JMI Wealth

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Estate and Taxation Planning Council

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Lets talk about inflation

- On Friday 26th August Federal Reserve Chair Jerome Powell delivered a short, sharp speech that knocked 1000 points of the Dow Jones.
- The rhetoric was clear – commitment to bring inflation back to 2% goal.
- “Restoring price stability will require a restrictive policy stance for some time”.
- And on the morning of the 14th of September – we were given another stark reminder of the impact of the stance – 1276 points off the Dow Jones

What did Powell say

- Three key messages
  - Not convinced inflation has peaked – “Lower prints for July are welcome, a single month's improvement falls far short of what the Committee will need to see before we are confident that inflation is moving down,"
  - Doesn’t see itself stopping rate hikes soon - “The Federal Open Market Committee estimates the federal funds rate will settle at a range of 2.25 to 2.5 percent in the longer run. But "with inflation running far above 2 percent and the labor market extremely tight, estimates of longer-run neutral are not a place to stop or pause,"
  - Is wary of stopping prematurely – “We must keep at it until the job is done," Mr. Powell said. He points out that, historically, the labor market has tended to take a greater hit when the Fed hasn't acted forcefully and swiftly enough to contain inflation. "Our aim is to avoid that outcome by acting with resolve now," he said.

Powell's three lessons from the 1970s and 1980s

- Central banks can and should take responsibility for delivering low and stable inflation.

- Inflation expectations can play an important role.

- Must keep conditions restrictive until the job is done.

But first – a quick recap of the year to date

- Worst first six months of the year for US equity market in 50 years
- Summer rally – and recent weakness

- Interest rates have resumed an upward track
  - Central bank pressure on policy rates would imply short-end yield curve pressure
  - But duration has still been a detractor from portfolio performance

- NZD weakness is starting to develop into a trend
  - Giving a tailwind to unhedged offshore equity exposures

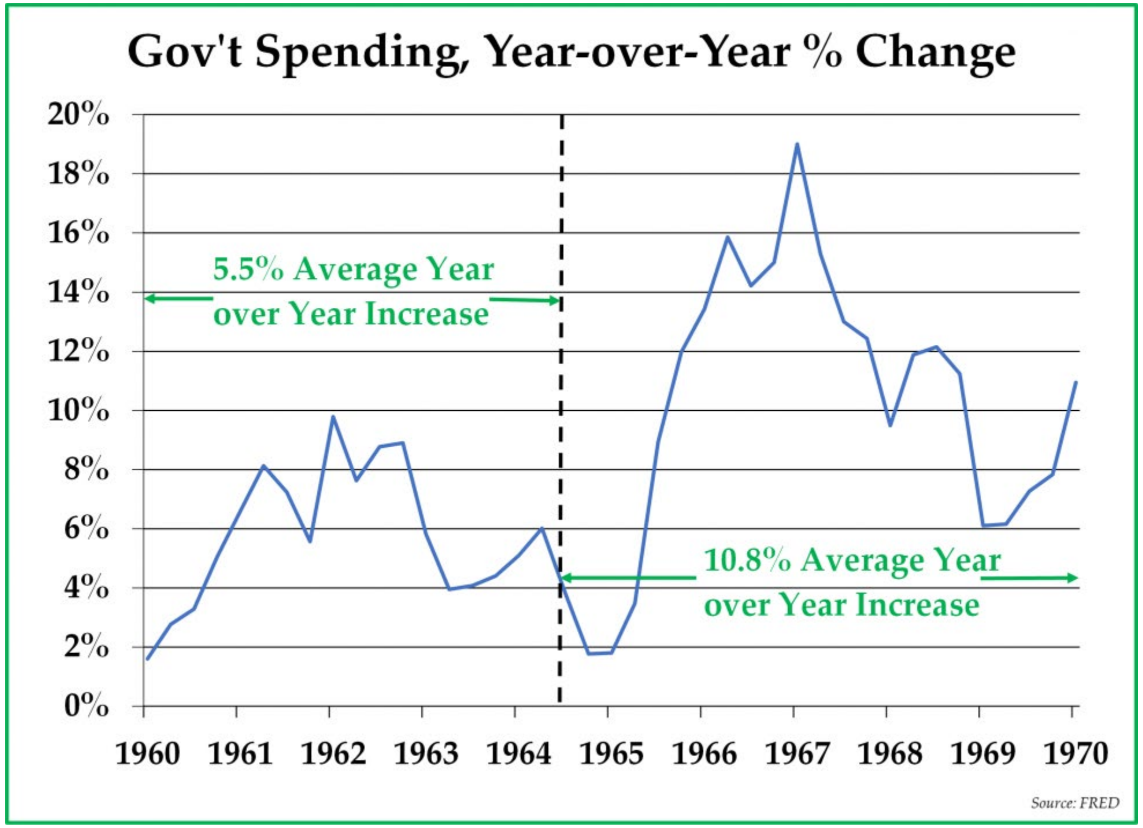
The 60's and 70's - Quick reminder of the key players

- US Presidents
  - Lyndon B. Johnson 1963-1969 (Vietnam War 1955-1975)
  - Richard Nixon 1969-1974
  - Gerald Ford 1974-1977
  - Jimmy Carter 1977-1981
- Fed Chair
  - William McChesney Martin 1951-1970
  - Arthur Burns 1970 – 1978
  - G. William Miller 1978-1979
  - Paul Volcker 1979 – 1987
- Great Society Programs 1964-1965

He’s worried about a repeat of rampant inflation – The Great Inflation of the 70’s

- Began in the early 60’s
- What was happening;
  - War in Vietnam – Lyndon B. Johnson was President
  - Wartime spending was pumping the US economy
  - The Great Society programs
    - Medicare
  - Taxes were not increased proportionally
  - This was the era of The Phillips Curve and the belief that inflation and unemployment were inextricably linked
  - Fiscal deficits (during Johnson and Nixon terms).
  - Abolition of the gold standard in 1971.
  - Ability of foreign countries to convert US dollars to gold.
  - Introduction of a price and wage freeze.
  - Oil shock in 1973 – 1974.
  - Federal Reserve did increase interest rates but didn’t keep them high.

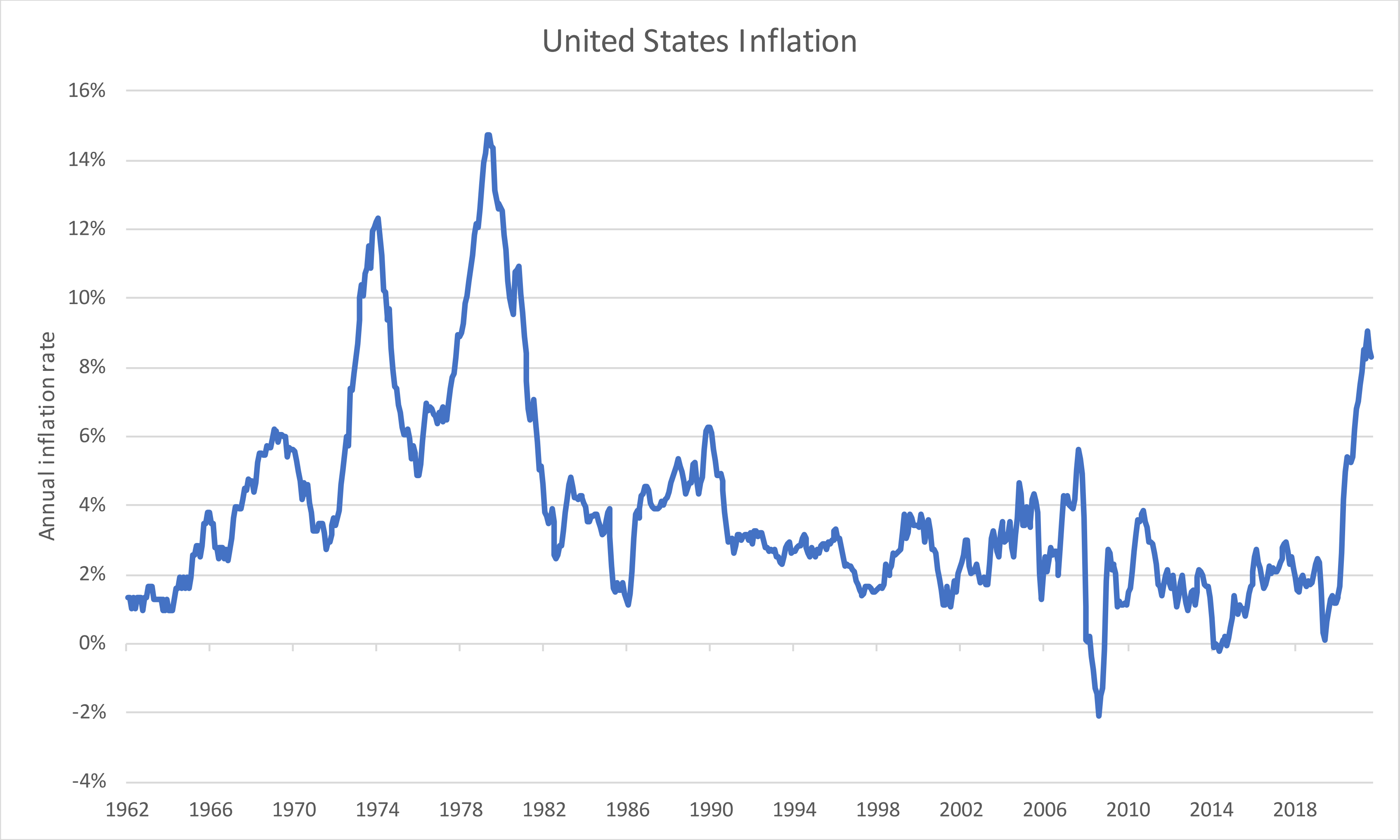
Guns *and* Butter……



But there were other issues

- Energy crises
  - Arab oil embargo October 1973
  - Iran Revolution – 1979
- Q Caps
  - regulated and capped interest rates on checking and savings accounts
  - When inflation ran rampant this led to a massive outflow of deposits from the banking system, increased aggregate demand
- The collapse of Bretton Woods
- Repeal of wage and price controls (in place from ‘71 to ‘74)

Inflation – what happened in the 1970s



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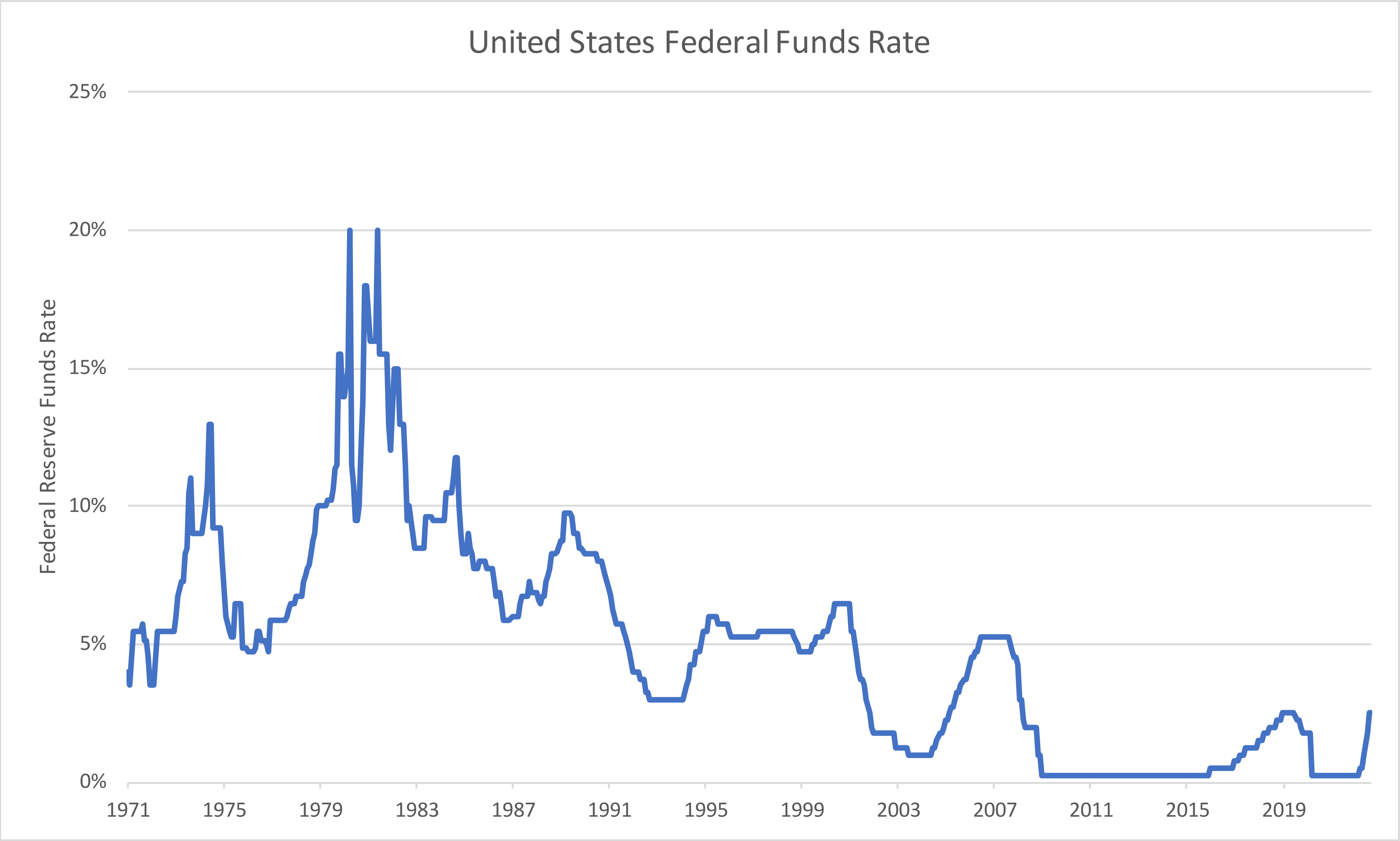
US Federal Funds rate

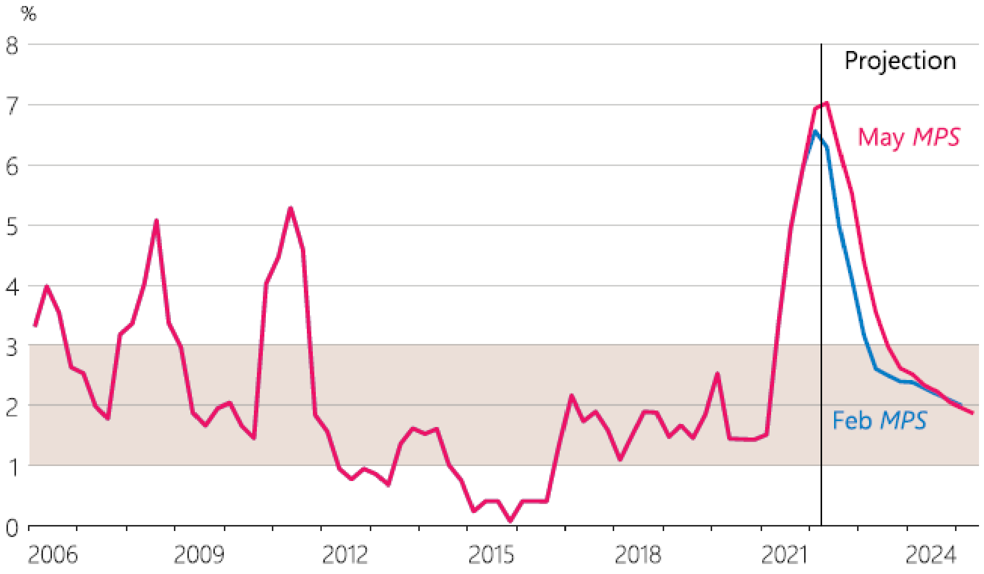


RBNZ – update from recent MPS

Inflationary pressures are more persistent

Figure 2.20

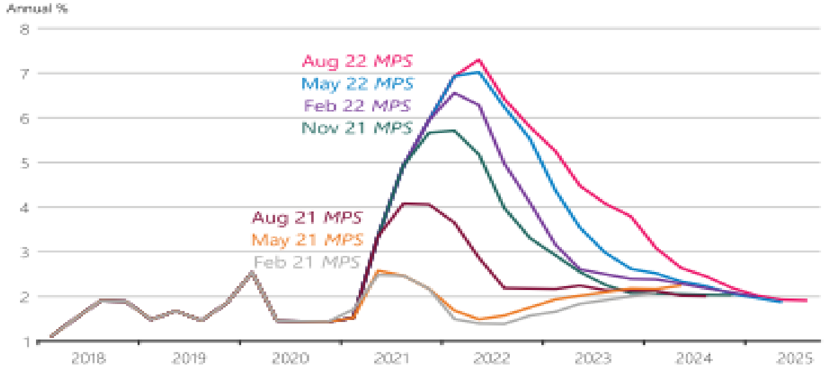
Annual CPI inflation



Source: Stats NZ, RBNZ estimates.

Figure 3.4

Reserve Bank annual CPI inflation forecasts since 2021

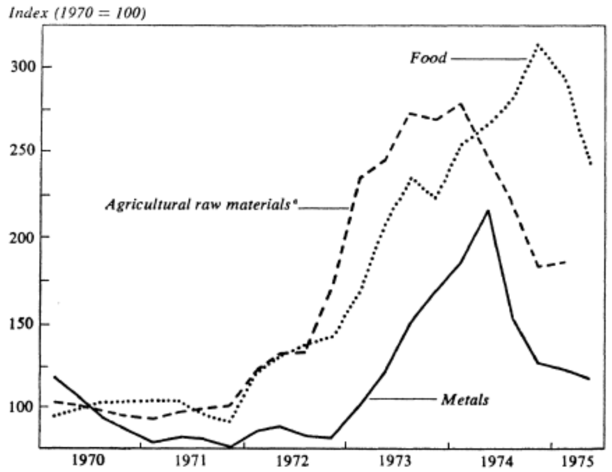


Source: Stats NZ, RBNZ estimates.

There are some parallels with the 70's that are unsettling....

- Energy price shocks
  - Natural gas shock and European and US winter approaching
  - Oil
- Commodity price boom (see insert – 70's)
  - Ukraine induced
  - Industrial metals
  - Wheat – soft commodities
  - 70's was a supply-side issue as well
- Large increase in fiscal spending

Figure 2. Major Components of the *Economist* Index of Commodity Prices, Quarterly, 1970–75



Sources: The index for prices of food, metals, and fibers appears in *Economist*, vol. 248 (July 7, 1973), pp. 70–71, and vol. 256 (September 6, 1975), p. 81; and the price indexes for hides and rubber are from United Nations, Statistical Office, unpublished tabulation (October 29, 1975).

a. The index for agricultural raw materials was constructed from the *Economist* index for fibers and from the hides and rubber components of the United Nations index of commodity prices.

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History repeating or what's changed?

- Central bank independence.
- Inflation targeting.
- Take politics out of the decision.
- Powell's three lessons.

But the key theme appears to be that inflation expectations matter as does perception that the Fed will fight inflation

- Former Vice Chair – Richard Clarida
  - Argued 20 years ago that inflation was at risk of spiralling out of control in the pre-Volcker era because individuals (correctly) anticipate that the Fed will accommodate a rise in expected inflation”
- So my take is that the Federal Reserve will really talk tough
- But what happens in the labour market becomes critical to avoid the wage-price spiral

Second tier data seems to be unequivocally weaker

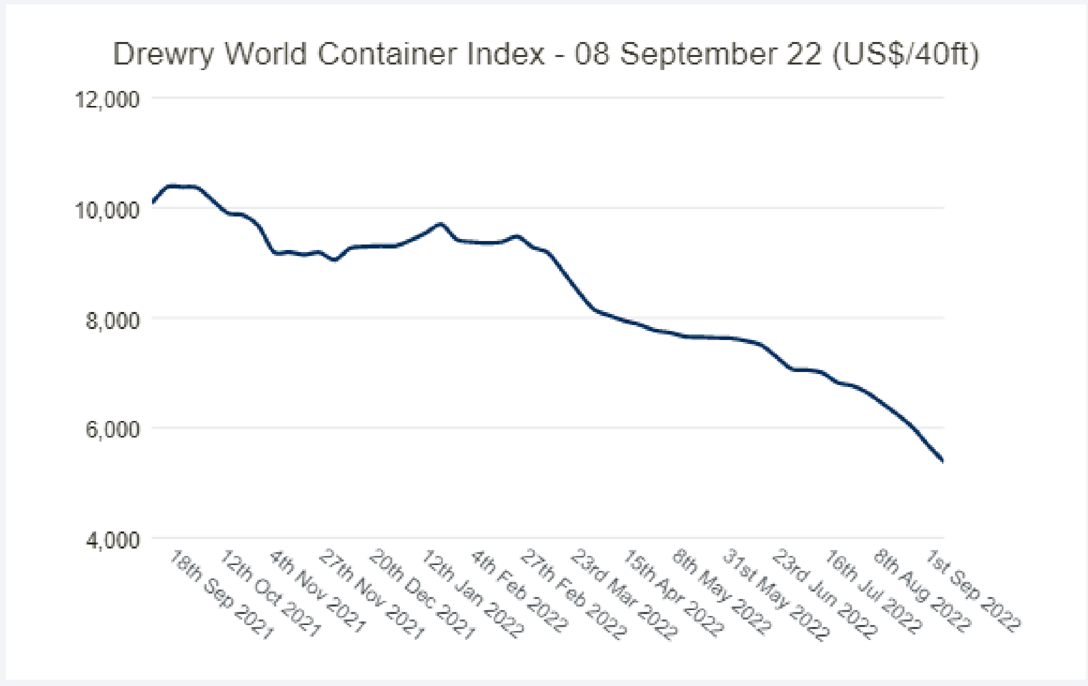
- Last week
- 23/08 S&P US PMI (Manufacturing/Services/Composite)
  - Manufacturing 51.3 versus 51.8 exp.
  - Services 44.1 versus 49.8 expected
  - Composite 45
  - Weaker activity
- 24/08 New Home Sales
  - 511k versus 575k expected
- 25/08 Durable Goods
  - 0.0% versus 0.8% expected
- Kansas City Fed Manuf. Activity
  - 3 versus 10 expected

Outlook

- Interest rates to remain high.
  - Is 4% – 4.25% high enough?
- Not enough supply – second round inflation impacts are starting to feed through.
- Demand needs to be reduced.
- Unemployment needs to rise or job insecurity increase.
  - In the United States, two job openings for every unemployed person.
- Where have all the workers gone?
  - Aging populations in the developed world?

Outlook continued

- Positive signs
  - Supply chain delays and costs being resolved.



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Outlook continued

- Positive signs (continued)
  - Oil back to pre Ukraine War levels (but US dollar higher).
  - Second order indicators imply that economies are slowing.
  - Starting to see headlines about lay-offs.

- Negative signs
  - Government’s are trying to offset the price increases.
    - Cap on energy bills in Europe.
    - Cost of living payment in NZ.
  - Wage price spiral has started.

Financial markets

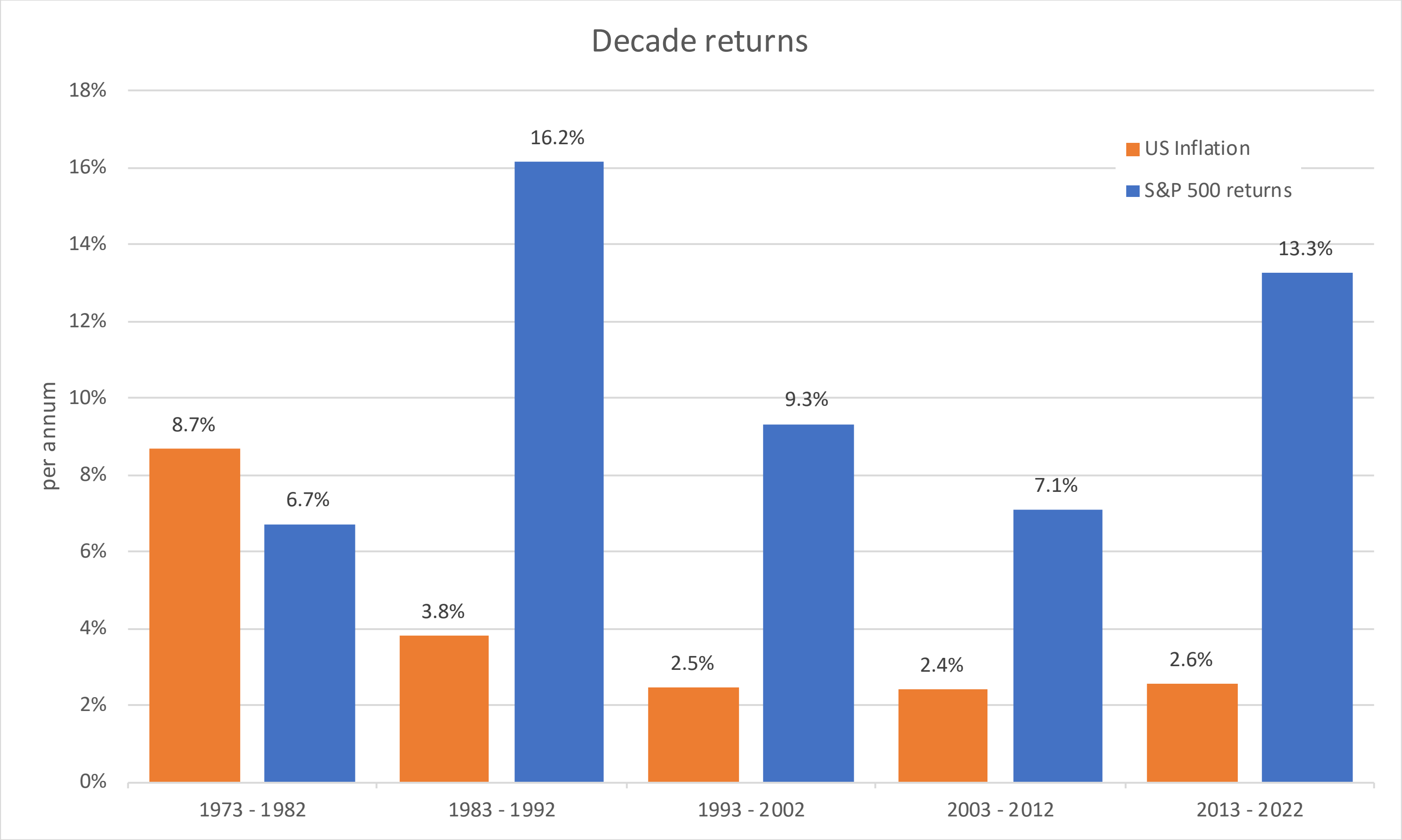
- Good news is bad news and bad is good. But Powell has shed some doubt over this paradox – its not as simple as that anymore – all news is not equal, some news is more equal than others!!

- Markets will be looking for signs that inflation is falling.

- But, lower demand is not good for company profitability.

- Short-term outlook is uncertain, long-term positive

Low inflation good for equity returns



Investment Views and Portfolio Positioning

- Caution regarding growth assets.
    - Valuation compression but earnings concerns.
    - This is likely to be the key determinant of portfolio performance over next six to twelve months.
    - Value style versus growth.
- Reducing the underweight exposure to Australasia.
- Fixed Interest.
    - Favour domestic over global exposure.
    - Still cautious of duration.

My take

- The labour data is key to interest rate expectations
  - Equity markets will react to what's happening in labour markets – it will be a rocky ride

- But there is the ongoing background of the degree to which monetary policy tightening and money supply tightening will constrain corporate profits
- We are not living in the 70's
  - It took a long time for authorities to figure out what to do – we do now have the benefit of hindsight
  - We aren't starting from 1963!!!

Additional Info

US second quarter earnings – a mixed bag but earnings growth is slowing

- Factset data
- Earnings Scorecard: For Q2 2022 (with 87% S&P 500 companies reporting actual results), 75% of S&P 500 companies have reported a positive EPS surprise and 70% of S&P 500 companies have reported a positive revenue surprise.

- Earnings Growth: For Q2 2022, the blended earnings growth rate for the S&P 500 is 6.7%. If 6.7% is the actual growth rate for the quarter, it will mark the lowest earnings growth rate reported by the index since Q4 2020 (4.0%).

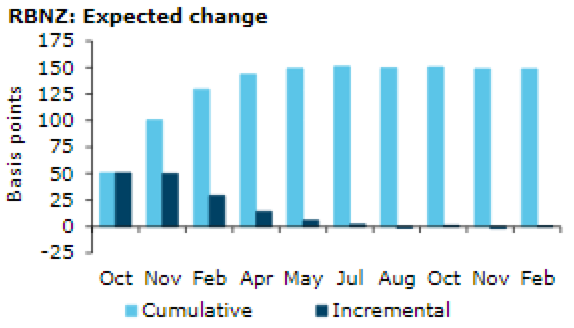
- Earnings Guidance: For Q3 2022, 42 S&P 500 companies have issued negative EPS guidance and 30 S&P 500 company has issued positive EPS guidance.

- Valuation: The forward 12-month P/E ratio for the S&P 500 is 17.5. This P/E ratio is below the 5-year average (18.6) but above the 10-year average (17.0).

Current Market Pricing has more rate increases priced in

New Zealand	Rate	Change from current
Current Rate¶	*3.00*	
Wed 5 Oct 22	3.51	*0.51*
Wed 23 Nov 22	4.01	*1.01*
Wed 22 Feb 23	4.29	*1.29*
Wed 5 Apr 23	4.43	*1.43*
Wed 24 May 23	4.49	*1.49*
Wed 12 Jul 23	4.51	*1.51*
Wed 16 Aug 23	4.50	*1.50*
Wed 4 Oct 23	4.50	*1.50*
Wed 29 Nov 23	4.49	*1.49*
Wed 21 Feb 24	4.49	*1.49*

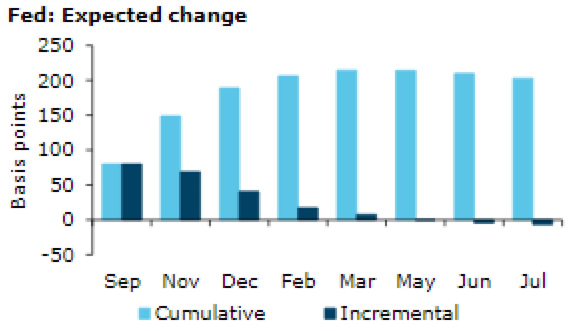
¶ OCR announced after RBNZ meeting at 2pm Wednesday, takes effect from Thursday



USA	Rate	Change from current
*Effective FFR^*	*2.33*	
Wed 21 Sep 22	3.13	*0.80*
Wed 2 Nov 22	3.82	*1.49*
Wed 14 Dec 22	4.22	*1.89*
Wed 1 Feb 23	4.39	*2.06*
Wed 22 Mar 23	4.47	*2.14*
Wed 3 May 23	4.47	*2.14*
Wed 14 Jun 23	4.43	*2.10*
Wed 26 Jul 23	4.36	*2.03*

^Effective Rate today 2.33%

Policy Rate 2.25-2.5% range; Interest Rate on Excess Reserves 2.4%



Navigating that path

- Hard Landing
  - Economies slow
  - Stagflation
  - Company earnings fall
  - Sharemarkets reprice
- Soft Landing
  - Inflation moderates
  - Growth moderates
  - Recessions are shallow and short lived – if in fact they happen
  - Central bank monetary policy response is as forecast by the central banks, or lighter
  - Company earnings growth moderates but doesn’t shrink

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