Inflation and Market Update from David Andrew

David Andrew
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[vc_row][vc_column][vc_column_text]Commentary and opinion will be in overdrive this week, as markets around the world react to another period of heightened economic uncertainty. In this update, I want to provide the context in what is a very challenging environment for policymakers and investors, and I want to be clear that what is happening in markets around the world, while uncomfortable, is perfectly normal. I strongly encourage everyone to tune out as much ‘noise’ as possible. Importantly, markets are operating normally as we would expect them to which means there are no known systemic risks. We fully expect that markets will continue to operate normally, and asset prices will adjust up and down based on new information.

Inflation Fears

The last time there was a major outbreak in interest rates was in the late 1980s when I'm sure many readers were first home buyers. Back then the official interest rate peaked in 1990 at 17.5% causing considerable discomfort for homeowners. Since the 1990s we have had a dream run of unbroken economic growth with over 30 years of economic sunshine. The major inflation outbreak before that was when I was in primary school! I was too young to remember the details but aware enough to recall the narrative. I have studied the causes of the 1970s inflation period and will provide some commentary on the similarities between now and then.

How we are thinking

It might be useful to share what we are thinking as we enter this period. We are not forecasters, but we try to create solid foundations in advance to provide you with the pathway certainty you need to navigate difficult times. Pathway certainty creates safety. Here's a reminder of what is in place…

1. We are clear about your objectives and priorities, and you have a detailed financial plan supporting your future;
2. While we can't predict *every* uncertainty, we *do plan for* uncertainty. Each financial plan we build has an expectation of economic shock built into its foundations.
3. Our investment process is systematic, consistent, and reliable. Your portfolio is built on the core principles of *Systematic Reliability*™ and is fully diversified and designed to weather storms.
4. You have a team of people here at Capital Partners dedicated to keeping you on the right path.

There is no perfect portfolio to deal with inflation because every asset class is impacted in one way or another as inflation finds its way into every corner of the economy.

Fast forward to 2022

We now see the cracks beginning to appear from the Covid era where enormous economic stimulus from governments across the globe cushioned the impact of the pandemic on households. For those with long enough memories, the story was quite similar in the 1970s to today. Loose fiscal settings in the Johnson and Nixon governments, huge indebtedness post the Vietnam war, near full employment, and oil shocks were all part of the stimulus that caused inflation to run out of control in the 1970s. Today in Australia we see tight labour markets and rising wages, a booming construction industry, and food prices inflated by the Eastern States floods, just to open the conversation. All of this was probably manageable until we add to the mix the Chinese zero-Covid policy – severely impacting supply chains and therefore consumer prices. The final piece of the puzzle is the Russian war on Ukraine, causing shocks in food prices across Europe and a spike in the cost of energy worldwide. Rising fuel prices have dramatically increased the cost of transporting goods. It is the combination of these factors that has seen Central banks around the world taken by surprise by the inflation surge. In hindsight, they are collectively being blamed for too much economic stimulus and then, being too slow to raise interest rates to cool inflation. This economic dislocation causes uncertainty, and financial markets are responding to the uncertainty. As I was reviewing the markets for the end of May, I reflected to a colleague on just how rare it is to see every major asset class in a negative position. On a brighter note, in our portfolios, the Value sub-asset classes globally and in Australia continue to provide our portfolios with significant resilience. The Value asset class tends to perform well in times like these.

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Recession?

The latest prediction from market commentators is that we are heading for a recession, despite the Australian economy being in strong shape. A technical recession is two consecutive quarters of negative growth and should not be a cause for concern if it is a short and sharp recalibration of the economy. Recessions can provide a valuable reset where the economy is cleansed of struggling and underperforming businesses. A more prolonged economic downturn is far more difficult and if it comes to pass, will put pressure on businesses and households. The worst-case scenario is higher unemployment and falling property prices.

Market response to Inflation

Bond portfolios factor in expected inflation very efficiently every day as the market assesses the likely impact of future inflation. This normally keeps bond prices very stable. In the past six months, inflation expectations have surged and it has been this unexpected inflation that has caused markets to adjust future expectations, causing bond prices to fall. This is unusual but not unheard of, and the last time it occurred in Australia was in the early 1990s. While it is uncomfortable to see bond portfolios with negative returns, they remain very secure assets and an important part of portfolio construction. Stock markets are also under pressure. For the year since January 1st, the tech-heavy Nasdaq index is down almost 25% while the broad US market indicator the S&P500 index is down 14% in Australian dollar terms. The Australian market remains resilient but will be impacted by global uncertainty. Overall, diversified portfolios are holding up very well and will be a reliable store of wealth going forward.

Interest rate rises

Governments around the world are responding to inflation by raising official interest rates. This flows through to mortgage holders and business borrowers, increasing interest costs and limiting their capacity to invest and consume. The inflation risks Central banks cannot control with interest rate rises are the cost of food and energy prices. We see three possible outcomes from the current situation:

1. Inflationary pressures ease as Covid supply chain issues in China return to normal. As inflation eases so do interest rate pressures earlier than markets are expecting. Growth may slow, and we may even enter a short recession, but economic impacts are limited.
2. Inflation bites harder and longer and unable to curb inflation, Central banks react with significant and sustained interest rate increases. This will see the global economy fall into recession and a period of economic difficulty will ensue. Ultimately this will give rise to lower inflation, followed by an economic recovery.
3. The final and worst-case scenario is that inflation rises despite the efforts of Central banks. With sustained rising interest rates, economic growth slows and asset prices fall, but inflation continues to rise. This is the worst-case option.

It is too early to have a view of which of these outcomes will happen, but we strongly recommend that you consume any forecast or opinion with a healthy dose of scepticism. Over the next days and weeks, you will hear the word recession every time you turn on the news. This doesn't mean we will have one, nor does it mean that if we have one, it will be deep. At this stage, we all need Central banks to do their job well and we need Federal and state governments to find a solution to the energy crisis in the Eastern States. Partisan politics will just create further uncertainty. As I have said many times

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before, these periods of uncertainty and discomfort are the price we pay for the higher expected return we receive on our investments when compared to cash. A diversified portfolio of equities and bonds is central to long-term portfolio success. In history, recessions tend to be short-lived, as do market downturns. It's just not much fun when we're in the middle of it. Kind regards David Andrew.

If you have a question, please get in touch with me at communications@capital-partners.com.au. We will publish your Q&As for the benefit of all our clients.

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> *Founder and CEO of Capital Partners, and author of Wealth with Purpose, David firmly believes that sound, objective financial advice can transform peoples' lives and wellbeing. Find out more about how our evidence-based approach to wealth planning, investment management, legacy planning and insurance distinguishes our award-winning team, our results and our clients' lives.*