JMI Wealth

Economic & Investment Market Review

May 2021

Prices are Rising

All around the globe price inflation is evident. In China and the United States Producer Price indices have increased. In China the producer price index for March jumped 4.4% versus last year. In the US year over year the producer price index surged 4.2% the largest annual gain in 4 years. The surge in indices is also impacted by higher commodity prices and supply-chain bottlenecks.

The lift in producer prices is yet to translate into as marked increases in consumer prices but consumer expectations of an increase in inflation are also evident in survey data. US consumers expect 3.2% inflation and 3.1% inflation on 1 year and 3-year time horizons.

The US administration is further fuelling the US economy by increasing federal support programmes. Since the advent of the Biden administration proposed federal spending has been increased through a US$2.3 trillion American jobs programme, US$ 1.9 trillion infrastructure package, and if it passes a US$1.8 trillion American families plan. These fresh expenditures are built on the massive increase in the monetary supply which occurred following the COVID 19 outbreak. Although the numbers are large, careful interpretation is required in assessing the effects. The infrastructure package which equates to approximately 10% of US GDP will be spread over eight years.

New Zealand is not immune from these inflationary pressures. Recent property market intervention may take pressure out of the residential housing market, but businesses are preparing to increase prices. ANZ's recent business outlook survey indicated a net 53% of respondents intended to raise prices, a record since the survey's inception in 1992. Despite what may be investors personal experience at present the official annual consumer inflation rate is 1.5% and remains below the RBNZ's target level. Similarly, in Australia the consumer price index remains muted year on year with the annual increase for the March quarter 1.1%.

The extent of any inflationary tendency will be offset by available capacity within economies. Illustrative of this is the level of unemployment. Although unemployment has declined from peak levels in the United States it is yet to decline to pre COVID levels. The number of people employed is still 8 million lower than pre-COVID numbers. This provides some justification for assuming some of the inflation will be transitory.

Interest Rate Impact

The increasing inflation outlook was the core driver of interest rate increases in February. To some extent the rise in rates represents a re-evaluation from unreasonably low expectations to expectations consistent with Central Bank targets. If inflation persists this will continue to lift prevailing interest rates, particularly in 3 year and beyond maturities. If demand led inflation does not become embedded, then inflationary pressures resulting from supply bottlenecks etc should dissipate and further increases in interest rates abate. Key Central Banks for New Zealand investors in the US, Australia and here at home remain committed to monetary stimulus and have indicated that they will allow inflation to run at levels in excess of target. If inflation rises too far too fast however Central Bank action could be expected to cap interest rate rises as financial stability objectives take precedence. Therefore, the extent to which interest rates potentially rise is capped in the short-run.

The current consensus view from Central Banks and economic forecasters is that the inflation spike is a temporary phenomenon. There is risk however of further interest rate curve steepening in the near-term and over time the bias remains to interest rates rising given negligible real returns from fixed income. JMI would therefore differentiate between tactical fixed income positioning and long-term portfolio positioning.

Short-term rises in interest rates in New Zealand will also be constrained by the impending wall of maturities. Between 31 March 2021 and 17 December 2021 there will be $7,397 million of maturities from domestic corporates, banks and the Local Government Funding Agency. This capital represents a substantial supply in a market where issuance thus far has been subdued.

Local financial institutions have been able to tap into the various government financing schemes and this has dampened banks demand for short-term deposits. The Funding for Lending programme has a term of 3 years. However, for maturities beyond three years inflation expectations are relevant and some small increases in term deposit rates will likely eventuate.

Large US banks have assessed the current point in the interest rate cycle as favourable for debt capital raising. JPMorgan sold US$13 billion of 31-year securities in the largest bank bond issue ever. This was subsequently trumped by Bank of America which sold US$15 billion of bonds.

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Equity Ramifications

Rising inflation is not necessarily negative for share values. Inflation in conjunction with increasing levels of economic activity is consistent with rising share values. Inflation becomes a concern primarily when inflation rises too quickly and to too high a level. Companies which have pricing power that is the ability to increase prices in response to rising costs are able to cushion against input cost inflation provided they move with sufficient rapidity or on an anticipatory basis. Those companies that have long duration assets i.e. business models whose valuation is dependent on cash flows further into the future are vulnerable to rising interest rates. If the current inflationary impulse does prove to be temporary and symptomatic of pent-up demand as economies re-open, then share price weakness to likely to limited. Interest rates would need to lift substantially and for a prolonged period for a material reset in equity values.

Given the current mix of low rates and rising earnings the balance of probabilities is in favour of share prices continuing to be supported.

Housing Market Implications

House prices and residential construction remain important in terms of the wealth effect and effects on employment levels. Supply chain constraints are definitely evident in this sector. Imported building products can take 3 weeks to reach Auckland from Tauranga after landing due to congestion. Order times for items such as weatherboards have stretched out to many weeks. Capacity constraints in the form of labour availability and increase in the minimum wage are also contributing to rising costs.

The bounce in interest rates has started to transmit to the mortgage market. A variety of banks have lifted mortgage rates. ASB and Westpac have increased three, four, and five-year fixed mortgage rates by 20 to 40bps. This may represent an inflection point in the mortgage market.
Whether these influences together with the regulatory changes will impact house values is yet to become apparent. Some quietening of the market seems likely as auction completions have declined in the first month after the implementation of deductibility rules and bright line tests.

Growth Versus Value

In the most recent month growth shares have slightly outperformed value and made up some of the ground lost over prior months. The re-emergence of performance leadership by growth shares is a function of the consolidation of interest rates in April. The recent reporting by FANG stocks Facebook, Amazon and Google will also have contributed to the relative outcomes. These growth leaders reported very strong first quarter 2021 results with reported results exceeding most forecasts. The share prices of the three companies improved into the results and in the immediate aftermath. Netflix the fourth FANG disappointed in terms of new subscriber numbers.

Given the early stage of the economic recovery and the continuing normalisation, cyclical companies generally outperform growth. This market phase offshore looks set to continue. It therefore appears to be prudent to continue to hold a balance of companies to ensure a diversified portfolio.

Conclusion

Assessing the relative risk and reward and the opportunity cost of withdrawing from share investment, the balance of risk remains in favour of continuing to tilt portfolio weights to equity assets. Although valuations continue to be at a premium to historical levels the interest rate environment, availability of capital and rising activity levels continue to support participation in the market.

Some pull backs will be inevitable, and investors should regard these as opportunities. A diversified portfolio continues to remain appropriate.