Volatility – the new world order

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Financial markets need to prepare for shorter, sharper cycles and take a longer-term approach to battle greater volatility. TCorp chief economist Brian Redican looks at the various risks and forces at play for investors and portfolios.

Inflation has been a major global issue over the past 2 years. Will it persist and what is the impact on investment strategy?

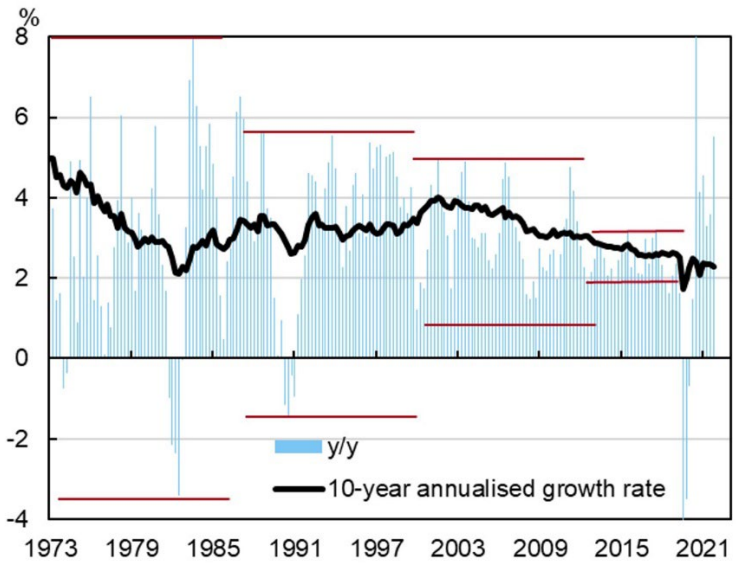
Whether you're in bonds or equities, private equity or property, inflation is kryptonite to financial markets. Most breakeven inflation rates are now back at 2%, so markets are backing that this nightmare will end in the next 12 to 18 months and things return to normal. But is that really the case?

A key assumption is that central bank actions can squeeze inflation down but there is a growing position that the drivers of inflation are not something they can control. This could lead to shorter and sharper economic cycles than what we've been accustomed to, with potential risks for investment portfolios and the way we should think about investing.

What do you mean by short, sharp cycles?

Let's look at the Australian economy's year-on-year growth rates going back to the early 1970s. Chart 1 shows the amplitude of the cycle over that 50-year period where we've seen very volatile cycles, and some with less amplitude.

Chart 1: Australia GDP growth



Source: TCorp, Bloomberg

Some market participants think we will now see a return to the conditions we had in the 10 years leading into the pandemic, but I think we will see more volatility. The decline in volatility in that decade was because of a range of factors. As developed economies became more service-oriented, they became more stable and with smaller agricultural, mining and manufacturing shares, you get fewer volatile cycles over time.

Since the ’70s, we have also seen some positive supply shocks; for example, the collapse of the Soviet Union at the end of the 1980s released a huge supply of commodities back into western markets, which had a beneficial impact on global inflation during the 1990s and into the 2000s. The accession of China to the World Trade Organization had a very similar impact. Suddenly, we had another billion workers pushing goods into western economies which really reduced the amplitude of that cycle.

Lower inflation, which is one of the impacts or implications of an increase in supply, meant that central banks could respond very quickly to temporary demand fluctuations or wobbles in financial markets, and respond so that they didn't develop much over time.

The question remains whether the world that has been in place for quite a while will still be there for the next 5, 10, or even 15 years. We have seen numerous examples that things are changing – with geopolitical tensions suddenly there is much more risk in manufacturing goods in China, and there are issues with supply chains. If we consider onshoring global manufacturing production or “friend-shoring”, moving it to a “friendly” nation rather than China will come at a higher cost. A big shift here would be the need to look at the resilience of supply chains rather than what is most efficient.

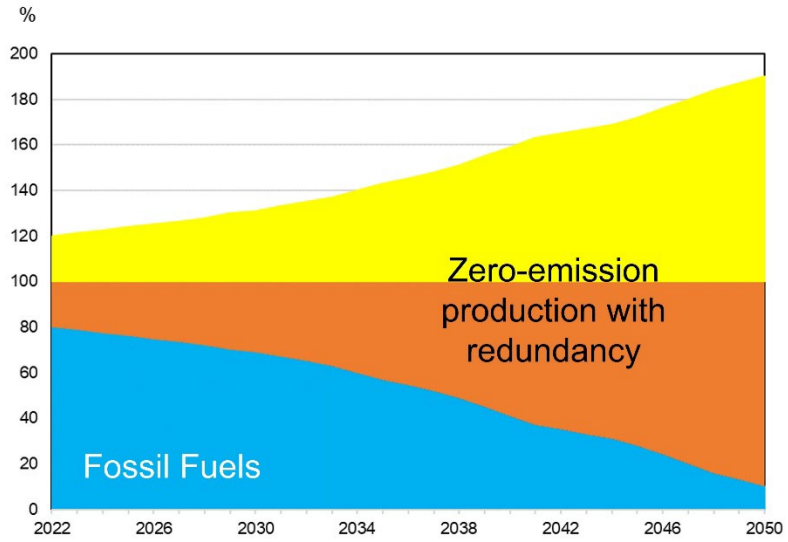
The other aspect of geopolitics is defence spending which tends to be quite inflationary over time. Again, after the collapse of the Soviet Union, global defence spending as a share of GDP kept falling, Now, with the situation in Ukraine, European countries have talked about doubling their defence spending over a run of years. Even Australia is talking about spending on tanks, aircraft, and submarines.

What are the other inflationary impacts? A big focus for financial markets is climate change considerations and the transition to net zero. Will actions here contribute to inflation?

Potentially yes. Apart from the cost of building infrastructure to assist in the transition and funding damage caused by more frequent climate change events, as well as the insurance cost, I think there could be several inflationary consequences.

But one that I want to focus on is the mix of energy during this transition phase. If we achieve the transition to a low-carbon energy base, energy prices should be low and steady. During the transition, things can go wrong – the last 12 months give some insight into what can happen there.

Chart 2: Electricity production capacity



Source: TCorp

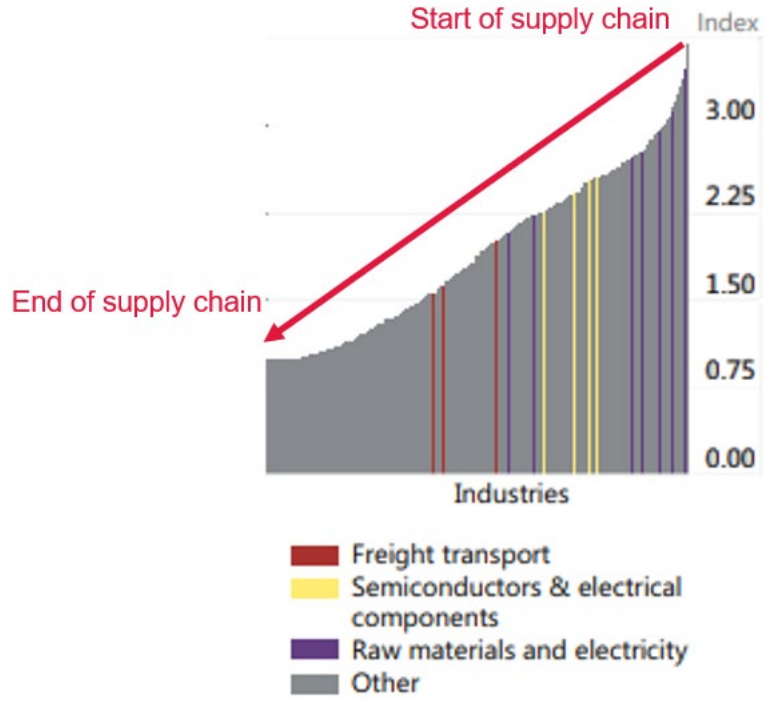
Looking at the bottom of Chart 2, you can see that fossil fuels have a share of electricity production that could fall to about 10% by 2050 and be replaced by zero-emission technology, nuclear or renewable power. But as a lot of critics of the shift to net zero say, you can't rely on wind or solar, because sometimes the wind doesn't blow and the sun doesn't shine. The very simple response to that is you don't just aim for 100% capacity, but for redundant capacity; when the wind is not blowing in NSW, it might be blowing in Queensland or Victoria, and you shuffle the electricity around.

But what happens when potentially all the energy demand can be met by renewables? That has been the case already in some areas of Australia for short periods over the last 12 months. So, when conditions are favourable and all electricity demand is met by renewable sources, fossil fuel producers get no revenue. When conditions are not working, we must suddenly shift back to baseline sources such as coal and gas and see prices spike. That's exactly what happened in 2022.

As we get closer to 2050, supply capacity from fossil fuels will get smaller. Reliance on that could see the amplitude of electricity prices get higher, a problem exacerbated because that baseline power will increasingly be gas-fired. Australia's east coast is tied to the global gas price – our gas prices are so high now because of the geopolitical situation in Europe. What we do in terms of renewable energy in Australia is not all that matters – we are tied into costs because of what has happened in Europe.

Energy costs can have a major impact on inflation because of the supply chain and where it occurs. Looking at the right-hand side of Chart 3, you see the start of a supply chain.

Chart 3: Bottlenecks have affected upstream industries



Source: TCorp, BIS

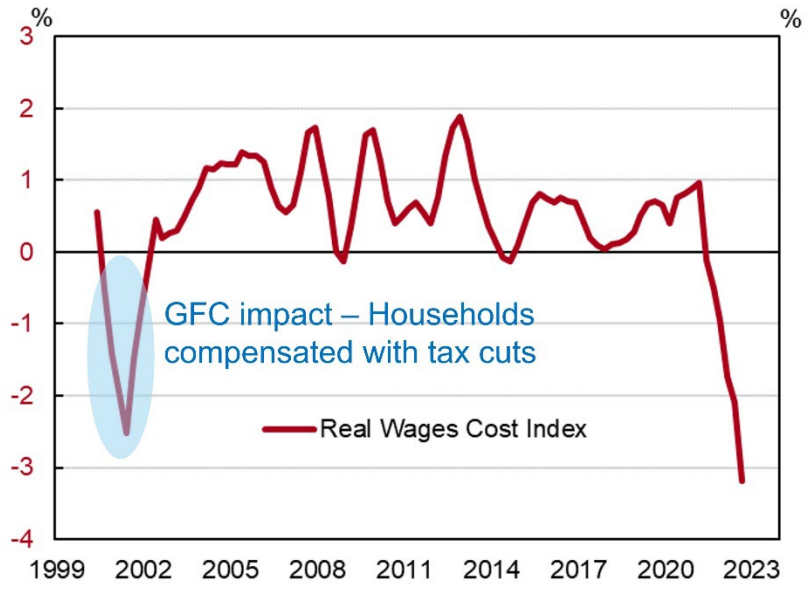
Think about, for example, manufacturing a car. The purple bars in this chart represent the raw materials, such as copper and aluminium. If those prices spike and everyone else in the supply chain adds a margin it will have a pervasive effect on the cost of the car. Then there are things like semiconductors and other electrical items that come through a global supply chain that is in its reasonably early stages. We then need to add the cost of shipping goods from China or Germany to the US or Australia.

Any disrupted supply of these materials in the future will see a repeat of the very large spike in prices. Central banks remain very focused on delivering 2% inflation over time, but a scenario like this could mean they must fight that inflationary spike more frequently.

What are the inflationary impacts of the move to increase real wages?

Central banks have made it clear that households must pay the price for getting inflation back down. Chart 4 shows the wage cost index deflated by actual inflation and you can see that real wages are falling very sharply now.

Chart 4: Australia real wages



Source: TCorp, Bloomberg

It seems that households currently are willing to shoulder that burden and conceding a wage/price spiral must be avoided at all costs. But let's say that next year we get back to 2% inflation followed by another negative supply shock in 2025 and inflation spikes to 5 or 6%. Will households push back against a 3% wage cut in real terms? What happens to consumer spending, the housing market, Australia's growth prospects?

Further, if profits are tied to the size of the economy, they cannot grow unless the economy does. This may have important implications for investors and where we allocate our capital over time.

There are issues in England, in New Zealand. If you look at Europe, Italy's economy is about the same size as it was 10 years ago, with Greece even worse – 20% smaller than a decade ago.

If all these economies have much lower growth, it will mean global growth will not be at the rate we've been used to. Where will the profit growth come from? If interest rates move higher, valuations might move lower. Are we truly moving back to the pre-pandemic economy and, if that is not the case, how can investors respond?

The issues posed here give a sobering outlook. What are the opportunities for investors?

When economic cycles are long and steady and not too exciting, it's actually a great time for investors and financial markets. Investors can be more short-term focused because the economy and the markets are probably going to look very similar tomorrow as they do today.

In a volatile environment, where growth could be +6% or -4% and change over a 12-month period, it is not an environment to go on a predestined investment path. There is a paradox that when cycles are long and grinding you can afford to be short-focused, but short and sharp cycles need a longer-term approach.

Investors and regulators need to shift away from this 12-month focus and look more at the medium term. Getting caught up in volatility and trying to chase what worked in the previous 12 years with your portfolio allocation may well exacerbate bad returns, rather than even them out over time.

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