Portfolio Perspectives

Insights from the CIO Office
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Key Messages for Investors

- Inflation continues to be sticky, but how sticky it is from here is now in focus.
- A recent IMF paper examining the historical record of inflation provides a good framework to consider how much longer will inflation remain "unresolved".
- Inflation took, on average, three years to be "resolved”
- The US and Australia have now exceeded the average duration to successful normalise inflation.
- Wage growth remains well above levels associated with normalised inflation.
- Australia also suffers from robust, broad money supply growth which will likely further expand following the Stage 3 tax cuts.
- A resolution to the current bout of inflation seems further away in Australia than in the US.
- Lonsec sees no rate cuts by the Reserve Bank of Australia in 2024.

Lonsec's mantra has been that inflation was going to be sticky. While inflation would fade over time, the time would likely be longer than most expected. Recently, this forecast was cemented with comments from the US Federal Reserve acknowledging inflation remains persistent. Even in Australia, the March Consumer Price Index reading reveals inflation running at 3.5% Year-over-Year, up slightly from the 3.4% recorded over the last three months. We now look at how long this period of sticky inflation might last, concluding that from a historical perspective, this current bout of inflation has already exceeded the average period for inflation to resolve itself typically. Extending the geographical comparison, the US seems closer to "resolution" than Australia.

The International Monetary Fund (IMF) recently conducted a study reviewing more than 100 inflation shocks in 56 countries since the 1970s. The paper makes several observations, but three observations stood out for us.

1970s Oil Shock

Focusing on the oil shocks of the 1970s, which, according to the authors, has the closest parallels to today's supply side shocks, inflation took on average three years to be "resolved", that is as defined by the authors for inflation to return to be within 1% of the pre-shock level within five years of the initial inflation shock. Notably, deep recessions like the Global Financial Crisis and the Asian Financial Crisis saw quick resolutions to inflation (within one year), highlighting the tricky path for policymakers to avoid a hard economic landing.

Tight monetary policy

On average, countries that resolved inflation raised their effective real short-term interest rate by about 1% compared to the pre-shock levels. In contrast, the real rate in countries that did not resolve inflation was 4.5% lower on average compared to pre-shock levels. Furthermore, gauging broad money supply growth was used to measure the persistence of tight policy. Resolved countries had negative year-over-year broad money supply growth. Unresolved countries had persistent growth through the 5-year measurement window.

Wage Growth

On average, countries that resolved inflation saw nominal wage growth fall to -1.59% after the inflation shock, while unresolved countries saw wage growth average 2.56%.

We can now review the US and Australia's progress towards resolving inflation using this framework.

Current Reading for Factors from the IMF Inflation Study for the US and Australia

	US	Australia
Real interest rate	2.9%	3.1%
Money Supply Growth	-3.0%	5.2%
Nominal Wage Growth	4.7%	4.2%

<table>
<tr><td></td><td colspan="2">US</td><td colspan="2">Australia</td></tr>
<tr><td></td><td>Pre-Shock Level</td><td>Current Reading</td><td>Pre-Shock Level</td><td>Current Reading</td></tr>
<tr><td>Inflation</td><td>1.6%</td><td>2.8%</td><td>1.5%</td><td>3.6%</td></tr>
<tr><td>Target: Within 1% of pre-shock level?</td><td colspan="2">0.2% / NO</td><td colspan="2">1.1% / NO</td></tr>
<tr><td>Length of current shock</td><td colspan="2">February 2021 – April 2024, 38 months</td><td colspan="2">March 2021 – April 2024, 37 months</td></tr>
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Source: FRED, ABS, Lonsec estimates. Figures are the most current available.

In the US and Australia, real interest rates have risen well above 1%, as they were near zero in the years before the inflation shock.

Australia is taking a wildly divergent position with money supply as it continues to grow strongly at 5.2% versus the US, which is seeing negative growth.

Nominal wage growth for both countries is also well above zero.

With Australia having only one of the three markers of a country that was able to bring inflation under control, it is not surprising to see that we are still well away from being within 1% of pre-shock levels of inflation (3.6% versus a target of 2.5% [1.5% + 1%]). Alternatively, the US is only 0.2% away from reaching the target as monetary policy is very restrictive.

Wage growth for both nations will very likely remain the key challenge to fully overcoming inflation. However, Australia also has the added challenge of reigning in money supply growth.

How sticky inflation will remain is a function of how the labour market and potentially geopolitical events evolve from here. Strong nominal wage growth reflects robust employment conditions, as evidenced by record-low unemployment levels. Until we see a marked increase in unemployment, demand-driven inflation is likely to persist.

Geopolitics are an additional factor Lonsec is considering. Even though inflation measures typically exclude energy from their headline calculation, high energy prices still pressure costs indirectly as businesses must absorb these costs and presumably pass them on. Given the multiple ongoing conflicts globally, our analysis must still weigh up energy prices.

Macroeconomic data continues to point to modestly improving economic conditions, which is a tailwind for inflation. Coupled with an uncertain outcome in Ukraine and Israel, Lonsec maintains that inflation is sticky, and the policy pathway for Central Banks will more likely see monetary conditions remain tighter for longer. Timing-wise, we are already past the average date when others could normalise inflation. The optimist would suggest we must be closer to the end, but the realist would acknowledge that putting the handbrakes on growth is politically unpopular. As such, we believe any easing by policymakers now will be a mistake and thus expect no easing measure in the near term.

For Australia, in particular, it's bad news for mortgage holders as we expect no cuts from the Reserve Bank of Australia in 2024. Besides ongoing wage growth and high energy prices, the Stage 3 tax cuts will further fan the flames of inflation likely creating further upside pressure to broad money supply.

Outlook and Positioning

We remain in the soft-landing camp, with recent macroeconomic data and sentiment supporting this positioning. We observe generally positive but muted macroeconomic figures across countries and regions that are neither alarming nor exciting. Central banks' policy remains favoured towards loosening their monetary policies, but sticky inflation should temper the pace.

Our Dynamic Asset Allocation (DAA) remains unchanged this month, with a broadly neutral stance across asset classes. We prefer investing in Global Small Caps over Global Large Caps in the Global Equities category, given the relative valuation opportunity that we see. Regarding defensive investments, we see value in holding longer-duration fixed income as it provides some protection if we are wrong and macroeconomic conditions worsen.

Looking ahead, we recommend monitoring employment markets for signs that labour conditions may soften and the pace of any deceleration. With conflicts near strategic resources and trade routes, watch for potential knock-on effects on energy prices. Also, monitor developments in the US presidential race and regulatory developments within the global technology sector.

Growth Assets		Underweight		Neutral		Overweight	
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market Equities				●			
Large Caps			●				
Small Caps					●		
Emerging Market Equities				●			
Australian Listed Property				●			
Global Listed Property				●			
Global Listed Infrastructure			●				
Growth Alternatives				●			

Defensive Assets		Underweight		Neutral		Overweight	
Australian Bonds					●		
Global Bonds				●			
Diversified Income				●			
Conservative Alternatives				●			
Cash				●			

Current Position ● (white)
New Position ● (orange)

Growth Assets

Asset Class	Position	Rationale
Australian Equities	Neutral	The outlook for Australian equities remains positive driven by strong commodity prices, population growth and a resilient consumer. Market valuation appears 'fair' with ongoing strength in iron ore prices and the potential for upward earnings revisions.
Developed Market Equities	Neutral	Global equity valuations appear more stretched, particularly in the US, thanks to the stellar outperformance of the Magnificent 7 this year. This robust performance has resulted in a dispersion in valuation between Small/Mid-Caps and Large Caps, with small/mid-caps looking attractively priced.
Emerging Market Equities	Neutral	While valuations look attractive on a relative bases, emerging market currently look to be fairly priced, with main valuation metrics sitting in line with their long-term average. But with so much uncertainty around China and its growth outlook, risk look to be slightly elevated.
Australian Listed Property	Neutral	Valuations are attractive enough to maintain a neutral position and the risk of further interest rate hikes has decreased. Highly nuanced depending on sub-sector, with the office sector in particularly remaining structurally challenged.
Global Listed Property	Neutral	Valuations are attractive enough to maintain a neutral position and the risk of further interest rate hikes has decreased. Highly nuanced depending on sub-sector, with the office sector in particularly remaining structurally challenged.
Global Listed Infrastructure	Slight Underweight	Better risk/return opportunities in defensive assets for investors seeking yield, and better growth opportunities in equities. Uncertainty over the path of inflation and rates presents a headwind for this sector, given the leverage typically associated with these companies.
Growth Alternatives	Neutral	Prefer liquid multi-strategy hedge funds over private market exposures where prices remain elevated. We maintain FX hedges within our global exposures as the AUD continues to trade at levels we consider cheap.

Defensive Assets

Asset Class	Position	Rationale
Australian Bonds	Slight Overweight	Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios.
Global Bonds	Neutral	Supply/demand imbalances in the US and the end of yield curve control policy in Japan may see yields move higher offshore.
Diversified Income	Neutral	We are balanced towards our preference between floating and fixed rate yields given current cyclical dynamics at play
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Neutral	Provides short term liquidity with a modest yield.