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Portfolio Perspectives

Insights from the CIO Office

May 2024

Key Messages for Investors

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- 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?

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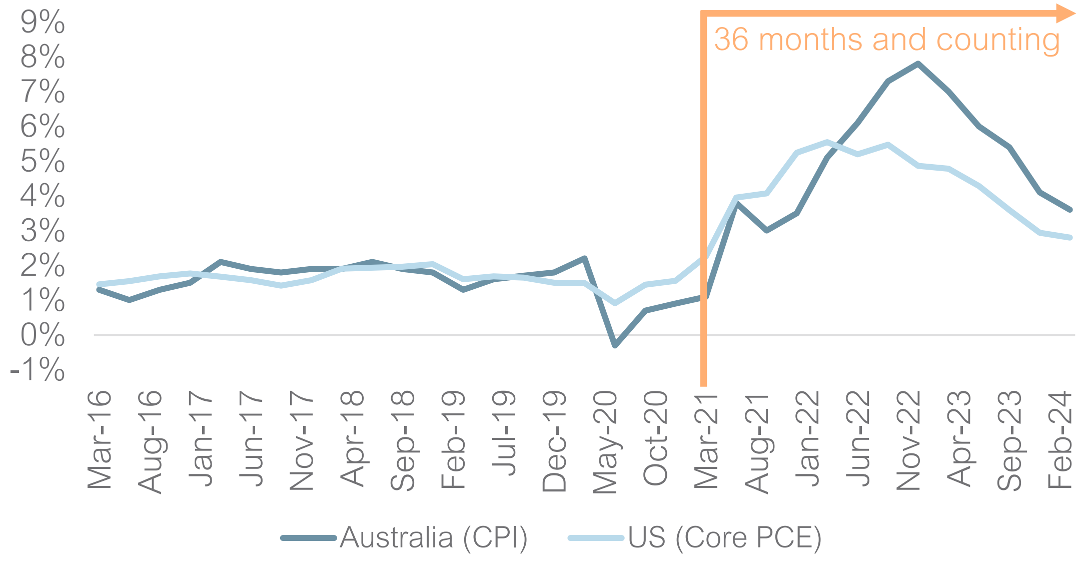
Historically, the average country that successfully resolved its inflation took 3 years

US and Australian Inflation (YoY % Change)



- 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”.

Three Key Considerations from the IMF Paper

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

- 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

Source: FRED, BEA, US Federal Reserve, Bloomberg, Lonsec estimates.

Monetary Policy is Restrictive

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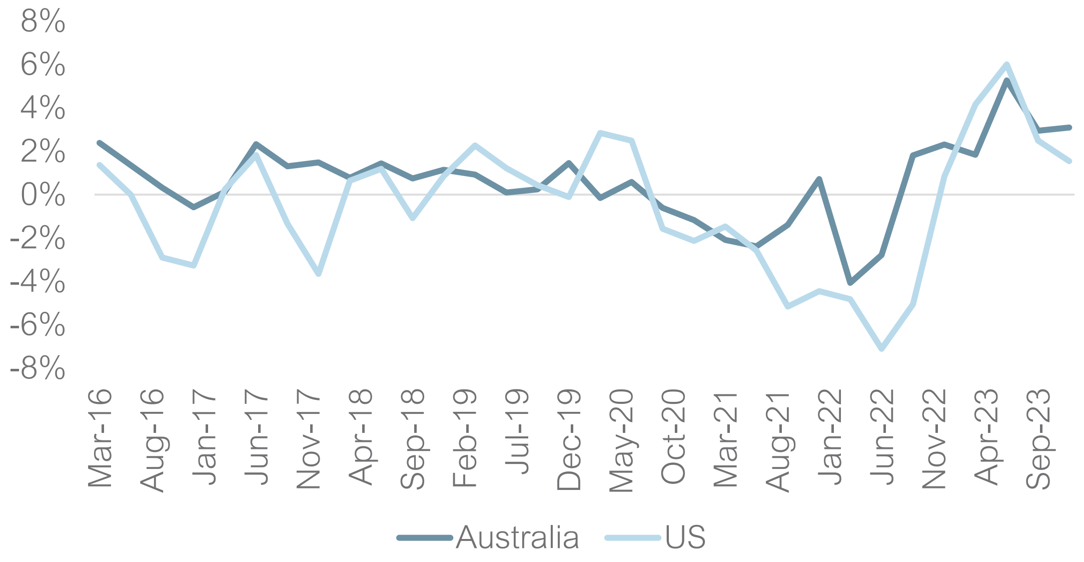
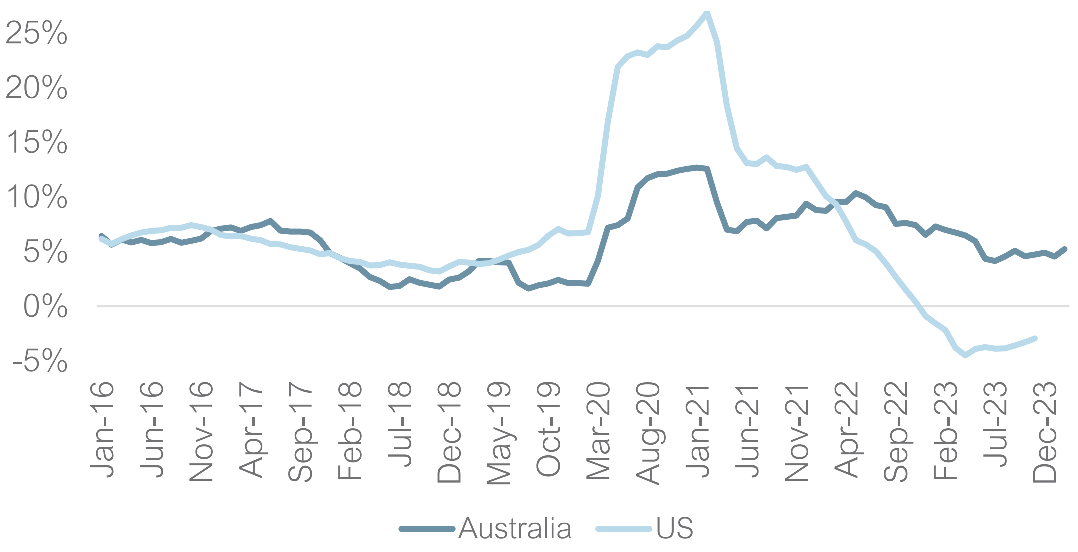
Restrictive monetary policy in the US seems to be working but not so in Australia

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% ad 3.1%, respectively, consistent with the IMF definition of restrictive policy

Broad Money Supply Growth (YoY % Change)



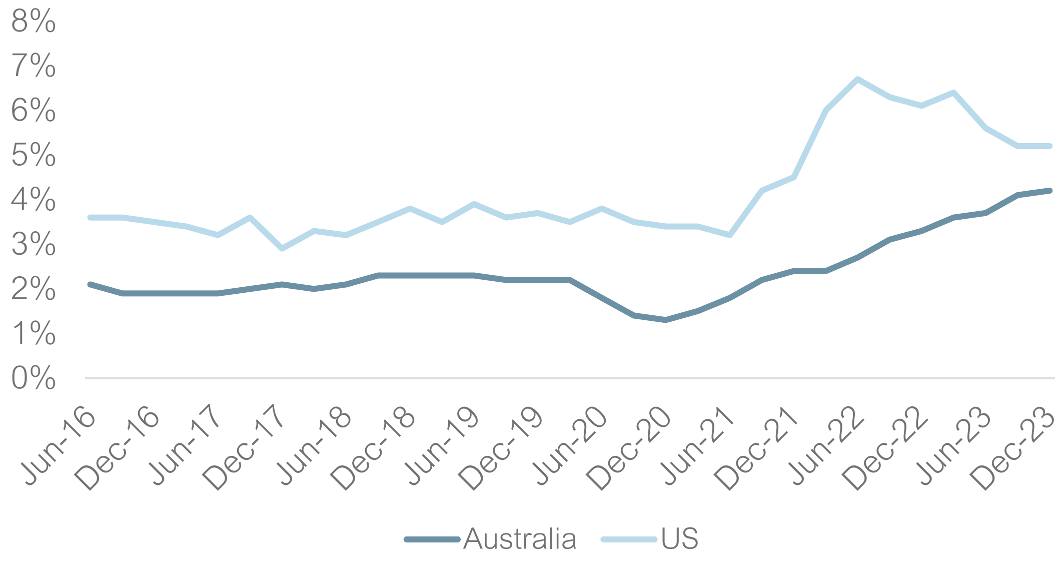
- The result of tight monetary policy is seen in the growth of broad money supply (M3) in the US, which is now shrinking.
- However, in Australia broad money supply remains elevated, suggesting monetary policy settings are not tight enough or being counteracted.

Source: FRED, RBA, ABS, Lonsec estimates.

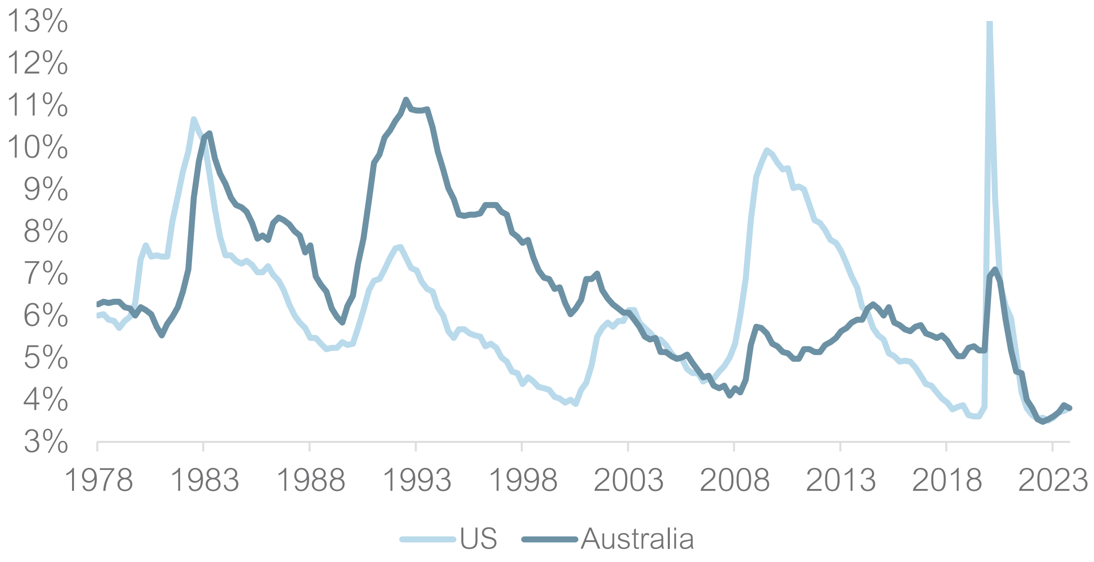
Wage Growth Remains High

Robust employment conditions support wage growth

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



Unemployment in the US and Australia at record lows



- 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.

- 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.

Source: FRED, RBA, ABS, Lonsec estimates.

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.

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