



# Portfolio Perspectives

Insights from the CIO Office

May 2024

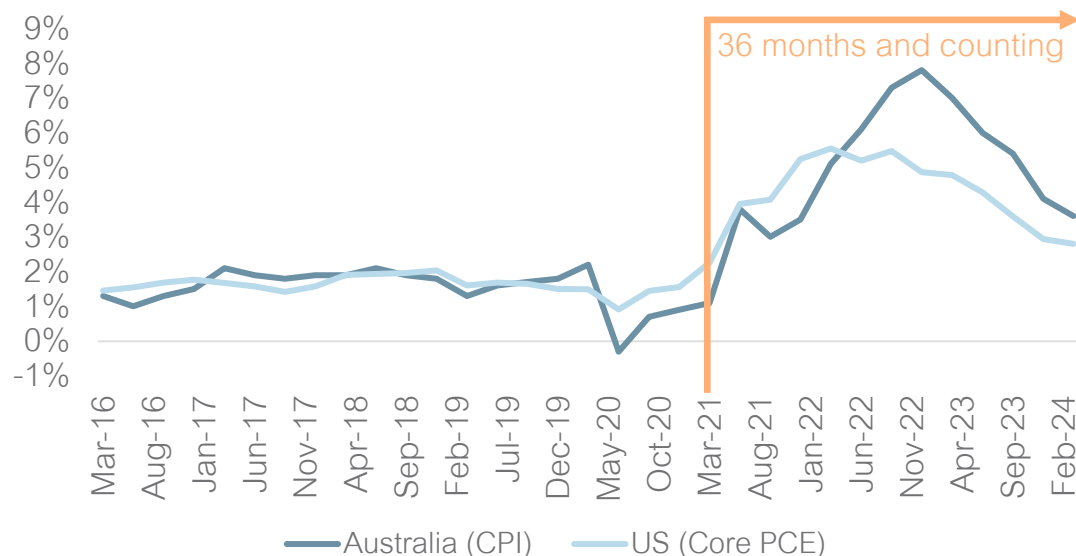
# Key Messages for Investors

- Inflation continues to be sticky, but how sticky it is from here is now in focus.
- A recent IMF paper examines the historical record of inflation provides a good framework to consider how much longer will inflation remain "unresolved".
- The US and Australia have now exceeded the average duration of successful resolutions to inflation.
- Comparable to both countries is wage growth that remains well above levels associated with normalised inflation.
- Australia also suffers from robust, broad money supply growth.
- 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.

# Inflation is sticky, but for how much longer?

Historically, the average country that successfully resolved its inflation took 3 years

**US and Australian Inflation (YoY % Change)**



**Three Key Considerations from the IMF Paper**

1. 1970s Oil Shock
2. Monetary Policy Setting
3. Wage Growth

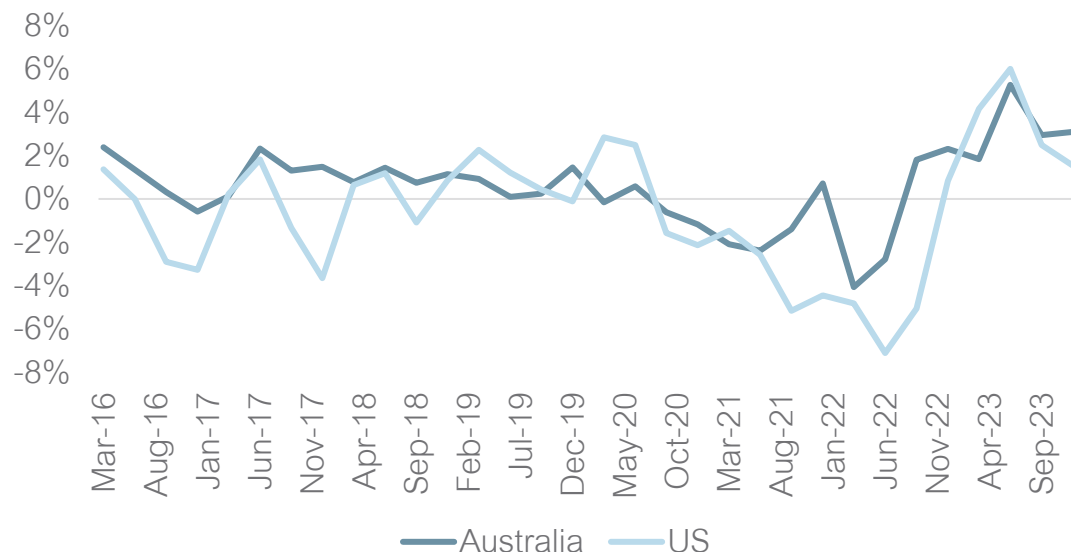
- The International Monetary Fund (IMF) recently conducted a study reviewing more than 100 inflation shocks in 56 countries since the 1970s.
- Inflation took, on average, three years to be "resolved", as the authors defined it: returning to within 1% of the pre-shock level within five years of the initial inflation shock.
- The inflation shock started in the US and Australia in February 2021 and March 2021, respectively, and remains "unresolved".

- The IMF paper identifies factors that are associated with successful attempts to tame inflation.
- The current bout of inflation draws many parallels with the oil shock in the 1970s as energy prices are again elevated.
- Monetary policy should be tight with real rates 1% higher than pre-inflation shock levels and money supply growth negative.
- Wage growth should be negative

# Monetary Policy is Restrictive

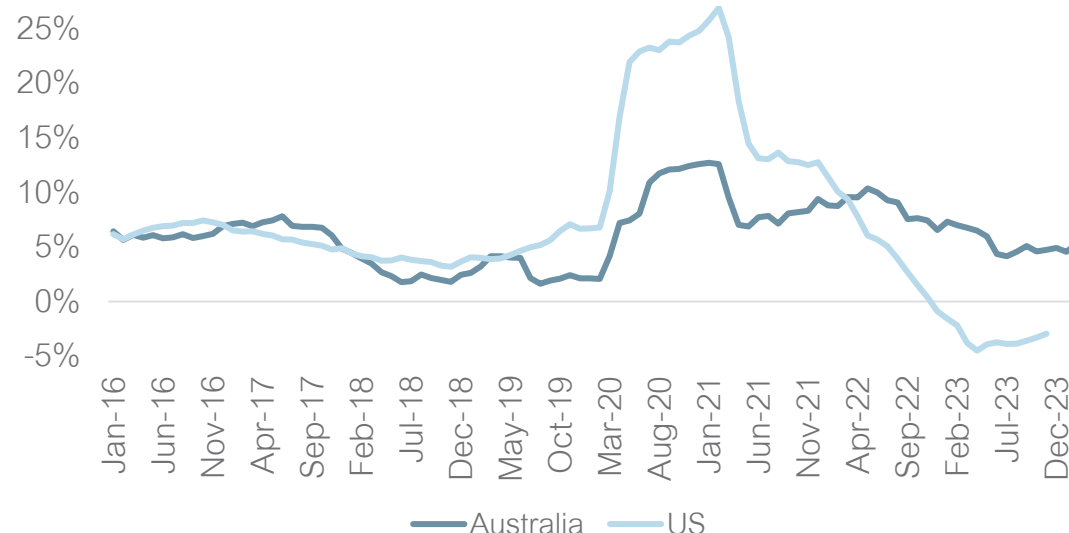
Restrictive monetary policy in the US seems to be working but not so in Australia

US and Australia Real Interest Rate (%)



- Real interest rates in the US and Australia were around 0% before the current bout of inflation. Currently, real rates are at 2.9% and 3.1%, respectively, consistent with the IMF definition of restrictive policy

Broad Money Supply Growth (YoY % Change)

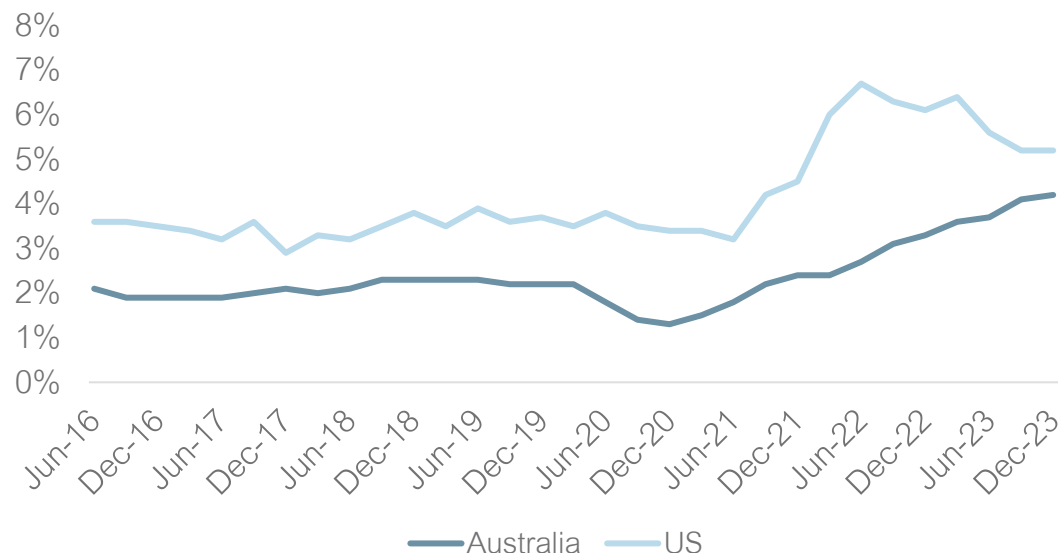


- The result of tight monetary policy is seen in the growth of broad money supply (M3) in the US, which is now shrinking.
- However, in Australia broad money supply remains elevated, suggesting monetary policy settings are not tight enough or being counteracted.

# Wage Growth Remains High

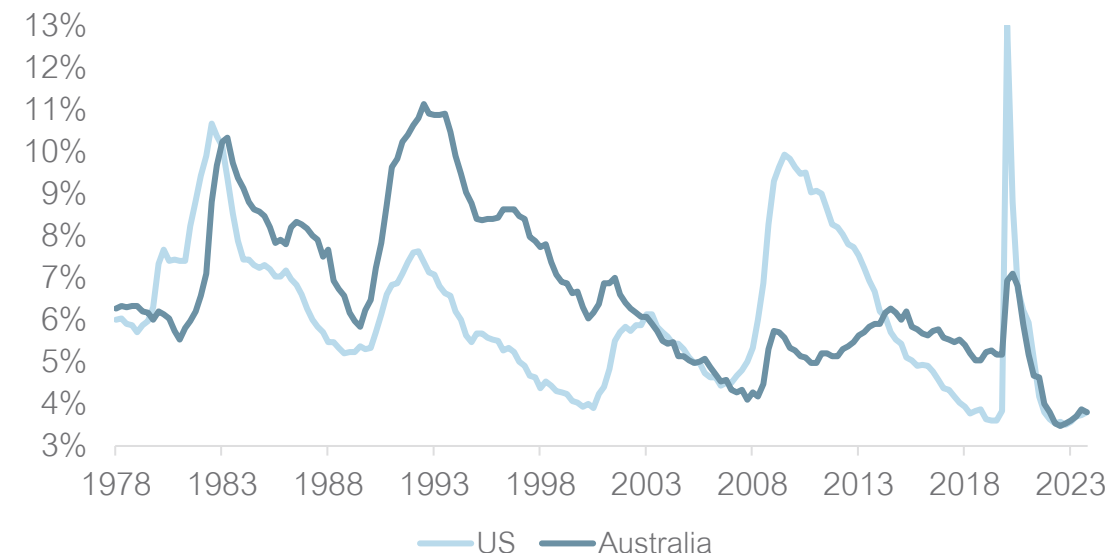
Robust employment conditions support wage growth

Wage Growth in the US and Australia (YoY % Change)



- Strong nominal wage growth reflects robust employment conditions, as evidenced by record-low levels of unemployment.
- Nominal wage growth typically turned negative for countries that resolved their inflation, suggesting more work ahead for policy makers.

Unemployment in the US and Australia at record lows



- 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.

# Outlook and Positioning

We remain in the “soft landing” camp. Central Banks should be cutting interest rates, but sticky inflation will temper the pace. Prefer DM Small Caps

Growth Assets	Underweight		Neutral		Overweight	
Australian Equities				●		
Large Caps				●		
Small Caps				●		
Developed Market (DM) Equities				●		
Large Caps			●			
Small Caps					●	
Emerging Market (EM) 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				●		

## Growth Assets

- DM Equities. DM Small Caps typically move ahead of the turn in the economic cycle, and US Small Caps, in particular, could move with the Fed starting its easing cycle. This leads to a Slight Overweight DM Small Caps at the expense of DM Large Caps with a preference for US over ex-US Small Caps.
- Global Listed Infrastructure. We see better risk/return opportunities in other asset classes for those seeking yield or capital appreciation.

## Defensive Assets

- Australian Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios. Focus on long-duration assets.
- Global Bonds. Supply/demand imbalances in the US treasury market remain a focus, reducing their relative preference versus Australian government bonds. The end of YCC policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
- The potential start to an easing cycle reduces the relative attractiveness of floating rate yields.
- We maintain an allocation to gold which acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.



Important Notice: This document is published by Lonsec Investment Solutions Pty Ltd (LIS) ACN: 608 837 583, a corporate authorised representative (CAR number: 1236821) of Lonsec Research Pty Ltd ABN: 11 151 658 561 AFSL: 421 445 (Lonsec Research). LIS and Lonsec Research are owned by Lonsec Holdings Pty Ltd ACN: 151 235 406. LIS creates the model portfolios it distributes using the investment research provided by Lonsec Research but has not had any involvement in the investment research process for Lonsec Research. Please read the following before making any investment decision about any financial product mentioned in this document.

Disclosure at the date of publication: Lonsec Research receives a fee from the relevant fund managers or product issuers for researching financial products (using objective criteria) which may be referred to in this document. Lonsec Research may also receive a fee from the fund manager or product issuer (s) for subscribing to research content and other Lonsec Research services. LIS receives fees for providing investment consulting advice, approved product lists, model portfolios to financial services professionals and other advice to clients. LIS' and Lonsec Research's fees are not linked to the financial product rating(s) outcome or the inclusion of the financial product(s) in model portfolios. LIS, Lonsec Research and/or their associates may hold any financial product(s) referred to in this document, but details of these holdings are not known to the analyst(s).

Warnings: Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is limited to "general advice" (as defined in the Corporations Act 2001 (Cth)) and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of their financial circumstances or should seek independent financial advice on its appropriateness. If the advice relates to the acquisition or possible acquisition of a particular financial product, the reader should obtain and consider the Investment Statement or the Product Disclosure Statement for each financial product before making any decision about whether to acquire the financial product.

Disclaimer: LIS provides this document for the exclusive use of its clients. It is not intended for use by a retail client or a member of the public and should not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by LIS. Financial conclusions, ratings and advice are given on reasonable grounds held at the time of completion (refer to the date of this document) but subject to change without notice. LIS assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, LIS and Lonsec, their directors, officers, employees and agents disclaim all liability for any error or inaccuracy in, misstatement or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.

This report is subject to copyright of LIS. Except for the temporary copy held in a computer's cache and a single permanent copy for your personal reference or other than as permitted under the Copyright Act 1968 (Cth), no part of this report may, in any form or by any means (electronic, mechanical, micro-copying, photocopying, recording or otherwise), be reproduced, stored or transmitted without the prior written permission of LIS. This document may also contain third party supplied material that is subject to copyright. Any such material is the intellectual property of that third party or its content providers. The same restrictions applying above to LIS copyrighted material, applies to such third-party content.

Copyright © 2024 Lonsec Investment Solutions Pty Ltd