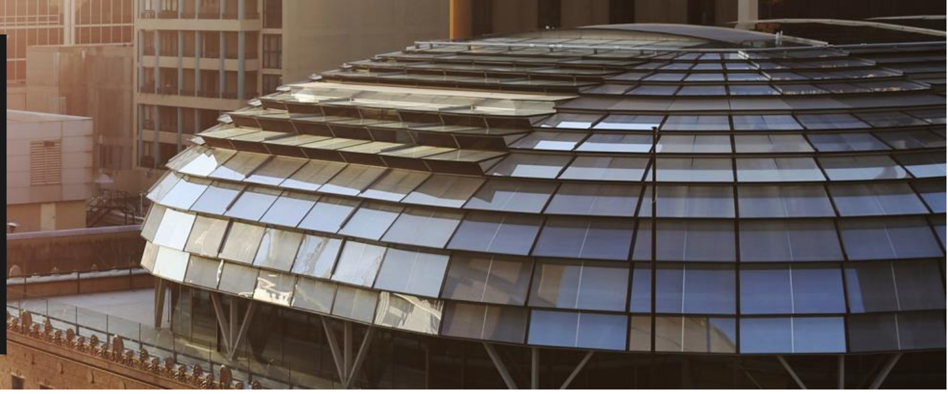
Research
18 October 2021
MACQUARIE



Investment Strategy Update #74

Buyer Beware - Inflation is about to become your problem

- Official inflation measures still paint a "nothing to see here" picture for the average Australian household. But, in the real world, we need somewhere to live, require a mode of transport (usually a car), gas to fill it up as well as food to eat, it's hard not to have noticed the price of "stuff" going higher.

- As mobility returns, as households release pent up demand for services on top of strong ongoing demand for goods, we think the hit to the back pocket is going to get worse. Whether it be a straight out rise in the price of goods, rising shadow inflation (the sneaky way of offering less for the same price) or whether you just can't get what you want, you'll likely be paying more in the months ahead. In addition, after the first wave of goods inflation, watch for services inflation to emerge.

- Experts will argue that price increases are temporary, so we don't need to worry about it. But, unless businesses are prepared to wear the 4-fold increase in shipping costs or the quadrupling of energy costs or the need to pay someone more just to get them back to work, we'd guess the cost of many things is going higher. Moreover, if/when supply shortages normalize, we'd hazard to guess that any price increases put through to compensate are not reversed out.

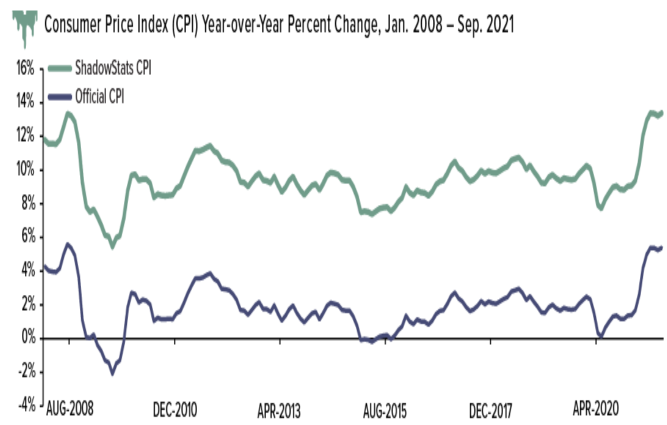
- Higher prices may not drive an earlier than expected rate hike cycle by the RBA but, given how many other global central banks have recently been pushed to tighten earlier than expected, it's a growing risk. For households, who are not particularly worried about the policy response which remains some way out regardless of near-term inflation pressures, be prepared for the inconvenience of not getting what you want, having to pay more if you can, or just getting less for the same price. Hashtag *#EmptyShelvesJoe* is actually a real thing trending on twitter … and potentially coming soon to your supermarket and toy store!

According to *"official channels"*, no one has really <u>had</u> to worry about a general rise in the price of goods and services for many years. However, in the real world (the one we all live in), it seems like we are always paying more for the same (general price inflation), or more for less (shadow price inflation), even if "*official measures"* say otherwise. Unfortunately, we think the trend, of paying more or getting less for the same price, is about to get a lot worse for the average Australian.

We think it is going to be hard to avoid some exposure to rising prices in the months and quarters ahead. If you live in a house, drive a car, eat food, buy anything that is not wholly "*Made in Australia"* or intend to consume certain services (such as hospitality or travel) than you should be prepared to pay more for it as we head into the New Year and this may actually be a best case outcome.

An alternative outcome is that you don't pay more but that you get less (a smaller packet of chips, a smaller can of drink or in terms of services – you wait longer for the same meal or drink, or your hotel room is cleaned once and not twice a day. This is called shadow price inflation and, in the US, is running at a whopping 13%. Finally, a "*worst"* case outcome is that you don't have to pay more because you can't get what you want (something akin to the great toilet paper shortage of 2020 that was only resolved via rationing).

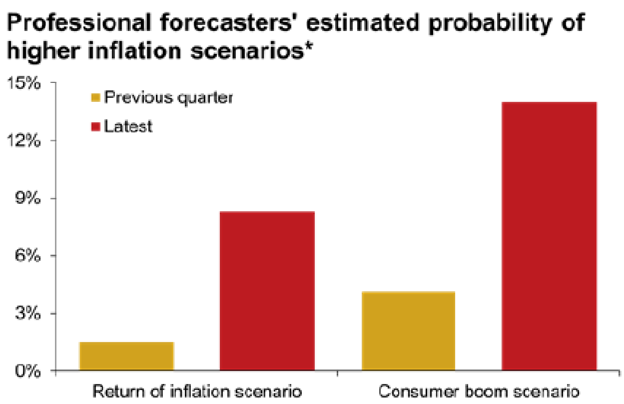
US *"shadow"* inflation is running at 13% !!



Source: Shadow Govt. Statistics, US Global Investors, Oct-21

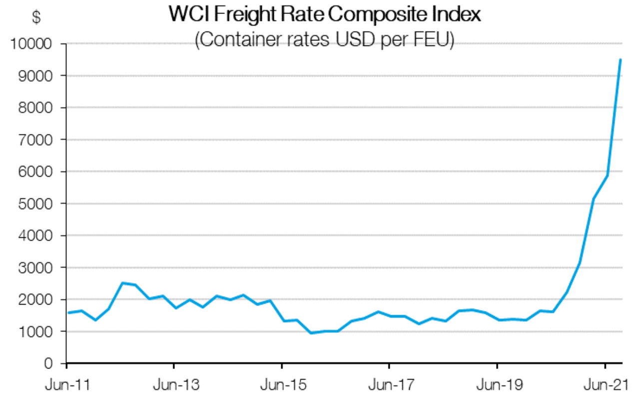
We think all three outcomes are on the cusp of occurring for many goods and as mobility returns to normal, increasingly for services (goods inflation is already leading services inflation for Australia). As we head into Christmas, households can expect the inconvenience of higher prices and/or goods shortages/delays to become far more acute. This is already happening in the US (which arguably bounced back faster than Australia post the pandemic and resultant outbreaks) with a shortage of products becoming so bad that "hashtag *#EmptyShelvesJoe"* which reflects a rise in empty supermarket shelves, has been trending strongly on Twitter in just the past week.

Experts are altering their views on inflation



Source: Oxford Economics, October 2021

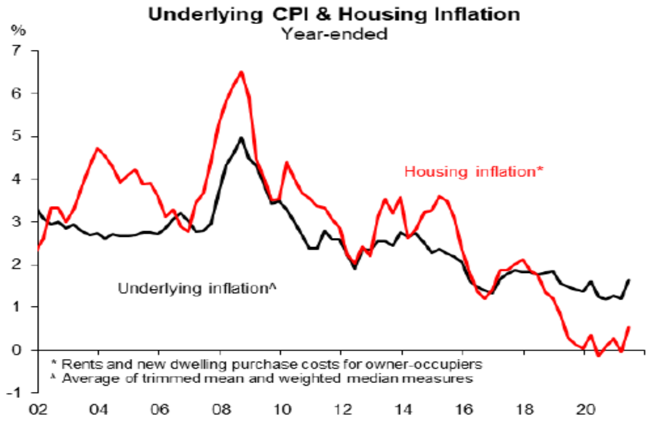
Freight prices have exploded higher …



Source: Bloomberg, MWM Research, October 2021

There is a simple set of reasons why the world (and likely Australia) is facing these cost pressures. Goods demand has recovered much faster than goods supply due to ongoing product and transportation bottlenecks because of shutdowns over the COVID-19 period. But, if manufacturers cannot quickly catch up to the demand, if there are no additional ships on planet earth to hasten the delivery of products, if ports continue to sit on mountains of unloaded containers due to worker shortages and if energy and gas prices which have already doubled, tripled, or quadrupled begin to seep into prices, then higher inflation is a certainty.

Housing has supressed Australia's inflation rate



Source: ABS, Macquarie Macro Strategy, October 2021

We think the prospect of higher prices as well as potential supply shortages through Christmas and beyond is going to be what greets the broader population just as they begin to emerge from lockdowns and border restrictions. Perhaps a more pertinent question is why this is not yet a topic of concern? We think there are several reasons that explain the broad apathy towards the future price of "stuff" and why it's going to get worse.

- First, half the population has been in lockdown and so are not yet feeling much price pressure, but if developments in the US are anything to gauge the future by, then there are big problems coming as demand and mobility begin to normalize.

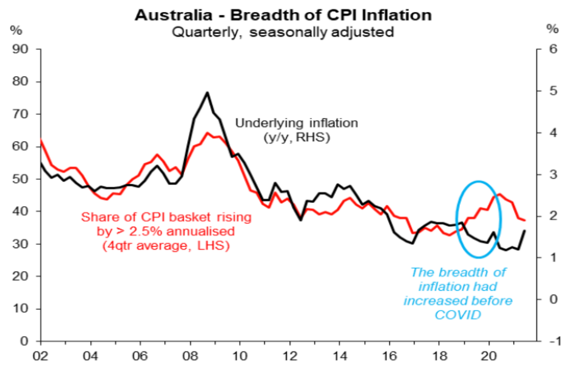
- Second, for the past 12 months there has been a very one-sided consensus view that inflation pressures would be temporary and that as supply caught up to demand, prices would begin to fall back to more normal levels (particularly for transport and raw materials). This, experts have told us there is no need to worry (even as they have been wrong in its persistence).

- Third, while Australia's latest headline inflation print of 3.8% was at a 13 year high, the overall core measure has been supressed due to the impact of the pandemic on rents and government subsidies (including HomeBuilder). This has disguised the underlying strength in new dwelling purchase inflation.

- Fourth, Australia has suffered from a long period of weak wage growth and a post pandemic world is not likely to have dramatically altered this backdrop. Thus, unlike the US which has already experienced strong wage inflation (where job openings are higher than available workers) as well as broadening goods price inflation, Australia has thus far managed to avoid both, and the RBA has held into its view that it remains unperturbed.

However, in a few short weeks, most of the country will no longer be under "stay at home" orders and if NSW is anything to go by, demand for services is like a coiled spring that will bounce back sharply. Similarly, as pandemic driven housing supports are removed, this depressing impact on inflation will reverse out and excluding these impacts. Macquarie already believe inflation will be close to the bottom of the RBA's 2% range once the housing impact is removed. Finally, inflation might prove transitory as supply side constraints are alleviated, and businesses simply choose to absorb rising costs, but, in the real world (the one we all live in), we'd be surprised if this was the case.

Will inflation breadth rise as COVID drags decline?



Source: ABS, Macquarie Macro Strategy, October 2021

Unfortunately, price increases don't tend to be reversed if input costs start to fall at some stage in the future so even if inflation is temporary, price increases tend to be sticky. And last, Australia more than most other countries, has the potential for some catch-up inflation pressures particularly as services demand ramps up and restrictions for international workers remain in place.

This means households should prepare for higher prices - either directly or indirectly via shadow inflation. Don't expect to see a quick offset from rising wages - this is not likely. While it may not drive a response by the RBA which impacts financial markets, in the world we all live in, it's going to be notable and that's if you manage to get the toys for under the Christmas tree, or for that matter, the Christmas tree!

Macquarie WM Investment Strategy Team

The report was finalised on 18th October 2021.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return