THE INFLATION GENIE: BACK IN THE BOTTLE?

March 2024

Is the Inflation Genie back in the Bottle? This is the major macro question for investors right now. The answer will determine whether rates can fall, as opposed to sticky inflation and strong US growth seeing rates remaining higher for longer. It will determine whether low rates and a soft landing can dominate the economic narrative, as opposed to a slower growth regime that eventually sees credit impairments.

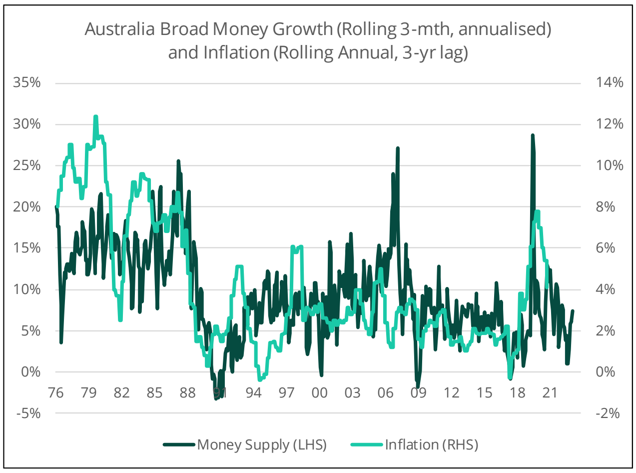
In this paper we set out the Daintree view on inflation and outline how our view impacts asset allocation decision-making, both in bonds and across asset classes more widely. We do this through the lens of five key drivers of inflation:

1. Money supply: "Too much money chasing too few goods".
2. Inflation expectations: If inflation is expected to rise consistently then economic behaviour may be impacted, making inflation harder to dislodge.
3. Labour market: The Phillips Curve in economic theory illustrates an inverse relationship between inflation and unemployment.
4. Commodity prices: Increased revenues from relatively less expensive exports relative to imports (i.e., the terms of trade) may be passed through to consumers via fiscal policy, fueling inflation.
5. Bottom-up composition: Changes in prices are skewed, and this skew enhances explanations of aggregate inflation even after controlling for other factors.

Driver 1: Money supply

If there is one major driver of the post-Covid inflation wave, it was the various forms of fiscal support that were enacted to deal with the Covid fallout. Stimulus measures led to a wave of spending and the amount of money in the economy grew sharply, as shown in Figure 1, as a lack of supply of various goods met a massive wave of demand fueled by fiscal stimulus.

Figure 1: Money supply growth leads inflation by around three years in Australia – this indicates normalisation ahead



Source: RBA, Daintree

The link between money supply growth and inflation is clear, but somewhat inconsistent. For this reason, monetarism has had mixed acceptance among mainstream economists. The current trend from money supply growth is, however, one that supports the case for downside inflation risks.

Driver 2: Inflation expectations

Figure 2 shows that although inflation expectations recovered post-Covid to their historical range, a move higher such as that seen in 2007/8 cannot be ruled out. A further global supply shock could be problematic, potentially pushing inflation expectations beyond levels with which the RBA would feel comfortable. We characterise inflation expectations as being a potential driver of upside inflation risks.

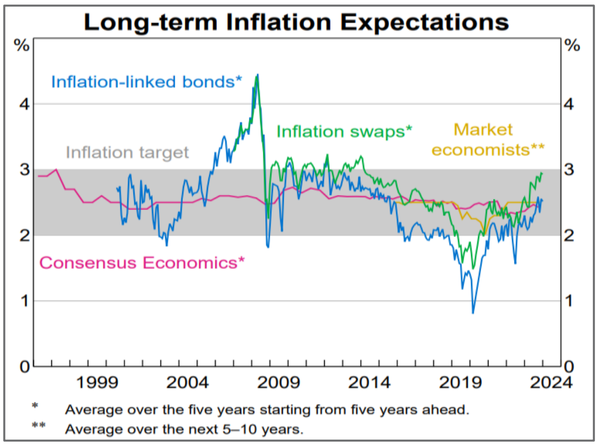
Driver 3: Labour market

In Australia and elsewhere, labour markets are indeed showing weaker momentum. Figure 3 shows that trends in gross domestic income are likely to lead to lower employment growth. We characterise the labour market as being a potential driver of downside inflation risks.

Driver 4: Commodity prices

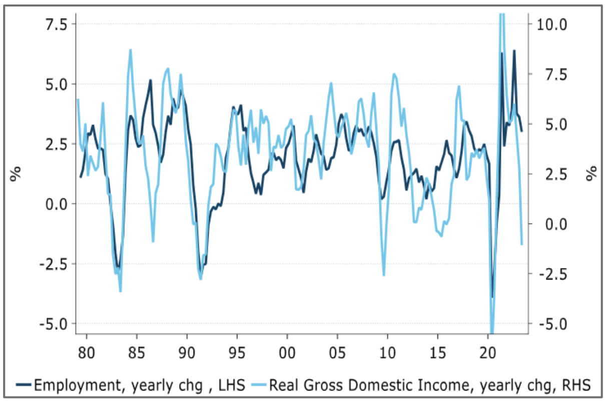
Commodity prices have an impact on inflation expectations in the short term. This is particularly the case for oil prices, and the signaling effect of energy costs more

Figure 2: Inflation expectations high relative to recent history



Source: RBA

Figure 3: Gross domestic income growth points to weaker employment growth

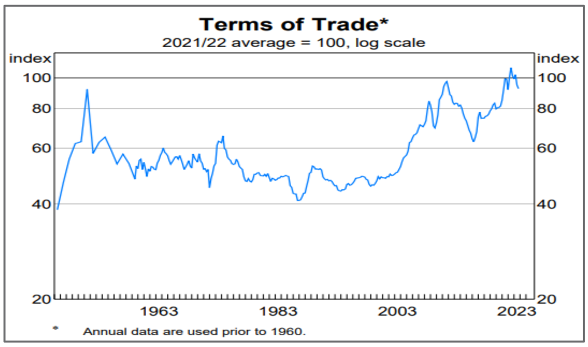


Source: ANZ

broadly. Over the longer term, however, commodities that make up a nation's terms of trade are also important. Figure 4 shows that Australia's terms of trade may have peaked for now. This indicates that a source of income growth for government coffers may fall away, indeed Australia's gross domestic income is already falling per Figure 3. Fiscal policy may become less expansionary and therefore less supportive of inflation at the margin in the coming years.

We characterise commodity prices as being a potential driver of downside inflation risks in the long-term, but upside inflation risks in the short-term.

Figure 4: Commodity prices have seen Australia's terms of trade peak; gross domestic income is likely to fall further

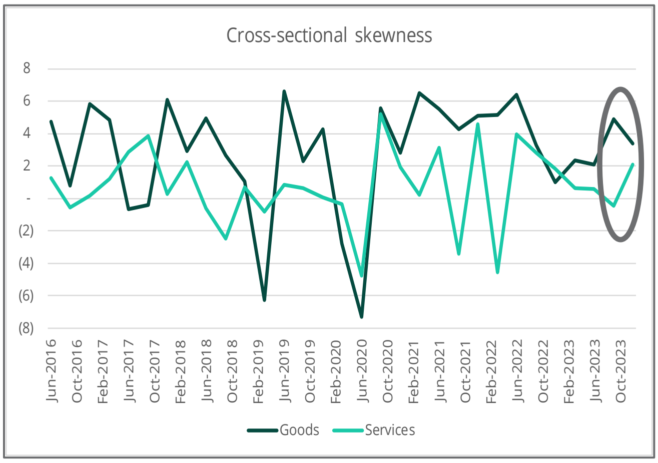


Source: RBA

Driver 5: Bottom-up influences

Firms face costs when changing prices. This means prices are generally only altered if the change offsets associated costs, and price changes are not evenly distributed across the economy at an individual firm level. Put another way, changes in prices are skewed. Although the data is noisy, Figure 6 shows that goods prices have been becoming less positively skewed since 2021, but the next few quarters will show whether this downtrend can continue. The same is the case for services prices, where skewness has tended lower since 2022. For now, we characterise trends in bottom-up price-setting behaviour as being a potential driver of downside inflation risks.

Figure 5: Skew of prices across the Australian CPI basket trended lower from 2020-2023



Source: Daintree, ABS

Inflation scenarios and portfolio construction

Daintree's base case is for inflation to fall. This is a finely balanced view though, and Table 1 outlines both credible upside and downside risks that exist for each of the drivers we have addressed.

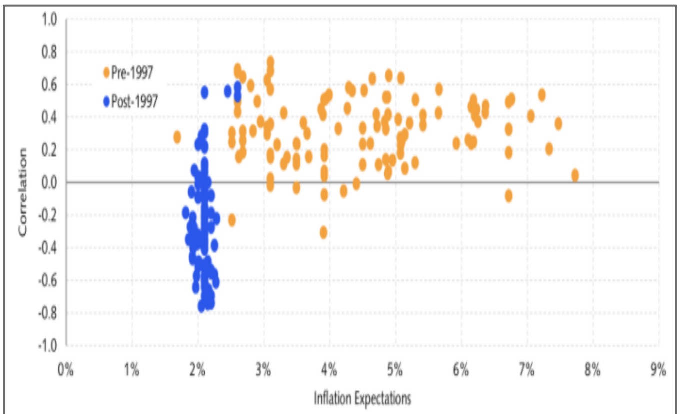
Table 1: Daintree's base case is for inflation to fall, but this is a finely balanced view with credible upside risks

Driver	Higher inflation scenario: 40% likely	Lower inflation scenario: 60% likely
Money Supply	Money supply continues to normalise, pulling inflation lower before waning as a driver later this year	Money supply continues to normalise, pulling inflation lower before waning as a driver of inflation in 2025/6
Expectations	Supply normalisation is completed, downward goods price inflation momentum is moderating, and a tight labour market is supporting services inflation. Markets are slow to re-price easing cycles, keeping inflation expectations elevated	Expectations to fall to levels seen in the latter part of the last decade as growth accelerates while inflation remains under control
Labour Market	Unit labour costs remain high amid stubborn services inflation	Broad labour market weakness sees unit labour costs fall as the economy slows and layoffs accelerate
Commodity Prices	Commodity prices remain resilient, with geopolitical pressures pushing oil prices higher and feeding back to upward stickiness in inflation expectations	Sharp falls in commodity prices ultimately lead terms-of-trade and gross domestic income lower
Bottom-up Composition	A persistent positive skew to prices across the CPI basket amid higher commodity prices and stubborn unit labour costs	Bottom-up price setting behaviour normalises as disinflation becomes entrenched again

At Daintree we believe the main issue investors need to focus on is not a high conviction view on where inflation is going to go. After all, central banks with hundreds of PhDs at their disposal did not fully appreciate upside risks to inflation in 2020-2021. It is entirely possible that central banks and markets are being too sanguine now in their view that inflation can fall largely of its own accord. The more important issue is this: how to build a resilient portfolio that will perform well regardless of whether inflation does fall as expected, or whether it instead continues to surprise to the upside.

Figure 7 illustrates movements in inflation expectations are crucial for multi-asset portfolio construction. It illustrates that the environment from 1997 to 2022, where a negative correlation prevailed between government bonds and equities, was characterised by low and stable inflation expectations. In 2023 this did not play out though, which is not surprising given the inflationary backdrop. If the backdrop remains inflationary, investors should not expect government bond duration to play its traditional defensive role in multi-asset portfolios. After all, the 30-year period to 2022 may have been a historical aberration. The better historical analogue for the future may well be the pre-1997 period rather than the post-1997 period.

Figure 7: Low and stable inflation expectations are crucial for the effectiveness of traditional 60/40 portfolio construction



Quarterly correlations based on daily returns of the S&P 500® and 10-year U.S. Treasury note. Inflation expectations refer to the 10-year expected PCE inflation measure from the Federal Reserve Board's FRB/US model, which we splice (beginning in 2014) to 5- to 10-year inflation expectations from the Consensus Economics survey. Source: Bloomberg; Consensus Economics.

Source: Bank of America

If defensiveness is a less important function of bonds in portfolio construction going forward, what role might bonds be better suited to play? The answer is the production of income. Figure 8 shows the yield on a typical 3-year Australian A-rated bond. In 2020, this bond was yielding 0.42%. This meant that with three years of spread duration, only a 14 basis point widening of credit spreads was required to offset one year of carry. Now, the same bond is yielding almost 5%. This means the amount of cushion provided by the income of these bonds is almost 12 times greater.

Figure 8: Margin of safety is almost 12 times better than it was in 2020

Source: Bloomberg

The yield on funds like those managed by Daintree is much higher than it was just a few years ago. At the same time, the resilience provided by the income on offer is significant. Bonds are contractual obligations. Sensible credit analysis and portfolio construction can ameliorate the potential for defaults to impact returns, leaving an income stream that drives equity-like returns that are strongly resistant to drawdowns.

Conclusion

At Daintree we believe the main issue investors need to focus on is not a high conviction view on where inflation is going to go, or indeed a high conviction view on the myriad of other macroeconomic data. After all, central banks with hundreds of PhDs at their disposal did not appreciate upside risks to inflation. It is entirely possible that such forecasting errors will occur in the future as well – this is why the Daintree investment process is not reliant on forecasting. Investors are better served focusing on how to build a resilient portfolio that will perform well across different macroeconomic backdrops. With this in mind, we are very aware of the potential for the diversification potential of government bonds to remain hampered for some time to come. Equally, we believe that the income-driven return that floating rate credit investments provide is significant, and well worth consideration from a wide range of investors.