

CIO MONTHLY NOTE

May 2016

STRUCTUALLY LOWER INFLATION



At its latest policy meeting, the RBA cut the official cash rate by 25 basis points to a new record low of 1.75%.

So what are the implications for the equity market?

Unlike most RBA rate cuts over the past two decades, this one

was not due to weak demand but rather much weaker than expected inflation.

Indeed, the latest estimate of growth was a healthy 3.0% and the latest labour market report showed the unemployment rate continues to trend lower.

Rather, what spooked the RBA this time was a big downward surprise to inflation. The latest reading from the ABS confirmed that headline inflation has now missed the 2-3% target band for six consecutive quarters – the longest period below the target since the late 1990's.

Critically for the outlook, the RBA does not expect inflation to recover any time soon. In fact, the bank is now forecasting underlying inflation to be below, or at the very bottom of, its target band until at least mid-2018. Stepping back, it is clear that the phenomenon of disinflation is not just a local one. Policymakers in Europe and Japan have been dealing with it since the GFC and the Fed has battled hard to avoid a similar fate in the US.

Given Australia is a small open economy — that no longer has the mining boom to support it — it is not surprising that these disinflationary forces have finally reached our shores. In addition to these global forces,

Australia is also experiencing some bottom-up drivers of disinflation.

More recently we've seen increased competition in industries such as supermarkets (Aldi), telcos (driven by the introduction of the NBN) and apparel (global brand competition). Despite the obvious benefits to consumers, this extra competition puts downward pressure on prices.

Given the weak outlook for inflation and the lack of any wages pressure in the economy, it is very likely the RBA will need to cut interest rates again. Potentially more than once. So what does this mean for the performance of the equity market?

Lower rates are generally good for the equity market as they support earnings and valuations. Companies with foreign earnings will benefit via a lower AUD and the more cyclical construction and retail sectors will also be supported.

Lower rates should extend the hunt-for-yield trade as investors seek alternative sources of income in this low interest rate environment.

High yielding sectors such as REITs, utilities and some infrastructure should benefit the most. However, the impact on banks is not universally positive as the benefits from increased demand will be partly offset by some margin compression as rates fall to such low levels. The bottom line is that reliable dividends (and the franking credits) will be in very high demand for investors.

George Boubouras
Chief Investment Officer
Contango Asset Management Limited
(16 May 2016)