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Is there a mini-tantrum brewing?

- **The divergence between the Fed's view and the market's view on rates is growing**
- **Higher yields have not hindered a surge in equities this month**
- **The real test for the bond market lies in the future, not now**
- **Energy prices keep surging as the northern winter approaches, adding inflation risk**

The release of the **US Employment Cost Index (ECI)** on Friday capped a month that brought several challenges to the notion that the current inflation will prove to be transitory. Employment costs increased at their highest pace on record in the third quarter as companies across sectors raised wages amid growing labour shortages. The gauge registered a 1.3% quarterly gain and increased 3.7% from a year ago. Significantly, the wages and salaries component rose 1.5% on the quarter, the highest since 2001.

The ECI is not always the most likely data release to move markets, and this one was no exception. However, the implications for the future path of inflation will not be lost on the Fed. Even if the current level of 5.3% of headline CPI inflation reflects temporary factors, wage increases will add upside risks to the Fed's projections. To quote classic economic texts, wages are notoriously "sticky downwards". That is to say, even if supply chain issues, energy price spikes and commodity price rises fade, higher wages will be here to stay. We wait with some interest how the Fed will respond to this new development.

The market is making its verdict known. October saw a large spike in the US 2Y bond yield: from the end of September to the end of last week, the yield rose to 0.5% from 0.2%. That is a sharp spike – more than doubling in the space of five weeks. Just as significantly, the futures market is now discounting a different outcome for the fed funds rate compared to the published dot plots of the Fed.

Chart 1: Short-dated yields are rising fast (US 2Y Treasury Yield)



Source: Bloomberg

As a reminder, the dot plot is where the voting members of the FOMC forecast their expectations for the Fed Funds rate at the upcoming FOMC meetings. In line with the jump in the 2Y yield, the futures market sees much more action from the Fed than the Fed itself. The median Fed member sees one hike between now and the end of 2022. By contrast, the market is pricing in at least two more hikes within this period. Until the end of 2023, the futures market is still ahead of the Fed, before the market and the Fed agree on a rate of 1.75% by the end of 2024.

Does this count as a mini-tantrum? Just what the market is pricing in for that long a period is not likely to be all that significant for client equity and bond portfolios for the next two quarters. What is of greater significance is the progression over the next two quarters. Should the recent trends in the underlying price indices persist, and inflation finally settles closer to what the breakeven market is pricing (2.6%), then the market will be right and the Fed in a difficult position. Thus far, the move in bond yields has not proved to be too disruptive for equity markets. Things may, however, change if money and bond markets keep diverging from the Fed's assumed narrative.

Only the very long end of the bond curve performed in October: With the jump in the short end yields, it was little surprise to find that for once, the long end performed better in return terms over the month. The best performing sector was the 20+ year US treasuries, which rose 1.57% for the month. Coming in second was US TIPS, with 0.78%. The overall Treasury market dipped 0.82% in November, leading declines in more or less all of the other major fixed incomes indicators. Global High Yield and Global EM were both down, 0.52% and 0.46%, respectively.

Credit fundamentals remain sound: Despite the drop in returns, credit markets have not shown any inclination to stress, apart from the Chinese bond market weighed down by the travails of the property sector there. Global HY and EM spreads have been trading largely sideways at levels very close to the best on record. Investors remain relaxed and convinced that the underlying economy does not hold any nasty surprises for credit in the immediate future.

Equity markets were unperturbed by higher yields: Despite higher yields and evidence of persistent inflation, the MSCI World Index surged 5.1% in October. That brings the YTD number to 19.44% and the 12-month gain to 40.42%.

The US once again led the major markets in gains, as the S&P 500 rose 5.7%, and the tech-heavy Nasdaq Composite surged 6.7% for the month. Europe continued to track quite strong, too, with the Euro Stoxx 50 gaining 5.48% for the month. Asia was the laggard once more, weighed down by the Chinese market's weakness and a noticeable correction in Japanese stocks. The MSCI Asia ex-Japan Index rose 2.09%, as the Shanghai CSI 300 Index dipped 0.58% to drag returns lower. The Nikkei rose by 0.42%, lagging behind its global peers significantly.

At the sector level, the majority of the S&P Index's subcomponents posted strong gains, with the exception of Communications, which rose only 0.85%. Consumer Discretionary was up 10.23%, leading the other sectors, which were all up approximately 5% to 6% for the month.

Energy still on a high: In commodity markets, the picture was somewhat mixed. The energy sector still dominates the headlines, and with some justification. Liquid natural gas futures rose by all of 69.06% in November, bringing the three-month gain to a whopping 183%. No matter how transitory this rise proves to be, it will still be causing some spill over effects into broader measures of inflation. Other energy prices were higher, too. Crude oil was up 11.68% on the month, and jet fuel rose 8.36%.

Precious metals staged a mild recovery, with silver gaining 5.4% and platinum rising 4.5%. Gold rose by a modest 1.06% in October. In base metals, there were winners and losers. Prime among the losers were aluminium (-6.5%) and iron ore (-13.69%). By contrast, copper rose by 6.92%.

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