GPS WEALTH

Inflation Scare Underway

GPS Wealth Monthly Market Update

Despite both NSW and Victoria emerging from lockdowns the Australian share market failed to find any real direction in October. The share market was influenced by significant moves in the bond market late in the month as the RBA abandoned its yield curve target of 10 basis points for the April 2024 Australian Government bond. In its statement, the RBA excluded the line "The central scenario for the economy is that this condition (for a rate rise) will not be met before 2024" suggesting it may bring forward the timing of a rate rise. The Australian 10-year yield rose by a substantial 0.59%, to 2.08%. Persistent levels of high inflation has caused markets to question central bank policy, with the short end of the curve pushing up by more than the long end, resulting in a material curve flattening.

The RBA forecasts inflation at 2.25% in 2022 (up from 1.75%) and 2.5% in 2023 (up from 2.25%). GDP growth in 2022 is forecast at 5.5% (up from 4.25%), although this mainly reflects the downgrade of 2021 from 4% to 3%, as the Bank revises down its assessment of the contraction in the September quarter. There is no change to the forecasts for wages growth in 2022 (still 2.5%) although, significantly, 2023 has been lifted from 2.75% to 3.0%. The forecasts for the unemployment rate are unchanged – 4.25% in 2022 and 4% in 2023. However, the Governor does note that "one of the main uncertainties relates to the behaviour of wages at the lowest unemployment rate in decades." The Board expects that the conditions necessary for the first-rate hike will be in place earlier than the indicated 2024 date however, the Board avoided moving the guidance given the range of uncertainties particularly around wages and inflation. In this writer's humble opinion, the Board is worried that a bubble may be developing in the housing market and has allowed fixed rates to rise to quell the seemingly unstoppable price rises which could accelerate if stronger growth is realised.

In the US, the Federal Reserve met market expectations by tapering asset purchases by $15bn a month. They also pre-announced the purchase pace for November and December, further commenting that as long as the economy evolves as expected, a similar pace would continue into the new year. Mr Powell explained that they expected the elevated inflation levels to return to the Federal Reserve's long-term goal as supply bottlenecks abate and COVID-19 restrictions are eased. The CPI reading was strong and markets are beginning to doubt if the inflation genie has, in fact, been let out of the bottle.

Emmanuel Calligeris
Chairman of the Investment Committee

The US CPI outcome for October was materially above expectations. It was not just the monthly outcome that was significant, but also the annual rate of 6.2%, a new three-decade. Further, there was breadth to the above results, with the core CPI up 0.6% in the month and 4.6% over the year. The stronger-than-expected core CPI reading supports the view that Federal Reserve officials will become increasingly uncomfortable with upside risk to inflation and potentially raise rates in June 2022 then twice more by year end as per market expectations. It is important to now monitor for overall strength and the extent to which that strength is broadening across categories. Strong advances in auto prices that are clearly tied to issues with semiconductor supply chains should attract less attention from markets and Fed officials. More telling is the broader inflationary pressure in categories such as furniture, which shows that the goods price inflation story is not specific to one bottleneck. Ultimately more important for the 2022 inflation outlook is the extent to which inflation migrates into the price of services which can be gauged from employment data and overall economic strength. The ISM services index increased to a record high of 66.7 (vs. 62.0 expected) suggesting economic growth will be strong over the next 6-9months. The ISM manufacturing reading for October was slightly above expectations at 60.8 (vs. 60.5), however the prices paid index similarly rose to 85.7 (vs. 82.0) for the second month in a row with the data showing further signs of supply-chain issues from the supplier delivery time measure, which hit a five-month high of 75.6.

On the employment front, the ADP report of private payrolls for October showed an increase of 571 000 (vs. +400 000 expected), which is the strongest growth since June. Non-farm payrolls increased by 531,000 and there were solid upward revisions to the prior two months. Jobs gains were broad based and led by a 164,000 increase in leisure and hospitality. The unemployment rate moved down to 4.6% from 4.8%, but labour force participation remained unchanged. Wage gains were robust, recording an increase of 4.9% year-on-year, as employers continue to compete amidst tight availability of workers. Notably, faster hiring in sectors worst-hit from supply chain woes, such as the manufacturing and transportation sectors, point to some lessening of these bottlenecks in the months ahead.

In China growth slowed to 4.9% year-on-year in the third quarter of 2021. Covid-19 flare-ups hit private spending and caused supply disruptions, while flooding further weighed on momentum. Industrial output was likely held back towards the end of the quarter by abrupt cutbacks in electricity generation, as local governments rushed to meet Beijing's emissions standards, while tougher regulations weighed on the property sector. Other policies are still in place including data privacy compliance on technology companies and deleveraging in the real estate sector. These policies will continue into 2022 with the intention of creating structural change for "better long-term growth." Producer price inflation (PPI) should be confined to around 10% year-on-year for the rest of the year. This seemingly high PPI is mainly a result of a low base effect. Consumer price inflation (CPI) has been low, however global freight disruptions have added some upward pressure on agricultural prices. This could be seen in October and November. But even so, the rise in CPI should be moderate. Current domestic headwinds are likely to carry over into the new year however, Beijing will likely loosen policy to preclude a sharp slowdown.

In Europe, the inflation rate jumped to 4.1% mainly caused by higher energy prices on the back of the gas crisis and a rise in oil prices. The energy inflation rate is now 23.5% and consumer gas prices have yet to be fully incorporated into these numbers because of contract adjustments that have yet to be passed on. Services inflation also boosted core inflation, from 1.9% to 2.1%. Like the US, the core picture is one of steadily increasing goods inflation as businesses price supply chain price pressures through to the consumer. This is set to last for some time as the price pressures are unlikely to abate until well into 2022. The ECB continues to guide that the inflationary pressures are temporary and interest rates were firmly on hold. However, the market seems far from convinced as rate hike expectations have been brought forward to within a year.

In October Australian shares underperformed global equities (MSCI World Index +1.65%) as expectations of earlier RBA rate hikes impacted market sentiment. Technology (+2.4%) was the best performing sector in October despite higher yields, whilst the Resources sector was weaker with the share prices of BHP, Rio and Fortescue enduring another challenging month in line with the softening iron ore price. Washington H Soul Pattinson share price declined 16.8% over the month. The company has a material holding in New Hope (NHC) which was negatively impacted by falling coal prices in late October.

The gold price increased despite headwinds from higher yields and US dollar strength. The share prices s of Newcrest and Northern Star Mining increased 9% and 6% respectively. Within the industrials segment of the market, sector performance was mixed. Healthcare was buoyed by CSL, with headwinds in plasma collection beginning to abate as economies reopen. The Consumer Discretionary sector gained +0.6% for the month, albeit with mixed performance. Encouragingly, a number of the boutique retailers including JP HiFi (+11.53%) performed well posting better than expected first quarter sales and highlighted improved sales momentum since NSW re-opened. However, the sector was weighed down by hefty falls from Star Entertainment in light of the money laundering accusations, Pointsbet following a soft trading update on its lofty US expansion plans and a soft trading update from Domino's Pizza, which had enjoyed a stellar run courtesy of the lockdowns. Conversely, the Consumer Staples sector finished the month lower, largely as a result of Woolworths and the Endeavour Group intimating the challenges of navigating COVID-related disruptions through their supply chains, a major obstacle for many companies as festive season volumes ramp up.

Finally, the listed property trust sector increased 0.42% in October. Vicinity Centres (+3.3%) outperformed with retail assets buoyed by market transactions of key large regional malls (Pacific Fair and Macquarie Centre) at book value during the period, justifying valuation. GPT (+1.8%) similarly outperformed, also with a significant retail portfolio, as well as the Melbourne reopening improving the outlook for their office exposures. Mirvac (-5.7%) was amongst the worst performers, with investors cautious on the outlook for residential given implied interest rates.

Returns

31st October 2021

ASSET CLASS RETURNS ARE BASED ON

Australian Cash
RBA Bank accepted Bills 90 Days

Australian Bonds
Bloomberg AusBond Composite 0+ Yr TR AUD

International Bonds Hedged
BarCap Global Aggregate TR Hdg AUD

Australian Listed Property
S&P/ASX 200 A-REIT TR

International Property Hedged
FTSE EPRA/NAREIT Dv REITS TR Hdg AUD

Australian Shares
S&P/ASX 200 TR

International Shares
MSCI World Ex Australia NR AUD

Emerging Market Shares
MSCI EM GR AUD

RETURNS TO THE 31ST OCTOBER 2021

	1 Month	3 Months	1 Year	3 Years	5 Years
Australian Cash	0.00	0.00	0.03	0.73	1.17
Australian Bonds	-3.55	-4.93	-5.30	2.72	2.58
International Bonds Hedged	-0.26	-1.45	-1.05	4.06	2.85
Australian Listed Property	0.42	4.38	30.87	9.87	8.95
International Property Hedged	5.58	1.44	41.12	7.83	6.48
Australian Shares	-0.10	0.51	27.96	11.92	10.88
International Shares	1.65	1.61	31.36	16.05	15.88
Emerging Market Shares	-2.88	-2.62	9.35	10.15	9.68

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