October 2021 — Over the Horizon Market Commentary by David Offer

The Australian share market was flat over the month of October, rising just 9 points to close at 7,639 points.

The dominant topic for investment markets to digest of late has been whether the sudden re-emergence of inflation is here to stay. Surprising inflation numbers continue to be reported around the world. This includes America's headline inflation presently running at 6.2%, European inflation at 4.1% and the Chinese Producer Price Index recently rocketing up 13.5%, suggesting input price rises will inevitably start to flow through to the Chinese consumer.

In Australia, our core inflation rate of 2.1% is slowly playing catchup to our headline inflation rate of 3.0%.

As per the chart below, long term debt instruments such as 10-year Australian Government bonds have started to respond;

By way of comparison, below is a chart of Australia's core inflation rate for the last 10 years. The last time Australia's core inflation was at 2.1% (back in 2015), 10-year Australian Government bonds yielded approximately 2.75%. When core inflation peaked above 2.5% in 2014, 10 year Australian Government bonds yields were above 4%.

With 10-year Australian Government Bonds presently yielding 1.86%, but core inflation running at 2.1%, in real terms these bond investors are seeing their purchasing power eroded. This suggests that investors are expecting inflation to reduce going forward.

However, it is increasingly hard to see inflation as transitionary. In Australia, numerous inflationary pressures will continue to apply for the year ahead. This includes high energy prices, Sydney and Melbourne emerging from long-term lock downs with their populations cashed up and ready to splurge, labour shortages due to minimal migration, supply constraints impacting many areas of the economy (the building sector for one), significant Federal and State Government spending initiatives to elevate economic activity, historically low interest rates and global inflation gradually flowing into Australia.

One 'release valve' could be Australians starting to travel abroad again and therefore spend surplus money overseas. However, this will take time to normalise and we will have to wait and see to what extent this will impact on reducing demand for goods and services.

Australia's Reserve Bank (RBA) has recently abandoned its timeline of no interest rate rises before 2024. Likewise, it has done away with its emergency policy measure called 'yield control', which was to buy short dated bonds to depress interest rates and in doing so lower borrowing costs to help support the economy. Most economists are now forecasting the RBA to implement one or two 0.25% interest rate rises in the second half of 2022.

If investors have a change of heart and view current inflation levels as being more permanent in nature, expect bond yields to rise further. If this happens suddenly, this would have flow on effects for all investment markets. Consider America, where the core inflation rate has recently doubled to over 4% and yet 10-year US Government Bonds remain stubbornly depressed on a yield of just 1.56%. That US bond investors appear willing to lose approximately 25% of their buying power over the life of a 10-year bond is not sustainable. As such, should inflation stay elevated, a meaningful bond market sell off is a real consideration.

With bond markets vulnerable and share markets at record highs, we are viewing the outlook for 2022 cautiously. This includes reducing exposure to interest rate sensitive investments such as passive property, steering clear of fixed interest investments and bond funds, avoiding highly priced growth investments and looking to hold a reasonable level of cash. Our preference remains for more conservative value orientated blue-chip shares that generate strong cashflow and pay a reasonable dividend. Thankfully our share market is presenting opportunities with plenty of pockets of value to be found.

On a different topic, we have recently changed our Australian Financial Services License (AFSL). Our former license is now used exclusively by related business Integrated Portfolio Solutions (IPS). IPS is responsible for the administration and reporting of your investment portfolios. Since its inception in 2010, IPS has grown strongly and now reports on $9 billion in assets for investors all around the country. With this growth and decoupling from the Horizon business, it has become appropriate for IPS to run with its own exclusive AFSL. As such, Horizon has relinquished its AFSL to IPS and now operates under a new AFSL – Number 527462. There will be no change to how we operate but it is a legal requirement to provide a new **Financial Services Guide** (FSG) that reflects the issuing of our new AFSL.

David Offer
Investment & Financial Advisor
phone: 08 9791 9188
fax: 08 9791 9187
email: david.offer@horizonis.com.au
website: www.horizoninvestmentsolutions.com.au

HORIZON INVESTMENT SOLUTIONS | UNIT 4, 2-4 JETTY ROAD, BUNBURY WA 6230