

June 14, 2021

Inflated Complacency

- Bond market fails to be impressed by a record 5.0% US inflation
- The market's characterisation of high inflation as 'transitory' seems exaggerated, in our view
- Global core inflation at a 25-year high
- ESG and wage inflation could still spring a significant inflation surprise
- Fundamentally, a 1.45% 10-year government bond yield offers little value
- Equities can enjoy the inflation across certain sectors but not necessarily across the whole market

The fact that US inflation hit 5.0% year-on-year in May, a 13-year high, seemingly pails into insignificance in the eyes of the bond market. It is difficult to square the massive surprise on the inflation data with the **US 10-year government bond yield, which fell 11 basis points on the week to 1.45%**. In passing, it is worth observing that core inflation hit 3.8% and the weekly jobless claims number fell to half the level seen back in March.

We agree that some elements of inflation may be transitory. However, we firmly believe that structural reasons can keep inflation elevated at levels that markets do not discount today.

At present, too much of the global inflation dialogue is about the US. It gives the impression that the US is the exception to deflationary conditions in the rest of the world. However, **global core inflation is running at the fastest rate in 25 years**.

We find it quite ironical that just as central banks start to achieve their inflation targets, commentators seem to want to wish it away, characterising high inflation as transitory. On this occasion, though, we believe there are structural and not just transitory factors at work, that give impetus to future inflation.

ESG is a long-term driver of inflation

The world's commitment to ESG compliance is providing a significant stimulus to future inflation. We do not think anyone would argue that the world's transition to a carbon-neutral and ultimately a carbon-negative future can be anything but inflationary. Bringing about a carbon-neutral world requires heavy investment in technology with rich commodity content that can only push up commodity prices further purely from demand-pull factors.

Commodities have complex upward pressures

There are also supply-push factors that bring immediate pressure on mining companies to show that their green credentials are forcing commodity buyers to source the resources from around the world ethically. Two-tier markets are already developing in some commodities where the ethical mines will charge significant price premiums for a particular commodity.

Suppliers of commodities are also facing significant cost inflation. Many commodity suppliers are facing lingering challenges of sourcing a commodity from an increasingly scarce resource world. Against this backdrop, shipping costs have been the most evident increase for any commodity that serves an overseas market. Although the supply of iron ore is plentiful, the industry's decarbonization is increasing demand for high-grade ores, which trade at high and rising premiums to spot. S&P Global Platts points out that in just one Chinese city of Tangshan, the government targets to reduce emissions at 23 local mills by 30-50%; the targets can only be achieved with higher-grade ore products such as pellet and lump.

Signs of Wage Inflation

Wage inflation is another potential source of persistent inflation, and to be fair, the jury is still out. On some measures, real hourly wages are the lowest in history. In the US, workers are fighting back with the seeming stay-at-home strike 'funded' by President Biden's payouts, forcing many large companies to increase their minimum wages by tens of percentage points. Last week Japan reported that total monthly wages grew 1.6% after a 0.6% rise in March, and the country is only just starting to unwind its coronavirus restrictions. To be sure, wages have recovered back to more normal levels, but there is a strengthening trend, nonetheless.

A US 10-year government yield of 1.45% feels plain wrong

Fundamentally, we believe investors can't argue that 1.45% for the US 10-year government bond yield offers good value. With core inflation running at 3.8%, investors are losing real purchasing power by holding on to bonds – actual inflation (not expected) is eating away at the value of the investment. It could make sense if there was compelling evidence that the inflation rate was set for a precipitous drop in the immediate future, mitigating the corrosive effect on the value of the investment. The market, at the moment, is not pricing in that possibility. As reflected by the TIPS market, expectations are for inflation to remain higher than the yield on all Treasury bonds for the foreseeable future.

So why is the US 10-year at such a low nominal and real level? Let us turn to liquidity and technical justifications to argue why US yields failed to spike this week.

First: the market is flush with cash. Nobody wants any more of it. However, there is a weird conundrum facing money market funds. Anecdotal evidence and surveys suggest that the pervasive sentiment towards Treasuries is negative. For that reason, investors have been searching out low-duration alternatives, driving up demand for short paper and flooding the market with cash.

The Fed's overnight repo rate, a measure of liquidity, has declined steadily from above 10 basis points to 2 basis points this week. The link between the 10-year and the repo rate is not cast in stone, but there is clearly some influence.

Second: overall positioning before this week was most likely reflective of the bearish sentiment, meaning the average player in the market was short and had to buy back some bonds when money market rates dipped.

These factors are helping the credit markets, over and above the absence of default risk. With low defaults the new norm, the lack of yield combined with significant cash build-up has led to credit spreads generically performing well. Two things are evident when looking at the composition of the indices compared to last year:

Most indices are shorter in duration and a bit worse in terms of average credit quality. It is thus the case that on a risk-adjusted basis, current spread levels probably already reflect the lows for the current cycle, even if they have a little bit of space left to rally to reach outright record lows.

For the week ahead, the FOMC meeting could be more critical than usual. Do not trust the calm in the bond market. Subtle hints from the Fed about tapering or tightening could significantly affect the markets.

Impact on equities - it depends

The equity market has taken the higher-than-expected inflation data in its stride with the S&P 500 up marginally on the week. We believe the equity market continues to believe that the Fed is not going to upset the party in risk assets by increasing interest rates anytime soon. While there are apprehensions that the Fed will surely taper its bond buying at some stage, investors see that as something that can be dealt with by switching between assets and sectors rather than abandoning the market altogether. The higher inflation will, however, set off a chain of events that equity investors need to be watchful of. Higher input prices without higher consumer prices lead to margin squeeze, which in turn leads to lower corporate profits and damaged prospects in the equity market. On the other hand, if companies can pass on price increases to consumers real incomes are squeezed, and households go on a buyers' strike. Growth slows down and equities are again challenged.

Our preferred strategy is to invest in companies with good potential for earnings surprises. The list includes commodity plays, real estate names, and companies with strong franchises that allow them to have pricing power. We retain our positive view of equities certainly when compared with a paltry 1.45% on the US 10-year.

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