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Inflation, interest rates and what it means for equities

Research & Insights

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Paul Xiradis, Executive Chairman, Chief Investment Officer and one of the founders of Ausbil Investment Management talks about the spectre of inflation, and how Ausbil is making sense of what is happening in equity markets.

Paul Xiradis
Executive Chairman, Chief Investment Officer, Head of Equities

Since 1990, the cash rate has been in a secular 30-year decline, a journey from 17.5% to where we are today, with an official cash rate of 0.1%. What happens now?

The good news for investors, we believe, is that advanced economy central banks and government treasury departments have a well-considered, well researched and very well signalled plan to normalise inflation levels, and normalise the emergency monetary and fiscal policy settings we have been experiencing since the onset of the pandemic in early 2020.

Unprecedented monetary policy in the form of low rates and unconventional broad measures, including quantitative easing, have been in place since the Global Financial Crisis (GFC). However, this is now changing as monetary policy is set to reverse its recent trend.

Equity investors are rightly focused on inflation and are asking what rising interest rates mean for the value of equities. To make sense of this complicated change in markets, let's take it in simple steps: the economy from a macro perspective, inflation and interest rates, and ultimately what this means for earnings.

Macro. Inflation has been rising for a good reason. The extensive monetary and fiscal policy launched to avert and stabilise a pandemic-induced economic disaster has worked. The economy experienced a two-quarter technical recession, is now growing strongly, heading towards full employment, and is projected to grow over the years ahead.

Inflation. Without talking too much on COVID, the extraordinary conditions and behavioural changes caused by lockdowns has seen inflation return in a bumpy and, most likely, non-persistent manner. This is because of distortions in spending, and supply chain and labour market bottlenecks during the course of the pandemic. With vaccines released in late 2020, and close to full-vaccination achieved in late 2021, the path is now towards more stable markets, improving supply chains, spending and employment conditions. This is seeing inflation shift from intermittent spikes towards a more normal, 'healthy' level that runs sustainably within the 2% and 3% RBA target band. We are in the transition to this phase. We do not subscribe to the market's view that there will be major policy mistakes during this transition, we see it more as a re-calibration that can be adjusted if the central banks take one too many steps.

Rising inflation does benefit some equities. Research and experience shows that sectors like banks, diversified and specialist metals and mining companies, energy, gold, insurance, and steel all benefit in growth-driven inflationary environments. Those inflation-exposed sectors that typically underperform in an inflationary environment include agriculture, construction materials, real estate investment trusts, software and services, telecommunications and capital goods. But every stock has its own story and business model so there will be exceptions in both cases.

Interest Rates. As interest rates are the main lever the RBA has to manage inflation, rates will rise as persistent inflation is experienced. What we know about interest rates is that they are rising. They are already rising in term debt, you will see this when you try to fix your mortgage interest rate. The official cash rate will also rise – all central banks have been telling us this for some time – and our view is currently that the first Australian rate rise will come later this year, if not by February 2023. Will interest rates rise a lot? We do not think so. Ausbil sees a careful calibration of interest rates with existing levels of household indebtedness, and central banks taking care not to push the economy into reverse.

It is critically important to note that the cash rate is the lowest it has ever been, and interest rates relative to history are very low, and will remain low for some time even with some rate rises. This benefits equities in providing access to relatively cheap debt, funding for growth and acquisitions, and also assists private capital in the pursuit of listed companies.

Company Earnings Impact. Remember, we are in the early phase of sustainable economic growth, a return to relative normality as COVID subsides in risk, and company earnings are benefiting. We believe markets tend to track earnings growth over time. Market consensus earnings for the S&P/ASX 300 Index currently points to EPS growth of around +13.6%, +3.5% and +2.9% for financial years 2022, 2023 and 2024 respectively. This view changes dynamically, but overall, earnings are growing in the context of low rates and a healthy economic growth profile for some years.

Equity investors will however see markets sell down inflation-exposed equities when they fear inflation is stronger than expected, and you will see them bid-up inflation beneficiaries. We saw some of this in late January. The challenge is to stay invested in the best companies, and not to try and time the movement of rates too much. Success follows a steady hand and focus on earnings and earnings growth because the market follows earnings.

Looking ahead, we see cyclicals as a group continuing to perform with the strong economy, with strong earnings outlooks for financial year 2022, but we think cyclical leadership will change, with energy, materials and post-COVID beneficiaries in discretionary spending the key beneficiaries. Quality growth and structural leaders are also offering a strong earnings rebound into financial years 2022 and 2023. Companies that are major leaders in their sectors and that can pass on the impact of inflation through relatively inelastic demand for their services will benefit here, in health care, infrastructure, some discretionary businesses, and leaders in decarbonisation resources are good examples.

We think earnings in 2022 and 2023 will be stronger than anticipated by consensus because we see the positive impact and sentiment from a growing economy and the shift from pandemic restrictions benefiting Australian businesses across the spectrum.

There are risks. There is a risk of new COVID strains, but eminent scientists are telling us the pandemic is becoming more endemic, more similar by-and-large to the common flu. There is risk of an interest rate policy mistake, though we do not subscribe to this theory. There are risks around trade, China relations, and more recently, the Ukraine, but these are unquantifiable and while important, should not derail a good long-term investment strategy.

The best approach to succeeding is to actively tilt to the beneficiaries of the inflation we are seeing, stay invested, and invest in the leading names in the market that retain relative pricing power across the cycle.

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