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A new phase

It was a very pessimistic start to the year. Inflation, interest rates and market volatility were all on the rise, we were not yet out of COVID and were feeling the pinch from related supply chain issues.

Today, expectations are still bearish. Markets have factored in official interest rates of around three to four per cent, with several rate hikes predicted over the next 12 months. Markets like the US and potentially the UK are seeing inflation at around ten per cent, global trade is continuing to experience bottlenecks, the war in Ukraine seems likely to be prolonged, China is locked down and we're still getting Covid. All in all, a pretty dismal environment!

But there are reasons for some optimism, not least that all of this has already been well and truly priced into equity markets. Maybe reality might be slightly better? China may start to open up, official interest rates may not reach predicted levels (and even if they do, they're still low by historical standards), we're learning to live with Covid, and although inflation is higher than normal, that can actually work in favour of equity markets as long as it remains at a reasonable level.

A favourite quote of mine is from Mark Twain, who said, 'History does not repeat, but it does rhyme'. I think this applies nicely to markets. We're now in a new environment of rising inflation and interest rates and I think it's useful to look back to see what happened in markets during similar economic environments. As the quote indicates, markets won't be exactly the same as last time, but there are likely to be certain similarities.

So if we look back at times when interest rates were rising, we see that equity markets generally do reasonably well through these periods. At the early stages, it seems markets focus more on *why* interest rates are going up rather than the fact that they *are* going up. Interest rates are rising because we're learning to live with Covid, the economy is recovering, and unemployment is very low. They're going up because things are getting better.

In environments when interest rates go up very quickly (current expectations), equity markets do not perform as well as when they are steadily going up, but returns are still more often positive. Indeed, equities investments can help keep pace with inflation as many businesses actually benefit from this type of environment.

Once again, in terms of history, the businesses that tend to do well during inflationary periods are those linked to commodities (both soft and hard), as well as essential businesses that have pricing power. The opposite is true for businesses that have no pricing power or offer fixed-price contracts. Businesses such as contractors and building companies that have fixed-price contracts and rising input costs see their margins significantly squeezed through inflationary periods.

Another interesting movement in the market is 'goods' versus 'services'. Pre-Covid, we saw a structural trend of services growth outstrip the growth in goods. During Covid, this completely reversed. Services took a significant hit. We could not travel, go to restaurants, go to the movies or get our hair cut, and were completely constrained in our movements. While we could not travel or eat out, we could buy lots of things online. Growth in goods accelerated but services declined. As we learn to live with Covid, we're starting to see this reverse again. As a quick example: if we have $100 in our wallet, let's assume for this exercise that $50 is spent on the essentials (food, shelter, insurance, electricity, interest) and $50 is spent on discretionary items. Within the discretionary space, $30 is spent on goods and $20 is spent on services. As inflation enters the system, the $50 that is spent on essentials grows to $60 as prices increase. We now only have $40 for discretionary items. Of the $40 spent on discretionary items, services grow from $20 to $30 as we re-start travel, eating, entertainment and leisure activities. This all means that discretionary goods will decrease from $30 to $10. We are likely to see good growth in services again, but a decline in goods.

So, what does all this mean for the Fidelity Australian Equities portfolio? I'm very much taking a barbell strategy to the portfolio. At one end of the barbell is commodities (metals, mining and energy) and includes stocks like IGO, BHP, Rio Tinto, Iluka and Santos. At the other end of the barbell are companies that sell the essentials and have pricing power (consumer staples, healthcare, insurance, financials) and include stocks like Coles, Woolworths, Ramsay Healthcare, Suncorp and CBA.

We are entering a new phase in the economic environment. That change in environment has caused short-term volatility in markets and created some interesting opportunities in individual stocks, but also potentially a great long-term entry point for equity markets. I do believe we will see better returns from commodity businesses as well as businesses that sell essential services and have pricing power.

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