The Election, Inflation and Interest Rates – What Does it Mean for Australian Equities?

The Federal Election campaign is well underway and we are observing a "safety-first" approach from the major parties with no radical reforms or urgency to balance the budget and a strong desire to keep voters onside. This "business-as-usual" approach is generally a good backdrop for listed equities, however raises some risks in the form of higher inflation and interest rates.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Concentrated Australian Equities Fund and the Warakirri Ethical Australian Equities Fund.

The Politics

The Federal Election campaign is well underway, and we are observing a safety-first approach from the major parties. No radical reforms, no urgency to balance the budget and a strong desire to keep as many voters happy (or at least not angry) as possible.

In contrast to most election campaigns, proposals from the traditional parties carry few uncertainties for the corporate sector or the Australian taxpayer. This business-as-usual approach is a good backdrop for most of the listed domestic market. Perhaps the main area of uncertainty (as has been the case for a number of years) relates to energy policy, as the pace of transition to cleaner energy sources and exactly how we get there remains somewhat murky. We think this raises the importance of domestic gas as a "transition fuel" over the coming decade, with producers from established fields becoming increasingly well placed. In contrast, energy retailers risk becoming stuck between a rock (higher and more volatile energy input costs) and a hard place (political pressure to keep the retail price low whilst simultaneously investing in emission reductions).

Inflation

The potential downside of this generally favourable backdrop is that it adds to inflationary pressures. The inflation rate exited 2021 at a decade-high 3.5%. Since then, the meetings we have been having with miners, retailers and tech companies amongst others all report ongoing cost increases to varying degrees. After many years of restraint, cost of living pressures combined with a political culture of saying yes to as many people as possible may well lead to an era of higher inflationary expectations in Australia.

Interest Rates

As widely expected, the RBA raised interest rates at its most recent meeting for the first time since 2010. How much and how quickly rates will rise in the coming meetings remains a point of speculation. However, the bond market suggests consensus opinion about the medium-term prospects have moved quickly.

At the start of 2022, the 3-year Commonwealth bond rate was 0.9%. By April, this had moved up to 2.5%. If interest rates follow the path the market now expects, this may take some of the heat out of inflation, but possibly also tap the brakes on the economy in general.

What to Look For

The first thing to note is that this represents a different investing environment from what we have seen over the last decade. It is not uniformly bad for the equity market. However, some companies will adapt better than others. We think there are 3 main characteristics to look for in an investment:

1. Pricing power – the ability to pass on higher input costs such that profit margins are protected.

2. High operating margins. Higher rates of inflation and interest expenses can eat into profit margins, whilst lower rates of economic growth are a risk to sales volumes. Companies with high operating margins are far better at absorbing these problems without risking dividends or the balance sheet.

3. Structural growth. Companies with growth drivers that are not overly reliant on the general health of the economy are poised to differentiate themselves from the pack if the environment softens.

What's an Example of a Well Placed Company?

Transurban (TCL) is a large holding of our fund and meets all of the above criteria. The contracts that dictate their tolling arrangements generally index per trip costs to the official inflation rate. Operating costs generally account for less than 25c on the dollar of revenue earned and don't escalate much with inflation – the majority of roads TCL operate are already built and paid for. Finally, growth is linked to population and alleviating the associated congestion this causes in major cities, both in Australia and North America. This congestion is a structural trend that is re-emerging as COVID lockdowns recede into the past.

Conclusion

The political climate, as judged by the election campaign to date, is benign. Paradoxically, this raises some risks for investors, in the form of higher inflation and interest rates. In this environment, separating winners from the rest becomes more important.

Our investment process is designed to differentiate between opportunities in exactly this way, and we are confident that our investment portfolio is well placed for what lies ahead.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au