NEWSLETTER
February 2022

Introduction

Happy New Year! It is good to be back. In this newsletter, we look at the performance of the Australian Share Market and the current state of play in interest rates and examine the role that inflation might play in both of these markets.

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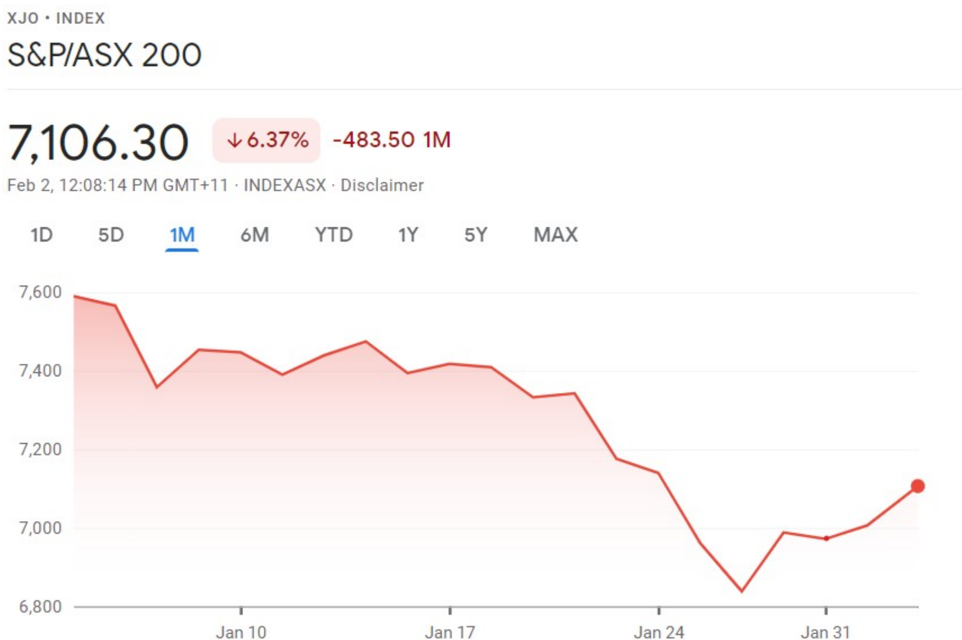
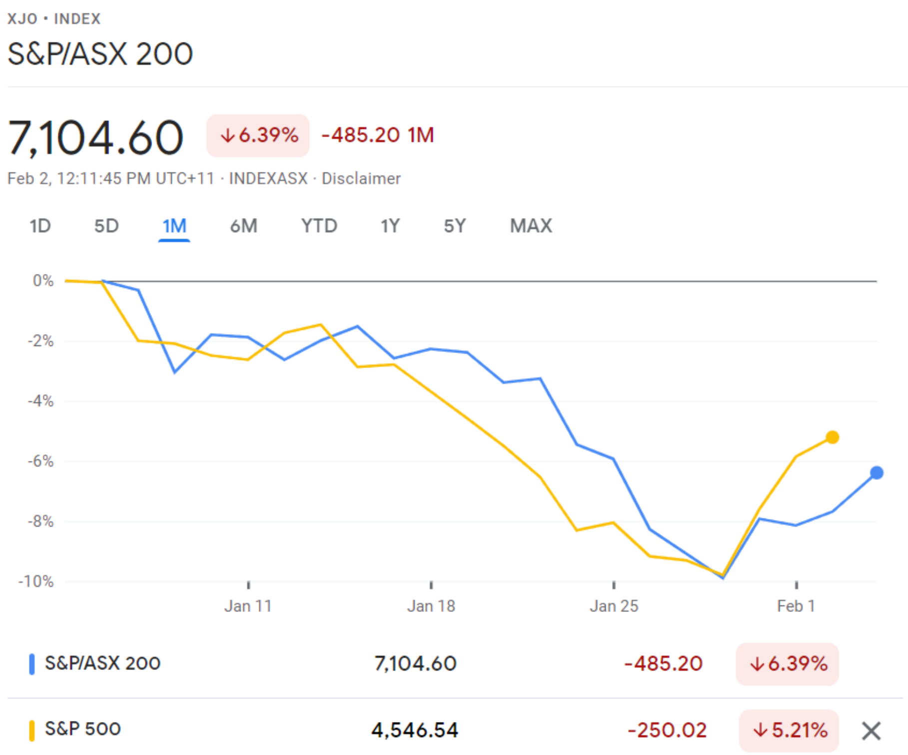
The Share Market

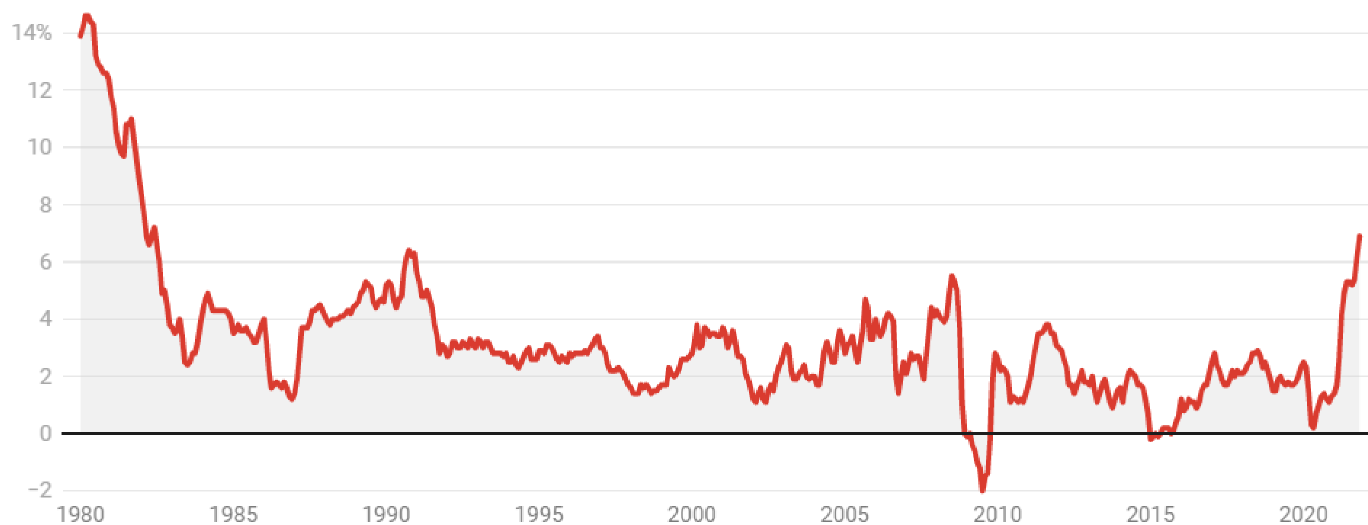
January was a 'red month' for the Australian Market. As shown in this graph of the performance of the ASX 200 (thanks to Google), the market fell by 6.37% between the 2nd of January and the 2nd of February (and that was after the market rose by 2% in the first two days of February).



The market fall (and the bounce in early February) almost exactly replicated the performance of the US market, as indicated in this comparison between the ASX 200 and the S&P 500 (again, thanks to Google):



The falls in the US market appear to have been caused by a rise in prices in that country that have increased fears of inflation. Prices are rising faster than they have in quite a while, as shown in this graphic from The Conversation:



In the section below on interest rates we give a good analysis of price rises and whether they should be viewed as worrisome. Essentially, it all comes down to whether a price rise is likely to be a temporary situation to which the market can respond, or a permanent one which will create ongoing problems. The performance of the US market makes clear that market participants there are worried that the recent price rises are not temporary. If that is the case, then the US Federal Reserve may be forced to increase interest rates, which generally dampens economic activity. If this happens, then profits fall – and this is why share prices took a tumble.

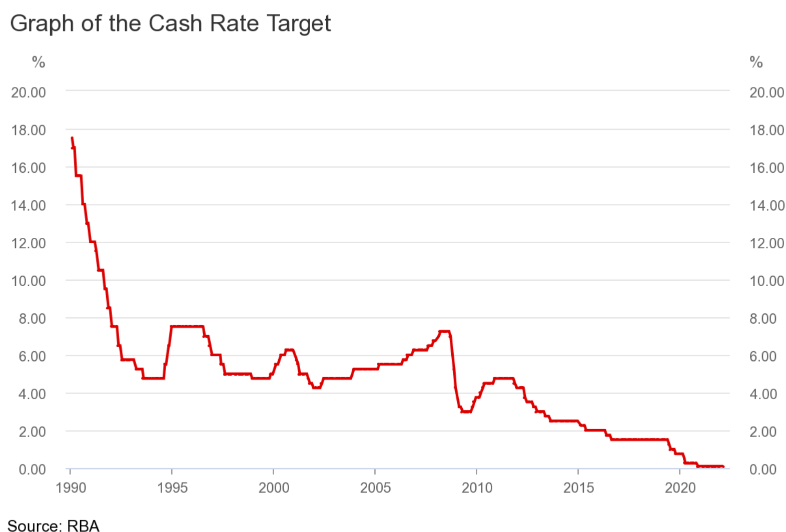
Note, though, that we are really looking at a market becoming spooked. Profits have not started falling – investors are simply worried that they might in the future. This is (yet another) reason that temporary moves in the price of shares should usually be ignored. In the short term, the market tells you how it is feeling today. But feelings change – as the increase in prices on the first two days of February make clear.

Inflation is best understood as a repeated rise in prices over several periods of time, rather than one or two episodes of rising quarterly prices. In the US, prices have risen over one year (in Australia, it is less than that). Time will tell whether these rises endure.

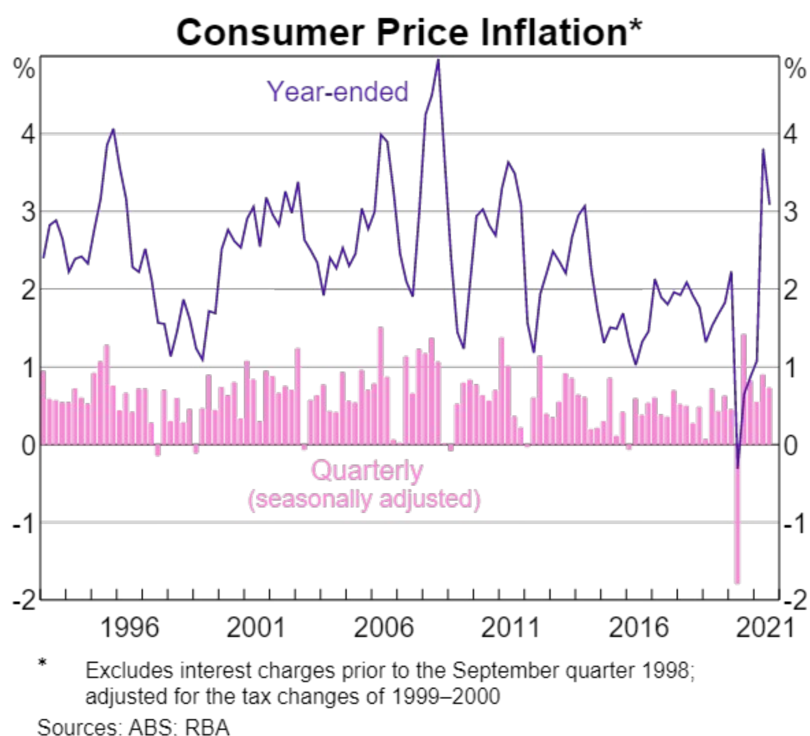
Interest Rates (& Inflation)

If you will excuse the financial planner's in-joke, interest rates are interesting right now.

In Australia, interest rates are effectively set by the Reserve Bank of Australia. They do this by using their power in one particular cash market to influence all the other cash markets. Over the last two years, the RBA has worked to keep interest rates at their lowest level ever, as shown by this graph provided by the RBA:



The main question now is: will that little red line start to cycle upwards? And that is where the conversation gets interesting. The RBA has consistently said that it will keep interest rates low until "actual inflation is sustainably within the 2 to 3 per cent target range" and it repeated that statement earlier this week. As this graph from the RBA and the ABS shows, inflation has been below 2% for quite a few years.



However, as the spike in the line on the right hand side shows, over the last two quarters inflation has risen above 3%. The issue, then, is whether the recent rise in inflation will be sustained.

The sharp rise in prices for various things is largely attributed to what are known as 'supply-side shocks.' These are situations where the supply of something falls – perhaps due to worker shortages somewhere along the supply chain. If the demand for that thing does not fall, then the price paid 'in the market' should rise.

Whether this represents 'inflation' is another matter. In a market economy like Australia, prices are supposed to change when supply and/or demand changes. The change in price is needed to motivate players in the market to change their behaviour.

To give a recent example: think of the situation with hand sanitiser in March 2020 when the pandemic started. Prior to the pandemic, there was some demand for hand sanitiser – we used about 20 million litres a year in Australia, according to the Commonwealth Government. The same source estimated in October 2020 that annual demand had risen to 77 million litres and was likely to stay there.

When demand first started to rise, there was not enough sanitiser to go around. This led to an increase in price for the sanitiser that was available. The increased price encouraged more producers to start making hand sanitiser, as they could see the increased profits available in that market. This meant that supply increased, which allowed prices to reduce as buyers now had more chances to buy.

The upshot of that increased supply is that the price of hand sanitiser fell back to around the previous price. The industry was almost four times larger, so it was more profitable, but the price per unit had fallen back to about where it started because the increased demand was now being matched by increased supply.

This is an example if inflation that would not be 'sustained' in the eyes of the RBA. The price rise was temporary because the market adjusted to the changing market conditions that the price rise indicated. This is actually one of the benefits of price changes and shows why it can be wrong to consider all prices rises to be problematic. Price rises can be good things if they make the market more responsive.

In their commentary earlier this week, the RBA said that they are not sure that the recent prices rises will not prove to be temporary indicators of market conditions. They also said that they are prepared to be patient while they wait for evidence of prices not being temporary. That tells us that the RBA is unlikely to increase interest rates any time soon.

That said, when something is at an historic low, we should expect that it will rise again at some time in the future. So, interest rates will not stay this low for ever. If you have debt, then taking this opportunity to reduce the amount of that debt by using the money you are saving on interest to repay principal makes very good sense.

The Legal Stuff

General Advice Warning

The above suggestions may not be suitable to you. They contain general advice which does not take into consideration any of your personal circumstances. All strategies and information provided on this website are general advice only.

We recommend you seek personal financial, legal, credit and/or taxation advice prior to acting on anything you see on this website.

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