Wednesday 5 October 2022

focus

Riding the Inflation Rollercoaster

Markets continue to whipsaw. Concerns around inflation, and potential recession, are front of mind. Central banks are committed to bringing inflation down to target levels. But what will it take to get there? How far will interest rates rise? And will it require a recession? By their own admissions central bankers don't know. Outcomes will be affected by unpredictable factors such as the war in Ukraine, China's perseverance with a zero-COVID policy, and the continued blockages in global supply chains. Unfortunately, uncertainty and market volatility may run for a while yet.

FORSYTH BARR

... uncertainty and market volatility may run for a while yet...

Why inflation matters

Most central banks — including our own Reserve Bank (RBNZ) — have a "dual mandate" of two, somewhat conflicting, goals. The first is to maximise jobs. The second is to keep prices broadly stable — for the RBNZ that is keeping the consumer price index (CPI) within a 1-3% range.

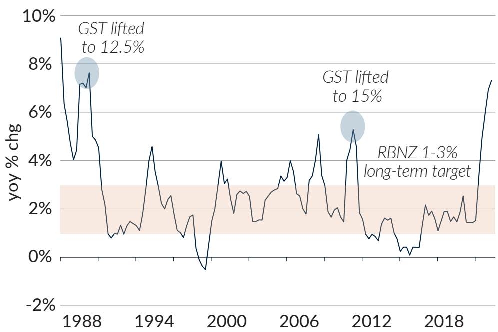
For central banks this is a balancing act. Lowering interest rates heats up the economy and creates jobs but if it overheats you get inflation. Conversely, raising rates to combat inflation cools the economy which typically reduces jobs. In a perfect world central banks want the goldilocks outcome — not too hot, not too cold.

High inflation (or rising prices) can affect the economy in many ways. It hurts consumers' spending power — higher prices for rent, food, and petrol means less money available for other things. It reduces savings — people need to spend more to buy the same amount of goods and services and therefore save less, plus the real value of existing savings (what it can buy at the new higher prices) reduces. It also makes businesses more cautious to invest given the uncertainties around costs, interest rates, and demand.

The perfect storm for inflation

This year we have seen inflation around the world soar to levels not seen since the 1980s.

INFLATION HAS SOARED TO MULTI-DECADE HIGHS: NEW ZEALAND CPI

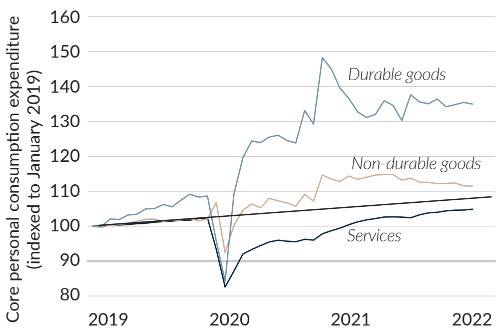


Source: Stats NZ, Forsyth Barr analysis

The initial burst last year was fuelled by a big shift in consumer spending. With economies closed by COVID and people locked at home they could no longer spend on services such as travel or hospitality. Instead they reallocated this money to goods such as cars, furniture, and appliances. The boom in demand for goods — coupled with COVID restraints on manufacturing and logistics — put immense pressure on supply chains. When demand exceeds supply, prices typically rise. Shipping costs soared and so did the prices of many goods.

...for the majority of consumers, the most immediate impact was felt at the petrol pump....

CONSUMERS SWITCHED SPENDING FROM SERVICES TO GOODS: US CONSUMER SPENDING



Source: Refinitiv, Forsyth Barr analysis

SUPPLY CHAINS STRUGGLED TO RESPOND—FREIGHT COSTS BOOMED: SPOT CONTAINER SHIPPING RATES

Source: Refinitiv, Forsyth Barr analysis

Exacerbating inflation pressures earlier this year was Russia's invasion of Ukraine. Whilst neither Russia nor Ukraine are huge economies both are big suppliers of commodities. Russia is the second largest oil producer in the world. Together they are major providers of agricultural commodities such as wheat and corn, industrial metals including copper, nickel and aluminium, and other essential raw materials like neon, palladium and platinum. After the invasion commodity prices spiked — for the majority of consumers, the most immediate impact was felt at the petrol pump.

A SOARING OIL PRICE HIT BUSINESSES AND CONSUMERS: BRENT CRUDE PRICES

Source: Refinitiv, Forsyth Barr analysis

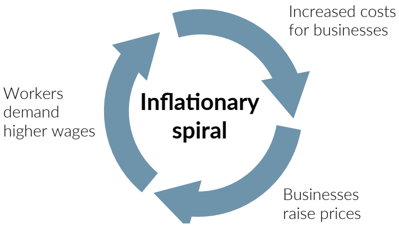
...Cooling inflation requires bringing demand and supply back in balance...

The dreaded inflationary spiral

When inflation initially spiked central banks took a patient view. They expected it to be largely "transitory" (or temporary) caused by the combination of changes in spending patterns (more goods, less services) which would revert as economies reopened, disruptions to supply chains which eventually would ease, and massive stimulus from governments whose benefits would fade with time.

The big change in the past year has been the rising concerns of an inflationary spiral. The longer inflation persists the more likely it becomes self-sustaining — higher prices and tight labour markets allow workers to push for wage rises; wage rises, in turn, lift costs for businesses; strong demand and tight supply allows these costs to be passed on through higher prices; people become accepting of increasing prices... that is how an inflationary spiral becomes entrenched. Early this year central banks ran out of patience and have been rapidly raising interest rates since.

CENTRAL BANKS FEAR AN INFLATIONARY SPIRAL



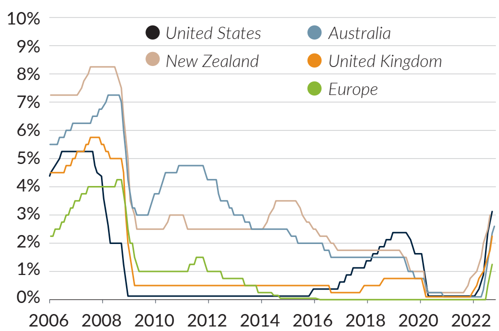
Source: Forsyth Barr analysis

Economics 101

One of the first things any economics student learns is the price of a good or service reflects the balance between demand and supply. Inflation occurs when either there's too much demand or not enough supply. Cooling inflation requires bringing demand and supply back in balance. Central banks' main tool for achieving this is interest rates. Higher interest rates lowers demand (and vice versa) — unfortunately these tools do nothing to boost supply.

Not so long ago interest rates were at the lowest levels in human history. Central banks were striving to support demand (and therefore jobs) through COVID. Today they're raising rates, determined to reduce demand to tame inflation.

CENTRAL BANKS ARE HIKING RATES: POLICY INTEREST RATES



Source: Refinitiv, Forsyth Barr analysis

The positive news is there are some signs inflation pressures may be peaking...

Will interest rates continue to rise?

So can central banks achieve their objectives? And what will it require?

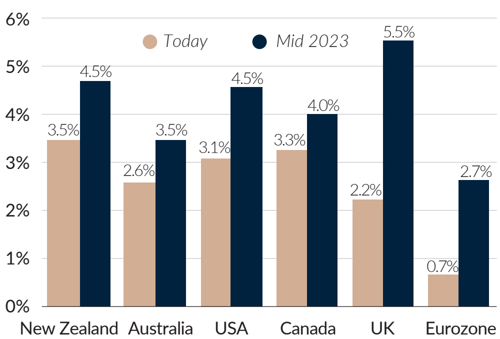
The answer to the first question is yes. Central banks appear committed to their inflation targets. If they keep raising rates the economy will slow and demand will fall sufficiently to bring inflation under control. The key question for markets, however, is the second. And the answer to that is, it depends.

It depends on how sensitive demand is to higher interest rates — it's uncertain how businesses and households will respond; many haven't experienced meaningful rates rises in a decade or more. It depends on how quickly global supply chains unclog which in turn will be influenced by the Ukraine conflict and its impact on the supply of commodities, and how long China persists with its zero COVID policy. It depends on how quickly spending patterns revert to pre-COVID norms (less goods, more services) and whether goods prices, which have soared, pull back at all. In New Zealand it will depend in part on migration — recently net migration has been negative, adding to tightness in the workforce. There are many moving parts.

The positive news is there are some signs inflation pressures may be peaking. Around the world many housing markets (including our own) have slowed sharply and prices are falling which, in time, will flow through to reduced construction activity and consumer spending. There are early signs labour market tightness may be easing. Commodity prices are off their peaks from when Russia first invaded Ukraine. Container shipping costs, which soared during 2021, have pulled back to the lowest levels since early last year. As have the prices for semiconductors, which have been a key constraint for manufacturers over the past two years. And there are signs of inventory build-up and greater price discounting from retailers.

It is, however, too early for central banks to declare job done. For now they will continue to raise rates. Central bank statements and economic data will be scrutinised over the weeks and months ahead. Market volatility (positive and negative) is likely to continue.

THE MARKET EXPECTS CENTRAL BANKS TO CONTINUE TO RAISE RATES INTO THE MIDDLE OF NEXT YEAR: POLICY INTEREST RATES



Source: Bloomberg, Forsyth Barr analysis

...we believe building resilience in portfolios is crucial...

Build resilience

We appreciate extreme market volatility doesn't make an easy backdrop for investors. We do see room for optimism that inflationary pressures, and therefore concerns around central bank tightening and market instability will ease through next year. That said, we recognise just how challenging it is to predict the global economic outlook with any confidence. We certainly would not place all our investing bets on any single scenario coming to fruition in the months and years ahead.

In today's uncertain environment we believe building resilience in portfolios is crucial. First and foremost that means diversification — not putting all your eggs in one basket. Holding a diversified portfolio across different asset classes, markets, and sectors provides the best opportunity of having an investment portfolio that is resilient across the broad range of possible paths the global economy may take in the years ahead.

Matt Henry
Head of Wealth Management Research

Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

0800 367 227

forsythbarr.co.nz