May 17th, 2021

How Much Inflation Do You Need Before You Believe?

- **Actual inflation is showing up in the numbers: PPI and CPI surprised to the upside.**
- **US wage pressures are starting to build**
- **COVID brings a confluence of additional factors that adds to the inflation argument**
- **Bond markets have been surprisingly muted**
- **Equity markets are favouring Financials and Materials over Technology**

The investor mindset of global deflation has never been so challenged. How much longer will it take for the financial markets to realise that this spike in inflation is real? It is always challenging for the markets to believe that things had materially changed when for years, it was better not to fight the trend. Two decades of falling inflation and then just over a decade of central banks fighting a threat of deflation are difficult to erase from investors mind. Thinking has become anchored on low inflation, low interest rates and easy policy. However, we believe that there are factors building that shows that inflation is not just at hand but that he could have far more longevity than the markets currently price.

The current economic data flow is showing that inflation is emphatically at hand. The US consumer price inflation report for April was a blowout. A monthly increase of +0.8% month-on-month was miles ahead of a market consensus of +0.2%. The core prices index rose 0.8% on the month, the largest monthly increase since 1982. US headline inflation now stands at 4.2%, whereas economists had expected it to peak at 3.5%. It is worth noting that a surge in inflation occurred without a monthly rise in energy prices. Apparel prices rose for the first time in three months. Notable was the 0.4% monthly increase in food prices. Increases in global agricultural products are starting to push grocery prices higher.

To add to the weight of evidence of rising inflation was the producer price index, which showed that overall producer prices rose 6.2% on an annualised basis in April, up from 4.2% in March. Stripping out food and energy, the inflation hit 4.6%.

For inflation naysayers, the past lack of wage pressures has kept a significant cap on inflation. However, there are now signs of wage inflation. While some economists were fretting over the lack of substantive jobs growth in the last US jobs report, it was the 0.7% m-o-m increase in average hourly earnings that, in our view, was more telling. The higher-than-expected wage inflation corroborates other evidence that staff are demanding higher wages to return to work. It is also worth reframing the ranges for wage inflation: too often, we can anchor on recent experience. But, for a moment, consider that US wage growth averaged 6.1 per cent from 1960 until 2021, reaching an all-time high of 13.78 per cent in January of 1979.

Chart 1: US Inflation at a multi-year high (% year-on-year)

Source: Bloomberg

Considering the growing case for inflation, we find especially the bond market's muted reaction interesting. After a brief rise to 1.7%, the US treasury yield has settled back down to 1.62%, barely higher than its level before the slew of higher inflation data. Equity market volatility spiked very briefly, but it has settled below 20% again (the VIX index). Last week's blip was smaller than most seen during the previous twelve months. It is almost as if nothing happened.

Some technical factors support lower bond yields at the moment, including how cheap it is for non-USD investors to buy Treasuries on a fully hedged basis. This makes owning them a better deal than holding EUR or JPY-denominated bonds, which don't have any yield. However, this situation cannot last forever. Our take is that the market remains anchored in its "lower-for-longer" mindset. The coming reset will only happen when the inflation genie is fully out of the bottle.

Anecdotal evidence reinforces the view that wage inflation could be the driver for more substantial inflation than many investors had bargained for. Surveys show that there are genuine labour shortages in both the manufacturing and service sector. Those labour shortages are both due to the reluctance of people to return to work and severe skill shortages. In a recent survey, 28% of small businesses said they were increasing salaries to attract staff. Broader surveys of wage inflation showed the most significant increases in wages since 2007. Remember this wage inflation is taking place with still very high levels of unemployment. It's almost become a game of poker between employers and potential workers. US workers are empowered by funding from the government to sit out the next six to nine months and wait for higher wages.

In our view, there is a confluence of structural issues that only add to the current upward pressures on prices. Our COVID-affected world is only accelerating some of those effects. For the first time, the world seems to be reflecting more on the meaning of life: trying to tackle climate issues and the unequal distribution of wealth with more vigour. Tackling climate change will require a marked acceleration in the phasing out of energy sources with large carbon footprints. However, using alternative energy sources means a very substantial increase in demand for copper and lithium, both of which are in short supply. A battery-powered electric vehicle, for example, uses 83 kilogrammes of copper, compared to a combustion engine of only 23 kilogrammes of copper. Renewable energy sources are also heavily dependent on copper in their construction; wind energy requires, on average, 2000 tons of copper per gigawatt, solar energy 5,000 tons of copper per gigawatt.

Combining these factors with evidence of supply chain strains explains why the Materials sector is doing so well. The S&P Info Tech Index is up 2.49% so far this quarter. Materials have risen 11.6%, marginally ahead of Financials (11.4%) as the strongest performer. The move is some reversal from a year ago when the market saw the technology sector as the only sector capable of delivering strong earnings growth under the strain of the pandemic. The tables have turned as the heady valuations of the technology sector weigh against it in the face of the old-school sectors that stand to gain from the resource-heavy demand we are witnessing.

Maybe the most straightforward argument we can make favouring more inflation is the simple fact that almost all of the major central banks in the world want more inflation. The Fed, for example, has a stated policy of increasing inflation above its target. Governments wish for more inflation. Quite frankly, most heavily indebted countries in the world would not mind a burst of inflation to reduce their debt burden.

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