

May 10th, 2021

This is Not Normal but Probably for Real

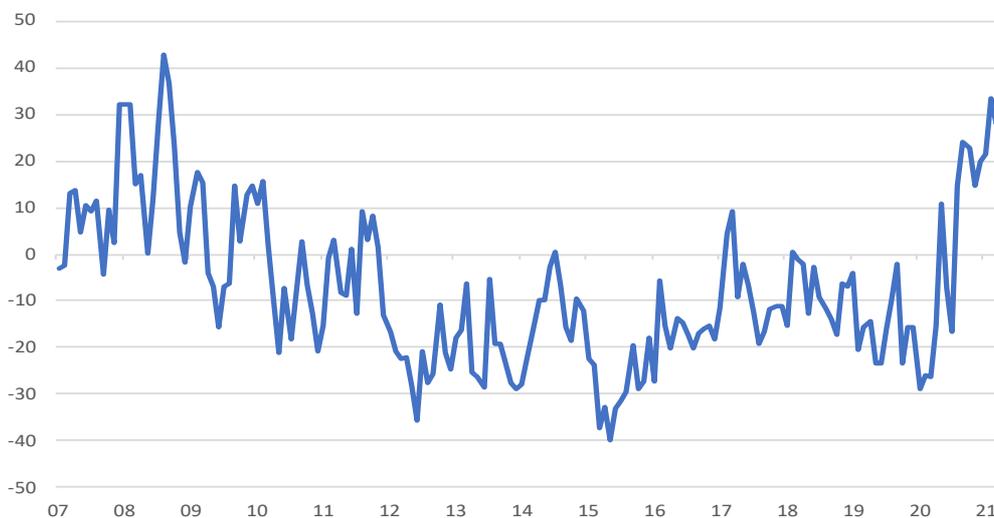
- COVID challenges still abound – a smooth pick up in global growth not assured
- The gold price may be a bellwether of concerns about the spread of virus variants
- Growth so far has pushed inflation pressures not seen in decades
- Some inflation particularly in metals may stick for structural reasons
- Japanese equity underperformance may start to reverse in coming months

The mounting evidence of more inflation than many people had bargained for could provide further impetus for markets despite some strong gains seen since the start of the year. The increasing recognition that the world is moving away from the old normal of very low inflation should encourage further investment in commodities and equities.

The US employment data was another clear signal of building inflation pressure. Despite lower than expected payrolls average hourly earnings rose 0.7% month-on-month. The higher-than-expected wage inflation corroborates other evidence that staff are demanding higher wages to return to work.

Signs of wage inflation would be the final nail in the coffin of the naysayers who say that inflation will never take hold. To be fair it is still early days but there is much anecdotal evidence that US domestic companies are having to pay up to get staff back to work particularly in the services sector. If more investors start to believe in inflation, then it is easy to start to believe that nominal growth will be higher, hence corporate profits growth will be higher and in the absence of central banks allowing rates to rise, risk assets could be set for further gains.

Chart 1: Citi US inflation Surprise Index



Source: Bloomberg

The bond market certainly shrugged off whatever hints of slowing inflation pressure the below expectations overall payrolls number of 266k implied. There was a brief rally in the 10-year Treasury from 1.57% to 1.5%, but that evaporated quickly. More telling, the inexorable rise in the implied inflation breakeven rate (10Y) was not halted. It now stands at 2.5%, having started the year at 2.0% and from the low near 0.5% in March 2020.

If you needed a signal that inflation is now much more persistent it was the move higher in gold. On the week, the spot price rose from \$1779 to \$1830, which silver was nearly 6%. Gold watchers such as Rhodes Precious Metals Consultants believe that the technical level to watch is the \$1851 a failure to breach could lead to profit taking and a mark back to the \$1800. The bulls will remind investors that the last two emphatic breaks of the gold above \$1800 have taken us to \$2063 in June last year and \$1950 in January.

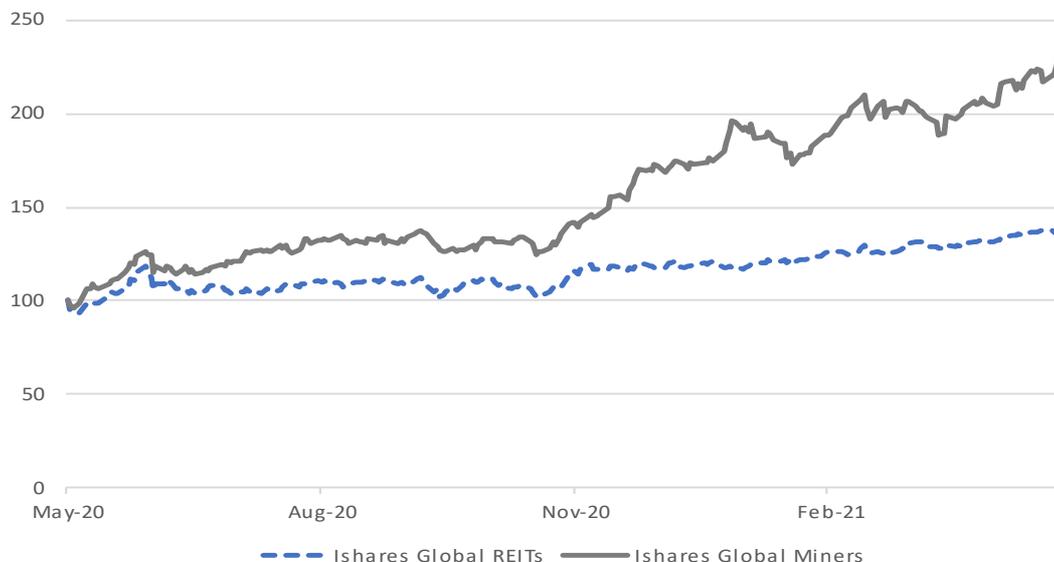
If we have more inflation, then it is clearly a challenging environment for bonds. Yes, bonds are expensive over the longer term, **but it remains hazardous calling the downside risk for bonds with central banks still heavily engaged in anchoring their respective government yields.** The UK and Canadian central banks have signalled their intention to reduce the pace of their bond buying but are not tapering their purchases at present. However, JPMorgan calculate that just a drop in the pace of bond purchases would be sufficient to push yields up to 30bps higher.

The point about vulnerability of bond return in developed markets has been well-made, and the very weak performance of total returns in the long end of the US market – more than 10% YTD – illustrates the risk of holding this paper if yields were to rise above 2% from where they are. Furthermore, the inflationary picture facing Emerging Market central banks may force them into action sooner than would be the case in the developed world.

One argument doing the rounds in the market is that the strong rise in commodity prices is the harbinger of better growth of emerging economies, and that this suffices as a reason to remain invested in bonds. This may be a dangerous route to take. It may well be that the growth picture is rosier than thought, but it is also likely that the inflation surprise lurking around the corner could force yields higher. In such a situation, the preferred exposure in EM would instead be in equity markets, and specifically in commodity-related exposures, rather than fixed income.

Despite the very strong showing of commodity prices in recent months we believe there is more to go for. While some commodity prices have hit decade highs, we are seeing something quite unprecedented in terms of the imbalance between supply and demand in many markets. As we remarked last week, the new factor on the block is the huge scale of commodity buying as a consequence of the government aims for a greener world. But in aggregate supply shortages and surges in demand could lead to significant rises in many commodity prices in coming quarters.

Chart 2: Miners Outpace REITs by a Large Measure



Source: Bloomberg

The REITs sector is an inflation linked sector with still catching up to do. The REITs sector is one of the few inflation led sectors that has not seen a stratospheric period of performance in recent months. To be sure some stocks have performed well however the sector is a mixture of star performances and significant laggards. As the major economies re-open and investors realise that people will still use shopping malls, cinemas and offices some of the laggards could catch up rapidly.

COVID is the one factor that could potentially deflate the market rallies. Only time will tell if the COVID-19 variants currently taking their toll on India and surrounding countries have leaked out more broadly. The world will be on watch for the next two weeks in particular. It was only in the past week that countries lined up to close their borders to flights from India. The online world is alive with unsubstantiated claims and anecdotes about the new strain. A lesson to be learnt for governments from the early days of the first outbreak is that it pays to get ahead of the curve: denial is not an option. Good, clear and timely communication, plus swift action to reduce infection risk, are critical to prevent a rerun of the mistakes seen last year. Sadly, some countries appear to be repeating the errors.

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