of a rate cut from the RBA in 2024, and instead are now pricing in a modest chance of rate hike in 3Q. The Governor's strategy of "not ruling anything in or out" has been shown to be very prudent in light of recent developments.

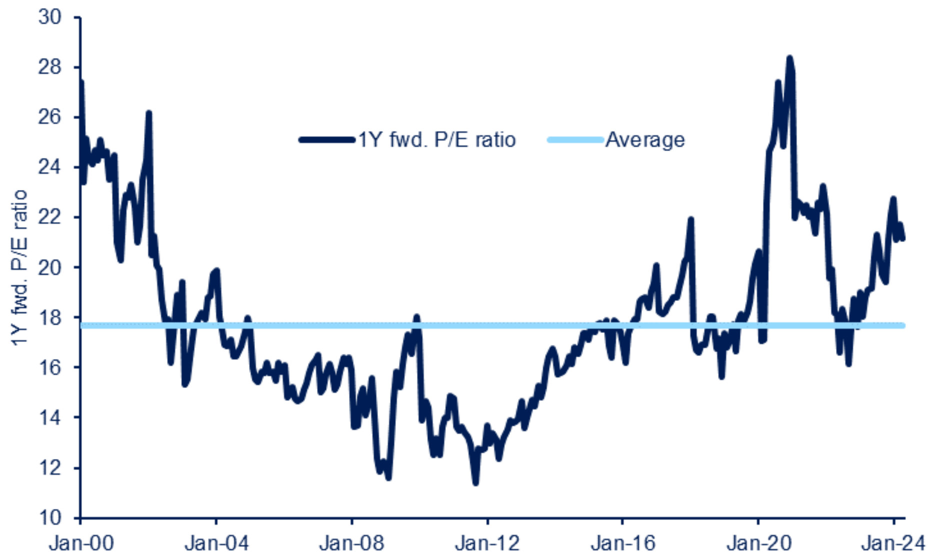
In the US, the Fed Chair has responded to the stronger inflation data of late by observing that this likely requires a longer period of stable policy than previously estimated. In other words, at the moment, the Fed won't be easing in mid-year but instead holding the cash rate target at 5.25-5.5% for longer than anticipated. We will hear more on the FOMC's thinking later this week, when the Fed Chair speaks at a post FOMC meeting press conference.

For US markets, the prospect of a higher for longer rates environment has been broadly positive for the US dollar, negative for US Treasury bonds (yields higher) and so far, neutral for equity markets at an index level. Clearly, for sectors or stocks that benefit from low rates, digesting the prospect of a higher for longer rates regime might be a headwind in coming months.

Fundamentally, it should be remembered why rates are likely to stay higher for longer – because policy makers believe that growth needs to slow by more than has currently occurred. Slower economic growth should loosen the labour market and put pressure on profit margins, all else equal. This reinforces our view that the risk/reward in equity markets is not especially attractive at present, given a 1Y forward P/E ratio of 21x for the S&P500 (**Chart 4**) and 9% (was 12%) earnings growth factored in for the year ahead.

The mix of elevated valuations, robust earnings expectations and a higher for longer rate outlook in the US suggests limited upside for equities

Chart 4: The 1Y forward P/E ratio for the S&P500 is elevated



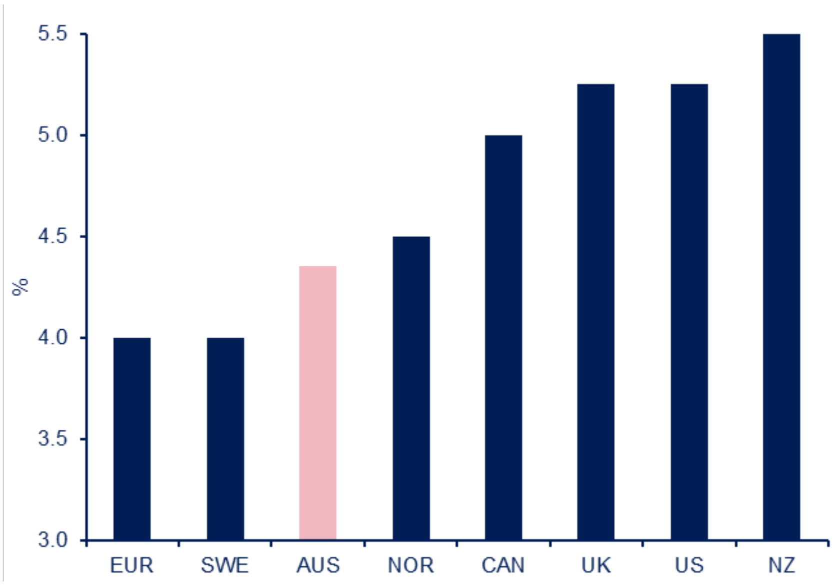
Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Indeed, with both nominal and real rates elevated and valuations already above average, multiples should be capped to the upside. With stable to lower valuations, further index appreciation thus relies on earnings growth to out-perform, which might be more challenging in an environment where policy makers see the need for slower economic growth.

In Australia, the context is rather different. The RBA has attempted to engineer an outcome in which inflation comes down over a relatively long period of time (on current forecasts, back in the target band end-2025). If successful, this allows minimal damage to the labour market, meaning the RBA can successfully tread the so-called "narrow path". To give itself the best chance of traversing the narrow path, the RBA raised rates by less than comparable peer economies, such that the level of our policy rate looks more European than Dollar-Bloc (usually defined as US, NZ, CAN and AUS) (**Chart 5**).

Australia's current policy rate looks more European than Dollar-Bloc

Chart 5: Australia's policy rate has more in common with the Europeans than the Dollar-Bloc



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

The RBA has little or no tolerance for upside surprises on inflation; the Board will likely discuss the need for a hike at next week's meeting

We have always been sceptical that a materially lower cash rate relative to peers would be sufficient to successfully engineer the necessary disinflation in Australia. And while appealing on a number of fronts, the RBA's narrow path strategy means that it has no tolerance for upside surprises in inflation. Inflation must be brought back to target over a reasonable time period, otherwise the RBA further risks its (already compromised) credibility.

So an upside surprise on inflation, as was reported last week, is consequential for the RBA. When it releases its updated set of forecasts in next week's *Statement on Monetary Policy*, the Bank will need to revise up its near-term inflation forecasts, and likely will revise down its near-term unemployment forecast. This process will reflect the fact that b**oth the labour market and inflation have been stronger than the Bank expected in the first 3 months of 2024**.

In November last year, a similar set of circumstances forced the RBA to deliver an additional 25bp rate hike.

This time around, we suspect the Bank won't rush into a rate hike, but we also don't believe the chance of a rate hike to be zero at the RBA Board meeting next week. We'd put the chance of a 25bp hike at around 1 in 3 (which is a higher probability than the market currently ascribes). Further retail weakness in March (albeit influenced by a post Taylor Swift slump in some sectors) will probably keep the RBA a little cautious near term.

We strongly believe that if the next quarterly inflation number comes in higher than the RBA expects, then a rate hike is more likely than not in August. There will be no tolerance for another upside surprise on inflation and consumer inflation expectations are still running almost 200bp above their pre-COVID average level (**Chart 6**).

Meanwhile, consumer inflation expectations remain elevated

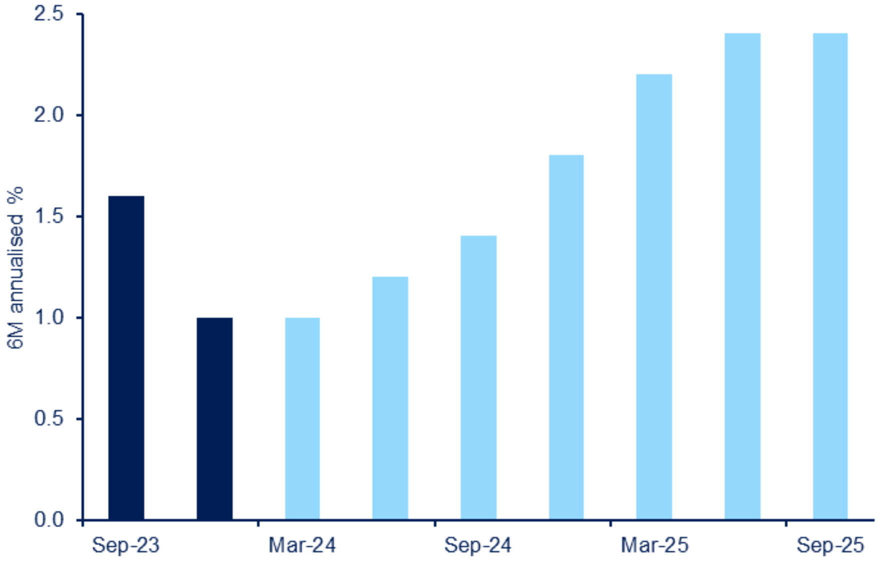
Chart 6: Consumer inflation expectations are still elevated relative to the pre-COVID average

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

The additional complicating factor for the RBA is that the growth outlook appears to be stabilising, in our view. It is possible that 1H24 will mark the trough for economic growth, as house prices continue to rise, mortgage demand remains solid, Stage 3 tax cuts are coming and real incomes growth improves (albeit gradually). Even on the consensus forecasts, GDP growth is expected to accelerate from here (**Chart 7**).

GDP growth is forecast to accelerate from here...

Chart 7: Consensus forecasts for Australian GDP (light blue bars are forecast, dark blue are actual)

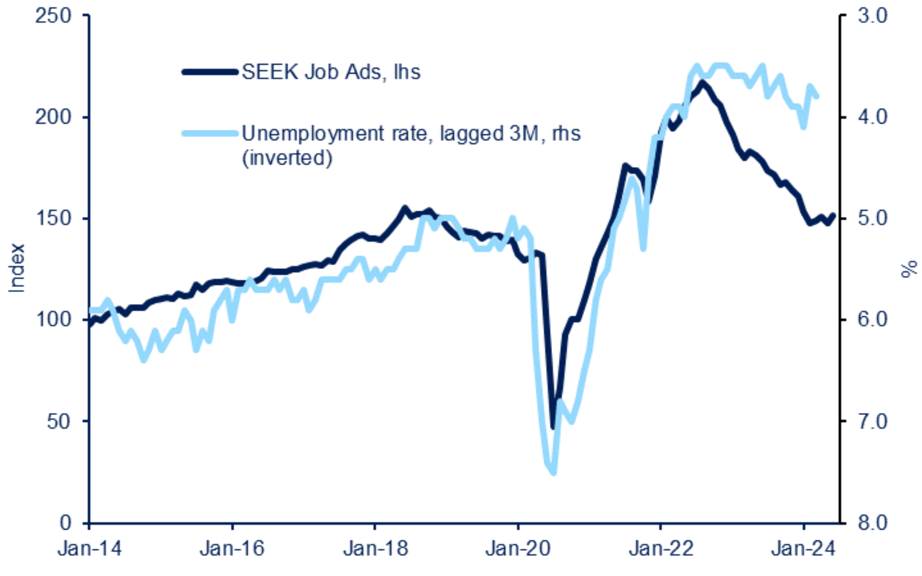


Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Perhaps more importantly, forward indicators of labour demand appear to be stabilising. Granted, it is only tentative evidence so far, but this development biases the distribution of risks to the unemployment rate lower relative to the consensus expectation.

...and there are early signs of stabilisation in forward indicators of labour demand

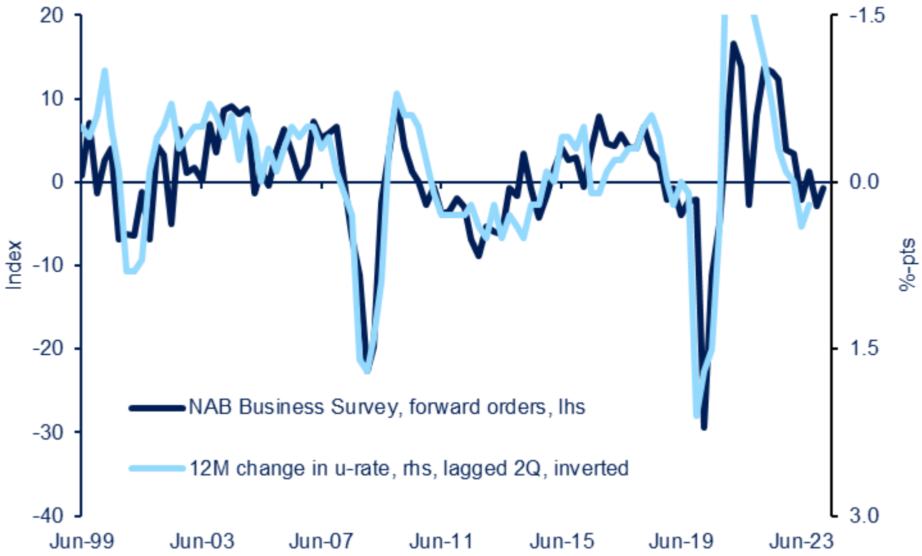
Chart 8: Early signs of stabilisation in Job Ads



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Chart 8 shows that SEEK Job Ads have stabilised in recent months, while **Chart 9** illustrates – assuming recent momentum is sustained – that the Forward Orders series from the NAB Business Survey is consistent with a broadly stable (and sub 4%) unemployment rate in coming months.

Chart 9: Further stabilisation in Forward Orders would be significant for the unemployment rate outlook



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

The combination of higher inflation and a shift to the distribution of risks to economic growth in a more positive direction are potentially quite impactful for the rates outlook in Australia

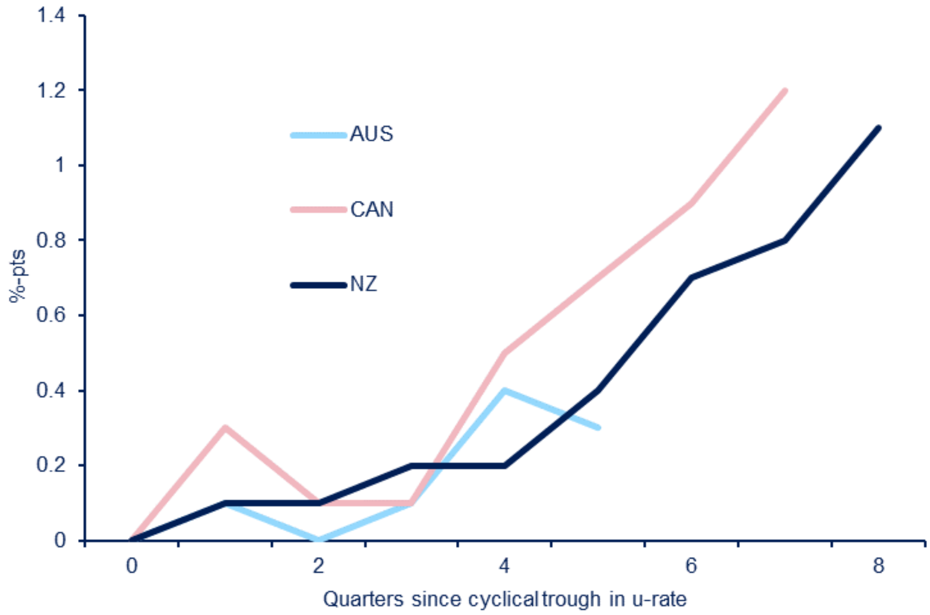
The combination of higher inflation and a shift to the distribution of risks to economic growth in a more positive direction will mean rate cuts remain a very distant prospect in Australia. Further, the impact (and shock) of higher rates will be starting to fade now that we are two years on from the first rate hike of the cycle.

The risk is rising that the RBA needs to do further work to ensure the policy setting is consistent with target-consistent inflation over a reasonable time period. For markets, we would make the following observations:

- **The AUD/USD will rise if the RBA is hiking rates while the Fed is on hold**. Interest rate differentials have already moved in favour of a stronger AUD. This is a reminder that foreign currency exposures should be adequately hedged, in our view.
- **As our colleagues in Australian equities have noted this week, higher - or higher for longer - rates are negative for cyclical stocks such as banks, durable goods, and select industrials**. Investors should also be wary of companies with high levels of debt, in our opinion. Our preference remains for IT, Healthcare, and Consumer Discretionary, specifically services.
- **Investors with floating rate credit in portfolios have little urgency to switch from floating to fixed exposures** at present.
- AUS 10Y government bond yields are currently trading in the middle of the 3.9% to 5% range that has held since the beginning of Q3 2023. **A resumption of the RBA tightening cycle will pressure yields into the top-half of this trading range, but we think that would present a very attractive opportunity to add duration to portfolios**.

From a top-down portfolio construction perspective, the prospect of more restrictive monetary policy in Australia together with a delayed start to the easing cycle in the US suggests that defensively positioned portfolios remain appropriate. By definition the fading of the soft-landing narrative implies more chance of a "less soft" landing. On this front, the experience in New Zealand and Canada is instructive. In those economies, the unemployment rate now is over 100bps above its cyclical trough (**Chart 10**).

Chart 10: The unemployment rate has risen significantly in NZ and Canada, and not really at all in Australia

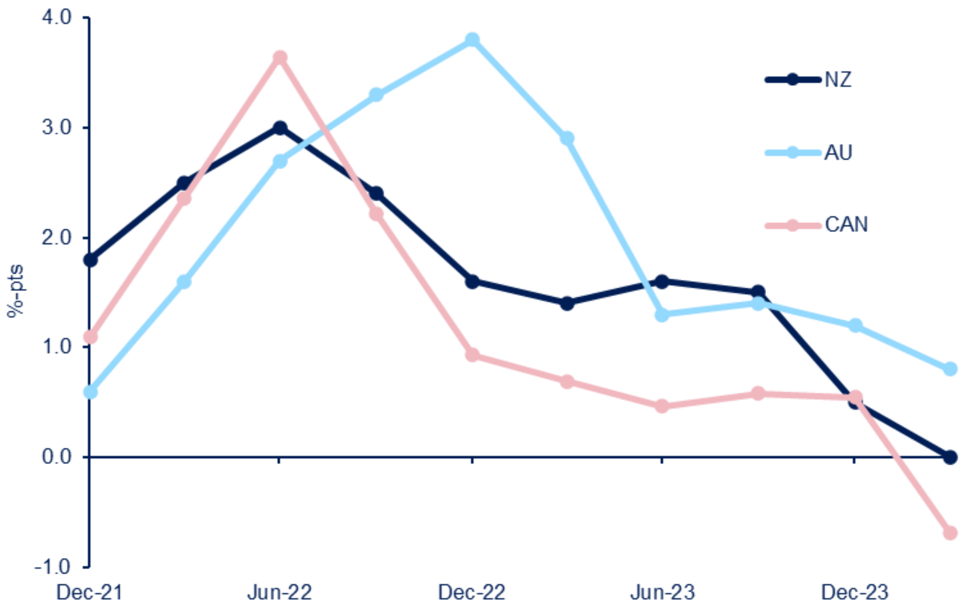


Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

There are some interesting economic signals coming from NZ and Canada, where rates are much higher than they are in Australia

On 6M annualised measures, core inflation is now in the respective target band for Canada, at the top of the target band for New Zealand but still 80bp above the top of the target band in Australia (**Chart 11**). The respective policy rates in these economies are 5.5%, 5.0% and 4.35% and in our view, reflect the fact that sacrifices are usually required (in the form of higher unemployment rates) in order to bring inflation to target-consistent levels. We are not sure there is a compelling reason as to why the experience would be so different in Australia, and so remain biased towards a more defensive footing at both an asset class and whole of portfolio level.

Chart 11: Deviation of core inflation* from the top of the target band (3%)



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance. *Calculated as the average of 6M annualised growth in the trimmed mean and weighted median measures in each country.

While a less soft landing is likely to generate some near-term challenges for equities, the silver lining is that a policy response (ie rate cuts) will be reasonably quick to emerge. Indeed, the consensus is still forecasting rate cuts in both New Zealand and Canada in 3Q despite the recent repricing in other markets of late.

The risk to our view is that the soft-landing narrative reasserts itself in the data, and that inflation resumes its trajectory towards target without requiring damage to the broader economy. Based on recent developments, we see this as more possible in the US than Australia, given relatively more favourable supply side developments in the US (productivity growth and capex spend). As we noted in our recent *Portfolio Strategy* presentation, adding some exposure to the now attractively valued US small cap sector is a good strategy to partially ameliorate this risk.

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