

Get set for inflation to stick around, warns fund manager

Strategy

William McInnes

Australian investors will need to brace for a period of sustained inflation that they are not necessarily ready for, prompting Sage Capital to warn that the “transitory” narrative pushed by the US Federal Reserve last year is well and truly dead.

The Fed has already made steps to tighten monetary policy to combat soaring consumer prices, lifting interest rates last week, and winding down its quantitative easing.

But Sage chief investment officer Sean Fenton said many investors were underestimating just how far the Fed may be willing to go this cycle, with inflation poised to be around longer than originally expected.

“Markets are still pretty sanguine about the potential for much higher interest rates and recession,” he said during a presentation to clients yesterday. “At the end of the day, inflation is back.”

Mr Fenton said the market was in the middle of a secular shift after almost three decades of consistently low rates

and inflation, with investors now beginning to expect above-average inflation will persist, putting pressure on risk assets such as shares.

“It’s feeding back into the whole dynamic of wage expectations and settings, but also into the broader psychology,” he said.

“There’s been a real shift in attitude in terms of being able to push up prices. Companies have been able to put through price rises and there’s been a lot more willingness from consumers to accept them.”

On Monday, Fed chairman Jerome Powell said the US central bank could raise rates in 50-basis-point increments at upcoming meetings and leave them higher in the long term than would have been expected.

The market moved to rapidly price in more aggressive interest rate rises on the back of those comments, sparking a global bond sell-off, pushing yields higher.

The US two and five-year Treasury yields jumped by more than 10 basis points while the US three-year Treasury yield jumped 20 basis points to 2.34 per cent, its highest level since March 2019.



Sage Capital's Sean Fenton says inflation is back. PHOTO: JAMES BRICKWOOD

The yield on the Australian 10-year bond jumped 13 basis points to 2.7 per cent, hitting its highest level since 2018. The UK 10-year bond also joined in the action, with its yield rising 10 basis points to 1.62 per cent.

Mr Fenton said the volatile environment had created an abundance of opportunities for the long-short investment manager.

“We see a great environment with a lot of volatility and while we’ve seen some forced unwinding of positions, it’s a great environment for active stock selection,” he said.

“Don’t fight the Fed is always a good lesson, and it pays to keep a close eye on their policy and communication to the market.”

Sage Capital’s Equity Plus Fund returned 0.47 per cent in the three months to February 28, outperforming the S&P/ASX 200 Accumulation Index which fell by 1.72 per cent over the same period.

The fund has made the most of the market rotation, shorting unprofitable technology stocks, and taking long positions in stocks directly benefiting from inflationary pressures and Ukraine’s conflict with Russia.

Incitec Pivot has been one of the market’s strongest performers in 2022, but Mr Fenton said he believed it still represented great value in a tight market.

“The impact of gas shortages has been felt across the Northern Hemisphere, and even before the invasion of Ukraine, fertiliser plants were being shut down,” he said.

“That had already tightened up fertiliser markets and then after the invasion, prices have boomed.

“Incitec has shot itself in the foot with some plant outages but even allowing for that, higher fertiliser prices won’t be resolved in a hurry and will deliver some super profits to them.”

The fund also has a long position in Computershare, a stock likely to benefit from rising interest rates, given it earns income on cash held on behalf of clients before dividends and distributions are paid to shareholders by client companies.

Sage argued that Computershare’s Wells Fargo corporate trust acquisition made at the bottom of the cycle was prescient. “If things do get out of control, their business is quite defensive, and they also have the upside of even higher interest rates,” Mr Fenton said.

The fund was short stocks like Zip Co and PointsBet Holdings, which have been caught up in a global sell-off in “land grabbing” tech names that do not have substantial earnings behind them.

“Be careful of chasing rainbows,” Mr Fenton warned.