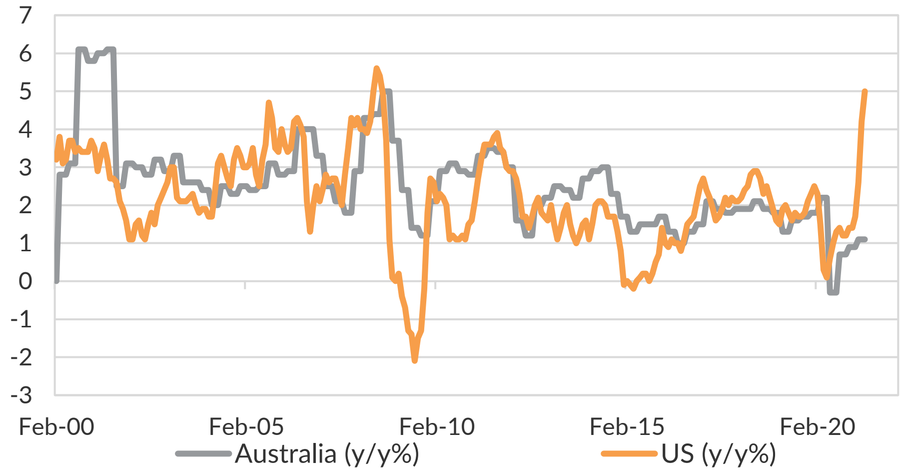
Portfolio Advisory Service Insights

June 2021

Inflation is here to stay.

There are growing signs that inflation is rising. Headline inflation in the US and Australia is on the rise (Chart 1). Wage pressures are beginning to emerge. The price of a range of goods and services have increased compared with a year earlier. Partly that reflects very weak inflation during the height of the pandemic. But we think inflation pressures are likely to be more persistent than central banks expect over the medium-term. That will put upwards pressure on sovereign bond yields.

Chart 1: Inflation is moving higher in the US and Australia.



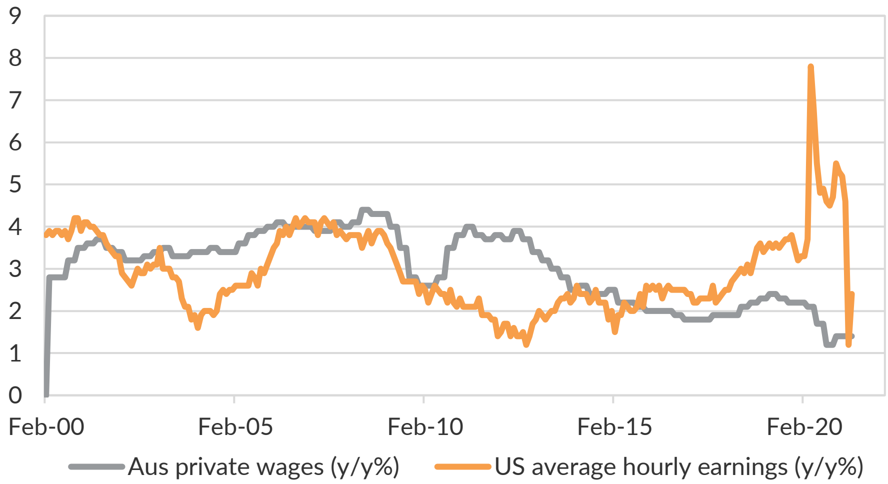
What matters for the Fed and the RBA?

The US Federal Reserve and the Reserve Bank of Australia will focus on wage pressures. Wage pressures have been weak for some time in both economies (Chart 2). But there is anecdotal evidence of wage hikes in lower wage jobs. Labour supply has been tight, particularly in the US. This has been exacerbated by schools remaining closed – and so keeping some workers out of the labour force – and by generous fiscal packages that have reduced the incentive to work in some cases.

We expect wage pressures to remain subdued relative to longer-term history. But we think they will increase compared to the past five years. That will be a gradual, continued rise over the medium-term.

In the near-term, inflation will be significantly higher than central bank targets. That reflects the weak inflation during the pandemic and a recovery now. In the medium-term, we expect this excess inflation will ease back. But it should still leave inflation at or slightly above central bank inflation targets over the medium-term.

Chart 2: Wage pressures have been low for more than five years but are set to pick up.



Are rate hikes coming soon?

We do not expect any rate hikes from the US Fed or the RBA in the near-term. Instead, we expect both central banks will carefully prepare the market for a rate-hike lift-off, probably sometime in 2023.

In the near-term, financial conditions are still likely to tighten. We expect that will occur as longer- and shorter-dated US Treasury yields drift higher. Higher longer-dated Treasury yields will lift mortgage rates in the US, cooling the economy somewhat.

In Australia, we expect Australian banks to increase standard variable mortgage rates. This could be by up to 100bps over the coming two years. That will ease some of the pressures in the housing market, helping to contain inflationary pressures.

Will housing markets crash?

We continue to expect house prices to benefit from a broader positive environment for asset prices. Tailwinds from economic and wages growth, as well as interest rates that remain low relative to history (albeit higher than right now) will offset the impact of higher rates. In Australia, banks are also likely to tighten lending standards, making it harder to access credit but extending the housing cycle.

Can equities continue to outperform?

We have maintained our overweight view on equities since Q2 2020. Higher inflation and wages pressures will have some impact on profit margins in the US and Australia. But strong economic growth will support earnings. We also expect to see dividend payouts and share buybacks begin to rise, further supporting the market. Higher rates are a risk, but we expect solid fundamentals to offset that impact.

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Contact PAS for more information.

The Portfolio Advisory Service has been working closely with clients across Australia and Asia to help manage investment solutions and investment governance. Our work is supported by deep asset class research and manager review expertise within the team.

Reach out to our Portfolio Advisory Service to find out how we can assist you with managing your investment challenges.